

IMA RESPONSE TO FCA CONSULTATION CP14/16

***“Proposed rules for independent governance
committees”***

October 2014

1. The IMA¹ strongly supports the Government's measures to improve the quality of workplace DC pension provision, and look forward to working with Government, regulators and other stakeholders to secure the effective implementation of these measures.
2. Our response is in two parts. The first provides general comments, the second more detailed answers to FCA questions.

PART ONE: General Comments

3. The IMA welcomes the Government's emphasis on enhanced governance and transparency, in line with the conclusions of the market study by the Office of Fair Trading. In this respect, we support the creation of Independent Governance Committees (IGCs) for contract-based schemes and the broader focus on better defining quality standards for Defined Contribution (DC) schemes. We agree that the investment and pensions industry needs to work towards greater transparency and consistency in its disclosure of charge and cost information, and are working to facilitate that objective.
4. Our detailed comments – set out in the accompanying Annex to this response – focus particularly on investment governance, which we see as a key responsibility for IGCs and trustees in trust-based schemes. We believe that a mechanism needs to be created that brings investment quality standards for DC schemes under a single framework encompassing both trust and contract-based arrangements. To that end, we have proposed a quality check provided by schemes for investment governance in relation to the default strategy.
5. This takes the form of actionable quality standards for default investment arrangements, which would offer a concise, practical way for all DC schemes to operate, avoiding potentially onerous regulatory or auditing requirements. While we have focused our proposals on default DC investment arrangements, such an approach could also extend to other aspects of DC operation.
6. The IMA is proposing an approach, which would provide:
 - A *practical roadmap* to develop and implement default investment strategies, acting as a quality check for standards.
 - A *'one stop shop'* that could be accessed in order to assess behaviour and ensure that requirements in both the contract- and trust-based environments are met.
 - A *consistent document supplied by schemes to employers* who need to ensure that they are selecting a default arrangement that is fit for purpose when making scheme selections.
 - A *procedure with the flexibility and capacity to evolve over time*, adapting to changes in the marketplace, including innovation in delivery.

¹ The IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of around £5 trillion of assets in the UK on behalf of domestic and overseas investors.

7. The objective is to deliver a way to demonstrate a consistent quality of process in an environment where investment approaches and delivery architecture will continue to differ widely, but where the core governance questions remain constant.
8. While there is no 'right answer' in DC investment terms, there are certain processes that are fundamental to providing the best chance for good outcomes to occur – for example, defining a clear member objective – and we believe that this checklist provides the best way to ensure those processes are followed.

PART TWO: Answers to Specific Questions

Equality and diversity considerations

Q1: We would welcome views on the likely equality and diversity impacts of the proposed rules.

9. We do not have a specific view on this area.

Deferred members

Q2: Do you agree that deferred members of workplace personal pension schemes should be within the mandatory scope of IGCs?

10. Yes, we agree with this proposal for the reasons set out by the FCA – namely that deferred members may be less likely to engage with their pension than active members, and that employers have less incentive to protect the needs of former employees. The ban on Active Member Discounts eliminates one of the biggest problems in this area, but it does not deal with these other problems.

Individual personal pensions

Q3: Do you agree that individual personal pensions, other than those that originated as workplace personal pensions, should not be in the mandatory scope of IGCs?

11. Yes, we agree with the FCA's view in this area. Mandating personal pensions to be covered by IGCs may dilute the benefits of the IGC for workplace personal pension scheme members by requiring its resource to be used to look after the interests of a different group of members that were subject to different sales processes and may have a different level of engagement.
12. We recognise that there are issues for individual personal pension plan holders who may not have or know how to access advice or guidance in relation to these arrangements; some of these individuals may have been 'orphaned' from a financial adviser for a long time. However, we feel that this is an issue that needs to be addressed separately and should therefore not be in the mandatory scope of IGCs.

Employer contributions to individual personal pensions

Q4: Do you agree that individual personal pensions should not be in the mandatory scope of IGCs, even where the employer contributes or facilitates payments?

13. Yes, we agree. The key point is that the individual has made an active choice in relation to the selection of the pension provider and scheme. Whether or not the employer chooses to contribute is irrelevant.

Which firms will be required to establish an IGC

Q5: Do you agree with our proposals for which firms will be required to establish and maintain an IGC?

14. Yes, we agree with the FCA's proposals.

IGCs established at a group level

Q6: Do you agree that IGCs may be established at a group level?

15. Yes, we agree with this proposal, which seems a proportionate solution that avoids duplication of resources in creating and running multiple IGCs in a corporate group.

Composition of an IGC

Q7: Do you agree that an IGC must have a majority of members independent of the firm and that the IGC Chair must always be independent?

