AREF

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Dear David

Response to the Improving outcomes for members of defined contribution pension schemes

We, the Association of Real Estate Funds[1] (AREF), responded to the February 2019 consultation "Investment Innovation and Future Consolidation" and welcome the opportunity to respond to this consultation on improving outcomes for members of DC pension schemes.

We support DWP putting in measures to encourage DC schemes to invest in illiquid assets. Pension schemes are investors in many of the property funds that are members of AREF.

DC schemes can currently access illiquid assets via Qualified Investor Scheme (QIS) and investment trusts and, with the recent changes to the FCA permitted links rules for unit-linked life funds, through life funds too. Although, there are issues with the permitted links rules; notably the 35% cap on a life fund's holdings of illiquid assets. In addition, we agree that DC schemes should be given the opportunity to invest through fund vehicles suitable for retail investors and whose net asset value (NAV) directly reflects the value of the underlying assets, thus providing true illiquid exposure, which is not always true of listed investment trusts.

As noted in the responses received to last year's consultation, one barrier to investment by DC schemes in illiquid assets is that investment platforms, which the vast majority of DC schemes use, often only accommodate investments which are priced and dealt daily. This means DC schemes may struggle to gain access to the existing products especially if the FCA's proposal for authorised property funds to have notice periods for redemptions is taken forward without platforms having the systems in place to offer them. This is of great concern to us and we have

[1] The Association of Real Estate Funds (AREF) represents the UK real estate funds industry and has 67 member funds with a collective net asset value of more than £70 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the MSCI/AREF Property Fund Vision Handbook.

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mentioned this in our response to the FCA CP20/15 Liquidity mismatch in authorised open-ended property funds.

Please find below our responses to selected questions in the consultation. You are welcome to contact Jacqui Bungay (jbungay@aref.org.uk), Policy Secretariat at AREF, to discuss any aspect of our response. Also, as our members invest in real estate and other real assets for various types of open-ended and closed-ended funds we are always willing to assist the DWP by sharing this wealth of knowledge and experience.

Yours sincerely

Paul Richards
Managing Director, The Association of Real Estate Funds

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Response to selected consultation questions

Chapter 2: Encouraging Consolidation

We can see the benefits of encouraging the consolidation of smaller DC schemes as this would enable them to invest in a more diverse range of investment products including property funds.

We have no comments in relation to Q1-3.

Chapter 3: Diversification, performance fees and the default fund charge cap

Amendment to the charge cap compliance mechanism: an in-year adjustment to prorating performance fees

Q4. Do the draft regulations achieve the policy intent of providing an easement from the prorating requirement for performance fees which are calculated each time the value of the asset is calculated?

In relation to private equity real estate funds, we support this proposal, as it could help remove the challenges related to treating partial year members fairly. However, it may not completely solve the fundamental mismatch between DC schemes' requirement for daily valuations and the reality that private equity real estate assets are difficult to value more frequently than annually, and that an estimate of the amount of carried interest based on NAV may differ from the ultimately realised total.

In order to ensure all schemes have access to the same range of investments regardless of their charging structures, we believe that the easement should be available in respect of an existing rights charge in a combination charge structure not just for single charge structures. Both single charge and combination charge structures are a complex aggregation of all the cost items laid out in Annex F of the current consultation document, but this complexity is not exposed to scheme members. A performance fee embedded in an existing rights charge in a combination charge structure would appear no more complex than a performance fee embedded in a single charge structure.

The nature of the proposed amendment is to provide relief from an existing requirement and is not capable of triggering a breach of the charge cap. Therefore, we see no reason to delay the application date beyond the date on which the amendments are made, and no reason why it cannot become applicable during a charges year.

Further option for the charge cap compliance mechanism: creating a multi-year rolling calculation approach

Q5. What should we consider to ensure a multi-year approach to calculating performance fees works in practice?

We would suggest that DWP consider the impact that the accounting treatment of private equity real estate funds' carried interest and escrow arrangements may have on the proposed mechanism. These arrangements are commonly agreed as a means of ensuring that any payments of carried interest during a private equity real estate fund's life do not distort the agreed profit share proportion between manager and investors, looking at the whole fund's overall performance during its lifetime. Carried interest entitlements may accrue on the basis of NAV valuations before being paid in cash that is retained in an escrow account and only released to the fund manager once investors have received further cash distributions sufficient to cover any undrawn capital commitments which the manager could still draw down. For the purposes of a multi-year smoothing mechanism, we assume that the relevant performance fee element would be the amount of carried interest paid in cash into escrow, but we would ask DWP to clarify this.

Another feature of private equity real estate funds that DC scheme trustees, assessing performance fees using a multi-year approach, may need to take into consideration is the typical reduction in management fees at the end of a fund's investment period (usually around five years into the life of a fund). At this point, the basis on which management fees are charged shifts from committed capital to invested and unrealised capital, to reflect that the manager's role no longer involves finding and executing new investments. Although this is not directly related to the performance fee element of the charge cap calculation, the progressive decline in management fees after a fund's investment period will presumably affect any 'headroom' below the cap.

