

The governance of work-based pension schemes

Discussion paper

April 2007

www.thepensionsregulator.gov.uk 

Contents

Chapter 1: Executive summary	3
Chapter 2: The governance of pension schemes.....	7
Chapter 3: The importance of pension scheme governance.....	10
Chapter 4: The Pensions Regulator’s regulatory priorities for governance	15
Chapter 5: Knowledge and understanding	18
Chapter 6: Conflicts of interest.....	22
Chapter 7: Monitoring of employer covenant	26
Chapter 8: Relations with advisers.....	30
Chapter 9: Administration	32
Chapter 10: Processes for investment choice.....	35
Chapter 11: Governance during wind-up	38
Chapter 12: Contract-based schemes	42
Chapter 13: Achieving and monitoring our regulatory priorities	54
Chapter 14: Responding to the discussion paper	56

Chapter 1: Executive summary

- 1.1 This discussion paper is on the governance of pension schemes. It focuses on those areas where the Pensions Regulator ('the regulator') continues to develop its priorities for regulation. A summary version of this discussion paper will be available on the regulator's website at www.thepensionsregulator.gov.uk.
- 1.2 The proposals in this discussion paper do not add to regulatory requirements. We are not proposing steps beyond those which a well-run scheme should take. We believe that good governance generally leads to the reduction of risks and potentially lower costs. In some areas moreover we state clearly that what is proposed is the voluntary application of good practice.
- 1.3 The discussion paper sets out some areas of good practice which should be of interest to trustees, advisers, employers, managers, and providers of pension schemes. It brings together areas we see as key in the governance of schemes, but is not a definitive statement on all aspects of governance.
- 1.4 Under each priority we have set out what the regulator is already doing and highlight areas where there is potential benefit in further steps. Case examples are given to demonstrate some good and poor practice from real-life situations.¹ We are aware that what is good practice can be different for smaller schemes and we consider this later. We also appreciate the diverse types of scheme which we regulate and that practical application of our priorities will reflect these differences.
- 1.5 The regulatory priorities we have identified are in line with our risk-based approach of educating and enabling first, and intervening only when necessary.

¹ In some of the case examples, companies or schemes are named. We believe doing so will make it easier for others to relate to these examples. Naming should not however be read as any general endorsement by the regulator of any scheme or an indication that what is described is necessarily suitable for others. We would like to thank Capital Cranfield, Higham Dunnet Shaw, Watson Wyatt and others for their valuable assistance in providing some of the case examples.

1.6 The Pensions Regulator's regulatory priorities for pension scheme governance are as follows:

(i) **Knowledge and understanding**

Trustee education has been one of our main priorities and the regulator has accordingly produced codes of practice, practical guidance, and an e-learning programme (the 'trustee toolkit'). We are also developing standards of performance for trustee governance, working with other organisations: Chapter 5 sets out more detail. We continue to see this as the most important area where we can help trustees in the area of governance, without imposing onerous requirements.

(ii) **Conflicts of interest**

The identification and management of conflicts is important in the way trustees carry out their duties. They are in a position of trust and need to have policies and protocols for handling conflicts. Our 2006 governance survey² indicated that relatively low numbers of schemes have established these, and the regulator frequently advises individual schemes where they have encountered problems. We also deal with this issue in the trustee toolkit. We will provide further guidance.

(iii) **Monitoring of employer covenant**

The employer plays a vital role in all work-based schemes but 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. Lack of understanding poses clear risks to scheme funding. The regulator already considers the employer's financial strength when assessing recovery plans, as well as in applications for clearance of corporate transactions. Again, this issue is dealt with in the trustee toolkit, where there are several case examples and trustees can learn many of the methods of monitoring the employer covenant. We will continue to give monitoring the employer covenant a high profile.

² <http://www.thepensionsregulator.gov.uk/docs/governance-survey-report-2006.pdf>

- (iv) **Relations with advisers**

Expert advice is essential to help trustees run schemes. Risks of adviser conflict potentially arise in some circumstances where advisers work for both the trustees and the employer. Trustees should also ensure their advisers are suitably qualified for the issues they are addressing, and should challenge the advice to test it is robust and applicable. This topic has already been the subject of the regulator's guidance and is covered in the trustee toolkit. We also consider relations with advisers when reviewing cases which are referred to us. We will issue good practice guidance, working with industry bodies, including questions for trustees to consider when reviewing or appointing advisers.
- (v) **Administration**

Good administration is important in every scheme, though it is of particular importance for defined contribution (DC) arrangements. Surveys show varied experience in the quality of service provided by administrators. The regulator's material in this area has included issuing codes of practice and the trustee toolkit. Our interventions have assisted trustees to resolve data issues and we will continue that work where necessary. We also propose to work with administrators and to engage more actively with professional bodies within the industry to promote higher standards.
- (vi) **Processes for investment choice**

Poor investment returns can lead to lower benefits, increased costs to the employer, or both. The trustee toolkit focuses on investment matters, from the foundations of understanding the four major asset classes to tactical asset allocation, and we have recently issued a module on strategic investment issues. In addition to its educational role, the regulator's consultation document on DC risks proposed steps in this area and we are considering a number of initiatives with pensions and financial professionals.
- (vii) **Governance during wind-up**

Winding up pension schemes imposes additional tasks on trustees. The government has launched an initiative to speed up the process of wind-up. We will work 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 the key activities of winding up a scheme are completed within two years. The regulator will target administrators, service providers, and trustees (particularly independent trustees) to speed up action plans. We are starting with the oldest cases and will use our powers to appoint and remove trustees in cases where there is persistent failure to act. We will also produce further educational material on this subject as well as adding to the trustee toolkit.

- 1.7 This statement is aimed primarily at the trustees, and their advisers, of trust-based pension schemes. Some similar issues apply, however, to work-based contract-based pension schemes. In Chapter 12 we look at how our governance priorities apply to contract-based schemes, and consider how the regulator should meet its responsibilities to members of these schemes, taking account of the FSA's role in this area.
- 1.8 Implementation of these priorities will be principally through the provision of educational material, guidance and examples of good practice. We intend also to build closer relationships with those involved in the governance of schemes such as administrators.
- 1.9 Good governance is at the heart of all aspects of a well-run pension scheme, and we are keen to promote it strongly. We will keep our priorities under review using our annual governance surveys, research, and learning from the practical examples we see in our work.
- 1.10 This is a discussion paper about our regulatory priorities for the governance of pension schemes. We are interested in the reaction of our stakeholders to these priorities. Some questions for respondents are given in Chapter 14. Should you wish to comment, please send your responses by **13 July 2007** in one of the following ways:
- By post:
Louise Robinson
The Pensions Regulator
Napier House
Trafalgar Place
Brighton
BN1 4DW
 - By email: gov.paper@thepensionsregulator.gsi.gov.uk
(We would prefer to receive email responses in Word format but appreciate that this may not always be possible.)
 - By fax: 01273 627248

Chapter 2: The governance of pension schemes

What is governance in the pension scheme context?

- 2.1 In this and the following chapters we consider the governance of trust-based schemes. Chapter 12 considers governance in relation to contract-based schemes.
- 2.2 We do not seek to define the term governance. There are in any case many different definitions.³ The National Council for Voluntary Organisations (NCVO) and a number of other bodies have developed a code for trust-based voluntary sector bodies. This defines governance as 'the systems and processes concerned with ensuring the overall direction, effectiveness, supervision and accountability of an organisation.'⁴
- 2.3 Our focus is on particular aspects of the governance of pension schemes. In the scheme context there is no easily definable boundary between what is governance and other activities. Governance will involve the governing body of the scheme; however nearly every scheme activity involves the governing body to some extent.
- 2.4 In developing regulatory priorities for governance we have focused on those aspects whose fulfilment is principally determined by the behaviour of the governing body.

What is the Pensions Regulator's vision for the governance of pension schemes?

- 2.5 Our medium term strategy stated that 'the desired longer term outcome is to have in place well informed, capable trustees acting in the best interests of their members.'⁵
- 2.6 This vision reflects the vital role played by trustees in the governance of occupational pensions. Trusteeship is an immensely responsible role.

³ For example, in the corporate governance context the Organisation for Economic Co-operation and Development states that governance 'provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.' (*Principles of Corporate Governance*, OECD, 2004, page 11.)

⁴ Page 4, *Good Governance: A Code for the Voluntary and Community Sector*.

⁵ The Pensions Regulator, *Medium Term Strategy*, April 2006, page 40.

- 2.7 The regulator recognises that the overwhelming majority of trustees seek to comply with legislative and regulatory requirements, where appropriate with the help of their advisers. Our approach therefore is to provide material which helps trustees to do their valuable work; our trustee toolkit is one example. We only seek to take enforcement action or impose sanctions where circumstances render this proportionate.

What does the governance of pension schemes involve?

- 2.8 We identify below a number of aspects of the governance of pension schemes within this framework. Our regulatory priorities are listed in Chapter 4 with further expansion in Chapters 5 to 11.
- The appropriate *composition* of the governing body
 - *maintaining the supply of trustees*
 - *the member-nominated trustee / director requirements*
 - The *knowledge and understanding* of the members of the governing body (TKU)
 - *TKU*
 - The *relationships*, including the management of conflicts of interest, of the governing body with:
 - *employer(s)*
 - *advisers (including professional trustees)*
 - *administrators*
 - *scheme members*
 - *regulators*
 - *investment managers*
 - The *procedures* of the governing body, ie how trustees carry out their work
 - *administration, eg service level agreements*
 - *frequency of meetings and effectiveness*
 - *recording of decisions*
 - *management of risks*
 - *internal controls*
 - The *constitution* of the governing body, including up to date trust deed and rules, and other key documents.

What has the Pensions Regulator already done on governance?

- 2.9 The governance of pension schemes has been a legislative and regulatory priority for many years. For example, the composition of trustee boards has been legislated for via member-nominated trustee requirements since 1995, supplementing the existing general obligations of trust law. Likewise the regulator has already provided substantial material relevant to the governance of schemes. This includes ten codes of practice.
- 2.10 In particular the regulator has produced a code of practice and scope guidance which interprets the requirement for trustees to have knowledge and understanding of the law relating to pensions and trusts, and other matters; and to be conversant with the scheme trust deed and rules and other material. We have also provided extensive material designed to help trustees to meet requirements for the funding of defined benefit schemes.
- 2.11 Governance is not therefore an area like scheme funding where recent legislation required a completely new approach. Our priorities therefore reflect existing work as well as proposing new directions.

