GOOD HOUSEKEEPING

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Pension scheme governance has taken on increased importance, with very large numbers automatically enrolled and perhaps having no active involvement in their pension arrangements. It is essential that there is sufficient governance in place to protect their interests. Key elements of good governance are independent oversight and competence.

Pension schemes all fall under one of two structures.

- Personal pensions and most stakeholder pensions are known as 'contract-based' because there is a contractual arrangement between the pension provider and the scheme member.
- Occupation schemes, including multi-employer master trusts are known as 'trust-based' because there is a trustee board to make decisions and protect the interests of members.

Both forms of governance have their supporters. Those favouring trust-based pensions point to the legal duty of trustees to act in the interests of the members, and suggest that with contract-based pensions the provider will always seek to protect its commercial interests. Advocates of contract-based pensions point to the tight regulation of them by the FCA and the duty to treat all customers fairly, and also highlight that many pension scams have been perpetrated through master trusts, precisely because of the lower level of regulation.

As always, there is truth in both viewpoints, and an ideal system will take the best of both systems. That's broadly what the Government has aimed to do following the investigation by the Office of Fair Trading (OFT – now the Competition and Markets Authority) into workplace pensions. It identified possible conflicts of interest for contract-based schemes and competence issues for smaller trust-based schemes.

Contract-based schemes now have independent governance committees (IGCs) performing many of the duties of trustees, while the Pensions Regulator (tPR) has published detailed guidance for trustees, aimed at promoting best practice among all schemes.

GOVERNANCE PRIORITY 1: VALUE FOR MONEY

The importance of providing value for money has increased greatly in prominence in recent years. It was a key element of the OFT investigation, which was followed by a detailed review of charges by insurance companies. The Government also, against the recommendation of the OFT, implemented a 0.75% a year charge cap from April 2015 on default investment schemes being used by employers to fulfil their automatic enrolment obligations. A further review is due in 2017, and it's possible that transaction costs which are currently outside the charge cap will be brought into it.

> A scheme offers value for money where the costs and charges deducted from members' pots or contributions (the cost of membership) provide good value in relation to the benefits and services provided (the benefits of membership), when compared to other options available in the market.
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> *The Pensions Regulator – 'Regulatory guidance for defined contribution schemes'*

Of course, value for money is not only about low charges, as tPR's definition in the box makes clear. It must also take into account investment options and services offered. People who shop in Waitrose don't expect Lidl prices, and similarly many are prepared to pay more for their pension to get extra features and services. TPR suggests that the benefits of membership which help define value for money include:

- Investment performance
- Design of the default investment strategy
- Financial advice offered
- Support at retirement
- Scheme administration – type and quality of services offered
- Scheme governance

We examine several of these below. The key thing is that if charges are higher than those elsewhere in the market (where the benchmark these days is 0.5%) they must be justified by added value. Ensuring that is a key part of the role of trustees and IGCs.

GOVERNANCE PRIORITY 2: SERVICE AND COMMUNICATIONS

Standards of service and communications vary enormously among pension schemes and providers, and are a key area of focus for regulators.

TPR has been particularly concerned about record-keeping, especially among smaller schemes. Accurate records are essential to scheme administration, and when they're not readily available service suffers and costs increase, not least in dealing with complaints and rectifying mistakes. TPR identifies three types of record:

- Common data – fundamentally, this is the data needed to identify a member such as name, address, date of birth and National Insurance number.
- Conditional data – this is more scheme-specific and will depend on benefit structure, contribution basis etc. It might include, for example, dates of joining and leaving, salary information, contribution history and investment choices.
- Numerical information – this enables the trustees or administrator to monitor the scheme and identify any changes needed, as well as providing data to regulators and others.

These days most data is likely to be stored electronically, and the scheme must ensure that it is handled in line with the Data Protection Act. This is likely to include regular refresher training for staff.

