



Whose duty?

Ensuring effective stewardship
in contract-based pensions

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DKK	7,12	7,87	7,4582
GBP	0,85	0,92	0,8813
JPY	108,48	122,48	112,61
PLN	3,46	4,85	3,9964
CHF	1,14	1,23	1,1720
ZAR	7,75	12,15	9,6099
	20,44	26,84	24,...
			2,301

Executive Summary

Over the next few years, millions of people will be automatically enrolled into workplace pension schemes. The vast majority of these schemes will be defined contribution (DC), meaning the saver bears the risk – their retirement income depends on the performance of their investment. Moreover, auto-enrolment is predicated on savers' inertia: most will neither make active choices about their pension, nor be in a position to evaluate the choices made on their behalf by employers, advisors and providers.

These savers will be heavily reliant on those who manage their money. Ensuring that these entities are well-governed and act in savers' long-term best interests will be critical to the success of auto-enrolment – both in terms of building trust in the system, and in terms of delivering decent retirement incomes. Yet to date this imperative has received surprisingly little attention from policymakers and regulators. Previous FairPensions publications have explored how trust-based pension schemes could better serve savers' long-term best interests; this paper focuses on contract-based pensions.

Trust v contract

Trust-based pension schemes are governed by a board of trustees with strict fiduciary duties to act in the best interest of beneficiaries. The two key fiduciary duties are the duty of loyalty (which requires trustees to avoid conflicts of interest and put beneficiaries first) and the duty of prudence (which requires them to invest funds wisely based on appropriate advice).

“ *Auto-enrolment is predicated on savers' inertia: most will neither make active choices about their pension, nor be in a position to evaluate the choices made on their behalf by employers, advisors and providers.* ”

Contract-based pension schemes are run by commercial providers, usually insurance companies. The 'contract' is between the individual saver and the provider. Savers are protected by the terms of this contract and by the Financial Services Authority's (FSA's) rules. These rules impose no duty on providers to put beneficiaries' interests first.

“ *The absence of fiduciaries makes it unclear who in the contract-based chain is charged with looking after the best interests of the saver.* ”

The investment chain

Both trust- and contract-based pension schemes are in practice run by a long chain of intermediaries. The absence of fiduciaries makes it unclear who in the contract-based chain is charged with looking after the best interests of the saver. Our analysis suggests that nobody has a clear responsibility or incentive to do this, leaving the potential for an oversight deficit at each link in the chain:

- **Employers** will effectively act as 'proxy consumers', choosing providers and schemes on savers' behalf, but many will have neither the incentive nor the expertise to ensure that savers get a good deal or to oversee providers on an ongoing basis.
- **Employee benefit consultants** will play a key role in advising employers on these decisions, but this function is wholly unregulated, leaving savers unprotected from poor or conflicted advice.
- **Insurance companies** are the most direct equivalent of the pension fund trustee board; yet many appear to regard themselves simply as a platform linking savers to investment funds, rather than as an owner with a responsibility to steward the assets invested on their customers' behalf.

- **Asset managers** run the underlying funds in which savers' money is invested. Most legal experts regard asset management as a fiduciary function, but fiduciary standards are often not adhered to in practice. Moreover, our research suggests that oversight of their activities by insurance companies is lacking, particularly in respect of external asset managers.

Fiduciary duty or consumer responsibility?

The saver is the only person in this chain who exercises virtually no influence over any key decisions – and, under auto-enrolment, may well make no active decisions about how their money is invested. In the trust-based investment chain, this vulnerability is recognised in law: the saver is assumed to be in need of protection through the imposition of fiduciary duties on those looking after their interests. But in contract-based schemes, the saver is assumed to be an active consumer making informed decisions in a well-functioning market. This model is fundamentally at odds with the mechanics of auto-enrolment.

Moreover, long-term savings vehicles are intrinsically different from other consumer products. Someone who buys a car can be expected to have a reasonable grasp of what they are buying – and, if the car does not perform as expected, they can complain or withhold their business from the seller next time. Someone who buys a pension product will generally have little grasp of exactly what they are buying – and, by the time they are in a position to know whether it has performed as expected, it will likely be too late for them to do anything about it. This makes pension savers vulnerable in precisely the way which fiduciary obligations exist to address.

