ALTERNATIVE CREDIT COUNCIL
LENDING FOR GROWTH

AIMA

167 Fleet Street, London EC4A 2EA, UK
+44 (0)20 7822 8380
info@aima.org

aima.org

Submitted via email: pensions.investment@dwp.gov.uk

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Dear Des, Andrew,

Enabling investment in productive finance

The Alternative Credit Council (ACC)[1] and the Alternative Investment Management Association (AIMA)[2] welcome the opportunity to respond to the Department for Work and Pensions' (DWP) consultation: Enabling investment in productive finance.

We have been pleased to support the Productive Finance Working Group convened by HM Treasury, the Bank of England and Financial Conduct Authority, as well as other industry efforts, to address the barriers to investment in long-term, less liquid assets. While such assets, and alternative assets more generally, pose different challenges for investors compared to more traditional assets, they can offer investors potentially higher returns, support investment diversification and contribute towards better retirement outcomes. We support the Government's efforts to remove structural barriers that prevent Defined Contribution (DC) pension schemes from investing in such assets where they feel it is in their members' interests to do so.

[1] The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents 200 members that manage over $450bn of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits. Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

[2] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org

Investment in alternative assets and strategies typically entails higher costs than investment in traditional assets as it is more costly to manage these investment portfolios in an active manner. For example, originating a private loan will require greater investment by the asset manager in deal sourcing capacity, credit underwriting, due diligence, investment monitoring and reporting compared to purchasing a publicly traded corporate bond on a regulated market. In the same vein, managing a market neutral investment strategy that uses sophisticated financial instruments (on both the long and short side) requires more involvement on behalf of the manager compared to purchasing an index fund. The involvement of the manager in managing the assets is also an essential driver of the better and differentiated real returns (i.e. net of fees) that alternative assets can provide over a pension saver's investment horizon compared to public equities and other traditional assets.

Further, fee structures associated with investment in alternative assets tend to have a higher performance-based fee element – meaning that the fees are only payable when real returns are delivered. This is precisely because alternative asset managers are tasked with delivering returns that outperform traditional markets and strategies. These performance fee structures play an important role in supporting the alignment of interests between investors and asset managers, as well as protecting investors against the risk of incurring higher fees compared to other products which offer similar (market-based) returns.

The challenges of incorporating performance fee structures, both in terms of fee levels and variability, represents a structural barrier to investment in alternative assets by default funds of occupational DC pension schemes which are subject to the Charge Cap. While it is not the only barrier, it is a gating item for many investors and asset managers. We therefore welcome the Government's proposal to remove performance-based fees from the Charge Cap. This will provide DC pension schemes with more flexibility to invest in a broader range of assets and support better retirement outcomes for their underlying beneficiaries. Crucially, in many areas, it will allow for new sources of financing to flow to the UK economy.

The consultation seeks views on how an exemption may work in practice, and what other measures may be necessary to meet the Government's stated objectives to increase the flexibility for DC schemes to invest, while maintaining the protections afforded to members under the Charge Cap. We support the Government's approach and agree that any reform of the Charge Cap should be informed by both these objectives. The introduction of an exemption for performance fees with place a greater onus on Trustees to ensure default investments provide value for members. The Government's focus should therefore be on supporting and monitoring good governance, particularly at the authorised master trust level.

We have provided a detailed response to the questions posed within the consultation paper in the annex to this letter, but would highlight the following key comments on how to ensure an exemption for performance fees meets the Government's policy objectives:

- **The exemption should apply broadly and not be limited to specific assets or investment strategies:** This will ensure that DC pension schemes have the flexibility to consider the broadest range of assets and strategies in which to invest their members' capital. Limiting the scope of an exemption to specific assets or strategies will distort how DC schemes determine the best investments for their members, for example preventing investing in mixed asset funds to spread risk and access a range of assets efficiently. A rigid exemption structure may also struggle to accommodate further asset classes or investment structures developed in future, risks creating incentives for arbitrage and may lead to further operational and administrative issues for investors when determining whether the exemption applies. We are not aware of any assets or investment strategies that pose unique risks to investors that cannot be addressed in the proposed guidance and would necessitate an exclusion from any exemption. The DC marketplace itself would also provide a further layer of investor protection as trustees would not be advised to invest in assets with performance fee structure that do not deliver value for members.

