Securing the future of pensions

UK Pensions Regulation Compared

October 2008

Key findings

A study of pensions regulation in several OECD countries prepared by John Ashcroft for the National Association of Pension Funds.

NAPF Research Report

Key Findings

Introduction

This report compares key elements of the UK regulatory framework for private pensions with those in five other OECD countries which have large private pension sectors: Australia, Germany, Ireland, the Netherlands and the USA. Drawing on a comparative analysis of the regulation in each country of design rules, benefit security, and governance, the report aims to identify those aspects of UK regulation that are significantly heavier or lighter than elsewhere. It is hoped that the analysis will help promote informed discussion on how the regulatory framework in the UK should evolve in the future.

Overview

Overall, a complex picture emerges with the results varying depending on whether DB or DC pensions and trust-based or contract-based pensions are compared. While UK pension regulation for trust-based DB schemes is, on balance, somewhat higher than that of other countries especially if the typically small size of UK schemes is taken into account, the regulation of trust-based DC pensions is in the middle of the range of regulatory approaches. As for the regulation of UK workplace contract-based DC arrangements, this appears a little lighter than in other countries, in particular with regard to design rules and the lack of formal governance obligations. However, contract-based schemes are subject to extensive point-of-sale and Treating Customers Fairly requirements.

An analysis of the design rules, benefit security and governance requirements across the countries studied reveals the following conclusions:

Design Rules

DB Schemes

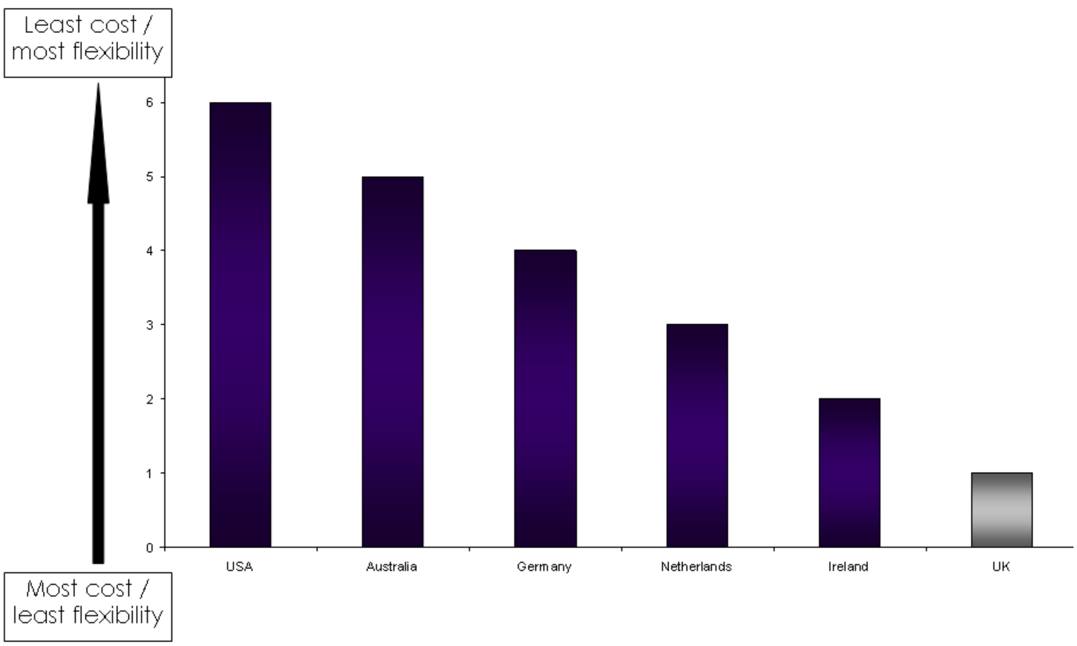
The UK's requirements for the mandatory indexation of deferred pensions and of pensions in payment are out of step with international practice. Of the countries studied, only Ireland requires indexation of deferred pensions (revaluation), while Germany and the Netherlands only require indexation in so far as it is affordable. (Crucially, no reserving for indexation is required unless there is a specific promise.) No revaluation or indexation requirements apply in the other countries.

