

How the regulator will promote better governance of work-based pension schemes

The regulator's response

October 2007

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Contents

1: Introduction	2
2: What the discussion paper said	4
Key priorities	5
Proposed activity.....	7
3: The response to the discussion paper	8
Regulatory priorities	8
Smaller schemes.....	13
Contract-based schemes	14
Summary.....	15
4: Taking work forward	17
Education and guidance.....	17
Working in partnership	19
Intervention	19
5: Conclusion	20
Annex A: List of respondents	21
Annex B: Points raised that were specific to the priorities	22

1: Introduction

On 25 April 2007 the Pensions Regulator ('the regulator') issued a document entitled *The governance of work-based pensions schemes: Discussion paper*, setting out our views on the main priorities of governance and outlining proposals on how these priorities could be addressed.

We invited comments from interested parties, and the deadline for responses was 13 July 2007. We received 40 responses from a broad section of the pensions industry including representative bodies, insurers, pension professionals and third party administrators as well as trustees and pension managers.

Our objective is not to increase burdens upon those running pension schemes. Instead we aim to provide guidance and support that will help bring parties to a similar level of good practice, with the goal of raising standards when needed. In fact, we believe our guidance will support parties involved in pension schemes by helping to avoid the costs resulting from poor practice. We feel that well-run schemes provide better value for money and are more cost-effective in the long run.

Indeed the comments received have been very supportive of our view that we should provide educational support, primarily through the voluntary application of good practice guidance and the provision of our e-learning programme (the 'trustee toolkit'). We would only want to use our existing powers to intervene as a last resort and in an appropriate and proportionate manner, whilst working with industry and other regulators in the development of all elements of our approach to ensure they are consistently practical and effective.

As education is the key focus of our approach we do not believe that our proposals will increase regulatory burdens on industry, nor create new costs for business. We will, however, modify some aspects to address concerns raised where we consider it appropriate to do so.

For the regulator, governance is equally important for DB and DC schemes although the focus of the governance activities does differ. With regard to contract-based schemes, we want to state clearly that any guidance we provide for employers over and above complying with their legal obligations (eg paying contributions on time) is for employers who wish to exceed their legal requirements on a voluntary basis, for example by setting up a management committee.

Collaborative working with our industry partners, the FSA, DWP and Government remains key to the successful delivery of our products and activities.

I would like to thank those of you who responded to the governance discussion paper. The following document outlines the main comments we received and our response to those comments.

A handwritten signature in black ink, consisting of several overlapping, sweeping lines that form a stylized, cursive representation of the name Tony Hobman.

Tony Hobman
chief executive, the Pensions Regulator
October 2007

2: What the discussion paper said

The regulator has statutory responsibilities in relation to work-based pension schemes, comprising:

- occupational pension schemes;
- personal pension schemes where direct payment arrangements exist; and
- stakeholder pension schemes.

Our medium term strategy identified three key themes for the regulator over the next three years:

- i. Strengthen the funding of defined benefit schemes.
- ii. Improve the governance of work-based pension schemes.
- iii. Reduce the risks to members of defined contribution schemes.

To enable the achievement of these objectives, and supported by the evidence collated from our 2006 governance survey, our discussion paper set out the main priorities appropriate for the regulator to focus on, namely:

- trustee knowledge & understanding;
- conflicts of interest;
- monitoring the employer covenant;
- relations with advisers;
- administration;
- processes for investment choice;
- governance during wind-up; and
- contract-based schemes.

In order to address these priorities we proposed a three-pronged approach:

- **Education, guidance and enabling:** this is the key focus of our approach, aiming to combine existing initiatives (including our e-learning modules in the trustee toolkit and our codes of practice) with new initiatives, primarily good practice guidance including case examples.
- **Working in partnership:** central to the successful delivery of proposals, this includes working with the pensions industry, the FSA and the Government in the development of good practice guidance. It also involves identification of future initiatives and consistency of approach, whilst taking current initiatives and working practices into account.
- **Intervention:** in line with our risk-based approach, we will focus on areas posing most risk to the regulator's objectives, and any intervention will be proportionate to the level of risk.

Key priorities

We identified eight key governance priorities from the evidence taken from our 2006 governance survey and from our casework teams. These are the issues that we believe need to be addressed, as described below.

Trustee knowledge & understanding

Trustee education has been one of our priorities, and the regulator has produced codes of practice, practical guidance and an e-learning programme (the trustee toolkit). Our governance survey shows that there is a clear link between the level of knowledge and the improvement of standards of governance. It is likely that trustees who know and understand their responsibilities and duties pose less of a risk than those who do not. Those with a poor level of knowledge and understanding could also impact adversely on employers.