16. Yes, we agree with this proposal as it is the best way to avoid any potential conflicts of interest.
17. We do however have a more general concern as to the relative scarcity of the expertise and experience required to fulfil the role of the IGC Chair. Clearly, making the right appointments will be all important. A potential solution would be to allow a transitional period of two years within which firms can ensure they achieve the full IGC membership requirements.

IGC members

Q8: Do you agree that an IGC should have at least five members?

18. Yes, although we have no strong views on the precise number, the reasoning set out by the FCA is sound.

Definition of independence

Q9: Do you agree with our proposed definition of independence that would allow trustees of a firm's mastertrust to be independent IGC members?

19. Yes, we agree with the proposed definition of independence. A trustee of a firm's mastertrust could have valuable experience that would be beneficial to the firm's IGC. In each case the responsibility is to the member, so there should be no conflict of interest with the provider arising.

Indemnification of IGC members

Q10: Do you agree that we should not require firms to indemnify IGC members?

20. Yes, we agree that guidance that firms should consider indemnifying their IGC members is helpful and sufficient. Compulsory indemnification seems an unnecessary piece of regulation at this stage. If problems arise further down the line from some firms choosing not to indemnify (the main issue we can see would be the potential of a reduced pool of IGC members if there was a perceived risk of personal legal liability), regulation could be an option at that stage.
21. Where firms do choose to indemnify their IGC members, communication of the scope of the indemnity will be important to ensure that IGC members have a full understanding.

Approved persons

Q11: Do you agree that members of the IGC, including the IGC Chair, should not be approved persons at this time?

22. Yes, we agree with the FCA for the reasons set out in the consultation paper. However, it is worth the FCA retaining the option to designate IGC members as approved persons in future if it is deemed necessary in the event of either unqualified members being appointed or duties not being performed correctly.

Appointment of IGC members

Q12: Do you agree that we should require firms to recruit independent IGC members through an open and transparent recruitment process?

23. Yes, we agree with this requirement and since firms will be well-versed in established processes for the recruitment of independent board members, it should pose no problems. We also fully agree that the independent chair should be fully involved with the appointment of the other IGC members. The use of open and transparent recruitment processes should ensure the independence of the IGC and in doing so create confidence in the committees.

Duration of appointment

Q13: We would welcome views on the proposed duration of appointment of IGC members.

24. We have no specific views in this area other than to note that where the FCA expects firms "...to replace any vacancies that arise within IGCs as soon as possible and in any event

within six months”, we suggest that temporary appointment arrangements are allowed in the event of unforeseen circumstances resulting in the six month limit being breached. For example, if a candidate becomes unable to resolve a conflict or otherwise becomes unable to take up the role; or for some other good reason a suitable candidate cannot be secured.

Corporate persons as IGC members

Q14: Do you agree that we should permit the appointment of corporate persons to IGCs, including as the IGC Chair?

25. Yes, we agree. As the FCA has pointed out in the consultation paper, there may be additional benefits to be gained by having a corporate person on the IGC. We see no reason why the IGC Chair cannot be a corporate member.
26. However there is one caveat here, which is the risk of concentrating decision-making in the hands of a comparatively small group of trustees who sit on multiple IGCs or trustee boards, a possibility that may not facilitate good outcomes. This may be a theoretical issue, depending on the future size of the corporate trustee and IGC market, but one that is worth flagging. The pensions environment benefits from a diversity of skill sets and experience, and continual debate about best practice.

Q15: Do you agree that there should be no restriction on the duration of a corporate appointment?

27. Yes, we agree. The case for rotation of a corporate appointment is weaker than in the case of an individual IGC member. Corporate persons have a commercial incentive to be professional and competent, maintain independence from the firm and act in the best interest of the member at all times, since that is the basis on which their services as a corporate trustee are offered.
28. As long as contracts are specified correctly (making clear the fiduciary duty to the member), then incentives for the corporate appointee to govern well are aligned with the interests of members. Furthermore, a poorly performing corporate appointee can always be fired at any stage. But if term limits were to be imposed, then a corporate appointee doing a good job would have to be removed at the end of their term, irrespective of the quality of their work and the fact that the provider setting up the IGC may want to retain them.

Duty to assess value for money on an ongoing basis

Q16: Do you agree that IGCs should consider in particular the value for money received by individuals enrolled in default funds?

29. Yes, we agree with the focus on default strategies for the simple reason that the majority of scheme members are likely to be in the default and will not have made an active choice to be there. Focussing on the default will therefore mean the majority of scheme members’ interests are being looked after.
30. In assessing the value for money received by individuals in default strategies, we would

emphasise a need to focus on both elements – quality and cost – and not just the latter, which is what characterises the current debate on transaction costs and fund charges.

