IGG | Investment Governance Group

Report on consultation responses

Investment governance of defined contribution (DC) pension schemes

Principles and 'best practice' guidance

November 2010

Contents

1 Introduction

The **Investment Governance Group** (IGG) was established in 2008 as part of HM Treasury's response to a review of the Myners' Principles for investment governance *Updating the Myners Principles: A response to consultation – October 2008*. The remit of the Group has been to encourage greater engagement with investment governance and raise the quality of investment governance practices across all scheme types.

Full terms of reference can be found at the IGG website at: www.thepensionsregulator.gov uk/about-us/investment-governance-group.aspx

The subgroup of the IGG specifically responsible for defined contribution (DC) schemes published a consultation paper in February 2010 on a revised set of investment governance principles which were tailored specifically to the needs of DC work-based pension schemes.

This report covers the key areas of feedback to the consultation paper and explains how the final version of the IGG *Principles for investment governance of work-based defined contribution (DC) pension schemes* (published alongside this document) has been influenced by the input received.

The consultation attracted 42 responses (a list of respondents can be found at the end of this report) and also input from stakeholder seminars and the media. While some of this input was critical, it was constructive, enabling the IGG to produce a workable set of final Principles. It has also informed further work on DC pensions provision by both The Pensions Regulator (the 'regulator') and the Department for Work and Pensions (DWP).

Overall, the proposed Principles, tailored specifically to the features of DC schemes received wide approval from respondents, particularly in the context of auto-enrolment and a tangible shift away from DB pensions provision in recent years.

'In principle, the development of investment governance guidance for DC pension schemes is valuable and necessary in view of the continuing shift from DB to DC schemes, the introduction of auto-enrolment and the resultant increased focus on DC schemes'*

**Quote from undisclosed respondent to the consultation.*

The work of the IGG was considered to be of benefit in the following areas:

- Raising investment governance up the agenda of the pensions industry as a whole
- Prompting industry and Government to consider what governance and risk mitigation activities are achievable to improve member outcomes
- Acknowledging and complementing existing regulatory requirements and highlighting the 'governance gap' in contract-based DC schemes
- Encouraging greater employer engagement with their DC pension arrangements
- Encouraging the clear allocation of investment governance responsibilities
- Highlighting the importance of a default strategy as a key focus for ongoing monitoring and review, as well as at inception of the scheme.

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2 Approach to reporting responses to the consultation

Since many of the written responses submitted did not follow the question-by-question format of the consultation paper, this report does not do so either. Rather, it identifies areas which attracted the most comment and addresses them in order of priority. Each issue is described with the views of respondents summarised. The consequent changes to the principles are then outlined, or, where there has been no change, the rationale is explained. In each case there are references to both the relevant question from the consultation paper and to the relevant principle, where applicable.

Changes made to the Principles reflect not only the views expressed in writing during the initial 12 week formal consultation, but also ongoing informal consultations with key stakeholders, including stakeholder seminars.

3 Approach on the key issues raised by the consultation

A. Distinguish the Principles from the existing legal and regulatory framework

One of the common objections to the IGG consultation paper was that the 'requirements' described could be seen to overlap with existing regulatory requirements including Financial Services Authority (FSA) rules on Treating Customers Fairly (TCF), Conduct of Business (COBs) rules and other regulations on advice, financial promotions and member communications. These points were recognised by the Group and the redrafted 'Background and context'* to the final Principles offers much greater reference to the existing legal and regulatory framework. Furthermore, FSA rules on regulated advice have been taken into account in the approach to member communication in Principle 6.

** 'Background and context' can be found in the new Principles guidance.*

A further purpose of re-drafting the preface of the document was to clarify the fact that the IGG is not a regulator by the back door. The IGG has no powers to regulate or enforce, nor does it want them. This point is expanded further under point B.

There was a misconception in many consultation responses that the Principles prescribed legal liability for investment governance to the decision makers. This is not the case, and it is hoped the increased emphasis on existing regulatory requirements and the fact that the principles are voluntary 'best practice' will avoid this misconception in future.

