

National Association of Pension Funds Response to the Pensions Regulator's Consultation on DC Pensions

Executive summary

The NAPF is the leading voice of workplace pension provision in the UK. Some 10 million working people are currently in NAPF member schemes while around 5 million pensioners receive valuable retirement income from them.

We support The Pensions Regulator's objectives of protecting members' benefits in defined contribution schemes and promoting the high standards of scheme administration.

We agree with the Regulator's assessment of the main risks related to DC pensions and suggest that it should address them in the following order of priority:

- 1: poor administrative practices;
- 2: poor decisions on retirement choices;
- 3: unduly high charges;
- 4: poor investment practices;
- 5: lack of member understanding.

In addition, we would like to emphasise that these risks may be exacerbated in the following cases:

- in contract-based schemes where no expert intermediary ("trustees" in the case of occupational pension schemes) is available to act on the member's behalf;
- where legacy funds exist and are not being actively managed or reviewed.

In overall terms, we would prefer the Regulator to use the regulatory instruments of education, industry partnerships, and spreading best practice. We are not convinced that the use of sanctions on trustees or public reporting would be effective tools in this area as the trustee community is already eager to enhance administrative practice.

In addition, such regulatory approaches may simply discourage trustees to come forward for such roles. In its approach to these issues, we urge the Regulator to ensure any guidance documents clearly distinguish between the roles of the employer and that of the trustees or pension provider.

Chapter 1 – Overview of proposed approach

- Do you agree that the main risks and issues have been identified? If not please provide your views on where you think other significant risks occur.

In broad terms, yes, we agree that the regulator has identified the main risks. However some aspects do require emphasis:

- Scheme trustees (or the provider in contract-based arrangements) may have difficulty in ensuring effective administration as they do not have formal authority over certain key corporate functions on which good administration may depend – corporate HR payroll, third party administrators or investment providers. This can only be achieved with the support and commitment of company management. The company payroll function is critical to the functioning of DC schemes as it is the 'engine' which generates flows of data and contributions to the administrator.
- Contract-based schemes have no intermediate body to safeguard members' interests, in order, for example, to monitor providers and negotiate charges. This is the "governance vacuum" which we referred to in our 2005 discussion document.
- The existence of different regulatory regimes and levels of protection causes confusion. For example, advice given for individual transfers of pension rights between occupational DC schemes is not regulated whereas any transfer involving a contract-based scheme is.
- Undue administrative delays in the annuity purchase may cause losses to members' benefits if there are adverse market movements between the date of retirement and the annuity purchase. Delays can also occur with notifications and payment of outstanding contributions from the employer to the administrator.
- "Legacy" money purchase AVC funds within occupational defined benefit schemes, where contributions may have ceased, and providers have closed the contract to new business, may not receive the time and attention that they require from trustees.

- Do you consider that certain risks should be given a higher priority than others? If so, do you have experience of these risks occurring within your pension scheme, or a scheme of which you have knowledge?

We believe that certain risks should be given a higher priority. Our view on the appropriate order is set out below:

- Priority 1: poor administrative practices, including absence of regular reconciliations or incorrect investment allocations;

- Priority 2: poor decisions on retirement choices, including the failure to secure the best value or most appropriate form of annuity;

- Priority 3: unduly high charges within some contract-based arrangements (over 10 years this can result in a ratio of less than would be the case for a typical over 2% a year trust-based arrangement);

- Priority 4: poor investment practices, for example, where some trustees may lack the skills necessary to select and monitor investment managers;

- Priority 5: lack of member understanding which is part of a much wider agenda of building financial capability and skills involving other agencies;

In rating the issues, we have taken account of both the potential detriment to members and the ability of the Pensions Regulator to rectify the problems. Finally, we urge the Pensions Regulator to seek further evidence of where the greatest risks and weaknesses lie so that interventions can be directed most effectively.

- Do you agree with the proposed high level approaches and interventions, and do you think that they address the risks? If not, please provide your views and any alternative suggestions.

In general terms, we prefer an approach which focuses on education and using industry partnerships to identify best practice and to publicise it, using intervention or sanctions as the instrument of last resort. Ensuring that the message reaches all employers, providers and trustees is key, because even excellent guidance materials will be ineffective if they are not read. The cooperation of providers, advisers and trade bodies will be essential. However, the appropriate balance of education and enforcement will emerge from experience so it is important that the Regulator's strategy is flexible. We favour an incremental approach that uses existing materials wherever possible and takes account of the ability of trustees, providers and employers to absorb new material and implement.

Chapter 2 – Addressing the risks: poor administrative practices

- Do you agree that we have correctly identified the key issues that contribute to poor administration practices? If not please provide your views on the issues that you consider key to ensuring good administration practices within DC schemes.

We agree that The Pension Regulator has correctly identified the key issues.

