



**Pensions  
Management  
Institute**

Learning



# Defined Contribution Arrangements Study Manual

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# FOREWORD

PMI was formed in 1976 to promote professionalism amongst those working in the field of pensions. Today, we are acknowledged as the institute for pensions professionals. We have developed study and examination facilities leading to a nationally recognised qualification – the Advanced Diploma in Retirement Provision. This embraces all aspects of law and practice relating to the management of workplace pension arrangements. The Advanced Diploma is a comprehensive and in-depth qualification for retirement benefit professionals. It is the qualification component for Associateship (APMI) of the Pensions Management Institute (PMI).

The structure of the Advanced Diploma was comprehensively revised for first examination in 2016. This revision was to ensure that the syllabuses were up to date and the qualification continues to meet the needs of users. The Advanced Diploma framework comprises five core units and seven specialist units. To complete the Advanced Diploma students will need to complete eight units as set out below.

The foundation of the qualification is formed of four core units. These compulsory units cover all aspects of retirement provision in the UK, including regulation, administration, financing and investment. There is an additional option covering international employee benefits. The core units are assessed by a two hour examination. The core units are then followed by specialist units. Students choose either, or both, of the Tier 1 specialist units - Defined Benefit Arrangements or Defined Contribution Arrangements as most appropriate for them. Depending whether both or just one of the Tier 1 specialist units are selected either one or two further specialist units can be selected from the Tier 2 specialist options including Reward, Retail Pensions or International Employee Benefits. These choices allow the students to select those areas that best fit their current work or future career aspirations. Finally the Professionalism and Governance Unit must be completed by all Students. All of the specialist units are assessed by 3 hour written examinations.

There are several Diploma level qualifications comprised of units from within the structure of the Advanced Diploma for those who do not want or need to complete the Advanced Diploma. These have also been revised as part of the changes to the Advanced Diploma.

The Diploma in Retirement Provision (DRP) includes all four UK focussed core units and either of the Tier 1 specialist units (Defined Benefit Arrangements or Defined Contribution Arrangements). The DRP would be completed by all those who proceed to complete the Advanced Diploma.

The Diploma in Employee Benefits and Retirement Savings (DEBRS) is ideal for those who need to understand pensions in the wider savings and employee benefits context, and consists of two of the core units and the Tier 2 specialist Reward unit.

The Diploma in Regulated Retirement Advice (DRRA) consists of two Tier 2 specialist units: Taxation, Retail Investment and Pensions; and Retail Advice and Regulation. It is an appropriate qualification for the FCA regulated activity “Advising on Packaged Products” which includes pensions and retirement planning and advising on pensions transfers.

The Diploma in International Employee Benefits (DiplEB) consists of the two internationally focussed units: the Foundation in International Employee Benefits core unit and the Tier 2 specialist unit - Managing International Employee Benefits. These units have been developed in partnership between PMI and the International Employee Benefits Association.

Those who wish to complete the Advanced Diploma can opt to take the units that comprise the DRP, DEBRS, DRRA and/or DiplEB on the way to becoming Associate Members of PMI. Alternatively, those who only wish to sit those Diplomas can become Diploma members of PMI on completion.

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There are many benefits to be gained from studying for, and attaining, these qualifications. These include the body of knowledge and understanding gained and its application to practical situations, a demonstrated commitment to learning and development, and enhanced status, confidence and opportunities for career progression.

Undertaking this rigorous professional qualification places demands on students and we are committed to supporting studies with quality learning provision. Under the banner “Shaping the pensions professionals of tomorrow” we are delighted to be working with some of the UK’s leading companies and firms within the pensions industry who have taken on the role of study support partners. In each unit the study material comprises a study manual and access to a web-based distance-learning course designed to prepare students for the examinations.

Professionalism and Governance seeks to provide an understanding of the importance of professionalism, ethics and continuing their own professional development and to provide an appreciation of risk and governance issues as they apply to pension schemes, and to enable candidates to demonstrate their ability to apply risk and governance principles in a practical situation and that they can communicate their knowledge in a way that is relevant to their audience. The 2021 version of the study manual reflects the Pensions Regulator’s focus on 21st Century Trusteeship and increased focus on environmental, social and governance issues together with updates and guidance from industry standard setting bodies in administration, accounting and governance.

Further details on the other units that comprise the Advanced Diploma and the work of the PMI can be found on the website. We hope you will enjoy studying for the Advanced Diploma. We welcome feedback and this should be directed to the Qualifications Department at PMI, e-mail: [qualifications@pensions-pmi.org.uk](mailto:qualifications@pensions-pmi.org.uk)



# PREFACE

This manual will provide you with an overview of the key features of Defined Contribution (DC) pension arrangements, their design and operation.

Part 1 focuses primarily on scheme and system design, examining the key decisions that need to be made when establishing a DC pension scheme. It considers the benefits and disadvantages of both trust and contract based schemes, and how scheme design should take a number of factors into account. The Part also discusses how technology has helped to improve administration practices and system requirements for successful administration.

Part 2 considers the processes involved in day-to-day and year-to-year management of workplace DC pension schemes, both on a scheme level and an individual member level. This Part of the manual is designed to help you get a handle on how DC schemes work in practice and how these are administered in order to ensure that contributions are processed efficiently and records are accurately maintained.

Part 3 looks at the benefits provided for members in DC schemes, and the legislative requirements for processing and paying benefits for early leavers, retirements and on death.

Part 4 considers the different governance requirements of running a DC pension scheme. This Part also covers the importance of risk management within DC scheme provision, the importance of effective member communication and education, and the importance of good investment governance, including the design of default funds, particularly crucial with the introduction of automatic enrolment and the charge cap.

Part 5 covers individual arrangements, and how the administration of these arrangements differs from 'normal' workplace DC schemes. It outlines the various types of DC pension schemes that fall under this category, including those used to provide specialist pension provision for executives and directors. It also contains material on personal pensions – a significant element of the DC market.

Finally, Part 6 contains a review of recent and forthcoming legislation affecting DC pension provision. In particular, students will be required to know about recent developments in the regulation of master trusts and the introduction of new data protection legislation. In addition, this Part covers the latest reforms tackling pension scams, plans for a Pensions Dashboard and a single financial guidance body.

While Parts 1 to 5 will give you a solid understanding of the current state of play regarding DC schemes, Part 6 is designed to give you some idea of where DC schemes are heading in the next few years.

DC pensions are becoming the norm for many people in the UK. This unit is therefore extremely relevant for all those working in the pensions industry and on completion the student will have a good understanding of the current structure of the DC pensions market in the UK and an appreciation of the principles of design, administration and financing for both trust and contract based schemes.

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# SYLLABUS

### **Aim:**

To provide an in depth understanding of trust and contract-based DC arrangements, building on and utilising the knowledge they have gained in the core units to show that they can apply this in a variety of scenarios and recognising the requirements of different stakeholders.

1. **demonstrate an understanding** of the factors which influence DC arrangement design and their influence on administration

**explain** the impact of the following:

- employee needs
- employer strategy including corporate activity
- legislation and legacy issues
- State provision
- administrative considerations
- eligibility conditions, contractual enrolment and automatic enrolment
- design of contribution structures including automatic enrolment phasing
- salary sacrifice and its application
- charging structures and costs

2. **understand** the different types of DC arrangements and current trends

**analyse** each of the following workplace arrangements:

- trust-based
- contract-based
- group
- employer-sponsored arrangements
- bundled and unbundled arrangements
- master trusts

**describe** the difference between a Lifetime ISA and other forms of DC pension saving

3. **evaluate** the importance of system design in the administration of DC arrangements

**analyse** the impact of the following:

- system requirements
- legislative requirements
- interfaces
- online access
- online enrolment
- Straight Through Processing

4. **demonstrate an understanding** of the regulatory bodies and their key functions and consider the financial aspects of DC administration

**explain** the functions of each of the following:

- Her Majesty's Revenue and Customs
- The Pensions Regulator
- Financial Conduct Authority/The Prudential Regulatory Authority

**explain** the requirements for each of the following:

- anti-money laundering
- bank accounts
- cash management
- scheme accounts and auditing
- risk benefits and rebroking

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5. **describe** the member level requirements for the administration of DC arrangements

**explain** the procedures involved in:

- contribution management
- contribution investment processing including:
  - payment of contributions
  - investment switches/redirections
  - purchase of units
  - unit reconciliation checks
  - disinvestments

**analyse** the impact of the following:

- tax relief on contributions
- Annual Allowance, Tapered Annual Allowance and Money Purchase Annual Allowance and Scheme Pays
- active and deferred member communications:
  - pension savings statements
  - benefit statements and Statutory Money Purchase Illustrations

6. **explain** the authorised pension benefits payable from DC arrangements

**describe** each of the following:

- options on early leaving:
  - refunds
  - deferred benefits
- transfer options
- death benefit options:
  - death in service
  - death in deferment
  - death in retirement
- retirement options:
  - different types of annuities, including enhanced and the open market option
  - lump sum options including full commutation
  - income drawdown (capped and flexible)
  - uncrystallised funds pension lump sum
  - at retirement advice
- timing of retirement
  - early retirement
  - phased/flexible retirement
  - ill-health retirement
- Pensions Advice Allowance
- bulk transfers, closing and winding up schemes
- disclosure requirements including retirement risk warnings

**analyse** the impact of the Lifetime Allowance:

- various protection regimes
- Benefit Crystallisation Events
- registration and deregistration

## Defined Contribution Arrangements

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7. **identify** the roles of the employer, trustees, providers and employer and provider governance committees and distinguish between stand-alone trust-based arrangements, contract-based pension arrangements and master trusts

**evaluate** each of the following:

- *governance structures/committees:*
  - *stand-alone trustee (e.g. DC sub-committee)*
  - *master trust trustee (e.g. participating employer committee, member forum)*
  - *employer*
  - *provider*

**describe** the master trust authorisation regime

**evaluate** the importance of:

- *legal requirements around governance*
- *best practice*
- *charges and value for money*
- *internal controls*
- *conflicts of interest*
- *record keeping and regular reconciliations*
- *the Chair's statement*
- *risk management including reviewing advisers, delivery vehicles and providers*
- *good member outcomes including member communication and engagement*

**describe** the role of the Pensions Regulator in supporting good governance in relation to:

- *guidance*
- *Code of Practice*
- *How to Guides*

8. **understand** the investment considerations for members of DC arrangements

**analyse** each of the following:

- *different types of investments and the risk attached to each:*
  - *default funds*
  - *target date funds*
  - *lifestyle options*
- *types of investment management and charging*
- *investment platforms*
- *lifestyle strategies*

9. **describe** what factors should be taken into account by employers, trustees and governance committees when determining investment strategy

**analyse** the impact of the following:

- *trustees' role in choosing investments*
- *default funds and their review*
- *pension charges and the charge cap*
- *transparency with disclosure of DC costs, transactions and charges*
- *monitoring performance*
- *Statement of Investment Principles*
- *Investment Governance Group Principles*

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10. **demonstrate an understanding** of individual arrangements and specialist pension provision for executives and directors

**describe** each of the following:

- *different arrangements for executives and directors*
  - *Executive Pension Plans*
  - *Small Self Administered Schemes*
  - *Employer Financed Retirement Benefit Schemes*
- *different types of individual pension arrangement*
  - *personal pension plans*
  - *stakeholder schemes*
  - *self-invested personal pensions*
  - *retirement annuity contracts*

11. **outline** forthcoming changes that will impact on DC pension provision

**explain** the impact of recent developments:

- *master trust developments*
- *Pensions Dashboard*
- *General Data Protection Regulation*
- *latest measures to tackle pension scams*
- *creation of a single financial guidance body*



# PART 1

# DEFINED CONTRIBUTION SCHEME AND SYSTEM DESIGN

## OVERVIEW

Good design is fundamental to the successful operation of any pension scheme – and any scheme design needs to be considered alongside the design of the administration systems that will be used to run the scheme. A complex scheme which employees do not understand, no matter how generous, will not be fully appreciated and there could be an adverse impact on the membership take up rate. This Part of the study manual introduces the student to defined contribution (DC) schemes and the environment in which they operate.

Chapter 1 of this Part considers the factors that influence DC scheme design. Chapter 2 looks at the important decisions that need to be made when establishing a scheme and also outlines the basic types of DC schemes that exist in the UK. Chapter 3 considers the implications of DC pension provision for administration systems.

After studying this Part, the student should have a good understanding of how DC schemes work and the various factors that affect their design, as well as the systems required to administer them successfully. The student should also understand the direction that DC pension provision is moving towards and the reasons for this.

This Part contains vital information for the student to understand before embarking on the more detailed administrative considerations in Part 2.

# CHAPTER 1

## Influences on Scheme Design

### INTRODUCTION

In a typical DC (also known as 'money purchase') arrangement, members and/or employers make contributions to individually allocated pension accounts, where these contributions accumulate along with investment returns. The resultant fund is used to provide retirement benefits for the individual in question (for example, part of it being paid as a tax free lump sum, and the rest of it being used to buy an annuity or some other form of income). This means that the cost of the benefits (i.e. the contribution rate) is defined in advance but the benefits are not guaranteed.

Whereas a defined benefit (DB) scheme provides a relatively predictable pension at a relatively unpredictable cost, a DC scheme provides a relatively unpredictable pension at a predictable cost.

For most DC schemes, cost and controlling costs are key design factors. The pragmatic designer, however, should always bear in mind that the relative value of a pension will always be established by the employee by comparing it to pre-retirement earnings. In addition, the cost of a retiring employee's lifestyle is likely to be closely linked to his or her earnings just before retirement. It is therefore logical to attempt to produce a retirement income which is comparable to the level of pre-retirement income.

The fact that DC schemes are commonly perceived as more conceptually straightforward than their DB counterparts does not negate the importance of scheme design. Indeed, whilst DC schemes are not usually plagued by the complex benefit structures and historical guarantees of many DB schemes, the need for members to understand contribution structures and investment options is arguably even more crucial.

The primary factors that influence the design of a DC scheme are:

- Employee needs
- Employer strategy
- Legislation
- State provision
- Administrative/Practical considerations

It is important for the student to understand that each of these factors is considered in detail to ensure the design of the pension scheme meets the employee and employer needs and is sustainable in the long term.

### 1.1 EMPLOYEE NEEDS

Since 1988, employers have been unable to make it a condition of employment that employees automatically join occupational pension schemes. However, the introduction of automatic enrolment has meant that many more employees have joined a workplace pension scheme (see Chapter 1.3.5).

Workplace pension schemes have to be attractive to employees so that they understand where their contributions are going when they are automatically enrolled, and to discourage them from opting out of the scheme. Automatic enrolment is there to encourage a greater level of retirement savings, rather than just relying on State provision.

## Defined Contribution Arrangements

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A workplace pension scheme, whether DB or DC, is a significant cost commitment from an employer and as such it is therefore sensible that it actually meets the needs of the employees. Furthermore, as a matter of social policy, it is vital that ways of encouraging employees to make appropriate pension provision are developed.

The needs of employees should be closely examined, so that they can be considered in the design process.

The most common employee needs are for:

- Financial security in retirement, taking into account that many employees have alternative financial commitments and start saving for pensions much later in life
- Protection of family and/or dependants in the event of death
- Security of the pension

These fundamental needs shape any pension and life assurance provision, whether DB or DC. In a DC scheme design, the following employee needs must also be taken into consideration:

- **Contribution Flexibility.** A scheme may offer tiered contribution rates with the possibility for members to contribute different amounts according to age and length of service (subject to the minimum requirements under automatic enrolment legislation).
- **Investment Flexibility.** There must be sufficient options to cover a range of attitudes to market risk, without confusing members by providing too many fund choices.
- **Portability.** There is now greater fluidity in employment markets and many employees may wish to take pension savings with them to other companies when they change jobs.
- **Employer Support.** Historically, smaller employers may have only provided their employees with a stakeholder pension scheme, where the employer had a choice on whether to contribute or not. This is not an option in order to comply with automatic enrolment duties but the level of employer support can vary.

A pension scheme can generally be designed so that it can accommodate the different needs of different types of employees by splitting it into sections, each with a different contribution structure. However, in some cases it may be necessary to have more than one scheme, for example, if the senior management of a company wish to be certain of the confidentiality of their own benefits.

### 1.2 EMPLOYER STRATEGY

Whilst employee needs have to be taken into account when designing a DC pension scheme, it is the sponsoring employer's strategy on pension provision which has driven the large scale shift from DB to DC in recent years.

The main employer needs that will be taken into consideration are:

- **Cost.** Undoubtedly the critical factor for employers is cost – indeed, many pension schemes are designed almost on this consideration alone.

The imposition of a prescriptive Accounting Standard to reflect the realistic cost of pension provision on the balance sheet, together with fluctuating investment markets, has prompted many employers to review the type of pension scheme that they provide and to move away from the traditional DB scheme (where the employer is responsible for any shortfall in assets versus liabilities), to DC arrangements where there is no additional unexpected cost.

The beauty of a DC scheme from an employer's perspective is that it makes the cost of pension provision much more predictable – and often employers pay less into their DC schemes than they would have paid into a DB scheme. Generally, DC schemes enable businesses to better control their pension expenditure, which can often reflect a large portion of their HR budget.

- **Remuneration Policy.** For example, where employers operate a flexible benefits programme, DC schemes are more of a natural fit, whereas in this scenario DB schemes are more difficult to integrate.
- **Staff Attraction and Retention.** Regardless of the fact that they are sometimes perceived as inferior to DB schemes, DC schemes are still a valuable benefit in the recruitment, motivation and retention of staff. A scheme that offers generous employer contributions and gives an appropriate range of investment choices can be a key factor in an attractive remuneration package. Linking contribution rates to length of service can also be useful in rewarding staff loyalty, although age discrimination legislation should be considered carefully.
- **Paternalistic Image.** Some employers may take a paternalistic attitude towards their employees and therefore design a pension scheme that reinforces this image via generous contribution rates and substantial death benefits. It is worth noting that paternalism is a key reason why a minority of employers continue to offer DB schemes to their employees, rather than establishing DC arrangements instead.
- **Workforce Patterns.** In employment sectors where there is high staff turnover, DB pension provision that is tied to length of service may be seen as inappropriate and inefficient to administer. A DC arrangement may therefore be the better option for employers in this situation. Similarly, where employees work variable hours, the pension scheme design should recognise fluctuating pay patterns.

A pragmatic designer will also recognise that whatever the typical profile of a company, it will always have employees who do not conform to the norm.

### 1.3 IMPACT OF LEGISLATION

Legislation influences scheme design in a variety of ways. Firstly, there is the obvious requirement for schemes to be compliant with relevant legislation. Some legislation, however, is optional rather than compulsory and schemes are free to decide whether to take advantage of the flexibility legislation offers. Moreover, certain pieces of legislation can impact on scheme design as employers try to ensure their pension provision remains competitive in a changing market.

#### 1.3.1 Stakeholder Pensions

Between October 2001 and October 2012 employers in the main had to designate a stakeholder pension scheme where they did not provide relevant alternative pension arrangements for employees. The removal of this requirement coincided with the introduction of the employer duties under automatic enrolment. However, stakeholder pensions as a product are still offered by insurance companies and some employers may find these a suitable vehicle for fulfilling their automatic enrolment requirements, or to offer to employees who are not eligible to be automatically enrolled.

#### 1.3.2 Tax Simplification

'Simplified' taxation rules introduced from 6 April 2006 ('A-Day') impacted significantly on scheme design. In essence, most people are now able to save more for retirement and receive more tax free cash lump sum – although those with large pension savings will be affected by the Lifetime Allowance, which sets an overall ceiling on the amount of tax privileged savings.

The changes which came in can be broadly summarised as follows:

- One single tax regime applying to all kinds of pensions.
- No limit on pension savings – only on the amount of tax relief that can be received.
- Previous limits on contributions and benefits were replaced by an Annual Allowance and Lifetime Allowance.
- Pension benefits on retirement and death are tested against the Lifetime Allowance where there is a Benefit Crystallisation Event (BCE)
- A charge of up to 55% will be applied to funds in excess of the Lifetime Allowance.

- The earliest age for retirement was increased from age 50 to age 55 (other than on the grounds of ill-health) with effect from 6 April 2010.
- Tax free cash sum available of up to 25% of the value of the retirement fund (or 25% of the available Lifetime Allowance if less).
- Transitional arrangements to protect benefits accrued prior to 6 April 2006 in line with the previous applicable tax regime, with the potential to avoid any recovery tax charge on retirement.

A number of the original changes at A-Day have been revised via amending legislation since 2006. Most notably, the Annual Allowance and Lifetime Allowance have been significantly reduced since 2006.

### 1.3.3 Taxation of Pension Savings

In order to qualify for tax concessions the scheme must comply with regulations laid down by HM Revenue & Customs (HMRC). Consequently, the design of most schemes is ultimately influenced by the Annual and Lifetime Allowances.

These allowances have been the subject of Government cost saving exercises in the past with both having been reduced.

The Lifetime Allowance restricts the tax relief that a member can receive on the benefits that they accrue over their lifetime in all registered pension schemes. This limit has changed a number of times since its introduction in 2006 and is set at £1,073,100 for 2021/22.

The Annual Allowance acts to restrict the tax relief that is available to a member over what is usually a 12 month period. This period is known as the Pension Input Period (PIP) and from 2016/17 onwards, this is aligned to a tax year. Prior to this the PIP may have covered a period based upon different dates. The standard Annual Allowance is £40,000 for 2021/22 but a member's allowance could be reduced if the member is subject to either the Money Purchase Annual Allowance or the Tapered Annual Allowance. Further details on the Annual Allowance and Money Purchase Annual Allowance are set out in Section 2.2.1 of Part 2.

Members of registered DC pension schemes qualify for tax relief on total contributions paid up to a maximum imposed by the Annual Allowance rules, and to an extent on the growth earned on the fund. Some employers have agreed to adapt their scheme design to re-direct pension contributions so that they do not exceed the Annual Allowance with the balance used to provide alternative employee benefits, usually as additional taxable pay.

Benefits paid out by registered pension schemes are subject to various conditions set out by HMRC, which if not met, would deem a payment to be unauthorised. Unauthorised payments can result in tax charges for both the recipient and the scheme.

It should be noted that the manner in which tax relief on contributions is processed usually differs between trust-based and contract-based pension schemes. Trust-based schemes tend to operate 'a net pay arrangement' which provides tax relief on member contributions up front via payroll. Contract-based pension arrangements more commonly use 'relief at source' which provides basic rate tax relief, with any higher rate tax relief being claimed directly by the member either through arranging a change to their personal tax code or through their self-assessment tax return. This can be quite a change for members to understand if moving from one type of arrangement to another.

### 1.3.4 Abolition of DC Contracting Out

The Social Security Act 1986 introduced contracting out money purchase (COMP) schemes. The first COMP schemes began contracting out in April 1988. The contracted out rights built up in a COMP scheme were known as Protected Rights.

Protected Rights, arising from contracted-out flat-rate and age-related rebates, were a source of complexity, resulting in high administrative costs for schemes and a lack of flexibility for members on retirement. For this reason, the Pensions Act 2007 introduced primary legislation to abolish contracting out on a DC basis for both occupational and personal pension schemes with effect from 6 April 2012 ('the abolition date'). This applied to all schemes, including DB schemes, which were contracted out on a DC basis (also known as a Protected Rights basis). Thereafter, members of contracted-out schemes accrued benefits in the State Second Pension (S2P) until it was abolished in April 2016 and replaced with the Single Tier State Pension.

The key features of a COMP scheme were that Protected Rights were ring-fenced from the rest of the member's funds by effectively creating a separate account. This was an individual account into which minimum payments were made and benefits paid out. The Protected Rights were paid in place of the Additional State Pension – S2P. Minimum payments consisted of the rebate, any 2% incentive paid between 1988 and 1993, and any age-related additions payable after 6 April 1997. Incentives and age-related additions were paid by the Government.

The abolition of contracting out on a DC basis:

- Reduced the administrative burden on schemes
- Reduced the costs borne by scheme members
- Allowed members greater choice in the investment of funds and in the provision of survivor benefits
- Made buying an annuity on the open market more viable
- Simplified the decumulation process (moving steadily into less risky funds as a member approaches retirement)

One consequence of abolition is that National Insurance rebates may have been taken into account by the employer when setting their contribution rate. When these rebates ceased in April 2012, employer and employee contributions may therefore have changed as a result.

A second Short Service Refund Lump Sum (SSRLS) can be paid for a member who left the scheme before 6 April 2012 who was paid a SSRLS at the time, but left Protected Rights in the scheme, provided the normal SSRLS conditions are met, the scheme rules allow such a payment and it represents member contributions, i.e. the employee part of the minimum payment and the age related rebate paid by HMRC. Any investment growth can be paid as a Scheme Administration Member Payment. The employer's part of the minimum payments should not be included in the SSRLS.

### 1.3.5 Automatic Enrolment

In the Pensions Act 2008, the Government legislated to require employers to automatically enrol their employees between the ages of 22 and State Pension Age into a 'qualifying scheme' and pay in a minimum level of contribution.

These requirements for employers started to be phased in from 1 October 2012, with the largest employers having complied first. The process was set out in monthly stages over a five and a half year period from October 2012 to February 2018.

Any employee entered into such an arrangement has the right to opt out, but they will be re-enrolled at a later date. This is because the employer must make arrangements for an automatic re-enrolment exercise broadly every three years.

## Defined Contribution Arrangements

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If an employer does not comply with their duties under the automatic enrolment regime then the Pensions Regulator (TPR) has the power to issue financial penalties.

If an employer provides a qualifying scheme for the purposes of automatic enrolment, then this will satisfy their statutory duty. A qualifying scheme can be an occupational pension scheme, a workplace personal pension scheme, or another suitable arrangement which will all be registered under the Finance Act 2004.

The quality requirements for a DC scheme under the automatic enrolment regime are set out below:

- An employer contribution of at least 3% of qualifying earnings, with the total amount paid by the employee and the employer being at least 8%. A transitional period, during which phased lower contributions are payable, applied until 6 April 2019.
- Qualifying Earnings are defined as earnings between £6,240 and £50,270 (for 2021/22). These figures are subject to review by the Secretary of State on an annual basis.
- In the case of a workplace personal pension scheme, there must be direct payment arrangements (and other agreements) for contributions between the employee, employer and pension provider.

The definition of Qualifying Earnings includes items other than just basic pay; e.g. overtime and bonuses. Where a scheme continues to calculate contributions on basic pay only, then this can lead to a shortfall.

The Department for Work & Pensions (DWP) has published guidance on certifying money purchase pension schemes. This explains how employers can use certification as a means of ensuring that DC schemes can qualify to be used for automatic enrolment.

DC certification allows a scheme to continue using basic pay, rather than using qualifying earnings, if they can certify that the scheme is on track to meet the quality requirements over the period of the certificate. For qualifying DC schemes, employers were able to control costs by phasing-in contributions over a prescribed period (see Chapter 2.2.1).

Employers are able to use a contractual agreement, rather than legislation, to enrol their workers into a pension scheme. This may be the case, for example, where an employer does not want to distinguish between eligible and non-eligible jobholders, and wishes to enrol all jobholders.

However, it must be remembered that membership of a pension scheme cannot be made compulsory (some right to cancel membership must be allowed for) and any agreement to exclude or limit the operation of the automatic enrolment and employer duties legislation is void.

Contractual enrolment does not set aside the automatic enrolment legislation; it only influences the operation of its requirements.

### 1.3.6 Money Purchase Definition

The definition of 'money purchase benefits' was tightened up with retrospective effect from January 1997 in response to the decision of the Supreme Court in *Houldsworth v Bridge Trustees Limited* ('the Bridge case'). In the Bridge case, the Supreme Court decided that the definition of a money purchase scheme at that time was wide enough to include schemes that could have a funding deficit.

The Government was very concerned about this because:

- it could put the UK in breach of the Insolvency and the Institutions for Occupational Retirement Provision (IORP) European Directives; and
- the protection regime in place for DB schemes would not apply to money purchase schemes with a funding deficit.



## Defined Contribution Arrangements

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The definition of money purchase, under section 29 of Pensions Act 2011, which came into force from July 2014, provides that a benefit is only money purchase where 'its rate or amount is calculated solely by reference to assets which must necessarily suffice'. In other words, the assets must always match the benefit. This money purchase definition is set out in two sets of regulations.

Schemes which may be affected include those:

- where the value of members' accounts is calculated by something other than a simple application of investment returns; for example, those with a guaranteed investment return or discretion about investment returns;
- where the members' benefits are subject to a minimum amount (underpin and top ups); or
- where scheme pensions (or dependants' pensions) are paid, instead of an annuity, in respect of a member's account. This could include money purchase Additional Voluntary Contributions (AVCs).

This is important because whether a scheme is money purchase or DB affects:

- how those benefits should be administered in future and the legal requirements that apply to those benefits both in relation to the calculation of any scheme funding deficits and the protection that would apply to such benefits on wind up; and
- the extent to which the new regulations will apply retrospectively to a pension scheme and require past actions and decisions to be revisited.

Although the definition had retrospective effect back to 1 January 1997, the regulations ensured that schemes did not normally need to revisit past actions and decisions.

The impact for affected schemes has been quite wide-ranging. For example, where money purchase benefits are treated as defined benefits, such benefits would not be protected on winding up meaning they could be reduced. In addition, actuarial valuations have to be undertaken, and these benefits have to be included in the scheme's Pension Protection Fund (PPF) valuations. Such benefits are also subject to revaluation and indexation rules which apply to defined benefits.

The legislation that sits behind these new rules is complex and trustees and employers should seek legal advice to understand whether, and how, their schemes will be impacted.

### **1.3.7 TUPE Regulations**

When the assets of a business are sold, most liabilities of the seller in respect of its employees pass under the Transfer of Undertakings (Protection and Employment) Regulations 2006 (TUPE) to the buyer.

The Transfer of Employment (Pension Protection) Regulations 2005 were amended with effect from 6 April 2014. Under these regulations, where individuals are transferred under TUPE and they have pension rights under an occupational pension scheme, the new employer has to offer membership of an occupational pension scheme or stakeholder pension scheme, and either match employee contributions up to 6% of basic pay or where the transferring employer paid into a money purchase or stakeholder scheme match the contributions paid by the transferor employer immediately prior to the transfer.

These contribution levels are applicable for where the transferee's scheme is a money purchase or stakeholder arrangement. Different rules apply for non-money purchase schemes.

### 1.3.8 DC Flexibilities and Transfers

From 6 April 2015, additional flexibilities for DC pension savings at retirement (referred to often as 'Freedom and Choice') were introduced via the Taxation of Pensions Act 2014. They apply to 'money purchase arrangements' as defined under the Finance Act 2004 and therefore apply to pure DC schemes or sections of schemes including DC AVCs and also cash balance schemes/sections.

As a result of the flexibilities, an individual taking benefits from a money purchase arrangement, subject to scheme rules, potentially gained the following additional retirement options once they reach an appropriate age (Normal Minimum Pension Age or earlier if this is protected or the member is retiring on ill-health):

- Designate some or all of their fund to Flexi-Access Drawdown in conjunction with paying a PCLS, which can then be used to provide withdrawals, buy an annuity (including a short term annuity payable by an insurance company for up to five years) or scheme pension. These income options are all taxable.
- Take an Uncrystallised Funds Pension Lump Sum (UFPLS). A PCLS is not payable but 25% of the amount can usually be paid tax-free with the remainder taxable as income.

These options were in addition to the existing options, which dependent on the scheme rules could have included buying a lifetime annuity or taking a scheme pension, in conjunction with a PCLS.

Flexible drawdown funds set up before 6 April 2015 automatically converted to Flexi-Access Drawdown on 6 April 2015. Capped drawdown funds already set up before 6 April 2015 can continue or can be converted to Flexi-Access Drawdown. No new capped arrangements could be set up after 6 April 2015.

The legislation introduced the money purchase annual allowance rules, which apply where pension rights have been flexibly accessed. An individual subject to the money purchase annual allowance rules has a reduced annual allowance for money purchase savings (£4,000 for 2021/22). This was introduced to ensure that there were no potential recycling issues. Recycling happens where individuals use their benefits to pay additional contributions into pension schemes to generate further tax relief.

The legislation relaxed some of the restrictions on lifetime annuities to create flexibility. An annuity can be set up with a guarantee period of any length, without the member needing to have an open market option and it is possible for it to decrease in payment. Annuities that can decrease in payment are known as 'flexible annuities' and trigger the money purchase annual allowance rules.

Since 6 April 2015, it has no longer been possible to take a Trivial Commutation Lump Sum from a money purchase arrangement but it is still possible to pay a Small Lump Sum Payment where the value of the benefits under the scheme is less than £10,000.

The legislation also introduced 'Pension Wise', the name for the impartial pensions guidance service, which is available from age 50 for members with money purchase pension savings. Pension Wise is now part of the Money and Pensions Service (MaPS).

Alongside the changes to the taxation rules, there were complementary amendments to the transfer rules. The Pension Schemes Act 2015 amended the statutory right to transfer so that it applies to specific categories of benefits (including money purchase as a specific category), rather than all benefits in a scheme. These changes are overriding on scheme rules.

This effectively gives members a statutory right to a partial transfer of benefits provided all benefits in a category are transferred. The Government introduced this in order for individuals with money purchase and non-money purchase benefits to be able to transfer the former away to access the new flexibilities whilst keeping the latter in the scheme if a scheme chooses not to offer all of the flexibilities.

An advice safeguard was introduced for transfer values in excess of £30,000 which requires the transferring trustees to check that the member has received appropriate independent advice. The test is to establish whether or not the member has received appropriate advice rather than whether or not they have followed the advice. This safeguard does not apply to pure money purchase benefits, i.e. where there is no guarantee attached to the benefits.

These flexibilities have undoubtedly impacted scheme design.

### 1.4 STATE PENSIONS

It is logical that scheme design should consider and recognise the level of State pension provision that a member can expect to receive at retirement. To enable members to target an amount of retirement income, some schemes used to provide a Combined Pension Statement (CPS) which included details of the member's State pension along with their scheme benefits. However, the DWP's CPS service ceased at the end of the 2015/2016 tax year. It is hoped that in future information about an individual's State pension entitlement will be available on the Pensions Dashboard. For further information see Section 1.2 of Part 6.

The Pensions Act 2014 introduced a new Single Tier State Pension from April 2016, with a flat-rate payment set just above the current level of means-tested support. This replaced the previous two-tier system of the basic and additional State pension. All schemes ceased to contract out at the same time which could have prompted a review of scheme structures to keep them relevant to the current State benefit provision.

#### 1.4.1 Single Tier State Pension

Key features of the State pension:

- The Single Tier State Pension is available for those reaching State Pension Age (SPA) after 6 April 2016. Those reaching SPA before 6 April 2016 were eligible for the previous two-tier State pension.
- To receive the full weekly rate, an individual needs 35 qualifying years of National Insurance contributions or credits (NICs); those with fewer receive a proportionally reduced amount. This was an increase from the 30 qualifying years which applied to the two-tier system.
- A minimum number of qualifying years is required to gain an entitlement to the Single Tier State Pension, which will usually be 10 years.
- The Single Tier State pension is increased annually by at least the increase in the general level of earnings.
- NICs made by the self-employed count towards the Single Tier State Pension in the same way as those paid by employees.
- It is not possible under the Single Tier State Pension to derive or inherit a pension from a spouse or civil partner (although transitional arrangements apply to entitlement built up under the two-tier system).
- It is still possible to defer claiming the State pension in return for a higher weekly amount; however, there is no longer the option for individuals to receive a lump sum deferred payment instead.

Transitional arrangements exist and these are designed to protect entitlements built up under the two-tier system.

The State pension can be an important, and in some cases substantial, component of an individual's retirement income and those individuals close to State Pension Age (SPA) will be keen to understand the impacts for them personally. The level of the State pension also is a key consideration in scheme design so employers sponsoring workplace pension schemes will need to consider whether the changes to the State pension require any scheme modifications; for example, contribution levels.

### 1.4.2 Changes to State Pension Age (SPA)

The Pensions Act 2014 also brings forward the increase to SPA for men and women from 66 to 67 eight years earlier than it was originally timetabled. The increase will be phased-in between 2026 and 2028. The Act also provides for periodic reviews of SPA and for these reviews to be informed by reports in relation to life expectancy.

Also, the Pensions Act 2014 requires the Secretary of State to review whether the rules around the SPA are appropriate, given life expectancy and other relevant factors, and to prepare and publish a report at least every six years on the outcome of the review. The first report was published in July 2017 and the next is due in 2023. The Government has confirmed its intention to increase SPA from age 67 to 68 between 2037 and 2039 but has not yet brought forward legislation to enact this change.

For many, the State pension represents a substantial proportion of an individual's pension income, so the forthcoming changes may impact when individuals can afford to stop working and take benefits from workplace pension schemes. It may also cause some schemes to consider re-design where the scheme's normal retirement age is lower than SPA.

### 1.5 ADMINISTRATIVE/PRACTICAL CONSIDERATIONS

A scheme should meet employee and employer needs, and take account of legislation and State benefits, but it also needs to be practical. A scheme will be of no real value if it cannot be efficiently and accurately administered.

Good scheme design if intended to work in-house, will always recognise the capability of the employer's HR, finance, payroll functions, computer systems, and the calibre of staff resources attached to pensions and benefits. The employer payroll, whether in respect of an in-house arrangement or where administration is provided by a third party, plays a particularly important part in a DC scheme. If the payroll system is inadequate and delays in receiving contributions into the arrangement occur, it will be the member who will suffer financially from the impact.

A well designed scheme will optimise efficiencies by allowing streamlining of procedures and processes between the relevant employer and the administrators.

From considering the factors that influence scheme design, Chapter 2 will discuss three of the main areas in which design decisions need to be taken – eligibility, contributions and retirement – before looking at the various types of DC arrangement available in the UK. Investment decisions are another major component of scheme design; however, these are covered in more detail in Part 4.

### Summary

DC schemes are conceptually straightforward, but good design – taking account of employee and employer needs, legislation, State provision and administrative practicality – is still very important.

Schemes need to be attractive to employees and offer them the benefits they are looking for. Employers on the other hand need to reconcile the needs of their employees with their own needs, which primarily centre on controlling costs.

Legislation also has a large impact on scheme design as employers try to ensure their pension provision remains both compliant and competitive in a changing market.

### Self Test Questions

- Outline the main features that influence scheme design.
- What might be an employee's main needs from a workplace pension scheme?
- Identify the employer's objectives in operating a pension scheme.
- What are the two main processes for receiving tax relief on pension contributions?
- Outline the definition of money purchase and the impact that it has had for those schemes that fall outside of it.
- List the key features of the Single Tier State Pension.

# CHAPTER 2

## Scheme Design Considerations

### INTRODUCTION

There are a number of important decisions that need to be made when establishing a DC pension arrangement. Although certain decisions made at this point can be amended at a later date, a number of the decisions are fundamental to the nature of the arrangement. As such, scheme design decisions can influence whether the pension scheme is successful in attracting and retaining members.

After reading this chapter, the student should be able to demonstrate an understanding of the various decisions that need to be made by employers when establishing a DC pension arrangement. This includes deciding whether to opt for a trust-based or contract-based pension scheme and the level of contributions that will be payable to the scheme. It is important that anyone involved with DC pension schemes has a sound knowledge of the design considerations covered in this chapter.

### 2.1 ELIGIBILITY

When setting up a DC scheme, it is important for an employer to consider whether the scheme will be available to all employees, or whether certain eligibility conditions will be imposed. In particular, an employer must consider whether they will provide one single qualifying scheme for the purposes of automatic enrolment, or whether they will provide different schemes with eligibility criteria.

Possible eligibility conditions include:

- **Minimum age requirement** – for example, only employees over 18 can join. Setting a minimum and a maximum age for admission to a scheme is one of the many exemptions in the age discrimination legislation.
- **Minimum service requirement** – for example, employees may be eligible only after completing a probationary period of six months' service.
- **Scheme only open to certain sections of the workforce** – for example executives.

Additionally, a DC scheme may be set up specifically to cater for employees who were formerly in a company's DB arrangement, which subsequently closed. Such a scheme might then only be open to employees who were formerly part of the DB scheme.

#### *Automatic Enrolment*

In order to comply with their automatic enrolment duties, employers must arrange for eligible employees to become active members of a qualifying scheme. These employees are known as 'jobholders'. Once a jobholder is an active member of a qualifying scheme, the employer must not do, or omit to do, anything that stops them being an active member or for the scheme to cease being a qualifying scheme.

Employers can use a postponement period of up to 3 months to postpone the automatic enrolment of a jobholder.

## Defined Contribution Arrangements

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The term jobholder can be split into two groups:

### *Eligible Jobholders*

These are workers that are eligible for automatic enrolment as a result of being between age 22 and State Pension Age, working ordinarily in the UK with qualifying earnings during a pay reference period that exceed the earnings trigger.

### *Non-Eligible Jobholders*

These are workers who do not meet the conditions for an Eligible Jobholder either because they do not meet the age conditions (so they are between age 16 and 22 or between State Pension Age and 75) or where they have met the age conditions (so are between age 22 and State Pension Age) but they have Earnings above the Qualifying Earnings lower threshold but below or exactly equal to the Earnings Trigger. Qualifying Earnings are defined as earnings between £6,240 and £50,270 (for 2021/22). These figures are subject to review by the Secretary of State on an annual basis.

The Secretary of State ultimately determines the Earnings Trigger and for 2021/22 this was again frozen at £10,000. Previously, the trigger was aligned with the personal tax allowance but this link has now been broken. This means that workers earning below £12,570 (the personal tax allowance for 2021/22) who are automatically enrolled into a pension scheme using the Net Pay system won't be able to fully benefit from tax relief on their pension savings.

### *Contractual Enrolment*

Some employers use contractual enrolment, as described in Section 1.3.5, as an alternative to automatic enrolment.

