

# Enabling investment in productive finance

Isio response to consultation on  
proposals to remove performance-  
based fees from the charge cap

# Isio view

**The proposals to remove performance-based fees from the charge cap seem to be an imperfect fix to a problem requiring a more radical solution.**

We acknowledge that investment in illiquid asset classes by defined contribution (DC) pension schemes is currently a challenge, but removing performance related fees will not have a meaningful impact on increasing illiquid allocations.

## Playing devil's advocate

### Why not just remove the charge cap altogether?

It's done its job and driven down charges whilst the auto-enrolment market took root. Competition is now doing the rest – that is why charges are already well below the cap.

Most DC schemes don't look at the charge cap as their "line in the sand" when reviewing strategy or changing providers, they look at their current level of charges as a comparator. Value for money would therefore need to be assessed by net performance return comparisons.

Without the cap, DC schemes could be free to invest as they wish. But we acknowledge it's not quite as simple as that.

**We do not believe the charge cap is the problem here.**

There are more significant hurdles to accessing illiquid assets – fund structures, the level of complexity and lack of available funds on DC platforms, to name a few, and these need a more radical solution.

Removing performance fees from the charge cap has the potential to dilute member protections, making charges much less transparent. There's a real risk that providers try to hide their fees to appear more competitive, and simply requiring disclosure in the Chair's Statement (which is unlikely to be viewed widely) is not the answer.

We do recognise that the removal of performance-related fees is one complexity which is easy to fix. Doing so could encourage fund managers to explore more options and drive innovation in the DC market – this of course would be in members' best interests. However, we believe the market will eventually overcome these obstacles and find a way to make private market investment work in DC – indeed some schemes already have.

# Consultation questions

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## Question one (a)

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?

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## Isio response

We have some DC clients who invest in assets like private equity already, but the vast majority do not. Overall we are supportive of illiquid assets in the DC space and believe it would improve member outcomes to access these long-term assets.

We don't see the charge cap as a significant issue as most large schemes (including Master Trusts) are so far from the 0.75% cap. Given illiquid assets are unlikely to ever be a significant allocation (say at most 20%) we believe there is headway to do this within existing fee structures. It is instead price competition and other complexities around accessing private markets which is preventing this. DWP do acknowledge in the consultation that this won't be a silver bullet but may aim to reduce one of the factors.

The proposals do not remove the operational challenges around actually calculating performance fees on a member-by-member basis, although we acknowledge that this has been considered as part of previous consultations, e.g. through smoothing.

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## Question one (b)

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?

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## Isio response

This could encourage more fund managers to think about creating DC suitable offerings but may not necessarily encourage changing their structures. We expect many managers who offer existing illiquid offerings (e.g. in the DB space) would be reluctant to form anything too different here, given there is so much demand for long-term assets.

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## Question one (c)

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?

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## Isio response

Resolving some structural issues (e.g. making it easier for illiquid funds to be accepted on platforms) and relieving competitive pricing pressures by focusing on broader Value for Money for members is important, and both are being considered under various consultations but are challenging to achieve in practice.

We believe DWP need to think of more radical solutions in this space, for example:

- Compel schemes to state why they do not have an allocation to illiquid assets in VFM disclosures / Chair's Statement
- Compel schemes to have minimum x% in illiquid allocations in their default growth phase
- Relax the requirement to have daily dealing
- Encourage platforms to consider how to better accommodate illiquid funds
- Compel gatekeepers (like consultancies) to allow for illiquid allocations in their selection criteria

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## Question two

**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?**

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## Isio response

Due to price competition and consultations on other VFM disclosures, we don't think this change alone would significantly increase charges across the board. We believe all parties would continue to be conscious of overall fees if making a change in default strategy, and providers will still need to compete in terms of charges.

The important factor will be making sure any performance related fees are genuinely paying for actual outperformance (rather than just delivering say cash) and that fees are properly disclosed and easy to compare.

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## Question two (a)

**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?**

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## Isio response

The DWP has suggested a good range of considerations on this, for example specifying a hurdle rate, and we believe these are all really important factors to avoid costs being hidden outside of the charge cap.

However, we note that being too prescriptive with the requirements may deter fund managers from wanting to innovate in the DC space.

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## Question three

**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?**

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## Isio response

As above – the consultation proposals sound sensible but we are conscious that over-regulation may defeat the point of encouraging innovation in this space.



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## Question four

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.

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## Isio response

We believe performance fees should still be disclosed and suggest providers are required to quote these when pitching for new business or quoting fees to members and advisors. It is crucially important that this doesn't become a "hidden cost" or a way for providers to look cheap vs. their competitors.

We would suggest disclosure needs to be more explicit than merely including in the Chair's Statement, which from our experience can be viewed as more of a governance tick box exercise than adding value, and therefore is rarely looked at.

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## Question five (a)

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?

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## Question five (b)

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?

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## Isio response

Our sole comment here would be that we expect it will still be a challenge to calculate performance fees even if they are not part of the charge cap, particularly on a member-specific basis.

