ShareAction
the movement for Responsible Investment

Formerly FairPensions
Fairshare Educational Foundation
Trowbray House, 108 Weston Street,
London SE1 3QB | 020 7403 7800

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

Response from ShareAction (formerly FairPensions)

About ShareAction

ShareAction (formerly FairPensions) is a registered charity established to promote Responsible Investment practices by pension funds and other institutional investors. In particular, we work to encourage active stewardship of listed companies through the informed exercise of shareholder rights. ShareAction also champions greater transparency and accountability to the millions of people whose long-term savings are entrusted to the capital markets.

We are a member organisation and count amongst our members a growing number of globally recognised NGOs and trade unions, as well as over 8000 individual supporters.

Summary of response

- Consideration of defined contribution pension schemes will cover a wide range of scheme structures, including trust- and contract-based schemes. Although we have addressed the approaches and suggestions in the consultation as they relate to different scheme types, it is not our view that trust-based governance is necessarily better than governance of contract-based schemes. Both types of schemes present governance challenges.

- Governance bodies may help to address the "governance gap" that exists in contract-based schemes. Bodies at employer level and provider level have valuable roles to play, but it is at provider level that they should be mandated. If these bodies are to be effective, they must have the powers and resources which allow them to be independent, conflict-free decision makers.

- We understand anecdotally that some providers have expressed concern that the establishment of provider level bodies will lead to conflicts between provider companies' duties to their shareholders and duties of governance bodies to act in the interests of members. Such concerns need not be an issue as to the extent that the government mandates these boards and their duties, provider companies will be required to obey the law before fulfilling their duties to shareholders. This is the case for all legislation with which companies comply; companies are not permitted to put their obligations to shareholders above their legal and regulatory duties.

- If all workplace schemes are to be required to produce Statements of Investment Principles (SIPs), we suggest that the requirements as to content and use of SIPs be strengthened. Furthermore, we suggest below ways in which the current default option guidance could be clarified and strengthened.

- Whilst small schemes may be well-governed, we believe that scale is important and, if the government does not want to mandate full integration or consolidation, there are other

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ways in which small schemes can be encouraged to access economies of scale, including mechanisms for collaboration with other schemes through formal bodies.

- In setting quality standards, the government should include requirements relating to Responsible Investment (RI), being investment which takes account of long-term environmental, social and governance (ESG) risks which may affect investment returns. This could be done in practice through requiring schemes to fully address ESG issues and stewardship in their SIPs and/or to produce specific policies covering RI. It would also be positive if all schemes used under automatic enrolment were required to comply with the UK Stewardship Code.

ShareAction welcomes the Minister of State for Pensions' expressed intention to ensure that people are automatically enrolled into schemes meeting "certain core standards"[1] and that schemes eligible for automatic transfer are also subject to such standards. This is particularly important because, as noted at paragraph 3 of the consultation, most people being automatically enrolled will not have made an active decision about their pension scheme. Furthermore, in defined contribution schemes it is the saver who bears the investment risk of complex decisions made without their knowledge or input. It cannot be left to the market to raise these "core" standards because the pensions market is by nature not truly competitive: in addition to the lack of choice over pension providers and the fact that decisions are made by employers rather than consumers themselves, there is no repeat business and poor performance may not be evident until it is too late.

We note that the proposed scope of the statutory minimum quality standards is "the whole variety of defined contribution schemes, both occupational and personal"[2]. It is important to keep in mind the range of scheme structures which will fall within this reference group. No doubt in recognition of this, the consultation at times refers to "multi-employer" schemes (which we understand to include trust-based auto-enrolment providers) and references master trusts, as well as referring to schemes governed by FCA rules, which would include contract-based schemes provided by insurance companies. There is also some overlap in the way schemes may be categorised, for example some insurance companies have set up master trusts to oversee their schemes.

We have responded to the suggestions set out in the consultation as they appear to apply to various types of schemes, but it is not our view that trust based schemes will necessarily be better governed than contract-based schemes. There are governance challenges for all types of schemes and we are not advocating one type over the other in our discussions below.