Assuming that data is in good shape, it must then be used to meet the needs of members. A large part of that is providing the information they need, some of which is highly regulated by law or by the regulators (especially the FCA for contract-based pensions). However, there's a big difference between providing statutory information and truly communicating with members. Pension schemes and providers must consider carefully both what information they provide and how they communicate it. Increasingly, consumers will look for electronic communications, whether online or via mobile phones and tablets. This is both an opportunity and a challenge. Electronic communications allow for much greater interaction, for example by providing online planners which use member data to help model future outcomes. But simply taking information that was on paper and transferring it to a computer screen will not engage scheme members or help them understand their pensions.

Alongside information, schemes must be able to process transactions efficiently, whether they are changing contributions, processing pension sharing orders on divorce or providing benefits at retirement. Increasingly, automation is key to efficient administration.

Faced with all these requirements, scheme providers and trustees have many decisions to make. Aon Hewitt has helpfully divided possible actions into three categories:

Get busy – Some things just have to be done. This might be, for example, setting strategy, developing processes or deciding the recipients of death benefits.

Get simple – This largely centres around member communications and key life stages such as retirement. By keeping things as simple as possible, schemes and providers can make things easier for both the members and themselves. However, this may mean providing a streamlined rather than 'Rolls Royce' service.

Get help – Even for the largest providers, some things are better outsourced to experts, and this is even more the case for smaller schemes. A good example would be developing online facilities for members, where few schemes will have the ability to do this effectively in-house.

GOVERNANCE PRIORITY 3: INVESTMENT MONITORING

With no one required to make an investment choice under automatic enrolment, the choice of default investment becomes critical. If investments under-perform, it is possible that members could take legal action against a pension provider, a scheme or even an employer. Robust processes for developing and monitoring defaults are essential. A good example of this is NEST, where there was extensive consultation before an innovative investment strategy customised for its members was developed, and then refined following the introduction of pension freedoms.

This is a case where 'get help' is likely to be a good strategy for most providers and schemes, making extensive use of investment specialists and stochastic modelling to determine the optimum strategy. It will also be a key discussion point at meetings of trustees and IGCs.

GOVERNANCE PRIORITY 4: RETIREMENT PROCESSES

The pension freedoms implemented in April have highlighted the importance of effective processes at retirement, both in ensuring that scheme members understand the options available and in paying benefits quickly and efficiently. Schemes have also had decisions to make on which of the options they offer, and have specific responsibilities to act as a 'second line of defence' to ensure members understand the risks associated with their chosen options.

This is perhaps the most important single point for pension schemes, because decisions are being made which can't subsequently be changed and members expect to receive their money on time. The speed with which the new freedoms were introduced means that processes were developed and implemented in haste, and a priority for many schemes in the coming months should be to review and improve their treatment of the freedoms. The Government review of transfers and exit charges may also lead to new requirements.

GOVERNANCE PRIORITY 5: INDEPENDENT OVERSIGHT

Sitting on top of all the other priorities is oversight of the pension scheme, by trustees or an IGC. It's early days yet for the new requirements, and they will be closely monitored by regulators. They will be particularly concerned with whether the oversight truly is independent and has sufficient influence to prompt changes, particularly for contract-based arrangements and master trusts established by pension providers.

The amount of effort put into oversight will also have to increase substantially for many schemes following automatic enrolment, and irregular meetings of trustees will no longer be sufficient. Employers who choose contract-based pensions or master trusts will also have to consider what governance they should put in place to review their pension arrangements and ensure they remain appropriate for staff. The level of formality for this will depend heavily on the size of the company.

CONCLUSION

Governance is the nuts-and-bolts of pension provision, and if it isn't effective the whole system will fall apart. Governance standards shouldn't depend on the type or size of pension scheme, and the changes following the OFT review should bring more consistency. With the right governance in place, schemes can fulfil the purpose for which they were established – helping members to prepare for a financially secure retirement.