Introduction

On 10 January 2013, the Pensions Regulator published 145 pages of materials designed to confirm its expectations of governance standards for occupational trust based Defined Contribution pension plans. Trustees will need to take action; we provide overleaf a checklist of points to note and action points.

Although one of the Regulator’s publications is a consultation document, the other three papers (which consist of a regulatory approach document, a draft Code of Practice and regulatory guidance) together set out a comprehensive architecture for achieving the Regulator’s “good member outcomes” for DC members and an adequate income at retirement. These outcomes are the hallmark of what the Regulator regards as quality DC pension plans and were the subject of separate publications in January and December 2011, which were then followed by a series of draft quality features in June 2012. The DC principles and outcomes are:

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<thead>
<tr>
<th>Principles</th>
<th>Outcomes</th>
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<td>Essential characteristics: pension plans are designed to be durable, fair and deliver good outcomes for members.</td>
<td>Appropriate contribution decisions.</td>
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<td>Establishing governance: a comprehensive governance framework is established at set up, with clear accountabilities, and responsibilities agreed and made transparent.</td>
<td>Appropriate investment decisions.</td>
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<td>People: those who are accountable for pension plan decisions and activity understand their duties and are fit and proper to carry them out.</td>
<td>Efficient and effective administration.</td>
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<td>Ongoing governance and monitoring: pension plans benefit from effective governance and monitoring through their full lifecycle.</td>
<td>Protection of assets.</td>
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<td>Administration: pension plans are well-administered with timely, accurate and comprehensive processes and records.</td>
<td>Value for money.</td>
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<td>Communications to members: communications to members are designed and delivered to ensure members are able to make informed decisions about their retirement savings.</td>
<td>Appropriate decumulation decisions.</td>
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The Regulator’s publications represent an important and valuable contribution to the governance debate. It has set out a lot of challenges to trustees and many good ideas to improve the quality of day-to-day oversight of trust-based pension plans. Some parts of this governance jigsaw are, however, still missing.

- The approach can only be enforced in relation to trust-based arrangements as the Regulator has no real jurisdiction over providers of group personal pensions and stakeholder pension arrangements.
- Similarly, the Regulator can exercise control over trustees but not sponsoring employers; nor can it influence the behaviour of members to assume responsibility for their own affairs, although the Regulator says “it is important that members keep under review the suitability of the funds that they have chosen”.

On one level therefore, the publication by the Regulator of the above papers is a culmination of previous work, together with some refinements to the DC quality features which were published last year. However, the volume of paper which has been produced by the Regulator to support its approach demonstrates its keenness to regulate a trust based DC market which it has always claimed is too fragmented and, in particular, has too many pension plans in total and too many small pension plans in particular. (At the last count, there were some 46,000 occupational DC pension plans of which over 43,000 had fewer than 12 members1.) The sub-text of the consultation exercise is therefore about the Regulator’s agenda to rationalise the size of the occupational DC market.

NB. The outcomes and principles are not aligned but to be read as a whole.

1 Figures taken from the Regulator’s discussion paper: “Enabling good member outcomes in work-based pension provision”, January 2011.
The DC market - a level playing field for governance?

Of course, the DC landscape is made up of both contract and trust-based pension plans and the majority of members (3m out of 5.5m in 2011) are in contract-based arrangements such as group personal pensions where the Regulator has very little control. This is because the product providers, who are almost exclusively insurance companies, are regulated in their conduct of business by the Financial Services Authority. This regulatory landscape means that while the Regulator has, understandably, expressed the hope that the six DC principles will also be embraced by contract-based pension plans it has no power to enforce them. The Regulator states that it has undertaken some work with the FSA to ensure that there is a parallel regulatory framework. That work has not yet been published - we are promised further details later in the year - so it remains to be seen just how this regulatory circle will be squared. We are frankly sceptical that any meaningful parallels can be drawn where there are no fiduciary obligations on insurers, but a completely separate prudential régime.

