Independent Trustees

White paper

Five things that should scare the chair of a DC scheme

Defined contribution (DC) schemes have become an increasingly important part of UK pension provision. As this continues into the future, it is no surprise the Pensions Regulator has focused more and more closely on DC and the outcomes members achieve.

It is not an easy time to be the chair of a DC scheme. This paper looks at just few of the reasons why:

1. The increasing DC governance burden and potential fines for failure to comply
2. DC is not DB: members are relying on trustees
3. The increasing risk of complaints and litigation
4. Value for member
5. New pension flexibilities increasing cost and complexity

1. The increasing DC governance burden

DC schemes are sharply in focus. The burden of regulation on them, including the associated governance, is increasing.

Governance standards apply to all occupational pension schemes holding money purchase benefits incldúing AVCs unless there are no other DC benefits, and are overseen by the Pensions Regulator. One crucial new regulation is the requirement for the Chair of trustees (to be identified on the Scheme Return) to **sign off an annual statement** describing among other matters the default fund, the level of charges and transactions costs and how the trustees have met the knowledge and understanding requirements.

Contract-based workplace pension schemes do not escape the forensic focus - providers must establish an independent governance committee (IGC) or governance advisory arrangement (GAA), and employers are encouraged to engage in appropriate governance.

New regulations that apply an annual cap of 0.75% to default funds used by DC schemes may pose challenges for some schemes and **a full review of the existing investment options, design and charging structure is urgently needed** to ensure compliance.

Scary thought

Completing an annual governance statement is **not a simple task** and the process may highlight **considerable gaps in trustee knowledge** and cause issues with members.

A few points for a DC chair to consider:

- Can your adviser provide sufficient support and advice to ensure compliance? Not all can.
- Are you comfortable you (a) understand and (b) have the time to review your DC scheme(s)against the governance standards? An annual statement to members needs to be made by the DC Chair in April 2016 so **time is short**.
- When you have completed your review, do you have the knowledge and experience needed to **fully understand the outcome** and act on the findings?
- Is your scheme geared up to **deal with any issues or non-compliance** identified in your DC governance statement? Remember they may result in member queries or, at worst, dissatisfaction, which will need addressing appropriate.
- Failure to produce an annual Chair's statement attracts an **automatic penalty** of between £500 and £2,000.

2. DC is not DB: members are relying on trustees

The unfortunate reality is that, for many hybrid schemes, the chair of trustees is often more familiar with defined benefit (DB) schemes than DC arrangements. Despite being with us for decades, DC is still often regarded as 'a brave new world' or the poor relation. Historically, DC has been relegated to the end of the trustee meeting agenda. Too often time runs out and the DC scheme or section is **not given the consideration it deserves**.

This is perhaps an understandable mindset as DB schemes have been around far longer and many employers and trustees will still be dealing with closed or legacy DB arrangements with big deficits that involve scary numbers. That **doesn't help DC members one bit** though.

After all, unlike DB members, their benefits will be directly affected by the pot of money that sits in their scheme at the point they retire. Very few DC members have the knowledge or enthusiasm needed to properly manage their own pension pot – they are relying on the trustees to apply their experience and understanding to ensure their pension scheme is managed properly.

It is solely up to the trustee Chair to **ensure discussions regarding DC matters are given a higher priority**. Placing them further up the meeting agenda so they are considered at an earlier stage in the meeting when energy levels are higher is a good start. Ensuring your trustee board has the r**ight knowledge** and understanding to properly assess DC issues is vital. This may require regular trustee training and, for some, adding **independent expertise** to the board may prove invaluable.

Scary thought

Not making the time to properly consider the governance of your DC scheme **may be costly**. Finding the time to properly consider DC governance is not easy either, nor is finding the time to undertake the required amount of training.

Trustee Chairs must take the lead and show proper diligence towards the governance of their DC scheme. They must also **be unafraid to recognise when appropriate skills on the trustee board are lacking**.

3. The increasing risk of complaints and litigation

A major concern for the DC Chair is the scheme's **failure to deliver the anticipated 'good member outcome'** at the point of retirement. This concept is difficult to pin down as it is subjective and may mean different things to different members.

A study of over 2,000 DC members by Barclays (June 2014) suggested the 'perfect annual income during retirement' is £17,500 a year. Achieving this requires a pension fund of over £425,000 (based on a 24.5:1 annuity rate for a single life with 3% increases, as at November 2015).

A separate study by Prudential suggests average retirement income is in fact falling – from £18,663 a year in 2008 to £15,800 a year in 2014 (a decrease of 15%). So, **are members being over optimistic** about the performance of their fund or the amount of pension they expect to receive? **Or are DC trustees failing to provide value for money** or enable 'good member outcomes'?

The task of the DC Chair is to communicate to members the pitfalls of not making sufficient contributions (especially at an early stage) and failing to regularly review their contributions, fund choice and retirement aspirations. In short, they need to **manage member expectations with reality**.

