Statement by The Pensions Regulator

October 2011

The role of trustees in DC schemes

This statement is targeted at trustees of defined contribution (DC) schemes with more than 12 members, as well as qualifying schemes set up in anticipation of the new workplace pensions reform commencing from 2012.

The role of a pension scheme trustee is crucial to the delivery of good member outcomes, outlined in our discussion paper **'Enabling good member outcomes in work-based pension provision'** published earlier this year. Trustees in both defined benefit (DB) and DC schemes play a critical role in ensuring effective scheme governance. They must also be 'fit and proper' and ensure they have appropriate scheme knowledge and understanding of pension issues to undertake their role competently.

This statement reminds trustees of key differences between DB and DC schemes and emphasises that whilst governance functions may be similar, steps taken to manage these functions are not identical. This statement clarifies behaviours we expect DC scheme trustees to demonstrate. Trustees must recognise that they owe fiduciary duties to all scheme members, noting that this does extend to deferred members, and are accountable to The Pensions Regulator (the 'regulator') for compliance issues.

The regulator can take action in the event trustees fail to demonstrate behaviours outlined in this statement and standards in other regulatory material, for example our guidance on internal controls (see **Useful links** section on back cover). Where persistent non-compliance results in poor member outcomes we may decide to remove trustees and/or appoint an independent trustee with exclusive powers.

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The Pensions Regulator

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A changing landscape

There has been a substantial shift in the pension landscape, with a reduction in the number of DB schemes and an increase in DC provision. This trend is likely to continue as employers enrol their workforce into qualifying DC arrangements.

Historically, the core focus on trusteeship has been predominantly DB schemes. Regulation of DB schemes has had higher profile but more recently the regulator has intensified its approach to managing DC risks and regulation in response to the changing landscape. As we progress into 2012 and beyond, trustees of DC schemes, or schemes with DC sections, need to ensure that they have appropriate knowledge and understanding to govern their schemes properly.

Our scheme governance survey continues to highlight patterns of poor governance standards in DC schemes. Our analysis of our survey over the last 4 waves indicates that (in schemes with more than 12 members) 67% of all DB trustees are likely to be engaged with their scheme compared to 34% of all trustees of DC schemes. This lack of engagement is not merely confined to smaller schemes.

Engaged trustees are more likely to undertake governance activities encompassing administration, external expertise and training. **We expect to see improvements in this area and expect trustees to embrace the behaviours outlined in this statement.**

In the case of schemes which offer both DC and DB benefits (hybrid schemes), the DC section often tends to be the poor relation and is not always given sufficient time and attention by scheme trustees. We do not view this position as sustainable and intend to publish a statement specifically addressing the complexities and risks associated with schemes offering mixed benefits.

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What are the key differences?

Whilst governance functions in DB and DC schemes are similar, the steps taken to manage underlying risks will differ. A more detailed analysis is included in Appendix 1 on pages 6 to 8. There are some fundamental differences between DB and DC schemes, relating solely to the nature of the retirement provision:

- A DB pension is essentially a lifetime contract offered to members post-employment, funded by an employer. In a DC arrangement, the employer is essentially offering a long-term savings plan which accumulates during the period of employment, without further employer funding post-employment.
- In a DB scheme a member's pension is determined on known factors, for example usually on length of service and pensionable pay. In a DC scheme a member's final pension cannot be determined with any certainty as it will be based on prevailing market prices when the pension is taken.

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What are the key differences continued...

- In a DB scheme, key risks such as poorly performing investments, inflation and longevity are effectively underwritten by the scheme's sponsoring employer(s). In a DC scheme, the investment and inflation risk falls on the member and longevity risk is factored into annuity prices.
- Members of DB schemes have recourse to Pension Protection Fund (PPF) levels of compensation where the sponsoring employer is insolvent and the scheme is unable to provide a certain level of benefits. There are no similar arrangements for DC schemes.

Expectations of trustees of DC schemes

Trustees must understand how their scheme operates and should not underestimate the different steps required to manage underlying risks properly. As noted earlier, trustees owe fiduciary duties to all scheme members; trustees must not overlook the needs and interests of deferred members. We expect all trustees to demonstrate behaviours and practices which will help schemes deliver good member outcomes. This includes, but is not limited to:

Trustee knowledge and understanding (TKU)

- Trustees must have sufficient skills to manage the scheme effectively. They must formally assess the capabilities of the trustee board and manage DC specific knowledge gaps promptly (see **Useful links** section on back cover).

Conflicts of interest

- Conflicts of interest are likely to be inherent in certain DC products, for example multi-employer schemes with non-associated employers. Trustees must be able to demonstrate that they are able to act impartially without their decisions being tainted by actual or perceived conflicts.
- Trustees must ensure that non-trivial conflicts of interest are suitably managed and disclosed. They should produce a conflicts of interest policy to assist with the governance process (see Useful links section on back cover).

