



## **IMA RESPONSE TO DWP COMMAND PAPER**

***"Better workplace pensions: Putting savers' interests first"***

**November 2014**

## **General comments**

1. The IMA<sup>1</sup> strongly supports the Government's work to improve the quality of workplace DC pension provision and believes enhanced governance and transparency provide the key to rebuilding confidence, in line with the conclusions of the 2013 pensions market study by the Office of Fair Trading.
2. In this respect, we support the focus on better defining quality standards for Defined Contribution (DC) schemes. We also agree that the investment and pensions industries need to work towards greater transparency and consistency in their disclosure of charge and cost information, and are working to facilitate that objective. Our view is that this objective needs to be a feature of the investment and pensions market regardless of the product type. We have already taken steps to provide additional information on transaction costs, and further work is currently taking place. It is important that trustees and other scheme decision-makers are able to access information in a manner that is supportive of their aims and objectives (including compliance with the charge cap).
3. Although we believe that high standards of scheme governance are the most effective way to drive an improvement in scheme quality, we are committed to working with Government to ensure implementation of the charge cap is effective. In this respect, there are a number of practical issues. First, it is important that compliance with the cap - limiting 'member-borne deductions' to 0.75% - does not become a proxy for good disclosure. As we have noted in other submissions, there must be clear and intuitive language to explain charges, and information about transaction costs must be available both to decision-makers and consumers. Second, while investment managers will need to work closely with schemes to ensure that all information is available to help overall compliance with the charge cap, the end-to-end 0.75% may include many other costs that do not relate to investment. Ultimately, investment managers will be accountable to schemes that use their services, and a third-party compliance regime should reflect that.

## **Answers to Selected Questions**

### ***The scope of the charges measures***

#### **Q2: Do the draft regulations (regulations 4(3) and 4(4)) meet the policy intention of excluding from the charge cap members of qualifying schemes who have the advantage of a third party promise?**

4. We do not have a specific view on the legal drafting, but we do question the effectiveness of the policy intention itself. The idea that DC arrangements with guarantees or the option of guarantees would not be subject to the charge cap implies that a guarantee at any price might be preferable to the uncertainty perceived in pure DC. This is a questionable conclusion to reach since it takes no account of the cost and value of the guarantee. Good investment options that are aimed at reducing volatility might be precluded from being offered in default arrangements due to the charge cap, but there is no judgement as to the

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<sup>1</sup> 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.

value of guarantees that might be offered in schemes that lie outside the scope of the cap. The Department should be wary of creating such an un-level playing field in the DC market because it risks favouring guaranteed products at the expense of non-guaranteed products.

5. Furthermore, an approach that favours guarantees could go against the general direction of travel on transparency in charging practices, which is at least partly about improving trust in the pensions industry. Guarantees that are opaquely priced could lead to perceptions about providers hiding charges in certain structures and this would be a backwards step in terms of transparency.

### ***Governance measures***

#### **Q6: Do the draft regulations meet our policy intention of ensuring that occupational schemes are well-governed?**

6. Our comments here focus on: (i) the measures aimed at promoting good governance in default strategies; (ii) the assessment of charges and transaction costs.

### ***Default strategy governance and the annual Chair's statement***

7. The draft regulations set out certain actions that trustees must take with respect to the design and on-going suitability and performance of the default strategy. The IMA agrees that the requirements are the right ones – we have long argued for the default investment strategy to have a clear and communicable member objective and for the suitability and performance of the default to be reviewed on a regular basis. We therefore support the requirements to ensure that the default strategy must be designed in the members' best interests; and that the suitability and performance of the default must be reviewed at least every three years or in the event of any significant changes in scheme investment policy or membership demographics.
8. The Department's approach of specifying required actions in legislation but then giving trustees discretion on precisely how to fulfil these obligations leaves open the way for different approaches to meet the legal duties. We would agree that there should not be a single, prescriptive approach to the definition of quality. However, we do believe that there could be value in developing a relatively short, actionable and consistent approach to key governance questions that brings investment quality standards for DC schemes under a single framework encompassing both trust and contract-based arrangements.
9. To that end, we have proposed a quality check provided by schemes for investment governance in relation to the default strategy. While we have focused our proposals on default DC investment arrangements, such an approach could also extend to other aspects of DC operation. 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 consistent.
10. The quality check takes the form of actionable and documented quality standards for default investment arrangements, which would offer a concise, practical way for all DC schemes to operate. This approach 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.
11. The quality check covers a number of processes that are important for ensuring the quality of DC default strategies, such as quality of member communications and the safeguarding of assets, but most relevant to the legal duties set out in the draft regulations is the focus on:
- Ensuring the definition of a communicable member objective (as distinct from the investment strategy employed to implement that objective) and the factors taken into account when defining this objective;
  - Ensuring that there is an on-going review process in place that allows scheme decision makers to monitor: (i) whether the member objective remains the right one over time; and (ii) the overall performance (including a value for money judgment) of the default strategy and its underlying funds.
12. Completion and submission of the document as part of the Chair's annual statement could form a way for trustees to discharge their legal obligations under the regulations that the Department is consulting on.
13. We recognise that there are a number of existing initiatives<sup>2</sup> that cover some of the areas set out in the quality check, however 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.
14. Further detail on the quality standards document can be found in the accompanying Annex to this response.

