

A thematic review report

How trustees of small and micro DC schemes are assessing value for members

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The Pensions
Regulator

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Introduction

Many trustees of defined contribution (DC) occupational pension schemes are legally required to assess whether the charges and transaction costs paid for from member funds provide good value. This requirement, which was introduced in The Occupational Pension Schemes (Charges and Governance) Regulations 2015, is commonly known as the value for members (VFM) assessment, and needs to be carried out annually by the trustees of approximately 5,000 DC schemes.

We believe that VFM underpins all areas of scheme management, and that failure to carry out an adequate assessment suggests that trustees may not be able to identify and address underperforming areas. This significantly increases the risk of members receiving poor value.

Although we do not prescribe a particular approach to carrying out a VFM assessment, we have set out the standards we expect to be met in our DC code of practice¹, supported by guidance for trustees. The code also makes it clear that charges and transaction costs are likely to represent good value for members where the combination of costs and what is provided for the costs is appropriate for the scheme membership as a whole, and when compared to other options available in the market.

The purpose of this thematic review was to help us understand the challenges trustees face when conducting the assessment, and to use such insights to provide a focus for further regulatory action.

Background

Our 2017 annual survey of DC schemes indicated that many trustees, particularly of small and micro schemes, were failing to meet the standard of governance as set out in the DC code.

Less than 50% of trustees of small and micro schemes reported having a documented process in place to assess and report the extent to which member borne charges and transaction costs represent value for members.

The survey also highlighted that only a third of trustees of small (12-99 members) and micro (up to 11 members) schemes had engaged with our codes of practice and supporting guidance, further indicating that they are unlikely to be aware of the standard of VFM assessment we expect.

A high proportion of trustees, regardless of scheme size, reported they were confident of obtaining the relevant information and had a good understanding of member costs and charges. However, less than half said they had researched and taken account of the characteristics and preferences of their members.

1 Code of Practice no. 13: Governance and administration of occupational trust-based schemes providing money-purchase benefits

The review

We randomly sampled 101 micro and small schemes from the register of pension schemes to participate.

The review was conducted in two phases. In phase one, we wrote to the trustees and asked them to provide us with the section of their chair's statement relating to their VFM assessment (all participants had confirmed compliance with the chair's statement requirement in their most recent scheme return).

We received 68 statements in response to our request. The remaining 33 had not prepared a statement as they were either non-compliant or exempt from the requirement. We then reviewed the statements to see which VFM assessments were meeting our expectations.

In phase two, we conducted interviews with trustees of 19 schemes from the 68 that had responded. We wanted to understand how the trustees had interpreted the requirement to annually assess VFM, the steps they had taken to implement processes, and what support they had sought in order to conduct meaningful assessments.

Following the interviews, we wrote to the trustees to share our feedback on areas where they had met our standards and aspects of their assessment that could be improved. We then analysed the findings of our review and the interviews to identify common themes relating to risks and good practice.

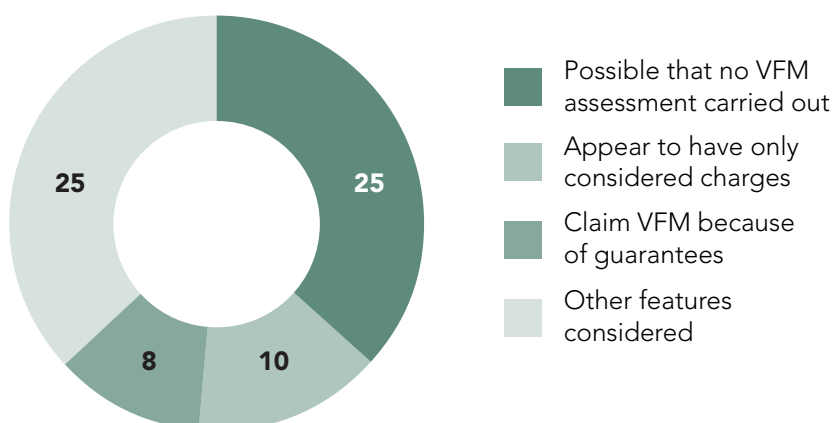
Key risks and failures

Explanation of VFM assessments in chair's statement lacking in detail

We expect chair's statements to provide a meaningful narrative of how the relevant governance standard (in this case the VFM assessment) has been met. It is important that members are able to understand from the statement what steps the trustees have taken to assess value. This enables members to determine whether or not the scheme is meeting their needs.

