Dalriada Trustees – Industry Changes

Your Quarterly Pensions Update

Q2 2018

Dalriada. A better way

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Introduction

The purpose of this report is to provide an update for pension scheme sponsors and trustees on recent industry changes in the quarter

For your convenience, we have summarised the key developments and highlighted the necessary actions sponsors and trustees may need to take.

We also include links to further relevant information and any deadlines you should be aware of.

We trust you will find the update useful and informative. If you require further information about how any of the topics covered might impact on your scheme specifically, please get in touch with Adrian Kennett, adrian_kennett@dalriadatrustees.co.uk or your usual Dalriada contact.

NOTE

This document is aimed at providing you with generic information about recent developments in the pensions industry.

You should not take any action as a result of information included in this document without seeking specific advice in relation to the impact these matters might have on your scheme or company. Dalriada Trustees Limited accepts no liability for actions taken or not taken as a result of this document.

Collective DC – A Bright New Future?

There appears to be a surprisingly high number of idealists working in pensions these days. The seemingly irresistible move to Defined Contribution (DC) schemes faces a new challenge from Collective DC (CDC) arrangements – a clever wheeze whereby people get better outcomes using the radical tactic of co-operating with each other.

There is no doubt from a technical perspective that pooling risk and smoothing benefits in a CDC scheme could substantially enhance retirement income for participants. With lower contribution rates now the norm, a boost of 15-30% (depending on which modelling you believe) would be extremely welcome. CDC would be particularly attractive as an alternative to drawdown or annuities in retirement, with the possibility of trading a guaranteed level of income for the likelihood of a higher pension, without having to run excessive personal risk throughout later life. The idealists are singing the praises of this middle way of pension provision and so they should.

Not everyone is completely convinced though. There are many objections put forward, but the true believers are not to be deterred and match each argument with a passionate defence, which is often utterly compelling. We feel that some of the challenges are genuinely difficult, such as the risk of future regulatory intervention like we saw in Defined Benefit (DB) schemes. Most worthwhile goals take a bit of effort to achieve though. So perhaps we should fight for the best pension system possible, rather than settling for the easy, “follow the crowd” option.

We could therefore get quite excited about the agreement by Royal Mail and the Communications Workers Union to lobby for a CDC framework, except that we just don’t think it will ever happen. There is no realistic prospect of any Parliamentary time being available over the next few years and we simply can’t see the Government making CDC a top legislative priority with everything else going on.

It’s worth putting the numbers into context. There were almost 3,500 open DB schemes in the private sector in 2006, but that had dropped to 700 last year. There are still 1.3m active members of DB schemes, but that is a third of the figure from a decade ago. That’s a huge number of schemes and members that have already moved to DC arrangements and there is no evidence of employers lining up to reverse those decisions and find a new middle ground.

We are absolutely convinced that the time for CDC has come. Sadly we suspect it’s come and gone again already.

Collective DC Continued…

ACTION

There are no actions required from employers or trustees, as the legislation to permit CDC schemes does not yet exist. However, interested parties should keep an eye on developments in this area, and might like to join in with the lobbying efforts.

Dealing with the evolving threat of 'Cyber Risk'

"Cyber risk" for a pension scheme can be broadly defined as the risk of loss, disruption or damage to a scheme or its members as a result of the failure of its information technology systems and processes. It includes risks to information (data security) as well as assets; both internally (e.g. from staff) and externally (e.g. hacking).

Pension schemes hold large amounts of sensitive personal data and assets, meaning they are a prime target for fraudsters and criminals. As such, this is a risk which all trustees should be very aware of and have appropriate protections and controls in place.

Cyber risk can be assessed in the three steps outlined below:

1. Assess and understand the risk
2. Put controls in place
3. Monitor and report

Trustees are accountable for the security of scheme information and assets, even where they delegate or outsource day-to-day functions of the scheme. Regular training should be received, and trustees should have access to the required skills and expertise to understand and manage the cyber risk.

In addition to this, IT infrastructure and security should be sufficient for the work undertaken. There should be multiple layers of security around systems and pensions software. If there is a suspicion that any systems or software are behaving suspiciously, this should be reported.

Finally, it is important to understand that cyber risk is complex, evolving and requires a dynamic response, to include:

a. controls, processes and response plans should be regularly tested and reviewed

b. Trustees should be regularly updated on cyber risks, incidents and controls

c. Trustees and other parties should seek appropriate information and guidance on cyber security threats.