31. In this regard, we recognise that there needs to be further discussion about how value for money can be measured in an environment where the consequences of decisions taken, particularly around asset allocation, may not be apparent for a number of decades. We would also encourage the IGCs to be given a remit to consider the extent to which good outcomes are also the product of other inputs, notably contribution levels. Has an individual under-saving for 40 years received a good outcome if an investment strategy has performance as expected (value for money), but his/her pension is much smaller than they might have expected?

Q17: Do you agree that, at a minimum, IGCs must assess whether the characteristics and net performance of all investment strategies are reviewed regularly by the firm?

32. An investment strategy is different to a component fund (e.g. a UK equity fund), which might be a building block in a strategy. Where a provider is offering a wide choice of funds that simply provide investment exposure of different kinds, there is a question as to whether significant scrutiny is a good use of the IGC's time, other than to ensure that mechanisms for review of those funds exist within the firm. The situation is further complicated where an external adviser might be working with an employer and their employees to construct a strategy based on funds available on a given provider platform. Should the IGC oversight extend to all such strategies? This is a complex area with respect to IGC responsibility.
33. Therefore, while the proposal for funds other than provider-driven default strategies sounds reasonable in theory, we would question whether in practice this might be much harder for IGCs to carry out. We would be concerned if this were to detract from scrutiny of the default, where the IGC members' time would be better spent, given the likely coverage of the default.
34. Furthermore, the issue of value for money is a highly subjective one; individuals differ in their willingness to pay for a service and will view value for money differently. We would argue that any one engaged enough to make an active fund choice will have made a judgment that the fund charge is worth it to them. There is a danger that by focussing on the entire range of fund choices offered, IGC members' judgment results in access to funds being removed when these might be valued by members. Such restriction in choice would go against the grain of the Government's pension reforms.

Q18: Do you agree that, rather than mandating a particular approach, we should allow individual IGCs to determine how best to assess value for money?

35. Yes, we agree that this is the right approach, since as discussed in our answer to the previous question, an assessment of value for money is subjective and is likely to differ across individuals and schemes. It is therefore better to let individual IGCs determine how best to make that judgment. However, while we do not believe there is a 'right answer' in investment terms, there is – as we note earlier – a right answer in terms of process and minimum quality standards.

Scheme quality and minimum governance standards

Q19: Do you agree that IGCs should be required, at a minimum, to review the three aspects of scheme quality proposed, and should consider other aspects as appropriate?

36. We fully support the need for IGCs to assess the appropriateness of default investment strategies for members and have set out at length, in part 1 of our response, our views in this area, including a proposal for ensuring the appropriateness and quality of default strategy choices.
37. We also agree with the need to focus on the fact that core scheme financial transactions are processed promptly and accurately. Scheme members have every right to expect that such basic transactions are carried out promptly and to a high standard.
38. However, as we explained in our answer to question 17 we are concerned that regularly reviewing the entire range of funds available to members may pose an infeasible burden on IGC members and distract them from their key focus, which should be on the default strategy, since this is where the majority of members will end up. There is also a risk that fund choice for more engaged members who want the freedom to choose may be constrained by IGC recommendations and this would be undesirable – the IGC should be focussed most on protecting the un-engaged members who do not make active choices. Those members who do make active choices should be considered to have weighed up the costs and benefits in arriving at their decision.
39. We agree that IGCs should have the freedom to determine which other services they consider as part of their assessment of scheme quality.

Costs and charges

Q20: Do you agree that IGCs should consider all costs and charges, as proposed? If not, what would you suggest?

40. Yes, IGCs should consider all costs and charges as set out in the consultation paper. However, we would emphasise the need, as the FCA notes, to weigh costs and charges against the level of service provided – not just for investment management services, but all relevant services. Too often the debate on value for money has focussed solely on cost and unduly focussed on investment management rather than looking at all sources of cost, including administration.
41. Our view on costs incurred in relation to the investment and management of pension assets will be covered in more detail in our response to the next question. At this point we would simply note that disclosure of investment management charges and transaction costs must be meaningful and helpful for IGC members in their decision-making. Equally, IGC members must be able to correctly interpret and act as appropriate on the information they receive when considering their value for money judgments.

Improving transparency of all costs and charges

Q21: We would welcome views on how best to improve the disclosure of all costs and charges, and how we could transpose the industry standards for authorised funds to pensions.

42. From an investment perspective, the debate about transparency is not about DC schemes exclusively, but extends across the product and client range. The IMA believes that significant improvement is needed across the investment and pensions landscape and is working to facilitate that.

Charge disclosure

43. The methodologies and terminology for calculating and disclosing charges in all long-term savings and investment vehicles (including pensions) need to be more consistent. Members need to be told what they are paying in an accessible and consistent manner.

