The Governance Gap

Ensuring a level playing field for pension savers

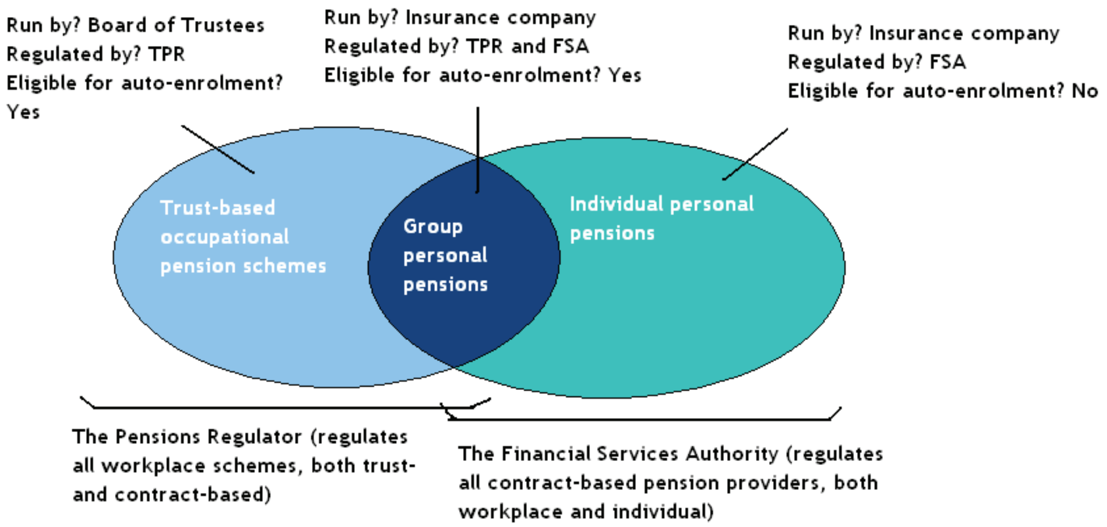
Savers depend on those who manage their money. With the decline of defined benefit pension schemes and the advent of auto-enrolment next year, 5-8 million more people will become reliant on the capital markets for their wellbeing in retirement.

It is vital that investment agents are accountable to those whose money is at stake, and responsible in their exercise of ownership rights in major companies. Failure on these counts could undermine both outcomes for pension savers and the trust in the system that will encourage them to save in the first place.

THE CURRENT SYSTEM

As the recent report of the Workplace Retirement Income Commission noted, "the UK's workplace pensions landscape is highly fragmented."[1] Different forms of pension provision are subject to different laws and regulations – with the most important distinction being that between 'trust-based' and 'contract-based' providers.

- Trust-based pension schemes are overseen by a board of trustees who have a strict fiduciary duty to act in the best interests of scheme members. Trustees are often not investment experts and most delegate day-to-day decisions to external asset managers.
- Contract-based pension providers (insurance firms such as Standard Life and Prudential) are subject to a separate legal regime. There is no equivalent of the board of trustees and these providers do not have the same fiduciary duties as trustees. However, they are subject to FSA rules which do not apply to pension fund trustees.



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POLICY BRIEFING

In countries which do not have the legal concept of the trust (such as South Africa and some European jurisdictions), all pension providers are subject to the same legal and regulatory framework.

There is a much greater body of UK law applying to trust-based schemes than to contract-based. Yet such schemes represent a dwindling proportion of the market: from 1997 to 2010, workplace contract-based pensions rose from 1% to 14% of all private pension saving.[2]

Most pension savers will be unaware of the legal differences between different types of pension. Moreover, many will have little or no choice over what type they end up in: under auto-enrolment, the decision is up to the employer. From the consumer point of view, the relationship is the same regardless of the type of pension: they hand over their money to someone whom they entrust to look after it with the goal of providing them a pension in old age. It is therefore logical that the framework in place to ensure consumers' interests are protected should be equally robust for all types of pension provision.

THE 'GOVERNANCE VACUUM'

The recent report of the Workplace Retirement Income Commission expressed concern about a 'governance vacuum', saying:

> *In a world where individuals lack the time and expertise to drive a good deal with service providers it must be clear who is standing up for their interests and driving the best deal with suppliers. In trust-based schemes the trustees can play this role but the extent to which they do so seems variable. For contract-based schemes it is usually only the employer who could do this and the extent to which they do so is variable.*

We agree, except that we believe the implications of the governance gap go beyond the question of agreeing a 'good deal' with providers. Standing up for savers' interests also means holding those providers to account on an ongoing basis - including with respect to their exercise of 'stewardship', or responsible ownership, to ensure that investee companies are well-governed and deliver sustainable long-term returns. This may be jeopardised by weaknesses in the legal framework on both sides of the pensions market.

Trust-Based Pension Schemes

Trustees increasingly delegate their powers but cannot delegate their fiduciary responsibilities. As the Myners Report noted ten years ago, they also may not have the expertise to effectively challenge or hold to account those they delegate to. This potentially creates an accountability gap on the part of the asset managers and consultants who make and advise on key decisions affecting members' interests.

Recommendation:

The Law Commission has stated that asset managers and consultants, like trustees, have the same strict fiduciary duties as trustees under common law.[2] But this is not widely accepted in the industry. We recommend clarification by the regulator to ensure that high standards of protection are applied by those who actually manage savers' money as well as the trustees who appoint them.

Contract-Based Pension Provision

In contract-based provision there are no trustees at all. In theory, this arguably makes the chain of accountability shorter and therefore more effective. Many have expressed concern about this absence of anyone charged solely with championing savers' interests. In practice, personal pensions can seem like much more of a 'black box', with nobody entrusted to intermediate between the interests of the individual saver and those of the commercial provider. There is clear potential for conflicts of interest to arise in large financial conglomerates - for example, the temptation to choose funds managed by the firm's asset management arm, or the difficulty of engaging robustly with companies where tht firm has importnat business relationships. FSA rules aim to ensure that such conflicts are managed and disclosed, but these rules are much less strict than fiduciary duties.