Chapter 3: The importance of pension scheme governance

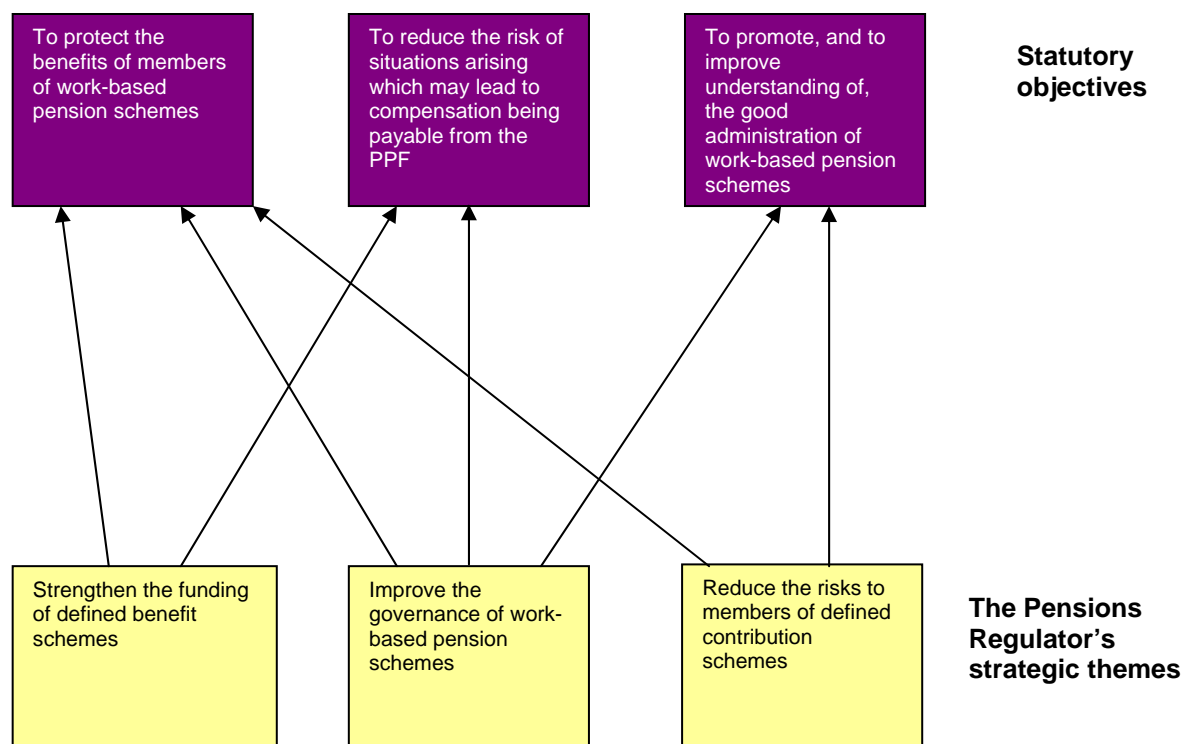
Why is governance important to the Pensions Regulator?

3.1 Our medium term strategy⁶ 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.

Of these, governance is the only one which underlies all of our statutory objectives.

Figure 1
Governance underlies fulfilment of our statutory objectives



⁶ The Pensions Regulator, *Medium Term Strategy*, April 2006, page 4.

The following paragraphs consider the importance of governance to each of our objectives in turn.

Protecting members' benefits

- 3.2 Trust-based pension schemes have a separation of beneficial ownership and day-to-day control of assets. Members own rights to receive benefits under the terms of the trust, and, particularly in DC arrangements, in some cases may be able to exercise certain choices over how those rights are secured, for example by exercising choices between available investment funds. Trustees have legal ownership of the assets and control the range of choices available. Potential risks to members' benefits arise from this separation.
- 3.3 In well-governed schemes, however, where trustees or managers act in accordance with their fiduciary obligations to members (including putting the members' interests above anyone else's including their own), the separation of ownership and control means that a level of skill may be brought into the management of assets beyond that which the beneficiaries could provide on their own behalf.
- 3.4 However, not all trustee boards are in a position to identify potential conflicts between members' interests and other interests. The regulator's governance survey found, for example, that 40 per cent of DB schemes had no means of identifying and recording conflicts of interest.⁷

Reducing the risk of situations which may lead to calls on the Pension Protection Fund

- 3.5 In a well-governed scheme the trustees will be aware of the scheme's funding position and of the employer covenant; they will be taking action, where appropriate and possible, to address these. The regulator found, however, that 40 per cent of DB schemes did not review the sponsoring employer's credit rating or covenant.⁸

Promoting good administration

- 3.6 A well-governed scheme will have systems in place to achieve a high standard of administration. The Pensions Regulator's governance survey asked trustees to self-assess whether they agreed that they 'managed the scheme's administration to ensure an acceptable level of service'. Those who strongly agreed that they managed the scheme's administration in this way were much more likely to describe the service from their administrators on a range of issues as excellent than those who only tended to agree (see figure 2 below).

⁷ Figure 27, page 32, Governance Survey 2006.

⁸ Figure 29, page 33, Governance Survey 2006.

Figure 2
Trustees' self-assessment on management of scheme administration⁹

Consider service to be 'excellent' on:	All schemes: row percentages	
	Self-assessment on managing the scheme's administration to ensure an acceptable level of service ⁸	
	'Strongly agree'	'Tend to agree'
Timeliness	33	8
Value for money	21	10
Accuracy	39	16
Member satisfaction	27	7
Compliance and meeting legal requirements	51	19

Base: interviews with trustees representing 500 schemes (unweighted), 9,901 schemes (weighted)

What determines our regulatory priorities?

3.7 There are a number of factors which influenced our choice of regulatory priorities.

(i) **Existing approaches to governance**

The previous chapter described the extensive work already carried out by the Pensions Regulator on scheme governance, and noted that we will be building on existing priorities rather than purely developing new ones.

(ii) **Evidence of how schemes are governed**

We intend our regulatory approach to governance to be evidence-based. Regulatory intervention should be based where possible on evidence of a risk (or potential risk) to our statutory objectives.

We carried out an extensive survey of governance in 2006.

⁹ Figure 36, page 39, Governance Survey 2006.

The Pensions Regulator's governance survey

In 2006, we carried out a large-scale survey of the governance of open private sector occupational schemes. This comprised in-depth interviews with the trustees of 500 schemes which were a representative cross-section of occupational schemes in general.¹⁰ The survey was developed in consultation with an external advisory group of governance experts from the public and private sector.

Key findings of the survey were:

- A strong association between certain inputs and standards of governance.
- This association was very strong in respect of training. For example, there was a 43 per cent difference in the proportion of trustees strongly agreeing that their scheme 'regularly reviewed its investment strategy' between schemes whose trustees had received advanced training in the last 12 months and those who had received no formal training.
- Other inputs associated with better governance included the presence of a professional trustee, the frequency of board meetings, and having risk management processes in place. Those schemes which had the last of these were considerably more confident that they had internal controls in place to monitor and mitigate a wide range of specific risks.
- Large schemes generally showed higher standards of governance than smaller schemes. This was particularly the case for DB schemes with more than 5,000 members. The survey did not, however, suggest that only large schemes were well-governed nor that they were well-governed in every respect.
- Trustees were generally confident in their self-assessment of governance. The proportion who 'strongly agreed' or 'tended to agree' that their schemes displayed a range of desirable behaviours, such as conducting effective negotiations with the employer, did not fall below three-quarters.
- Nevertheless the survey showed some important gaps in good practice on governance. For example, nearly 70 per cent of trustees of DB schemes have no specified policy to manage conflicts of interest; 37 per cent of trustees of DB schemes do not review the sponsoring employer's credit rating or its covenant. Twenty per cent of schemes have no service level agreement with their administrator.

We have also considered other evidence, for example the Capita Hartshead Pensions Administration Survey, and have formed an industry working group to consider risks to members of DC schemes, following our recent consultation document.¹¹

(iii) Recent and future developments

Our governance priorities are also informed by recent and future developments in the pensions environment. For example, the introduction of scheme specific funding intensifies the need for trustees to communicate with the employer and to be aware of the employer covenant. As a result we might anticipate improvements in our future survey results in this area.

¹⁰ <http://www.thepensionsregulator.gov.uk/docs/governance-survey-report-2006.pdf>

¹¹ <http://www.thepensionsregulator.gov.uk/docs/defined-contribution-consultation-doc.pdf>

A summary of recent and future issues, and the aspects of governance on which they impact, is given below.

Figure 3
Impact of recent and future issues on governance

Development	Likely to increase importance of:
Scheme specific funding to be agreed by trustees and employer	<ul style="list-style-type: none"> Trustees need to <i>know and understand</i> funding and investment issues Trustees need to manage <i>conflicts of interest</i> Trustees need to <i>monitor employer covenant</i>
Legal framework for corporate transactions gives greater weight to impact on pension scheme	<ul style="list-style-type: none"> Trustees need to <i>monitor employer covenant</i> Trustees need to understand <i>implications for members of transactions</i>
Need for independent advice in use of contingent assets	<ul style="list-style-type: none"> Trustees need to manage <i>conflicts of interest</i> Trustees need to <i>manage relations with advisers</i>
Shift from DB to DC	<ul style="list-style-type: none"> Trustees need to ensure <i>good administration</i> Trustees need to <i>offer appropriate investment choices</i> to members
Greater use of contract-based arrangements	<ul style="list-style-type: none"> Potentially <i>greater governance role</i> for provider and employer?
Personal accounts: mandatory auto-enrolment and minimum employer contributions into those work-based schemes whose employers are exempt from requirement to auto-enrol employees into personal accounts	<ul style="list-style-type: none"> Trustees of exempt schemes, and participating employers, will need to <i>ensure good administration of the new requirements</i>

(iv) **The Pensions Regulator's approach to regulation**

Components of our approach include a risk-based approach to regulation, where we intervene according to the scale of risk posed to our statutory objectives, and using our regulatory tools in order to educate and enable as well as enforce.¹² These principles will be reflected in how we implement our governance priorities.

¹² Our approach to regulation was set out in our *Medium Term Strategy* published in April 2006.

Chapter 4: The Pensions Regulator's regulatory priorities for governance

What are our regulatory priorities for the governance of pension schemes?

4.1 Our priorities are set out below:

Knowledge and understanding of the governing body

1 Knowledge and understanding

Relationships of the governing body

- 2 Conflicts of interest
- 3 Monitoring of employer covenant
- 4 Relations with advisers

Procedures of the governing body

- 5 Administration
- 6 Processes for investment choice
- 7 Governance during wind-up

4.2 Chapters 5 to 11 consider each of these priorities in respect of trust-based schemes. For each priority it looks at the evidence, the resulting risk to pension schemes, what the regulator is already doing, and what new proposals we are considering. Chapter 12 considers the application of these priorities to contract-based schemes.

Why have we selected these priorities?

4.3 These priorities are consistent with the determining factors set out in Chapter 3: building on our existing approach to governance issues; evidence of some current shortcomings; the impact of recent and forthcoming developments; and consistency with our risk-based approach to regulation.

4.4 The regulatory priorities are for the medium term (approximately the next three years). They will be reviewed during that period, however, in the light of the determining factors listed above and any other relevant developments.

- 4.5 We believe our regulatory priorities should also be priorities for those who run pension schemes. Any costs of compliance (both in time and money) devoted to governing a scheme well, including in respect of the priorities in this discussion paper, are likely to be saved through the avoidance of costs arising from, for example, untangling poor administration or failing to understand the financial position of the employer. Good governance is also likely to increase the satisfaction of scheme members. We would not expect any costs of compliance to be high.

What is the nature of these regulatory priorities?

- 4.6 We regard the priority of knowledge and understanding as distinct from the others. This is because it deals with the causes of poor governance rather than the behaviour of those who are governing inappropriately. Trustee knowledge and understanding is moreover a legal requirement.
- 4.7 Our view is that trustees who have acquired knowledge and understanding about the nature of schemes and how they should be run are more likely to be able to govern their schemes well. Similarly, trustees who have become conversant with the scheme documents of their own scheme will govern that particular scheme better than those who have not. Participation in the required learning is likely to change behaviours and to achieve the desired results. As an example, we can take the trustee who has always accepted performance benchmarks as a given but who learns for the first time how they are put together and the importance of the appropriateness of any benchmark for a scheme. Thereafter the trustee is much more likely to examine performance benchmarks carefully.

4.8 This view of the importance to governance of knowledge, understanding and conversance with scheme documents is also borne out by the governance survey which showed a strong association between ‘inputs’ such as training (see figure 4 below) and standards of various measures of governance.

Figure 4
Trustees ‘strongly agreeing’ that the board performs in four selected areas¹³

	All schemes: column percentages			
	All schemes	Advanced training in the last 12 months	No formal training in the last 12 months	Difference in percentage points
Regularly reviews its investment strategy	62	84	41	+43
Reviews the scheme rules at regular intervals and updates these as required	55	72	42	+30
Takes steps to ensure it follows good practice in governance	67	81	52	+29
Ensures a high standard of member communications	36	49	22	+27

Base: interviews with trustees representing 500 schemes (unweighted), 9,901 schemes (weighted)

Smaller schemes

4.9 Our approach to regulation seeks to be proportionate and risk-based. We are conscious of the diversity of schemes which we regulate and that the measures required to ensure good governance in a large scheme may not be appropriate in a small scheme. We also understand that not all schemes will have access to advice in interpreting regulatory requirements.

