Institute and Faculty of Actuaries

Quality standards in workplace defined contribution pension schemes

DWP: call for evidence

Consultation Response

9 September 2013

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Institute and Faculty of Actuaries

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09 September 2013

Dear Ms Fortune

Call for evidence: Quality standards in workplace defined contribution pension schemes

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to this call for evidence. This response has been prepared by members of the IFoA who have experience and expertise in defined contribution (DC) pension schemes.

Governance

Q1) What are the essential features of good governance?

The introduction of the Pensions Regulator's (tPR) new DC code of practice sets a framework for improving governance standards. IFoA believes that the presence of a governance committee that is independent, transparent and accountable and which: engages with scheme members; demonstrates consistent professional oversight; and is empowered to make decisions and/or recommendations regarding members' best interests, is the most important feature of good governance.

The autonomy required allows the committee to:

- take independent advice;
- regularly carry out reviews of the providers and/or advisers;
- regularly review scheme management information to ensure that there are no underlying issues affecting the current arrangements;
- give proper consideration to the key aspects of the scheme that affect good member outcomes; and
- have awareness of and, where appropriate balance, the needs of the employer.

Members of the governance committee should have clarity about the role and responsibility of the committee, and understand their roles; these should be outlined in the committee's Terms of Reference. This enables members to be aware of any potential or actual conflicts of interest and the appropriate procedures for dealing with them. Good governance would require all members to receive appropriate training and to be aware of and consider current legislation, as well as best practice in DC schemes.

A governing body should have a key aim to act to improve members' outcomes, which can often be constrained in both trust and contract based arrangements by a range of internal and external factors.

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The presence of a strong governance structure is not by itself going to lead to larger DC pots or better outcomes for DC members as all of the different governance bodies have barriers that prevent intervention. Irrelevant of the focus on members' interests, where contribution rates are low the implication for decent retirement incomes would not be avoided through organisation, good decision-making, careful review or member communication.

Whilst focusing on good outcomes would be the correct approach, IFoA suggests that some work is needed in trying to define and measure what a good outcome is i.e. the extent to which governance, investment default option, administration, scale, legislative minimum standards (plus any other factors that could be controlled by the governing body), can really have a positive impact or influence on such outcomes being achieved. While it is reasonably straightforward to identify a number of factors that would result in an adverse outcome, the absence of a 'bad' outcome does not automatically mean that the outcome was good.

Structurally, trust based schemes are well set up to address the challenges of good governance. However, we would question whether this translates into the required level of autonomy needed for the governance committee to be able to truly independently review all aspects of the scheme, for example the investment and administration providers.

There may be a greater challenge for contract based schemes. There are cases, particularly amongst larger employers, where advice has been taken and a governance structure implemented, where many of the features of a good governance structure are present. However there are a large number of, usually smaller, companies that are reliant on their provider to implement good governance. Where the onus lies with providers to balance members' interests (as per the FCA's Treating Customers Fairly rules) against commercial and regulatory considerations, there is greater potential that this could lead to conflicts of interest.

We note the discussion in the call for evidence (paragraphs 3.2 to 3.4) regarding membership of the governing body. We believe the independence of the governance committee would be enhanced by having sufficient independent membership.

Q2) How does the presence of these features affect the decisions taken about running a pension scheme?

We believe the features outlined above would ensure that the committee could promptly identify any governance issues while empowering it to act. Good governance ensures that decisions will be in the members' best interests and not overly focused towards company considerations. The role of the committee in taking proactive decisions regarding the running of the scheme would be through regular consideration of scheme governance matters. The features of good governance set out in response to question 1 would ensure that the decisions taken reflect current legislation and best practice. A governance committee should be equipped and empowered to make decisions that maximise beneficiaries' welfare, while monitoring and managing risks associated in achieving the desired outcome.

Currently, good governance does not always translate to improved outcomes. In many cases this is due to cost limitations and a restraint on the committee's ability to take action. The DWP may wish to consider that the introduction of standards does not necessarily encourage the implementation of good governance, but rather a tick box compliance approach.

Q3) How many schemes currently exhibit these features?