- **DWP guidance should be principles-based:** Investors will consider several factors when assessing the appropriateness of any investment fee structure. For example, the type of fund being used, the expected return strategy, applicability of hurdle rates, relevance of specific expertise, and whether the investor is early stage or not will all impact on the investment fee structure. As such, there is a wide variety of fee structures and fee levels across the alternative investment management sector. Any attempt to specify fee structures in guidance will impair the ability of investors to achieve fair and balanced fee structures. We propose that any DWP guidance on what constitutes well designed performance fee structures should be principles-based. This will support the ability of investors to assess whether fees are reasonable and proportionate to the returns delivered to investors without requiring them to adhere to pre-determined structures. This approach will also future proof the guidance to accommodate innovation on fee structures.

- **DWP guidance should build on existing practices:** There is already a significant amount of regulatory and supervisory material relating to fee structures in the asset management sector, including from the FCA, ESMA and IOSCO.[3] Building on this material and existing industry practices will ensure DWP guidance aligns with existing practices and support the ability of investors to evaluate fee structures across different assets and investment strategies.

- **Meaningful transparency and disclosure:** Any disclosure requirements should reflect the value of the investment more broadly rather than focus solely on costs. We support the Government's position that performance-based fees exempted from the Charge Cap should be disclosed to members in the Chair's Statement. This would be consistent with the existing obligation on trustees to express a view on value to members, align with broader efforts to provide meaningful and material disclosure to DC pension fund beneficiaries and reduce overall operational burdens on investors. Consideration should also be given to how disclosures align with Government policy in other areas to support the ability of members to exercise their consumer power and move their DC pension pots from underperforming pension schemes to better performing schemes. The returns which can accrue from investment in less liquid, private or alternative assets may take longer to realise than other assets. If this is not effectively conveyed to members more generally, there is a risk that performance fee disclosures might have the unintended consequence of motivating members

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[3] See COLL 6.7 Payments - FCA Handbook, https://www.esma.europa.eu/document/guidelines-performance-fees-in-ucits-and-certain-types-aifs and https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf

to move their pension pots before they receive the full benefit of the illiquid investment (i.e. redeeming at the bottom of the J-curve).

- **Any legislative changes to implement the exemption should be introduced as a standalone provision:** Creating a "safe harbour" for performance fees in the manner proposed by the consultation may inadvertently prohibit other structures which are already compliant with the current Charge Cap. Such an outcome would be inconsistent with the policy intent of encouraging investment in productive finance. We would encourage the DWP to reconsider the proposal to add well designed performance fees to the list of items exempt from the Cap under the definition of "charges" in Art 2(1) of the regulations. This approach may adversely affect impact existing fee structures by creating additional uncertainty regarding the treatment of such fee structures under the current guidance. We propose that a free-standing provision to the effect that "notwithstanding Regulation 4, a performance fee shall be disregarded" would be a more effective way to implement this change.

We would be happy to elaborate further on any of the points raised in this letter or annex below. For further information please contact Nicholas Smith (nsmith@aima.org).

Yours sincerely,

Jiří Król
Deputy CEO, Global Head of Government Affairs, AIMA
Global Head of the ACC

ANNEX

AIMA and ACC response to the DWP consultation: Enabling investment in productive finance

Question 1a: Would adding performance-based fees to the list of charges which are outside the scope of the charge cap increase your capacity and appetite, as a DC scheme, to invest in assets like private equity and venture capital? Are you already investing in assets like private equity and venture capital, and if so would this change increase how much you invest? If you do not currently invest in such assets would this change make it more likely for you to, and do you have an idea of to what % of AUM that might be?

