Pension Scheme Governance - fit for the 21st century

A Discussion Paper from the NAPF

July 2005

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Introduction

Governance – the manner or function of governing – is an issue of our times. As organisations and the environment in which they operate become more complex, and as legitimate interests in those organisations become more diversified, how those organisations are governed becomes a more critical issue. From the largest plcs to public sector organisations and the voluntary sector, the pursuit of good governance is a concern to all.

Funded pension schemes – with assets in excess of £700 billion, and whose activities touch the lives of over 20 million people in the UK – cannot, and should not be immune from the pressure to be well governed. They are significant institutions, both in terms of size and the importance of the role that they play.

It was within this context that the NAPF embarked on a review of the governance arrangements of pension schemes. We wanted to know whether the current system of pension scheme governance is delivering for both scheme members and scheme sponsors – a matter of growing importance as the pensions environment becomes increasingly contract-based. If not, where are the gaps? And how could it be improved?

By publishing this Discussion Paper the NAPF wishes to promote a debate on the important issue of pension scheme governance. The composition, style, competence and effectiveness of a pension scheme's governing body can make all the difference to the quality of decisions taken on investment, funding and administration and the extent to which members' interests can be effectively promoted and enhanced. And ultimately it will affect the security – and adequacy – of the pensions received by millions of the UK's workers.

We are seeking the views of stakeholders – Government, the pensions and investment industry, the consumers, employees and employer representatives and pensioner organisations – to start a national debate on pension scheme governance to raise standards and develop a system of governing all workplace pension schemes that is fit for the 21st Century.

We would like to hear your views. Please write to us giving your views on the issues and questions raised in this Discussion Paper by **Monday 3 October 2005** to:

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Executive summary

- Governance is a key issue of our times. As the bar has risen on standards of governance within companies, the NAPF believes that pension schemes – on which millions of working people depend – should also apply high governance standards.
- The traditional trust-based model of pension scheme governance has generally worked well. But in today's changing pensions environment, new ideas are needed. But important issues must first be tacked.
- **The DC governance vacuum** Contract-based, defined contribution, workplace schemes have grown in number over the last five years and are likely to continue to do so. But there is no effective mechanism to promote or represent the collective interests of the millions of workers in these schemes after the point of sale, effectively creating a "governance vacuum". The Discussion Paper suggests three possible governance models currently in use by contract-based schemes (a trust board, a Pensions Management Committee, and a Pensions Committee) that could be used to represent and promote the collective interests of scheme members.
- **The question of scale** The burden of trusteeship is increasing. From improved scheme administration standards, the requirement to be active investors, through to new trustee knowledge and understanding requirement the demands on trustees are growing rapidly. And the very large numbers of small occupational pension schemes (80% of which have fewer than 12 members) cannot effectively deal with the challenges of responsible trusteeship today. Ways should be sought to bring these small schemes together under a multi-employer scheme arrangement with an overarching governance structure that could benefit from economies of scale.
- **Trustee board effectiveness** For the system of governance to work well for today's pensions environment, there is a need for effective governance standards to apply to trustees (or other governing body). Trusteeship today requires significant expertise, yet many have identified trustees as being the weak link in the value chain. But if standards of competence around trustee tables are to rise more quickly, then recruitment, selection and reward issues all need to be addressed.
- Trustee board effectiveness could be dealt with through the adoption of a voluntary **Governance Code** for trustees and quasi trustee bodies which ensures that they have a clear idea of what constitutes good governance, can comply with these standards and report to members that good governance is being applied. Such a Code, which would be applicable to all types of pension scheme and which would operate on a 'comply or explain' basis, would be concerned with the way in which schemes govern themselves in the functioning of their duties to manage the scheme in the interests of the members and beneficiaries. A draft Code is appended to the Discussion Paper and covers: the obligations of the governing body; board structures, appointments and removals; collective skills and competence; risk management; managing conflicts of interest; internal controls; and the scheme's dialogue with the sponsoring employer.
- This Discussion Paper seeks the views of stakeholders on 22 questions on all aspects of pension scheme governance with a view to ensuring that all schemes – whether defined benefit or defined contribution, trust-based or contract-based – enjoy good governance arrangements that can effectively protect the interests of working people. This will be an important step in helping to restore workers' confidence in saving for retirement.

Governance – an issue of our time

In the last 10 years the UK has seen increased focus on governance arrangements across the whole economy. Sophisticated codes of governance for private companies (corporate governance) have been encouraged[1] and developed to provide a self regulatory framework for the structure, behaviour and processes adopted by plc boards, in order to promote and protect the interests of the owners of companies, the shareholders. It is widely acknowledged that well governed companies are more effective, better able to manage risk, and better at ensuring that potential conflicts of interests between owners and managers are managed and minimised. Well governed companies generally have access to broader based, cheaper capital. There is also evidence to show that good governance tends to lead to enhanced long term shareholder value.

Governance is also an important issue in the public sector. The Nolan Commission in 1995[2] made important recommendations on Standards in Public Life. The Better Regulation Task Force[3] now provides guidance for public bodies on their governance arrangements, including splitting the roles of Chair and Chief Executive and appointing a Board comprising executive and non-executive directors. Different parts of the public sector have evolved their own distinctive governance approaches. In the health sector, for example, clinical governance has become the key means by which health professionals seek to 'assure the sacred duty of trust' to patients. Good governance is now promoted by the OECD[4], who claim that "good, effective public governance helps to strengthen democracy and human rights, promote economic prosperity and social cohesion, reduce poverty, enhance environmental protection, and deepen confidence in government and public administration".

The voluntary and charitable sector are also now working to improve its governance arrangements in an effort to make more effective use of resources available and ensure proper standards are maintained[5].

