

## A quick guide to the security of DC assets

What protection is available for DC assets in the event of provider failure, or the failure of the other parties involved in the product? This question is becoming more important as members' DC pots grow in size, and in light of wider market volatility and economic conditions, but it's not a straightforward one to answer.

This quick guide sets out an overview of the ways in which protection may be available for DC assets (including AVCs in an otherwise DB arrangement) held in funds on a provider's platform. The position may differ in the less usual case where investments are held directly by trustees.

### What the Regulator expects, and what trustees should do

The 2016 DC Code sets out the Regulator's expectation that trustee boards will 'assess the extent to which, and in what circumstances, any loss of scheme assets might be covered by indemnity insurance or similar arrangement, or a compensation scheme such as the Financial Services Compensation Scheme'. Trustees are also expected to communicate their overall conclusion about the security of assets to members and employers. However, determining the nature and extent of asset protection can be a complex task, and in providing information to members, trustees should take care not to provide conclusive statements regarding the availability of the Financial Services Compensation Scheme (FSCS).

The key issue is that different forms of protection may apply to assets held in different investment structures, so it's crucial for trustees to analyse and understand the structures involved in any existing or proposed new offering. The exact position regarding where the credit risk lies will ultimately depend on the nature of the product offered, and how it is structured – for example, as a pooled investment such as an open-ended investment company (OEIC), or via a provider's insurance platform. DC trustees commonly offer funds via an investment platform in the form of an insurance policy provided by their chosen investment manager – but again, protection may vary depending on whether the provider is UK-based and/or UK-regulated (for example, a non-UK insurance platform provider will be subject to different compensation arrangements).

Trustees and their advisers should carefully analyse the structure of the DC arrangements including the underlying investments on a platform and the risks associated with these structures. Unravelling the various layers of asset security in these structures and the multiple counterparties can be difficult. The scheme's fund manager, in conjunction with your legal advisers, should be able to help you establish the facts and identify the extent of protection available and any outstanding risk, including any impact from other funds offered by the same provider.



## Asset protection mechanisms

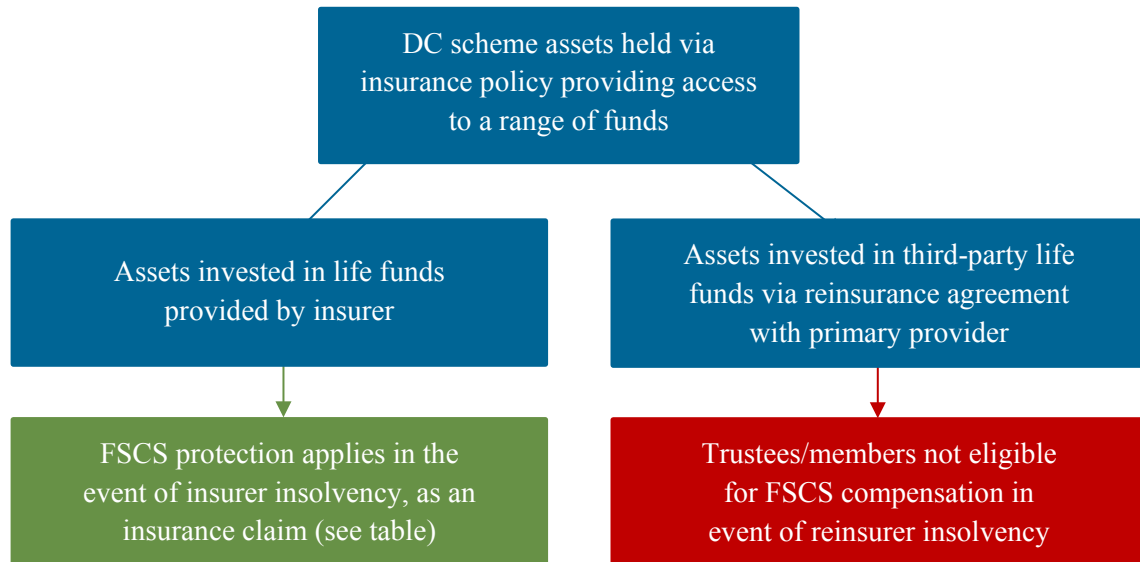
### 1. Financial Services Compensation Scheme

The FSCS is a statutory compensation scheme of last resort for clients of authorised financial services firms who have suffered financial loss where a firm is unable or likely to be unable to pay claims against it. The criteria for FSCS protection are complex, and the availability of and limits on protection will depend on the type of claim or investment involved.

In relation to occupational DC schemes, the FSCS will look through to individual members and treat them as claimants for the purpose of calculating compensation (even if the trustees actually make the claim). This means that claim limits will apply on a per member basis.

