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Our ref: ICAEW Rep 54/13

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By email: [DCCP@thepensionsregulator.gov.uk](mailto:DCCP@thepensionsregulator.gov.uk)

Dear Mr Elliott

**Regulating work-based defined contribution (DC) pension schemes**

ICAEW is pleased to respond to your request for comments on *Regulating work-based defined contribution (DC) pension schemes*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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## ICAEW REPRESENTATION

### REGULATING WORK-BASED DEFINED CONTRIBUTION (DC) PENSION SCHEMES

Memorandum of comment submitted in March 2013 by ICAEW, in response to The Pensions Regulator consultation paper Regulating work-based defined contribution (DC) pension schemes published in January 2013

<b>Contents</b>	<b>Paragraph</b>
Introduction	1
Who we are	2
Major points	5
Responses to specific questions	10

## INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *Regulating work-based defined contribution (DC) pension schemes* published by The Pensions Regulator (tPR) on 10 January 2013, a copy of which is available from this [link](#).

## WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. This response reflects consultation with the ICAEW Business Law Committee which includes representatives from public practice and the business community. The Committee is responsible for ICAEW policy on business law issues and related submissions to legislators, regulators and other external bodies.

## MAJOR POINTS

5. We are supportive of this tPR initiative. However, there is a need for a level playing field between trust-based and contract-based schemes and, whilst this consultation is a step in the right direction, it deals only with trust-based schemes whereas we believe that the regulation of contract-based schemes should be considered (in detail) at the same time. In particular, the FSA's regulation of contract-based schemes focusses on investor protection at point of sale and looks at 'provider' level, not at 'scheme' level and is based on disclosure of information to members (who often do not want information, they simply want the reassurance that someone is looking after their interests on their behalf, for example, trustees), whereas tPR is more governance oriented. We believe this results in significant differences in the two regulatory regimes and we believe that, in order to have a level playing field, the FSA regulation would also need to be at scheme level. We acknowledge that this consultation makes some high level observations regarding the regulation of contract-based schemes, stating that tPR has begun its review of this FSA regulation and considers it is in many ways 'parallel' to the framework applicable to DC trust-based schemes. However, more (detailed) analysis is required, particularly at the governance level, and we therefore urge TPR to finalise its review of the FSA regime as soon as possible, so that the two regulators can have a joined up approach and work towards a level playing field, which we acknowledge will require some change in regulation. We are particularly concerned about governance because, given the lack of trustees for contract-based schemes, it is not clear whether/how the FSA will require providers to carry out key governance requirements at scheme level. For example, should providers establish a risk register for each scheme, and how will they deal with conflicts in terms of quality of service (for instance if their own levels of administration are poor, or if their investment returns are lower than their competitors)? We would expect trustees of pension schemes to be able to handle these things independently of the providers, notwithstanding the conflicts in master trusts. Once this review of the two regimes has been completed, it would be helpful if tPR and FSA could issue some high level guidance outlining how the two regimes operate and where responsibilities lie under trust and contract-based arrangements (for example, in a trust-based scheme the trustees are responsible for monitoring the performance of IMs and TPAs, whereas in a contract-based scheme this usually falls to the provider).

6. The approach set out in these consultation papers appears to be attempting to introduce regulation (in the form of guidance) by setting out various regulator ‘expectations’. For example, paragraph 9.5.5 of Annex 1 (DC regulatory approach) contains the statement that tPR “*will expect master trusts to implement voluntary disclosure that will enable them to demonstrate consistency with standards in the DC code and DC regulatory guidance*”. This ‘comply or explain’ regime is supposed to be voluntary, but this ‘expectation’ could be seen as introducing a mandatory requirement and therefore could be considered to be regulation ‘by the back door’. Similarly, the draft Guidance includes provisions such as paragraph 98 “*Where the scheme insurer provides retirement literature for trustees to issue they should obtain assurance from their insurer that it is compliant with the ABI’s code. Trustees remain responsible for the information and the process and must ensure that sufficient governance and controls are applied.*” If the use of the terms “expect”, “should” or “must” is intended to impose requirements, this should be subject to the usual formalities associated with the imposition of regulation eg Impact Assessment. If not, the regulator’s approach should be revised to remove these ‘expectations’ or otherwise make it clear that these are not mandatory requirements.
7. In our view, it would be preferable for the Code to be more principles-based, supported by some examples/guidance to amplify what is meant/intended. The proposed draft DC Code currently includes an uneven level of detail, and is overly prescriptive in places regarding the procedural aspects of how to run a scheme. For example, paragraph 48 states that trustee training should be included as a standing agenda item at trustee meeting, and paragraph 60 amplifies this by setting out that this could be an hour of relevant/topical training at the beginning/end of the meeting. However, there are many other appropriate ways of ensuring that trustees receive a sufficient level of training (and we note that including training at trustee meetings would not necessarily be the best method of training, as different trustees – eg MNTs and ENTs – will have differing training needs). The DC Code should instead be more consistently principles based with examples, rather than including overly prescriptive detail as to how a particular principle should be achieved (this will avoid the issue that, as currently drafted, the DC Code sets out tPR’s expectation as to the manner in which the objective should be achieved). In the case of the training example we use above, the DC Code should instead include the principle that trustees should receive a sufficient level of training, with perhaps some examples of how this could be achieved but not prescribing how it should be done. Alternatively, this could be on a ‘comply or explain’ basis, ie trustees can instead explain how they are achieving the objective/requirement in an alternative way. See also our comments at Q7 below.
8. We are also concerned that the structure of the regulatory documentation could be confusing and overly complex, particularly for trustees of smaller schemes. We would therefore support the suggestion of combining the Code and Guidance into one document, clearly distinguishing the Code content from Guidance (for example, by font format).
9. We are strongly of the view that the value for money section of the draft DC Guidance should be amended given the current lack of available benchmarking information and also given that a proper impact assessment is needed. See also our more detailed comments at Q18 below.

