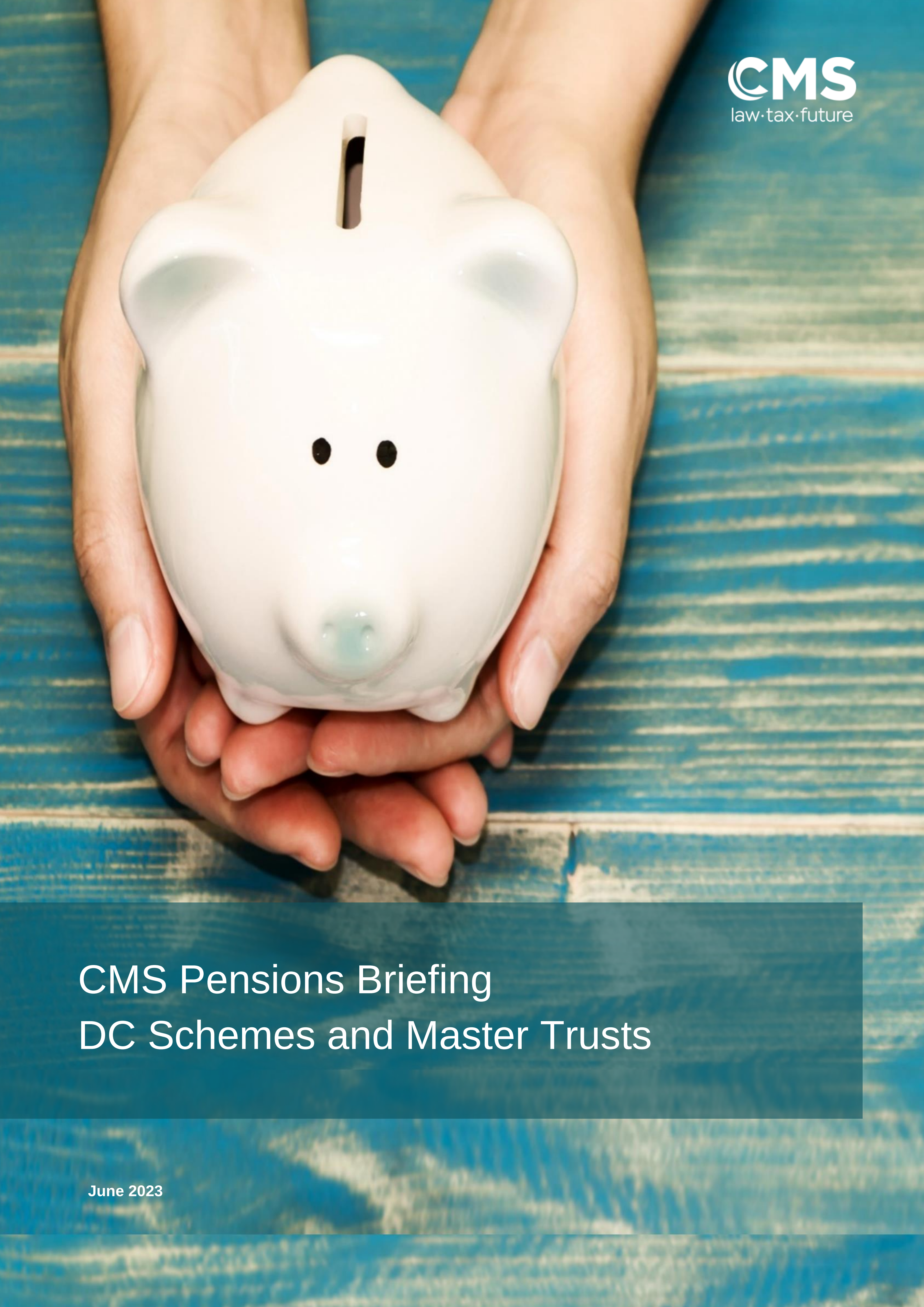

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# CMS Pensions Briefing
# DC Schemes and Master Trusts

June 2023

## Welcome to our regular briefing on topical issues facing defined contribution (DC) pension arrangements, including DC Master Trusts.

