



Monitoring Changes in DC Asset Security

A report from the
Security of DC Assets Working Party

March 2018

How should trustees monitor and respond to potential changes in the security of their DC assets?

(Including AVCs and DC benefits of hybrid schemes)

In February 2016, our Working Party produced a guide for trustees on how to consider DC asset security. The guide, supported by the Pensions Regulator in its DC guide on investment governance, was produced to help trustees ask the right questions of their investment consultants, fund managers, platform providers and lawyers and to improve their level of understanding of protections in place for their scheme members.

In February 2017 we provided further guidance on how trustees might want to communicate their findings with scheme members.

Of course, very few things remain static and it is likely that the structures employed in a scheme's investment arrangements may change over time. This might be prompted by a change in the fund options or fund provider initiated by trustees themselves. However, it might also come about as a result of changes in the structures used by investment providers, even where the trustees themselves have not requested that any changes be made. Often the changes may seem innocuous, particularly in the latter case where the underlying investment strategy may be identical to that in place before the change. However, as those trustees who have dug into this issue know, asset security depends a great deal on the underlying legal structures of the investment arrangements used, so any change in those arrangements may have an impact.

In this guide we look at the sorts of changes trustees should look out for. This guide accompanies the working party's guide on how to assess asset security. It is not intended to provide an exhaustive list of every change which might affect a scheme's asset security position, but it may assist in identifying the most likely scenarios. As always, any change in the investment funds used or changes impacting the provider of those funds should be discussed with your investment consultants and lawyers to help you decide what impact it may have on your scheme. Depending on the nature of any change, the position previously communicated to scheme members may also need to be reviewed and updated.

As we have emphasised in our previous guides, asset security is important but it is also a very low risk in investment terms. However, it remains important that trustees are aware of the protections in place in managing their scheme effectively and that the position is kept under review where changes occur.

Rona Train

Chair, Security of Assets Working Party

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

What are the features of a scheme's DC asset security position that might be open to change?

As the asset security position for any given scheme will depend on the legal structures used for members' DC pots, the current asset security position is likely to vary from scheme to scheme. Trustees should first remind themselves of the structures employed in their own scheme and upon which any previous asset security review was based.

As a reminder, some of the key determining factors in any asset security review may include:

1) The legal structure of the underlying funds in which members' monies are invested.

Frequently these will be "life-wrapped" policies with an insurer (in which case the nature of the investment will be a contract with that insurer). However, that is not the only way in which an investment fund might be structured and there are other non-insured vehicles that might be used. These might include funds set up as open-ended investment companies (OEICs), or unit trusts (in which case the nature of the investment will be the ownership of shares or units in that fund). Increasingly use is also being made of Tax Transparent Funds (TTFs).

2) How the funds are accessed. Trustees increasingly structure their DC investments through a platform to ease aspects such as the white labelling of funds. In this case, trustees have a contract with the platform provider but the provider may access the underlying investment funds in a variety of different ways as described in 1 above.

The net result of 1 and 2 is that trustees must consider their asset security position in "layers". For example, trustees might have an insurance contract with their appointed platform provider but the underlying investment funds might be structured as OEICs. Alternatively, both the provider contract and the underlying investment funds might be set up as insurance contracts. The asset security position will be different for these different structures. To add further complexity, in many cases the structure might be a mixture, with underlying investment funds set up in a variety of different ways.

3) The financial strength of the fund or platform provider. Where the legal nature of an investment (or relationship with a platform provider) is based on a life insurance policy, the asset security risk will, in part, depend on the insurance company's financial strength. This should be thought of, not just in terms of their financial strength to provide the service or fund which the trustee might be accessing, but also whether there is any danger of "cross contamination" from their other business lines. In other words, if an insurance company providing money purchase funds to DC trustees also writes annuities to members of the public or even DB trustees, then as part of an asset security review trustees should consider whether that might also have some call on the same assets of the life business.

All of the above points may change over time. It is therefore important for trustees to understand the basis and legal structures on which any previous asset security review was based so that changes to that structure can be properly considered.

What changes should trustees look out for?

Trustees may themselves wish to make changes to the investment choices offered to members, to the composition of the default fund or even the provider through which investment funds are offered. All of these should prompt trustees to consider whether the change will have any impact on the scheme's asset security.

However, it is not just changes made by trustees that might have an impact. Providers may themselves make changes to the legal structure of investment funds or the way in which platform services are provided. There may also be other changes within a provider's business which have a knock-on impact.

If in doubt, trustees should check any change with their advisers but below are a few of the most common changes which might prompt trustees to review their understanding of a scheme's DC asset security position.