The IFoA is not in a position to provide a detailed answer to this question. However, the members involved in the drafting of this response have provided an indication of situations where such features are not displayed.

<u>Trust based schemes</u>
While trust based plans are more likely to exhibit such features, particularly where the scheme is solely DC, where trustees also have responsibility for Defined Benefit (DB) schemes, often DC is not given the full attention it deserves because legacy DB issues dominate meetings.

<u>Contract based schemes</u>
In terms of contract based schemes, it is more common for larger schemes to have a form of governance committee. Management committees are rare at the smaller end of scheme size.

We are aware that, where schemes have input from a corporate pensions adviser, schemes are more likely to exhibit these features, as they would be discussed as part of the advice process. In a personal pension contract based environment however, it would be common for the committee to make recommendations to the company but not be able to act on them directly. There will be many contract based schemes that do not have independent committee oversight through their employer. In these cases, it is expected that the provider will execute a minimum level of governance, but they will be unlikely to display all of the features of good governance. The issue of affordability and feasibility for governance structures in some contract based schemes does not mean that good governance does not have a place. If there is an assumption that providers will provide a minimum level of governance, this should be explicit and schemes should be encouraged to implement employer led governance where possible, to benefit from more features of good governance, especially those features surrounding independent review of investment and administration of the scheme.

<u>Master Trusts</u>
In Master Trusts, the governance committee has a responsibility that covers many of these features. However, there can be concerns that governance is not truly independent. For example, in those instances where the governance committee believes it would be in the members' interests to move investment or administration providers, what power does the governance committee have in practice?

Q4) What are the barriers to exhibiting these features?

The current economic environment makes it difficult for many employers to allocate time and money to good governance within DC if they are not required to do so, particularly in the case of personal pension contract based arrangements. This reduced requirement has been cited as a major reason for choosing contract based provision.

It is not apparent that employers understand the benefits of good governance for both the company and scheme members. The lack of understanding corresponds to a lack of knowledge about the issues that should be considered. Consistent professional oversight comes at a cost but not all companies are willing, or perhaps able, to pay for it. If members benefit from an external layer of governance that adds value and improves outcomes, then perhaps there should be a sharing of the costs. This has not been consistent with the focus of 'driving down charges'. It may be beneficial for DWP to alter the outlook from 'driving down charges' to investing in a structure that will result in more positive outcomes (or a reduced risk of poor outcomes) by requiring that all arrangements demonstrate good governance.

The combination of these factors contributes to inertia towards the implementation of a good governance structure.

A governing body, having evaluated the effectiveness of a provider, is constrained in terms of the changes that can subsequently be made. If the employer were to change provider it can do so more easily for future contributions, although moving the existing assets may be more difficult. Deferred members have been less well served - although “pot follows member” should help, even though there will still be significant assets in ‘legacy’ arrangements when the thresholds are exceeded.

Other barriers include the perceived legal risks of straying into personal advice and the potential implications or repercussions if the actions taken do not deliver the anticipated results. As already discussed, some providers may have conflicts of interest by nature of their business models and so it is very difficult for them to resolve these. Even where good governance structures are in place for personal pension schemes, the committee may only have the power to make recommendations rather than to act on them directly.

Q5) Given what we say about what good governance should achieve, what would the impact of the suggested approaches be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

There would certainly be a cost impact of increased governance, particularly for small companies. Whilst IFoA would not advocate for the evolution of a two-tier system that imposes conditions or standards on schemes dependent on their size, whilst exempting others, we suggest the introduction of guidance regarding the expectations of different sized companies as a potential pragmatic solution. For example, schemes that have fewer than a specified number of members may have to provide a suitable minimum level of governance, which increases as the size of the scheme membership grows.

The introduction of a standardised minimum level of governance may introduce its own problems as there is a risk that companies will aim for the minimum level necessary. With this approach, the company specific considerations for each group of members’ best interests could be lost.

The ability of the governance committee to freely exercise its duty to act in members’ interests would not be appropriate in all circumstances. This feature would invalidate many of the governance committees in place for companies with personal pension arrangements and for providers of Master Trusts. There is a valid place for governance structures within these environments which do not have this level of autonomy. In all cases there must be a clear level of guidance for all schemes (both personal and occupational), on the key areas that must be reviewed and considered by a governance committee.