The key to ensuring good administrative practices is that the payroll function, administrators and other service providers understand that DC schemes must be administered with the same care and priority as paying salaries. Training for payroll, HR and finance staff in these functions would be a valuable way of improving DC administration.

Service level agreements (SLAs) are only one tool for managing administrators and care needs to be taken over the design of SLAs. For example, a scheme member lost her right to a guaranteed annuity rate because the administrator sent her option form to the AVC provider late, one day outside the cut off date for the guarantee. The administrator denied liability because the option form had been processed within its 10 working day target time.

- How prevalent do you consider poor administrative practices to be within the DC pension landscape and do you have any examples?

While there is no doubt that poor administration exists, it is hard to estimate how widespread it is and the evidence available is generally anecdotal. However, consultants (and NAPF members) Higham Dunnett Shaw estimate¹ that in their experience about a third of pension schemes experience administration errors and omissions, for example, contributions being unchecked or unreconciled.

(N.B. This estimate may overstate the problem as it is drawn from a group of schemes where problems require professional help.)

One example of poor administrative practice reported by one of our business members is of a large DC scheme of 50,000 contributors, where the unit pricing function was outsourced by the investment manager to a custodian and subsequently by the custodian to a sub-custodian. This resulted in errors in the unit pricing process which cost £0.5m to put right. (In our view, effective and robust internal controls are the key to preventing such errors.)

We are also aware of anecdotal evidence of failures to carry out the basic discipline of regular reconciliations by administrators and investment providers.

- Do you agree that the regulatory response is appropriate to address the risks and result in better administration? If not please provide your views and/or alternative suggestions.

On balance we believe that the regulatory response is appropriate, though we emphasise, that any response should be proportionate and evidence-based.

In our view TPR will be best able to achieve its objectives by helping pension schemes improve their performance via regular communication and feedback. Development of the website, while welcome, will only be a part of this process. Effective partnership working with industry bodies is also essential and this will take time.

¹ *Restoring Confidence: Measuring and Managing Performance in Pensions.* Higham Dunnett Shaw/Cranfield School of Management, December 2006

- Do you agree with the regulatory interventional approach suggested for third party administrators and/or payroll providers? If not, please provide your views and other suggestions for tackling the issue of poor administrative practices and regulation of TPAs.

We support the provision of guidance and assistance for all parties and the use (or threatened use) of improvement and third party notices where there are persistent or wilful breaches of legislation.

However, we would not recommend removing trustees unless there was strong evidence that they knew about administrative failings and did nothing. We are aware, particularly in the insurance sector, that providers may report problems to the Regulator but not necessarily to scheme trustees. We suggest, instead, that the TPR considers appointing an independent trustee to assist the trustee board.

We are not convinced that public reporting of recalcitrant or consistently poor performing providers is the best way forward. Such action could have a very severe impact. However, if the TPR adopts this approach, we recommend that they apply due process and a right of appeal as is the case for other punitive actions, such as fines or formal sanctions. "Naming and shaming" needs to be carefully thought through, given that the objective of improving administration requires cooperation from all parties.

It may be best for trustees and/or employers to exercise commercial pressure on poorly performing administrators by regular reviews and by the use of effective internal controls.

- Have you identified any other specific risks or issues relating to scheme administration that you think appropriate for the regulator to address?

We have not.

Chapter 3 – Addressing the risks: poor investment practices

- Do you agree that we have correctly identified the key issues? If not please provide your views and clarify the issues you consider key.

In contract-based schemes the lack of expert and informed trustees acting on behalf of the member (the “governance vacuum”) means that investments are often not monitored nor the range of funds and default choices reviewed. This is a major weakness.

One further issue is the problem of legacy funds. These are often neglected particularly where funds are closed. Because of unfavourable transfer terms or due to the problems and risk associated with advice, they cannot easily be consolidated with open funds.

- In your experience, do you agree that poor investment practice exists on a large scale within the industry? Please provide your views and any examples.

We do not know if the practices described exist to any great extent.

Our annual survey on investment in DC schemes shows that members overwhelmingly do not make choices but allow money to be invested in default funds with hardly any switching between funds. This lack of activity may be due to inertia or a lack of understanding or both. However it is worth exploring the underlying reasons to ensure that, as far as possible, members have the tools to help them make appropriate investment decisions rather than rely passively on default funds.

- Do you agree that the proposed activities will result in the regulator’s expectations being achieved?

Given effective acceptance of the main messages, there should be improvements but it will take time.

- Do you think that the proposed regulatory response is appropriate? If not, please provide your views and any other suggestions.

The response appears appropriate but we would add a caveat that smaller schemes may struggle to handle some of the requirements.

Chapter 4 – Addressing the risks: unduly high charges

- Do you agree that the main issues are the right ones for the regulator to pursue in the aim of reducing the risk of unduly high charges?

