KPMG

Pensions Accounting, Assurance and Regulatory Round-Up

Private sector occupational pension schemes

Autumn 2018

Introduction

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Welcome to the Autumn 2018 edition of Pensions Accounting, Assurance & Regulatory Round-Up for private sector occupational pension schemes.

Since our last update in April, we have seen a continued number of developments in the pensions arena. The Regulator has revealed its new approach at a time when fines and criminal charges for non-compliance and fraud seem at their highest. The DWP have responded to consultations, turning new legislation around quickly, and more recently we have had much awaited legislation on the implementation of IORP II for UK pension schemes. A busy time indeed and it doesn't seem to be quietening down for trustees and managers anytime soon.

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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IORP II: Impact on pension governance

On 23 October 2018, the DWP published the Occupational Pension Scheme (Governance) (Amendment) Regulations 2018 (the "Regulations"). These Regulations set out the legal framework for implementing IORP II in the UK. The IORP is due to be implemented in the UK by 12 January 2019. These Regulations meet the UK's obligation to implement the IORP. However, trustees need not take any actions until the Pensions Regulator (TPR) has issued a governance code of practice which will be developed during 2019.

The Governance Regulations amend the requirement for internal controls, as set out in the Pensions Act 2004. "Internal controls" becomes "an effective system of governance". Trustees must establish and operate an effective system of governance including internal controls. This system of governance must be "proportionate to the size, nature, scale and complexity of the activities of the occupational pension scheme".

The Regulations require TPR to issue a code of practice that covers:

- The effective system of governance, including internal controls;
- Key functions, being risk management, actuarial and a function that internally evaluates the adequacy and effectiveness of the system of governance;
- Outsourcing of activities;
- Written policies in relation to key functions and outsourcing ;
- Remuneration policies;
- Own-risk assessment of the system of governance;
- Benefit protection mechanisms e.g. the PPF; and
- Where ESG are considered in investment decisions how new or emerging risks are identified.

Schemes with less than 100 members will not be covered by the code of practice. They will nonetheless still have to have an effective system of governance.

The Regulations closely follow the governance requirements of the IORP in most respects with the notable exception of internal audit. The IORP explicitly states one of the key governance functions is internal audit. The Government's approach to implementing this requirement is to refer to a function which "internally evaluates adequacy and effectiveness of the system of governance". This will give TPR flexibility in implementing what could be a costly requirement and this flexibility is to be welcomed. However, as always the devil will be in the detail!

The first of this own-risk assessment of a scheme's system of governance must be prepared within 12 months beginning with the last day of the first scheme year that begins after TPR has published the necessary codes of practice, or if later, by the date on which the trustees are next required to obtain an actuarial valuation or an annual governance statement. Subsequent own-risk assessments must be prepared at intervals of not more than 3 years.

Next steps for trustees

It is not expected that schemes will have to make major changes to their governance systems, especially if they have followed existing guidance issued by TPR – e.g. the 21st Century Trustee Campaign and existing Codes of Practice.

Detailed guidance on how to comply with the Regulations' requirements will not be issued by TPR until next year, after a consultation period, the Government giving trustees and managers sufficient planning time. Trustees may wish to wait for the publication of the draft code, but in the meantime, it may be useful to review existing governance systems that are already in place against the high level requirements set out in the Regulations.

TPR Future - a new regulatory approach

In September, the Pensions Regulator (TPR) launched a new approach to focus their regulatory supervision. Following a series of high profile cases questioning TPRs role in guiding and monitoring schemes facing challenges, this new approach emphasises the Regulator’s recent drive to provide clearer, quicker and tougher action.   There is also recognition of the Regulator’s role as part of a wider framework of financial sector supervision.

The new approach, ‘TPR Future’, is designed to cover all types of scheme. it focuses on proactive engagement with a wider range of schemes and aims to provide clearer guidance about the Regulator’s expectations. While continuing to educate and support schemes, a tougher stance is introduced on those who are wilfully ignoring or avoiding responsibilities, with member protection remaining paramount.

‘TPR Future’, is formed of a three part programme. Phase 1 commenced in April 2018, establishing recommendations for change and recognising the significant changes to risks in the pensions landscape since the Regulator’s inception following the Pensions Act 2004. Phase 2 built on the recommendations of Phase 1, designing a new operating model linking statutory objectives, identified risks and the Regulator’s aspirations over a five year period.

Five opportunities for change were identified *:

- Clarifying TPR’s identity and improving engagement
- Setting clear expectations
- Improving regulatory oversight
- Using a wider range of regulatory interventions
- Being more efficient and effective.

