

REALIGNING INTERESTS, REDUCING REGULATION

A vision for reforming UK workplace pensions



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Executive Summary



Regulatory policy has given little attention to issues of market structure and the nature and effectiveness of competition, instead developing detailed and often prescriptive rules governing market conduct, with substantial cost and limited success. Regulation should focus on the establishment of market structures which provide appropriate incentives, rather than the fruitless attempt to control behaviour in the face of inappropriate commercial incentives.¹



Professor John Kay,

'The Kay Review of UK Equity Markets and Long-Term Decision Making'

The problem of poor saver outcomes in UK pension plans

This report asks if UK policymakers are making the right interventions in the area of workplace pensions in order to improve outcomes for the millions of savers whose retirement security is at stake. At present, there is evidence that system is not working as well as it should be for savers. The Office of Fair Trading's 2013 report into the workplace pensions market unequivocally concluded that competition is not working effectively in this market and found that fees and charges are often high, impossible to compare and frequently cancel out any investment returns.² A government-backed independent audit of contract-based providers found that up to £25.8 billion of savers' money is trapped in schemes with unacceptably high charges.³ Also Better Finance EU reported that from 2000-2012 the average real annual return delivered to UK savers in workplace pensions was negative, at -0.7%.⁴

If outcomes are defined more widely than just fees, charges and annual investment returns to also include trust, accountability and Responsible Investment, the UK pension system must still be judged as underperforming. Responsible Investment (RI), an investment approach which takes account of environmental, social and corporate governance (ESG) factors in the belief that they are often financially material, particularly over the long term, is gaining mainstream acceptance.⁵ Pension schemes are by definition long-term savings products, but the governing boards of schemes often select and assess asset managers based on short-term performance data and have been slow to adopt RI. This focus on short-term metrics has been found to damage returns⁶ and many see it as contributing to the 2008 financial crisis. Perhaps unsurprisingly, trust in the pensions

sector is very low; and distrust is the most powerful driver for people opting out of auto-enrolment.⁷

The evolution of UK pension provision over recent decades has seen more and more risks and costs pass from the state and employers onto the shoulders of individual pension savers. In 1979, final salary defined benefit (DB) pension funds composed 92% of all workplace pension funds, meaning pension fund beneficiaries were guaranteed an income throughout retirement linked to their final salary.⁸ However most provision in today's auto-enrolment era will be Defined Contribution (DC). This means savers' incomes in retirement depend on contribution levels, investment performance, and fees and charges: there are no guarantees. Yet communications to and rights for savers have not yet adapted to the new reality that they are the main risk bearers.⁹ Furthermore, although studies report that consumers care about what financial services institutions are doing with their savings,¹⁰ it is difficult for pension scheme beneficiaries to find out how their money is invested or to hold their provider to account.



Communications to and rights for savers have not yet adapted to the new reality that they are the main risk bearers.

Bovenber, L., Mehlkopf R., and Nijman, T.



Business and governance models in workplace pensions have been overlooked

The idea of the ‘paradox of privatisation’¹¹ describes how as the state seeks to minimise its financial responsibilities for pensions by encouraging private saving, it then must assume a greater responsibility to set market conditions and oversee providers. If private pension providers fail, savers may well seek redress from the government, as the Equitable Life affair shows. Savers have received £1.5 billion in compensation from the government so far¹² and a European Parliament led inquiry judged that ‘regulatory failure was a major contributory factor’¹³ in Equitable Life’s losses and ultimate failure.

Following the logic of the Kay Review that detailed regulation is costly, often ineffective and that promoting appropriate market structures is a better solution, this report set out to find whether some business and governance models in workplace pension provision deliver better results for beneficiaries. Our research finds that there may be less need for detailed regulation and regulatory oversight in the context of the workplace pension system where business and governance models achieve strong alignment of interests between beneficiaries and the people who run and govern the pension schemes. UK policymakers have recently begun to pay more attention to the topic of governance. However, given the significance of governance for performance demonstrated by our research, we do not believe that sufficient attention has yet been given to this topic or to the question of whether some business models may be fundamentally inappropriate for delivering workplace pensions and protecting beneficiaries who bear most of the risks in the automatic enrolment era.

The Research

This report examines the pension systems of Australia, the Netherlands, and Denmark, widely recognised as amongst the best in the world, alongside the different types of scheme available in the UK. Literature was examined from a variety of sources in addition to data on returns and charges of different models. Interviews were conducted with individuals with a variety of relevant expertise and experiences in the pension sector and we held a roundtable event to discuss our main research question.

The differences in business models examined include whether schemes are trust, contract or master-trust based; how scheme governance is structured and how it functions; the scale of pension schemes; the extent to which key functions are carried out internally or outsourced; and whether the business model is for-profit or not. The research finds that well governed pension schemes have the following features:

- motivation and alignment of interests of key parties, including beneficiaries; scheme boards; scheme executives; asset managers; and employers
- independence and diversity of decision makers on boards
- board members and supporting staff with suitable skills, knowledge and resources
- accountability and transparency of board decision making
- appropriate and clearly defined allocation of powers and responsibilities within the scheme and throughout the investment chain.

Lessons from overseas on pension scheme governance and business models

In Australia, not-for-profit ‘industry’ pension schemes, where trustees are appointed by employers, beneficiaries or unions, have outperformed their for-profit ‘retail’ counterparts, where trustees are appointed by commercial providers or via executive search. The not-for-profit funds delivered on average 2.4% higher real returns over the last decade than their for-profit counterparts.¹⁴ The not-for-profit industry funds also seem to be leading the way on innovative and RI strategies. For example, 30 industry funds established their own asset management company, IFM, due to dissatisfaction with the services available on the market. As these not-for-profit pension funds own IFM investment, decisions can be taken with a longer term view and in beneficiaries’ enlightened best interests, according to IFM and the funds who use them.¹⁵

The Danish Pension system has been judged to be the best in the world,¹⁶ with the lowest costs¹⁷ and according to Better Finance EU delivered real average annual returns of +4.7% over a 12 year period where UK savers received -0.7%.¹⁸ There are 3 business model types for workplace pensions in Denmark. Firstly, multi-employer saver owned funds, similar to master trusts, established via collective bargaining and with saver and union elected trustees. Secondly non-commercial life-insurance companies also established via

collective bargaining and owned by sectorial unions with boards composed of employer and union representatives and the company's employees. Thirdly, for organisations not covered by industry or sector wide collective agreements there are commercial life insurance companies where scheme beneficiaries elect trustees at AGMs and company employees are also represented on the board. According to some commentators, the well enshrined participation rights of employers, beneficiaries and unions in Danish pension governance means that less detailed regulation is required.¹⁹ Another defining feature is that most investment management is conducted in-house.²⁰

The Dutch pension system is similar to the Danish in that workplace pensions are either provided for through not-for-profit pension funds, which can be single company or industry wide, or via contracts with commercial insurance companies. The OECD judges the Dutch system to have the third lowest costs out of 40 countries examined.²¹ Our research suggests that one reason for this is the culture of Dutch boards who seem to negotiate harder on fees and charges than British ones.²² Board structures in the Netherlands are bi- or tri-partite with functions of accountability, management and scrutiny clearly separated.

Following the 2008 Financial Crisis, many Dutch schemes suffered heavy losses and public trust was undermined. Regulators have responded with a package of reforms including a strong focus on governance. Stricter diversity requirements have been introduced for pension fund and insurance company boards which require age and gender diversity alongside the established role for stakeholder groups (beneficiaries, deferred beneficiaries, unions and pensioners) on pension fund boards. The new Code of

the Dutch Pension Funds states;

'When representatives of various groups are involved in the process, a multi-dimensional perspective can be achieved, which is of benefit to the decision-making process... To perform optimally, a board requires a range of skills cultures and views'.

In the Netherlands including representatives of different age groups was seen as crucial for restoring public faith in the intergenerational fairness of the system, and a similar justification was given for the diversity requirements on insurance company boards.

In addition to including stakeholders in governance structures, Dutch not-for-profit pension funds are also more likely to consult with the wider membership base than the commercial insurance companies, for example through open AGMs, surveys, and public meetings around the country to discuss policy. Comparing benchmarking studies by the Dutch Association of Investors for Sustainable Development (VBDO)²³ reveals that pension funds outperform the insurance companies on virtually every RI measure as well as doing more to communicate with members.

Scheme size matters to beneficiary outcomes

Our research also identified that the size of a pension scheme is a strong indicator of good outcomes for beneficiaries. Schemes must operate at scale to ensure adequately skilled governing bodies, sufficient internal support and to access economies of scale and better bargaining power. Costs per saver can be brought down when there are more beneficiaries in a scheme to bear them. The other countries examined have more numbers of large schemes compared with the UK.

Scale does not guarantee RI will be pursued, but bigger schemes consistently take it more seriously. One recent study of RI by UK pension funds found that 'smaller funds find it more difficult to fully consider ESG issues due to lack of time, resources and in some cases understanding.'²⁴

In the UK the data shows bigger schemes performing better for beneficiaries.²⁵ However the UK is unlike the other countries examined because nothing has been done at a policy level to encourage or require consolidation of

“When representatives of various groups are involved in the process, a multi-dimensional perspective can be achieved, which is of benefit to the decision-making process... To perform optimally, a board requires a range of skills cultures and views.

Code of the Dutch Pension Funds

small schemes. In Australia, schemes have to report to the regulator annually on whether insufficient scale in terms of beneficiaries or assets means the financial interests of their beneficiaries are compromised compared to the beneficiaries of bigger schemes. As a result of this nudge the number of schemes fell from 5,000 in the mid-1990s to 500 by the end of 2009²⁶ and the average scheme size in Australia is 26,000 beneficiaries compared with 2,500 beneficiaries in the UK.²⁷ UK policymakers should intervene on this issue as market forces will not drive consolidation at sufficient speed.²⁸

Poor governance and inappropriate business models are detrimental for beneficiaries

The research found that misaligned interests between savers and those running and governing pension schemes appear to be a significant cause of saver detriment, and such misalignments derive from a pension scheme's business and governance model. Some business and governance models do seem to perform consistently better than others, for example according to one major study, annual returns net of fees 'are superior for trust based (or similar) schemes as opposed to contract-based ones' in the USA, Canada and Australia.²⁹

Our research identified a variety of business model and governance features which are significant for saver outcomes. It is difficult to isolate the effects of these different variables and determine which is most important causally. In the countries examined not-for-profit schemes are also more likely to include stakeholder representation in governance; and they are subject to different legal duties towards beneficiaries in the case of the UK and Netherlands. What is clear is that more representative, diverse governance arrangements, less shareholder owned businesses and a smaller number of large schemes are a defining feature of the Dutch and Danish systems and the best performing model in Australia. The research indicates that no single feature is enough on its own. There must be a package of positive business model and governance features in order to achieve the right organisational culture and good outcomes for savers.

Another important variable is whether pension schemes outsource investment management or conduct it in-house. Outsourcing is meant to benefit beneficiaries through

providing access to a wider range of skills and investment opportunities and thus portfolio diversification. Yet this research corroborated a key message of the Kay Review, namely that heavily intermediated investment chains are often detrimental for end beneficiaries. Outsourcing does seem to be a significant cause of misaligned incentives and interests, in particular by driving short-term investment horizons.

There has been an increase in institutional investors bringing investment management back in-house following the 2008 financial crisis.³⁰ However this is a challenging process that must be done with care. In order to realise the benefits such as better alignment of interests between principals and agents, higher net-of fee investment returns and more sustainably constructed portfolios, the systems, processes and human capital of the pension scheme need overhauling. This must be underpinned by strong governance.³¹

“ The research indicates that no single feature is enough on its own. There must be a package of positive business model and governance features in order to achieve the right organisational culture and good outcomes for savers. ”

UK business and governance models do not serve pension savers well

Out of the business and governance model types available in the UK, large, single employer trusts best exemplify the ideal characteristics identified but are a priori not an option for the thousands of small and medium sized employers in the UK now entering the auto-enrolment system. Although the master-trust model has the potential to deliver these benefits to smaller employers, this potential has not been realised as the governance arrangements in master trusts do not exhibit best practice. There are troubling conflicts of interest in the business models of some master-trusts, particularly where commercial insurance companies have established a master trust and handpicked the trustees.

The Collective Defined Contribution model is also unlikely to achieve the good saver outcomes hoped for if scheme governance is not considered with more care, and attention given to the Dutch and Danish governance models which

apparently provide the inspiration for this type of scheme. Contract-based schemes least exhibit the good business and governance model features identified.

In the UK there has been a tendency to blame the poor performance of some schemes on the presence of member nominated trustees from outside the financial services industry. The fact that there is no requirement for member nominated representatives on master-trust trustee boards or on the newly established Independent Governance Committees at contract-based providers certainly suggests that policymakers do not have faith in the capabilities and value of member nominated representatives. However the research did not find evidence that the poor performance of some schemes is due to the presence of lay trustees or representatives. Lack of scale, expensive investment management fees and poor oversight of outsourced arrangements seem to be the main causes of saver detriment.

“ *The research did not find evidence that the poor performance of some schemes is due to the presence of lay trustees or representatives. Lack of scale, expensive investment management fees and poor oversight of outsourced arrangements seem to be the main causes of saver detriment.* ”

The evidence from abroad and from large single employer trusts in the UK suggests that lay trustees can be effective if they are given training, sufficient time to fulfil their duties and adequate support from internal staff. Expectations of trustees must be realistic considering they meet 3 or 4 times per year; even if they are investment experts they cannot conduct detailed scrutiny of service providers or day-to-day management. The research identified that benefits of including saver, union or employer representatives on boards who are not finance industry experts can include: a healthier culture on the board, and an openness to challenge service providers in beneficiaries' best interests; true independence from scheme or service providers; and trust of the wider membership.

Including saver representatives in governance cannot be a substitute for transparency and accountability to the wider membership if schemes are to secure the trust of their beneficiaries and ensure that schemes are performing in the enlightened best interests of different beneficiary groups. The best schemes are embracing new technologies like online surveys and webinars, in addition to holding public meetings and starting to realise that in order to fulfil duties to invest in beneficiaries' best interests, they must find out what those interests are.

Conclusions

We hope that this report and the recommendations made will catalyse a genuine debate and more consideration from UK policymakers as to the importance of business models and governance in workplace pension schemes. The findings strongly suggest that getting the business models and governance right can reduce the need for ever more detailed regulations and codes of conduct which regulators lack the capacity to oversee compliance with. The findings also imply that any attempts by UK policymakers to copy more successful pension scheme outcomes found overseas, for example Collective Defined Contribution schemes, are unlikely to achieve the desired results if the full range of business and governance model features driving those good outcomes are not adopted here.

Recommendations

A number of recommendations to policymakers are made throughout this report. They are summarised below.

- The governing structures of all schemes should include representatives of beneficiary groups. Beneficiaries should be able to elect representatives and put themselves forward for such positions.
- Training for beneficiaries on governance boards should be compulsory. The training should be designed to give candidates the confidence and ability to ask challenging questions.
- In the DC world, employers have less motivation to make sure schemes are working well than in DB where they bear risk. Therefore in any given workplace senior management should be obliged to place a significant portion of any pension contribution from their employer in the same scheme as the rest of the workforce to align interests and provide motivation for senior management to scrutinise the scheme.
- Policymakers should monitor and publish figures on the diversity of the governing boards of automatic-enrolment compliant pension schemes.
- In addition to including beneficiaries in the governance structure, all schemes should adopt mechanisms to communicate with the membership as a whole and ascertain their views. Positively, regulations have recently been introduced in the UK for some schemes to do this. The government should advise on best practice in relation to this.
- All those responsible for governing and running pension schemes, including those responsible for investment management should be subject to fiduciary standards and to duties requiring them to act in the best interest of savers, including prioritising savers' interests above those of other stakeholders where conflicts of interests exist.
- Amend the Employment Rights Act 1996 so that Member Nominated Trustees or member representatives in other types of pension schemes have the same rights to request reasonable time off work to fulfil their duties as magistrates, school governors, trade unionists, beneficiaries of the Army Reserve forces and other roles prescribed in the legislation.
- Policymakers should take action to drive economies of scale in DC pension schemes rather than waiting for market forces to have an effect, as the potential for market forces to drive scale particularly in small single employer trusts is questionable. Trustees could be required to demonstrate that a lack of scale is not disadvantaging beneficiaries. If they cannot, the schemes or fund should be required to merge with another, as is the case in Australia.
- The duties of Independent Governance Committees should be amended to include scrutiny of the providers' policies and practices on stewardship of investee companies and its consideration of environmental, social and corporate governance risks.

Note on terminology

In this report we use the term “saver” or “beneficiary” to refer to individuals with savings in all different types of workplace pension scheme. The term “pension scheme” is used as to refer to all the different business models and

governance models that can be used to deliver workplace pension schemes, although it should be noted that large providers such as insurance companies deliver multiple schemes.