The Law Commission has defined a fiduciary relationship as one where there is 'discretion, power to act and vulnerability'. The final report of the Kay Review has concluded that this applies to all those looking after other people's money, and that government and regulators should act to uphold fiduciary standards. We agree. There are many precedents for applying fiduciary duties to commercial entities: they are not inconsistent with making a profit, but only with profits that are unauthorised or made at the consumer's expense.

As the Kay Report observes, rules do not always have the desired effect if the underlying culture remains at odds with their objectives. One way of dealing with this is to prescribe ever more detailed rules to reduce firms' room for manoeuvre. Another is to try and address the cultural issue head-on by reasserting the appropriate nature of the relationship between provider and consumer. The fiduciary principle has a vital contribution to make in restoring trust in an industry where the tail is too often perceived to wag the dog.

“ *There are many precedents for applying fiduciary duties to commercial entities: they are not inconsistent with making a profit, but only with profits that are unauthorised or made at the consumer's expense.* ”

Achieving fiduciary standards in practice

The assertion of fiduciary duties in law or regulation is necessary, but unlikely to be sufficient. Achieving fiduciary standards requires structures which effectively align the interests of all parties with those of the consumer, and clear incentives created by government policy. This report explores various mechanisms for achieving this, and makes recommendations in four key areas:

- **Governance structures** such as policyholder committees could help embed consumer interests in insurance company decision-making, mirroring the advantages of trustee boards.
- Questions remain over whether such measures can be wholly effective where there is an intrinsic conflict of interest, for instance between policyholders and shareholders. There is a need to identify and promote the **institutions and business models** which can structurally eliminate conflicts and effectively align the interests of firms with their customers.
- Consideration should be given to strengthening the **qualifying criteria** for schemes eligible for auto-enrolment, to ensure that minimum standards of good governance are met. The UK is out of step with other jurisdictions such as Australia in this respect.
- Similarly, the government's **default fund** guidance should be strengthened to provide greater clarity on the core responsibilities of each player in the investment chain, or at the very least the key issues on which responsibilities must be agreed.

“ Asking savers to remain opted in to pension schemes they know little or nothing about demands an act of trust. Both industry and government must act to ensure that this trust is earned. ”

Conclusion

Millions already entrust their retirement security to contract-based pension products, and they will soon be joined by millions more. Ultimately, these savers' pensions will depend on their money being invested to generate sustainable wealth, whilst minimising the costs of intermediation. At present, it is not clear that anyone in the contract-based investment chain has the incentive or the obligation to ensure that this is achieved. Asking savers to remain opted in to pension schemes they know little or nothing about demands an act of trust. Both industry and government must act to ensure that this trust is earned.

Introduction



In the last five years, there has been a wide erosion of trust in financial intermediaries and in the financial system as a whole. This erosion is not a result of misplaced public perception, which can be addressed by a public relations campaign; it is based on observation of what has happened. That erosion of trust is the long-term consequence of the systematic and deliberate replacement of a culture based on relationships by one based on trading increasingly characterised by anonymity, and the behaviours which arise from that substitution. In the context of asset management, trust implies stewardship.



Report of the Kay Review of UK Equity Markets and Long-term Decision Making

Savers depend on those who manage their money. With the advent of auto-enrolment, 5-8 million people are expected to be newly saving or saving more, many of them low-paid workers.¹ The vast majority will be in defined contribution (DC) schemes, where benefits depend on investment performance and the saver bears the associated risk. The way in which these investments are managed, including the oversight of companies owned on savers' behalf, will be a crucial determinant of the next generation's security in old age.

As Professor Kay observed in the interim report of his Review, *"the purposes of equity markets are to generate returns for savers and to improve the performance of companies ... There is a fundamental alignment between the success of companies and the returns to savers."*² But this alignment is in danger of getting lost or diluted in the chain of intermediaries which separate savers from the companies in which they invest.

