

# **PENSIONS: INVESTMENT REQUIREMENTS**

**Government response to the consultation**

**THE OCCUPATIONAL PENSION SCHEMES (INVESTMENT)  
REGULATIONS 2005**

OCTOBER 2005

**DWP** Department for  
Work and Pensions

## **CONTENTS**

Introduction	3
Responses to consultation	4
List of respondents	10

## RESTRICTED – POLICY

### INTRODUCTION

1. On 21<sup>st</sup> March 2005, the Government undertook a consultation exercise on new regulations on occupational pension scheme investments that transpose into GB law the investment requirements at Articles 18(1) and 18(2) of the European Pensions Directive<sup>1</sup>. The consultation ended on 20<sup>th</sup> June 2005.
2. 32 written responses to the consultation were received. A list of respondents is at **Annex A**. The Government is very grateful to all who contributed to the consultation. Their comments have been very helpful in finalising the draft regulations.
3. The Occupational Pension Schemes (Investment) Regulations 2005 will be laid shortly.
4. The regulations will be available on HMSO's website at <http://www.legislation.hmso.gov.uk/stat.htm#2005>.
5. This document is available on the Department's website at <http://www.dwp.gov.uk/consultations/2005/index.asp>
6. A paper copy of this document can be obtained from:  
Alan Napier  
Department for Work and Pensions  
3<sup>rd</sup> Floor  
Adelphi  
1-11 John Adam Street  
London WC2N 6HT  
Email: alan.napier@dwp.gsi.gov.uk
7. This document describes the policy underpinning the changes being made. Comments on the regulations should not however be taken as an authoritative interpretation of the law. Such an interpretation can only be provided by a court.

---

<sup>1</sup> Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision

# RESTRICTED – POLICY

## RESPONSES TO CONSULTATION

### Introduction

1. This document sets out the issues raised in response to the consultation exercise and provides the Government's response.
2. Although there was a general welcome for the Government's policy of not adding further regulatory burden, concerns were expressed that the draft regulations' copy-out approach to transposition of the Directive might lead trustees to adopt excessively cautious investment strategies by failing to make it clear which investments were and which were not permitted. A number of correspondents requested that the regulations were accompanied by guidance to help trustees with some of the unfamiliar terms transposed from the Directive.
3. The Government does not believe that a further tier of financial services guidance would be helpful, particularly as trustees are already required to seek advice on the suitability of investments, but the regulations that will be put before Parliament will take account of many of the comments made in response to the consultation.
4. This response may be taken as an indication of how the Government plans that the regulations should work in practice.

### Specific comments and the Government response

**The requirement that investments are made in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole**

5. Respondents were concerned that by requiring investment powers to "be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole", the regulations appeared to impose a duty on trustees & investment managers to *ensure* that the portfolio was both liquid and profitable. It was pointed out that the wording in Article 18(1)(b) of the Directive was balanced by Recital 33 of the preamble, which made it clear that "as very long-term investors with low liquidity risks [pension schemes] are in a position to invest in *non-liquid* assets such as shares as well as in risk capital markets within prudent limits". In addition, respondents pointed out that the fundamental obligation of a scheme was to meet its liabilities, not necessarily to make a profit.

*The term "security, quality, liquidity and profitability of the portfolio as a whole" is taken directly from the Directive, where it is used to give expression to the "prudent person principle". The requirement for "prudence" is already a central feature of trust law and it is not the Government's intention to place a higher duty of care upon trustees than that which already exists. By requiring that investments are made not only "in a manner calculated to" ensure the security,*

## RESTRICTED – POLICY

*quality, liquidity and profitability of the portfolio as a whole, but also with regard to the scheme's expected liabilities, the regulations will focus on the matters trustees should consider when making investment decisions, rather than judging them against the outcomes of the overall investment strategy.*

6. The view was expressed that requiring a delegated fund manager to have regard to requirements of the draft regulation took no regard of the development of the market practice of specialist mandates, whereby a manager would be bound by the investment management contract entered into with the trustees, and could not undertake the overall responsibility for compliance with the regulation. It would therefore be difficult to see how one manager alone could ensure all of these characteristics are satisfied in respect of the "portfolio as a whole".