44. While pensions differ from investment funds, the IMA believes that the approach used in the UCITS Key Investor Information Document (KIID) offers a template for pension charge disclosure in its use of a single methodology and single terminology. For investment funds, the IMA issued its [Enhanced Disclosure Guidance](#) in 2012 and recommended that its members focus on the Ongoing Charges Figure (OCF) used in the KIID, a stance subsequently echoed by the FCA. It is perfectly feasible to devise a methodology that would allow the emergence of an OCF for pension products, presented in combination (as applicable) with other forms of charge, such as contribution charges.

Transaction costs

45. Transaction costs need to be more readily available, expressed in a meaningful way. The IMA is working to develop better metrics for transaction costs. Disclosure of explicit costs is already a regulatory requirement for investment funds. They are to be found in the annual fund report and accounts.² Our 2012 Enhanced Disclosure Guidance aimed to make these existing disclosures more accessible by recommending that a three-year average for aggregate transaction costs be published on firms' websites, accompanied by suitable narrative to aid an understanding of the significance of the figures.

46. In May 2014 we issued a revised [Statement of Recommended Practice](#) (SORP) for investment funds, which requires a simple summary in the report and accounts, in "pounds and pence per unit" terms, of the performance, the operating costs and the direct transaction costs for the year. In addition, the analysis of the transaction costs includes an indication of the bid/offer spread on the portfolio. The SORP approach could be used conceptually for other pooled vehicles, although the mechanisms for collecting and disclosing the data may be different, and more challenging in some areas of DC delivery.

47. The IMA has always been clear that fund accounts do not provide all of the information necessary to ensure manager accountability. In that respect, far more detailed

²The SORP for authorised funds requires disclosure of each type of transaction cost in the fund's accounts. Notwithstanding that the SORP offers recommended practice, compliance is a matter of regulatory compulsion.

standardised disclosure frameworks already exist in some areas, notably the [Pension Fund Disclosure Code](#) (and its CIS counterpart), which address in particular the issue of broker payments and research procurement.

48. We have also stressed that there is more to do and have established two new workstreams, which will report in the coming months. The first is examining Portfolio Turnover Rate (PTR), with a view to identifying a consistent and meaningful methodology. The second is looking at the disclosure of implicit transaction costs.
49. In the UK pensions transparency debate specifically, we are exploring mechanisms to bring all of this information together to provide a holistic accountability mechanism.
50. We will continue to pursue this work in close conjunction with the Government, regulators and other stakeholders including the ABI, which is taking the lead on unit-linked disclosure issues.

Raising and escalating concerns

Q22: Do you agree that IGCs should be able to escalate concerns directly to the FCA, alert relevant scheme members and employers, and make their concerns public?

51. Yes, we agree that IGCs should have recourse to all these options. They are likely to give the IGCs the teeth necessary to alter a provider's behaviour if necessary. Public disclosure in particular is an important power since it can have a powerful effect on provider behaviour in order to avoid reputational risk.
52. However we believe that proper procedures should be followed. We would not expect concerns to be made public before the escalation process has been suitably followed. We believe that IGCs should be required to inform the firm's governing body if it intends to raise concerns and allow the firm to rectify any issues. This obligation should be aligned with existing whistleblowing obligations

Requirement to publish an annual report

Q23: Do you agree that the IGC Chair should be required to produce an annual report and that the firm should be required to make this report publicly available?

53. Yes, we agree that the IGC Chair should be required to produce a publicly-available annual report on the work of the IGC – this is an important way of ensuring scrutiny and accountability of the IGC as well as scrutiny of the pension provider.
54. As far as reporting on the level of direct and indirect costs incurred for transactions and other activities in managing and investing the pension assets of scheme members, we would note that the FCA needs to be alert to the fact that there will be a diverse audience for these reports, and that scheme decision-makers and scheme members may well approach such information very differently. With respect to members, there is a clear risk of unintended consequences, whereby members may draw misleading conclusions about different elements of the capital markets – such as seeing one sector of the markets having lower associated transactions costs than others and making an investment decision on that

basis. Disclosure requires carefully prepared, clear descriptions to accompany data.

Priorities for IGCs

Q24: We would welcome views on where IGCs should focus their attention.

55. We agree that mandating what individual IGCs should prioritise would not be the correct approach because priorities will likely differ across schemes and over time. It is therefore sensible, as the FCA proposes, to let IGCs determine their own priorities.
56. We would suggest that the initial focus for IGCs should be in assessing the appropriateness of the default fund for the membership of each of the schemes that they are responsible for monitoring. As we outlined in our comments in part 1, investment is the area that makes the single biggest difference to members and is therefore an obvious priority area for IGCs. Given the expected high membership in the default fund, focussing on the default will be the most efficient way of ensuring that the interests of the majority of members are looked after.

Duty to provide all information reasonably requested

Q25: Do you agree that we should place a duty on the firm to provide the IGC with all information that it reasonably requests for the purposes of carrying out its duties?