We respond below to the specific questions which fall within our area of expertise.

Governance

1) What are the essential features of good governance?
2) How does the presence of these features affect the decisions taken about running a pension scheme?

We broadly agree with the qualities set out at paragraph 21 as forming the foundation of effective governance, being:

- "an alignment of interests between people running the scheme and members of the scheme so that decisions are taken in the interests of members; and
- that people running the scheme have the skills and knowledge to be able to act in the interests of scheme members."

[1] Page 3 of the consultation
[2] Paragraph 4

Good governance of pension schemes requires robust oversight by independent parties with adequate powers, resources and knowledge to act in members' best interests. We respond below to the particular approaches to governance discussed in the consultation.

Governance bodies

There is a real risk of a 'governance gap' in contract-based schemes, such as personal pension schemes, arising from the lack of oversight of the scheme by an independent body responsible for protecting members' best interests (the role which is theoretically played by the trustees of occupational schemes). A requirement for personal schemes to be overseen by an un-conflicted, independent body with a clear duty to act in savers' best interests could overcome this gap. We note the distinction made in the consultation between governance arrangements at provider level and those at employer level. As their roles are different, we do not see why both levels of oversight cannot co-exist, but we believe that provider level governance structures should be mandatory, as explained below. Given the number of small employers who will be brought into the pensions system under auto-enrolment, the primary responsibility for safeguarding good governance must sit with large and well-resourced providers rather than under-resourced and inexpert employers.

Employer level governance bodies

Arrangements at employer level have the benefit of enabling external scrutiny of providers. They also allow employers, with detailed understanding of their workforce's needs, to assess the appropriateness of the scheme being provided. However, we agree with the observation in the consultation that such arrangements may not be practical or economic for all employers[3] and therefore we do not believe these should be mandatory.

Where such arrangements are already in place or where employers do have the resources to implement them, we believe that they could benefit from some official guidance or clarification on the role and status of these bodies. Anecdotally, we have heard that some former trustees who now sit on employer-led management committees overseeing contract-based schemes feel much less clear about their role and responsibilities. Current guidance is very general and high-level, and the fact that these bodies lack any formal status creates uncertainty.

Provider level governance bodies

Regardless of any arrangements at employer level, independent governance arrangements should be implemented at provider level. Providers have both the capacity and resources to implement the type of robust and formal systems required for good governance. Moreover, it is providers who are entrusted with savers' money and who are best placed to fulfil the role played by trustees in trust-based schemes, i.e. monitoring and overseeing the asset managers looking after savers' funds and reviewing the on-going appropriateness of investment options. However, our 2012 survey of major insurance companies found that most do not accept that they have this responsibility.[4] Essentially, the current system treats contract-based savers as informed consumers capable of taking responsibility for the performance of the funds they choose, while trust-based savers are treated as vulnerable beneficiaries whose interests must be protected by un-conflicted fiduciaries. This is at odds with the mechanics of auto-enrolment and has the potential to result in a significant governance gap. It is therefore essential that contract-based providers are required to act in the best interests of savers and to maintain governance arrangements which discharge this duty.

In response to the points at paragraph 29, the important practical features of provider level governance bodies include:

- Decision-making powers in line with those of trustees of occupational schemes, including the power to hire and fire advisors and asset managers, to seek investment advice and to

[3] Paragraph 28

[4] FairPensions, 2012, 'The Stewardship Lottery', http://www.shareaction.org/sites/default/files/uploaded_files/researchpublications/StewardshipLottery.pdf

enforce decisions about the schemes they oversee. In our view it is vital that these bodies have more than advisory powers if they are to be effective: they must be genuine decision-making bodies and not simply an additional layer of oversight. The experience of, for example, with-profits committees shows that bodies designed to protect consumers are generally ineffective if they are merely advisory, tending to be side-lined within firms' governance structures.[5]