Despite the recent high profile of pensions issues in government and the media, there has been little discussion of the nature and suitability of pension scheme governance for tomorrow's pensioners. Governance issues did not feature, even in passing, in the first report of the Pensions Commission last October[6]. Whilst in his 2001 review[7], Paul Myners drew attention to the importance of scheme governance in relation to investment issues, there has been little thinking about the governance of trust boards themselves. Instead recent regulatory initiatives have focussed on the composition of scheme governing boards in so far as they represent members, rather than looking more fundamentally at governance as a whole and its suitability to the new pensions environment in which employers, employees and providers are operating.

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1 Combined Code on Corporate Governance, May 2003

2 Nolan Committee on Standards in Public Life, May 1995

3 Independent Regulators Report by the Better Regulation Task Force, Cabinet office, October 2003.

4 OECD Principles of Corporate Governance, OECD, 2004.

5 see for example A Guide to Conflicts of Interest for Charity Trustees at www.charity-commission.gov.uk

6 Pensions: Challenges and Choices - the first report of the Pensions Commission, October 2004.

7 Institutional Investment in the UK - a review, HM Treasury, 2001

Yet pension schemes in the UK are significant institutions. 112 pension funds have assets in excess of £1bn. Table 1 shows the distribution of pension funds by assets and members and compares them with the distribution of listed companies.

Table 1: distribution of schemes by market value

Fund size/ company size (by market value) (£m)	Number of schemes	Total numbers of members (millions)	Numbers of companies[8]
> 1000	112	13	169
500-999	83	2.05	88
100-499	1015	1	253
<100	563	1.2	60

The largest scheme, with assets of £22 billion, is equivalent in financial size to the 13th largest company in the FTSE 100. Even middle size schemes are, on average, responsible for around £250m of assets and provide benefits for 800 people[9].

So, put simply, governance of pension schemes – by which we mean collective, workplace-based schemes whether defined benefit or defined contribution, occupational or contract-based – is just too important to ignore. As the bar has risen on standards of governance within companies, so too should the governance bar be raised for pension scheme governance.

8 Gross market cap per FTSE all share, ex investment companies

9 Data from NAPF Yearbook 2005. FTSE 100 data taken from Observer 19 June 2005. Schemes are BT Pension Fund and Arnotts Staff Pension Fund. Listed company is British American Tobacco.

Governance today

The principle method for governing occupational pension schemes is trust law as amended by statute; trust law itself has been in continuous development for over 500 years.

The principle is, in essence, a simple one: to enable assets to be managed by the trustees for the benefit of others and to segregate the scheme's assets from those of the employer so that they are protected from the employer's creditors. The trustees own and manage the fund for the benefit of others and have an obligation to act honestly and prudently and in the best interests of the beneficiaries (which could include the employer). Trustees' fiduciary and other duties include[10]:

- a duty to act in good faith and loyalty to the trust beneficiaries, which must not be subordinated to the trustees' own interests or those of third parties;
- a duty not to profit from their position;
- a duty to preserve the trust assets and to deal with them in what they honestly conceive to be the best interests of the beneficiaries;
- a duty to act impartially, fairly balancing the interests of different classes of beneficiary.

These essential requirements on pension trustees have been developed through case law and statute. In addition to the Trustee Act 1925 and the Trustee Investment Act 1961, the Pensions Acts of 1995 and 2004 have further codified and added to the considerable responsibilities and duties of a pension fund trustee.

Table 2: strengths and weaknesses of trust law

Strengths	Weaknesses
Flexibility and adaptability.	Complexity and uncertainty.
Separation of assets from sponsoring employer and creditors.	Fixed (and high) regulatory costs – problematic for small schemes.
Provides a mechanism for discretionary decisions.	Successive governments have layered additional regulatory burdens on trustees.
Separation of beneficial and nominal ownership.	Potential conflicts of interest.
Trustees can use their bargaining power in market to purchase expertise.	Absence of proper balance of power between parties and absence of any mechanism to ensure the trustees act at arm's length.
Permits the appointment of a diverse decision-making group.	Poor governance standards.
The law and the courts ensure that the trustees should take account of the interests of the beneficiaries and the scheme sponsor.	Members' ability to enforce their rights has been limited until the creation of the Pensions Ombusdman. But if the dispute is not about the members' right to benefit their ability to complain is limited.

10 Pensions law Reform - the report of the Pension law Review Committee, 1993, CM23242.

In 1993 the Pensions Law Review Committee (PLRC)[11], headed by Professor Goode, which was charged with reviewing the framework of law and regulation within which occupational pension schemes operate, considered whether the trust model was adequate and the right model of governance going forward. Whilst proposing some improvements to pension scheme governance (including automatic disqualification for trustees who are bankrupt and the appointment of at least one-third of member-nominated trustees) they concluded it was the correct legal framework for UK pension schemes saying: “Trust law in itself is broadly satisfactory and should continue to provide the foundation for interests, rights and duties arising in relation to pension schemes”.

But twelve years on, the pensions world looks very different to that which Professor Goode and his colleagues considered. Two-thirds of DB schemes are closed to new members[12] and there has been a shift in provision to DC schemes, and contract-based DC schemes at that. So whilst for those plans that still operate as occupational pension schemes (whether still open to new members or closed to new members and running off their legacy), the trustee model will still have some relevance, for increasing numbers of plans it will not.

New ways must be found to address the deficiencies in today’s governance arrangements to ensure that all schemes – and all scheme members – can benefit from high standards of pension scheme governance. The remainder of this paper sets out some of the issues and sketches out possible solutions for consultation and discussion.

11 ibid

12 ACA Pension Trends Survey 2005

Governance fit for purpose

We have identified three key issues which we believe need wider debate in considering how we develop a governance system for pension schemes of all types that is fit for purpose and fit for a 21st Century pensions environment:

1. **The governance vacuum** - contract-based, defined contribution workplace schemes have grown in number over the last five years and are likely to continue to do so. But there is no effective mechanism to promote or represent the collective interests of scheme members.
2. **The question of scale** – the long tail of very small pension schemes cannot effectively manage the costs and administrative burden required of trustees today, still less apply high standards of scheme governance.
3. **Trustee board effectiveness** – there is further scope improve the effectiveness of scheme governing bodies, whether they be trustee boards or management committees.