4.10 We expect the principles of our regulatory priorities to apply to all schemes, regardless of size. However, smaller schemes may wish to meet these principles in different ways. Where the regulator has already catered for the needs of smaller schemes, this is highlighted in subsequent chapters. One of the questions for discussion asks for views on how all the priorities can be addressed for smaller schemes.

¹³ Figure 12, page 20, Governance Survey 2006.

Chapter 5: Knowledge and understanding

Introduction

5.1 Legal requirements concerning trustee knowledge and understanding (TKU) are set out in the Pensions Act 2004.

What does the evidence say?

5.2 The governance survey shows an apparent link between knowledge and standards of governance: there was a strong association between good practice in governance and the undertaking of advanced training, as shown in figure 4 above and in figure 5 below.

Figure 5
Formal review at least every three years by DC and segregated schemes¹⁴

	All schemes: row percentages		
	Advanced training in the last 12 months	No training in the last 12 months	Difference in percentage points
Appropriateness of investment choices offered to members	93	66	+27
Performance of investment funds offered to members	91	71	+20
Level of fund charges	89	64	+25
Administrative services for individual members with DC benefits	69	60	+9

Base: interviews with trustees representing 251 DC and segregated schemes (unweighted), 4,461 DC and segregated schemes (weighted)

5.3 Trustees need opportunities to increase their knowledge and understanding. Below is an example of how one board of trustees used trustee meetings to do this.

¹⁴ Figure 13, page 18, Governance Survey 2006.

Case example

The trustees of the UK pension fund of a multinational company (20,000 members, DB and DC sections, £½ bn in assets) developed the routine of holding a training session before each of the regular quarterly trustee meetings. With the meeting normally at 1.30pm, the trustees would convene at 11.00am for a 1½ hour session with the advisers covering in detail a specific topic on the agenda, such as the actuarial valuation, asset allocation or a new trust deed and rules. This was an opportunity for the rationale and methodology to be explained in detail, and for the trustees to ask questions on the technical content of the subject. The intention was that not only would the trustees gain a deeper understanding but that the afternoon's meeting was free to focus on the principles and the decision without its being side-tracked by minor technical matters. This was also a good and efficient use of advisers' time.

What is the risk to pension schemes?

- 5.4 We would expect trustees who know and understand their duties to pose lower risks of poor scheme governance than those who do not.
- 5.5 A poor level of trustee knowledge and understanding could also impact adversely on employers, for example through the development of an investment strategy which led to or increased a scheme deficit.

What is the Pensions Regulator already doing?

- 5.6 The regulator has produced:
 - (i) the TKU code (see www.thepensionsregulator.gov.uk/codes/code-trustee-knowledge.aspx);
 - (ii) 'scope guidance' (the scope of the knowledge required under the trustee knowledge and understanding provisions);
 - (iii) the 'trustee toolkit', an e-learning programme which aims to help trustees acquire the knowledge and understanding required. The toolkit is built in such a way as to allow learners to follow the running of a fictitious scheme over a period of time and to participate in the decision making of the trustees of that scheme. Through simulation, the learner joins a board of trustees running a well-governed scheme, and participation demonstrates what contributes to good governance in a very real way. Over 17,000 people have registered with the trustee toolkit, and the rate of sign-up averages around 280 per week;
 - (iv) other codes of practice, nearly all of which are directed at trustees;
 - (v) an indicative syllabus, which has been handed over to the Financial Services Sector Skills Council and is the building block of the Pension Management Institute's award in trusteeship (40 registered for this as at the end of October 2006).
- 5.7 Our preferred approach to TKU is to effect behavioural change rather than be enforcement-driven.

What new proposals are we considering?

- 5.8 We will seek to meet with key organisations and service providers to encourage institutions within their own fields to promote targeted education.
- 5.9 We will continue a concerted effort to publicise the toolkit as a way for trustees to acquire knowledge and understanding. For example, pension providers have been asked, following discussion with the ABI and insurance companies, to include material on the toolkit in their communications with trustees. We have discussed with professional advisers how they might use the toolkit as part of a ‘blended learning’ solution. Several articles have also appeared in a variety of publications. Below is an example of how a trustee board used the toolkit.

Why Veolia UK Pension Trustee Limited chose to use the trustee toolkit

The Veolia Trustee Board is trustee to three trusts comprising 22 DB and DC pension schemes with assets of approximately £500 million and 9,200 members. It is supported by a number of committees to whom it delegates certain activities. These include an Investment Committee and four Committees of Management (one for each of Veolia’s major business sectors).

While many of the committee members do not sit on the trustee board, Veolia UK considered nonetheless that trustee knowledge and understanding (TKU) applied to all 42 board and committee members. Veolia considered that the most appropriate way to ensure at least the minimum level of TKU was through the self-learning and self-examination offered by the regulator’s trustee toolkit.

Veolia’s required standards of TKU differed between individuals. Trustee board members have to aim to have passed in all subjects within two months of issue of each module. Those who sit only on the Investment Committee are initially required to have passed only the investment and funding modules; those who sit only on a Committee of Management (which mainly deals with early retirements, late entrants and deaths) are not initially required to pass the funding or investment modules.

Each committee member has a personal training log and has targets to increase his or her learning during 2007. For those on committees who currently do not need to have passed all modules, their target is to achieve all modules. For those who need all modules, the target is for 75 per cent of them to have also achieved the PMI’s new Trustee Certificate.

To back all this up Veolia has a monitoring system and a review system initially involving the in-house head of pensions and, subsequently, the trustee chairman for those who fail to achieve the required levels.

During the six months from April 2006, when committee and board members were getting to their individually required level of module passes, Veolia organised a day in its National Centre for Development. This was extremely successful in getting many of the committee and board members started on the toolkit, giving them confidence to progress to other modules on their own, and building a team spirit among them.

- 5.10 We are taking steps to secure that the scope guidance will form the basis of National Occupational Standards (NOS) for pension scheme trustees. We are taking on this work on behalf of the Financial Services Sector Skills Council. In addition to the scope (and the related indicative syllabus), the NOS will comprise desired activities and outcomes.
- 5.11 We will be reviewing the code, scope guidance, indicative syllabus and the toolkit in 2008 to ensure they continue to be fit for purpose.

Smaller schemes

- 5.12 The needs of small schemes are reflected in the explanatory notes to the scope guidance and the tailored learning paths within e-learning. Specifically, there are separate scope requirements for DB (or DC with a DB element) which are typically larger schemes, compared with DC only, which are typically smaller schemes. All schemes have access to publicly available material on knowledge and understanding.
- 5.13 Moreover, as our information about smaller schemes improves, particularly through data from our scheme return, we will consider how we can use this to direct the trustees of smaller schemes towards relevant information and training. The trustee toolkit remains an effective, free, readily available resource which should suit smaller scheme trustees.

Chapter 6: Conflicts of interest

Introduction

- 6.1 The potential for conflict of interest arises for many of those involved in the governance of pension schemes. Trustees are covered in this chapter; potential conflicts arising for advisers to trustees are covered in Chapter 8.
- 6.2 For trustees it is a breach of their fiduciary obligation not to put the interests of members above their own or their employer's. The state of being conflicted is not in itself a breach of fiduciary obligation, but a breach may occur as soon as action or a decision is taken without the conflict being resolved.
- 6.3 Conflicts (and indeed our other regulatory priorities) are likely to be easier to manage when there is trust between employers, trustees and others, as the example below illustrates.

Case example

- This case originally came to our attention as a result of an MFR extension application which was duly granted subject to an annual review of compliance. The scheme is a small DB arrangement with approximately 300 members.
- As a result of the change in the statutory funding regime, and taking into account the financial history of the group, the Pensions Regulator was approached jointly by the trustee board and employer to listen to their concerns regarding future funding. The employer had a number of concerns following the publication of the regulator's statement on funding, and wished to discuss the impact on what they considered to be a fragile employer covenant. Following discussions with the regulator, it was evident that the managing director, with a dual role as chairman to the trustees, was subject to a material conflict of interest which was beyond mitigation.
- In the light of the circumstances, and taking into account the dialogue which would take place between the trustees and the employer, it was evident that the conflict would prejudice the role of the trustees. Had any comments from the conflicted person resulted in a certain course of action being taken, it would be difficult for the trustees to demonstrate that they had had full regard to their fiduciary obligation to members.
- As a result of these circumstances, the conflicted director / trustee abstained from any decision making or attendance at meetings until the funding issues had been addressed fully. This was supported by the role of the independent trustee, who had been a member of the trustee board for a number of years, and who was able to negotiate the exclusion of the conflicted trustee on an entirely amicable basis. This was considered to be the most appropriate course of action while also recognising that the conflicted person had in the past provided the trustee board with a level of scheme knowledge which would not have been available to the board had his initial appointment not been approved.
- The trustees and employer recognised the seriousness of the level of funding and the inability of the employer to make good this deficit within a reasonable period of time. A decision was therefore made at an early stage to address matters and share concerns with the regulator. We recognise that there will be circumstances where trustees and / or the employer may wish to approach us to discuss funding-related concerns.
- The Pensions Regulator recognises that for smaller schemes in particular appointments of this nature ensure that schemes are managed by the most experienced and knowledgeable person. What need to be recognised and managed are those situations when a conflict becomes untenable. In the case outlined above, the board of trustees and employer recognised the extent of the conflict and took corrective action early in the funding process.

6.4 The regulator's general position on conflicts of interest is as follows.

- Given the importance of pensions to many employers it is understandable that those who hold senior positions with the employer, and have greatest knowledge of the employer's business, will want to be trustees of the pension scheme. It is also an advantage to the scheme to have senior staff as trustees.
- Senior employees are more likely to be conflicted than other employees, but all trustees, including MNTs, are potentially conflicted.
- Resignation of a trustee is usually a sub-optimal means of resolving conflicts; other means are generally available.
- Various mechanisms can be used to manage conflicts, including: considering in advance where conflicts may arise and taking appropriate action beforehand; more specifically, maintaining registers of conflicts; removal of trustees from decisions affecting conflicted areas; and taking responsibility for the source of material, eg ensuring that advice taken by trustees is independent from that received by the employer where circumstances make this appropriate.
- Transparency about potential conflicts is essential, through recognition of the conflict and informing others.
- The key message is to ensure that conflicts are identified and managed appropriately.

