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Securing the future of pensions

Call for evidence: Quality standards in workplace defined contribution pension schemes

The NAPF's response

September 2013

Overview

The NAPF has been leading the way in raising standards in DC pensions. The NAPF's Pension Quality Mark recognises best practice and schemes have been changing their rules to meet its standards. The NAPF has also developed codes of conduct for the industry, such as the Code of Conduct on Charges. So the NAPF welcomes the Government's work on minimum standards in DC. With millions of workers now being automatically enrolled into DC pension schemes, it is time to ensure that those schemes are capable of delivering good member outcomes.

However, the DC landscape is currently fragmented. There are almost 40,000 trust-based schemes and even more contract-based schemes. There is also a growing governance gap as some contract-based schemes have been established with no layer of governance at all.

The NAPF believes that we need fewer, larger DC schemes. Large, well-governed pension schemes are best placed to deliver good outcomes for DC savers. Large, trust-based schemes developed on a not for profit basis to serve multiple employers are known as Super Trusts. These Super Trusts can benefit from economies of scale and leverage those savings to benefit members. The Government's proposals represent an opportunity to establish higher barriers to entry to the DC pensions market to drive better member outcomes.

The Government's proposed approaches are broadly welcome and are a step towards addressing the fragmentation in the current DC pensions market. However, the NAPF does have a number of concerns:

- The standards must focus on the issues that have greatest impact on members.
- Placing trustee-style duties into contract-based schemes is problematic. Instead, governance in contract-based schemes should be placed at the employer level.
- There is much overlap between these approaches and those of other regulatory, government and industry bodies. These different sets of standards should complement each other.

For most employers, a Super Trust arrangement is the most appropriate solution for automatic enrolment. The government should consider the case for encouraging employers to choose a scheme with trustee-style governance and scale for automatic enrolment. However, contract-based schemes can deliver good outcomes where there is an engaged employer. Where an employer opts for a contract-based scheme, the employer should take the responsibility for providing governance.

High quality pension schemes need to be able to evolve with best practice, and this is perhaps the key function of governance. A governance body needs to be stable and with a clear responsibility to monitor and make changes to the scheme when appropriate. Whereas trust-based schemes have trustees with that responsibility, it can sometimes be unclear who is responsible for managing a contract-based scheme.

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About the NAPF

The NAPF is the leading voice of workplace pensions in the UK, speaking for 1,300 pension schemes with some 16 million members and assets of around £900 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

Introduction

1. Automatic enrolment is projected to bring millions of people into workplace pensions, many of whom will join a defined contribution (DC) scheme. This important reform has tackled one major failing in the UK pensions system, namely that too few people are saving for their retirement. But automatic enrolment cannot ensure that people are saving into a good pension, which will deliver an adequate income when they retire. This call for evidence is a welcome step towards ensuring that pension provision is both widespread in the workplace and adequate for savers.

2. The NAPF has experience of operating a quality standard through its Pension Quality Mark (PQM). PQM recognises schemes that meet its standards on contributions, governance and communications. More recently, PQM has begun to recognise high quality master trusts that have independent governance and strong communications through its PQM READY initiative. PQM has been driving up standards, and we have seen schemes changing their rules or employers increasing their contributions to get the PQM.

3. The Department for Work and Pensions (DWP) is not alone in considering quality in DC pensions. The Pensions Regulator (TPR) has developed a Code of Practice for trust-based DC schemes. There are also industry standards, such as the NAPF's PQM. There is also increasing interest from the European Commission on quality in pension schemes, focusing on personal pensions but with potential implications for some workplace pension schemes. The DWP must ensure that its initiative complements those of other government bodies, regulators and the industry.

4. Despite this work, the UK pensions system is still fragmented, with large numbers of small schemes, and there is a growing governance vacuum in DC schemes. Although there are signs of consolidation in the DC landscape, there are still 38,000 separate trust-based DC schemes.[1] There are as many as 100,000 contract-based schemes.[2] Furthermore, there is also a growing governance gap, largely due to growth in contract-based schemes which do not need to have any governance arrangements in place. There can also be concerns around trustee knowledge, understanding and independence in trust-based schemes, especially smaller ones.

5. The Government is rightly concerned that its proposals for a pot follows member system to automatically transfer small pension pots could cause consumer detriment. The NAPF shares these concerns and estimates

[1] The Pensions Regulator, *DC Trust 2013*, January 2013

[2] The Association of British Insurers, *Time to Act: tackling our savings problem and building our future*, June 2012

that in the worst cases members could lose up to 25% of their savings if they are repeatedly transferred from low charge, well governed schemes into schemes with high charges and poor governance. While these proposals may stop members from being transferred into bad schemes, they will not address the market risk caused by repeatedly transferring a member's whole pot.