Claim	FSCS compensation	Conditions
<b>Insurance claim against insurer under pension fund management/life policies</b>	Subject to the FSCS first trying to secure continuity of insurance, there is no upper limit on compensation; but eligibility depends on the existence of a direct relationship with a UK regulated insurer.	Cover applies in relation to claims under a contract of long-term insurance, including annuities and investment management contracts, where scheme assets are managed by an insurer which becomes insolvent, subject to valuation rules and other conditions.  FSCS compensation is <b>not</b> payable to trustees where loss is owed to a platform provider rather than directly to the scheme (eg funds accessed via reinsurance – see chart below).
<b>Investment claim against UK-regulated adviser/fund manager</b>	In principle, up to GBP50,000 per affected DC member, where trustees have a claim against the manager of a failed fund, for example as a holder of fund units. However, FSCS compensation will <b>not</b> be payable to trustees where shares/units are held indirectly via an investment platform provider.	Where compensation is available (eg trustees are direct investors in a fund), eligibility depends on having a valid civil claim for eg misleading advice or fraudulent conduct by a UK-regulated adviser/fund manager operating in the UK, with investment loss traceable to a right of action against FSMA-authorized firm.  FSCS does not cover eg investment performance failing to match guarantee or representation.
<b>Cash deposit compensation</b>	FSCS compensation may be available in some circumstances, for example where the bank is a member of the Deposit Guarantee Scheme, up to GBP75,000. See also the section on cash deposits, below.	Trustee bank accounts are only protected where the scheme sponsor has a turnover of EUR50 million or less.

*How might FSCS compensation apply to investments on an insurance platform?*



Even where the FSCS compensation applies (for the purposes of long-term insurance), there is a risk that under FSCS valuation rules, the FSCS manager will not put the same value on a claim as the trustees or a member. In addition, in some circumstances payment may be reduced, deferred or delayed – this may lead to difficulties where the trustees still remain liable (for example, to pay a transfer value or cash lump sums/drawdown) in the interim.

FSCS limits and eligibility criteria change over time, so periodic monitoring is required.

## 2. Contractual protections

As indicated in the table above, where DC investments are held via an investment (rather than an insurance) platform, FSCS compensation is normally unlikely to be payable to trustees/members. However, that doesn't mean that assets are unprotected. The platform provider may offer an indemnity under its contract with the trustees or a contractual undertaking to pursue the underlying third-party managers for enforcement. Trustees should check and if possible re-negotiate their contractual arrangements with the platform provider to establish whether, and in what circumstances, any such protection (or structural protections – see below) would apply in the event of default. Trustees should check, for example, whether any indemnity applies only to the platform provider's own-managed funds rather than to funds managed by third parties (as these are managers with whom the trustees have no contractual relationship).

Where funds are held under an insurance arrangement, and members may invest in third-party life funds which are structured as reinsurance, FSCS compensation will not apply in the event of the insolvency of the reinsurer – see diagram above. Trustees should confirm with the primary insurer what steps it has taken to mitigate its own risk of loss in relation to reinsurance arrangements.

Trustees considering a change of platform provider (or a change between investment and insurance platforms) should ensure that they consider contractual protections as a key part of their due diligence – it may not be appropriate to change platforms if there is a material adverse impact on the protection available to the scheme in the event of provider failure. Trustee due diligence should include checking the applicability and level of insurance cover held by fund managers/custodians for errors and omissions, to ensure that it is adequate in relation to the value at risk. Trustees should also obtain an undertaking from the platform provider to monitor the underlying managers on an on-going basis.

### 3. Structural protections

In some cases, scheme assets may be protected through segregation or ring-fencing – for example:

- Funds held as client money by an FCA-regulated UK adviser: the fund manager will open a client money account with a bank; funds will be segregated from the fund manager's own monies. This will normally protect scheme assets if the fund manager becomes insolvent. However, it does not protect against the insolvency of the bank.
- Pooled fund investments, such as UK umbrella OEIC (also known as ICVC) investments: in this case, assets are protected as a result of internal ring-fencing through the protected cell regime. Under this regime, an umbrella OEIC's sub-funds are segregated portfolios of assets; the assets of each sub-fund belong solely to that sub-fund individually and cannot be used to discharge the liabilities or claims of any other person, body or sub-fund.

### 4. What about cash?

In most cases, so-called 'cash funds' are not in fact held in cash but are funds predominantly invested in other very liquid assets. Normally, cash will actually only be held during transition periods, for example where members are switching between funds. It's worth noting that, in the absence of other protection, a scheme may be exposed during transition periods because the member is still entitled to the completion of his transfer even if loss occurs – trustees should ensure that member investment switches proceed as smoothly and swiftly as possible.

