



Pensions accounting, assurance & regulatory round-up

Private sector occupational pension schemes

Spring 2017



Introduction



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Welcome to the Spring 2017 edition of Pensions Accounting, Assurance & Regulatory Round-Up for private sector occupational pension schemes.

In this edition we take a look at the issue of FRED 67, the Government's green paper focusing on security and sustainability of DB schemes which will undoubtedly inform the direction of future legislation. We also take a look at forthcoming revisions to audit reports introduced by the updated ISAs, bring you an update of news from the Pensions Regulator and review developments in Europe with an update on the implementation of EMIR.

If you have any queries or would like to discuss any of the matters herein further, please do get in touch with your usual contact at KPMG, Anne or Sarah, or email us at:

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FRC issues FRED 67

New proposals from the FRC outline 'incremental improvements and clarifications' to FRS 102...

The FRC have issued FRED 67 'Draft Amendments to FRS 102' following their first triennial review of FRS 102. The FRED's title includes the words 'Incremental improvements and clarifications' and indeed the proposed amendments are of a modest nature. FRED 67 follows on from an earlier consultation by the FRC. The main points of interest for pension scheme financial reporting are summarised below.

A welcome proposed change is removing pension schemes from the definition of 'financial institutions'. In practice this change makes no difference to current accounting requirements for pension schemes because they are carved out of the additional disclosures applicable to financial institutions. However, it does remove the risk of pensions schemes being caught by future changes to financial institution disclosures and also brings the standard into line with the view that pension schemes are not the same as financial institutions such as banks and insurers.

An expected change to bring the determination of fair value into line FRS 102's disclosure of fair value (levels 1, 2 and 3) and IFRS 13 has not been included. FRED 67 comments that 'respondents' feedback highlighted that incorporating IFRS 13 definition of fair value may lead to unintended consequences. That definition, anchored as it is in the market approach, may lead to changes that would be particularly significant for certain entities that have only recently implemented the FRS 102 fair value requirements'. This is intriguing, as it seems to suggest there could be differences between FRS 102 and IFRS 13 view of 'fair value'. So for the time being FRS 102 will continue to refer to fair value determination in terms of categories (a), (b) and (c) and require fair value disclosure using levels 1, 2 and 3. Not ideal, but we will have to wait and see what these 'unintended consequences' are and what impact, if any, they would have on fair value reporting.

FRS 102's specific content on pension scheme financial reporting remains unchanged.

The consultation period for FRED 67 runs to 30 June 2017 and any changes arising will be applicable for accounting periods commencing 1 January 2019.

Revised ISAs – impact on pension scheme audit reports and Practice Note 15 'The Audit of Occupational Pension Schemes in the United Kingdom'

Revised ISAs bring an updated Practice Note for auditors of occupational pension schemes and new formats for audit reports.

Where did the revised requirements come from?

International Standards on Auditing (ISAs) have been revised and the revised standards apply to audits of financial periods commencing on or after 17 June 2016. As part of this process, ISA 700 'Forming an Opinion and Reporting on Financial Statements', which is applicable to pension scheme audit reports, has been revised and Practice Note 15, *The Audit of Occupational Pension Schemes in the United Kingdom (PN15)*, is being updated following the amendments to the ISAs.

Audit reports - what are the key changes?

The most obvious impact of ISA 700 is to significantly amend the format of the audit report.

The opinion now forms the first paragraph identifying clearly which statements are within its scope. Following this, the 'basis of opinion' deals with applicable law, independence, adequacy of audit evidence and cross refers to the more detailed paragraph dealing with auditors responsibility which follows later in the report. The order of the remaining content of the audit report is not specified by the ISA but it does require the use of specific headings.

A further change introduces a new paragraph focussing on going concern and other information. ISA 700 requires pension scheme auditors to report in accordance with ISA 570 'Going Concern' on whether the 'going concern' basis of accounting is appropriate in the preparation of the financial statements and to report, by exception, if this is not the case. The going concern assessment is for a period of 12 months from the date of approving the financial statements.

Detailed paragraphs dealing with trustees' and auditors' responsibilities follow, requiring the trustees to acknowledge responsibility for internal controls and assessment of the scheme as a going concern (including appropriate disclosure) and clarifying responsibilities around information issued with the financial statements. The revised report concludes outlining the purpose of an

audit and clarification on the extent of the auditor's duty of care in relation to the opinion given.