### ***Assessment of charges and transaction costs***

15. The IMA agrees that trustees should consider all costs and charges and we support the requirement for trustees not just to focus on the level of charges and transaction costs, but to assess the value for money received by members. Too often the debate on value for

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<sup>2</sup> These are the DWP default fund guidance, TPR DC code and the industry-led Investment Governance Group for workplace DC schemes.

money has focussed solely on cost and not value.

16. However, we would emphasise the need to assess value for money for all relevant services and not just for investment management services. Investment management is of course an important component of the total cost of the scheme, but there are other highly important services, such as administration and communication which do not appear to be subject to the same level of scrutiny. Our reading of the regulations suggests that additional focus may be needed on some of these other sources of cost – as currently written with the references to “funds” and “default arrangements”, the regulations seem exclusively focused on investment costs.
17. To be clear, we are not suggesting that there should be less scrutiny of investment costs and services – merely that all third party services in the pensions delivery chain should be subject to the same scrutiny as investment services since these are also important parts of the service that the member is paying for.
18. The focus on investment costs may be due to the fact there is a perception that they can be more easily squeezed, simply by switching to a cheaper fund or strategy on offer; whereas switching to a new and cheaper administration provider, for example, may be more onerous. This would be unfortunate since, along with the rate of contributions, it is the investment process which has the biggest impact on member outcomes.
19. With respect to costs incurred in relation to the investment and management of pension assets we would note that disclosure of investment management charges and transaction costs must be meaningful and helpful for trustees in their decision-making. Equally, trustees must be able to correctly interpret and act as appropriate on the information they receive when considering their value for money judgments.
20. The role of the investment manager will be to provide the necessary information but it must be for the trustees to interpret this information and act accordingly and we therefore support the legal obligation being placed on the trustees to obtain and interpret the necessary information. We would note that trustees may need professional advice in obtaining and interpreting this information and subsequently acting on it.
21. The IMA believes that significant improvement is needed in the consistency and transparency of charges and transaction costs across the investment and pensions landscape, and is working to facilitate that. Our work is intended to offer a way to provide trustees and other decision-makers with the information that they need to make judgments on the value for money provided by schemes.

#### On-going charges

22. The methodologies and terminology for calculating and disclosing charges in all long-term savings and investment vehicles (including pensions) need to be more consistent. Trustees should be able to communicate to members what they are paying in an accessible and consistent manner; and to be able to judge whether this represents value for money for members.
23. 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

24. 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.<sup>3</sup> 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.
25. 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.
26. 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 standardised disclosure frameworks already exist in some areas, notably the [Pension Fund Disclosure Code](#) (and its collective investment scheme counterpart), which address in particular the issue of broker payments and research procurement.
27. We have also stressed that there is more to do and have established two new workstreams, which will report shortly. 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.
28. In the UK pensions transparency debate specifically, we are exploring mechanisms to bring all of this information together to provide a holistic accountability mechanism.
29. 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.

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<sup>3</sup>The 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.

### ***Responsibility for complying with the charges measures***

#### **Q7: Do you have any comments regarding the policy on who should have the duty of compliance with the charges measures?**

30. We agree that it should be trustees/managers (trust-based schemes) and pension providers (contract-based schemes) that have the legal obligation to comply with the charges measures. They will select all the different service providers in the pensions delivery chain and will therefore be best placed to monitor and control costs in order to comply with the charges measures. Individual service providers cannot be responsible since they are only in control of the costs of the service they provide. This means that it has to be the entity running the scheme which is responsible for compliance with the charges measures.

