Sackers

Alert: Response to consultation on improving outcomes for members of DC schemes and new call for evidence

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Introduction

On 21 June 2021, the DWP issued its response to two consultations, together with a new call for evidence on "the future of the DC pension market: the case for greater consolidation" in the UK. The response addresses both its September 2020 consultation on proposals to drive consolidation of the DC market and its March 2021 consultation on incorporating performance fees within the charge cap.

Key points

- Subject to certain exceptions, trustees of DC / hybrid schemes with less than £100 million in total assets ("Smaller Scheme(s)") will be required to undertake a "more holistic" annual value for members' ("VfM") assessment, and to report on it in their chair's statement and scheme return.
- To give schemes extra time to access the necessary net return and costs and charges data, the first new VfM assessment will apply to schemes in their first scheme year ending after 31 December 2021.
- Trustees of all "relevant schemes" regardless of size, will be required to state in the chair's statement the net investment returns for their default(s) and self-selected funds.
- The charge cap regulations will be amended to allow schemes to smooth performance fees over five years.
- The call for evidence seeks views on how to accelerate the pace of consolidation for schemes under £100 million, but also looks ahead to the "second phase of consolidation for medium to large schemes" (ie schemes with assets between £100 million and £5 billion).

Background

Since the introduction of AE in 2012, there has been significant growth in the number of DC schemes. Whilst that number is now falling by between 8-10% each year, the Government's priority is to accelerate the consolidation of the DC market into fewer larger schemes. TPR is also a keen exponent of DC consolidation.

On 11 September 2020, the DWP published "Improving outcomes for members of defined contribution pension schemes", setting out a response to its February 2019 consultation, "Investment Innovation and Future Consolidation". It also included a further consultation on changes to regulations and statutory guidance intended to improve DC pension scheme governance, facilitate the diversification of investment portfolios, and to signal the Government's commitment to transparent disclosure to scheme members.

On 19 March 2021, the DWP issued a consultation on proposed measures to allow occupational DC schemes to smooth performance fees within the charge cap, and a call for evidence on "look-through" in relation to charge cap compliance.

Quite separately, an industry working group has been tasked with addressing the rise in deferred small pots in AE schemes.

Encouraging consolidation – new VfM assessment

The annual assessment

Smaller Schemes, except those in operation for less than three years at the assessment date, will be required to complete a "more holistic" annual VfM assessment and to report on it in their chair's statement. Only the DC element of a hybrid scheme will be subject to the assessment.

The proposed factors to be assessed by reference to new statutory guidance are:

- costs and charges — to be assessed relatively, based on comparison with at least three other "large" schemes (ie with assets of £100 million or more) at least one of which must "have had discussions" with the smaller scheme over a potential transfer. This is a change from the original proposal which required there to be "reasonable grounds" to believe that at least one of the larger schemes would accept a transfer in of the smaller schemes' members.

- investment returns

- governance and administration — which includes promptness and accuracy of core financial transactions, quality of record keeping, appropriateness of default investment strategy, quality of investment governance, level of trustee knowledge, understanding and skills to operate the scheme effectively, quality of communication with scheme members and effectiveness of management of conflicts of interest.

Possible exceptions

If the trustees conclude that the scheme is not delivering good overall value, the Government expects the scheme to be wound up and consolidated. However, if the trustees are "realistically confident" that required improvements can be made, and/or:

- it may be more expensive to wind up

- valuable guarantees would be lost on consolidation

the scheme may seek to improve first. Trustees will be required to report to TPR, in their next scheme return, the outcome of the assessment and the action they intend to take / are taking (if any).

Following consultation, the DWP has amended the regulations so that a Smaller Scheme that would ordinarily have been in scope will be exempt if it has informed TPR at any time before the next chair's statement is due that it is in the process of winding up.

The current VfM assessment (ie the extent to which member-borne costs and charges represent good value for members) will continue to apply to those outside of the scope of these changes, although they may choose to have regard to the new assessment.

What next?

The Government intends to review the £100 million threshold at regular intervals to see if the new assessment is achieving the required effect of ensuring members are in schemes that offer tangible value.

Call for evidence on consolidation

Perceived benefits of consolidation

The Government believes that greater consolidation will improve member outcomes primarily through:

- Governance – larger schemes are less likely to fail key governance criteria
- Charges – member charges are typically lower in larger schemes as a result of economies of scale. The Government cites the example of consolidation in Australia leading to lower charges. But the average charge in the UK is significantly lower than other countries, suggesting that there may be less scope for UK DC schemes to reduce charges by consolidation.
- Investments – larger schemes are generally more likely to perform better and have the governance, resource and/or capacity to invest in a more diverse portfolio. Their size also enables them to negotiate more easily on fees when investing in private markets, an area that may offer higher returns but is often inaccessible without paying a premium
- Potential savings for employers – compared to the amount spent on in-house schemes and whether these savings might feed through to members as higher employer contributions.

What next?

The call for evidence is intended to begin "the next conversation on what best value looks like for the millions of pension savers in medium and large schemes that are not in scope of the new [VfM] assessment". It also asks:

- to what extent pension schemes can provide additional benefit for their members, and play a role in economic growth through investment in new businesses, infrastructure and the commitments to net zero emissions
- whether a lack of scale currently limits schemes' ability to play this role.

This evidence will "help the Government understand the opportunities for schemes and whether there are barriers to greater consolidation".

Performance fees

Changes to the default fund charge cap to allow schemes to smooth performance fees over five years will come into force on 1 October 2021.

The performance fee consultation also included a call for evidence on "look-through" costs. The current position is that trustees of occupational DC pension schemes should 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 manager as it invests in other funds, known as the underlying investments.

Overall, the evidence shows that, as a minimum, the current requirement needs to be clarified and may need to change to remove the requirement to look-through. The Government intends to work through options with industry and other partners over the coming months and aims to announce its revised position before the Houses of Parliament rise for summer recess.

Other changes to legislation

Additional changes proposed in the September 2020 consultation are also going ahead:

- The statutory guidance on reporting costs and charges has been revised to, among other matters, clarify expectations for illustrations and to remove the need for trustees to publish signed versions of scheme documents

- Schemes with a third party "promise" as to the level of benefits are currently carved out from the definition of a default arrangement and, as such, also exempted from the default fund charge cap and the production of a default SIP. Regulations will require such schemes to produce a default SIP within 3 months of the end of the first scheme year to end after 1 October 2021, or 1 April 2022, whichever is later.

- Since 6 April 2018, in their chair's statement, schemes must set out the level of charges and transaction costs for all their default arrangements and self-select funds. The DWP is amending the regulations to make clear that cost and charges disclosures cover funds that members would have been able to select in the past in any year.

- Wholly-insured schemes are exempt from the requirement to produce most sections of the SIP as, typically, a combination of their rules and the terms of their insurance policies mean the trustees have no discretion as to how the scheme's funds are invested. This exemption was not extended to cover recent additions to the contents of the SIP or implementation statements, and the DWP intends to remedy this.

Next steps

The regulations introducing the new VfM assessment and amending the charge cap requirements will come into force from October 2021.

The call for evidence closes on 30 July 2021.

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