Into the Void

Ending the Governance Vacuum in DC Pensions

October 2009

STANDARD LIFE

Introduction

Pressure for improved governance has been given added impetus in light of the role of governance failures in contributing to the banking crisis, pressures for global regulatory reform and even the MP expenses row in Parliament.

Good governance is fundamental to restoring the trust and confidence that is essential for the successful delivery of effective workplace pension provision. However the current standards and practice in governance are still focused on practices that evolved to meet the requirements of the Defined Benefits model.

In this paper we assess the issues that companies and trustees need to consider if they are to deliver fit-for-purpose governance structures and ensure that it is adaptive to the evolving demands of the market place.

As a consequence of the migration from Defined Benefits (DB) to Defined Contributions (DC) in recent years, The National Association of Pension Funds (NAPF) has identified what they described as 'a governance vacuum' around DC pensions in general and highlights contract-based DC in particular.

The Organisation for Economic Cooperation and Development has similarly highlighted that pension fund governance needs to be improved in order to avoid exposure to risky assets and investments. With the Financial Secretary to the Treasury calling for a statutory governance duty for managers, set out in the so-called Myners Principles, and with the increasing impact of Treating the Customer Fairly in this area, the issue has become a watershed for the industry with wide-reaching implications for, and substantial impact on the DC pensions system.

In this paper we assess the issues that companies and trustees need to consider if they are to deliver fit-for-purpose DC governance structures and ensure that it is adaptive to the evolving demands of the market place.

This entails an understanding of key issues: the major implications of the trend towards DC from DB; the key challenges faced by corporates and providers; and the main drivers of best practice.

Finally we provide a blueprint of what best practice looks like in terms of the five core areas:

1. Member Engagement
2. The Governance Model
3. Safe Harbour Status
4. Policing Fund Performance
5. Decumulation

Changing Structures: The shift from DB to DC

A generation ago, the majority of supplementary employer-sponsored pension schemes were defined benefit (DB). But over time employers have turned away from this open-ended funding commitment and instead opting for defined contribution (DC) schemes.

Trust-based DC occupational schemes, also known as Money Purchase schemes, have been around for many years but personal, or contract-based, DC schemes have evolved from the introduction of personal pensions in July 1988, through to Stakeholder pensions in 2001 to the emergence of Group SIPPs. The DC pension landscape will expand further with the introduction of Personal Accounts and auto-enrolment with compulsory employer contributions scheduled for 2012.

Trust-based governance arrangements have had the opportunity to evolve gradually over the last 25 years, adapting effectively to take account of legislation such as the Pensions Act 1995 and Pensions Act 2000 which were predominantly focused on specifying how trust-based governance should look.

Evolution of contract-based schemes has been more rapid with the result that the governance framework has had less time to become embedded, tried and tested. However all the components of a robust and comprehensive governance framework are available.

The compelling need for good governance in DC - The challenges

Good governance is vital for all pension schemes to ensure that they are efficiently managed and meet the requirements of both sponsor and of the scheme members. However for corporate sponsors and trustees familiar with DB schemes, it is important to understand the differences between effective governance of DB and DC schemes.

Governance as it relates to the investment and custody of defined benefit scheme funds is not readily transferable to DC. Governance for DC must focus on enabling members to make appropriate investment decisions and be supported to enable them to ultimately achieve their future financial security.

While it is true that one of the core attractions of contract DC schemes for employers is that they reduced the governance burden by transferring the investment risk and responsibility of saving for retirement onto individual members, this does not absolve the employers or trustees from a duty of care.

Indeed there are several major challenges, specific to the contract DC sector, that sponsoring employers must take account of if good governance is to be achieved and the threat of litigation is to be mitigated or avoided.

Appropriate processes must be put in place to ensure compliance with the laws and effective administration and investment of the pension plan and funds.

The core risks in contract DC governance identified by The Pensions Regulator (TPR) are:

- poor administrative practices;
- poor investment practices;
- unduly high charges;
- poor decisions on retirement choices and decumulation;
- lack of member understanding.

From the contract DC scheme member's point of view there are four clear considerations regarding the pension scheme.

