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Authors
John Dunkley
Nikki Williams

Measures to boost illiquid asset investment by DC pension schemes

Greater investment in illiquid asset classes is something the government is keen to encourage defined contribution (DC) pension schemes to actively consider, both to benefit pension savers and to benefit the UK economy.

As part of its consultation into broadening the investment opportunities of DC pension schemes, the DWP has previously consulted on proposals for trustees to disclose and explain their policies on illiquid investment and their default fund asset allocations, along with exempting certain performance fees from the DC charge cap.

The government has now responded to the consultation. In addition to regulations, that are expected to come into effect from April 2023, statutory guidance has also been finalised. This is part of a broader suite of work aimed at creating "fairer, more predictable, and better-run pensions".

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Background

As part of its drive to encourage pension schemes to consider investing in illiquid assets, the DWP has consulted on plans to require DC pension schemes to disclose their policy on investment in illiquid assets within their statement of investment principles (SIP), and to require public disclosure of their default fund(s) asset allocation in the annual chair's statement. All schemes that are required to produce a chair's statement are covered by this change.

This is intended to encourage trustees to accurately reflect on whether their current investment policies and asset allocations align with market changes and if their current offerings are still in their members' best interests.

This could also lead to helping members better understand the investments made on their behalf, which could help drive up overall pensions' engagement. It would also drive industry-wide transparency and standardised disclosure, which will be beneficial to other schemes, members, employers, and

regulators wanting to understand the rationale behind investment decisions and the overall value schemes offer.

How are "illiquid assets" defined?

Illiquid assets are normally assets which cannot be easily or quickly sold or exchanged for cash and, where assets are invested through a pooled fund, includes those assets.

However, the government recognises that there may be instances of unusual market conditions where trustees should use their objective judgement and discuss with their advisers when considering any temporary market conditions that may widen the scope of illiquid assets.

SIP disclosure

Trustees must ensure that the SIP includes their policy on illiquid asset investment, which must include:

(a) a statement as to whether or not investments held for the purposes of the default arrangement will include illiquid assets;

(b) where those investments **will include** illiquid assets:

- a description of the age profile of those members in respect of whom investments will be held in illiquid assets;
- an explanation of whether investments will be held directly in illiquid assets, or via a pooled fund;
- an explanation of the types of illiquid assets in which investments will be held; and
- an explanation of why the trustees have a policy of investing in illiquid assets including their assessment of the advantages to members of investing in illiquid assets, when compared to investments in other classes of assets;

(c) where those investments **will not include** illiquid assets, an explanation of why the trustees have a policy of not investing in illiquid assets; and

(d) an explanation of whether the trustees have any plans to invest in illiquid assets or increase their investment in illiquid assets, in the future.

When does this requirement take effect?

This applies with effect from the earlier of the first date on which the SIP is revised after 1 October 2023 and 1 October 2024.

Annual chair's statement disclosures

In relation to the default arrangement, trustees are required to explain their asset allocation and also the amount of any performance-based fees, in their annual chair's statement from the first scheme year ending after 1 October 2023 and publish that alongside other relevant parts of the statement on a publicly available website.

Asset allocation disclosure

Trustees must, at least annually, calculate the percentage of relevant scheme assets allocated to each of the following asset classes in the default arrangement:

(a) cash;

(b) bonds: corporate bonds or UK/other government bonds;

(c) listed equities;

(d) private equity: shares either listed or not listed on a recognised stock exchange;

(e) infrastructure comprising of physical structures, facilities, systems, or networks that provide or support essential public services and including water, gas and electricity networks, roads, telecommunications facilities, schools, hospitals, and prisons etc.;

(f) private debt/credit: non-bank lending to companies, not issued or traded publicly;

(g) property; and

(h) any other assets which do not fall within the above paragraphs.

The statutory guidance gives examples of how the information should be displayed in the chair's statement.

Averaging

If a scheme's asset allocation has fluctuated or changed significantly throughout a scheme year, trustees may wish to use averaging to represent their allocation; however, this is not a requirement. Where completed, this could be done by selecting four valuation points throughout the year, no closer than three months apart, at which the percentage allocation to each asset class is calculated. A mean average of these percentages could then be calculated and disclosed as an average from across the scheme year.