Conflicts of interest

The identification and management of conflicts is important in the way trustees carry out their duties. Trustees are in a position of trust and need to have policies and arrangements in place to identify and manage conflicts. The consequences of not managing conflicts appropriately can be severe, with trustees inadvertently or deliberately making decisions which are not truly in the best interests of members.

Defined benefit schemes are particularly prone to risks in relation to conflicts of interest as these schemes are more likely to be exposed to decisions made by the employer affecting the interests of members, for example matters in relation to scheme funding or corporate transactions. We plan to publish guidance on this subject later in the year.

Monitoring the employer covenant

The employer plays a vital role in all work-based pension schemes, particularly as the sponsor of defined benefit (DB) schemes. Understanding the employer covenant is essential to trustees, particularly in the context of technical provisions and recovery plans. According to our 2006 governance survey around two-fifths of DB schemes do not regularly review the employer covenant or business plans. If trustees of DB schemes do not monitor the employer covenant they will not be in a position to make appropriate decisions about funding and any necessary recovery plan, thus risking members' benefits and possibly leading to calls on the Pension Protection Fund (PPF).

Relations with advisers

Expert advice is essential to help trustees run schemes. There are two types of risk associated with advice. First, an adviser may have a conflict of interest if he or she (or the same firm) is also advising the employer. Secondly there is the risk that the advice is not properly understood by trustees, or is not provided by suitably qualified advisers. We plan to provide guidance for trustees in this area by the end of the year.

Administration

Good administration is vital in every scheme, although for defined contribution (DC) arrangements it is of particular importance. The regulator's governance team works closely with the DC team since poor administration is one of the main DC risks. Our survey shows varied experience in the quality of service provided by administrators. There are four main risks associated with poor administration: beneficiaries receiving incorrect or delayed benefits on transfer, death or retirement; members receiving inaccurate information, which may lead to inappropriate decisions; non or late payment of contributions; and, in the case of DB schemes, inaccurate record-keeping which could lead to the wrong value being placed on benefits, with potentially harmful consequences for the employer.

Processes for investment choice

Trustees may be required to demonstrate that they have followed appropriate processes in the area of investment, for example in setting their investment strategy, their statements of investment and funding principles and in their appointments and reviews of their investment managers and consultants. For a DB scheme the risks of poor investment performance include underfunding and higher costs to the sponsoring employer. The risks to a DC scheme include a reduction in fund value fund for members and reputational damage to the scheme and employer.

Governance during wind-up

Winding up a pension scheme imposes additional tasks on trustees. The Government has launched an initiative to speed up the process of wind-up. We are working with the Department for Work and Pensions (DWP) and HM Revenue & Customs (HMRC) to ensure that schemes in this position take more positive steps to conclude their actions, with the aim of ensuring that key activities of winding up a scheme are completed within two years.

If schemes are not wound up correctly or quickly enough, there is a risk to members' benefits. There are some similarities in the activities needed to go through both the PPF assessment period and the wind-up process, so we will draw on the experiences of the PPF when considering the relevant activities.

Contract-based schemes

Our statutory objectives apply to work-based personal stakeholder pensions as well as those arranged under trust. Contract-based schemes are different from trust-based schemes, and the risks to the regulator's objectives are in many cases also different. In contract-based schemes many of the ongoing risks associated with the scheme are mitigated by the FSA. In our discussion paper, we considered how each of the other priorities in turn applied to contract-based schemes.

Proposed activity

Education and guidance

We explained that, in order to provide support to those parties that need it, we will produce information, primarily good practice guidance, appropriately tailored and building on existing initiatives such as the trustee toolkit.

Working in partnership

We highlighted that we want to work together with industry representatives and other regulators, particularly the FSA, where appropriate. We do not regard working in partnership as a one-off activity solely for the purpose of this exercise. We want to continue on an ongoing basis with the encouragement of desirable behaviours within the industry, as well as the development of proposed initiatives to ensure they can be put into practice effectively and proportionately.

Intervention

We set out existing powers that we could use where it was brought to our attention that actions to mitigate risks were not being taken, emphasising that we would use these powers proportionately and where we felt it was necessary, based on the risk to the regulator's objectives.