## 2.2 CONTRIBUTIONS

In a DB arrangement, the contribution rates will largely be determined by the current and future liabilities of the scheme, as assessed by the scheme actuary. The level of contributions an employer can afford and the level necessary to secure the benefits promised under the scheme will also be taken into account.

In a DC arrangement, however, the contribution structures are a key part of the scheme design. Whilst a well-run scheme will keep its contribution structures under review, they will not generally vary as frequently as there are no defined benefits (as in a DB scheme) that need to be paid for.

Most DC schemes require contributions from the members and the employer. The introduction of automatic enrolment has introduced a minimum level of contribution for employers.

It is, however, worth bearing in mind that, whilst investment returns play a major part in determining eventual benefits, low contributions will tend to produce lower benefits, although the member's benefits will obviously also bear the impact of good or poor investment performance and the negative effect of member-borne charges.

Where a scheme is a qualifying DC scheme or automatic enrolment scheme, contribution rates are impacted by the minimum contribution requirements.



### 2.2.1 Employer Contributions

Employer contributions will partly be determined by the amount the employer is prepared to spend on pensions and employee benefits in accordance with its business plan. Budgetary restraints therefore need to be considered when putting forward proposals for a DC scheme, as employers do not have unlimited funds available for pension provision.

In the most simple scenarios, the employer contributes at a fixed percentage of the member's salary, which may or may not be the same as that contributed by the member.

Where employer contributions are equivalent to member contributions, this is called a matching contribution. Matching contributions are common where there are tiered contribution structures – for example, if the member contributes 4% of salary, the employer will also contribute 4%, but if the member contributes 6%, the employer's contribution will also rise to 6%. Some schemes may only offer a matching element up to a certain ceiling, for example 5% of salary.

#### *Automatic enrolment phasing*

Where the scheme is an automatic enrolment scheme or qualifying scheme, a minimum level of contribution will be required and employers need to consider this when deciding how to structure their DC scheme and its contribution rates.

Employers were able to control costs by phasing-in contributions over a prescribed period:

- From the employer's staging date to 5 April 2018 - an employer contribution of at least 1% of qualifying earnings, with a total amount paid by the employee and the employer of at least 2%.
- From 6 April 2018 to 5 April 2019 - an employer contribution of at least 2% of qualifying earnings, with a total amount paid by the employee and the employer of at least 5%.
- From 6 April 2019 onwards - an employer contribution of at least 3% of qualifying earnings, with a total amount paid by the employee and the employer of at least 8%.

The above rates are those required where a scheme uses qualifying earnings. Schemes are able to instead use three alternative definitions of earnings and self-certify these to the Pensions Regulator. For schemes that are not using qualifying earnings, different rates of contributions apply during the phasing period.

In the original legislation, the above phasing dates were set to end on 1 October prior to the current dates. The change to the phasing periods did create issues for some schemes. Depending on how the contributions were documented in governing documentation, it could have required member consultation as a listed change to effectively change the phasing date.

### 2.2.2 Member Contributions

It is rare for DC schemes not to require some sort of contribution from members. Rates will vary from scheme to scheme.

Member contribution rates can be impacted by automatic enrolment which requires a total overall minimum contribution with a minimum amount which must be paid by the employer. Unless the employer pays an amount equal to or more than the total overall minimum contribution, then member contributions would be needed to meet this requirement.

Some schemes offer a tiered structure giving members the option to contribute at different rates – thereby catering for a range of attitudes towards pension saving.

A tiered contribution structure may also be used to vary rates paid by the employee based on factors including age or length of service. This will again be subject to relevant exemptions in the age discrimination legislation.

Some schemes now give members total freedom to contribute at their chosen percentage of salary, either as part of their normal contributions to the scheme or as part of an AVC arrangement. Subject to the scheme rules and providing they are easily identifiable, AVCs can be invested within the member's main DC fund, although they do not need to follow the same investment strategy. Alternatively, a scheme may make available separate arrangements for AVC investment; i.e. with an insurance company.

Contributions can be targeted to meet the needs of groups of employees who have differing requirements from their workplace pension arrangements. This can also enhance the perception of the value of belonging to the scheme.

DC schemes can be designed to target a fund aiming to secure a pension of a specified level at retirement, though they cannot guarantee this. Many employee benefit consultants or pension providers offer online retirement planning systems to support this feature.

### **2.2.3 Salary Sacrifice**

One recent trend amongst DC schemes has been the introduction of salary sacrifice arrangements, by which employees do not actually contribute directly to the pension scheme. Instead, they agree to forego a percentage of their salary (normally equivalent to the scheme's contribution rate) and the employer pays this money to the scheme as part of the employer contribution.

The main advantage is that this delivers cost savings for both members and employers. Employee pension contributions, which are subject to National Insurance (NI), become employer pension contributions, which are not subject to NI. Salary sacrifice therefore offers a low cost way of increasing the efficiency of pension contributions – essentially a member can make the same contribution to his or her pension but with a smaller reduction in take home pay.

### **2.2.4 Other Costs**

The cost of the pension scheme is not just the contribution towards pension benefits. Death benefits may have to be paid for, as well as administration, investment, documentation, audit fees, communication and other costs. Appropriate scheme design should keep these costs in perspective within the overall budget constraints and the objectives set by the sponsoring employer. This will be a key factor in considering whether a trust-based or contract-based arrangement is most appropriate for the employer.

Death benefits are nearly always insured, with the employer paying the cost, because the assets held by each member are unlikely to provide substantial death-in-service benefits – particularly in the early years of membership.

Some schemes may require the member to pay some of these costs – for instance, the annual fund management charges from the investment managers. These are called member-borne charges.

The charging structure of DC schemes can vary between trust and contract-based schemes. Following the implementation of the Retail Distribution Review (RDR) recommendations and the commencement of the automatic enrolment duties, the Government has been keen to ensure that members are achieving 'good outcomes' from DC schemes. A significant factor is the level of charges in an automatic enrolment scheme and the Government has banned consultancy charges being deducted from members' funds for DC automatic enrolment schemes, affecting all contracts taken out after 10 May 2013.

From 6 April 2015, the member-borne charges for DC qualifying schemes are capped. This cap is based on a limit of 0.75% p.a. of funds under management. An important principle is that the cap only applies where members have made no active choice. This means that the cap only covers 'default arrangements' into which members have been put into by 'default'. The ban on consultancy charges to all qualifying personal pension schemes also applies from April 2015. From 6 April 2016, active member discounts are also banned in qualifying schemes. Adviser commission is also banned but only in respect of arrangements entered into or amended on or after 6 April 2016. For further information see Section 2.3 of Part 4.

### 2.3 RETIREMENT PROCESS

In a DC arrangement, the pension benefits members receive in retirement will largely depend on the terms of the annuity or drawdown product they purchase with their DC fund. However, there are still design decisions to be taken in respect of the scheme's normal retirement age, retirement flexibility, and lifestyling – a process by which a member's fund is automatically switched from higher-risk, higher-return asset classes into lower-risk, lower-return asset classes in the years immediately prior to retirement. The scheme designer should also bear in mind that annuity rates offered by insurance companies will vary with changes to the yields on fixed interest securities, and will also reflect allowances made for mortality. When planning the retirement element of the scheme, the need to accommodate this should be taken into consideration.

As well as specific decisions regarding eligibility, contributions and retirement, the scheme designer will also want to make the more fundamental choice of what type of DC scheme will be offered.

The introduction from 6 April 2015 of additional flexibility in the way benefits can be taken from a DC scheme has already started to have a huge impact on scheme design as it is no longer the case that the purchase of an annuity is the default choice for members.

### 2.4 TYPES OF SCHEME

There are several different types of DC schemes in operation in the UK, including both occupational pension schemes and personal pension schemes. They can be broken down according to the following categories:

- Trust-based and contract-based schemes
- Individual and group arrangements
- Individual sponsored and employer sponsored schemes
- Insured and self-administered schemes
- Master-trusts

The March 2016 Budget also introduced "a brand new flexible saving opportunity for the next generation", called the Lifetime ISA or 'LISA', which was made available from 6 April 2017. It allows an individual to save in one place for both a home and for retirement.

There are also schemes that utilise features from both DB and DC schemes. These can take the following forms:

- A transfer into a DB scheme may secure DC benefits in order to minimise the risk on the fund when compared to a promise of increased DB benefits
- AVCs to a DB scheme may be funded on a DC basis, for the same reason as above
- Hybrid schemes which contain DC and DB elements and underpins
- Schemes where employees can choose between DB and DC sections
- Schemes which have DC for future benefits and DB for past service
- DB schemes which have been changed to provide DC only for new joiners

### 2.5 TRUST-BASED AND CONTRACT-BASED SCHEMES

With the introduction of personal pensions in 1988 and stakeholder pensions in 2001, some employers reviewed whether a trust-based arrangement was most suitable for their needs and those of their employees.

Trust-based occupational schemes have traditionally been favoured by employers, partly because the concepts of trusts and trustees were familiar ones and allowed the scheme to be tailored to their requirements.

However, with the requirements for Trustee Knowledge and Understanding under the Pensions Act 2004, the costs of running trust-based schemes – legal costs, governance costs, trustees' liability insurance, auditors' fees, tailored communications, etc. – and automatic enrolment duties, more and more employers set up contract-based schemes such as Group Personal Pensions (GPPs) or Group Stakeholder Pensions (GSPs) in preference to the traditional trust-based occupational schemes.

These factors have coincided with a dramatic reduction in the charges by the providers running these schemes, brought about initially by the introduction of the 1% stakeholder annual management charge cap in 2001. The stakeholder charging rates have led GPPs to reduce charges as well, in order to compete in the corporate market. As described in Section 2.2.4, the Government also introduced a charge cap of 0.75% for default arrangements in all qualifying schemes from April 2015..

Many GPP and stakeholder providers now also offer a full service option which includes a tailored communication service and a wide range of investments from which individuals can choose.

In a GPP or GSP, the member joins the provider's registered pension scheme and is treated as an individual customer, receiving all the material specified by the Financial Conduct Authority (FCA), including the right to cancel. When the member has signed up there is an individual contract arrangement between the provider and individual, and the member receives his or her own terms and conditions of membership. The employer's legal responsibility is to deduct contributions through payroll and ensure that these are paid across in accordance with regulatory requirements.

For some employers this approach may be very attractive. It reduces the costs of pension provision, as there is no need to establish and operate a trustee body, and fits well with the DC emphasis on member responsibility.

Recently, however, concerns have been expressed about the lack of a governance framework in the contract-based market. It seems that some employers still prefer the security offered by trust-based schemes – and this has led to the development of Master Trust schemes, which operate a centralised trustee body at the heart of a scheme in which any number of non-associated employers can participate. This arrangement provides the governance structure of a trust-based scheme, but also delivers the cost savings and administrative efficiencies of a contract-based product - see Section 2.9 for further information.

### 2.6 INDIVIDUAL AND GROUP ARRANGEMENTS

#### 2.6.1 Individual

This term usually refers to a pension arrangement that is effected either by, or on behalf of, one person or member.

Examples of individual pension arrangements can be found both in the occupational pension scheme and personal pension/stakeholder spheres. For example, an Executive Pension Plan (EPP) is a one person occupational pension scheme and a personal pension arrangement is, unsurprisingly, a one person personal pension.

#### 2.6.2 Group

The word 'group' is used within pensions to describe an arrangement, which is established for the benefit of more than one individual.

The word is most commonly applied to an arrangement offered by a pension provider; for example a GPP, GSP or, in the context of life assurance provision for members of a pension scheme, a Group Life Assurance Scheme (GLAS).

The word group may also imply the application of the concept of economies of scale to the arrangement in question. The participation of several individuals within one arrangement facilitates both a more cost effective charging structure and usually less onerous underwriting requirements.

It should be noted that GPPs and GSPs have no legal standing, as these are just marketing terms to describe a number of individual contracts grouped together for convenience.

### 2.7 INDIVIDUAL AND EMPLOYER SPONSORED SCHEMES

#### 2.7.1 Individual

Another aspect of a true individual pension arrangement is that it is established by, and for the benefit of, the individual in question, who also retains overall responsibility for the payment of all costs and charges relating to that particular arrangement.

For example, depending upon when it was first effected, it may have a charging structure comprised of a monthly policy fee and/or an annual management charge. These fees and charges will typically be deducted out of the pension fund that is accumulating within the arrangement.

#### 2.7.2 Employer Sponsored

Employer sponsored pension arrangements refer to those arrangements that are effected by and financially supported by the employer of individuals who constitute either their current and/or previous employees.

Occupational pension schemes require both the existence of a sponsoring employer, to whom the scheme relates, and also an anticipated level of employer contributions.

An Executive Pension Plan (EPP) represents an example of an employer sponsored individual pension arrangement. Here, it is common for the employer to also be the individual member; for example the controlling director of a private limited company. Further information regarding EPPs can be found in Part 5.

Employer Financed Retirement Benefit Schemes (EFRBS), which are unregistered arrangements, are another example of employer sponsored arrangements. Further information on EFRBS can be found in Part 5.

### 2.8 BUNDLED AND UNBUNDLED ARRANGEMENTS

#### 2.8.1 Bundled Arrangements

A bundled arrangement is one where the services provided to a pension scheme, such as administration, investment advice and scheme communications are all provided by a single company, chosen by the trustees of the occupational scheme, or the employer in respect of GPPs or GSPs. For a combined fee, the provider will provide all of the scheme requirements, so it is an attractive prospect for employers who are looking to control costs.

The arrangement would be established to accept employer and/or employee contributions, either on a regular or single premium basis. Those contributions would then be invested into one or more of the funds offered under the arrangement by the provider. Such funds can either be those administered and managed by the provider itself or, increasingly these days, external links may be offered, allowing contributions to be invested into funds that are managed by other investment managers. The advantage here is that if one investment manager performs poorly then there is access to other investment managers without having to change arrangements, which can be costly and time consuming.

#### 2.8.2 Unbundled Arrangements

When occupational pension schemes are unbundled, this means that the management of the scheme is run by the trustees, who may choose to outsource some or all of their duties to different providers.

Unbundled arrangements tend to be those occupational pension schemes that are of a size to warrant more control by the trustees over the strategies and methods by which assets are invested. The scheme trustees are able to monitor investment performance on an ongoing basis, and make changes to their investment manager appointments depending on performance and investment strategy.

The advantage of such arrangements is that the trustees get to exercise greater control over their choice of providers; however trustees should ensure that they have sufficient governance procedures in place to ensure that decisions are made which will result in the best outcome for scheme members, while receiving good value for money.

### 2.9 MASTER TRUSTS

A master trust is a multi-employer occupational pension scheme where each employer has its own, effectively ring-fenced, section within the master arrangement. Within the arrangement, there is one trustee board. As such, it provides a trust-based scheme for employers who do not want the kind of onerous governance requirements which would arise from having their own scheme under trust. The balance of powers between the trustee, employers and service providers of the master trust are set out in its documentation.

The trustees of the master trust retain control of the choice of providers and investments, while the participating employers typically get to choose the contribution rates. Master trusts are relatively cost effective with lower charges and offer greater simplicity and expediency.

Interest in master trusts has increased as a result of automatic enrolment, as employers are looking for a low cost solution in combination with a strong governance framework. This last point was the subject of scrutiny by the Government and their conclusion was that governance of master trusts required tightening up to ensure that these schemes are sustainable and that their members have a reasonable level of protection. This was addressed in the Pension Schemes Act 2017 and more information can be found in Part 4.

## Defined Contribution Arrangements

A number of large commercial master trusts have been established in recent years and perhaps the most well-known master trust is the National Employment Savings Trust (NEST) which was set up in response to employer duties around automatic enrolment.

The following table sets out some of the main features of the arrangements covered in 2.5 through to 2.8. Master trusts share some similarities with both trust and contract-based schemes.

	Unbundled trust	Bundled trust	Master trust	Contract-based
Tax relief (non-salary sacrifice)	Member usually contributes after full tax relief. Non-taxpayer gets no tax relief.  Relief at source method (see column for contract-based schemes) can be used but rarely is.			All contributions get basic rate relief (even non-taxpayers).  Higher rate tax payers need to reclaim additional relief.
Investment control	Trustees have full control over assets.	Trustees can select from provider's range.		Employer may be able to influence the scheme funder's/provider's range.
Administration	Specialist is selected and reviewed by the trustees.	Administered by provider.	Reviewed by the trustees, but normally set by the scheme funder.	Administered by provider.
Communication	Trustees can adopt an approach that suits them.		Employer may have limited influence.	
Advisers	Requires appointment of auditor, legal adviser, to the scheme, etc.		Not necessary to appoint advisers. In the case of the master trust, advisers will be appointed at scheme level.  Some ongoing consultancy is usual.	
Scheme Development	The trustees drive change.		Change will be at the scheme funder's/provider's pace.	

### 2.10 LIFETIME ISA

The Lifetime ISA is a longer-term savings product designed to encourage individuals to save for their first home and to save for retirement. While a Lifetime ISA cannot be used by employers, it is important to understand the features of these products as they could influence scheme design and saving habits.

The key features of the Lifetime ISA are noted below:

- The maximum annual contribution is £4,000.
- Contributions can be made up to age 50 but only those aged between 18 and 40 are able to take out a Lifetime ISA.
- The Government provides a 25% bonus (maximum £1,000) on contributions made during the tax year. The first bonuses were paid in April 2018 and monthly thereafter.
- Like other ISAs, contributions are made out of post-tax income and investment growth on savings and future withdrawals should normally be tax-free. Any contributions to a Lifetime ISA count towards the overall £20,000 ISA annual contribution.
- Individuals can open more than one Lifetime ISA but are only able to make contributions to one Lifetime ISA in each tax year.
- Transfers-in from other ISAs are allowed and in line with existing ISAs transfers do not count towards the current year's contribution limit (of £20,000).

## Defined Contribution Arrangements

Lifetime ISA providers, authorised by HMRC, may also set their own conditions when an individual signs up for an account.

### 2.10.1 Withdrawal of funds from the Lifetime ISA

The following withdrawals are permitted to be made from Lifetime ISA savings without penalty:

- Buying a first home (subject to a number of conditions, for example, that the property costs less than £450,000).
- Retirement - full or partial withdrawals can be made from age 60 (and not age 55 like registered pension schemes) without penalty and the withdrawal (including the bonus) could be used for any purpose.
- Terminal ill health - where an individual is diagnosed with terminal ill-health, based on HMRC's serious ill-health definition for pension schemes, they are able to withdraw all of the Lifetime ISA funds without penalty and regardless of how old they are.

Any withdrawals made outside of these scenarios will be subject to a 5% exit charge as well as forfeiting the Government bonus and any investment return upon it.

#### *Comparison of Lifetime ISA versus traditional DC scheme*

Criteria	Lifetime ISA	Traditional DC scheme
Eligibility	Must be between age 18 and 40.	No minimum or maximum age (other than for those being automatically enrolled).
Contributions	Up to £4,000 pa. No employer contributions.	No minimum or maximum contributions (other than for automatic enrolment schemes using qualifying earnings bands). Employer contributions permitted.
Tax relief	Flat Government bonus of 25% on contributions made. Salariesacrificenotavailable. Savings are not subject to the Annual Allowance. Investment returns exempt from tax.	Tax relief at marginal rate of income tax. Salary sacrifice possible on employee pension contributions meaning potential National Insurance savings. Savings are subject to the Annual Allowance. Investment returns exempt from tax. 25% of fund available as tax-free Pension Commencement Lump Sum.
Withdrawals	Only for a first house or from age 60. Exceptions for serious ill health. Penalty of 5% exit fee and bonus forfeited for earlier withdrawals.	Generally from age 55 only unless on ill health. Earlier withdrawals would be subject to unauthorised payment charges for both the member and scheme of up to 70% if they could be made (most policies/scheme rules would prevent the payment)

### 2.11 CURRENT TRENDS

The trend of DB pension schemes closing to future accrual continues. A lot of DB schemes have been closed to new entrants for some time.

The reasons for the move to DC can be attributed to:

- falling world market returns
- increased longevity
- the impositions of tighter funding and governance requirements
- the pressure of scheme deficits on company balance sheets and automatic enrolment



## Defined Contribution Arrangements

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The Pension Protection Fund (PPF) and its risk based levies also increased the financial burden of operating DB schemes.

Although there are a few employers who remain committed to their DB schemes, the financial reasons to switch to DC are compelling. To comply with their duties under automatic enrolment, the vast majority of employers would have found it too expensive to enrol all of their employees into a DB scheme, so even those DB schemes which remain open are likely to be supplemented by a DC scheme for employees who had not made an active decision regarding membership of a pension scheme, or in respect of earnings above a scheme cap.

DC looks set to dominate the future of UK pension provision and some current negative perceptions must be overcome. The increased responsibility for investment decisions that DC members face needs to be addressed via structured programmes of member education. This is necessary to ensure that the millions of people who are in DC schemes now and in the future, understand the scheme benefits and the investment options available under it.

Clear, regular and accurate communication is also vital in DC schemes. Members may want and need to keep up-to-date with the performance of the funds in which they are investing, as they seek to plan for retirement. In particular, members need to understand that investments can go up and down in value, and be prepared to accept such fluctuations in fund value. One of the ways schemes can help members with this is by the production and issue of annual benefit statements which must include a Statutory Money Purchase illustration (SMPI).

The Government has committed to analysing whether further risk sharing schemes have a future within the UK pension landscape and has introduced the legislative framework for 'Defined Ambition'(DA) and 'Collective DC' schemes via the Pension Schemes Act 2015. However, it is not clear if there is currently much appetite for this in Government circles and it may be some time before we see supporting regulations brought in which will actually allow for these types of scheme.

DA is essentially a method of risk sharing, although it is up for debate whether the implied ambition should be in respect of the size of fund or the amount of income to be provided at retirement, or somewhere in between.

Collective DC schemes are a form of DA scheme where resources are pooled together with those of other members (possibly working for different companies) instead of each member saving into their own ringfenced pot. Contribution levels are fixed and pensions depend on investment returns. The major difference from money purchase schemes is that rather than buying an annuity, the member gets an income from the fund which can be reduced if returns are poor.

The advantage of such schemes is that they can achieve economies of scale, for example, by negotiating lower fees and they can also invest for longer in more risky and less liquid asset classes that might achieve higher returns. The main disadvantages are that the trustees of such schemes have to balance the interests of those retiring with those joining the scheme and ensure that there is enough money left in the pot, and members face the risk of having benefits reduced while in payment.

Even without further legislation, schemes already exist where the risk is shared more evenly between the employer and member; for example, in cash balance schemes.

### Summary

When it comes to setting up a DC pension arrangement there are a range of options available in terms of eligibility requirements, contribution structures, and retirement arrangements. The current tax allowances still allow relatively high levels of contributions to be paid in.

In a DC arrangement, members bear all of the investment risk and have no guarantee as to what benefits they may achieve. However, the level of benefits payable is normally commensurate to the level of contributions paid in, subject to investment returns and annuity rates on retirement.

There are several types of DC scheme available, although there is a current trend for sponsors to set up a contract-based scheme or participate in a master trust rather than establish their own trust based arrangement.

A Group Personal Pension arrangement is a series of individual contract-based personal pensions, grouped for the purpose of contribution collection.

A master trust is a multi-employer occupational pension scheme where each employer has its own, effectively ring-fenced, section within the master arrangement.

DC arrangements have become very popular over the last ten years, as DB arrangements have closed or wound up and employers have introduced replacement DC schemes. The introduction of automatic enrolment has seen this trend continue further, although risk sharing models are now possible under the legislative framework.

### Self Test Questions

- What are the main cost considerations for the type of pension scheme to operate?
- List the design decisions that a scheme will have to make in respect of retirement.
- Discuss the advantages and disadvantages of contract-based schemes and trust-based schemes.
- Identify the different contribution structures in a DC arrangement.
- Describe the difference between bundled and unbundled arrangements.
- Describe how a salary sacrifice arrangement works.
- What are the advantages and differences between GPPs and master trusts?

# CHAPTER 3

## Scheme System Design

### INTRODUCTION

Technology and its use within the administration of DC schemes is an area that requires careful consideration. Historically, DC schemes have been considered to be much easier and cheaper to administer than DB schemes. When DC schemes were first introduced, scheme design tended to be relatively simple with often only one or two fund choices for members and only one fund manager. Over recent years, however, DC schemes have become increasingly complex and as such the DC administration system now needs to be able to deal with the complexities of lifestyling and investment switching, together with a raft of legislative requirements relating to benefit payments. DC schemes are only easy to administer if the software system can cope with such requirements.

Traditionally, the pensions department was often the poor relation within the corporate structure. HR and payroll were seen as essential functions within the business, and as a result, have had far more investment in technology. It is only recently that schemes, members and the pension industry as a whole have been fully benefiting from technological advances in software and system design.

After reading this chapter, the student should be able to demonstrate an understanding of the basic functionality of a DC administration system, including the data and various transactions that a system should be able to accurately record. Furthermore, the student should also understand the principles of data protection, a very important subject given the recent introduction of the General Data Protection Regulations (GDPR) and the UK's Data Protection Act 2018 from 25 May 2018 which give the Information Commissioner powers to fine organisations up to either €10 million (£7.9 million) or 2 per cent of an organisation's global turnover (whichever is greater) for smaller violations. The most serious violations could result in fines of up to €20 million or 4 per cent of turnover (whichever is greater). Further information on the recently introduced data protection legislation is available in Part 6. Finally, as technology progresses at an ever increasing rate students should be able to understand some of the recent system developments that are being utilised by DC schemes, ranging from online enrolment to straight through processing.

### 3.1 BASIC SYSTEM REQUIREMENTS

There are a number of basic requirements of a computer system to allow the successful administration of a DC scheme. The system must be capable of storing and maintaining a number of basic items of data. The trustees/managers and administrators should take into account TPR's guidance on record keeping when storing and maintaining data.

#### 3.1.1 Member Details

The following items should be the minimum data stored:

- Full name
- Sex
- Address
- Date of birth
- Date joined company
- Date joined scheme
- National Insurance number
- Pensionable pay
- Membership category
- Investment choices – lifestyle switch dates

The following additional items may also be stored:

- Marital status
- Target retirement date (where different from that of the scheme's NRD)
- Payroll number
- Employing company or location
- Branch/unit code
- Part time service
- Periods of absence, including maternity
- Personal health insurance (PHI) cover
- Transfer in details (if applicable)
- Indication of whether the Money Purchase Annual Allowance has been triggered
- Indication of whether the Pensions Advice Allowance has been used
- Details of any Lifetime Allowance protection certificates held

#### 3.1.2 Contributions and Units

For each type or 'stream' of contribution the administration system should hold a record of:

- The contribution rate – i.e. whether a percentage of salary or a fixed monetary amount
- The amount of contribution received
- The units purchased for each investment relative to that 'stream'

The contribution 'stream' relevant to a member will vary depending on the nature of the scheme and the member's specific circumstances, but can include:

- Employee regular contributions
- Employer regular contributions
- AVCs
- Any employer special contributions received (e.g. from salary sacrifice or bonus sacrifice)
- Transfers in received

Further to the items listed above, the administration system should also hold for each member the following:

- Date contributions are received
- Date contributions are invested
- Transaction history of units bought and sold such as where:
  - contributions have been invested for the member
  - there has been a switch in investment funds following a change in the member's investment strategy or as a result of lifestyling
  - the member's unit allocation has been rebalanced so that the monetary value of the unit holding between each investment fund matches the member's investment strategy
  - there has been a disinvestment, either in part or in full, due to a transfer (e.g. pension sharing order) or the member crystallising benefits
- Unit prices for each fund for any date on which investment or disinvestment transactions take place
- Different unit prices and different investment dates in respect of the same contribution period

As well as fund holdings for each member, the system may also be required to hold separate investment holdings, which can result from processing short service refunds to members where the employer investment amount is not disinvested. These amounts are often held as a balancing item and may be referred to as an 'unallocated account'.

### 3.1.3 Switching and Lifestyling

Lifestyling is a means by which funds are gradually moved into less volatile investments as a member approaches retirement age. Lifestyling members are given some protection from market volatility drastically affecting the value of their funds at retirement. It is often designed by the trustees/managers using the scheme's normal retirement age. However, it is also possible for members to select a target retirement age and the system should be able to handle either option.

The system must be able to handle switches of individual member investments between different funds, either on member request or automatically, as part of the lifestyling process.

### 3.1.4 Charges

There are a variety of ways in which charges can be applied and collected from a scheme. For example:

- The unit price set by the investment manager can be adjusted to take account of their charges.
- The charge can be deducted from new money invested so that, for example, 99% of the contributions would be invested, and 1% retained by the investment manager.
- The charge can be deducted from the member's 'pot' either based on a fixed monetary amount, or as a percentage of fund which in turn can be capped at a fixed amount.

From 6 April 2016, 'active member discounts' are banned. This means it is not possible to charge non-contributing members more than they would have paid if they were contributing to the scheme.

The ban applies to certain occupational pension schemes that provide money purchase benefits and are being used as qualifying schemes for automatic enrolment.

It is common for a scheme to apply more than one type of charge at the same time and so an administration system will need to be flexible enough to allow for this as well as being able to vary the rate of charges being applied potentially at an individual level.

The application of charges on pension savings has been the subject of much debate with regards to the level they are applied at and the level of transparency for employers and members. Employers are being urged to consider closely the impact of charges especially when selecting a default fund for a qualifying scheme to meet their automatic enrolment duties. Trustees of DC schemes will have to report on the value for money of scheme charges in the annual Chair's report dealt with in 1.3.6 of Part 4 and charges are dealt with in 1.4 of that Part.

### 3.1.5 Calculations

The main and most frequent calculation that the system will be required to perform will be to value a member's fund on any given date. This is usually a relatively straightforward calculation requiring the system to identify the latest fund price and multiply this by the unit holding.

DC schemes are required to provide Statutory Money Purchase Illustrations (SMPIs) to members on an annual basis. This has created a need for the system to be able to calculate and produce these figures annually. The SMPI calculation is relatively complicated and requires various assumptions to be incorporated into a system's calculation routines.

### 3.1.6 Reporting

One of the main functions of a good administration system is the ease of reporting. Usually reports would be needed for:

- Standard administration reports, e.g. member movements, members approaching retirement age, performance against service level agreements
- Contributions paid by employees
- Contributions paid by employer
- Unit holdings per member
- Units purchased on any given date
- Units sold on any given date
- Total unit holdings per fund
- Lifestyling events

It is imperative that a full audit trail of any system changes or transactions can be produced, to provide clarity to the administrator and members, to provide comfort to the trustees/managers/employer and to provide information to the auditors.

## 3.2 DATA PROTECTION

Trustees/managers of DC schemes, and administrators, must comply with their obligations under the General Data Protection Regulation (GDPR). GDPR is EU legislation which came into effect from 25 May 2018. A new Data Protection Act 2018 was also introduced to sit alongside the GDPR and together these replace the provisions of the Data Protection Act 1998.

The legislation makes provision for the regulation of the processing of information relating to individuals, including the obtaining, holding, use or disclosure of such information. It applies to any information held or processed on a pension scheme administration system.

The trustees/managers, and any administrator contracted to process personal data on their behalf, must act in accordance with the GDPR principles. Administrators must also ensure that they comply with the GDPR principles when disclosing information to third parties. There are certain issues that need to be considered in respect of data protection for benefit processing. In terms of system access, an employer representative may not have the same degree of access to system information as pension administrators and trustees/managers.

Pension administrators can justifiably be given access to virtually all information regarding a member, as it is deemed necessary for performing their duties.

An employer representative, on the other hand, should have limited access. For example, they should not have access to see if the member has carried out 'what if' modelling projections to bring forward their retirement date, as this could be prejudicial to the member's future employment prospects. Therefore, while trustees/managers could require a report on the number of visits that the pension site has had and what activity has occurred on the site relating to each member, the employer should not be able to see who is doing what.

### 3.3 INTERFACES WITH PAYROLL AND HR

There are a number of different ways in which contributions can be received by the scheme administrator from the various payroll sites. The scheme administrator must agree with the payroll department the means by which the data is transferred from the payroll system to the administration system. Paper schedules and spreadsheets are two of the formats in which contributions can be received and these have both been widely used in the past.

As a result of advances in technology, building interfaces to transfer data from one system to another is now more common. The use of interfaces to transfer contributions from the payroll system to the administration system has the following advantages:

- The process is automated but allows for a degree of validation.
- Automated reports identifying any errors speeds up the identification of unreconciled members/ contributions.
- Minimal human intervention in the process reduces the chance of human error.
- TPR expects scheme sponsors to transfer contributions to schemes electronically.

Interfaces may also be used to transfer member data in addition to contributions; e.g. updates to pay, address details, etc.

When setting up interfaces between systems, the scheme and the payroll department need to decide who is driving the data through and which system is the data owner. In most situations, it is usually the payroll department who is the driver; they push the data through to the administration system. An alternative would be to have the scheme as the data owner, with the scheme providing a pre-populated contribution schedule.

#### 3.3.1 Middleware

Middleware is computer software that sits between different software applications to provide additional functionality from that already provided. This type of solution is often provided by a third party where the replacement or development of the current systems would be too costly or time restrictive to meet the specified requirements.

This software solution has been adopted by many employers to facilitate their duties for automatic enrolment. Successful implementation of middleware is critical for these duties as there is specific information that has to be passed between an employer's payroll, HR and pensions functions to ensure that worker assessments and reporting requirements are met.

Advantages for an employer to adopt middleware as an automatic enrolment tool include:

- A single over-arching process removes the requirement for the associated HR, payroll and pensions administration tasks to be carried out manually.
- The employer and their workforce see a single joined up, end to end process.
- Management information should be available from one place.
- In-house system development costs to meet the employer duties for automatic enrolment is currently out of reach for most small to medium employers.
- Support is available where changes are required as a result of legislative change or a change in the dynamics of an employer's workforce.
- Depending on the nature of the workforce, automatic enrolment requirements can be complicated and the expertise to develop a system may put a strain on available human resources.

### 3.4 INTRANET VERSUS THE INTERNET

The adoption of the web as a tool for the pensions industry has occurred in stages and different areas of the industry use the facility in a number of different ways.

The internet is a worldwide, publicly accessible network of interconnected computer networks. Most websites on the internet can be visited by anyone with access to a computer. When employers or schemes are considering posting information on an internet site, they therefore need to be comfortable with everyone having access to the information on it.

The intranet is an internal version of the web. The information is held within the internal company network and in contrast is not accessible to outside users. Within the intranet, an internal information site can be set up to include company information. It would normally include HR details, such as the employer's handbook, company guidelines, standard forms; e.g. holiday or sickness forms, as well as more general company information such as product range, history and organisational structure. It is not generally accessible outside of the company network, unless employees are given very specific software and security to dial in using either a modem or the internet.

Many schemes only provide information via their intranet. This restricts access to the information to employees only. Access to online information is therefore not available for deferred members who are no longer employed by the company.

The web is therefore attractive where scheme information should be available to all categories of members with access to their scheme details. However, the question of security and data protection arises. Most sites will employ the use of a secure area. Members, trustees/managers, employers or their advisers may be provided with access to information held behind the security controls. Software has been developed to provide the person accessing the site with an account number or username and password, which must be entered before the individual can view the information held upon the website. This security also ensures that the person has access to only information that they are authorised to view.

Recent developments have seen a holistic approach with a single access method, linking the intranet site to the internet. This has the advantage to a member of one portal, with access to employer and pension benefits.



### 3.5 USE OF THE WEB BY SCHEMES AND MEMBERS

There are many ways the web can be used by a pension scheme and its members including:

- Electronic communications at either an individual or group level
- Provision of educational support including access to scheme specific literature
- Flexibility to perform administration tasks without direct involvement of the scheme administrator

#### 3.5.1 Static Information

The earliest use of web functionality within the pensions industry was the provision of static information websites. Both in-house and outsourced arrangements began providing information regarding the scheme online. This information was, to an extent, a visual reproduction of the member booklet.

The advantages of providing static online information are that it:

- Allows mistakes to be easily remedied
- Can be amended within hours rather than weeks or months
- Can be amended for very little cost
- Does not involve the costs associated with reprint as with hard copies
- Is possible to direct members to the website for instant access to up- to- date information
- Is possible to email members and potential members the hyperlink to the pension website
- Saves money on stationery and postage

#### 3.5.2 Interactive Information

The next stage of development introduced more interactive elements, which assisted in communicating the benefits to the member, whilst also educating them. This included features such as:

- Answers to frequently asked questions
- Bulletin boards for pensioner groups promoting social activities and pensioner welfare
- Hyperlinks to related pensions sites, such as:
  - The Money and Pensions Service
  - The Pensions Regulator
  - Fund Managers
- Access to personal details for members, including:
  - A summary view of their personal details from their member record
  - A view of their completed nomination or expression of wish form
  - A view of their fund holdings including their contribution splits
  - A view of their last benefit statement and possibly previous benefit statements
  - A facility to email enquiries to the pensions administration team
- The introduction of financial modelling tools for members
- Access for trustees/managers/advisers/employers to externally administered schemes
- Availability of high level scheme management information for employers/trustees/ managers/advisers

#### 3.5.3 Ability to Update

Giving members the ability to not only view but also to update their records was a serious breakthrough in the administration of pension schemes. It meant that members could, for the first time, input information onto the system themselves. Members could update changes to their address or marital status, beneficiaries or dependent children. They were also able to change their contribution rates and investment choices.

### 3.5.4 Modelling Tools

The first modelling tools were standalone and not linked to the member's actual data. These required members to enter details regarding their salary, age, contribution rates and retirement age. The model could then work out the projected fund value and annuity that a member could expect to receive at retirement.

The next generation of modelling tools were produced by taking data from the member's record, pre-populating the screen with the member's contribution rates, investment choices and target retirement date and projected fund value and pension at that date. Members were able to model their benefits by changing their contribution rates to see the effect on their pension, or input a target pension to see what contribution rate would be needed to reach it.

The latest generation of modelling tools uses the same calculation rules as the administration system used by the scheme administrators.

The use of modelling tools is important for schemes as they look to encourage members to seriously consider their retirement options. Some of the latest tools developed enable members to input additional information, such as mortgage commitments, and use these to give a real life reflection of living costs during retirement.

### 3.5.5 Real Time Access

Real time access provides online facilities for employees, allowing individuals to view live information and process amendments. These facilities now include online enrolment and the ability to set contribution rates and update fund choices with data files interfaced to payroll and administration systems.

The use of real time access opened up debates as to whether schemes wanted members to see their details. What caused concern was the state of the data and how much was out- of- date or incorrect. Some schemes felt that it was a risk to allow members to see the data held on their member records. Others saw it as an opportunity to clean the data. By allowing access via the web and encouraging members to review their details, these schemes found that the data became self-cleaning. Experience has shown that members are more likely to amend and update the scheme with details regarding their marital status, dependants and addresses via the web.

A further concern when web capabilities were being developed revolved around security. There were worries that computer hackers would use the pension website to send a virus into the network and crash or corrupt the pension records or the company's internal systems. There was also a fear that members would worry that other people could hack into the website and view their personal details.

Initially, the system providers solved the problem by setting up stand-alone copies of the working pension system. The data on the stand-alone copy system would be refreshed with the data held upon the production system either on a weekly or monthly basis. This was a long-winded but secure method of allowing access safely.

The problem with this solution was that access and updates were one way. Members could see their details but could not update their personal records. This method usually offered the option of emailing the administration team directly from the website or completing a template that would make the member think they were updating their records.

The data transfer between the live system and the copy system, however, soon became a two way process. This meant that certain update actions would kick start a workflow item in the administration team. For example, a change of address would set off a task for the automated production of a confirmation letter.

Given the nature of DC schemes, the timing of updates could have an impact on the periodic cycle of events and therefore it is important that updates, changes or requests by members are actioned as soon as possible.

Real time access is growing amongst pension schemes as trustees/managers and employers become more comfortable with members having access to their data. What the member now sees is the same data that administrators see, but usually in a much simpler format. The web pages are simply a different presentation of the underlying data. Administrators, however, naturally have access to much more information about the member and the scheme.

Giving member real time access benefits schemes by:

- Reducing the number of queries from the membership.
- Allowing a degree of self- administration, lightening the administration burden of the administrator.
- Encouraging members to alert the scheme more frequently to changes to their personal data.
- Giving a greater degree of transparency, as members can see exactly what has occurred on their accounts.

### **3.5.6 Electronic Disclosure**

With effect from 1 December 2010, pension schemes have been able to fulfil a number of their disclosure requirements using online media, as well as through traditional written communication. This can include emails, intranets and the internet.

Schemes can therefore provide traditional communications such as benefit statements by email, and provide web links to online documents rather than hard copies. However, members must be given the opportunity to opt out of the electronic communication and continue to receive hard copy documents.

Information can only be given by electronic means where the trustees/managers are satisfied that the recipient will be able to get access to and store or print the information, taking into account the requirements of disabled persons.

Clearly this presents the opportunity for cost savings for schemes, especially where a large proportion of the membership adopts electronic communications. In addition, this allows documents on a website to be signposted, ensuring up- to- date versions are always available.

## **3.6 ACCESS FOR TRUSTEES, EMPLOYERS AND ADVISERS**

Where an external body administers a pension scheme, the internet has also become a valuable tool. Like scheme members, other parties can be given access to information via the internet.

### **3.6.1 Employer/Trustee Access**

A pension manager employed by the scheme sponsor or an internal pension team may be provided with some access to a third party administrators (TPAs) system via the internet.

Areas where this may assist include:

- Scheme level information
  - Membership movement statistics
  - Fund values
  - Contribution levels

- Member level access
  - Update and view individual members' records
  - Ad hoc member enrolment
- Management information
  - Statistics for service level agreements
  - Monitoring workflow
  - Identifying where an item of work is within a process

In addition to being a useful tool for keeping abreast of the day to day administration of the scheme, the internet can also be a tool for transferring data.

### **3.6.2 Payroll Access**

Data can be transferred between the administration system and the payroll system using the internet. This process has become very sophisticated. The pension administrator can send the payroll department a pre-populated file of expected contributions including any new entrants and any changes or deductions to the schedule. In turn, the payroll department can check and validate the file before approving it for loading onto the system. This is all conducted via the internet.