6.5 An example of how one trustee board used different procedures for managing conflicts is below:

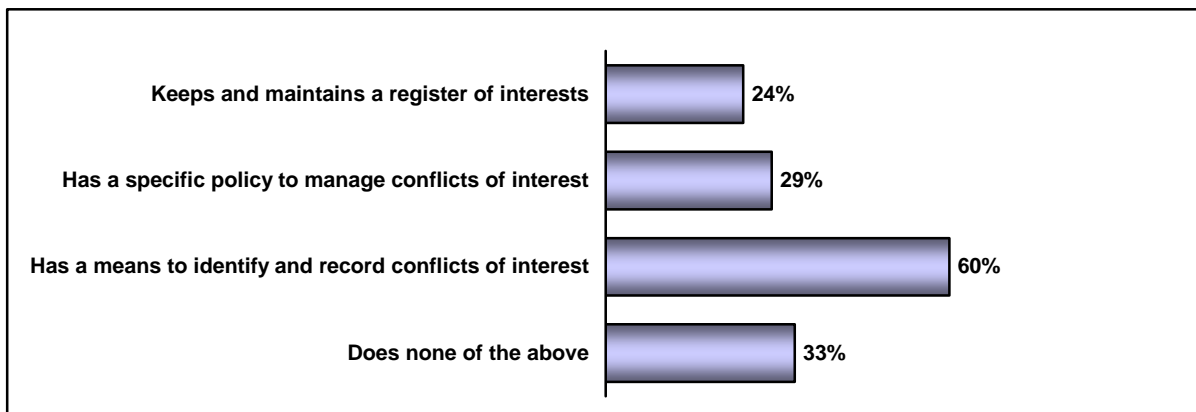
Case example

- The scheme has approximately 9,300 members. Following agreement of the scheme's first scheme specific funding valuation with the principal employer, a quoted plc, the trustees submitted a recovery plan and schedule of contributions to the regulator. This information was subsequently reviewed, at which stage concerns were raised by regulatory staff over the large proportion of employer-nominated trustees on the board. A meeting was subsequently arranged by the regulator with the trustees and their actuarial adviser to discuss these concerns and other issues. As a result of discussions, however, it was evident that the trustees had indeed recognised the extent of the conflicts and had put in place detailed procedures to avoid any subsequent accusations of bias. These included:
 - a conflict document detailing all the individual trustee duties (both internal and external) and identifying areas of potential conflict;
 - proposed procedures for dealing with conflicts; and
 - a set format for inclusion in trustee meeting minutes of disclosure of conflicts and action taken by the board and / or individuals (eg non-participation in discussion or absence from meeting).
- The trustees had fully embraced the importance of identifying and managing conflicts of interest. This was further emphasised during a meeting with regulatory staff. During the course of discussions, matters in relation to the employer were raised. The non-executive director / trustee immediately declared a conflict and proceeded to exclude himself from the subsequent discussions and decision making.

What does the evidence say?

- 6.6 The governance survey indicated that relatively low proportions of schemes had policies in this important area. Only around a quarter of DB schemes had a register of interests (24 per cent) and a specific policy to manage conflicts (29 per cent). However, three-fifths (60 per cent) of DB schemes said they had the ability to identify and record conflicts of interest.

Figure 6
Activity in the area of conflicts of interest amongst all DB schemes¹⁵



Base: interviews with trustees representing 313 DB schemes (unweighted), 6,454 DB schemes (weighted)

What is the risk to pension schemes?

- 6.7 If trustees do not manage their conflicts of interest, they may not act in members' best interests.
- 6.8 The risks to pension schemes from conflicts of interest are greatest in defined benefit schemes. This is because decisions by the employer which potentially conflict with the interests of scheme members, for example on resource allocation, are likely to arise more frequently. Moreover, developments such as the greater role of trustees in corporate transactions and scheme specific funding are likely to lead to greater potential for conflicts. Conflicts also arise, however, in DC schemes.

What is the Pensions Regulator already doing?

- 6.9 Conflicts are touched on in a number of publications: the scope guidance for TKU, the trustee toolkit and the code of practice on funding defined benefits. They are also mentioned in our guidance on applications for clearance.
- 6.10 Where conflicts of interest are not being managed we work with, and if necessary replace, conflicted trustees.

¹⁵ Figure 27, page 32, Governance Survey 2006.

What new proposals are we considering?

- 6.11 We will issue guidance specifically on conflicts of interest. This will include the circumstances when advice which is independent from that received by the employer is likely to be appropriate in order to manage the conflict which would otherwise exist.

Smaller schemes

- 6.12 The principle of needing to manage conflicts is the same regardless of the size of scheme.
- 6.13 Smaller schemes may need different solutions because, for example, appointing an independent trustee is disproportionately expensive. We will consider the needs of smaller schemes in the forthcoming guidance.

Chapter 7: Monitoring of employer covenant

Introduction

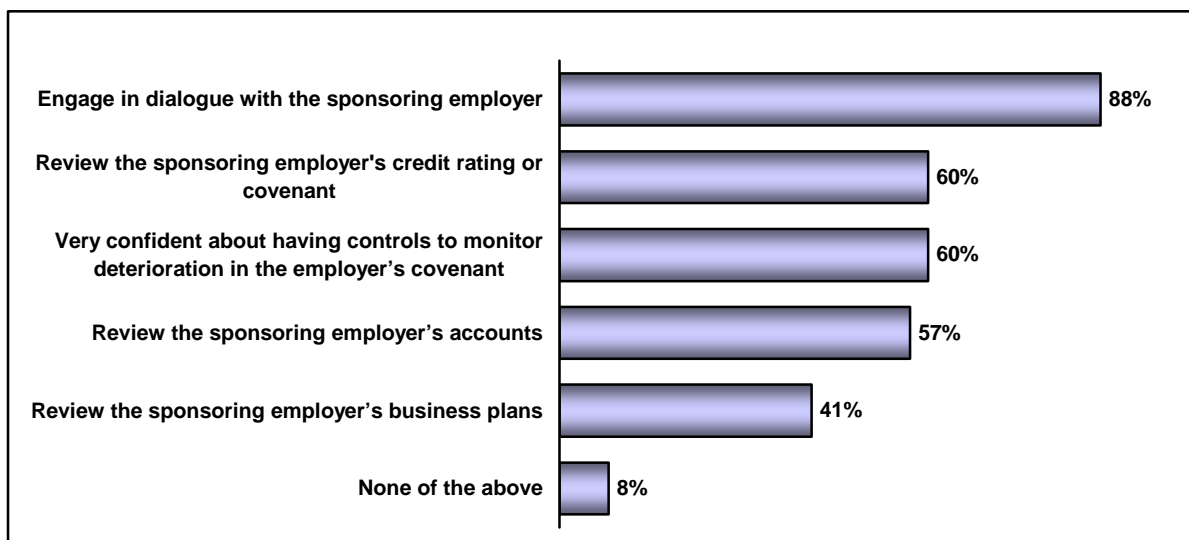
- 7.1 For defined benefit schemes in particular the employer plays a vital role as the sponsor of the scheme. The employer covenant is crucial to understanding the context of a scheme's technical provisions and any recovery plan. Trustees need therefore to understand the financial strength of the employer. They also need to be prepared to understand the implications for the scheme of proposed changes in ownership of the employer or other significant transactions.
- 7.2 Not all employers are commercial businesses, for example charities, but the trustees should still have an understanding of the sponsoring employer's financial status.

What does the evidence say?

- 7.3 According to the 2006 governance survey around two-fifths of DB schemes did not regularly review the employer's covenant or business plans. We would expect implementation of the new scheme specific funding framework to lead to a reduction in this proportion.

Figure 7

Dialogue or engagement with the employer in respect of scheme funding amongst all DB schemes¹⁶



Base: interviews with trustees representing 313 DB schemes (unweighted), 6,454 DB schemes (weighted)

¹⁶ Figure 29, page 33, Governance Survey 2006.

What is the risk to pension schemes?

- 7.4 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 a call on the Pension Protection Fund. Below is an example of how increased knowledge of an employer's financial position assisted in the agreement of a recovery plan.

Case example

- The scheme in question has 2,500 members and assets of approximately £65 million. Below is the covenant review process that the trustee board went through prior to agreeing a suitable recovery plan.
- The UK employer, whose principal activity is the manufacturer of quality food products, is a subsidiary of a large overseas parent. The employer has developed a prestigious brand name. While the pension scheme had a substantial deficit when compared with the net worth of the employer's balance sheet, it was considered to be fairly modest when compared with the consolidated results of the group.
- The parent has provided considerable funding to support the UK employer's operations. The trustees recognised this financial support and therefore sympathised with the parent's reluctance to provide further funds to eliminate the deficit immediately, as originally requested by the trustee board. Instead, meetings were held with the employer and representatives of the overseas parent to negotiate the length of the recovery plan.
- To assist with these discussions, the trustees appointed a firm of accountants to prepare an Independent Business Review (IBR) of the employer's covenant (and effectively assess the availability of future cash flows to fund the scheme deficit). Prior to the work commencing, the trustees agreed precise terms of reference with the appointed firm in order that the correct level of financial information was delivered within given timeframes. Because of the complex nature of the group structure, there were also a number of specific areas that the trustees wished the IBR team to focus on, including intangible assets.
- The IBR identified that, although the longer term prospects for the company appeared positive, there was limited funding available to eliminate the pension deficit in the short term. The IBR highlighted that all bank borrowing had been repaid, with the charge on the company's assets released. The trustees were also better placed to establish that, in addition to the value attributable to the tangible assets of the employer (namely property and stock), there was also value attributable to the brand name. After receiving appropriate advice from the accounting team, the trustees proposed an arrangement which granted the employer greater flexibility in the terms of the period of recovery, in return for contingent assets. This took the form of a charge over a specific company asset with a market value of £20 million.
- The employer accepted the terms proposed by the trustees in recognition of adopting a nine-year recovery plan. The length of the recovery period also recognised the need for the employer to maintain firmly its presence in a competitive market place: consideration was given to cash flow constraints as well as the cost of reinvestment by the employer to maintain a competitive edge, while providing the trustees with the comfort afforded by the contingent asset.

- 7.5 In the absence of monitoring the covenant, trustees are also unlikely to be in an appropriate position to assess the impact of corporate transactions which may alter the employer's financial strength. The example below illustrates the benefits of knowing the employer's strength during such a transaction.

Case example

- As a result of a number of changes to core activities, it was decided that one of the participating employers of a multi-employer arrangement was to be sold. The trustees recognised that this might result in a deterioration in the strength of the employer covenant as well as that of the group, and that this posed a substantial risk to members' benefits. The scheme, a defined benefit arrangement with assets of £236 million and 1,800 members, had an FRS17 liability of approximately £80 million.
- The parties to the transaction applied for regulatory clearance of the transaction and discussions with both the trustees and regulator commenced. To ensure the best financial outcome for the members of the scheme, the trustees commissioned an independent business review (IBR) of the group to be used in the negotiation process. The trustees appointed a firm of accountants to undertake this specialist piece of work, ensuring that the firm appointed were independent from the advisers to the employer group. It was also agreed with the employer that sufficient access would be given to sensitive financial information.
- The IBR provided the trustees with concise financial information relating to the employer and its fellow subsidiaries. Following this review it was evident that there were a number of substantial unencumbered assets. Discussions were held with the relevant parties with a view to the trustees taking a charge over these assets, in addition to cash consideration, on the basis that the transaction posed a financial risk to the scheme which needed to be mitigated.
- As a result of negotiations, including dialogue with professional advisers, various assets were granted as security to the scheme. Following further advice from the accountants advising the trustees, concerns were raised in respect of the overseas location of ownership of the assets. After a series of meetings an agreement was reached such that ownership of the contingent assets pledged as security was transferred to the UK operations resulting in an immediate improvement to the covenants of the UK subsidiaries.

What is the Pensions Regulator already doing?

- 7.6 Knowledge of the employer covenant is included within the TKU scope guidance, and its importance is emphasised in the code of practice on funding defined benefits. It is also covered in the trustee toolkit. We may in addition provide more targeted material based on the information in our scheme returns.
- 7.7 The trustee toolkit also has material for trustees whose sponsoring employer is not a commercial business.
- 7.8 The regulator will consider the employer covenant, and the steps taken by trustees to assess it, when reviewing the trustees' determination of technical provisions and their setting of recovery plans. We also consider in the context of applications for clearance of corporate transactions whether an employer is seeking to avoid its obligations to its pension scheme; additionally, some of the events which have to be notified to the regulator are relevant to the employer covenant.

What new proposals are we considering?

- 7.9 The regulator is already devoting considerable resources to this area. This discussion paper contains no new proposals; rather our priority is to help trustees embed monitoring of the covenant in their activities.

Smaller schemes

- 7.10 As with conflicts of interest, the principle of the need to monitor the employer covenant applies to all schemes but the approach may need to be different for smaller schemes. For example, full independent business review may not be cost effective, but trustees may be able to refer to other sources of information, including plans provided by the employer.