*The requirements on delegation are carried forward from the current requirement at section 36(2) Pensions Act 1995, which requires trustees or (as the case may be) the delegated fund manager to have regard to:*

- *the need for diversification of investments, in so far as appropriate to the circumstances of the scheme, and*
- *the suitability to the scheme of investments of the description of investment proposed and of the investment proposed as an investment of that description.*

*Fund managers are required by the law to comply with the regulations only where they have the discretion to do so, and, in addition, they can exercise only those discretions that have been delegated to them. Clearly, fund managers with specialist mandates cannot exercise their discretion in relation to the whole portfolio. As now, it would be for the trustees to consider the position with regard to the fund as a whole.*

### **The requirement to invest predominantly on regulated markets**

7. Respondents had concerns that the regulation transposed certain expressions directly from the Directive without offering definitions. For example, the regulation requires assets to be invested "predominantly on regulated markets" without defining the term "predominantly". Fears were expressed that as a result direct investment in property, private equity, hedge funds, and assets transacted on an OTC basis would be severely curtailed. Similarly, there was no definition on what was a "prudent level" in terms of investments not held on regulated markets.
8. Further concerns were raised that the definition of regulated markets used in the draft regulations had been overtaken by that used in Directive 2004/39/EC on markets in financial instruments (MiFID), and that a definition based on the wider concepts therein should be substituted for that in the draft regulations.

## RESTRICTED – POLICY

*The Government wishes to continue to allow trustees the choice of the widest range of investment opportunities, and indeed neither the Directive nor the regulations in any way **preclude** investment in any particular class of assets.*

*We take the view that defining the terms "predominantly" and "prudent levels" in regulations would set an arbitrary limit on the proportion of a scheme's total assets that must be invested on "regulated markets". The Government has no wish to impose such a limit - not least as it would place trustees in the position of having to consider an adjustment to their portfolio merely to ensure that the proportion of assets invested on and "off" regulated markets was kept within the legislative limits. The inclusion of the terms "predominantly" and "prudent levels" indicate that were all investments held outside "regulated markets", trustees would risk being held to breach the regulation unless their circumstances are unusual.*

*The regulations will be amended to:*

- take account of the framework for financial services laid out in MiFID;*
- make it clear the investments in "regulated markets" include investments in assets "admitted to trading" on such markets; and*
- take account of the position of schemes in wind-up.*

### **The use of derivatives**

9. Respondents were concerned that the draft regulations defined neither the term "derivative instruments" nor "efficient portfolio management" – particularly as the terms are defined in relation to the rules for both collective investment schemes and insurance companies. One respondent was concerned to have received legal advice that the regulations would prohibit certain existing investment strategies, another that the regulations should make clear that they allow transactions that are entered into "for the purposes of" risk reduction or efficient portfolio management even if the outcome may not always be as originally planned.

*The terms "derivative instruments" and "efficient portfolio management" will be defined in regulations:*

- "derivative instruments" in terms of the arrangements listed in MiFID<sup>2</sup>; and*
- "efficient portfolio management" to include an intention to reduce risk and costs or generate additional capital or income with an acceptable level of risk (it remains for the trustees or delegated fund manager (as appropriate) to determine the level of "acceptable" risk based on the particular circumstances of their scheme).*

### **Borrowing and acting as guarantor**

10. The interaction between regulation 5, which restricts borrowing and prohibits trustees acting as guarantor also caused concern, respondents

---

<sup>2</sup> see MiFID Annex 1 Section C.

## RESTRICTED – POLICY

wanting reassurance that the regulation would not affect activities such as gilt repurchase agreements, non-financial borrowing, swaps, derivative instrument and borrowings by scheme subsidiaries, nor the use of borrowing or derivatives in indirect investment vehicles such as pooled funds, hedge funds and property unit trusts.

*Section 36A of the Pensions Act 1995 allows regulations to impose restrictions on trustees' or fund managers' ability to borrow money. The restriction in regulation 5 is thus limited to cash borrowing. It is not the Government's intention to restrict the activities in the example given above. We believe that defining the term "derivatives" will help to clarify the position legislatively.*

11. Clarification was sought as to the meaning of "acting as guarantor", particularly in relation to non-cash guarantees and as to whether the practice of guaranteeing third party borrowing in private equity and PFI projects was permitted.