Introduction

The UK's pension landscape has changed significantly over the past 15 years and the speed of change has not abated. In the last eighteen months alone there have been multiple changes to our pension system, including; automatic enrolment staging dates for thousands of employers; scrapping the compulsory requirement to purchase an annuity; the announcement of a charge cap for default funds; the introduction of Independent Governance Committees (IGCs) to oversee all contract-based occupational pensions; a new single-tier State pension; a new Code of Conduct from The Pensions Regulator; and new regulations covering trust and master trust based schemes.

The latest raft of legislative and regulatory changes in the pensions arena has in part been necessary because an automatic enrolment pension system predicated on inertia rather than active choice by savers 'brings new dynamics to the pensions market and new responsibilities on government and industry to protect savers'³² in the words of the Department for Work and Pensions (DWP). Also, there is mounting evidence that the pensions industry is presently not delivering good outcomes for many of its beneficiaries. This is the case if outcomes are narrowly defined in terms of fees, charges and investment returns but also if they are more widely defined to include trust, accountability and effects on the wider economy. For example an audit of the occupational pensions sector conducted by industry and government representatives recently reported that up to £25.8 billion of savers' money is trapped in schemes with unacceptably high charges and that there are 38 different types of charge and 291 different charging structures in existence.³³ Better Finance EU also suggested that from 2000-2012 the average real annual return delivered to UK savers was negative, at -0.7%.³⁴

This report seeks to take a step back and asks if piecemeal, incremental changes and ever more detailed regulations will actually deliver a high quality system that operates in the best interests of British pension savers. The starting point for this research is the observation in the Kay Review that regulatory policy has focused on:

'developing detailed and often prescriptive rules governing market conduct, with substantial cost and limited success. Regulation should focus on the establishment of market structures which provide

*appropriate incentives, rather than the fruitless attempt to control behaviour in the face of inappropriate commercial incentives'*³⁵

“ *if the private sector providers fail to deliver the desired outcomes, individual savers may still hold the government accountable for failing to set adequate standards* ”

Although some regulatory intervention is welcome and necessary, the intervention experienced in the UK may not be effective in delivering the world-class pensions system needed. Also, consumer trust of the pensions industry will not be rebuilt via regulation; the industry must demonstrate willingness voluntarily to align its interests with those of its customers. The role of governance and business models in driving good outcomes for savers has been neglected in policy discussions. The late introduction of IGCs and other policy measures to improve governance in trust and master trust schemes,³⁶ 3 years after the introduction of automatic enrolment, suggests that UK policymakers are recent converts to the value of good governance.

Our research also found that as the government in the UK, and elsewhere, has sought to minimise its responsibilities for pension provision by shrinking the state pension and encouraging private savings, it has landed itself with an ever increasing responsibility to oversee private pension providers. This has been called the 'paradox of privatisation';³⁷ if the private sector providers fail to deliver the desired outcomes, individual savers may still hold the government accountable for failing to set adequate standards as the hand of the state is so visible in the pension system. Furthermore, the government may have to step in to provide financial redress if providers fail or if beneficiaries do not end up with adequate savings to live on throughout their retirement.

“ *If policy makers focus on getting the business and governance models in pensions right, this could minimise the need for detailed regulation and regulatory scrutiny of pension schemes and reduce the financial risk to the state.* ”

Savers' expectations regarding the state's involvement and the scale of tax incentives in shaping the pension system gives policymakers a clear mandate to intervene in this market. This report questions whether they are making the right interventions. If policy makers focus on getting the business and governance models in pensions right, this could minimise the need for detailed regulation and regulatory scrutiny of pension schemes and reduce the financial risk to the state.

This report looks at what 'good outcomes' would mean for savers in our DC workplace pensions system. The research considered the development of the pension landscape over the last 30 years and compared the existing and emerging UK business and governance models to some leading international systems. The business and governance models examined in the UK

include trust-based (single employer), master trust-based (multi-employer) and contract based schemes alongside the newly legislated for Collective Defined Contribution model. The following features of business and governance models were also identified as relevant for saver outcomes; whether they are for-profit or not-for profit; if they are heavily outsourced or vertically integrated; the scale of the organisation; and the range of stakeholders who are included in governance structures. The international examples drawn on to contextualise the UK's present position and future options are from Australia, Denmark and the Netherlands. These countries were selected as it is widely acknowledged that they have amongst the best pension systems in the world.³⁸ Finally this report makes suggestions for how the UK might move towards a world-class pension system.

Methodology

To examine whether some business and governance models in pensions are better than others at delivering good outcomes for beneficiaries, we use a combination of analytical approaches. Data on returns and charges of different models are examined. Such data is incomplete due to the different ways pension schemes and asset managers report, and gaps in what regulators collect, but are nevertheless a useful indication of trends and patterns. Literature was examined from a variety of

sources including academic publications, government commissioned reviews, articles from the pensions and investment press, reports by think tanks and government regulations and codes of conduct. Fourteen interviews were conducted with individuals with a variety of relevant expertise and experiences in the pension sector, in the UK and the other countries analysed. A roundtable with 12 attendees was held in April 2014.

Chapter 1

What are good outcomes in pensions and does the UK have them?

In this section we consider what good outcomes for a world-class pensions system would look like. Fundamentally, of course, pensions should provide financially for people's retirement. Individuals and society must be able to manage the costs associated with increasing life expectancy and this 'longevity risk' should be shared fairly. There are several different components relevant to reaching this outcome.

Fees and Charges

The quantum of income in retirement is influenced by levels of fees and charges, which may be considerable. Even small differences in headline charges can cause significant detriment to the saver: the Office of Fair Trading's 2013 report into workplace pensions found that an Annual Management Charge of 0.5% over a working lifetime can reduce a pension pot by 11% whereas a charge of 1% could entail a 21% reduction³⁹ and uncovered extensive evidence of inappropriate and misleading charges. Furthermore, average real returns (net of charges and tax) delivered to UK savers has been reported as being actually negative between 2000-2012, at -0.7%, compared with +4.7% in Denmark.⁴⁰

There is thus mounting evidence that the pensions industry is not presently delivering a good deal for many of its beneficiaries and customers. The system looks to many like it is calibrated to serve the interests of intermediaries rather than the end beneficiaries and suppliers of capital, in this case pension scheme beneficiaries. Given the under-performance of pension schemes detailed above, the 'industry's remuneration has been excessive' in the words of a report by the Centre for Policy Studies.⁴¹ This is a key driver of fees and charges.

The charge cap of 0.75% in annual management costs for automatic-enrolment compliant funds introduced in April 2015 is a good step, but has limitations; charges related to investment transaction costs are not included in the cap; only default funds are subject to the cap; and truly good governance should constantly seek to reduce charges, not stop once the charge cap is achieved. The investment transaction costs can dwarf the headline annual management costs figure; Railpen, one of the UK's largest occupational pension schemes recently reported

that the headline fees they paid to asset managers were only around a fifth of the total fees paid. It took months and much effort for them to find out the true figure.⁴²

This is not to say that cheap is necessarily best; sometimes higher charges get higher quality governance, or a more sophisticated investment strategy. But fees paid for active asset management often cancel out any upside in investment returns; a report by independent pension consultancy Hymans Robertson for the government looking at the Local Government Pension Scheme (LGPS) found that:

'taken in aggregate, equity performance before fees for most geographical regions has been no better than the index. This outcome is consistent with wider international evidence which suggests that any additional performance generated by active investment managers (relative to passively invested benchmark indices) is, on average, insufficient to overcome the additional costs of active management'.⁴³

“ There is thus mounting evidence that the pensions industry is not presently delivering a good deal for many of its beneficiaries and customers. ”

The study concluded that the LGPS could save £230 million per year on investment fees without damaging performance by using more passive funds. Furthermore the Office of Fair Trading found evidence of many charges deemed to be inappropriate (see box on page 11).

Competition is not working to control fees and charges

The Office of Fair Trading's 2013 report into the workplace pensions market unequivocally concluded that competition is not working in this market. Although the extent of bad practice and saver detriment is very substantial, this should not come as a surprise given that beneficiaries do not have the ability to select a scheme, exit a scheme they are not satisfied with or reward good providers with repeat business; all essential ingredients for market-based competition to

function. Employers act as ‘proxy consumers’ who select the scheme for their workers, but employer and employee interests are not always aligned. Employers can lack capacity or motivation to ensure employees get good value for money. Factors such as the compatibility of the pension providers’ platform with that of the employer’s payroll provider may be given more weight by the employer than the fees charged to deferred beneficiaries, for example.

The government’s decision to introduce a charge cap on all pension schemes used for auto-enrolment is a welcome effort to tackle overcharging but also an admission of failure; a charge cap would not be necessary if the business and governance models used to deliver pensions had appropriately aligned incentives and competition was functioning properly in occupational pensions.

Furthermore the potential benefits to beneficiaries from market based competition between providers, for example efficiency savings and innovation, must be offset against the added costs. Competing providers must spend money on marketing, advertising and the business development staff required to win and retain clients. These costs are ultimately borne by beneficiaries. One key benefit of the industry wide pension fund model found in Australia, Denmark and the Netherlands is that these costs are stripped out because it is mandatory for workers in a particular industry to join the scheme. The UK’s 2002-2006 Pension Commission, referred to as the Turner Report, found that ‘in the absence of a price cap, competition between providers is more likely to take the form of higher marketing costs than low charges.’⁴⁴

In the absence of a price cap, competition between providers is more likely to take the form of higher marketing costs than low charges.

The Turner Report

The Office of Fair Trading’s Key Findings

The OFT found that ‘competition alone cannot be relied upon to drive value for money for all savers in the DC workplace pension market’ (1.6). They noted that:

- ‘The buyer side of the DC workplace pensions market is one of the weakest that the OFT has analysed in recent years’ (9.7)
- They identified £30 billion of savers’ money trapped in schemes ‘at risk of being poor value for money’ (1.19)
- Charges are complex and opaque; it is ‘difficult to compare charges of different pension providers because there is a lack of consistency in the way that charges are presented’ (1.16). The study found 18 different names for charges that can be paid by beneficiaries in pre-2001 schemes. When stakeholder pensions were introduced in April 2001, ‘the pensions industry moved towards levying a single charge, known as an AMC, although this has not precluded the industry from using other charges as well’ (1.15).
- Investment transaction costs are particularly hidden; ‘the costs associated with investment management transactions (the buying and selling of assets within a fund) are often not visible’ (1.16)

Investment Performance

Investment performance is another key ingredient for achieving good outcomes for savers. Pensions are by definition long term investments and schemes can invest beneficiaries’ funds in a way that promotes sustainable wealth creation. Unfortunately, pension funds have not been behaving like long-term investors; the Kay Review found misaligned incentives at every stage of the investment chain working against savers’ long-term interests. Kay found that asset holders, including pension funds, typically select and assess asset managers based on short-term performance data and quarterly discussions.⁴⁵ This focus on short-term returns and performance metrics was also found by Kay to fuel excessive risk taking, bubbles and crashes, and ultimately, to damage returns.

In the language of the Kay Review, many asset managers behave as ‘traders’, hoping to exploit short term market movements or passively track indices rather than behaving as ‘investors’ making decisions based on analysis of underlying performance and earning potential of investee companies. This means that market pricing mechanisms are not working effectively, leading to market inefficiency or even failure.⁴⁶ Furthermore, remuneration incentives are often badly designed with too much emphasis on the short term.

The investment practices and performance of pension providers and their asset managers also matters for the health of the entire economy. According to the OECD the market value of assets held by UK pension funds is greater than the country’s total GDP.⁴⁷ Thanks to automatic enrolment it is estimated that UK DC workplace pension funds will be worth £480 billion by 2030.⁴⁸ Due to their long-term liabilities and size, pension funds have the potential to provide much needed patient, long-term investment capital. As the Bank of England surmised in a recent paper,

‘In principle, by being better placed to look through short-term market volatility than many other types of investor, they [Life insurance companies and pension funds] also have the potential to be a stabilising influence on the financial system. ICPFs could therefore play a crucial role in supporting both financial stability and long-term economic growth, which are in turn mutually reinforcing.’⁴⁹

“ Thanks to automatic enrolment it is estimated that UK DC workplace pension funds will be worth £480 billion by 2030. ”

Policymakers of all political stripes from time to time express hopes that this money can be a source of patient capital to be invested in a way that benefits the British economy and society. The Mayor of London Boris Johnson, for example, recently advocated pooling all the UK’s public sector pension funds to create one giant pot which could be used as a Citizens’ Wealth Fund to finance projects ‘from new roads to new tunnels to hundreds of thousands of new homes for sale or rent’.⁵⁰ While there are criticisms of the idea that private sector

finance from pension funds and others should invest in infrastructure if the result is privatisation of public goods, there has in fact been little concrete action from UK policymakers to achieve this consolidation.

The European Commission’s March 2015 Green Paper on a Capital Markets Union is also premised on the idea that the €12 trillion in assets held by Europe’s pensions and insurance sector ‘can help to fund investment’ in much needed jobs and growth if schemes are ‘prudently managed and in a way that reflects their societal function’.⁵¹ Yet the Green Paper does not contain any measures to tackle the misaligned incentives or promote RI over negative sum game trading activity.

Responsible Investment

RI can be defined as an investment approach that acknowledges the importance of ESG factors and the need to consider the long-term stability of investments and the market as a whole. There is growing recognition in the investment world that proper consideration of ESG factors is an essential part of good risk management,⁵² particularly for investors with long-term horizons as these factors are more likely to be financially material over longer time horizons. 82% of UK pension funds surveyed in 2014 now believe that ESG factors can have a material impact on their fund’s investments over the long-term.⁵³ Responsible investors also act as stewards of their assets, engaging with investee companies to improve their performance. In 2001, the Myners Review called for pension fund managers to have:

‘an explicit strategy [on stewardship], including the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy’.⁵⁴

But fourteen years on this is still not a reality throughout the occupational pensions sector.

Flaws in the business and governance models in the UK pension system have also been acting as a barrier to adoption of RI, in particular the extensive intermediation and misaligned time horizons. Adopting a RI approach requires investment in skills, resources and the development of new methodologies. The benefits of this

approach are normally only seen over a few years. For example it is resource intensive for asset managers to engage with investee companies to improve their performance and it could take several years to change company behaviour and see an effect on the returns.

The UK Stewardship Code introduced in 2010 has helped to stimulate the adoption of RI and stewardship by institutional investors and asset managers, partly by clarifying their respective duties:

‘asset owners... set the tone for stewardship and may influence behavioural changes that lead to better stewardship by asset managers and companies. Asset managers, with day-to-day responsibility for managing investments, are well positioned to influence companies’ long-term performance through stewardship’⁵⁵

The Code also requires transparency of investment policies and practices and has had a positive, if limited, impact on investor behaviour. For example, according to the National Association of Pension Funds (NAPF), 80% of pension funds’ Request for Proposals to asset managers now mention ESG.⁵⁶ But change is slow and disclosure requirements alone, which are voluntary and not currently enforced under the ‘comply or explain’ mechanism, are not sufficient to overcome commercial disincentives to pursue long-term, RI strategies. For example conducting stewardship is time and resource intensive, can take several years to bear fruit and other investors in a company can ‘free-ride’ on the eventual benefits. It is still difficult for asset owners such as pension funds to understand which asset managers are genuinely doing a good job on RI and to compare firms.

In addition to misaligned time horizons, interests in commercial pension funds are also misaligned to the detriment of the saver due to the conflict between the commercial imperative of the firm to make a profit and the savers’ interests in low management costs. When profits are returned to owners such as shareholders or used to fund over-generous executive pay packets, this conflicts with the interests of the beneficiaries. Tackling these conflicts should be a key concern for policymakers. The Kay review argues that:

‘if the market structure is such as to give the right incentive, then appropriate behaviour should follow and regulatory oversight of such behaviour can be reduced: if market structure and incentives are not right, then regulation which imposes behaviour which conflicts with the commercial interests of participants is likely to enjoy limited success.’⁵⁷

Good business and governance models

Policymakers should follow this logic and focus on identifying and promoting business and governance models which eliminate misaligned incentives and conflicts of interest as far as possible. Robust governance structures are necessary to ensure that any conflicts that cannot be eliminated are effectively managed in beneficiaries’ best interests. The 2009 Walker Review of corporate governance in UK banks and other financial industry entities also highlighted the limitations of regulation in securing good outcomes, and the need to focus on governance structures:

‘the fact that different banks operating in the same geography, in the same financial and market environment and under the same regulatory arrangements generated such massively different outcomes can only be fully explained in terms of differences in the way they were run...that is, of corporate governance.’⁵⁸

The 2011 Vickers Commission on Banking Regulation also focused on issues of market structure and governance.⁵⁹ These findings on the importance of business and governance models for banks are applicable to other financial institutions such as pension funds and insurance companies. Indeed the Cooper Review of the Australian Superannuation system concluded that:

“ ‘Nearly all the issues looked at in the Review link back to trustee governance in some way or other. Improving governance practices and structures is key to improving saver outcomes’⁶⁰
The Cooper Review ”

Poor governance has been found to cause saver detriment due to, for example, outdated investment strategies, sub-standard administration,⁶¹ failure to challenge asset managers on charges or costs particularly resulting from excessive portfolio churn, or costs associated with changing asset managers unnecessarily frequently.⁶² One study by the internationally renowned pensions academic Keith Ambachtsheer suggests that good governance adds as much as one percentage point per annum to pension fund returns.⁶³

Yet the policy response to poor saver outcomes in UK pensions has largely been to continue layering additional veneers of regulation and compliance processes on to business and governance models that may not be fit for purpose. This is not only ineffective but also counter-productive as the costs of complying with ever-more detailed regulations and codes of conduct are ultimately borne by the beneficiaries. Also, over-detailed regulation limits genuine innovation that could be in beneficiaries' best interests. The 2014 Murray Report into the Australian Financial System also highlights the importance of culture in financial firms. The Report advises that:

“ ‘to expect regulators to create the ‘right’ culture within firms by using prescriptive rules is likely to lead to over-regulation, unnecessary compliance cost and a lessening of competition. The responsibility for setting organisational culture rightly rests with its leadership.’⁶⁴

The Murray Report

The question of whether some organisational types and structures are fundamentally better than others at creating the desired culture and delivering good outcomes for pension beneficiaries has not been adequately addressed in the UK.