* from The Pensions Regulator – Making workplace pensions work.

The current initiative comprises Phase 3 of the programme involving establishment of a new operating model which will see action over the next 12 – 18 months. Identification and mitigation of ten key threats will enable focus on those areas where members face the greatest risks. Focus areas will be kept under regular review to ensure the list remains appropriate.

Areas of focus

- Four key areas of focus form the basis of the TPR’s new approach. These are noted as:
- Setting clear and measurable expectations – ensuring standards are clear and complied with. Expectations will be clarified through refined online content.
- Identifying risk early – safeguarding members’ assets through supervision and prompt intervention. Efforts will be focused on higher risks areas identified from both short term and longer term horizon scanning and make use of insight gained from improved data analysis and research. Risk profiles, relating to different scheme circumstances, will be developed and continually enhanced to inform regulatory activity.
- Driving compliance through supervision and enforcement – utilisation of a wide range of regulatory interventions incorporating systematic and escalating interaction with an increased number of schemes, leading to behavioural change and an expectation that identified improvements will be implemented on a timely basis.
- Working with others – to ensure a comprehensive and consistent framework, together with the FCA, comprising regulation, communication and services to trustees and others. TPR intend to publish a strategy later this year setting out how they will work with scheme stakeholders and the key risks and issues which will be tackled.

TPR Future - a new regulatory approach (contd.)

A select population of higher risk schemes will be subject to 1:1 regulatory supervision with a nominated TPR contact. Such schemes, initially expected to number less than 100, will be identified from TPR's horizon scanning informed by regulatory interventions, feedback and information gathering. Additional and escalating regulatory effort will be focussed on schemes found not to be meeting TPR's standards. Different approaches to scrutiny will be tested depending on the risks identified and TPR have not ruled out issuing improvement plans where appropriate.

A second strata of schemes will experience interactions based on a specific regulatory risk or issue, again making use of a range of possible interventions. These may vary from the appointment of a nominated TPR contact (maintaining looser contact with the scheme than for those schemes on the '1:1' regime) to interactions based on letters, phone calls and participation in a thematic review. Responsive regulatory action will be taken where circumstances demand.

TPR emphasise that the new approach is not aimed at increasing use of their enforcement powers but rather encouraging schemes to engage and meet the required standards. All DB, DC and public sector schemes must complete a scheme return (the scope of which will evolve and may be followed by requests for follow up information); the level and degree of any further intervention will be determined by the regulatory risk identified. TPR anticipate that between 20 and 40 % of schemes will experience some form of further supervisory interaction through activities such as participation in focussed thematic reviews and responding to information gathering requests.

In order to deliver this new approach, TPR have engaged in a training programme for their staff and to bring the message home visually, introduced new branding emphasising their tougher approach and are working towards relaunching their website later this year.

Implications

TPR began their horizon scanning contacting a range of schemes which were potentially at risk and requesting specified actions to mitigate identified risks. Use was made of risk assessment questionnaires to enable a view to be formed around the need for any further intervention. Trustees were targeted in an information campaign reminding them of their accountability for all areas of scheme operations, including continuity planning. Publication of compliance failures reinforces TPR's zero tolerance towards poor governance.

As the new approach takes hold, TPR will publish updates on key achievements, continually review the effectiveness of their work and provide opportunities for industry feedback.

Conclusions

TPR will measure and track their success with the aim of providing credible and robust regulation in collaboration with industry partners. Members will benefit from increased assurance that workplace pensions are secure and be fully aware of scam activity and retirement information resources.

As scheme auditors, we expect to see greater interaction between our clients and the Regulator, particularly for larger schemes and schemes experiencing challenging circumstances and will continue to note any issues and actions identified. Ultimately, early supervisory involvement must improve scheme governance, leading to a better outcome for trustees, scheme sponsors, scheme members and the assurance community.

DC Update

Since our Spring Edition of Round-Up, developments in the defined contribution arena have continued at a pace. Changes in regulations, including the latest investment responsibilities together with the additional disclosure requirements introduced earlier this year have meant trustees have had another busy Summer.

Costs and charges

We previously reported on the extended disclosures required on costs and charges as well as the need to include an illustration of the compounding effect they have on members' pension savings. In preparing the illustrative example, trustees must have regard to the statutory guidance issued by the DWP, and in September, a revised "Reporting of costs, charges and other information: guidance for trustees and managers of relevant occupational schemes" was published which provides additional instruction on implementing the requirements of the legislation.