57. Yes, we agree since this information is central to the work of IGCs. We suggest that the FCA Code of Practice should highlight that the firm has a duty to respond to reasonable requests for information within an acceptable time frame. We believe that the simplest way to support this is to extend the IGC's whistle blowing rights to any issues around the receipt of information requested.
58. We suggest it would also be helpful for the FCA to outline the process they would follow if such a failure to provide information was escalated to them by the IGC Chair. In such cases it would be informative to know what criteria the FCA intend to consider in any arbitration.

Duty to provide sufficient resources

Q26: Do you agree that we should place a duty on the firm to provide sufficient resources to the IGC as are reasonably necessary for it to carry out its duties?

59. Yes, we agree. It is difficult to see how the IGC can carry out its duties without being sufficiently resourced. It should be the responsibility of the firm whose schemes the IGC is responsible for monitoring that is required to ensure that the IGC is appropriately resourced. We would note that in general terms it would be expected that the cost of setting up and maintaining IGCs will be passed on to members as part of the charges they pay for their pension.

Duty to ensure that member views are directly represented to the IGC

Q27: We would welcome views on possible arrangements to ensure that member views are directly represented to the IGC.

60. We do not have any specific views on how to achieve this. We would simply note that we consider it unlikely that members would engage to the extent that they would seek to offer their views to the IGC. One of the key rationales for the IGCs existing in the first place is that members are not engaged or informed enough to assess the value for money of their pension scheme. In this context they should not be expected to want to engage with IGCs.

Duty to make annual report and terms of reference publicly available

Q28: Do you agree that the firm should make the IGC's annual report and terms of reference publicly available?

61. Yes, we agree that the firm should do this. It is a key to ensuring that IGCs do their work well. Such a report and terms of reference could be made readily accessible online.

"Comply or explain" duty

Q29: Do you agree that we should place a duty on the firm to address concerns raised by the IGC or explain to the IGC why it does not intend to do so?

62. Yes, this is a sensible suggestion. It gives the firm a chance to respond to the IGC's concerns and clarify any reason for non-compliance. The ability of the IGC to subsequently make any un-answered concerns public is an important part of the process of holding the firm to account.

Governance advisory arrangements

Q30: Do you agree that GAAs should be allowed as an alternative to IGCs for firms with smaller and less complex workplace personal pension schemes?

63. Yes, this approach seems sensible for smaller firms for whom the cost of setting up and maintaining IGCs would be disproportionate. In such instances, the availability of a third party service provider is helpful. Corporate trustees have worked well in trust-based pension schemes and we see GAAs as being the analogue to corporate trustees in contract-based provision.

Threshold for use of a GAA

Q31: Do you agree with our proposals for the types of firm that can use GAAs?

64. Yes, this seems like a sensible approach.

ANNEX: AN IMA PROPOSAL FOR DC DEFAULT ARRANGEMENT GOVERNANCE

Government and regulators are asking for a clearer definition of what constitutes quality in DC pension provision. Focusing on the default investment strategy, the IMA is proposing an approach, which would provide:

- A *practical roadmap* to develop and implement default investment strategies, acting as a minimum standards quality check.
- A *'one stop shop'* that could be accessed in order to assess behaviour and ensure that requirements in both the contract- and trust-based environments are met.
- A *consistent document supplied to employers* who need to ensure that they are selecting a default arrangement that is fit for purpose when making scheme selections.
- A *procedure with the flexibility and capacity to evolve over time*, adapting to changes in the marketplace, including innovation in delivery.³

The objective is to deliver a way to demonstrate a consistent quality of process in an environment where investment approaches and delivery architecture will continue to differ widely, but where the core governance questions remain relatively consistent.

Key considerations

Developing a definition of quality in DC is challenging, particularly given the length of the pension saving process and the fact that outcomes will ultimately only be evident – and subject to final judgement – many years in the future. There are no universal 'right' answers on investment strategy, but there are processes that clearly need to be followed to ensure that members have the best possible chance of good outcomes in retirement. In this respect, demonstrable quality of process is absolutely critical.

Our quality check approach was developed prior to the Office of Fair Trading (OFT) market study of the DC workplace pensions market. It could play a key role in satisfying OFT concerns about the need for a "minimum governance standard that will apply to all schemes."⁴ We understand the pressures to use legislation to create standards around the governance of default investment arrangements, but we do not believe that this would be the most effective approach.

In common with the OFT and The Pensions Regulator (TPR), we are also concerned to ensure that we do not sleepwalk into a conflation of quality with lowest cost. Charges and costs must always be an important focus as part of the scheme governance process and are an important factor in our approach. However, the debate over quality of delivery must start with an expression of what this means for scheme design and scheme members, and how quality can be delivered in a cost-effective manner.

