Good practice, good outcomes

Philip Stear, Travers Smith, considers the possible consequences of the new Charges and Governance Regulations for DC schemes and trustees

The trustees of most schemes that offer any defined contribution (DC) benefits will by now be very aware of the Charges and Governance Regulations. These came into force from April 2015, following two rounds of government consultation during 2014. They are designed to tie in with parallel Financial Conduct Authority (FCA) requirements and to meet the government's overall objective to make sure that members are not overcharged by schemes into which they are automatically enrolled. There are additional statutory governance requirements for all workplace schemes.

The regulations come in two halves. The charges provisions have received plenty of attention. Most DC schemes which are "qualifying schemes" for auto-enrolment purposes will be aware of the charges cap and will have taken any necessary action. The governance provisions have been less well publicised, but these too are potentially far reaching in their consequences for DC schemes (or schemes with DC sections).

To make practical sense of new legislation, it is often helpful to assess the purpose of the complete package of new requirements, rather than to look at them one by one for boxes to be ticked. The purpose of the governance provisions seems to be to try to ensure that the behaviour of trustees in the management of DC benefits produces optimal outcomes for members. In many cases, they may therefore do little more than reinforce what is already good practice for trustees and arguably already required by trustees' fiduciary duties to members. The governance requirements do not only apply to schemes used for auto-enrolment: they apply to any occupational schemes with DC benefits, unless the only DC benefits relate to additional voluntary contributions (AVCs). But it seems that the advent of auto-enrolment has caused the policymakers to focus on DC provision generally and to worry that schemes – perhaps particularly DB schemes that have added DC sections during the long retreat from DB – are treating DC as a bit of an afterthought.

Purposes

So what are the purposes of the regulations?

The first set of requirements reinforces the investment duties of trustees in relation specifically to default arrangements. Trustees must invest in the best interests of members and other beneficiaries (which was already a requirement for schemes with 100 members or more). They must also adopt a specific SIP (statement of investment principles) for the default arrangement and then review it from time to time.

A second set of requirements is designed to assist good outcomes in relation to the administration of schemes. Core financial transactions (which include investment instructions, transfers and benefit payments) must be processed promptly and accurately. Charges and transaction costs must be assessed at least annually to decide whether they offer good value for members. This applies to all of the scheme's DC investments (not just to default arrangements).

A third set of requirements will affect fewer schemes, but is designed to ensure that it is scheme trustees who have the responsibility for selecting service providers (such as fund managers, administrators and insurers). Where scheme rules restrict this choice – so that in practice they can only be changed by amendment or otherwise by agreement with the employer – these limitations are overridden.

In a nutshell

- regulations came into force from April 2015
- the governance provisions could have far reaching consequences for DC schemes and schemes with DC sections
- further government consultation may happen in the autumn if the regulations are proving to be problematic.

A fourth set of requirements strengthens accountability: ensuring not only that good practice is done, but that it is seen to be done. The chair – and, if the trustee board does not have a chair, it must appoint one – is required to give an annual governance statement, which gives an account of the matters set out above, together with a description of any review that has been carried out of the default investment strategy and the performance of the default arrangement.

Master trusts

There is a fifth set of requirements, which will change the shape of some trustee boards and is potentially the most far reaching of the new governance

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requirements, although there are signs that its detail has not yet reached final form. Its purpose seems to be to require master trusts – which, although they are occupational pension schemes, are most often established by providers with a commercial objective – to have a majority of trustees (including the chair) who are not affiliated with the provider.

In addition to this, the trustees of master trusts must encourage members to make their views about the scheme known. The chair must report on this, as well as on the appointment of non-affiliated trustees, in the annual governance statement.

During the consultation process, the Department for Work & Pensions (DWP) announced that these master trust requirements would also apply to industry wide schemes. Because of the drafting of the regulations, it looks as if these requirements may also apply to any occupational pension scheme offering DC (unless just AVCs) which has employers that are not in the main sponsoring group. This would include, for example, cases where a joint venture company has been admitted to participation in a scheme to allow the continuity of pension provision for transferred employees. It would also include a company that has been allowed to participate after a sale.

It may even be that the regulations, as they have been made, would catch schemes where a previous employer is no longer associated with the sponsoring group, and that would apply to many large occupational pension schemes where there has been merger and acquisition activity in the past.

A trustee will only be non-affiliated if he or she is independent of service providers. This may be a problem if the employer group provides services to the trustees (for example, administration or, less commonly, investment management services). Non-affiliated trustees must be appointed in an open and transparent way; examples given include advertising the vacancy, using a recruiter or following statutory member nomination procedures. There are restrictions on how long a non-affiliated trustee may hold office without either being reappointed or having a five year break.

Consultation

There are arguments that these requirements do not apply, or apply innocuously, to schemes that are neither commercial master trusts nor industry wide schemes. Trustees will need to take their own advice. The obvious solution, though, is for the DWP to rein back the regulations so that they are limited to their original purpose – that of requiring the independent management of master trusts (and perhaps also industry wide schemes, although these are not normally run with a commercial objective). Otherwise, they have the potential to cut across established and effective trusteeship arrangements.

The Pensions Regulator has the power to issue penalties for non-compliance with the regulations. The Regulator has recently announced that the DC Code is to be revised and reissued next year. However, the Regulator can only work within the confines of the law which, at present, are not entirely clear.

These requirements apply from 5 July 2015, except that the additional report in the annual governance statement about the scheme's non-affiliated trustee appointments and member representation arrangements is not required until some time in 2016, depending on the scheme's year end.

Stear far reaching consequences

The DWP has indicated that it may consult on changes to the regulations in the autumn, if it is persuaded that the requirements would cause difficulties in practice.

Schemes which might be affected may wish to make representations. The National Association of Pension Funds is also engaging with the DWP on this topic and you may wish to contact Penny Pilzer to register your concerns: penny.pilzer@napf.co.uk

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