All are potentially important weaknesses in the current system of workplace pension scheme governance and, in our view, need to be addressed.

This section examines each of these issues in greater depth and suggests some alternatives aimed at modernising today's pension scheme governance model to ensure it is fit for the 21st Century.

Issue 1: The governance vacuum in contract-based DC workplace schemes

Contract-based defined contribution schemes are becoming increasingly common, both in the small and medium sized-enterprises (SME) sector and in larger organisations where traditional trust-based defined benefit (DB) schemes are being closed and replaced by group personal pensions (GPPs) or stakeholder pensions. Since 2001, 350,000 workplace stakeholder pension schemes have been designated by employers and around 1.5 million people have joined stakeholder schemes. Over the same period, GPPs have also grown rapidly – now covering 8% of working people. In some cases the GPP or stakeholder scheme will have been set up as first scheme the employer has designated, the result of the employer needing to meet the legal requirement for employers with 5 or more employees to offer access to some form of pension. But in others it is a reflection of the fact that employers are abandoning final salary occupational pension schemes in favour of cheaper, less risky, more lightly regulated contract-based products. The Government Actuary's Department[13] found that 36% of defined benefit schemes had closed to new entrants since 2000, and almost all had provided an alternative, often a defined contribution scheme.

Whilst many of the people who are now members of GPPs and stakeholder pensions may not have been previously saving for retirement, the overall effect has been to increase the

13 Occupational pension schemes 2004, Twelfth Survey by the Government Actuary, June 2005 numbers in pension schemes not covered by any kind of collective governance arrangement to oversee the management of their retirement savings. And this trend will increase with the continuing shift from DB to contract-based DC.

In such arrangements, individual employees have the illusion of being part of a collective scheme sponsored by their employer (who deducts money from their pay, to go into the scheme). But, in fact, their pension 'scheme' is nothing more than a personal pension, an individual contract between them and their insurance company or life office. Whilst the employer might negotiate the terms collectively (and in so doing achieve better terms – including the annual management fee and range of investment options available to members) in regulatory terms, the schemes are individual. Whilst stakeholder pension schemes *can* be established under trust – and indeed it was the Government's initial intention that this should be the *only* governance arrangement for stakeholder pension schemes – few in practice are. There are 46 stakeholder pension schemes registered with the Pensions Regulator: only four have been established on a trust basis[14]. For the vast majority, then, there is in effect no mechanism to promote and represent the collective interests of 'scheme members' or employees who are part of that particular stakeholder or GPP contractual arrangement. Whilst the pension provider (the stakeholder manager) must be authorised by the FSA, each individual is on their own – there is no accountability between them and their scheme provider. We believe this represents a 'governance vacuum'.

Were there to be a governance mechanism for members of GPPs and contract-based workplace stakeholder schemes then it would be possible to represent and promote the collective interests of members in the following ways:

- negotiating with providers in order to make available good value products;
- ensuring the best provider was available – the managing authority would be able to contract with a provider (ie an insurance company) for a limited period which, subject to review, could be changed just as trust-based schemes are currently able to change third party administrators or investment mandates;
- monitoring performance and overseeing the quality of the product(s) on behalf of members;
- providing information, generic advice and guidance to members to actively help them select appropriate products in which to invest;
- helping members with their choice of annuity from an appropriate range of products, when the time came to converting the pension 'pot' into an annuity; and
- ensuring effective and efficient administration of benefits throughout the process.

Governance arrangements and structures for contract-based defined contribution could take a range of forms which might be viewed along a spectrum ranging from no or low governance at one end to high governance structures at the other:

14 The four are: TUC Stakeholder Pension Scheme; MW Stakeholder Pension Scheme; Teams Stakeholder Pension Scheme; and FPS Stakeholder Pension Scheme

Trusteeship for contract-based schemes

At the high end, contract-based schemes could be required to have trust boards. As noted above, a number of stakeholder schemes are already established under trust. This concept could be extended to more schemes. Consideration could also be given to resurrecting the governance model originally proposed for stakeholder pension schemes and require stakeholder pension schemes to be established under trust. In this way, stakeholder pension schemes would operate in a similar way to Australian 'Super' schemes.

Example 1 – TUC Stakeholder Pension Scheme

The TUC Stakeholder Pension Scheme is established under trust, run by a board of corporate trustees (TUC Stakeholder Trustees Ltd) whose members are principally appointed by participating trade unions. The scheme has a master trust board, with a trust deed and rules, and is responsible for appointing the main scheme administrator, and external fund managers, range of fund choices and the scheme's pricing policy. The trustees appoint the main administrator via a contract and the fund manager(s) via side letters. The trust board is responsible for signing off the scheme's report and accounts and ensuring compliance with the Pensions Act and other regulatory requirements. As such, TUC Stakeholder Trustees 'own' the scheme and are able to change scheme provider, add (or delete) external fund managers or investment options and control the communications to scheme members. The Trustees are the point of contact for scheme members with a complaint about the scheme.

Pensions Management Committee

At the next level, there is no reason in law why the sponsoring employer could not set up a Pensions Management Committee for contract-based DC workplace pension arrangements. This could work in a way similar to the trust board outlined above, but without the need for full scheme trust-deed and rules, or exposing the management committee to the sanction of the Pensions Regulator. It could work in the following way:

- The employer would establish a GPP or stakeholder pension scheme into which contributions would be paid directly and invested in accordance with the scheme members' wishes. The employer would appoint a management committee (which could comprise scheme members, employer nominees, independents or other suitably qualified persons) which would be able to monitor the performance of the provider in terms of investment returns, costs and charges as well as administration standards. Ultimately it would have the right to replace the pension provider with another pension provider whenever it deemed fit. The change of the provider would not be challengeable by employees.