Chapter 8: Relations with advisers

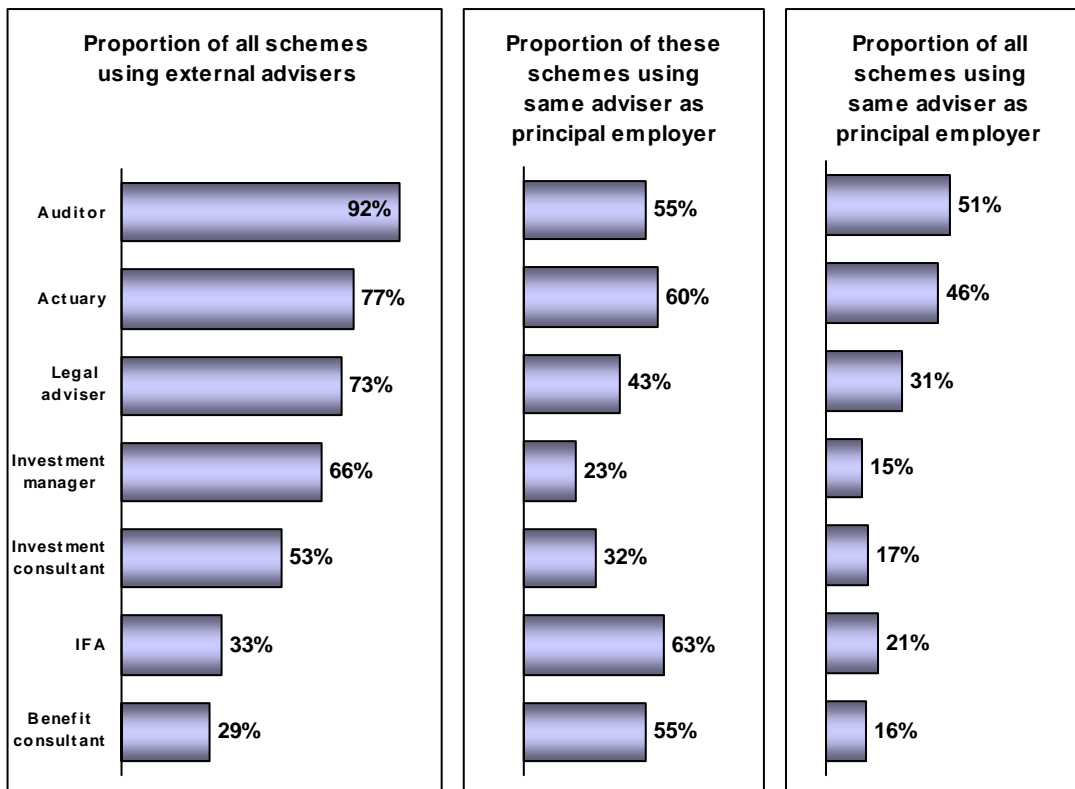
Introduction

8.1 Trustees are required to take advice from suitably qualified persons in areas such as investment and actuarial matters. Expert advice is essential to help trustees act in the best interests of members.

What does the evidence say?

8.2 The governance survey identified that a substantial proportion of schemes had the same advisers as the employer (see figure 8 below). For example around half of the schemes surveyed used the same actuary and auditor.

Figure 8
Use of advisers¹⁷



Base: interviews with trustees representing 500 schemes (unweighted), 9,901 schemes (weighted)

¹⁷ Figure 31, page 35, Governance Survey 2006.

What is the risk to pension schemes?

- 8.3 Risk potentially arises in two areas. First, an adviser may have a conflict of interest if he or she (or the same firm) is also advising the employer or, in certain circumstances, advising another scheme or employer with whom the trustees are engaged.
- 8.4 Secondly, there is the risk that advice is not properly understood by trustees, or is not provided by suitably qualified advisers.

What is the Pensions Regulator already doing?

- 8.5 The TKU code, scope guidance, and trustee toolkit all cover the issue of understanding advice.

What new proposals are we considering?

- 8.6 We intend to issue questions to ask advisers. These will be aimed at trustees, and employers where relevant, for example where they have the power to appoint scheme advisers. The questions will cover issues such as the suitability of the adviser for the issue on which advice is sought and how advisers will manage conflict (for example Chinese walls) as well as identifying circumstances where care over advisers is needed, such as on the use of contingent assets.
- 8.7 The Morris Review considered that a regulatory code of practice on how trustees manage adviser relationships would be useful, and that case study materials should be made available.¹⁸ We are not convinced at this stage that a code is necessary but will keep this option under review, depending on future evidence on adviser relationships.

Smaller schemes

- 8.8 The risks of conflict of interest, failure to understand advice, and use of advisers who are not suitable for the issue on which advice is sought can arise at least to the same extent in smaller schemes. We recognise that, in line with our proportionate approach to regulation, it is not generally cost effective for small schemes to manage conflict by using separate advisers from the employer. Trustees of small schemes should however be aware of the scope for conflict, and of limitations in the range of issues their advisers may be expert in. We will aim to ensure that the questions we provide are relevant for trustees of all schemes.

¹⁸ Morris Review of the Actuarial Profession, March 2005, final report, page 35. (http://www.hm-treasury.gov.uk/media/CA0/9C/morris_final.pdf)

Chapter 9: Administration

Introduction

9.1 Good administration is integral to ensuring that legislative and regulatory requirements are met, that the provisions of the trust deed and rules are complied with, and that members receive the level of benefits and service to which they are entitled.

What does the evidence say?

9.2 The evidence on administration standards is mixed, with high levels of service and satisfaction reported by some but shortcomings identified by others.¹⁹ Our governance survey showed that trustees are largely satisfied with the administrative services they receive. It revealed, however, that 36 per cent of all DC schemes surveyed had not reviewed their administrative services in the previous three years. Our survey also showed that around 25 per cent of schemes either had no service level agreement in place with their service provider or at least were not aware of any such agreement.

9.3 Finally, our survey also indicated that formal risk management processes are only common among the largest trust-based schemes, and of those DC schemes surveyed only 33 per cent had formal processes in place (see figure 9 below).

Figure 9

Trust-based schemes with formal processes in place to identify risks²⁰

All DC	33%
DC 12-99	24%
DC 1,000+	51%
10,000+ members (DB and DC)	85%

¹⁹ For example Cranfield University and Higham Dunnett Shaw, in *Restoring Confidence: Measuring and Managing Performance in Pensions*, said 'our experience is that **one in three** pension schemes suffer systematic, wholesale administration errors and omissions' (p4); and 'the range of common ills is staggering' (p9). The Pensions Advisory Service and the Pensions Ombudsman also both report poor administration as a major source of complaints. On the other hand the Capita Hartshead 2006 Pensions Administration Survey said: 'Pleasingly, the 2006 Survey has identified an improvement in scheme administration standards across the board, particularly in terms of cost savings'.

²⁰ Figure 20, page 25, Governance Survey 2006.

9.4 An example of a trustee board which used a Governance Plan to enable good administration is set out below.

Case example

- The board of trustees of the LogicaCMG Defined Contribution Pension Scheme showed a commitment to good scheme governance. To assist trustees in their role and help give them direction, a 'Governance Plan'²¹ was produced which captured not just some key processes, but also the trustees' objectives.
- The Governance Plan collated key information and permanent data in one user-friendly 'living document'. The document included a business cycle which summarised a number of key dates for important areas of stewardship, including reviews of investment management and performance, advisers (including administrators), trustee training, and levels of communication.
- The Plan could be updated to take account of changes. It provided a very useful planning tool for future trustee meetings, ensuring efficient use of time not just for the trustees and the various sub committees, but also for the professional advisers.

What is the risk to pension schemes?

9.5 The risks of poor administration include the following:

- members receive incorrect or delayed benefits on transfer, death or retirement;
- members receive inaccurate information, which may lead to inappropriate decisions;
- non- or late payment of contributions, especially to a defined contribution scheme, may lead to delay or inaccuracies in payment of benefits;
- in a defined benefit scheme, inaccurate records could lead to the wrong value being placed on benefits. This may have consequences for calculating technical provisions, benefits, and the levy. These may in turn have harmful consequences for the employer.

9.6 Risks to members from poor administration are often higher during periods of change to the employer(s), for example during mergers, takeovers or insolvencies. At such times the focus may be on other areas of the business, so it is important trustees ensure that members' records are preserved and their interests safeguarded at these times.

9.7 The greater complexity of administering a DC scheme makes it particularly important for trustees to ensure their administrators are equipped for the change when a scheme is moving from DB to DC.

²¹ In the trustee toolkit and scope guidance the document which fulfils a similar purpose is called a 'business plan', and this is the term which the regulator uses.

What is the Pensions Regulator already doing?

- 9.8 The Pensions Regulator's codes of practice of particular relevance for administration are:
- internal controls;
 - reporting breaches of the law; and
 - reporting late and non-payment of contributions.
- 9.9 The regulator's e-learning syllabus and modules also emphasise the importance of administration.
- 9.10 We receive reports of poor administration, such as delays in scheme wind-ups. Where appropriate, trustees are replaced if they are not taking sufficient steps to meet their obligations.
- 9.11 Our industry-wide consultation group on DC risks is considering both administration and costs.
- 9.12 Other parties are also taking steps to ensure good practice in administration. We welcome these initiatives and will contribute to and support them where appropriate.²²

What new proposals are we considering?

- 9.13 The regulator intends to do more of the following:
- the promotion and sharing of good practice;
 - developing closer relationships with administrators and those who work with them, eg auditors;
 - making greater use of the regulator's enforcement powers where other means have not succeeded;
 - giving more publicity to interventions by the Pensions Regulator.

A full description of our proposals on administration is in the consultation document on risks to members of DC schemes.

²² For example, the Model Administration Agreement published by the Pensions Management Institute (www.pensions-pmi.org.uk) and the forthcoming standards for administration produced by Raising Standards in Pensions Administration (www.raisingadminstandards.com).

Chapter 10: Processes for investment choice

Introduction

- 10.1 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 appointment and review of investment managers and consultants. Poor investment performance does not in itself mean that trustees have failed in their obligations, provided that they have followed appropriate processes.
- 10.2 A scheme's trust deed and rules will often give the trustees wide powers of investment. They may also however impose limitations on, for example, the types of investment trustees are allowed to make. Trustees must understand these limitations and act within them.
- 10.3 The Pensions Regulator's role is not one of advising schemes specifically on how to invest their assets. Nor does our role extend to other significant influences on investment return such as the level of contributions.

What does the evidence say?

- 10.4 Our 2006 Governance survey reported that 82 per cent of trustees considered themselves 'fairly well equipped' or 'very well equipped' to understand how scheme assets are invested. Trustees of larger schemes regularly review investment strategy, but the proportion of trustees of smaller schemes (particularly small DC schemes) who do so is much lower.
- 10.5 The survey also highlighted that around a quarter of DC schemes surveyed had not reviewed their investment fund charges in the previous three years.

Figure 10

Formal review at least every three years: differences by scheme size²³

	All trust-based DC and segregated schemes			
Review Topic	All schemes	12–99	100–999	1,000+
Level of fund charges	75%	67%	82%	88%

Base: interviews with trustees representing 251 DC and segregated schemes (unweighted), 4,461 DC and segregated schemes (weighted)

²³ Figure 23, page 28, Governance Survey 2006.

What is the risk to pension schemes?

- 10.6 Poor processes for investment choice risk lower investment returns; these impact in different ways on DB and DC schemes.
- 10.7 In a DB scheme the risks of poor investment performance include underfunding and higher costs to the sponsoring employer.
- 10.8 In a DC scheme (and the AVC component of DB schemes) risks include a reduced fund value for members and reputational damage to the scheme and employer.

What is the Pensions Regulator already doing?