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B. 'Comply or explain'?

It was observed by many respondents that a 'comply or explain' regime was inappropriate and unenforceable. The IGG's remit was not to regulate, but rather to encourage engagement with, and improve standards of, investment governance. This remit was seen to be at odds with a 'comply or explain' regime.

'An alternative wording to the options proposed needs to be agreed. While 'comply or explain' or 'justify or comply' do not impose legal responsibilities on an employer the wording implies that not meeting the guidance is wrong'*

**Quote from undisclosed respondent to the consultation*

After further discussion with key industry stakeholders, all reference to the previous 'comply or explain' regime has been removed. This means that the IGG is now reliant on the industry, including providers and advisers, to promote the importance of sound investment governance to clients and the industry at large. The IGG would support any activities facilitated by the pensions industry which will push investment governance up the agenda for employers, trustees, members and schemes of all types.

C. Encouraging 'best practice'

There was support for the focus on 'best practice', but the expectations on employers' responsibility for contract-based schemes and the degree of detail on member communications were considered unrealistic, especially for smaller schemes.

Following the precedent set by the Myners' Principles (2008), the DC Principles have been written as a list of 'best practice' considerations for planning, implementing and monitoring investment governance. Implicit in this is an understanding that 'best practice' is not achievable in every situation. The IGG expects schemes to consider all of the Principles and make a decision on whether or not they must, should and/or can act on them.

Many of the points raised on the best practice approach related to the lesser ability of smaller schemes to implement complex and perhaps costly investment governance frameworks. This is covered further in section F of this document.

D. Accountability for investment governance in contract-based DC schemes (including delegations of responsibility) (ref: consultation question 1a and 1b and Principle 1)

One of the key objections to the consultation was to the Table of accountabilities*, which asserted that the employer choosing to set up a contract-based DC scheme is accountable for many of the functions of investment governance (although this accountability could be delegated to other parties). This assertion was positioned as 'best practice' and therefore not achievable in all circumstances, however, many respondents (or their representative associations) insisted that this duty on employers was not practical and could lead to many employers transferring members into the Government-sponsored National Employment Savings Trust (NEST).

This was not seen as a desirable outcome by respondents if the market is to remain competitive.

** The 'Table of accountabilities' can be found on page 12 of the original IGG consultation paper*

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Whilst the IGG still maintains that 'best practice' in this area is for an employer to be engaged in the investment governance of a scheme and also to be responsible for delegation of the various investment governance functions, it has made the following changes to the principles and guidance:

1. The Table of accountabilities has been removed.
2. It has been replaced by a template for an investment governance plan. This 'checklist' helps employers (and trustees), in conjunction with providers and advisers, to document the responsibilities for various functions of investment governance and for these to made transparent to all parties, including members.
3. Specific reference to this document is made in the principles, asserting that an investment governance plan must be completed at the inception of a scheme and remain up to date and accessible to all named parties through the life of the scheme.

The IGG believes that the employer should be ultimately responsible for the completion of this document, however, it is acknowledged that providers and advisers are likely to have a vital role in the process of apportioning responsibilities at scheme set up. It was also observed that the member is also a decision maker in this process. Member representation has been included on the investment governance plan template to reflect this.

It was also suggested by respondents that two 'Tables of accountabilities' might be made available – one for trust-based schemes and one for contract-based schemes. IGG has resisted providing separate documents on the basis that the investment governance activities in each scheme type are very similar, even though the responsibilities and delegations are likely to differ.

E. Selling the benefits of investment governance to non-pensions professionals

It was observed by a number of respondents that the consultation paper, and the Principles themselves were written 'by pensions professionals, for pensions professionals'. If the purpose of the Principles were to encourage engagement with investment governance, the tangible benefits to employers and members would need to be identified and stated clearly. Therefore, the IGG has worked with the Confederation of British Industry (CBI) to develop a guide for employers on the rudiments and benefits of investment governance. This guide is published along with the *Principles for investment governance of work-based defined contribution (DC) pension schemes* and can be found here: www.thepensionsregulator.gov.uk/docs/igg-cbi.pdf

This document is designed to explain how establishing even a high-level investment governance framework will not only protect the employer and members, but also improve the reputation of the business as a good employer willing to provide well governed and structured benefits to its employees.