6. It is important to recognise that the Government is not aiming to set quality standards, but instead minimum standards. Rather than promoting best practice, this initiative is designed to address cases of bad practice by setting a legislative minimum for pension schemes. This distinction is important and helps to differentiate between this and other government proposals and industry standards, such as the NAPF's PQM.

7. There is strong evidence to show that good outcomes are most likely to be delivered where there is effective governance over large schemes; so-called Super Trusts. Super Trusts are large scale, low-cost, multi-employer, trust-based DC pension arrangements. These well governed, large schemes are able to benefit from economies of scale and can access better performing asset classes. Good governance should be aligned with members' interests. The table below shows how charges are lower as schemes get bigger.

Annual management charges in DC pension schemes by size and type[3]

	Scheme size (no. of members)			
	12-99	100-999	1,000+	All
Trust-based schemes	0.82%	0.66%	0.48%	0.71%
Contract-based schemes	1.06%	0.82%	0.48%	0.95%

8. The NAPF believes that members have a lot to gain from saving in a Super Trust. The NAPF estimates that when good governance and scale are combined, the cumulative benefits of better investment returns, lower investment expenses and lower scheme operating costs could result in a pot that is 28 per cent bigger after 40 years of saving. This larger pot could secure a substantially better retirement income.[4]

9. Indeed, TPR's research has shown that larger schemes are more likely to demonstrate its six principles and corresponding features of good DC. TPR found that 75 per cent of large schemes could demonstrate at least 15 of the 21 features tested, while 51 per cent of medium schemes could demonstrate the same number of features and just 18 per cent of small schemes.[5]

10. In some ways, the market is already moving towards large scale, well governed pension schemes. As part of the 2008 Pensions Act, the Government created the National Employment Savings Trust (NEST), a trust-based multi-employer scheme with a public service obligation to serve any employer for auto-enrolment. In addition, a number of new master trusts, such as NOW: Pensions and the People's Pension, have strong governance arrangements and the potential for scale. Furthermore, a number of providers of insurance-based pension products have now established master trusts.

[3] The Department for Work and Pensions, *Pensions landscape and charging: quantitative and qualitative research with employers and pension providers*, June 2012

[4] The total pension pot after 40 years of constant contributions, investment returns, costs and charges is £148,800 as a result of being in a larger scheme. This could buy an income of £8,780 compared to £6,840 for someone saving similar amounts in a smaller, less well governed, scheme. This is a single life annuity for a 65 year old, non-smoking man with no guarantees. Figures are from the FT Annuity Tables.

[5] The Pensions Regulator, *Defined contribution trust-based pension scheme features*, January 2013

11. However, to go the full way towards a small number of large, well governed schemes, there will need to be a different regulatory structure. This would involve a system for approving pension schemes and a process for monitoring the management of each Super Trust. The Pensions Regulator would also need the resources and powers to effectively regulate this new pensions landscape.

12. The DWP's proposals in this call for evidence go some way towards a DC pensions market dominated providers who meet specified standards. Many of the DWP's suggested approaches are sensible and focus on the right issues. It is good, for example, to see that the paper has an extensive section on governance, which includes consideration of how it can be aligned with members' interests. The paper also includes a section on scale, an important factor in securing good member outcomes. The NAPF does, however, have some concerns around whether fiduciary-style duties can be given to providers of contract-based schemes given that the regulatory and legal framework in which these schemes operate is very different to that of trust-based schemes.

13. More broadly, any minimum standards must focus on the factors that have most impact on member outcomes. The DWP's approaches cover governance, investments, administration and scale. While there are other areas of DWP work which cover other important factors, there is a strong case for these to be considered as part of the work on scheme standards. The DWP's *Reinvigorating Workplace Pensions* identified four key factors which influence outcomes in DC pensions; contribution levels, charges, investment strategies and returns and decumulation. The proposed minimum standards only fully cover one of these four key factors: investments. It is notable in particular that the paper does not include any approaches around decumulation to improve processes for members approaching retirement.

14. It is welcome that these proposals apply across both contract-based and trust-based pension schemes. It is right that the two types of scheme are held to equal standards. But the NAPF does have concerns about how a fiduciary-style duty can be applied to providers of contract-based schemes. Trustees have a fiduciary duty to uphold members' interests, but there are a different set of duties that apply to providers of contract-based schemes. These include duties to shareholders and the limitations of contract law, under which such schemes operate. Placing trustee-style duties on providers of contract-based schemes is challenging, and there is a potential for conflicts of interest.