- 10.9 Investment matters form a major part of our educational activity. The TKU code of practice covers the broad responsibilities of all trustees in relation to investments.²⁴ The scheme funding code of practice covers the responsibilities of trustees of DB schemes.
- 10.10 E-learning modules on investment-related issues include: the four major asset classes; funding your DB scheme; recovery plans, contributions and funding principles; how a DC scheme works; and fund management. A further e-learning module on strategic investment was published early in 2007. There is also some high-level guidance for trustees on investment on the regulator's website.

What new proposals are we considering?

- 10.11 The consultation document on risks to members of DC schemes proposes that the regulator provides examples of:
- effective processes to aid selection and regular review of performance of investment managers and funds;
 - different approaches to the design of default funds and a list of issues to be considered;
 - investment options, including diversification;
 - clear and simple information that can be provided to members, including investment options, investment performance, decisions to make, levels of risk, and a list of questions that should be expected from members.
- 10.12 We also propose to provide examples of good practice in processes for investment choice in relation to DB schemes.

²⁴ Units 3–9 of the DB scope guidance and units 3–6 of the DC scope guidance relate to investment matters. The regulator has issued an indicative syllabus for TKU, of which units 3–9 and 11 relate to investment.

10.13 We are currently engaged with industry bodies, through the regulator's DC industry working group, in addressing these and other areas.

Smaller schemes

10.14 Smaller schemes have different needs in this area. This is reflected in our trustee toolkit and we will also take account of the needs of smaller schemes in our consultation with industry bodies mentioned above.

Chapter 11: Governance during wind-up

Introduction

11.1 Achieving a successful wind-up in a reasonable time requires a pension scheme to be governed well. Wind-up is often the point at which the consequences of previous poor governance will become apparent. Poor record-keeping can lead to significant delays, to the detriment of members' benefits.

11.2 Below is an example of a wind-up which was completed relatively quickly.

Case example

- When a scheme goes into wind-up, the trustees must as far as possible drive the process towards buyout efficiently and effectively. The trustee directors of this scheme (with 1,400 pensioners and deferred members) took a decision to wind up in May 2006 with a view to fully winding up the scheme by the summer of 2007. The chairman and the pensions manager have driven the process hard and as a result there is every chance that the trustee directors will achieve this ambitious timetable.
- The rapid progress to date is the result of a number of factors. First the administration of the scheme was brought in-house three years ago and the pensions manager and her assistant undertook a thorough data-cleansing exercise to make sure that the records were complete and accurate. This included existence checks and use of the DWP tracing service, which resulted in the discovery of unknown addresses of some of the deferred members as well as someone claiming a pension to which they were not entitled. Second, and following advice from the scheme actuary, a decision was made to move from equities to bonds and other fixed interest assets and to align the portfolio so that it would be acceptable to an insurer when the decision to wind up was taken. Third, the trustees ensured they received timely advice from professional advisers, including advice in relation to the buyout process and the selection of potential providers. As part of the selection process, the trustee directors visited the potential providers to satisfy themselves that they would handle the transition efficiently and swiftly. They also asked their lawyers to vet the contractual terms offered by the providers.
- Trustee meetings have been held on a regular basis to ensure that there is no slippage in the timetable. In between meetings, papers requiring trustees' input are circulated and advisers work to tight deadlines reviewing all documentation including communications to members. The contract with the provider has been signed and the work is now progressing to the stage of transferring assets, data, and payment of pensions. A detailed work plan has been agreed by all parties to achieve the various stages by specific dates.
- The investment managers too have been kept informed of the situation and will shortly be transferring the assets to the provider. The in-house pensions team is geared up to transfer all the necessary data, and the recipient administrator's systems have been confirmed as compatible.
- This example illustrates the effectiveness of agreed and well planned procedures to manage the process of winding up a scheme. Of critical importance is the need to cleanse data. It is only too common for scheme wind-ups to be delayed as a result of incomplete records.

11.3 Below is another example of how project planning helped the wind-up process.

Case example

- This is the approach the corporate trustee body of the Henlys Group Plc Pension Scheme (the Henlys Scheme) adopted during the wind-up of this scheme (which was triggered by the insolvency of a participating employer).
- The Henlys Scheme was an underfunded defined benefit scheme with around 2,200 deferred pensioners and 1,800 current pensioners (including a small defined contribution section covering about 30 people). Members were naturally upset and anxious about their individual financial positions, and keen to understand exactly what reduced benefits they could expect from the scheme. The trustee understood the need to progress the wind-up with minimum cost and disruption and maximum efficiency. They also recognised the need to communicate with members in a sensitive manner. After various meetings, the trustee decided to appoint advisers to help facilitate the wind-up process.
- Following advice the trustee decided to implement a project plan to manage the execution of the wind-up process to completion. The plan also covered procedures in relation to the handover of information from the outgoing administration team as delays in this area were detrimental to the completion of a number of other key processes.
- In order to control costs, the project plan involved the completion of all key tasks within a two-year period: as agreed with the advisers, it included a number of target dates at which key actions had to be completed. After this period, the scheme could be run in a highly cost-efficient manner, while the trustee collected outstanding contributions from the employer, payable under a court-sanctioned 'agreement'. Once all such monies are collected the initial work means that the finalisation of an official wind-up can be concluded.
- At regular intervals the advisers reported to the trustee outlining progress, highlighting any issues arising, consequential actions and further recommendations. Communication channels were also agreed should any urgent issues need to be escalated between quarterly meetings.
- As a result of carefully managing and monitoring the process of wind-up, the scheme is well on track to meet the targeted two year deadline of effectively completing the majority of the wind-up. To date, the vast majority of milestones have been met and corrective action has been taken where this has not been the case. As a result of good project management, it was possible to identify potential delays at an earlier stage, giving the trustee and the adviser better control over activities.

What is the risk to pension schemes?

11.4 Risks arise to members' benefits if wind-up is not done properly. Benefits are either delayed or, in the worst cases, calculated incorrectly or not paid at all. Moreover, the fund available for benefits can become greatly depleted by fees which, in the worst cases, may also be excessive.

11.5 There is potential interaction with the Pension Protection Fund (PPF). A scheme which is eligible for PPF protection, because for example it had a sponsoring employer at April 2005, could become liable for compensation payments if its funds become depleted.

What does the evidence say?

11.6 The regulator is aware of a number of wind-ups which are unsatisfactory. The example below illustrates the problems which can arise.

Case example

- The scheme is a small hybrid scheme with approximately 150 members. The trustees commenced wind-up in 1993. Due to members' complaints relating to alleged excessive fees and the time taken to date to complete scheme wind-up, an independent trustee was appointed.
- Due to errors on the membership records database, a lot of work had to be rectified which had a large impact on the cost and duration of the wind-up. As a result, administrative fees of over £500,000 were taken from the pension fund (of which approximately half were trustee fees) which represented approximately 50 per cent of the assets of the scheme.
- By the time the scheme came to the regulator's attention it was in the final stages of wind-up. The view was taken that the appointment of another trustee at this late stage of the wind-up would be likely to result in even higher fees being charged than if the original trustee were kept. A meeting was arranged with the trustee and other advisers to the scheme to agree a timetable to complete the wind-up. A cap was placed on the amount of further fees to be taken, and the trustees took further steps to complete this wind-up successfully.

What is the Pensions Regulator already doing?

11.7 As part of the Government's commitment to speeding up wind-ups,²⁵ the regulator is working with DWP and HMRC on a joint project to identify and encourage faster effective action on schemes in wind-up. The regulator continues to intervene on specific schemes, for example to encourage faster wind-up, to help trustees overcome legal obstacles, or to appoint an independent trustee where there are no current trustees. Reporting to the regulator on the progress of a wind-up is a legal requirement.²⁶

What new proposals are we considering?

11.8 As part of the government's initiative the regulator will:

- target administrators and / or providers that hold significant portfolios of schemes that are winding up, and whose schemes seem to have been winding up for the longest period of time;
- where appropriate publish information on the time schemes are taking to wind up, when the regulator's scheme return cycle is complete;
- consider publishing reports of individual investigations and outcomes under section 89 of the Pensions Act 2004;

²⁵ DWP Statement November 2006 - *Speeding up Winding up of Occupational Pension Schemes* (www.dwp.gov.uk).

²⁶ See section 72A of the Pensions Act 1995 and The Occupational Pension Schemes (Winding Up Notices and Reports etc) Regulations 2002 (SI 2002/459).

- ensure that, where it appoints an independent trustee to oversee a wind-up, the trustee acts effectively and in a timely fashion. Where a trustee consistently fails to do so, the Pensions Regulator will use its powers to remove the trustee from both the scheme(s) involved and its register of independent trustees.
- 11.9 We will also provide appropriate guidance and regulatory support to trustees and administrators. We will introduce an e-learning module on wind-up, and will issue guidance which will explain how we will regulate schemes winding up and what we consider to be best practice, including a sample project plan to support those winding up a scheme.

Smaller schemes

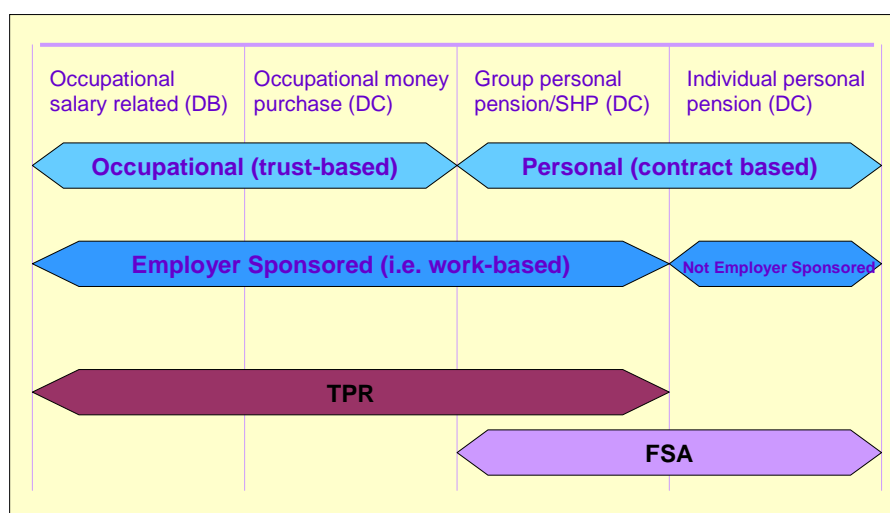
- 11.10 It is likely to be reasonable for a small scheme to use different procedures to achieve wind-up than a large scheme, but the principles of good management of the wind-up process remain the same.
- 11.11 The forthcoming guidance, project plans, and e-learning module will take account as appropriate of the needs of smaller schemes.

Chapter 12: Contract-based schemes

Introduction

- 12.1 We have regulatory responsibilities for all work-based pensions. Our statutory objectives apply to work-based personal pensions as well as those arranged under trust. Work-based personal pensions (hereafter referred to as 'contract-based schemes') comprise group personal pensions (GPPs) and most types of stakeholder pension.
- 12.2 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, moreover, many of the ongoing risks associated with the scheme are mitigated by the FSA.
- 12.3 The FSA is responsible for the regulation of all personal pensions, whether work-based or not. From April 2007 the establishment, operation and winding up of all personal pension schemes are activities regulated by the FSA. Hence the regulation of non work-based personal pensions is the sole responsibility of the FSA, but there is some degree of regulatory overlap in respect of contract-based schemes between the Pensions Regulator and the FSA as shown in figure 11 below.

Figure 11
Regulatory responsibilities



- 12.4 Our interaction with the FSA is managed through a Memorandum of Understanding. Among other things this sets out the different activities carried out by each regulator in the area of regulatory overlap. We are aware of the risk of a lack of clarity in the area of overlapping responsibility and continue to work with the FSA to prevent this. The FSA was consulted on the proposals in this chapter.

