PENSIONS AND LIFETIME SAVINGS ASSOCIATION

26th April 2018

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Dear Ms. Gold,

PLSA RESPONSE: CMA WORKING PAPER 4 – TRUSTEE ENGAGEMENT

We welcome the CMA's recognition – and that of the Financial Conduct Authority (FCA) before it – that in seeking to understand how well the market for investment consultancy and fiduciary management services is working, it is important to examine both the supply- and the demand-sides. The trust-based model works well and is an effective way of protecting pension scheme members and ensuring schemes are run properly. However, trustees need to be able to properly hold their investment service providers to account and achieve the best possible value for money, in order to achieve good member outcomes.

Our response is principles-based, drawing upon input not only from the PLSA's previous work on broader governance and trustee engagement issues, but also from the full breadth of our members, including trustees, pension scheme investment managers and investment consultants. We would be happy to explore any of the issues outlined below in further depth with the CMA at a later stage, or to provide a forum for deeper engagement with members involved in this area.

Evidence and emerging findings

The CMA's findings that there is a variation in the level of active trustee engagement with their investment service providers is in line with the results of other work undertaken by TPR in their *21st Century Trustee* campaign and the Financial Conduct Authority's Asset Manager Market Study. Policymaker concerns about pension governance – inextricably linked to trustee engagement – more generally has also been reflected in initiatives such as the new rules for Independent Governance Committees (IGCs) introduced by the FCA in 2015 and the Pension Schemes Act 2017 which aimed at transforming the quality of master trust governance.

We note that although the broader strategic decision-making regarding institutional investment advisers may not be overly complex, issues such as the nature of the service provided or the performance of the consultant's recommendations on asset allocation or manager selection can be one of the more complicated issues that trustees face. Although The Pensions Regulator (TPR) and others have undertaken a significant amount of work to raise the standards of trustee knowledge and understanding (TKU) on a variety of investment issues, we agree that more could be done.

The CMA's analysis has highlighted some interesting issues. The first is that Defined Contribution (DC) schemes "appear to be significantly less engaged than average." Although we have seen some excellent practice and good engagement from many DC trust-based schemes, it could be that this reflects the basic structure of DC risks, where all of the investment risk being borne by the member. It may also derive from the long-term focus of scheme trustees on reducing their DB scheme funding gaps.

The finding that "there is some evidence that size of pension scheme is a determinant of engagement" with "small schemes…significantly less likely than average to have undertaken a formal review of fees and/or quality, and large schemes are significantly more likely than average to have done so" also resonates. A scheme's quality of governance is not only determined by the nature of the trustees themselves, but also by the support structures and personnel surrounding the trustees and which are fundamental to ensuring the effective application of a trustee board's knowledge and experience. Support staff which are able to advise and execute the decisions of the governance body are essential as they can do the job on a day to day basis, freeing up trustee board resource to focus on more strategic issues. However, a well-resourced executive function may be beyond the means of smaller schemes.

We have mentioned in previous responses the particularly complex nature of fiduciary management, and the particular knowledge and understanding that trustees need to have of this issue before making even the initial decision as to whether or not to pursue a fiduciary management arrangement. We are therefore unsurprised by the CMA's finding that "levels of engagement are lower in fiduciary management on each indicator"; we agree that some of this may be with the measure used and the fact that many schemes have only pursued fiduciary management relatively recently so have not yet reached the stage in the process where it would make sense to either re-tender or switch. It may also be the case that moving to a delegated management solution such as fiduciary management means trustees shift resources to focusing on other pressing issues.

Potential remedies

We look forward to seeing the forthcoming Working Paper from the CMA on the gains from trustee engagement, as well as the Provisional Decision outlining some further analysis and evidence in other areas. We recognise that the CMA's analysis is still emerging at this stage but

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thought it worthwhile commenting on a few of the potential remedies mentioned in the Working Paper, as well as two key changes that we think could have a significant impact on trustee engagement in this area.

Potential remedies suggested by the CMA

We welcome the recognition by the CMA that many of the suggested remedies outlined in other Working Papers could, if proposed, potentially drive better engagement. We have noted in previous responses (as well as below) that other policy changes currently underway or being proposed – such as the work of the FCA's Institutional Disclosure Working Group (IDWG) – should have a positive impact on trustee engagement and their ability to scrutinise all their investment service providers (both managers and advisers).

Switching costs: we agree with the principle that trustees should, at certain key points in their decision-making journey regarding the choice of investment consultant or fiduciary manager, be informed of the potential costs of switching. Understanding how to unwind a decision if necessary should be a fundamental consideration in the initial conversation. However, given the number of variables involved in calculating the cost associated with a switch or change in approach, this may be difficult to predict. We agree that any such information should be presented in a consistent and clear way, to support trustees in making comparisons.