In this briefing we take a look at how the DC market is evolving as a result of both new requirements on trustees, forthcoming changes and some of the big issues yet to be addressed.

Will more rigorous Value for Money reporting requirements achieve the government’s drive for consolidation? Will trustees revisit their investment strategy and asset allocation to consider the pros and cons of a less liquid portfolio? Will a solution be found to address the small pots dilemma? There is certainly no shortage of challenges or debates to be navigated by trustee boards. We also consider next steps for auto-enrolment and reflect on one of its biggest weaknesses: the gender pay gap.

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# Your guide to…

Value for Money: Increased regulation of DC schemes and investment reporting

*Since auto-enrolment was introduced and with the large number of savers now paying into DC schemes, there has been an increasing regulatory emphasis on trying to ensure better member outcomes. This has included the Occupational Pension Schemes (Charges and Governance) Regulations 2015 and, more recently, the snappily-titled Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021 (the* ***2021 Regulations****).*

*The 2021 Regulations brought in performance reporting in respect of members' default and self-select funds and a requirement for trustees to keep their funds' performance under review or consider a transfer to a better scheme for members. All of this was done under the auspices of giving members of DC schemes better value for money (****VfM****), a theme which both the Pensions Regulator (****TPR****) and the Financial Conduct Authority (****FCA****) have been discussing with the industry since at least 2018.*

## Recent developments

In May 2022, TPR and the FCA released their response to a prior discussion paper and have since, working with the Department of Work and Pensions (**DWP**), sought to develop a new VfM Framework (the **Framework**). The DWP published a consultation on the Framework in January 2023 and the consultation has now closed.

The Framework seeks to address the following key elements of VfM identified by TPR and the FCA:

— Investment performance;

— Costs and charges; and

— Quality of services.

We've taken a look at each of these in turn below.

## Investment performance

In broad terms, the Framework is seeking a massive expansion in the reporting requirements associated with investment performance. This is so that savers and trustees have improved visibility of fund management to drive accountability and, in theory, better member outcomes.

The DWP is proposing that under the Framework schemes report annualised returns based on 1, 3 and 5-year periods, as well as longer periods (10 and 15-years), if the data is available. Many schemes provide some of this data already, but on a non-standardised basis. The Framework therefore proposes to standardise these metrics for the investment performance and for them to be net of all costs (including employer-borne costs and guaranteed investment returns provided by some legacy DC schemes). There will also be two metrics used to indicate risk-weighting in investment performance to allow for comparison between funds with different risk profiles. The exact details on what will need to be disclosed in respect of the backward-looking element remains subject to future FCA consultations. However, the general point is for savers and trustees to be able to consider and compare schemes based on a standardised basis.

Alongside the increased standardised reporting, the DWP is planning to extend the current requirement for occupational schemes to report performance for different age cohorts (at ages 25, 45 and 55) to all workplace schemes (i.e. group personal pension schemes will now be in scope).

For master trusts, the Framework also specifically identifies the potential difficulties in reporting on different VFMs for employers who have agreed separate contractual subsidies and costs with a master trust. The current proposal under the Framework is for employers to be grouped into bands of cohorts based on assets under management, with net returns reported for each band. Nonetheless, several master trust providers have expressed concern of the expansion of reporting required and particularly in respect of reporting by cohort. Trustees of master trusts will want to carefully evaluate any concessions made under the future Framework in light of this.

The DWP sets out other investment reporting requirements under the Framework, including reporting net of investment charges only (to make administration costs more transparent), asset allocation disclosures (in line with the proposed approach taken in respect of DC Chairs' Statements) and reporting forward-looking metrics. Under the last of these, the DWP is proposing several methods of providing forward-looking metrics (using 'stochastic' and 'deterministic' modelling) to provide members better visibility on what the fund's future performance might be.

