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Dear Alistair,

Regulating work-based defined contribution pension schemes

This is the Financial Services Consumer Panel's response to The Pensions Regulator's (TPR's) consultation on 'Regulating work-based defined contribution pension schemes'.

We welcome TPR's consultation on delivering good quality Defined Contribution pension schemes and agree with the general principles laid out in the consultation document.

It is our view that good outcomes for members are key to ensuring that auto enrolment and DC saving are a success. As you rightly stress, this demands high standards of governance which have member (consumer) outcomes as their primary focus. This framework should ensure that pension schemes deliver the best possible income in relation to charges, administration and risk-adjusted returns for the millions of savers who will rely on these schemes for their financial security in retirement. We set out our responses to some the questions below but first I would like to highlight our concerns in several key areas:

Contract or trust based schemes

We want to see fair and equal treatment of all members of private sector workplace DC schemes under auto-enrolment, irrespective of whether these are contract or trust based (a feature over which the member has no control). However, in the absence of a single regulatory regime, we are concerned about the different standards that can apply to schemes under these two legal and regulatory structures. We are keen, therefore, to see concerted effort directed at ensuring that the standards set by TPR for trust-based schemes are *fully and demonstrably* replicated by the incoming Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), in the contract-based DC market. This is an important issue we believe the Government should take ownership of by stipulating the minimum quality standard to which pension schemes must adhere.

Benchmarking

We are pleased that TPR is undertaking a formal benchmarking evaluation of the FCA and PRA's regulation of DC schemes against TPR's code as set out in Annex 2 (code of practice) and Annex 3 (regulatory guidance) and we look forward to seeing the qualitative and quantitative results. However, despite assurances that the initial analysis indicates the FSA regime matches TPR's, we think it is likely that a significant number of DC schemes will not meet the code's requirements. This is because TPR's requirements are based on the assumption that schemes are selected by independent trustee boards and are run by trustees that have a fiduciary duty to put the members' interests first. There is no such member-focused fiduciary mechanism in contract-based DC that is recognised in law and regulation. Moreover, TPR requires trustees, who are the purchasers of the scheme, to meet clear standards of competence that build upon well-established trustee knowledge and understanding (TKU) requirements. There is no equivalent training process and regulatory support for employers, who are the buyers of contract-based schemes. This means that the quality of the contract-based scheme is likely to depend on the employer's adviser. For smaller schemes in particular it is not clear that the advisory market is competitive and functions effectively.

If your analysis reveals areas of regulation that the FCA/PRA need to address and possibly to amend, this will take time. Meanwhile thousands of employers will have reached their staging date, potentially putting contract-based DC members at a disadvantage relative to members of trust-based schemes. We suggest that to rely on the assumption that DC scheme providers will adopt your code immediately on a voluntary basis is not a strong regulatory position.

Master trusts

The Consumer Panel is particularly concerned about the growth and regulatory oversight of master trusts. We would like to see the TPR address all conflicts and bias currently inherent in some master trusts. We are concerned that master trusts can sometimes operate under a trustee board that includes senior members of the provider's firm, which is responsible for the asset management and administration, among other functions. Arguably this significantly undermines the fundamental principle of trust-based pension schemes, namely that trustees should operate solely in the interest of the members. It is doubtful that the inclusion of senior members of the provider's firm, on the board of trustees, provides sufficient independence and allows the trustees to carry out their most important tasks objectively e.g. select the most appropriate supplier of services. We recommend, therefore, that master trusts (or possibly just the master-trusts with provider-trustee members on the trustee board) should be classed as a separate category from traditional trust-based schemes. Additional and very robust supervision of this sub-category of trust-based DC schemes would ensure that the trust-law basis is not just notional and potentially used as a way for firms to arbitrage the regulatory gaps and inconsistencies between TPR and FSA/FCA/PRA.

We have not answered all the questions in the consultation but make the following comments in relation to specific questions.

Q 2: Do the DC code and the DC regulatory guidance, together with the DC regulatory approach sufficiently address risks to members within the different segments of the DC market, for example those relating to master trusts?

We welcome the introduction of trust-based schemes that can accommodate multiple non-associated employers and hence deliver economies of scale to employers of all sizes, as we note above. However, the emergence of master-trusts in practice raises important questions, especially, but not only where the provider is a life office and historically has provided GPPs and stakeholder schemes under the regulation of the FSA.

Master trusts can be run in a very similar way to the conventional single trust scheme (eg Nest, BlueSky etc) where all trustee board members are independent and in many cases are experts in finance and pensions. However, as you note in the document, they can also operate under a trustee board that includes senior members of the provider's firm. In these cases, we doubt whether these trustees can act solely in the interests of the members. The litmus test, we suggest, is this. Does the trustee board of a master trust scheme have the power (set out in the trust deed and rules) and the willingness to sack the asset manager and administrator, if necessary?

Q 4: Do you agree that independent assurance will help provide another layer of rigour to help improve standards of governance and verify accountabilities of trustees' master trusts? If not, what other sources of assurance can trustees of master trusts use to demonstrate the presence of DC quality features and operational effectiveness of related control processes?

While this requirement might reduce the risk of provider bias on the trustee board, we are not convinced that it would remove it. Our view is that master trusts with provider members of the trustee board are more akin to contract-based schemes. This is especially (but not only) where they are run by proprietary life offices, which have a responsibility towards shareholders as well as scheme members. We would therefore reiterate our recommendation that master trusts that include provider-trustees on the trustee board should be classed as a separate category from traditional trust-based schemes and new schemes such as Nest. Also we would like to see additional supervision introduced to regulate them effectively, particularly in relation to cases where the potential for provider bias is embedded within the governance structure.

Q 19: We have set out practical guidance for trustees on deciding how to disclose costs and charges to members. Do you agree with the approach that we have suggested?

In the interests of consistency, we think that the ABI/NAPF code of practice on disclosure of member charges for contract-based schemes should also apply to trust-based schemes.

Q 20: We have set out practical guidance for trustees on helping members to optimise their retirement outcomes. Do you agree with the approach that we have suggested?

Irrespective of whether a scheme is contract or trust based, in the foreseeable future most members will use their funds to buy annuities, which are FSA/FCA/PRA regulated. We consider this to be a crucial area in which regulatory gaps between contract and trust based schemes might arise in workplace schemes and would expect the regulators to ensure that workplace DC annuity purchasers are treated equally, irrespective of the legal basis of the DC scheme chosen by their employer.

Yours sincerely

Adam Phillips
Chair
Financial Services Consumer Panel