Accountability to Beneficiaries

The current system is also failing to consider savers' extra-financial interests such as the society and environment that they live in and will retire into. Numerous studies report that consumers care about what financial services

institutions are doing with their savings.⁶⁵ A 2014 report by the NAPF, for example, found that 70% of adults surveyed 'felt it important for pension providers to invest in companies that concentrate on avoiding unethical practices'.⁶⁶ Currently savers' rights to information about, let alone influence over, where and how their money is invested are very limited.

To build trust and enthusiasm for saving, good schemes will actively engage with savers to inform them and take their views into account when deciding their investment and engagement policies. In ShareAction's report 'Our Money, Our Business' we set out our vision for a world where pension savers see themselves as owners, with stakes in companies that build wealth selling goods and services that people desire and society needs.

“ Although savers may not understand fully how the investment system works and are put off by investment jargon, people are meaningfully interested in issues like executive pay, climate change, and human rights abuses in company supply chains. ”

Savers earn their pension contributions and should have the right to know where their money is invested, what decisions are made on their behalf and if the investments contradict their values. Although savers may not understand fully how the investment system works and are put off by investment jargon, people are meaningfully interested in issues like executive pay, climate change, and human rights abuses in company supply chains.

Accountability and transparency to savers is also necessary to ensure that the investment system is functioning efficiently. Following the 2008 crash, policymakers enacted a series of measures to make companies more accountable to their shareholders in the hope that this would improve long-term performance. But those who have been empowered are often themselves unaccountable and opaque intermediaries, subject to limited market discipline. The accountability of companies to their investors must be matched by accountability of investors to the savers whose money they manage. Clearly, most savers will never become involved in scrutinising the behaviour of their pension fund, but the scrutiny of an engaged minority and of civil society on beneficiaries' behalf can improve outcomes for all.⁶⁷

How did we get here? The Evolution of the UK Pensions Landscape

The evidence shows that the UK pension system currently delivers poorly for beneficiaries in terms of fees and charges, investment performance, the responsible stewardship of companies and in failing to listen and respond to savers' views. So how did the UK end up with a system characterised by misaligned incentives that benefit intermediaries whilst loading risk onto savers?

The rise and fall of employer responsibility

The UK has one of the less generous state pension systems in the developed world; the International Longevity Centre places the UK 21st out of 27 EU countries in terms of state pension generosity.⁶⁸ Although the Netherlands and Denmark have even less generous state systems, the International Longevity Centre judges that pensioners in those countries are less at risk of poverty than in the UK due to state and employment related pensions working well together.

In the UK, a well-developed system of voluntary funded schemes set up by employers meant that the system appeared to be working well for many years.⁶⁹ Where employers did provide pension schemes they were usually Defined Benefit (DB), with payments in retirement linked to employees' final salaries. In 1979, final salary DB pension funds composed 92% of all pension funds.⁷⁰

Membership of occupational schemes peaked at 12.2 million active beneficiaries in 1967⁷¹ and remained high throughout the 1970s and 1980s. But by 1995 there were only 5.2 million beneficiaries of open private sector DB schemes⁷² and by 2012 this had fallen to 1.4 million⁷³ as companies closed DB schemes, first to new beneficiaries and then to new accruals by existing beneficiaries.

This rapid decline was due to employer liabilities growing rapidly due to increasing life expectancies and a spate of new regulation which made DB schemes much more costly and risky for employers. For example mark-to-market accounting meant assets and liabilities had to be priced daily at market value giving employers less flexibility to manage deficits over the long run and encouraging a short-term mind-set. These regulations were largely a response to the Mirror Group Pension Scheme scandal

when it emerged that the head of the Mirror Group Robert Maxwell had stolen around £440 million from the company pension scheme to pay other debts.⁷⁴

During this 'golden age', the state was able to provide relatively low benefits because it was assumed that large numbers of private employers would provide occupational schemes, motivated by a desire to recruit and retain staff. However according to the 2005 Turner Report, the golden age was in fact a "fool's paradise":

*'UK pension policy has, thus, for the last 25 years been based on the belief that the declining state role will be compensated for by an increase in voluntary employer provision, unaware that the underlying trend has been since the 1980's and continues to be for employers to exit from the social security role which they had accidentally assumed.'*⁷⁵

In addition to rising life expectancy making DB promises increasingly expensive for employers, many refrained from offering pension schemes because they stopped believing that generous pension packages were beneficial in terms of staff retention and recruitment. Participants in the Turner Report's Small and Medium Enterprises Focus Groups 'were almost unanimous in arguing that there is no significant benefit in terms of recruitment and retention from providing pensions as most employees do not perceive value in having a pension.'⁷⁶ This view spread to large employers and today only 3 FTSE 100 companies still have a DB scheme open to new beneficiaries.^{77 78}

When it comes to looking after workers in retirement, the paternalistic responsibility that many big employers once accepted in relation to their employees has largely vanished. The shift from DB to DC has been much discussed, but this is not the full picture. DC schemes have not grown nearly as quickly as DB schemes have declined. In the private sector, the proportion of employees in DC pension schemes increased from 17.7% in 1995 to 37.0% in 2012. However, the actual number of DC beneficiaries has remained broadly flat, estimated at around 1.0 million in 2012,⁷⁹ the start point of automatic-enrolment. The increasing percentage in DC schemes is explained by an overall decline in workplace pension scheme membership.

Savers generally get a worse deal in DC schemes compared with DB not just because of the lack of guarantees concerning the income they can expect in retirement. Contributions to DC schemes are typically less generous and, of course, contribution levels matter for DC outcomes in a way that they do not for beneficiaries of DB schemes. In 2005, total DB contributions were around 16-20% of salary (11-14% employer and 5-6% employee) compared with total DC contributions of 7-11% (4-7% employer and 3-4% employee).⁸⁰

Furthermore instead of maintaining their own trust-based company scheme, employers are increasingly offering employees contract-based schemes run by external providers, usually insurance companies. In 2005, 89% of NAPF beneficiaries said their main DC scheme was trust-based, but by 2010 this had fallen to 49%. Over the same period, contract-based schemes rose from 38% of NAPF beneficiaries' offerings to 54%.⁸¹ In the contract based environment there is no equivalent body to the board of trustees with clear legal duties to prioritise beneficiaries' interests; although IGCs have now been established to represent saver interests they do not have comparable legal duties or powers.

“ As employers no longer have a financial motivation to make sure their workplace scheme is performing well, this has left a governance vacuum in many schemes. ”

The introduction of automatic enrolment addresses the problem that many workers were not offered a workplace scheme and therefore were not building up savings to supplement the state pension. Yet there is widespread concern that beneficiaries are not building up big enough pots, not least from the former Pensions Minister Steve Webb MP,⁸² and have to shoulder risks that they do not fully understand. Employers with DC schemes no longer face the risks relating to increasing life expectancies, inflation or poor investment performance. Their roles are limited to contributor and bulk buyer. As employers no longer have a financial motivation to make sure their workplace scheme is performing well, this has left a governance vacuum in many schemes.⁸³

The role of the state

Responsibility for pension provision lies across an intersection between the state, employers, and individuals. The state uses tax incentives and the “nudge” of automatic-enrolment to encourage workers and employers to make contributions that private sector providers then invest via financial markets. There are long standing concerns that the UK pension system does not distribute risk and responsibility between these different stakeholders in a satisfactory way. Thus the 2005 Turner Report recommended a new settlement for the 21st century in which ‘the appropriate roles of individuals and of the state’ are clarified.⁸⁴ Although automatic-enrolment means millions are now building up pension savings for the first time, the appropriate distribution of risk and responsibility called for by Turner has not yet been achieved.

Most auto-enrolees will be beneficiaries of DC schemes. The employer chooses the provider, or in a dwindling number of cases sets up their own scheme, but the saver individually bears all the risk relating to inflation, investment performance and longevity. Beneficiaries are often ill-equipped to take on these risks, not least because, as the Network for Studies on Pensions, Aging and Retirement points out, ‘communications to beneficiaries have not yet adapted to the new reality in which they are the main risk bearers’.⁸⁵

Governments faced with aging populations are justifiably keen to minimise the risk to state finances posed by ballooning pension promises but are equally keen to ensure people achieve adequate retirement incomes. Yet, even in an extensively privatised system like the UK’s, citizens still consider the state to be responsible for ensuring adequate pensions, whether from state coffers or at least by overseeing a well-functioning private system. For example, when mutual provider Equitable Life collapsed in 2000, affected savers launched a legal and political campaign to force the government to provide compensation. Several investigations including a report by the Parliamentary and Health Service Ombudsman⁸⁶ and a dedicated Committee of Inquiry established in the European Parliament⁸⁷ found that ‘regulatory failure was a major contributory factor to those losses’ and labelled this an ‘outrage’.⁸⁸ The affected policyholders have succeeded in getting £1.5 billion in compensation from the government and are still fighting for a further £3 billion.⁸⁹

Professor Bernard Ebbinghaus, an academic specialising in welfare and pension systems, terms this the 'paradox of privatisation'.⁹⁰ Governments can retreat from their responsibilities to finance pensions out of tax revenues by encouraging workers to build up savings with private sector providers but this creates a growing responsibility to regulate and oversee a plethora of private sector providers, a role which the state may not be resourced to play. The Baird Report commissioned by the Financial Services Authority into the Equitable Life affair, for example, found that a total government staff of 135 people involved in the prudential supervision of 200 insurance companies was not sufficient.⁹¹

“ Savers look to the state for redress when expectations are not met because the hand of the state is so visible in shaping, regulating and frequently changing the pension system.”⁹²

Savers look to the state for redress when expectations are not met because the hand of the state is so visible in shaping, regulating and frequently changing the pension system.⁹² This gives policymakers the justification and responsibility to intervene in the workplace pensions market. Different countries have developed different approaches to structuring and controlling private pension provision with the goal of minimising the degree of state support for citizens in their later years. In the UK, the answer has been to develop ever more detailed rules, codes of conduct and guidance notes. Other countries have instead mandated the use of certain business and governance models. In Australia, for example, all workplace schemes must be governed by a board of trustees. In Denmark workers, unions and employers have well-enshrined participation rights in the governance structures of all scheme types, which means that less detailed regulations are required. In the Netherlands, as in Australia, policymakers have intervened to drive scale and reduce the number of small schemes. The next chapter looks at business and governance models in pensions from the best performing countries globally to identify what an ideal model entails.

Chapter 2

Identifying good business and governance models

The research identified a framework for unpacking good governance into its several constituent parts, to facilitate the comparison of different systems. These are:

- motivation and alignment of interests of parties, including beneficiaries; scheme boards; scheme executives; asset managers; and employers
- independence and diversity of key decision makers
- skills, knowledge and resources of board beneficiaries and the scheme
- accountability and transparency of board decision making
- allocation of powers and responsibilities within the scheme and throughout the investment chain.

Motivation and Alignment of Interests

As noted, a central finding of the Kay Review is that incentives are misaligned throughout the heavily intermediated equity investment chain. The system looks like it is calibrated to serve the interests of intermediaries rather than the end beneficiaries and suppliers of capital, in this case pension scheme beneficiaries. As discussed, net returns to UK pension savers have been negative in real terms for most of this century but, in the words of a report by the Centre for Policy Studies, the 'industry's remuneration has been excessive'.⁹³ The Office of Fair Trading's comprehensive study of the workplace pensions market also concluded that:

*'better alignment of the incentives of employers, trustees, advisers, providers and investment managers with those of scheme beneficiaries is the best way to ensure that actions are taken in the interest of scheme beneficiaries'*⁹⁴

Aligning interests is crucial as regulation is unlikely to work if it conflicts with agents' incentives.

One obvious way to ensure incentives are aligned is through participants in governance structures having 'skin in the game'. This term is associated with the investor Warren Buffet who requires people investing his money to also have some of their own money invested in the portfolio. The think tank Demos defines it as: 'sharing some of the risk, not just the rewards, when taking decisions with significant implications for others.'⁹⁵

“

better alignment of the incentives of employers, trustees, advisers, providers and investment managers with those of scheme beneficiaries is the best way to ensure that actions are taken in the interest of scheme beneficiaries

Office of Fair Trading

”

Demos argues that this principle could be applied to regulation: instead of relying on increased information disclosure and oversight from regulators, which is unlikely to work in complex markets involving huge numbers of transactions, decision makers should have skin in the game. Skin in the game mechanisms, they argue, can be particularly useful in markets characterised by principle-agent problems and asymmetries of information. Such mechanisms need to be designed carefully to avoid perverse consequences, as some argue has been the case with share options for corporate directors. Whether or not there is skin in the game depends largely on the ownership or business and governance models.

Saver Representation in Governance

The clearest example of skin in the game in the context of pension schemes is the inclusion of saver elected representatives in governance structures. An individual whose own pension savings are invested in the scheme has a strong alignment of interests with the wider membership. Non-saver representatives, who are selected or elected by beneficiaries and beholden to them for reappointment, are the next best option. The evidence examined suggests that saver representation can bring numerous benefits.

In the research gathered for this report member nominated trustees (MNTs), or individuals with experience of working with them, repeatedly said that despite not being pensions or investment experts, MNTs would often ask difficult questions of providers. Several interviewees and roundtable participants said MNTs can be less reticent to ask questions that seem 'silly', or obvious, compared with professional trustees with a reputation to uphold.

For example, one MNT said their scheme received advice that VAT on scheme services could not be recovered when the scheme went into administration. As this did not seem logical they wrote to HMRC, recovered the VAT and received an apology from the administrators for the incorrect advice. We heard other examples of MNTs making a difference to outcomes included fighting for cost savings resulting from a scheme merger to be passed onto beneficiaries; initiating the formation of sub-committees, for example on audit, investment or administration; putting contracts for professional advisors out to tender, resulting in fee savings; and acting as an approachable point of contact for other beneficiaries, who were nervous about asking questions to professional representatives of the scheme.

Some commentators doubt that member representation is workable in a multi-employer environment, because the membership is too diverse, they do not know each other and they may have very different needs. Yet even within a large single-employer there will be beneficiaries in different geographies, with very different salaries and opinions, but member nominated representatives have played a valuable role for many years. Although the employing organisations can be very different, the point of view of beneficiaries may not be all that different, and the key is that whichever individual organisation a member comes from, they share with all other beneficiaries a stake in good outcomes.

Dutch pension giant ABP achieves member representation in a multi-employer environment through the involvement of trade unions and allowing the whole membership to vote for representatives to the supervisory and accountability bodies. Although the 2.3 million beneficiaries are all public sector workers, they come from across the civil service and the education sector. Four different unions are involved in governance, showing that unions can play a role even when there is not one union recognised by all employers in the scheme.⁹⁶

It is certainly challenging to engage all beneficiaries in pension scheme governance even in the Netherlands where representation and accountability mechanisms, such as Works Councils to represent employee interests at firms, are a more common feature of the working culture. APB, like The Pensions Trust in the UK, held elections for saver representatives in 2014 and reported that turnout was low.⁹⁷ In ABP's case turnout was 4% which nevertheless represents over 84,000 votes cast. Yet neither organisation views low turnout as a reason to abandon the practice, rather an area they seek to improve in years to come. To say that low turnout is a reason not to hold elections is to misunderstand the role and value of saver representatives and feeds a cycle of disengagement. What is important is a selection mechanism for a proportion of board beneficiaries that is independent from the scheme management, and that saver representatives bring a distinctive, non-conflicted perspective to governance.