To date, analysis of this problem has tended to focus on trust-based occupational pension funds – yet they represent a dwindling proportion of the market. In 2011, while 3.4 million people were active members of trust-based occupational pension schemes, 3 million were members of contract-based workplace pensions, usually run by insurance companies.³ In 2010, UK insurance companies owned more of the UK stock market than UK pension funds (8.6% compared to 5.1%).⁴

While trust-based pension schemes are governed by a board of trustees charged with protecting members' interests, the saver's relationship with a contract-based provider is governed by the terms of their contract and by the Financial Services Authority's (FSA) rules. FairPensions' 2010 report, *'Protecting our Best Interests: Rediscovering Fiduciary Obligation'*,⁵ raised the question of whether this might lead to imbalances in consumer protection – and, if so, what could be done about them.

An expert roundtable was held in April 2012 to explore these issues further. (A list of attendees can be found at Appendix 1.) Participants almost unanimously agreed that there was indeed a 'governance gap'. In discussing how this might be addressed, two key themes emerged:

- There is a need to examine the whole investment chain, including not just the providers (i.e. insurance companies), but also other key players including asset managers, employers and consultants.
- There is a fundamental underlying question about the nature of that investment chain. To what extent can it be viewed as a well-functioning market, in which competitive pressures and consumer engagement can be expected to drive up standards of governance? At what point do regulators need to step in to correct market failures? This is closely related to the role in which the saver is cast: should they be seen as a consumer actively making informed decisions about their money, or as a vulnerable beneficiary with little influence and still less understanding of the decisions being made on their behalf?

This paper attempts to take forward these key themes. It makes some provisional policy recommendations and identifies areas where further work is needed. We hope it will also help to catalyse a wider debate about which models of provision will best serve the interests of tomorrow's savers.

“ *Should the saver be seen as a consumer actively making informed decisions about their money, or as a vulnerable beneficiary with little influence and still less understanding of the decisions being made on their behalf?* ”

To be clear, it is not our view that trust-based governance is intrinsically good or that contract-based provision is intrinsically bad. We are not recommending that trust-based governance structures be forced onto contract-based providers, or that the distinction between trust and contract be eradicated. Rather, our concern is with ensuring that all pension investments are well stewarded in the long-term best interests of savers. The challenges for achieving this aim in a trust-based context were explored in our 2010 report and will be addressed in further publications later this year. This paper explores the distinctive challenges facing contract-based pension provision, and suggests some possible solutions.

1. The current system

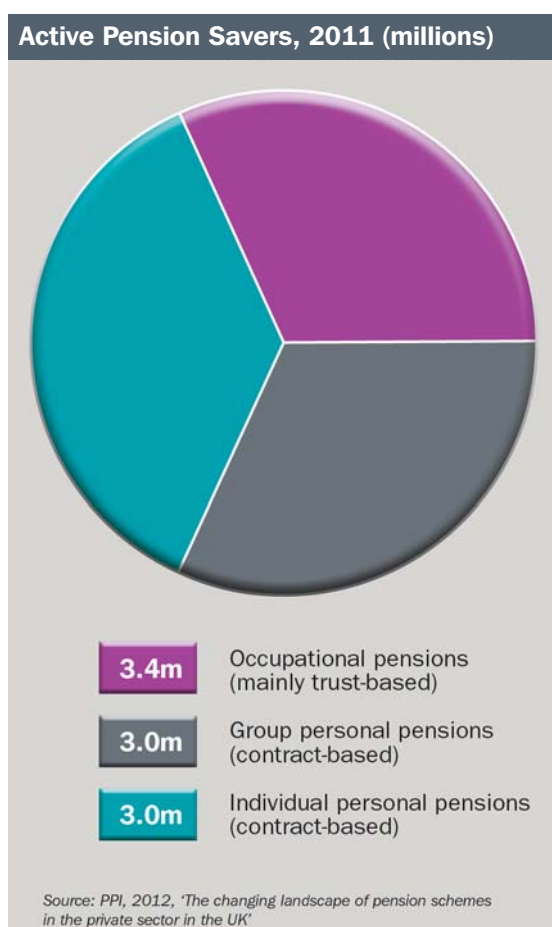
1.1 The UK pensions landscape

The UK's private pensions system is a patchwork of different types of provision. The categories commonly used to distinguish one type of pension from another are overlapping and can be confusing. The chart below sets out the key terms used in this paper, what they mean and