## **RESPONSES TO SPECIFIC QUESTIONS/POINTS**

### **DC regulatory approach and DC quality features**

**Q1. Since publishing the draft features in June 2012, we have made some drafting improvements to make the DC quality features clearer. What further changes could we make to improve the DC quality features?**

**10.** We have no suggestions for further improvements.

**Q2. Do the DC code and DC regulatory guidance, together with the DC regulatory approach, sufficiently address risks to members within the different segments of the DC market, for example those relating to master trusts? Please comment on coverage by segment.**

11. Yes, subject to our comments at paragraph 5 above regarding the need for a level playing field with contract-based schemes.
12. Master trusts are retail financial institutions that are similar to contract-based schemes in certain respects, for example (unlike single-employer trust-based schemes) there are likely to be no trustee representatives from the individual employers, and there is no requirement for the trustees to include MNTs. This means that master trusts do not have the benefit of some of the protections/safeguards associated with having a sponsoring employer, and there will be no monitoring of the scheme at an individual employer level. Given that master trusts will have many governance and operational similarities to contract-based providers, and regulation for trust based schemes predicated on single employer arrangements may not be fully appropriate, the FSA approach would seem to fit these master trust arrangements better, subject to our comments about the need for FSA regulation of governance at paragraph 5 above.
13. We further note that there is an unlevel playing field in relation to the audit requirements for ear-marked schemes, see Q8 below.

**Q3. Do you agree that voluntary disclosure of consistency with the principles and features is a suitable approach for trustees to demonstrate the presence of DC quality features contained in the DC code and DC regulatory guidance? If not, why not? When responding to this question, it would be helpful if you could outline what you envisage trustees disclosing to demonstrate their accountabilities to members.**

14. We don't see the logic of having a voluntary disclosure regime. Unlike company stakeholders, the member of pension schemes have limited scope to leave the scheme, and therefore the need for regulation differs from the governance of companies, and we therefore question whether a voluntary or 'comply or explain' regime is appropriate in relation to schemes. For instance, we anticipate many smaller schemes will simply choose not to make such disclosures.

**Q4. Do you agree that independent assurance will help provide another layer of rigour to help improve standards of governance and verify accountabilities of trustees of master trusts? If not, what other sources of assurance can trustees of master trusts use to demonstrate the presence of DC quality features and operational effectiveness of related control processes?**

15. We are working with tPR to develop a voluntary assurance framework for master trusts, and in our view an internal controls report will provide confidence that quality standards are in place, which trustees of master trusts may want to (or be asked to) demonstrate to existing employers and potential clients. There is clearly a cost but also a commercial aspect to this which might incentivise master trusts to take this up, for example, we have seen the major pensions administrators adopt the voluntary AAF reporting and many trustees will now only appoint administrators who provide such a report. However, we note that paragraph 9.5.6 of Annex 1 (DC regulatory approach) refers to the regulator's 'expectation' that master trusts will obtain such assurance, which in our view is another example of 'regulation by the back door' that should be subject to appropriate Impact Assessment (see also paragraph 7 above). We make some further comments on costs at Q23 below.