The Guidance states that trustees and managers should present the costs and charges typically paid by a member as a figure in pounds or pounds and pence. The illustration should be realistic and represent a range of savings levels, contribution rates and investment returns, although trustees do not have to prepare an illustration for every combination. Although allowing some flexibility, the Guidance states the following should be taken into account:

- Savings pot size;
- Contribution rates;
- Real terms investment returns gross of costs and charges;
- An adjustment for the effect of the costs and charges borne; and
- Time.

Preparation to satisfy these requirements could be complex and time consuming. The costs and charges information must be published within seven months of the first scheme year end-date on or after 6 April 2018.

Governance

Governance standards remain a focal point of the Regulator. In June, the watchdog published its annual DC survey, the results of which will continue to inform the 21st Century Trusteeship Campaign. The survey was based upon five key governance requirements (KGRs):

- **KGR1**: Trustee boards must possess or have access to the knowledge and competencies necessary to properly run the scheme;
- **KGR2**: Trustee boards must assess the extent to which charges / transaction costs represent good value for members;
- **KGR3:** Core scheme financial transactions must be processed promptly and accurately;
- **KGR4**: Trustees of master trusts must meet independence requirements; and
- **KGR5:** Trustee boards must ensure the default investment strategy is suitably designed for their members.

Main findings revealed a general improvement from previous years, although there were some exceptions. Overall, 54% of members were in a scheme that met all of its applicable KGRs, and there was a strong correlation between the size of the scheme and the number of the governance requirements met, the same pattern emerging with the proportion of schemes meeting the expectations set out in the DC Code of Practice, with investment governance and administration the weakest areas.

DC Update (cont.)

* Source TPR's Quick Guide to the Chair's Statement – September 2018

Schemes of all sizes continue to find the value for member assessment challenging. Schemes were found to be lacking in their research and failed to take into account what the member valued were the stumbling blocks to meeting this requirement.

Significant improvements were noted in meeting the trustee knowledge and understanding expected standards, but compared to 2017, the number of schemes meeting the requirement to have a suitably designed default investment strategy decreased.

Chair's statement

Another area of continued focus for the Regulator has been the Chair's Statement. A revised Quick Guide and an accompanying Technical Appendix has been published by the Regulator. Included within the Appendix are example of common mistakes made since the introduction of the governance statement. These include*:

- The SIP for the scheme's default arrangement either has not been included at all, or only an extract has been included, or the trustees have merely confirmed that a copy is available on request.
- For the review of the scheme's default arrangement either a statement has been made that no review has taken place in this scheme year, but no date has been provided for when the latest review was carried out, or a statement has been made that a review has taken place, but no details have been provided regarding its outcome.
- Relating to the processing of core financial transactions, the administrators have confirmed that core transaction requirements have been met but no explanation has been provided as to how this has been established, or the accuracy of core financial transactions has been checked but makes no mention of timeliness.
- The value for members' assessment include a statement that the trustees believe that the charges represent value for members but no explanation has been given as to how this has been assessed.

Trustees have the task of not only ensuring good value for members in their retirement options with a constant review of the increasing number of products in the market, but also that their members understand the options available to them. Legislation requires more and more disclosure of costs, but are individual pension scheme members able to understand what can be complex and confusing information?

In August, the Work and Pensions Committee launched an inquiry on how individuals are able to understand the costs, performance and the concept of value for money applied to their pension savings.

Value for members continues to be a focal point, and is now one of the priorities for the recently announced FCA/TPR Joint Strategy, with a plan to develop a framework to assess value for money, including the setting and enforcement of clear standards and principles.

In this latest period of change, we have seen a number of new requirements either proposed and / or incorporated into the law and it looks like it will continue for some considerable time in the future.

Trustees' investment duties

Since the Kay Review of UK Equity Markets and Long-Term Decision Making published in 2012 which identified concerns about the interpretation of fiduciary duties as applied to investment, the Government has been considering amendments to the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378).

On 18 June 2018 the Department for Work & Pensions (DWP) published a consultation to seek views on changes to the Investment Regulations which are aimed at "clarifying and strengthening trustee investment duties". The consultation ran to 16 July 2018 and on 11 September 2018 the Government published its response. A few changes were made from the original proposals, as well as clarification being added that trustees have "primacy in investment decisions".

What are the new requirements?

From 1 October 2019 trustees will be required to update or prepare their SIP to set out how they take account of financially material considerations* over the appropriate time horizon**, including but not limited to those arising from environmental, social and governance (ESG) considerations, including climate change. This will replace the current requirement to state the extent (if at all) to which "social, environmental and ethical" considerations are taken into account.