DB indexation – Mandatory / Conditional / None

	Revaluation	Indexation
Australia		
Germany		C
Ireland	M	
Netherlands	C	C
UK	M	M
USA		

Other elements of DB regulation in the UK are also more prescriptive than in several other countries studied, e.g. the UK's rule on vesting (3 months rather than 5 years in Germany or 5-7 years in the USA) and the absence of the power unilaterally to transfer members with small balances out of the scheme that exists in Ireland, the Netherlands and Australia. The restrictions on altering accrued rights are similar to those elsewhere.

DB design rules – flexibility and cost



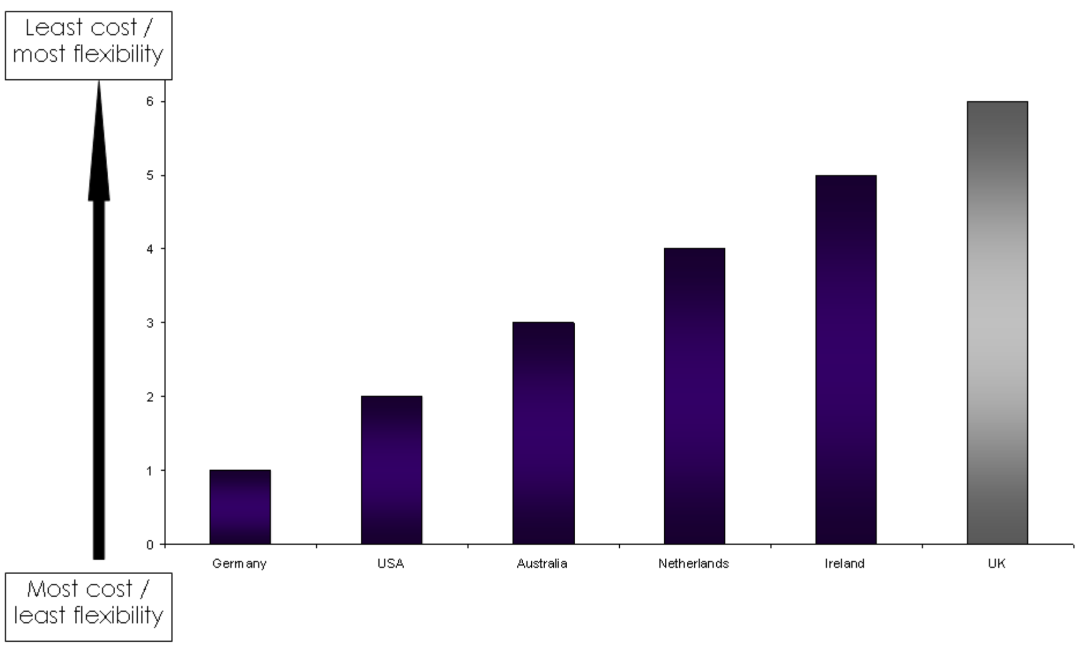
DC Schemes

The countries studied fall into two categories, those like the UK, Ireland and the USA, that take a 'liberal approach' where they allow DC schemes to operate with few constraints on pension design, and others, such as Germany, the Netherlands and Australia, where they must either provide a guarantee, or target a certain level of benefits or keep fees within certain limits. It is true, however, that all the 'liberal approach' countries, make provision for an optional regulated pension product, which includes elements such as a specified mandatory default fund and, sometimes, charge caps. Both of these elements apply in the case of the UK's stakeholder pension and Ireland's Personal Retirement Savings Account.

The UK's rules on the payout phase, which involve the provision of a life-long income for at least 75% of the fund, are more flexible than those in the other European countries, but more restrictive than the rules in the USA and Australia.

Looking across the countries studied, the most striking element is the degree to which the fiduciary responsibility of the employer and scheme varies, with none applying to contract-based schemes in Ireland or for group personal pensions in the UK while, in normal circumstances, they would apply in the Netherlands, USA and Australia.

DC design rules – flexibility and cost



Benefit Security

DB Schemes

The countries studied use three different regulatory approaches to securing members' benefits:

- 'employer protection' where the sponsor underwrites the liabilities backed up by a pension guarantee scheme (used for German book reserve schemes).
- 'funding protection' where the scheme is funded at or close to termination level, thereby placing minimal reliance on the sponsor (used for Collective DC schemes in the Netherlands and for German funded schemes).
- 'combined employer and funding protection', where the liabilities are funded but the sponsor is the ultimate guarantor (used in Australia, Ireland, the UK and the USA).