## Costs and charges

The Charges and Governance Regulations which came into force in 2015 set out the original charge cap for default funds (0.75%). However, having a flat charge does not necessarily guarantee value for money (e.g. underlying funds could charge this irrespective of other factors such as actual investment performance). To address this, the Framework seeks to make charges and costs more transparent (for example, requiring providers to unbundle investment and administration charges). The main step that the Framework is proposing however is a single percentage for costs. More guidance is to come, but those schemes which have more complex or combined charging structures will likely need to make significant changes to their charging model.

## Quality of services

In addition to assessing investment performance and the overall costs and charges for that performance, the Framework aims to take account of other 'quality of service' factors (e.g. scheme administration, governance and effective member communication) to support members' understanding and decision-making. Schemes will be required to report on certain quantifiable metrics regarding, for example, their scheme's administration (e.g. promptness of financial transactions, record keeping etc.) and the engagement of members at certain key lifestyling points (e.g. selecting options at retirement). Governance will not have its own metric but the DWP recognises its importance and there may therefore be separate moves made on this alongside the Framework.

## The bottom line - what are the implications for DC schemes and master trusts of the Framework's proposals?

The Framework has been a long time coming but in short, the implications are increased reporting, disclosure and governance requirements. While some of these reporting obligations were expected, others (notably the forward-looking metrics) will require careful consideration by Trustees and may be more complicated to communicate to members. Further, the amount of data Trustees will be required to gather regarding each of these aspects of reporting will be time-consuming and Trustees will want to engage with their advisers to understand what information is relatively straightforward to collect and where the issues and gaps are.

This will naturally mean additional costs for Trustees in the short to medium term, but also management time that schemes and master trusts will need to devote to implementing the Framework (including potentially reshaping their business to a different charging structure).

Many in the industry recognise that putting together a better disclosure and reporting framework will give members more visibility and more engagement and hopefully provide better outcomes. In practice, most large schemes and master trusts have processes in place for many of the reporting areas covered in the Framework. However, schemes will need to keep abreast of the actual guidance and regulations which will be published in the future. There are still particular concerns (e.g. for master trusts) that will need to be addressed but schemes should be able to provide input by contributing via industry bodies and their own consultation submissions.

## What about smaller DC schemes?

However, of particular note will be smaller DC schemes which may not have as robust processes for assessing investment performance and overall value for members as larger schemes. The introduction of the Framework may prompt trustees and employers of smaller DC schemes to look to transfer to another vehicle given the scope of the reporting obligation. This may be positive for members and result in better outcomes, but the assumption that economies of scale will benefit all schemes is not a given and smaller schemes will still need to spend money obtaining appropriate legal and investment advice on the benefits of any transfer. Trustees of smaller schemes may wish to begin considering with their advisers (and supporting employer) their options.

## What next?

The DWP's consultation on the Framework closed on 27 March 2023. We expect a response this year but, especially given the inter-departmental nature of the Framework, it is likely to be many months until the outcome of the consultation is known. However, Trustees and managers of DC and master trust schemes will want to start considering the implications of the Framework with their investment, legal and other advisers.

# Our thoughts on…

Investing for the future: A question of liquidity

*In the world of DC governance, change continues to be the only constant. Earlier this year, the Government published a response to its consultation on regulations designed to broaden the investment opportunities available to DC schemes, particularly in respect of illiquid asset classes. Most provisions in the Occupational Pension Schemes (Administration, Investment, Charges and Governance) and Pensions Dashboards (Amendment) Regulations (the* ***Regulations****) came into force on 6 April 2023.*

## Why have these changes been introduced?

Investing in illiquid assets, such as property or infrastructure, can be an expensive and long-term game, which has traditionally made it out of reach for a diluted and dispersed legacy DC market.