### **3.6.3 HR Access**

The HR department can also make use of this facility. The HR department can upload new members or changes to members' details using this rather than using interfaces.

### **3.6.4 Scheme Advisers/Independent Financial Advisers**

Members' financial advisers or the scheme adviser could be given limited access to information via the internet.

## **3.7 ONLINE FUNCTIONALITY AND ENROLMENT**

### **3.7.1 Member Enrolment**

Directing members to a website to join a pension scheme has definite advantages. It allows members to read and digest information at their leisure as well as introducing members to the pension website and functionality. Research has also found that if members enrol online, they are more likely to make use of the facility going forward.

The introduction of automatic enrolment and re-enrolment results in a shift, in some cases, from the member applying to join a pension scheme to the employer enrolling them if the individual meets the eligibility conditions. Many employers have taken advantage of these technological advances to ensure they meet their statutory duties.

### **3.7.2 Process for Enrolment**

The member visits the pension website or intranet site after having consulted the scheme booklet, investment guide or other information available. Having made the decision to join the scheme, the member visits the member application page. This page is, in effect, the application form. The member enters the necessary information. If the member has difficulties there may be the option to view an online help facility or select the most appropriate entry from a drop down list. Having completed the application form, the form is submitted by the member online and this kick starts action by the administrator.

The administrator picks up this piece of work from the work queue. The information that the member entered online is reviewed before accepting the member into the administration system. The member's status is changed at this point. The member is added to the payroll contribution file and when this is next run, it alerts payroll that they need to deduct contributions for the member.

Following completion of member enrolment, a welcome pack is either posted or emailed to the member. For stakeholder and GPPs, a policy document and cancellation notice is also provided.

### 3.7.3 Online Switching

Online switching offers the ability for members to change their investment choices via the web functionality offered by their pension scheme. This enables members to switch their future contributions and/or rebalance their existing fund values.

Members can visit their pension website and have access to all their latest fund values, split between each fund option, together with a record of the contributions they have made into each. They can look at the fund factsheets to see how each fund manager has performed and review the risk profile attached to each. Members have all the necessary information at hand to make an informed choice.

This web facility allows members to redirect their future contribution and/or rebalance their funds. Information passes through the administration system, which sends off the appropriate disinvestment and investment instructions to the investment manager. In another part of the system, changes to the contribution rates are picked up and notified to the payroll department in the next payroll pre-populated schedule. This may not require any input from the administration department, or it may be passed to them for validation and checking.

Real time switching is becoming more common, but is not a standard approach for several reasons:

- Trustees/managers are wary of members making a decision without the administrators first having sight of the action:
  - Worry that the dealing cycles may not be understood by the members, for example the concept of time out of the market if the switch is between fund managers.
  - Members may not understand that they have to request the switch by a certain cut off point or that day's cycle is missed.
  - Members may not understand that the price they see on the screen will not be the price used for the deal.
  - The trustees could be charged per transaction and unlimited switching could increase the costs of administration considerably.
- Technology has been a major barrier:
  - Interfaces between pension administration systems and investment dealing systems used to be rare, unless responsibility for the administration and investment management were with the same provider and they had developed integrated systems. Where they did exist, it often only worked if the different funds were on the same platform. There was also an unwillingness to take responsibility for building or paying for the integration between the different platforms. This, however, has changed with the advent of straight through processing.
  - Until recently, there was no industry standard means of communicating electronically between investment managers and different administration platforms. Indeed, some providers have not yet adopted straight through processing.

### 3.8 STRAIGHT THROUGH PROCESSING (STP)

Straight Through Processing (STP) is the ability for two computer systems to exchange and process information without human intervention. STP provides an industry standard means of communicating electronically between investment managers and different administration platforms. It therefore offers considerable benefits in terms of speed, cost savings and reduced risk of error and will undoubtedly become more popular in the future.

Prior to the introduction of STP, the interfaces between administrators and investment managers were built around manual processes for exchanging data. However, with the development of STP, there is reduced manual intervention in investment transactions, which should lead to a quicker exchange of information, providing greater efficiency, providing better management information and improving risk control.

### **3.8.1 The Benefits of STP for Defined Contribution Schemes**

Where a switch in investment funds is conducted using the manual process, the process begins with an instruction from the member, usually in hard copy. This needs to be processed and checked by the administrator before the relevant disinvestment instruction is created and sent to the fund manager. The transaction is two fold. It involves selling and buying. The buying element cannot be performed under the manual process until the selling transaction is complete. The limitations of manual processing are the time delays involved, which could mean that the member's funds are out of the market, and the risk of human error.

With STP, the creation of an electronic interface between the administration systems and fund manager allows reconciliation of units trade by trade and eliminates the need for human intervention during the investment process. The data is transferred rapidly between all parties involved. An investment instruction is issued automatically and the transaction confirmation is received much faster. With this method, there is less chance of human error and less out-of-market time for members.

## **3.9 PENSIONS DASHBOARD**

In the 2016 Budget, the Government announced that it would ensure the industry designs, funds and launches a pensions dashboard by 2019. The broad remit is to provide a free-to-consumer online resource that enables people to find and check their pension savings in one place. Further details are provided in Part 6.

### Summary

A well designed DC system will ease the burden of scheme administration. It is essential that DC schemes take advantage of technology as a means of communication and education in order to ease the administrative burden. Schemes that have developed online capabilities, allowing members to update records, submit online applications and even perform online switching, have limited the amount of manual intervention needed from an administrative perspective. In addition, legislation enables schemes to take further advantage of online media.

However, there are a number of reasons why schemes may not be making full use of the technology available to them:

- Lack of monetary investment on the part of the scheme sponsor.
- The trustees/managers or scheme sponsor not being comfortable with allowing members full access to all facilities either for reasons of security or because of doubts concerning the accuracy of member data.
- Lack of links between pensions and investment systems to allow straight through processing for switching instructions.
- There may be a perception that those without computers or access to the intranet/internet will be disadvantaged.

It is vital that DC schemes recognise and value the use of technology in providing a service to members. For TPAs, technology should be integral to their service to clients. This is especially more apparent with the advent of automatic enrolment.

### Self Test Questions

- List the information that a system needs to be able to hold in relation to a member and contribution holdings.
- Outline the different ways that information can be transferred from payroll.
- Why does trustee and employer access to member information differ?
- What would a member expect to be able to see and do via the internet?
- Describe the major barriers to online switching.
- Outline the benefits of straight through processing for both pension scheme administrators and members.

## PART 2

# ADMINISTRATION OF WORKPLACE DEFINED CONTRIBUTION SCHEMES

### OVERVIEW

This Part covers the operation of DC schemes in the workplace with the intention of giving the student a sound understanding of how they work in practice. It is important that students are aware of the impact of different processes on the scheme and the member.

For all registered pension schemes, the Pensions Regulator (TPR) and HM Revenue & Customs (HMRC) have certain reporting requirements. The first Chapter sets out some of these requirements and explains the role and powers of TPR. The financial management including accounting and auditing requirements are discussed herein along with certain bulk exercises that are dealt with on a scheme level.

Chapter 2 looks at member level administration and the importance of maintaining clean data through streamlined processing and regular reconciliations. This has become a hot topic for TPR as it steps up its review of governance for DC arrangements. Fundamental to the administration of any DC arrangement is an understanding of the contribution cycle and how the steps can sometimes vary between different employers.



# CHAPTER 1

## Scheme Level Administration

### INTRODUCTION

This Chapter covers the scheme level principles and processes involved in running DC schemes – that is, those things that must be done for the scheme as a whole in order to ensure smooth running and legislative compliance. It begins by outlining the compliance regime for DC schemes which initially is a vital area for the student to learn.

By the end of the Chapter, the student should be able to understand the legislative changes incorporated in the Pensions Act 2004 and Finance Act 2004 that have strengthened the compliance regime. These changes build on those included previously in the Pensions Act 1995.

### 1.1 HM REVENUE & CUSTOMS (HMRC)

#### 1.1.1 Scheme Registration

Schemes are required to be registered for tax purposes with HMRC in accordance with Chapter 2 of Part 4 of the Finance Act 2004, in order to benefit from tax relief. Prior to 6 April 2006, pension schemes had to seek tax approval under Chapters I and IV of the Income and Corporation Taxes Act 1988.

Schemes which were tax approved at 6 April 2006 were automatically registered under a process known as 'Deemed Registration' as per Part 1 of Schedule 36 of the Finance Act 2004 (existing schemes could opt out of registration and were subject to a de-registration tax charge of 40% of the value of the scheme's assets).

Schemes established from 6 April 2006 have to register online for tax relief using HMRC's online portal. This was Pension Schemes Online but it changed to the Manage and Register Pension Schemes Service in mid-2018. For schemes which have been registered online, a Pension Scheme Tax Reference (PSTR) number is issued as evidence of registration.

In October 2013, HMRC made a number of changes to the registration process to deter pension scams and safeguard pension savings. They moved away from a 'process now, check later' approach with scheme registration no longer confirmed on successful submission of the online form.

The revised process enables HMRC to conduct detailed risk assessment activity before making a decision on whether or not to register a scheme. The risk assessment will in many cases include writing out to the Scheme Administrator (this will usually be the scheme trustees (or manager) or the provider) for further information. Schemes then have 45 days to submit the required information, or the application will be rejected. Only once all necessary checks have been carried out will a decision be made on whether to register a pension scheme.

There is no time limit on how long HMRC can take to decide whether to register a pension scheme. However, if a decision hasn't been made within 6 months of getting the application, it is possible to appeal to a tribunal as if HMRC had decided not to register the scheme.

In some cases, HMRC may also need to inspect certain documents. Where they do, they will usually send a written notice at least 7 days before the visit.

Amending legislation was introduced via Finance Act 2014 to widen the circumstances in which HMRC may refuse to register a pension scheme, to include where it believes:

- that the Scheme Administrator is not a fit and proper person to fulfil that role; and
- that the scheme has been established for purposes other than for providing authorised pension benefits.

### 1.1.2 Electronic Filing

Registered pension schemes are required to file certain returns and forms online. All schemes are therefore required to be registered with HMRC for online services. Schemes may be registered via the Manage and Register Pension Schemes service.

It is mandatory to file the following forms electronically:

- An application to register a pension scheme
- A Registered Pension Scheme Return
- An Accounting for Tax Return
- An Event Report
- Application to pre-register as a Scheme Administrator/Practitioner
- Scheme Administrator's declaration
- Notification of winding-up of a registered pension scheme
- Notification of termination of a Scheme Administrator's appointment

It is not yet possible, however, to file the Self Assessment Tax Return for Trustees of Registered Pension Schemes electronically.

The Scheme Administrator is required to supply an Accounting for Tax Return on a quarterly basis to HMRC, disclosing their tax liability; e.g. for short service refund lump sums or amounts crystallising in excess of a member's available Lifetime Allowance, that were made during the period and the tax deducted from such payments.

### 1.1.3 Other Forms

The following forms may be filed electronically, but may also be submitted in paper format:

- Relief at Source Details
- Authorising and De-authorising a Practitioner
- Change of Scheme Administrator/Practitioner user details

### 1.1.4 Information Required to Register a New Scheme

From June 2018 registering a new scheme is done via an online form through the Manage and Register Pension Schemes service. The first part of the form requires information about the scheme, such as its name, its legal structure, an approximation of the size of the membership at the end of the tax year of application and the name and address of the individual or organisation establishing the scheme.

The second part of the form requires the Scheme Administrator (the trustees/managers) to declare that:

- The scheme meets all the criteria to be registered as a pension scheme under the Finance Act 2004.
- To the best of knowledge and belief, the information given in the application to register the pension scheme for purposes of tax relief is correct and complete.
- The instruments or agreements by which the pension scheme is constituted do not directly or indirectly entitle any person to unauthorised payments. In addition, the way in which the pension scheme is to be administered will not knowingly entitle any person to unauthorised payments.

- They understand that the Scheme Administrator is responsible for discharging the functions conferred or imposed on the Scheme Administrator of the pension scheme by the Finance Act 2004, and intends to discharge those functions at all times, whether resident in the UK or another EU member state or non-EU member state in the European Economic Area (EEA).
- They are a fit and proper person and that HMRC may refuse to register the scheme or de-register the scheme if HMRC believes the Scheme Administrator is not a fit and proper person.
- They understand the penalty if a false statement is made on the declaration and that false statement may lead to de-registration of the scheme and prosecution.

The Scheme Administrator can normally request on the form that a copy of the registration form goes to a Practitioner if they complete the Practitioner's name and ID reference.

### 1.2 THE PENSIONS REGULATOR (TPR)

#### 1.2.1 Compliance and Audit Regime

TPR is the regulatory body created by the Pensions Act 2004 to monitor and regulate workplace pension schemes in the UK. It has wider powers than its predecessor, the Occupational Pensions Regulatory Authority (OPRA), and is proactive in looking at ways to reduce the risks to members' benefits. TPR is the compliance body for the employer duties under the automatic enrolment legislation.

The objectives of TPR in relation to DC schemes are to protect members' benefits and promote good standards of scheme administration. It also aims to ensure that the trustees/managers of a pension scheme act in the best interests of members and in line with the law.

TPR has produced detailed guidance with regard to regulating pension provision to help trustees/managers, employers and members to better understand their role and the importance of pensions.

Students are recommended to browse the literature that can be found on their website:

**[www.thepensionsregulator.gov.uk](http://www.thepensionsregulator.gov.uk)**

#### 1.2.2 Gathering Information

In order to ensure they have an understanding of the pension schemes for which they are responsible, TPR has extensive powers for gathering information. It has the power to obtain all of the information it needs in order to decide whether a scheme requires support and to determine how best to assist that scheme and those running it.

TPR has an online facility, known as 'Exchange', which is used to share information about workplace pension schemes. For example, this can be used to submit scheme returns and whistleblowing reports.

#### 1.2.3 Scheme Returns

Scheme returns assist TPR by providing the detailed information that it needs in order to identify risks to schemes and recognise trends and themes emerging in the pensions industry.

The majority of DC schemes are required to complete a return annually. The scheme return, in relation to DC schemes, includes details relating to the scheme, employer(s), advisers, service providers and membership statistics.

Trustees/managers have ultimate responsibility for ensuring that scheme returns are completed.

### 1.2.4 Other Sources of Information

TPR has access to information from other sources, for example:

- Registrable information; i.e. the information that trustees and managers must provide to TPR within three months of registering with HMRC and must keep up to date on Exchange
- Information provided by other regulatory bodies within the pensions community
- Financial information such as stock market performance
- Problems and trends within specific sectors of industry or pension schemes in general

### 1.2.5 Whistleblowing

It is a requirement that anyone involved with running occupational and workplace contract-based pension schemes (including stakeholder schemes) should report to TPR anything that they consider is a breach of legislation or rule of law concerning that scheme. For guidance, there are two rules that individuals should consider before making a judgement:

- Is there a reasonable cause to believe there has been a breach of the law?
- If so, is the breach likely to be of material significance to TPR?

The whistleblowing requirements apply to the following:

- Trustees, their advisers and service providers including administrators and fund managers
- Managers of schemes not set up under trust
- Employers sponsoring or participating in work based pension schemes

TPR has published a Code of Practice which provides further guidance on the whistleblowing requirements.

### 1.2.6 Codes of Practice

TPR provides Codes of Practice to assist trustees/managers, employers and administrators in a number of areas. A Code of Practice is not a statement of law but does provide practical guidelines for those involved with running a pension scheme.

Codes of practice are available on TPR's website on the following subjects:

- Reporting breaches of the law
- Notifiable events
- Funding defined benefits
- Early leavers
- Reporting late payment of contributions to occupational pension schemes
- Reporting late payment of contributions to personal pension schemes
- Trustee knowledge and understanding
- Member-nominated Trustees/Directors – putting arrangements in place
- Internal controls
- Modification of subsisting rights
- Dispute resolution - reasonable periods
- Circumstances in relation to the material detriment test
- Governance and administration of occupational trust-based schemes providing money purchase benefits
- Governance and administration of public service pension schemes
- Authorisation and supervision of master trusts (only a draft version had been published at the time of writing)

### 1.2.7 Risk Assessment

A major part of TPR's role is assessing the risk to members' benefits. To do this, it has to identify and anticipate risks to pension schemes. By reviewing the information gathered on a scheme, TPR assesses the likelihood of risk to benefits. A risk is any event that reduces or prevents payment of benefits due to members.

There are two elements in assessing risk:

- The likelihood of an event occurring that affects the security of members' benefits
- The impact of that event should it occur

TPR assesses the likelihood of the risk and what the effects would be before deciding upon the level of regulatory supervision required. It will work with trustees/managers to avert, reduce or eliminate risks to their schemes.

### 1.2.8 Powers

Under the Pensions Act 2004, TPR has the power to:

- Order an employer to pay any shortfall or late contributions to a scheme
- Order that financial support is put in place for an underfunded scheme
- Issue a contribution notice where there is an action to avoid a pension debt
- Order an administrator (third party or in house) to improve the service they provide to the trustees and correct their mistakes
- Make sure that money stolen from a scheme is returned
- Stop activity on a scheme such as members paying into the pension scheme or new members joining
- Disqualify trustees who are unable to carry out their role adequately
- Modify the future accrual of benefits in specific circumstances
- Direct pension schemes how to calculate their liabilities and the contributions required.
- Impose civil penalties

## 1.3 THE FINANCIAL CONDUCT AUTHORITY/THE PRUDENTIAL REGULATION AUTHORITY

The Financial Services Authority (FSA) was originally established as the sole regulatory authority for financial and investment business in the UK by the Financial Services and Markets Act 2000. Following the banking crisis in 2008, the FSA was criticised for failing to protect consumers from regulatory failures. As a result, a new model of regulation was proposed with the duties of the FSA being split between the new Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA), established under the Financial Services Act 2012.

### 1.3.1 Financial Conduct Authority

The strategic objective of the FCA is to ensure that relevant financial markets function well.

Its three operational objectives are:

- To secure an appropriate degree of protection for consumers
- To protect and enhance the integrity of the UK financial system
- To promote effective competition in the interests of consumers

It must also act to minimise the extent to which regulated businesses may be used for a purpose connected with financial crime.

The FCA regulates firms and individuals that promote, arrange or provide stakeholder and personal pension schemes.

### 1.3.2 Prudential Regulation Authority

The PRA's purpose is to protect and improve the stability of the UK's financial system through regulation and supervision.

The PRA is a subsidiary of the Bank of England and has three statutory objectives:

- To promote the safety and soundness of banks, building societies, credit unions, insurers and investment firms
- To contribute to the securing of protection for current and future insurance policyholders (specific to insurance firms)
- To facilitate effective competition

## 1.4 ANTI-MONEY LAUNDERING

The Money Laundering ,Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 came into force on 26 June 2017.They introduced certain requirements which impact pension schemes.

### 1.4.1 Duty to register

In order to comply with these anti-money laundering regulations introduced in June 2017, it was originally believed that pension scheme trustees (as trustees of an express trust) would have to register with HMRC's Trust Registration Scheme (TRS) if the pension scheme incurs a liability in the relevant tax year for one or more of the following taxes:

- income tax
- capital gains tax
- inheritance tax
- Stamp Duty Land or Reserve Tax
- Scottish land and buildings transaction tax

However, HMRC confirmed in June 2018 that if the scheme is already a registered pension scheme having completed the HMRC online registration process then they do not need to register separately under the TRS. Where a trust based pension scheme is not already registered with HMRC either through the Pension Schemes Online or the Manage and Register Pension Schemes services, trustees must use the TRS portal to complete the registration process.

There are certain instances where trustees do not have a trust registration obligation, these include where the scheme administrator only pays UK income tax due to:

- the deduction of tax from a pension or a lump sum through the PAYE system
- joint liability for payment of a lifetime allowance or overseas transfer charge
- joint liability for payment of a member's annual allowance charge (known as scheme pays)
- liability for other charges including a short service refund lump sum, a de-registration charge or a scheme sanction charge.

Where applicable, there is a legislative requirement for trustees to provide and maintain this information and penalties may apply where deadlines are missed.

### 1.4.2 Duty to keep records

Under the regulations, trustees of all occupational pension schemes are required to keep records containing accurate and up-to-date details of all beneficial owners in relation to their scheme. In brief, this means keeping records of the following:

- The original employer who set up the scheme along with the current employers
- The trustees
- The active, deferred and pensioner members
- Any other individuals benefiting from the trust. Where these individuals have not yet been identified (such as the future recipients of a death benefit), the class of persons who may receive a benefit from the trust
- Any individual who has control over the trust

The records required are full name and date of birth and a National Insurance number or unique tax reference. If the latter is absent, then either a UK address is needed or where there is no UK address, a copy of a passport or ID card is needed for members based overseas.

### 1.5 BANK ACCOUNTS

Under the Pensions Act 1995, it is a statutory requirement for trustees of occupational pension schemes to open and maintain a trust bank account, unless exempt. A bank account is necessary to evidence the separation of employers' and employees' contributions. Therefore, both employees and the employer can make contributions directly to the trustee bank account, although in practice the majority of employee contributions will be remitted by the employer following deduction through payroll. This requirement includes any special payments such as transfer values, special contributions by the employer, donations and bequests and any monies that have been made payable to the trustees unless transferred directly to the investment manager.

The bank needs to be formally appointed by the trustees. The trustees would evidence the operation of the account by establishing mandates with the bank covering the authority levels for the drawing or transfer of monies from the account for:

- Payments to beneficiaries
- Transfers out of members' benefits
- Payment of contributions to investment managers
- Payment of expenses

Trustees are required to evidence the granting of authorities within the trustees' minutes. These should be amended when any of the authorised signatories change and following a review of the authorities. A review of the authorities should be carried out annually to ensure that they are still appropriate and current. Normally, it is expected that two signatories would be required to sign an instruction to the bank and that a majority would be required to effect significant transfers of money to other funds or to effect disinvestments from the fund managers. The terms of operation of the bank accounts, including charges, should be recorded in the trustees' appointment letter, which should be reviewed regularly.

Where the administration of a scheme is outsourced to a third party administrator (TPA), the TPA may be given a requirement to invest the contributions in a timely manner and operate the trustee bank account. TPAs can handle multiple accounts for little or no additional costs due to technological advances in banking systems and the changing attitudes of the banking industry.

Internally, TPAs operate a hierarchy of authorised signatories in the same way that trustees do. TPAs also maintain the cashbook and monitor the payments through the accounts. Unlike in a DB arrangement, it is unlikely that the TPA will hold a deposit account in respect of a DC scheme. The need for money to flow swiftly through the current account negates the requirement for money to be held in a deposit account. There is a growing trend to move away from an interest bearing account due to the difficulties it can cause from an administrative point of view.

### 1.6 CASH MANAGEMENT

Within the DC world, contributions are invested for the benefit of an individual, who has an individual account within the scheme. This differs from a DB arrangement where contributions are pooled and invested for the benefit of the entire membership. There is pressure on DC schemes to ensure that contributions spend as little time as possible within the bank account and that they are invested as soon as possible.

Trustees must, however, ensure that there are sufficient funds within the bank account to meet the scheme's day- to- day expenses. To avoid this, it is important that future income and expenditure are predicted accurately.

Cash flow projections should be undertaken at least monthly to encompass all anticipated income and expenditure. Whilst the timing of many items can be predicted such as contributions and administration expenses, others such as death benefits and transfer payments are more difficult to predict. A close relationship with insurers and investment managers will greatly assist when making such payments.

### 1.7 SCHEME ACCOUNTING AND AUDITING

The format and content of pension scheme accounts is governed by the requirements of:

- The Pensions Act 1995
- The Statement of Recommended Practice (SORP) as revised and issued by the Pensions Research Accounts Group (PRAG)
- General Accounting Principles

#### 1.7.1 Pensions Act 1995

The trustees' report and accounts need to comply with the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013.

The trustees' report and accounts have to be signed within seven months of the scheme year end. HMRC sends out notices to the trustees of larger occupational schemes to produce audited accounts. The deadline for submission is the later of the date stated in the notice or seven months from the end of the period of account.

Smaller schemes are issued with a notice from HMRC to make a Registered Pension Scheme Return. Notices are issued mainly to small occupational schemes with less than 50 members and to non-occupational schemes that are investment-regulated, such as Self Invested Personal Pensions. The Registered Pension Scheme Return will normally have to be filed by 31 January following the tax year to which it relates.

The availability of the report on request has to be communicated as part of the basic information about the scheme sent to members. Copies of the report and accounts must be submitted to those requesting them within two months of the request being made. If the trustees fail to sign their reports and accounts within seven months of the scheme year end to which they relate, they may be liable to sanction and fines by TPR.



The Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 require a statement within the audited accounts to the effect that they have been prepared in accordance with the Statement of Recommended Practice (SORP) which applies at the end of the scheme year to which the accounts relate. If not, an indication is required of any material departure from the SORP guidelines.

### 1.7.2 Statement of Recommended Practice (SORP)

SORP sets out the formal guidelines relating to financial statements and disclosures and recommends areas that an attaching trustee report should cover.

SORP covers all pension arrangements including:

- Occupational DB and DC schemes
- Fully insured schemes
- Earmarked schemes
- Employer financed benefit schemes
- Schemes in wind up
- Overseas schemes
- Trust-based stakeholder schemes

It excludes:

- Unfunded schemes
- Group Personal Pensions
- Free standing Additional Voluntary Contribution (FSAVC) arrangements
- Non trust-based stakeholder schemes

The original SORP 1, Pension Scheme Accounts, was published in 1986. This was replaced by a revised SORP, Financial Reports of Pension Schemes, which took effect for scheme years ending on or after 6 April 1997. The latest revision to the SORP was published by PRAG in December 2014, and is effective for all accounting periods on or after 1 January 2015.

### 1.7.3 General Accounting Principles

Accountancy has generally shown evolutionary rather than revolutionary change. Given the episodic nature of annual accounts, it is natural that accountants see merit in continuity of method in preparing the figures. It is generally accepted that four concepts are fundamental, insofar as non-compliance needing to be stated. These are:

- **Going concern** – The enterprise is assumed to be continuing in operation at a similar scale for the foreseeable future.
- **Consistency** – There is a consistency of accounting treatment of like items within each accounting period and from one period to the next.
- **Accrual** – Revenue and costs are accrued, i.e. recognised for accounting purposes as they are earned or incurred (regardless of when received or paid). This leads to the idea of 'matching' revenues against the costs incurred in earning them.
- **Prudence** – This leads accountants to bias their reports, when faced with incomplete knowledge or uncertainty. They will set aside something for an uncertain liability but will not anticipate an uncertain gain.

These accounting concepts have different applications for pension fund accounts:

- **Going concern**

Any clause in a scheme's Trust Deed and Rules enabling the employer to terminate or suspend support for the scheme at short notice is to be ignored. A particular scheme could be closed to further accrual in the future but it must be assumed to be a going concern.

- **Consistency**

No particular exceptions for pension schemes.

- **Accrual**

The concept of accrual within a DC scheme is far more simplistic than in a DB arrangement. The matching of revenue and costs is more straightforward because with the payment of contributions over to the investment manager the liability ceases and there is no requirement to accrue for future benefit payments.

- **Prudence**

Within a DB pension arrangement the concept of prudence is one of the most debated, i.e. whether assets should be viewed at the lower or upper end of the market value. With a DC scheme, the problems revolving around future liabilities do not exist.

### 1.7.4 Format of Accounts

A trustees' annual report and accounts will normally include the following:

- The trustees' report
- The investment report
- The auditor's report
- The financial statements
- Actuarial certificates (not relevant for wholly DC schemes)

The trustees' report gives useful and relevant information on stewardship. It usually includes the following information:

- Details of the trustees
- Trustee appointments
- Details of professional advisors including a contact address for queries
- Membership movements
- Any changes to the scheme rules
- Contribution rates
- Additional Voluntary Contribution (AVC) providers
- Registration under the relevant data protection legislation
- Internal dispute resolution procedure and details of the Money and Pensions Service and the Pensions Ombudsman

The investment report should include reference to the Statement of Investment Principles together with details of custodial arrangements.

The auditor's report is effectively confirmation that the records and financial statements have been prepared and audited properly.

It has become normal practice to condense the trustees' annual report and accounts and to issue a shortened and simplified version. Whilst a simplified report, in the experience of many trustees, has a greater chance of being read by the membership than a full version, it is a legal necessity that a full report is available on request. It is a disclosure requirement that this is made available for members, prospective members, beneficiaries and trade union representatives.

### 1.7.5 Financial Statements

Responsibility for the production and accuracy of a scheme's accounts resides firmly with a scheme's trustees. Expert advice is available from the scheme auditors, who are able to provide guidance on the compliance of financial statements.

The overriding necessity is for trustees to produce a 'net assets statement' and supporting documents to show how the trustees have discharged their responsibility for the stewardship of fund monies over a year and the way in which the fund assets have been managed and deployed.

In conventional accounting terms, a net assets statement is a document in which assets and liabilities are marshalled with a view to disclosing the overall state of affairs. It is a 'snapshot' at a point in time.

Financial statements are typically presented as a net revenue statement in relation to dealings with members and a separate return on investments, together referred to as the fund account. This leads to the reconciliation of the net assets.

The change in the market value of investments over the year will be identified either in the fund account or one of the notes. The notes to the accounts in relation to investments will also disclose the total purchases and sales of investments during the year either in aggregate or analysed by major categories. It is necessary to disclose any self- investment (including unpaid contributions) and how this has changed in the accounting period.

### 1.7.6 Auditing and Audit Trails

The Pensions Act 1995 requires a scheme's annual accounts to be audited. The Act also sets out the requirements for the appointment of an auditor by the trustees. An auditor of a scheme cannot be the scheme's employer, hold a position as a trustee or administrator to the scheme nor be a member of the scheme.

A formal letter of appointment needs to be drawn up and signed by the trustees and the auditor. This sets out the scope for the audit, the terms of the engagement and the respective responsibilities and duties of the trustees and the auditor. Each appointment must be acknowledged and the trustees should be notified of any conflict of interest.

On resignation or removal, an auditor must produce a statement detailing any circumstances connected with the resignation or which is believed to 'significantly affect' the interests of scheme members or beneficiaries. The trustees have three months in which to replace an auditor.

Auditors have a duty to inform TPR immediately (i.e. whistleblow) if there is reasonable cause to believe that there has been a breach of the legislation that is likely to be of material significance to TPR in the exercise of its functions.

An auditor need not be appointed for:

- Unfunded arrangements
- Employer financed retirement benefit schemes
- Occupational schemes with less than two members
- Occupational schemes providing only lump sum death benefits
- Certain public sector arrangements
- DC and DB schemes where there are fewer than 12 members and all members are trustees and either all decisions are made by unanimous agreement of the members or the scheme has an independent trustee

## Defined Contribution Arrangements

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While trustees have the responsibility of producing the financial statements, the auditors are charged with the duty of expressing an independent opinion on those statements.

The standard audit opinion, which is contained in the auditor's report to the trustees, confirms that for the period under review, in the auditor's opinion:

- The financial statements give a true and fair view of the financial transactions in the period
- The financial statements give a true and fair view of the disposition of the scheme's assets and liabilities
- The statements contain the information specified in the regulations
- Contributions have been paid in accordance with the payment schedule and the scheme rules

The audit is an examination of the books and accounting records kept by (or on behalf of) the scheme in order for the auditors to arrive at an opinion regarding the financial statements. Clearly, for a large scheme it is not possible to check every detail of every transaction and the audit includes a detailed review of a sample of transactions. In selecting what to review, the auditors will use statistical sampling techniques whilst keeping in mind what is likely to be material and the risk to the scheme of a potential misstatement. An audit may extend to a review of administration procedures to ensure that benefits are being calculated in accordance with scheme rules.

Adequate supporting documentation needs to be kept in relation to every financial transaction in order to keep an audit trail. In general terms, an audit trail is the ability to trace the history of a financial transaction from initiation to payment so that if needed, it can be reviewed and checked for accuracy at a later date. For benefit calculations this means the information on which the calculation is based, for instance the date and prices used to calculate the value of the member's fund. For other payments, there may be an invoice, receipt or other form of authorisation which provide a clear audit trail.

### 1.8 RISK BENEFITS AND REBROKING

In addition to the provision of retirement benefits, a pension scheme also provides for the eventualities and occurrence of unexpected instances of death and incapacity due to injury or illness. Pension schemes usually provide death in service lump sums to members' beneficiaries in the event of the death of an active member of the scheme and, in some cases, pensions for beneficiaries.

DC schemes invariably choose to insure at least the death in service lump sum benefit but may, or may not, insure separately any survivor pensions, depending on how generous these are going to be. Where a scheme only provides for the value of a member's fund to provide death benefits, no separate insurance will be required.

For insured benefits, a scheme must select the most suitable provider based on the size of the membership and the type of scheme. The scheme must decide with the employer what benefits they wish to provide. HMRC limits the maximum tax relievable amount that can be paid as a lump sum death benefit from a registered pension scheme to the member's remaining Lifetime Allowance.

The insured scheme may be run separately or in conjunction with the pension scheme and may allow access to non-pension scheme members in certain circumstances.

#### 1.8.1 Group Life Cover

A scheme providing risk benefits can be separate from the pension scheme, established under its own trust and be registered with HMRC for tax purposes. The difference between a group life assurance scheme (GLAS) and a registered pension scheme is that a GLAS exists solely for the purpose of providing a benefit upon the death of a member. A scheme's benefit consultants may provide a service to assist with the selection of a suitable provider.

## Defined Contribution Arrangements

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There are several providers currently operating within the group life cover marketplace and it is a very competitive market. Typically, a provider recommendation will be dependent upon the intermediary securing the most competitive quote in some or all of the following areas:

### *Premium Cost*

The cost of the insurance cover will depend upon the size of the scheme. A small scheme may be required to pay a “single premium” charge. This is for one year’s cover and will be based upon the age of each individual member. The cost of the premium increases, as the membership ages.

Where the scheme is large, the premium will be based on a unit rate for 1,000 members with different rates for males and females. The scheme will be required to provide details of:

- The number of lives
- The number of males
- The number of females
- The age distribution of those insured
- The occupations of those insured
- The locations of those insured

This method relies on economies of scale and therefore favours larger schemes.

### *Free Cover Limit*

With a free cover limit, a monetary limit is set on benefits and members whose benefits fall below the limit are not required to be underwritten for insurance purposes. It is only members that have life cover in excess of the limit that need to be assessed – typically high earners.

### *Rate Guarantee Period*

The scheme may look for providers who will guarantee the unit rates for a number of years, typically two years but occasionally three years. The provider may place restrictions on the guarantee; for example the scheme structure must remain the same, the membership must not alter by +/-10%, or the demographic profile of the lives covered must not change substantially.

### *Data to be Provided by the Scheme*

When reviewing the options available, a scheme may need to supply certain data to the providers in order to receive a realistic quotation. The scheme must ensure that it has a record of data usually going back a period of at least five years because it is not unusual for an insurance company to ask for five years’ claims history. The administrators of a pension scheme may be responsible for recording the details of life assurance only members alongside pension scheme members. A scheme may request the necessary data from the administrator in order to ascertain the most suitable risk benefits provider.

The type of information that needs to be provided by the scheme would normally include:

- The number of employees to be covered
- Dates of birth
- Sex
- Salaries
- Amount of cover

### *Paying for Risk Benefits*

Responsibility for the payment of insurance premiums usually resides with the employer, although in DC arrangements it is not unknown for an element of members’ contributions to be used for this purpose.

### Summary

The Pensions Act 2004 and Finance Act 2004 changed the way pension schemes are established. The Finance Act 2004 requires schemes to be registered for tax purposes. The change to the tax regime also introduced electronic filing for pension schemes from 6 April 2006.

The creation of TPR under the Pensions Act 2004 served to strengthen the compliance regime for workplace pension schemes. The scope and powers of TPR are extensive in comparison to its predecessor, OPRA. Trustees/managers need to be aware of the penalties and sanctions that TPR can impose for non-compliance.

TPR requires schemes to complete returns on an annual basis in order for it to identify areas or anomalies that might put members and their benefits at risk. TPR wants to work with schemes to reduce risks to member benefits and is open for consultation to all schemes and their advisers.

Schemes are expected, on an annual basis, to provide accounts together with a Trustee Report. These requirements are covered by disclosure regulations and the Statement of Recommended Practice (SORP), and there is a need for the accounts to be audited within specific timescales.

### Self Test Questions

- Outline what a scheme must do to become tax registered.
- Define the main functions of TPR with respect to DC schemes.
- Describe the banking procedures that trustees are required to operate.
- Which arrangements are covered by the Statement of Recommended Practice and which ones are outside of its scope?
- Outline the factors that may influence the selection of a group life provider.

# CHAPTER 2

## Member Level Administration

### INTRODUCTION

The very nature of DC schemes places greater emphasis on the individual member, as each member takes responsibility for their own pension fund within the scheme. This necessitates close attention to detail at a member administration level – contributions and investment holdings must all be carefully tied to individual members and regularly reconciled.

By the end of this Chapter, the student should be able to describe the processes involved with member administration of DC schemes.

The objectives of DC scheme administration are to:

- Ensure pension contributions are deducted from members in line with the payment schedule/ direct payment arrangement
- Ensure the correct levels of contributions are paid to the pension scheme within the statutory timescales
- Ensure that the contributions are invested in accordance with members' investment choices in a timely fashion
- Ensure that the eligibility criteria are controlled
- Educate and communicate with members effectively throughout their membership lifecycle (i.e. from a new joiner in the early stages of their working lifetime to a member retiring)
- Ensure that any disinvestments and investment switches are actioned promptly
- Ensure the fund derisking process is robust, members are communicated all the options under the scheme rules and legislation and their choices are processed promptly

From the members' perspective, the DC administration process is straightforward. Money goes into the pension scheme and is invested, then at retirement investments are realised and benefits secured. Although a simple theory, it is far more complex in practice!

From the scheme's perspective, there is a need to provide timely and accurate information, and to have in place processes for various financial transactions, plus a requirement to understand and reduce the risks inherent with DC administration. The quality of the data and the speed with which it is delivered to the administrator is crucial to an effective administration and investment process.

Members now request information by a variety of communication methods, which means that levels of customer service must match the expectation of the member if confidence in the pension scheme is to prevail.

### 2.1 CONTRIBUTION LEVELS

Schemes may be contributory, meaning an employee contribution is required, or non-contributory meaning an employee contribution is not required. Employer sponsored schemes will always have an employer contribution. Where a DC scheme is a qualifying scheme or an automatic enrolment scheme, then minimum levels of total contributions and employer contribution apply.

There is no maximum amount of contribution set by legislation, but there are restrictions on the amount of tax relief available (see section below). Scheme rules, however, may impose a limit on the amount of contributions that can be paid.

Employee contributions, where required, may be a fixed percentage of pay or vary according to the length of the employee's service or age.

There has been considerable discussion in the past as to whether contributions linked to age or service would be legal under age discrimination legislation. There is a specific exemption in the age discrimination legislation for age related contributions, provided the aim is to equalise the benefits in respect of members of different ages who otherwise are in comparable situations.

Employers are not required under legislation to offer their scheme members an AVC arrangement, although many schemes do allow members to make AVCs.

### 2.2 TAX RELIEF AND THE ANNUAL ALLOWANCE/TAPERED ANNUAL ALLOWANCE/MONEY PURCHASE ANNUAL ALLOWANCE

The Finance Act 2004 sets out the rules for providing tax relief on contributions. The maximum amount of tax relief that is available on employee contributions is the greater of 100% of a member's taxable earnings for that tax year or £3,600.

In addition to this, the Annual Allowance restricts the amount of tax relievable contributions available by limiting the amount of tax privileged saving in a tax year. The Annual Allowance was initially introduced in April 2006 at £215,000 and then after a number of steady increases was significantly reduced to £50,000 from tax year 2011/12. It was reduced again to £40,000 for tax years 2014/15 onwards. If a scheme member exceeds the Annual Allowance, an Annual Allowance tax charge is triggered on the excess pension savings.

#### 2.2.1 Testing Against the Annual Allowance

To determine whether the Annual Allowance has been exceeded it is necessary to know the total Pension Input Amount (PIA) for the tax year, aggregated across all registered pension arrangements. For schemes that are just providing benefits on a defined contributions basis then the PIA is simply the contributions paid by, or on behalf of, the member which are deemed to fall within the Pension Input Period (see Section 2.2.2). Investment returns are ignored for this test.

If the PIA relates to a hybrid benefit where, for example, the DC benefits have a DB underpin then the calculation is further complicated by having to determine which basis provides for the greatest of the possible input amounts.



### 2.2.2 The Pension Input Period

The Pension Input Period (PIP) is typically a period of 12 months over which the PIA for a pension arrangement is measured.

For DC arrangements, prior to the 2016/17 tax year, the start date of the PIP was based on the earlier of the date on which the first contribution was deducted from the individual's salary or the date on which the scheme first received a contribution in respect of the individual. This resulted in different PIP dates for different members within a scheme. However, it was possible for trustees to nominate a different end date so that all members had a PIP which, for example, coincided with the scheme year for simpler reporting procedures and individual members could have also nominated a different end date.

The Government announced at the Summer Budget 2015 on 8 July 2015 their intention to restrict the Annual Allowance for high earners from tax year 2016/17 onwards with introduction of the 'Tapered Annual Allowance' (see section 2.2.4). The tapering takes into account the taxable income that an individual receives during a tax year and therefore to ensure that the Tapered Annual Allowance works as intended, all PIPs for all schemes needed to be aligned with the tax year from 2016/17.