Some employers set up 'management committees' which mirror the role of a board of trustees. DWP has suggested that this negates the need for policymakers to address the governance gap.[4] Yet it is far from universal: only around half of employers choose to do this.[5] In addition, when an employee leaves an employer, their pension pot is likely to be defaulted into another product from the same provider, with no ongoing role for the employer. Employer-led governance structures therefore cannot be a substitute for addressing the governance of pension providers themselves.

Recommendation:

The framework governing commercial pension providers should be urgently reviewed in two key respects::

- *Duties:* should they be given 'fiduciary-like' responsibilities to act in savers' best interests, given that they fulfil the same role as a trust-based scheme?
- *Structures:* should there be a body within firms that can play the same role as a board of trustees, as is required of pension providers in jurisdictions like South Africa?[6] Should firms establish 'policyholder committees' that can defend the interests of savers if they conflict with those of the firm?

If employer-led management committees are considered to improve governance, consideration should also be given to mandating them in the same way that trustee boards are mandatory for trust-based pension schemes.

RESPONSIBLE OWNERSHIP

Savers have an interest in knowing that the companies in which they invest are well-run and deliver sustainable returns in the long-term. Shareholders – including the institutions who look after savers' investments – have an important role to play as company owners in ensuring that this is the case. In the aftermath of the financial crisis, it was widely accepted that institutional investors had not done enough to challenge risky business models in the banks they owned. This led to the creation of the UK Stewardship Code, overseen by the Financial Reporting Council, which aims to promote best practice in shareholder engagement with investee companies. The Code is primarily aimed at asset managers but stresses that asset owners such as pension funds also have a role in mandating and monitoring their asset managers' engagement activities. As yet, only four commercial pension providers have signed up to the Code, compared to around 30 occupational pension schemes.[7]

FREQUENTLY ASKED QUESTIONS

Won't these savers all just end up in NEST anyway?

Not necessarily. Several commercial providers have already said they plan to launch products to compete with NEST – including HSBC, Aviva and Dutch firm ATP.[8] Moreover, NEST is targeted particularly at low-income savers – and the cap on contributions means it is unlikely to be the sole provider for higher-income workers. Although low-income savers are particularly vulnerable, consumer protection matters to all.

Surely it's for employers to choose the best pension for their members - government shouldn't bias that decision by placing additional burdens on one sort of pension provider or another.

We are not suggesting that government should interfere with employers' discretion. Rather, government should ensure there is a level playing field between different types of provision, so that consumers are equally well protected whichever choice their employer makes. The DWP has already recognised the need for this by publishing a consultation on regulatory arbitrage. Some experts have predicted that employers will be more likely to opt for contract-based arrangements since they are perceived as easier, placing fewer governance responsibilities on the employer – a case of regulatory arbitrage par excellence. Yet, as the McFall Report points out, this very absence of governance responsibilities may create an accountability gap which does not serve the best interests of savers.[9] Addressing this issue is not a case of creating an imbalance in the legal framework, but of correcting an imbalance that already exists.

A level playing field cuts both ways - - if insurance firms were given duties similar to trustees, wouldn't we also have to subject trustees to the same FSA rules as insurance firms?

No. Creating a level playing field does not mean subjecting all types of provision to identical rules – and indeed, we are not suggesting that the differences between trust- and contract-based provision could be erased. Rather, it means making sure that each model offers comparable standards of governance and accountability, recognising that the mechanisms through which this is achieved may differ. We believe that strengthening the duties owed by commercial providers to their customers may be part of this levelling process.

It is also worth bearing in mind that the vast majority of trustees delegate day-to-day management of the fund to asset managers, who are subject to FSA rules in the same way that contract-based providers are. The trustee's role is to act as an independent champion for members, and it is the absence of such a role in commercial provision that gives rise to concern. The suggestion that reforming the system would mean subjecting trustees to FSA rules may therefore be something of a red herring.

ABOUT FAIRPENSIONS

FairPensions is a registered charity which works to promote Responsible Investment (RI) by pension schemes and fund managers, and to ensure that the ultimate beneficiaries are well served by institutional investors and other professional agents in the investment world.

As a member organisation, FairPensions is supported by a number of leading UK charities including Oxfam, Amnesty International and WWF, as well as organisations representing the beneficial owners of pension schemes, such as the National Federation of Occupational Pensioners, UNITE and Unison. FairPensions also enjoys the support of more than 8000 individual supporters.

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1. Workplace Retirement Income Commission, July 2011, *'Building a transparent and stable pensions system'*, p28
2. ONS Annual Survey of Hours and Earning, 2010, cited in WRIC, July, 2011
3. Law Commission ref; For further details see 'Protecting our Best Interests', 2011, Chapter 2
4. DWP, 2011, *Preparing for automatic enrolment: Response to the call for evidence*, p17
5. TPR, 2011, *Enabling good member outcomes in work-based pension provision*
6. See FairPensions, 2011, *'Protecting our Best Interests: Rediscovering FIcuciary Obligation'*, p48
7. See http://www.frc.org.uk/corporate/stewardshipstatements.cfm
8. See http://citywire.co.uk/new-model-adviser/hsbc-plans-to-rival-nest-with-workplace-retirement-service/a451303; http://www.financenews.co.uk/pensions/aviva-may-develop-nest-alternative/; http://www.ipe.com/news/atp-to-bring-low-cost-pension-scheme-to-uk-market_39020.php

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