Some schemes, eg the industry wide Printing Industry Pension Scheme (PIPS) go some way towards providing these sorts of governance arrangements already.

Example 2 – Printing Industry Pension Scheme

The Printing Industry Pension Scheme (PIPS) was established in 1986 by the employer federation (the British Printing Industries Federation, BPIF) and the trade union (now Amicus) for companies without occupational pension arrangement. It currently operates on a stakeholder/ GPP basis and has assets in excess of £20m. There is a Management Committee which comprises 50% employer representatives and 50% union representatives, in both cases elected from the BPIF's and Amicus' governing bodies. The Management Committee has an independent secretary and chair which changes every two years. It is independent of both the Amicus and BPIF and retains executive control of the scheme. The Management Committee meets with the advisers to ensure the scheme is run in the interests of the scheme members.

Pensions Committee

A further alternative would be to establish a Pensions Committee that oversees the contract-scheme manager, reviews from time-to-time the continuance of the contract, and meets to consider any other scheme-related issues that arise. Such an arrangement would have the benefit of not being over-legalistic, yet would ensure that there were proper checks and balances in place to ensure that the scheme was well run and operated in accordance with the rules and in the interests of scheme members. In other words, it could be a lighter touch version of the Pensions Management Committee described above.

Example 3 – Coal Pensions Trustee Services Stakeholder Plan

A small Pensions Committee has been established to oversee the running of this 30 person scheme. The Committee meets on an event-driven basis and in any event every two years to consider a report from their advisers on investment performance of the active management options. An executive acting for the Committee regularly checks the timeliness of contribution allocation by the pension provider. Committee members also assist in communicating about the plan, although not on individual benefit issues.

Question 1: What other governance models exist? Are there other examples of collective governance models for contract-based DC schemes? What are the pros and cons, and likely cost implications, of the three options described above?

Question 2: Should there be a single governance model or a selection to suit differing organisations. If a selection, should there be certain minimum standards and, if so, what should these be?

Question 3: What other benefits are there of this (or other such models) to the employees?

Question 4: Would such an arrangement add significantly to the costs of running contract-based arrangements. How would these balance against benefits of improved governance arrangements?

We recognise that, were the employer to do this, they would implicitly be agreeing to take on some of the responsibility and reputational risk involved in providing collective forms of retirement provision for their workforce (for example, they would be taking on more responsibility for the choice of the provider and for monitoring that provider). Yet one of the reasons why we have seen the recent shift from trust to contract-based forms of workplace scheme is exactly because employers have wished to transfer its pensions risk (primarily the financial risk) elsewhere: in this case to insurers, and to their own employees. So, extending governance arrangements to contract-based DC schemes would require employers to take on more risk in respect of those schemes. Having said that, in any case, employers offering contract-based DC schemes cannot entirely live in a risk-free zone. They have a common law duty of care to their employees and so once the scheme has been established will need to have some regard to its operation and performance.

It is for government to determine whether there is a public interest in seeking to spread the risk of providing pensions such that employers bear a share, and whether it is desirable to provide efficient collective forms of pension provision that can be more economic and effective in helping people save than individual contracts. But if government decides that collective workplace schemes should play an important role in any future pensions system, they must set a policy framework that incentivises employers to share some of the risk involved, and encourages effective governance of DC contract-based workplace schemes.

Question 5: What other risks would the employer be taking on? How could these be managed or mitigated?

Question 6: Would these risks outweigh the benefits gained by extending good governance to contract-based DC pension schemes.

Issue 2: The question of scale

It is estimated that some 450,000 "live" workplace pension schemes exist in the UK[15]. Approximately 94,535 are trust-based occupational schemes (9,834 final salary; 72,697 defined contribution; and 3,097 hybrid – figures exclude the public sector schemes established under statute). 350,000 are workplace stakeholder schemes. Around 12% of employers offer GPPs[16].

But, as table 3 shows, the global figures mask a long tail of very small schemes which still exist and which are still accepting new members: over 80% of 'live' schemes have fewer than 11 members, and 60% have 2-3 members.

15 Figures compiled from Opra Annual Report 2004; ABI Annual Report and stakeholder pension reports; and DWP Employers' Pension Provision Survey 2003

16 Employers' Pension Provision Survey 2003, DWP

Table 3: occupational pension scheme by size[17]

Band – member numbers	Percentage of schemes
2-11	81.0
12-99	11.3
100-999	6.1
1000+	1.6

We consider that these very small trust-based schemes are probably too small to be viable and efficient under today's conditions. These schemes were set up at a time when regulation was minimal, the fiscal climate and commission structures positively encouraged the establishment of very small (even for just 2 or 3 people) pension arrangements under trust. Those days are long gone.

Larger schemes can achieve higher standards of control framework, procedures, secretariat, advice, administration, accounts, reporting, probity, and governance. They have more investment flexibility and they can achieve economies of scale in investment and other fees, custody, secretariat, advice, administration and accounting. These benefits are simply not available to small schemes.

It is no longer efficient for a very small scheme – especially one set up on a defined benefit basis – to carry the regulatory overhead needed to meet the standards of governance required. In order to comply with the law today they need to:

- provide annual reports and audited accounts;
- arrange for high quality legal, actuarial services, administration and investment management services;
- prepare of a statement of investment principles; statement of funding policy; and schedule of contributions or payment schedule;
- meet disclosure of information requirements;
- comply with the Myners' principles;
- report to the Pensions Regulator; and
- meet the Pensions Act 2004 requirement on trustee knowledge and understanding – which requires each trustee to be knowledgeable and conversant with 81 items in 13 modules of learning.

Unless ways can be found to bring smaller schemes together to help them meet the costs of today's governance requirements and the costs entailed, then maintaining such schemes under the current regulatory framework is inefficient and a drag on the overall pension system. If the public policy objective is to enable and promote a healthy collective funded pensions sector, then means need to be found to consolidate these smaller schemes into fewer, larger entities that can afford to govern themselves to the required standard and which deliver economies of scale.