The UK's approach to the funding requirement (100% of liabilities) is typical of the countries surveyed, although Ireland and Australia have a generally stricter definition of liabilities and, at the other extreme, the USA and German book reserve schemes apply weaker ones. Only in the Netherlands and German funded schemes, where additional buffers are added, is the requirement higher than 100%.

The employer in the UK is expected to meet the full termination cost of benefits in the event of insolvency or scheme closure. Of the countries studied here, only the USA and the entirely unfunded German book reserve schemes use such a high standard. Similarly, only the UK, the USA and Germany have a guarantee scheme.

On the other hand, if a scheme does fall into deficit, the UK's period for correction is in the middle of the regulatory range and makes some allowance for affordability. While for German funded schemes recovery must be immediate, in the Netherlands it must be within 3 years, in Ireland 3 years (although schemes are often allowed up to 10 years), in Australia 5 years, and in the UK the deficit must be made good as soon as possible and, if later than 10 years, it will trigger particular regulatory scrutiny. However, in the USA, the requirement is 7 years whilst for German book reserves there is no such requirement. Access to surpluses is generally more restricted in the UK than in Australia and Ireland.

DB benefit security

	UK	Ire	Aus	USA	Ge (BR)	Ge (PF)	Nl
Archetype	Combined	Combined	Combined	Combined	Employer	Funding	Funding
Employer guarantees up to what level?	Buy-out	Implicitly to Full Funding	Full Funding	Buy-out	Buy-out	Paying premiums required	Paying premiums required
Guarantee scheme	✓	×	×	✓	✓	✓ (low risk)	×
Formulaic funding standard?	-	✓	-	✓	✓	✓	✓
Funding discount rate	Scheme specific - average just below IAS19	Buy-out for pensioners formula for others, 4.5-7.25%	Part buy-out, part actuarial best estimates	Approx IAS19	6%, being strengthened to IAS19	Risk free rate	Risk free rate
Full funding?	100%	100%	100%	100%	Funding not needed	104.5%	105%
Solvency margins	×	×	×	×	×	✓	✓
Transfer values	Below funding level – best estimates	Same as funding level	Same as funding level	No regulation	Same as funding level	Same as technical provisions	Same as funding level
Recovery period (years)	10 year trigger	3 - 10 years	5 (some benefits only)	7 years	No requirement	Immediate (<100%) or 3(<104.5%)	3 years

(dark purple)	Strictest
(light blue)	Average
(white)	Least strict

Governance

Within the countries surveyed, there are three broad approaches to the provision of pension schemes:

- 'Direct employer provision', where the employer directly provides the pension and is subject to certain corporate governance requirements and some aspects of pensions regulation. This is the approach used in Germany for book reserve schemes.

- ‘Employer sponsored trust or pension company’ where the entity has one purpose, which is to provide employee benefits on behalf of one or more sponsoring employers with a primary fiduciary duty to members. This approach is used in trust-based schemes in the UK and Ireland.

- ‘Financial services providers’, via the employer, which are commercial companies that contract directly with members and may, or may not, place the management of the scheme under a manager or board with a fiduciary duty to members.

Trust-Based Schemes

All the countries studied place core fiduciary duties on the trustees or managers, eg duties to the beneficiaries, requirements to obtain expert advice, and to manage conflicts of interest. The main differences arise with regard to licensing, member representation, the qualifications of fiduciaries, and risk management. The requirements on professionalism are most stringent in Australia, Germany and the Netherlands. The nature of regulation in the UK, Ireland and the USA is, perhaps, a little more general.