For the 2015/16 tax year, there were transitional rules because of the need to extend PIPs so that they became tax year aligned. As a result the PIA had to be split between a pre-alignment period and a post alignment period and the dates for these periods ran from:

- Pre-alignment Period: Start date of the original PIP that was to end in 2015/16 and 8 July 2015
- Post-alignment Period: 9 July 2015 to 5 April 2016

In addition, for the 2015/16 tax year, some concessions were introduced because some PIPs would have been more than 12 months in length as a result of the alignment to the tax year. Therefore, for the pre alignment period there was an allowance of £80,000 and for the post-alignment period the allowance was the unused PIA from the pre-alignment period (subject to £40,000 maximum).

### 2.2.3 The Pension Input Amount

To determine whether the Annual Allowance has been exceeded for a tax year, a test is made by calculating the PIA for each pension arrangement.

For DC arrangements the PIA for an individual is the total of:

- Any tax relievable pension contributions paid by or on behalf of the individual, and
- Contributions paid in respect of the individual by an employer

The date to be used for determining in which PIP a contribution falls for a DC arrangement:

- in the case of a Net Pay arrangement is the date deducted from salary (employee contributions) and the date of receipt (employer contributions)
- in the case of a Relief at Source arrangement is the date of receipt

### 2.2.4 Tapered Annual Allowance

The Tapered Annual Allowance (TAA) was introduced from 6 April 2016 for those with 'Adjusted Income' of £150,000 or more in a tax year. This effectively reduced the Annual Allowance for such individuals by £1 for every £2 of Adjusted Income that the individual receives over £150,000. The maximum possible reduction was £30,000, which would leave a TAA of £10,000. Therefore, earners with Adjusted Income of between £150,000 and £210,000 were affected by the TAA and those with Adjusted Income over £210,000 had a TAA of £10,000.

Adjusted Income is the total of all sources of taxable income in a tax year plus the value of pension saving (employee and employers contributions included). However, those with income, excluding pension contributions, below a £110,000 threshold, will not be subject to the TAA (regardless of their level of Adjusted Income).

In his spring budget of 2020, chancellor Rishi Sunak increased both the threshold and adjusted income thresholds by £90,000 (i.e. £110,000 to £200,000 and £150,000 to £240,000.) The minimum annual allowance for those subject to the TAA has been reduced from £10,000 to £4,000.

### **2.2.5 Money Purchase Annual Allowance**

The Taxation of Pensions Act 2014 introduced pension flexibility for money purchase pension savings which took effect from 6 April 2015. The Act also introduced the Money Purchase Annual Allowance (MPAA) rules designed to ensure that individuals do not use the pension flexibilities to avoid tax on their current earnings by diverting their salary into their pension with tax relief, and then immediately withdrawing 25% tax free.

The MPAA is only triggered when an individual first flexibly accesses their benefits, for example, if:

- they receive an uncrystallised funds pension lump sum (UFPLS)
- they drawdown funds from a flexi-access drawdown fund (FAD), including when a pre 6 April 2015 drawdown pension is converted to FAD
- they receive a payment from a 'flexible annuity'; i.e. an annuity in which the annual rate of payment can be reduced
- they receive a scheme pension from a money purchase arrangement where the arrangement provides scheme pensions to less than 12 members

The MPAA rules are not triggered if a member receives a Pension Commencement Lump Sum or a Small Lump Sum under the de minimis rules.

The fact that a scheme does not permit flexible access to benefits does not mean that it will be unaffected by the MPAA legislation. There are certain requirements which will apply to a scheme once the administrator is advised that the MPAA has been triggered for a member, even if this was triggered in another scheme.

The MPAA only applies to contributions made, or benefits accrued, from the day after the trigger date. The MPAA is tested in the same way as the standard Annual Allowance; however, it only applies to members who trigger the MPAA rules. Those members for whom it is triggered must have their total money purchase, cash balance and hybrid savings tested against it.

The MPAA was £10,000 when it was first introduced in the 2015/16 tax year and was reduced to £4,000 from the 2016/17 tax year following a change in legislation.

If the MPAA is not exceeded then the combined total of pension savings (including DB pension savings) must still be tested against the standard Annual Allowance. If the MPAA is exceeded, an Annual Allowance charge will be payable even if the total amount is less than the overall current Annual Allowance of £40,000. In this case, a member's DB pension savings would be tested against a reduced or 'alternative' Annual Allowance of £36,000.

### 2.2.6 Carry Forward

Where an individual's total PIA for a tax year exceeds the standard Annual Allowance then it may be possible to offset some or all of the excess by carrying forward unused allowance from the three previous tax years. For those previous years to which the Tapered Annual Allowance applies, the amount of carry forward available will be based on the unused TAA.

It is not possible to use carry forward to offset a charge if the MPAA has been exceeded but it can be used for any DB pension savings which are tested against the alternative Annual Allowance.

### 2.2.7 Exemptions

There are some exemptions from the Annual Allowance test which are set out below:

#### *Ill Health*

Where the conditions for a Serious Ill Health Lump Sum are met then the individual will be exempt from the test against the Annual Allowance. This exemption was then extended to include 'severe ill health'.

For the purpose of this exemption, the severe ill health conditions are that:

- all benefits are taken under the arrangement
- a registered medical practitioner provides evidence of ill health
- as a result of ill health, the individual is unlikely to be able to undertake gainful work (in any capacity) at any time up to State Pension Age

#### *Death*

Where an individual dies, no PIA will arise for the PIPs ending within the tax year in which the date of death falls.

#### *Deferred Benefits*

For DC arrangements, the test is based on contributions received and therefore the exemption only applies where the individual has not contributed in a PIP.

### 2.2.8 Reporting Requirements

There are various reporting requirements.

#### *Pension Savings Statement*

A 'Pension Savings Statement' will have to be provided automatically to a member of a registered pension scheme where:

- the aggregated PIA for all arrangements under that scheme, exceeds the standard Annual Allowance
- the member has triggered the MPAA and has a PIA relating to money purchase saving in a tax year exceeding the MPAA (£4,000 from 2016/17 tax year onwards) Transitional arrangements applied for the 2015/16 tax year.

When determining whether a member has exceeded the Annual Allowance, all PIAs for PIPs that fall within the relevant tax year will have to be aggregated. Some schemes are made up of a number of arrangements (e.g. a scheme providing DB benefits with an associated DC AVC provider). The reporting requirements will necessitate liaison between the various arrangements so that the PIAs can be aggregated before a statement is sent out.

## Defined Contribution Arrangements

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To enable a member to be able to calculate the correct Annual Allowance charge there are four items that must be included in the statement:

1. The aggregate PIA for the relevant PIP for each arrangement relating to the member under the registered pension scheme
2. The Annual Allowance specific to the tax year relating to the end of the PIP
3. The aggregate PIA in respect of each arrangement for the PIPs ending in each of the three tax years immediately preceding the relevant tax year
4. The Annual Allowance for each of the three preceding tax years

The information for the three preceding tax years will enable the member to determine whether they have any unused allowance to carry forward; where available, this amount can be offset against the PIA and therefore reduce or eliminate the Annual Allowance charge.

This statement must be provided no later than the 6 October following the end of the relevant tax year.

### *Member Requests*

An individual can make a written request for a statement in respect of a PIP ending in a tax year. The request could be for information in relation solely to the PIA for one PIP, or it could be that the individual also requests the PIAs for the three preceding PIPs simultaneously if the individual is trying to work out their carry forward position.

### *Event Report*

Where the member has been issued a Pension Savings Statement due to the fact that they have exceeded the standard Annual Allowance or MPAA, this must be included within HMRC's Event Report.

Where the standard Annual Allowance or MPAA has been exceeded, HMRC requires the following information on the Event Report:

- The tax year for which the Annual Allowance was exceeded
- Name of the member
- National Insurance number
- Where the standard Annual Allowance has been exceeded ;the aggregate PIA for the relevant PIP for each arrangement relating to the member under the registered pension scheme
- Where the MPAA has been exceeded, the aggregate PIA for the relevant PIP for cash balance, money purchase and hybrid arrangements and the aggregate PIA for the relevant PIP for DB arrangements

The information will need to be included in the Event Report corresponding to the tax year of issue of the Pension Savings Statement.

### **2.2.9 Annual Allowance Charge and 'Scheme Pays'**

The Annual Allowance charge arises when the total PIA for an individual for the tax year concerned, exceeds the amount of the Annual Allowance for that tax year. For those to which the Tapered Annual Allowance or Money Purchase Annual Allowance applies, the Annual Allowance charge arises where the total PIA exceeds the reduced allowance that applies.

The charge is levied on the excess and is applied at the individual's marginal rate of tax.

The charge will normally be paid through an individual's Self Assessment tax return. However, where the charge is greater than £2,000 and where the total PIA exceeds the standard Annual Allowance, the member can make an election for the scheme to pay the charge on their behalf provided the standard Annual Allowance has been exceeded under that scheme and the scheme is required under legislation to comply with this. This is referred to as 'mandatory scheme pays'. A scheme cannot charge members who use this facility.

## Defined Contribution Arrangements

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For those impacted by the TAA, mandatory scheme pays is only applicable in respect of the PIA which is in excess of the standard Annual Allowance of £40,000 and is not available on the portion of the PIA in excess of the individual's TAA (and the Annual Allowance charge still must exceed £2,000).

Similarly, for those impacted by the MPAA, mandatory scheme pays is only applicable in respect of the PIA which is in excess of the standard Annual Allowance of £40,000 and is not available on the portion of the PIA in excess of the MPAA (and the Annual Allowance charge still must exceed £2,000).

By 6 October each year, a member should be aware if an Annual Allowance charge has arisen as a result of receiving their Pension Savings Statement. If a member is eligible for mandatory scheme pays and opts for this, they must report this on their Self Assessment tax return and make an irrevocable election to their scheme by 31 July after the deadline for Self Assessment (31 January). If this deadline has passed, a scheme is not obligated under legislation to comply.

If mandatory scheme pays is not applicable at all or is only applicable to part of the excess over the Annual Allowance, then a scheme could allow members that are subject to the Annual Allowance charge to opt for the scheme to pay the charge on a voluntary basis, irrespective of the amount of the charge or whether it has arisen in their scheme. Different deadlines apply for voluntary scheme pays.

Where the scheme pays the charge on behalf of the member there must be a corresponding reduction in the member's benefits. Schemes have the flexibility to decide how benefits should be reduced, provided the reduction is broadly fair and accurate. In DC schemes, it is simple and the member's funds or units held are reduced by the amount of the tax paid. Having reduced the fund, the scheme would then pay the tax charge via the Accounting for Tax Return (AFT).

### 2.3 ANNUAL BENEFIT STATEMENTS

Annual benefit statements must be provided to all active and deferred members of DC schemes, within 12 months of the end of each scheme year. There is an exemption from the requirement to provide an annual benefit statement for new scheme members where no contributions have been credited in the scheme year or where the member is still in an automatic enrolment opt-out period.

The Occupational and Personal Pension Schemes (Disclosure of Information) Amendment Regulations 2002 first introduced the requirement for Statutory Money Purchase Illustrations (SMPIs) to be provided to members of occupational or contract-based schemes that provide benefits on a money purchase basis from 6 April 2003. SMPI statements illustrating members' prospective pensions have to be sent to members on an annual basis. In practice, these are usually sent out alongside the annual benefit statement.

The requirement to provide an SMPI applies to schemes with a money purchase element including DB schemes with money purchase AVCs, schemes with both DB and DC sections and DB schemes with a money purchase underpin (unless the scheme actuary confirms that the underpin is not a significant element of the pension benefit).

SMPIs do not have to be provided to members within two years of the scheme's normal retirement age or the selected retirement age, if this is different. This is to prevent confusion and unrealistic expectations in the short term for those close to retirement. There is a further exclusion for deferred members whose fund values are below £5,000 and are unlikely to exceed this amount and for new scheme members where no contribution have been credited in the scheme year or where the member is still in an automatic enrolment opt-out period. Most schemes, however, send statements to all active and deferred members regardless of the size of fund because it is easier from an administration perspective.

The pension projection must be presented in real money terms, allowing a direct comparison of the illustrated pensions with the member's present day income and cost of living. The calculation uses mostly prescriptive assumptions such as the annuity basis, but the regulations do provide some flexibility to allow for an individual's personal circumstances to be included. The projection can factor in a cash lump sum at retirement and a varying percentage of dependant's pension (including zero). Investment returns must be adjusted to reflect the scheme's investment strategy.

The actual calculation basis is defined in Technical Memorandum 1 (TM1) which is supplied by the Financial Reporting Council and has been updated a number of times since its introduction. At the time of writing, TM1 version 4.2 is the current version in force.

### 2.4 CONTRIBUTION MANAGEMENT

The timing of events is vital for DC schemes, particularly in relation to collecting and distributing members' contributions. Legislation is in place to ensure that schemes receive contributions in a timely manner. Legislation requires that employee contributions deducted by an employer are paid to the scheme by the 19th of the month following deduction from payroll (or 22nd of the month for electronic payments only). In the DC Code of Practice TPR reminds trustees and employers that this is the absolute maximum deadline and prompt payment is expected.

There are special rules for the first deduction of contributions on automatic enrolment under the Pensions Act 2008. The due date for any new joiners to either a qualifying pension scheme or to an automatic enrolment scheme is extended and is the 19th of the month (or 22nd of the month for electronic payments only) following completion of three months from the date on which active membership is effective. Thereafter, contributions will fall due in the standard manner.

Failure to comply could result in TPR levying a fine. In the event that contributions are more than 90 days late or if the late payment is due to a material payment failure, schemes must notify members and report the late payment to TPR.

To ensure that payments are received in a timely manner and are compliant with the legislation, a DC scheme must have a payment schedule or a direct payment arrangement in place that details the amounts and timings of both employer and employee contributions to the scheme.

### 2.5 CONTRIBUTION AND INVESTMENT PROCESSING

Core financial transactions must be processed promptly and accurately. This is a requirement of legislation. Core financial transactions include investments of contributions, as well as transfers in and out, investment switches and payments to members.

It is, therefore, pivotal that the process is streamlined to ensure that the investment of contributions can happen promptly and without error.

#### 2.5.1 Collecting the Monies

The collection of contributions is normally handled by the scheme accountant or payroll/accounts department.

The employer's payroll department will collect the contributions from the member's pay, and make the payment to the scheme. Electronic payments are the usual method for making the payment of contributions into the scheme.

Collecting and paying the monies across to the scheme can create some issues which need to be considered:

### *Weekly Paid Employees*

If members are weekly paid this condenses the DC cycle and administrators must have a robust procedure to investigate any queries prior to investing the members' contributions.

If the administrators are unable to settle queries with the payroll department, then a default procedure must be agreed; e.g. members with queries will have their monies go into a suspense account or default investment fund until each query has been resolved.

Where weekly payrolls occur, the payroll department may retain the contributions and pay the funds over in a lunar or monthly cycle by the payment deadline. This raises a number of issues:

- Is it right to retain the monies?
- If they are retained, are the members missing out from lost investment opportunities?
- Should the monies be invested on a weekly basis straight away into the investment fund?

Whichever way the trustees and payroll operate, it is good practice to ensure the contributions are processed and invested as soon as they are received.

### *Multiple Payroll Sites*

The scheme must take into account the issues arising where multiple payrolls are in operation. If a central payroll exists for multiple sites, a straightforward payroll cycle can be agreed. However, where a company operates multiple payrolls, perhaps using multiple payroll systems, the scheme must ascertain whether the payroll frequencies are the same, monthly, weekly, fortnightly etc and whether they operate to the same payroll date.

If the payroll dates differ, the scheme will have to make the decision whether to hold off the contribution processing or to run separate contribution processing cycles. If the payrolls are only a matter of days apart, then it makes sense to wait and amalgamate the contribution processing. If, however, the payroll dates are weeks apart, it is good practice to invest the contributions as soon as possible and if the contributions are accumulated over a number of months, the interest earned should theoretically be apportioned across the membership.

If the payroll frequencies differ; i.e. one site operates weekly, where another operates monthly, the scheme may decide to run the weekly cycles and accumulate the fourth weekly cycle with the monthly cycle. This can cause problems, however, as the two cycles will rarely if ever tie up.

### **2.5.2 Data Formats for Contribution Collection**

The administrator must agree with the payroll department the means by which the data is transferred from the payroll system to the administration system. These can include:

#### *(a) Paper Schedules*

- A very rare occurrence given today's technology
- To be avoided due to time issues and risk of human error

#### *(b) Excel Spreadsheets*

- A popular and universally used means of transferring data between applications
- Whilst allowing data to be uploaded automatically, it does little in the way of validation for administrators

### *(c) Interfacing*

- Software designed to transfer data from one system to another with a degree of validation in the middle
- Reduces the chance of human error and reports on the errors, speeding up identification of non-reconciled data items

### *(d) Online Contributions Processing*

- An interactive process allowing the payroll to validate the contribution file before downloading it via the internet into the administration system
- Moving the onus to the payroll department to correct the data prior to sending it to the administrators

The administrator should agree with the payroll department the timings for receipt of the data. Communication between the two parties is of paramount importance. They must also agree exactly what information will be coming across and when and who will be responsible for resolving errors or discrepancies.

### **2.5.3 Timing – Investing the Contributions**

One factor that historically impeded DC administration was the dealing cycles; i.e. when the investment manager would actually process the investment or disinvestment. Originally, investment managers limited the dealing to one day a month. The contribution processing therefore needed to have been completed by a certain cut off point in order to get the instruction and funds to the manager for the dealing date. If this dealing date was missed the contributions would be out of the market for an unacceptable amount of time. Whilst there are still discrepancies between investment managers and their dealing days, some of them will only accept dealing instructions in a particular format (e.g. via email, interface files and some still require a signature), they have improved considerably. The majority offer daily dealing except for those with specialist funds; e.g. property or hedge funds.

The issue of the timing of contributions processing is vital to effective DC administration, as any delay and investment loss has a direct impact on individual member's funds. There is now a legislative requirement for contributions to be invested promptly and accurately. Schemes will often have a Service Level Agreement in place with their administrator for the investment of contributions.

TPR sets out its expectations in relation to the investment of contributions in the DC Code of Practice. Where there is daily dealing then TPR expects that contributions would be invested within three working days following receipt of contributions and conclusion of the reconciliation exercise. Where the dealing cycle is less frequent than daily, TPR expects investment to take place at the next available dealing date, and within a maximum of five working days, after completion of the reconciliation exercise.

When trustees/managers are considering the fund options to offer to members, they take into account many factors, one of which being how often the investment manager deals. Where a specialised fund is offered that does not offer daily dealing, this should be communicated to the members so they are aware of the dealing dates available.



### 2.5.4 The Defined Contribution Cycle in Action

The following steps outline the typical DC administration cycle. The student should also refer back to 'Straight Through Processing' in Part 1.

#### *Step 1: Payment*

Payment may be remitted by BACS, or in rarer instances, cheque.

The company should provide schedules to accompany each set of contributions paid. These schedules should identify:

- The amount of contribution paid by each employee
- Any AVCs paid per employee
- The amount paid by the company on behalf of each employee
- Any new joiners
- Any leavers
- Members on family leave
- Members on long term sick leave
- Members on sabbatical
- Members changing hours from full time to part time or vice versa

#### *Step 2: Checking/Reconciling contributions*

The administrator should check the following when contributions are received:

- Have the contributions been paid within statutory timescales and within timescales set in the payment schedule/direct payment arrangement agreed by the trustees/managers and the company?
- Have schedules been provided, detailing all of the contribution information required?
- Does the total amount remitted agree with the schedules provided?
- Have contributions been paid in respect of all active members? If not, is there an explanation?
- Have investment instructions been provided for each new member?
- Are there any leavers not previously notified?
- Have employer contributions been paid at the correct rate for anyone on paid family leave?
- Have contributions been paid at the correct rate for each member; e.g. does the employer increase contributions on anniversary dates?
- Are there any negative contributions; e.g. adjustments to cover errors in an earlier pay period?

Some payroll departments seem to have difficulty understanding the concept of defined contribution – particularly if the company also has a DB scheme. It is not uncommon for payroll to deduct a contribution overpayment made in a previous period (resulting in a negative contribution) and it is not understood that, by so doing, they are affecting someone else's investment. Any such shortfalls must be brought to payroll's attention immediately, as this could result in investment delays.

## Defined Contribution Arrangements

To look at the principles of why negative contributions are an issue for DC schemes, shown below is a simplified example of a DC scheme with five members, where:

Month 1 Schedule Shows:		
Member A:	£100	employer contributions
Member B:	£100	employer contributions
Member C:	£100	employer contributions
Member D:	£100	employer contributions
Member E:	£100	employer contributions
	£500	Total contributions sent:

Therefore the pension scheme administration team allocates £100 to the retirement accounts for members A-E. As this is a DC scheme, there is no cross-subsidy of contributions and each specific contribution amount is allocated to each specific member's fund and invested according to their particular instructions.

### *Month 2 Schedule Shows:*

Member A: £100 employer contributions (due to a previous overpayment)  
Member B: £100 employer contributions (due to a previous overpayment)  
Member C: £100 employer contributions  
Member D: £100 employer contributions  
Member E: £100 employer contributions    Total contributions sent: £100

Therefore, the £100 contributions due to be allocated to the funds for Members C-E cannot be allocated until £100 is disinvested from each of Member A and Member B's funds.

This disinvestment process would cause significant delay in the investment of that month's contributions. This could cause Members C-E to complain of lost investment return, due to the delay in investing their contributions.

Any other issues should, if at all possible, be resolved before arranging for investment. If not, monies may have to be held in a holding or suspense account. It should be emphasised that any delay could result in possible financial loss to members.

Most administrators will be instructed by trustees/managers what they should do under such circumstances – it is usual for the majority of the contributions to be invested without delay and monies retained only where investment is not possible. Sometimes, administrators may be instructed to invest outstanding monies in a default fund until clarification has been obtained. Trustees may often have a Service Level Agreement in place which sets out how long an administrator has from receipt of contributions before investment should take place. Administrators would be expected to report on this in regular stewardship reports and highlight any breaches of these timescales to the trustees.

TPR expects that where any discrepancies in contribution reconciliations arise, that only the unreconciled contributions would be held pending resolution, and for the remainder to be invested accordingly.

Most administration systems allow for the member contributions to be loaded at this stage, so that data checks can be carried out.

### *Step 3: Switches*

Before forwarding contributions, the administrator should check whether any switches have been requested since the last investment date and process these. Investment switches are a core financial transaction and as such there is a legal requirement for these to be done promptly and accurately.

The administrator will also be responsible for checking whether any lifestyling switches should be made at this time. The investment manager will be instructed to sell units in one fund and use the sale proceeds to buy in another.

### *Step 4: Forwarding*

Once the contributions have been reconciled and all switching instructions included, contributions should be allocated by each fund and fund manager, and monies forwarded.

The fund manager will usually only be responsible for the total monies in each fund and it is not necessary for member information to be forwarded. Indeed, depending on the contract between the trustees/managers and the fund manager, it may be a breach of data protection legislation to forward individual member details to the fund manager.

A final check should be made before sending the money, to ensure that the total of all contributions received equals the total amount remitted to all investment managers.

### *Step 5: Contract Notes*

Once an investment manager has invested the contributions, a contract note for each fund will be forwarded by them to the administrator. This will detail:

- The amount of money received
- The fund(s) in which it was invested
- The date invested
- The total units purchased/sold
- The dealing price applicable to the transaction

If contract notes are not received promptly, the administrator should confirm with the investment manager that funds have been received.

### *Step 6: Allocation*

Once each contract note is received, the administrator should process 'buying' units on the system and allocate them to each individual member. This would normally entail entering the unit price and running a programme to calculate the units purchased.

### *Step 7: Reporting/Reconciling units purchased*

A report should then be run to check that the total units purchased on the system equals the number of units bought by the fund manager. If there are any discrepancies, these should be investigated; hopefully, the majority of discrepancies will be small and due to rounding.

Once the total agrees, it is usual for there to be a sign-off process by a senior administrator, although checking may take place at any of the other stages, particularly when investing the contributions.

Failure to reconcile contribution and investment information regularly could result in historically incorrect records being held and ultimately incorrect benefits being paid out, which is a major risk for DC schemes; and it can be very costly to unwind errors.

### **2.5.5 Disinvesting**

The process so far has covered investing only but, of course, disinvestment instructions may also take place at the same time.

There is a practice called 'offsetting' whereby, in order to save charges, any disinvestments required (in respect of refunds, transfers or retirements) may be offset against the contributions to be invested. This process adds complexity to DC administration, especially for the regular reconciliations that must be completed.

Under this practice, the administrator calculates the amount of disinvestment required and deducts this value from the contributions to be invested. The lesser amount is forwarded to the fund manager and then, when the contract note is returned, the administrator 'sells' the units for the leavers and 'buys' the correct total amount of units for the new contributions at the dealing price.

A very brief review of this will show where a problem can occur. With unit prices changing on a daily basis, it is not uncommon for the units sold to not equal the units bought. If there is a shortfall, this must be made up. If there is an 'unallocated' fund, then units may have to be switched from this to individual members' funds.

Disinvestments are going to fall into the category of core financial transactions (as they will be transfers or payments out of the scheme) and there is a legal requirement that these will be done promptly and accurately. The 'offsetting' approach can involve delays so is unlikely to meet the requirement of legislation.

Consequently, by far the simplest approach and the one which provides the most clarity and least risk of breaching legislation is for disinvestments to be separately requested. If there are lots of disinvestments to be dealt with, the trustees/managers will often agree to these being grouped together and being requested once a month, which will help save on investment manager fees.

### Summary

DC administration requires a different discipline to DB administration:

- Investments and disinvestments must be handled promptly to ensure no financial loss to the member
- Administration systems must be flexible, to cover the additional data and reporting requirements of DC schemes
- Accurate records of individual members' fund holdings are essential
- Fund holdings on the administration system need to be regularly checked against those recorded by the investment manager
- Members need to be more financially aware, as the investment risk lies with them, rather than the employer or the trustees/managers
- Regular, good quality member communication is essential

DC administration is reliant on a (usually monthly) cycle to receive and invest contributions. The cycle covers the following steps:

1. Payment
2. Checking
3. Switches
4. Forwarding
5. Contract Notes
6. Allocation
7. Reporting/Reconciliation

There is no legislative limit on the amount of contributions a member may pay into a scheme but tax relief may not be available or could be restricted by becoming subject to an Annual Allowance charge.

### Self Test Questions

- List the objectives for DC scheme administration.
- Explain what an SMPI is and when one must be provided.
- What issues are there with weekly payroll runs?
- What checks should the administrator undertake on receipt of regular contributions?
- Explain what happens at each stage of the DC contribution and investment cycle.
- A member of the Colourboxx Money Purchase Pension Plan wants to switch future contributions and existing fund holdings to a new fund. Design an appropriate form, ensuring you provide for the collection of all relevant information.
- Under what circumstances must a Pension Savings Statement be issued and what items should be included.

# PART 3

## BENEFITS FROM WORKPLACE DEFINED CONTRIBUTION SCHEMES

### OVERVIEW

The benefits being provided for in a workplace DC scheme are of paramount importance to members. This Part looks at some of the legislative requirements for processing and paying benefits to the member, as well as noting how their form can vary depending on the scheme rules.

After studying this Part, the student should have a good understanding of benefits payable to members at retirement, on death, and on leaving the scheme. The student should also have an understanding of the different forms of protection available to members to protect their benefits against the Lifetime Allowance, and the process of winding up a DC pension scheme.

# CHAPTER 1

## Processing and Paying Benefits

### INTRODUCTION

Before paying any benefits, the administrator should check the provisions of the scheme rules. DC schemes vary considerably in how they are set up and an unwary administrator can easily make a mistake.

The payment of benefits is a core financial transaction and there is a legal requirement for such transactions to be processed promptly and accurately.

A robust process should be in place to ensure that the administrators are informed promptly by the scheme's employer when a member leaves service, so that the member's leaving options can be progressed within the disclosure regulations timescales.

By the end of the Chapter, the student should understand the principles that underlie such a process.

### 1.1 EARLY LEAVERS

The options available for early leavers from occupational DC schemes depend on the date that the member joined the scheme and these are explained in more detail below.

These rules do not impact the automatic enrolment opt out period which should be considered separately. In most cases, the automatic enrolment opt out period will be one month from the first day of the opt out period, but in some exceptional cases, it can be extended by a further two weeks. By the time an automatic enrolment joiner's opt out deadline has passed, the early leaver rules outlined below will apply.

The early leaver options changed for DC schemes with effect from 1 October 2015 as a result of amendments in the Pensions Act 2014. This change aligned the vesting period of trust based and contract based DC schemes. Those who joined a scheme prior to 1 October 2015 would have had their early leaver options processed in accordance with the previous rules.

#### **1.1.1 Early Leaver Options for Members who only have pure DC benefits who joined the Scheme on or after 1 October 2015**

Leavers with at least 30 days' qualifying service in a DC scheme must be granted a deferred benefit within the scheme, with the future option to transfer benefits to another registered pension arrangement.

A deferred benefit is where the pension fund (consisting of the value of the total member and employer contributions, including any investment returns) remains in the scheme. Although, typically no more contributions can be paid in by or on the member's behalf, the contributions already paid in will remain invested until the member retires, dies or transfers them out into another pension arrangement. The value of this deferred benefit will fluctuate in accordance with the value of the underlying investments. Deferred members still have the flexibility to change their investment choices, if they wish.

Members with deferred benefits remain entitled to an annual benefit statement and a Statutory Money Purchase Illustration. There is more information about members transferring out their benefits in this Chapter.

If a scheme does not offer to preserve the member's benefits in the scheme at date of leaving, then for members with less than 30 days' qualifying service, the scheme should offer a refund of member contributions (however, see 1.2 below). HM Revenue & Customs (HMRC) calls this a 'short service refund lump sum'. The administrator should check the provisions of the scheme rules to see what options should be offered to members in this category.

### **1.1.2 Categories of Leavers for Members who joined the Scheme prior to 1 October 2015. Early leavers from DC occupational pension schemes who joined the scheme prior to 1 October 2015 can be divided into three categories based on their length of service:**

- Those leaving with less than three months' service
- Those with three months' to two years' service
- Those with more than two years' service

These rules also continue to apply for members who hold any form of defined benefits or cash balance benefits, irrespective of their date of joining the scheme.

### **1.1.3 Pre 1 October 2015 Joiner Leaving with Less than Three Months' Service**

If a scheme did not offer to preserve the member's benefits in the scheme at date of leaving, then for members with less than three months' service, the scheme had to offer a short service refund lump sum. Individual schemes could have chosen to offer a 'cash transfer sum' and/or a deferred benefit.

### **1.1.4 Pre 1 October 2015 Joiner Leaving with Three Months' to Two Years' Service**

If a scheme did not offer to preserve the member's benefits in the scheme at date of leaving, then for members with more than three months' but less than 24 months' service, the scheme had to notify the member of their right to take either a cash transfer sum or a short service refund lump sum. The cash transfer sum offered had to be in respect of the full fund and not just the portion relating to the member's contributions. It was up to individual schemes whether a deferred benefit was also offered to members.

### **1.1.4 Pre 1 October 2015 Joiner Leaving with More than Two Years' Service**

The member had to be granted a deferred benefit within the scheme, with the future option to transfer benefits to another registered pension arrangement.

## **1.2 SHORT SERVICE REFUNDS FROM OCCUPATIONAL PENSIONSCHEMES**

There are different ways for schemes to calculate refunds of member contributions, such as:

- The current value of the member's contributions (i.e. the present value of the investments purchased by the member's contributions)
- The return of the member's contributions (i.e. the cash amount of the member's contributions they have paid into the scheme)
- The value of the member's contributions taking into account investment returns, subject to a minimum of the cash amount of the member's contributions paid

Note: references to member contributions also include Additional Voluntary Contributions (AVCs).

When a refund of member contributions (i.e. a short service refund lump sum) is paid, this cannot exceed the total amount of the contributions made to the scheme by the member. Schemes are, however, free to make interest/investment growth payments in addition to the short service refund lump sum. Such payments are treated as a Scheme Administration Member Payment (SAMP). This should be made on an arm's length commercial basis; i.e. for interest no more than would be provided on a reasonable commercial rate. The investment growth on a DC arrangement is acceptable for these purposes. Anything in excess of this would be taxed as an unauthorised member payment.



Since 6 April 2010, the tax charge on refunds of contributions has been as follows:

- 20% on the first £20,000 of the refund
- 50% on amounts in excess of £20,000

The rules of the scheme will, in most cases, give the trustees the power to deduct this tax from the amount paid to the member. The administrator is responsible for paying the tax deducted from all refunds to HMRC via the quarterly Accounting for Tax Return.

Where a SAMP is payable, it is paid gross but is subject to income tax in the hands of the member. Members should therefore declare such amounts as part of their self-assessment tax return.

Short service refunds are not permissible from contract based pension schemes, such as GPPs.

### 1.3 DEATH BENEFITS

Whether death occurs in service or in deferment, the administrator will be required to obtain proof of death usually in the form of a death certificate and, depending on whether dependants' pensions are to be set up, relevant birth and marriage certificates may also be required. Details of the Legal Personal Representative (LPR) are also required as the LPR needs to be aware of the various responsibilities associated with the role set out by HMRC. The position can be slightly different on death in retirement, and this is covered below.

#### 1.3.1 Death In Service

Before quoting or paying any benefits, it is important that the administrator checks to see what the scheme rules state should happen to the member's accumulated fund. The scheme rules may provide for one, or a mixture, of the following:

- The value of the member's fund to be paid as a discretionary lump sum to the member's beneficiaries, together with any insured lump sum (for example, a multiple of salary) where applicable
- The value of the member's fund to be used to purchase an annuity, pay a scheme pension or provide a drawdown pension

From 6 April 2015, legislation allows for annuities or drawdown pensions payable on death to be provided to nominees or successors of the member in addition to, or instead of, a spouse and/or dependants. Also, certain lump sums can now be paid on the death of a dependant, nominee or successor.

A nominee is an individual nominated by the member, or in the absence of a member nomination, by the scheme administrator, who is not a dependant of the member. A successor is an individual nominated by a dependant of the member, a nominee of the member, a successor of the member or, in the absence of a nomination, by the scheme administrator.

#### *Lifetime Allowance Test*

A lump sum payable under the scheme rules on death can usually be paid tax free up to the amount of the member's remaining Lifetime Allowance. The payment is usually a Benefit Crystallisation Event meaning a Lifetime Allowance test is triggered at the point of payment.

Transitional rules were introduced when the standard Lifetime Allowance reduced from £1.25m to £1m from 6 April 2016 meaning that if a member died between 6 April 2014 and 5 April 2016 and a lump sum death benefit was paid on or after 6 April 2016, the Lifetime Allowance test had to be carried out against £1.25m, i.e. using the Lifetime Allowance in force at the date of death rather than at the point of payment. Similar transitional rules also applied when the Lifetime Allowance was reduced to £1.5m from 6 April 2012 and to £1.25m from 6 April 2014.

## Defined Contribution Arrangements

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Since 6 April 2015, the purchase of an annuity or designation to drawdown for a beneficiary is also usually a Benefit Crystallisation Event meaning a Lifetime Allowance test is triggered at the point of purchase or designation.

Where a lump sum death benefit is greater than the member's remaining Lifetime Allowance, the amount by which it exceeded the remaining Lifetime Allowance would be subject to a tax charge, payable by the recipient of the benefit.

### *Taxation of lump sums*

In order for any lump sum death benefit to be paid tax free (subject to a Lifetime Allowance test), the member must have died before reaching age 75 and the lump sum must be paid within two years of the earlier of the notification of the member's death, or when the trustees could have reasonably been expected to be aware of the member's death. Depending on the type of lump sum payable, any payment made outside of this two year timeframe will either be taxable at the beneficiary's marginal rate of income tax or, if paid to a non-individual (such as the deceased member's estate), will be subject to a special lump sum death benefit tax charge of 45%.

If the member dies aged 75 or over, the two year timeframe for tax-free payment is removed and the lump sum death benefit will either be subject to a tax charge at the beneficiary's marginal rate of income tax or the special lump sum death benefit tax charge of 45%. Lump sum death benefits of this type paid prior to 6 April 2016 would have been subject to the special lump sum death benefit tax charge, irrespective of who the recipient of the payment was. The special lump sum death benefit tax charge was previously set at 55% for lump sums paid before 6 April 2015.

The scheme administrator is responsible for paying the tax on any taxable lump sum death benefits which means that the tax will be withheld from the payment received by the beneficiary.

There is no test required against the Lifetime Allowance when the member dies over age 75 or when a lump sum death benefit is taxable.

For lump sums paid prior to 6 April 2016, different taxation rules applied. A lump sum death benefit paid outside the two year timeframe would have been an unauthorised payment if paid prior to 6 April 2015 and, if paid between 6 April 2015 and 5 April 2016, would instead have been subject to the special lump sum death benefit tax charge.

### *Taxation of income payments*

Where the member died before reaching age 75, spouses', dependants', nominees' and successors' annuities and drawdown pensions are usually payable free of income tax if they were set up after 6 April 2015 and so long as the funds have been tested against the Lifetime Allowance which for unused funds requires the annuity purchase or designation to drawdown to happen within two years of date of notification of death. If the member died after age 75 or if the annuity purchase or designation happens outside of the two year period, any income is subject to income tax in the hands of the recipient.

Payments from such arrangements set up before 6 April 2015 will be subject to income tax in the hands of the recipient.

'Scheme pensions' payable to spouses or dependants are still subject to income tax in the hands of the recipient.

### 1.3.2 Death In Deferment

Typically, the payment for death in deferment would be a return of the value of the member's total fund as a lump sum. The same test against the member's remaining Lifetime Allowance must be made as for death in service.

As with death in service, the scheme may offer a range of options with regards to the member's fund. It can be paid out as a lump sum, or be used to buy a spouse's or dependant's annuity/ drawdown pension or a mixture of these options, so it is important for the administrator to check the scheme rules. In addition, the benefits are distributed at the discretion of the trustees for the reasons outlined in the death in service summary described above.

### 1.3.3 Death In Retirement

Historically, the majority of retirement benefits from a DC scheme were secured by way of annuity purchase with an insurance company. Where an annuity has been purchased, the benefits paid on death depend entirely on the provisions of the annuity purchased on retirement which could include options chosen by the member, for example, the option of a spouse's pension, or a guarantee period.

Where the scheme does not provide a pension via an annuity, for example, where the member is using drawdown, the death benefit provisions will be different. In these circumstances, the administrator will need to carefully check the scheme rules to see whether benefits will be paid in lump sum format or whether drawdown for beneficiaries would be allowed.

## 1.4 TRANSFERS

### 1.4.1 Transfers In

Schemes may allow members to transfer in benefits from a previous pension arrangement. Transfers into DC schemes will typically provide an increase in the member's fund value, which will represent the transfer value received from the previous scheme.

In general, administrators deal directly with the previous arrangement in order to facilitate transfers effectively and efficiently on the member's behalf. The receiving arrangement will obtain explicit authority from the member in order to do so, and correspond directly with their previous arrangement.

Care must be taken to ensure that the receiving scheme can accept the benefits to be transferred. DC schemes can accept former protected rights without restriction and can accept a cash equivalent of GMPs and Section 9(2B) rights providing certain safeguards are met and that the scheme rules allow.

The information required from the transferring arrangement may include:

- The member's personal details
- The name of the transferring scheme
- The type of arrangement (e.g. DB scheme, personal pension)
- Confirmation that the receiving scheme is a registered arrangement with HMRC together with the Pension Scheme Tax Reference number(PSTR)
- Whether any contracted out benefits are included in the transfer value
- Pensionable service details
- Whether the transfer contains a transfer in from a previous scheme and, if so, details of this
- Value of member's benefits and contributions included in transfer, including any AVCs
- Current transfer value and whether any guarantee period applies
- Statement of equalisation for pensionable service post 17 May 1990 (if applicable)
- Confirmation of any court orders on the member's benefits (for example Earmarking or Pension Sharing Orders, maintenance or bankruptcy orders)
- Whether the member has triggered the Money Purchase Annual Allowance

When the administrator of the receiving scheme has all the necessary information, an illustration of the benefits to be provided in the new scheme will be forwarded to the member, together with instructions on what the member should do if they wish to proceed with the transfer. If the transfer includes contracted out benefits, then an explanation of what these benefits provide will need to be included within the illustration.

Whilst transfers from a DB scheme will be guaranteed for a period (normally three months), transfers from DC schemes are not guaranteed, as the value of the units to be sold/purchased will vary according to market conditions at the time of disinvestment. This should also be brought to the member's attention by the transferring scheme.

If the member decides to proceed with the transfer in, they will be required to complete a discharge form, which will also include an authority for the administrator to instruct the transferring pension arrangement to transfer the member's benefit to the new scheme. The receiving scheme will have to sign to confirm they are a registered pension arrangement with HMRC and provide payment instructions.

On receipt of the transfer monies, it is important for the administrator of the receiving scheme to undertake prompt investment of the transfer amount, so that the member does not suffer any potential financial loss; for example, if investment returns are favourable whilst the transfer monies are being held in cash.

Full details of the transfer will need to be entered on the member's record, and the transfer value should be split between employee and employer contributions, as appropriate. This will also help if the member subsequently leaves the receiving scheme and decides, at a later date, to transfer out all of his/her benefits (including the existing transferred in benefit) to another registered pension arrangement.

### **1.4.2 Transfers Out**

Members of DC schemes are usually able to transfer their benefits out of one scheme to another, either as a statutory right (i.e. a right contained in legislation that overrides the scheme rules) or as a scheme rule right.

The Pension Schemes Act 2015 amended the statutory right to transfer from 6 April 2015 so that it applies to specific 'categories' of benefits, rather than all benefits in a scheme. Prior to 6 April 2015, in order to have a statutory right to transfer, a DC member had to be more than 12 months away from the scheme's normal pension age and transfer out all benefits in the scheme at the same time.

However, DC members now have the right to transfer out all of their DC benefits up to and beyond normal pension age. These changes are overriding on scheme rules. Some members transfer out at the point of retirement to consolidate their pension savings from multiple sources prior to drawing their benefits.