F. Ensuring the Principles are relevant to all sizes and types of scheme

One of the issues underlying a number of objections to the Principles has been that of scalability – ie ensuring the Principles are usable across all sizes and types of DC scheme. As in the Myners' Principles of 2008, IGG has adopted a high-level approach, which therefore cannot provide a level of detail which many schemes might value. The scalability of the Principles is achieved by setting out high-level areas to which consideration should be given, and then supplementing this with reference to tools and guidance which underpins the Principles and provides further information on how these measures be implemented.

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More specifically, a number of respondents to the consultation paper questioned the use of non-specific language throughout the document (eg 'appropriate' or 'adequate') as being of limited value to non-pensions professionals. IGG has retained this approach for the following reasons:

1. It is consistent with the high-level, 'best practice' approach of the original Myners Principles
2. It is not possible to provide specifics which would be applicable to all pension types, sizes and circumstances
3. We provide, as part of the document, signposts to tools and further guidance which will take a more specific 'how to' approach.

The IGG believes that by continuing with this approach, the IGG Principles are highlighting key areas in which schemes, trustees, employees and other stakeholders need to direct further effort, as well as directing them to further information on how to set up appropriate controls in each area.

NB: The IGG also has a small schemes subgroup which has been looking at the specific needs of small pension schemes. The subgroup are currently developing a guide to the fundamentals of investment governance which will include templates and tools to support rudimentary investment governance activities. These will be available in early 2011 from the IGG website.

G. Design and governance of the default strategy (ref: Consultation question 4a and Principle 4)

Respondents supported the emphasis on the default strategy as the most critical investment option. Its design is one of the key elements to the provision of any DC pension arrangement, as is the need to monitor it thereafter. This is a view shared by The Pensions Regulator and the DWP in their respective workstreams around DC pension provision.

Subsequent to the formal consultation, the IGG liaised further with the DWP on their guidance for the design and monitoring of default funds. This is likely to comprise minimum requirements for product design, suitability and governance (as opposed to 'best practice') and to contain more detail than it is possible to include in the IGG DC principles. While the detail in Principle 4 of the IGG document has been extended, a specific reference to the developing work of the DWP has also been added.

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4. More specific points

In addition to the fundamental issues covered already in this document, there were also a number of interesting questions raised by individuals, or small groups of respondents which we have also taken into consideration in our final revisions of the Principles. These issues are described below, along with comment on any changes made.

A. Responsible ownership
(ref: Principle 1)

It was suggested in a number of responses that the Financial Reporting Council's UK Stewardship Code (formerly the Institutional Shareholder Committee Stewardship Code) on responsible ownership may not be a relevant reference point for all DC schemes, particularly smaller schemes and contract-based arrangements (this document was referenced under Principle 1 of the IGG Principles*). This has been acknowledged and specific reference to the UK Stewardship Code has been removed. However, the IGG still asserts that schemes should assess whether or not a specific policy on responsible ownership/investment is appropriate. Under 'best practice', particularly in a trust-based DC arrangement, this should be included in the Statement of Investment Principles. The IGG supports the development and application of the UK Stewardship Code in promoting responsible ownership.

* Page 11 of the original Principles document at: www.thepensionsregulator.gov.uk/docs/igg-con-doc-2010.pdf

B. Gauging the risk appetite of members
(ref: Consultation question 3b and Principle 3)

A small number of respondents questioned the assertion that the risk appetite of members should be a key consideration in the design of investment options, since this is difficult to define. While it is acknowledged that this is not an easy function to perform, it is still a critical part of designing appropriate investment options and default strategy for the scheme's membership and sufficient time and effort should be allocated to this task. It was also observed that determining how benefits will be drawn by members many years in advance is a problematic exercise. However, once again this is still a key consideration in scheme set up and should not be disregarded.