- Whether they should join the scheme or make other arrangements, such as an individual personal pension;
- How much should they pay in contributions;
- How best to invest the funds;
- How to realise the benefits once they retire.

Good pension scheme governance practice requires that these issues be addressed from the perspective of both sponsoring employer and member. Doing so delivers several significant benefits for all stakeholders including a reduction in potential legal risks, optimal performance of the pension fund and employee satisfaction and engagement.

The key driver for the employer and provider is to deliver on meeting their obligations and also to ensure that their own needs are met in turn.

A well designed scheme with appropriate governance arrangements will stand a better chance of meeting expectations and allows the employer to show 'due diligence' in the event that investment performance or other circumstances lead to members being disappointed.

A well designed scheme with appropriate governance arrangements will stand a better chance of meeting expectations...

Myners and FSA's Treating Customers Fairly principle - Twin drivers of best practice

Myners		Treating Customers Fairly
Clear Objectives Transparency Regular Reporting	⟷	Clear Information No post-sale barriers
Expert Advice	⟷	Advice is suitable
Choice of default fund	⟷	Products meet needs
Appropriate Benchmarks Performance Measurement Explicit mandates	⟷	Products that perform
Activism	⟷	Fair treatment of customers

What does best practice look like?

1. Best practice in member engagement

Excellence in member and employer communication

Communications has a vital role to play in delivering good governance in DC schemes. The NAPF quality mark requires communications to be one of the core tests. Standard Life provides management information (MI) which acts as evidence of good practice which in turn provides an audit trail for assessing the effectiveness of governance procedures.

Increasingly, there will be a requirement for employers to evidence robust governance procedures and contract-based governance committees should expect support from their providers covering reporting and management information through to secretariat services.

DC pension schemes must establish and maintain engagement with members from the point at which they join the scheme through to taking benefits, especially in an era when flexible retirement practices will become the norm.

It is important that DC scheme members understand the risks and realise that different courses of action, in terms of contributions and investment strategy, have different distributions of possible outcomes. Employers, supported by providers, can target communications to influence behaviour without actually crossing the threshold into offering advice.

Such engagement is achieved through a comprehensive contact programme with members of pension plans ranging from presentations, seminars, and workshops, through to websites and commissioned research. In conjunction there must be a sufficient level of communication with members on the specific performance of their own pension plan including personal statements, income estimates and benchmarking.

Creation and monitoring of scheme metrics is an integral part of this ongoing engagement. Sources of intelligence such as levels of fund switching activity, deviation from default contribution rates and even volume of calls to helplines are valuable in monitoring member engagement with their retirement planning.

2. Best practice for an adaptive DC governance model

BT Corporate SIPP Management Committee

One option, certainly for larger employers, is to introduce a management committee.

The innovative governance approach taken by BT in structuring their corporate SIPP demonstrates best practice in a contract DC context, setting a new benchmark of excellence in ensuring that members' best interests are monitored.

BT effectively addressed the core issues of the governance vacuum by establishing a management committee. This is structured in a similar way to a trustee board, fulfils a similar role with similar responsibilities and comprises both employer and employee representatives with an independent chair from the Law Debenture.

Not only does the committee have oversight of the monitoring of investment managers and funds, it has a key function in agreeing the parameters for the provision of information and guidance to members.

This can be achieved effectively by analysis of all activity related to the administration of the DC pension from the initial joining process, the on-going member engagement via internet, phone and written media, to the reconciliation of contributions.

3. Best practice on guidance and advice

Safe harbour - lessons from abroad

In cases where the management committee model is adopted, the employer should make use of the protection offered by so-called safe harbour rules.

Already a proven concept in the United States and Canada, safe harbour rules allow scheme sponsors to fulfil their governance role and provide greater support and guidance to members by exempting them from prosecution or other legal action, providing due care was taken in reaching decisions.

According to the OECD these rules enable the plan sponsor to carry out due diligence in the choice and ongoing monitoring of service providers, investment alternatives and default options as well as helping to determine the nature and scope of the information and advice that is provided to members, while limiting liabilities.

