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The future of defined contribution pension schemes

Government policy is to drive defined contribution (DC) pension schemes to consolidate wherever possible.

The DWP has responded to two consultations on investments and overall governance of DC pension schemes and at the same time signalled its desire for those with under £5bn in assets to now consider consolidation, on the basis that "the rate at which this is occurring is slower than is needed".

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Background

In February 2019, the DWP published a consultation: 'Investment Innovation and Future Consolidation' on proposals to encourage DC pension schemes to consider a wider range of investments (the 2019 consultation).

On 11 September 2020, the DWP responded to the 2019 consultation and issued a further consultation: 'Improving outcomes for members of defined contribution pension schemes' on changes designed to deliver better value for money for members of DC pension schemes (the 2020 consultation). This 2020 consultation set out proposals to drive consolidation in the DC market.

Then, on 19 March 2021, the DWP issued another consultation: 'Incorporating performance fees within the charge cap' on draft regulations on performance fee smoothing and a call for evidence on the issue of look-through (the 2021 consultation).

Response to the 2020 and 2021 consultations

On 21 June 2021, the DWP issued its responses to both the 2020 and 2021 consultations together with a new call for evidence: 'Future of the DC pension market: the case for greater consolidation'. The call for evidence runs until 30 July 2021 and the DWP plans to issue a response in the form of policy consultation in the Autumn.

Reporting of net returns and the new value for members assessment

The government is pushing ahead with its proposals contained in the 2020 consultation to require trustees of DC pension schemes:

- regardless of scheme size, to state in their next chair's statement relevant to the first scheme year that ends after 1 October 2021, the net investment (performance) returns for their default arrangement(s) and self-select funds calculated on a specific basis and over certain time periods. This information should be added to that which must currently be published on a publicly available website
- with total assets of less than £100 million and that have been operating for at least three years, to assess key elements of the value achieved by their scheme on behalf of members for their next chair's statement relevant to the first scheme year that ends after 31 December 2021. This would involve assessing their net investment performance and costs and charges against three other larger schemes operating in the market, and a self-assessment of the scheme's own administration and governance against prescribed criteria
- to report on the outcome of the value for members assessment in their chair's statement and to The Pensions Regulator via the next scheme return. This includes outlining next steps, where trustees conclude that their scheme does not provide good value for members, either immediate improvement or consolidation / wind up. Again, this should be added to the information that must currently be published on a publicly available website
- with assets of £100million or more, to continue 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

The value for members assessment applies to hybrid schemes where the total assets (DC and DB together) are below £100 million. However, it is only the DC element of the scheme that will be subject to the assessment.

At least one of the larger schemes that the trustees choose for the comparison must 'have had discussions' with the trustees over a potential transfer in of the smaller scheme's members.

Trustees of smaller schemes that would ordinarily have been in scope will be exempt if they have informed the Regulator at any time before the next chair's statement is due that they are in the process of wind up.

Performance fee smoothing and look-through

In the 2021 consultation, the DWP consulted on draft regulations to allow trustees to smooth the performance fee element of their charges regime over five years.

It was anticipated that this would remove an identified barrier to investing in illiquid asset classes that generate performance fees, allowing schemes to accommodate the 'ebb and flow' sometimes associated with the performance of these assets and still remain within the charge cap.

The 2021 consultation also included a call for evidence on 'look-through' costs. Currently, trustees of occupational DC pension schemes are required to 'look-through' closed-ended funds or pooled investment vehicles. This means that trustees should not just incorporate the costs of investing in the pooled vehicle but look-through this structure and consider the costs paid by the pooled vehicle manager as it invests in other funds, known as the underlying investments.

In the DWP's response they acknowledge that the current requirement needs to be clarified and may need to change to remove the requirement to look-through. The intention is to work through options with industry and other partners with an aim to announce a revised position (i.e. formal next steps for revised guidance or regulatory reform including a timeline) on look-through before 22 July 2021 (when the Houses of Parliament rise for Summer recess).

Call for evidence: the case for greater consolidation

Both the government and The Pensions Regulator are convinced that small schemes are not run as well as larger schemes and are looking to increase the rate of consolidation in order to improve member outcomes.

The call for evidence, whilst seeking views on how to accelerate the pace of consolidation for schemes under £100 million, also looks ahead to phase two which will look at schemes with assets under management of between £100 million and £5 billion. As there are very few DC schemes in the UK with assets of £5 billion or above, trustees should not focus too much on this figure, but on the clear policy intent of the government.

Statutory guidance

The government is moving forward with new regulations which will come into effect in October 2021.

The two statutory guidance documents that accompany the final draft regulations have also been published. 'Reporting of costs, charges and other information: guidance for trustees and managers of occupational schemes' will be effective from 1 October 2021. The existing guidance effective from September 2018 continues to apply until October 2021. 'Completing the annual Value for Members assessment and Reporting Investment Returns: Guidance for trustees of relevant occupational DC schemes' will be effective from 1 October 2021, subject to approval of corresponding draft regulations by Parliament.

Next steps for trustees

Trustees should read and understand the new statutory guidance and consider the following steps:

- include net investment performance in their next chair's statement relevant to the scheme year that ends after 1 October 2021 and add it to the information published on the publicly available website
- identify if they are subject to the new detailed value for members assessment and understand the timeline for their scheme
- be prepared:
  - start considering how they will select three comparator schemes
  - if they think the conclusion might be that the scheme does not offer good value for members, start scoping out what a wind up (or bulk transfer of DC members from a hybrid scheme) will involve
  - if they are undertaking a value for members assessment and chair's statement before the changes take effect, consider doing a shadow assessment under the new requirements

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