The wider regulatory context

It should be stressed that the Regulator has no new statutory powers which would support the publication of the new Code of Practice and other documents. It is relying on the power given to it under Section 90 of the Pensions Act 2004 which allows it to publish codes of practice which contain practical guidance in relation to the exercise of functions under pensions legislation and to promote the standards of conduct and practice expected of those who exercise such functions. Presumably, the Regulator felt that the existing library of codes of practice was inadequate as far as the special requirements of DC occupational pension plans were concerned. The draft Code therefore complements all of the other existing codes of practice that are relevant to DC plans (which equate to several hundred pages of regulatory materials).

The draft Code also repeats chunks of existing regulatory guidance material. Codes of practice carry more weight than guidance material as they have an evidential value if trustees are challenged in the courts or other forums. So compliance is not really voluntary and there is some regulatory creep here. Where trustees cannot demonstrate compliance with the 31 quality features underpinning the draft Code, they are expected to explain why not to their members, via, the Regulator’s annual report.

Who is affected by the new Code?

The regulatory material is aimed more widely than at pure DC arrangements. The Regulator expects compliance from all trustees who offer any money purchase benefits, including additional voluntary contribution arrangements. So all DB and hybrid DB/DC pension plans are affected by it, unless they have no money purchase facilities.

What is new?

The Regulator has only made minor drafting improvements to the 31 quality features which underpin the draft Code and other documents since they were published in June 2012. The changes are set out in a table in the Regulatory Approach document.

The Regulator states that it is not seeking to impose additional burdens on well-run pension plans that comply with their legal obligations. As a consequence its cost impact assessment estimates, perhaps optimistically, that the range of additional costs on a “comply or explain” basis is only between £2,300 and £8,400 in the first year for plans that are not established on a master trust basis. This does not include the costs associated with implementing new measures where a pension plan’s governance standards fall short of the new expectations. According to the Regulator’s research large (1000+ member) plans are likely to comply with more of the quality features than small/medium sized plans. Therefore, the headline figures are not representative of the true cost in many cases. For very large master trusts, the set up costs for the required assurance framework is “anticipated to be less than £1 per member”. This includes external audit costs for the proposed independent accreditation the Regulator believes master trusts should have.

Employer issues

The Regulator comments in several places on the trustees’ relationship with the employer and makes some radical and surprising suggestions. Trustees are warned that they should be discussing corporate activity affecting the pension plan, by which it means benefit changes arising from automatic enrolment or changes in membership numbers from corporate acquisitions or divestments.

Similarly radical is the suggestion in the guidance document that “trustees should act as demanding consumers on behalf of their members, challenging their service providers to provide better services or reduce costs where they are not delivering value for money”. This is fair comment, but one might not expect the Regulator’s suggestion that this may lead trustees to conclude that the single employer trust model is not justifiable when compared with the better economies of scale offered by master trusts and work-based personal pensions.

Some would see the above suggestions as usurping the responsibilities of the employer for benefit design. The sub-text here is presumably that disengaged employers can only be brought to book (in regulatory terms) via trustees, given that the Regulator’s only real reach over employers is to ensure that automatic enrolment duties are complied with and contributions are paid on time.

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Overview of requirement | Comment
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An increase in pension plan knowledge requirements. This includes checking employment contracts, booklets and communications to ensure that benefits are consistent with the trust deed and rules. Pension plans with complex histories may find it useful to create a history document so that detailed knowledge is not lost on a change of trustees. | This is good practice but is unlikely to have been routinely observed by all trustees. Legal advice would be needed.

Numerous standing agenda items for each trustee meeting. The comprehensive list includes a legal update and discussion on costs and charges (as well as investment and administration performance and governance matters). | The list will focus the attention of trustees but is likely to lead to much longer meetings.

Trustees of hybrid pension plans (or DB pension plans with money purchase AVCs) should have a separate meeting for the DC element. Spending time on DB to the detriment of DC is not acceptable. | This will increase the focus on the DC elements of hybrid and DB pension plans, but in some cases a whole meeting (with the standing agenda items mentioned above) may be disproportionate.