Dealing with the evolving threat of 'Cyber Risk' Continued…

Helpful Links:

Guidance: www.ncsc.gov.uk/guidance

Threat advice: www.ncsc.gov.uk/threats

Cyber essentials: www.cyberessentials.ncsc.gov.uk

10 steps to cyber security: www.ncsc.gov.uk/guidance/10-steps-cyber-security

ACTION

Be aware that pension schemes are a very lucrative target for fraudsters – be diligent and stay alert to any suspicious activity.

Ensure appropriate training is put in place and that all trustees have access to the required skills and expertise.

Ensure appropriate controls and processes are in place, monitored and reviewed.

Auto Enrolment Update

The vast majority of businesses have now successfully completed the auto enrolment (AE) process. You may be forgiven for thinking that now the project is complete, you can now let pensions take care of themselves and move onto other matters. Unfortunately, nothing is that simple and the attention now turns to contribution phasing, compliance and re-enrolment.

Contribution Phasing

The initial minimum contributions for AE were set at 1% (employee) and 1% (employer) based on Qualifying Earnings. Whilst many employers will have auto enrolled at higher contribution levels, those who proceeded on a minimum compliance basis must raise contributions in line with the statutory increases.

The first step up took place from 6th April 2018, with contributions increasing to 3% employee and 2% employer. If you have not increased contributions to or beyond these levels from 6th April 2018, you will be at risk of further action from The Pensions Regulator (TPR). The next (and as-yet final) step up will take place on the 6th April 2019, with contributions then increasing to 5% employee and 3% employer.

If you operate a qualifying scheme, you may have chosen to ensure compliance on a different basis using a different definition of earnings. There are three allowable approaches here, and you should check the appropriate percentages for the selected basis to ensure you remain compliant (see below for a link to TPR’s website for further information).

Compliance

The most recent compliance and enforcement bulletin issued by TPR covered the period 1st January 2018 to 31st March 2018.

This was the busiest period on record with over 20,000 compliance notices issued, over 11,000 Fixed Penalty Notices (for £400) and over 2,500 Escalating Penalty Notices. This quarter represents over 20% of the total AE interventions brought by TPR.

The update includes an interesting case study regarding a personal fine applied against a Director who provided false information. The full statement, including the case study, is linked below.

Auto Enrolment Update Continued…

Re-Enrolment

The majority of larger employers have already been required to go through a re-enrolment process. Every three years, all employers will have to reaffirm AE compliance, including carrying out an appropriate process to re-enrol those who initially opted out (subject to permitted exemptions). This will be an ongoing process affecting all businesses, and should be appropriately managed to ensure regulatory compliance.

Helpful Links:

http://www.thepensionsregulator.gov.uk/en/employers/phasing-increase-of-automatic-enrolment-contribution

http://www.thepensionsregulator.gov.uk/docs/compliance-and-enforcement-quarterly-bulletin-january-to-march-2018.pdf

ACTION

Employers should check they are complying with their auto-enrolment duties including ensuring their contributions are compliant with the minimum levels and the re-enrolment process is being followed correctly.

Pensions Legislative Changes

Several amendments to pension legislation are effective from April 2018 and this will mean notable changes for occupational pension schemes.

Lifetime Allowance

The lifetime allowance has increased from £1 million to £1,030,000. This reflects the rise in the Consumer Price Index (CPI) for the 12 months to the end of September 2017. Trustees should ensure that this new allowance is implemented into their scheme's administration processes.

Note that for 2018/19 the annual allowance limit will remain constant at £40,000, except for individuals with income of £150,000 or more where the allowance continues to taper down to £10,000, subject to certain conditions.

Auto-enrolment: Minimum Contributions

The second transitional period for minimum contributions begins on 6 April 2018 and runs to 5 April 2019 and in this period, mandatory employer contributions rise from 1% to 2% with the total contribution (including tax relief) increasing from 2% to 5%. The qualifying earnings band has also increased on both the lower and upper end to £6,032 and £46,350 respectively.

PPF Compensation Cap

The PPF compensation cap at age 65 has risen from £38,505.61 to £39,006.18 for 2018/19.

Scottish Income Tax Rates

In previous Updates we discussed the implications of revised rates of income tax in Scotland. The new rates were introduced on 6 April 2018, to include an initial rate of 19% on income between £11,850 and £13,850, with an additional rate of 46% for those with income over £150,000. Current rules for pension schemes operating tax relief at source will continue to apply for members resident in Scotland who pay the starter rate of 19%. Those members paying the higher rates (i.e. 21%, 41% and 46%) will need to claim additional relief over the current 20% rate.

ACTION

Trustees should consider whether any of their scheme's literature (e.g. Member booklets, retirement information packs, online guides) should be updated to reflect these changes, as well as their administration processes.