* financially material considerations includes (but is not limited to) environmental, social and governance considerations (including but not limited to climate change), which the trustees of the trust scheme consider financially material;

** appropriate time horizon means the length of time that the trustees of a trust scheme consider is needed for the funding of future benefits by the investments of the scheme.

State the extent (if at all) to which "non-financial matters" *** are taken into account in the selection, retention and realisation of investments.

*** non-financial matters means the views of the members and beneficiaries including (but not limited to) their ethical views and their views in relation to social and environmental impact and present and future quality of life of the members and beneficiaries of the trust scheme.

In addition, the Statement of Investment principles (SIP) will have to include the trustees' policies in relation to the stewardship of their scheme's investments, including engagement with investee firms and the exercise of the voting rights associated with the investment.

An optional policy has been added to the original proposals on non-financial matters, including not only members' ethical concerns, but also social and environmental impact matters and quality of life considerations.

Trustees of "relevant schemes" (broadly DC schemes with few exceptions) will be required to publish their SIP on a publicly available website and inform scheme members of its availability in their annual benefit statement.

Trustees' investment duties (cont.)

From 1 October 2020 trustees of relevant schemes will also need to produce and publish an implementation statement setting how the extent to which the SIP has been followed, describing any review carried out, any changes made and if no review undertaken, the date of the last review. The implementation report is required to be published online as for the SIP and members made aware of its availability in their annual benefits statements.

TPR guidance on the key changes to the Regulations is expected before the end of the year and trustees are urged to discuss the new requirements with their advisers as soon as practicable.

Code of practice no. 15: Authorisation and supervision of master trusts

Since our discussion of the new Master Trust Authorisation and Supervision regime in our Spring 2018 edition of Regulatory Round-Up, there have been some further developments.

33 master trusts took part in The Pensions Regulator's ("TPR") voluntary readiness reviews where schemes received individual feedback commenting on whether the evidence provided to TPR would be sufficient for them to make an assessment. Following the readiness reviews, TPR published further guidance and some general feedback to provide master trusts with more information to help support their imminent registration applications.

TPR has now published its Code of practice no. 15: Authorisation and supervision of master trusts together with its Master trust authorisation: Decision-making procedure.

Authorisation

Authorisation began on 1 October 2018 and existing master trusts' trustees have until April 2019 to submit their applications to TPR. Master trusts that existed before 1 October 2018 need to pay a fee of £41,000 before applying for authorisation. If an existing master trust fails to make an application before April 2019, then this will generate a triggering event and the master trust will be required to follow continuity option one – wind up and transfer out.

A new master trust must pay a fee of £23,000 and must be authorised before it begins to operate. If a scheme commences to operate before authorisation has been achieved, it will experience a triggering event and automatically be required to follow continuity option one – wind up and transfer out.

Schemes should only apply when they are in the best position to demonstrate that their scheme meets all of the authorisation criteria as follows:

1. Persons involved in master trusts are fit and proper;
2. The scheme is financially sustainable;
3. The scheme funder must meet set requirements
4. The systems and processes used are sufficient to ensure the scheme is run effectively; and
5. The scheme has an adequate continuity strategy.

Supervision and enforcement

Following consultation, in October 2018, TPR released the Master trust authorisation: Supervision and enforcement policy which details TPR's approach to monitoring the on-going authorisation of master trusts.

The regularity and magnitude of TPR's interactions with master trusts will be driven by the risks and issues associated with them. Master trusts subject to the most in-depth supervision will be assigned a named lead supervisor.

Once a master trust has been authorised, those responsible for the running of the master trust will need to be able to provide comfort to TPR that the master trust is maintaining the authorisation criteria. Failure to continue to comply with the Code could result in TPR imposing their enforcement powers or taking regulatory action, this can include deauthorising of the master trust.

The master trust authorisation regime was designed and implemented to produce higher standards in the master trusts market and to ensure pension scheme members have equivalent protection to pension scheme members in alternative types of schemes.

EU withholding tax reclaims and the implications of a 'no deal' Brexit

Payments of dividends from certain EU territories to pension funds suffer withholding tax ('WHT') under the domestic law in force in each EU territory. These withheld amounts are usually only partially reclaimable through a Double Tax Treaty claim. Generally, domestic pension funds (or their equivalent entities) in these EU territories can either reclaim the entire amount or suffer no such WHT. These discriminatory rules are in breach of the EU principle of the free movement of capital and number of pension funds have secured repayments from a number EU jurisdictions. As a result of these claims, a number of EU countries have altered their legislation to reduce or eliminate the WHT suffered by foreign pension funds.

