



# How safe are your DC assets?

A report from the Security of Assets Working Party

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## (including AVCs and DC benefits of hybrid schemes)

“How safe are my assets?”

That’s a question few DC members have yet asked their scheme’s trustees - but it’s likely that more questions of this type will start to come your way as more people become members of DC schemes and members’ pot sizes grow.

So how would you as a trustee answer the question? We suspect that many trustees would simply say that the assets are covered by the Financial Services Compensation Scheme. But that may well not be the case and the levels of protection in place for members will depend on a number of factors including whether funds are held directly or on a platform and whether the funds are set up as “insured life” funds or structures such as open ended investment companies (OEICS).

This short guide is not intended to answer the question for you. It has, however, been produced to help you explore the types of questions you should think about asking your investment consultants, fund managers, platform providers and lawyers to help you improve your level of understanding of the protections currently in place for your members. It should also help you focus on some of the key areas to explore when seeking to change your platform provider or fund managers.

Why are we producing this guide now? There are three main reasons for this.

The first is the increasing number of people who are now members of DC schemes, particularly following auto enrolment. The second reflects the significant growth in master trust arrangements and the third is the requirement for trustees to understand this issue as part of their assessment against the Pensions Regulator’s Code of Practice 13 including, when published this summer, the revised version of that Code which is currently out for consultation.

What we don’t want to do with this guide is create panic and unnecessary stress for trustees – the risk of things going wrong is, in reality, very low – a “tail risk” in investment terms. However, what we do want to do is draw attention to the issue and make sure that protection is a factor that all DC trustees think about in managing their scheme effectively. Trustees may also want to think about how this is reflected in their risk register as well as in the scheme’s objectives.

We hope you find this short guide helpful. The Working Party that has produced this guide is continuing to explore the issue of security of assets with various industry bodies and hopes to provide regular updates to help you further understand this area.

**Barry Parr**

Chair, Security of Assets Working Party

*Members of the Working Party come from a range of funds, consultancies, pensions law firms and platform providers. Full details of the current members of the Working Party can be found at the end of this guide.*

## Background - why does this matter?

The security of member assets within defined contribution schemes has always been an important matter, as it has been for defined benefit schemes.

However, security of DC assets has received increased prominence over recent years, particularly as the Pensions Regulator included as one of the original 31 Quality Features an expectation that trustees understand the levels of protection available to members and carefully consider situations when compensation is not available, should something go wrong with either a platform provider or a fund which is used by a DC pension scheme (or DC benefits of a hybrid scheme or AVCs).

Whilst this seems like quite a simple thing to answer, the more you dig into this area, the more opaque things become. And it is an important issue – if funds failed in DB world, ultimately it would be the responsibility of the sponsoring employer to make good any losses. In DC world, those losses would be suffered directly by members, with no recourse to the sponsor.

And this issue is highlighted within the latest version of the draft DC Code of Practice 13, which is currently out for consultation. This states that “The law requires trustees to give due consideration to asset protection and to understand what would happen in the event of a problem.”

Given the complexity of this topic, the Regulator expects trustee boards to assess the extent to which, and in what circumstances, any loss of scheme assets might be covered by a compensation scheme, such as the Financial Services Compensation Scheme, indemnity insurance or similar arrangement and to communicate the overall conclusion about security of assets to members and employers”. This will undoubtedly be a challenge for Trustees to do.

## But I thought all DC members are covered by the Financial Services Compensation Scheme (FSCS)?

No.

This is a popular misconception but is, in fact, not true. Even where funds are invested via regulated markets (and the law requires scheme assets to be invested predominantly in regulated markets), the protection afforded to members will depend on a number of factors.

The questions we have set out below should help you explore with your advisers what protections are in place for your members, based on your scheme’s investment structure.

This guide does not constitute legal or investment advice – you will need to speak to your own investment consultants and legal advisers and, if appropriate, your platform providers and managers to help you understand your unique position.