how they relate to each other. Many individuals will have several different pension pots which may fall into different categories. The key distinction for the purposes of this paper is between trust- and contract-based pensions – which, broadly speaking, matches the distinction between occupational and personal pensions.

Defined benefit (DB)		Defined contribution (DC)	
Guaranteed pension benefits related to salary and years of service.		No guaranteed benefits – instead, the size of pension depends on investment returns. At retirement, an individual's pension pot is normally used to buy an annuity.	
Trust-based		Contract-based	
Pension schemes run by a board of trustees with a duty to act in members' best interests. Trust-based schemes can be DB or DC. NEST is an example of a trust-based DC scheme.		Pension schemes run by a contract provider, usually an insurance company. There is no board of trustees. The contract is between the saver and the provider: even if the pension is provided through the workplace, the employer is not a party to the contract. Contract-based products are always DC.	
Occupational		Personal	
Pension schemes run by an employer for its employees. Most occupational pension schemes are trust-based.		'Personal pensions' are essentially contract-based pensions. The term does not mean that the pension is not provided through the workplace:	
		Group personal pensions are essentially contract-based pension schemes offered through the workplace and are likely to be widely used under auto-enrolment.	Individual personal pensions are contract-based pension products held by an individual saver with no workplace involvement (e.g. SIPP, Personal Pension Plan, etc).

This complex landscape has changed significantly over recent decades and is set to change further with the introduction of auto-enrolment. Defined benefit schemes are in decline and many are closed to new members: defined contribution is now the norm in the private sector. (Public sector pensions – still overwhelmingly DB – fall outside the scope of this paper, since they are funded out of taxation rather than by investing members' contributions on the capital markets.) Alongside this, contract-based pensions appear to be replacing trust-based schemes as the dominant form of provision. In 2011, workplace pension saving was roughly evenly split between occupational and personal pensions. Once individual personal pensions were taken into account, contract-based pensions accounted for almost two-thirds of all pension savers (see chart below).⁶



The effect of auto-enrolment on this picture remains to be seen. On the one hand, it is anticipated that many workers will be enrolled into NEST, which is trust-based; on the other hand, employers who do not choose NEST are likely to prefer contract-based arrangements because they impose fewer governance obligations on the employer themselves. The question of whether this will serve savers' best interests has so far received little attention. However, its significance for the success of auto-enrolment is beginning to be recognised by policymakers, with the Work and Pensions Select Committee currently addressing it in its inquiry into governance of workplace pensions.

1.2 The legal and regulatory landscape

The legal position

Trust- and contract-based pension provision in the UK are subject to entirely separate legal regimes (broadly speaking, trust law and contract law) with primary oversight by separate regulators (The Pensions Regulator and the Financial Services Authority).

It appears to be generally accepted that the framework of fiduciary obligations which underpins trust-based governance does not apply to contract-based providers.⁷ As a recent OECD paper put it, "*contract-based DC plans and personal pension arrangements are not usually run by a governing board that caters exclusively to the interest of members and beneficiaries.*"⁸ Instead, savers are protected by their contractual relationship with the provider and by the enforcement of FSA rules. In some areas (for instance, solvency rules or requirements that must be met by authorised persons) these rules are more stringent than those applying to trust-based schemes. In relation to duties to savers, they are generally weaker (see table on the following page).