C. The removal of underperforming funds in a contract-based arrangement
(ref: Principle 5)

It was highlighted that in a contract-based scheme there is a lesser possibility of changing under-performing funds, particularly when an employer has purchased a bundled product. There is also an issue on whether or not the employer is authorised to make investment choices of this type. While the IGG is aware that a number of employers in conjunction with their advisers and providers do actively manage the fund choices available to members, it accepts that many do not feel comfortable in doing so from a legal perspective. It is expected that in such cases the adviser and/or provider would be deemed the appropriate decision maker for this element of the governance plan.

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D. Greater emphasis on the run-up to retirement (ref: Principle 4)

A good number of responses indicated that the Principles should provide greater detail on activities which should be carried out in the run up to retirement. We have resisted providing further guidance on the amount of reference we make to this part of the investment governance chain for the following reasons:

1. The variable scale and circumstances of employers and schemes made it very difficult to go into a level of detail which was relevant to schemes of all sizes
2. There is already a good level of valuable information and guidance available in this area
3. Whilst this is considered to be very important to member outcomes, it is not strictly an investment governance issue

Due to these considerations, the IGG has decided to reference other sources of valuable information on the run-up to retirement, rather than attempting to reproduce this material in another format. These materials are referenced in our table of existing guidance on in Annex B of the final Principles document.

E. Management committees and the NAPF Pensions Quality Mark (ref: Principle 1)

It was suggested by some respondents that establishing a Management committee for reviewing and monitoring investments and governance is not a workable solution for many smaller schemes with limited resources. This is seen as a valid point and the reference to Management committees has been removed. However, the IGG supports the existing NAPF Pensions Quality Mark as a gold standard of scheme governance – this includes the creation of a Management committee.

F. Responsibility for members leaving a scheme

The question was raised as to who assumes responsibility for members who defer from a contract-based DC scheme and whether a previous employer retains any responsibility for ex-employees. Under the current framework, responsibility for monitoring of investments of deferred members is assumed by their product provider. In a trust-based arrangement, responsibility is retained by the scheme trustees.

In either scenario, any expectations of members should be clearly communicated to them by a representative of the scheme (provider or trustee). Responses suggest that the FSA and The Pensions Regulator should consider whether the current legislative framework in this area is appropriate.

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5 Recommendations for Government regulators and other departments from respondents

As part of the consultation process, a number of policy suggestions were made for Government departments to improve engagement with, and the quality of investment governance in, DC pension provision. The IGG is not in position to respond to these suggestions directly, but will pass them on to The Pensions Regulator, the FSA, the DWP and other relevant Government departments.

The following suggestions do not represent the views of the Investment Governance Group, but rather were stated by respondents to our consultation:

A. Extend The Pensions Regulator's Trustee toolkit to specifically cater for the needs of contract based pensions provisions

B. Create version of the Trustee toolkit' for employers

C. Introducing a set of 'core competence' standards for employer knowledge and understanding (equivalent to The Pensions Regulator's 'Trustee Knowledge and Understanding' regime)

D. Introduce a mandatory level of engagement for employers in contract-based DC pension schemes

E. Provide greater clarity on the existing regulatory framework surrounding DC pensions provision, including the regulatory requirements of the FSA, DWP and The Pensions Regulator

F. Encourage both members and employers engagement with saving for retirement

G. Provide guidance for employers and trustees of DC schemes on investment options and retirement planning

H. Provide guidance for employers and trustees of DC schemes on calculating the 'expected risk tolerances' of members

I. Provide employers with clarity on how they are able to communicate with their scheme members without breaching FSA rules on regulated advice.

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6 Summary of key changes to the Principles

As set out above, the major changes to the final IGG *Principles for investment governance of work-based defined contribution (DC) pension schemes* have been to emphasise that the aim is to influence the market rather than to regulate it, and to remove of the 'Table of accountabilities' and its inherent duties on employers and replace it with a template to be completed by trustees, employers and other involved in the operation of the scheme. There have been few material changes to the content of the Principles themselves. However, where changes have been made, these are listed here.