Denmark: Saver, Union and Employer involvement in Governance

In Denmark worker and employer representation is a far better established and widespread feature of pension scheme governance. There are 3 types of business and governance models for occupational pensions, which are predominantly DB/DC hybrids:

- Multi-employer saver owned pension funds. These are established through collective bargaining between the union for that sector and the employer organisations. Under Danish law, at least half the board must be elected by beneficiaries. Typically the rest of the trustees are elected by the unions.
- Non-commercial life insurance companies. These are also established through collective bargaining, the company is owned by the union for that sector and the employer organisations, who elect trustees to sit on the board at the company's AGM. Employers and union representatives, therefore, sit on the board and unions usually have the majority of seats. Company employees are also represented on the board, as is required for all Danish companies.
- Commercial life insurance companies. Organisations who are not covered by an industry or sector wide arrangement enter into contracts with commercial insurance companies. These are not established via collective bargaining, but schemes have AGMs where beneficiaries elect independent, professional trustees. Company employees are also represented on the board, as is required for all Danish companies.⁹⁸

The Danish Pension System has been ranked as the best in the world for several years in a row by the well-respected Melbourne Mercer Global Pension Index.⁹⁹ According to the OECD's Pension Markets in Focus 2013 report the pension system in Denmark had the lowest costs out of 40 countries studied, and the Netherlands had the third lowest.¹⁰⁰ This is assessed by measuring total operating costs in relation to total assets managed.

Research by the World Bank into the Danish system found that average total operating expenses, which includes investment and administration costs, from 1995-2004 was significantly lower for the multi-employer,

saver owned funds (0.323% of average assets) than for the insurance companies (0.643%).¹⁰¹ The study did not separate out the insurance companies into the commercial and non-commercial. Returns on investment were slightly higher for insurance companies (7.4%) than for the multi-employer funds (6.9%), but not high enough to compensate for the higher fees.

There are several explanations for these impressively low costs, all related to Danish business and governance models. For example, the quasi-mandatory nature of sector wide schemes means there are no costs relating to marketing to attract beneficiaries or employers. Also, if individuals change jobs but stay within the same sector or profession, they still stay in the same scheme which minimises administration costs. There is a much lower number of schemes than in the UK, meaning beneficiaries benefit from economies of scale.

The well established presence of stakeholder representatives in governance, whose interests are aligned with the wider membership, is a clear hallmark of the Danish system. In the multi-employer funds and non-commercial life insurance companies, the saver and employer representatives do not have conflicting loyalties to other stakeholders, for example an obligation to deliver profits to shareholders. As collective bargaining is trusted and functions well, regulatory interference is minimised. As the academic Andersen says:

*'Labour Market pensions are in accordance with the Danish tradition of including labour market agreements and supplementary benefits in the collective negotiation system, rather than legislation.'*¹⁰²

Government intervention in the Danish Pension system is small and limited to gender equality requirements, surveillance by fiscal authorities and risk control measures set at a 'high ceiling'.¹⁰³ This type of system is a clear example of what the Kay Review calls 'relationships of trust and confidence' delivering good outcomes for beneficiaries and minimising the need for detailed regulation of inappropriate structures.

Employer Representatives

In workplace pension schemes in the UK employers pay a large part, or even the majority, of contributions. This in itself should motivate the sponsoring employer to care whether or not the pension scheme delivers good outcomes and means that employer representatives have roles in the governance structures of some types of scheme.

“ Numerous participants in our roundtable and interviewees said that employer scrutiny of pension providers needs to be encouraged and facilitated even though in DC schemes they no longer bear investment and inflation risk. ”

In a defined-benefit model, employers' interests can often be opposed to those of beneficiaries, particularly when schemes have a deficit which employers may want to reduce by cutting beneficiaries' entitlements. In a defined-contribution context, where employers do not bear investment or inflation risk, their interests are better aligned with those of beneficiaries but employers can lack motivation to actively scrutinise the scheme. The Office of Fair Trading's report on DC schemes found evidence that where a single trustee board oversees an employers' DB and DC schemes 'trustees often tend to deprioritise reviewing the DC scheme'¹⁰⁴, which demonstrates what can happen when employers are not exposed to investment risk.

Numerous participants in our roundtable and interviewees said that employer scrutiny of pension providers needs to be encouraged and facilitated even though in DC schemes they no longer bear investment and inflation risk. Although employers' interests are not perfectly aligned with those of beneficiaries, they are independent of pension service providers and other third parties who profit commercially from pensions business. Furthermore employers do pay the bulk of contributions and have a stronger link to active beneficiaries than external pension scheme providers.

Employer involvement in governance, for example via employer nominated trustees, is perhaps most straightforward in a single-employer environment. But the scrutiny of employers who care about pensions can also improve outcomes for all scheme beneficiaries in a multi-employer arrangement and can take the form of employer

representatives on governance structures or separate employer panels. Although many employers would not be interested in committing time and resources for such involvement, enough employers do care about DC outcomes and scheme performance that finding candidates for these positions should be possible. As one interviewee said:

'Some employers care passionately about pensions and want to 'do pensions' but other employers don't, they just want to achieve compliance with the rules.'

Employers' alignment of interests with scheme beneficiaries and motivation to scrutinise the scheme can also be encouraged through aligning company directors' pension provision with the rest of the workforce. Instead, research by the TUC found that

*'executives are increasingly being offered a menu of options with the majority using ostensible retirement contributions as a cash top-up to their overall pay package. These pension options are provided on significantly better terms than those available to employees.'*¹⁰⁵

If company executives had to place their employer provided pension contributions in the same scheme as the rest of the workforce, this alignment of interests would provide a powerful motivation for the executives to ensure the scheme was working well. There is a precedent for this kind of approach in the United States, where some senior executives can only receive employer contributions if they can demonstrate 'substantial' employee engagement with the company's 401k plan.¹⁰⁶

For-profit versus not-for-profit schemes

A key business model feature affecting alignment of interests is whether the pension scheme is delivered by a for-profit or not-for-profit entity. Commercial pension providers who are listed companies, such as the majority of insurance firms in the UK, have an inherent conflict between the obligation to deliver returns on investment to beneficiaries and to deliver profits to shareholders. Furthermore, quarterly reporting to shareholders drives short-termism which is misaligned with the decades long time horizons over which beneficiaries save for their pensions.

If commercial firms purchase services like asset management or administration from another part of the company, there may be little incentive to drive costs down to benefit the beneficiaries. Where cost savings are achieved, the provider must decide whether to pass these back to beneficiaries or on to shareholders. The 2014 Independent Project Board's finding that between £23.2bn and £25.8bn of savers' assets are in contract-based workplace pension schemes which may have unacceptably high charges¹⁰⁷ shows the potential for profit-making providers to ignore beneficiaries' best interests. However there was no equivalent audit of trust-based schemes.

“there are serious problems with the law relating to contract-based pensions, particularly in an auto-enrolment context.

The Law Commission

It is difficult to find completely clear cut evidence comparing not-for-profit to for-profit workplace pension providers. Data on the commercial and the non-commercial insurance providers in Denmark are not recorded separately for example. In Australia, there is clear evidence, discussed in more depth below, that not-for-profit schemes delivered better returns to beneficiaries over a decade¹⁰⁸ but, as in all the countries examined, there are several different variables operating at once. Not-for-profit models are more likely to have member or union representatives on trustee boards; schemes often resulted from collective bargaining, and different legal duties apply to the governing bodies.

Legal Duties

An alignment of interests between beneficiaries and the people managing their pension can also be promoted via the legal duties placed on the latter. Trustees in the UK have a clear fiduciary duty to prioritise beneficiaries' interests and resolve conflicts of interest in their favour. In Australia, the governing bodies of all workplace pension funds are subject to fiduciary duty. Comparable legal duties apply to trustees in other jurisdictions, for example Dutch and EU legislation refer to the 'prudent person principle' and duties to act in beneficiaries' best interests.

As discussed in more depth in ShareAction's 2012 report 'Whose Duty?' the legal regime protecting savers in

contract based schemes is significantly weaker than fiduciary duty which applies in the trust-based setting. Under trust law, the beneficiaries are seen as vulnerable and in need of protection by the trustees but the contract-law framework defines savers as active consumers capable of making informed decisions. In theory, the beneficiaries of contract-based schemes are protected legally by the binding terms of their contract. In practice, the asymmetries of information between parties to contracts for complex financial products mean that these agreements can be, and often are, written in a way that favours the provider and imposes unfair terms on customers.

The UK Financial Conduct Authority's (FCA) regulations covering contract-based providers require providers 'to act honestly, fairly and professionally in accordance with the best interests of its client.'¹⁰⁹ This 'Treating Customers Fairly' (TCF) Regime is weaker than the fiduciary duties covering trustees in several ways. Contract-based providers must 'manage conflicts of interests fairly', rather than avoid conflicts of interest altogether as trustees must,¹¹⁰ and they do face a significant conflict between the duty to deliver a profit to the firm and to deliver the best financial outcomes for pension savers.

The weakness of the FCA's TCF regime is shown by the numerous scandals that have hit financial services providers covered by its rules. For example, as of November 2014 UK banks have paid a total of £23 billion in compensation for Payment Protection Insurance mis-selling¹¹¹ and the mis-handling of these claims has become an issue in itself. The Law Commission thus concluded that 'there are serious problems with the law relating to contract-based pensions', particularly in an auto-enrolment context.¹¹²

Independence and Diversity

The Walker Review of Governance in UK banks and financial institutions identified 'a disciplined process of challenge' by a governing board as crucial for sustainable high performance in financial institutions:

'The most critical need is for an environment in which effective challenge of the executive is expected and achieved in the boardroom before decisions are taken on major risk and strategic issues. For this to be achieved will require close attention to board composition'.¹¹³

The question of culture in financial services institutions and their boards has been much discussed. Calls for cultural change have become louder following the 2008 crisis when it became clear that many boards exhibited groupthink and a lack of genuine scrutiny. It is widely acknowledged that diverse boards foster lively debate, robust decision making, and a willingness to challenge decisions made below board level, including those by suppliers. The government's own 2011 review of 'Women on Boards' concluded that:

“boards make better decisions where a range of voices, drawing on different life experiences, can be heard.”¹¹⁴

Abersoch, M., for Department of Business Innovation and Skills

Achieving diversity in the governance structure of pension schemes requires individuals of different ages, backgrounds, genders, sexual orientation and ethnicities (identity diversity), as well as professional backgrounds, experiences and mind sets (cognitive diversity). In his book 'The Difference', University of Michigan Professor Scott Page draws on an extensive range of evidence to show that diverse groups generally outperform non-diverse groups, particularly when tasked with problem solving, and even sometimes when the non-diverse group comprised of experts, or the 'best and the brightest'.¹¹⁵ Page concludes that diversity can often, but not always, trump ability and that the two qualities are certainly complimentary. Cognitive diversity is more important while identity diversity has value mainly as a predictor of this, Page argues.

The issue of identity diversity has additional relevance for pension schemes due to the different outcome experienced by different groups. Calculations of the income 'replacement rate' a worker will achieve in retirement (compared with their pre-retirement income) if they contribute certain percentages of their salary to their pension fund are still predicated on the assumption of 40 years of full time work. This may be typical for a male worker but is rare for females as a result of working part time or taking career breaks to fulfil caring responsibilities. Many women thus do not build up enough savings when in fact they need more due to increased female life expectancies; two-thirds of pensioners in poverty in the UK are female.¹¹⁶

It is not unreasonable to assume that a continuing failure to adequately consider outcomes from women's perspectives is linked to the male dominance of pension scheme boards and senior management. The finance sector is notoriously male dominated and a recent study of small trusts in the UK found that 84 percent of trustees are male, for example.¹¹⁷ Identity diversity in the governance structure is important for other groups apart from women; one interviewee pointed out that member nominated trustees in schemes they had worked with had been instrumental in pushing for same sex couples to have rights in relation to their partners' pension pot, for example.

There has been little attention from UK policymakers on how board diversity affects pension scheme outcomes, particularly when compared to the high profile of the debate led by the Department of Business Innovation and Skills on gender diversity on company boards. Policymakers in other countries, however, have taken measures to promote cognitive and identity diversity.

The Netherlands – recognising the importance of diversity for good governance

It is difficult to pin down the causes of organisations' particular working cultures; many factors including individual personalities and national traditions influence this. However, one distinctive feature of the Dutch system is that the importance of diversity for a successful governance culture is recognised and even enshrined in law. One interviewee suggested that the particular culture of Dutch pension fund boards explains why schemes achieve amongst the lowest costs and charges in the world for their beneficiaries.¹¹⁸

'Boards of trustees in the Netherlands generally negotiate more than they do in the UK, for example in the Netherlands pension fund boards will negotiate a lower bonus cap for their asset managers, 20% is common but in the UK the cap is more like 100% or sometimes unlimited'

The Dutch pension system is similar to the Danish in that workplace pensions are either provided for through not-for-profit pension funds, which can be single company or industry wide, or via contracts with commercial insurance companies. The Code of Governance Principles for insurers stipulates that 'Complementarity, a collegial board and diversity are preconditions for the executive board to perform its tasks properly.'¹¹⁹ Insurers are governed by a dual board structure, executive and supervisory, and the same diversity requirements apply to the supervisory board. The diversity requirements for pension funds are more specific and far reaching. The law has long required governing boards to have equal numbers of employers and employees and bi- or tri-partite board structures to ensure supervision.

Dutch pension schemes suffered heavy losses from the 2008 financial crisis with the result that many schemes had to cut benefits in payment to pensioners. The question of intergenerational fairness in the Dutch system has often arisen and is particularly important as beneficiaries' money stays in the same pool during the accumulation and decumulation phases. As part of a package of governance reforms to raise standards and improve trust, stricter diversity requirements have been introduced which require age and gender diversity alongside the established

diversity of stakeholder groups (beneficiaries, deferred beneficiaries, unions and pensioners).

Governance structures for Dutch pension funds must include an executive function, performed by trustees, an internal supervisory function and a stakeholder body. There are 5 different models permitted for the arrangement of these three functions. The new Code of the Dutch Pension Funds requires each of the 3 functions to be comprised of at least one man and one woman and at least one saver over the age of forty, and one saver under forty. The rationale encompasses the need for identity diversity, so that management reflects the membership, and cognitive diversity:

*'When representatives of various groups are involved in the process, a multi-dimensional perspective can be achieved, which is of benefit to the decision-making process...To perform optimally, a board requires a range of skills cultures and views. This applies even if the composition of the beneficiaries provides no reason for diversity'*¹²⁰

To help ensure independence of mind-set, the Dutch regulator has also recently introduced a requirement that the Chair of Trustees must hold a maximum of 2 posts. 'This prevents individuals from holding 9 or 10 posts and all the posts going to the old boys' network' according to one interviewee and is another example of the Dutch regulating the governance structure rather than the activities of pension funds.

Compared with the UK's regulations, Dutch pension regulation seems to focus more on governance requirements than the detail of pension fund operations. Recent reforms have been much debated in the Netherlands, especially the new financial assessment framework (FTK) and indexation rules. The debate regarding composition of governing and supervisory bodies has centred around how to achieve the right balance between experts, different stakeholder groups and regulators, not questioning that there should be a balance. The Federation of the Dutch Pension Funds for example responded to FTK proposals saying it would be

impossible to achieve intergenerational fairness through legal means and instead the task should be left to workers, employers, pension fund boards and internal bodies to decide collaboratively.¹²¹

In the Dutch system, like in Australia, the emphasis is on appointing diverse boards and ensuring their capabilities through training. For example, the Chairs of boards at insurance companies have to organise programmes of lifelong learning to maintain and improve the expertise of the rest of the board beneficiaries.¹²² All board

beneficiaries have to participate and the effectiveness of the programme must be regularly assessed. At pension funds, the knowledge and skills of boards are assessed as a whole, so individual beneficiaries do not all need to be experts to take up a post. As the Director of pension funds at supervisor De Nederlandsche Bank explains:

*'a fresh look could be a welcome addition to the collective...The smartest person is not by definition the best board member. We also assess whether he or she can hold his or her ground within the board.'*¹²³

Skills, Knowledge and Resources

The Myners Review recommended that decisions should only be taken by 'persons or organisations with the skills, information and resources to take them effectively'.¹²⁴ A criticism of representative models is that trustees or other stakeholder representatives from outside the financial services industry lack the necessary skills and knowledge for the complicated task at hand. Some pension schemes undoubtedly have poor governance and deliver poor outcomes; an estimated £0.9 billion of savers' money in the UK is in schemes with fees greater than 3% per annum for example, far higher than the new 0.75% charge cap for automatic enrolment default funds.¹²⁵

Our research did not find evidence that the poor performance of some schemes is due to the presence of lay trustees or representatives, or indeed that business and governance models involving more stakeholder representatives perform worse than those run exclusively by finance industry professionals. Where schemes with lay-representatives do perform poorly, lack of scale, expensive and outdated administrative systems, use of expensive investment strategies, poor oversight of outsourced arrangements, opacity of fees paid and the investment strategies were cited most frequently as the cause.¹²⁶

Are experts always best?