### ***The charge cap – definition and exclusions***

#### **Q8: Do you have any comments on the policy regarding member borne deductions that fall within the cap, and how draft regulations reflect the policy intention? These exclusions are:**

**(a) the non-recurring variable transaction costs which are incurred by a scheme when buying, selling, lending and borrowing underlying investments (“transaction costs” definition in regulation 2)**

**(b) pension sharing and compliance with court orders (“charges” definition in regulation 2)**

**(c) winding up costs (“winding up costs” definition in regulation 2)**

31. The costs that fall within the cap are the right ones and we agree with all the exclusions. We have previously explained that transaction costs are necessary in order to obtain any form of investment return and that including them within the cap may limit the manager’s ability to trade, possibly resulting in detriment to the member. We therefore welcome that the regulations explicitly exclude transaction costs from the cap.

32. However, we have a concern with the proposed definition of transaction costs in regulation 2(1) as “*the costs incurred as a result of the buying, selling, lending and borrowing of investments*”. This is a very general description which leaves open to interpretation exactly what costs constitute transaction costs and we think it inevitable that further clarification will be required in order to determine what transaction costs are for the purposes of this regulation. Therefore it would be helpful if the regulations explicitly stated precisely what costs the Department regards as transaction costs.

33. In that regard, including the second table in Annex B of the DWP paper (“Excluded from the default fund charge cap on MBD”) in the regulations would be a positive step. We regard this as a good list of exclusions from the cap.

34. However, there are some further points to note in relation to this list. Although we think that taxes should be excluded from the cap, they are strictly speaking not transaction costs. More importantly, we think there is a distinct lack of clarity around item 6 in the list – “*deductions of expenses or fees from profits such that they are not shared equally with members*”. This appears to be addressing a circumstance in which profits arise by reason of

the holding or exploitation of a client's property and some of those profits are retained by the fund manager, by agreement. These include interest on bank accounts which the Financial Services and Markets Act envisages can be retained under FCA rules and which consequently provides protection from what would otherwise be a breach of fiduciary duty.

35. We have difficulty understanding how the wording that relates to them not being "shared equally with members" could be correct. It would appear that this is not a matter of equality but about equitable accounting and that it should refer to the retention of any interest or fees arising from cash belonging to members (investors) under the control of the manager and from the lending of stock. The IMA would be happy to work with the Department to provide further clarity on this point.
36. More generally, we think it important that the term 'member-borne deduction' is seen as a compliance term and not a term that is included in disclosures to members. To give a concrete example, a scheme that operates a contribution charge or administration charge in combination with an ad valorem charge on funds under management will be required to show that total member-borne deductions do not exceed the charge cap. For individual members, however, we would like to see disclosure using clear and intuitive language that embraces best existing practice: for example, as relevant for an individual scheme a 'Contribution Charge' and an 'Ongoing Charges Figure' rather than Annual Management Charge or Total Expense Ratio (TER). The OCF replaced the TER in the UCITS regime and could be adapted for the pensions environment. Whatever the terminology adopted, we strongly agree that it must be consistent and not subject to argument about what may be included or excluded.

### ***Transitional questions on the default arrangement***

**Q10: Do you agree that the draft regulations (regulation 3(3)) should allow members who have made a recent active choice to remain in an arrangement which is not subject to the charge cap? Is the 3 month time period allowed reasonable?**

37. The principle that members can actively opt to be in a strategy that costs more than is permissible under the cap is vital, otherwise investment choice for members who want it will be unfairly restricted. In that regard we consider it crucial that regulation 3(3) allows for members to remain in arrangements that may not be charge cap compliant. Without this regulation coverage of the default arrangement would be drastically expanded and investment options would be significantly restricted. The 3 month window during which members must be notified that an active choice must be made to remain in a non-cap compliant strategy seems a reasonable period of time.

### ***Assessment of charges***

**Q13: Do you have any comments on the policy described in relation to the valuation of the member's fund and the period over which the charge cap applies?**

38. The policy of measuring the member's average fund value over the year (or if less than a year the period over which they are invested) on specific reference points is sensible. From an investment perspective, given the prevalence of daily liquidity and pricing in the DC

market, there are no problems in providing fund values on the reference dates.