We believe there is considerable scope to bring these smaller schemes together under a multi-employer scheme arrangement with an overarching governance structure which would enable the costs of governance to be shared. At the DWP's request, the NAPF has been preparing some possible models for trust-based multi-employer schemes (MESs) on a

17 Opra Annual Report 2003/4

defined benefit, defined contribution and hybrid basis. One such governance model that could be adapted for MESs would be that which currently exists for the former nationalised industries, where:

- there is a co-ordinating company which comprises the employers and acts as the principal employer – all participating employers become members and the appointment of directors of the governing trust company is by election amongst members.
- Scheme members are elected via trade unions (in the case of the former nationalised industries) but could this be by direct election in the case of other MESs.

Alternatively, the examples described in the previous section could be readily adapted to a MES.

Question 7: How can small schemes be helped to federate on a multi-employer basis, eg on a sectoral, regional or other affinity basis?

Question 8: What could the governance arrangements in such schemes look like?

Question 9: What kinds of cost savings on scheme governance matters could be generated if small schemes were able to pass responsibility for governance to a multi-employer scheme?

Question 10: What changes would be needed to existing legislation and incentives?

Issue 3: Trustee board effectiveness

Our examination of the trustee model suggests that, as a legal form, there is nothing wrong with a trust-based system per se. For the system to work well, however, there is an increasing need for effective governance standards to apply to the trustee board itself. In private company boards there has been a need to codify and scrutinise the way in which risks and conflicts of interest are managed around the boardroom table and to strengthen the range of talent and expertise available, such that the board can do its job properly. And it is generally acknowledged that this has worked well. Similar considerations should now apply to the governance and oversight of pension schemes.

Defined benefit trustee boards have full responsibility for pension fund investment decisions, and lead responsibility (they must seek and secure the employer's agreement, or refer to the Regulator) for scheme funding. These are important tasks, requiring significant expertise in relatively specialised areas which include pension law, risk assessment and management, funding (including corporate finance), and investment. There are, of course, other responsibilities and MNTs generally start with a good understanding of what is needed in benefit delivery and the need to maintain reputation.

As schemes have matured, and as the funding climate has become more difficult, so trustee boards need to demonstrate their competence and effectiveness across all these crucial areas, which to a degree dwarf what was seen as their main function in the past – the proper safeguarding of assets, segregated from the employer, and the sound administration of scheme.

To date, trustees have generally been lay people. This has led to suggestions that they are a "mass of well-intentioned but not necessarily expert folk", to quote John Plender[18]. According to him, they have represented "a residual enclave of amateurism in British business life". And others have said that trustees are the weak link in the value chain – so the pressure is on trustees to 'raise their game' just at the time when their job is becoming more pressured due to the new requirements of the 2004 Pensions Act, a more pro-active Pensions Regulator, and more stringent scheme funding requirements. The new requirements on trustees to demonstrate knowledge and understanding in key areas of expertise should help to develop a greater degree of professionalism, but this will take time to work its way through the system.

But if standards of competence around trustee tables are to rise more quickly then recruitment, selection and reward issues need to be addressed. At present there is little by way of guidance on who should become a trustee (or, more importantly, Chair a trustee board); the sorts of competencies and expertise needed; and the overall range of skills that might be needed round the trustee board table. Yet the trustee board must demonstrate it has the requisite skill and expertise to either take the necessary decisions itself or to oversee decisions delegated to others.

Instead, the focus has been on the representative nature of trust boards, and ensuring that boards comprise both scheme member nominees as well as employer nominees. And, as the Government prepares to consult on the move to requiring trust boards to comprise 50% member-nominated trustees, this focus continues.

This suggests a need for a proper nomination process for filling trustee vacancies, as happens with Non-Executive Directors (NEDs) on company boards or other governing bodies, ie one that borrows from the Combined Code and identifies skills gaps. Once such posts have been filled, it could well be that those who have the requisite expertise and skill expect to be properly remunerated for their work.

Greater consideration may also need to be given to the potential benefit independent trustees – and in particular independent chairs of trustee boards – could bring to the governance process. Just as the Combined Code recognises the importance of having an independent NED on the board of listed companies to ensure the right checks and balances are in place, an independent trustee or equivalent for quasi trust boards could play a similarly valuable function. An independent would be able to ensure trustees decisions were not coloured by a conflict of interest and that decisions were taken in the best interests of the scheme members. Such a trustee might also be best placed to make an independent evaluation of the collective and individual skills of the lay trustees or their equivalents and be able to assess skills gaps. An independent chair would be able to avoid any deadlock arising on the trust board. An independent trustee would not necessarily have to be a professional trustee.

One way of addressing the skills gap would be to move from the current unitary governance model to a system whereby key decisions on specialist issues, particularly funding and investment, are delegated to either professional staff or to expert external agents – in other words moving towards a two-tier structure. The risk with such a model would be that there

18 A big shake-up pension trustees, John Plender, Financial Times, 16 January 2005 still may not be sufficient expertise at trustee level to effectively hold those decision takers to account.

Question 11: What is an appropriate nomination process for filling trustee vacancies? Is the current representative model appropriate?

Question 12: Should trustees be remunerated?

Question 13: Are there benefits in moving away from a unitary board to a two-tier board?

Question 14: What are the key qualities for a Chairman of Trustees (and trustees themselves) and what guidance should be given on who should become a trustee and chair of trustees?

Governance for pension schemes – leading the way to high standards

In his speech to the 2005 NAPF Annual Conference[19], Paul Myners said he did not see the need for a Combined Code for investors. We agree. But we do believe there is scope for a Governance Code for trustees and quasi trustee bodies which ensure they have a clear idea of what constitutes good governance, can comply with those standards and report to scheme members that good governance is being applied. The result, we believe, would be to strengthen workplace pension schemes and further increase workers' confidence in pensions as a good place through which to save for old age.