If the most important quality for scheme management is professional knowledge and industry experience, it would be reasonable to expect that contract-based schemes would deliver better results for beneficiaries. Contract-based schemes within large insurers have access to skills, knowledge and resources and cannot be said to be held back or disadvantaged by inexperienced lay trustees. However contract-based schemes are not delivering better results for beneficiaries, for example through lower charges, higher returns or more comprehensible and engaging communications. Research by the Australian Institute of Superannuation Trustees comparing Australia, Canada and US found that annual returns, net of fees, 'are superior for trust based (or similar) schemes as opposed to contract-based ones.'¹²⁷

The Kay Review was also highly critical of the trend towards relying exclusively on professional experts and sees this as evidence of trust between stakeholders breaking down:

*'there has been an explosion of intermediation in equity investment, driven both by a desire for greater professionalism and efficiency and by a decline in trust and confidence in the investment chain. The growth of intermediation has led to increased costs for investors, an increased potential for misaligned incentives and a tendency to view market effectiveness through the eyes of intermediaries rather than companies or end investors.'*¹²⁸

Australia: the success of diverse, genuinely independent trustee models

The Australian experience also provides evidence that representative governance models incorporating diverse stakeholders in a not-for-profit business model are more successful than models where commercial providers appoint professional trustees. In Australia, all pension schemes are trust based¹²⁹; for-profit retail schemes appoint two thirds of their trustees internally, or appoint trustees through executive search or personal contacts. Less than 5% of for-profit scheme trustees are elected by employers and none are elected by beneficiaries.¹³⁰

In the not-for-profit schemes the majority of trustees are elected by employers or beneficiaries or appointed by unions or employer groups. Less than 3% are appointed through executive search. The McKell Institute has provided comprehensive evidence that in Australia's Superannuation system:

*'the not-for-profit representative trustee model has outperformed its for-profit appointed trustee competitors on virtually every important criteria of superannuation performance over a long period. Although there may be scope for further improvement of the representative governance model, it promotes higher levels of diversity among trustees, more effectively minimises conflicts of interest and, importantly, has continually outperformed the for-profit model over the past decade, generating higher net returns for fund beneficiaries.'*¹³¹

Using data from the Australian Prudential Regulation Authority they show that the not-for-profit schemes with representative governance models generated risk-adjusted returns that were on average 2.4% higher per annum on a risk adjusted basis than the retail pension

funds over the last decade.

Despite the clear success of the representative model, the latest Government Review of the Australian system, the Murray Report, recommends mandating a majority of independent directors on the board of trustees of superannuation funds, including an independent chair.¹³² Reasons given for this are that independent directors bring an objective perspective and hold other directors accountable for conduct particularly in relation to conflicts of interests. Although this is likely to be the case when improving the ratio of independent directors to firm employees on the board, it is not clear that the same logic is applicable when replacing stakeholder representatives with independent directors.

The Murray Report acknowledges that 'funds using the equal representation model have generated higher returns than other funds in recent years.'¹³³ It must be concluded that the recommendation to 'replace the industrial relations system'¹³⁴ with more market-based competition is ideologically motivated rather than evidence based. The report asserts that:

*'consumers are generally best placed to make financial decisions that meet their financial needs and have a responsibility to accept the outcomes of those decisions when they have been treated fairly'*¹³⁵

This philosophy has been widely discredited in the context of occupational pensions where consumers have limited choice and are disadvantaged by huge asymmetries of information and poor comparability of products.

Balancing Experts and Stakeholders

In Denmark there has also recently been a debate around achieving the right balance of expertise and stakeholder representation with the fallout from the 2008 financial crisis leading to calls for more expertise. The regulator recently introduced a requirement for boards to include some independent experts, but the majority of seats are still reserved for saver or employer representatives.¹³⁶ Independent expertise is sought in addition to stakeholder representation, not instead of it.

the not-for-profit representative trustee model ... has continually outperformed the for-profit model over the past decade, generating higher net returns for fund beneficiaries.

McKell Institute

The independence of expert 'independent' trustees is also debatable. Several interviewees praised the independent trustees they had worked with saying this is a good way to get expertise onto the board and cost effective compared with using consultants. But some interviewees told us that they had experienced boards where the 'independent' professional trustees, who had worked for many years in the financial services industry, were the least likely to challenge service providers during board meetings, particularly around fees and charges.

Industry outsiders, such as member or employer nominated representatives, can have a different view of what seems fair or reasonable which sometimes makes them more likely to ask tough questions. One interviewee expressed the view that:

'Member Nominated Trustees are sometimes the only people from outside the 'cosy club' of providers, advisors and consultants who are actually independent. They can be the only people prepared to ask difficult questions and challenge things like fees and charges, whereas an adviser who is themselves on £100k a year wouldn't.'

Another interviewee also said that independent experts can focus on the area that they are experts in and neglect scrutiny of other matters, so investment experts fail to properly concern themselves with member communications for example. Therefore a balance of stakeholder representatives and experts in a variety of different fields would seem to be the most desirable combination. Although pensions and investments are undoubtedly complex topics the 1993 Goode Report found that fears relating to the competency of MNTs had been 'exaggerated'.¹³⁷ Most interviewees also strongly rejected the idea that lay trustees are just not up to the task. One said that individuals who put themselves forward for these roles are 'bright, competent people, they just don't necessarily have experience in the finance world'. Another went further, saying:

'Member trustees are professional people with years of good experience in their profession. We should not buy into the financial services industry's 'mystique' that only people who are investment experts can possibly understand how this all works.'

The capabilities of trustees, lay and professional, have been found to be 'heterogeneous'¹³⁸ according to one academic study and several interviewees raised the issue of training (or the lack of it). For example, one interviewee although a vocal defender of the role of MNTs in the system said:

'we do have to be honest that not all trustees are up to speed, we are carrying deadwood in the system. This is because they haven't been given the training.'

The other key issue identified in relation to trustee capability is the in-house support they receive, both administrative and expert. Several interviewees stressed that meeting several times a year for a few hours makes it extremely challenging to cover all the necessary ground or adequately scrutinise service providers. The 2001 Myners Review found that 77% of trustees have no in-house professionals to assist them and thus concluded that we 'make wholly unrealistic demands of pension fund trustees.'¹³⁹ Thus the poor performance of many smaller and medium sized trust-based schemes cannot be blamed upon the inclusion of member and employer representatives on the boards.

Member Nominated Trustees are sometimes the only people from outside the 'cosy club' of providers, advisors and consultants who are actually independent.

Interviewee

Training

The need for individuals responsible for governance to have the necessary skills and knowledge must be balanced against the need for a diverse board with different professional backgrounds and viewpoints. An obvious way to achieve this is to provide training to trustees and managers from outside the pensions industry. In the other countries examined in this study, training is compulsory for individuals with pension scheme governance responsibilities and usually facilitated by the regulator but this is not the case in the UK.¹⁴⁰ It is difficult to argue why programmes like The Pensions Regulator's Trustee Toolkit should not be compulsory considering the potential saver detriment resulting from poor trustee governance.

Interviewees did emphasise that lay trustees need to be given time off by employers for training as well as to attend board meetings. Some suggested that training should include negotiation skills to make sure trustees have the confidence to challenge providers. As one interviewee said:

'The financial services people deliberately try to bamboozle outsiders, for example with jargon and abbreviations. It can be very intimidating for outsiders to walk into a room of well-dressed finance professionals... and challenge them. This is why you need people with confidence.'

Allowing MNTs time to fulfil their duties needs to be made attractive to employers as, understandably, many may be reluctant to give workers the time off, particularly in a multi-employer pension scheme environment. However, this is not an insurmountable obstacle. Roundtable attendees agreed that employers could be reimbursed from the scheme for the paid hours that an MNT spends on pension scheme duties. The skills and knowledge that the employee would build up could be emphasised to the employer. Training could even be accredited by recognised bodies so that it would count towards continuing professional development requirements or points that employees in certain sectors or companies have to accrue.

Also, there is a precedent for individuals balancing full-time or part time jobs with public duties. Magistrates, local councillors, school governors, health authority beneficiaries, trade unionists and beneficiaries of Army Reserve forces for example all have rights to time off work to fulfil these duties under the Employment Rights Act 1996.¹⁴¹

Legislation obliges employers to be supportive of reasonable requests for time off. Some companies also have Corporate Social Responsibility policies which include a provision to allow employees a certain number of days off a year to undertake voluntary work if the employer is supportive of the mission of the organisation where the voluntary work will take place.

The Australian Cooper Review of the Superannuation system concluded that trustee-directors do not need any 'specific pre-appointment skills or training' but that they must fulfil on-going training requirements on an annual basis. The skill set of the board of trustees is assessed on an individual rather than a collective basis.¹⁴² This facilitates greater diversity whilst ensuring competence.

The Dutch, Danish and Australian approaches contrast noticeably with the philosophy of UK regulators who favour appointing master-trustees or IGC members who already have all the necessary knowledge instead of trying to secure a diverse mix and providing training to facilitate the involvement of industry outsiders.

Scale

The size of a pension fund clearly influences the available skills, knowledge and resources and there is a growing body of evidence regarding the benefits of organisational scale to saver outcomes. Modelling by the NAPF concluded that consolidation in the UK to a smaller number of larger schemes 'would deliver considerable savings.'¹⁴³ The London Pension Funds Authority and the Lancashire County Pension Fund recently announced that they would merge their assets into a joint investment vehicle and expect this to halve costs per saver within 5 years and save £50 million a year.¹⁴⁴

“ *The clear benefits of greater scale give policymakers a strong reason to intervene in the market to ensure DC schemes are of an adequate size.* ”

Bigger schemes are better able to secure people with the necessary capabilities to govern the scheme thanks to their greater resources and larger pool of candidates they can draw from in the case of member or employer representatives. For example the Office of Fair Trading found that:

*'large single employer trust-based schemes tend to have good scheme governance...By contrast, we have significant concerns about the governance of smaller, single employer trust-based schemes. Trustees in these schemes may lack the necessary expertise and may not provide governance oversight on an ongoing basis.'*¹⁴⁵

Scale is also important for the resources available for governance within the business model. A trustee or scrutiny board typically meets quarterly so adequate executive support is crucial and is most cost effectively provided in a bigger scheme. Several interviewees also noted that the larger the scheme, the more bargaining power they have to drive down prices for services of third parties.

Scale is a benefit for beneficiaries but also for regulators. One interviewee pointed out:

'the regulator also has a limited budget, so as there are so many schemes in the UK the regulator can't oversee them all and just focuses on the biggest ones...this means that beneficiaries in small schemes through no fault of their own are much less well protected by the regulator.'

The clear benefits of greater scale give policymakers a strong reason to intervene in the market to ensure DC schemes are of an adequate size. Regulators in other countries have been doing this. It is an example of regulatory intervention to amend the business and governance model instead of detailed regulation of processes in pension schemes. The Dutch pension regulator, for example, has been active in seeking to reduce the number of schemes in their country from over 3,000 to around 500.¹⁴⁶

In Australia, schemes have to assess and report to the regulator annually on whether insufficient scale in terms of beneficiaries or assets means the financial interests of their beneficiaries are compromised compared to the beneficiaries of products in other schemes.¹⁴⁷ Therefore small schemes that are working well are not forced to merge or transfer beneficiaries to a different scheme; but they must justify how they are overcoming the inherent disadvantages of operating at a small scale. The number of schemes fell from 5,000 in the mid-1990s to 500 by the end of 2009¹⁴⁸ and the average scheme size in Australia is 26,000 beneficiaries compared with 2,500 beneficiaries in the UK.¹⁴⁹

UK policymakers do acknowledge the importance of scheme scale,¹⁵⁰ but hope that market forces will drive consolidation. It could take a very long time for this to happen organically, particularly considering the extremely long tail of small schemes in the UK. As automatic-enrolment is currently underway and bringing millions of new savers into the pension system, action is needed sooner rather than later. Also, as a Centre for Policy Studies report points out, despite the clear benefits of scaling up:

'it is naïve to expect professional trustees to be pursuing scheme consolidation ("scaling up") with enthusiasm; it runs contrary to their interests. Fewer schemes means less business'.¹⁵¹

An alternative to forcing or nudging smaller schemes to merge is to facilitate collaboration. In Denmark it is common for schemes to collaborate, for example by pooling funds for investment or jointly purchasing services from third-parties.¹⁵² The detailed and complex pension regulations in the UK do not encourage or facilitate collaboration. For example, The Pension Regulator's 58-page Code of Practice for the 'Governance and administration of occupational DC trust-based pension schemes' does not contain a single reference to collaboration with other schemes.¹⁵³

The clear advantages of scale to beneficiaries, but clear loss in business that it poses to professional services firms such as asset managers who make profit from pension scheme clients, does suggest that government inaction is a result of successful lobbying from the industry.

Scale and Responsible Investment

Pension fund scale also seems to affect the quality of investment stewardship because of the resources available, knowledge of the topic and commitment to training. VBDO's study of RI by insurance companies in the Netherlands found a correlation between the size of a company and its performance on RI.¹⁵⁴ Although large companies performed best, followed by medium and then small companies, there were examples of small companies performing well showing that size does not have to be a barrier to doing RI. In the Law Commission's review of fiduciary duty, stewardship of investee companies was deemed to be appropriate for pension funds of all sizes, as smaller funds generally outsource investment management and can instruct their managers to act as engaged shareholders.¹⁵⁵ The caveat is that small funds must thus instruct managers and scrutinise them.

The lack of training for trustees at small schemes compared with larger ones is a likely explanation for why small schemes exhibit less knowledge and acceptance of evolving thinking on RI. UKSIF's Ownership Day survey found that out of the 6% of pension funds who disagreed with the proposition that ESG factors are material to long-term performance of the fund, all were smaller funds (assets of under £5 billion).¹⁵⁶ Larger funds (assets over £10 billion) were also likely to be committed to the UK Stewardship Code whilst smaller funds (assets of under £2 billion) were most likely to say they had no intention of committing to the Code. The survey points out:

*'There is further anecdotal evidence that smaller funds find it more difficult to fully consider ESG issues due to lack of time, resources and in some cases understanding.'*¹⁵⁷

Scale is also important because the larger an investor's stake in a company, the more clout they have to influence. Of course, in an era of highly diversified portfolios large schemes may still have small stakes in individual companies but they have the potential to make larger investments. The disadvantage faced by smaller schemes can be mitigated by investor collaboration, indeed a headline requirement of the UK's Stewardship Code is willingness 'to act collectively with other investors where appropriate'.¹⁵⁸ This provides a further reason why regulators should facilitate collaboration between schemes, as is more common in Denmark; if schemes were already collaborating on other matters it would be easier to collaborate on stewardship issues.

Although there does seem to be a link between scale and RI adoption, bigger does not necessarily mean better in this respect; in ShareAction's last benchmarking study of Responsible Investment by the UK's 24 largest Occupational Pension Schemes, two schemes received zero points.¹⁵⁹ The desire to innovate and manage long-term risk must also be there.

Clear Allocation of Powers and Responsibilities

How powers and responsibilities are distributed in different business and governance models is essential for effective management and goes to the heart of the debate around balancing the involvement of industry experts with stakeholders. An international study of pension fund governance by the well-respected Rotman International Centre for Pensions Management found that clarity concerning the correct role for the board and for management is often lacking.¹⁶⁰

The distinction between oversight and management is crucial; boards are responsible for the former and must clearly delegate day-to-day management to managers. The Rotman study emphasised that boards must be competent and capable of strategic thinking but board beneficiaries need not be investment experts. The role of

the board is to set strategy, provide governance and monitor the scheme and external service providers; they are not meant to pick stocks or make investment decisions. As one interviewee said:

'It is not their role to be investment experts just like on the boards of companies, you would not expect all the board beneficiaries to be experts in the products that the company made; they are meant to provide governance. If a company makes widgets you wouldn't expect all the board members to be experts in widget making'

Although the Myners Review advises that:

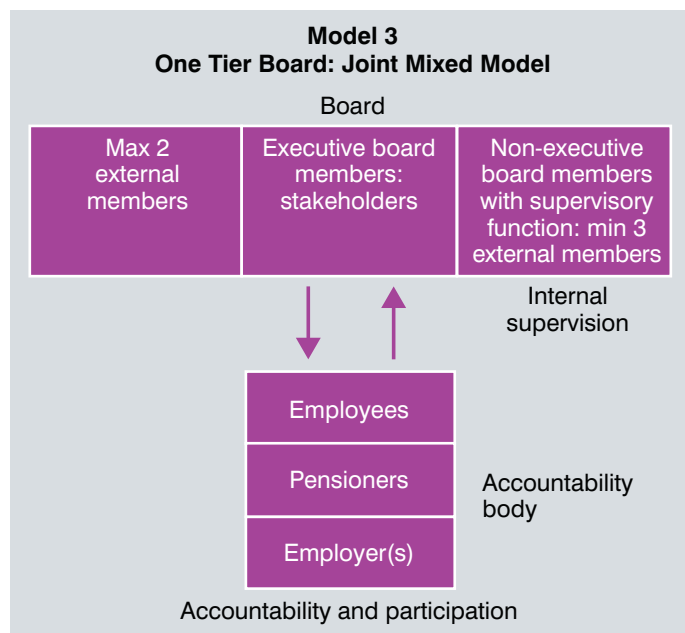
*'Decisions [in DC pension schemes] should be taken only by persons or organisations with the skills, information and resources necessary to take them effectively. Where trustees elect to take investment decisions, they must have sufficient expertise to be able to evaluate critically any advice they take.'*¹⁶¹

It is clear that trustees do not have to take investment decisions but can delegate this, so long as clear objectives and mandates are set and appropriate benchmarks and performance measures are used.

