PSIT Independent Trustees

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Governance – the next pensions challenge for employers?

Gillian Graham outlines approaches needed to ensure defined contribution schemes meet the Pensions Regulator's new governance requirements.

Speed read

- The Pensions Regulator means business in his current drive for good governance in workplace pension schemes and has made it known that it will not shirk from enforcement.
- Poor governance is amongst the four key risk areas in DC schemes and trustees must be able to demonstrate that they have considered the risks, and manage and monitor them.
- Whilst governance frameworks and regulation may vary slightly between different types of DC scheme, the overall approach is encapsulated in the Regulator's six DC principles.
- Schemes must be 'fit for purpose' and trustees and employers should assess theirs against 31 detailed DC quality features designed to ensure good member outcomes. Action needs to be taken where schemes fall short.
- DC governance is now essential and no longer a 'nice to have' - but it can benefit both employers and scheme members.

Make no mistake; the Pensions Regulator means business in its push for good governance of workplace pensions. A primary driver behind this is the need to ensure auto-enrolment is a success, as millions more employees start to save for their retirement. The whole initiative could backfire if employees are enrolled into schemes that fail to deliver reasonable benefits. For it to work, the schemes employers use must be 'fit for purpose'.

Background

There are currently around 2.4 million members in almost 40,000 trust-based defined contribution (DC) schemes, and a further 2.7 million in other workplace DC schemes. There are now considerably more active members in DC than in defined benefit (DB) schemes - and these numbers will only continue to grow as most employers will use a DC scheme for auto-enrolment.

The Regulator has developed its approach for good workplace DC schemes around six core principles. These principles are underpinned by 31 detailed quality features, designed to ensure good member outcomes. The Regulator's 2013 Survey showed that less than a third of DC schemes meet all six principles. If you have a DC scheme, you need to assess it against these quality features and take action in any area that falls short.

Although the Financial Conduct Authority (FCA) regulates contract-based schemes, such as group personal pensions, both regulators are working together to ensure similar levels of protection across all DC schemes.

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Master trusts

An interesting consequence of the roll out of auto-enrolment has been the increased use of master trusts. Perhaps the best known of these is NEST (the National Employment Savings Trust), but there are many others. Whilst the Regulator recognises that master trusts play a key role in the new workplace pensions landscape, it fears they could also be at risk of damaging confidence in pensions if they are not closely monitored.

Therefore, not only will master trusts need to produce an annual governance statement, but they will also have to undergo a tough assurance analysis conducted by independent external auditors. If your business uses a master trust, you need to be sure your scheme provider is meeting these requirements.

Trust-based schemes

Although the six principles are sensible at a high level, more detail is needed to develop a practical approach that achieves the level of governance required. This is where the 31 quality features come in. Trustees are expected to review their scheme and produce an annual 'comply or explain' governance statement detailing how they measure up.

Although the Regulator has developed comprehensive guidance and an example template and assessment tool, the review process can prove somewhat daunting and the time it will take should not be underestimated. There are many ways to go about the assessment, but a 'gap analysis' may be the most straightforward and there is value in having a review conducted by an independent party as a way of double checking any advice on governance you may already have received.

If you are not fully compliant, you need to draw up an action plan to explain how you will get there and demonstrate progress at the next annual review.

Case study

I was recently appointed as Secretary to the Trustees for a scheme where governance standards had slipped and urgent action was needed. This is a hybrid scheme with DB and DC sections. After appointing new advisers, the initial focus was entirely on DB issues. Once these had been addressed, the trustees recognised a great deal of work was needed to improve governance in the DC section.

The Regulator's Code of Practice 13, which covers the governance and administration of DC schemes, suggests trustees can prioritise key areas and work through them on a step-by-step basis. However, for this scheme, everyone agreed more drastic action was required. A special trustee meeting was arranged in which workshop style training covering the code was included under each section of the agenda.

This meant each area of governance was set in the context of a normal trustee meeting, and training was broken into bite size chunks and delivered by different specialists in each area. Training was made more relevant by looking at case studies of the scheme's own specific issues.

For example, under the 'Administration' agenda item, the trustees:

- reviewed the DC section against the relevant parts of the Regulator's code
- looked at an in-depth case study into the scheme's process for retiring DC members
- considered the regular administration report and how they could analyse it more effectively in future

At the end of the meeting, the trustees asked their consultant to draw up a draft governance statement based on the day's discussions.