**Q5. Should requirements outlined for disclosure and independent assurance outlined above be incorporated in pensions legislation? Please give reasons.**

16. We note that the disclosure referred to at Q3 above is voluntary (ie not a mandatory requirement). Therefore, please see paragraph 6 and Q4 above regarding our view that this guidance should not be a vehicle for 'regulation by the back door'.

## DC code

**Q6. Does the DC code sufficiently address the standards of trustee practice necessary to evidence compliance with pensions legislation? If not, why not?**

- 17.** The DC Code (eg paragraph 201 *et seq*) does not deal with the preparation of the annual accounts and the requirement for the scheme accounts to be audited including an auditor's statement about contributions (see also Q8 and Q17 below).
- 18.** As a more general point, it is not clear whether the draft DC Code is intended to be standalone (and thus comprehensive), or whether it is supposed to be read in conjunction with other relevant Codes of Practice and their associated guidance. The DC Code should be revised to make this clear and (in the latter case) should include specific references to the relevant sections in these other Codes of Practice (with links to assist in cross referencing). See also our comments at Q7 below.

**Q7. Does the level of guidance included in the DC code in relation to internal controls and trustee knowledge and understanding provide sufficient detail to enable trustees to comply with pension legislation and undertake their role effectively?**

- 19.** The DC Code appears to include a sufficient amount of detail in respect of TKU except in respect of risk management. The DC Code is said to 'build on' the TKU and internal controls Codes of Practice, but (as mentioned at Q6 above) it is not clear whether the draft DC Code is intended to be standalone (and thus comprehensive), or whether it is supposed to be read in conjunction with other relevant Codes of Practice and their associated guidance (eg on internal controls). The DC Code should be revised to make this clear and (in the latter case) should include specific references to the relevant sections in these other Codes of Practice (with links to assist in cross referencing).
- 20.** As mentioned at paragraph 7 above, we note that the proposed draft DC Code includes an uneven level of detail, and is overly prescriptive in places regarding the procedural aspects of how to run a scheme. For example, paragraph 48 states that trustee training should be included as a standing agenda item at trustee meeting, and paragraph 60 amplifies this by setting out that this could be an hour of relevant/topical training at the beginning/end of the meeting. However, there are many other appropriate ways of ensuring that trustees receive a sufficient level of training (and we note that including training at trustee meetings would not necessarily be the best method of training, as different trustees – eg MNTs and ENTs – will have differing training needs). The DC Code should instead be more consistently principles based rather than including overly prescriptive detail as to how a particular principle should be achieved (this will avoid the issue that, as currently drafted, the DC Code sets out tPR's expectation as to the manner in which the objective should be achieved). In the case of training, the DC Code should instead include the principle that trustees should receive a sufficient level of training, with perhaps some examples of how this could be achieved, but not prescribing that it is a standing item at meetings. Alternatively, the prescribed detailed requirement could be on a 'comply or explain' basis.

- 21.** See also our comments on risk management at Q13 below.

**Q8. Are there any other legal requirements which you think should be brought within the scope of the code?**

- 22.** As noted at Q6 above, the DC Code does not deal with the preparation of the annual accounts and the requirement for the scheme accounts to be audited including an auditor's statement about contributions (and see also and Q17). We further note that ear-marked schemes only require an external audit of their contributions and not their financial statements, and therefore some large DC schemes which happen to invest solely in unitised insurance policies do not receive a full external audit. tPR should consider whether this is appropriate, given there is no

difference in practice between these schemes and schemes that invest in other types of unit funds.

**Q9. Are there any other key actions that you believe trustees must take in order to meet the legal requirements set out in the code?**

**23.** No, in our view the draft Code is comprehensive in this respect.

#### **DC code - Section 1: Introduction**

**Q10. Do you agree that the regulator should issue a code of practice in order to clarify the standards it expects in occupational DC trust-based pension schemes? If not, what other vehicle could we use to provide further education and enablement tools to trustees, and why?**

**24.** Yes, we agree the regulator should issue a code of practice for DC trust-based pension schemes, but we have some general comments on the draft Code. For example (as we mention at Q7 above) it is not clear whether the draft DC Code is intended to be standalone/comprehensive, or whether it is supposed to be read in conjunction with other relevant Codes of Practice and their associated guidance (if so, it should include specific references to the relevant sections in these other Codes of Practice (with links to assist in cross referencing)).

**Q11. Do you agree that we have targeted the DC code at the right schemes?**

**25.** Yes, in our view the DC Code covers all schemes, drawing out various aspects in relation to different types of schemes, and making it clear that smaller schemes are still subject to the Code (ie small size is not a reason not to comply, but the inclusion of small schemes is proportionate because compliance will be easier as they are smaller/more simple).