The auditor's statement about contributions has also been amended. The revisions here are solely in relation to formatting.

Practical implications of the revision

The introduction of an explicit requirement to report on whether the going concern basis is appropriate for the preparation of the financial statements of the pension scheme (or whether there are uncertainties casting doubt on this) is interesting. The pension SORP recognizes that the going concern concept for pension schemes does not play the same role as for commercial entities and notes that the basis of preparation does not need to refer to going concern unless a formal decision to wind up the scheme or a trigger event has occurred. It is worth noting that a scheme, even in formal wind up, may continue operations for a number of years whilst the wind up formalities are completed.

ISA 700's revised wording reiterates the current position concerning responsibilities around other information issued with the audited financial statements, such as the Report on Actuarial Liabilities for DB schemes and the Chair's Statement for DC schemes. It clarifies that the trustees are responsible for other information issued within the annual report and the auditor has responsibility for consideration of whether it is materially misstated or inconsistent with the financial statements or audit knowledge.

Next steps ...

For the majority of schemes, the first scheme year for which the revised audit report will be effective will be that ending after 16 June 2017. However, if you are intending to undertake a short period of account with a commencement date on or after 17 June 2016 the provisions of the revised ISA 700 will apply before then.

PN15 is likely to be issued for comment over the summer and to be finalised in Autumn 2017.

Security and sustainability in DB schemes – DWP consultation paper

The collapse of BHS and the impact on its pension scheme have triggered renewed focus on the security of defined benefit pensions. On 20 February the Department for Work and Pensions published a Green Paper looking at suggestions on how the regulatory system for defined benefit schemes might be changed to deliver better outcomes.

Background

The DWP has published its [green paper](#) on DB pension schemes looking at suggestions on how the regulatory system could be changed to deliver better outcomes.

Overview

Much of the paper is given over to analysis of the state of the DB market. The overall conclusion is that DB pensions are not generally unaffordable for employers and that there is little evidence of deficits driving employers to insolvency. However, there are some employers for whom the level of deficit repair contributions may become unsustainable. It is this group that is the primary focus of many of the paper's proposals.

The paper considers the current position and makes suggestions under four broad headings:

- Funding and Investment;
- Employer Contributions and Affordability;
- Member Protection;
- Consolidation of Schemes.

Funding and investment

The paper concludes that the DB system is not in immediate crisis, but it may not be operating optimally. There may be a case for limited regulatory changes to help employers and trustees manage liabilities more effectively.

Acknowledging that a one-size-fits-all approach may no longer be appropriate, scheme funding issues under consideration include:

- Whether flexibilities in setting the scheme funding discount rate are being used appropriately;
- Whether shorter valuation cycles are needed for high-risk schemes (and longer ones for low-risk schemes);
- Whether the 15-month timescale for completing valuations should be reduced;
- Whether other valuation approaches (e.g. stochastic modelling) should be mandated or encouraged;
- Whether schemes need to do more to help members understand funding issues.

This section also addresses a range of issues surrounding trustees' investment choices:

- Whether the market offers sufficient investment options to trustees;
- Whether the Regulator should help determine an appropriate level of risk for a scheme;
- Whether asset-pooling or consolidation would help schemes to access better investment opportunities;
- Whether regulation incentivises overly risk-averse decisions;
- Whether there is evidence of herding or poor advice by advisors.

It was anticipated that the green paper would take a wider look at trusteeship standards. However, this subject is relegated to a brief question under the funding and investment heading as to whether enhanced trustee training or greater professionalisation of trusteeship is needed.

Security and sustainability in DB schemes (cont.)

Employer contributions and affordability

Whilst modelling by the PPF suggests that the funding position of schemes is likely to improve in the future, deficits have been stubbornly persistent for some years despite very substantial payments by employers. The paper notes four possible ways of improving the funding position of schemes:

- Employers pay more deficit repair contributions into the scheme;
- Trustees change their asset allocation to get better returns from investments;
- Schemes reduce their liabilities, by reducing benefits or restructuring exercises;
- Reducing prudence in the valuation assumptions (although this would only change the perceived funding position rather than actually change the cost of the liabilities).