Age-specific disclosures

The statutory guidance recommends that trustees use age profiles as part of the default asset allocation disclosure to represent the different asset allocation phases in accumulation. The government suggests that trustees may wish to consider using ages that are consistent with existing disclosures.

For example, in the statutory guidance on completing the annual Value for Members assessment and reporting of net investment returns, age specific asset allocations for savers aged 25, 45 and 55 years are used. It also recommends using "1 day prior to State Pension Age" as a further age cohort for disclosure to capture asset allocations close to retirement age and just before decumulation begins, when de-risking is more prevalent. This is intended to make the disclosures more consistent where different schemes have different default end ages and members select different retirement ages.

When does this requirement take effect?

This applies with effect from the first scheme year that ends after 1 October 2023.

Exempting performance-related fees from the DC charge cap

Performance-based fees aim to align the financial interests of the investment/fund manager and investors, in their joint aspiration for profit. They are commonly associated with investments where there is a high level of involvement by the fund manager in executing the fund's investment strategy and the management of underlying assets.

They are often found in privately traded assets such as private equity, venture and growth capital, and private credit as well as liquid alternative funds. Such funds may also invest in publicly traded assets. A performance-based fee can, therefore, be applied to any asset class or a fund that blends multiple asset classes.

The new regulations enable trustees to exclude performance-based fees that are paid when a fund manager exceeds pre-determined performance targets from their charge cap of 0.75% p.a. where this is in the best interests of their members.

Performance-based fees, and their interaction with the charge cap, have been cited as limiting trustees' consideration of certain illiquid assets, and their removal from the cap has the potential to open doors for schemes to work with fund managers to gain access to private markets in greater numbers.

The statutory guidance includes further details on this criteria to enable trustees to determine whether particular fees can be excluded from the charge cap.

Performance-based fees that are not considered to meet the criteria can still be used by trustees, although they will remain subject to the charge cap.

Performance-based fees disclosure

The regulations will require that the amount of any specified performance-based fees incurred in relation to each default arrangement (if any) for the scheme during the scheme year, is stated as a percentage of the average value of the assets held by that default arrangement during the scheme year.

This information must be included in the annual chair's statement and made available on a publicly available website.

Trustees should carefully consider how they present the monetary amount of performance-based fees in the annual chair's statement as there may be periods when their magnitude differs considerably to the other fees paid on their default fund or other industry default funds. There may also be periods when the year-on-year changes are very significant.

Other disclosures that trustees may wish to consider include:

- Further detail to supplement the above disclosures with detail to add context to performance-based fees, such as the assets and funds to which the specified performance-based fees relate, the application of the hurdle rate, and a timeline of how performance-based fees are measured and paid. Additionally, trustees may consider including previous years' information, and additional narrative to relate to the fund's performance and how that is expected to impact member outcomes.
- Additional disclosure more frequently than once a year, which could be relevant if that aligns with measurement or payment periods for the performance-based fee, and if there may be a desire to disclose information in relation to fair treatment of members that may join or leave a scheme, or alter contributions, part way through a scheme year. This additional information could take the form of literature or interactive graphics to help members understand how performance-based fees have been considered and does not need to be contained in the chair's statement. Trustees could refer the reader to an alternative outlet, such as a web page that is freely available to members. This could be bespoke to the scheme or could refer to the fund manager's website, which may be relevant for pooled funds where the same information could be relevant for multiple schemes.
- Further information on performance-based fees could be reported to members in the normal course of reporting, for example by making use of guides and fund sheets.

Value for members

The regulations require that trustees that do pay specified performance-based fees must assess the extent to which these represent good value for members. However, schemes with under £100million in assets under management are not required to include this as part of their extended value for member comparison against larger schemes.

When does this requirement take effect?

The regulations concerning the exemption of certain performance-based fees from the charge cap are expected to apply from 6 April 2023, and from the first scheme year ending after 6 April 2023, the amount of any specified performance-based fees in relation to each default fund will need to be included in the chair's statement and put on a publicly available website.

Action for trustees

Trustees should review the current structure of their default arrangement(s) and determine their future policy on illiquid investments with the support of their investment advisers in order that a new SIP can be prepared after 1 October 2023.

Although the changes to the chair's statement may not be required immediately, trustees should also review with their advisers the asset allocation of their default fund(s) and if invested in illiquid assets consider whether the exemption of performance-based fees from the charge cap applies to the scheme, in order to prepare for these new disclosure requirements.

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