Questions asked

We suggested six questions for respondents:

- 1) Is the regulator right to place importance on the governance of pension schemes?
- 2) Do you agree with the determinants of our regulatory priorities? These are:
 - a. the regulator's existing approaches to governance;
 - b. evidence of how schemes are governed;
 - c. recent and forthcoming developments in the pensions environment; and
 - d. our approach to regulation.
- 3) Do you agree with our regulatory priorities?
- 4) Are there particular points you wish to make about any of the priorities?
- 5) Do you have any suggestions for how these priorities should be addressed for smaller schemes?
- 6) Do you agree with our analysis of contract-based schemes, and the new proposals we are considering on:
 - a. providing examples of employer-led 'management committees'?
 - b. guidance providing questions to ask on commission and fees?
 - c. administration and investment processes?

3: The response to the discussion paper

We received 40 responses to the discussion paper, which represented a broad cross section of industry representatives (see Annex A).

The responses showed that:

- there is broad support for the active promotion of good governance by the regulator, as this should instil public confidence and will assist in raising standards among more poorly run schemes;
- in focusing on governance, the regulator should set out principles and avoid more detailed prescription;
- there is support for the view that the regulator should help trustees to understand how to meet the requirements of legislation;
- the regulator should recognise that controls and processes for governance need to be proportionate to the related risks and individual circumstances, and that governance tends to be more problematic for smaller schemes; and
- there is a considerable diversity of views on the regulator's role in relation to contract-based schemes.

A wide range of more detailed issues was raised, the most important of which are summarised below along with our response, under the headings of regulatory priorities, small schemes and contract-based schemes. Some more detailed comments on the specific priorities are set out in Annex B.

Regulatory priorities

The responses generally supported the priorities we had identified, apart from one response which suggested that a different approach could have been taken. A few other responses suggested two additional priorities relating to internal controls and member communications.

The regulator's response: While it would be possible to identify a different set of priorities that would be relevant to promoting good governance, we consider that the priorities provide a good match with the concerns arising from our governance surveys and other evidence. While a wider range of issues is covered in the trustee toolkit, its focus is on these priorities. In relation to the specific suggestions:

- We recognise that risk management and internal controls should underpin all aspects of governance, including the priorities we have identified. We shall continue to place great emphasis on trustees acting upon our code of practice and associated guidance, and will continue to emphasise their importance for good governance.
- We have already recognised that communication with DC members is very important by identifying member understanding as a key DC risk, and will focus on helping schemes to improve such communication. While communication with DB members is less of a priority, the respondents were right to raise this as a concern. The summary funding statement that schemes are now required to

provide to members (annually where they have 100 or more members) provides an important means of communication, especially where schemes also choose to disclose details of benefits on an individual level. We will reflect on whether the way this new communications requirement is being implemented meets members' needs. More generally we will contribute to the DWP's principle-based disclosure review which will cover DB and DC schemes.

Relations with advisers

The priority of relations with advisers received particularly strong support. Some responses suggested that more emphasis should be placed on trustees acquiring skills to engage effectively with their advisers.

The regulator's response: We agree that it is an important priority for the regulator to help strengthen trustees' ability to manage and question their advisers so they can get the best from them and take properly informed decisions. We have already given priority to addressing this issue through the trustee toolkit, a key purpose of which is to enable trustees to seek the right advice and make best use of the advice they receive. We will seek to reinforce this learning resource through guidance elsewhere on our website.

Emphasis on DB

It was suggested that the governance paper was unduly weighted towards DB schemes rather than DC.

The regulator's response: This was perhaps an unintended consequence of publishing the discussion document alongside our response to the consultation on our approach to DC risks and our desire to avoid too much duplication between the documents. We believe that good governance is equally important for DB and DC schemes, and are concerned that our governance survey shows that governance tends to be weaker in DC schemes. Our approach to DC risks focuses on poor administrative practices; poor investment practices; unduly high charges; poor retirement decisions; and lack of member understanding. We will therefore seek to strengthen the guidance available in these areas, and hence strengthen the governance of DC schemes. DB schemes, however, tend to pose different governance challenges and it is important that we address these too.

Reducing regulation

It was suggested that the regulator should not be seeking to extend the regulatory burden for schemes but focusing on ways in which regulation can be reduced to concentrate on areas where it can demonstrate the benefits.

The regulator's response: We are not looking to increase burdens upon those running pension schemes and do not believe that our proposed approach will have that effect. Our goal is to provide guidance and information that will help bring those involved in running schemes up to an appropriate and similar level of understanding of good practice, with the objective of raising standards where needed. We consider that well run schemes provide better value for money and are more cost-effective and efficient. In the longer term this should reduce the burden on the employer. We shall therefore continue to use a range of different methods to achieve this objective, such as guidance, workshops and good practice examples.