Environmental, social and governance issues for pension schemes

There has recently been greater interest in the extent to which pension scheme trustees consider environmental, social and governance ('ESG') issues when making investment decisions.

Following an interim response to the Law Commission's 2017 report on pension funds and social investment, the Department for Work and Pensions (DWP) is proposing changes to regulations and that trustees update their Statement of Investment Principles to include:

- how they take account of financially material considerations, including (but not limited to) those arising from ESG considerations;
- policies in relation to the stewardship of the investments, including engagement with investee firms and the exercise of associated voting rights; and
- a separate statement on how they will take account of members' views (including, but not limited to, views on ethical, social impact, and present and future quality of life matters).

Financially material considerations

The DWP want this to encourage trustees to consider ESG issues as part of the investment process and not just to focus on maximising investment returns. We believe in the sentiment in getting trustees to think about all the risks that they are exposed to, but this may be a difficult area for trustees to assess, as it may not be entirely obvious which factors are financially material. Some guidance from the Government in this area would be useful.

More active stewardship

This could be done directly by the trustees or via the investment manager. Our view is that this will be easier for larger schemes to achieve due to size of their investments and also because they use more segregated mandates. Smaller schemes typically invest in pooled funds and so are typically dependent on the policies adopted by the investment managers.

Member views

The statement on member views applies to trust based schemes with 100 members or more and all contract based arrangements. It is noted that trustees are still responsible for making the investment decisions and are under no obligation to act in accordance with the views of the membership.

Environmental, social and governance issues for pension schemes Continued…

Trustees or governance committees may need to engage with members and keep an ongoing dialogue. However, our experience suggests this could prove to be challenging for many schemes as they have found it difficult to engage members. In some areas the Government has indicated that trustees may be able to make broad assumptions based on their knowledge of their members. However, we feel the government may need to be more prescriptive on how trustees can do this.

Summary

These proposed changes were subject to consultation (this closed on 16 July 2018) and the intention is that any new legislation would be effective from October 2019.

We see this change in legislation as a positive step in widening the scope of areas the trustees should consider in the investment process and in increasing member engagement. However, this needs to be balanced with how much additional governance the trustees are required to take on and the costs of implementing this.

ACTION

Whilst there is no immediate call to action, trustees could make a start to considering these issues as part of their investment process.

Changes to Guidance on Pension Disputes

As will be set out in any pension scheme's Internal Dispute Resolution Procedure (IDRP), members have a variety of routes they can take in the unfortunate event of a complaint. As well as following the process laid out in their particular IDRP, members could (until recently) have approached either or both of The Pensions Advisory Service (TPAS) and The Pensions Ombudsman (TPO) for external assistance.

TPAS's role was to provide support and guidance typically before and during an IDRP process, although they could not unilaterally change the outcome. In contrast, TPO typically dealt with complaints that have been through an IDRP and can direct changes to be made to the scheme and/or compensation paid to aggrieved parties.

Earlier this year, TPAS's dispute resolution function merged with the office of TPO, which should make it simpler for members to resolve their complaints. This move has been generally welcomed across the industry as it clarifies the various roles and should lead to a smoother and quicker process all round. The merger, which became effective on 1 April 2018, has involved the transfer of the staff in the TPAS dispute resolution team and a network of over 350 volunteer advisers.

In future, TPAS will focus on a pure information and guidance role, and will in due course become part of the new Single Financial Guidance Body, which is due to be up and running in the winter, combining TPAS with Pension Wise and the Money Advice Service.

Helpful Links:

https://www.pensionsadvisoryservice.org.uk/news/tpas-dispute-function-moves-to-the-pensions-ombudsman

ACTION

Trustees should be aware of the TPAS/ TPO merger when communicating with their membership. They should review and refresh the content of Scheme documentation such as the Internal Dispute Resolution Procedure and Scheme booklets which are likely to make reference to TPAS and TPO.

Cold Call Ban – So close but …

Back in May we published a blog (link below) which applauded the Government for listening to industry pleas to do something to protect consumers from pensions scammers by introducing a cold call ban. The legislative framework for this was set out in the Financial Guidance and Claims Act 2018 with detail to be set out in regulations. It was intended that these regulations would be published quickly. The legislation even set out, in section 21 (6), that:

"If before the end of June in any year the Secretary of State has not made regulations under this section (whether or not in that year), the Secretary of State must—

- publish a statement, by the end of July in that year, explaining why regulations have not been made and setting a timetable for making the regulations, and
- lay the statement before each House of Parliament"

Not a normal clause to insert and it certainly pointed to Parliament recognising the importance of the issue.