The three categories of benefits are:

- Money purchase benefits (i.e. DC benefits)
- Flexible benefits other than money purchase benefits, e.g. cash balance benefits
- Benefits that are not flexible; e.g. safeguarded or defined benefits

This effectively gives members a statutory right to a 'partial transfer' of benefits provided all benefits in a category are transferred. The Government introduced this in order for individuals with money purchase and non-money purchase benefits in the same scheme to be able to transfer the former away to access the DC flexibilities whilst keeping the latter in the scheme.

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The conditions for a statutory transfer from a DC scheme are as follows:

- The member has accrued rights to any category of benefits under the scheme rules. This means that members who are not entitled to a deferred benefit, and are instead entitled to a cash transfer sum, fall out of scope of these rules
- No crystallisation event has occurred in relation to the member's accrued rights to benefits in that category
- The member is no longer accruing rights to benefits in that category
- All benefits under the category have to be transferred

Where the above conditions are met, the scheme administrator cannot refuse to provide a member with a cash equivalent transfer value (or a statement of entitlement for non-money purchase benefits). The cash equivalent transfer value quoted is not guaranteed in the case of DC schemes. A member is entitled to at least one quotation free of charge in any 12 month period. It should be provided within three months of the request under legislation. Typically, DC schemes have a policy of providing these more frequently than DB schemes. This is because the transfer out quotation can be provided by simple reference to the current value of the units held by the member's fund.

A member who does not have a statutory right to transfer can still do so if they have a scheme rule right to transfer. Examples of non-statutory transfers include members who have already had a transfer value quote in the last 12 months, or those who have not left pensionable service and are still accruing benefits in that category. Any requirements or provisions within the scheme rules have to be observed; for example, the need to obtain consent or any special provisions about the destination of the transfer value.

Transfer quotations are often requested because the member has left the scheme and wishes to transfer to a new pension arrangement. In some cases, however, a transfer quotation may be required for valuation purposes if the member is undergoing divorce proceedings and they may still be active in the scheme.

The same type of information (listed previously) as required by the scheme when processing transfers in should be provided by the scheme to the member within a transfer out pack, which must contain a current transfer value plus information required by legislation. For unitised funds, a statement confirming that the transfer value is not guaranteed will typically accompany the transfer value.

For a DC scheme, the transfer value must be paid within six months of the final notification to transfer out being received. The transferring scheme will include a statement confirming that upon completion of the transfer (unless there are some benefits left within the previous arrangement/category), the trustees/managers are discharged from all liabilities in respect of that member.

For overseas transfers, the member and scheme administrator need to check that the receiving arrangement has notified HMRC that it is a Qualifying Recognised Overseas Pension Scheme (QROPS) and will also need to advise the member of the amount of Lifetime Allowance that the transfer value represents, because transfers to QROPS are Benefit Crystallisation Events which need to be reported to HMRC. As with other Benefit Crystallisation Events, a check will need to be made to ensure that the member has sufficient Lifetime Allowance, otherwise a Lifetime Allowance tax charge of 25% applies which will ordinarily be deducted from the transfer payment.

The Government has introduced a 25% tax charge for certain overseas transfer requests on or after 9 March 2017. Scheme administrators need to check whether the charge applies prior to payment.

### 1.4.3 Overseas Transfer Charge

The overseas transfer charge was introduced on 9 March 2017 and applies to certain transfers from a:

- UK registered pension scheme to a Qualifying Recognised Overseas Pension Scheme (QROPS)
- QROPS (or former QROPS) to another QROPS

Where it applies, the amount of the overseas transfer charge is 25% of the transfer value and this must be deducted from the transfer value by the scheme administrator prior to making the transfer payment.

The overseas transfer charge is levied on all QROPS transfers that were requested on or after 9 March 2017 unless an exemption from the charge applies. This includes transfer requests relating to the onward transfer of pension credit rights to a QROPS following a divorce and transfers of any pensions in payment. It would not apply to a pension credit being paid to an external arrangement located overseas (as this is not strictly a transfer but compliance with a court order) but would apply to any onward transfers of a pension credit once it had been secured internally or externally.

#### *Exemptions from the Overseas Transfer Charge*

An exemption from the overseas transfer charge will apply to any QROPS transfer where:

- the individual is resident in the same country in which the QROPS is established
- the QROPS is established in one country in the European Economic Area (EEA) (a European Union Member State, Norway, Iceland or Liechtenstein) and the individual is resident in another EEA country or
- the QROPS is an occupational pension scheme sponsored by the individual's employer, an overseas public service pension scheme or a pension scheme established by an international organisation

Residency refers to tax residency and the definition of tax residence will vary from country to country. It is the member's responsibility to determine where they are tax resident and inform the scheme administrator of this, plus other information, within HM Revenue and Customs (HMRC) form APSS263. This form should be completed by the member within 60 days of the transfer value request.

The overseas transfer charge will also automatically apply if the member has not provided the scheme administrator with all the required information before the transfer is made to determine whether or not the charge should apply.

Where a transfer was not liable to the overseas transfer charge when it was made, the overseas transfer charge can still become due for a period of up to five tax years after the tax year in which the transfer is made where circumstances change. Similarly, where an exemption does not apply at the point of the transfer but circumstances change in the five tax years after the tax year of transfer such that one of the exemptions is now met, then a tax charge may be reclaimed.

### 1.4.4 Pension Scams

Pension scams (also known as 'pension loans' and 'pension liberation') is the transfer of a member's pension savings to an arrangement that will allow them to access their funds before age 55 in good health or to access a higher tax free lump sum than is allowed under the legislation.

In usual circumstances, members cannot access their pension savings until normal minimum pension age, which is currently age 55, their tax free lump sum is restricted to 25% and they are not permitted to receive a loan from their pension pot.

Scam arrangements are usually offered through companies who make money by charging members a fee or by taking money direct from their pension savings. Company representatives or advisers may be pushy and promise members a loan or advance or cash back from their pension. They may even offer to share their commission for doing this.

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Some members may be willing participants, others victims of unscrupulous companies and advisers. Any early access to pension funds, or a lump sum in excess of 25%, will result in HMRC levying an unauthorised payments charge on the member and the scheme.

The Pensions Regulator (TPR) has come together with various other bodies, including HMRC and the Financial Conduct Authority (FCA), to produce guidance on pension scams for members, trustees/managers and pension professionals in an attempt to combat the growing trend. Where a concern has been identified regarding pension scam activity then this can be reported to a body called Action Fraud. Following the increase in the number of pension scam cases across the industry, HMRC introduced a revised approach to both its scheme registration process and how it confirms the registration status of a scheme following a request from a scheme administrator.

The scheme registration process is intended to greatly reduce the number of schemes set up for pension scam purposes. The 'process now, check later' approach was replaced with a more rigorous procedure to allow HMRC to conduct detailed risk assessment activity before making a decision. In addition, it is possible to confirm a scheme's registration status with HMRC without seeking consent from the receiving scheme. HMRC only confirms where the receiving scheme meets both the conditions of being registered and not posing a significant risk of scam activity; however, the confirmation does not guarantee the scheme's legitimacy.

At time of writing, the Government is still considering ways to tackle scams including restricting the statutory right to a transfer. Further information can be found in Section 1.4 of Part 6.

### 1.5 RETIREMENT BENEFITS

Traditionally retirement benefits from DC schemes included lifetime annuities, pension commencement lump sums, and trivial commutation lump sums where fund values were small. More sophisticated income options, such as capped and flexible drawdown, were also available but were not as popular as the annuity option.

From 6 April 2015, retirement options came into force to allow members to access their money purchase benefits flexibly. Therefore, in addition to the traditional options, schemes can also choose to offer its members the option of withdrawing funds as a lump sum via an Uncrystallised Funds Pension Lump Sum (UFPLS) or as regular income withdrawals via Flexi-Access Drawdown (FAD). These options can all be paid from age 55 (or earlier if protected pension age or ill-health conditions are met). The trivial commutation lump sum option was removed from 6 April 2015 but payment of small lump sums of less than £10,000 remains an option.

The disclosure requirements state that a member must be provided with details of their forthcoming retirement at least four months before the scheme's normal retirement age or the member's target retirement date, if applicable. The April 2015 reforms also saw the creation of a Government-backed pensions guidance service called Pension Wise, for individuals with DC pension savings. The member must be provided with information about how to access Pension Wise when they receive their retirement options. It is not compulsory for members to receive guidance from Pension Wise before choosing their retirement options, but it is highly recommended.

Since 6 April 2016, schemes have also been required to issue risk warnings (either generic or tailored) when the scheme provides the member with the means to apply to take their benefits. A retirement risk warning is a statement that sets out the characteristic attributes of the benefit to be taken and the factors that have the potential to affect the appropriateness of that benefit for a member such as:

- the impact of health status and lifestyle choices
- whether a member has dependents, is in debt or in receipt of means tested benefits

When sending the retirement risk warning, trustees must also give a statement reminding the member to read the retirement risk warning and noting the importance of accessing pensions guidance or professional financial advice.

### **1.5.1 Retirement Checks**

Before disinvesting the member's fund to convert into retirement benefits, the administrator should check that all contributions are up to date. On disinvestment, a further check will be required to ensure that the correct unit price has been applied and, if a terminal bonus is payable (applicable for with-profit funds only), that this has been paid at the stated rate.

The administrator will also need to establish evidence of age and possibly status. This is usually evidenced by the member providing the scheme with a birth and/or marriage certificate but can also be done using electronic identity verification tools.

#### *Lifetime Allowance*

The taking of retirement benefits, with the exception of a small lump sum (see section 1.5.4), is a Benefit Crystallisation Event. This means that a number of checks will need to be performed before benefits can be processed.

This subject is expanded upon in 1.10 below.

### **1.5.2 Annuities**

Traditionally, at retirement the member's fund value would usually be used to purchase an annuity (known as a lifetime annuity) from an annuity provider.

An annuity is a guaranteed income payable for the rest of a person's life. The annuity provider undertakes to pay a regular income in exchange for the value of the member's accumulated fund. Once set up, the 'basis' of the annuity is usually fixed, so it offers a secure lifetime income, regardless of stock market performance. Income from an annuity is taxable in the same way as most other sources of income (i.e. through PAYE) and depends on the member's individual tax liability.

From 6 April 2015, it is possible for annuity payments to decrease if this is set out in the annuity contract terms and conditions. An annuity that can decrease in payment is known as a 'flexible annuity'.

The value of a member's pension fund at retirement depends on such things as the amount of contributions paid into it, the investment returns on that money and any charges applied. Similarly, the amount of benefits that a member's pension fund will be able to buy at retirement depends on several things, including the cost of buying a pension and what benefit options they choose on retirement. A member's age at retirement also affects the amount of pension they can buy, because the younger a member is, the more expensive it is to buy a pension. Pension projections, known as Statutory Money Purchase Illustrations, which are provided as part of the member's annual benefit statement should give members an idea of what to expect.

The cost of buying an annuity is closely linked to interest rates and how long people are expected to live. As future interest rates are (to a certain extent) uncertain, no guarantee can be given as to the size of the pension a member will receive.

#### *Open Market Option*

Annuities are provided by many different insurance companies. They offer different annuity rates and these change frequently. This means that at any particular time, some firms will be more competitive than others. The Open Market Option was introduced in the Finance Act 1978 and gave members the right to 'shop around' for annuities from external providers to compare what is on offer.



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With effect from 6 April 2015, the legislation was amended so there is now a disclosure requirement to inform members with flexible benefits who are approaching retirement that they have a right to transfer their benefits to another arrangement, and there is a requirement to provide a transfer value. However, many schemes still continue to offer members an Open Market Option, especially if it is a requirement of the scheme rules.

By offering an Open Market Option, the trustees/managers can be assured that the member has the ability to obtain the best annuity available at the time of retirement. There is no need for the trustees/managers to check current rates with each provider individually; there are a number of firms which offer these services on a chargeable basis.

Members are strongly recommended to take professional financial advice when looking at the Open Market Option.

### *Annuity Options*

The scheme rules may determine the type of annuity the member may buy; for example, legislation used to require that annuities purchased with contributions made after 6 April 1997 had to increase in line with Limited Price Indexation (LPI). Although this requirement has now been removed from legislation, the old requirement may still be incorporated in the scheme rules.

Leaving aside the constraints that may exist by either scheme rules or legislation, there are currently a number of options available which can offer greater flexibility over future income. For example:

- Taking a tax-free pension commencement lump sum and having a reduced annuity
- An annuity that provides for a spouse or dependant's pension on the member's death • A flat rate annuity or one that increases in payment to counter the effects of inflation.
- An annuity with an attached guarantee period. This guarantee period runs from the date of retirement. It means that, should the member die within this guarantee period, the remaining pension payments that would have been made until the end of the period are paid to his/her spouse or dependants
- From 6 April 2015, a flexible annuity that can decrease in payment

### *Enhanced Annuities (Impaired Life Annuities)*

Annuity providers will pay a higher income if the member has certain medical conditions. For example, the annuity provider may be able to offer a better income (on the same fund value) if the member: • Smokes, and has done so for a significant amount of time

- Takes regular medication
- Suffers from chronic asthma
- Has high blood pressure
- Has recently undergone major surgery
- Suffers from diabetes
- Has ever suffered a serious illness such as cancer, stroke, or multiple sclerosis

This is because the length of time the annuity provider would expect a member to live, if they fell into any of the categories above, would be less than that of a healthier member.

### *Annuity Documentation*

It should be noted that annuity rates offered are generally guaranteed for only a limited period. Therefore, it is important that as soon as the member has completed the necessary paperwork, the fund is disinvested and paid across to the provider as soon as possible.

There is normally a considerable amount of paperwork required to set up an annuity. The member will usually be required to provide:

- An application form
- Medical questionnaire
- Original birth certificate
- If a spouse or dependant's pension is also being provided, then the spouse/dependant's birth certificate may also be required, together with a marriage certificate if appropriate
- If the annuity is being set up in the trustees' name, the trustees will also be required to complete the application form

### **1.5.3 Pension Commencement Lump Sum (PCLS)**

A tax-free PCLS of 25% of the fund value may be taken, subject to a maximum of 25% of the remaining Standard Lifetime Allowance providing the scheme rules allow and Scheme Specific Lump Sum Protection does not apply. This means that based on the Standard Lifetime Allowance of £1,073,100 for 2021/22 a maximum of £268,275 may be payable.

Members who had a lump sum entitlement greater than £375,000 at 5 April 2006 may have applied for protection under transitional arrangements. Members with Enhanced Protection or Primary Protection, who did not apply for lump sum protection and do not have Scheme Specific Lump Sum Protection are able to take 25% of the fund value, subject to a maximum of 25% of the remaining Standard Lifetime Allowance, but calculated as though the Standard Lifetime Allowance is £1.5m. This means a maximum of £375,000 may be payable.

Members with Fixed Protection 2012, 2014 or 2016 have a protected Lifetime Allowance of £1.8m/£1.5m/£1.25m respectively. A member who holds a form of Fixed Protection is entitled to a tax-free PCLS of 25% of the fund value, subject to a maximum lump sum equal to 25% of their protected Lifetime Allowance. This is providing the scheme rules allow and Scheme Specific Lump Sum Protection does not apply.

A member who holds Individual Protection 2014 or 2016 is entitled to a tax-free PCLS of 25% of the fund value, subject to a maximum lump sum equal to 25% of their personal Lifetime Allowance. This is providing the scheme rules allow and Scheme Specific Lump Sum Protection does not apply.

Where the member's lump sum entitlement was greater than 25% as at 5 April 2006, this larger lump sum can be protected under the scheme rules. This is known as 'Scheme Specific Lump Sum Protection'. The scheme administrator is responsible for checking whether this protection applies and for calculating the current value of the protected lump sum. In order to pay a lump sum under Scheme Specific Lump Sum Protection, the member must have available Lifetime Allowance.

The administrator should therefore check carefully any protections the member may have when calculating their retirement benefits.

A PCLS can currently be paid up to six months prior to and twelve months after the entitlement to the connected pension arises; payment outside of this window will be an unauthorised payment.

### **1.5.4 Trivial Commutation and Small Lump Sums**

The benefits available on retirement will depend on the value of the member's fund and also on the rules of the scheme. There can be issues with small DC funds, as it can be difficult to find a provider willing to provide a very small annuity. However, there may be the option to trivially commute small DC funds where the conditions for payment are met.

### *Post 6 April 2015 position*

Where the fund value is less than £10,000, a lump sum payment can be made under the small lump sum rules, provided the scheme rules allow. The small lump sum rules were introduced from 1 December 2009. This figure increased from £2,000 for payments from 27 March 2014.

If a member has a fund value in excess of £10,000 and wants to receive their entire benefit as a one-off lump sum then payment of an Uncrystallised Funds Pension Lump Sum would be appropriate (see section 1.6.3).

Small lump sum payments can be made to members from the age of 55 (or earlier if protected pension age or ill-health conditions are met).

Since 6 April 2015, it has no longer been possible to pay a trivial commutation lump sum from a DC arrangement under the £30,000 rules. It is still possible to pay a trivial commutation lump sum (or a small lump sum) from a DB arrangement. Importantly, any DC benefits held by the member must still be included in the valuation of benefits but they cannot be included in the actual trivial commutation payment.

### *Pre 6 April 2015 position*

Prior to 6 April 2015, the standard rule for trivial commutation was that it was only available where the value of the individual's pension rights from all registered schemes (including pensions in payment before this date) did not exceed £30,000, (prior to 27 March 2014 this was £18,000). Prior to 6 April 2015, payment of trivial commutation and small lump sums was only available to members who had reached age 60.

### *Taxation*

Small lump sums are paid via payroll because they need to be taxed under the PAYE system. Where benefits that are not in payment are paid as a small lump sum, the first 25% of the payment will be tax free, with the balance taxed initially usually using the basic rate tax code. This 25% deduction is given to reflect that the member would generally have been entitled to a PCLS of 25% of the capital value of their benefit.

If the member's benefits are in payment, the whole of the benefit is taxed using the PAYE code already in operation.

## **1.6 ALTERNATIVES TO BUYING AN ANNUITY**

In recent years, more members have begun to explore alternative options to the traditional route of annuity purchase. This may be because they do not need the security and regular payments provided by an annuity and would rather leave their pension fund invested, or the current annuity rates do not provide value for money. While this provides more flexibility, it does carry more risk.

Annuities have become more expensive. This is largely as a result of increased life expectancy and low interest rates. Now that people are living longer, annuity purchase may involve locking in pension funds into a product that is fixed earlier on in an individual's life. It is very difficult for members to be able to determine the right annuity type and right death benefits given that their lifestyle may change significantly in later years. Also, annuities were historically always fixed meaning it is not possible for income to fluctuate (outside of indexation within the terms of the annuity contract), which can cause issues with tax planning in later years.

From 6 April 2015, more flexible options were made available to members in the form of an Uncrystallised Funds Pension Lump Sum (UFPLS) or Flexi-Access Drawdown (FAD). Depending on the scheme rules, members of DC schemes may now be able to take their benefits through the following alternative methods:

- Uncrystallised Funds Pension Lump Sum
- Flexi-Access Drawdown (FAD)
- Short term annuities

### 1.6.1 Drawdown Pensions

Drawdown pension can be started from age 55 onwards, unless the member has a protected pension age or is retiring due to ill health where it may be available earlier.

The term 'Drawdown Pension' replaced the previously used terms 'Unsecured Pensions' and 'Alternatively Secured Pensions' from 6 April 2011. Prior to 6 April 2011, unsecured pensions were previously only available to members under the age of 75 where instead of buying an annuity the member could call on their invested funds subject to an annual maximum limit. Alternatively Secured Pensions worked in a similar way except they were available to members from age 75.

Prior to 6 April 2015, there were two available types of drawdown pension - capped drawdown and flexible drawdown. From 6 April 2015, flexible drawdown was abolished and FAD was introduced to enable members to access their pension benefits even more flexibly.

However, despite the introduction of FAD, many trust-based schemes still do not offer a drawdown facility due to administrative complexity. If a scheme does not offer such a facility and a member wishes to enter into a drawdown arrangement the member will need to transfer their funds out of the existing scheme to an external drawdown arrangement.

#### *Capped Drawdown*

Capped drawdown, like unsecured pensions, provided an individual with a means of taking variable pension benefits without setting up an annuity, subject to a maximum annual withdrawal limit.

Capped drawdown arrangements already in existence on 6 April 2015 were allowed to continue, with further designation of funds under the same arrangement, but no new capped drawdown arrangements could be set up after 6 April 2015. Capped drawdown arrangements can also be converted to FAD from 6 April 2015.

The maximum pension income that may be paid from capped drawdown plans, for drawdown years which started on or after 27 March 2014, is equal to 150% of the annual amount of a level, single-life, lifetime annuity, without guarantee, which could be bought for the member on the date of calculation. The amount withdrawn was taxable as pension income.

The maximum limit is reviewed at set intervals dependent on the age of the member. For example, capped drawdown is available to members over age 75 but the maximum withdrawal limit must be reviewed annually.

#### *Flexible Drawdown*

Flexible drawdown was abolished with effect from 6 April 2015. It was only available to members who were no longer active members of any pension scheme and who met a 'minimum income requirement' of £12,000 per annum. This could include other scheme pensions or lifetime annuities in payment and state pension benefits. Providing they met the qualifying conditions, flexible drawdown enabled individuals to have full access to their drawdown pension without limit. The amount withdrawn was taxable as pension income. Prior to 27 March 2014, the minimum income requirement was £20,000 per annum for flexible drawdown.

Members who made a flexible drawdown declaration prior to 5 April 2015 automatically fell under the new FAD rules from 6 April 2015, and consequently are subject to the Money Purchase Annual Allowance rules.

### *Flexi-Access Drawdown (FAD)*

FAD was introduced with effect from 6 April 2015. There is no minimum or maximum limit on the amount of income a member can take from their drawdown fund each year. This means it is permissible to draw the maximum pension commencement lump sum immediately and defer taking any income from the drawdown fund until a later date. The maximum income is limited to the amount being designated to FAD.

The Money Purchase Annual Allowance rules apply where a member draws down income from a FAD fund (including income from a short-term annuity – see section 1.6.2). If a member designates funds to FAD and receives a pension commencement lump sum but does not draw an income immediately, the Money Purchase Annual Allowance is not triggered until the point that income is subsequently drawn from the FAD fund.

A scheme offering FAD could choose to impose some restrictions within its rules; for example, limits on the minimum fund that can be designated to FAD or a maximum number of times that FAD funds can be designated.

### **1.6.2 Short Term Annuities**

Short term annuities are annuities which pay a set income for a period of up to five years. These annuities are purchased from funds that have already been designated to a drawdown arrangement. They may be an attractive option for members wishing to ease themselves into retirement by a move to part time working.

### **1.6.3 Uncrystallised Funds Pension Lump Sum (UFPLS)**

An UFPLS forms part of the package of measures allowing flexibilities for money purchase arrangements that came into force from 6 April 2015.

The UFPLS option allows members to draw their uncrystallised money purchase savings either as a one-off lump sum or as a series of lump sums. 25% of the UFPLS is payable tax-free (but this is not classed as a pension commencement lump sum) and the remaining 75% is taxable at the recipient's marginal rate. If scheme trustees do choose to offer members the UFPLS option they may wish to impose restrictions; for example, on the number of times a member may take an UFPLS (an annual limit or a limit in the member's lifetime) or a minimum amount of income that can be taken as an UFPLS.

The payment of an UFPLS is a Benefit Crystallisation Event and an UFPLS can only be paid if a member has available Lifetime Allowance.

The Money Purchase Annual Allowance rules are triggered when a member receives an UFPLS.

## **1.7 TIMING OF RETIREMENT**

A DC scheme will have a Normal Pension Age but there is often a facility for members to specify their own Target Retirement Age. In some cases, retirement at an age other than Normal Pension Age may require trustee and/or employer consent.

With effect from 6 April 2010, the earliest age at which pension benefits can be taken (known as normal minimum pension age) is age 55, other than on ill health as is set out below. Some members may have a right to retire earlier because they have what is known as a protected pension age.

The Government intends to increase normal minimum pension age from age 55 to 57 in 2028, so that it is consistent with the rise in the State Pension Age. However, this has not yet been finalised in legislation.

### 1.7.1 Early Retirement

A pension scheme is primarily designed to provide benefits at and during retirement. If a member takes benefits earlier than originally planned, the amount a member is likely to be able to purchase/designate with their pension fund will be less due to the following factors:

- Depending on the retirement option chosen, the fund may have been invested for a shorter period, in which case it would have received a lower level of investment return than expected (and may therefore have a lower value)
- If the member is retiring from active status, the fund will have received fewer contributions than expected (and may therefore have a lower value)
- The cost of buying an annuity is generally more expensive the younger the member is, because the pension is likely to need to be paid out for a longer period of time. This latter point is also relevant for members who take a regular income via FAD as the income will need to be paid out for a longer period of time which increases the probability of a member running out of funds.

Taking benefits early will usually therefore lead to a lower income in retirement.

### 1.7.2 Flexible Retirement

Employers can offer employees flexibility in their transition from a full time working life to retirement by allowing employees to take their pension benefits and remain in employment.

Some of the options offered could be:

- Employees could take all of their pension benefits from the scheme, continue to work for the same employer and cease further accrual of pension benefits
- Employees could take all of their pension benefits from the scheme, continue to work for the same employer and continue to build up further pension funds in the same pension scheme
- As above, but employees could build up further pension funds in a different scheme with the same employer
- Phased retirement – where the employee takes only part of his/her pension fund from the scheme. For example, this could allow an individual to smooth the move into retirement, by working only part time but increasing income with the 'part-pension'

The scheme rules will set out the flexible retirement options that the scheme offers. In some cases, an employee may be automatically enrolled if they opt out of pension saving after drawing benefits.

### 1.7.3 Ill Health Retirement

Members may have the option under the scheme rules to take ill health retirement at any age. The administrator must check the scheme rules to see what conditions are attached to ill health retirement and particularly to check whether the employer's and/or the trustees' consent is needed.

Where an annuity is payable, the amount of benefit provided on ill health retirement will be determined by the value of the accumulated fund and annuity rates at the time, although more favourable annuity rates may be available if the member has an illness that may shorten his lifespan. Typically, the younger a member is on retirement, the less likely it is that they will have a significant fund value.

Some employers may agree to pay a sum into a member's fund, in order to boost the value of that fund. It may be that the company will provide some form of Permanent Health Insurance (PHI) – sometimes referred to as Income Protection, to provide an income to the member after they have been off sick for a certain defined period. This insurance will usually allow for pension contributions to continue during the period of ill health. PHI benefits typically cease on normal retirement age, at which time the member's accumulated fund would be used to purchase a pension in the normal way.

If the member has a life expectancy of less than one year, a serious ill health lump sum may be paid in respect of uncrystallised benefits. This is paid tax free up to the value of the member's remaining Lifetime Allowance before age 75. If paid after age 75, it is subject to a tax charge at the recipient's marginal rate of income tax (previously 55% for serious ill health lump sums paid before 6 April 2015 and 45% if paid between 6 April 2015 and 5 April 2016).

### 1.8 TESTING AGAINST THE LIFETIME ALLOWANCE

On retirement or overseas transfer, the administrator must check whether the member has any form of transitional protection (e.g. Primary, Enhanced, Individual or Fixed Protection) and the amount of the member's remaining Lifetime Allowance. The Lifetime Allowance is reduced by the amount of Lifetime Allowance already used up by previous Benefit Crystallisation Events (BCEs), including pre A-Day retirement events.

The standard Lifetime Allowance was increased from £1m to £1,073,100 for 2020/21. This increase was in line with the increase in the previous September's CPI and it was originally intended that this method would be followed for future tax years. However, it remained at £1,073,100 for the 2021/22 tax year and will remain at this level until April 2026.

#### 1.8.1 Lifetime Allowance Charge

If the member exceeds the Lifetime Allowance, any funds in excess of the Lifetime Allowance will be taxed at 55% if taken as a lump sum. If taken as a pension (scheme pension, annuity or FAD), there will be an initial tax charge of 25% on the excess, and the pension payable will be taxed at the member's marginal rate through the Pay As You Earn (PAYE) system.

Once benefits have been processed the member will need to be informed of the amount of Lifetime Allowance used up by the BCE within 3 months.

#### 1.8.2 Protection from the Lifetime Allowance Charge

If the total value of benefits that an individual was entitled to at 5 April 2006 exceeded £1.5m, it was possible to apply for either Primary or Enhanced Protection and gain a protected Lifetime Allowance. It was also possible to apply for Enhanced Protection if it was thought that despite ceasing to contribute from 5 April 2006 the value of benefits after this date would exceed the Standard Lifetime Allowance in future. Applications for these protections had to be made to HMRC by 5 April 2009.

The standard Lifetime Allowance was reduced from £1.8m to £1.5m from the 2012/13 tax year. This had a knock on effect for the existing transitional protection measures and also for those individuals that immediately prior to 6 April 2012 had targeted benefits with a Lifetime Allowance of £1.8m in mind.

To ensure no-one was disadvantaged, transitional provisions were put in place, including the introduction of Fixed Protection 2012 and special measures for those individuals relying on Scheme Specific Lump Sum Protection.

The same transitional process happened when the standard Lifetime Allowance reduced from £1.5m to £1.25m from the 2014/15 tax year. Fixed Protection 2014 and Individual Protection 2014 were introduced to ensure those individuals with benefits above £1.25m were not disadvantaged. Fixed Protection 2016 and Individual Protection 2016 were introduced from 6 April 2016 when the standard Lifetime Allowance reduced further to £1m.

## Defined Contribution Arrangements

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The registration deadlines were/are as follows:

- Fixed Protection 2012 – applications had to be made by 5 April 2012
- Fixed Protection 2014 – applications had to be made by 5 April 2014
- Individual Protection 2014 - applications had to be made by 5 April 2017
- Fixed Protection 2016 and Individual Protection 2016 - no deadline for applying for these protections but members will need to have the protection in place before they wish to take their benefits. Applications should be made using an online portal provided by HMRC

Following a successful application, HMRC issues either a certificate or simply a reference number for Fixed Protection 2016 and Individual Protection 2016 to the individual confirming that transitional protection has been awarded. The member should ensure that a copy of the certificate, or reference number where applicable, is provided to the scheme administrator before any benefit crystallisation events occur.

Further detail on each type of protection is provided below.

### *Enhanced Protection*

Broadly speaking, Enhanced Protection was granted to individuals who left pensionable service prior to 6 April 2006 and stopped contributing to a pension arrangement; i.e. ceased active membership, irrespective of whether or not their pension rights exceed the Lifetime Allowance. For DC arrangements, all contributions regardless of the source had to cease on 5 April 2006. All growth is protected from the Lifetime Allowance tax charge.

### *Primary Protection*

Primary Protection was usually granted to individuals still in pensionable service or contributing to a pension arrangement at 6 April 2006 where the value of their pension rights exceeded the standard Lifetime Allowance of £1.5 million. Individuals were given their own personal Lifetime Allowance Enhancement Factor.

Where an individual has a Lifetime Allowance Enhancement Factor, their personal Lifetime Allowance level is enhanced at each BCE that occurs going forward. To arrive at the individual's personal Lifetime Allowance, the standard Lifetime Allowance at the time of the calculation being performed (e.g. benefit crystallisation event) is multiplied by the enhancement factor. Following the reduction in the standard Lifetime Allowance from 2012/13, the enhancement factor is applied to the higher of £1.8m or the standard Lifetime Allowance.

### *Fixed Protection 2012, 2014 and 2016*

Fixed Protection provides an individual with a personalised Lifetime Allowance, providing that certain conditions are met and the application was made prior to the relevant deadline. The personal Lifetime Allowance is as follows:

- Fixed Protection 2012 - £1.8m
- Fixed Protection 2014 - £1.5m
- Fixed Protection 2016 - £1.25m

To retain Fixed Protection 2012, 2014 or 2016, the conditions to be met include:

- No contributions can be made to a DC arrangement after 6 April 2012, 6 April 2014 and 6 April 2016 for Fixed Protection 2012, 2014 or 2016 respectively
- Accrual in a DB or cash balance arrangement will be very limited
- A new arrangement cannot be set up, unless it is solely for the purpose of transferring out of an existing arrangement

Individuals with Primary or Enhanced Protection were/are unable to apply for Fixed Protection 2012, 2014 or 2016.



### *Individual Protection 2014 and 2016*

Individuals may have applied for Individual Protection 2014 before 5 April 2017 if they had pension savings of greater than £1.25 million at 5 April 2014. This form of protection gives members a personalised Lifetime Allowance equal to the value of their pension rights at 5 April 2014, but subject to a maximum Lifetime Allowance of £1.5 million.

Individuals may apply for Individual Protection 2016 if they had pension savings of greater than £1 million at 5 April 2016 and they will receive a personalised Lifetime Allowance equal to the value of their pension rights at 5 April 2016, but subject to a maximum Lifetime Allowance of £1.25 million.

The personalised Lifetime Allowance will be expressed as a monetary amount and will not increase, unless the standard Lifetime Allowance overtakes the amount in the future.

It is possible for an individual to hold Individual Protection 2014 or 2016 where they already hold either Fixed Protection 2012, 2014 or 2016 but Fixed Protection would take precedence until it was lost.

### **1.9 PENSIONS ADVICE ALLOWANCE (PAA)**

The Pensions Advice Allowance has been available to members with DC benefits since 6 April 2017. The basic principle is that a member will be able to withdraw up to £500 tax free from their pension fund in a tax year and use this to pay for regulated financial advice. The withdrawal is classed as an authorised payment. However, it is important to note that it is not mandatory for a scheme to provide this facility.

#### *Key features of the PAA*

The key features of the PAA are noted below:

- Funds can be withdrawn from DC and cash balance benefits. Hybrid schemes remain in scope where they include elements of these benefits, for example, a DB scheme with DC AVCs
- Not mandatory for providers to offer the PAA
- Only possible to use the PAA once in any tax year
- A maximum of three uses per person in a lifetime
- Up to £500 per use
- No tax charge on withdrawal
- Available at any age and not restricted to those approaching retirement
- Money to be paid direct from the scheme to a regulated financial adviser
- Advice must be fully regulated but can include automated advice models
- Must be requested by the member and accompanied by a written declaration

#### *Employer-arranged pension advice*

From 6 April 2017 the Government also extended the amount available under the provisions for employer-arranged advice on pensions from £150 to £500. This means that subject to meeting certain conditions the first £500 of advice is exempt from income tax and National Insurance.

This change was brought in to complement the PAA thus giving members the possibility of accessing up to £1,000 of tax advantaged financial advice in one sitting.

### 1.10 CLOSING AND WINDING UP TRUST BASED DC SCHEMES

A closed scheme is a scheme to which no new members are admitted, meaning contributions cease to be paid from the date set for closure (often referred to as the date of closure). Where scheme rules allow, a scheme can continue as a closed scheme without being wound up. If a scheme continues then the employer could still be liable for some expenses related to the ongoing running costs of the scheme. Closing a pension scheme is a listed change meaning employers are usually required to run a consultation prior to scheme closure.

The winding up of an occupational pension scheme normally occurs when the company decides it no longer wishes to make the required level of contribution to the scheme (for example, on the grounds of cost) or is no longer able to do so (for example, on insolvency). The merger or takeover of companies is another common reason for pension schemes to wind up.

Where a scheme wind up is planned, a date is set (often referred to as the wind up date) after which members no longer contribute to the scheme. The scheme rules may sometimes dictate that a period of notice has to be given to members of the wind up date.

The key difference between a scheme closing and a scheme winding up is that with the former the scheme continues to operate and pay benefits for the members who built up benefits prior to closure; whereas with the latter the scheme ceases to exist and the responsibility for paying benefits is transferred elsewhere.

The scheme rules will have provisions dealing with scheme closures, the winding up of the scheme and the way that any assets should be distributed.

#### 1.10.1 Company Insolvency

If an employer becomes insolvent, it is likely that an insolvency practitioner will be appointed to act in place of the employer.

For DC type arrangements, the existing trustees may continue in place and it is their responsibility to wind up the scheme in accordance with the scheme rules.

As occupational pension schemes are set up under trust, their assets are protected from an employer's creditors. However, a trust cannot protect the value of the investments. Therefore, if some of the assets are invested in the employer's business, and the employer then becomes insolvent, the trust does not protect the market value.

#### 1.10.2 Information during the Winding Up Period

When a scheme is being wound up, the trustees must issue a notice in writing to inform all members and beneficiaries within one month of the winding up having commenced.

In addition, this notice must:

- Give the reasons the scheme is being wound up
- Give a statement to active members on whether death benefits will continue to be provided
- Inform members whether an independent trustee has been appointed (generally only relevant for DB schemes)
- A summary of action planned to be taken
- Supply a name and address for further enquires

The trustees also need to issue a progress report to members at least every 12 months thereafter.

These subsequent reports must give details of:

- Action being taken to recover any assets not immediately available
- The estimated date when final details of members' benefits are likely to be known
- The extent (if any) to which the value of the member's benefits is likely to be reduced (unlikely to be relevant for DC schemes)

### **1.10.3 The Winding Up Process**

The winding up of an occupational pension scheme is a very lengthy process and can take a number of years to complete. Most scheme wind ups take at least 18 months, and it has been known for them to take in excess of ten years (particularly for DB schemes).

TPR has published guidance to help trustees of occupational pension schemes meet expectations that the key wind up activities should be completed within two years of the winding up date. The guidance provides suggestions for good practice on administration, planning a scheme wind up and buying out annuities.

The first part of the winding up process normally consists of the trustees checking the accuracy of the scheme data. They must also ensure they have not overlooked anyone who is (or will be) entitled to benefits from the scheme. These tasks are more difficult when the scheme's data records have not been kept properly, which can often occur where the employer becomes insolvent.

It may be possible for the receiver or liquidator of a company to claim from the State redundancy fund any contributions that were not paid in the last 12 months of the company's existence. To do this, certain checks have to be made and certificates provided.

Once all the records have been reconciled, the trustees may offer the members a transfer of their funds with consent or, alternatively, buy a deferred annuity on the member's behalf.

In some cases, a bulk transfer without consent may be made.

### **1.10.4 Bulk Transfers Without Consent**

The ability of trustees to make bulk transfers without member consent can be an essential tool in managing and winding up pension schemes. It is particularly relevant where a company is restructuring or following a merger. A consolidation of pension arrangements can result in lower costs for the employer due to increased economies of scale and a reduction in governance, management and administration.

Recently, with the emergence of Master Trusts, the demand for bulk transfers between DC arrangements has increased, which prompted a review of the bulk transfer rules.

Under the legislation that was in force up until 6 April 2018, a scheme could undertake a bulk transfer without consent provided the following conditions were broadly met:

- an actuary had to certify that each member's rights in the receiving scheme would be "broadly, no less favourable" than the rights to be transferred ("the scheme quality condition")
- the transferring and receiving schemes both had to relate to persons who were in employment with the same employers; or the transferring and receiving schemes had to relate to persons in employment with different employers and the transfer was either a consequence of a financial transaction between the employers or the employers were related for the purposes of the legislation ("the scheme relationship condition").

## Defined Contribution Arrangements

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The legislation governing bulk transfers without consent was amended from 6 April 2018 although, if needed, it was allowable to rely on the previous rules up until 1 October 2019.

There are three new options available for the transfer of pure DC rights (i.e. excluding DB, cash balance and other rights including some form of guarantee such as benefits with a guaranteed annuity rate). These options are briefly:

1. Bulk transfer to an Authorised Master Trust

The only condition for this option is that the transfer is to an authorised Master Trust as set out under the Pension Schemes Act 2017. However, it is important to note that the Pensions Regulator will only start approving master trusts from October 2018 and as a result even though the legislation changes take effect from 6 April 2018 there will be a time lag before this option is available.

2. Bulk transfer between 'connected schemes'

The option will apply when the principal or controlling employers for the transferring and receiving schemes are part of the same connected group. Each member who is to be transferred must be a current or former employee of a group employer linked to the principal or controlling employer of either the transferring or the receiving scheme.

3. Bulk transfer based on advice by an independent professional

The third alternative is that the trustees of the transferring scheme have obtained and considered the written advice of an 'appropriate adviser' in relation to the transfers. The adviser can be a firm as well as an individual.

Receiving schemes are required to continue to apply the charge cap on DC rights if the transfer is made without member consent from an arrangement that is already subject to the charge cap.

The Government has published guidance on which factors they should consider when taking advice from an appropriate adviser on a bulk transfer without consent exercise. One of the key messages is that trustees should ensure their decision is consistent with their fiduciary duties and that any recommendation that they rely on should be in the best interest of members.

### 1.11 DISCLOSURE OF INFORMATION

The trustees/manager of trust and contract based DC schemes must disclose certain information within set timescales to members and beneficiaries. This includes providing prescribed information on joining the scheme, annual benefit statements (including Statutory Money Purchase Illustrations), early leaver rights, transfer of benefits, options on retirement (including risk warnings) and on death, etc., all within defined timescales set out in legislation. Members and beneficiaries also have a right to see certain pieces of scheme documentation; e.g. Trustee Annual Report and Accounts, statement of investment principles, etc., on request.

Historically, trust based and contract based requirements were held under separate regulations but, with effect from 6 April 2014, these were consolidated into the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013/2734 ('the 2013 Regulations'). Subsequent amendments have been made to these Regulations as is noted elsewhere in this Chapter. There are some requirements that are still contained in separate legislation; for example, those relating to transfers and stakeholder schemes have retained their own disclosure regulations.

These regulations override any provisions within a scheme's Trust Deed and Rules. Failure to meet these timescales is a breach of the legislation.

Administrators of workplace contract based schemes are required to report any breach of the legislation to TPR which has a range of measures it can take including assisting scheme managers with compliance, providing guidance and imposing fines. The FCA is responsible for the disclosure requirements and regulation of authorised firms who provide contract based schemes.

As well as consolidating existing legislation, the 2013 Regulations made a number of changes particularly with regard to electronic disclosure and communications around lifestyling strategies.

