EXPLANATORY MEMORANDUM TO

THE OCCUPATIONAL PENSION SCHEMES (INVESTMENT) REGULATIONS 2005

2005 No. 3378

1. This explanatory memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Description

2.1 These regulations transpose the requirements of Articles 12, 18(1) and 18(2) of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision “the Directive”. The provisions include the provision of a statement of investment policy principles and the investment of assets within the “prudent person principle”.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 The regulations impose new requirements on occupational scheme trustees concerning their statement of investment principles and the manner in which scheme assets are to be invested.

3.2 These regulations are made under powers contained in sections 35, 36, and 36A, and 40 of the Pensions Act 1995. Powers to make the regulations were introduced in the Pensions Act 2004 by:

- section 244, which substituted a new section 35;
- section 245, which amended section 36 to provide a regulation-making power on choosing investments; and
- section 246, which inserted a new section 36A to provide for regulations on trustees’ powers to borrow or act as guarantor for third parties.

4. Legislative Background

4.1 Sections 33 to 36A and 40 of the Pensions Act 1995 contain the provisions for trustees’ duties on investment matters. These regulations set out the detailed requirements on the contents of the statement of investment principles and investment choices, and provide restrictions on employer-related investments. They replace the Occupational Pensions Schemes (Investment) Regulations 1996 (SI 1996/3127) “the 1996 regulations”.

4.2 Regulation 2 transposes Article 12 of the Directive. It largely reproduces the original requirements of section 35 of the Pensions Act 1995 and regulation 11A of the 1996 regulations, with the following changes:

- the statement must be reviewed triennially and revised without delay after any significant change in investment policy;
- in addition to their policy on risk, trustees must include information on the ways in which risk is measured and managed; and
- the requirement that the statement should include trustees' policy on compliance with the statutory provisions on scheme funding has been dropped as section 223 of the 2004 Act requires trustees to maintain a statement of funding principles.

4.3. Regulation 4 transposes the requirements of Article 18(1)(b-e) of the Directive, the wording of which, as far as practicable, has been reproduced. The regulation requires investments:

- to be made taking into account both the long-term health of the fund and its expected liabilities;
- to be made predominantly on regulated markets;
- to be properly diversified.

The regulation modifies these requirements in two situations:

- any investment in a collective investment vehicle (for example a unit trust) is treated as an investment on a regulated market to the extent that the underlying investments are so invested; and
- any investment in a relevant policy of insurance is treated as fulfilling both the "regulated markets" and the diversification requirements. This is because we consider that the Life Directive[1] imposes an equally stringent regulatory regime on insurers, and therefore there is no regulatory gap.

The regulation also allows the use of derivatives for risk reduction or "efficient portfolio management".

4.4 Regulation 5 transposes the requirement at Article 18(2) by prohibiting trustees from borrowing money or acting as a guarantor for a third party. It does allow trustees to borrow for the purpose of fund liquidity, and on a temporary basis.

4.5 Regulation 6 extends the current disapplication from the requirement to have a statement of investment principles to schemes which have less than 100 members, and continues the exemption for schemes with a public authority guarantee, as permitted under Article 5.

4.6. Regulation 7 also takes advantage of the provision of Article 5 of the Directive to disapply the detailed investment requirements at regulations 4 and 5 to trustees of schemes with fewer than 100 members, albeit requiring such trustees to have regard to the need for appropriate diversification.

4.7 Regulation 8 modifies the requirements for the statement of investment principles at regulation 2 for "wholly-insured schemes".

4.8. Regulation 9 provides for a partial disapplication of regulation 4 in respect of schemes which are in wind up.

[1] Directive 2002/83/EC concerning life assurance

Regulations 10 to 16

4.9. These regulations carry forward the existing requirements on "employer-related investments" at regulations 2 to 9 of the 1996 regulations.

Regulation 17

4.10 This regulation disapplies certain exemptions with regard to schemes that undertake cross-boarder activities.

Regulation 18

4.11 This regulation revokes the 1996 regulations and amending regulations.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

Summary of Policy

7.1 Article 18(1) of the European Pensions Directive requires institutions, when making investment decisions, to follow a "prudent person principle" and sets out rules to give effect to the principle - in particular, by requiring institutions to ensure that:

- assets are invested in the best interests of members and beneficiaries;
- assets are invested in a manner to ensure the security, quality, liquidity and profitability of the portfolio as a whole;
- assets are invested mainly on regulated markets (those that are not must be kept to prudent levels);
- any investment in derivative instruments contributes to risk reduction, or efficient portfolio management;
- assets must be properly diversified;
- investment in the sponsoring undertaking are no more than 5% of the portfolio as a whole.

7.2 Article 18(2) of the Directive prohibits institutions from borrowing or acting as a guarantor for a third party. It does allow member states to permit some borrowing for liquidity purposes on a temporary basis.

7.3 The combination of the domestic common law duties of prudence - often called the “prudent man of business test”, and the statutory requirements in the Pensions Act 1995 and the Financial Services and Markets Act 2000, may be said to ensure that investment decisions made by occupational pension schemes would be already compliant with both Art.18(1). However, on the basis of ECJ rulings, legal advice is that, to ensure transparency, there need to be specific statutory “hooks” for implementing European Directives - reliance on common law is insufficient, and compliance with the Directive must be demonstrable in regulation.