Emphasis on TKU

It was suggested that there is a danger of placing too much emphasis on trustee knowledge and understanding rather than other means of improving governance.

The regulator's response: We believe that good levels of trustee knowledge and understanding are a prerequisite for good governance in trust-based schemes. Our governance survey provides evidence of a link between training, understanding and standards of good governance. We therefore expect that trustees with a good level of knowledge and understanding should pose lower risks to members' benefits than those who are not so well equipped. Knowledgeable trustees are better placed to seek and understand advice and to take the right decisions. We will therefore continue to put strong emphasis on the priority of improving the knowledge and understanding of trustees.

We consider that there is a foundation level of knowledge and understanding that all trustees need to have for this purpose and have set this out in the code of practice and trustee toolkit. This does not mean that we would discourage trustees from developing particular areas of expertise above that minimum, nor would we discourage boards from taking actions to build collective knowledge and understanding beyond the basic level. But all trustees should be equipped to understand and challenge expert opinion from whatever source.

Trustee knowledge and understanding is, of course, just a foundation for improved governance and we recognise that there is more we should do to help trustees run their schemes effectively. It also does not address the governance of contract-based schemes, and our proposals relating to such schemes recognise the very different governance model that applies to them.

Experience in other countries

It was suggested that we could learn from reviewing governance experience in other countries such as Holland, the USA and Canada, and from corporate governance experience outside the pensions landscape.

The regulator's response: Some trustee boards have explicitly taken on board the corporate governance recommendations in the Turnbull report, and it is very encouraging that many schemes are operating in this manner and running schemes in such a businesslike manner. Evidently there are some schemes that need support in this area, in particular smaller schemes. We are looking to do more research on how governance is working overseas building on our contacts with overseas regulators. We are actively participating in the collation of experience of the regulation of governance currently being undertaken by the International Organisation of Pension Supervisors (IOPS).

Measuring effectiveness

Some responses questioned how the regulator will be able to measure the effectiveness of guidance and whether it is being implemented correctly.

The regulator's response: We should be able to measure the effectiveness of the guidance and education through our annual surveys of perceptions and scheme governance. We will also seek to evaluate the trends in the problems and queries that come to us from schemes and their advisers to see whether these reflect improving performance.

Relevance of the Myners Report

It was suggested that we have given insufficient recognition to the Myners Report.

The regulator's response: The work of the Myners Report underpins our overall strategic approach to governance and is mentioned in our medium term strategy. Furthermore, Myners' conclusion that the level of trustee expertise was a major impediment to good decision making led to the introduction of the TKU regime under the Pensions Act 2004, and thus the scope documents and the trustee toolkit itself. We are liaising closely with the NAPF as they review the implementation of the Myners' principles and will give careful consideration to the recommendations arising from this review.

Reliance on surveys

It was suggested that we might be over-reliant on surveys, in particular our 2006 governance survey, which self-rated performance, and the fieldwork for which was over a year old by the time we published the discussion document.

The regulator's response: Our governance survey is the largest survey in the pensions industry, and although it is self-rated there are strong correlations between objective measures of activity and more subjective views on confidence and performance. Smaller surveys that have been undertaken generally back up our findings. We will continue

to use a wide range of evidence including surveys to inform our regulatory approach and assess whether we are achieving our regulatory priorities in relation to both trust-based and contract-based schemes.

As our governance surveys are tracker surveys, most of the questions posed to trustees and pension managers are similar in content year on year. We now have the results from the 2007 survey which show that there have been improvements in certain aspects of governance but that there still remains work to be done to raise governance standards across all schemes. The 2007 survey reinforced the correlation between good governance and high levels of trustee training.

These positive findings suggest that our fundamental approach does not need to change. We are supplementing our 2007 survey with a separate qualitative survey focusing on DC risks.

Trustee-employer relationship

It was suggested that one of the key challenges going forwards is strengthening the relationship between the trustee and employer.

The regulator's response: We completely agree. In areas such as scheme funding it is becoming more important for trustees to have a regular dialogue with the sponsoring employer and to have a good understanding of the financial standing of the sponsor, hence monitoring the employer covenant is one of our priorities. We are pleased to note from the 2007 governance survey that the majority of defined benefit schemes had investigated the financial standing of the employer in the past year. However we acknowledge that this priority should cover more than just the assessment of the covenant as this normally does not include clear advice and recommendations.