- 12.5 The other institutions involved in the financial services regulatory landscape, in particular the Financial Ombudsman Service and the Financial Services Compensation Scheme, are also involved to different degrees in respect of contract-based schemes, as is the Pensions Advisory Service and the Pensions Ombudsman.
- 12.6 The Pensions Regulator has no preference for one type of work-based pension over another. The decision whether to offer a trust-based or contract-based arrangement is for the employer. Nor does the regulator have a position on what is the appropriate level of contributions to any DC arrangement.

Structure of contract-based pensions

- 12.7 A provider, for example an insurance company, will establish a personal pension scheme via a trust deed²⁷ or deed poll.²⁸ The provider must administer the scheme in accordance with its rules and comply with the statutory requirements placed upon personal pension schemes.²⁹
- 12.8 Most stakeholder pensions are established in a similar way, although some are established on a trust-based occupational basis.
- 12.9 Each individual member of a contract-based scheme has a contract with the pension provider and, if an intermediary has provided services to the member such as advice, the member will also have a contract with the intermediary in respect of those services. Complaints are resolved by the parties to the contract, with recourse to the Financial Ombudsman Service if the member is not satisfied with the way the provider (or intermediary) has addressed his or her concerns.³⁰
- 12.10 The employer has no formally defined role in the ongoing administration and review of a contract-based scheme. However, it will usually have selected the scheme, and has the ability to change it. Whilst the employer typically has no contractual relationship with the pension provider nor any mechanism equivalent to employer-nominated trustees to represent its interests, the ability to choose and change the scheme gives it influence over the provider. In addition, because the employer is the conduit through which contributions are made, it retains an interest in the efficient running of the scheme. More broadly the employer has an interest in the scheme as a part of its overall remuneration package to its employees.

²⁷ The trustees of such a scheme do not however have the same obligations as the trustees of a trust-based occupational scheme.

²⁸ By a Board Resolution in Scotland.

²⁹ For example, the Personal Pension Schemes (Disclosure of Information) Regulations SI 1987/1110 and the Personal Pension Schemes (Transfer Values) Regulations SI 1987/1112.

³⁰ Complaints in cases of maladministration can be to the Pensions Ombudsman.

What does the evidence say?

12.11 Estimates of the number of contract-based schemes compared with the number of trust-based DC schemes, and the number of members in each type of arrangement, are shown below.

Figure 12
Contract-based and trust-based schemes

Scheme type	Number of live schemes	Number of members of live schemes
Trust-based DC Occupational Pensions ³¹	81,000	2,800,000
Group Personal Pensions ³²	100,000	1,900,000
Group Stakeholder Pensions ³²	34,000	680,000

Source: the Pensions Regulator

12.12 The estimated number of members in each type of arrangement is roughly equal at around 2.8 million. The trend, however, is clearly towards an increase in the number of members of contract-based schemes. Recent research by Watson Wyatt found that around one third of DC schemes are contract-based compared with one quarter only two years ago. Moreover, about three-quarters of all new DC plans set up since 2004 have been contract-based. This trend is even more marked among smaller employers.

What is the risk to pension schemes?

12.13 We have considered, for each of the risks addressed by our governance priorities, whether and to what extent they apply to contract-based schemes.

Knowledge and understanding

12.14 Risks to members would arise if the trustees or managers of a contract-based scheme lacked knowledge and understanding of their scheme. While they are not under the statutory duty to possess knowledge and understanding placed on trustees of occupational schemes, the providers of contract-based schemes and their trustees / managers are subject to regulatory oversight by the FSA. Such oversight includes the requirements for providers to be authorised by the FSA before they can engage in the establishment, operation and winding up of a personal pension scheme. Moreover, the application of the High Level, Prudential, and Business Standards is intended to ensure a high

³¹ Based on the Pensions Regulator's 'Score' database, April 2007.

³² Estimates for group personal pensions and group stakeholder pensions based on extrapolated data from seven of the top ten providers, August 2006.

degree of integrity, capital protection and member protection as are the FSA's training and competency requirements. We see no case for the Pensions Regulator to intervene in the area of knowledge and understanding in respect of contract-based schemes, given the FSA's role.

Conflicts of interest

12.15 The relationships between the parties to a contract-based scheme are different compared to trust-based arrangements. There is no equivalent to the trustees of an occupational scheme³³ and hence the sorts of conflict described in Chapter 6 do not arise.

Monitoring of employer covenant

12.16 As with all DC arrangements the employer covenant in contract-based schemes is much less important than in DB schemes. In the event of financial difficulty of the employer, however, there is a risk of late or indeed no employer contributions being paid, and likewise of the employer not passing on members' contributions. We already regulate late payments into contract-based schemes.

12.17 This risk may become greater after the introduction of personal accounts: employers will be required to pay pension contributions for every employee (other than those who opt out of either personal accounts or an exempt scheme). Currently, employers choose whether to contribute towards a work-based pension.

Relations with advisers

12.18 Advice to employers on selection of a pension scheme is not subject to regulation (either by the Pensions Regulator or by the FSA) though there is normally a contract between the employer and the adviser. Those advising employers on contract-based schemes are usually employee benefit consultants or independent financial advisers (IFAs).

12.19 Smaller employers receive advice more often from IFAs. In a typical scenario the IFA will advise and recommend a suitable pension scheme for the employees of a company. Initial discussions might take place with the employer, finance director and any other relevant senior personnel. The recommendation will normally include the scheme provider and level of employer and employee contributions. The IFA might also provide advice on related products, such as group life insurance.

12.20 Once details of the scheme have been agreed, the IFA will provide information on the scheme to employees. The extent to which this

³³ As noted already, while some contract-based schemes have trustees, they do not have the same obligations as the trustees of a trust-based occupational scheme.

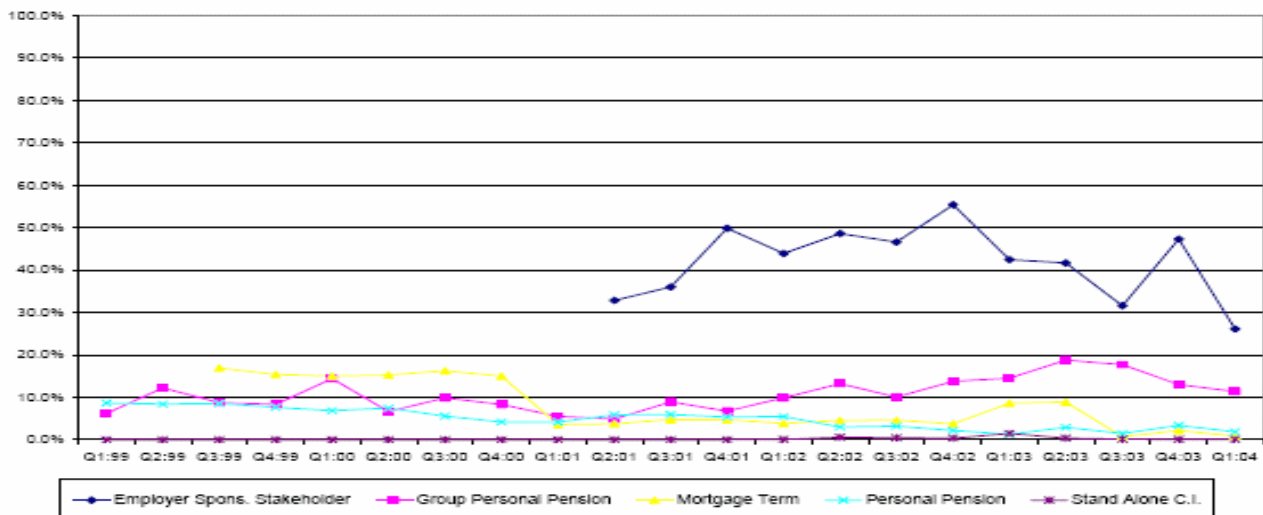
constitutes advice to the employee can vary from none at all (providing an information pack only) to full individual advice on wider financial matters, via intermediate steps such as workplace marketing (seminars, posters etc) and individual advice but on the pension scheme only. Employees decide whether or not to join the scheme. Any information provided by the IFA to employees will be regulated by the FSA.

12.21 Where the employer pays a fee for the cost of the advice, this cost will not be passed on to employees. However, where the employer does not pay a fee, the cost of advice may be met through commission paid by the provider to the adviser, the cost of which will be included in scheme charges borne by employees. The FSA disclosure regime is intended to ensure some clarity to members in the breakdown of charges.

12.22 The employer has potential incentives to select schemes which do not require it to pay a fee. Once selected, there may not be incentives for the employer to review periodically the level of charges of such schemes. Despite this, employees are, because of the employer's contribution, very likely to be better off in a scheme in which they pay the cost of advice than not being in a scheme at all.

12.23 The extent to which these incentives operate is uncertain. There is however some evidence (see figure 13 below) that a higher proportion of stakeholder pensions, which are subject to a charge cap, are written on a fee basis than personal pensions or group personal pensions (or certain other products).

Figure 13
Share of new premium income written on a fee basis for regular premium products³⁴



Source: CRA analysis

³⁴ Charles River Associates, *Study of intermediary remuneration: A report for the Association of British Insurers*, February 2005, page 31.

Administration

12.24 The risks of poor administration to members of a contract-based scheme are similar to those in trust-based arrangements. There is no equivalent of the trustees to represent the members' interests collectively on administration issues, or any requirement on the employer to represent members' interests. The employer does however have a reputational interest in the scheme and the way its employees perceive the scheme. The employer is able to make judgements on the efficiency of the provider through experience of dealing with them, and is able to change provider if the need arises. In addition, the administration of providers is subject to FSA regulation and may also be part of the contract between the provider and the member. Our Memorandum of Understanding with the FSA states that 'where appropriate, the Pensions Regulator will take responsibility for administration in respect of particular schemes, and the FSA for the administration problems which indicate difficulties within an FSA-authorized firm more widely.'³⁵ We would proceed on this basis in respect of any further interventions in the administration of contract-based schemes.

Processes for investment choice

12.25 The risks to members of poor processes for investment choice are again similar to those in trust-based DC schemes. There is in addition no trustee body to represent collectively the members' interests in this and other areas. Unlike in trust-based schemes, however, the FSA regulates the way that funds are promoted and described.

12.26 In contract-based arrangements the range of investments typically offered is far larger than under trust-based schemes. For example, one provider was found to offer 97 UK equity funds. In contrast most large trust-based DC schemes offer between 6 and 15 funds.³⁶

³⁵ Memorandum of Understanding between the Financial Services Authority and the Pensions Regulator, April 2005, para 3.9. (www.thepensionsregulator.gov.uk/docs/mou-fsa-tpr.pdf)

³⁶ The Watson Wyatt FTSE 100 DC Survey 2006.

12.27 Figure 14 below illustrates the position for the five largest group personal pension providers (as defined by the size of reserves shown in the annual FSA returns).

Figure 14
Investment funds offered by five largest GPP providers

	Number of investment funds offered
Provider 1	106
Provider 2	88
Provider 3	57
Provider 4	109
Provider 5	136

Source: Watson Wyatt research

12.28 There is evidence that members do not benefit from such a large number of choices.³⁷ We shall work with the industry to understand what investment propositions are currently offered and how members can be best served by investment processes in contract-based schemes.

12.29 There is also evidence that fewer GPPs have a default fund. One recent survey³⁸ showed that 78 per cent of DC schemes offer a default investment option. However, breaking this down by scheme type shows that while a large number of trust-based schemes have a default option, most group personal pension schemes do not. (Stakeholder pensions are required to have a default option.)

³⁷ 'There is extensive evidence that too many options make it more difficult for people to make a choice. Research has revealed for instance that participation rates in US company pension schemes decline when asset allocation choice becomes extremely wide. In the Swedish PPM scheme meanwhile expanding choice in the 'open system' has been matched by an increasing number of people choosing the default option.' *The Pensions Commission: A new pension settlement for the twenty-first century: second report*, p376.