The basis of already-filed EU Law based WHT reclaims should not be affected by the coming departure of the UK from the EU. However, from 29th March 2019 the UK will cease to be treated as an EU Member State (subject to the terms of the exit deal). EU WHT claims are further progressed for EU Member States when compared to non EU Member States. Therefore even where a potential claim has not yet reached the statutory time limit, claimants may want to considering accelerating claim filings to ensure submission before 29th Match 2019 so claims benefit from the strongest possible arguments. Following the exit date (and any potential transitional period), UK resident funds should still be able to file claims as third country claimants (i.e. non EU Member State), which is the same basis as current US and Canadian pension funds.

It is also worth noting that post Brexit UK resident pension funds may no longer be eligible for the withholding tax exemption/reclaim in several EU territories as they may no longer meet the EU/EEA resident condition.

News in brief

New KPMG Accounts Guide

The new 2018 KPMG Example Accounts Guide has now been published and will be available on the KPMG website.

The Guide takes account of the recent changes to FRS 102 and the SORP and provides practical guidance on application.

GMP equalisation

On 26 October 2018 a judgement was reached in the High Court in the Lloyds Banking Group Pensions Trustees Limited v Lloyds Bank Plc GMP equalisation case.

The High Court has now ruled that:

- Schemes will be required to equalise for the effect of unequal GMPs accrued between 1990 and 1997;
- A range of methodologies are available, trustees should use the method which results in “minimum interference” with the rights of any party; and
- Back payments are applicable subject to any limitations in the scheme rules, with interest applied at 1% over the Bank of England base rate.

The judgement may be subject to appeal and this will be clarified in the next couple of months.

Budget October 2019 – Pension Highlights

Cold calling – a consultation response confirms the government will proceed with a pensions cold calling ban; regulations and guidance will be issued as soon as possible.

Lifetime Allowance – this will rise in line with formula to £1,055,000 for tax year 2019-20.

DC charge cap – the government will consult in 2019 on the function of the charge cap to ensure it does not unduly restrict use of performance fees within default arrangements.

Investment – the FCA will consult by the end of 2018 on updating the permitted links framework to allow unit-linked pension funds to invest in an appropriate range of patient capital assets.

Pension dashboards – there will be a consultation later this year on the detailed design of the dashboard, with implementation supported by £5m extra government funding.

Self-employed – the government will publish a paper this winter on its approach to boosting pensions saving amongst the self-employed.

Public service pensions – there will be a reduction of the discount rate for calculating employer contributions in unfunded public service pension schemes, to 2.4% plus CPI.

News in brief (cont.)

Securities Financing Transactions Regulation

The European Commission published the Securities Financing Transactions Regulation (SFTR) in January 2016. The regulation, applicable from Q2 2019, looks likely to apply to pension schemes and will require companies to report their Securities Financing Transactions (SFTs) which are defined as transactions which involve cash being borrowed against securities – such as gilt repos.

The main aim of the SFTR appears to be to increase transparency to regulators and investors on the use of SFTs, and specifically how the collateral is reused across multiple transactions (hypothecation) and the associated default risks that may accompany this.

The implementation of the Regulation coincides very closely with the UK's exit from the EU and therefore, as with so many other regulations, we will await further news on its impact for UK resident schemes. It seems likely, however, that there will be a resultant increase in the level of reporting and consequently costs: scheme trustees may wish to raise the issue with investment managers.

FCA and Pensions Regulator joint regulatory strategy for pensions and the retirement income sector

The FCA and the Pensions Regulator have published their joint regulatory strategy for pensions and the retirement income sector, which sets out their priorities for the next five to ten years, and how they will work together to address fundamental changes in the sector.

The strategy, which will be reviewed after three years, describes how the two regulators will work together and with other bodies to address the key and fundamental risk of inadequate income in retirement. Four areas of focus are identified:

- Access and participation - supporting people in saving for retirement.
- Funding and investments – ensuring schemes are adequately funded and invested.
- Governance and administration – promoting high standards of governance including value for money considerations.
- Consumer understanding and decision-making – facilitating the production of helpful communications enabling scheme members to make appropriate decisions.

Together with two new areas of focus looking at, firstly, the 'customer pensions journey' (consideration of disclosures and information made available to members) and, secondly, value for money for members, including the setting and enforcement of clear standards and principles.

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