- Freedom and independence from the provider including the freedom to not use advisors employed by the same group company. We support the suggestion at page 11 that a majority of the individuals on the governance bodies for multi-employer schemes be independent[6]. We would also recommend representation on these boards by savers, as we do not agree with the statement at paragraph 34 that member-nominated representatives may not be appropriate for multi-employer schemes. As an example, The Pensions Trust is a multi-employer scheme which has member-nominated trustees on its board. As an illustrative example of how board independence could be achieved, governance boards could be required to be composed of one-third member representatives, one-third employer representatives and one-third independent representatives – building on the current requirements for trustee boards and on the structures currently used by some master trusts (for example, B&CE's People's Pension). 'Independent representatives' would need to be clearly defined according to robust criteria.
- Duties to act in the best interest of savers and to avoid conflicts of interest (including with the provider company itself). We note the query at paragraph 31 about whether it is sufficient for governing bodies to just identify and explain constraints arising from conflicts or whether there should be restrictions on being able to constrain the governing body in the first place. In our view there should be restrictions on conflicts arising and constraining the governing body: conflicts should be avoided and, to the extent this really is impossible, they should be actively managed to minimise impact. Disclosure and explanation alone is not sufficient.

Competence and resources of governing bodies

One issue regarding resources is the ability of governance bodies to effectively oversee their schemes' external asset managers. Research by ShareAction has identified that one of the key functions trustee boards fulfil which insurance companies do not is the oversight of asset managers.[7] This is partly because, while the average externally-managed trust-based scheme has a few different mandates, the average contract-based provider offers a significant number of funds (both internally and externally managed) on their platform. In this case, resources would need to be adequate to provide on-going oversight of all funds in which savers' money is invested. If this is not practical, it may raise the question of whether providers should reduce the number of funds offered in order to ensure that they are able to provide adequate oversight.

Members of governance bodies at either employer or provider level will also require adequate training to understand how to fulfil their obligations. We agree with the observations at paragraph 39 that there should be sufficient expertise on the board as a whole to effectively run the scheme. In addition to the proposals on page 11 for a minimum threshold of professionally qualified board members, all board members could be subject to competence requirements mirroring those applicable to trustees of occupational schemes, including understanding documents, the working of the available schemes and an understanding of regulatory requirements.

We would recommend that the governance body be required to meet more frequently than every 6 months, given the complexity of their oversight role. It would not be possible for a governance body overseeing a complex scheme offering dozens of different funds to replicate the role played by a trustee board with such infrequent meetings. However, it should be made clear that more frequent meetings do not mean that the bodies should set their service providers short-term targets for performance.

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[5] See FSA, June 2010, 'With-profits regime review report', www.fsa.gov.uk/library/communication/pr/2003/011.shtml

[6] We also support the suggestion that members should be represented on *employer* level bodies.

[7] ShareAction, 2012, 'The Stewardship Lottery', http://www.shareaction.org/research/surveys

4) What are the barriers to exhibiting these features?

We are anecdotally aware of arguments against provider level governance boards being made based on perceived conflicts between provider companies' duties to their shareholders and duties of governance boards to act in the best interests of savers / pension fund members. This need not be an issue as, to the extent that the government mandates these boards and their duties, provider companies will be required to obey the law before fulfilling their duties to shareholders. This is the case for all legislation with which companies comply; companies are not permitted to put their obligations to shareholders above their legal and regulatory duties. In fact, this argument demonstrates why governance bodies cannot be implemented on a purely voluntary basis, because voluntary measures would lack the legal imperative for providers to put savers' interests first and may indeed give rise to conflicts with duties to shareholders. Instead, governance bodies must be given clear legal status and duties which parallel the fiduciary duties of trustee boards.

A related issue is the nature and scope of the duties of people within insurance companies charged with managing other people's money. One way of overcoming the perceived barrier outlined above would be legal clarification that all such people have a duty to act in the best interests of savers - which would take priority over companies' duties to shareholders – as recommended by the Kay Review.[8] This would provide a solid foundation for the introduction of governance boards charged with protecting savers' best interests. Notwithstanding claims to the contrary, it would be possible to do this without undermining the distinction between trust and contract. For example, specific statutory obligations or regulatory rules could be imposed on providers which replicate fiduciary standards of care, but in a contract-based rather than trust-based legal framework. For example, FCA rules could be amended to require a stronger duty of loyalty to clients and a higher standard in relation to the avoidance of conflicts of interest.