We also believe that intermediate structures, such as a master trust, will be required to reconcile the illiquidity of underlying private equity real estate funds with DC schemes' need for ongoing liquidity. This can offer daily pricing information so trustees can ensure the cap is respected, although this approach would likely require the intermediate vehicle to be seeded with sufficient initial assets to mitigate the fact that private equity real estate investments involve an initial capital outlay followed by increasing returns during the later years of a fund's life (the 'J-curve').

Q6. We are proposing a five-year rolling period. Is this appropriate or would another duration be more helpful?

In relation to private equity real estate funds, we believe that a period of up to 10 years would provide a more appropriate timescale for DC schemes to measure performance accurately and allocate an appropriate performance fee element to the charge cap calculation. Any timescale applied at the asset level would need to reflect average property holding periods and allow time for business plans to mature into investor returns. Similar underlying considerations apply at a product/fund level, where the most accurate approach for a closed ended fund would be to judge performance at the end of the fund's life, once its performance is known. Ten years would be better than five years for reflecting the performance of a portfolio of property development projects with varying holding periods.

Q7. We are proposing offering a multi-year option as an alternative to an in-year option for schemes. Do you have any suggestions for how to improve this offer?

Q8. To what extent will providing a multi-year smoothing option give DC trustees more confidence to invest in less liquid assets such as venture capital?

DC trustees may decide not to invest in private equity real estate funds because the amount of carried interest payments, which cannot be accurately predicted, may end up greater than the amount of 'headroom' available across the portfolio on a blended basis. A typical institutional investor might allocate 5-10 % of its capital to illiquid assets including private equity real estate. Based on average historical returns, we believe that DC schemes investing similar proportions in private equity real estate funds would have insufficient headroom and would breach the charge cap even if they used the proposed multi-year accrual method. The lower the proportion of the portfolio allocated to private equity real estate funds the less likely a breach. Therefore, because of the charge cap, DC schemes may decide to reduce their allocation in private equity real estate funds to, for example, 1-2%. Although, the theoretical risk will remain, particularly where funds ultimately achieve top quartile performance. It does seem strange to us that schemes would be penalised for making good investment decisions.

Given that strong performance and realised returns seem to be prerequisite to any breach of the charge cap resulting from carried interest payments, we suggest that DWP should consider giving DC schemes trustees appropriate protection against any liability by enabling them to explain any inadvertent breaches caused by performance fees or carried interest (accrued or paid). This could take the form of an ability to cure any such breaches within a reasonable timeframe and should be subject to appropriate conditions, relating, for example, to the reasons why excess returns have been generated or the proportions in which any profit share is allocated (for private equity real estate funds this is typically 20:80 in favour of investors). Protections for trustees would help eliminate any liability for DC schemes that breach the charge cap because their investments have performed too well, and could provide further comfort that investing in the more successful private equity real estate funds would not have negative consequences for DC trustees. As a carried interest payment is a profit share rather than a fee, if it was reclassified as such there would not be this issue.

Cost of holding physical assets

Q9. Do the draft regulations achieve the policy intent? Do you have any comment on the definitions used?

We agree with the proposal to put the exclusion of the costs of holding physical assets from the charge cap on a statutory footing. The list of costs is relevant for the type of physical assets our member funds invest in i.e. real estate. Also, we agree with the definitions being used in the regulations.

Non-exhaustive list of charges

To provide more clarity to trustees, we would like to see the examples of costs relating to physical assets, set out in paragraph 68 of the consultation, added to the non-exhaustive list of charges in Annex F of the consultation. Also, in the interest of consistency, we would suggest aligning the costs in this list with the costs and expenses in the Cost Transparency Initiative's (CTI's) reporting templates. These are a recently introduced industry standard for making institutional investment cost data more transparent to investors such as pension schemes. They were developed by the Pensions and Lifetime Savings Association, the Investment Association and the Local Government Pension Scheme Advisory Board with the support of ourselves and the British Venture Capital Association.

The proposal in paragraph 75 of the consultation document which "propose[s] that schemes should look through all open-ended funds and all UK listed closed-ended investment funds and international equivalents" appears to exclude unlisted closed-ended funds. The revised drafting of the list of costs in Annex F (investment costs: ongoing charges for underlying funds …) also seems to exclude these unlisted funds as well as open-ended funds other than UCITS, NURS or QIS. As the treatment of carried interest, which arises in unlisted closed-ended investment funds, has been considered as part of this consultation, we assume that these funds should be included. We believe that the list of costs would be clearer and less ambiguous if it referred to the substance of the underlying funds rather than their form.

Also, we would like to point out that capital gains tax is not a transaction cost; it arises on profits made as a result of changes in the value of an investment. Therefore, it should be listed under the heading "Taxes" in the non-exhaustive list of charges and not under "Transaction costs".

Chapters 5 & 6

We have no comments regarding Q10-13