We support the principle that the Regulator acts as a collator and publiciser of information on what is best market practice, and allows market forces to spread it.

- Do you agree that the good practice topics as outlined above are the right ones to help mitigate the risk of unduly high charges? Are there any others that you consider appropriate to include?

We think so.

- Do you agree with the focus of attention and consider the appropriateness of the regulatory response adequate? If so, is it your view that the regulator should carry out this role in addressing the issues of value for money and transparency? If not, please provide alternative suggestions if possible.

We believe that further research is needed to establish the extent of high charges and the areas affected so that the regulatory response is directed in ways that will be most effective.

This could include surveys, scheme return data and provider information. There is a distinction between contract and trust based schemes which must be taken into account.

Chapter 5 – Addressing the risks: poor decisions on retirement choices

- In what way should members be engaged, and by whom, so that they can make well planned and informed decisions? What do you consider the role of the regulator should be?

It is the trustees in trust based schemes who are primarily responsible for engaging with members. Members of contract based schemes will be the responsibility of the provider and/or the financial adviser.

This is an area where much more work is needed because retirement choices involve a member requiring information, for example, about state pensions, eligibility for means-tested benefits, his/her tax position in retirement, other pension arrangements, commuting part of the fund for a tax free lump sum (not mentioned in the document), the consequences of deferring annuitising, household income, dependants, life expectancy.

It is unrealistic to expect trustees to provide more than generic guidance and we would hope that before using powers of intervention, the Regulator will ensure that good generic information and advice is available for distribution in retirement packs.

According to Mercers' survey of DC scheme members, 4 out of 5 members do not understand annuities and we cannot be confident that the 1 in 5 who claim to understand annuities have sufficient knowledge to be able to exercise choice.

We are aware anecdotally that defaulting annuities to the main provider and with occupational money purchase AVCs, paying a pension from the DB schemes, are still common practices.

Unsecured or alternatively secured pensions are unlikely to be mass market products in the short to medium term because of the large fund size needed to make them viable.

- Do you agree that this is the appropriate regulatory response in addressing the issues and the risk? If not, please provide your views and any alternative suggestions.

N/A

- Do you consider that there are other important areas that should be addressed to minimise the risk? If so, what are they and whose responsibility do you consider it is to address them?

Annuity Purchase

Members may suffer losses when annuity purchase is delayed either by adverse movements in interest rates or a fall in the value of their personal funds. Often several pots may need to be consolidated before an annuity can be purchased, which adds to the time and complexity of the exercise.

Other delays may include time taken for the final contribution from the employer, depending upon the payroll cycle.

In 2001, an occupational scheme member lost 25% of the value of her fund because her retirement date and the annuity settlement date were months apart, with a sharp fall in world stock markets in the interim. There were two insurance companies involved, each disclaiming responsibility and blaming the other for the delay. The trustees had not thought to invest the monies defensively which would have locked in the fund to the prevailing annuity rates.

We are also aware that the provisions of the 2004 Finance Act also cause delays. Where a member is purchasing an open market annuity, the restrictive wording of the legislation means that the lump sum cannot be paid until the annuity purchase money has been passed to the annuity provider. This means that the member may have to wait 6 to 8 weeks before the lump sum is paid, causing unnecessary hardship in some cases. The delay is a significant deterrent to members taking the open market option.

Chapter 6 – Addressing the risks: lack of member understanding

- Do you agree with our analysis of the key areas to address? If not, please provide your views on other areas that should be considered.

Providing clear information that enables members to make decisions is essential and we agree with the analysis. We would welcome the development of good practice guidance.

We believe that the responsibilities of employers and trustees should be limited to providing accurate and good quality information. Care should be taken not to extend their responsibilities to the education of members. This is part of a much wider agenda of building financial capability.

- Do you consider that the proposed regulatory response is appropriate to address the risk? If not, please provide your views and any alternative suggestions.

We would not underestimate the size of the challenge here and recommend that it proceed by stages.

- Do you agree that the regulator should continue to focus on routing information to members through those running and providing pension schemes rather than directly? If not, can you provide views on where and how you think the regulator will add value?

We agree.

- Have you experienced situations where lack of member understanding has caused a problem and, if so, what practices did you find effective?

Members may make inappropriate investments because the nature of the funds is not properly described. Younger members may sometimes be directed into a with profit funds when an equity-based fund might have been more appropriate. One older member was advised to contract out of the state additional pension and thought that because it was described as "protected rights" there was a capital guarantee. The Mercer survey showed that members preferred explicit descriptions of funds, e.g., "high risk" is better than "adventurous".

- You are welcome to provide any further information / views below.

We have no other views.

Thank you for your time.

When completed, please send this form to the Pensions Regulator by email or post, as follows:

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