However, DC consolidation has been a priority for both the Department for Work and Pensions (**DWP**) and the Pensions Regulator for many years now and various reforms designed to improve DC governance and value for money for members have accelerated this process. The economies of scale offered by larger DC schemes and master trusts, combined with the growing contributions made to DC schemes by the auto-enrolment generation, and beyond, makes it a good time for trustees to consider the potential for holding less liquid assets as part of a fully diverse investment portfolio.

That said, nothing relating to pensions is straightforward, and whilst investing in illiquid assets can mean higher net returns over the long-term, the liquidity pressures and related market volatility last autumn vividly illustrated the associated risks. Understandably, the Government has stopped short of actively encouraging such investments and focussed for now on broadening the possibilities and giving pause for thought.

### Defining Illiquid assets

The definition of Illiquid assets in the Regulations is intentionally very broad: "*assets of a type which cannot easily or quickly be sold or exchanged for cash and where assets are invested in a collective investment scheme, includes any such assets held by the collective investment scheme*".

## What are the requirements and when will they apply?

Trustees of relevant schemes will need to state their policy in relation to investing in illiquid assets in their default arrangement statement of investment principles (**Default SIP**). For CDC schemes, which don't have default arrangements, the policy is to be stated in their main SIP. Where trustees have chosen not to invest in illiquid assets, they will need state why they have made this decision. The idea is that trustees will have to at least consider the options and be able to explain their rationale.

### Scope

"Relevant schemes" for purposes of the Regulations include most occupational DC schemes except executive schemes, self-administered schemes with fewer than 12 members, public service schemes and schemes that only provide additional voluntary contributions. Collective DC schemes are also in scope if they have at least 100 members.

The policy will need to include the following:

- a statement as to whether or not the default arrangement will include illiquid assets;
- where illiquid assets are included:
  - the age profile of members in respect of whom illiquid assets will be held;
  - an explanation of whether investment will be direct or via a collective investment scheme;
  - an explanation of the types of illiquid assets; and
  - an explanation of why the trustees or managers have a policy of investing in illiquid assets including their assessment of the advantages to members of investing in illiquid

assets, when compared to investments in other classes of assets, and the associated risks;

- where investments do not include illiquid assets, an explanation of why the trustee has adopted that policy; and
- an explanation of whether the trustee has any plans to invest in illiquid assets or increase their investment in illiquid assets in the future.

In terms of timing, trustees will need to prepare the policy for inclusion in the Default SIP when it is first revised after 1 October 2023 or by 1 October 2024 (if earlier).

## Removal of performance-based fees

The Regulations also provide for the exemption of certain types of performance-based fees (broadly speaking, fees paid when a fund manager exceeds agreed targets over an agreed time period) from the charge cap limit of 0.75% which applies to default arrangements. This is intended to facilitate investment in illiquid assets by removing one of the long-perceived barriers.

It should be noted that in order to provide appropriate safeguards for members, there are particular criteria to be met for fund manager fees to fall within this exemption and trustees will need to carry out ongoing due diligence and carefully balance risk versus reward. In addition, schemes with over £100m in assets will be required to assess the extent to which specified performance-based fees represent good value for members.

Schemes will need to disclose performance-based fees as a percentage of the average value of total assets held in their default arrangement in their chair's statements for scheme years ending after 6 April 2023, and also publish them on a website.

The Government is clear that paying higher fees is only justifiable if the scheme receives higher net performance returns as a result. Agreements between schemes and fund managers will need to clearly link the payment of additional fees directly to realised returns.

### Asset allocation reporting

Neatly dovetailing with the illiquid asset policy requirements, trustees will also need to be ready to disclose in the chair's statement (and publish on a website) their full asset allocations for default arrangement(s) for the first scheme year ending after 1 October 2023. This will involve breaking down the percentage of assets allocated to specified asset classes in each default arrangement (i.e. not just for the main default arrangement).

Detailed information on disclosing and explaining asset allocation is set out in statutory guidance, which was published alongside the Regulations.

This disclosure is intended to provide trustees and members with a better understanding of the value for money provided by different asset classes, including cash, bonds, listed equities, private equities, property, private debt/credit and infrastructure.