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'Trustees must understand how their scheme operates and should not underestimate the different steps required to manage underlying risks properly'.

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Expectations of trustees in DC schemes continued...

Costs and charges

- Overall charges levied to pension schemes often lack transparency. Trustees must understand how charging structures operate and determine what levels of charges are paid by members.
- Excessive costs and charges in a DC scheme can significantly reduce a member's fund. Charging structures must be applied fairly to all categories of membership. Trustees must be able to demonstrate that they have assessed and concluded that the overall charging structures offer members value for money. The regulator does not view active member-only discounts (or deferred member penalties) as being fair and, therefore, acceptable.

Investment

- In a DC scheme, there will generally be a range of investment funds for the member to choose from, including a default fund. Trustees must formally and regularly review the range and appropriateness of investment funds available.
- Whilst members may select their own investment strategy, a large proportion will choose a default fund. Trustees must assess the appropriateness of the default fund and ensure that it complies with default fund guidance issued by the Department for Work and Pensions (DWP) (see Useful links section on back cover).

Asset protection

- Trustees must invest prudently. Trustees must predominantly invest scheme assets so that they are managed by entities registered with the Financial Services Authority (FSA) or similar regulated authorities. Trustees must be able to demonstrate why it was appropriate to offer unregulated investment options, why the level offered is prudent and must clearly communicate this information to members.
- In the absence of a financial guarantee, trustees must establish what compensation arrangements are available in the event an investment provider defaults. Trustees must understand levels of protection available to members under the Financial Services Compensation Scheme (FSCS) and carefully consider situations where compensation is not available.

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'Trustees must understand the steps necessary to manage their scheme efficiently and effectively'.

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Expectations of trustees in DC schemes continued...

Administration

- Trustees must devote sufficient time to manage their scheme including meeting regularly to discuss governance issues, eg at least quarterly.
- Trustees must understand the steps necessary to manage their scheme efficiently and effectively. They must be able to demonstrate that they have assessed key risks to their scheme and document risks in a risk register.
- Accuracy and timeliness of scheme records is very important. Failure to reconcile information regularly can result in incorrect benefit statements and can be very costly to unwind errors. Trustees must continually assess the quality of administration and record-keeping and seek assurances that outsourced services are operating effectively eg from independent assurance reports (AAF01/06) – an AAF01/06 report can provide reasonable assurance over the description, design and operational effectiveness of certain internal controls of a service provider.

Contributions

- A member's pension fund at retirement will depend on the level of contributions paid to a scheme and investment performance. Trustees must ensure members are aware of the impact contribution patterns will have on the overall size of their pension fund.
- Trustees have a legal duty to ensure that contributions are accurate and paid over to the scheme on a timely basis. Trustees must ensure that contribution processes and controls are ready to respond to the increased demands arising from automatic enrolment from 2012. Trustees must take reasonable steps to pursue and resolve all late payments.

Looking ahead

The regulator is committed to developing a DC framework which will help enable schemes to deliver good member outcomes.

Earlier this year, we launched this work with the publication of our discussion paper: **Enabling good member outcomes in work-based pension provision**. We will continue our dialogue with industry to help develop our understanding of what good looks like and over the coming months we aim to publish a series of statements and tools which will help define the criteria of a good scheme or product.

The longer term strategy will be to develop an operational framework which will enable us to determine compliance with standards of good practice and behaviours.

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Appendix 1: Comparison of some key differences between a DB scheme and DC scheme

It is not uncommon for trustees with a DB background to take on a role in a DC scheme. Likewise many trustees may only have DC experience. The table below contrasts the different steps and activities required in both types of scheme.

Function	DB scheme	DC scheme
Regulatory reporting framework	For DB schemes regular returns include: Annual scheme return Recovery plan if scheme in deficit on triennial review. Event-driven reporting includes: Notifiable events Breach of law reports Clearance applications	For DC schemes regular returns include: Scheme return – annual or triennial Event-driven reporting includes: Breach of law reports
Employer engagement	In a DB scheme investment risk and longevity risk is borne by the sponsoring employer(s). The sponsoring employer provides trustees with a promise to fund the scheme and provides trustees with a financial underpin. In the event an employer fails and the scheme is underfunded, members of a DB scheme may be offered financial protection by the Pension Protection Fund (PPF).	In a DC scheme, the employer does not provide any form of promise other than the obligation to pay over contributions within legal due dates. Members bear investment and longevity risk and unlike DB schemes, there is no PPF compensation available. This does not negate the requirement for trustees to maintain dialogue with employers and manage the accuracy and timeliness of contribution payments. Trustees have a duty to pursue and resolve late payments, and must take reasonable steps to do so.
Investment	In setting the investment strategy in a DB scheme, trustees must be clear how the downside risk will be met. The employer's covenant should cover this risk. Trustees should have a plan how the employer's covenant will cover the risk, for example through extra contributions, contingent assets or other mechanisms.	In a DC scheme, the investment strategy must reflect a scheme's membership profile, maturity and attitude to risk. Trustees will play a crucial role in ensuring that members have access to a suitable range of investments. Trustees must ensure that investments offer members value for money and, in the absence of a guarantee, ensure that investments are likely to deliver good outcomes.