Each of these affects the balance of interests of the parties involved, with many moral hazard issues for employers. Against that background, the paper asks:

- Whether there is any evidence that deficit repair contributions are currently unaffordable;
- Whether employers with significant resources should repair deficits more quickly;
- If measures for stressed employers and schemes are needed, how 'stressed' should be defined;
- Whether there are circumstances in which stressed employers should be allowed to separate from their schemes without having to demonstrate that they are likely to become insolvent;
- How it would be possible to avoid the moral hazard of employers manipulating the system to offload their DB liabilities;
- Whether employers should be able to negotiate reduction of accrued benefits;
- Whether, and in what circumstances, schemes should be able to reduce revaluation and indexation (for instance, by granting the power to move from RPI to CPI, or by allowing 'stressed' employers to suspend pension increases);

- Whether the government should allow or require longer, deferred or back-loaded recovery plans;
- Whether to make it easier to commute benefits on triviality grounds.

Member protection

The paper examines whether strengthening the power of the Regulator could help to ensure that employers make the necessary contributions and do not evade their responsibilities to the scheme. However, the government is clear that any new powers must be proportionate and workable, and must not harm the effective functioning of the economy. In particular, the government is wary of a suggestion by the Work and Pensions Select Committee that the Regulator should have powers in some circumstances to act proactively to prevent certain corporate activities, rather than using retrospective anti-avoidance powers. It notes that even a limited compulsory clearance procedure could make turnarounds more difficult and lead to more businesses being placed into insolvency. It could also reduce the attractiveness of UK companies to investors.

The paper queries:

- Whether members and employers need greater clarity over scheme funding requirements – and whether this should be delivered by legislation or through Regulator guidance/standards;
- Whether there is a viable mechanism for compulsory, proactive clearance by the Regulator of certain corporate transactions;
- Whether the Regulator should be able to impose punitive fines for corporate transactions that are detrimental to schemes;
- Whether the Regulator should have new information gathering powers;
- Whether trustees should have more powers to demand information from employers and whether trustees of underfunded schemes should be consulted when the employer proposes to pay a dividend.

Security and sustainability in DB schemes (cont.)

Consolidation of schemes

The paper considers whether consolidation of schemes would help to make the delivery of DB pensions more efficient – and perhaps as an alternative to buyout. The potential benefits include:

- Efficiency and lower costs ‘per member’, due to economies of scale;
- Access to more investment opportunities, and a more sophisticated investment strategy;
- Improved standards of governance;
- More cost-effective approach to buy-out for smaller schemes;
- Providing a potential solution to stressed schemes/sponsors.

However, there are notable obstacles – not just the up-front cost but also the difficulty of moving existing, complex arrangements to a unified benefit structure, and sensitivities around employers sharing covenant data.

The paper notes two possible models for consolidation:

Ring-fenced – Schemes share administration as well as actuarial, legal, investment and covenant assessment functions, but maintain the separation of assets and liabilities.

Full consolidation – This would involve all the shared services and asset pooling of the ring-fenced model, but would also involve the consolidation of liabilities.

The government is clearly not keen on setting up a consolidator scheme itself. (The Work and Pensions Select Committee had suggested that the PPF could take on this role.) However, it would like to see such consolidators enter the market. Consolidation raises questions regarding who bears the risk of the consolidated scheme – would this be the employer, the member, or the PPF Levy payers?

The Consultation questions concern:

- What barriers to consolidation exist (and how they might be overcome);
- Whether rules should be changed to allow the reshaping of benefits without member consent (perhaps with a standard, simplified benefit model for the reshaped benefit);
- Whether consolidation should be compulsory (which the government does not appear to favour) or whether the government should take steps to encourage it;
- Whether costs and charges in DB schemes are too high (and whether greater disclosure is needed);
- Whether changes are needed to the employer debt provisions for multi-employer schemes (as regards liability measure and treatment of orphan liabilities).

Next steps

The Consultation closes on 14 May 2017. However, any ideas taken forward are likely to take a long time to turn into reality.

EU rules on derivatives – EMIR update

The paperwork burden in relation to derivatives trading continues though we see further extension of the exemption from central clearing.....

Over the past six months there have been some developments in the rules for pension funds using over the counter (OTC) derivatives. (OTC derivatives are those not traded on a regulated exchange but instead privately negotiated between two parties.)

EMIR, the European Market Infrastructure Regulation sets the requirements for trading in derivatives, with the aim here of reducing counterparty risk. The most noted effects for pension funds since this was first introduced in 2012 have been the 'paperwork overhead' and the need to use centralised clearing.