Governance during wind-up

It was suggested in some responses that governance during wind-up should not be considered as important as the other key priorities (although other respondents suggested the opposite).

The regulator's response: We disagree. The risks to members can be particularly acute during the wind-up process. The time taken to wind up many schemes is excessive and leaves members exposed to risk for an inappropriately long period. Where members may be eligible for assistance from the Financial Assistance Scheme, delays can result in their losing out on benefits. We are working with the DWP towards a target of schemes completing the key activities of winding up within two years – a target that the PPF has proved is achievable for schemes in the assessment period if the will is there (although the activities do differ between the regulator and PPF). We look to such good practice becoming the norm and are targeting our efforts to this effect.

To meet our statutory objectives of promoting good administration and protecting members' benefits, and to support the DWP target, we therefore want to ensure that parties understand what is involved in winding up a pension scheme and how we will regulate schemes

during wind-up, whilst at the same time ensuring that good administration is carried out during the lifetime of the scheme.

Clarity of language

Some responses suggested that trustees needed clear language rather than pensions jargon.

The regulator's response: We agree that this is very important and seek to apply a plain English check to all our publications. We also include a glossary in most of our major publications. That said, pensions tend to be complex and we seek to tailor the complexity of language within our publications to the needs of the target audience.

Smaller schemes

We asked for suggestions for how these priorities should be addressed for smaller schemes. Specific responses included:

- Providing support and guidance is very important for small schemes but does run the risk of over-prescription. This could lead to employers withdrawing from a trust-based scheme.
- Working with providers and advisers and having links from their website to our trustee toolkit.
- Smaller employers and schemes giving serious consideration to replacing employer-nominated trustees with an independent trustee so as to reduce reliance on and hence cost of advisers, free up company executives and reduce potential conflicts of interest.
- Exploring the encouragement of scheme consolidation under a multi-employer arrangement.

The regulator's response: We recognise that we need to seek a careful balance between over-prescription and assistance, and we will look to achieve this through a balance of learning tools to provide guidance to different audiences. We therefore plan to produce a range of targeted communications taking into account the situation of smaller schemes, such as tailored information on our website and case examples. We look to continue building partnerships with providers and advisers and their representative bodies, and intend to put in place signposting to other relevant websites. We would also seek to support initiatives taken by other bodies to give substance to the above suggestions.

Contract-based schemes

We specifically sought views on our approach to governance in contract-based schemes. There were strong and diverse views on our proposals on contract-based schemes.

- Some respondents felt strongly that there was no requirement for the regulator to take action in relation to contract-based schemes as providers are already regulated by the Financial Services Authority (FSA).
- There was also a strong message that we should avoid implying that a contract-based scheme is a less desirable product than a trust-based scheme.
- It was pointed out that many employers opt to provide contract-based schemes to avoid the regulatory burden of trust-based schemes.
- It was therefore suggested that the regulator should focus more on developing close co-operation with the FSA rather than appearing to increase the burden on employers, which is the impression some respondents drew from the discussion paper.
- On the other hand, some respondents were concerned about the absence of trustees to look after members' interests in contract-based schemes and looked for us to do more than we had proposed.
- There was some recognition that management committees had an important role, for example in member communications, although other respondents were concerned that the regulator expected employers with contract-based schemes to put management committees in place.
- There was support for our suggestion on providing guidance for employers on commission and fees, although there was a feeling that many employers are already aware of these issues and already consider them when selecting a contract-based scheme.
- It was suggested that having an annual comfort statement would be beneficial, as although employers should already be aware whether contributions are being paid on time, it would be beneficial to receive confirmation from the provider that they were invested in a timely manner.
- It was questioned whether service level agreements would be appropriate for contract-based schemes as the contract is between the individual and the provider.
- It was suggested that the regulator needs to consider the full implications of personal accounts before considering the governance of contract-based schemes.

The regulator's response: We confirm that the regulator does not have a view on the desirability of one form of pension provision over another. It is for employers to decide which type of scheme to offer.

Contract-based schemes fall under the remit of both the FSA and the regulator. The FSA supervises at provider level rather than at pension scheme level and its remit embraces all personal pensions, both individual and group personal pensions (GPPs), whereas the regulator's remit covers only the latter. A provider may operate one or more personal pension schemes and each GPP arrangement will be a subsection of one of these schemes.

