

Summary of the Pensions Regulator's Consultation Paper on Scheme Governance

Introduction

The Pensions Regulator recently published a consultation paper entitled “**The governance of work-based pension schemes**”. In this consultation paper, the Regulator lays out its governance priorities and approach to regulation for both trust-based (defined benefit (DB), defined contribution (DC) and hybrid) as well as contract-based (eg group personal pension and stakeholder) pension schemes.

At the same time, it also published another report “**How the Pensions Regulator will regulate defined contribution schemes in relation to risks to members**”. This report follows on from the Regulator's consultation document issued in November last year setting out its views on the main risks to members of DC schemes and how it thought they should be mitigated. In its recent report, the Regulator summarises the feedback received from various organisations across the industry, (including insurers, pension professionals and third party administrators) and gives its response to that feedback.

The Regulator's growing interest in, and comments concerning, DC is equally relevant for trustees of DB schemes running money purchase AVCs as it is for anyone involved in running a pure DC scheme.

We summarise both the report and discussion paper below.

1. The governance of work-based pension schemes

This paper sets out the Regulator's seven “priorities for regulation” and those aspects of good practice that it considers should be of interest to all those involved in pension provision – employers, providers, advisers and, as applicable, trustees.

The “priorities for regulation” are:

1. Knowledge and understanding
2. Conflicts of interest
3. Monitoring of employer covenant
4. Relations with advisers
5. Administration
6. Processes for investment choice
7. Governance during wind-up

Whilst the document covers all types of pension scheme, the majority of our DB clients are unlikely to find much in the report that they have not already considered – although it does act as a useful reminder for DB trustees of the key issues. Perhaps more importantly, most clients are likely to find the comments in relation to DC and money

purchase AVCs more challenging to their current practice and therefore we focus more on this area in the following summary.

(a) Trust-based schemes

The document focuses mainly on trust-based schemes and devotes a chapter to each of the priorities and contains one or more case studies to illustrate the points the Regulator wishes to make. It refers to existing guidance and tools relevant to the particular topic together with any additional proposals the Regulator is considering.

Throughout the discussion paper, the Regulator draws on the results of its 2006 Governance Survey.

The Regulator's comments on each of the governance priorities are:

(i) knowledge and understanding of the governing body

The Regulator notes a correlation between the standard of governance and several factors – namely, the amount of training trustees receive, the size of the scheme and whether a professional trustee is present on the trustee board.

Reference is made to existing tools for improving trustee knowledge and understanding. These include the Code of Practice, Scope Guidance and the web-based trustee toolkit – all of which will be kept under review. Building on this, the Regulator intends to meet with key organisations to encourage targeted education and will assess scheme return data so as to direct trustees of smaller schemes towards relevant information and training.

(ii) identification and management of conflicts of interest

The Regulator recognises the valuable role played by senior management participation on trustee boards and that it is seldom the best solution for such trustees to manage conflict by resigning. However, trustees should prepare and maintain a formal register of conflicts and have a written policy on how they will manage them.

(iii) understanding of and monitoring the employer covenant

This is mainly of relevance to schemes providing defined benefits and we do not consider it further in this note.

(iv) relations with advisers and others (with particular focus on the scope for conflict and ensuring advisers are 'fit for purpose')

The Regulator intends to issue a set of 'questions' to ask advisers. Whilst largely aimed at trustees, some questions will be geared towards use by employers.

(v) administration and procedures adopted

The Regulator is concerned that significant numbers of schemes had not reviewed their administration services in the three years prior to the 2006 Governance survey. Many also appeared not to have agreed any service level standard with their 'service providers' and only one-third of DC schemes had a

formal 'risk management' process. However, the shortcomings tend to lie mostly with smaller schemes.

- (vi) **processes for investment choice and review** (of particular importance in relation to DC schemes)

Regular review by larger schemes is common. By contrast, one-third of DC schemes with 12–99 members had not done so in the three years prior to the 2006 Governance Survey.

This is already an area of specific focus in the Regulator's e-learning modules. However, it also proposes to provide examples of how to select and review investment managers and funds, together with information about different approaches to the design of default funds and issues to consider. The Regulator also intends to issue guidance on investment options and diversification and examples of what it considers to be 'simple' and clear information that can be used as the basis for member communication as well as a list of questions to expect from members.

- (vii) **governance during the winding up process** (with particular emphasis on speeding up the winding up)

The Regulator highlights the importance of clean data and project planning in speeding the winding up process.

(b) Contract-based pension schemes

The Regulator has made it quite clear over the last year or so that it fully recognises the role of contract-based vehicles in delivering work-based pension schemes and, as such, these types of scheme fall within its remit as well as the more conventional trust-based schemes. The paper therefore has a section focusing entirely on the governance of contract-based schemes.

The discussion paper describes the legal and existing governance structure of contract-based pension schemes and the interaction of various supervisory authorities with responsibilities for such arrangements. The Regulator recognises the important role that the FSA currently plays in the regulation of contract-based schemes and has worked very closely with the FSA in formulating its approach in this area.

The Regulator usefully divides scheme governance into two components:

1. “Operational” governance – ensuring a scheme operationally functions effectively (eg that contributions are paid and invested on time, benefits are paid on time, etc) and is run in accordance with the detailed legislative and regulatory requirements; and
2. “Qualitative” governance - ensuring a scheme functions in the interest of pension scheme members and seeks to improve the “member experience” (eg the fund range is appropriate, the investment managers are performing adequately, members are being communicated to effectively, etc).