Thus, there is a priori no problem with stakeholder representatives in pension scheme governance who are not pensions or investment specialists, so long as they are adequately supported and provided with training. Such stakeholders bring other qualities and perspectives that are valuable for protecting beneficiaries' interests.

The Rotman study commends the Dutch model, which separates pension fund governance into three functions; management, supervision and accountability and stipulates that a 'clear division of responsibility with a system of checks and balances is essential'¹⁶² with the board of trustees given overall responsibility. The new Code of the Dutch Pension Funds allows for 5 different business and governance models (one of which is shown below), but in each model stakeholder (meaning employer, employee and pensioner) representatives must be incorporated into each of the 3 functions because stakeholder interests are 'paramount'.

Example of the governance structures of Dutch Pension Funds



Source: Code of the Dutch Pension Funds, 2014

In-house or outsourced asset management

In each of the business and governance models examined; trust, master-trust and contract, asset management can be carried out in-house, or outsourced, although a combination of the two is common. Smaller schemes lacking internal resources are more likely to be heavily outsourced,¹⁶³ but even large insurance companies regularly outsource. Outsourcing is meant to benefit beneficiaries through providing access to a wider range of skills and investment opportunities and thus portfolio diversification. Yet a key message of the Kay Review is that heavily intermediated investment chains are often detrimental for end beneficiaries as intermediation increases costs and the potential for misaligned incentives.

A global study of pension fund organisational structures by CEM benchmarking found that funds with more internal management performed better than those with external management across all asset classes studied. They attribute this to higher fees for external management.¹⁶⁴ In Denmark, where pension scheme performance is among the best in the world, asset management is carried out in-house in all but the smallest schemes.¹⁶⁵ Interviewees pointed to other benefits of in-house investment; in-house investment teams can have remuneration structures better

linked to the long-term success of the scheme; teams can move faster to take advantage of investment opportunities and, crucially, close scrutiny of asset managers is easier.

In Australia, the advent of industry-wide, not-for-profit, superannuation funds completely changed the financial services landscape (see Box on page 34). These funds drove prices and fees down through their competitive tendering and bargaining with the commercial providers. Sometimes several funds join together to increase their purchasing power. When schemes could not obtain the services they wanted from the market some created the capabilities to do this in-house instead.¹⁶⁶ This suggests that if more pension schemes showed themselves willing to bring asset management in-house, it would exert competitive pressure on the providers of outsourced asset management services. Of course having a level of purchasing power necessary to secure discounts for beneficiaries or the ability to bring investment management in-house is contingent on funds operating at sufficient scale.

Although the evidence examined suggested that there are more potential problems associated with the outsourced model, this does not mean that carrying out investment in-house is without potential problems. For example, if a large commercial provider purchases investment services from a different division within the organisation there is little incentive to negotiate fees down for the benefit of beneficiaries.

Outsourcing Best Practice

Outsourcing can be made to deliver value for money for beneficiaries if mandates are appropriately set up and scrutinised, as several interviewees pointed out. But pension scheme trustees and managers have a very mixed record when it comes to negotiation with external asset managers over fees. Clark, for example asserts that:

*'because of their modest size (assets under management), many asset holders reach beyond their capabilities and resource, writing contracts with suppliers for investment management services that they barely understand.'*¹⁶⁷

Furthermore pension schemes' legal services are increasingly outsourced to providers often more interested in processing than scrutinising contracts, meaning contracts for investment management services often have

unfavourable terms for the asset owner or beneficiaries. For example, non-disclosure clauses prevent asset owners from comparing fees charged by different asset managers and this inhibits shopping around for a better deal.

Our research identified that best practice for outsourcing requires internal headcount with investment expertise to select and conduct ongoing scrutiny of external asset management. One interviewee explained that although their scheme outsources all investment, they have a seven strong internal investment team to scrutinise the external managers on an ongoing basis. Having internal staff who can advise the board on asset manager performance and selection also minimises reliance on external consultants who frequently have misaligned incentives. There is also a wide acknowledgement that outsourcing may still be the best option for less mainstream asset classes.

Outsourcing can also undermine accountability, as one interviewee said 'in the heavily outsourced model, no one has accountability, the liability is outsourced and it's not clear who has final responsibility'. In the trust-based context the result is that fiduciary duty is undermined. It is not clear whether fiduciary duty applies just to trustees or can be made to apply through the investment chain. The Kay Review found:

*'considerable uncertainty and difference of view among respondents as to whether a fiduciary duty exists in these relationships, and if it does exist as to its precise content.'*¹⁶⁸

Kay argued that fiduciary duties should apply throughout the investment chain and it should not be possible to contractually override them. But the Law Commission found that the courts have taken a more restrictive view and are reluctant to impose these duties in ordinary commercial relationships or to hold that parties in the chain owe duties to others, beyond their immediate client.¹⁶⁹ That said, even if the duty applies only to trustees, beneficiaries of trust-based schemes are still better protected than beneficiaries in contract-based schemes where no one has a fiduciary duty to look after their interests.

Fiduciary Management

An alternative option for an investment governance structure that lies somewhere between full outsourcing and

in-house investment is fiduciary management. This system originated in the US, has become particularly popular in the Netherlands and is slowly growing in the UK. It involves the trustees delegating certain elements of the investment process to the fiduciary manager, over and above what can be given to consultants. Trustees can delegate activities ranging from the hiring and firing of asset managers to deviations based on market movements or asset class allocations within different portfolios and even determining and managing the split of growth and matching assets.¹⁷⁰ Therefore, it is best understood as an outsourcing of governance rather than of investment.

The benefits of fiduciary management are that it frees up the trustees' time to concentrate on larger risks¹⁷¹ and the fiduciary manager can respond more quickly to changing market conditions and scrutinise day-to-day investment management in more detail than trustees who only meet 3 or 4 times a year. The trustees still have ultimate responsibility for the scheme so must carefully and explicitly set the parameters and expectations from their fiduciary manager and decide how to judge success. Therefore, fiduciary management can enable trustees to fulfil the recommendations of the Myners review.

Conclusion

If schemes are using outsourced asset management, the governing body should be required to justify why they are doing so and explain how they are providing adequate supervision. Annual statements from Chairs of Trustees or IGCs would be an appropriate place for such a disclosure. It should also be noted that although there has been an increase in institutional investors bringing investment management back in-house following the 2008 financial crisis¹⁷² this is a challenging process that must be done with care. In order to realise the benefits such as better alignment of interests between principles and agents, higher net-of fee investment returns and more sustainably constructed portfolios where assets match liabilities, the systems, processes and human capital of the pension scheme need overhauling and this must be underpinned by strong governance.¹⁷³

Responsible Investment

It has been discussed widely, in this report and elsewhere that the heavily intermediated investment chain reduces accountability, dilutes fiduciary duty and introduces

misaligned incentives. ShareAction has often heard anecdotally that a barrier to adopting a RI approach was that asset managers and asset owners both consider initiating this to be the other party's responsibility, and thus neither takes action. The UK's Stewardship Code seeks to clarify the situation in this regard, saying that asset owners, including pension funds and insurance companies, 'set the tone' for stewardship:

*'Asset owners' commitment to the Code may include engaging directly with companies or indirectly through the mandates given to asset managers. They should clearly communicate their policies on stewardship to their managers. Since asset owners are the primary audience of asset managers' public statements as well as client reports on stewardship, asset owners should seek to hold their managers to account for their stewardship activities. In so doing, they better fulfil their duty to their beneficiaries to exercise stewardship over their assets.'*¹⁷⁴

This clarity, and the Stewardship Code as a whole, does seem to be driving progress; according to a recent NAPF survey, 80% of pension funds take stewardship into account when selecting and appointing asset managers.¹⁷⁵ However outsourcing asset management is still likely to undermine scrutiny. ShareAction's 2012 survey of UK's 10 biggest contract-based pension providers found that the monitoring of voting and engagement activities was primarily restricted to internal fund management. Only one respondent said that they requested stewardship reports from external managers.¹⁷⁶

Perhaps one of the most damaging misalignments of interest that arise due to a heavily intermediated investment chain relates to investment horizons. Pension funds are by definition long-term investment vehicles that savers contribute to for several decades but the investments made are often short-term in nature. A long-term investor's portfolio should look different to that of a short-term investor, lower portfolio turnover would indicate a genuinely long-term investment strategy, as would engagement with investee companies which takes time to deliver results. Long-term investors should also take advantage of the fact that better prices or returns are available for investors prepared to lock away capital for long periods of time, the so-called 'illiquidity premium'.

But as 25% of mandates for equity investments are for 3 years or less,¹⁷⁷ asset managers often have little incentive to invest for the long-term, as the Kay Review explained:

*The appointment and monitoring of active asset managers is too often based on short-term relative performance. The shorter the timescale for judging asset manager performance, and the slower market prices are to respond to changes in the fundamental value of the company's securities, the greater the incentive for the asset manager to focus on the behaviour of other market participants rather than on understanding the underlying value of the business'*¹⁷⁸

This has led Clark and Monk, amongst others to conclude that:

*"the portfolio a long-term investor would like to hold and the portfolios that long-term investors actually hold are quite different due to an over-reliance on short term asset managers...realizing the advantages of being a long-term investor will inevitably require some level of insourcing due to broken agency problems"*¹⁷⁹

This conclusion was echoed by several interviewees, for example one said:

'The in-house model is also better suited to focusing on the long term and putting beneficiaries' interests first, rather than changing asset managers all the time and chasing the star performers in a particular year, who may not do well the next year.'

“the portfolio a long-term investor would like to hold and the portfolios that long-term investors actually hold are quite different due to an over-reliance on short term asset managers.

Clark, G. and Monk, A.

”

This is not to say that bringing investment in-house is easy. Significant new capabilities and structures need to be developed. Once again the issue of scale rears its head; it is clearly not practical or economical for small schemes to develop and maintain the necessary capabilities.

Australian Industry funds – investing for the long-term

Australia's IFM is an example of investment management for pension schemes that conforms to many of the good governance features identified. IFM investors is an asset manager created in 1998 and is jointly owned by a group of thirty Australian industry (non-profit) funds who sought better value for their beneficiaries than what was available on the market.¹⁸⁰ It is still owned by many of the ultimate investors in its products but operates independently from the pension funds. The organisation is free of conflicts of interest associated with shareholders in a pension provision context.

Thanks to IFM, the not-for-profit industry superannuation funds have led the way on long-term investing, for example in alternative, unlisted assets such as infrastructure. Industry Super Australia, the sector umbrella body, explains that:

*'Soon after the legislation of the Superannuation Guarantee [in 1991], Industry SuperFunds recognised the opportunities presented by direct investment and sought to build internal capability and expertise... Unlisted investments also are intended to be long-term in nature and seek to capture an illiquidity premium to compensate for the fact that they are not liquid and cannot be redeemed for cash readily'*¹⁸¹

It is argued that unlisted investment through pooled vehicles or direct ownership is also often able to

achieve better returns for beneficiaries by cutting down on costs of intermediaries and allowing asset owners more control over the performance of assets, investor protection and manager compensation. On average, Australian Industry Funds allocate almost 21% of funds under management to 'alternative assets', which includes direct and pooled infrastructure investments whereas the commercial funds allocate less than half this amount to similar assets.¹⁸²

One might expect the retail funds, which are delivered via experienced financial services institutions to be more innovative compared with industry funds governed by stakeholders who are not investment experts. But this has not been the case, according to an interviewee:

'the industry funds have been doing much more on ESG and they have been much more innovative than the retail funds. This is because they are saver driven... Industry funds can buy in the expertise they need when they want to innovate but the desire to innovate has to come from the top.'

It seems that the member-centric, not-for-profit industry funds have more of a motivation to relentlessly pursue the best value for their members. They can take a longer-term view than the commercial retail funds which can prioritise delivering profits to owners or shareholders in the short-term.

Accountability and Transparency

In addition to giving member, union or employer representatives formal roles in governance structures, accountability and trust can also be fostered via communication between beneficiaries and scheme management. Actual contact with beneficiaries can remind management who they work for, as Anne Simpson, Senior Portfolio Manager and Head of Corporate Governance at California Public Employees Retirement System (CalPERS) stated in a speech:

'The investment office is located over the Sacramento branch of the CalPERS benefits office – so every morning coming to work I have the chance to say hello

*to those waiting to get some help and advice on their benefits. This is a wholly good thing. There is no sense of being remote from those you are working for.'*¹⁸³

Also, as member representatives on boards do not and are not meant to know what all other beneficiaries are thinking and want from the scheme, member representation must be used in conjunction with other mechanisms to communicate with and engage the wider membership. The Pensions Trust recognises this and has conducted surveys, held webinars where any member or employer can ask questions, and engaged an external company to conduct interviews regularly with a sample of beneficiaries to gauge their views and satisfaction.¹⁸⁴ This

can help build trust amongst the membership but is also seen by management as a useful way to get feedback and evaluate their own effectiveness. Our research identified a range of methods being employed at other schemes. Some utilise new technologies such as Twitter and Facebook accounts, others use more traditional accountability mechanisms such as AGMs and road shows to meet beneficiaries in different geographies or holding board meetings in public.

The experience of the Washington State Investment Board, which invests pensions and some other state assets, suggests that including stakeholder representatives on the board is not enough to ensure a culture of healthy scrutiny and debate or that these stakeholder representatives are listened to. The investment board was set up in 1981 to consolidate dozens of smaller public sector pension plans into one agency and to protect the varied stakeholder interests. Statutes mandate a balanced board of 10 voting beneficiaries including two legislators, the administrators of the retirement and industrial insurance systems and 5 beneficiary representatives. These are supported by 5 non-voting board beneficiaries who are investment experts.

However, in the early 1990s several reviews into how the governance was working in practice were conducted by external advisers after the organisation suffered heavy losses which turned into a public scandal and loss of trust. The reviews found that the stakeholder representatives had little influence in practice:

*'all investment decisions were being made by the Executive Director and a handful of non-voting trustees. ... "if you weren't part of that group you were supposed to come to the meetings and shut up"'*¹⁸⁵

To repair the organisation's culture reforms were enacted to the governance model, for example establishing board sub-committees, setting out decision making processes in charter and expanding the board education programme. Proactive engagement with stakeholders was made part of the 'organizational DNA'¹⁸⁶ through a proactive media strategy, holding board meetings in public and on the record, and making it a strategic priority to actively engage with groups with ESG related concerns.

Trust as an enabler of long-termism

Trust is a major theme of the Kay Review, with Kay citing a loss of trust in investor relationships as implicated in the explosion of intermediation and short-termist 'trading and transactional cultures'.¹⁸⁷ A clear way of rebuilding trust in the occupational pensions sphere is via transparency and accountability to beneficiaries and the inclusion of beneficiary representatives in the governance structure. This can give schemes more space to execute a long-term strategy and to innovate instead of focusing predominantly on short-term indicators and following the herd.

The representative governance model and proactive engagement with societal stakeholders at the Washington State Investment Board means that it has room to manoeuvre which was particularly important following losses resulting from the 2008 financial crisis:

*'The two-decade evolution of this governance model has created a situation where today WSIB has full stakeholder buy-in to investment strategy and decisions. This is especially important because our large commitment to alternatives makes us an outlier relative to other public funds.... Because private equity and real estate lag the public markets, returns for those asset classes will recover more slowly, causing us to tack perilously close to the dreaded Keynesian state of "wrong and alone". But the Board fully understands short-term reputation risk, asserting as a primary goal of its 2009 strategic plan: "Maintain the conviction to stay with an investment strategy during the period when the strategy causes underperformance relative to peer institutional investors."'*¹⁸⁸

An RI strategy can take a long time to pay off. For example it could take several years to see the benefits of engaging with an investee company to improve its performance. Also the investment risks posed by climate change or resource scarcity are usually predicted for the medium to long-term although forward thinking investors and companies are starting to plan for them already. Safeguarding long-term value by mitigating these risks may impose a short-term cost, for example investing in research and development of less resource intensive products or production methods. This is not to say that pension schemes should ignore short-term results but that transparency and trust are important for enabling a move away from a damaging over-prioritisation of short-term results and pro-cyclical herding behaviour.