It is important to identify who should deliver this for multi-employer schemes and how certain aspects (e.g. the requirement for the default to be appropriate to the needs of the members) can be managed within that framework, if the workforces of the various employers have fundamental differences in their requirements and expectations. If they cannot be managed, such a requirement may not be suitable in the first instance.

Investment – default options

Q6) The default option guidance covers the key steps in governing; designing; reviewing and communicating the default option. Does this cover the most important steps or are there others missing?

As guidance focused solely on the design of a default option, the key points are covered. However, there are a number of requirements which are not explicitly covered in the guidance that providers might consider:

- The use of benchmarking for monitoring adherence to the scheme's objectives;
- The operational characteristics of the default funds, for example; liquidity/ dealing frequency and the suitability of the investment wrapper(s) being used;
- The security of the firms providing the investment management services used in the default;
- The competence of those individuals involved;
- The level of time and resources dedicated to the design of the default; and
- The optimisation of retirement income after the accumulation stage (i.e. OMO, income drawdown).

The communication to members will require an element of performance reporting. Performance reporting needs to serve different purposes:

- comparison against indices to establish reasons for out and under-performance, for which a gross figure is needed;
- comparison with other funds on a meaningful and like-for-like comparison, for which some standardised net figure is needed; and
- consideration against internal objectives i.e. members needs, which requires a net figure after all fees have been deducted for their particular scheme, reflecting the member journey from joining to retirement.

Further guidance on how to determine what is 'appropriate for members', such as objective setting, would be helpful for governing boards, management committees, employers, providers and advisers.

Q7) How far is this guidance followed and is it followed by all schemes (e.g. older schemes)?

The May 2011 default option guidance is specifically directed at automatic enrolment pension schemes; therefore, there is a greater possibility that it is not followed by older schemes. The reason for that will differ from scheme to scheme, but possible reasons may include that they do not have a default option, or because it is stated as not being relevant to them. It is worth noting that the response to this question generally applies to trust based schemes.

<u>Governing</u>

We have already mentioned that trustees of different pension schemes give different levels of attention to different facets of scheme governance. Our members consider that trustees are increasingly recognising that ongoing governance of their scheme is a necessity and are meeting quarterly or even more frequently.

As DC arrangements are becoming more prominent, trustee attention has become more focused on DC matters than previously. Where a single trustee body governs both the DB and DC arrangements of a single employer, DC only sub-committees are becoming more common, as is more time being dedicated to DC matters at the trustee meetings. Similarly, there has also been an increase in the number of sub-committees dedicated to different aspects of scheme management, for example, investment, communications and risk management.

<u>Designing – Objectives</u>

Generally, scheme objectives are communicated widely by means of factsheets, member communications and the SIP. This communication is clear and accurate.

Designing – Suitability
Ascertaining the needs of the membership can be a complicated exercise. For example, members may face changing risk and return objectives as they age. Whilst the default scheme cannot reflect each member's individual circumstances, trustees are giving more attention to the needs of the membership. This has been driven partly by a desire to provide the best outcome for employees and partly from the increased focus on membership needs through guidance and industry trends.

The ways in which trustees ascertain the needs of their membership varies by scheme. Some schemes may carry out membership surveys, others may engage with representative groups of employees/ ex-employees and others may employ Investment Consultants who have developed bespoke default designs focused on membership needs.

However, while the practical solutions may vary, the increase in the prominence of DC has meant that trustees are increasingly considering membership needs as a key determinant of their default investment strategy.

Designing – Affordability
Trustees are conscious of the fees levied on members and often push to lower the various sources of cost. However, it is recognised that increased sophistication, arising from the desire to have a scheme that better meets member needs, may come with increased charges (i.e. through the use of active multi-asset funds).

While some consideration is given to the absolute level of fees levied to members; trustees are focusing more on ensuring that value for money is provided, net of fees. Cost/ benefit analyses are often undertaken to ensure that the benefits of a more sophisticated investment strategy outweigh any higher costs (if applicable). Performance (e.g. on member factsheets) is generally shown net of Total Expense Ratio (TER)/ Ongoing Charges Figure (OCF) to reflect the member journey and both Annual Management Charge (AMC) and TER/ OCF are typically shown alongside each other with equal prominence.