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

The insurance industry, the main provider of personal pensions, and specialist automatic enrolment providers have an interest in being seen to be well-governed and responsible. Improved governance through better, independent oversight should help to promote the trust in the system that will encourage people to save and to save more. It should also help to ensure that savers' money is well-managed and that pension schemes are invested for the long-term benefit of savers. In a world where savers bear the investment risk and depend on the performance of the funds in which they invest, this is vital to the success of auto-enrolment.

Furthermore, it should be noted that automatic enrolment has the potential to re-invigorate the pensions sector by introducing millions of savers to pensions and thus represents a significant financial opportunity for pension providers. In light of this, it does not seem unreasonable to place requirements on these providers to act in savers' best interests.

Although we would strongly recommend the implementation of governance boards, complementary approaches could involve having standing policyholder / saver committees or policyholder "AGMs" to provide a way for savers' interests to be communicated to providers and for providers to be held accountable. However, as standalone policies, these would not necessarily have the desired impact if providers are free to ignore any requests or recommendations.

Investment – default options

We are pleased to see that the consultation paper references the Kay Review in its discussion of default fund options. We endorse the recommendations in Professor Kay's statement of good practice as set out in the consultation at page 13.

[8] Kay Review of Uk Equity Markets, Final Report (2012), Recommendation 7

We note the discussion of occupational pension schemes' Statements of Investment Principles (SIP) in paragraph 46 and the suggestion that these could be extended to all workplace personal pensions. In our experience, gained through our annual benchmarking surveys of the pensions sector, SIPs are often fairly high level documents. This is concerning because it is often the case that when savers seek information from their pension scheme about its investment practices they are referred to the SIP, which often discloses very little useful information[9].

Even if the government does not mandate improvements to SIPs (further discussed below), we recommend that providers be required to produce forward-looking annual reports on how they are managing long-term investment risks, such as climate change, which may impact on the default fund. This would mirror the narrative reports through which listed companies are supposed to account to their shareholders. Since most pension savers are much more dependent on a single pension fund than the average shareholder is on a single company, in our view such a reporting framework is appropriate. Its absence reflects the fact that the current regulatory framework was designed in a world dominated by defined benefit schemes, a world which no longer exists.

Regarding SIPs in particular, in our view, in addition to requiring all workplace schemes to produce these, the government should seek to improve the quality of the content and use of all SIPs. This should include:

- Requiring that SIPs fully address a scheme's approach to Responsible Investment (rather than just making a broad-brush reference to it as an issue the scheme takes into account - see below for further comments on this topic), including how it addresses environmental, social and governance (ESG) risks and stewardship.
- In addition to the current requirement that (occupational) schemes disclose any investments made in contravention of their SIPs and annually review the SIP, schemes should be required to report on *how* their policies have been implemented and *how* rights attaching to investments have been exercised.
- Schemes may also benefit from best practice guidance on how to produce, implement and review the SIP.

The above recommendations are consistent with the possible approach suggested at page 15 that default options "are designed in the interests of members". It would also be in line with the recommendation of the Myners Review, over a decade ago, that members should receive annual reporting on how their scheme's investment policy was being implemented. Myners argued that this "should develop into a forum for decision-makers to explain and justify their approach, and for stakeholders to exercise oversight of the decisions made on their behalf".[10]

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

Our main comment on the default option guidance is that it could usefully be strengthened by being made less "broad-brush" in relation to investment governance. For example, it states that roles and accountabilities at each 'stage' (design, monitoring, review) should be clearly defined and available to members on request. However, there is no elaboration as to what the role of providers, intermediaries and employers might be. Clarification on this point is limited to a general statement that "the on-going responsibility for the default option may vary between provider, adviser, fund manager, employer and governance committee in different situations and for different aspects of a scheme"[11]. Likewise, there is no indication of the kind of governance structures that might be desirable or appropriate to ensure that savers' interests are protected. Governance committees are mentioned as one party to whom the guidance might be relevant, but there is no discussion of the