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Appendix 1: Comparison of some key differences between a DB scheme and DC scheme continued...

Function	DB scheme	DC scheme
Administration: record-keeping	Trustees of both DB and DC schemes must maintain accurate, timely and complete records for all members.	
	Trustees must ensure common and conditional data fields are populated for all active and deferred members. This information is used by the scheme actuary to determine accrued benefits. Trustees also need to maintain accurate records for all pensioners and other beneficiaries to ensure benefits are paid to bona fide individuals. The costs of poor record-keeping tend to crystallise at scheme wind up, employer insolvency and cessation for multi-employer schemes. This can add significant delays to the time taken to wind up the scheme and will add additional costs. However, poor record-keeping can also result in additional fee charges as a result of de-risking activities such as scheme buy-outs.	The value of a member's DC pot is generally based on the number of units held multiplied by the unit price of each fund. As contributions are received, these must be accurately recorded and allocated to correct investment funds chosen by individual members. The nature of the administration process therefore results in a significant volume of transactions which need to be recorded on the scheme's administration database. Because of the underlying nature of unitisation in a DC scheme, and due to the volume of transactions, the costs for unwinding maladministration can be costly and very time consuming.
Conflicts of interest	Trustees of DB schemes may experience conflicts of interest arising from their roles in the sponsoring employer, for example senior management. Potential conflicts will become more significant as a result of certain scheme activities, for example funding negotiations, and must be managed appropriately. Adviser conflicts of interest may also be present particularly where certain firms are also used by scheme sponsoring employers.	Trustees of DC schemes, particularly multi-employer schemes, with a role in the sponsoring employer or provider, may also experience conflicts of interest. The trustee board often includes senior employees of the sponsoring employer or provider and actual, potential or perceived conflicts must be managed appropriately. DC trustees may be employed by the scheme provider, which requires them to manage conflicts of interest between their duties to members and the commercial interests of the provider. In schemes where administration and investment is provided by related parties, trustees must ensure they exercise independence over the management of these functions, and must ensure that their powers are not fettered in any way.

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Appendix 1: Comparison of some key differences between a DB scheme and DC scheme continued...

Function	DB scheme	DC scheme
Member communications	In both DB and DC schemes, trustees need to ensure that information provided to members is concise and clearly presented, however the nature of disclosure varies considerably.	
	Trustees need to ensure the Summary Funding Statement provides members with information which helps members understand the level of funding of their scheme and strategy for managing scheme deficits.	For the majority of DC schemes, members are responsible for selecting and reviewing investments choices. Trustees must ensure that information provided to members is clear and concise, and helps them make informed investment decisions. Trustees must ensure that investment choices are clearly labelled and investment risk profiles are clearly communicated.
Retirement	In both DB and DC schemes the retirement process needs to be properly managed.	
	In DB schemes, ongoing pension payments are funded by the employer and paid by the pension scheme. Trustees must ensure that the scheme is suitably funded to meet this on going obligation. Trustees need to ensure that members are advised of their benefits and any options available under the scheme in a timely manner so that they have sufficient time to consider their options.	In a DC scheme, the liability to pay a future pension is generally transferred to an insurer in the name of the individual member. Trustees of DC schemes must offer the the Open-market option (OMO) to all DC members in accordance with the Finance Act 2004 (Section 165, 167 and Schedule 28) and provide specific information to these members at least 6 months before they reach their intended retirement date. These communications must be effective and engaging to ensure that members achieve the optimal income from their DC savings as often their decisions at retirement cannot be reversed, and will affect the income members and their dependents receive for the rest of their lives.

Useful links

Page 1	
Final paragraph refers to our guidance on internal controls	www.tpr.gov.uk/controls
Page 3	
Paragraph on TKU refers to our guidance on internal controls which outlines the trustee behaviours we expect to see	www.tpr.gov.uk/controls#s2416
Page 3	
Second paragraph on Conflicts of interest refers to our guidance on conflicts of interest	www.tpr.gov.uk/controls#s2417
Page 4	
Second bullet on Investment refers to the default fund guidance issued by the DWP	www.dwp.gov.uk

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