Such a Code would be concerned with the way in which trustees should govern *themselves* in the functioning of their fiduciary duty to manage the pension scheme in the interests of the scheme members and beneficiaries (and as such it would not be purely concerned with the trustees' role as institutional investors). It would not just be concerned with getting the processes right – important though that is – but would also be concerned with getting the relationships (between trustees/scheme governors, their agents, and the sponsoring company) right[20]. As such, it would be comparable to the Combined Code for listed companies[21], and would be broad enough to cover trust-based and contract-based arrangements, multi-employer and other federated arrangements, and the Local Government Pension Scheme – hence we are not proposing developing a Code just for *trustees*, but rather a broader Code for pension scheme *governance*. For this reason we use the term "trustees" to describe those who are made responsible for the governance of trust-based schemes and "governors" to describe those who would be made responsible for the governance of contract-based schemes (ie stakeholder and GPPs). When talking about the roles of trustees and governors collectively, we use the term "board".

There are a number of UK and international examples – some directly related to pensions, others less so – which could be drawn upon as the basis for a governance code for trustees and quasi trustees in the UK[22]. At a high level, the OECD's *Guidelines for Pension Fund Governance*[23] provides a useful checklist of the indicators of good scheme governance. These may be broadly summarised as follows:

- All schemes should have some form of governing body with clearly defined responsibilities.
- The governing body is accountable to scheme members/beneficiaries (which may include the sponsoring employer).
- The governing body should take expert advice if it:

19 13 May 2005. Available at www.napf.co.uk

20 "Effective boards depend on the best people and on their behaviours and relationships" Derek Higgs, January 2003. press release accompanying the publication of the Higgs Review into Non-Executive Directors

21 Combined Code for Listed Companies, July 2003, available at www.fsa.gov.uk

22 See for example: Guidelines for Pension Fund Governance, OECD Secretariat, July 2002; Higgs Report on the role of Non-Executive Directors; Code of Proper Practice for Directors in New Zealand, 1999, available at www.iod.org.nz; Pension Fund Governance Code Dutch Association of Industry-wide Pension Funds (VB)

23 Guidelines for Pension Fund Governance, OECD Secretariat, April 2002 and OECD Guidelines for Pension Fund Governance, Recommendation of the Council, April 2005

  - does not itself have necessary skills; or
  - there is a conflict of interest.
- The governing body should be subject to minimum suitability standards to ensure a high level of integrity and professionalism in the running of the scheme.
- The governing body should establish appropriate internal controls.
- The governing body should appointment an auditor and/or actuary who are empowered to whistleblow to the appropriate authorities (and scheme members) where things go wrong.
- The governing body should ensure that redress is available for scheme members

Using these and other good governance principles, a draft Code is set out at **Annex 1.**

As the pre-amble to the Code makes clear, the application of this Code would need to take account of the fact that individual scheme's trust deed and rules may already refer to a number of the issues referred to in the Code, notably the appointment of trustees and the structure of the trust board (and in some cases, these will be set down in statute). So in considering the application of the Code to trustees/governors, it will be important to have regard to the fact that the trust deed and rules (or their equivalent) may override the Code.

We propose the Code should operate on a voluntary basis, ie in the same way as adherence to the Combined Code for listed companies. As the Combined Code notes, this approach offers flexibility and is welcomed by company boards and investors. Furthermore, as many commentators have acknowledged, the voluntary approach has led to improvements in pension funds' engagement with investee companies and, in turn, has led to higher standards of corporate governance in the UK. We consider the same would be true of the views of trustees and governors of pension schemes, as well as sponsoring employers. Just as with governance issues for listed companies and institutional investors, we do not wish to develop a "tick box" approach to applying high standards of governance by pension scheme trustees/ governors.

Consequently adoption of the Code would be on a 'comply or explain' basis, disclosed annually basis to members (eg in scheme reports or accounts) or to the Pensions Regulator (TPR). So schemes would be required to prepare each year[24]:

- a statement of how it has applied the Code, providing explanation which enables its scheme members to evaluate how the principles have been applied; and
- a statement as to whether or not it has complied throughout the scheme year with the Code. A scheme that has not complied with the Code provisions or (in the case of provisions whose requirements are of an on-going nature) complied for only part of the scheme year must specify the Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance.

It would need to be recognised that departure from the Code may be justified in particular circumstances. So where a board does not comply, it should not automatically be considered a breach of the Code.

24 Adapted from paragraph 12.43A of the LSE Listing Rules

The Code should not be seen as another layer of regulatory burden on trustees and other pension scheme governing bodies. Rather the Code would provide the scope to cut back on much of the legislative and regulatory requirements currently placed on trustees. We believe this is a better way than highly prescriptive "boiler plate" requirements such as those that are imposed by the Pension Regulator's Code of Practice on Trustee Knowledge and Understanding. Indeed, the regulatory dividend for pension schemes from a Code of the type set out in Annex A could be considerable, enabling sections of the Pensions Acts 1995 and 2004 as well as certain of the Pensions Regulator's Codes of Practice to be mothballed in favour of a flexible yet stretching Code.

Question 15: Do you agree there is scope for a Governance Code for trustees and others? What would be the benefits of a Code?

Question 16: If not, why not?

Question 17: If yes, what should it cover? Are the OECD principles adequate as a basis for pension scheme governance in the UK? If not, what other factors should be included (or omitted)?

Question 18: Should a Code operate on a voluntary 'comply or explain' basis?

Question 19: If a voluntary Code was introduced, what would the trade-offs be for schemes that adopted the Code? For example, would it be possible (or desirable) to ease some of the Trustee Knowledge and Understanding (TKU) requirements?

Question 20: Are the issues covered in the draft Code at Annex 1 the right ones? If not, what else should be included or omitted? How would the draft Code at Annex 1 interface with current legal requirements on trustees/ scheme managers or administrators?

Question 21: Would a governance Code, such as that set out at Annex1, impose significant cost and administration burdens on schemes? If so, can you provide an estimate of the additional costs it would place on your scheme.