[9] Our further analysis of communications between schemes and members, including occasions when members are referred to the SIP, is available on request.
[10] Institutional Investment in the United Kingdom; a Review, Paul Myners, March 2001, para 11.4
[11] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/185056/def-opt-guid.pdf , page 7, 2.1,

circumstances under which it might be appropriate to establish one, or of best practice in their composition, terms of reference or operation. If the quality standards are to involve governance bodies in some form, the default option guidance could contain more in-depth information on these.

Possible improvements to the default fund guidance could include greater clarity on:

- the key roles and responsibilities of different actors in the chain;
- the substantive issues for which roles and responsibilities need to be agreed (e.g. ensuring the risk/return profile of the fund is appropriate to the needs of scheme members; considering the fund's stewardship approach, etc.);
- best practice in terms of governance structures, including basic principles for the operation of bodies if they are established;
- the governance standards that should be met (e.g. providers to demonstrate that mechanisms are in place to effectively manage conflicts of interest, including in relation to internally managed funds);
- the types of charges that may be appropriate; and
- the key information that should be disclosed, including the SIP and its implementation, other policies, comprehensive disclosure of charges, etc.

Scale

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

Whilst a small scheme may be a well-governed one, we do think that scale is important. There is now overwhelming evidence that the UK's long tail of small trust-based schemes is not in members' best interests. As noted at paragraph 59 of the consultation, DWP's and TPR's surveys show that smaller schemes tend to have higher charges and to be less engaged than larger schemes.

To some extent NEST provides a model for how a larger not-for-profit, multi-employer trust-based scheme can lead the market in terms of good governance and low charges, as well as in relation to Responsible Investment and stewardship.

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

We support the suggestion at page 19 that "people running a pension scheme must consider whether members are disadvantaged by the size of their scheme and take appropriate action if they consider this to be the case".

Short of full integration or consolidation, there are other ways in which small schemes can pool resources in order to access economies of scale or improve their governance. Possible ways of achieving this could be through bodies like the Local Authority Pension Fund Forum and Trade Union Share Owners, which pool the stewardship and shareholder voting activities of a collection of smaller schemes. Such formal collaborations mean that small schemes are able to take advantage of economies of scale and to exert greater influence over the companies in which they collectively invest.

General approach to legislative minimum standards

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

Responsible Investment

ShareAction believes that the government should ensure that any minimum quality standards promote Responsible Investment (RI), being investment which takes account of long-term environmental, social and governance (ESG) risks which may affect investment returns. This means addressing both investment governance at individual scheme level and the ability of the system as a whole to invest savers' contributions to generate sustainable wealth. System level risks include, for example, excessive short-termism in investment horizons or inadequate investor attention to systemic financial risks. RI also requires investors to take an active role as stewards of investee companies, exercising voting rights and engaging in purposeful dialogue on ESG issues and other concerns.

If pension schemes generally, and governance boards in particular, are mandated to take seriously the long-term effects of investment decisions, rather than to pursue short-term "trading", schemes should act in a counter-cyclical manner rather than exacerbating "herding" within the market. This will benefit all schemes by contributing to a more stable investment system.

The quality standards could address RI in the following ways:

- Requiring funds to have a policy which addresses RI, ESG risks and stewardship. This could be included in a fund's SIP, subject to the points above about the need to improve the quality and use of SIPs.
- All schemes used under automatic enrolment should be required to comply with the UK Stewardship Code, disclosing whether and how they do comply in a comprehensive publicly available statement. Given that the Stewardship Code is a UK government initiative, introduced to address a major systemic failing exposed by the financial crisis and directed at long-term investors such as pension funds, there would seem to be no justification for pension schemes being used under auto-enrolment not to apply the Code's principles. At the very least, schemes should be required (as asset managers currently are under FCA rules) to disclose whether they comply with the Code and, if they choose not to comply, to explain why.