Question 1b: Would adding performance-based fees from the list of charges which are outside of the scope of the charge cap incentivise private equity and venture capital managers to change their fee structures?

Exempting performance-based fees from the Charge Cap is likely to be a significant incentive for asset managers to develop newer products for the UK DC market. Although the consultation specifically refers to private equity and venture capital we would expect this to also apply to other asset classes as well.

While fee structures will continue to be informed by the need to align the interests of investors and asset managers, as well as commercial considerations, exempting performance fees from the Charge Cap will remove this gating issue for DC schemes looking to invest in private assets. This will encourage further dialogue between DC pension schemes and alternative asset managers on fee structures that work for both parties and are suitable for the investment strategy being undertaken. This in turn will support the ability of DC schemes to invest in a broader range of assets where they feel it will help them achieve better retirement outcomes for their members.

Question 1c: If you do not believe that the proposal outlined in this consultation is the right solution to the barrier posed by the regulatory charge cap, what might be a more effective solution?

We support the Government's proposal and are not aware of any other approaches that would meet the Government's stated objective to support investor's ability to invest in a broader range of assets while maintaining the protection of the Charge Cap.

Question 2: How can we ensure members of occupational DC pension schemes invested in default funds are sufficiently protected from high charges, whilst adding the performance related element of performance fees to the list of charges outside the scope of the charge cap?

Q2a: Do you have any suggestions for how we can ensure that the regulations ensure members are only required to pay fees when genuine realised outperformance is achieved?

While DC pension schemes should always be cost conscious, we do not believe that the higher charges of some investment management strategies necessarily present an issue for concern, provided those charges offer value relative to the returns delivered to investors.

The introduction of an exemption for performance fees with place a greater onus on Trustees to ensure default investments provide value for members. The Government's focus should therefore be on supporting and monitoring good governance, particularly at the authorised master trust level. Greater emphasis should also be placed on real net returns instead of costs and charges. We support the approach suggested by DWP in the consultation paper to develop guidance on what constitutes well designed performance fee structures. This will support the ability of DC pension schemes to assess whether fee structures are offering value for money.

Any assessment of outperformance will depend on a combination of factors, many of which are directly referenced in the consultation paper and have been discussed through the Productive Finance Working Group. We propose that any DWP guidance on what constitutes well designed performance fee structures should address these factors, in a principles-based manner, to help DC pension schemes.

There is already a significant amount of regulatory and supervisory material relating to fee structures in the asset management sector, including from the FCA, ESMA and IOSCO.[4] Building on this material and existing industry practices will ensure DWP guidance aligns with existing practices and support the ability of investors to evaluate fee structures across different assets and investment strategies.

The consultation seeks view on the concern that creating an exemption for performance fees from the Charge Cap may lead to a greater number of funds in other asset classes introducing performance fees when they would not otherwise have done so. We do not consider that creating this exemption would lead to the suggested potential change in market. In this regard we note that performance fees are already permitted for other asset classes that DC pension schemes invest in, and that the market has regulated itself in this regard. Similarly, trustees of DC pension schemes will not invest in funds that charge performance fees where there is no real performance and lower cost alternatives are readily available.

[4] See COLL 6.7 Payments - FCA Handbook, https://www.esma.europa.eu/document/guidelines-performance-fees-in-ucits-and-certain-types-aifs and https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf

Question 3: Which of these conditions should the Government apply to the types of performance-based fees that are excluded from the list of charges subject to the charge cap? Are there other conditions we should consider? If supported by guidance on acceptable structures would this give confidence to more schemes?

We propose that any DWP guidance on what constitutes well designed performance fee structures should be principles-based. Introducing conditions for performance fee structures to be exempted from the Charge Cap is unlikely to work well across the broad range of assets and investment strategies that exist in the market, and risks disadvantaging investors.