The extent to which members will use, or engage at all, with this information has been questioned by the industry (and we understand the DWP is separately considering the overall effectiveness of the chair's statement) but that's a conversation for another day.

# Your guide to…

The first 10 years of Automatic enrolment: Maintaining the momentum

*In our December 2022Briefing for DC Schemes and Master Trusts, we reflected on the impact that auto-enrolment has had on pension savings in the UK, ten years after it was introduced.  Auto-enrolment has certainly been a success in terms of increasing the number of employees who participate in workplace pension schemes (or, rather, leveraging employee "inertia" on opting-out of pension saving!). However, most would agree, and there is broad political consensus, that there is more that could be done to widen pension scheme participation and to help more people make adequate provision for their retirement*

## The 2017 Review and proposed changes

Currently, employers are required to automatically enrol UK workers who are between 22 years of age and state pension age, and who earn at least £10,000 per year with that employer (the **Earnings Trigger**). Where employees are automatically enrolled, the standard minimum contribution rates (3% from employers and combined employer / employee contributions of 8%) apply only in relation to the employee's earnings between the lower earnings limit and the upper earnings limit, which are currently set at £6,240 and £50,270 respectively (**Qualifying Earnings**).

In 2017, DWP published a review entitled "Maintaining the Momentum" (the **2017 Review**), with a view to forming its medium term strategy for auto-enrolment. It is now proposed that the first steps to implementing certain of the recommendations of the 2017 Review will be taken under a new piece of legislation, the Pensions (Extension of Automatic Enrolment) (No 2) Bill (the **Bill**). The Bill is a private member's bill introduced by Jonathan Gullis MP (i.e. a bill that is proposed by an individual MP rather than a minister), however the Government has expressed its support. The Bill covers the same ground as an earlier bill, the Pensions (Extension of Automatic Enrolment) Bill, which was introduced by Richard Holden MP and has now been withdrawn.

If passed in its current form, the Bill, which is currently under review by the House of Lords (having been approved by the Commons), is expected to introduce powers for the Secretary of State to:

— lower the age threshold from which employers are required to auto-enrol employees; and

— reduce or repeal the lower earnings limit for Qualifying Earnings (the Earnings Trigger would be retained but it's worth noting that there is an existing requirement for the Secretary of State to review the level of the Trigger each year).

The Bill only introduces powers to make regulations (with any such regulations needing further Parliamentary approval), and it would also require the Secretary of State to first undertake a consultation before exercising the powers, so we don't yet know the exact details of the changes that might be made. However, on the basis that the intention is to implement the recommendations of the 2017 Review, it seems most likely that:

— the age threshold will be reduced to age 18, so that employees are more likely to participate in workplace pension savings as soon as they start employment; and