### *Electronic disclosure and communications*

The 2013 Regulations state that all disclosure requirements within the regulations can be satisfied by any of the following:

- Sending it to the member's last known postal address
- Sending it to the member's last known email address
- Making it available on a website

Where schemes want to make information available on a website for the first time, they may write to either the member's email or postal address advising them that the information will be placed on a website, the website address and how to access and read the relevant information (including login and/or password details).

### *Lifestyling*

All DC schemes (including DC AVC arrangements) which use lifestyling must notify prospective and new members that a lifestyling strategy will be applied, a statement explaining lifestyling, the date it has or will be adopted, as well as a summary of the advantages and disadvantages of lifestyling.

Such information on lifestyling must be provided again to members, broadly before the time that their funds are subjected to lifestyling; namely, between 5 and 15 years before their retirement. Further information on lifestyling strategies can be found in Part 4.

### *Retirement Process*

Amendments have been made to the Disclosure Regulations to support the April 2015 retirement reforms by requiring trustees to provide members with money purchase savings with enhanced information about their benefits, including risk warnings, and the pensions guidance service, Pension Wise.

### Summary

Benefits available to members leaving service early depend on the duration of their membership and the date that they joined the pension scheme.

Historically, retirement benefits were provided usually by means of an annuity. This has changed with the introduction of FAD and UFPLS and the ability to transfer funds at retirement to access such options.

It is possible for a member to take a PCLS from their pension fund and a reduced annuity/drawdown. Tax free pension commencement lump sums of 25% of the value of a member's fund are permitted under legislation. It is possible for schemes to protect the value of pre 6 April 2006 lump sums where the lump sum at that time was greater than 25% of a member's fund.

There are different options available to members with large fund values to protect their pension savings from the Lifetime Allowance charge.

Trivial commutation, in the form of a 'small lump sum', may be an option for some members with small DC funds valued at less than £10,000.

Flexible retirement options can now be offered by an employer where scheme rules allow. Trustees need to bear in mind age discrimination in relation to the provisions and policies associated with their scheme when looking to offer flexible retirement. Early and ill health retirement may be permitted under the scheme rules. However, the earlier a member takes benefits, generally the lower their retirement income will be.

There is a specific procedure for winding up a pension scheme and there are disclosure requirements governing the information that must be given to members and the timescales for doing so.

### Self Test Questions

- A member of the Colourboxx Money Purchase Pension Plan who joined on 1 August 2015 is leaving the company with less than three months' service. Draft a letter about refunding his contributions, assuming the Plan pays a refund of the value of the member's contributions.
- Describe how the overseas transfer charge operates and when it applies.
- Discuss the issues associated with traditional annuity purchase and outline the alternative options which were introduced from April 2015.
- List the key features of the Pensions Advice Allowance
- What information has to be given on the notice of intention to wind up?
- What disclosure requirements apply in respect of DC schemes that use lifestyling?

# PART 4

# DEFINED CONTRIBUTION SCHEME GOVERNANCE & INVESTMENTS

## OVERVIEW

Traditionally, scheme governance has been the preserve of DB pension schemes. However, the number of individuals who are members of DC schemes has and continues to increase dramatically due to the automatic enrolment requirements. Following the introduction of the first specific DC governance Code of Practice in November 2013, the Pensions Regulator (TPR) has taken an increased interest in ensuring that DC schemes are governed appropriately. Increased regulation followed from 6 April 2015 in the form of the Occupational Pension Schemes (Charges and Governance) Regulations 2015. The revised Code of Practice published in July 2016 includes the latest governance requirements and sets out TPR's general expectations. This in turn was followed by the Pension Schemes Act 2017 that introduces a new supervisory regime for master trusts. This Part of the manual therefore considers the various aspects of the governance of DC schemes.

Chapter 1 of this Part considers general principles for DC scheme governance from the perspectives, in turn, of employers, scheme providers, trustees of employer-sponsored schemes and trustees of master trusts. It also covers risk management under DC arrangements and the importance of good member communications.

Chapter 2 of this Part looks at the considerations for members in investing their contributions and the types of investments and investment strategies that could be offered by a DC scheme.

Chapter 3 of this Part focuses on charges, disclosure of transaction costs and investment governance. After an introduction about general trustee obligations in relation to investments it discusses the requirement to design a default investment fund, vital for employees who are being automatically enrolled into a qualifying DC scheme. It then turns to look at the different types of scheme charges and new requirements for the disclosure of transaction costs. Building on that it considers the importance of monitoring investment managers and maintaining an up-to-date Statement of Investment Principles (SIP).

By the end of this Part, the student should understand the increased importance of good governance of a DC scheme from an operational, investment and risk perspective.

# CHAPTER 1

## Governance Requirements

### INTRODUCTION

Governance is not just important because the Government and the regulators have an increased focus on scheme governance. Good governance matters because members of DC pension schemes entrust their savings into the hands of others. Having an effective governance programme in place has the potential to improve member outcomes and helps ensure the smooth operation of a scheme whilst at the same time greatly reducing its vulnerability to risk.

- In the case of contract-based schemes the employer and the provider both have an important role to play, as do Independent Governance Committees (IGC) from April 2015. For these arrangements the providers are subject to the rules of the Financial Conduct Authority (FCA). In addition, pension contracts must be reviewed by the provider's own IGC that has a statutory duty to ensure each type of contract meets certain statutory requirements.
- For trust-based schemes set up by employers the responsibility for implementing and monitoring the operation of a governance framework predominantly lays with the trustees, but the employer often appoints the trustees and has a reputational and employee welfare interest in the proper management of a scheme. For trust-based arrangements, the Pensions Regulator (TPR) issues Codes of Practice and detailed guidance on how it expects schemes to be run.
- For master trust schemes, which serve many different and separate employers, the trustees have greater responsibilities as the role of the employer is limited (with consequent saving in governance costs due to economies of scale). The introduction of a new supervisory regime regulated by the Pensions Regulator from 1 October 2018 will result in higher governance obligations for those trustees and managers operating master trusts. These responsibilities are in addition to those applicable to trustees of non-master trust schemes, but may provide greater reassurance to some.

Due to the nature of DC schemes and the responsibility members have for making investment decisions, which can greatly impact on the level of their benefits, it is highly important to have an effective member communication programme in place. Although the disclosure legislation dictates that certain information has to be provided to members in specific timescales, a scheme has considerable flexibility in how they engage with their members. Providing the right message at the right time can go a long way to determining the success or failure of a DC scheme.

After reading this Chapter the student should be able to demonstrate an understanding of the importance of high level scheme governance and how this interacts with charges in DC schemes, the role the employer can play and how an effective communication programme can enhance the operation of a DC scheme.



### 1.1 ROLE OF THE EMPLOYER

The employer has an important role to play in helping DC scheme members achieve good outcomes from their pension savings. For a start, the employer decides which type of pension scheme should be used to meet its obligations under the automatic enrolment legislation, the basis of its contributions, and the extent to which it supports the scheme with its own information and communications.

In response to the workplace pension reforms, TPR has given greater responsibility to employers in ensuring their employees are suitably informed about pension provision. The aim is to improve employee engagement with minimal additional burden on the employer and to encourage a greater level of appreciation by employees of the value of their workplace pension arrangement and the importance of retirement planning. It is important for trustees, employers, providers and advisers to ensure they have clearly defined responsibilities for the governance and management of their pension arrangements.

#### 1.1.1 Employer Governance Committees

In trust-based schemes, the trustees have the lead responsibility for governance activities. However, in contract-based arrangements, employers should take the lead role and work closely with their provider and adviser to establish an effective governance framework. This may include establishing an employer governance committee to help with such tasks.

The relationships between the parties to a contract-based arrangement are different compared to trust-based arrangements. An employer governance committee for a contract-based arrangement can operate a similar oversight role to the trustees of a trust-based scheme.

A governance committee will often be composed of several senior employees who meet periodically with the provider and the employer's advisers to review the pension arrangements. This can include considering the product information being made available by the provider's Independent Governance Committee (explained below in 1.2.2), reviewing the provider itself, for example; perhaps obtaining independent reports of its financial strength, products, operating capability, etc., monitoring its service levels and taking advice on what actions may be needed to ensure the scheme meets the employer's aims and satisfies any expected legal or regulatory developments.

An important part of an effective governance framework is to have a clear communication and education programme in place. This ensures that both members and potential members understand the need to plan for their retirement. The employer can play an important role in the communication process and this is covered in further detail below.

### 1.2 ROLE OF THE PROVIDER

With the introduction of automatic enrolment, the number of individuals contributing to DC pension schemes is increasing dramatically, and of those a significant portion will be contributing to contract-based schemes. In recognition of this, the aim is to ensure that those individuals in contract-based plans are subject to an equivalent level of governance protection as those in trust-based schemes. While a proportion of that governance will be the responsibility of the employer, the provider will also have a role to play.

The automatic enrolment requirements have increased the importance of providers offering a well-managed product with appropriate investment options, well run administration and adequate internal controls. This will be particularly important for small employers who do not have the resources to spend time on developing an appropriate pension scheme.

For a contract-based scheme, a risk to members' benefits would arise if the managers of a contract-based DC scheme lacked adequate knowledge and understanding of their scheme. Whilst they are not required under the statutory duty to possess the same knowledge and understanding as trustees of trust-based schemes (described below in 1.3.4), the providers of contract-based schemes are subject to regulatory oversight by the FCA. This requires providers to be authorised by the FCA before they can engage in the establishment and operation of a regulated pension product.

TPR continues to work with the FCA to ensure equivalence of governance standards applying to trust-based and contract-based schemes.

### **1.2.1 Ways in which providers support both trust-based and contract-based schemes**

An insurance provider may be used to support trust-based occupational pension schemes as well as contract-based pension schemes. There are a range of options as follows:

- Within the framework of an occupational pension scheme, a provider's role may be limited to being contracted to provide a range of scheme investment funds or an investment platform. This is an example of an unbundled arrangement and the FCA will regulate the provider, but the trustees will be regulated by TPR in respect of the overall running of the trust-based scheme. This route is usually chosen by larger trust-based DC schemes.
- Providers can also be used to provide a bundled service for an occupational pension scheme where they deliver not only the scheme investments but other services such as administration and member communications. In this event, the provider will be subject to FCA rules for all its services, although TPR will continue to regulate the occupational pension scheme as a whole.
- Contract-based schemes are generally bundled services, although the provider's administration services may be enhanced by consultancy, member portal and payroll services to improve the member and employer experience of the scheme processes. The provider will be subject to FCA rules for all its services.

### **1.2.2 Independent Governance Committees (IGCs)**

From April 2015, there have been requirements for providers of contract-based schemes to establish IGCs, who are responsible for assessing the value for money delivered by the provider's pension products and producing an annual report setting out its opinion on whether value for money has been delivered, plus other matters.

Each IGC must have a majority of members who are independent of the provider with an independent chair. They will have the power to escalate concerns to members, employers and the FCA if the provider does not respond appropriately.

A key limitation is that each IGC looks at the suitability of the products provided by the particular insurer that it oversees. Therefore, the function of an IGC is different to the function of a governance committee established by the employer which reviews the specific member experience of the employees of that one employer and the suitability of the scheme/product to that specific membership – see 1.1.1 above.

### **1.2.3 Comparison of Employer Governance Committees and IGCs**

The work of an employer governance committee and an IGC can complement each other.

The employer governance committee is well placed to review the suitability of a particular pension product compared with other providers. It can consider whether the current arrangements meet the specific needs of the members and their employer when compared to other products and other pension providers in the market. It can also review the service experience of that particular employer's staff and, if necessary recommend a change of arrangement or, even if necessary, provider. Its work will be private.

This is in contrast to the work of an IGC; important elements of which are public. The focus of an IGC review will be the overall costs and quality of service for that specific provider across all schemes using that particular product measured against the aims of that contract and statutory requirements.

### 1.3 TRUST-BASED SCHEMES AND GOVERNANCE

Trustees need to ensure they have the right skills, they get the right people to help them run their pension scheme and that they have the right processes in place to effectively manage scheme risks.

Trustees/managers are expected to implement an effective governance programme to minimise the risks to which members' benefits may be exposed. As part of this, they would be expected to deal with a number of potential risks.

#### 1.3.1 Internal Controls

Trustees have a duty to act in the best interest of a scheme's beneficiaries, as set out in the principles of trust law. In addition the Pensions Act 2004 requires that trustees must establish and operate internal controls that which are adequate for the purpose of securing that the scheme is administered and managed:

- In accordance with the scheme rules; and
- In accordance with the requirements of the law.

Therefore, it is vitally important that the trustees have a framework of internal controls. These include:

- The processes and procedures to be followed for the effective administration and management of the scheme
- Systems for monitoring that administration and management
- Arrangements and procedures to be followed for the safe custody and security of the assets of the scheme

A key requirement of the legislation is that trustees secure that 'core financial transactions' for money purchase benefits are processed promptly and accurately. These transactions include (but are not limited to):

- investment of member and employer contributions to the scheme;
- transfers of assets relating to members into and out of the scheme;
- switching of assets relating to members between different investments within the scheme;
- benefit payments from the scheme to, or in respect of, members.

Trustees need to identify, evaluate, control and monitor the risks to their scheme. TPR has published Code of Practice 9 explaining what steps it expects trustees of trust-based schemes to take to set up internal controls. The types of risk to a scheme could either be operational, financial, funding or regulatory and compliance. Risks can vary in terms of both their likelihood of happening and the impact they make if adverse events do take place. Trustees can take a proportionate approach where smaller schemes may need less formalised controls than larger complex schemes. More detail on risk management is given in 1.5 below.

A risk register should be used by the trustees to document the risk and show the controls in place to manage it. This document should be reviewed on a regular basis at each trustee meeting and should be used to identify any weaknesses in the scheme's internal controls.

#### 1.3.2 Conflicts of Interest

A conflict of interest can arise where a trustee has multiple interests, one of which could potentially influence the decision making in the other. The TPR has published detailed guidance on this topic for both DB and DC trust-based schemes.

An example of where a conflict of interest can arise in relation to a pension scheme is where an employer-nominated trustee is also the Finance Director of the sponsoring employer. In such a scenario, there may be occasions where that particular trustee is conflicted between their responsibility to act in the best interest of the scheme's beneficiaries and their desire to keep employer costs down in their role as Finance Director.

It is important that trustees have a process in place to identify potential conflicts of interest and a workable policy to deal with them as and when they arise. It may be that when the trustees are discussing a particular issue and it is recognised that a conflict of interest exists for one of the trustees, then that trustee may be required to remove himself from the discussion.

### **1.3.3 Record Keeping**

The need to have good records is necessary for all financial products. However, the length of time pension scheme records need to be kept and the number of transactions that need to be noted on a member's record, mean that accurate data is of vital importance to a successfully functioning DC scheme. TPR has stated its view that the fundamental requirement of good administration is that members can be told the correct value of their pension rights. However, this is very much dependent on accurate records being maintained in the scheme. Poor record keeping can lead to significant additional costs to a DC scheme in areas such as administration, error correction and claims from members. This is covered further in Section 1.7.1.

In addition, the quality of record keeping is likely to increase with the Government's intended introduction of 'pensions dashboards', with a target delivery date of 2019. A pension dashboard is an online portal that allows members of the public to log onto a website, validate their identity and then see all their various UK pension savings across multiple schemes (including the state pension) in one place. Once a person's identity had been validated the system network would draw select information electronically from all pension schemes and then consolidate that information on the dashboard webpage. This development has the potential to transform public appreciation of pensions but is not without its technical challenges. Looking ahead scheme trustees and providers could be legally required to provide a facility for such a network system to access their scheme records and this may mean having records electronically available. Consequently, the accuracy of records and the importance of modern administration systems can only grow in importance. Further detail is provided in Section 1.2 of Part 6.

### **1.3.4 Knowledge and Understanding**

The Pensions Act 2004 requires trustees to have a good knowledge and understanding of the law relating to pensions, and to be conversant with their own scheme's policy documents. In order to assist trustees in complying with this requirement, TPR published a Code of Practice 7 which is designed to guide trustees in ensuring they have adequate knowledge levels to effectively fulfil their obligations. Not only are trustees required to obtain the appropriate level of knowledge and understanding, the legislation requires them to ensure this level of knowledge is maintained.

TPR provides an accessible e-learning programme for trustees free of charge. The online Trustee Toolkit contains modules designed to help prepare trustees for some of the issues they may come across in their role. A number of firms also offer trustee training programmes and some also incorporate the PMI's Award in Pension Trusteeship (APT) and Certificate in Pension Trusteeship (CPT) qualifications for trustees. In addition, TPR has dedicated a section of their website to governance and administration, with relevant regulatory guidance and bite-sized learning giving an overview of the issues which trustees may be required to address in the course of their duties.

It is recommended that trustees maintain their own log of the training they have undertaken to update their knowledge and understanding. Alternatively, a trustee board may wish to maintain a central register of relevant training for all their trustees. There is also a legal requirement for trustee boards to record this information and report it in the Annual Chair's Statement as is covered in 1.3.6.

### 1.3.5 Monitoring Investments and Assessing Good Value for Members

As DC pension arrangements become more dominant in the UK pensions market, so the individual has to bear more risk and responsibility for the level of income they will receive upon retirement. Members of DC pension arrangements need access to a wide range of fund choices as well, as a default strategy, which is a requirement for all qualifying schemes under automatic enrolment legislation. The range of funds offered needs to strike the right balance between meeting the needs of different members, but without being overwhelming or restrictive.

Consequently, trustees/managers should undertake regular reviews of the funds offered and their performance, whilst having clear procedures in place for the selection and removal of investment managers and for any alteration to the range of investments/funds and ensure these are applied consistently. There are specific requirements in relation to default funds and these are looked at in Chapter 3 of this Part.

In addition from 6 April 2015 trustees of all schemes that have to produce an Annual Chair's Statement (see 1.3.6 below) are required to formally calculate the charges and, in so far as they are able to do so, the transaction costs borne by members of the scheme. They must then assess the extent to which those charges and transaction costs represent good value for members. This must be done at intervals of no more than one year. If a scheme provides non-money purchase benefits then this obligation does not apply to charges and transaction costs for those benefits but only the money purchase benefits.

### 1.3.6 Annual Chair's Statement

From 6 April 2015, existing occupational DC pension schemes must have appointed a chair of trustees within three months. Also, new schemes must appoint a chair of trustees within three months of establishment. Some schemes are exempt from this requirement including:

- Single-member schemes;
- Schemes with no money purchase benefits (or where the only money purchase benefits are in respect of additional voluntary contributions);
- Public service pension schemes;
- Schemes that are not registered schemes for tax relief;
- Schemes for company directors only where there is only one employer which acts as the sole trustee and at least one-third of the members are current directors; and
- Schemes for fewer than 12 members where all the members are trustees and either decisions are taken by unanimous agreement or an independent trustee registered with TPR participates.

The name of the chair is added to the scheme information that must be reported to TPR. That information must be updated with the name of the chair as soon as reasonably practicable once one is appointed. This is done on TPR's online service Exchange. Importantly, trustees also have a legal duty to ensure that any change in registrable information, such as the name of the chair, is updated on Exchange within a reasonable time period after the change.

Trustees will continue to have joint and several responsibilities in the running of their scheme. The chair is additionally responsible for signing off the annual statement each year. However, all the trustees are responsible for preparing an annual statement within seven months of the end of each scheme year. Statements only had to be produced for scheme years ending after 5 July 2015 but the first statement for existing schemes had to cover the period from 6 April 2015.

From 6 April 2016, regulations provide that where the chair of trustees has ceased to hold office as chair for any reason and a replacement has not been appointed then the chair's statement may be signed by a person appointed to act as chair in the interim period. This is particularly relevant to cases where the appointment of a chair would involve a formal open appointment process, for example a non-affiliated trustee in a master trust, as there may be delay in completing the replacement of a chair.

Failing to produce the statement results in a mandatory penalty that the trustees are jointly and severally liable for and which can be between £500 and £2,000.

The annual statement must cover specific areas around minimum governance standards set out in legislation:

- Default fund – the statement of investment principles (SIP) in respect of the default fund must be included together with details of all reviews into the default strategy or fund performance, or if none, the date of the last such review.
- Core financial transactions – the trustees must describe how the requirement that core financial transactions be processed promptly and accurately (see 1.3.1 above) has been met.
- Charges and transaction costs – trustees are required to publish, on a standard basis, the transaction costs (in so far as they are able to calculate them) and the charges applicable to each fund. For scheme years starting before 6 April 2018 they may choose to only show the range of such costs and charges for non- default funds. The trustees must separate out the charges and costs that apply to default arrangements from other funds. The trustees must provide what information they can on transaction costs and also indicate what they have not been able to obtain, and the steps that they are taking to obtain this information in the future. The latest steps to standardise the disclosure of transaction costs in pensions are summarised in Section 3.4.
- Good value for members - the trustees must say to what extent these costs and charges represent good value for members (following their assessment as covered in 1.3.5).
- Illustrative example of cumulative effect of charges over time – for scheme years starting on or after 6 April 2018 information in the form of a table should show the effect on the member's accrued rights over time of the application of charges and transaction costs – see Section 2.4.
- Trustee knowledge and understanding – the extent to which the trustees have met the learning and competency requirements set out in the legislation must be stated, together with confirmation of the professional support they have to properly exercise their functions.

### 1.4 MASTER TRUST GOVERNANCE

A built-in relationship with a single employer can act as a safeguard for protecting members' interests in a pension scheme. However, as master trusts do not have this, additional independence standards are required for them. The first additional governance requirements for master trusts were introduced from 6 April 2015. Following the Pension Schemes Act 2017 further formal regulation of master trusts by a new authorisation and supervision regime was introduced from 1 October 2018.

#### 1.4.1 Original Voluntary Assurance Framework

In May 2014, TPR and the Institute of Chartered Accountants in England and Wales (ICAEW) developed a voluntary assurance framework that enables trustees of master trusts to demonstrate to employers that their scheme is governed and managed to a sufficiently high standard.

It set out how trustees should report against a series of 'control objectives' relating to governance and administration, which were aligned with TPR's original DC quality features and it acted as a check against schemes being set up by those who lack the competence or financial resources to take care of pension savings properly.

Although the assurance framework was voluntary, TPR expected master trusts to obtain this independent assurance report. TPR also published a publicly available list of master trusts that obtained independent assurance, to which employers and advisers could refer when selecting a scheme for automatic enrolment.

TPR actively encouraged any schemes which planned to apply for authorisation in 2018 to obtain this master trust assurance.

### 1.4.2 2015 Standards for Master Trusts

From 6 April 2015 the Charges and Governance Regulations 2015 introduced additional requirements for master trusts as follows:

- There must be a minimum of three trustees, with the majority, including the chair, being 'non-affiliated' effectively being independent of the providers / founders of the scheme (see below).
- Where a scheme has been set up with a corporate trustee with individuals or trustee firms acting as directors within that company, the directors should have to meet the minimum number and independence requirements in the same way as individual trustees.
- The appointment process for recruiting non-affiliated trustees must be open and transparent.
- Trustee chairs must be consulted on the appointment of other trustees.
- Where a trustee ceases to be a trustee or to be a non-affiliated trustee for any reason including term limits then the requirements for trustee numbers and a majority of non-affiliated trustees must be met within three months.
- The trustees must make arrangements to encourage members, or their representatives, to make their views on matters relating to the scheme known to the trustees.
- Trustees should set out in the chair's annual statement on governance details of how the requirement for the chair and majority of the trustees to be independent have been met during the year; where a trustee who is non-affiliated was appointed during the year, details of how the recruitment process has been open and transparent and details of what arrangements have been made to encourage members to give their views.

A non-affiliated trustee is defined as 'independent of any company which provides advisory, administration, investment or other services' in respect of the master trust. Importantly, there are time limits on how long a person can be regarded as non-affiliated. Essentially, the limit is a maximum period of no more than five years for each period of office. If there is more than one period of office within any five year period, then the total maximum period of office is ten years.

### 1.4.3 Pension Schemes Act 2017 and the new regime

The Pension Schemes Act 2017 received Royal Assent on 27 April 2017. It sets out the framework for a new authorisation and supervision regime for master trusts in order to address concerns about sustainability and the level of member protection in the event of a master trust failing.

The Pensions Regulator (TPR) has oversight for the new regime and all master trusts will be required to demonstrate that they meet certain key criteria on establishment and on an ongoing basis. Importantly, existing master trusts in operation prior to the Act coming into force are subject to the same requirements. The key features of the new regime are detailed below. In scope it applies to any occupational pension scheme which provides money purchase benefits (whether alone or in conjunction with other benefits) and is used or intended to be used by two or more employers who are not connected with each other.

However, the following schemes are exempt from this master trust legislation:

- Schemes where all the employers are connected with each other through being part of the same group undertaking or through certain corporate activity such as joint ventures;
- Relevant public service pension schemes;
- Those defined benefit schemes with either no money purchase benefits or whose only money purchase benefits were only attributable to any one or more of the following:
  - additional voluntary contributions paid by members,
  - transferred-in benefits for members who were accruing non-money purchase benefits; and
  - pension credits (due to a pension sharing on divorce order);

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- Single-member schemes where that member has been employed by all the employers that use the scheme; and
- Schemes for a specific occupational group, industry or profession, which cease to accept new members before 1 April 2019.

### 1.4.4 Key roles and the authorisation criteria

There are a number of key roles in the new regime. These include those who are:

- Trustees of the master trust
- Scheme funder – the person responsible for financing the master trust if its administration charges are not enough to cover its costs, and/or the person who is entitled to receive profits where the scheme's income exceeds its expenditure.
- Scheme strategist – the person who is responsible for making business decisions relating to the commercial activities of the scheme and who must prepare, maintain and review its business plan annually.

In order to be an authorised master trust, the scheme will need to meet ALL of the following criteria:

- The persons involved in the scheme and who exert control are all fit and proper persons. These persons will include (A) the person or organisation that sets up the master trust, (B) the trustees, (C) the scheme funder, (D) the scheme strategist, (E) persons who can appoint or remove trustees or who have the power to amend the trust and (F) in some cases the promoter or marketer of the trust. Assessments will be based around three tests for (1) honesty, integrity, and financial soundness, (2) competency and (3) conduct. The scheme is financially stable. This means that the scheme has a sound business plan, there are sufficient financial resources to meet the costs of setting up and running the master trust, and there are sufficient spare financial resources to resolve the cost of resolving any triggering event (explained below), including any winding up costs if the event so requires. A key part of demonstrating that the authorisation criteria are met is by having a business plan in place setting out the expected activities and growth of the master trust and how they will be funded.
- Each scheme funder meets specified requirements around legal personality, the limitation of its activities, financial sustainability, and regular audited accounts. TPR will be looking for specific clear evidence in relation to its business activities that it can support the master trust. However, there are exemptions for scheme funders who satisfy TPR that there are good reasons why these specific requirements should not apply to them and that their arrangements for giving financial support to the scheme are sufficiently transparent.
- The systems and processes used in running the scheme are sufficient to ensure that it is run effectively. This will include IT systems, records, administration processes, risk management processes and resource planning. Master trusts will have to confirm that their IT systems can provide a minimum functional capability, and TPR may require them to demonstrate that.
- The scheme has an adequate continuity strategy to protect members if a triggering event occurs (explained below).

Where existing master trusts do not meet the criteria, they will be prohibited from continuing in operation (i.e. accepting money from members or employers in respect of fees, charges or contributions) and will need to wind up and transfer their members' benefits to another master trust.

### 1.4.5 Authorisation process

A master trust will need to make an application for authorisation to TPR. It must be accompanied by the evidence to support the application to show the five key criteria above are met and the fee of:

- £41,000 for an existing scheme in operation on 1 October 2018; or
- £23,000 for a new master trust that starts operation after that date.



An existing master trust had to make an application within the period from 1 October 2018 to 31 March 2019 or it would not have been able to continue to operate as a master trust. Failure to apply in time would constitute a triggering event and the master trust would be required to wind up and transfer members out.

A new master trust must be authorised before it begins to operate. If it begins to operate before authorisation is granted it will experience a triggering event and automatically be required to wind up and transfer members out.

TPR's Code of Practice no.15 covers the authorisation and supervision of master trusts including the application process and the matters it expects to take into account when assessing whether a scheme should be authorised or not. Trustees, scheme funders and strategists are expected to be open and honest in the information provided and in their dealings with TPR. Providing false or misleading information can lead to a master trust not being authorised or being de-authorised.

Under the statutory timetable TPR will have six months from the date of receipt of the application to make its decision.

If TPR is satisfied that the master trust meets the authorisation criteria, the master trust will be added to a published list of authorised master trusts. If TPR declines authorisation, it will notify the applicant and will include the reason for the decision alongside details of how to appeal.

### **1.4.6 Ongoing provision of information for authorised master trusts**

TPR must be furnished with key information. Revisions to the business plan and continuity strategy must be sent to allow it to assess whether the key criteria for authorisation are met on an ongoing basis. Scheme accounts and the scheme funder's accounts will also have to be sent to TPR within two months of them being obtained and within nine months of the end of the financial year respectively.

Similar to the current notifiable events regime, there will be a requirement for those involved in the master trust to notify TPR of any significant events which are set out in regulations.

### **1.4.7 Continuity strategy and triggering events**

A continuity strategy sets out how members' benefits will be protected following a triggering event. These events in broad terms are events that could indicate that the master trust cannot continue to operate. Specific events are given below.

The continuity strategy will vary with each master trust but will often be a high-level document that provides the framework for identifying key actions, decisions and owners of actions required to deal with matters following a triggering event. It needs to set out the principles and timescales for decisions and how the costs of continuing to operate the master trust and resolve the triggering event will be paid for. This will include a statement of all levels of administration charges. Such costs and charges set out in the continuity strategy must be reflected in the business plan and financial sustainability calculations. Where a 'triggering event' occurs, there will be notification requirements placed on those involved with the master trust. For existing master trust schemes, these notification requirements applied with immediate effect from 20 October 2016.

A triggering event includes:

- TPR issuing a warning or a determination notice of a decision to withdraw authorisation
- A scheme acting without due authorisation and TPR providing a notification

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- An insolvency event in relation to the scheme funder (or the scheme funder is unlikely to continue as a going concern if the funder is unable to be subject to an insolvency event)
- The scheme funder ending, or deciding to end, the relationship or arrangement with the master trust
- A scheme funder, a scheme strategist or the trustees, deciding that the scheme should be wound up where they have the power to do so or an event occurs resulting in the scheme winding up
- The trustees deciding that the master trust is at risk of failure and that it is necessary to pursue one of the continuity options.

Where a triggering event occurs, trustees must:

- Notify TPR and employers;
- Decide on a continuity option to pursue – see below
- Prepare and submit an implementation strategy to TPR for approval.

The legislation recognises two continuity options:

- 1 The decision that members' interests are best served by securing their benefits in another master trust, so the members will be transferred out and the scheme will wind-up. A scheme that is not-authorised, or is de-authorised, will have to follow this option.
- 2 The decision that a triggering event can be resolved and the normal operations of a master trust resumed.

Once approved by TPR it is the duty of the trustees to pursue the chosen continuity option in accordance with their implementation strategy. If necessary, TPR can force the trustees to choose continuity option 1 (winding up) by giving a notice to withdraw authorisation. During the period following a triggering event the charges in the pension scheme may not be increased.

### 1.5 RISK MANAGEMENT

Robust risk management and controlled processes are required to administer DC schemes correctly. TPR highlights DC administration, in particular poor record keeping, member awareness and investment as key areas of concern. Those responsible for running DC schemes need to understand the key risks and to have a clear strategy to manage them. It is very easy to overlook or not recognise risks associated with DC administration; however, it is very difficult and time consuming to correct the situation if it goes wrong. Some of the risks a DC scheme might face include:

- Risk that internal controls are not operating effectively
- Risk of fraud
- Risk of transfers being subject to pension scams
- Risk of inappropriate investment strategies
- Risk of failure to comply with legislation or scheme rules
- Risk of maladministration
- Risk of computer system and database failures and cyber security breaches
- Risk of ineffective scheme management
- Risk of poor value for money

As is already becoming apparent, the profile of risk management will increase with time as assets in DC schemes grow and more members retire.

Implementing an effective risk management strategy at an early stage, together with regular and effective monitoring, allows risks to be identified before they escalate. Areas that would normally be covered within a risk management framework include:

- Ensuring that the internal controls and monitoring process are robust and timely
- Ensuring that financial systems are adequate to minimise and extinguish the risks of fraud or misappropriation of scheme assets
- Ensuring transfer processes are designed to identify possible pension scams
- Ensuring that investment strategies are monitored and reviewed
- Ensuring that administrators have the requisite skills to deliver a good quality service evidenced by regular stewardship reporting, monitoring of service level agreements, performance appraisals and strict authorisation procedures
- Ensuring scheme advisers are regularly reviewed and having in place a conflicts of interest policy
- Ensuring that the IT platform has the capabilities to meet the needs of DC administration which could include online member access
- Ensuring that IT systems used by the scheme have adequate cyber security
- Ensuring that IT systems and other arrangements comply with data protection legislation
- Ensuring the scheme is managed effectively with a clear communication programme
- Ensuring the scheme delivers value for money and good outcomes for members

It is important to monitor the controls to these risks on an ongoing basis. This is to ensure that the relevant information is provided to the trustees/managers, and that it is understood, reviewed and, if necessary, challenged. If something fails the internal controls, the trustees/managers need to take corrective action to remedy the error and reduce the risk of it happening again. Managing a pension scheme is very similar to running a business; attention to detail is critical.

For trust-based schemes, TPR has published guidance on risk management. The same principles are built into the FCA rules that affect contract-based schemes.

### 1.6 MEMBER COMMUNICATION AND ENGAGEMENT

With DC schemes, the onus is very much on the member to make the important decisions; decisions which can greatly affect the level of benefits they then go on to receive. If members have a lack of understanding of their pension arrangements they may well make poor decisions or take no action at all.

The points below are good practice guidelines for member communications; they do not consider the legal requirements concerning what information should be provided to a member and when (as set out in the Disclosure of Information Regulations 2013).

#### 1.6.1 The Importance of Effective Member Communications

If members do not understand their pension scheme, then they may not appreciate its value or realise how it can help them to save for their retirement. Trustees/managers and employers have a shared interest where:

- members are engaged and motivated to plan for their eventual retirement
- the scheme is effective in attracting, motivating and retaining employees
- time and resources are not taken up by ineffective communications exercises

### 1.6.2 What Makes Member Communications Effective?

TPR has stated its belief that effective communications should have the following qualities:

- Impact –members give it their attention
- Clarity –members are able to understand it
- Accuracy – members receive full and reliable information

It is important that the right balance is struck between these qualities.

### 1.6.3 Good Practice When Communicating With Members

When looking to produce a communication aimed at pension scheme members, the trustees/ managers and employers should take the following factors into account:

- Clear communication plan
- Identify the best way to communicate
- Tailor communications to the audience
- Remember the needs of all different categories of members
- Be open and honest
- Avoid jargon
- Choose the correct time to engage

### 1.6.4 Pension Wise and Risk Warnings

All members with DC pension savings who have passed their 50th birthday can obtain free guidance from the public service called 'Pension Wise'. This service goes further than trustees or scheme administrators can in explaining a member's options but falls short of giving professional financial advice. All schemes are required to inform members about Pension Wise during the DC decumulation (fund de-risking) process. Please note that under the Financial Guidance and Claims Act 2018 this service is being integrated into the Money and Pensions Service (MaPS). Further information is provided in Section 1.5 of Part 6.

With DC pension flexibility providing members with many more retirement options than in the past, scheme communications must make it clear to members what flexible retirement options (if any) are available under their scheme and what their transfer rights are should they wish to transfer their funds to another scheme that is offering more flexibility for DC members.

In order to protect their customers further the FCA has introduced rules (the so called 'second line of defence') which requires providers to give appropriate risk warnings to consumers accessing their DC pension savings. Providers must ask customers relevant questions based on how they wish to access their pension savings, to determine which risk factors are present and the appropriate retirement risk warnings to be given. These risk warnings apply regardless of the member having received guidance from Pension Wise or taken regulated advice.

TPR originally introduced similar guidance ('essential guide to communicating with members about the pension flexibilities') but it was more light touch in that it suggested 'generic' risk warnings should be provided at the point a member is required to make a final decision (after the pack has been issued and even if the member has used Pension Wise) in taking their DC benefits in a particular form, or to take a transfer to another scheme or provider to access their benefits. The guidance also originally suggested that the members should sign a statement to confirm whether they have received Pension Wise or regulated advice, and to confirm they have read the generic risk warnings. From 6 April 2016, statutory requirements for occupational schemes to provide risk warnings were introduced. Nevertheless, occupational schemes are not obliged to provide tailored risk warnings and if they do they do not have to issue the generic risk warning as well.

### 1.7 SUPPORT FROM THE PENSIONS REGULATOR

TPR supports DC pension schemes and provides information, and guidance to support their good governance. The strategic aim is to deliver good outcomes for members. As a result of automatic enrolment, TPR has produced a great deal of material on governance and administration standards which it is routinely updating. Some of this is set out below.

#### 1.7.1 Guidance on Record Keeping

To address the issue of poor record keeping in schemes, which could result in significant costs in areas such as administration, buy-outs and wind-ups, including error correction and claims from members (not to mention reputational damage), TPR first published detailed regulatory guidance in 2010 aimed at trustees, providers and administrators on the testing and measurement of member data, in relation to:

- Common Data – this is data that is necessary and applicable to all members of all schemes and its absence is likely to mean that the member cannot be identified or traced, or their benefits calculated with any degree of certainty (for example name, date of birth, sex, address, membership status).
- Conditional Data – the nature of this data will vary from scheme to scheme and will depend on many factors including scheme type and design, a member's status in the scheme, system design and events that have occurred during their membership of the scheme.
- Numerical Data – numerical information regarding member's records that will help put the results of other measures into perspective.

Trustees/managers should ensure that a data review exercise is carried out at least annually, including an assessment of the accuracy and completeness of the above types of data. A data improvement plan is required to address poor quality data and such a plan should have a defined end date within a reasonable timeframe.

TPR expects all schemes to maintain 100% accuracy of all common data collected since June 2010 and 95% accuracy of all earlier common data. There is no target yet for conditional data but this has been expected for some time now.

#### 1.7.2 2013 Original Code of Practice 13 – 6 Principles and 31 Quality Features

A Code of Practice, entitled 'Governance and administration of occupational defined contribution trust based schemes', was first published by TPR in November 2013. Prior to that TPR invited the pensions sector to take part in a dialogue on six principles for good design and governance of workplace DC pension provision, which formed the basis of its regulatory approach.

Although the November 2013 Code was superseded (see below), those six principles and underlying principles remain at the core of what TPR considers to be a well-run DC scheme. The six principles were as follows:

1. Schemes are designed to be durable, fair and to deliver good outcomes for members
2. A comprehensive scheme governance framework is established at set up, with clear accountabilities and responsibilities agreed and made transparent
3. Those who are accountable for scheme decisions and activity understand their duties and are fit and proper to carry them out
4. Schemes benefit from effective governance and monitoring through their full lifecycle
5. Schemes are well administered with timely, accurate and comprehensive processes and records
6. Communication to members is designed and delivered to ensure members are able to make informed decisions about their retirement savings

The first three principles are relevant at scheme set up, with the remaining three relevant throughout the life of a scheme. TPR believed that if schemes follow these principles, it will help them to deliver the elements necessary for members to receive good outcomes, identified as:

- Appropriate contribution decisions
- Appropriate investment decisions
- Effective and efficient administration
- Protection of scheme assets
- Value for money
- Appropriate decumulation (fund de-risking) decisions

TPR further sub-divided the six principles into 31 quality features in order to meet the governance and administration objectives and define the standards trustees were expected to obtain.

### **1.7.3 2016 Revised Code of Practice 13 and How-to-Guides**

Following the introduction of DC pension flexibility and the Charges and Governance Regulations (both effective from April 2015) a revised version of the Code took effect from 28 July 2016 (September 2016 in Northern Ireland). The Code was renamed 'Governance and administration of occupational trust-based schemes providing money purchase benefits'.

The 31 quality features contained in the original 2013 DC code were removed in favour of a more principles-based approach supplemented by the specific regulatory DC governance requirements. The updated Code is more high level, providing much less detail and relying on supplementary guides for additional practical information. The main sections of Code are:

- The trustee board – which covers fitness and propriety of trustees, succession planning, board composition, the role of the chair and master trust requirements.
- Scheme management skills – which covers trustee knowledge and understanding, risk management, working with advisers, service providers and employers, and conflicts of interest.
- Administration – which covers working with the administrator, administration reports, quality assurance, business continuity plans, disaster recovery, core financial transactions, service level agreements, record keeping, data accuracy and data security.
- Investment governance – which covers the SIP, delegation, investment strategy including financial and non-financial factors, default investment strategies, performance monitoring, security of assets and changing investment funds.
- Value for members – which covers the requirements of the chair's statement and restrictions on costs and charges.
- Communicating and reporting – which covers knowing members' views, use of plain English, annual benefit statements, retirement options including risk warnings, transfers including pension scams, the chair's statement in the context of member communications, whistleblowing and mandatory reporting to TPR.

The guides to supplement the Code are made up of six separate How-To-Guides, each one titled to match the six sections of the Code above. The guides are intended to provide practical information and examples of the requirements and best practice described in the Code.

### **1.7.4 Supporting Trustees and Employers**

TPR has published material to help various parties in their quest for delivering good outcomes to retirement savers from workplace DC arrangements.

For trustees, there is guidance to help them understand their role, help in how they should manage their DC scheme and the advice on the role trustees should play alongside the employer's automatic enrolment duties.

For employers, it has published tools to help employers check whether their existing DC scheme meets the minimum criteria for an automatic enrolment scheme as set out in legislation. There is information to help employers begin planning and then implementing automatic enrolment. There is also guidance and resources to help employers understand their role in running a good quality pension scheme.

