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A pair of hands is shown from the top, holding a white ceramic piggy bank. The piggy bank has a slot on its back for coins and two small black dots for eyes. The background is a blue-painted wooden surface with visible grain and some wear. The hands are positioned centrally, with the piggy bank resting in the palms.

# CMS Pensions Briefing DC Schemes and Master Trusts

November 2020

Welcome to the first of our new regular briefings on topical issues facing defined contribution (DC) pension arrangements.

With the steady decline of DB pension provision, DC pension offerings have grown in prominence. At the same time, the landscape of UK pension provision is becoming increasingly diverse – and more regulated. There are now almost 30,000 occupational pension schemes with two or more DC members and, since the advent of the master trust authorisation and supervision regime, 38 authorised DC master trusts.

In this briefing, we explore some of the key trends that are driving the development of DC pension provision in the UK – from climate change-related requirements to consolidation. We also look at the new practical requirements for implementation statements that schemes and trustees are getting to grips with, and think about best practice for communicating with members during these difficult times.

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Please get in touch with one of us or your usual CMS contact if you would like to discuss anything further.



**Johanna Clarke**  
**Partner**  
T +44 20 7367 2606  
E johanna.clarke@cms-cmno.com



**Victoria Lee**  
**Senior Associate**  
T +44 20 7524 6952  
E victoria.lee@cms-cmno.com



**Richard Gibson**  
**Senior Associate**  
T +44 20 7524 6857  
E richard.gibson@cms-cmno.com



**Tasmin Patel**  
**Associate**  
T +44 20 7367 3542  
E tasmin.patel@cms-cmno.com

A focus on...

## Taking action on Climate Risk

Climate change is not a new concept for pension schemes, as trustees have been required since 1 December 2005 to record the extent to which “social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments” in their Statement of Investment Principles. But discussions about these obligations are gathering pace and there is a renewed focus on what trustees are doing in these areas.

A key development is the DWP consultation “Taking action on climate risk: improving governance and reporting by occupational pension schemes”, issued in August this year. In the Ministerial foreword Guy Opperman pulls no punches, stating that we need to respond urgently to the risks of climate change, especially those affecting the financial sector and wider economy. He is proposing to embed in pensions law the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD) - and in a stark warning he “*makes no excuses for the work this entails*”.

### The Risks

There are two main risks identified in the DWP consultation:

- **Physical risks:** relate to the physical impact that climate change is already having and will continue to have in the event of global warming. These risks include a rise in sea levels leading to flooding of industrial sites and mass migration, as well as extreme weather events which threaten physical assets and disrupt supply chains; and
- **Transitional risks:** are the risks associated with action to tackle climate change. What regulations, behavioural changes, or structural readjustments will be needed as we align our economic system towards low carbon, climate resilient solutions?

### Why is this relevant to occupational pension schemes?

The consultation explains that climate change is going to impact the markets in which pension schemes invest, and trustees have a duty to act in the best interests of their members, as well as duties to act prudently, conscientiously and with good faith. Given the increased materiality of the risk of climate change, trustees will see an increasing need to take it into consideration. There is also the ‘prudent person’ principle - trustees must exercise their powers of investment with the care, skill and diligence that a “*prudent person would exercise when dealing with investments for someone else for whom they feel morally bound to provide*”.

## Which schemes will be caught by the new requirements and by when?

Initially larger schemes - those with £5 billion or more in assets (who arguably have the resources to be at the forefront of such change) and all authorised master trusts - will be in scope. These schemes will be required from October 2021 to have in place effective governance, strategy, risk management, and accompanying metrics and targets for the assessment and management of climate risks and opportunities. By the end of 2022, they will be required to report on these in line with the TCFD's recommendations. There will be a mandatory penalty for failure to publish a TCFD report.

Schemes with assets of £1 billion or more will fall into line the following year, so by 2023 more than 75% of assets and 80% of members in UK pension schemes will be subject to these new requirements. And as the view is that no pension scheme is too small to make a difference, there will be a review in 2024 on extending the requirements to all other schemes.

The powers to introduce these new requirements are included in the Pension Schemes Bill. The consultation closed on 7 October 2020 and a further consultation on the details of regulations is expected next year.