Fiduciary obligations	FSA Principles
<p>Prudence:</p> <p><i>"The duty of a trustee is ... to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide."</i>⁹</p> <p>(Re Whiteley)</p>	<p>A firm must conduct its business with due skill, care and diligence. (Principle 2)</p> <p>A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment. (Principle 9)</p> <p>A firm must arrange adequate protection for customers' assets when it is responsible for them (Principle 10)</p>
<p>Loyalty:</p> <p><i>"The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets: a fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal."</i></p> <p>(Bristol and West Building Society v Mothewe)¹⁰</p> <p>Impartiality:</p> <p>Trustees must act <i>"impartially between different classes of beneficiaries"</i>¹¹</p>	<p>A firm must conduct its business with integrity. (Principle 1)</p> <p>A firm must pay due regard to the interests of its customers and treat them fairly. (Principle 6)</p> <p>A firm must manage conflicts of interest fairly, both between itself and its customers and between one customer and another. (Principle 8)</p>

The most significant difference between these two sets of obligations is that, while fiduciaries have a duty of loyalty to beneficiaries which requires them to avoid conflicts of interest, FSA-regulated entities are required only to 'manage conflicts fairly'. To be clear, the duty of loyalty does not preclude fiduciaries being paid for their services or being part of a profit-making entity. Trust corporations are one example of commercial institutions with fiduciary duties.¹² Legal opinion now generally accepts that this can be in beneficiaries' best interests, since they benefit from the care of well-remunerated experts. The key point is that fiduciaries cannot profit *at the expense* of beneficiaries or without

their consent. In other words, if a firm's interests are genuinely aligned with those of its customers, fiduciary obligations should not fundamentally threaten its business model; it is direct conflicts that are impermissible.

“ While fiduciaries have a duty of loyalty to beneficiaries which requires them to avoid conflicts of interest, FSA-regulated entities are required only to ‘manage conflicts fairly’ ”

The regulatory architecture

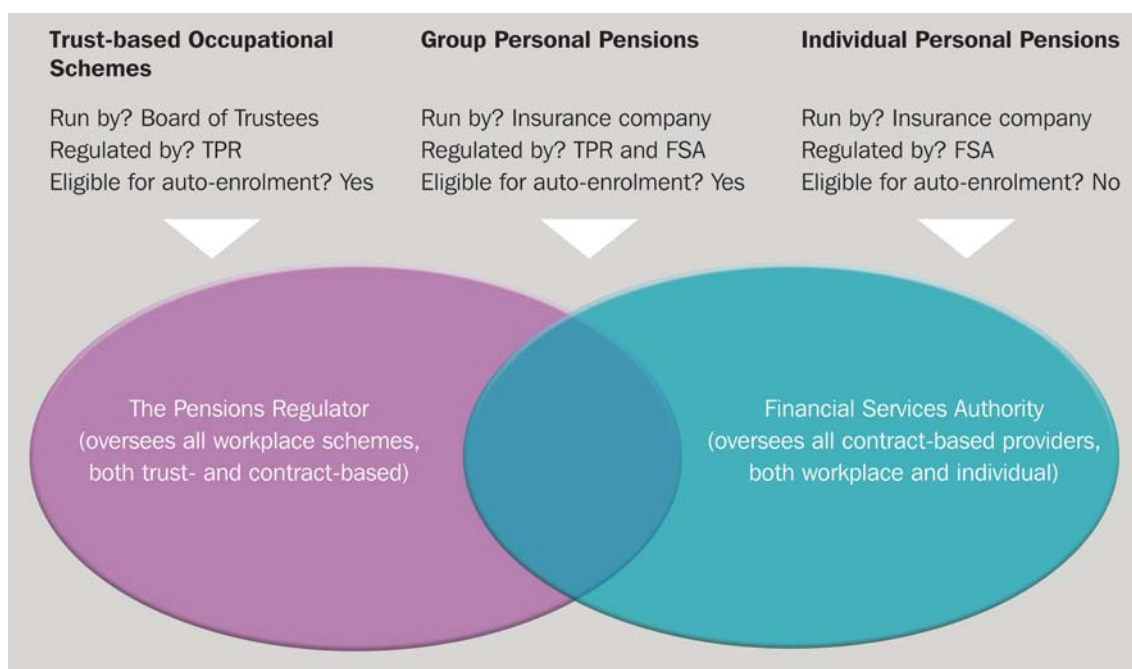
Workplace contract-based pensions are jointly regulated by The Pensions Regulator (TPR) and the Financial Services Authority (FSA), soon to become the Financial Conduct Authority (FCA). Guidance from the regulators indicates that TPR will generally lead on issues affecting group personal pensions only, while the FSA will generally lead on issues affecting the provider's entire personal pension portfolio.¹³ For comparison, trust-based occupational pension schemes are solely regulated by TPR; and individual personal pensions are solely regulated by the FSA (see diagram below). When an individual leaves the employer who auto-enrolled them into a group personal pension, their fund converts to an individual personal pension and TPR loses all remit.