Some common "change" scenarios:

- 1. Addition of new funds to member choices** – DC fund choices for scheme members are unlikely to remain static over time for a scheme. Trustees have a duty to keep all funds offered to members under review and to make changes to those funds where it is appropriate to do so. This may be prompted by a fund's performance, its fees or a desire to add a new asset class to the range of funds on offer. Where a new fund is added, trustees should update their asset security review to take account of the legal structure of the new fund. Trustees also need to take care to analyse any situations where funds are closed by providers and examine the implications for members of any replacement funds.
- 2. Mapping existing funds to new funds** – As well as adding new funds to the range of member choices, trustees may want to move member monies from existing funds to new ones. Advice should always be taken on this process, but it should also act as a prompt to review any changes in the asset security position and this should be factored in to any decision to move.
- 3. Changes in composition of default fund** – It is possible that any default fund established by trustees may in fact be a combination of different funds. This may be particularly so in the case of any lifestyle arrangements under which members' investments will move over time between different funds and asset classes. Where the component parts of any default fund are changed then trustees should consider whether that could impact the asset security position of the default fund.
- 4. Changes to the legal structure of an existing underlying fund** – As we have seen, DC investments may be structured in a variety of ways, including: insurance contracts, Open Ended Investment Companies (OEICs), unit trusts and Tax Transparent Funds (TTFs). The asset security position will be different for each. For example, where trustees use an investment platform and access any underlying funds through 'indirect' insurance contracts the security of those funds may depend on the way in which the platform provider has established the reinsurance arrangement with the underlying fund provider. They are also unlikely to be covered by the Financial Services Compensation Scheme ("FSCS"). A number of providers have recently made changes to the arrangements they use, preferring instead to access underlying funds through OEICs, unit trusts or TTFs rather than re-insurance agreements. This might provide a greater degree of protection as the assets are effectively "ring-fenced" within the OEIC, unit trust and TTF structure. But things like FSCS protection may be different. Trustees should always

review any change to the legal structure of a fund with their advisers. It should never be assumed that just because the underlying investment strategy remains the same the asset security position will be too.

5. **Change to platform provider** - When moving platform providers, you should always review any new contractual terms carefully. Not all contracts or providers will offer the same levels of asset security. Trustees should consider with their advisers what, if any, changes in their asset security position may result from moving provider.
6. **Merger or transfer of provider business** – Providers come and go and it is possible that the company chosen by trustees to provide a fund or a DC platform service may be taken over or merge with another organisation. Initially there may be no changes in the trustee’s contractual terms or the entity with which those terms are made. However, over time trustees may be notified that their contract is being moved to another part of a provider’s business. When insurance companies make these changes this is often by way of a “Part 7” transfer. These take their name from Part VII of the Financial Services and Markets Act 2000 which is a statutory process which an insurance company must follow to transfer the provision of existing insurance contracts from one entity to another. The statutory nature of the process means that trustee consent will not usually be required and, although the process is designed to ensure that existing contracts are protected, trustees should not assume that the asset security position will necessarily be the same under the new terms. On being notified of any transfer of a provider contract trustees should speak to their advisers to make sure they understand the nature of the change and whether this may have any impact on their asset security position.
7. **Other changes** – Whilst the above changes are probably the ones most likely to arise in a DC scheme, this is not an exhaustive list and trustees should take care to read all communications from their appointed providers and underlying fund managers carefully. Other changes might include changes in the custody arrangements or other changes to third parties used by underlying pooled funds.

What to do if something changes?

The first thing to do with any change is to ensure that its implications are fully understood. If trustees have previously undertaken or commissioned an asset security review, then this should be revisited in light of the changes.

What trustees decide to do next will depend on the nature of the change and the trustees’ view of its implications. Some changes may be minor and might just be noted by trustees as updates to the asset security position. However, others may be more fundamental. Not all changes need to be accepted. If trustees are concerned that a change has a sufficiently negative impact on a scheme’s asset security position they may wish to make changes to mitigate against it. In extremis this might include ceasing to use a particular fund or provider.

Whatever the change, trustees should carefully consider any statements or summaries they may have provided as to a scheme’s asset security and update any wording as necessary. This might include information in a scheme’s statement of investment principles or arrangements, the Chair’s statement and any member communications in booklets, literature or websites.

What about changes in FSCS coverage?

On 30 October 2017, the FCA published its second consultation [CP17/36](#) in relation to funding of the FSCS. The consultation follows [CP16/42](#) published in December 2016 which sought views on how FSCS funding could be reformed. It also proposes an increase in the compensation limit for “investment business” from £50,000 to £85,000, in line with the current FSCS limit for deposits. The FCA have stated that they expect to publish a Policy Statement in the first half of 2018 containing new rules for implementation in the 2019/20 financial year.

Whilst this may have some positive impact in protecting DC members from bad investment advice, trustees should bear in mind that the protection from default for insured funds is provided under different FSCS rules. As noted above, funds accessed through indirect insurance contracts under DC platform contracts are unlikely to be covered against provider default under current FSCS rules. At the present time we are not aware of any policy proposals to change this position. Trustees should therefore, review this in the context of the circumstances of their own particular scheme.

Security of DC Assets Working Party Members

Barry Parr – Association of Member Nominated Trustees

Rona Train – Partner – Hymans Robertson LLP

Anna Copestake – Partner, ARC Pensions Law LLP

Andy Cheseldine – Capital Cranfield Trustees Limited

Stuart O'Brien – Partner, Sacker & Partners LLP

Jason Bullmore – Aviva

Hugh Skinner – Fidelity

Laura Myers – Lane Clark & Peacock LLP

Important information

This analysis might 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 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.