More information on the climate change consultation can be found here: [Taking action on climate risk: improving governance and reporting by occupational pension schemes - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes)



# On the horizon...

## DC Consolidation – DWP’s response to consultation

Draft Regulations would impose significant new requirements on “smaller” DC schemes – broadly those with less than £100 million in assets. Any such scheme that cannot demonstrate value for its members may struggle to justify continuing to operate.

In February 2019, the Government produced a consultation paper on ‘**Investment Innovation and Future Consolidation**’ for DC schemes. The DWP’s response has now been published, focussing mainly on DC scheme governance, diversification of investment portfolios and transparency of disclosures to members.

Whilst there is still some way to go before a change to the law, the DWP’s response shows that the Government remains principally concerned with the question of whether smaller DC schemes can deliver value for money and whether these schemes have the capability to invest in a broad range of longer-term assets. As part of the DWP’s response, Pensions Minister Guy Opperman stated that the Government wants all pension scheme members to benefit from ‘*economies of scale*’ and ‘*efficient administration*’, and for schemes to provide members with access to diversified investments, including green infrastructure and venture capital.

In more detail:

- If “smaller” DC schemes cannot demonstrate ‘value for members’, trustees should not continue to operate them; instead they should immediately wind the scheme up and consolidate into a larger scheme, such as a DC master trust. An exception to this is where the trustees are ‘realistically confident’ they can demonstrate rapid and cost-effective improvements – in which case the requirement to wind up would not apply.
- These smaller schemes will need to report on how their scheme presents ‘value for members’: taking into account costs, charges, investment returns and other measures of administration and governance (including quality of record keeping, level of trustee knowledge and the quality of communication with members).

- If trustees do not believe that their scheme provides good value for members, they must state - in the scheme return - whether they are planning to wind up the scheme and transfer its members into a consolidated scheme. If they are not considering this step, they must provide reasons for not doing so, and set out the improvements they propose to make to ensure that the scheme will provide good value for members.
- The schemes affected would be those which provide DC benefits, excluding benefits arising from Additional Voluntary Contributions. Of the 3,000 DC schemes operating within the UK, the Pensions Regulator states that 2,150 of them have fewer than 100 members – so a significant proportion of schemes are likely to be impacted by the proposed new requirements.

Additionally, the DWP’s response to the consultation proposes:

1. That affected schemes report (within the Chair’s Statement) on the investment return on both default and member-selected funds. The net asset value would be included within the scheme return;
2. Changes to the charge cap legislation in relation to performance fees and the costs of holding physical assets; and
3. Amendments to the Scheme Administration Regulations, in order to clarify that disclosure requirements relating to costs extend to funds that members are no longer able to opt into.

The proposal is for these new provisions to be in force from 5 October 2021. The consultation closed on 30 October 2020.

# Our thoughts on...

## Communicating with members during the pandemic

The second wave is unfortunately upon us - the Government's furlough scheme has been extended, but employers are planning for an uncertain future and individuals are struggling in the run-up to Christmas. It is as important as ever that the member communication process and the appropriateness of scheme messaging remains under close review and in the immediate consideration of trustees of DC schemes.

Back in April, several weeks after national lockdown had been announced and the country was slowly getting used to facemasks and family zoom calls, TPR issued guidance about what trustees and administrators should be considering when communicating to scheme members during the Covid-19 crisis. With further lockdowns now in place and continued uncertainty about the future, much of that regulatory guidance remains highly relevant to the pensions industry – and possibly even more so than during the first stages of the pandemic.

One of the most talked-about topics within the April guidance was TPR's concern about DB to DC transfers. TPR also commented more widely on issues relevant to those who are already members of DC arrangements, with a particular focus on the need to provide "*clear, relevant and timely information*" so members can make informed decisions about their pension savings in these extraordinary times.