“ *The duty of loyalty does not preclude fiduciaries being paid for their services or being part of a profit-making entity. The key point is that fiduciaries cannot profit at the expense of beneficiaries or without their consent.* ”

Other players in the investment chain are regulated as follows:

- The FSA is responsible for regulating **asset managers**.
- TPR is responsible for ensuring **employers** comply with their auto-enrolment obligations.
- **Employee benefit consultants** are not regulated by either body or by any other regulator (see section 2.5 below).
- The Financial Reporting Council (FRC) oversees the **UK Stewardship Code**, which aims to promote effective shareholder oversight, and applies to both asset managers and asset owners.

This is broadly mirrored by the split of responsibilities across government departments: TPR is responsible to the Department for Work and Pensions, the FSA/FCA to HM Treasury and the FRC to the Department for Business, Innovation and Skills.



This split of responsibilities, with no single body responsible for overseeing the chain as a whole, creates the potential for regulatory underlap. While different regulators are responsible for different parties, arguably nobody is responsible for ensuring that the relationships between those parties function effectively. A recent report by the National Audit Office criticised the “*lack of a joined-up approach*” to DC pension regulation, with “*no single body leading on regulating schemes*”. It recommended action to ensure better integration between TPR and the FSA, setting clear objectives for regulation and addressing areas of potential underlap or overlap.¹⁴

“ While different regulators are responsible for different parties, arguably nobody is responsible for ensuring that the relationships between those parties function effectively. ”

Issues of investment governance and investor stewardship in particular may fall between two stools. TPR has historically focussed on ensuring that DB schemes are prudently funded and have clear deficit reduction plans, thereby preventing calls on the Pension Protection Fund - although it has recently begun investigating the governance of DC pension funds.¹⁵ Meanwhile, the FSA has historically focussed on 'point of sale' regulation, i.e. preventing mis-selling. Although it is now attempting to move beyond this approach, much of the focus of that shift has been on intervening *before sale* (i.e. at the product development stage) rather than monitoring ongoing issues of firm culture and investment governance *after sale*. This lacuna is reflected in the Memorandum of Understanding between the two regulators, which does not specifically identify investment governance as an area on which they will collaborate, and does not appear to have been updated since the publication of the Stewardship Code.¹⁶

KEY POINTS

- The UK pensions landscape is a patchwork of different forms of provision, subject to different legal and regulatory regimes.
- Traditional trust-based occupational pension schemes represent a declining proportion of the market: large numbers of pension savers are now saving into contract-based arrangements, usually run by insurance companies.
- Trust-based pension schemes are overseen by a board of trustees with fiduciary duties to act in the best interests of beneficiaries and avoid conflicts of interest. Contract-based providers are instead subject to regulatory rules, which – although stronger in some other respects – impose weaker duties towards savers.
- Pensions regulation is shared between The Pensions Regulator (TPR) and the Financial Services Authority (FSA), with the former responsible for trust-based pension schemes and the latter primarily responsible for contract-based providers. This presents a danger of regulatory underlap, with neither regulator having a strong interest in the quality of investment governance among those it regulates.