Accountability and Responsible Investment

Public pressure and scrutiny is also an important driver of RI adoption or ethical investment decisions. Most major Dutch pension funds divested from cluster munitions following a 2007 documentary which exposed their investments in American cluster weapons producers and caused considerable public outcry amongst Dutch citizens, for example.¹⁸⁹

Many pension savers care about RI, in particular ESG, even though they might not understand the jargon or know what happens to their pension contributions in the investment chain. A recent study by the UK's NAPF found that 60% of respondents 'were interested in their pension provider undertaking activities that support the long-term sustainable performance of the companies in which they invest' and 65% said they would like to receive more information about how their pensions are invested.¹⁹⁰

Issues like executive remuneration stimulate strong feelings in ordinary savers, 48% of respondents to a 2014 survey said pension funds should use their influence with companies to ensure 'that executive pay, including bonuses, is not excessive.'¹⁹¹ Institutional investors are starting to adopt a tougher stance. For example natural gas company BG Group was recently forced to halve the initial share award promised to incoming its CEO as part of a £14 million 'golden hello' after significant pressure from investors.¹⁹² This pressure included nearly two thousand emails sent by pension savers to their fund over a four day period via ShareAction's online tool urging pension funds to reject the pay deal. A recent study by Georgetown University¹⁹³ found that public opinion, as measured via surveys and media coverage, is having an increasing impact on institutional investor voting behaviour; investors are voting, voting against management and voting in favour of shareholder proposals more often. This is particularly the case for mutual funds, where voting records must be disclosed showing how transparency can drive more engaged shareholder ownership.

Savers that care about these issues seem to do so both because they believe that investing responsibly will enhance returns because of an ethical motivation; 39% of UK adults surveyed believe ESG issues can affect long-term investment value¹⁹⁴ and 49% would like their employer 'to choose a provider which makes a specific point of

investing ethically, even if this fund would achieve lower returns on investment.'¹⁹⁵ 80% of Europeans agree that fighting climate change and using energy more efficiently can boost the economy and jobs.¹⁹⁶ Whether the motivation is financial, ethical, or both, DC pension schemes arguably should be translating savers' preferences into action where it will not have an adverse effect on returns.

“ Whether the motivation is financial, ethical, or both, DC pension schemes arguably should be translating savers' preferences into action where it will not have an adverse effect on returns. ”

Netherlands – Better accountability and alignment of interests, better Responsible Investment performance

It is possible to directly compare the performance on RI of different business and governance models in the Netherlands using VDBO's Benchmark Responsible Investment by Pension Funds in the Netherlands 2014¹⁹⁷ and Benchmark Responsible Investment by Insurance Companies in the Netherlands 2014.¹⁹⁸

Dutch pension funds exhibit many of the good governance features identified. They are not-for-profit meaning there is no conflict of interests between shareholders and beneficiaries or duty to report quarterly results to the stock market. These pension funds also have fiduciary type duties.¹⁹⁹ They have established roles for stakeholders in the governance structure which consists of a board of trustees, a stakeholders' body or participants' council (representing beneficiaries, deferred beneficiaries, pensioners, and employers) and an internal supervisory board. As discussed above they also operate at a larger scale thanks to action by regulators on this issue; there are around 500 occupational pension funds in the Netherlands compared with over 44,000 in the UK for private sector workers alone.²⁰⁰

Beyond the inclusion of beneficiaries in formal structures, they are also more likely to consult with the wider membership base than their counterparts in the insurance sector, 18% surveyed their participants and 30% directly consulted the wider membership base (for example via open meetings) on RI. 21% of the insurance companies consulted or surveyed their policyholders and other stakeholders such as NGOs on RI.

Insurance companies are commercial organisations and the executive board has a duty to 'carefully consider the interests of all parties involved in the insurer, such as the insurer's clients, its shareholders and its employees'.²⁰¹ The governance structure consists of an executive board and a supervisory board; there is no requirement for inclusion of beneficiary representatives although these

boards are subject to diversity requirements and compulsory ongoing training requirements.

ShareAction combined the data from VBDO's two reports, revealing that the pension funds outperformed the insurance companies on virtually every RI measure, including additional measures not included below.

Responsible Investment Practices of Institutional Investors in the Netherlands

	Pension Funds (49 largest)	Insurance Companies (29 largest)
Set targets related to the actual societal impact of its investments	2%	0%
% female board members	15%	17%
RI policy covering over 75% investments	71%	62%
RI policy covers all 4 themes in UN global compact	84%	69%
Some form of ESG integration in equity investment decisions	84%	62%
Active engagement with companies on basis of ESG criteria	82%	52%
Demonstrable results of engagement shown	61%	21%
Voted on 75-100% of equity portfolio	84%	38%
Voted with demonstrable consideration of ESG issues	76%	38%
Average overall score (across all indicators)	2.6/5	1.9/5

¹Source: VBDO, 2014

Fiduciary Duty and the duty to consult beneficiaries

A further important evolution in the understanding of fiduciary duty is the beginnings of a move beyond a paternalistic duty of care whilst keeping beneficiaries in the dark towards the realisation that beneficiaries can and should be consulted. Paternalism may have been appropriate in a family trust setting, where the legal concept originated, but not for a DC pensions environment where beneficiaries earn their contributions and bear investment risk.²⁰² Waitzer and Sarro note in the Rotman International Journal of Pension Management that the Duty of Impartiality, a component of fiduciary duty, requires trustees to weigh up the interests of different beneficiaries and balance them evenly. This means the processes and outcomes of trustees' decision making must incorporate due regard for different beneficiaries' interests:

*'The idea of giving beneficiaries a voice accords with fiduciary law. It helps fiduciaries to fulfil their duties of loyalty and care by improving their understanding of the interests and preferences of beneficiaries.'*²⁰³

This suggests member involvement should not be limited to a handful of member representatives having seats on the governing board. MNTs add value by bringing a different perspective to the board and because their interests are aligned with other beneficiaries. They cannot be expected to know what the wider membership's priorities and preferences are regarding responsible or ethical investment. A recent statement by the chief executive of USS, a major UK occupational scheme shows that trust-based schemes now recognise this:

“I find the issue of representation really challenging...It must be very difficult for someone put on a trustee board [to assume] they will represent beneficiaries. How do you do that? How do you know? Do you assume what you want is what they want?”²⁰⁴

‘Although those opinions were sometimes poles apart, there was always substantial agreement on one thing at the end of these sessions, namely the value of such an exchange of views.’²⁰⁵

Looking around the world for emerging best practice we see schemes conducting surveys, focus groups, webinars and holding open meetings or AGMs to find out what beneficiaries are thinking. The Dutch ABP scheme, for example, has a participants’ council and seats for member representatives on the board but also holds open meetings with beneficiaries to inform the scheme policies, including the RI policies. In 2013, beneficiaries discussed investment questions that ABP faced with staff and trustees at 3 locations around the country. For example, if a Dutch Pension fund invests in an American company should it support bonus payments that are extremely high by Dutch standards but not unusual in the USA? They reported that:

In a trust based setting, if it can be shown that the beneficiaries care about certain ethical issues then the trustees may look at factoring this into the design of the investment strategy.²⁰⁶ This evidence suggests that those pension schemes where fiduciary duties apply and where mechanisms are in place to consult with the membership can be expected to lead the way on investing responsibly and ethically.

Chapter 3

Evaluating the UK's Business and Governance Models

This section examines how different the business and governance models used for automatic enrolment compliant pension schemes in the UK compare with the features identified above as most likely to result in good outcomes for savers. The 3 main business and governance models used are trust-based (single employer) schemes, master-trust based (multi-employer) schemes and contract based schemes. Collective Defined Contribution schemes are not yet on offer in the UK but the Pensions Act 2015 has provided a legislative basis to introduce them so the proposed model is also analysed. As the scale of pension funds and issues around outsourcing have both also been identified above as having a significant impact on saver outcomes, the UK pension system is also examined in relation to these business model features.

Trust-based schemes

Trust based schemes perform best out of the UK's pension scheme business and governance models when it comes to motivation and alignment of interests. This is due to the fact that they are not-for-profit, the fiduciary duty that trustees are subject to and the involvement of saver and employer representatives in the governance structure. In the UK it has been mandatory for over twenty years for trustee boards of single employer pension schemes to be composed of a third MNTs, and the rest either employer representatives or independent trustees.

The requirement was introduced following the Maxwell scandal at the Mirror Pension scheme which exposed the need for better governance and oversight of workplace pensions (see Chapter 1); The 1993 Goode Report, tasked with investigating pension governance after Maxwell recommended mandating MNTs:

*'There are many reasons why it is desirable to have member trustees. They impose the discipline of another view, bringing to the trustee board a different experience and perspective, and helping to ensure that the interests and views of scheme beneficiaries as potential beneficiaries are constantly kept in mind'*²⁰⁷

It seems that this lesson from the past has been forgotten by policymakers; the presence of member nominated representatives in UK workplace pensions is diminishing

as there is no requirement to include them in master-trust, contract based or collective defined contribution schemes.

The ability and willingness of trustees to challenge decisions made below board level and by third parties is affected by the independence and diversity of trustees. On this criteria trusts perform well in theory due to the presence of a mix of stakeholders on the board. However they do not perform so well when the identity diversity of the trustees is considered; it has been mentioned above that 84 percent of trustees in small UK pension schemes are male.²⁰⁸

The poor performance of some schemes is sometimes blamed on MNTs and used as a reason to restrict governance roles to professional industry experts only. This can be inferred from the FCA's decision not to require IGCs to include any beneficiaries, or representatives selected by beneficiaries themselves, despite the fact that the remit of IGCs is to represent beneficiaries' interests, for example. Of course there are underperforming trustees and schemes in the system but this poor governance cannot be blamed on MNTs alone. Instead, numerous studies have found lack of scale to be the most likely cause of trustee boards failing to deliver good outcomes for beneficiaries.²⁰⁹

Scale

The size of a trust-based pension fund impacts the skills, knowledge and resources that they can pay for and the automatic enrolment charge cap of 0.75% per saver per year will impact this even further. The problem of scale is particularly acute in the single employer trust based model which largely accounts for the long tail end of small schemes in the UK. Also single employer trusts are relatively immune from market forces, in particular mergers and acquisitions, which drive consolidation in the master trust and contract-based scheme sectors. The Office of Fair Trading found that:

*'large single employer trust based schemes tend to have good scheme governance... By contrast, we have significant concerns about the governance of smaller, single employer trust based schemes. Trustees in these schemes may lack the necessary expertise and may not provide governance oversight on an ongoing basis'*²¹⁰

Research commissioned by The Pensions Regulator found that smaller schemes in particular are failing to provide adequate training and, as discussed above, training is crucial for ensuring trustees have the necessary skills and expertise. Only 29% of small schemes in the UK have a training plan in place for their trustees, compared with 76% of large trust-based schemes.²¹¹

Another reason why small trusts often deliver poor outcomes for beneficiaries is due to less internal resources, particularly headcount to support the trustee board and oversee external providers, and outsourced arrangements need to be monitored and assessed by internal headcount in order to perform in beneficiaries' interests. Of course some large trusts may not appropriately allocate powers and responsibilities between the trustees, internal managers and outsourced providers but this is a particular challenge for smaller schemes which have typically less resources for staff. Smaller schemes are likely to outsource more key functions, such as investment management.

The issue, therefore, is not whether trustees are stakeholder representatives or independent experts but that trustees who meet 4 times a year simply do not have the capacity to select or scrutinise asset managers in the necessary detail even if they are investment experts. In the words of the interviewee, 'the beauty parade format just does not work.' Boards must be supported by adequate internal headcount.

Overall, our research findings were in line with the Office of Fair Trading's assessment that large trusts are performing well but smaller and medium sized schemes are a cause for concern.

Master Trusts

Master-trusts are a relatively new entrant in the UK workplace pension market and are defined by The Pensions Regulator as:

*'an occupational trust-based pension scheme established by declaration of trust, which is or has been promoted to provide benefits to employers which are not connected, and where each employer group is not included in a separate section with its own trustees. For this purpose, employers are connected if they are part of the same group of companies (including partially owned subsidiaries and joint ventures)'*²¹²

Master trusts are meant to replicate the key benefit of a single employer trust, namely the presence of a trustee board with fiduciary duties to act in beneficiaries' best interests, but in a multi-employer environment that achieves scale and is less of a burden for individual employers. The attractiveness of this business and governance model on paper helps explain the rapid growth of master trusts on offer; 44 were established in 2012-13 alone according to one estimate.²¹³

The Office of Fair Trading has raised concerns however that:

“some trustee boards may not be sufficiently independent of the master trust provider to avoid potential conflicts of interests and always act in beneficiaries' best interests.”²¹⁴
The Office of Fair Trading

Unlike with single employer trusts there is no requirement for master-trusts to include member or employer representatives on the trustee board, although some like the Pensions Trust choose to do so voluntarily. The trustees are paid by the provider and although recruitment processes must be 'open and transparent', ultimately providers choose who to appoint or reappoint. Also, a minimum of only 3 trustees is required which is not large enough to ensure a breath of views and challenge to executive proposals.

Industry representatives at master trusts who were interviewed for this report said they were sure that their trustee boards were independent and would challenge them robustly because they had chosen individuals who 'would not pull their punches', in the words of one interviewee. Yet this underlines the problem with allowing providers to decide who sits on the governing body; less scrupulous providers could just as easily choose individuals who they thought would not challenge them. As one interviewee said:

'It's human nature, if the people responsible for administering the pension scheme choose who sits on the trust board why would they want to choose individuals who are going to give them a hard time?'

Where professional trustees have numerous appointments on different scheme boards there is a real danger they will not want to gain a reputation as a troublemaker. This could harm their prospects of gaining further appointments or reappointments.

Master-trusts have been established in the UK by for-profit entities, such as large insurance companies or by not-for-profit entities, such as the government backed National Employment Savings Trust (NEST). They vary widely in terms of whether services such as investment management and administration are conducted in-house, outsourced or provided by a division of the parent company. Where large commercial providers have set up a master-trust there are concerns regarding the ability of the board of trustees to act independently and in beneficiaries' best interests. This is a legally complicated area as these companies have obligations to their shareholders and, as with any company, seek to make a profit but the trustees of the master trust cannot make an unauthorised profit to the detriment of beneficiaries.

Creating a master-trust product is attractive for parent companies because they can generate profit through providing a variety of services in-house, such as investment management and administration. When trustees are selected and appointed by the provider, it is hard to imagine trustees moving asset management or administration to a different provider. Of course, when trustees are unhappy with service provision there are courses of action they can pursue short of moving the business elsewhere. But knowing that the trustees could do so is important for keeping providers on their toes. One interviewee stressed that the ability and willingness of governance boards to move beneficiaries' assets out of underperforming vehicles is the 'acid test' of whether a governance model is fit for purpose.

Good governance, which includes non-conflicted parties amongst key decision makers is essential to ensure that fiduciaries duties are interpreted and applied correctly in a master trust setting and that the master trust can make a profit but not at the beneficiaries' expense.

An evolving model

As many master-trusts are new, they have not yet achieved the economies of scale that are so beneficial to good saver outcomes, in early 2014 it was estimated that there were only 380,000 beneficiaries across all master trusts.²¹⁵ Despite their claim to offer the benefits of single employer trusts, there was widespread concern that the benefits would not be realised, often due to lax requirements around governance or the business model of master trusts set up by for-profit providers.²¹⁶

Accountability to beneficiaries seems initially to be a problem with many master trusts. There are no member representatives and the research often came across the view that beneficiaries should not be given a voice in a multi-employer environment because it's too difficult for beneficiaries to know what other beneficiaries at different employers want. This is a misunderstanding of the role that beneficiaries can play for reasons discussed above, along with examples of multi-employer schemes such as ABP and The Pensions Trust which do successfully integrate a role for beneficiaries in governance.

The 'Occupational Pension Schemes (Charges and Governance) Regulations 2015' introduce stricter requirements for trusts and master trusts, particularly around the governance of master trusts and their accountability to beneficiaries. A new provision requires:

*'trustees or managers of a relevant multi-employer scheme must make arrangements to encourage beneficiaries of the scheme, or their representatives, to make their views on matters relating to the scheme known to the trustees or managers'*²¹⁷

This is a positive step forward, but overall the Regulations are a missed opportunity to improve the business and governance model of master-trusts. The minimum number of trustees remains 3 and they can all be selected by the provider.

As master trusts evolve and grow it will be interesting to compare how the schemes set up by profit making entities compare to those set up by not-for-profit organisations, in terms of fees and charges, investment returns, customer satisfaction, RI policies and practices, transparency and accountability to beneficiaries. We hope that valuable lessons will be drawn from this live experiment.

Member and Employer Panels

Member or employer panels can be found in each of the business and governance models we examined. In trust-based schemes these are a compliment to direct stakeholder representation on the governing body and in master-trust and contract-based schemes these are an alternative to this. As they are not mandatory, the exact purpose they serve differs according to the role they have been granted in the rules of the particular scheme. The NEST Members' panel provides a good example of the benefit such panels can bring to beneficiaries.