What do the minimum standards cover?	
Covered	**Not covered**
Governance	Contributions
Investment	Communications
Administration	Decumulation
Scale	*Charges*[6]

15. Instead, the NAPF would like to see the Government do more to encourage employers to participate in Super Trust type arrangements for automatic enrolment. Such arrangements would have strong, independent governance and can benefit from economies of scale. Of course, contract-based arrangements can also achieve good member outcomes where there is an engaged employer. Such options should be available for employers, though with a requirement that there be trustee-style governance at employer level, with the employer accountable for the governance of the scheme. Such schemes may be inappropriate, however, for unengaged employers who come to automatic enrolment without prior experience of pensions.

[6] Though the DWP is developing proposals on charges through other workstreams, these include a ban on consultancy charges and a potential charge cap.

16. That is not to say that trust-based schemes are always well run. The NAPF acknowledges that some trust-based schemes can struggle to deliver good outcomes. It is important that there are high quality trustees and that schemes have the administrative capacity to deliver for members. The DWP should consider whether there should be greater barriers to setting up a new trust-based pension scheme. There are currently very low barriers to new schemes entering this market, especially for master trusts. Minimum standards could play a key role in regulating the establishment of new DC schemes without placing onerous burdens on existing schemes. This would also help to address some of the concerns around pensions liberation.

17. Ultimately, a high quality pension scheme needs to be able to evolve. The best practice of the future will not be the same as the best practice of today. Members left in legacy schemes which have been unable to change with the times are likely to be worse off as a result. These minimum standards should set up clear lines of responsibility and accountability so that all pension schemes are monitored and updated by a governance body when appropriate.

18. The DWP's work on minimum standards in DC pensions is welcome, and the NAPF is pleased to contribute to the Government's work. The NAPF has been impressed by the willingness of DWP officials to share and discuss their thinking as it has developed. Such openness is reflected in the quality of the DWP's paper. While there are a number of concerns around how these standards would work in practice, the NAPF looks forward to further engaging with the DWP on how those challenges can be overcome.

Governance

19. The DWP is right to identify the two main issues in governance as alignment of interest and the competency of a governing body. The suggested approaches would require a governing body for all pension schemes, at provider level in contract-based schemes, which should be well aligned with members' interests and sufficiently capable to deliver for members.

20. Employers approaching automatic enrolment have a choice. They can choose to use their own trust-based scheme. In practice few employers will establish their own trust, but we have seen many larger employers using an existing trust for automatic enrolment. Alternatively, employers may opt to use a multi-employer trust. These schemes have the fiduciary duty of a trust-based arrangement, but it is at arm's length from the employer. Employers may also use a contract-based scheme, such as a group personal pension (GPP). These different types of governance come with different risks.

21. Trust-based schemes already have governance arrangements that are well aligned with members' interests. Trustees have a fiduciary duty to uphold members' interests. For single employer trust-based schemes there can be risks around employer and trustee engagement, especially for smaller schemes. Schemes serving a smaller employer may also have fewer resources. For master trusts, the risks tend to focus on trustee independence. Master trusts may have been established by an insurer or administration company, so there is potential for conflicts of interest. Trustees should be sufficiently independent of service providers so that they can effectively negotiate on behalf of members. This is why PQM READY's standards require trustees to have the power to make, break or vary any arrangement with fund managers and administrators.

22. Contract-based schemes are set up under a very different legal framework with a very different regulatory approach. These schemes are established as a series of individual, though similar, contracts between individuals and a provider. Here there are risks of an asymmetry of knowledge between the consumer and the provider. While providers are subject to a rigorous point-of-sale regulatory framework under Treating Customers Fairly (TCF), this can do little to ensure the ongoing suitability and quality of the product. Instead, TCF emphasises disclosure of accurate information to potential customers. This regulatory approach may be suitable for other financial products, but it is not suitable for pensions. Pension schemes are established by the employer and individuals are now automatically enrolled into them, sometimes unaware that they have even joined the scheme. Furthermore individuals cannot easily change provider since to do so often means losing their employer's contribution.

23. The regulatory framework for contract-based schemes in unsuitable at provider-level and virtually non-existent at employer level, besides the Pensions Regulator's enforcement of employers' automatic enrolment duties. There is a risk that there will be no governance in the scheme at all. This could mean that members' savings are left in inappropriate investment strategies or that members do not have access to valuable services. To gain good outcomes, these schemes need to have an engaged employer. Engaged employers will manage the scheme, making sure that it remains suitable for members.

24. Governance committees at employer-level are increasingly common. The NAPF's Annual Survey 2012 found that almost half of responding contract-based schemes (46.9%) had a management committee. Of those who did not have one, 35.6% were planning to establish a management committee. Furthermore, the NAPF's Pension Quality Mark requires employers to establish governance over a contract-based scheme. Governance committees can effectively operate as trust boards by gaining members' implied consent to amend the schemes' default fund. Since there is no requirement to have a governance committee in a contract-based schemes, and no formal requirements around their composition, duties or powers, members in these schemes are at risk of a change in their employer's attitude.