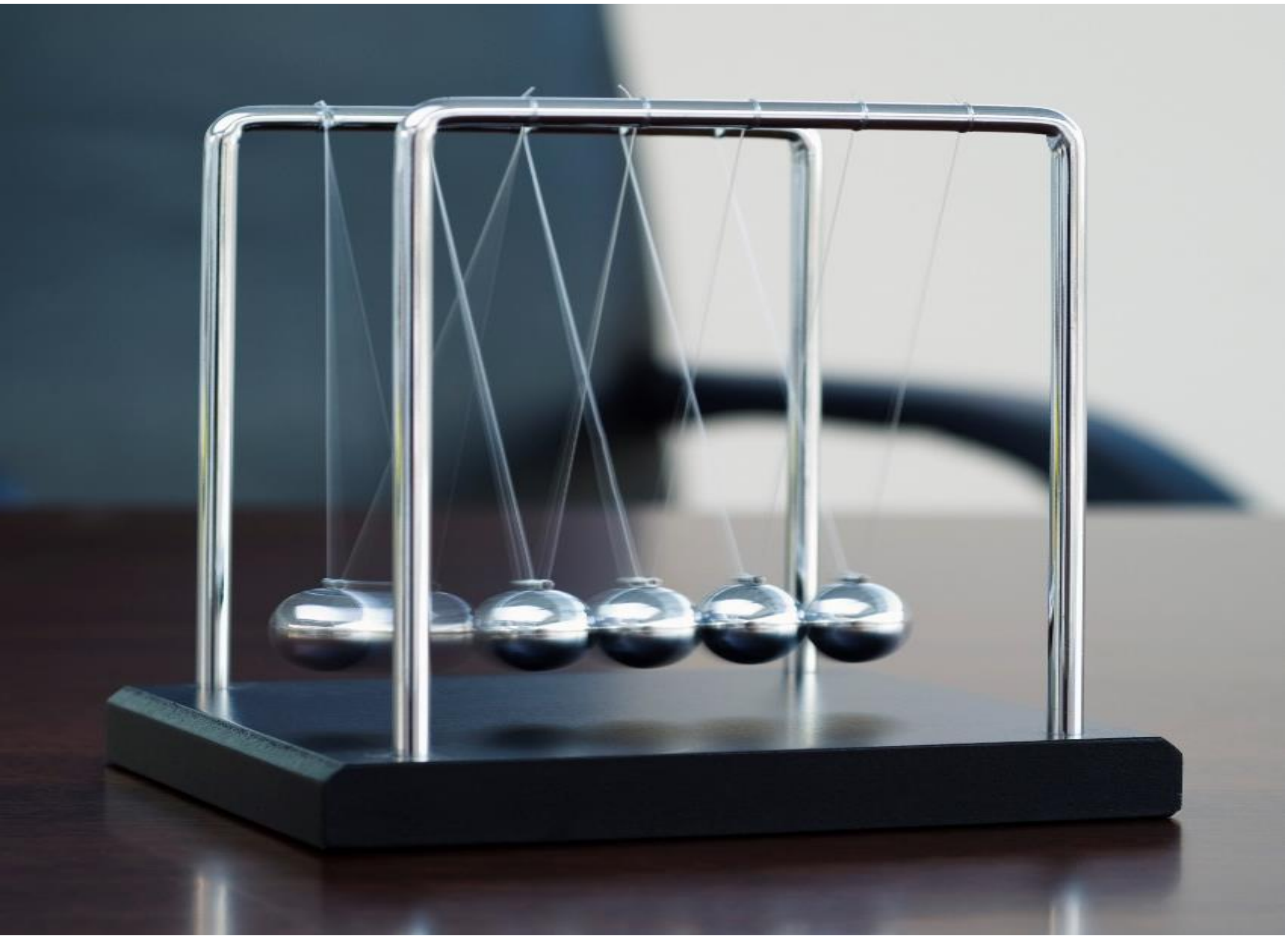
— the lower earnings limit will be repealed so that employees who are auto-enrolled (or who opt-into a scheme that meets auto-enrolment requirements) will begin saving into a pension from their first pound of earnings.

Reducing the age threshold would enable employees to benefit from earlier employer contributions and would mean there would be a longer period for compound growth to take effect on their savings. It is also likely to reduce administrative complexity for employers if they are simply able to auto-enrol all their employees upon joining (as most employers will not have employees under age 18). Repealing the lower earnings threshold would effectively increase the minimum contribution requirements by widening the Qualifying Earnings band: proportionately, this would have the biggest impact on pension contributions for lower earners, and it would also mean that all employees would have a right to opt-in to a pension scheme that meets auto-enrolment quality requirements (whereas currently employees earning below the lower earnings limit can opt-in to a pension scheme, but they do not have a right to employer contributions).

## Timings and other issues

There is no set date for the proposed changes, however, the Government has said that it would like to launch a consultation process in Autumn this year, with the new powers then being exercised in the "mid-2020s".