#### **DC code - Section 2: Know your scheme**

**Q12. Do you agree that we have correctly identified the key components we should take into account when assessing fitness and propriety? If not, why not?**

**26.** The DC Code (paragraph 67) identifies the (narrow) legislative provision permitting tPR to prohibit trustees who are not deemed to be 'fit and proper', and then makes brief mention of some other desirable characteristics (eg integrity and financial soundness), but does not set out any detail regarding these components or provide any criteria by which they could be judged. As we mention at Q7 above, it is not clear whether the draft DC Code is intended to be standalone/comprehensive, or whether it is supposed to be read in conjunction with other relevant Codes of Practice and their associated guidance. If the former, much more detail should be included in the DC Code regarding this rather nebulous and currently ill-defined concept of 'fit and proper'. If the latter, it should include specific references to the relevant sections of the TKU Code of Practice and associated guidance (with links to assist in cross referencing).

#### **DC code - Section 3: Risk management**

**Q13. Do you agree that we have set out clearly what actions are expected of trustees in relation to risk management and internal controls?**

**27.** No, because the DC Code does not distinguish between scheme level vs member level risk and great clarity is needed between member level and scheme level risk. For instance, the DC Code mentions operational procedures as an area of risk for DC schemes, outlining the importance of key data and failures by third party service providers (eg administrators), but no mention is made of the need to consider the impact at member level. It would therefore be helpful if the DC Code could expand on the risk management areas that raise member level risks in addition to scheme level risks, as they will have different levels of materiality. Further examples include the administrative risks associated with tracing cashflows, member choices

and switch instructions that are identified at paragraph 79 of the DC Code, which again should be considered at a member level.

**Q14. Certain activities or events may call into question the ability of a DC scheme to deliver a good member outcome. Should we develop a DC notifiable events regime that could require and enable certain events to be reported to us, for example a change in administrator as a result of poor quality service? If yes, what should the list of events include?**

**28.** We would have thought that one could define a suitable set of parameters that constituted notifiable events. However, the consultation is not clear as to what any such 'notifiable' information would be used for, and our initial reaction is that the example given (change of administrator) is not *per se* indicative that there is an issue (indeed, such a change might be more likely to be indicative that issues are being identified and addressed by the trustees). If any such DC notifiable events regime were to be developed, in our view it should focus on situations where member interests were prejudiced and the situation was not remedied (and we believe such situations would be covered by the general whistleblowing duty under s70 PA04 in any event).

#### **DC code - Section 4: Investment**

**Q15. Does the DC code include sufficient practical guidance on the design and governance of default strategies?**

**29.** The DC code includes sufficient practical guidance on the governance of default strategies, but not in respect of their design. For example, the Code should acknowledge the need to use investment consultants/advisers (by contrast, see the amount of detail included on designing the scheme's investment strategy at page 25).

#### **DC code - Section 5: Governance of conflicts of interest and advisers/ service providers**

**Q16. Do you agree that the practical guidance adequately addresses the risks of the different types of conflicts of interest which may occur within different segments of the DC market?**

**30.** Yes, we agree that the practical guidance adequately addresses the risks of the different types of conflicts of interest which may occur within different segments of the DC market.

#### **DC code - Section 6: Administration**

**Q17. Does the DC code include sufficient practical guidance on the standards of administration that we expect?**

**31.** Yes, except for our comments below, in our view the guidance provided in the area dovetails well with the Internal Controls Code of Practice.

**32.** Paragraph 201 *et seq* do not currently deal with the preparation of the annual accounts and the requirement for the scheme accounts to be audited including an auditor's statement about contributions (as we mentioned at Q6 above).

**33.** We also note that the DC Code does not refer to tPR's statement '*Member record-keeping: what trustees can expect from statutory auditors*', which was issued to help trustees understand the extent and limits of the auditor's work in a statutory pension scheme audit (and emphasises that trustees cannot rely on the statutory audit to inform them of the quality and accuracy of their member data, or the controls around that data). It also sets out some of the steps trustees can take to address these issues. See <http://www.thepensionsregulator.gov.uk/docs/auditors-statement-feb-2011.pdf>.)