The majority of the 68 statements we received and reviewed in phase one of this review did not meet the standard of assessment set out in the DC code – the breakdown of our findings are shown in Figure 1 below.

Figure 1: Breakdown of VFM sections received



We received 25 responses where it was unclear whether a VFM assessment had been carried out. These typically consisted of the statements detailing the charges or giving a short description of the scheme, while making no comment as to whether these represented value for members.

A minority appeared to have misunderstood the requirements, with one statement suggesting that the insurer of the scheme (not the trustee) had a legal duty to ensure value for members. Another stated that it was the members' responsibility to take advice as to whether the scheme was good value.

The trustees of 10 schemes recorded in their statement that they had considered charges and concluded they were of good value. However, there was no explanation of the considerations made nor why the services received in return for these charges presented good value for members.

We came across eight statements where the trustees had reached the conclusion the scheme was providing good value as they were invested in with-profits funds that included valuable guarantees and/or bonuses. The remaining 25 trustees listed other features they had considered, although there was often no explanation of why they believed each feature added value.

Most of the trustees we interviewed during phase two of the review had at least considered charges and performance in their statements. While they were able to elaborate on the various factors they had taken into consideration for the assessment during the course of the meeting, only a few provided us with documentation evidencing the steps they had taken.

Overall, our review of statements in phase one led us to conclude that many trustees did not understand the requirement to carry out a VFM assessment and had not carried out an assessment that met the standards set out in our DC code of practice and supporting guidance.

This was further supported by the findings of phase two, as half of the trustees we engaged with had not been aware of the DC code of practice and supporting guidance before being sent them in advance of our meeting. Those that had been familiar with the guidance often reported that it was not tailored to meet the needs of those running small and micro schemes, and that they struggled to find time to keep up to date.

Issues relating to with-profits investments

30 of the 68 schemes that provided their VFM sections were invested in with-profits funds. With-profits investments are pooled investments from which the fund provider's costs are deducted. A proportion of the remainder (the profit) is paid to the policy holders in the form of annual bonuses (although the amount may not be guaranteed and could be zero in some years). There may also be a terminal bonus paid if the policy is held to term, or a surrender value adjustment if the policy is terminated early.

The majority of trustees reported they had difficulties confirming the specific details of charges for with-profits policies with most reporting that such charges were implicit within declared bonuses. This resulted in the trustees focusing on other areas of the scheme where they felt able to consider value, such as the potentially valuable guarantees, bonuses and fund smoothing (rather than assessing the extent to which costs and charges represent value for members).

Evidence of good practice

Identifying areas of poor value

We appreciate that much of the trustees' focus is on compliance with the requirement to produce a chair's statement because of the mandatory penalties for breaching it. However, they need to be aware that identifying areas of poor value as a result of their VFM assessment is not a breach of their obligations to assess VFM (although they should be mindful of their trust law duties where they do consider there is poor value). We expect trustees to be transparent about such matters in their statement, as well as detailing any plans for improvement.

Only a minority of trustees that took part in the review had identified areas of underperformance and set out the steps they would take to address this. In one such case, the trustee identified very high member-borne charges and took the decision to close the scheme to new members, and set up a new arrangement where charges were significantly lower. The trustee then communicated this to their members along with details of how to transfer to the new scheme. We also encountered trustees who had committed to further work to improve and develop the services and options available to members. Despite having concluded that current charges presented good value to members, these trustees appreciated that improvements could be made to further increase the value for members.

Engaging membership to identify member needs

Our DC code sets out our expectation that trustees actively seek out the views of their members to better understand their needs and that they should take this into consideration when assessing what represents value for members.

Although limited, we did uncover examples of trustees engaging members in this review. In one case, we encountered a trustee who had considered transferring the members of a longstanding scheme to a more modern arrangement. However, through direct engagement they were able to identify that the members of this very small scheme all placed considerable value on the level of death in service benefit provided. As a result the trustee was able to focus their consideration of alternative arrangements based on the specific needs of the members.

In this case, they were not able to find a more suitable arrangement as even though charges could have been reduced slightly by transferring, the death in service benefit that their members all valued would have been lost. This illustrates the importance of trustees engaging with members and taking their preferences into account.