On the determinants of the costs of fiduciary management switching, we agree with the CMA's analysis that while some of this will be due to the liquidity of the underlying asset classes and funds, a significant part will be inherent in the structure of the vehicle. This would include whether or not such a vehicle is proprietary to the original fiduciary manager and the approach and preferences of the new service provider.

Demand-side remedies: we have noted in previous responses (and below) the current plethora of guidance, guidelines and regulations which apply to trustees. This can be confusing and could also encourage a compliance-led and cautious approach to decision-making. We believe that there would need to be compelling evidence to support the imposition of significant further obligations and duties on trustees, such as mandatory tendering or switching (we believe the latter would also reduce choice). Any such changes must be proportionate and seek to align with initiatives elsewhere.

There is already a significant policy focus on more explicitly encouraging DB and DC schemes to focus on achieving value for money. There is therefore significant scope for considering how the CMA could align any suggested requirements in this space with those suggested elsewhere. One way in which this could be done is through the DB Chair's Statement – this already exists for DC schemes, is a proposal currently under consideration in the DB White Paper and which we

examined in our DB Taskforce work. Such a document could potentially capture thinking on value for money achieved from investment consultants and fiduciary managers.

Changes to current regulatory oversight

In recent years, government and regulators have quite rightly – as mentioned above – focused on trying to improve the governance of occupational pension schemes. However, in doing so, the sector has often been regulated to the lowest common denominator, resulting in a highly prescriptive and micro-managerial approach to regulating the actions of trustees, scheme managers, and their advisers.

Regulatory approaches have also often been characterised by a strong focus on outputs rather than inputs, and on process rather than people. Our *Good Governance: how to get there* paper (published in August 2017) explores this issue in greater depth, highlighting the wide range of different regulations setting out outputs-focused expectations of trustee boards and resulting in a confusing array of guidance, codes of practice and code-related guidelines for trustees.

As we have mentioned in our previous responses to the CMA, we believe this has potentially led to a more risk-averse and compliance-led approach from trustees, which could result in reduced innovation in the sector and a reluctance to choose new or different providers of institutional investment advice. We also think such an approach is inimical to good governance and trustee engagement: the quality of the inputs determines the quality of the outputs, and the UK's widely well-regarded approach to governance of the *corporate* sector is, in contrast to pensions governance regulation, principles-based and input-focused. We therefore think the CMA should potentially consider remedies which aim to bring the UK regulation of pension scheme governance more in line with aspects of the UK's regulation of corporate governance.
Some additional changes which we think could help boost trustee engagement include:

- **Rebalancing TPR's priorities to include a great focus on scrutiny of board appointments and effectiveness**. Currently regulatory resources are focused on attempting to manage each individual process that the governance bodies undertake. Instead, TPR should assess boards and committees collectively/holistically, ensuring that a diverse range of backgrounds and perspectives is maintained, as well as an appropriate balance between technical expertise and softer skills.
- **Encouraging a governance structure which more closely resembles a split into a board (which carries out strategic oversight) and an executive body (responsible for day-to-day running of the scheme).** TPR could focus resources on assessing whether trustees have access to the kind of executive support which would support such an arrangement i.e. able to do the day-to-day job of implementing and executing the trustee board's strategic decisions.

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Encouraging consolidation

We note the CMA's findings in this paper– as well as those of TPR and the Department for Work and Pensions (DWP) elsewhere – that smaller schemes tend to have "less effective trusteeship and governance[1]". The second report of the PLSA DB Taskforce – *The Case for Consolidation* – summarised the growing body of evidence to demonstrate the benefits of scale in pension funds in a variety of areas, including improvements in scheme governance and oversight.

The UK's pension scheme system – in particular on the DB side – is highly fragmented and characterised by a significant number of small schemes. We believe that for many, consolidation with other pension funds into larger entities will be the best way of equipping such schemes with the appropriate governance capacity and structure and should facilitate trustee engagement. Regulatory nudges – such as the DB Chair's Statement suggested by the DB Taskforce and proposed in the DWP's recent DB White Paper – could have a significant impact on encouraging smaller schemes to assess the possible benefits of consolidation. We also welcome the DWP's other proposals which aim at creating the right legislative framework for a broader range of consolidation options than currently exists.

I hope that you find this helpful. If you would like any further information, or clarification, please do not hesitate to get in touch.

Caroline Escott
Policy Lead: Investment and Defined Benefit

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[1] The Department for Work and Pensions – *Security and Sustainability in Defined Benefit Pension Schemes* (February 2017)