NB: All page numbers reference pages in the original consultation document which can be found here: www.thepensionsregulator.gov.uk/pdf/igg-con-doc-2010.pdf

Page 4: Executive summary

This has been replaced with a revised 'Background and context' page which acts as an introduction to the Principles themselves. The key changes include:

A. Reiteration that the IGG is not a regulatory body, but has the remit of encouraging engagement with investment governance.

B. Acknowledgement of the existing and developing regulatory framework.

C. Reference to the beliefs of the IGG, including the importance of the default and greater employer engagement in DC pensions.

D. Stressing of the importance of a governance plan in the allocation of responsibility for investment governance functions and the belief that this document should be accessible to all stakeholders, including members.

E. Additional information on the structure and the context of the Principles.

Page 11: Principle 1

A. Included reference to governance plan to demonstrate and document responsibilities and delegations thereof.

B. Included reference to a Statement of investment principles not being a mandatory requirement across all DC pensions.

C. Removed specific reference to the Institutional Shareholders Committee Stewardship Code from bullet point 5 on responsible ownership.

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Page 12: Table of accountabilities

A. The Table of accountabilities has been removed and replaced by a template for an investment governance plan with clearly allocated responsibilities.

Page 14: Principle 2

L. Included an additional bullet point (relocated from Principle 3) concerning guidelines on the selection of investment managers.

Page 15: Principle 3

A. Promoted bullet point on default funds to first position to highlight the importance of this investment option within the wider portfolio.

B. Removed reference to 'investment time horizons' from original bullet point no.2.

C. Amended reference to 'fees' in original bullet point no.6 to 'fees/costs'.

Page 16: Principle 4

A. Added further emphasis that the default strategy is the most important of the investment options and appropriate time should be allocated to design and monitoring to reflect this (bullet points 2 and 3).

B. Added an additional bullet point describing the use of a clearly articulated objective on which to measure the default strategy.

C. Inserted bullet point asserting that investment fees/costs are reasonable and competitive given the performance expectations of the strategy.

D. Inserted specific reference to the developing work of the DWP on default funds which will expand on the information found within the IGG Principles.

Page 17: Principle 5

A. Replaced all references to 'benchmarks' with the word 'objectives'.

B. Included specific reference to default fund in bullet point no.1 to provide further emphasis of its importance.

C. Amended bullet point 3 to refer to funds which are not likely to perform well, rather than funds which have not performed well in the past.

D. Added a final bullet point on reporting of performance, risks and any alterations to members.

Page 18: Principle 6

A. Added final bullet point asserting that the scheme's governance plan must be made available to members.

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Annex A: List of respondents

Below is a list of the organisations and individuals who submitted responses to our consultation.

Respondents

1. National Association of Pension Funds
2. Institute of Chartered Accountants of Scotland
3. LEBC Group
4. BNY Mellon
5. Towers Watson
6. Investment Management Association
7. Confederation of British Industry
8. Society of Pensions Consultants
9. Pensions DCisions
10. Fidelity Investments
11. Hewlett
12. FairPensions
13. Sackers
14. Prudential
15. Institute of Chartered Accountants of England and Wales
16. Pensions Management Institute
17. Barnett Waddingham
18. Association of Pensions Lawyers
19. Heath Lambert
20. Hymans Robertson
21. Mercury Asset Management
22. Legal & General
23. Independent Trustee Services
24. Barclays
25. Mercer
26. Scottish Life
27. Standard Life
28. Tax Incentivised Savings Association
29. The Pensions Trust
30. Zurich
31. Aviva
32. Institute of Directors
33. Reckitt Benkiser
34. George Kirrin (Independent)
35. Aegon
36. Capita Hartshead
37. Russell Investments
38. JLT Group
39. Horwarth Clark Whitehill
40. Association of British Insurers
41. Matt Fuller
42. Best Trustees