In the event of significant risks affecting GPPs, the two regulators liaise regarding any action to be taken. Where significant risks are identified which relate to a provider's individual personal pension portfolio, this will usually be addressed by the FSA as these policies fall within the FSA's remit. Where there are systemic problems which primarily relate to GPPs then the regulators will liaise, with the Pensions Regulator being more likely to take the lead. In particular where there are issues which relate to the employer, these will usually be for the Pensions Regulator to address.

We already work closely with the FSA and are strengthening this relationship as we work together on DC issues, especially contract-based schemes. Our working relationship is underpinned by the memorandum of understanding between the regulators. The two regulators are also planning to produce a joint publication on the regulation of contract-based schemes. We will also consider with the FSA the scope for developing comfort statements, although we have been advised in talking to interested parties that comfort statements are not currently a regular practice and the costs and content of such statements will need to be carefully considered.

We are seeing more employers of all sizes switching to contract-based provision and therefore remain of the view that we should provide some help to employers who wish to engage positively on a voluntary basis with the way contract-based schemes are run, for example by setting up a management committee. We plan to provide case examples and we recognise that our guidance should respect the substantial differences in the extent to which different employers wish to engage with contract-based schemes and avoid any impression that one size fits all or that there is any legal requirement or expectation by the regulator that employers should put such committees in place.

Summary

On balance, we do not consider that the comments described above will result in any major changes to our approach outlined in the discussion paper. We will, however, take into account the responses and work closely with relevant parties over time. In particular we recognise that in taking forward the priorities we have identified we should be mindful of the importance of effective risk management processes and member communications.

We also want to send out clear and transparent messages that:

- We are not looking to increase burdens upon those running pension schemes. Rather we aim to provide guidance and support that will help bring parties to a similar level of good practice, with the goal of raising standards when needed. In fact, we believe our guidance will support

parties involved in pension schemes by helping to avoid the costs resulting from poor practice. Well-run schemes provide better value for money and are more cost-effective in the long run.

- As education is the key focus of our approach we do not believe that our proposals will increase regulatory burdens on industry.
- Governance is equally important for DB and DC schemes although the focus of governance activity differs.
- Central to the successful delivery of our products and activities is collaborative work with our industry partners, the FSA, DWP and Government. This ensures that our initiatives are effective and practical, encouraging a consistent approach and helping to raise standards by influencing behaviours. In particular, we will give careful consideration to developing our approach in line with the recommendations of the current review of the implementation of the Myners' principles.
- Any regulatory intervention will be considered as a last resort (unless issues brought to our attention have fraud implications), making appropriate and proportionate use of our powers.

4: Taking work forward

Education and guidance

The regulator's overall approach to fulfilling its objectives can be summarised as *educate, enable, enforce*:

- **educate** first;
- then, if necessary, **enable**, ie work with those running schemes to achieve the required outcomes; and
- use **enforcement** as a last resort only if required.

The focus of our work on governance is therefore education and guidance, in particular providing good practice guidance including case examples, tailored to suit the different audiences and enabling a good understanding of the governance of pension schemes, recognising that:

- trust-based and contract-based schemes have different frameworks;
- different audiences have different responsibilities; and
- the size of a scheme or employer can have an impact on the information required and the ability to put good practice into effect.

Arising out of the governance discussion paper and also the previous consultation report on DC risks, we are therefore planning to carry out the initiatives described below, some of which may go forward in partnership with other organisations.

Trustee knowledge & understanding

- Meet with key organisations and service providers to encourage institutions to promote targeted trustee education.
- Review code of practice, scope guidance, indicative syllabus and trustee toolkit.
- Use data from small schemes to market the trustee toolkit.
- Revised version of the trustee guidance with useful signposting to relevant material.

Conflicts of interest

- Issue guidance to help trustees manage conflicts more effectively, including case examples and templates relating to a risk register, declaration of interest document and example conflicts policy.

Monitoring employer covenant

- Revised guidance on clearance to incorporate guidance on monitoring and assessing the employer covenant.

Relations with advisers

- Issue a checklist of questions for trustees to ask their advisers, giving trustees the confidence to challenge advice and enabling them to establish aims and objectives for meetings with advisers.

Administration

- The TKU code and the trustee toolkit have sections on administration.
- Develop, promote and share good practice.
- Provide examples of good practice for service level agreements (SLAs), internal control processes (including risk management), effective data transfer processes, how member understanding can be raised (to result in higher standards) and timely products and campaigns relating to disclosure and communication.
- Develop closer relationships with administrators and those who work with them such as auditors.