## DC guidance

**Q18. We have set out practical guidance for trustees on assessing the value for money of their scheme. Do you have any comments on this guidance?**

- 34.** In principle, we agree that trustees should evaluate value for money, and we believe many schemes would already regard themselves as carrying out some form of value for money exercise. However, the guidance as set out is quite detailed and prescriptive and seems to go further than "guidance", and the value for money evaluation trustees currently carry out would not necessarily cover all the areas nor be as frequent nor with the disclosure suggested in the consultation. Therefore, whilst a requirement to assess 'value for money' appears to be a good idea in principle, tPR should acknowledge that imposing such a requirement on trustees will involve more work in order to achieve it in practice, and will add to the overall regulatory burden. It is also important to recognise that there is currently a lack of transparency in the market, which is not addressed in the guidance. At paragraph 48, the guidance states that trustees should consider collecting information relating to a range of other schemes and providers, but fails to give any advice on how to do this - which is necessary as information is unlikely to be accessible from publicly available documents. We acknowledge that expense ratios are disclosed for contract-based products but trust-based scheme accounts are not published so it would be very difficult for trustees to make a comparison with other trust-based schemes (even if the AMC is known, it would not be possible to do a cost comparison for the average member), and therefore the requirement in paragraphs 37 and 53 that a 'value for money' comparison is made with other schemes available in the market would be very onerous and difficult to achieve given the lack of information that is currently available in the marketplace. We also note that it is not an incremental step, but an entirely new requirement that is likely to require the need to instruct consultants to carry out the work (and would thus result in costs that will either be borne by the employer or the member, given not all employers pay scheme running costs). We are therefore strongly of the view that this section of the guidance is fundamentally re-visited, or a proper impact assessment is carried out. The requirement for trustees to document their value for money reviews in a report which sets out the activities they have undertaken, the minutes of trustee meetings and the risk register will also give rise to additional costs.
- 35.** Given that a value for money review would require more transparent information about scheme costs, we believe tPR should consider capturing scheme running costs in its annual return, which would help to provide a benchmark for trustees.

**Q19. We have set out practical guidance for trustees on deciding how to disclose costs and charges to members. Do you agree with the approach that we have suggested?**

- 36.** Yes. We note that most schemes negotiate an acceptable charging structure where charges are clear, which will enable the trustees to then communicate such information to members as anticipated in the guidance. However, we also note that alternative funds are likely to become more popular, which may have more opaque charging structures, and therefore such disclosure to members may become more difficult as investment products change, depending on their complexity.

**Q20. We have set out practical guidance for trustees on helping members to optimise their retirement outcomes. Do you agree with the approach that we have suggested?**

- 37.** We support the guidance on optimising retirement incomes set out in paragraphs 84 to 121, which in our view seem comprehensive.

**Q21. We have set out practical guidance for trustees on communicating with members. Do you agree with the approach that we have suggested?**

- 38.** Member communication is a very difficult area, given the relatively complex subject matter, widespread lack of member interest/engagement (especially as there is a significant time lag

until the pot has grown to a sufficient size to attract interest) and in some cases low comprehension levels of written material and numeracy skills. Member communication therefore presents significant challenges, with associated costs. Reference could usefully be made to the DWP's 'jargon busting' language guide, which can help schemes to present information using simple, consistent language (<http://www.dwp.gov.uk/docs/auto-enrol-language-guide.pdf>).

39. ICAEW has a long term initiative to try to address issues relating to financial literacy. Through the ICAEW's financial capability work, ICAEW members provide hands-on support and mentorship to school teachers (ICAEW members volunteer to mentor in secondary school teachers and thereby pass on financial responsibility to pupils) and also to community groups in deprived communities. The aim is to equip people with the basic skills to understand and better manage financial issues including credit, banking, savings and debt management. Further information is available at: [www.icaew.com/financialcapability](http://www.icaew.com/financialcapability).

#### Impact assessment statement

**Q22. Do you agree that the DC regulatory approach document, DC code and DC regulatory guidance do not place additional regulatory burden on trustees? If you do not agree, please explain and quantify additional costs.**

40. No, we believe the DC regulatory approach document, DC code and DC regulatory guidance would place a significant additional regulatory burden on trustees. The increased level of detail and required documentation will lead to significantly increased costs, but it is difficult to quantify these. A particular example of increased regulation/cost is the proposed 'value for money' comparison (see Q18 above).

**Q23. In the Impact assessment statement, we have outlined indicative costs for the voluntary 'comply or explain' regime and independent master trust assurance framework. Do you agree with our initial assessment of these likely costs?**

41.

We consider the range of costs quoted are about right for Reporting Accountant's fees, but Master trusts would of course have their own costs in implementing an internal controls report as they would need to document their controls in a particular way to support the AAF framework and would have to carry out their own monitoring procedures to ensure that they can make the declarations required of management in the annual AAF report.

**Q24. We consider that the DC regulatory approach document, the DC code and DC regulatory guidance help trustees in complying with their obligations to not discriminate against people with protected characteristics under the Equality Act 2010. Do you have any further comments on this area?**

42. No comment.

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