Then we got the following statement from HM Treasury which was widely reported in the trade press:

"We're committed to introducing a ban on pensions cold calling as quickly as possible. Following debates in Parliament, and having considered evidence from the industry, we will launch a short consultation on the draft legislation to ensure it is as effective and robust as possible. We intend to lay the required regulations before Parliament this autumn."

We are not entirely sure what evidence there is from the industry – it was all submitted to the previous consultations – but what we do know is the cold call ban will not be in place until at least the Autumn.

It is disappointing that the ban has been pushed back again. We must use the delay to ensure the regulations cover the many ways that cold callers and scammers contact and snare consumers, be it by phone, email, text or social media. If there is any form of unsolicited contact then it should be outlawed, and consumers educated that this sort of contact is likely to be from a scammer.

Helpful Links:

https://dalriadatrustees.co.uk/archives/cold-call-ban-at-long-long-last/

Disclosure of DC Costs and Charges

DWP has published the response to its consultation, 'Occupational pensions: improving disclosure of costs, charges and investments', together with the final Regulations, which became effective from 6 April 2018.

The new Regulations significantly extend the existing requirements on trustees of pension schemes providing DC benefits to disclose information on the costs and charges borne by their members. The DWP's goal is to stimulate member engagement by cultivating transparency in the market, and ultimately drive better outcomes. The industry, however points to yet another governance nuisance and the additional costs associated with compliance.

The new requirements apply to all DC schemes where a Chair's Statement is required. Again, Defined Benefit (DB) schemes where the only DC benefits are Additional Voluntary Contributions are off the hook, for now.

Chair's Statement

The Chair's Statement for year ends on or after 6 April 2018 must now include detailed information on costs and charges for each default arrangement and each self-select fund option.

The aspect of the new requirements that has been attracting the most attention (the words 'ire' and 'concern' could also be used) is the need to provide an illustration of the cumulative effect (in pounds and pence) of charges and transaction costs on the value of a member's pension pot. In preparing this, trustees must pay attention to statutory guidance issued by the DWP. This is not prescriptive though and will need some interpretation based on the needs of their membership.

The guidance does provide, however, a sample table and references to the financial assumptions to be used. The DWP intends these illustrations to be reasonably in-depth and meaningful and will expect some membership analysis to support the modelling. A link to the guidance is below.

Disclosure of DC Costs and Charges Continued…

Publication Requirements

The above disclosures and most parts of the Chair's Statement will have to be made publicly available on a website within 7 months of the first scheme year end falling on or after 6 April 2018. The publication should be done in such a way that the content can be indexed by search engines (i.e. not requiring any login details). The link to the website will have to be provided with the Annual Benefit Statements.

There is also a new requirement to provide information regarding pooled funds upon request, but this does not come into effect until 6 April 2019.

Whilst we are absolutely in favour of greater transparency and member engagement, we are not entirely convinced the Regulations are the right way to achieve these worthy objectives. It is hard to ignore the impression of this representing yet another way to encourage DC consolidation, particularly when the DWP does not shy away from pointing this out in their response to the consultation: "schemes always have the option to consider alternative strategies to limit any additional burdens, for example, consider consolidation into larger schemes using the new simplified process for DC to DC bulk transfers".

Helpful Links:

http://www.legislation.gov.uk/uksi/2018/233/made

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/684664/government-response-to-disclosure-of-costs-charges-and-investments-in-dc-occupational-pensions-consultation.pdf

https://www.gov.uk/government/publications/cost-and-charge-reporting-guidance-for-trustees-and-managers-of-occupational-schemes

ACTION

Trustees, managers and employers should engage in discussions with their advisers to ensure compliance with the new Regulations.

PPF Compensation – Hampshire v Pension Protection Fund

The Advocate General (AG) has given her opinion on the Hampshire v The Board of the Pension Protection Fund (PPF) case, which challenges the level of compensation offered by the PPF and could ultimately have a profound impact on the UK pensions landscape.

Background

The case centred on Article 8 of the EU Insolvency Directive (2008) which provides that EU member states must "ensure that necessary measures are taken to protect the interests" of current and former employees – with specific reference to their accrued pension benefits – in the event of their employer becoming insolvent. In short, the PPF was designed to protect these interests and fulfil the UK's Article 8 obligations.

Court of Appeal

As to how the matter arrived on the AG's desk, Mr Hampshire brought his action to the Court of Appeal in July 2006. He claimed that as a result of his former company's pension scheme being transferred into the PPF, his pension would be cut by 67% and this amounted to a breach of both Article 8, as well as the ECJ case Robins v SoS for Work and Pensions (2007) which found that compensation could not be reduced by more than 50% of accrued rights.