An increased focus on trustee training. It is suggested that trustees could set aside an hour at the start or end of each trustee meeting for relevant training. | A good idea in principle but this may be excessive depending on the experience of the trustees and other forms of training undertaken.

Newly appointed professional trustees should have a “Pensions Management Institute Qualification or equivalent”. | No specific PMI qualification is specified in the draft Code.

The Regulator expects all DC occupational pension plans to have a suitable default investment fund. | This is an extension of the existing requirement which strictly applies only to those pension plans which are being used for automatic enrolment.

Trustees are expected to devote significant time and resource to setting the investment strategy and assessing performance, with due regard to the membership profile. | Most trustees will need to devote additional attention to this area: for instance, how many boards really consider the membership profile in detail?

Trustees should consider how their chosen funds contain protection of the underlying assets. They are also encouraged to tell members about compensation and document why any unregulated (ie without such compensation) funds are offered. | The assessment of asset protection will require expert legal assistance and analysis.

Trustees are expected to have guidelines for the selection and removal of investment managers, advisers and providers. The trustees should seek to include a clause in the appointment which allows the renegotiation of the terms of appointment on a regular basis, or following regulatory intervention. | Trustees would need to consider the extent to which they currently understand their contractual obligations. Legal advice will be needed on new or renegotiated contracts but the only alternative with pooled products may be termination, not renegotiation.

Trustees should have adequate knowledge of the third party providers where administration and other services are outsourced. Contracts should be clear and binding. Trustees are also expected to have knowledge of the third party’s ownership structure, business model, strategy and insolvency risk. | The level of knowledge expected of trustees (for example, the need to understand “the likelihood of key personnel leaving” the third party) is not currently the norm for many plans and some might suggest that it is unnecessary (eg. for an index tracker fund). However, this significantly increases the due diligence requirements on trustees.

Trustees need to reconsider the timing and content of their member communications in line with the draft guidance. The Regulator gives particular focus to investments, contribution adequacy, costs and charges, and to the retirement process (which should be a programme of communication starting at least two years before retirement). Trustees should also have communication objectives in place and monitor the success of their communications. | This will require a communication strategy review and the setting of objectives where none are in place at present. We can help trustees to draft appropriate communications.
Overview of requirement | Comment
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Trustees should "ensure that all members receive value for money". This involves ongoing assessments and periodic strategic reviews of benefits and services against costs and charges deducted from member contributions or from member accounts. | An in-depth level of review is required. This is likely to be one of the more difficult issues for trustees to address.

Trustees should ensure that all costs and charges borne by members are disclosed to members. Trustees should disclose information about member charges to the employer in certain circumstances to enable strategic decisions to be made. | In many pension plans, it will be difficult to present information on costs and charges in a format that is digestible to members.

Trustees should ensure that the pension plan is designed to offer flexibility in terms of member contributions and should consider engaging with the employer to encourage additional member contributions. | This involves the trustees straying into areas of pension plan design that are normally the remit of employers. Many trustees will feel uncomfortable about this and about the risk of giving financial advice.

Trustees should review member retirement processes and where the trust deed and rules prevent them from offering the most appropriate process they should consider making amendments to the pension plan’s governing documents. | Again, this involves straying into areas of pension plan design that are normally the remit of employers, not trustees. One solution may be to simplify the detail of what the trust deed requires and have flexibility outside the deed and rules.

Next steps

Trustees of all occupational pension plans with a DC element should undertake a governance review when the Code and guidance are issued in their final form. DB trustees should also ask themselves how compliant they are in relation to AVCs. For many trustees the work associated with assessing their pension plan against the quality features will be substantial. We would suggest that trustees start by arranging a training session/workshop so that the expectations of the Code and guidance can be mapped against current practice and a pragmatic timetable of action can be agreed. A lot of the areas under scrutiny concern fundamental legal issues, such as the governing trust documentation’s fitness for purpose, contractual arrangements with fund providers and assessing the legal protection available on a provider’s insolvency. Squire Sanders is experienced in advising on all of these areas.

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