As such, we are unlikely to see any changes imminently, but we can expect further discussion on these issues and indeed other challenges for auto-enrolment, for example how to cater for groups such as gig-workers and the self-employed, how to address the "gender pensions gap", and whether the minimum contribution rates should be increased to a level that is more likely to provide for an adequate income in retirement.



# Where are we now…

Small pots, big ideas (again)

*Daylight saving, pension saving. The end of March marked the end of the DWP's eight-week consultation calling for evidence about the ever-growing number of small, deferred pension pots hiding down the back of the UK's collective retirement settee. The consultation paper summarises the history of the problem, the work done to date by industry groups charged with finding an answer to it and the different approaches which have gained popularity over time. At this stage, the two most likely solutions still look to be either an automatic default consolidator, or some form of 'pot follows member' structure – but it looks like there is a long way to go before the preferred solution springs into action.*

## Another call for evidence

The proliferation of small pots has been an issue on the industry's radar for over a decade, and in this latest publication on the topic, 'Addressing the challenge of deferred small pots: a call for evidence", released on 30 January 2023, the DWP wastes no time in re-emphasising the scale of the problem. It cites the claim (originally made in 2020 by the Pension Policy Institute) that there were an estimated eight million deferred pension pots in the UK, which "without intervention" are likely to rise to 27 million by 2035, and the projection that the value of lost pension pots has grown from £19.4 billion to £26.6 billion since AE's introduction in 2018. Some of the figures quoted are eye-catching, not least the PPI's estimate that the breakeven value of a deferred pot for it to be profitable to providers is around £4,000 – whereas of a sample of several million deferred pots within scope of a 'Small Pots Working Group' 2020 report, almost three quarters were smaller than £1,000. Data even suggests that perhaps up to one quarter of all deferred pots in the UK were of a value of less than £100.

The drive to improve savings outcomes for members, the DWP notes, can only be achieved in a market that functions efficiently – so the consultation is designed in particular to canvass the views of providers, in order gain a better insight into how these kinds of disparities can be overcome and most cost-effectively managed in the real world.

## Automatic consolidation – but how?

It is clear that Government is still far from settled on a preferred solution, and the number and variety of questions asked suggests it is still grappling with fundamental issues: there is still no consensus yet about whether and how to make small pot consolidation a member-initiated process, or about criteria for determining what a small, deferred pot is for consolidation purposes, with views sought on appropriate value limits and periods of inactivity in deferment. Views are also sought as to whether this initiative should be focused initially on managing the flow of new pots, or reducing the existing stock, though ultimately the new requirements will need to address both problems.

The consultation recaps the two main contenders:

— a default consolidator for all small pots, such as the scheme the member is first auto-enrolled into or a scheme chosen by the member from a list of approved consolidators; or

— a "pot follows member" structure which could be given a reprise after being decommissioned in 2016.

The consultation rehearses the likely features of each and is a useful reminder that both approaches have significant advantages and disadvantages for members and providers in terms of ease of understanding, data sharing, inputs required, set-up, oversight and management costs and minimising disruption to existing scheme systems. Initial reaction in the pensions press seems to suggest that both solutions have their advocates and that there is no clear favourite at this point in time – the follow-up response to the call for evidence is likely to make for interesting reading.

## Integration with other initiatives and requirements

Whichever consolidation solution the Government finally lands on, it will need to be harmonised with the incoming Pensions Dashboards regime, Automatic Enrolment requirements, the Value for Money agenda and the Stronger Nudge to pensions guidance, as well as taking into account changes to statutory minimum pension ages.

Looking at that list of objectives, it could be some time before small pots legislation sees daylight.