Designing – Managing Risk
Trustees are moving away from monitoring investment returns in isolation. Where more sophisticated investment strategies are adopted, both risk *and* return objectives are becoming more prevalent reflecting principles such as the following:

- Maintaining purchasing power of member pots over the long term, both in real terms and in relation to annuity prices;
- Providing a smoother member journey;
- Measures designed to reduce disengagement among members (e.g. limit absolute losses); and
- Decreased prominence (if used at all) of relative performance indicators (i.e. performance relative to a market index).

Objectives are designed to dovetail with the investment strategy and are considered to be achievable given the assets used, charges etc. The quantification of risk should also be communicated to members (i.e. on factsheets).

The way in which an investment strategy takes into account the retirement profile of members varies by scheme. Some element of risk (and therefore expected return) reduction is typically incorporated as members age. The degree to which this occurs (i.e. gradually during the whole working lifetime of a member, or in the final years before retirement) depends on the sophistication of the scheme.

Reviewing

Formal investment strategy reviews, which include a review of performance and continued suitability of the investment strategy and objectives, tend to be carried out at least every three years, although this would be subject to budgetary constraints (as explained in the response to question 8). Any change in the scheme would typically be communicated as part of the implementation of such a change.

Ongoing governance, such as investment performance monitoring, would be carried out at quarterly trustee meetings, subject to the restrictions set out in question 8.

For contract based schemes, the review process is probably the least robust/frequent as making changes post installation may be difficult. In practice, an adviser appointed to set up an arrangement may not have ongoing connection with either the scheme or the employer.

Communicating the default option

Communication is issued to members around any change or implementation of a new default option, including the detail listed in paragraph 46 of the guidance.

The details listed in paragraph 47 are typically contained in a scheme's SIP. Some of these may also be communicated as part of the default implementation communications strategy (particularly around the explanation of the investment strategy).

Communications are designed to be clear and concise and with an understanding of the media available to members.

Formal compliance with guidance

Trustees who place more emphasis on governance can formally document their adherence to the guidance. Some trustees have gone so far as to publish (e.g. on a member website) written statements of compliance with each individual point in the guidance provided by DWP, tPR, or other regulators to give members comfort that appropriate care and attention is given to the scheme.

Alternatively, trustees may view adherence to guidance as the Investment Consultant's responsibility and, as a result, not formally report on their compliance. The Investment Consultant would then be expected to bring any major deviation from the guidance to the trustees' attention.

Q8) What are the barriers to following the guidance?

The main barriers to following the guidance for trust based schemes are:

- time and cost;
- the impact of the cost of the changes combined with a reluctance to pass on the transaction cost to members; and
- where single trustee boards govern both DB and DC arrangements, often the DB scheme receives the majority of attention.

For contract based schemes, the main barrier is that there is no power that would enable an employer to make a change to current funds on the advice of the governing body, without individual member agreement (though pot follows member will reduce this issue to a degree).

Smaller schemes generally have limited options of making their default fund bespoke and instead may have to accept whatever the provider offers as the default, even if their membership were to be identified as requiring something different.

While DC has become more prominent in recent years, some employers are discovering a sudden and often new cost for DC which they are not accustomed to paying. Redesigning basic, outdated DC schemes in favour of new, more sophisticated, member-need driven designs can often be influenced by budgetary constraints.

Trustees may view the guidance as too lengthy and as a “tick-box exercise” without any value and are therefore not willing to formally adhere in the absence of compulsion, even though the spirit of the guidance is generally followed (as set out in our response to question 7).

Q9) Given what we say about how default options should be designed and reviewed, what would the impact of the suggested approaches be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

Setting the requirements as legislative minimum standards would further bolster the suitability of default options for single-employer trust based schemes. However, we believe some aspects would be more difficult to apply in a multi-employer arrangement, in particular aligning the interests of members where they come from workforces with different or even opposing interests.