25. One of the biggest risks for all pension scheme members is that their scheme does not evolve with best practice. Good practice evolves over time and scheme members could be saving in a scheme for their entire working lives. If the scheme does not evolve, it is likely that members will be worse off. Trust-based schemes have the power and responsibilities to make changes where necessary, and it is important that trustees do monitor their scheme and make changes when appropriate. The risks here in contract-based schemes are more profound. Often individuals join the scheme, and if changes cannot be made without member consent, the scheme will be unable to evolve (at least for current members). Engaged employers can manage this problem by gaining implied consent from members, but the risks of changing employer attitude remain, and could be amplified if a disinterested employer can make changes freely.

26. Employers should be encouraged to use a large, well governed scheme, a Super Trust, for automatic enrolment. This is suitable for unengaged employers, since using a multi-employer trust-based scheme allows them to delegate some degree of responsibility to the scheme. This also creates flexibility for governance to sit in different places, such as governance over a selection of funds from different providers. Indeed, the DC market has already begun to develop along these lines. Many providers, including insurance-based providers, are now establishing trust-based schemes.

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27. Employers who have actively decide to use a contract-based scheme, rather than a trust-based model, should take responsibility for governance. To protect against future changes in employer attitudes, there is a need for the Government to set out precisely what responsibilities should be placed on these employers. The role, powers and duties of governance committees should be formalised. This will help to ensure that governance in contract-based scheme is enduring so that the scheme can evolve with best practice. Employers would have voluntarily assumed these responsibilities by establishing a contract-based scheme so they would not be disproportionately burdensome.

28. In its paper, the DWP proposes that trustee-style duties be applied to the provider in a contract-based scheme. These schemes are established under contract law, and therefore operate within a very different legal framework to trust-based schemes. Simply taking trustees' duties and applying them to contract-based schemes is problematic and raises complexities around how this new duty would interact with providers' existing duties. Providers have duties to their shareholders and are bound by the limitations of their contracts with scheme members. Good governance over contract-based schemes can be provided by engaged employers, but it is difficult to put in place at provider level where the trust model provides a strong basis for oversight. The Government should consider whether governance at this level in contract-based schemes is appropriate.

29. There is a risk that placing responsibilities at provider-level could make matters worse. Often paternalistic employers will establish governance over a contract-based pension scheme because they know that no one else will look after it. Placing ineffective governance at provider level could give employers false assurance and discourage them from actively managing their pension scheme.

30. It is important that governing body members have the confidence to challenge advisers and service providers, so the DWP is right to focus on the knowledge and understanding of trustees and governance committee members. But a financial or even pensions qualification is no guarantee that a governance body member knows how a pension scheme should be managed. TPR's Code of Practice 7 on trustee knowledge and understanding (TKU) provides an existing basis for this, and the DWP should adopt existing standards rather than invent new ones where possible.

31. These standards should not discourage lay trustees from putting themselves forward. Lay trustees have an important role to play, and may be well attuned to the concerns of individuals who are joining a workplace pension scheme for the first time as a result of automatic enrolment. There is also an important role for specialist trustees who have expertise in specific areas, such as investments or pension law, but may not wish to gain a more general qualification in pensions. The DWP's requirements on trustee knowledge and understanding should focus on the expertise of trust board in the round rather than that of individual trustees. The approach suggested in the paper is reasonable, however, since its sets a relatively low threshold (25%) of members required to have a pensions qualification.

32. The strength of governing bodies often arises from the diversity and quality of its members. These standards should encourage high quality members from a range of backgrounds. It is important that some governance body members represent employees. It may be difficult for some larger multi-employer schemes to represent all of the members, so there may be alternative ways of representing scheme membership. For example, through a representative committee which reports to the main governance body.

Investment

33. As the DWP's paper identifies, most members who are automatically enrolled into a pension scheme will not make an active decision about where their savings are invested. Indeed, the NAPF's Annual Survey 2012 found that 83.2% of active members of responding schemes were investing in the default fund. It is therefore hugely important that the default investment strategy is designed to meet members' needs and that it is monitored against its objectives. Action should then be taken when its performance falls short of these objectives.

34. The approaches set out in the paper reflect these important factors and are broadly sensible. Current DWP guidance suggests that the default investment strategy should be reviewed at least every three years, and it is helpful that these latest approaches complement the existing guidance. The NAPF's Pension Quality Mark encourages schemes to regularly review default investment strategies and is currently reviewing its rules around default investments.