³⁸ The Watson Wyatt Pension Plan Design Survey 2006.

12.30 Changes to investments may be harder for providers to secure for contract-based schemes. There are no trustees to make changes on behalf of members, and individual member consent has to be obtained. There is evidence that where providers have ceased marketing particular funds, members nonetheless remain invested. Figure 15 below shows, for the five largest group pension scheme providers (as defined by the size of reserves shown in the annual FSA returns), the number of funds closed or no longer actively marketed over the last two years. We shall work with the FSA to understand whether more needs to be done on issues of fund choice and closure in contract-based schemes.

Figure 15
Funds closed or no longer actively marketed over the last two years (five largest GPP providers)

	Number of funds closed	Number of funds no longer marketed
Provider 1	1	Nil
Provider 2	Nil	1
Provider 3	3	Nil
Provider 4	Nil	1
Provider 5	Nil	3

Source: Watson Wyatt research

Governance during wind-up

12.31 As with all DC arrangements, the risk to members of a contract-based scheme of poor governance during wind-up is less than for DB schemes. The FSA regulates the wind-up of personal pension schemes by providers and we therefore do not see the need for further intervention by the Pensions Regulator.

What is the Pensions Regulator already doing?

12.32 We regulate late payments into all work-based pensions, including contract-based schemes. We also regulate pension providers' compliance with the legal framework for stakeholder pensions, including the charge cap.

12.33 As already stated, the FSA has a role in the regulation of contract-based schemes. In addition to our work, the FSA regulates providers of personal pension schemes. This includes: the systems and controls around their processes; the disclosure of information to prospective members of contract-based schemes; authorising providers of personal pension schemes; and training and competency of key personnel.

What new proposals are we considering?

- 12.34 In preparing this chapter we have sought the views of, and worked with, the FSA. We have also sought the views of other key stakeholders representing the pensions industry, government and trade unions.
- 12.35 One area we have considered is the ‘operational’ aspect of the governance of contract-based schemes. For example, are members’ and employers’ contributions made and then invested in accordance with members’ wishes? In the regulator’s view the regulatory framework for these ‘mechanical’ aspects of governance successfully mitigates the potential risks to members. Regulatory controls, principally via the FSA, including those of capital adequacy, allocation to investment funds, and the competence of scheme managers, are likely to be at least as good as those applicable to a well-run trust-based occupational scheme.
- 12.36 On the other hand the more ‘qualitative’ aspects of governance may be less well carried out compared with a well-run trust-based scheme. We would highlight in this regard relations with advisers, the role of employers, administration, and investment processes.
- 12.37 Our proposals in these areas are intended for discussion. In developing them we will take account of comments from the industry as well as from other regulatory and consumer bodies. We will engage with all stakeholders to understand the impact and potential costs of our proposals before making firm recommendations. We have already established an industry working group following publication of our consultation document on risks to members of DC schemes. We also intend to continue to collaborate with the FSA in this area under the Memorandum of Understanding arrangements.
- 12.38 The proposals are for the voluntary application of good practice and are intended for those providers, advisers, employers and members who are interested in the possibility of improving aspects of the governance of their contract-based scheme.

Involvement of employers

- 12.39 As already noted, once an employer has selected a scheme there are relatively few requirements for its continuing involvement. We believe there can be value in the employer having an ongoing role in reviewing the scheme. This can be achieved in several ways, and it is for employers to decide which suits them best and what level of employee involvement is required.

12.40 One means by which employers might choose to be involved is through employer-led 'management committees'. We will provide examples of such committees for those employers who wish, on a voluntary basis, to take a greater role in monitoring the contract-based scheme which they have selected. We will provide guidance for employers on setting up committees, and discuss possible legal risks, costs and benefits. Below is an example of how one employer set up and ran a monitoring committee.

Case example

In 2005 a UK manufacturing company was acquired by a US multinational. The UK company had participated in an occupational scheme which included both defined benefit and defined contribution sections. Going forward, the new US parent wanted to establish a group personal pension (GPP). The UK company has about 250 employees and has always prided itself on the quality of its benefit arrangements and the care it takes of its staff.

At the inception of the GPP, the company's pensions adviser suggested that a monitoring committee be set up to improve the management of the plan. The committee consisted of:

- managing director;
- finance director;
- HR manager; and
- member representative (this employee was formerly a trustee of the previous occupational plan and therefore had experience of pension scheme governance).

The committee meets quarterly and has written terms of reference to ensure that it does not inadvertently begin to take on quasi-trustee powers and responsibilities. Instead its remit is to make suggestions to the company where appropriate. The committee has also produced a year planner so that each meeting looks at a series of agreed items in order to give it focus.

For each meeting the GPP provider produces a report showing how many members are in the plan, average contribution rates, the fund choices being made and a snapshot of the funds' performance. The provider is also invited to attend periodically. The pensions adviser also provides at least annually an independent assessment of the provider's overall performance (both investment and administration) as well as its continued suitability.

The committee has already been able to intervene successfully to improve the effectiveness of the plan in a number of ways:

- following some issues over the accuracy of the first set of benefit statements, a pre-meeting is now arranged with the provider to plan the annual statement production effectively;
- the provider undertakes member presentations and one-to-one sessions at the time the benefit statements are issued in order to raise awareness and understanding of pensions;
- the committee has identified that the plan has a number of members approaching retirement. As a result the employer has agreed to:
 - provide some financial support for retiring members to obtain financial advice on their retirement options; and
 - run a two-day retirement course for employees and their partners covering financial and lifestyle considerations.

- 12.41 The extent and frequency of any monitoring is a matter for the employer and any other interested parties. Below is an example of how an employer with a small scheme monitors the performance of its stakeholder pension.

Case example

A UK manufacturing company closed its occupational DB scheme in 2003 and opened a stakeholder plan for new joiners after that date. As the company employs relatively few people in the UK with low staff turnover, the stakeholder plan has only 17 members. The company feels that it has a duty of care to monitor the plan effectively but on a scale that is proportionate to the size of the plan.

The company has therefore decided that the finance director, managing director and HR manager will meet once a year formally to review the performance of the plan. To assist with this, the company's pension adviser produces a brief report covering:

- an analysis of the provider's investment, administration and communication services as well as its financial standing and commitment to the group pension market;
- a summary profile of the scheme showing where the money is being invested; and
- a review of the performance of the key funds. Most of the members invest in the plan's default lifestyle strategy and so particular attention is paid to the funds that make up this strategy.

The purpose behind the performance review is to be satisfied that the company and its employees are getting value for money from the plan and are using it effectively.

The company intends to keep the level of governance under review and may expand its monitoring remit as the membership and assets grow.

- 12.42 More speculatively, we may also examine, in conjunction with industry bodies, proposals by such bodies for 'kite-marking' of schemes in order to promote, on a voluntary basis, approaches to better governance.
- 12.43 In considering all approaches we will take account of the costs to employers, employees and the industry, as well as the impact the approach has on meeting our statutory objectives.

Relations with advisers

- 12.44 We propose to raise awareness of situations in which the interests of members may not be taken into account. We also propose to provide guidance for employers on questions to ask advisers about commission and fees.

Administration

12.45 Proposals under consideration include:

- providing examples of service level agreements;
- encouraging an annual 'comfort statement' to the employer stating that payments have been made and invested on time, as well as reporting any breaches and member complaints;
- promoting the value of good member communication, including via case studies; and
- encouraging regular reviews by the employer of the contract-based scheme provider.

We shall work with the relevant stakeholders, including the FSA and the industry, to understand how administration in contract-based schemes can deliver appropriate outcomes for members.

Investment processes

12.46 We will consider encouraging, on a voluntary basis, greater 'qualitative' governance of investment processes by employers, providers and advisers. Proposals under review include:

- producing examples of good practice;
- promoting the value of good governance in this area, and producing associated guidance; and
- encouraging regular review by the employer, provider and adviser of investment fund choice and processes.

We shall work with the relevant stakeholders, including the FSA and the industry, to understand how investment processes in contract-based schemes can deliver appropriate outcomes for members.

Chapter 13: Achieving and monitoring our regulatory priorities

- 13.1 We will use survey and other evidence to assess whether we are achieving the regulatory priorities set out in this discussion paper in relation to both trust-based and contract-based schemes.
- 13.2 We will continue to put greatest emphasis on the priority of improving the knowledge and understanding of trustees. This is consistent with:
- using our regulatory tools to educate and enable, with intervention only where necessary;
 - the view that improving knowledge and understanding deals with the causes of poor governance rather than focusing only on behavioural outcomes;
 - our key performance indicator for governance in the medium term strategy: ‘there will be year-on-year improvement in the extent to which trustees demonstrate knowledge and understanding of the governance requirements for their schemes (as evidenced by surveys of knowledge and understanding, and key aspects of governance).’

Trustee supply

- 13.3 We recognise that achieving our governance priorities requires a continued supply of individuals willing to become trustees of pension schemes. We consider it important therefore to obtain evidence about the supply of trustees and we will cover this in future governance surveys. We will also ask whether actions by the regulator are cited as a reason for individuals being unwilling to become trustees. We intend this to provide an evidence-based assessment of whether we are achieving our priorities in a way which is consistent with maintaining the supply of trustees.
- 13.4 Employers and trustee boards also have key roles to play in maintaining and improving trustee supply. Employers can support trustees, for example by providing time off for employees for trustee duties. Future governance surveys will ask whether employers encourage employees to take up the role of trustee.

- 13.5 Trustee boards can also prepare prospective and new trustees. In this final example we describe a process that supports trustee succession and prepares future trustees for their challenging role. It also gives individuals the opportunity to understand the role of trustee thoroughly before accepting full appointment.
- 13.6 While the scheme in question is relatively large in terms of both assets and membership, the steps illustrate good practice which schemes may want to consider adapting to their circumstances.

Case example

- Prior to and leading up to the nomination process, members who may be potential trustees are prepared in readiness to fill vacancies. Educational material is provided to individuals along with relevant scheme documents so that prospective trustees can first come to a decision as to whether the role is in fact appropriate for them and, if so, can start to prepare for the role.
- Those who are appointed are therefore not only clearer about the role of the trustee; they also start with a firmer knowledge base. Additionally, for new trustees there is an induction day where they have the opportunity to meet advisers and existing trustees.

Chapter 14: Responding to the discussion paper

14.1 We welcome responses to this discussion paper. Below are some questions which may help to frame your response.

- 1 Is the Pensions Regulator right to place importance on the governance of pension schemes?
- 2 Do you agree with the determinants of our regulatory priorities set out in paragraph 3.7? These are:
 - the regulator's existing approaches to governance;
 - evidence of how schemes are governed;
 - recent and forthcoming developments in the pensions environment; and
 - our approach to regulation.
- 3 Do you agree with our regulatory priorities?

Knowledge and understanding of the governing body

1. Knowledge and understanding

Relationships of the governing body

2. Conflicts of interest
3. Monitoring of employer covenant
4. Relations with advisers

Procedures of the governing body

5. Administration
 6. Processes for investment choice
 7. Governance during wind-up
- 4 Are there particular points you wish to make about any of the priorities?
 - 5 Do you have 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:
- providing examples of employer-led ‘management committees’?
 - guidance providing questions to ask on commission and fees?
 - administration?
 - investment processes?

Please send your responses in one of the following ways:

- By post:

Louise Robinson
The Pensions Regulator
Napier House
Trafalgar Place
Brighton
BN1 4DW

- By email: gov.paper@thepensionsregulator.gsi.gov.uk
(We would prefer to receive email responses in Word format but appreciate that this may not always be possible.)
- By fax: 01273 627248

The deadline for submission of responses to this discussion paper is **13 July 2007**.