The problem of not being able to make changes arises if the default is judged to be unsuitable. Consideration could be given for employers to have the power and statutory protection to (on the advice of the governance body) change the default fund for existing assets without requiring member consent. An exception would be in place (where possible) where the member has ‘self-selected’ a fund other than the default fund. Employee opt-outs should be routinely available, where possible.

Option 1 - Default options are designed in the interests of members, with a clear statement of aims, objective and structure, and how these are appropriate for the membership.

Option 2 - The characteristics and net performance of the default option are regularly reviewed to ensure alignment with the interests of members, and action is taken to make any necessary changes.

<u>Option 1</u>
“Default options are designed in the interests of members…”
Focusing on member needs rather than member interests may be more suitable and consistent with other guidance.

While there is a need for wording to encompass a wide range of arrangements, this clause could run the risk of encouraging a tick-box exercise for schemes to explain why they are designed in the interests of members. Instead, providing some more detail around this clause, such as some of the points in the guidance (e.g. manage risks, reflect a high-level objective which itself is designed to meet member needs, take into account retirement profile of members etc.) would be more suitable. At the same time it would not be so specific as to inhibit innovation (while also changing the emphasis from “interests” to “needs”).

“… with a clear statement of aims, objective and structure…”
We support the use of this clause. These items are contained in a scheme’s SIP and as a result, should not be onerous. The requirement to state these upfront and with clarity will provide transparency and encourage more trustees to rethink the design of their default strategy on a triennial basis without the compulsion to change if this option is not available (i.e. due to budgetary constraints). However, the legal requirement for statements to be “clear” could provide some confusion. All communications should aim to be clear and in the absence of specific direction, this is difficult to quantify or formally adhere to, without the use of a communications specialist. Such additional expertise may not be available to smaller schemes and those with fewer resources.

"… and how these are appropriate for the membership."
It could be difficult for a scheme to formally claim to be appropriate for the entire membership. Instead this clause could be altered to "… and how these are considered appropriate by the trustees for the majority of the membership".

Option 2
"The characteristics and net performance of the default option are regularly reviewed…"
A formal investment strategy review is often a large exercise; however, aligning with the existing guidance of a review at least every three years is helpful (assuming that is the intention). This would be consistent with the frequency of DB valuations, recognising the greater significance of the DC market as a whole. Triennial DC strategy reviews are occurring more frequently in the marketplace, so this should not place an additional burden on well-maintained schemes.

While a triennial strategy review would be considered a good thing given the speed at which platform provider sophistication, industry standards and investment manager DC focus are all changing, requiring such a review under legislation could impact schemes with budget limitations. Consideration could be given to allowing schemes 5 years to carry out their first strategy review from the point at which any legislation is introduced.

Reviewing net performance is a strong approach which reflects the complete member journey and better aligns performance monitoring with the needs of the membership. This is carried out more frequently and would be a helpful legislative requirement without imposing additional costs on schemes.

"… to ensure alignment with the interests of members…"
We refer to the comments made for Option 1.

"…and action is taken to make any necessary changes."
Further detail should be provided to give clarity to schemes requiring changes and to facilitate those where it is not possible to do so, for example:

- consideration could be given to altering this clause to a "best efforts" basis; and
- the timescale over which changes are required should be specified (and should be sufficient to design, implement and communicate changes).

It should also be clarified that this requirement is in relation to a formal strategy review or long term inappropriate performance. The current wording could lead to short-term performance issues necessitating wholesale changes, which would not appear to be the intention.

Q10) Which stages of administration and record keeping are so critical to get right, in terms of a member's final pension pot, that they should be set in legislation?

The most critical areas are those relating to financial transactions, as any issues may have direct financial impacts on members' pots.

Q11) How far are these stages completed accurately and by how many schemes?

IFoA believes that the existing combination of legislation, FCA requirements and tPR's initiatives are already having the desired effect. In addition, there is already a large degree of auditing carried out to pick up any errors and further legislative intervention may not be necessary.

Q12) What are the reasons for mistakes occurring and how could these be avoided?

Examples of the cause for mistakes occurring are:

- solutions/processes that have been rushed through without sufficiently rigorous testing;
- incomplete automated solutions/processes that require manual intervention; and
- inadequate maintenance of systems.