Paperwork

The paperwork burden continues. Derivatives contracts should now be updated to meet the requirement that came in on 1 March to post variation margins on OTC derivatives that are not cleared by a central counterparty.

The International Organisation Of Securities Commissions noted reports by some market participants that they face difficulty in completing the necessary credit support documentation and operational processes to settle variation margins in accordance with the requirements despite efforts to do so. They recognise that some firms, including pension funds, may not yet have well-developed infrastructures to calculate and exchange margins by 1 March 2017.

The FCA issued a [press release](#) on 23 February concerning the new regime, aware that it has been difficult for all to have made the relevant changes in time. They confirmed that they will take a risk based approach in their supervision, and expect compliance within the coming few months.

Clearing

Pension funds were provided with an initial exemption from the use of central clearing counterparties (CCPs) for OTC derivatives. Certain classes of OTC derivative trades,

such as interest rate and credit default swaps, will need to be centrally cleared by pension schemes once the exemption ends. Using CCPs will require the posting of both initial and variation margin. CCPs, notwithstanding the legal requirements, will usually only accept certain assets as collateral, and typically prefer cash.

The expiry date for the pension scheme exemption was extended for a second time in a rule adopted by the European Commission shortly before Christmas 2016. (The rule is then considered by the European Parliament.) The exemption now runs until August 2018. We understand from press comments that the extension has been permitted because of the difficulties that CCPs have in accepting collateral besides cash, and the fact pension funds typically have minimal cash holdings. Sourcing the amounts of cash needed could prove very costly or force pension funds to change their business model.

Collateral

There has also been a development concerning the concentration limit for collateral. Under final rules adopted in October 2016, pension schemes posting more than €1 billion in collateral with a single counterparty will no longer face a requirement to diversify that collateral so that no more than half is in government bonds from a single country or issuer.

Under the final regulation, collateral of more than €1 billion posted by a pension scheme with a single counterparty must be 'adequately diversified' (the list of eligible collateral includes a mix of member state sovereign and agency debt).

The European Commission's review of EMIR is expected in 2017. It will consider as part of the remit whether pension funds should be permanently exempted from the centralised clearing obligation, or at least whether the exemption should be extended until a suitable solution can be found.

The Pensions Regulator – Recent activities

TPR continues to seek to raise standards of governance and administration.

Since our last edition of Regulatory Round-Up, there has been continued activity from The Pensions Regulator (TPR) centered on raising standards of governance and administration.

Record-keeping

As part of its drive to improve standards, TPR has turned its focus back to record-keeping. Its concerns were reignited following a survey of more than 530 trust-based occupational schemes, which revealed little improvement in record-keeping standards. The survey found that only 30% of schemes were measuring data, although larger schemes were far more likely to be doing so than smaller ones. Measurement of conditional data was seen as being secondary to common data despite its importance. The survey also revealed that administrators' understanding of the terms 'common' and 'conditional' data are not universal. In addition, trustees were found to not always consider record-keeping as a priority – even though good record-keeping is the bedrock of a well-run scheme. TPR expects all schemes to measure the presence and accuracy of their data, and put plans in place to resolve any issues arising. Engagement with the scheme administrator is therefore key to achieve this.

To help schemes meet their duties, the Regulator has launched a quick guide to record keeping (www.tpr.gov.uk/docs/record-keeping-quick-guide.pdf) and will be providing further educational products throughout the year. TPR have now added confirmation of record-keeping scores to the scheme return and has just announced its plans to inform the industry this summer about what sort of data should be included in scheme returns. From 2018, it will be mandatory for schemes to include common and conditional data scores. DB schemes are first from January 2018, with the first DC schemes from July 2018.

21st century trustee initiative and draft monetary policy

On 19 December 2016, in response to its July 2016 consultation on '21st century trusteeship', TPR set out the steps it will be taking going forward:

- Clarification on the definition of 'professional trustee' setting out what it means in practice by the higher standards already expected (see below);
- An education campaign in the Spring of 2017, signposting materials and producing additional tools and guidance;
- Following results of its education campaign, TPR will consider whether a 'fit and proper' regime, including barriers to entry as a trustee should be introduced; and
- Investment policy guidance which TPR believes is key to improving member outcomes.

As part of the initiative, TPR has very recently published a consultation on the clarification on the description of a professional trustee and the draft monetary policy on applying fines on trustees and other scheme managers where pensions legislation has been contravened.