Trust-based governance arrangements

	UK	Ire	Aus	Ger	Nl	USA
Licensing	×	×	✓	✓	×	×
Member representation	One third	50% (on request)	50%	Extensive	50%	× (50% for a few)[1]
Trustee qualifications	All trustees to have TKU	Collective TKU	Extensive comp-etence	Sufficient theoretical and practical experience	Expertise related to scheme operation	None explicit
Risk management	Regulatory recommendation	Little explicit	Extensive	Extensive	Extensive	None explicit

(dark purple)	Strictest
(cyan)	Average
(white)	Least strict

However, schemes in the UK, Ireland and the USA are much smaller than in the other group, meaning that governance requirements can be more onerous. The UK has over 48,000 schemes with less than 100 members. Even if only those schemes with more than 100 members are considered, the average scheme size is only 2,600, a quarter of that in

[1] 50% member representation is required for collectively bargained schemes

Germany and a tenth of that in Australia. There are also differences within this second group, for example, Trustee Knowledge and Understanding requirements apply to all trustees in the UK, whereas in Ireland only one trustee or their adviser must meet the requirement. Similarly, in the USA, there is no explicit requirement beyond a general ‘prudent person’ obligation.

Governance regulation in trust-based schemes (DB and DC): costs to the scheme

Cost	Trust-based schemes only	Average membership of scheme
1. Low	USA	2,500
2.	Ireland	2,400
3.	**UK**	**2,600**
4.	Australia	27,400
5.	Netherlands	10,500
6. High	Germany (funded)	7,000

NB. The UK figures relate to the average scheme size for schemes with 100 members or more. There are an additional 48,390 pension schemes with less than 100 members.

Contract-Based Schemes

The governance requirements for contract-based schemes are those in the regulatory licence of the commercial provider concerned. These require senior managers to be fit and proper persons and appropriate risk management to be in place. On the other hand, the legislative frameworks for contract-based schemes do not in themselves provide for representation of members, nor do the managers of the scheme have a primary duty to the members. In addition, there is no explicit fiduciary duty on the part of the provider or the employer.

However, in most of the countries studied, additional regulations apply to contract-based pensions to make them more like trust-based schemes, eg the retail public offer schemes in Australia are subject to pensions law and contract-based pensions in the Netherlands place a fiduciary responsibility on both the employer and the provider. Similarly, in the USA, strict requirements are placed on the employer if they provide a contract-based scheme without accepting a fiduciary responsibility.

Only group personal pensions in the UK and Retirement Annuity Accounts in Ireland are not subject to an overlay of pensions governance regulation. However, UK contract-based schemes are subject to extensive point-of-sale and Treating Customers Fairly requirements. In addition, the UK, Ireland and the USA, do all set governance requirements (eg mandatory default funds, suitability of investment requirements)for certain optional ‘regulated products’ such as stakeholder pensions in the UK and Personal Retirement Savings Accounts in Ireland.

NAPF
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October 2008

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Insights

The report identifies a number of important regulatory issues which require further analysis and, potentially, regulatory reform:

- **DB inflation proofing**: The mandatory inflation proofing in the UK of the benefits both of deferred members and of pensioners is out of step with regulation elsewhere and makes the DB promise far more expensive than in other countries with comparable levels of benefit security. Removal of the requirement would bring UK regulation into line with regulation in most other OECD countries.

- **DB employer covenant regulation**: The UK has unparalleled regulation of the DB employer covenant when compared to the regulatory regimes used elsewhere. While it can be argued that it plays an important role in ensuring the security of member benefits within the UK regime, it is an outlier in terms of international practice. If mandatory indexation were to be removed, it would be easier to apply higher funding levels which, in turn, would reduce the need for such strong regulation of the covenant.

- **DB and DC governance requirements**: The UK requirements for governance in trust-based schemes are high and are only exceeded in countries where most pension schemes are very large. The UK applies fairly high standards to all its mainly small schemes. Consideration should be given as to whether the UK's approach is sufficiently proportionate. One solution might be to make regulation more proportionate to scheme size. Another approach to reducing employer costs – but within a trust-based framework - would be a consolidation of pension provision, as has occurred in Australia and the Netherlands.

- **DC contract-based provision:** The UK regulation of contract-based schemes, especially group personal pensions, is out of line with the regulation of contract-based DC schemes in most other countries. In particular, in other countries either an explicit fiduciary responsibility is placed on the employer or the provider or product rules are applied to ensure suitability. This suggests that it may be worth reviewing the requirements in this area, perhaps by requiring the use of a default fund (as will anyway be required for auto-enrolment schemes from 2012) and the introduction of additional governance obligations, such as the use of management committees or a requirement on the employer periodically to review the scheme offered to ensure that it meets member needs.