The *Freedom and Choice* proposals outlined by HM Treasury in support of the Budget 2014

³ Much of the material in this annex can also be found in our response to the [DWP call for evidence](#) on quality standards in summer 2013. Our response focused in particular on the question of quality vs low cost, with an emphasis on investment governance standards in the default strategy. Alignment of interests between decision-makers and scheme members is not a sufficient condition for good outcomes.

⁴ Office of Fair Trading, *Defined contribution workplace pension market study* (2013), p.24.

announcement point towards a need to cater for differing individual member preferences for the payout phase. We believe this further highlights the importance of high standards in default strategies, and also underscores the need for a non-legislative approach to detailed quality standards that can adapt to a changing public policy environment.

What would the quality check seek to achieve?

The check would take the form of a single document supplied to employers to help ensure that the scheme they use as part of their automatic enrolment duties is adequate. It would cover:

- Decision-making responsibilities, including management of conflicts of interest.
- The overall member objective for the default strategy (including a requirement to ensure value for money in delivery of the strategy, and clarity as to assumptions about the transition from accumulation to payout phase).
- Implementation and review of the strategy.
- Communication to scheme members.
- Safeguard of assets.

Rather like an MOT, schemes that are not able to satisfy the minimum requirements would not be allowed 'on the road'.

Formal responsibility for producing the document would lie with pension schemes (both trust-based and contract-based) relying on input from their advisers as applicable. The completed document would form a statement of default arrangement.

While it must be for the scheme to demonstrate that it meets the quality standards (and indeed some of the processes covered in the document can only be implemented by scheme decision makers and providers), the input of advisers will be crucial. As the OFT notes, advisers are a key link in the governance chain and default investment strategies inevitably reflect adviser input, whether provision is trust or contract-based⁵. The provision of a completed quality standards document is therefore a stamp of quality: of the quality of investment advice – and by extension the default strategy that is implemented.

On-going review of the appropriateness of the default should also rest with the scheme decision makers and providers, with continued support from their advisers being an integral part of this process.

Compliance and enforcement

Given the number of UK DC schemes and default strategies, it is simply not feasible for regulators to monitor the suitability of every default investment strategy. However, a range of options would be available: from random sampling to a risk-based approach. A risk-based approach may be challenging though, because the nature of DC pensions – specifically the impact on member outcomes of external factors such as longevity and economic and financial market conditions –

⁵ Office of Fair Trading, Defined contribution workplace pension market study (2013), p.45.

means that the triggers for regulatory involvement are unclear and may not become known until years down the line.

While making completion of this document a universal requirement would provide a significant signal of intent with respect to demonstrable quality of DC processes, there is an option for this to be a voluntary initiative. Good schemes will have an incentive to comply with the quality checks and the more schemes that adhere, the greater the reputational risk for those that do not. Public disclosure that default strategies put in place by a scheme meet the quality standards will help ensure that the benefits of compliance and the reputational risks of non-compliance are real. Industry adoption without regulatory intervention would send a signal that this is something the industry is serious about and is prepared to take responsibility for.

Whether compulsory or voluntary, monitoring in some form will clearly be necessary. One possible approach could be to have a joint industry/regulatory board comprised of scheme decision makers and their advisers, legislators and regulators that monitors compliance with the quality check by monitoring a random sample of default strategies every year for their adherence to the quality check. The results of such exercises could be made publicly available. The possibility of being audited in this way, with the results disclosed to the public, will provide a powerful incentive for those schemes signing up to the initiative to ensure that their processes actually comply with the requirements of the quality check.

Advantages over other approaches

This approach would build on existing requirements, including DWP guidance, in a way to ensure 'one-stop' compliance and not create an additional burden for schemes. Indeed, the areas are already covered in a number of existing initiatives,⁶ although no other document makes an attempt to amalgamate and summarise them in a consistent format in one place, and apply to trust-based and contract-based schemes. While a Statement of Investment Principles (SIP) in the trust-based environment comes closest, the SIP approach can vary widely and is not a checklist of actions that should be undertaken.

Examples of this checklist approach can be found in professions such as aviation or medicine where highly qualified individuals are seen to benefit from what is essentially a behavioural support. Far from being the bureaucratic tool that some critics claim, it can be a valuable means to ensure consistency of process.⁷

"Aviation has required institutions to make discipline a norm. And we have national regulations to ensure that [National Transport Safety Board] recommendations are incorporated into usable checklists and reliably adopted... To be sure, checklists must not become ossified mandates that hinder rather than help. Even the simplest requires frequent revisitation and further refinement."

This quality check document also has a number of advantages over a purely legislative approach, as we outline below.

⁶ Principally, these are the DWP's default guidance, TPR DC code of practice and regulatory guidance and the IGG DC (best practice) principles.

⁷ This is a point emphasised in a recent report by CASS Consulting / BNY Mellon, [Pension Scheme Governance in a Risk-Focused World](#). See in particular Atul Gawande, *The Checklist Manifesto*, 2011.