Processes for investment choice

- Currently five modules in the trustee toolkit are concerned with investment issues.
- Give examples of effective processes to aid selection of investment managers and performance review.
- Give examples of different approaches to the design of default funds, list of issues to consider, and clear and simple information that can be provided to members including investment options and performance.
- Give examples of investment options, including diversification.
- Give examples of good practice in the processes for investment choice in DB schemes.

Governance during wind-up

- Introduce e-learning module to help trustees with wind-up (launched via the trustee toolkit).
- Issue guidance on how we will regulate schemes in wind-up including good practice guidance, which will include a section on project planning.

Contract-based schemes

- Provide examples of employer engagement committees including setup, legal risks and benefits.
- Provide a checklist for employers to ask advisers about conflicts of interest and aggregate commission.
- Provide examples of SLAs, eg between providers and employers.
- Promote (via case examples) value of good member communication.
- Promote good practice in the governance of investment processes, encouraging regular review by the employer, provider and adviser of investment fund choice and processes.

Working in partnership

Responses generally supported the regulator's position on partnership working to ensure activities can be implemented effectively and appropriately, taking into account current activity within the environment. A number of organisations offered assistance regarding their specific area of expertise.

Currently we have an internal governance forum which we hope to extend to our external partners including the FSA and the DWP and other interested parties. Where appropriate, this group would develop good practice guidance and identify suitable communication channels so that messages reach all the relevant types of audience. We still have the DC consultation working group which focuses on the major DC risks that we have identified, which relate closely to some of our governance priorities. We would also expect to work closely with the Treasury and other partners once they have completed the current review of the implementation of the Myners' principles.

Intervention

Our approach to intervention will ensure that any 'standard' process will include an opportunity for the relevant party to rectify the situation, although this approach may differ where there are potential fraud implications. Where a problem persists, or where it has a materially significant detrimental impact on the pension scheme or the regulator's objectives, then we will intervene as appropriate.

5: Conclusion

We remain of the view that the responses to the discussion paper do not require a change to our fundamental approach. We have taken on board the concerns expressed and will consider these during further development of our proposals. We will also give careful consideration to the recommendations from the current Treasury and NAPF review of the implementation of the Myners' principles.

We should emphasise that our aim is not to increase our powers but to use the ones we currently have. We are not planning to increase the burden on trustees, employers and advisers but to provide education and support to enable a similar understanding on running work-based pension schemes, and to encourage good practice resulting in raised standards where appropriate.

Our approach is primarily focused on education and guidance, with strong emphasis on the production of good practice guidance, appropriately tailored in consultation with industry, Government and other regulators to ensure it is practical and effective. Only where it is deemed appropriate will enforcement action be taken, in line with the regulator's risk-based approach. We believe that in general, efficient and well run schemes will lead to the reduction of risks and potentially reduce costs to the industry, as issues arising from poor governance can be time-consuming and costly to rectify.

We would like to thank all those who have taken the time to submit responses to the governance discussion paper (details are given in Annex A).

Annex A: List of respondents

Association of British Insurers (ABI)
Association of Consulting Actuaries (ACA)
AEGON
Allan Martin
Association of Pension Lawyers (APL)
AstraZeneca
Balfour Beatty
Buck Consultants
Coal Pension trustees
Confederation of British Industry (CBI)
Faculty & Institute of Actuaries
Fidelity
Foresight Trustees
Gazelle Pensions Advisory
Hewitt Bacon & Woodrow
Higham Dunnett Shaw
Independent Trustee Group
Institute of Chartered Accounts in England & Wales (ICAEW)
Investment Management Association (IMA)
Jaguar
Landrover
Lane Clark & Peacock
Marubeni
Mercers
NAPF
Occupational Pensioners' Alliance
Pan Trustees
PensionDCisions Limited
Pensions Management Institute (PMI)
Pete Davis (Personal reply – Prudential)
PricewaterhouseCoopers (PwC)
Prudential
Punter Southall
Royal Mail Pensions Trustees
Saul Trustee Company
Standard Life
The Pensions Advisory Service (TPAS)
USS
Watson Wyatt
Xafinity Paymaster

Annex B: Points raised that were specific to the priorities

Trustee knowledge & understanding

It was suggested that increasing the number of member-nominated trustees (MNTs) to 50% is likely to reduce the knowledge and understanding of trustee bodies while new MNTs go through the learning process.

The regulator's response: It is not currently clear whether regulations will be introduced to increase the proportion of MNTs to 50%. Whether such a change impacts on individual schemes will depend on the way they are implemented and the steps taken to maintain the knowledge base of the board.