We also encountered trustees who had taken a more informal approach to engaging their members. These were generally trustees of micro schemes who had personal relationships with members and were therefore aware of their individual financial circumstances and retirement objectives. These trustees could then use this information to take a proportionate approach to their assessment, targeting the areas of importance to members. While this approach can be effective we appreciate that it does not scale up to larger arrangements, and trustees should be aware that this relationship can be lost once members leave service.

Detailed explanation of measures taken to assess value

A minority of trustees provided comprehensive explanations of their VFM assessments, specifying the aspects of services they had considered and comparisons with alternative arrangements.

We also noticed that some trustees had taken care to avoid the use of technical language and jargon, positioning their statement in a way that could be interpreted by readers with little or no experience in pensions.

By taking such steps, these trustees have provided their members with clarity about the costs they are paying and reassurance that their scheme is being governed well. This approach also provides a basis for comparison for further assessments, and can act as a record of the process to assess VFM. This helps to guard against loss of knowledge if there are any changes to the people responsible for running the scheme.

Failures to comply

The focus of this thematic review was not enforcement but to understand how trustees are assessing value for members. This report therefore does not provide specific details of any enforcement action we took as a result of this review and aims to highlight examples of good and bad practice we encountered. The details of any penalties resulting from this review will be published in our quarterly enforcement bulletins.

Under regulation 23 of the Occupational Pension Schemes (Scheme Administration) Regulations 1996, trustees are required to prepare a chair's statement that meets certain requirements within seven months of the scheme's year end.

Trustees who fail to prepare a statement that meets the requirements, or fail to produce a statement at all by the statutory deadline, are liable for a mandatory penalty of £500 - £2,000. Additionally, TPR has discretion to issue a penalty for breaches of the underlying governance requirements.

Our case team identified that 22 of the 33 schemes that failed to provide us with the VFM section of their chair's statement were in fact exempt from the regulations. Mandatory penalties were issued to the trustees of the remaining 11 schemes but some of these were revoked following a review.

There were several instances of non-compliance with the chair's statement requirements where the trustees had appeared to use templates to assist them. When using a template to draft a statement, trustees should ensure that it has been developed to meet the legal requirements, and seek professional advice where necessary. We also came across two statements where the trustees had failed to meet the specific requirement to provide details of all member-borne charges, so we were obliged to issue them with a mandatory penalty.

Trustees should be aware that further amendments to the regulations which came into force on 6 April 2018 state that, in addition to the VFM assessment, the chair's statement should:

- ▶ Set out the level of member borne charges and (where available) transaction costs for:
 - each individual default arrangement
 - each individual arrangement where members can select the funds and where the assets were invested during the year
- ▶ Provide an illustrative example of the cumulative effect over time of the relevant costs and charges on the value of a member's benefits

Please note that, as previously, trustees must indicate what (if any) transaction cost information they have been unable to obtain and explain what steps are in place to obtain the remainder.

We also identified 17 statements where the trustees had not included any explanation of their VFM assessment. This did not necessarily mean they hadn't carried out an assessment, but had failed to give an explanation of it, and therefore we had to issue them with a mandatory penalty.

Next steps

We have recently updated our **quick guide to the chair's statement** including a new section highlighting common mistakes. This should go some way to helping trustees understand both the legal requirements and our expectations when completing their chair's statement.

We are considering taking further steps to improve the rate of correct responses to the chair's statement question in the scheme return, which could include spot checks of chair's statements in the future.

We will also be investigating the challenges that with-profits investments pose to trustees being able to conduct meaningful VFM assessments. This includes adding new questions to this year's scheme return and working with industry to explore this matter in greater detail.

We will be more directive with trustees of small and medium DC schemes and communicate with them in a way that sets very clear expectations about the actions they should be taking across a wider range of governance duties.

As a first step, we will be piloting a regulatory approach that seeks to ensure members are in schemes where the default arrangements are properly governed. We will target segments of DC scheme trustees with tailored communications, setting out what we expect them to do in reviewing the strategy and performance of their default arrangement, including the considerations they should be making about VFM. We will then follow this up with interventions to ensure the reviews meet our expectations.

We will also review our winding-up guidance to help trustees who believe that winding up their scheme would provide the best value for their members. These trustees may decide that their members would be better served by being moved into a scheme that is more likely to be better run and provide better value, such as a master trust.

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