### The need to keep in touch

TPR urges trustees to communicate about the steps taken to continue running their schemes, and to make different channels available for members to raise queries – a point reflected in the PASA Covid-19 Guidance of August this year. Where there are any changes, delays or a disruption to member services, trustees are encouraged to keep members informed – either through website updates, recorded messages and where appropriate, by post. In particular, schemes should communicate:

- Which types of member service are being impacted (if any), the effect on timescales for processing member requests, as well as the reasons for any issues, and the steps being taken to restore normal service levels.
- In the case of delays to annual publications and/or member communications such as annual benefit statements, an expected timescale for publication or issue.

As the trustee meeting season progresses (albeit largely virtually), trustees would be well advised to check they are comfortable that their communications processes remain up-to-date and correct, and that any delays to usual scheme services are being explained clearly and in a way which does not cause confusion or alarm.

### DC investments and market volatility

TPR notes that falls in the market and individual fund values may cause some members to switch their investments and crystallise current market losses. Where contact is made (e.g. when providing annual benefit statements or statutory money purchase illustrations), trustees are encouraged to highlight what current market volatility might mean to members retiring over different future time periods, in particular the need to think carefully and consider getting investment advice before switching funds in the current market (to avoid crystallising losses) – in the words of EIPOA "*to discourage potential short-term decisions that may jeopardise long-term member outcomes.*"

## Flagging the dangers of transferring out

Comments about transfers in the April guidance weren't confined to transfers out of DB schemes – TPR noted the danger of deciding to transfer away from quality DC schemes as a result of the financial pressures caused by the pandemic. The concern is that, in more usual times, members may not have made such a decision, or might have only decided to transfer at a later stage after giving more consideration to the risks of doing so.

Many of the protections referred to may already be embedded within scheme processes, but trustees should continue to keep the following transfer recommendations in mind:

- Providing appropriate warnings of the risks and implications.
- Encouraging members to take regulated independent financial advice to understand their options, and to ask questions of their financial adviser to identify any increased risks with how funds are accessed.
- Highlighting the free and impartial pensions guidance offered by Pension Wise.

Unfortunately, as the pandemic continues and personal finances become increasingly strained, members are likely to be increasingly vulnerable to scams. TPR has already emphasised the need for trustees to provide support for members who may be at risk, including:

- Always carrying out due diligence when a member asks to transfer their pension and using TPR's scheme transfer checklist.
- Following the Pension Scams Industry Group (PSIG) code of good practice, which provides the practical steps for carrying out due diligence and assessing transfer requests.
- Directing savers to the Pensions Advisory Service website for guidance on how Covid-19 may have affected their pensions.

Despite the warnings, Action Fraud has reported a significant increase in scamming over the lockdown period. So again, although many of these protections should already form part of a schemes' transfer processes, this may be a sensible time to check that all appropriate safeguards are in place in the communications which members are or should receive.

## Flagging the dangers of opting out

TPR anticipated that the pandemic might increase the number of members considering opting out of active scheme membership. That concern certainly seems to have been borne out by economic experience over the past few months. A recent study by Canada Life has noted that as many as one in ten workers have paused their pension contributions since the start of lockdown, with a further 13 per cent also considering suspending contributions. The analysis revealed that amongst those who have halted contributions, over a third had done so in order to use the money for essential spending, while a further thirty per cent paused contributions as a result of redundancy or furlough. The analysis notes the significant effect on the value of pension pots if contribution holidays are taken – without a significant catch-up after the holiday to make up for the contributions lost, which in today's economic climate may seem unlikely.

TPR is clear on the key points that trustees should be flagging where members request cessation of membership of a scheme, which include making members aware that:

- They will lose future employer contributions.
- They may lose any other benefits that scheme membership provides, including death in service and survivor benefits.
- The Pensions Advisory Service may be available for any guidance which may be appropriate.

Clearly, these are no less relevant today than in April.

Looking ahead, TPR has anticipated that as the pandemic is brought under control, trustees may want to contact members who have left the scheme and remind them of any rights they may have to opt-in or re-join the pension scheme – though at the time of writing, it seems that it may be some time before such a communication becomes appropriate.

# A quick guide to...

## Implementation Statements

Legislative changes in 2018 expanded the information which must be included in the trustees' Statement of Investment Principles (SIP) and introduced the concept of an annual implementation statement in which trustees must set out how and the extent to which their SIP has been followed during the scheme year.