35. The approaches on investments are closely related to those on governance. It is important that members of governing bodies are sufficiently independent, and that they have the confidence and knowledge, to challenge fund managers where appropriate. Governing bodies should also be able to set their own investment objectives, though in some cases this will be delegated to an investment committee. Having strong and independent governance in place is the best way to ensure that the default investment strategy is designed with members' interests in mind and that it is effectively monitored.

Administration

36. Competent administration is an essential component of pension saving. The DWP's suggested approaches aims to ensure a high quality of administration and record keeping. These approaches are broadly sensible.

37. These suggested approaches are broadly positive, but there is overlap with several TPR initiatives. In particular, the NAPF has been engaging with TPR with regard to its Maintaining Contributions proposals for monitoring contributions and reporting payment failures. Any new standards should be well integrated with existing scheme requirements.

38. On common data, the DWP is right to resist placing TPR's deadlines into legislation. While these deadlines are an important ambition, some schemes have found that the investment required to bring data standards up to these levels and maintain them would exceed the benefits gained. The important point is that trustees and scheme managers have a plan to improve or manage data and are working towards these objectives. The proposed approach recognises the need for schemes to have a process in place that is appropriate for them and their membership.

Scale

39. There is much evidence that greater scale can help to ensure good outcomes for members. This scale should be leveraged in members' interests by an effective and independent governance body. Such schemes, Super Trusts, can provide low charges by benefiting from economies of scale and larger schemes can access better performing asset classes.

40. The substantial body of evidence suggesting that larger schemes are better placed to deliver good outcomes is explored more fully below (Q14). But, in short, larger schemes tend to have lower administration costs, get better investment performance, have lower charges for members and have better services available for members approaching retirement. The NAPF's research suggests that where scale is combined with good governance outcomes for members could be improved by up to 28 per cent.

41. However, the DC pensions market is fragmented. There are almost 40,000 trust-based DC schemes with a further 100,000 or more contract-based schemes. The DWP's research suggests that the average number of members of trust-based DC schemes is just 49 and only one per cent of schemes have more than 1,000 members. Of group personal pensions (GPPs), only three per cent have more than 100 members.[7] UK DC pension schemes are not just small in absolute terms they are also small by international comparison. Excluding schemes with fewer than 100 members, UK DC schemes average around 2,600 members, whereas in Australia the average scheme size is 26,000 members and in the Netherlands 10,500 members.[8]

42. There are also international examples where regulatory or government intervention has been leveraged to promote scale. In Australia, the 2010 Cooper Review into the governance, efficiency and structure of Australia's superannuation system argued that further consolidation of Australia's superannuation funds was required. Federal legislation to enact the Review's main findings was subsequently brought forward. In Ontario, a 2008 review concluded that legislation should be produced to facilitate the development of large-scale pension schemes. It also recommended that large schemes should look to expand by accepting members from beyond their traditional membership base.

43. There is a case, therefore, for regulatory intervention to promote scale in DC pension schemes. In the UK, this should take the form of barriers to entry, so that there is a limit on the number of pension schemes. The NAPF sees minimum standards as an important part of placing greater barriers to entry in the DC pensions market.

44. Of course, this does not mean that small schemes cannot deliver good member outcomes. Small schemes can have strong and independent governance arrangements and an engaged employer who may be able to ensure that members get good value for money. There can be barriers to small schemes providing good value for money. Small schemes may struggle to negotiate low charges for members. The DWP has proposed a sensible approach that would require a scheme's governing body to decide whether members would be better served by moving to a scale arrangement.

45. One further point is that the paper's definition of 'disadvantaged' appears to focus on the accumulation stage exclusively. However, there is evidence to suggest that large schemes are better able to provide members with

[7] Department for Work and Pensions, *Employer Pension Provision Survey,* 2011
[8] NAPF, *UK Pensions Regulation Compared, October 2008*

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good retirement outcomes. Recent NAPF research into the at retirement market has found that advisers and brokers can sometimes struggle to provide a serve to smaller schemes unless some of the set up costs are covered by the scheme or employer.[9] The result is that just 46 per cent of small DC schemes appoint a broker compared to 81 per cent of larger DC schemes. Large schemes also report a greater take up of the open market option when members purchase an annuity, use of which can improve at retirement outcomes by up to 20 per cent. The scheme's governing body should consider whether the scheme's size is having an adverse effect on members' outcomes at retirement.

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[9] NAPF, *Supporting DC savers at retirement: an analysis of the advice and brokerage market*, June 2013

Questions

Governance

1. What are the essential features of good governance?

Governance in the DC market is currently a mixed picture. On the one hand are traditional occupational schemes which operate as a trust. These schemes have a layer of governance which is removed from the employer and subject to responsibilities under trust law. Recently, a number of multi-employer trusts have emerged which can serve non-associated employers. By contrast, many pensions schemes are established under contract. The scheme is established as a series of individual contracts between a pension provider and the individual. While there is a growing trend for such schemes to have a governance committee, such schemes do not need to have a layer of governance.