### Summary

Having in place an effective scheme governance programme and a co-ordinated and targeted approach to communicating with members are two important parts of running a successful DC scheme.

In devising a programme of governance, the trustees of a DC scheme should consider its internal controls and procedures to manage scheme risk, manage conflicts of interest effectively, ensure their data and records are of a high standard, keep their knowledge and understanding up to date and monitor investments of the scheme. For a contract-based scheme, the issues are relatively similar and it would be the employer's responsibility with the manager for dealing with them rather than a trustee body.

As members are responsible for making their investment choices in a DC scheme, it is vital to have a targeted member communication programme in place. If members have a lack of understanding of their pension arrangements they may well make poor decisions or take no action at all. Members' understanding of their pension arrangements must also extend to the charges that are being applied on their funds and to this end, it is important for employers to understand the charges too.

TPR has produced a range of materials in support of its recent focus on good governance and administration standards. Most recently, the TPR produced the 2016 Code of Practice and How-to Guides for occupational pension scheme trustees. TPR polices the requirement to produce a Chair's Statement.

Master trust governance is an area where there has been increasing regulation. After the 2015 governance changes, the new authorisation and supervisory regime amounts to a radical transformation of how that sector is regulated.

### Self-Test Questions

- What are the types of risk a scheme could encounter?
- Identify the resources TPR provides to support good governance.
- Why is it important for trustees to have a policy in place to deal with conflicts of interest?
- Describe the role that the employer should play in relation to the governance of a DC scheme.
- Explain why it is important for DC schemes to have an effective communication programme in place.
- Outline the recent measures taken to improve the governance of master trusts.
- Summarise the key requirements for annual chair's statements.

# CHAPTER 2

## Member Investment Considerations

### INTRODUCTION

Investment of contributions is absolutely crucial in DC schemes. The investment decisions that members take will affect the value of their pension funds. By the end of this Chapter, students should understand the factors that influence investment strategy and member choice.

The value of a member's investments can go down as well as up, and past performance is not a guide to future performance. These caveats will need to be carefully communicated to members in order to manage their expectations.

Neither the trustees nor the sponsoring employer can provide the member with investment advice or be held responsible for the day-to-day decisions taken by the investment manager. However, the trustees are responsible for monitoring investment performance, querying decisions taken by the investment manager and taking further action if required.

As all automatic enrolment schemes must achieve enrolment without members having to express any choice, perhaps the most important role of the trustees is in setting up (and reviewing) the default fund. Experience has shown that the great majority of members in the great majority of schemes choose to remain in their default fund. The requirements for governance of default funds are detailed in the Chapter 3. For the remainder of this Chapter we will look at the investment universe from the perspective of members choosing investments and introduce the idea of lifestyle strategies.

If members are in any doubt about their investment decisions it is recommended that they seek independent financial advice.

### 2.1 MEMBER'S ROLE IN CHOOSING INVESTMENTS

For those who do choose not to remain in the default fund, perhaps the most difficult area for members to deal with in relation to DC schemes is where to invest their contributions. This applies to all types of DC schemes. The fundamental issue remains how best to invest, based on the member's attitude to risk, age and number of years to retirement.

DC investment risk sits largely with the member, as the amount of money in the member's pension fund at retirement depends on the contributions both the member and the employer pay in, as well as the investment returns these contributions receive. Generally, the lower the potential risk, the lower the potential rewards; the higher the potential risk, the higher the potential rewards – but the precise choice of funds will depend on the scheme/provider. Also, the level of the investment charges that apply to a fund have an impact on the level of reward – a key debate concerns the extent to which higher charges result in higher value. More detail is provided in Sections 2.2 to 2.4 below and in Chapter 3.

The members' role is to select which of the available funds they want their pension fund to be invested in. This decision lies entirely with the member, who must consider his or her own attitude to risk in relation to the potential returns of the available investment options.



On setting an investment strategy, the member may wish to take into account factors such as other savings, other sources of income and how close they are to retirement.

The member may choose to invest all of his or her pension fund in a 'freestyle' strategy or a 'lifestyle' strategy.

A lifestyle strategy is essentially where the member's fund gradually switches into less volatile types of funds as he or she approaches retirement, whereas a 'freestyle' strategy is where this automatic switching into less risky funds does not happen, unless the member makes the decision and issues the appropriate investment switch instructions to the administrator.

One option for members to consider is to spread their pension investments over a number of different asset classes, to balance the risk undertaken. If members do not make an active investment choice, their fund will be invested in accordance with the trustees' default strategy.

Employees who are automatically enrolled will usually be invested in the scheme's default fund unless otherwise stated. Members usually specify their chosen investment options at the point of joining the pension scheme or moving out of the default fund but will have the opportunity to revise their options by switching or redirecting their investments. It is the responsibility of the member to review the scheme documentation (e.g. the membership booklet, fund descriptions, and past performance figures), which should provide them with information about the particular funds available within the scheme and the rules on switching and redirecting investments.

It is important for members to monitor their investment options and make amendments where they see fit. This is particularly important for members who have funds invested in higher risk asset classes, such as equities. Market performance is difficult to predict, but if the opportunity exists for members to easily alter their investment options then they should seek to use this to their advantage. Members may also be able to change their investment strategy for future contributions, whilst retaining existing funds as they are currently invested, depending on the sophistication of the administration system used and the scheme or contract terms.

Members in lifestyle strategies need to ensure that they inform the scheme of any changes to the target retirement date to ensure that the protection phase of the lifestyle strategy is implemented at the correct time.

The range of investment options and the complexities of the various pension products on the market mean that the member should always seek independent financial advice if they are unsure of the investment choice to make.

### 2.2 TYPES OF INVESTMENT

The member's aim is to maximise the value of his DC pension account over his working life. Making a short term gain is less important than the overall performance of the pension fund during the whole of the period of membership.

Trust-based DC schemes typically allow members to select their own investments from a limited range of funds. Personal pension arrangements, stakeholder arrangements and SIPPs generally offer a broader range of investments for members.

The member's investment options are likely to include one or more of the following basic asset classes:

- Equities
- Property
- Bonds
- Cash

Sometimes these are combined together in what is known as a balanced fund.

As noted DC schemes used for automatic enrolment must have a default fund for those who do not make an active investment choice see Section 3.2.

### 2.2.1 Equities

Generally, equity funds:

- Are made up of shares in companies traded on stock markets in the UK or overseas
- Are affected by rises and falls in their respective markets – their value can go up or down
- Are expected to experience the highest short term volatility (i.e. rise and fall in value) when compared with bonds or cash
- Are expected to achieve higher long term returns than bonds or cash
- Are normally considered suitable for members with a longer period until retirement, but too risky for those close to retirement who do not want to see a sudden drop in the value of their fund

In general, it is a good principle of investment for members to spread the risks to which they are exposed by diversifying and not having 'all their eggs in one basket'. Giving members the ability to invest some of their assets across overseas markets is one way of allowing this; e.g. overseas equities. However, it is important to remember that choosing funds with overseas investments does introduce an additional element of currency risk. For example, an overseas equity investment could do very well (in local currency) but if the value of that currency decreases relative to sterling, the equity return that the member receives (in sterling) will be reduced and vice versa.

### 2.2.2 Property

Generally, property funds invest in a range of commercial properties such as retail outlets, office blocks and industrial buildings. They:

- Have returns that depend on the change in market value (up or down) of the individual properties and rental return
- Are normally suitable for members with a longer period until retirement, but too risky for those close to retirement who do not want to see a sudden drop in the value of their fund
- Are likely to give lower returns than equities, but higher than bonds so the risk of these investments is therefore likely to lie between equities and bonds

### 2.2.3 Bonds

Generally, Government and corporate bond funds:

- Are made up of debt securities issued by the Government (gilts) or companies (corporate bonds) where the government or company borrows an amount of money for a fixed period, pays interest on the amount borrowed and the capital is repaid at the end of the fixed period
- Rise and fall in value over their lifetime, but returns are not expected to be as volatile as equities or property
- Are suitable for those nearing retirement that will soon need to buy a pension, as the price of pension annuities are closely linked to the price of long-dated bonds and the price of inflation protected pensions is linked to the price of index-linked bonds
- Are often considered to be suitable for lower risk investment

### 2.2.4 Cash

Generally, cash funds:

- Work in the same way as a deposit account with a bank or building society
- Are expected to provide lower returns over the long term than equities or bonds
- Ensure that the members' capital will not decrease in value, although inflation may reduce the real value of the investment
- Helps to protect the value of a tax free cash amount from falls in value just before the member retires
- Are generally thought less suitable for members with more than five years until they retire
- Are often considered to be suitable for lower risk investment

### 2.2.5 Balanced Funds, Generally balanced funds:

- Are invested in a mixture of UK and overseas equities and other assets including bonds, cash and property
- Are affected by the rise and fall in equity values, but because they also contain other assets, they are likely to be less volatile than pure equity funds
- Are expected to provide higher returns over the long term than bond funds and cash, but lower than pure equity funds
- Are normally suitable for members with more than five years until they retire – depending on the mix of growth assets (equities) and less risky assets (gilts and corporate bonds) each fund will have different characteristics, although typically they have a high proportion of equities
- Are likely to be a mixture of growth and lower risk investments, hence the term 'balanced'

### 2.2.6 Other Funds

There are a number of other funds that are available for pension scheme investment:

- **Derivatives**

These are financial instruments that derive their value from the price of an underlying asset; e.g. an interest rate, equity, commodity or currency. Common derivatives include futures and forwards, options and swaps.

- **Private equity funds**

These usually invest in unquoted companies.

- **Pooled funds**

These enable small schemes to invest in a wide range of assets which otherwise they would not be able to access. Common pooled vehicles include unit trusts, investment companies with variable capital (ICVCs) and investment trusts.

- **Blended funds**

These are similar to balanced funds in that they give investors a diversified mix of investments but they invest only in different types of equities.

- **White label funds**

These are funds which are branded by the name of the asset class rather than according to investment managers. This allows trustees to more easily replace investment managers without having to replace the fund offering.

- **Multi manager funds**

These are funds that use the best managers in each asset class in order to get the best possible investment return. There are two main types:

- **Manager of managers** – This is where a few select managers are appointed who are given specific mandates to manage the investment in a single fund. The manager of managers has to select the specialist managers, monitor their performance and alter the composition of the team to adapt to market conditions or fund performance.
- **Fund of funds** – This is where a manager builds up a portfolio that invests in funds that are run by a number of other managers.

- **Target date funds**

These are funds which target the year in which the member is expected to take their benefits. Funds are gradually switched from higher risk investments until they are in the lowest risk investment at the target date. In practice, however, because the concept of a set retirement date is largely non-existent, most target a retirement 'window' rather than a specified date. Target date funds are different to 'lifestyle' funds (covered in Section 2.4) in that a scheme will typically have many different target date funds and the member simply selects the one which targets the date closest to when they expect to take their benefits. Lifestyling is an automated process in the run up to retirement and applies in the same way to all members who have chosen that strategy whereas with target date funds, the fund manager has a greater level of discretion to manage market swings. For example, if the target asset allocation for a particular year is not met due to external stock market conditions, the fund manager will rebalance the fund. The National Employment Savings Trust (NEST) uses target date funds as its default option.

### 2.3 TYPES OF INVESTMENT MANAGEMENT

Within the various asset classes available there are both 'actively' and 'passively' managed funds.

#### 2.3.1 Active and Passive Management

##### *Active Management*

Active management is the process of buying and selling investments with the intention of outperforming a specific index, a benchmark, other investment managers, or a combination of these. If successful, active management can generate significant extra return versus the stated benchmark. However, if the manager's decisions prove unsuccessful, they can underperform relative to the benchmark. Charges for active investment management tend to be higher than for passive management as it requires the investment manager to analyse the market to a much greater extent, in order to identify the stocks to buy (which are expected to do better than the index) and avoid those which are expected to do worse than the index.

##### *Passive Management (Sometimes Known as Index-Tracking)*

Passive management is the process of buying and selling investments with the intention of matching the performance of a chosen index. For example, this could be the FTSE All-Share Index in the UK. The passive manager is attempting to match the index (i.e. produce investment returns very similar to what the index, or market is doing) and will hold a broad range of stocks, very similar to those in the index. This means that passive investments follow the market index whether it goes up or down. Passive management therefore removes much of the potential for outperformance as well as underperformance versus the index, but not the risk of markets producing negative returns. Charges for passive management tend to be lower than for active management as the process is highly automated.

#### 2.3.2 Use of Investment Platforms

Investment platforms are being used increasingly more by DC trustees because they offer a broad range of asset classes and investment styles without the need for direct engagement with fund managers. They allow trustees access to a series of investment funds, across all asset classes, and a comprehensive range of investment managers, through one platform. Investment platforms allow trustees to create blended funds.

Investment platforms allow trustees to more easily and more efficiently implement and deliver their investment strategy by accessing their preferred investment options and investment managers through a single structure and uniform administrative platform.

### 2.4 LIFESTYLE STRATEGIES

A lifestyle strategy is a set investment strategy that automatically switches a member's fund to what are considered to be lower risk asset classes, as the member approaches retirement. It is common for trustees/managers of existing DC schemes to offer a lifestyle strategy as the default investment option for members.

Lifestyle strategies are split into two general phases – the 'growth phase' and the 'protection phase'. In the initial growth phase funds tend to be invested in asset classes that are likely to achieve the highest fund growth, yet also have high fund value volatility (such as equities).

When members approach retirement they will then enter the protection phase, in which their funds are gradually switched into 'safer' asset classes such as corporate bonds, gilts, and cash. This aims to prevent a scenario in which the member's pension pot is depleted by a stock market crash shortly before they retire, greatly reducing their retirement income. The protection phase does, however, offer lower projected investment return than the growth phase.

An example of a lifestyle strategy is shown below:

Years to Target Retirement Date (TRD)	Equities	Gilts	Cash
5 years +	100%	0%	0%
4 – 5 years	80%	15%	5%
3 – 4 years	60%	30%	10%
2 – 3 years	40%	45%	15%
1 – 2 years	20%	60%	20%
0 – 1 year	0%	75%	25%

One benefit of opting for a lifestyle investment strategy is that the member should not have to micromanage their pension fund in order to protect their fund value as they approach retirement. For example, in the above instance, when the member reaches five years from retirement 20% of his or her fund is automatically switched from equities into gilts and cash. The member does not have to specifically request this transaction or complete any additional paperwork.

Since 6 April 2014, The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 have required DC scheme using a lifestyle strategy to:

- notify prospective and new members that a lifestyling strategy will be applied, with a statement explaining lifestyling, the date it has or will be adopted, as well as a summary of the advantages and disadvantages of lifestyling
- reissue information on lifestyling again to members, broadly before the time that their funds are subjected to lifestyling; namely, between 5 and 15 years before their retirement

Lifestyle funds are often compared to target funds because the asset allocation is adjusted automatically for the member based on a target date. It is important for members to consider the date that they intend to retire when opting for a lifestyle strategy. For example, if a member of a trust-based DC scheme is intending to retire at age 60, but their scheme operates a normal retirement age of age 65, then they will need to specify their target retirement date as their 60th birthday. This will ensure that their funds enter the protection phase of the lifestyle strategy at the appropriate time in order to protect their funds for retirement at age 60.

Lifestyle strategies may not be appropriate for all members, and as with any investment choice the member needs to consider their own attitude to risk. A member with a large fund and a wide portfolio of other investments may feel more willing to invest in higher risk asset classes when close to retirement than a member whose only source of retirement income is one modest pension fund. In order to recognise this, a growing number of trustees are offering multiple lifestyle strategies, so that members can select the strategy that best suits their own outlook on investments.

The vast majority of DC schemes have lifestyle strategies that aim to match annuity prices at a certain retirement age. However, since 6 April 2015 members are no longer required to purchase an annuity with their DC fund and they have more freedom in how they can take their retirement income. This means that these lifestyle funds may no longer be appropriate and trustees should review them – that is it is no longer obvious that the member would invest 75% of their fund in an annuity and so a movement towards a low risk 75% gilts strategy is no longer the obvious solution. In a drawdown fund then either a higher level of cash or a returns-based approach featuring equities may be appropriate.

In 2015, the FCA told advisers and providers to review the suitability of lifestyle investment strategies. There was the need for such reviews to be timely and supported by clear communications about how lifestyle strategies had been adjusted in the light of DC flexibility. By June 2017, the FCA was still concerned that some were still reviewing pre-2012 pension investment strategies.

Any review of lifestyle funds needs to consider the membership demographics. These reviews will have to consider likely member behaviour and the use of 'big data' can be applied to predict likely average behaviour of various social groups. This needs to be used to inform trustees on how the funds arising under any lifestyle fund are likely to be used.

### Summary

Investment is a crucial element in determining the level of retirement benefits payable from a DC scheme.

Members are responsible for investment choices and need to seriously consider their choices in order to get the retirement income they want. Trustees, however, are responsible for selecting the funds that are available for members to invest in and how investments are managed.

Lifestyle strategies can assist members who do not wish to take an active role in their investment decisions.

### Self-Test Questions

- Outline the considerations for members in choosing their investment strategy.
- What types of investment are commonly available to members in a DC scheme? Give a brief description of each.
- Explain the difference between passive and active management.
- Outline the main features of a lifestyle strategy.
- What is a 'target date fund'?

# CHAPTER 3

## Investment Governance

### INTRODUCTION

One of the advantages of DC schemes for employers is that the investment risk within the scheme lies with the member. However, it is in the interests of all parties to ensure that the member is able to make the most appropriate investment choices to increase the probability of achieving their retirement goals. Therefore, it is vitally important that those in charge of the investment choices within a DC scheme consider the most appropriate investment options for their members, monitor these regularly and communicate effectively with the members about the options available and their risks.

Neither the trustees nor the employer can provide the member with investment advice or be held responsible for the day-to-day decisions taken by the investment manager. However, the trustees are responsible for monitoring investment performance, querying decisions taken by the investment manager and taking further action if required.

By the end of this Chapter the student should understand the role of the trustees/managers in selecting and monitoring the investment options available to members, the importance of the design of the default option, and the statutory rules applicable to default funds under qualifying schemes used to meet the employer duties.

### 3.1 TRUSTEES' ROLE IN CHOOSING INVESTMENTS

Trustees are involved in the initial selection of the choice of investment funds available under the scheme. Pension law sets out what trustees must consider when choosing investments.

The Pensions Act 1995 requires trustees who make investment decisions or, where they have delegated that responsibility, their fund manager to consider the need to have a spread of investments and the suitability of investments.

The effect of the Pensions Act 2004, coupled currently with European law is that trustees or fund managers will have to exercise their investment powers prudently. This includes:

- Investing in the best interests of members and beneficiaries and, in the case of any potential conflict of interest, in the sole interest of members and beneficiaries
- Exercising their powers with a view to securing the security, quality, liquidity and profitability of the fund portfolio as a whole
- Having regard to the need for a diversified spread of investments for the scheme as a whole so as to avoid accumulating too much risk by the excessive reliance on any particular asset or group of businesses
- Making sure that the scheme assets are invested mainly in regulated markets (with any assets not traded on regulated markets kept to a prudent level).

Trustees normally employ a regulated benefit consultant or investment consultant to determine which funds would be most appropriate for their membership, including the selection of a default fund.

It should also be borne in mind that the charges that are applied to the investment vehicles can erode overall performance and growth of the assets. Therefore, trustees should take into account charges when considering appointing an investment manager. The level of charges should therefore be made clear in any member communication on investment matters.

When choosing investments, trustees (or the fund manager acting on their behalf) must exercise their investment powers in line with the scheme's Statement of Investment Principles (SIP).

The Annual Chair's Statement referred to in 1.3.6 requires the trustees to consider and report on both charges and value for money.

### 3.2 DEFAULT FUNDS

Many schemes have long had a default investment fund for those members who have not made an active investment choice. The default investment fund is normally designed to be suitable for the widest range of members. Stakeholder schemes are legally required to have a default fund that is a lifestyle option.

With the introduction of the automatic enrolment requirements this has become standard as all DC qualifying schemes are required to have a default fund. A key element of automatic enrolment is that the employee should not have to make any active decisions as part of the joining process. It is therefore recognised that having been automatically enrolled, the vast majority of members will end up in the default option, and it is important therefore that these funds represent value for money.

The Government has long recognised the importance of offering an appropriate default fund and first published guidance in May 2011 for the trustees of trust-based schemes, and the sponsoring employers and providers of contract-based schemes.

#### 3.2.1 Regulatory Requirements for Default Funds under Qualifying Schemes

A step change in the regulation of default funds started with new requirements from 6 April 2015. Charge caps were introduced on default funds set up for complying with automatic enrolment and the other employer duties. Exactly what qualifies as a 'default fund' for this purpose is explained below in 3.2.4 below but the essential principle is that the cap only applies where members have made no active choice – i.e. the cap only covers arrangements into which members have been put into by 'default'. More detail on the charge cap is given in section 3.3.

In addition, from 6 April 2015 trustees of qualifying schemes must ensure they prepare a separate Statement of Investment Principles (SIP) in respect of the default arrangement.

The design, performance and continued suitability of a default fund must be reviewed by the decision maker at least every three years when revising the default fund's SIP (see 3.6.3 below). A review may also be required when certain events occur in relation to the employer, investment funds, scheme demographics or where there are significant changes in wider economic conditions.

#### 3.2.2 Designing the Default Option

When designing the default option, the decision maker responsible for the default option should ensure that it:

- has a high level objective, which explains its aim for member outcomes and its strategy for achieving this
- is suitable for its employees, taking into account their characteristics and needs
- is appropriately and competitively priced and the effects of the charges should be made clear
- has an investment strategy that manages risks through an appropriate and diversified allocation of assets with the overall objective in mind



### 3.2.3 Communicating the Default Option

Communications to members regarding the default option should include:

- a description of the default option
- a statement of the overall objective of the default option
- the risk profile
- the charging structure
- signposting on how to request further information

Default funds commonly include lifestyle funds or balanced funds. However, as more sophisticated investment products become available, trustees/managers are increasingly considering funds such as absolute growth and diversified growth funds, with a view to reducing the investment risk for members while still delivering acceptable returns.

### 3.2.4 Default Funds and Employer Duties

As already noted, the Government introduced the charge cap with effect from 6 April 2015 and it applies to default funds in qualifying schemes used to meet the employer duties.

In principle, a default arrangement would simply be the DC investment arrangement a member was placed in if they had made no choice or expressed any preference. However, the definition of a default fund (or arrangement) in such circumstances has been extended. The reason is that schemes set up before automatic enrolment was introduced could compel employees to make a choice on joining. Because a choice had to take place, there might not be an arrangement that can easily be recognised as the default one. The test for a default arrangement was altered as follows:

- Where 80% or more of the existing members are in the same arrangement where a choice was required for scheme membership over where contributions were allocated. A transitional easement applies – see below
- Where 80% or more of new joiners after April 2015 (or later employer staging date) are in the same arrangement where those members are required to make a choice

The test is applied separately to arrangements for each employer and once an arrangement is classed as a default, its status is fixed.

These rules are in addition to any scheme default nominated by the trustees.

The transitional provisions for default funds referred to above is that such an arrangement is not classed as a default fund and so not subject to the cap if before 6 April 2015 or later staging date where the following applies:

- Each worker has been informed that, unless they agree that contributions should continue to go to their current arrangement, all future contributions from the test date will be redirected to a new arrangement
- That, in the absence of such an agreement, the promised redirection of future contributions takes place and is to be to a new default arrangement that satisfies the cap without the worker having to express any choice
- That any worker's agreement to continue using their current arrangement is in writing and includes a statement that the worker acknowledges the charges in that arrangement will be higher than the cap

This easement is to allow employees to retain contract terms such as a waiver of premium or loyalty bonus that would otherwise be lost.

### 3.3 PENSION CHARGES AND THE CHARGE CAP

All DC schemes have a charging mechanism in place to cover the cost of administering and investing members' funds. The amount and method by which charges are collected varies depending on the type of scheme and between providers. It is important for members to be aware of the charges that apply to their pension to make sure they are getting value for money, an important part of scheme governance.

#### 3.3.1 Scope of the Charge Cap on Member-borne Deductions

Since 6 April 2015 legislation imposes a charge cap on 'default funds' under qualifying schemes in relation to 'member-borne deductions'. The duty applies to both trustees of occupational DC schemes and providers of personal pensions that are used as qualifying schemes.

Member-borne deductions include both general scheme administration and investment administration charges. The deductions are referred to as 'charges' and defined in the regulations as all 'administration charges' other than the following exceptions:

- Transaction costs – these are formally 'the costs incurred as a result of the buying, selling, lending and borrowing of investments'
- Charges ordered by a court
- Pension sharing charges
- Costs solely associated with the provision of death benefits
- Winding-up charges; and
- Charges for member opt-in services – where the member has specifically elected to purchase a voluntary service.

Importantly, charges that the employer pays (instead of the member) are not within scope of the charge cap (for example, the employer could pay the scheme set-up costs).

#### 3.3.2 Level of the Charge Cap

Schemes can charge up to 0.75% of funds under management. However, the legislation also restricts the kind of charge structure that can be imposed to only one of only three permitted charge structures and sets broadly equivalent limits:

- **Annual management charge (AMC)**

Here, an amount is charged each year based on the size of the existing accrued rights fund (often described as an 'annual management charge' and expressed as a percentage of the fund). This is a single charge structure with no other charges that fall within the cap.

The limit is 0.75% annually of the value of the member's rights in their default arrangements.

- **Contribution charge and AMC**

This is a combination of two charges involving a contribution percentage charge (on all payments made into the scheme) and an accrued rights charge each year or AMC (based on the existing funds). This therefore allows a lower AMC along with the contribution charge (e.g. the AMC that applies in NEST is 0.3% per annum combined with an additional 1.8% contribution charge).

The contribution charge may not exceed 2.5% of the contributions paid. The limit on the AMC depends on the contribution charge chosen as set out in the table below:

## Defined Contribution Arrangements

Contribution charge rate	Maximum AMC
Up to 1% of contributions paid	0.6% of existing funds
Over 1% but no higher than 2% of contributions paid	0.5% of existing funds
Over 2% but no higher than 2.5% of contributions paid	0.4% of existing funds

- **Flat fee and AMC**

This is a combination of two charges involving a flat fee charge (where a specific amount is levied over a period of time) plus an accrued rights charge or AMC (based on the existing funds).

The flat fee may not exceed £25 a year. The limit on the AMC depends on the flat rate fee chosen as set out in the table below:

Flat rate fee	Maximum AMC
£10 a year or less	0.6% of existing funds
Over £10 but not more than £20 a year	0.5% of existing funds
Over £20 a year but not more than £25 a year	0.4% of existing funds

It is important to recognise that other charging models will not comply with this legislation but may apply to contracts that are outside the scope of this legislation and particularly to legacy schemes (see 3.3.5 below).

### 3.3.3 Other Restrictions on Charges

From 6 April 2015, the existing ban on consultancy charging was extended to all qualifying personal pension schemes.

The second phase of the reforms brought in the removal of member-borne commission from 6 April 2016 and the introduction of a ban on active member discounts. These practices would have ceased before that date where the scheme was unable to comply with the charge cap on default funds.

For contract-based schemes, the ban relates to all contracts regardless of when they were entered into. For certain DC trust-based schemes, the commission ban initially applied to all contracts entered into or amended on or after 6 April 2016. Legislation to extend the ban to contracts entered into before 6 April 2016 took effect from 1 October 2017 but gave service providers a six-month window to make changes and modifications to enable compliance so that the prohibition did not apply until 1 April 2018.

In 2016, both the DWP and the FCA launched consultations on introducing a cap on early exit charges which may be imposed by providers of money purchase pension arrangements. The proposals were designed to ensure that members of DC pension schemes and personal pensions have access to the pension flexibilities without early exit fees being a barrier.

Both consultations concluded that early exit charges for those aged 55 and above should be restricted to 1% for existing members and 0% for all new members. Administrators of existing schemes with exit charges of less than 1% are not be able to increase them after the rules come into effect. For contract based pension schemes (including stakeholder schemes) the cap took effect from 31 March 2017 while for occupational pension schemes it took effect from 1 October 2017.

However, administrators of contract-based schemes and policies (that may be held under an occupational pension scheme) who apply a market value adjustment (MVA) to transfer values can continue to do so. Terminal bonuses are not excluded and must be taken into account when calculating the 1% or 0% exit charge cap if, and only to the extent that, the member has a 'reasonable expectation' of receiving such a bonus.

### 3.3.4 Review of the Charge Cap

The Government had previously said that it will review the charge cap further in 2017 to decide whether some or all transaction costs should be included in the default fund charge cap and whether the level of the cap should be reduced.

In a Ministerial Statement to Parliament on 16 November 2017 Guy Opperman MP, the Pensions Minister, stated that the cap was working broadly as intended in helping to drive down member-borne costs, whilst allowing flexibility to allow asset diversity or tailored services for members. The Government's focus was the lack of transparency on transaction costs, which was deemed to be hindering trustees and IGCs' attempts to monitor and evaluate whether those costs represented value. Further steps were being taken (see 3.4 below) to deal with that issue and the position was expected to be come much clear by 2020.

Accordingly the Government is currently examining the level and scope of the charge cap, as well as permitted charging structures, to see whether a change is needed to protect members. This timing will also allow it to evaluate the effects of the next stage of automatic enrolment and the new master trust and transaction costs regimes. It will report once evidence from industry stakeholders has been obtained.

### 3.3.5 Charges outside the Cap and Legacy Scheme Charges

Examples of charges that might apply in a DC arrangement not covered by the charge cap include the following charges:

- **Annual management charge (AMC)**

This is the same as charge cap legislation except its level is not capped and what exactly is or is not included in the AMC will vary between providers and contracts. Additional charges may be applied to the fund such as dealing costs for switching funds (see below) or charges for certain decumulation options.

- **Fund Switches and Bid/Offer Spread**

If a member wants to move their fund from one investment to another, there may be a fee for doing this; either a fixed amount or a proportion of the member's fund. The trustees/provider may however allow members a certain number of free switches a year.

The bid/offer spread is an investment charge (typically for legacy schemes) which usually applies when switching investments and reflects the difference between the buying and selling price of a unit in a unit linked investment. A unit linked investment is a fund split into smaller parts called units and contributions into the fund buy further units. The value of the units fluctuates in line with the underlying investments. A typical bid/offer spread can be 5%.The buying and selling price is related to the value of assets in the fund.

- **Policy Fees**

These cover the cost of administration and are usually included within the AMC (but may be separate for legacy policies).

- **Allocation Rates**

Under the terms of some pension policies (typically legacy ones), the provider may use less than 100% of a member's fund to buy investment units and they keep the rest. The proportion that is invested is called the 'Allocation Rate'. Older policies tended to have a low allocation rate but due to pressure to offer fairer terms, most providers have increased the amount they allocate to be closer to 100%.

- **Initial and Accumulation Units**

Charges may be taken through using different types of units (often used in legacy schemes). Typically, in the first few years of a pension policy, contributions are invested in capital units, which have higher charges. Then, as per the terms and conditions of the policy, additional contributions are invested in accumulation units which have lower charges. At the end of a year, a provider may allocate additional accumulation units rather than pay a bonus reflecting the investment performance.

- **Transferring a Pension Fund**

There may be charges involved in transferring a pension fund between schemes/providers and the charges in the new scheme may be higher or lower than those in the existing scheme.

It should be borne in mind that IGCs are pressing providers about the use of some of these charges going forward.

### 3.4 DISCLOSURE OF TRANSACTION COSTS

In March 2015, the FCA and DWP published a joint Call for Evidence that sought views from industry stakeholders on the disclosure of transaction costs, particularly around the technical issues of calculating and amalgamating transaction costs.

There were two main objectives:

- To introduce consistency in how transaction costs are reported; and
- To give trustees and IGCs confidence that they are receiving a comprehensive assessment of costs incurred on their behalf by fund managers.

One push for reform came from many in the industry who have been demanding transparency in transaction costs for many years. Another factor was the April 2015 governance reforms involving the trustees calculating charges assessing value for members and publishing an annual Chair's Statement on these points that gave a focus to the need for clarity in transaction costs.

#### 3.4.1 FCA Policy Statement 17/20, Transaction cost disclosure in workplace pensions

This Policy Statement introduced new rules that came into effect from 3 January 2018 that require FCA-regulated firms that manage assets in workplace pension scheme assets to disclose charges and transaction costs on a standard basis.

Such firms must provide:

- Transaction cost information using the 'slippage cost method' (see below)
- Information about administration charges
- Appropriate contextual information

It is up to trustees and IGCs to request this information.

If the asset manager firm does not have all the relevant information then it must seek it from other firms in the supply chain (for example investment banks or custody banks) and those firms that are FCA-regulated will have to provide it. The asset manager will then provide data to the trustees or IGC. This information will be vital for meeting the governance requirements on assessing value for members and completing the Annual Chair's Statement.

### 3.4.2 The slippage cost method

This method is the difference between the price of the transaction when executed and the price when it was first placed with a third party. This difference is the actual cost to the scheme and members. It is seen as a true test of the loss of value and has been used in the investment industry for over 20 years. It is also in line with the costs methodology required for products subject to the Packaged Retail and Insurance based Investments (PRIIPs) Regulation.

Because of the emphasis on actual costs this slippage cost method is designed to give trustees the opportunity to properly assess transaction costs and therefore the value for money that investment managers offer them. The downside of this approach is that market movements and other costs can be included in the cost figure for a transaction which does not represent direct fees or charges. For example, transaction taxes are a cost of undertaking a transaction, but they are not normally within the control of the investment manager. However, the true cost to the scheme is shown and this is why the FCA chose this approach.

### 3.4.3 Illustration of the effects of charges and transaction costs

For scheme years ending 6 April 2018 or later those schemes that have to produce an Annual Chair's Statement must include an illustrative example of the cumulative effect over time of the application of member-borne charges and transaction costs on the value of a member's accrued rights to money purchase benefits.

Full details are required on the costs and charges for each default fund and each alternative fund the member are able to select and where at least some assets were invested in that fund during the year. This rule applies regardless of the number of funds.

Legislation makes it clear that trustees must have regard to statutory guidance produced by the Department for Work and Pensions. This guidance sets out what is expected when presenting the costs and charges typically paid by a member in relation to the funds available under the scheme. The basic premise is that the illustration includes a 'pounds and pence figure' taking into account a representative range of combinations of pot size, contribution rates, real terms investment returns, time and rate of charges and costs.

Importantly, it will not be necessary to produce an illustration for every combination of factors and the trustees are afforded a degree of flexibility so that they can tailor it to suit the characteristics of their membership. An example illustration and accompanying notes have been included in the guidance. The trustees must also publish this illustration, along with other relevant information on a publicly available website free of charge. They must also tell members where it can be found.

## 3.5 MONITORING PERFORMANCE

If trustees take investment decisions, they must obtain and consider proper advice, which in relation to regulated activities (as defined in the Financial Services and Markets Act 2000) means advice from a regulated adviser. The trustees must decide when they should review an investment and, when they do so, obtain appropriate advice.

Pension law allows trustees to delegate day-to-day investment decisions, and sets out their responsibility for the decisions taken when they do so. Many trustees choose to delegate such decisions. They may delegate investment decisions to an investment manager (or fund manager) who is authorised under the Financial Services and Markets Act 2000.

Trustees will need to review the investment clauses as set out in the Trust Deed which will indicate responsibilities for taking investment decisions. There is debate in the industry as to how much trustees should delegate their authority and what role they should have. Legal advice should be taken if the trustees are in any doubt.

Whenever trustees delegate day-to-day investment decisions, they remain responsible for:

- The investment strategy that the fund manager must follow
- Making sure that the fund manager is a suitably qualified person to carry out the scheme's investment business on their behalf

As a general rule, trustees will not be held personally responsible for any mistake the fund manager makes as long as they have made sure that the fund manager:

- had the appropriate knowledge and experience for managing the scheme investments
- carried out their work competently and in line with trustees' policy for choosing investments, as set out in the Statement of Investment Principles

The choice of investment funds should be reviewed on a regular basis as a matter of course, particularly if the trustees become concerned with a particular investment manager, for example, due to prolonged poor performance or key staff leaving the investment manager. The trustees should have access to performance measurement statistics in order to effectively monitor investment manager performance. Most trustee boards also have an appointed investment consultant to advise them on managing the investment risks for their scheme.

The trustees reserve the right to change any of the funds offered without prior notice. This may include closing funds to new contributions or transferring part of or all of the members' accumulated pension funds into other investment options. It is good practice to bring this right to the attention of the members, through the investment communication material.

### 3.6 STATEMENT OF INVESTMENT PRINCIPLES (SIP)

A SIP is a document that sets out the principles that govern trustees' decisions about investments. The trustees of most schemes are required to have this document in place, and available to members on request.

The SIP must include the trustees' policy on:

- Compliance with legal requirements on choosing investments (including those requiring trustees to take proper advice, to properly diversify the investments held and to ensure the security, quality, liquidity and profitability of the portfolio as a whole)
- The kinds or types of investment assets to be held
- The balance between different kinds of investment
- Risk measurement and management processes
- The expected return on investments
- The realisation of investments (for example to meet cashflow requirements)
- The extent to which, if at all, the trustees take account of social, environmental or ethical considerations when taking investment decisions
- Corporate governance, including using rights (including voting rights) attached to investments if the trustees have them

### 3.6.1 Preparing the SIP

Before the SIP is drawn up, the trustees must consult with the employer.

They must also obtain and consider the written advice of a person (such as an investment consultant) who they believe to be qualified by an ability in and practical experience of financial matters and who has the appropriate knowledge and experience of investment management for their type of scheme.

This consultation process, in practice, can be more contentious in a DB type arrangement, as the employer bears the risk of the investments not doing as well as expected. However, for a DC scheme the employer will still want to be happy that the range of investment options available to its staff is appropriate, as these investment options form part of the overall package of benefits offered by the employer. Consulting means considering the employer's views carefully – it does not mean that the trustees are forced to agree with the employer, or carry out its wishes. However, any dispute should be documented carefully to show that the trustees have considered all appropriate options.

### 3.6.2 Default fund SIP

As mentioned in 3.2.1, a separate SIP is required in respect of the default fund or funds used in a qualifying scheme for the purposes of the employer duties. The SIP must cover at least the following:

- The aims and objectives of the trustees in respect of the default fund's investments;
- The trustees' policies on the same matters as the normal SIP (except that those relating to choosing investments and corporate governance do not need to be covered); and
- An explanation of how the aims and objectives above and the policies mentioned are intended to ensure that assets are invested in the best interests of those who are in the default fund.

### 3.6.3 Reviewing and Revising the SIP

Trustees have to review their SIP at least every three years, and without delay whenever there has been a significant change in investment policy. Additionally, the SIP for a default fund must also be revised where there is a significant change in the demographic profile of those members who in the default fund.

When revising the SIP, the trustees must take advice and consult with the employer in the same way as when the SIP was initially drawn up.

### 3.6.4 Consultations when there are multiple employers

If there are multiple employers in a scheme then consultations will be with a person nominated by all the employers to act as their representative (e.g. the principal employer). If there is no such nomination then the trustees should consult all the employers (unless they have waived their right to be consulted).

## 3.7 INVESTMENT GOVERNANCE GROUP PRINCIPLES

As has already been discussed in this part, TPR has been focusing heavily on the governance of DC schemes generally and particularly investment governance.

The Myners' Principles, which were published in 2001 and updated in October 2008, have proved very helpful in improving trustees' investment decision making and pension fund governance, facilitating the spread of best practice among trust-based pension schemes. However, TPR identified that a gap remains for best practice guidance relating to the investment governance of DC pension schemes.

The Investment Governance Group (IGG) was set up in response to the 2008 review of the Myners' principles, as an industry-led forum to provide tools and guidance for raising the bar in investment governance. The remit for its DC sub-group was to look at how the Myners Principles could be applied to DC schemes.



The IGG developed the Principles for Investment Governance of DC workplace pension schemes, designed to encourage better investment governance and decision making by all stakeholders. These principles have been taken into account by TPR in its development of the Code of Practice and regulatory guidance.

### **3.7.1 Principle 1: Clear Roles and Responsibilities**

This principle states that schemes should have clear roles and responsibilities for decision making at each stage of the investment governance chain, and that each party is aware of the role that they are expected to play. For trust-based schemes, this should be documented within the SIP.

### **3.7.2 Principle 2: Effective Decision Making**

This principle aims to ensure that the decision makers identified above are able to make timely and effective decisions based on accurate and up to date information. Decision makers should have the relevant knowledge and skills, and the time and resources to make effective decisions. They should also review decisions that have been made for effectiveness.

### **3.7.3 Principle 3: Appropriate Investment Options**

This principle ensures that investment options are available to members which take account of a range of risk profiles within the pension schemes, and offers appropriate choice to meet members' needs without being overwhelming. Options should be clearly named and described to make it easier for members to make appropriate choices, and investment fees/costs should be considered.

### **3.7.4 Principle 4: Appropriate Default Strategy**

This principle determines a sound investment strategy principally for those members who prefer not to take an active investment decision.

### **3.7.5 Principle 5: Effective Performance Assessment**

The aim of this principle is to ensure decision makers monitor the performance of investment options, including the default strategy, and take appropriate action where necessary. The default strategy should be assessed against its objectives and the performance of all investment options should be regularly reviewed and communicated to members.

### **3.7.6 Principle 6: Clear and Relevant Communication**

The aim of this principle is to provide pension scheme members with clear, relevant and timely information so they can:

- make an informed choice relevant to their circumstances about which fund(s) to invest in
- understand their personal responsibility for their pension plan, the choices they have available and how these affect the value of their fund and retirement income

### Summary

The importance of good investment governance within DC schemes is coming increasingly to the fore, particularly with the introduction of the automatic enrolment requirements. Trustees, employers and providers need to be aware of the guidance on investment governance, including the selection of default funds. The vast majority of members of DC schemes are invested in the default fund, and this will only increase as automatic enrolment is rolled out further, therefore it is vitally important that schemes consider their default option carefully to ensure that it remains suitable.

