

Implementing IORP II in the UK

► In brief

- Directive introduces new governance and risk management requirements, including own-risk assessments
- Regulations implementing the Directive's governance and cross-border provisions come into force on 13 January 2019
- Governance requirements will largely be implemented through a revised TPR code of practice (from which schemes with fewer than 100 members will largely be exempt)
- Directive also requires provision of annual benefit statements
- UK pension schemes will only need to update their processes as and when legislation and/or codes of practice are updated to implement the Directive

► Next steps

- Trustees should consider reviewing how well they comply with the 21st Century Trusteeship programme ahead of the introduction of the revised code of practice on internal controls
- Trustees may also wish to consider what changes may be needed to implement an own-risk assessment when it is introduced

EU Member States have until 13 January 2019 to implement the IORP II Directive into national law. On 23 October 2018, the UK Government laid regulations before Parliament which will implement the Directive's governance and cross-border provisions. However, pension scheme trustees will not be required to make any changes by 13 January 2019.

Background

The European Commission first published its draft IORP (Institutions for Occupational Retirement Provision) II Directive in March 2014. After a lengthy negotiation process, during which many of the main concerns for UK pension schemes were addressed (in particular, the possibility of an onerous solvency funding regime for pensions was removed), the IORP II Directive finally came into force on 12 January 2017.

Initially there was some uncertainty as to whether the UK would have to implement the Directive as a result of Brexit. However, given that the two-year negotiation period following the triggering of Article 50 runs until 29 March 2019, and that Member States must incorporate the Directive into national law by 13 January 2019, the UK must still comply in some form. Over the last few months, it has become increasingly clear that the UK will be taking a relatively 'light-touch' approach to implementation.

On 23 October 2018, the Department for Work and Pensions (DWP) laid regulations before Parliament to implement the Directive's governance and cross-border provisions; these will come into force on 13 January 2019. As implementing IORP II is an action for Member States, individual pension schemes do not need to refer directly to the wording of the Directive. Pension schemes will only need to update their processes as and when UK legislation and/or codes of practice are updated to implement the Directive.

Governance provisions

The new governance regulations require trustees to establish and operate 'an effective system of governance including internal controls', which must be 'proportionate to the size, nature, scale and complexity' of the scheme's activities. The DWP does not envisage this will require pension schemes to make drastic changes as it believes that many schemes already operate effective governance as a matter of good practice.

The DWP notes that the governance elements of IORP II are aligned with the expectations set out in the Pensions Regulator's (TPR's) 21st Century Trusteeship programme. However, for many schemes, it seems likely that the new governance requirements will still require a step-change in approach, especially in terms of increased documentation. For example, TPR's recent research on defined benefit (DB) pension schemes showed that only 26% of schemes met all its 21st Century Trusteeship expectations (although 92% met at least half).

Revised code of practice

Whilst the regulations impose few new requirements on trustees directly, they set out the various matters that must be covered in a revised code of practice on internal controls to be issued by TPR. These include:

- what constitutes an effective system of governance;
- the key functions of a pension scheme (i.e. risk-management, internal evaluation of the system of governance and, where relevant, actuarial);
- the use of outsourcing; and
- remuneration policies (which will be completely new for most trustee boards).

Trustees must approve written policies in relation to key functions and outsourcing, and review them at least every three years.

The matters to be included in the code of practice largely repeat the provisions of the Directive, although there are some changes. In particular, the requirement in the Directive for schemes to have an 'internal audit function' is replaced with the vaguer wording 'function which internally evaluates adequacy and effectiveness of the system of governance'.

Most of these requirements will not apply to schemes with fewer than 100 members. TPR is also expected to review its codes of practice on defined contribution (DC) schemes, DB funding and master trusts to ensure that they reflect the requirements of the Directive.

Own-risk assessments

The revised code of practice must also specify how trustees should carry out and document an 'own-risk assessment of the system of governance'. This should cover (amongst other things) how the trustees:

- integrate the own-risk assessment into the management of the scheme and their decision-making process;
- assess the effectiveness of the risk-management system;
- prevent conflicts of interest with the employer (where key functions are outsourced to the employer or to the same person as the employer uses for that function (e.g. an audit function));
- assess funding needs and the risks to members relating to the payment of their benefits;

- assess operational risks; and
- take account of environmental, social and governance (ESG) factors in their investment decision-making.

The first own-risk assessment must be carried out:

- within 12 months of the last day of the first scheme year that begins after TPR has issued the code of practice; or, if later,
- by the date on which the trustees are required to sign off their next actuarial valuation or prepare their next DC Chair's Statement.

This could mean that, for some trustees of DB schemes, the date when they are first required to produce an own-risk assessment could be several years away, especially as TPR must consult formally on the code of practice, and lay it before Parliament before it can come into force.

Subsequent own-risk assessments must be prepared at least every three years.

Cross-border provisions

The cross-border regulations transpose the relevant provisions of the Directive into UK law, in particular in respect of cross-border bulk transfers. These changes are intended to ensure that the UK complies with the Directive on cross-border issues until the UK exits the EU, including during any implementation period.

Other IORP II provisions

Disclosure is another key element of the Directive, which requires all members to be given standardised annual pension benefit statements. It now seems clear that the Government will not be introducing any new legislation to implement this with immediate effect. Instead the DWP is more likely to address this through existing policies, such as the introduction of the 'simpler annual statement' (launched on 18 October 2018) and/or the pensions dashboards (which are currently being developed and on which a DWP consultation is expected later this year).

The requirement in the Directive for a scheme's Statement of Investment Principles to include how the investment policy takes ESG factors into account was covered separately by recent DWP amendments to the 2005 Investment Regulations.

For further information

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