Figuring out how to effectively communicate DC pensions can feel like searching for the Holy Grail. Add to it the fact that how contributions are invested is a key determinate of outcome, and the **double whammy** of communication and investment decisions are enough to give a committed trustee Chair sleepless nights.

DC investment has become more complex with time, as the industry tries to find new, clever ways to overcome the problem that is member inertia. DC Chairs now need to answer questions such as:

- **what will the design of the default fund be?**
- **what other choices are appropriate for the member dynamic?**
- **if annuitisation is no longer required, how should funds be invested if flexible access is needed?**
- **how are investment losses best avoided both before and after retirement in an often volatile investment world?**

In addition, there are seemingly more mundane issue such as whether the scheme administrator invests contributions promptly to ensure members are not exposed to out of market risk? We have seen a scheme where this was an ongoing issue. Fortunately for the administrator, markets worked in their favour and members ended up better off, but it could easily have been the other way around and we would have been looking at **a DC scheme with a deficit**!

The DC Chair will understand the unenviable task they face as a combination of a lack of engagement, financial awareness and competing priorities for members' money mean that even the clearest communication strategy may not be successful in **helping members to help themselves**.

Scary thought

There is a very real risk that complaints and/or litigation arises in the future from members who claim the outcomes they expected were not delivered and look to the trustees or the (former) employer to make good any shortfall.

In future, a DC Chair may be judged by the success or failure of keeping off the FCA's or TPR's radar and out of the courts. Already the Pensions Ombudsman is supporting complaints for DC maladministration and it **can be costly** to put a poorly treated member back into the position he or she should have been.

4. Value for members (formerly 'money')

A key responsibility of the DC Chair is to assess whether the scheme provides members with 'value for members'. The trouble is it can be difficult to know what this actually means. There is **no accepted definition** or mandatory guidance currently in place to direct the DC Chair, although some guidance has recently been issued by TPR and FCA and other organisations, such as Cass Business School, have added to the debate.

New ideas for the design of default strategies are emerging taking into account member dynamics and with the likely manner in which benefits will be taken predicted on pot size. When judging value for members, the net performance of investment strategies need to be reviewed to **ensure alignment with member** or policyholder **best interests**. The monitoring of core financial transactions and level of charges should also be considered.

Scary thought

Whilst the uncertainty about what exactly value for member is and how it should be measured and communicated to members remains, contract-based schemes need to act now.

The timescale for the DC Chair to produce a **governance statement** that meets FCA (for IGCs and GAAs) and The Pension Regulator (for trust based arrangements) requirements is short, as it **must be put in place in 2016**. Depending on the complexity of the workplace pension scheme, this could be a daunting task.

5. New pension flexibilities increasing cost and complexity

The new DC pension flexibilities introduced in the 2014 Budget have helped keep DC pensions in the headlines by providing greater freedom for members in how they use their pension savings. That's great, but what about the cost?

The DC Chair needs to assess whether the flexibilities over-ride, or need to be introduced into, the scheme rules. There is a **cost for revising the rules**. Will members actually take advantage of the flexibility once it is introduced? There are additional costs for **administration and** the **revision of systems** to cope with drawdown and the associated tax due.

Who should pay these costs? The employer/sponsor, or members?

The DC Chair also needs to be familiar with the **new disclosure** relating to the new flexibilities. Information that is not provided to the member or is provided outside of the required timescales will lead to concerns/complaints and additional costs.

Scary thought

The new disclosure regulations and flexibilities are complex. Complying with them and making decisions over how to best to respond to the new flexibilities are a challenge that needs a **tailored approach** scheme by scheme. Understanding the **membership dynamic** and their likely needs are key.

The DC Chair will need to be on top of this, **managing the trustees' advisers** to get best value and support from them and meet the demands of the Pension Regulator to avoid fines and/or scrutiny.

Eliminating the scare factor

To be effective, the chair of a DC scheme (or one with DC benefits) needs to:

- **structure meetings** to ensure the key issues are considered with due care and attention
- **support co-trustees** lacking the necessary knowledge and experience of factors affecting DC schemes, benefit and members
- **manage scheme advisers** to get the best out of them
- **bring an expert eye to** developing member communications
- **oversee the administrative function** and service standards, ensuring it is fit for purpose, correct member records are maintained, contributions are invested and vesting is dealt with in timely fashion
- **design the default fund** and fund choices specifically for the membership of your scheme
- **closely monitor investments** on an ongoing basis
- **analyse** the investment and other scheme **expenses**
- **decide what value for money means** to your scheme and how you will measure it
- **sign off a Chair person's annual report** to comply with the regulations

In short, nowadays, a DC Chair needs a formidable range of experience and expertise otherwise things could go wrong. Some may seek additional help from advisers. For others, the simplest solution is to **appoint a professional Chair** to your trustee board or workplace governance arrangement.

PSIT provides expert governance services and acts as DC Chair to a range of trust and contract-based arrangements. Contact us now to find out how we can help eliminate the scare factors involved in running a DC scheme.

What do you think? Share your thoughts with us, email mark.homer@psitl.com

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