The danger is that without safe harbour employers will refuse to take any responsibility beyond the statutory minimum duty of care to provide automatic enrolment, adequate contribution and default investment strategy. There is a risk that this could result in a levelling down in terms of quality of provision.

4. Best practice in investment

Policing fund management performance and the investment platform

The Pensions Regulator has identified four governance risk areas for DC schemes as it in terms of the investment platform. These are:

- Inadequate processes for selecting funds and reviewing their performance
- Provision of inappropriate funds or ranges of funds
- Inappropriate design of the default fund
- Lack of member understanding

Contract based schemes tend to offer a far greater range of investments, up to several hundred, than trust-based schemes, where the average is between 6 and 15 funds. There is growing evidence that this excessive choice can paralyse decision-making.

Currently, more than 90% of new savers in the UK fail to make a choice and their savings go into the default fund.

This in itself presents a governance conundrum. How can the single default fund be structured so that it is deemed appropriate for the vast majority of scheme members regardless of their individual demographic and risk profiles?

Certain providers are pioneering the use of target-date funds and managed accounts as possible replacements for the traditional, off-the-shelf lifestyle default funds.

Members can select the target date fund that has a date closest to their planned retirement and the risk and asset allocation are managed around this.

...the employer should make use of the protection offered by so-called Safe Harbour rules.

Key good governance questions on investment of funds

- How much choice should members be offered?
- Should new categories of investment be introduced?
- Is the default fund appropriate?
- Is the approach lifestyle or targeted?
- What is the appropriate balance between active and passive fund management?
- How far should a holistic approach be taken, integrating investment choices with other decision processes such as enrolment, contribution levels and decumulation/annuity purchase?
- What is the best strategy to communicate with members and get them to engage on choices?
- How frequently is performance measured?
- What metrics and measures are used to compare performance?
- Does the performance meet the needs of the member?
- What criteria and procedures are used for changing investment managers?
- Have policies been put in place to cover such areas as hedging and derivatives?

5. Best practice in decumulation

Bespoke retirement: One size does not fit all

Turning pension savings into retirement income is one of the most important financial decisions faced by a member of a contract DC scheme.

Just as there are complex and fraught issues surrounding governance of default funds in the accumulation stage, so there is a need for greater clarity, suitability and flexibility in the decumulation phase.

Clearly this requires the providers and employers to ensure that there are guidelines in place not only to ensure the best decision is taken on annuity purchase but also to ensure that alternatives to annuity purchase are provided.

However, until recently the decumulation phase was neglected in analysis of pension performance and appropriateness. The issue has been brought into sharp relief by a recent major study by HSBC which revealed that seven in ten pension trustees do not have confidence in their scheme's retirement process which indicates that governance procedures are vulnerable in this key area of maximizing the value when members' DC funds are converted into income. Greater clarity and tighter procedures are required to avoid ambiguity, uncertainty and the threat of litigation.

Such considerations are one of the reasons why larger employers are paying more attention to products such as Group SIPP which can be tailored more to suit individual needs within a structured framework.

Seven in ten pension trustees do not have confidence in their scheme's retirement process.

Summary

- Ensure administrative practices are rigorous, robust and fit-for-purpose.
- Extend the employer's duty of care and responsibility beyond the role of mere facilitator and collector.
- Define and clarify the nature of the relationships between providers, employers and employees.
- Implement a comprehensive contact programme with pension scheme members. This should include group-wide tools such as presentations, seminars and websites as well member-specific information such as personal statements, income estimates and benchmarking.
- Where appropriate, establish a management committee model comprising employer and employee representatives and an independent chair. Charge the management committee with oversight of the monitoring of performance and setting parameters for providing guidance to scheme members.
- Adopt safe harbour status. This allows scheme sponsors to provide greater support and guidance to members while protecting them from legal action.
- Request detailed management information from the scheme provider as evidence of good practice and to create an audit trail.
- Put in place robust processes covering fund management performance and the investment platform. These should cover: degree of fund choice; categories of investment; choice of default fund; specialist investments; and the balance between active and passive investment.
- Ensure that there is adequate focus on decumulation issues with clear and well-communicated member information covering annuity purchase and the alternatives.