Features	Default arrangement quality check	Legislative / regulatory approach to defining standards
Practical roadmap to implement required standards in default provision, acting as a quality check not a best practice guide.	✓	✗
Compatible with both contract- and trust-based arrangements.	✓	Not yet clear
Consistent, accessible document supplied to employers who need to ensure in making scheme selections that they are selecting a default arrangement that is fit for purpose.	✓	✗
Tool for regulators or any other interested body that wishes to assess and compare investment governance quality on a consistent basis across the <u>whole</u> pensions market.	✓	Not yet clear
Flexibility to evolve over time, adapting to changes in the marketplace, including innovation in delivery approaches.	✓	Not yet clear

Governance and development

The IMA has already undertaken preparatory work on a minimum standards document (see attached) and has been discussing it with stakeholders over the past twelve months. A number of points should be emphasised:

- The current draft requires practical development in a number of areas, including content and implementation. Although we have suggested a possible approach to monitoring, this is another area that requires further refinement. However, we wish to table the concept of an accessible, actionable and consistent approach to default investment governance at a critical time for the development of DC schemes.
- Further development, including evolution over time, would be best achieved in partnership between Government, regulators, employers and pensions industry (including those representing the interests of scheme members). We do not envisage this remaining an IMA initiative.

- For the proposal to be most effective it requires acceptance from Government and regulators – a joint industry-government initiative carries the most credibility. In particular, we hope that it can become a central part of the DWP’s current work on defining DC quality. Detailed legislation around quality standards in areas such as investment decision-making is not optimal.

With millions of individuals being auto-enrolled into pensions in the next few years, it is imperative that quality can be defined in a way that builds confidence and trust in the delivery architecture, whether trust-based or contract-based. The IMA wishes to make a concrete contribution to bridging both the philosophical and regulatory divide in the UK in a way that can tangibly help employers fulfil their responsibilities and improve DC decision-making processes.

GOVERNANCE QUALITY CHECK FOR DEFAULT INVESTMENT ARRANGEMENT

This is a draft template, subject to further development. It is strictly confidential and not to be distributed without IMA approval.

The objective of this statement is to ensure that the default investment arrangement in place for any specific pension scheme, or part of a scheme, has been developed and is kept up-to-date in a manner which is consistent with what could reasonably be expected from an individual member placed in that arrangement. It is important not only that the features that define a good default arrangement are assessed to have been checked and reviewed on an ongoing basis, but that a named party is made responsible for each aspect of the default arrangement and that suitable levels of independent oversight are in place for the protection of scheme members.

IMPORTANT: The completion of this check is intended to ensure quality standards in default arrangement governance, in particular to ensure that the arrangement is compliant with current regulatory requirements. It in no way provides a guarantee of future performance of the default investment arrangement to which it applies, nor the appropriateness or otherwise for any individual member in that arrangement.

Name of scheme:

Name of sponsor:

Date of completion:

The statement remains valid for a three-year period from the date of completion.

Responsibility for completion and on-going adherence to the statement:

In the case of a trust-based arrangement this should be the trustees and in the case of a contract-based scheme this should be the FSA-regulated entity the scheme member contracts with.

Where adherence with parts of the test has been outsourced to a third party, for example to an independent financial adviser, this should be recorded below in the 'Responsibility' column. Where this is left blank it is assumed that the responsibility sits with the person(s) or firm stated above.

1. Documenting responsibilities

Pass Fail Responsibility

This section outlines requirements for clarity of scheme governance arrangements. While they focus on the default arrangement, they are also more broadly applicable to the investment governance of the scheme.

Note: There are alternatives to a Pass / Fail approach, which provide more flexibility to the assessment process. This is a topic for further discussion.

- a. Are the responsibilities and accountability for the development, implementation and review of the default strategy clearly delineated and documented?
This information should be available to scheme members on request. It does not have to be routinely distributed either on enrolment or subsequently. The document should clearly delineate responsibilities for sections 2-6 of the statement. [To be revised to take account of IGC role]
- b. Does the document state whether potential conflicts of interest exist and, if so, outline how they are managed?



Note: Detailed guidance as to how to answer these questions would have to be developed as part of the statement. For now, additional information is indicative of the kind of material that might be required.

2. Objective

This section outlines the need for a communicable default arrangement investment objective, considered separately from the investment strategy implementing it.

- a. Does the default investment arrangement have a stated and communicable member-centric objective?
A communicable and member-centric objective is defined as one that focuses on what is to be achieved for the scheme member and can be clearly communicated as such.

Asset allocation and investment decisions are distinct from an overall member objective.
- b. Has the objective taken account of the likely characteristics of the scheme members?
This does not require full advice or individual suitability checks. However, the development of the default strategy should consider whether there might be any reason why a proposed objective would not be in the interests of the majority of the scheme members. This can be considered across a book of business, and does not have to take place for every individual employer arrangement.