Governing bodies of pension schemes should be well aligned with members' interests, and also have the capability to act accordingly.

In trust-based schemes, there is a trustee with a legal responsibility to uphold members' interests. There is, therefore, a good alignment of interests. The challenge in trust-based schemes is to ensure that the trustees are effective. This means that trustees should have the confidence to stand up for members. Trustees should also be sufficiently independent, so that they have the powers to get the best deal for members.

In contract-based schemes, there can be a governance vacuum where there is nobody standing up for members. It is essential that there is a governing body with a duty to uphold members' interests, and this is most appropriately placed at employer level. Ultimately, however, this will only be effective where there is an engaged employer. Less engaged employers should join a Super Trust arrangement.

2. How does the presence of these features affect the decisions taken about running a pension scheme?

Where good governance is in place, an independent governing body will be able to argue on behalf of members and negotiate with service providers.

The academic Keith Ambachtscheer has argued that good governance can deliver an extra 1-2% in investment returns each year.[10] This is as a result of fiduciaries flexing their bargaining power, acting as informed investors (thereby not falling victim to the information asymmetries individual investors may face) and acting independently, avoiding producer or provider 'capture'. Ambachtscheer concludes that operating at scale and in a not-for-profit environment is most likely to guarantee the governance bonus fully is maximised.

[10] Keith Ambachtscheer, *Pensions Revolution*, 2007

3. How many schemes currently exhibit these features?

It is difficult to place an exact figure on the number of schemes with good governance. The NAPF believes, however, that if the UK pension schemes are to reach scale there must be some restriction on the number of schemes. Ultimately, there should be a small number of large DC schemes. Greater barriers to entry can help to place limits on the number of pension schemes.

4. What are the barriers to exhibiting these features?

This varies between different types of DC scheme.

Single employer trust-based schemes can reach scale and many exhibit very good governance. But smaller schemes can sometimes struggle to find engaged, high quality trustees. The quality of governance can also depend on the level of engagement from the employer, and good governance is more difficult when the employer is disinterested. Generally, though, large single employer trust-based schemes are well placed to deliver good member outcomes.

Many new multi-employer trust-based DC schemes, master trusts, have entered the market in recent years. Many of these have very good governance and the potential to reach scale. In short, there is great potential for these schemes to offer high quality outcomes along the Super Trust model. Many have professional trustees with high standards of knowledge and understanding. However, the new and rapidly changing market also brings risks. In some cases, governance is insufficiently independent from either the scheme's founder or a service provider. This could limit the ability of trustees to negotiate with service providers to get the best possible outcome for members. In other cases, new master trusts may have untested administrative systems. These master trusts must be able to cope with the demand from the market as a result of automatic enrolment.

The solution to these problems is to increase barriers to entry. There should be greater restrictions on setting up new master trusts. TPR is also working in this area and its independent assurance framework for master trusts, although excessively onerous and expensive, will at least assess master trusts in a number of these areas. There is also a case for better prudential regulation of master trusts to assess whether their business plans and administrative systems are adequate.

In contract-based schemes, the risk is simply that no governance exists at all. Though many contract-based schemes have high quality governance, this tends to be where there is an engaged employer. Where there is no governance, members' savings and future contributions can be left in inappropriate investment strategies. If a member starts saving in such a scheme early in their career, their savings could be left in old investment funds for decades.

The NAPF believes that employers with little intention of engaging with their pension scheme beyond their legal obligations should be signposted towards master trusts. These trust-based multi-employer schemes offer high quality governance at arm's length from the employer.

5. Given what we say about what good governance should achieve, what would the impact of the suggested approaches be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

Many of the approaches are welcome and will bring significant benefits to members.

However, it is not clear whether it is appropriate to place a fiduciary duty (or near fiduciary duty) at provider level in contract-based schemes. Providers have an existing set of legal duties to shareholders and are bound by the restrictions of contract law. The very different legal framework for contract-based schemes makes such a plan complicated and could undermine good employer-level governance which currently exists. Instead, where employers opt for a contract-based scheme, they should assume responsibility for providing governance.

Investment – default options

6. The default option guidance covers the key steps in governing; designing; reviewing and communicating the default option. Does this cover the most important steps or are there others missing?

The guidance can be slightly vague around who in a contract-based scheme is responsible for meeting its requirements. This ties into a bigger problem around who (if anyone) in a contract-based scheme is responsible for upholding members' interests.

The guidance walks a fine line between setting minimum standards in default design and mandating how members' contributions should be invested. Clearly, highly prescriptive requirements on default design, for example covering asset allocation, are not welcome. Well governed pension schemes are better placed to make these decisions themselves. To effectively design and monitor default investments, schemes should have strong, independent governance and access to investment expertise.