39. However, it would be helpful if the regulations explicitly stated that the valuation frequency should be appropriate to the fee basis. If this is not the case then it is possible that some distortions could arise. As an example, consider a fund that charges the fee monthly, but uses the average of the quarterly values of the member's pot (i.e. the legislative minimum) to calculate the value of the applicable cap. If in the final month of the year the fund value plummets this would cause an otherwise compliant scheme to breach the cap. In this example, using the monthly average of fund values based on the full twelve months would ensure that the cap would not be breached.

### ***Member agreement for services***

**Q14: Do you have any comments on the policy regarding opt-in services described above?**

**Do you have any comments on the draft regulation (regulation (8)) which reflects that policy?**

40. The policy seems reasonable. However we do have a concern about regulation 8(4), in particular the designation of 'designing and implementing an investment strategy' as a "core service". Our concern is that it is not clear what this means since it is too general. It would not be desirable (nor is it the policy intention) to catch under the cap any investment strategy that members actively select. However, as currently written the regulation seems to imply that the provision of any investment strategy is a core service and therefore must be caught by the cap. The wording on investment strategies perhaps needs to be more focused on the default strategy.

### ***Compliance notices and penalties issued to third parties***

41. We note that the draft regulations give TPR the powers to issue compliance notices and penalties to third parties in the event of any regulations being breached. We do not believe this is necessary since the contract between the trustees and the relevant third party service provider should govern what happens in the event of the third party not adhering to the agreed level of service. In particular, a well-specified contract should cover what happens in the event of the actions of the third party causing the trustees to be in breach of their legal duties under these regulations. There should be no need for TPR to intervene in this fashion.
42. In the case of asset managers, very often their fund or funds will only be component parts in a wider vehicle which would be used for automatic enrolment and often a very small component. So overall control over the design and composition of the scheme will rest with the trustees/managers (trust-based schemes) and pension providers (contract-based schemes), and would not be within the control of the underlying asset manager. In addition, very often the asset manager's fund used by the scheme for automatic enrolment will have other investors in that fund, so it would not be appropriate for TPR to be given enforcement powers which may have an impact on that fund and the other investors in that fund. For both these reasons giving TPR the power to issue compliance notices and penalties to asset management firms as third parties does not seem practical or desirable. The one area

where it might be appropriate is where information necessary to judge compliance with the charge cap is not forthcoming.

***Complying with the charge cap in the light of unexpected events***

**Q20: Do the adjustment regulations (regulation 9(2)b)) meet the policy intention of providing an adjustment mechanism for occupational schemes when, as a result of an unexpected event, they are unlikely to be able to comply with the cap?**

43. We would note our support for the policy and advise a pragmatic approach. There may be good reasons why the cap may be breached by small amounts and regulatory flexibility is welcome in such instances. A short period during which the cap is breached by a small amount does not automatically result in member detriment.

## 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.<sup>4</sup>

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."<sup>5</sup> Furthermore we believe it could be used by trustees as a way of discharging their legal obligations under the Department's proposed amendments to the Occupational Pension Schemes (Scheme Administration) Regulations (1996) which require trustees to provide an annual statement regarding governance.

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.

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<sup>4</sup>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.

<sup>5</sup>Office of Fair Trading, *Defined contribution workplace pension market study* (2013), p.24.

The *Freedom and Choice* proposals outlined by HM Treasury in support of the Budget 2014 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 which could be part of the newly-required annual statement regarding governance.

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-based<sup>6</sup>. 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

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<sup>6</sup> Office of Fair Trading, Defined contribution workplace pension market study (2013), p.45.

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 – 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 used by trustees to meet their legal obligations under the Department's proposed regulations on minimum governance standards. 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,<sup>7</sup> 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.<sup>8</sup>

*"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,

<sup>7</sup> Principally, these are the DWP's default guidance, TPR DC code of practice and regulatory guidance and the IGG DC (best practice) principles.

<sup>8</sup>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.

as we outline below.

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

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**Name of sponsor:**

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**Date of completion:**

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

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**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 FCA-regulated entity the scheme member contracts with.

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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

## 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.*

- a. The responsibilities and accountability for the development, implementation and review of the default strategy should be 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.
- b. The document should 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. The default investment arrangement must have a stated and communicable member-centric objective. This can be described as follows:  
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. The objective has taken account of the likely characteristics of the scheme members in one or more of the following ways:  
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.

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.

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## 4. Review

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*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?

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

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- 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.

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

The annual 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.

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## 5. Communication

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*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.

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

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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?

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## 6. Safeguarding of assets

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*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?

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