7.4 In transposing the Directive’s requirements into domestic legislation, the Government has had regard to the need allow trustees the widest possible latitude in making investment decisions commensurate with the principle of prudence and demonstrable transposition.

Consultation

7.5 A thirteen-week consultation exercise was conducted earlier this year seeking comments on the draft regulations. 32 responses to the consultation were received. Four topics attracted the most comment: the general approach taken on the transposition of Article 18(1) of the Directive; the provisions on scheme borrowing and acting as guarantor; “employer-related” investments; and the proposed modification of the regulations in respect of certain schemes and exemptions in respect of others. Amendments were made to the regulations as a result, although the overall policy intention has remained unchanged. The comments received are discussed in the Government’s response to the consultation, available at: http://www.dwp.gov.uk/consultations/2005/index.asp

8. Impact

8.1 The impact of the changes was included in the Regulatory Impact Assessment (RIA) considering the Directive’s implementation into UK legislation published on 24th June 2004. The relevant extract from the RIA is found at the end of this memorandum.

8.2 There are no public sector costs.

9. Contact

Alan Napier at the Department for Work and Pensions Tel: 020 7962 8476 or e-mail: alan.napier@dwp.gsi.gov.uk can answer any queries regarding the instrument.

Extract from the Regulatory Impact Assessment considering the Directive's implementation into UK legislation activities and supervision of Institutions for Occupational Retirement Provision

"5. Investment – Articles 12 and 18

Article 12 – Statement of Investment Policy Principles

41. The Government's initial assessment of the legislation on Statement on Investment Principles (SIPs) was that it complied with Article 12 of the Directive, except that it needed to be modified to introduce a requirement for schemes to update their statements of investment principles triennially. It was estimated that this new requirement would result in policy costs of around £0.2 million per year, across, all schemes. This was based upon 25% of occupational schemes with between 12-99 members updating their SIPs less than triennially, 12% of schemes with between 100- 499 members updating their SIPs less than triennially, and 2% of schemes with between 1,000a and 4,999 members updating their SIPS less frequently than triennially.[2]

42. Schemes with less than 12 members are exempted from producing a SIP currently and will continue to be exempt from this requirement.

43. To generate an estimate of the impact of requiring the schemes above to review their SIPS triennially, it was assumed that such schemes currently review their SIPs every 6 years on average – i.e. half as frequently as they will be required to do so under the Directive.

44. The costs of reviewing these SIPs more frequently will depend upon the administrative arrangements in place with specialists such as investment managers. It has been assumed that, on average, updating a SIP takes one day of a pension manager's time, and half a day of an investment manager's time for larger schemes (over 100 members). Smaller schemes are likely to spend far fewer resources updating their SIPs, perhaps only half an hour of the manager's time, on average. On this basis, and using the information in the table above, the total estimated implementation cost to schemes of this requirement are estimated below. Note that the costs have been averaged per year even though the SIP only has to be updated every 3 years.

Table 2

Scheme size (total number of members)	Number of schemes	Annual cost to schemes of requirement to update SIP at least triennially (£m)
10,000+	0	0
5,000 – 9,999	0	0
1,000 – 4,999	20	neg
100 – 999	680	0.2

[2] GAD Occupational Pension Schemes Survey 2000, Table 7.6, results for private sector schemes only

12 – 99	2,900	neg
TOTAL	3,500	0.2

45. The Government has estimated the potential impact across different sized businesses. This has led it to conclude that for all sizes, the impact is likely to be minimal (less than 0.1% of the total costs associated with the pension scheme).

46. The consultation confirmed this view. Other than the change to regulations outlined, no other changes will be necessary to comply with this Article of the Directive.

Article 18 – Investment rules

47. The Government's implementation plans for Article 18 have changed as a result of legal advice, although this should have minimal impact upon UK investment practice. In order to satisfy good practice in implementing European legislation, including the caselaw of the European Court of Justice, it will be necessary to provide specific implementing legislation for the articles of the Directive.

48. Those elements of Article 18(1) which are not currently found in domestic legislation will now be incorporated through regulations. We do not envisage that these will have any great impact on the current investment practice of schemes, as trust law, which is the basis of pension scheme establishment in the UK, already effectively requires schemes to invest in a prudent manner.

49. Responses to the consultation paper indicated that existing legislation already covers the requirements of the Directive with regard to scheme's investment in the sponsoring company or group of companies. No new legislation will therefore be introduced, and there will be no additional costs to pension schemes or sponsoring employers.

50. On borrowing, responses received to the consultation paper confirmed that there will not be significant costs to business from the requirement for pension schemes to cease borrowing (except where it can be justified on temporary and liquidity grounds). The responses received indicated that it would be unusual for a scheme to currently justify borrowing as prudential unless it was on temporary or liquidity grounds. The overall policy cost of this Article should therefore be negligible but there may be non-negligible costs to individual schemes.

51. The Government will issue draft regulations for consultation on these provisions.

Costs / Benefits

52. The costs and benefits of this article have been considered above."