Conflicts of interest

It was suggested that as this is a difficult subject, legal input is very important for the guidance. Trustees and sponsors should be given licence to identify and manage conflicts appropriate to their circumstances.

The regulator's response: We recognise this, and have consulted extensively both with our in-house lawyers and external stakeholders including the Association of Pension Lawyers (APL). We do not aim to make our guidance over-prescriptive, as we recognise that different schemes govern themselves differently; in particular, differences between smaller and larger schemes can be significant.

Employer covenant

It was suggested that the regulator should acknowledge financial expertise on many trustee boards and that additional analysis may have little benefit compared to the cost involved. It was also suggested that trustees should not just monitor the employer covenant but should seek to interact and negotiate with the sponsor.

The regulator's response: We appreciate the fact that many boards have a wide range of skills including financial expertise. However, for those schemes that need extra guidance, in particular for the small schemes that are unlikely to be able to afford specialist advice, there will be some guidance on the employer covenant in the revised clearance guidance. We also have plans to provide specific guidance on this subject. The trustee toolkit modules *Pensions Law* and *How a DB Scheme Works* also provide guidance, with tutorials, on this subject. We encourage a stronger relationship between the trustee and the sponsoring employer which will ensure more effective interaction and negotiation.

Relations with advisers

It was stressed that we should acknowledge the circumstances in which advisers are engaged and the advice sought. It was also suggested that it would be very helpful in improving relations with advisers to have a list of suitable questions for trustees to ask advisers and provide guidance on expected behaviours.

The regulator's response: The reasoning behind any adviser appointment is very relevant and could prevent potential conflicts of interest from occurring. We are planning to issue a checklist of questions for trustees to ask their advisers, enabling trustees to establish aims and objectives for what they want to get out of the meeting and giving them the confidence to challenge the advice provided. This would be a non-prescriptive checklist that trustees could use in preparation for the meeting with their adviser rather than a tick-box list.

Administration

It was commented that when we develop guidance on service standards the regulator should work with DWP, HMRC and Financial Services Authority (for consistency).

The regulator's response: We already work closely with these bodies to ensure consistency of regulation and guidance. The DWP are also on the regulator's DC working party.

It was suggested that the chapter on administration seemed to focus primarily on DC schemes, implying that the administration of DB schemes is not a priority for the regulator.

The regulator's response: Poor administration can occur in both types of scheme, although there is a bigger risk in DC schemes so there is a greater need for guidance and support on the DC spectrum. However, if there are inaccurate records in a DB scheme this can lead to the wrong value being placed on benefits, which may have consequences for calculating technical provisions, benefits and the levy.

Processes for investment choice

It was suggested that trustees should be encouraged to focus more on scheme design and member communications rather than being too focused on selecting the 'best' products.

The regulator's response: Responsibility for scheme design really sits with the provider. However, it is important that the trustees and employer are involved. Effective communications are very important, and trustees and employers should be fully aware that member communications need to improve so that members gain a better understanding of investments. One of the key DC risks the regulator has identified is poor member understanding, and we have made a commitment to provide guidance such as case examples on this subject.

It was pointed out that monitoring of investment choices and taking effective action when those choices are no longer appropriate is as important as the initial process of investment choice. It was also suggested that the regulator should explore the American concept of 'safe harbours' where, providing the employer follows certain governance standards, the employer is not held liable for the investment performance of funds selected.

The regulator's response: We aim to provide different types of guidance covering processes for initial choices and monitoring of investments, so as to improve trustees' understanding of the issues. We place considerable importance on trustees having the confidence to play a full role in relation to DC default funds as well as DB investments, and the trustee toolkit covers these issues. Legislating for 'safe harbours' would be a role for the DWP, but we are not yet convinced that this provision is needed.

Governance during wind-up

It was suggested that the regulator needs to focus on the selection by trustees of the bulk annuity provider, as this is seen as biggest risk to members of schemes in wind-up. Other suggestions included issuing guidance on project planning to ensure tasks are undertaken as early as possible and improving existing standards of governance and administration.

The regulator's response: The regulator would expect trustees to exercise the same care in the selection of a bulk annuity provider when winding up a scheme as they do in the selection of other service providers during the life of the scheme. They should consider the interests of the members and beneficiaries in the selection of provider. The regulator will be releasing e-learning material, similar to the trustee toolkit (and accessed through it), which will assist trustees with the wind-up process. We also plan to issue guidance which will both explain how we will regulate schemes in wind-up and set out what we consider good practice, drawing on industry experience. This guidance will include a section on project planning.