*We understand that Article 18(2), by prohibiting the institution from acting as guarantor for a third party would prevent trustees, or as the case may be the delegated fund manager, from guaranteeing another party's borrowing. The regulation will be amended to clarify that the trustees, or delegated fund manager may not guarantee the liabilities of another person.*

### **The Statement of Investment Principles**

12. Respondents requested clarification on the requirement to state the scheme's "risk measurement methods and risk management processes".

*The regulations will be amended to require that the statement includes trustees' policy on risk, including information on the ways in which risk is measured and managed. This makes clearer that schemes may adopt risk management methods appropriate to the circumstances of their particular scheme.*

### **Wholly-insured schemes**

13. Concern was expressed that the definition of a wholly insured scheme was more restrictive than that used in the current regulations, and that such schemes must maintain a statement of investment principles. Respondents also noted that the new requirements would come into force with no transitional period.

*In the light of these, and similar comments, we have simplified the definition of "wholly-insured scheme" and the regulations will treat a policy of insurance both as being an investment on a regulated market, and as fulfilling the requirement for "diversification".*

*We note, however, that Article 12 of the Directive offers no exemption from the requirement to maintain a "statement of policy principles". The Government recognises that trustees of a wholly-insured scheme are unable to comply with*

## RESTRICTED – POLICY

*the detailed requirements of the article, and the regulations will require them instead to state simply the reason why the scheme invests solely through policies of insurance. A wholly-insured scheme with fewer than 100 members will be exempt from the requirement.*

### **Schemes with fewer than 100 members and small schemes**

14. Respondents commented that it was unclear why the regulations distinguished between “small schemes” and “schemes with fewer than 100 members”, given that any scheme with fewer than 100 members was exempt from the Directive.

*Currently, small self-administered schemes (SSASs) are exempt from much of pensions legislation. A SSAS, however, is a tax concept, which will disappear from 6th April 2006. The regulations use a standard definition of “small scheme” which will appear throughout pensions legislation to preserve the current exemptions that a SSAS enjoys.*

*In addition to small schemes, the Government wishes to take advantage of the general exemption at Article 5 of the Directive for schemes with fewer than 100 members. The regulations, in effect, ensure that, where appropriate, such schemes continue to be governed under the original requirements at sections 35 and 36 of the Pensions Act 1995.*

### Employer-related investments

15. Concern was expressed that Article 18(1)(f) of the Directive (restricting the investment in relation to employers within the same group to 10%) had not been transposed.
16. Respondents noted the anomaly that although “small schemes” could continue to act as guarantor in certain “directors’ schemes”, the draft regulations effectively prohibited schemes with fewer than 100 members holding similar investments, despite the general exemption from the Directive. Respondents also noted that the transitional provisions introduced in April 1997 cease from 2010.

*The Government considers that section 40 of the Pensions Act 1995 already imposes a stricter requirement than the Directive, and has no wish to change the current requirements.*

*We recognise that the withdrawal of the transitional arrangements for pre-owned investments may lead to schemes being required to dispose of assets in what in other circumstances may be considered an “imprudent” manner. Given the current arrangements already protect the financial health of schemes, the regulations will be amended to allow the current transitional provisions to continue.*

## **RESTRICTED – POLICY**

### **Thanks**

17. We are most grateful to everyone who took the time to comment on this consultation document.

## RESTRICTED – POLICY

### List of respondents

ABI  
ACA  
Actuarial Profession  
APL  
APT  
AXA  
Barclays Capital  
Barnett Waddingham  
BPF/IPF/RICS  
Bristows  
Electricity Supply Pension Scheme  
Hermes  
Hewitt Bacon and Woodrow  
HSBC  
Hymans Robertson  
ICAEW  
IMA  
Independent Trustee Group  
ISDA  
KPMG  
Lane Clark & Peacock  
Law Debenture  
Law Society of Scotland  
Mercer  
Merchant Investors  
NAPF  
Norwich Union  
Royal Mail Pensions  
S A Brain & Co Ltd  
SPC  
Standard Life  
Watson Wyatt