According to NEST:

*'The Members' Panel allows NEST to take the views and considerations of members into account. The panel is a sounding board for ideas and suggestions proposed by NEST. It provides recommendations on key issues ensuring that specific saver concerns are raised at Trustee level. The Members' Panel will also participate in the appointment of future Trustee beneficiaries and will be consulted on any reviews of the Statement of Investment Principles (SIP).'*²¹⁸

The panel scrutinises the scheme and the trustee board and defines its own, challenging metrics by which to measure the success of the scheme. They judge success not by looking at the number of beneficiaries and employers in the scheme but from beneficiaries' perspectives, looking at dimensions including administration, handling of customer services, investment choices and performance, costs/value for money, confidence of beneficiaries to make investment choices, saver satisfaction with expected levels of retirement income and the amount they actually receive. The Panel visited the call centre of the scheme administrator to scrutinise operations first hand.²¹⁹

However, the question of allocation of powers and responsibilities is problematic where stakeholder panels

in the UK are concerned. These panels have largely advisory roles, so there is a risk that the scheme management or board of trustees could just ignore their recommendations and concerns. The FCA's Review of with-profits committees (which are not composed of beneficiaries but play a similar role to member panels) indeed found that some firms were not properly engaging with the committee; the committee was not aware of or involved in key issues and the firm did not act upon their recommendations or concerns.²²⁰

To ensure this does not happen there are powers these panels can be given, which still befits their role as scrutinisers and respects the ultimate responsibility of the board. In the Dutch pension fund model stakeholder panels have powers to make binding nominations to or give binding advice concerning dismissals from the governing board.²²¹ Panels can be given the duty to write an annual report which is made public, as with the NEST panel, allowing them a chance to voice concerns if they feel they are being side-lined by the scheme. A role on a member or employer panel can also be a useful first step for non-industry experts before taking on a full trustee role. This benefit was cited by the Goode Report, which quoted a private sector Pensions manager saying:

*'if a new trustee is required they normally come from this group, the pensions advisory committee. They've got some experience in pensions, rather than getting somebody cold off the shop floor.'*²²²

Involving member representatives in governance helps to achieve alignment of interests with membership, diversity of viewpoints, accountability and trust. These panels should therefore be seen as a compliment to involving stakeholders in governing bodies with real powers and final responsibility rather than a substitute for that.

Contract-based schemes

Contract-based schemes least exhibit the good business and governance model features outlined so far; there is no member or employer representation on governing boards; the legal duties offer a weaker protection to beneficiaries; there is a serious conflict of interest between duties of the firm to make a profit and to provide returns to beneficiaries; governing bodies lack independence and diversity. In the case of large, bundled providers there is also a conflict of interest between purchasing services from the parent company instead of seeking the best deal for beneficiaries on an open market.

Although large insurance companies should have much better access to skills, knowledge and resources, particularly compared with a small single-employer trust for example, they do not seem to be deploying these in beneficiaries' interests. According to the UK's DWP, visible charges are higher in contract-based schemes than in trust-based schemes. In 2013, the average annual management charge for a trust-based scheme was 0.75% of the fund per year, while in contract-based schemes it was 0.84%.²²³ Comparing ShareAction's benchmarking studies of the largest occupational funds²²⁴ with the largest insurance companies²²⁵ which provide contract-based schemes also reveals that the insurance companies are the laggards in terms of RI performance.

One key test of the adequacy of a pension scheme governance structure is whether beneficiaries in a default fund can be moved out of underperforming investment vehicles. On this basis the contract-based system looks unfit for purpose. It is legally unclear how scheme management could make such a change without having to obtain consent from each individual saver. As it is hard to change the terms of a contract that has already been agreed the contract-based set up is fundamentally less suited to the exercise of voice than trust-based schemes. The only real option for expressing dissatisfaction legally speaking is to exit the arrangement, which beneficiaries of a workplace pension scheme cannot do without sacrificing their employer contributions. In the trust based governance model trustees have scope to make changes while the scheme is ongoing. This flexibility is an enormous advantage of the trust based system.

Independent Governance Committees

In the contract-based environment there is no equivalent structure to the trustee board whose function is to provide independent governance and scrutiny of scheme management. This 'governance gap' has been acknowledged by regulators, and from April 2015 providers were obliged to set up IGCs whose role is to scrutinise the scheme in beneficiaries' interests. This is a welcome step, particularly in light of the high charges and poor returns many contract schemes have delivered to beneficiaries for years. But as these Committees exhibit almost none of the good governance features examined in this report it is unclear whether they will deliver all they could for beneficiaries. The failures of some With-Profits Committees could well be repeated; lack of powers and status, lack of independence or ability to challenge the insurer and lack of confidence in them from consumer groups and beneficiaries.

This necessary layer of oversight is to be welcomed given the Office of Fair Trading's unequivocal conclusion that commercial providers in this non-functioning market have been routinely overcharging consumers for many years. Yet 'independent' looks like a misnomer. As with master-trusts, the provider can choose who sits on these committees and up to, but not including, half the seats can go to employees of the provider itself.²²⁶

The definition of independence for an IGC member only covers whether an individual is an employee of the provider, a recent ex-employee or has a 'material business relationship with the provider.'²²⁷ There is no requirement for representatives of beneficiaries or employers to be included. The industry asked for this definition of independence to be relaxed, saying there is a 'limited pool'²²⁸ of candidates to draw from. The initial proposals predicted that around 20 of these bodies will be set up across the UK, each requiring 3 independent beneficiaries, so a total of 60 individuals are required nationwide. If the providers think it will be difficult to find 60 people it does show that they are fishing in very shallow waters when it comes to the recruitment pool.

The regulator does acknowledge the importance of independence of mind:

'Our definition of independence is intended as guidance for providers and there may be situations where a provider is able to justify a different approach.'

*It will be for the provider to determine whether such a member is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, that member's judgement.*²²⁹

But without binding requirements to ensure independence and a depth of views, such as in the Dutch code, it is likely that some IGCs will lack these characteristics.

Although IGCs are meant to represent beneficiaries' views and protect their interests, there is no requirement to include beneficiaries themselves on the committee, or even representatives selected by beneficiaries. All IGC members can be employees of the provider itself, or selected by the provider even though the Financial Services Authority's review of with-profits committees, which are comparable, found the arguments in favour of including a provider's employees on committees meant to scrutinise and challenge a firm to be unconvincing:

*'While we acknowledge the view that having members of the with-profits committee with corporate history of the firm and its with-profits fund can improve the understanding of the committee, such connections with the firm can reduce the level of independent input provided by the committee, and increase the inherent risk of conflicts of interest within the governance process. We believe the benefit of corporate history can be achieved in ways other than having the majority of with-profits committee members connected to the firm'*²³⁰

“ Although IGCs are meant to represent beneficiaries' views and protect their interests, there is no requirement to include beneficiaries themselves on the committee, or even representatives selected by beneficiaries. ”

IGCs are also likely to lack diversity; their design prioritises recruiting people who already have the relevant expertise rather than incorporating candidates from diverse backgrounds, including scheme beneficiaries themselves, and then providing the necessary training. As discussed, providers have also asked for the definition of 'independence' to be relaxed because of the narrow pool they expect to draw candidates from.²³¹ Cognitive diversity could be improved by recruiting individuals with different

professional backgrounds, for example communications experts as well as investment experts. Identity diversity could be improved by introducing a requirement such as that in the Code of the Dutch Pension Funds, that each body must include at least one man and one woman and one saver under and one saver older than 40 years old. Such requirements make sense for bodies whose function is to represent a broad membership.

As a single IGC will be established at firm level, rather than having lots of different governance committees for different schemes or employers, the committees ought to be able to access the skills, knowledge and resources required. Providers will have a duty to provide IGCs with the information and resources they require to operate effectively. As it is acknowledged that 'there may be a tension between what an IGC wants and what a firm may be willing to provide',²³² the regulator should keep under review whether IGC are given adequate information and resources by providers.

The question of allocation of powers and responsibilities is particularly problematic in the IGC set up. The new rules would require the Chair to publish an annual report that the firm must make publicly available, they can ask the provider to review the investment strategies and can escalate concerns to the regulator or the public if the provider fails to act satisfactorily.²³³ These powers are significantly weaker than those possessed by a board of trustees, who legally own the pension assets and can therefore decide to hire and fire service providers or move the assets out of an underperforming investment vehicle. This reveals a flaw not just in the design of IGCs but the inherent impossibility of designing a scrutiny function with real powers in a contract-based pension system. As the contract is drawn up between two parties, the saver and the provider, making a third actor such as the IGC or employer party to the contract would go against hundreds of years of contract law.

Furthermore it is disappointing that IGCs have not been given any remit to look at the provider's policies and practices on RI and stewardship of investee companies, although they could choose to if they wished. This is a missed opportunity to improve investment performance of pension funds and accountability to beneficiaries in an area where they may have strong feelings.

Collective Defined Contribution

The UK's Pension Schemes Act 2015 introduces a legislative framework to enable the introduction of Collective Defined Contribution (CDC) schemes, inspired by the Dutch and Danish systems. Under this system beneficiaries can stay in the same fund throughout their working life and into retirement, with savings pooled into one collective pot instead of individuals having their own contracts and personal pots.

Research commissioned by DWP found that incomes in retirement for a median earner in a CDC plan would be 10 percentage points higher than in if they placed their money in a lifestyle DC fund.²³⁴ This outperformance is attributed to lower running costs, the ability for beneficiaries to remain for longer in high earning assets and less volatility of investment performance due to risk sharing between beneficiaries.²³⁵

Despite growing recognition of the importance of scheme governance for saver outcomes, policy discussions around CDC in the UK have neglected this aspect of scheme design. Yet our analysis shows that lower costs are contingent on schemes having effective governing boards who act in beneficiaries' best interests, for example by negotiating hard on fees paid to asset managers. Lower costs cannot be attributed solely to the larger scale of most CDC schemes and longer timeframes that beneficiaries stay in the scheme. It is also not entirely clear if beneficiaries would stay in a CDC scheme for their whole working life and retirement or whether the pot would follow the saver every time they changed employer.

In CDC schemes, the question of intergenerational fairness and the possibility that benefits in payment to pensioners can be cut means that transparency and trust are particularly essential. In the Netherlands following the 2008 financial crisis which badly damaged many pension schemes' funding levels, indexation payments to pensioners have been reduced or cut in many schemes for several consecutive years. Understandably this has not been well received by pensioners and the wider public. To restore trust and the visibility of equitable decision-making, pensioner representatives have been given a larger role in scheme governance under the new Code of the Dutch Pension funds.

The UK policy proposals do not include any role for employer, member or pensioner representatives in the governance of CDC plans. An influential white paper by the consultancy Aon-Hewitt acknowledges that due to the

sharing of surpluses between different stakeholders, there must be a 'high degree of public confidence' in CDC scheme governance.²³⁶ But their recommendation, accepted by policymakers, is that this should be achieved by appointing professionally qualified independent trustees rather than any stakeholder representatives.²³⁷ The report cites research from DWP saying that:

*'employers were sceptical that "given the complexity of CDC scheme, [lay] trustees would have sufficient experience to make investment decisions."*²³⁸

This suggests that the true role of trustees has not been understood. The question of whether CDC schemes would be delivered by non-for-profit or by profit making entities also needs proper consideration if policymakers proceed with this new model.

In the design of CDC governance requirements, as with IGCs, policymakers have not properly heeded the lessons of the continental model, nor have they learnt the lessons of the past. The sharing of surpluses between beneficiaries under CDC is similar to the 'with-profits' pension model. In response to concerns raised by the Treasury Select Committee and consumer focused stakeholders, the Financial Services Authority undertook a review of the with-profits market in 2010. They found that the majority of firms exhibited poor practice in a number of areas causing significant saver detriment.²³⁹ Consumer groups reported that the potential for the with-profits model to deliver saver benefits was not realised. With-Profits committees, which are supposed to represent beneficiaries' interests to insurance companies running with profits schemes but are not required to include stakeholder representatives, have often been lacking in independence and willingness to challenge the firm they serve. They have not been transparent in how they reach decisions and have communicated inadequately with beneficiaries.²⁴⁰

If the government does proceed with CDC schemes we suggest that this happens in a trust-based environment where boards contain a mix of professional trustees and lay trustees representing stakeholder groups. Beneficiaries would also need to have the option to stay in the CDC scheme when they changed employer to help these schemes achieve economies of scale and so beneficiaries could realise the benefits of remaining in the same scheme for long periods of time.

Conclusion

Towards Good Outcomes in the UK

Our research suggests that the failure of the UK's workplace pension system to consistently deliver good outcomes for beneficiaries is linked to unsatisfactory business and governance models in pension provision. Attempts to use ever more detailed regulation of scheme activities to address the problem of poor outcomes for savers are likely to fail. Furthermore the cost of complying with regulation is inevitably passed on to beneficiaries. Although UK policymakers have recently begun to consider good governance and look at the best performing pension models from overseas, we are not convinced that enough attention has yet been paid to the governance and business models of pension provision that are needed in the automatic enrolment era to protect beneficiaries and deliver long-term public policy objectives. In a DC environment beneficiaries bear all the investment risk but communications to beneficiaries have not evolved to reflect this and nor have savers' rights to information.

An exemplary pension scheme would ensure a strong alignment of interests between beneficiaries and those running and governing the scheme. This can be achieved by including saver representatives on governance a body with genuine powers and applying legal duties to prioritise savers' interests to all individuals responsible for overseeing the scheme. A diverse balance of experts and stakeholder representatives is most likely to deliver good outcomes for beneficiaries as a balanced board can achieve the independence and diversity of views necessary for effective scrutiny and debate. Training can be mandated, and possibly provided, by regulators to help ensure all beneficiaries of governing committees are capable. To ensure that governance is effective, there must be a clear distinction between day-to-day management, responsibility for the scheme overall, and responsibility for scrutinising internal and external managers.

The research also finds that pension schemes must operate at scale to deliver value for money. The Australian and Dutch experiences show that action from policymakers can be very effective at driving consolidation and is certainly more efficient than waiting for market forces. Finally, the research also indicates that no single business model or governance feature is enough on its own. There must be a package of positive business and

governance model features in order to achieve the right organisational cultures and good outcomes for savers.

The analysis of the business and governance model types available in the UK found that they currently do not serve savers well. Large, single employer trusts best exemplify the ideal business and governance model features but are a priori not an option for the thousands of small and medium sized employers in the UK who need a scheme in which to automatically enrol their employees. Although the master-trust model has the potential to deliver the benefits of a large, single employer trust to smaller employers, this potential has not been realised as trustee boards only need to have 3 members who can all be selected by the provider and none need to be stakeholder representatives. The Collective Defined Contribution model is also unlikely to achieve the good saver outcomes hoped for if governance is not considered with more care, and attention given to the Dutch and Danish templates. Contract-based schemes provided by commercial insurance companies were the least satisfactory model.

The question of whether the for-profit business model is appropriate for delivering workplace pensions also merits further consideration by policymakers. The benefits of market-based competition do not appear to outweigh the disadvantages in terms of marketing and sales costs and the introduction of misaligned incentives. What is more, competition cannot be expected to function properly when savers cannot choose their workplace pension provider. The fact that the UK now has master trusts delivered by non-for-profit and by for-profit providers means that there is an opportunity to isolate this variable and compare performance more definitively in the next 3 to 5 years.

We hope that this report and the recommendations made will catalyse a genuine debate and more consideration from UK policymakers as to the importance of business and governance models to workplace pensions. Regulators lack the capacity to oversee ever more detailed regulations and codes of conduct and these measures have not resulted in good outcomes for beneficiaries. We believe that getting the business and governance models right can reduce the need for complex regulation and is a better driver of good outcomes.

Appendix 1

Interviewees

Ingerlise Buck - Economist, Danish Confederation of Trade Unions

John Gray - Saver Representative on the Tower Hamlets Pension Scheme

Brian Hill - Former Investment Consultant

Emily Kenway - Head of Projects, ShareAction

Professor Deborah Mabbett - Professor of Public Policy, Birkbeck College, University of London

Ewan McGaughey - PhD Candidate, Public Participation in Corporate Governance, London School of Economics

Aveen McHugh - Former Trustee of BT Pension Scheme and current member of Board of Governance of contract-based scheme

Morten Nilsson and Amy Mankelow - Chief Executives and Public Relations Manager, NOW:Pensions

Barry Parr - Chair of the Association of Saver Nominated Trustees and trustee at The Pensions Trust

Darren Philp - Head of Policy, B&CE/The People's Pension

Fiona Reynolds - Managing Director of PRI and former CEO of the Australian Institute of Superannuation Trustees

Sarah Smart - Chair of the Trustee Board, The Pensions Trust

Bill Trythall - Pensioner Director of the Corporate Trustee of the Universities Superannuation Scheme

Eric Veldpaus - Strategy Director, Novarca

Attendees at Roundtable - held 30th April 2014

Dennis Gadsby – BACM

Hilary Salt – First Actuarial

Phil McEvoy – GMB

Baroness Jeannie Drake – House of Lords

Ewan McGaughey – LSE

Nick Kirby - NUT

Camilla de Ste Croix – ShareAction

Jo Mountford – ShareAction

Janet Williamson – TUC

Helen Nadin – TUC

Bryan Freake – Unite

Debra Blow – USDAW

Fiona Draper - TUC

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