But it will hopefully put you in a better position to build an answer to that “how safe are my assets?” question.

## So what sort of things do we need to consider?

Below, we have highlighted just a few of the many differences in protections for members that you will need to be aware of:

- 1) The FSCS covers long term direct insurance contracts. So for example, if trustees hold a direct insurance policy with a fund or platform provider the FSCS should provide protection (although this has never been tested in practice).

If trustees invest part of the scheme's assets through investment platforms the funds on the platform may be accessed through 'indirect' insurance contracts or structured as non-insured vehicles (e.g. OEICs or unit trusts) in which case those funds will not benefit from FSCS protection. However, in some circumstances, they could potentially provide a greater degree of protection as the assets are effectively "ring-fenced" within the OEIC structure.

- 2) Trustees increasingly structure their DC investments through a platform to ease aspects such as the white labelling of funds. A platform usually has multiple layers. The trustees have a contract with the platform provider and the provider accesses the underlying funds in a variety of different ways. It's important to note here that the trustees will not usually have a direct relationship with the underlying fund managers managing the funds offered to members. The arrangements of platforms and the underlying funds vary and these may have different levels of protection depending on their structure.
- 3) A separate point trustees should consider is whether there is any danger of "cross contamination" within the provider's life company from their other business lines (e.g. if they also offer annuity business, does this have some call on the same assets of the life business which could impact the trustees' investment?).
- 4) The FSCS states that "whether there is FSCS cover for a particular loss if a firm fails is determined by FSCS at the time of the failure in the light of the particular circumstances of the case and the law and rules at the time". So things could change over time (e.g. the level of protection for insurance contracts has recently been raised from 90% to 100% of the value of the insurance product).
- 5) Some insurance companies may stand behind losses in some of their own funds held on their platforms but not external life funds. This may be a key aspect to consider if you have significant investments, say, in index tracking funds that are not held on the passive manager's parent platform.
- 6) Trustees don't actually "own" DC assets held on platforms. They effectively hold a "promise" from either the platform provider or the fund manager they are directly invested with to the assets. Most trustees don't appreciate this point.
- 7) When moving platform providers, your new contract may have less "protections" in place than your previous one. Don't just read the application form – read (or better still get your lawyers and consultants to read) all the terms and conditions. Some platform providers have in place protections they'd rather not offer going forward – so you'll need to assess what change if any you will see in moving provider.

## This all sounds quite complex and scary – what can we do to help us understand how our members are protected?

Firstly, don't panic!

All trustees are in the same boat and even the Working Party don't yet have answers to all of the questions on this topic. There is further work to do but it makes sense now to start to understand what position your scheme is in, what questions you should be asking in relation to your current structure and what you should be mindful of if you are looking to change your arrangements going forward.

### Questions to ask

#### If the scheme is invested directly into funds (i.e. not via an investment platform):

- 1) How are the funds my members invest in set up (e.g. life funds/OEICS) and what security do my assets have in the event of your business failure?
- 2) If the funds are life-wrapped are they likely to be covered by the Financial Services Compensation Scheme? What level of compensation, if any, would our members be likely to get if something went wrong with one of the funds?
- 3) Does the fund allow gearing and, if so, to what extent? What could this mean for our members if things go wrong?
- 4) Is the fund segregated from the provider's or manager's other business? If not what other business does it have and is there a "cross-contamination risk"?
- 5) What jurisdiction is the fund manager regulated under and what does this mean for the fund in terms of the way it will be treated in the event of an occurrence such as fraud?
- 6) To what extent does the fund hold cash and is this routinely "swept up" with other cash and held overnight in the US? (If this is the case, the Patriot Act may come into play, ensuring the US citizens get first call on any assets in the event of a fund collapse)?
- 7) For life and non-life funds (as well as any funds used within the default strategy), who are the custodians and what controls are in place?
- 8) If With-Profits funds are offered to members, what protections are in place here that may differ from other funds (this is particularly the case for AVC schemes)?
- 9) What level of Professional Indemnity cover is held by the managers?