The consultation runs to 4 May 2017 and the documents can be accessed through the links below:

[Draft monetary penalties policy and revised professional trustee description consultation document \(PDF, 108kb, 17 pages\)](#)

[Draft monetary penalties policy \(PDF, 107kb, 17 pages\)](#)

The Pensions Regulator – Recent activities (cont.)

First fines for master trusts' chair's statements

In January we saw the Regulator issue its first fines against a number of master trust schemes for failing to complete a Chair's Statement. In 2016, it had issued maximum fines against professional trustees of occupational schemes as well as other separate schemes. The Regulator's spokesperson commented: 'We will enforce the law and impose a penalty where trustees of schemes fail to prepare an annual governance statement signed by the chair of trustees. These requirements apply equally to trustees of master trusts'.

Pensions Scams

Late in 2016, the Government opened a consultation on tackling pensions scams, looking at banning cold-calling 'in relation to pensions', limiting the right to take a transfer payment and tightening HMRC registration criteria so that a new occupational pension scheme can only be registered by an active (i.e. non-dormant) company. Views were sought on ways to prevent such schemes from being used as scam vehicles. The Consultation closed on 13 February 2017 and the Government is expected to publish its response this spring.

In March, TPR launched a series of anti-scam tools to aid savers in spotting scams before they fall victim to them. As part of its Scorpion campaign, these tools include:

- New videos for trustees and savers alerting them to typical scammer tactics and the devastating consequences for scam victims;
- An on-line scam-spotting tool for savers considering investing their pension pot;
- A five-step guide to help savers protect themselves; and
- A checklist for trustees helping them work through the due-diligence they have to do when looking at transfer requests.

Consolidation of DC schemes

In January TPR called for greater consolidation of defined contribution (DC) schemes, after its latest figures revealed private sector DC membership had, for the first time, overtaken that of defined benefit. TPR believe that sub-standard schemes pose an 'unacceptable risk to consumer protection'. While many schemes are well run, there are many concerns around the quality of smaller schemes. The Regulator has launched a three-pronged approach to resolve the issue, including education and enforcements of its 21st century trustee initiative.

Conclusion

The Regulator had been criticised by the Work and Pensions Committee of being too reactive following the conclusion of the BHS saga. In response, TPR said it will take a more interventionist approach and take advantage of rarely-used powers to prevent problems as soon as possible. We expect to see more educational tools and trustee guidance issued over the next few months all aimed at raising governance and administration standards and, if TPR's declarations come to fruition then increased investigatory and punitive powers.

The Pensions Regulator – Recent activities (cont.)

STOP PRESS:

On 30 March, TPR published a guide for defined benefit schemes covering investments, laying out the Regulator's expectations of trustees when they set out their investment objectives. The guidance also looks at governance standards and conflicts of interests and is set out in six sections following the common principles outlined in its defined contribution investment guidance:

- Governance;
- Investing to fund defined benefits;
- Matching assets;
- Growth assets;
- Implementation; and
- Monitoring

The guide provides examples of approaches and factors to consider when investing scheme assets, emphasising the importance of timely monitoring. The Regulator suggests the use of an investment monitoring dashboard – providing trustees an “at a glance” financial position.

News in brief

FRC consultation: Transaction costs

The FRC's consultation on transaction cost disclosure by asset managers to their clients, such as pension scheme trustees, closed on 4 January 2017. We await a policy statement in the second quarter of this year.

The proposals consulted on rules requiring asset managers to provide full disclosure of transaction costs in a standardised form including a breakdown into identifiable categories.

Budget 2017

The key provision for pension schemes is the introduction of a 25% tax charge on transfers to qualifying recognised overseas pension schemes (QROPS).

The charge will apply to transfers requested on or after 9 March 2017. There will be exceptions and a five-year quarantine period from date of transfer. So, the new tax charge will apply to an initially tax-free transfer if, in the five years following the transfer, an individual becomes resident in another country so that the exemptions would not have applied. Similarly, the tax will be refunded if the individual made an initially taxable transfer and within five tax years one of the exemptions applies to the transfer. Also, payments out of funds transferred to a QROPS on or after 6 April 2017 will be subject to UK tax rules for five tax years after the date of transfer, regardless of where the individual is resident.

Recent publications:

Scheme accounting: A way forward?

In this new publication, we explore potential developments in scheme accounts presentation, taking advantage of the flexibilities under FRS 102 and the revised SORP, and a year's experience of reporting under these new requirements.



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