The changes mean that trustees must now state in their SIP:

- How financially material considerations (including, but not limited to, Environmental, Social and Governance considerations including climate change), over the time horizon of the scheme, are taken into account in the selection, retention and realisation of investments;
- The extent (if at all) that non-financial matters (e.g. members' ethical views) are taken into account; and
- Engagement and voting policies – including details on monitoring and engaging with 'relevant persons' on 'relevant matters'. This includes engagement with managers employed by the trustees.

In addition, trustee annual reports must include an implementation statement which must also be published online (as outlined below).

### Which schemes are caught by the new requirements?

The requirement to produce a SIP and an implementation statement applies to pension schemes with 100 or more members. The detail and timing required for the implementation statement is different for DB and DC schemes, and we set out below only the requirements for schemes holding DC benefits (other than where the only DC benefits are AVCs). It is worth noting that if an occupational pension scheme has both DB and DC benefits, the DC requirements will apply to the whole scheme, even if they are run with segregated sections.

### Timing

An implementation statement must be included in annual reports produced from 1 October 2020 and must be made publicly available online as soon as the annual report has been produced.



## What are the requirements?

Schemes are required to produce annual statements, each one covering activity during a scheme year (i.e. for the same reporting period as the annual report). The implementation statement details how the trustees have carried out the principles contained in their SIP and this information must be included in the first annual report produced after 1 October 2020.

In summary, the new requirements say that trustees must include:

- A description of any review of the SIP (and any changes to the SIP). If the SIP wasn't reviewed in the relevant period, the trustees must confirm the date when it was last reviewed;
- Details of how and the extent to which, in the trustees' opinion, the SIP has been followed; and
- A description of the voting behaviour (including the most significant votes by or on behalf of the trustees and the use of any proxy voter).

In July 2019 TPR updated its guide to the investment governance document which accompanies DC Code of Practice 13. The updated guidance advises that the purpose of the implementation statement is to help ensure '*action follows intent*' where possible, and the process of considering the content of the statement will help focus trustees' minds on how well their investment policies and stewardship arrangements are delivering when compared to their agreed investment principles.

Importantly, the information requirements are such that trustees will need to document the behaviours that they need to include in the statement as they go along (e.g. how and the extent to which, in the trustees' opinion, the SIP has been followed), rather than producing a 'tick box' report at the end of the relevant period.

To that end, TPR's guidance suggests that the implementation statement might include details on the following:

- How trustees have developed their policies on voting and engagement, including the relevance of investment beliefs underpinning those policies and their investment time horizons.
- The time and resource dedicated to the process, including details of any relevant sub-committees and advice taken.
- How those policies have been implemented in practice.
- Public policy work undertaken.
- Lessons learned in engaging with specific assets on specific issues.
- The relative effectiveness of these actions in achieving their aims.

The statement must be published on a publicly available website (at no cost to the members) and trustees will need to inform their membership of its availability when they publish their annual statement.

## Penalties

Implementation statements are subject to discretionary civil penalties for non-compliance (not mandatory civil penalties, as with Chair's Statements). We hope that there will be further guidance provided to assist trustees with the preparation of these statements in due course.

## Help is on hand

In addition to TPR guidance noted above, the Pensions and Lifetime Savings Association (PLSA) has published guidance which provides a comprehensive summary of the new obligations and also includes a helpful flowchart of the requirements. The guidance can be assessed here: [PLSA-Implementation-Statement-guidance-for-trustees-July2020.pdf](#)



# Have you thought about...?

## DC Investment in Infrastructure: Unlocking Patient Capital

There has, for a while now, been a movement to encourage the investment of defined contribution funds in long-term, illiquid asset classes. But there have also been a number of regulatory barriers in the way.

Is all that about to change? Could the increasing prominence of “responsible investing” encourage developments to give trustees greater flexibility in this area?

### Why?

- **DC members:** Investment in long-term assets has the potential to generate higher investment returns over the longer-term – vital for members of DC schemes, particularly those further from retirement looking for a sustained period of growth for their pension pots.
- **UK economy:** It can generate financial support for infrastructure projects and high-growth companies.