'Characteristics' refers in particular to age (implying years to retirement) and contribution levels, but may also consider features such as risk appetite.



If so, has this been done by taking account of (tick at least one to pass):

For each option that applies, please document the manner in which the consultation was carried out, what characteristics have been taken into account, what research has been undertaken and how this is reflected in the arrangement's objectives.

- Characteristics of the scheme member
- Characteristics of a specific employer
- Characteristics of a broad savings group/target market
- Formal consultation with members

- c.** Where the default investment arrangement is reliant on data provided by individual members or participating employers, are arrangements in place to ensure that this data is kept both accurate and up-to-date?

The default arrangement should not be reliant on on-going engagement at the individual or employer level to work effectively for the scheme members. This will require arrangements that use initial data, but there should be processes in place to ensure the data remains valid over time.



- d.** Does the objective have a clear statement of any fundamental beliefs or constraints that may affect its performance?

This would include specific cost constraints or objectives such as SRI. In setting such constraints, it is important that they can be communicated to potential scheme members.



3. Implementation

This section sets out the need for ensuring both robustness and flexibility in the implementation of the default strategy.

- a.** Is the objective implemented with the aim of minimising the threat of large capital losses in the outcome of the accumulation phase?

The threat of large capital losses does not refer to unrealised losses resulting from investment activity at any given point in the savings cycle. It refers to the need to ensure that adequate diversification protects the scheme members against significant, and potentially irrecoverable, investment losses. The question of the pre-retirement glide-path (often referred to as life-styling) is part of this process.

The implementation process should also include consideration as to whether individual components within the strategy are sufficiently diversified in terms of provider, e.g. whether there is any risk created by having different parts of the strategy delivered by the same asset management firm.



- b.** Does the implementation of the default strategy allow for member choice in the election of their preferred retirement income option and a glide-path reflecting this choice?

The objectives and investment strategy of the underlying default investment arrangements should allow for scheme members to select their preference for how they will access their pension under the freedoms set out in the 2014 Budget. This may allow for a generic default arrangement with scope for members to choose a specific glide-path at a pre-determined point



- c. Does the implementation of the objective have the flexibility to accommodate changes in the saving behaviour and retirement needs of potential scheme members?



The objectives and investment strategy underlying the default investment arrangement should be cognisant of the broad range of likely circumstances amongst the scheme members; e.g. the likelihood that they may retire early or later than expected (especially in periods of economic hardship), uncertainty over the timing of future contributions and the broad range of income options that are available at retirement.

The default strategy also needs to have the flexibility to deal with changing work and retirement patterns, as well as legislative change over time.

4. Review

This section focuses on the need to ensure an ongoing review process for the objectives, implementation and performance of the default investment arrangement.

- a. Is the performance of the default arrangement monitored at least annually?



- b. Are the objectives and their implementation subject to full review at least once every three years?



- c. Is there a clear process in place for acting on the review recommendations?



- d. Is the review subject to audit on an independent basis?



This audit does not have to be undertaken by an external third party. However, if conducted internally, it should operate according to established principles of independence whereby there is a clear functional separation and no conflicts of interest between responsibilities for conducting the review and other responsibilities.

- e. Does the periodic review include a process to consider the impact of charges?



The three-year review should include a process to consider the impact of charges. This should consist of a process to consider the expected net-of-fees performance of the underlying investment managers and also whether the cost of implementation of the default arrangement would be considered 'value for money' if it were to be reviewed today.

5. Communication

This section strives to ensure that communication with the scheme decision-makers and the scheme members is simple and effective, covering all important aspects of the delivery.

- a. Has an effort been made to communicate the default strategy to scheme members in a clear and understandable manner?



This should use, as appropriate, a variety of mediums. It is not confined to formal scheme documentation.

- b. Are the charges and costs of the default strategy clearly disclosed to scheme decision-makers and scheme members?



All decision-makers should have access to detailed, consistent data on charges and costs. This should include transaction costs. Scheme members should also be provided with clear and consistent information.

REF: relevant charges guidance / disclosure requirements

- c. Does the communication express the scheme members' investment outcomes net of fees?
- d. Are members presented with suitable guidance and information supporting the election of an appropriate glidepath for their preferred income option?
- e. Is there a feedback process in place to ensure scheme members have a reasonable understanding of the default strategy?



6. Safeguarding of assets

This section stresses the need for decision-makers to sufficiently familiarise themselves with the safeguarding arrangements put in place for all scheme assets.

- a. Are key decision-makers familiar with the safeguarding processes for all assets within the default strategy?
- b. Are key decision-makers aware of all compensation arrangements in the event of delivery failure?
- c. Is the financial stability of key providers within the delivery chain regularly monitored?