Question 22: Are there any other general points you would like to raise on:

- ***the issues raised in this report; or***
- ***pension scheme governance for today's pensions environment***

that are not covered elsewhere in this Discussion Paper?

Next steps

We are seeking the views of stakeholders – Government, the pensions and investment industry, consumer, employer and employee representatives, pensioner organisations as well as pension scheme trustees and members themselves – to the issues raised in this Discussion Paper.

Following receipt of comments from stakeholders in October, we will analyse the views expressed. These will form the basis of further discussion at a seminar later this year. We then plan to work with stakeholders to further develop the Code of Governance for Pension Scheme Trust Boards and Management Committees for publication in Spring 2006.

Annex 1: Draft Code of Governance for Pension Scheme Trust Boards and Management Committees

Draft Code of Governance for Pension Scheme Trust Boards and Management Committees

Pre-amble

Coverage

It is intended that the Code should be capable of being widely applied to a variety of different types of pension schemes. So it is not just intended for trust-based defined benefit occupational pension schemes. It is capable of being applied to contract-based schemes, councils managing local government pension schemes, and multi-employer and other federated types of arrangements.

Descriptions

The term “trustees” is used to describe those managing trust-based schemes, and “governors” to describe those belonging to a management committee or other governing body of a contract-based scheme. When referring to the role of trustees and governors collectively, the term “board” is used.

Smaller funds

It is acknowledged smaller funds may judge that the provisions in the Code are disproportionate or less relevant to their case. Nonetheless, these schemes may consider that it would be appropriate to adopt the approach outlined in the Code, and are encouraged to do so.

Reporting

The Code will operate on a voluntary basis. Consequently adoption of it would be on a ‘comply or explain’ basis, disclosed on an annual basis to members (eg in scheme reports or accounts) or to The Pensions Regulator (TPR). Schemes would be required to prepare each year:

- a statement of how it has applied the Code, providing explanation which enables its scheme members to evaluate how it has been applied; and
- a statement as to whether or not it has complied throughout the scheme year with the Code. A scheme that has not complied with the Code provisions or (in the case of provisions whose requirements are of an on-going nature) complied for only part of the scheme year must specify the Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance.

Departure from the Code may be justified in particular circumstances and where this happens it should not automatically be considered a breach of the Code.

Relationship with scheme's trust deed and rules or other governing documentation

Nothing in this Code should be taken to override the general requirements of trust law to act in the best interests of scheme members and beneficiaries.

Wherever possible, the Code should be referred to in the Scheme's trust deed and rules or other governing documentation (eg in the case of a contract-based defined contribution scheme). But it is also acknowledged that there will be occasion where the trust deed (or other supporting documentation) overrides the Code. This may be because certain conditions are specified in statue.

1. The governing body and its obligations

- Every scheme should have a governing body (a "board") which is charged with managing the scheme in the interests of the scheme members and beneficiaries. The board will also wish to have regard to the interests of the sponsoring employer.
- Trustees and governors will be responsible for setting the strategic direction of the scheme and monitoring its performance. To this end, the board should develop and keep under review a forward-looking business plan for the scheme.
- They have overall (fiduciary) responsibility for the scheme and its members –the board may delegate activities to their agents but ultimate responsibility rests with the trustees/ governors.
- The form of the board will be appropriate to the scheme and its sponsoring employer. So it may be a trust board (with trustees) in the case of occupational pension arrangements, a management board (with governors) in the case of contract-based schemes, or a supra-trust/ management body in the case of smaller schemes that federate to guarantee good governance in a way that maximises economies of scale.
- The board should meet sufficiently regularly to ensure that the scheme is being well run, and keep records of all meetings. Members of the board should be diligent and attend board meetings and devote sufficient time to familiarise themselves with the scheme, its benefits and documentation. Attendance will be recorded and published in the Scheme's annual report and accounts.
- The board will publish annually a report of its own effectiveness. This should cover, amongst other things, collective and individual skill sets and competence; policy creation; effectiveness and the business plan; use of advisers; clarity of delegation; and communication with members.
- The board will have responsibility for ensuring effective communication with scheme members and the sponsoring employer. It will keep in touch with scheme member opinion in the most effective way practicable. The views of the members should be communicated to the whole board.

2. Board structures, appointments and removals

- The exact mix of trustees/ governors will vary from scheme to scheme, and in some cases will be set out in the Trust Deed and Rules or in statute. But overall the composition of the board should ensure that collectively it has sufficient knowledge and experience and individually trustees'/ governors' decisions carry weight in the decisions of the board.
- The board should have a written policy on appointments, re-appointments and removals which covers not only their own appointments and removal but also those of their agents and advisers. This should cover terms of office and the conditions under

which trustees can be removed from office. Trustees should also put in place a succession plan in place for planning trustee appointments.

- Each board should appoint a Chairman. There should be clear guidance on how s/he should be appointed which should include a job description of what is required.
- Boards should consider including at least one independent trustee or governor on the governing body. Where an independent is not used, the trustees/ governors should explain why in the Annual Report and Accounts. An independent could effectively play the role that Non-Executive Directors play in companies, and would help to:
    - ensure there was a genuinely independent voice on the Board;
    - plug skills gaps; and
    - act as an avenue for scheme member redress where one was needed.
- The board should determine whether the independent trustee is truly independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the independent trustee's judgement. An independent trustee or governor will not be considered independent if they:
    - have been an employee of the company or group within the last five years;
    - have, or have had within the last three years, a material business relationship with the company either directly, or as a partner shareholder, director or senior employee of a body that has such a relationship with the company;
    - have received or receives additional remuneration from the company apart from a fee in connection with their role as a trustee/ governor of the scheme, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
    - have close family ties with any of the company's advisers, directors or senior employees;
    - hold cross-directorships or has significant links with other directors through involvement in other companies or bodies;
    - represents a significant shareholder; or
    - have served on the scheme board for more than nine years from the date of their first appointment.
- The board should establish sub-committees to allow for the efficient operation of their activities and responsibilities. Sub-committees should have clear, written, Terms of Reference and a fair balance of trustees/ governors on all sub-committees so that no one constituency dominates the decision making process. Any trustee/ governor would be free to attend any sub-committee.
- To ensure that power is not vested in one individual and to help manage risks, decisions should be taken by a majority.