The PPF argued that Article 8 only required member states to guarantee that all members in a pension scheme entering the PPF would get at least 50% of the value of their accrued pension benefits, on average – not individually.

The Court of Appeal were of the view that Mr Hampshire was in the right and that the PPF compensation cap had not "correctly or adequately transposed the provisions of Article 8" into UK law. However, the Court didn't feel on solid ground – stating the issue was not "entirely free from doubt" – and so referred the matter to the European Court of Justice (ECJ), for clarity on Article 8.

The ECJ and AG

The AG's opinion was very clear, stating that under Article 8 every employee should be entitled to at least 50% of the total value of their accrued rights or entitlements in the event of insolvency of their employer. The exclusion of individual employees from that minimum standard (via the compensation cap or otherwise) is incompatible with EU law.

PPF Compensation – Hampshire v Pension Protection Fund Continued…

The AG went further to clarify that, in her view, it would be unlawful for inflation linked increases (to which members were entitled) not be reflected in the compensation paid by the PPF if it led to the value of the compensation falling below 50% in any given year.

The Court of Appeal also asked the ECJ whether Article 8 was directly effective against the PPF, by individuals – in other words, could individual members rely upon Article 8 to bring a case against the PPF directly. Significantly, the AG confirmed that direct effect does apply to Article 8, given the PPF performs its role in the public interest, using "special powers".

Implications

The ECJ will now consider the AG's opinion and the case will then return to the UK's Court of Appeal. If the ECJ agrees with the AG – it is under no duty to do so, but rarely disagrees – there are potentially some significant ramifications for the PPF and schemes.

There could be an increase in the cost of providing PPF compensation, as the compensation cap would need to be revised to ensure they meet the minimum level of compensation required. This would more than likely cause an increase to the PPF levy. Although industry reports have suggested that only 500 of 250,000 members receiving PPF compensation are affected by the cap, if the 50% test is to be based on an overall accrued value that takes account of higher inflationary increases, the proportion of members affected could be much higher.

Crucially, while we wait for the final conclusion of this case, it will be difficult for trustees to buy out benefits at "PPF-plus" levels, as it is not clear what the standard PPF compensation may be. If trustees buy out below the level employees may eventually obtain from the PPF (once the final decision is available), there is a real risk of claims arising that they have not applied the scheme funds correctly or acted in the best interests of members.

Helpful Links:

Advocate General's Opinion - Grenville Hampshire v the Board of the PPF

Robins v Secretary of State for Work and Pensions [2007]

ACTION

No general action for trustees at the moment, with the ECJ decision not expected until the end of the year. However, for schemes considering buy-out proposals based on PPF compensation, real thought should be given to what their members could receive from the PPF in the future.

Coming Up Next...

No Quarterly Update would be complete without our "heads up" on some of the topics that we expect to hit the headlines in the next quarter. With the end of the third quarter falling not long before the deadline for the conclusion of Article 50 negotiations on 18 October – when a Brexit deal with Brussels will no doubt be the talk of the country – the chances of many developments coming from Whitehall in respect of pensions might be slim.

That said, we still think it's worth keeping an eye out for:

- The **DWP consultation on new powers for The Pensions Regulator** – following on from the White Paper published earlier in the year – closes for responses on 21 August 2018. From measures to improve transparency of corporate transactions, to the creation of a new criminal offence against directors who conduct "wilful or grossly reckless behaviour" in relation to a DB scheme, this consultation could have some tangible results for the future of DB schemes.
- The consultation on the draft **Occupational Pension Schemes (Master Trusts) Regulations 2018** closed earlier this year and the Regulations are targeted to come into force from 1 October 2018. Parliament still has to formally approve this date, but if passed, from that date master trusts will be subject to ongoing supervision from the Regulator, assuming they have been authorised to operate in the first instance by the Regulator of course. To be authorised, the Regulations estimate that a new scheme will have to pay about £24,000, while an existing master trust will pay £67,000.

Trustees and sponsoring employers alike should also be aware of the following key dates coming up:

- **17 August 2018** – Deadline for responses to HM Treasury consultation on draft regulations to introduce a pensions cold-calling ban.
- **24 August 2018** – Deadline for responses to CMA's consultation on investment consultancy market investigation.
- **6 September 2018** – Deadline for responses to FCA consultation on changes to its rules and guidance in the non-advised drawdown market.
- **1 October 2018** – Regulations come into force removing the actuarial certification for DC-to-DC bulk transfers.

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Dalriada. A better way

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