The Regulator believes that the current regulatory framework, principally through the FSA and imposed upon providers, successfully mitigates the potential risks to members

and that the “operational” governance of contract-based schemes is likely to be at least as good as that of a well-run trust-based scheme.

On the other hand, the Regulator believes that the “qualitative” governance of contract-based schemes is generally not as good as that of a well-run trust-based scheme. As a result it calls upon everyone involved in running contract-based schemes – ie employers, providers and advisers – to work together to improve this aspect of scheme governance.

In the discussion paper, each of the Regulator’s governance priorities is considered in the context of contract-based schemes.

Knowledge and understanding (of the governing body), conflicts of interest, employer covenant and governance through the winding up process are largely irrelevant or adequately addressed by existing FSA supervision.

Administration, investment choice and relations with advisers are areas of some concern to the Regulator and it believes that the role - in spirit, if not law - of the employer is pivotal.

The Regulator’s key proposal, therefore, is that employers consider adopting an active ongoing role in the monitoring and management of their contract-based pension schemes. In this regard, the Regulator wants to encourage employers to apply (voluntarily) what it believes to be good practice as well as to call on providers to better work with and support employers in this regard.

Having said all this, the Regulator’s overall approach is to encourage and promote good practice and an understanding of the value that it can bring. By doing so, it hopes that employers, providers and advisers will work together to enhance the governance of contract-based schemes. The Regulator does however recognise the danger in a “one size fits all” approach and encourages employers to consider what level of ongoing monitoring and management they wish to adopt and which approach suits them best. The Regulator does not wish to impose responsibilities and actions on employers, but rather to educate and guide them in this area.

To assist in this, the Regulator in particular intends to consider:

- providing guidance and examples of how employers can adopt an ongoing role in the monitoring and management of their schemes. A couple of example case studies are given in the paper
- providing examples of service level agreements between employers and providers
- encouraging employers to regularly review their selected provider
- providing examples of good practice in adopting suitable investment processes
- promoting the value of good member communication, and
- encouraging providers to give employers a “comfort statement” that contributions have been invested correctly and promptly .

2. Regulating DC schemes in relation to risks to members

The November 2006 consultation document stated that the Regulator had two objectives, namely:

- (i) to protect members' benefits, and
- (ii) to promote and improve understanding of good administration.

It focused on the main risk areas of:

- Poor administrative practices
- Poor investment practices
- Unduly high charges
- Poor decisions on retirement choices
- Lack of member understanding

The Regulator's proposed approach was for:

- **Education and guidance** in the form of e-learning modules and providing good practice guidance on the standards expected for a well-run DC scheme.
- **Working in partnership** with the industry, the Financial Services Authority (FSA) and Government to develop good practice guidance.
- **Intervention**, as a last resort, which would be appropriate for the level of risk.

Comments received and the Regulator's responses

Overall there was broad support for the Regulator's interest in DC. It was also generally agreed that the main risks to members have been identified correctly and that the proposals would support the pensions industry in addressing those risks. The Regulator considers that the feedback suggests that there is no need for any fundamental changes to their broad approach.

(i) Risks identified

Some respondents suggested that not all risks have been covered. In reply, the Regulator explains that the consultation paper focused on those risks for which it has responsibility and where they can make a difference. In addition, however, the Regulator will support the activities of others in areas of risk-management for which they are not directly responsible (for example, by working in partnership with the Department for Work and Pensions (DWP) and FSA).

(ii) Increased burden on employers

A common theme was the concern that some employers may be driven out of providing pensions at all, due to over-regulation resulting in increased costs. The Regulator will focus on education and guidance and it believes that costs should not be more than those faced by a well-run scheme. The Regulator makes a further point that an efficient and effective scheme should lead to a reduction in risks and, therefore, potentially lower costs.

(iii) Differences between trust-based and contract-based schemes

The responses highlighted that clarification is needed in relation to the roles and responsibilities of the Regulator and the FSA, especially in relation to contract-based schemes. There is a Memorandum of Understanding which is intended to ensure a coordinated approach between the Regulator and the FSA, with no gaps or duplication. The Regulator's objectives for regulating contract-based and occupational-based schemes are the same given that members may not know or be concerned about the type of scheme to which they belong.

(iv) Proposed involvement in the regulation of charges

There were concerns that the Regulator may become a price regulator and be seen as attempting to drive costs down. It has no intention of doing so, but wishes to highlight that charges should be reviewed periodically and should be transparent and their impact on the pension scheme understood.

(v) Over-regulation

There are many reviews currently taking place and the Regulator recognises that it needs to take these into consideration and identify any information gaps and issues that have to be addressed to ensure guidance is necessary and effective.

Summary

We would endorse many of the observations of the Regulator and note that much of what it cites as good practice reflects what many clients are already doing. However there are certainly issues within these papers that are relevant for virtually every pension scheme, whether DB or DC, or trust or contract. As a result we would welcome the opportunity to discuss how this affects your scheme and what you may wish to take away as an action from the Regulator's proposals.

In the meantime, if you have any queries or simply wish to discuss these documents in more detail and how they may affect your pension arrangements, please do not hesitate to give me a call.