Pension Quality Mark (PQM)

Your governance strategy does not need to focus solely on the Regulator's guidance; there are other tools and approaches available. The PQM, for example, was introduced so employers can demonstrate their DC scheme is of good quality and it is popular with those who take pension provision seriously. It is open to any DC scheme and can be awarded at two levels, depending on how well your scheme meets certain quality standards for the level of contributions, governance and communications.

Contract-based schemes

Since one of the key reasons for setting up a contract-based scheme (such as a group personal pension) was the less onerous governance requirements, at first glance it may be surprising that many employers already have voluntary governance arrangements in place. However, given the desire to work in line with best practice and the fact that pension spend is often so significant, it makes sense that employers want their schemes to be well managed.

The Regulator published a guide for employers who use a contract-based scheme, suggesting the use of a management committee as one possible approach to governance, but making it clear this is entirely voluntary. However, many believe that 'best practice' may soon become a requirement. This is part of the reason pension providers are placing more emphasis on their own governance arrangements to give comfort to their employer clients and scheme members.

Case study

Soon after WRAP was established, they decided to set up a 'Pensions Forum' for their group personal pension with the assistance of their consultants, Punter Southall. The Forum is composed of three management and seven staff representatives and meets quarterly with a structured agenda. Their provider attends once a year and Punter Southall attend every other meeting.

Eileen Anderson, Head of HR and Organisational Development, says, "Running the Pensions Forum has been extremely beneficial to WRAP, and has helped ensure the success of our auto-enrolment project." She feels this is due to key tasks undertaken by the Forum, including:

- monitoring performance and ensuring the plan is administered correctly
- helping WRAP promote the plan to members and eligible employees
- educating members in areas such as retirement planning and annuity options
- selecting and reviewing the default fund and wider investment options, and deciding how they are communicated to members
- identifying and managing potential risks
- keeping in touch with member opinion

Compliance and enforcement

At the other end of the scale, in contrast to the employers voluntarily operating governance committees, there are some trustees who have paid insufficient attention to their responsibilities. The Regulator is clear that, whilst it has made a significant effort to educate and enable compliance, it will not shirk from taking enforcement action where necessary.

The Regulator has identified four key risk areas in DC schemes – one of which is poor governance standards. This could be as a result of inadequate internal controls, or trustees not having appropriate levels of knowledge and understanding, or failing to recognise and manage conflicts of interest.

Members bear most risks in DC schemes but trustees should be able to demonstrate they have considered the risks, and continue to manage and monitor them. A risk register is a good way of doing this and ensuring most attention is paid to areas of greatest risk - an example extract is shown below:

Risks	Owner	A. Likelihood (1-5)	B. Impact (1-5)	Total AxB	Controls
DC Investment					
Contributions not paid & invested promptly	Employer Trustees	1	1	1	• Timeliness of contributions reviewed quarterly • Reviewed as part of annual audit of accounts
Default investment strategy no longer suitable	Trustees	1	4	4	• Regular investment strategy reviews • Administrator writes to members before lifestyling starts
Poor investment returns	Member Trustees	3	4	12	• Regular investment strategy reviews • Professional advice obtained

The Regulator will monitor compliance using a three stage review. This could result in no further action, trustees and advisers being required to take certain steps within set timescales, or an investigation could be opened which may lead to enforcement. The worst-case scenario could involve the Regulator issuing statutory compliance notices and fines of up to £50,000.

What is a good framework for effective governance that employers can follow?

Although regulation may differ slightly, in essence the same framework for achieving effective governance can be applied to all types of DC scheme. Central to this are the Regulator's six principles:

1. Essential characteristics - schemes should be durable, fair and deliver good outcomes for members
2. Establish a governance framework - with clear accountabilities and responsibilities
3. Understand duties - people running schemes should understand their duties and be fit and proper to perform them
4. Ongoing governance and monitoring - through the scheme's full lifecycle
5. Effective administration - schemes should be well-administered with timely and accurate processes
6. Communicate with members - enable informed decision-making about retirement savings

Conclusion

DC governance is no longer a 'nice to have'- it is now essential. By developing a proportionate approach, it does not need to be onerous. Done well, it will benefit employers as well as members.