Investors will consider several factors when assessing the appropriateness of any investment fee structure. For example, the type of fund being used, the expected return strategy, applicability of hurdle rates, relevance of specific expertise, and whether the investor is early stage or not will all impact on the investment fee structure. As such, there is a wide variety of fee structures and levels across the alternative investment management sector. Any attempt to specify what fee structures should look like in regulations or guidance will impair the ability of investors to achieve fair and balanced fee structures.

Adopting a principles-based approach will support the ability of investors to consider the most appropriate factors when assessing whether fees are reasonable and proportionate to the expected returns without requiring them to adhere to pre-determined structures. This approach will also future proof the guidance to accommodate innovation on fee structures.

There is already a significant amount of regulatory and supervisory material relating to fee structures in the asset management sector, including from the FCA, ESMA and IOSCO. Building on this material and existing industry practices will ensure DWP guidance aligns with existing practices and support the ability of investors to evaluate fee structures across different assets and investment strategies

Question 4: Do you agree with our proposal to require disclosure of performance fees if they are outside the scope of the charge cap? If so, we propose this is done in a similar way to transaction costs – do you agree? Could you provide details of any new financial costs that could arise from a requirement to disclose performance fees? Please outline any one-off and ongoing costs.

Any disclosure requirements should reflect the value of the investment more broadly rather than focus solely on costs. We support the Government's position that performance-based fees exempted from the Charge Cap should be disclosed to members in the Chair's Statement. This would be consistent with the existing obligation on trustees to express a view on value to members, align with broader efforts to provide meaningful and material disclosure to DC pension fund beneficiaries and reduce overall operational burdens on investors.

Consideration should also be given to how disclosures align with Government policy in other areas to support the ability of members to exercise their consumer power and move their DC pension pots from underperforming pension schemes to better performing schemes. The returns which can accrue from investment in less liquid, private or alternative assets may take longer to realise than other assets. If this is not effectively conveyed to members more generally, there is a risk that performance fee disclosures might have the unintended consequence of motivating members to move their pension pots before they receive the full benefit of the illiquid investment (i.e. redeeming at the bottom of the J-curve).

Question 5a: If we add performance fees to the list of charges which are not subject to the charge cap, do you agree that we should remove the performance fee smoothing mechanism and the pro-rating easement from the Charges and Governance Regulations 2015?

Question 5b: Is there a need for transitional protection arrangements to be brought in for schemes that have decided to make use of the performance fee smoothing mechanism, and if so what do these transitional arrangements look like?

Creating a "safe harbour" for performance fees in the manner proposed by the consultation may inadvertently prohibit other structures which are already compliant with the current Charge Cap. Such an outcome would be inconsistent with the policy intent of encouraging investment in productive finance.

We would encourage the DWP to reconsider the proposal to add well designed performance fees to the list of items exempt from the Cap under the definition of "charges" in Regulation 2(1) of the regulations. This approach may adversely affect impact existing fee structures by creating additional uncertainty regarding the treatment of such fee structures under the current guidance. Whilst this risk applies to any existing funds in which DC pension schemes are invested, we particularly note the risk to any long-term asset funds that may be launched prior to any changes being made. We propose that a free-standing provision to the effect that "notwithstanding Regulation 4, a performance fee shall be disregarded" would be a more effective way to implement this change.

If the Government does exempt performance fees from the Charge Cap it will be necessary to introduce either transitional measures or grandfathering provisions to ensure any existing investment structures and fee arrangements are not unduly affected. It is likely that asset managers and their investors will need to review the final legislation and guidance before being able to fully assess whether this is the case. We would encourage DWP to recognise this and be open to further dialogue with industry on this matter once an assessment has been made.

We support the removal of the smoothing mechanism and pro-rating easement to the extent it does not disadvantage existing investment structures and fee arrangements as noted above.