7. How far is this guidance followed and is it followed by all schemes (e.g. older schemes)?

The guidance is generally well followed, especially for schemes approaching automatic enrolment. There may be some issues, however, for smaller schemes.

8. What are the barriers to following the guidance?

There are different barriers for different types of schemes. Among smaller schemes, awareness may be an issue. TPR's research around awareness of its quality features suggests that scale is a major factor.[11] Smaller schemes are simply less likely to be aware of new rules and regulations.

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[11] The Pensions Regulator, *Defined contribution trust-based pension scheme features*, January 2013

Another problem is that the guidance can get lost in the sheer volume of rules, regulations and guidance around automatic enrolment. The prominence of similar rules in TPR's Code of Practice for trust-based DC schemes will help to remedy that situation, though will not increase take up amongst contract-based schemes.

The NAPF has been publicising the guidance among its members. The NAPF is also researching how its members review their default investment options. Furthermore, the NAPF's PQM is currently reviewing its rules around default investment options. A discussion paper published in August 2013 sets out some possible approaches that PQM could take to promote high quality default investment strategies.

9. Given what we say about how default options should be designed and reviewed, what would the impact of the suggested approaches be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

The approaches set out in this paper are broadly sensible.

Administration and record keeping

10. Which stages of administration and record keeping are so critical to get right, in terms of a member's final pension pot, that they should be set in legislation?

The payment of contributions into the pension scheme is perhaps the most critical administrative function. This is already set out in legislation and TPR's recent *Maintaining Contributions* proposals have created a considerably onerous set of processes around contribution payments and monitoring.

The proposal that contributions be invested within five days is highly prescriptive. The process for investing contributions will vary from scheme to scheme and sometimes even between different funds within a scheme. The key point is that schemes have an agreement with their service providers on how and when contributions are invested. Good governance bodies should then monitor this as part of their general monitoring of administrative processes.

The DWP is right to resist placing TPR's strict deadlines on common data into legislation. Schemes should be able to operate proportionate data processes suited to the scheme and its membership. Placing strict deadlines into legislation could force schemes to disproportionately invest in record keeping processes to comply with the law but without benefiting members.

11. How far are these stages completed accurately and by how many schemes?

At the moment, pensions are still largely voluntary. The larger employers who have begun automatic enrolment tend to have a history of offering pensions. Therefore employers have tended to be both willing and capable of good administration.

As automatic enrolment moves to smaller employers, some will have little experience of pensions and may be reluctant to comply with the law. It is at this stage that poor administration could become a bigger concern.

12. What are the reasons for mistakes occurring and how could these be avoided?

In NAPF member experience's administration tends to work most smoothly where processes are automated. As automatic enrolment is introduced, and the market develops more automated software, it is expected that these automated processes could become more widespread. Currently, larger employers with greater resources have been better placed to invest in automated processes.

13. Given what we say about administration and record keeping, what would the impact of the suggested approaches be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

As discussed above, the DWP should avoid placing prescriptive deadlines into legislation. Schemes must have a process in place that is suitable for the scheme and its members.

The NAPF's PQM takes a different approach to administration. It asserts that where good governance is in place, a competent and independent governing body will be best placed to put sound administration in place. The PQM, therefore, sets strict rules around governance covering, for example, trustee independence and competence. During the PQM assessment, there is a check to ensure that the governing body is sufficiently reviewing administrative processes.

Scale

14. What are the advantages and disadvantages of small and large schemes?

There is much evidence that large pension schemes are well placed to deliver good member outcomes.

Larger schemes are able to pool resources to benefit from economies of scale. They are also more likely to have in-house expertise. The cost savings are clear: Capita Hartshead's Annual Scheme Administration Survey showed that for schemes with more than 50,000 members, costs stand at between £10 and £30 per member, whereas for schemes with fewer than 1,000 members, annual costs per head can often exceed £200 per member.[12]

Similar efficiencies are available to larger schemes when it comes to investment. Larger funds will typically pay lower investment fees than smaller funds. In Australia, QSuper (with AS$32bn – £20bn – AUM) has a fee of just 0.08% for its and 0.35% for its default fund (the QSuper balanced default fund). The giant Norwegian Government Pension Fund – the second largest in the world at £344bn – has an investment management

[12] Capita Hartshead, 17th Annual Pensions Administration Survey, 2010

charge of just 0.08%. The evidence in the UK, as discussed above, is that there is a strong negative correlation between scheme size and charges. The bigger the scheme, the lower the charges.