These could be avoided through the provision of sufficient notice for any legislative change giving providers the opportunity to take considered action.

Q13) Given what we say about administration and record keeping, what would the impact of the suggested approaches be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

The areas that DWP has suggested for consideration by the governing body would encourage improvement by those providers/ administrators who fail to meet best practice, as such, failures may result in an inability to retain business. Market perception can have a great impact in this area.

There will likely be many more financial transactions as a result of the automatic transfers regime. However, we do not consider that underpinning legislation would necessarily have an effect here. Instead the new model, fully automated and fully tested, needs to be supported by the industry. Sufficient time will need to be given to companies to prepare so that manual processes are avoided as a fall back.

Q14) What are the advantages and disadvantages of small and large schemes?

Whilst we agree that there are some advantages in a scheme having scale (e.g spreading the fixed costs of governance, pooling of investments) there are also disadvantages. Examples of these include losing some of the ability to create a bespoke default fund to suit the membership profile, or lower costs of governance/ administration may mask inferior performance in other areas.

Small schemes can have the potential to deliver good member outcomes and it may not be beneficial to members for legislation to directly or indirectly cause small schemes to move to larger arrangements. If a small scheme satisfies tPR's quality standards then it can be used as an automatic enrolment scheme and an automatic transfer scheme.

Q15) What options do smaller schemes have to access scale, how far are they already achieving this, and what are the barriers to this?

Small schemes can already access scale in terms of investment options, by means of pooled investment funds. A bundled solution may also provide access to costly systems, the cost of which can be spread across all customers.

The main barriers that we see to existing small trust based schemes moving further towards a bundled larger-scale solution are:

- the DC section sits within a much larger trust, with a legacy DB section;
- the belief that trust based schemes will deliver better outcomes; and
- the effort and costs associated with effecting a large-scale change.

Q16) Given what we say about scale, what would the impact of the suggested approach be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

Those actively involved in the running of the scheme, whether trustees or providers, may not be best placed to determine whether members are disadvantaged as a result of a scheme's size. However, it is definitely a consideration that should be within the remit of a governing body.

General approach to legislative minimum standards

Q17) Do the suggested approaches work together as a package to achieve our aims?

We welcome the overall approach, but as discussed above there are specific issues that may require further consideration.

The suggested approaches are based on extending current legislative provisions to alternative pension structures. We believe issues may arise relating to applying, for example, the requirements of the SIP regime to workplace personal pensions.

As pension's law is complex, there is a risk that adding more legislation to pension schemes may add additional cost which would ultimately be borne by the individual members or employers. It may be more appropriate to provide a regulatory framework around governance and investment rather than a legislative framework. However, some form of legislative control over charges may be appropriate.

Q18) Are there any other areas that standards should cover?

Although the call for evidence notes that decumulation is to be covered elsewhere, the importance of that issue cannot be overlooked.

The conversion of a pension pot to an income for retirement is the key factor in producing good member outcomes. Development of the market should be encouraged as there is a restricted supply of suitable products available to allow a competitive market to produce the desired outcomes.

Decumulation is as important as both investment and charges. Innovation should be encouraged to allow product providers to offer appropriate contracts for those who do not want, or cannot manage, drawdown.

Our response to question 19 sets out further factors in relation to minimum standards of qualification for governance purposes.

Q19) How could compliance with the standards best be evidenced and monitored?

We note that the FCA and tPR have a joint responsibility for workplace pensions. It is important that both regulators work together to develop a consistent approach for all schemes.

We believe the Disclosure of Information Regulations should be used to ensure an open and transparent approach is taken to compliance.

The proposal to include independent third parties (as with non-executives) may help with issues of transparency; in addition, the inclusion of a proposal for 25% of the governance body to hold an appropriate qualification is also pertinent.

We believe the Government should engage further with the industry to establish what an "appropriate qualification" would look like, ensuring that the major governance and professional bodies have an opportunity to contribute towards setting an appropriate minimum standard qualification for independent entities to achieve.

If you wish to contact the IFoA about this response, please contact Philip Doggart, Policy Manager, in the first instance. You may contact him on 0131 240 1319 or Philip.Doggart@actuaries.org.uk.

Yours sincerely

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