# And finally…

The gender pensions gap

*According to the Now: Pensions "Gender Pensions Gap Report…and how to close it" published in June 2022*, three million women are effectively "locked out" of workplace pension savings because they do not meet the criteria for auto-enrolment. Whilst the report recognises that auto-enrolment has a been a success, it notes that it was not designed for employees who take significant career breaks, work in multiple or part-time roles or move frequently between jobs. Typically, women spend 10 years away from the workforce to start families and look after children and/or relatives. This contributes to both the gender pay and pensions gap. Rather worryingly, the report highlights that by the time women reach age 65, they will typically have £69,000 saved into their pension pots, which is £136,800 less than the average man, who will have saved £205,800.*

Women would need to work an additional 18 years in full-time employment to save the same amount of money into their pension as a working man

In the previous year, Legal & General (L&G) revealed that the gender pensions gap was 17% at the beginning of women's careers and reached 56% at retirement compared to men, further to their research which analysed data from approximately 4 million L&G pension scheme members. In its 2021 report** L&G confirmed that it would press for a lowering of the auto-enrolment threshold to encourage more women into auto-enrolment and suggested that the pensions industry needs to communicate better the importance of pension savings for women at all stages of their working lives.

According to L&G, who looked at the pension pots of more than 37,000 people in the UK who retired in 2020, the average size of man's pension pot at retirement is £21,000, compared to £10,000 for a woman - which is less than half **

Fast forward to January 2023 and the Work and Pensions Committee (**WPC**) published the responses of the Government, FCA and MaPS to the recommendations in its report of 30 September 2022 entitled "Protecting pension savers – five years on from the pension freedoms: Saving for later life". The response notes that the government is committed to incorporating the recommendations of the 2017 auto-enrolment review in the mid-2020s and aims to bring forward legislation at a suitable opportunity and when parliamentary time allows – although there are no details on the timeframe for such changes.

In respect of the gender pensions gap, the response acknowledges that there is no consensus on how the gender pensions gap should be defined and that there has been little progress in reducing it – but notes the DWP's view is that the gender pensions gap is "*mainly caused by inequality in the labour market, including the differences in working patterns and earnings*" and that any plan to reduce the gender pensions gap will need to address this 'head on'. As a consequence, the response recommends that the DWP works with colleagues across the government and other stakeholders to agree a definition and a target to reduce the gap.

In the shorter term, the response recommends that the government looks at ways to make existing policies work better for lower-paid and part-time workers, including:

- A review of the £10,000 earnings trigger for auto-enrolment (**AE**) (and whether it excludes too many lower earners who are disproportionately women);
- Ensuring non-taxpayers benefit from tax relief regardless of the type of pension arrangement they are paying into (as some low earners (disproportionately women) miss out on tax relief because their pension uses the net pay arrangement for tax relief);
- Ensuring people caring for children get credits towards their State Pension; and
- Improving the take-up of pension sharing on divorce.

A subsequent letter from Laura Trott, Pensions Minister to the WPC dated 6 February 2023, confirmed that the Government will bring forward legislation on AE reforms when Parliamentary time allows and that she is looking at the possibility of regular reporting on the gender pension gap by DWP. In her letter Ms Trott confirms that the government is committed to:

— ensuring that as people approach retirement, they can access the quality services and timely guidance they need to plan their finances in later life; and

— working to better understand the scale and challenge of the gender pensions gap and to find a suitable definition of the gender pensions gap, which enables the development of a metric for measuring progress on reducing the gap.

More recently, we are aware of research from TPT Retirement Solutions which suggests that due to the cost-of-living crisis, nearly half of women in their 50s expect to work longer so that they can afford retire – typically planning to work for an extra five years. The results indicate that the current additional financial pressures being faced are having a long-term impact on preparing for retirement or having to delay it as a result – particularly for women, which potentially could widen the gender pensions gap even further.

It seems at this stage there are no easy or quick fix solutions to this issue but it will be interesting to see what the government do next to address the gap.

* **gender-pensions-gap-report-2022-080622.pdf (nowpensions.com)**

** **press-release-gender-pensions-gap-280721-final.pdf (legalandgeneral.com)**

*This briefing and many other useful resources are now available on our new app, Pensions Law Appraised, which provides real-time guidance on the latest pensions law developments while helping pension scheme trustees to comply with their statutory knowledge duties. To start using it, scan the QR code below or click here to download it.*