FYI® Alert
For Your Information®

Volume 2020

Issue 38

12 October 2020

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Improving outcomes for members of defined contribution pension schemes

The DWP has responded to its February 2019 consultation: Investment Innovation and Future Consolidation by publishing a further consultation with more developed proposals aimed at improving defined contribution (DC) pension scheme governance and encouraging trustees to increase diversification of their investments.

Most smaller DC schemes will be required to annually undertake more stringent value for money assessments, including a direct comparison of value against three larger DC schemes of their choosing. Smaller schemes which are not able to demonstrate good value for money will be expected to make rapid improvements or consolidate, with an additional requirement to report their approach to The Pensions Regulator on an annual basis.

There are also measures to encourage all DC schemes to invest in a more diverse range of long-term assets including illiquid products such as venture capital and green infrastructure.

The consultation closes on 30 October 2020 and the draft regulations are to come into force a year later, on 5 October 2021.

Background

The government wants to improve the governance of all occupational DC arrangements and to encourage them to invest in innovative and diversified investment strategies, to both improve long-term returns and drive new investment in important sectors of the economy.

It sees smaller DC schemes as a barrier to these aims, as they do not have the scale to bring the benefits of investing across a broad range of asset classes. It has also concluded that small schemes generally persistently underperform, have poor governance and would in many cases thus benefit from consolidation.

Consolidation

The government has defined ’smaller schemes’ as DC (or hybrid) schemes with less than £100m in assets, which have been in operation for more than three years at the assessment date. These schemes will be required to complete a more standardised ‘holistic’ annual value for money assessment than larger DC (or hybrid) schemes and report on their findings in their scheme return, as well as in their chair’s statement.

Unlike the ‘value for member’ assessments currently required, which cover only member-borne charges and allow trustees discretion as to how to perform the assessment, the new ‘holistic’ assessment will consider as standard:

- Costs and charges;
- Net investment returns;
- Measures of administration and governance; and
- benefits of existing guarantees.

In assessing costs and charges, smaller schemes will be expected to make a comparison with three other schemes – all of which must have assets over £100m and at least one of which must be willing to accept a transfer in of the smaller scheme’s members.

In assessing administration and governance, trustees should look at:

- quality of record keeping;
- promptness and accuracy of core financial transactions;
- quality of communication with members;
- appropriateness of the default investment strategy; and
- the quality of investment governance.

Where a smaller scheme concludes it is not giving good value for money, it will be expected to make rapid improvements or be wound up and consolidated. Where trustees decide to make rapid improvements, they will be required to report this in the next scheme return submitted to The Pensions Regulator and set out the action they intend to take or are taking.

Regulations will bring the above proposals into force on 5 October 2021. The assessment will need to be carried out annually and be reported for the first time in the chair’s statement for the first scheme year ending after 5 October 2021.

However, it is expected that schemes which wish to make improvements, rather than wind up and consolidate, will have made the improvement before their assessment falls due under the Regulations. Only in exceptional circumstances will schemes be able to make improvements following the assessment.

Schemes which do not fall under the definition of smaller schemes because they have been going for less than three years or have assets over £100m will continue to have to comply with the current requirements for assessing ‘value for members’ by reviewing the extent to which member-borne costs and charges represent good value for members, although they will be able to choose to voluntarily adopt the new form of assessment.

Charge caps for default arrangements used in automatic enrolment

The government has recognised that the charge cap may hinder the ability of schemes to increase diversification given the prevalence of performance-related fees in wider investment classes such as private equity or venture capital investments

The consultation proposes a limited easement in relation to the default fund charge cap to alter the treatment of performance fees and costs associated with holding physical assets. Schemes will be allowed to smooth the calculation of performance fees in a year and Pensions Minister, Guy Opperman, also states in the consultation his intention to introduce the option of multi-year smoothing. Guidance will also make it clear that the charge cap does not apply to costs associated with holding physical assets such as property. Both of these measures will enable an increase in investment in illiquid assets in DC schemes.

The consultation states further that the government is still performing a wider review of the scope and operation of the automatic enrolment charge cap but will report back on this by the end of 2020.

Publishing net returns in chair's statements

'Relevant schemes' (broadly schemes that provide DC benefits other than AVCs) are to be required to publish net returns for their default and self-selected funds in their annual chair's statement.

The information will need to be published in the annual chair's statement for the first scheme year ending after 5 October 2021. Draft statutory guidance sets out exactly what needs to be reported and how the information should be presented.

Other changes

The proposed legislation and statutory guidance also contains changes to the requirements for the statement of investment principles (introducing a requirement for a default statement of investment principles where a with-profits fund is a default arrangement, while clarifying that wholly-insured schemes will not need to include a policy on arrangements with investment managers) and to the costs and charges disclosures (for instance, extending them to include funds that members are invested in but that are no longer available for selection).

Comment

Given that the current consultation is in response to a previous consultation from February 2019, the DWP has been slow to react but quick to act. A previous suggestion that smaller DC schemes should assess the merits of consolidation on a three-yearly basis has turned into an 'improve or consolidate' cycle every 12 months. The Regulator previously defined small schemes as having 12-99 members, medium schemes as having 100-999 members, and large schemes as having 1,000+ members. The DWP proposal to apply the new requirements to schemes with less than £100m in assets is a significant recalibration and reinforces the message from DWP and the Regulator that bigger is better.

Although it is a year before the planned changes come into effect, trustees should also be quick to act, by considering their impact now and what actions they need to take. Trustees of smaller schemes should begin planning now and not wait for 5 October 2021, particularly if they foresee being required to improve or consolidate. The need for DC schemes to have data on net returns is also new and trustees may need to talk to their investment managers to ensure that it is available.

Overall, the new measures will see a marked increase in DC consolidation over the coming years, not least because mandatory consolidation may be introduced should these changes not drive consolidation at “sufficient pace”. Whether these changes will deliver higher standards of governance, improved value and better outcomes for all members of smaller DC schemes remains to be seen.

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