### What’s the history?

- In November 2016, the Government announced that HM Treasury would lead a “Patient Capital Review”, to consider all aspects of the financial system affecting the provision of long-term finance.
- A “Pensions Investment Taskforce” was set up – made up of institutional investors, asset managers and regulators – to look at how to tackle existing barriers to defined contribution investment in illiquid asset classes.

### What are the barriers?

- **DC Charges Cap:** The charges cap means that DC trustees can be wary of the higher fees that are typically charged when investing in these long-term assets. And funds offering access to certain types of illiquid investment – such as venture capital and infrastructure – usually levy a performance-related fee, which is paid on top of the ordinary management fee.
- **FCA’s Permitted Links Regime:**
  - The FCA’s rules are designed to ensure that investments underlying unit-linked life policies are suitable for retail investors, by specifying the types of investment that they are permitted to invest in.
  - Crucially, they imposed a limit of 20% on the proportion of a unit-linked fund which could be invested in a Qualified Investor Scheme, or a “QIS” - a type of authorised investment fund that is often used to access illiquid assets.
  - As DC schemes typically invest in financial markets via unit-linked funds, this clearly presented a barrier to investment in illiquid assets.

## A quick recap

- **February 2019:** The DWP published a consultation on DC investment innovation and consolidation – which focused, in part, on ways to facilitate the patient capital agenda. It proposed that trustees of DC schemes above a certain size should have to include a statement in their Statement of Investment Principles, setting out the extent to which they had considered illiquid investments in the scheme’s investment strategy.
- **Mid-2019:** The Investment Association announced initial details of a “Long-Term Asset Fund”, which would help to widen access to illiquid assets. This new fund would be specifically structured to facilitate long-term investment – and its target market would be DC pension schemes, professional investors and private wealth/discretionary portfolio managers.
- **February 2020:** The FCA published a feedback statement, summarising the responses received to its 2018 Discussion Paper on Patient Capital and Authorised Funds, and setting out further detail about the Long-Term Asset Fund.
- **March 2020:** The FCA outlined their amendment of COBS 21.3 permitted links rules in a consultation response. The new rules seek to address any unjustified barriers to retail investors investing in a broader range of assets, including long-term investments.
- **September 2020:** The DWP published its consultation on “Improving outcomes for members of defined contribution pension schemes”, in which it has proposed amendments to the charges cap legislation in relation to performance fees, the cost of holding physical assets and other underlying investment costs.

## What does the future hold?

Earlier this year, Guy Opperman was emphatic that the industry should not be under any illusion that investment in infrastructure and illiquids is something the Government is passionate about – and this has been supported by a number of regulatory developments that have taken place over the last year.

What’s next?

In its September consultation, the DWP has indicated that it will review the scope and operation of the charges cap for Automatic Enrolment default funds, with a view to ensuring that trustees are able to invest in a wide range of asset classes, while also maintaining clear and transparent protection for savers.

So it’s worth keeping an eye out for what’s coming along in the pipeline.



And finally...

## DC Master Trusts: A focus on governance

Last month, the PMI's Master Trust Working Group launched their thought leadership report on "Governance as a driver of member outcomes".

The report explores what good governance means in the DC master trust context, helpfully highlighting the features of good governance you would expect to find – including diverse trustee boards, robust systems and processes, and a programme of continuous monitoring and assessment. The report also looks to demonstrate why it is important for participating employers to focus on governance when selecting the right master trust for their employees and former employees, the view being that members benefit from better outcomes – in terms of building up their pension and choice of access – which must be a good thing.

The report concludes with a helpful checklist for employers and third party evaluators when contemplating a move to a master trust. Asking the same questions of the trusts being considered will allow for useful comparison and assessment, and there are certain questions they should all be able to answer. If your scheme is currently assessing a possible move, or looking to evaluate existing service, it's well worth looking at the questions and issues highlighted.

A full copy of the report can be found here: <https://www.pensions-pmi.org.uk/knowledge/reports-and-guides/master-trust-working-group-governance-as-a-driver-of-member-outcomes>



### CMS Pensions LawCast

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