#### If the scheme is invested via an investment platform:

- 1) Is the platform structured as an insurance policy? (If not, the levels of protection at the highest level are likely to be less than they would be were the trustees to hold an insurance contract with the platform provider).

- 2) Is there any limit on liability of the platform provider built into the terms and conditions?
- 3) What legal structure is used for the funds used by the platform provider (i.e. are they set up as life wrapped funds or OEICs etc.?). Do we have funds with different structures and what could this mean for members holding different funds within the scheme?
- 4) If the underlying funds are set up as insured life funds, and are run by the same legal entity as the platform (e.g. ABC Investment Management funds on the ABC platform), will the platform provider stand behind the funds if they were to collapse for any reason or does the platform provider treat them as if they are external funds?
- 5) If the underlying funds are set up as insured life funds but are not run by the same firm as the platform (e.g. ABC Life funds sitting on a XYZ platform), what protections, if any, are in place?
- 6) Where the funds are insured life funds, does any other part of the relevant life business (e.g. annuity business) potentially have a call on any of the assets?
- 7) If the funds are not within an insured life wrapper, what jurisdiction is the fund manager regulated under and what does this mean for the fund in terms of the way it will be treated in the event of an occurrence such as fraud?
- 8) To what extent does the fund hold cash and is this routinely “swept up” with other cash and held overnight in the US? (If this is the case, the Patriot Act may come into play, ensuring the US citizens get first call on any assets in the event of a fund collapse).
- 9) For life and non- life funds (as well as any funds used within the default strategy), who are the custodians and what controls are in place?
- 10) If With-Profits funds are offered to members, what protections are in place here that may differ from other funds (this is particularly the case for AVC schemes).?
- 11) What level of Professional Indemnity is held by the platform provider?

**Additionally, for master trusts/multi-employer schemes:**

If schemes used by small employers (less than 50 members) are invested in the same way (i.e. on the same platform and in the same funds) as larger employers, will they all be treated the same way in the event of a platform or fund collapse?

**For investments in trustee bank accounts:**

What protection is available to the Trustees in the event of the collapse of the bank/other entity used to hold trustee funds (e.g. are trustees covered for the full amount or a lower amount e.g. the £75k for individual investors)?

## Security of Assets Working Party Members

- **Barry Parr** Co-Chair of the Association of Member Nominated Trustees and Trustee of The Pensions Trust
- **Anna Copestake** Senior Associate, Sacker & Partners LLP
- **Jane Kola** Partner, Wragge Lawrence Graham & Co LLP (Gowling WLG LLP from 22 February 2016)
- **Rona Train** Partner, Hymans Robertson LLP
- **Andy Cheseldine** Partner, Lane Clark & Peacock LLP
- **Michael Craig** Head of Product and Technical Consultancy, Standard Life

### Important information

This analysis may contain information of general interest about current legal and investment related issues, but does not give legal or investment advice. It is not intended to be a detailed or definitive statement of the matters relating to the security of assets for pension schemes. No liability or responsibility is accepted by any of the Working Party members – you should always seek your own professional advice.

This guide is aimed at trustees of occupational trust-based schemes and covers assets invested in defined contribution and AVC schemes. It does not cover the protections in place in relation to DB schemes. It does not constitute any form of advice (including legal or investment advice). The guide is based on our current interpretation of the position with respect to protections for DC members and is likely to change over time.

Many aspects in terms of the levels of protection for members remain unclear and trustees should always seek legal and (where appropriate) investment advice both in assessing the current structure for their scheme and making any changes to their structure or funds offered within the scheme. The questions highlighted above may not be sufficient for trustees to understand the levels of protection in all cases and further investigation may be needed, particularly where more esoteric funds are offered to members.