The Investment Governance Group has also published its best practice principles on DC investment governance, with a view to ensuring that trustees and sponsors of DC schemes give it the same level of attention as has been the case with DB schemes in the past.

### Self-Test Questions

- Describe the main responsibilities in relation to selecting a default fund.
- What are the new regulatory requirements for default funds under qualifying schemes?
- How should a group of trustees monitor their investments, and what responsibilities can be delegated?
- What is a SIP and what should it cover?
- What is covered in a default fund's SIP and how is this different to a normal SIP?
- Describe the Investment Governance Group and the reasons it was founded.

## PART 5

# INDIVIDUAL ARRANGEMENTS

### OVERVIEW

This Part covers defined contribution (DC) pension arrangements established on an individual basis, whether established by an employer or by the individual in question.

The first Chapter of this Part looks at arrangements specifically established by employers for executives and directors. Following the introduction of the Finance Act 2004 on 6 April 2006, all registered pension schemes became subject to the same allowances in respect of contributions and benefits. Many of the former types of arrangements which employers used to meet the needs of company directors and senior executives became less attractive, as the differences which made them appealing were largely swept away.

Chapter 2 - Personal Pension Plans, sets out the different types of individual arrangements in the contract-based pensions market and the main features of each.

After studying this Part, the student should have a sound understanding of how individual DC arrangements work, and the circumstances in which they are normally used. Students should also be able to identify relevant legislation governing individual arrangements and be aware of recent trends and developments in this area.

# CHAPTER 1

## Pensions for Executives and Directors

### INTRODUCTION

Employers often used different arrangements for company directors and senior executives because it was sometimes difficult for the main company occupational pension scheme to meet the needs of such employees following the introduction of the 'earnings cap', via the Finance Act 1989.

The earnings cap set a ceiling on the salary that could be used to determine the contributions that could be paid to and the benefits that could be paid by, formerly tax approved pension schemes. It generally applied to people who contributed to a personal pension scheme, joined an occupational scheme set up after 14 March 1989 or joined any occupational scheme after 1 June 1989 that was set up before 14 March 1989. Due to the restrictions that the earnings cap imposed for company directors and senior executives, it became common practice for these individuals to be members of the main company scheme to provide benefits up to 'old' Inland Revenue maximum limits and to use a separate arrangement to provide additional benefits.

Some employers, however, used separate arrangements to provide all pension benefits for company directors and senior executives. These were usually in the form of Executive Pension Plans (EPPs) or where directors were subject to the earnings cap, unapproved schemes.

The tax simplification changes effected by the Finance Act 2004 meant that many employers reconsidered the arrangements they offer for company directors and/or senior executives. However, it is important for the student to be aware of these historic arrangements, as many employers may still have these in place for existing employees.

The choice is now really between two types of pension arrangements – registered and unregistered. This is because many of the restrictions on membership, contribution limits and benefit limits have been removed. All registered arrangements have to follow broadly the same rules laid down by HM Revenue & Customs (HMRC), with contributions and benefits subject to the same allowances.

However, highly paid individuals should take into account recent Government legislation in respect of reductions in the Annual and Lifetime Allowances (including the introduction of the Money Purchase Annual Allowance and the Tapered Annual Allowance as explained in Section 2.2 of Part 2).

### 1.1 CONTROLLING DIRECTORS

The Finance Act 1973 allowed controlling directors to join approved occupational pension schemes from 6 April 1973 for the first time. A controlling director is a director who, in the last ten years, has owned or controlled 20% or more of the ordinary share capital of the company. The ownership or control could have been in his or her own right, or with one or more associates, and could have been directly, indirectly or through other companies. Associates in this context include any relative (i.e. spouse, parent, child or sibling) or business partner.

HMRC monitored employer contributions paid in respect of controlling directors or close friends and relatives of the controlling director because controlling directors were in a position to abuse the tax relief given in respect of pension contributions.

### 1.2 EXECUTIVE PENSION PLANS (EPPS)

EPPs were introduced in the early 1970s to provide enhanced executive pensions as the needs of directors and key executives were different to the pension needs of the other employees.

EPPs are almost exclusively money purchase and were never contracted out of any element of the State pension. They offer a large degree of employer discretion as to who joins and the level of contributions paid. EPPs are registered pension schemes and, as such, individuals are subject to the Annual Allowance (with the Tapered Annual Allowance being of particular relevance for high-income individuals) with any contributions in excess of the Annual Allowance subject to a tax charge. Once an individual takes any money purchase benefits in any scheme flexibly then the Money Purchase Annual Allowance will apply to all future contributions to any of their money purchase schemes, including any money purchase EPP.

Arrangements can be set up under a trust deed and rules, a master trust operated by a specialist provider or by an exchange of letters. The employer pays premiums into an insurance policy and employee benefits are provided from the proceeds. EPPs can allow several employees and their insurance policies into one scheme under one set of documentation. Within the EPP funds are earmarked for individual members.

#### 1.2.1 The Appeal of EPPs

EPPs can be an important component of both personal financial planning and the company's taxation and growth strategies. Their appeal lies in the fact that they can:

- Provide flexible, individual tailoring of benefits to suit personal circumstances, balancing immediate cash needs with future income and capital requirements in retirement. While the intention is that they will be used by executives, like controlling directors, an employer could allow other members of staff access.
- Be used as the sole pension provision for an individual or as a 'top up' for other benefits. This may be useful if there is not an occupational pension scheme or if the individual does not want to join this perhaps for confidentiality issues.
- Act as a tax shelter for accumulating funds for retirement, as well as a shelter for bonus payments. Members are, however, subject to the Annual Allowance on contributions/accrual (which is increasingly restrictive, particularly the Tapered Annual Allowance), and the Lifetime Allowance on the crystallisation of benefits.
- Allow the executive to choose the exact proportion of pension contribution in relation to total earnings and can be used by an employer to invest very substantial sums with relative confidentiality (albeit that the Annual Allowance, particularly the Tapered Annual Allowance feature, increasingly restricts the tax efficiency of doing so).
- Provide death in service and ill health early retirement benefits.

### 1.3 SMALL SELF ADMINISTERED SCHEMES (SSASS)

#### 1.3.1 Background

Prior to the Finance Act 1973, a director could not be a member of an occupational pension scheme, meaning that his or her only option was a Retirement Annuity Contract (see Chapter 2). In 1973, the rules were relaxed, allowing directors to be included as members of occupational pension schemes. This relaxation of rules prompted the introduction of specific pension schemes for senior employees.

The first of these was the Executive Pension Plan (EPP). However, the industry wanted something more flexible that enabled directors to control their own investments. This idea was developed and the first SSAs were set up in the mid 1970s.

SSASs differ from self administered schemes in that such schemes are typically operated for the directors of smaller limited companies, where the scheme members are also the trustees. These schemes provide the trustees with freedom over the choice and methods of investment and the ability to borrow and make loans, which can assist a limited company in its ongoing growth and development. HMRC, however, has always rigorously monitored such schemes.

HMRC was concerned about these plans from the beginning, due to an unrealistic fear that they were being used for the enjoyment of the assets and tax relief, rather than for the purpose of retirement planning. Consequently, the Social Security Act 1990 introduced the requirement for all members of a SSAS to be trustees in order to permit more than 5% investment in the sponsoring employer. Exemption from the Act could only be obtained if all members were trustees and the rules required unanimous consent for trustee decisions and resolutions. This tended to limit the appeal of SSASs to all but controlling directors of smaller companies.

Prior to 6 April 2006, every SSAS had to have a Pensioner Trustee. Every Pensioner Trustee was approved by HMRC and acted as HMRC's watchdog. This requirement was removed, however, by the Finance Act 2004. In addition, the Finance Act 2004, which came into effect from 6 April 2006, brought the self investment rules for SSASs in line with other occupational schemes. The 5% limit on investment in the sponsoring employer's shares now applies regardless of whether or not all members are trustees. Loans can still be made to the sponsoring employer but should not exceed 50% of the market value of the scheme's assets.

Since 6 April 2006, the generic term 'member directed pension schemes' has been used to describe both SSASs and Self Invested Personal Pension (SIPP) arrangements (see Chapter 2).

### 1.3.2 Deregistration

In order to discourage 'SSAS busting', whereby the trustees of a SSAS break the underlying trust and obtain access to the funds, HMRC is able to deregister any scheme if, for example, funds were accessed illegitimately, and impose a deregistration charge. This is a very severe measure that is rarely used.

The consequences of deregistration are as follows:

- Corporation tax relief on the employer's contributions is removed
- Members become liable to Schedule E tax on the employer's contributions and on their own contributions (if any)
- Tax charges on investment income and capital gains within the fund are payable
- Pensions in payment are taxed as unearned income
- Lump sum death benefits cease to be free of inheritance tax
- A deregistration charge of 40% of the value of the SSAS's assets becomes payable

If a scheme is deregistered, HMRC notifies the trustees of the date from which the scheme will not be a registered pension scheme.

### 1.3.3 Attraction of SSASs

The attraction of SSASs to directors is that money which has built up in a pension fund can be used to finance the company in a number of ways. For example, directors can:

- Make commercial loans within certain limits from the SSAS to the company
- Purchase commercial or industrial property to be used by the company or leased to a third party
- Invest freely in a wide range of quoted investments
- Buy the company's shares. Purchase of a sponsoring employer's shares is now limited to 5% of the SSAS fund

## Defined Contribution Arrangements

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A SSAS allows directors to make provision for retirement and enjoy the tax concessions available to company pension schemes without depriving the company access to part of the funds for the benefit of the business.

Some directors may consider investing in a SIPP instead of a SSAS. A SIPP provides a lot of flexibility over the type of investments. However, a SSAS still has the advantage of loans to the employer. A SSAS used to have the advantage of providing a route to pass assets down to succeeding generations. However, the changes to death benefits from 6 April 2015 mean that it is now possible to pass down uncrystallised funds tax free from other types of pension schemes to dependants, nominees and successors if the member dies before age 75.

### 1.3.4 Investments

Historically, the freedom to control investments in a SSAS came with restrictions in the form of specific regulations linked to tax approval and limitations on HMRC discretion. However, members of a SSAS had the widest scope for investment amongst approved pension schemes.

From 6 April 2006 many of the old tax restrictions were removed for registered pension schemes so that the scope of possible investments that could be held in a SSAS for tax purposes was similar to other registered schemes, but with the SSAS benefiting from the potential freedom of the member to direct investment policy. However, the following needs to be borne in mind:

- Restrictions were introduced through the use of tax penalties for inappropriate investments in “taxable property” (see below).
- As noted above, the self-investment rules for SSASs were tightened as they were brought into line with other occupational schemes.
- The rules of many SSASs may not have been fully updated through formal amendment so historic restrictions can still apply even after the legislation has been repealed.

Occupational pension schemes where one or more members (or persons related to a member) are able to direct, influence or advise on the manner of investment are described in legislation as ‘investment regulated pension schemes’. Such schemes are not supposed to invest in certain kinds of property known as taxable property.

A SSAS will generally be the kind of scheme caught by this legislation. Occupational pension schemes with more than 50 members will not be caught by this legislation.

Taxable property includes:

- Residential property
- Arts, antiques, jewellery, fine wines, classic cars, yachts, etc.
- Timeshares and beach huts
- Ground rents on residential property
- Machinery and office equipment
- Other forms of ‘tangible moveable property’ including commodities

Where any investment in taxable property occurs this will be an unauthorised payment and penal tax charges will apply.

There are certain limited exceptions to the taxable property rule (for example, investment grade gold bullion, student halls of residence, etc.). In addition, special transitional provisions apply to investments held before the rules changed on 6 April 2006. The legislation is complex and its detailed interpretation is a specialist matter beyond the scope of the syllabus for this unit.

## Defined Contribution Arrangements

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Certain investments are permitted without restrictions:

- Quoted debentures, loan stock
- Government securities
- Traded futures and options
- Insurance funds and unit trusts
- Deposits with banks, building societies, etc.
- Care homes, hospitals and prisons
- UK and overseas quoted stocks and shares (5% self investment restrictions apply)

Certain investments are permitted with restrictions:

- Hotels, provided that this does not give any privileged rights to use part of the hotel, i.e. in a way that a member of the public would not be able to do so
- Commercial property, provided that if any sponsoring employer uses that property then it pays the commercial rent due
- Shares of a sponsoring employer (up to 100% of its shares), provided that no more than 5% of the SSAS fund was invested in any one of the sponsoring employers at the time of purchase and subject to an overall limit of 20% of the SSAS fund invested in aggregate in shares across all the sponsoring employers
- Other unquoted equities, provided that the taxable property restrictions (described above) are not triggered. This is a complex area but the following principles should be applied:
  - The SSAS and connected parties should not own over 50% of the shares
  - A SSAS member or connected party; i.e. spouses, partners or relatives, should not be a controlling director of the company or another company which has an interest in it
  - The purpose of the investment must not be for the SSAS member or connected parties to be able to use the company's assets

The tax exemptions for investment do not apply to income or gains from investments held by the scheme as a member of a property investment limited liability partnership (LLP). A property investment LLP is a LLP whose business consists wholly or mainly in the making of investments in land and the principal part of whose income is derived from such investments.

- Loans to companies participating in the SSAS may be made provided that:
  - Loans do not exceed 50% of the fund and the loan is secured throughout its term by a first charge in an asset of higher value
  - Interest is commercial and at least 1% over base rate
  - The term of the loan must not exceed five years and the loan must be repaid in equal instalments of capital and interest
- Loans to third parties may also be made provided that they are not connected parties and that the loan is not used to provide taxable property (see above)
- Loans to members and connected persons (relatives, spouse/civil partner) will be unauthorised payments and a scheme sanction charge will also be made on the scheme administrator

### 1.3.5 Benefits

At retirement, there is usually the option of:

- A lifetime annuity
- Drawdown pension

A pension commencement lump sum of up to 25% of the accumulated fund can be taken at retirement. With effect from 6 April 2011, there is no longer any requirement to purchase a lifetime annuity before the age of 75. Also, designation of drawdown pension can commence at age 55 and continue until death of the member.

From 6 April 2015, members may also be able to use the DC flexibilities. See Part 3 for further information.



### 1.4 EMPLOYER FINANCED RETIREMENT BENEFIT SCHEMES (EFRBS)

Former unapproved arrangements (FURBS and UURBS) were renamed Employer-Financed Retirement Benefit Schemes (EFRBS) with effect from 6 April 2006. As an unregistered scheme, an EFRBS is not subject to the pensions taxation regime. Contributions are not subject to the Annual Allowance and benefits are not tested against the Lifetime Allowance.

Tax conditions applicable to an EFRBS are:

- The employer does not receive any tax relief on contributions to an EFRBS until benefits start to be paid to and taxed on the employee
- Benefits are liable to income tax. There is also a National Insurance contribution charge unless retirement benefits are drawn as at least 75% pension (i.e. the lump sum is restricted to 25% as it is for registered schemes) and the member has ceased to work for the employer
- The member is neither taxed nor subject to National Insurance contributions on employer contributions
- Death benefits are subject to Inheritance Tax
- Any investment returns and capital gains will be taxed
- Where the employee has been taxed on contributions as they were made and no further contributions were made on or after 6 April 2006, then benefits can be paid as a tax free cash sum and the member's death benefit lump sum will retain an exemption from inheritance tax.

However, with effect from 6 April 2011, employees are required to pay income tax and National Insurance contributions on any reward, recognition or loan in connection with the employee's employment. This is deemed to include funded EFRBS and removes the tax advantageous status of funded EFRBS going forward from 6 April 2011. Funded EFRBS that had closed to new members and were closed to accrual at 5 April 2011 are not affected by the changes.

The Government also introduced disguised remuneration legislation to make vehicles which attempt to reduce or remove liability to Annual Allowance and Lifetime Allowance tax charges, less tax efficient.

In the summer 2015 Budget, it was announced that the Government would consult on tackling the use of unfunded EFRBS in obtaining a tax advantage in relation to remuneration. However, at Budget 2016, the Government confirmed that no further action was being taken for the time being but that it would keep the issue under review. For the time being unfunded EFRBS remain a possible solution for securing retirement benefits for high earners with Lifetime Allowance and/or Annual Allowance issues.

### Summary

- EPPs and SSASs were used by companies to provide pension benefits for certain company directors and/or senior employees.
- EPPs mainly provided top-up pension benefits, especially where the Earnings Cap restricted benefits employees could receive from an occupational pension scheme.
- The tax simplification rules have changed the requirements and made SSASs less attractive because of the imposition of a restriction on self investment.
- Under the current tax regime, many occupational schemes are now be able to offer senior executives more benefits from the main occupational scheme, with probably little need for any top-up arrangements.
- Any top-up arrangements were likely to be provided from an Employer-Financed Retirement Benefit Scheme (previously FURBS or UURBS), but the tax advantages of these schemes have been largely removed for funded arrangements.

### Self Test Questions

- Describe the nature and role of an EPP.
- Define a controlling director.
- Why has the appeal of SSASs diminished?
- Outline the consequences of deregistration for a SSAS.
- Describe the investment restrictions for SSASs.
- Outline the tax conditions for Employer Financed Retirement Benefit Schemes.

# CHAPTER 2

## Personal Pension Plans

### INTRODUCTION

A personal pension is, as the name suggests, a personal contract between an individual and an institution (usually an insurance company) with the objective of providing a retirement income together with tax-free lump sum cash on retirement (if required) and, occasionally, life assurance benefits. Personal pensions are contract-based arrangements.

Personal pensions are based on a money purchase type principle where the member (and possibly an employer) pays contributions into a fund that should accumulate over time with the benefit of investment growth. The member chooses the date on which he would like his retirement benefits to come into payment and the accumulated fund is then used at that date to provide these benefits. These usually consist of a tax free pension commencement lump sum, with the balance of funds being used to provide an income in retirement.

The amount of any pension (or annuity) provided is dependent on the value of the fund at the retirement date, the member's choice of annuity (single life, joint life with an attaching dependant's pension, non increasing or increasing during payment each year), charges and annuity rates at the time of purchase. Drawdown or the payment of an Uncrystallised Funds Pension Lump Sum may be offered as an alternative to traditional annuity purchase.

Personal pension type arrangements have been around for a long time and the money purchase principle still exists but under different names and guises. It is important for the student to be aware of the main types of individual arrangements and by the end of this Chapter they should understand how they developed historically over time.

### 2.1 PERSONAL PENSIONS

#### 2.1.1 Introduction

Personal pensions were introduced in July 1988 and, at that time, were seen as a threat to occupational pension scheme provision. This was largely because the Social Security Act 1986 abolished compulsory membership, which stopped employers from forcing new employees to join the occupational scheme and also allowed existing members to opt out of occupational pension schemes. At that time, personal pensions were seen as a viable alternative to occupational pension scheme provision.

In 1995, it was demonstrated that many individuals had been mis-sold personal pension plans, as existing members of occupational pension schemes were targeted and encouraged to transfer their final salary benefits into personal pension policies. Policies were sold to these members on the expectation that they would be better off opting out of their company pension scheme (even though they would be giving up the benefit of the company contribution) in favour of a personal pension plan.

A review took place to identify those who had been disadvantaged financially by opting out or transferring out of their company pension scheme. Where it was identified that there was a financial disadvantage, firms had to offer to correct the situation. This took the form of paying for the employee to be fully or partially reinstated into the employer's scheme or by augmenting benefits accrued within the personal pension.

Personal pensions are marketed by leading banks, building societies and major unit trust groups, as well as the traditional life offices.

Despite the mis-selling scandal, personal pensions remain a suitable pension alternative for many people and many employers contribute to personal pension plans on behalf of their employees. As is outlined in Chapter 2 of Part 1, these arrangements are often called group personal pension plans (GPPs) but they are still made up of individual contracts between each member and the provider.

### 2.1.2 Eligibility

Any 'Relevant UK Individual' under the age of 75 may join, and obtain tax relief in respect of contributions paid to a personal pension scheme, although there may be a restriction on the amount of tax relief.

A Relevant UK Individual for a tax year is a person who:

- has Relevant UK Earnings chargeable to income tax for that tax year
- is resident in the UK at some time during that tax year
- was resident in the UK at some time during the five tax years immediately before the tax year in question and also resident in the UK when they joined the scheme
- has, or is the spouse of a person who has, for that tax year general earnings from overseas Crown employment subject to UK tax

It is possible to contribute to a registered personal pension plan and obtain tax relief even if an individual does not have any earned income.

Relevant Overseas Individuals or their employer are able to contribute to a UK registered pension scheme but relief from UK income tax may not be available or may be restricted on such contributions. In practice, providers tend not to accept such business.

### 2.1.3 Contributions

There is no limit on the amount that can be paid into a Personal Pension but tax relief may not be available on all contributions. Since 6 April 2006, it has been possible for Relevant UK individuals to make a gross tax relievable contribution to a personal pension plan up to the greater of:

- £3,600
- 100% of relevant UK earnings

However, if total contributions to all pension arrangements from all sources exceed the Annual Allowance, any contribution in excess would effectively not be tax relievable, unless they can rely upon unused allowance under the carry forward provisions (see Part 2).

Relevant UK Earnings include:

- employment income
- income derived from the carrying on or exercise of a trade, profession or vocation
- income arising from patent rights and treated as earned income
- general taxable earnings from an overseas Crown employment

Personal pensions introduced the concept of Relief at Source (RAS) in contrast to the net pay arrangement of tax relief. With RAS, all member contributions attract tax relief at the current basic rate of tax. Member contributions are therefore paid net of basic rate income tax to the scheme provider who will then reclaim the tax paid on the contribution from HMRC, therefore providing tax relief to the contributor. Individuals that are eligible for higher rate tax relief can either complete a self assessment tax return or write to HMRC and request that their tax code is changed (mid-year) to reflect the contributions that they are paying in order to claim additional tax relief. Any employer contributions are paid gross and the employer must reclaim the tax relief.

### 2.1.4 Benefits

Personal pensions are typically on a money purchase basis. In April 2010, the minimum age from which benefits could be taken was increased from 50 to 55. However, there were exceptions to this rule, including members with a protected retirement age and those with a special occupation (e.g. sportsmen) where a retirement age lower than the minimum was accepted and can be retained so long as the member takes all benefits at the same time.

A retirement benefit available to an individual from a personal pension may be in the form of:

- A lifetime annuity
- A drawdown pension
- An Uncrystallised Funds Pension Lump Sum

With effect from 6 April 2011, there is no longer any requirement to purchase a lifetime annuity before the age of 75. Also, designation of drawdown pension can commence at age 55 and continue until death of the member.

Any pension income is taxable under PAYE.

Up to 25% of the fund value under a personal pension can be taken in the form of a pension commencement lump sum if a lifetime annuity or drawdown pension is selected.

The ability to commute DC benefits to pay a trivial commutation lump sum for benefits that are deemed trivial was removed from 6 April 2015. However, it is still possible to commute funds worth less than £10,000 under the small lump sum rules provided that a number of requirements are met.

### 2.1.5 Death Benefits

The benefits on death before vesting (that is, before benefits have come into payment) are generally based on the value of the fund accumulated to the date of death. This can be paid as an uncrystallised funds lump sum death benefit. It may instead be used to provide an annuity or drawdown pension for a dependant or a nominee. If the lump sum is payable on a discretionary basis, the policy is written under trust, or the beneficiary is the spouse or civil partner, the payment is normally free of Inheritance Tax if it is paid within two years of the date of notification of death.

If a member dies after vesting, any death benefits will be dependent upon the form of benefits chosen (annuity or drawdown fund). For example, if an annuity was purchased any death benefits would depend on whether it was a joint life annuity and whether it had an attaching guarantee period. If a member dies while drawing income using drawdown, any uncrystallised funds and the balance of the drawdown pension fund can be used to provide a lump sum, an annuity or flexi-access drawdown fund to provide income for any dependant or nominee.

### 2.1.6 Regulation of Personal Pensions

The Financial Conduct Authority (FCA) has regulated the operation of all personal pension schemes in the UK since 6 April 2007.

### 2.2 STAKEHOLDER SCHEMES

#### 2.2.1 Introduction

Stakeholder pension schemes were introduced under the Welfare Reform and Pensions Act 1999 with the stated objective of providing an accessible pension vehicle for those on lower incomes who did not have access to a company pension scheme and were less inclined to take responsibility for their own retirement. This broke the requirement for contributions to be directly related to earnings as, for the first time, it permitted contributions to be paid by individuals who did not have earnings, such as parents and carers.

From 1 October 2012, as a result of the automatic enrolment legislation, employers are no longer required to designate and offer access to a stakeholder scheme for their employees.

#### 2.2.2 Contributions

The contribution rules are generally the same as those payable from ordinary personal pensions set out in 2.1.3 above.

The minimum contribution to a stakeholder scheme cannot be set higher than £20, although schemes may set a lower limit if they wish. Contributions can be paid weekly, monthly or they can be paid as one off contributions.

#### 2.2.3 Benefits

Benefits are the same as those payable from ordinary personal pensions set out in 2.1.4 above.

#### 2.2.4 Other Features of Stakeholder Schemes

Other key features of stakeholder schemes include:

- A stakeholder scheme must be a DC arrangement. It may be a trust-based or contract-based arrangement.
- The annual management charge is limited to 1.5% of the fund's total value during the first ten years. After this time, the charge may not exceed 1%. Pension providers may, however, recover costs and charges above the 1.5% annual management charge for expenses that are incurred in other pension schemes, not just stakeholders, such as stamp duty or other costs of buying and selling investments or the cost of sharing pensions on divorce. There are additional restrictions on charges where the governance requirements set out in Section 2.2 of Part 4 apply.
- A stakeholder scheme must accept transfers in and no charge may be made for transfers to a different stakeholder pension.
- Stakeholder schemes must appoint a scheme auditor or a reporting accountant to check the annual declaration made by the trustees or managers to ensure that the scheme complied with the charging regulations.
- Stakeholder schemes must have a Statement of Investment Principles.
- Stakeholder schemes must have a default lifestyling investment option.

#### 2.2.5 Regulation of Stakeholder Schemes

Stakeholder schemes must be registered with the Pensions Regulator (TPR). The FCA regulates the marketing and promotion of all stakeholder schemes.

### 2.3 SELF INVESTED PERSONAL PENSIONS (SIPPS)

#### 2.3.1 Introduction

Prior to the introduction of Self Invested Personal Pensions (SIPPs), directors of small family owned businesses, for example, would provide for their retirement via a SSAS because of the wide range of investment choices, including loans to the business. Self employed professionals, however, could not fund for their retirement in a similar fashion and they were restricted to the more conventional life product. The introduction of SIPPs in 1989 enabled the self employed to also invest in a wider range of investments.

SIPPs are personal pension arrangements where the individual has greater investment options than the traditional personal pension contracts sold by life offices. They are designed for individuals who want to manage their own investments by dealing and switching investments when they choose. For this reason, they are really only suitable for those with large funds and those who are knowledgeable about investments or are willing to pay for investment advice. Most SIPP holders would have an Independent Financial Advisor to assist them.

#### 2.3.2 Contributions

The contribution rules are generally the same as those payable from ordinary personal pensions set out in 2.1.3 above. In addition, a SIPP provider may specify a minimum investment needed to set up a SIPP.

#### 2.3.3 Benefits

Benefits payable are the same as those available from ordinary personal pensions as set out in 2.1.4. Drawdown pension is often a popular choice for members of SIPPs because it allows individuals to retain control over investments while drawing an income.

#### 2.3.4 Investment Options

SIPPs offer a wide range of investment options with the flexibility of the member to select their chosen investment directly with access to the right kind of platform and the possibility of economies of scale. However, a SIPP will qualify as an 'investment-regulated pension scheme' as the member is able (directly or indirectly) to direct, influence or advise on the manner of the investment of their pension assets. As such, SIPPs are subject to the same tax rules that apply to SSAS; they are not supposed to invest in certain kinds of property known as 'taxable property' (i.e. residential property and in most forms of tangible moveable property). Taxable property has already been described in Section 1.3.4.

Where a SIPP does invest in taxable property then the same kind of punitive tax measures that would apply to a SSAS will also apply to the SIPP. So, whilst investment in such assets is not actually prohibited, in practice it is extremely unlikely that SIPP members will invest in them.

SIPP providers may introduce their own restrictions (often to avoid the risk of scheme sanction charges) and will not necessarily allow for the full range of permitted investments.

Typically, a policyholder of a SIPP can invest in the following investment types:

- UK and overseas quoted equities
- UK and overseas bonds
- Life assurance managed funds
- Unit trusts, investment trusts and open ended investment companies (OEICs)
- Commercial property

### 2.3.5 Regulation of SIPPs

From 6 April 2007, the FCA has been responsible for regulating the operation of SIPPs and the sales advice process.

## 2.4 RETIREMENT ANNUITY CONTRACTS (RACS)

### 2.4.1 Introduction

Retirement annuity contracts (RACs) date back to 1956.

Personal pensions replaced RACs from 1 July 1988 and from that date it was no longer possible to take out a new RAC. Contracts started before that date can still accept contributions and may continue until the annuitant retires. As RACs are registered pension schemes, there are few differences between the tax treatment of RACs and other types of registered pension schemes.

### 2.4.2 Eligibility

The following groups were eligible to contribute to a RAC:

- Self employed (including a partner of a professional partnership)
- An employee who worked for an employer that did not provide a company pension scheme
- An employee who was not eligible to join his employer's pension scheme
- An employee who had additional earnings from a second job that was non-pensionable For example, a dentist who had additional earnings derived from a private practice, in addition to his NHS salary

### 2.4.3 Contributions

As registered pension schemes, RACs are subject to the same contribution limits that apply to other registered pension schemes. The contribution rules are generally the same as those payable from ordinary personal pensions set out in 2.1.3 above.

Prior to 6 April 2006, there was a maximum limit on contributions that could be paid into a RAC during any one tax year.

Contributions are often paid from taxable pay and relief is claimed through the self assessment tax return (where the provider does not operate relief at source).

An employer could theoretically contribute to a RAC on behalf of an employee provided that the contract allows such contributions.

### 2.4.4 Benefits

Benefits payable are the same as those available from ordinary personal pensions as set out in 2.1.4.

If a member is retiring early, a couple of checks should be made before the member takes these benefits. If there are guaranteed annuity rates (GARs) in the rules of a policy, they may not apply on early retirement before age 60 so a check should be made by the member on this point. Secondly, the RAC provider may have to change the policy conditions in order to allow retirement before age 60.

Prior to 6 April 2006, the maximum tax free cash available was three times the initial annual annuity. Transitional protection is not available for individuals with a RAC who had a pre 6 April 2006 entitlement to a lump sum of more than 25%. HMRC took a very different stance on this issue in comparison to what is allowed for members of occupational pension schemes.

### 2.4.5 Other Features

Under a RAC, it was also possible to provide for a life assurance benefit. Under the basic contract, it was common to arrange for the premiums to be refunded on death either with or without interest.



### Summary

This Chapter has covered various types of personal pension arrangements, including:

- Personal Pensions
- Stakeholder pension schemes
- Self Invested Personal Pensions
- Retirement Annuity Contracts

They have developed to meet various needs – for example, Retirement Annuity Contracts were targeted at the self-employed and employees with no occupational pension available to them. Personal Pensions developed in response to the removal of compulsory scheme membership, Stakeholder pensions offered a low-cost way of saving for retirement, and SIPP's provided greater investment flexibility.

Whilst many aspects of the administration of these types of arrangements are similar, and became more similar following the tax changes in 2006, it is important for the student to understand the differences between the arrangements and the reasons that these differences have evolved.

### Self Test Questions

- What are the contribution limits for Personal Pensions?
- List the key features of Stakeholder pension schemes.
- Outline the features of Self Invested Personal Pensions and list their permitted investments.
- Describe the reasons for the introduction of Retirement Annuity Contracts and list the groups of individuals eligible to contribute.

# PART 6

## NEW AND FUTURE LEGISLATION

### OVERVIEW

The complexity of pensions is due mainly to the layers of legislation that have built up over the last century. The management of a scheme is covered by numerous different sections of UK law, notably legislation governing pensions, trusts, finance and employment. These laws have also been influenced by European Directives. This could change in the future, however, given that Article 50 was triggered in March 2017, beginning the United Kingdom's exit from the European Union. Nevertheless, with such diversity of laws, regulations and directives, there is little wonder that the situation is far from straightforward.

In recent years, the pensions industry and employers sponsoring workplace pension schemes have had to deal with major pension reform, including:

- pensions tax simplification from 6 April 2006 and various changes to the taxation rules and allowance system
- the abolition of DC contracting out from 6 April 2012
- the introduction of the new single-tier State pension from 6 April 2016
- automatic enrolment and associated employer duties, introduced on a staged basis between October 2012 and February 2018, compelling employers to enrol their workers into a workplace pension scheme
- wholesale reform to retirement, death and transfer options introduced from 6 April 2015, with new DC pension flexibilities for members with money purchase pension savings;
- the introduction of governance standards for trust-based and contract-based schemes to maintain trust in the DC market; and
- the introduction of a new framework for master trust regulation.

By the end of this Part, the student should have a good understanding of how forthcoming reforms will impact DC pension provision and the wider pension landscape.

# CHAPTER 1

## Reform of the UK Pensions System

### INTRODUCTION

This Chapter deals with recent and forthcoming legislative and policy changes impacting DC pension provision and covers:

- Forthcoming changes for master trusts
- The introduction of a Pensions Dashboard
- The General Data Protection Regulation (GDPR)
- Plans to tackle pension scams

### 1.1 MASTER TRUST DEVELOPMENTS

The Pension Schemes Act 2017 received Royal Assent on 27 April 2017, which set out the framework for a new authorisation and supervision regime for master trusts. Chapter 1 of Part 4 has further information on the governance requirements for master trusts, including the new authorisation criteria and process effective from 1 October 2018.

While the Act contains the framework, the detailed rules around master trusts are set out in the Occupational Pension Schemes (Master Trust) Regulations 2018. These are to be supplemented by a Code of Practice (expected July 2018).

A significant shake-up of the master trust landscape is expected as a result of the new regime and the Regulator expects that some schemes will merge.

The deadline for a master trust to apply for authorisation, or notify the Regulator that it has decided to leave the market, was 1 April 2019. However, an indication of whether an application will be accepted was available earlier than this deadline because the Regulator has been undertaking a 'readiness review' process and it will have provided feedback to schemes by the end of August 2018 about the quality of their authorisation application. It is expected that the Regulator will then publish guidance on lessons learned with formal applications needed within six months from 1 October 2018.

Perhaps the most pressing action for trustees is to start embedding the climate governance requirements. The government has confirmed that trustees of authorised master trusts will need to comply with Task Force on Climate related Financial Disclosures (TCFD) governance requirements by 1 October 2021 and to publish a TCFD report within seven months of the end of their scheme year underway on or after 1 October 2021.

### 1.2 PENSIONS DASHBOARD

In the March 2016 Budget, the Government announced that it would ensure the industry designs, funds and launches a Pensions Dashboard by 2019. This will be a free-to-consumer online resource that enables people to find and check their pension savings in one place and ideally should include all types of schemes, including the State pension.

In May 2016, a key publication, 'Creating a Pensions Dashboard: Pension Finder Alpha White Paper', set out the conclusions of an initial Alpha 1 phase of work by the industry.

## Defined Contribution Arrangements

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The White Paper sets out the three core components of the Pensions Dashboard which are:

- **Digital Identity (ID):** identification technology that verifies the user's identity before they can access their data
- **Dashboard User Interface (UI):** a set of screens, menus and commands through which the consumer views their information and carries out tasks and
- **Pension Finder Service (PFS):** the technology that facilitates finding an individual's pension savings, collects information from pension providers (and DWP for State Pension) and delivers it to the UI

The White Paper also addressed issues surrounding the delivery, governance and funding of the Dashboard.

Legacy DC schemes and the complexities of DB schemes pose a serious challenge to the Pensions Dashboard. It is not immediately obvious how these arrangements will be dealt with and how the necessary work will be funded. However, the White Paper suggests that a phased implementation approach would be necessary for delivery.

### *Development of a Prototype*

At the end of March 2017, the project steering group presented their newly designed prototype system for the Pensions Dashboard.

### *Feasibility study*

The Department for Work and Pensions, who have taken over responsibility for the Pensions Dashboard from HM Treasury, has conducted a Feasibility Study into the Dashboard. It is likely to set out the future direction of travel. At the time of writing, it had yet to be published.

There have been calls from some in the industry for the Government to legislate to force every pension scheme in the UK to feed member information into the dashboards. In addition, the more expensive elements involved in the development for Pensions Dashboards have yet to be funded and questions have arisen over whether a broader base of contributors will be called upon to support this work. Government funding is deemed highly unlikely.

In December 2020, the Pensions Dashboard Programme published the first version of guidance on data standards and called on schemes to get their data in shape for members to access via the dashboard. A pensions Dashboard Programme timeline was published in the spring of 2021. This sets out the planning, testing and implementation phases of the delivery of the dashboard and confirms that there will be a staged delivery from 2023, which is four years later than originally intended.

As Pensions Dashboards evolve so will the data requirements. Subsequent phases are likely to focus on displaying more information on the amount of the benefit due and providing sufficient information to support individual members in retirement planning, including the level of detail that a professional financial adviser would require.

To support pension schemes in this area, the Pensions Administration Standards Association (PASA) has also set up a Working Group which will work closely with TPR on meshing the practical administration standards with the new technology behind the Dashboard.

Guidance for dashboard providers on what will be required from them will be published in Q4 2021.

### 1.3 GENERAL DATA PROTECTION REGULATION(GDPR)

The EU General Data Protection Regulation (GDPR) is European Union (EU) legislation, which came into force on 25 May 2018. The UK's Data Protection Act 1998 could have been replaced without the need for further national legislation. However, the UK has enshrined its data protection laws in the Data Protection Act 2018 which received Royal Assent on 23 May 2018.

The GDPR applies to data 'controllers' and 'processors'. For example, the trustees of a pension scheme would be the data controllers and the third party pensions administration company which acts on behalf of trustees would be a data processor.

The GDPR places further obligations on data controllers to ensure their contracts with processors comply. In addition, one of the key changes in the GDPR is that data processors will have direct obligations for the first time. These include an obligation to:

- maintain a written record of processing activities carried out on behalf of each controller
- designate a data protection officer where required
- appoint a representative (when not established in the EU) in certain circumstances; and
- notify the controller on becoming aware of a personal data breach without undue delay

Under GDPR, it is not possible to rely on the implied consent of scheme members as the basis for processing data. Trustees and providers, therefore, either need to obtain member consent or otherwise rely on one of the other legal bases for processing. It is expected that member consent will not be the route that most trustees/providers take because it could be withdrawn which would make processing impossible. It is expected that a lot of trustees and providers will use one of the permitted exceptions which include where processing is necessary for compliance with a legal obligation and where processing is necessary for the purposes of a legitimate aim pursued by the data controller. Regardless of which basis is chosen, data subjects (scheme members) need to be told how their data is used which will usually be in the format of a privacy notice.

Under the new legislation, data subjects (pension scheme members) have more rights than they had under the previous data protection legislation. As well as the right to access their data, data subjects have the right to rectification, right of portability and right to erasure. Any data subject right must be actioned within one month, unless of course there are grounds for refusing to comply but the subject must be made aware of these grounds.

Trustees and providers should be aware of the GDPR and ensure that procedures are put in place to ensure compliance.

### 1.4 PENSION SCAMS

There are still initiatives underway designed to combat pension scams. In the November 2016 Autumn Statement, the Chancellor Philip Hammond pledged to look at ways to tackle pension scams via a consultation process. The subsequent consultation focused on three different areas where direct intervention is required:

- A ban on pensions cold calling
- Making it more difficult for fraudsters to open small pension schemes, in particular Small Self Administered Schemes (SSASs)
- Limiting the conditions for a statutory right to transfer where the transfer is to an occupational pension scheme

The power to introduce a ban on pensions cold calling has been introduced within the Financial Claims and Guidance Act 2018, which received Royal Assent in March 2018. The Act contains a power to make regulations to enforce a ban. At the time of writing, no regulations have been laid.

The Finance Act 2018 which received Royal Assent on 15 March 2018 and came into effect from 6 April 2018 provided HMRC with the relevant powers to register and deregister pension schemes where the sponsoring employer is a dormant company, which should make it more difficult for a SSAS to be opened, unless there is a genuine active employer sponsoring the scheme.

If the statutory right to transfer conditions are changed in line with the proposal then this would mean that a member would need to have a genuine employment link to the receiving occupational scheme demonstrated with regular earnings from employment and confirmation that the employer has agreed to participate in the receiving scheme. The Government committed in the consultation response to take this forward but at the time of writing no legislation has been laid to enact a change.

### 1.5 CREATION OF A SINGLE FINANCIAL GUIDANCE BODY

The Financial Guidance and Claims Bill received Royal Assent in May 2018. This Act allowed for the merger of the existing services provided by Pension Wise, The Pensions Advisory Service (TPAS) and the Money Advice Service (MAS). The objective was to create a clear, single financial guidance body, which was called the Money and Pensions Service (MaPS) from April 2019.

MaPS is a non-departmental public body sponsored by the Department for Work and Pensions.

#### Summary

There have been some extensive changes to the DC pension landscape over recent years, most notably with the introduction of the pension flexibilities at relatively short notice with effect from 6 April 2015.

Focus has also turned to consolidating pension schemes with the increased popularity of master trust arrangements leading the Government to legislate for a new supervisory regime to be monitored by TPR. In addition, plans for a Pensions Dashboard are still underway aimed at improving consumer engagement and enabling members to make better informed decisions.

The Government also continues to progress its ongoing campaign to tackle pension scams and to improve the support available for members through the creation of a single entity with responsibility for providing and commissioning pensions, money and debt guidance.

#### Self Test Questions

- Outline the Government's plans for a Pensions Dashboard.
- Describe how GDPR will impact data processors.
- Explain the latest measures to tackle pension scams