3. Collective skills and individual skill sets and competence

- The board should have in place proper procedures to acquire the skills necessary to execute their duties both individually and collectively. The method of acquiring these will vary from scheme to scheme, but should be disclosed to members. As part of this process, they should have in place procedures to identify skills gaps. New trustees/governors should insist on a comprehensive, formal and tailored induction programme.
- The board should have in place procedures to determine whether a prospective trustee/governor is 'fit and proper' for the purposes of considering their appointment. This should apply to employer-nominated as well as trustees/governors nominated

and elected by scheme members.

- Boards should have a formal rigorous evaluation of their own performance, that of its committees and individual trustees.

4. Risk management

- Boards should ensure there are appropriate risk management systems in place and that these are regularly checked and updated. These will vary from scheme to scheme, depending on its size and structure, but could be expected to cover:
  - monitoring compliance with the law;
  - the strength of the employer's covenant;
  - the longevity risk held by the scheme, in the case of defined benefit schemes;
  - the adequacy of the scheme's support staff;
  - record keeping and disaster recovery;
  - an audit of the strength of, and any risks (including reputational risks) associated with the trustees'/ governors' agents;
  - a regular audit of regulatory compliance systems; and
  - a regular review of information processes, operational systems, and accounting and financial review systems.
- The board should put in place a regulatory compliance and monitoring programme – ie clear procedures about how the trustees go about ensuring compliance of the fund with legal provisions.
- Any risks that are realised should be disclosed to the members and beneficiaries in a timely fashion by the trustees or governors.

5. Managing conflicts of interest

- Conflicts of interest may occur from time to time and boards should put in place a procedure for dealing with such conflicts should they arise. Conflicts may occur, for example, if a trustee or governor may be influenced by conflicting loyalties.
- Boards may wish to maintain a register of board members' interests.
- Trustees/ governors should declare any conflicts, and these should be documented in the minutes of board meetings. Trustees/governors may need to absent themselves from meetings where decisions relating to the conflict are taken.

6. Internal controls

- The board should establish a transparent process for securing internal controls to safeguard the rights of members and beneficiaries which ensure that all those concerned with the running of the scheme act in accordance with the scheme's governing documentation. Whilst this will vary from scheme to scheme, it should cover basic procedures that are central to effective internal controls.
- This should cover:
  - Effective lines of reporting within the board (eg from the Chairman to trustees/ governors or between sub-committees and the main trust/ management board) and clearly specified systems of authorisation and recording.
  - Regular monitoring of the performance of those involved in the day-to-day operation and oversight of the scheme, including those employed as in-house administrators as well as third party administrators and other agents of the board.
  - Proper reporting lines between the board and external service providers/

agents which ensure the timely transmission of information.
  - Regular reviews of compensation mechanisms to ensure they provide the correct long-term incentives for those responsible for the management and oversight of the pension fund.
  - Mechanisms to sanction the improper use of confidential information.
- The Board should, at least annually, conduct a review of these internal controls and report to scheme members and the Pensions Regulator that they have done so.
- The Board should establish channels of redress for scheme members, which are easily accessible and clearly publicised to members.

6. The scheme's dialogue with the sponsoring employer

- The board should enter in to a dialogue with the sponsoring employer based on a mutual understanding of each other's objectives.
- The role of the employer in relation to the scheme should be documented, as should the role and responsibilities of a commercial pension provider in the case of a workplace group personal pension or stakeholder pension.

Annex 2: Questions - summary

For convenience, the questions asked throughout this Discussion Paper are set out again below. Please let us have your views on the questions asked in this Discussion Paper, no later than **Monday 3 October 2005.**

Question 1: What other governance models exist? Are there other examples of collective governance models for contract-based DC schemes? What are the pros and cons, and likely cost implications, of the three options described above?

Question 2: Should there be a single governance model or a selection to suit differing organisations. If a selection, should there be certain minimum standards and, if so, what should these be?

Question 3: What other benefits are there of this (or other such models) to the employees?

Question 4: Would such an arrangement add significantly to the costs of running contract-based arrangements. How would these balance against benefits of improved governance arrangements?

Question 5: What other risks would the employer be taking on? How could these be managed or mitigated?

Question 6: Would these risks outweigh the benefits gained by extending good governance to contract-based DC pension schemes.

Question 7: How can small schemes be helped to federate on a multi-employer basis, eg on a sectoral, regional or other affinity basis?

Question 8: What could the governance arrangements in such schemes look like?

Question 9: What kinds of cost savings on scheme governance matters could be generated if small schemes were able to pass responsibility for governance to a multi-employer scheme?

Question 10: What changes would be needed to existing legislation and incentives?

Question 11: What is an appropriate nomination process for filling trustee vacancies? Is the current representative model appropriate?

Question 12: Should trustees be remunerated?

Question 13: Are there in moving away from a unitary board to a two-tier board?

Question 14: What are the key qualities for a Chairman of Trustees (and trustees themselves) and what guidance should be given on who should become a trusteeand chair of trustees?

Question 15: Do you agree there is scope for a Governance Code for trustees and others? What would be the benefits of a Code?

Question 16: If not, why not?

Question 17: If yes, what should it cover? Are the OECD principles adequate as a basis for pension scheme governance in the UK? If not, what other factors should be included (or omitted)?

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Question 22: Are there any other general points you would like to raise on:

- ***the issues raised in this report; or***
- ***pension scheme governance for today's pensions environment***

that are not covered elsewhere in this Discussion Paper?

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