FSCS compensation for cash deposits is restricted in a number of ways, including the size of the scheme sponsor and the amount of cash held (see the table above). Where trustees may have eligible aggregate deposits, it's worth noting that FSCS compensation is also restricted by reference to individual banking licences, and a single licence may cover multiple banking brands. Where relevant, banking arrangements may need to be restructured to optimise FSCS coverage.

Alternatively trustees could consider not maintaining cash deposits but converting these into money market funds to diversify risk.

## Communicating with members

The Regulator's view is that trustees' assessment of the level of risk, and any measures taken to reduce it, should be communicated to members, and that trustees should be prepared to provide further information if members request it. Changes to the level or availability of protection should also be communicated promptly and these can be integrated with wider communications to members. Trustees should take care to strike a balance in communications to members and employers about asset security, to avoid causing undue alarm.

Where the level of protection varies on a fund by fund basis, trustees may wish to consider whether this is sufficiently described in the fund information which is provided to members as the basis for them to make their investment choices.

## What to do next

Our checklist of questions (see final page) is a starting point to obtain relevant information from providers, fund managers and investment advisers.

Armed with this information, trustees then need to obtain a legal review as appropriate and consider whether any outstanding risks are acceptable within their overall strategy, or whether they should take action to mitigate risks further. Trustees should then review the information which is provided to members (both generally and on request): Is it accurate? Are any outstanding risks appropriately described?

Finally, trustees should monitor protection levels on an ongoing basis – for example, FSCS compensation thresholds are likely to change in connection with preparations for or implementation of the UK's exit from the European Union.

Our pensions and investment specialists can help you analyse and improve the security of your scheme's DC assets. For more information, contact one of our experts:



**Maria Stimpson**  
Partner – Pensions  
Tel +44 20 3088 3665  
[maria.stimpson@allenovery.com](mailto:maria.stimpson@allenovery.com)



**Däna Burstow**  
Partner – Pensions  
Tel +44 20 3088 3644  
[dana.burstow@allenovery.com](mailto:dana.burstow@allenovery.com)



**Neil Bowden**  
Partner – Pensions  
Tel +44 20 3088 3431  
[neil.bowden@allenovery.com](mailto:neil.bowden@allenovery.com)



**Jane Higgins**  
Partner – Pensions  
Tel +44 20 3088 3161  
[jane.higgins@allenovery.com](mailto:jane.higgins@allenovery.com)



**Pavel Shevtsov**  
Partner – Investments  
Tel +44 20 3088 4729  
[pavel.shevtsov@allenovery.com](mailto:pavel.shevtsov@allenovery.com)



**Paul Sampson**  
Senior Associate – Investments  
Tel +44 20 3088 4255  
[paul.sampson@allenovery.com](mailto:paul.sampson@allenovery.com)



**John Goodhall**  
Partner – Investments  
Tel +44 20 3088 2506  
[john.goodhall@allenovery.com](mailto:john.goodhall@allenovery.com)



**Stephen Richards**  
Senior Associate – Pensions  
Tel +44 20 3088 2025  
[Stephen.Richards@allenovery.com](mailto:Stephen.Richards@allenovery.com)



**MaameYaa Kwafo-Akoto**  
Associate – Investments  
Tel +44 203 088 3516  
[maameyaa.kwafo-akoto@allenovery.com](mailto:maameyaa.kwafo-akoto@allenovery.com)

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## Questions to ask providers, fund managers and investment advisers

- Cash in trustee bank accounts (only where scheme sponsor has turnover of EUR50m or less)** – Is the deposit holder an authorised deposit-taker in the UK (or EEA branch), so that deposits fall within the scope of the deposit protection regime?
- Cash held by advisers/custodians** – Is this covered by the FSCS? If not, what forms of protection apply (for example, client money rules/insurance)?
- Funds on a provider's platform** – Is the platform structured as an insurance policy or another investment product?
- Is there any limit on provider liability, and does this vary from fund to fund (for example, does the provider offer an indemnity in relation to all its funds on the platform, or only in relation to internally-managed funds)?
- Investment products** – Are available investment options structured as pooled investment vehicles (eg OEICs), insurance linked products or other investment product types?
- What security is available in the event of business failure? Are funds relating to investment business segregated from other business of the same provider/manager?
- Insurance products** – Are particular investment options made available via reinsurance policies?
- Is trustee consent required if the provider seeks to pass on reinsurance risk?
- What steps has the primary insurer taken to mitigate the risk of reinsurer default?
- Investment/fund manager** – What level of professional indemnity cover does the manager offer, and in what circumstances does this apply? Under what jurisdiction is the manager regulated and what impact could this have on trustee/member protection?
- Counterparty risk** – What contractual or structural protections are available in cases where FSCS cover does not apply?