Larger funds are able to use their superior buying power to negotiate down fees and charges and are more likely to be afforded special terms or co-investment rights than smaller funds. But it is not just in lower fees that larger funds have the edge when it comes to fund investment considerations; larger schemes are also more likely to outperform smaller schemes. Data from the P&I/Towers Watson Global 300 report shows that the world's largest 20 funds have experienced the greatest growth over the past 5 years, with annual growth rates of 7.1% since 2005 when compared to others in the (already large) data set of the world's largest 300 funds.[13]

Research by Dyck and Pomorski suggests that larger schemes (those with around $35bn - £22bn of assets under management) outperform smaller plans by around 43-50 basis points a year.[14] In terms of the benefit to scheme beneficiaries, that represents a 13% larger return in larger schemes than smaller schemes.

As discussed above, NAPF research also suggests that larger schemes are more likely to have an annuity broker and that their members are more likely to use the open market option when purchasing an annuity.[15]

15. What options do smaller schemes have to access scale, how far are they already achieving this, and what are the barriers to this?

Smaller schemes can be well managed and can offer good member outcomes. It is most important that a scheme considers whether, due to its size, it is able to deliver the best member outcomes.

For schemes concerned about their size, there are now a number of master trusts which they could join. This could be done in a number of ways, either as a merger, a bulk transfer of members' pots or an arrangement only for future members or contributions.

There has been some consolidation in the market place in recent times. TPR's research suggests that between 2011 and 2013, the number of trust-based schemes fell from 46,000 to 38,000. The Dc market however remains fragmented. In order to develop a market with a small number of large schemes, there must be higher barriers to schemes entering the market.

Contract-based schemes may be unable to access due to the way in which the scheme is established. Where members are required to give consent for any changes, it may not be possible to move the scheme into a scale arrangement.

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[13] Towers Watson, *P&I/TW Top 300 Pension Funds,* September 2011
[14] Dyck and Pomorski, *Is bigger better? Size and performance in plan management,* Rotman International Centre for Pensions Management, July 2011
[15] NAPF, *Supporting DC savers at retirement: an analysis of the advice and brokerage market*, June 2013

16. Given what we say about scale, what would the impact of the suggested approach be (including costs and benefits to schemes)? Are there alternative approaches that would better achieve our aims?

These proposals are welcome step in the right direction. It is right that schemes consider whether members could be better served by moving to a scale arrangement. But this is only part of the answer.

There must also be greater barriers to entry, and the minimum standards as a whole represent an opportunity to set more stringent conditions on scheme providers. The NAPF is especially concerned around the lack of barriers to creating new master trusts. This is a rapidly developing market and there have been several new entrants in recent years. Master trusts may have to cope with scale as automatic enrolment is introduced, so it is important that their administrative systems are sound.

General approach to legislative minimum standards

17. Do the suggested approaches work together as a package to achieve our aims?

The package of proposals is welcome, but will not achieve all of the Government's aims. In particular, simply setting minimum standards for DC schemes will not prevent consumer detriment as a result of the Government's pot follows member proposals. There will still be variation within the market, so it will still be possible to be transferred from an excellent scheme into a mediocre one. Furthermore, transferring members' entire savings whenever they move jobs exposes them to substantial market risks.

There is also a risk that these proposals will fail to establish an equal regulatory landscape which covers both contract-based and trust-based schemes. Simply recreating trustees' duties in the provider of a contract-based scheme will be difficult while the two operate in such different legal frameworks. Providers of contract-based schemes already have a set of legal duties to their shareholders and must operate through the restrictions of contract law.

Ultimately, the answer to these problems is scale combined with good governance. In a world where there are just a small number of large schemes, a system of automatic transfers would be easier to implement. It is regrettable that the Government has opted for an automatic transfers solution (pot follows member) which does nothing about the UK's fragmented pensions system.

18. Are there any other areas that standards should cover?

The standards cover a selective range of areas, and it would be helpful to bring in a broader range of work. The Government is currently working to address concerns around excessive charges. This work should be more explicitly brought into the work on quality. In order to ensure that members get good value for money, it is necessary to consider both what the member is paying and what they get for it.

It is also strange that decumulation has been left out of these proposals. The incremental gains of good governance, sound administration and suitable investment options can be undermined by a bad deal at retirement.

19. How could compliance with the standards best be evidenced and monitored?

TPR has long had a focus on quality in DC pensions, and indeed much of the DWP's work has mirrored requirements already set out in TPR codes. More broadly, the NAPF has long argued that TPR should have a bigger role in regulating all workplace pensions. It is not appropriate that contract-based workplace pensions are regulated as though they were a personal financial product, especially with the introduction of automatic enrolment.

The proposals in this paper, which apply across both contract-based and trust-based schemes, are an opportunity to give TPR responsibility for regulating contract-based schemes. TPR would need the appropriate powers to enforce these standards across the DC market.