2. Analysis of the investment chain

2.1 Overview

The principal/agent problems which characterise the trust-based investment chain are relatively well understood – although diagnosing the problem has proved easier than prescribing solutions. The increasingly important world of contract-based pension provision is only just beginning to be analysed in this way. Inevitably, the investment chain is not the same: it involves different players facing different practical and commercial pressures, and poses distinctive challenges. The below diagram sets out what we believe are the key stages of the contract-based investment chain as it will operate under auto-enrolment. The remainder of this section takes each of these actors in turn, examining their role and the challenges it presents.

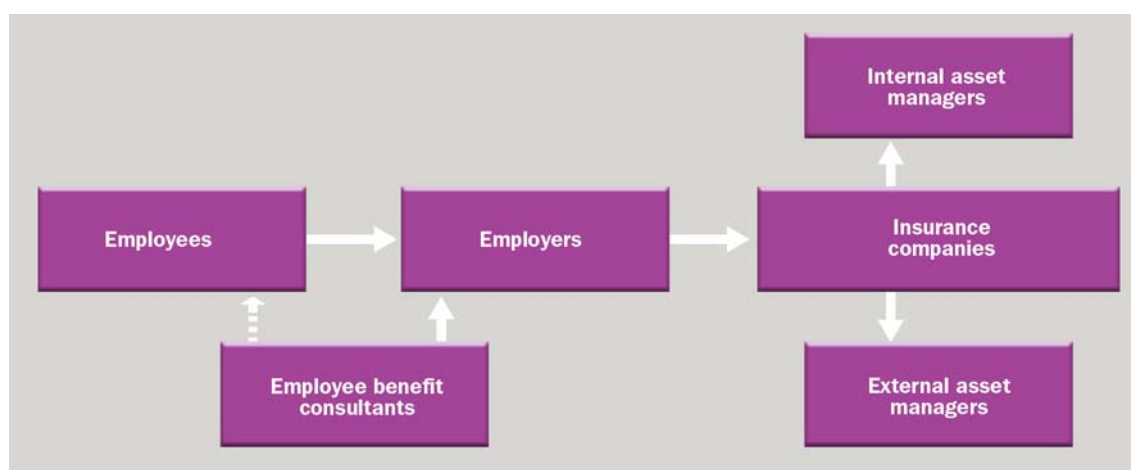
The picture is further complicated by the position of insured trust-based schemes, where trustees contract with insurance companies in much the same way that individual savers do in contract-based schemes. These schemes may also suffer from a lack of clarity over the division of responsibilities. Unlike other trust-based schemes, where the trustees have direct control over investments, in insured schemes the insurance company is the legal asset owner and the trustees only have rights under the terms of their contract. If the insurance company does not see itself in the role of an asset owner (see section 2.3), there is the potential for a governance gap to arise.

2.2 Asset managers

When an individual saver contracts with an insurance company, the underlying funds in which their money is invested will generally be managed not by the insurance company itself but by asset management firms. In relation to stewardship, it is asset managers who will be primarily responsible for engaging directly with companies. Our original report concluded, following the Law Commission, that asset management is *prima facie* a fiduciary function, and that asset managers may therefore have duties which exceed FSA requirements.¹⁷

The relationship between insurance companies and asset managers is in some ways analogous to the relationship between occupational pension schemes and their asset managers. One key difference is that, while virtually all UK pension schemes outsource their asset management functions to external fund managers, most UK insurance companies will have relationships with both internal and external fund managers, each of which presents their own distinct challenges:

- **Internal managers:** Of the ten largest UK commercial pension providers, eight have an internal asset management arm. Default funds offered to savers under auto-enrolment will often be internally managed. On the one hand, this offers a higher degree of control: our research suggests that oversight of



internal managers by insurance companies is closer than for external managers (see section 2.3 below). On the other hand, this relationship carries obvious conflicts of interest: internal managers may not be subject to the same commercial sanctions for poor performance as they would in relation to pension fund clients, since the insurance company may be less likely to take its business elsewhere.

- **External managers:** Most insurance companies will offer clients a wide range of external funds and fund managers. In principle this relationship is very similar to that between an occupational pension fund and its external managers. However, our research suggests that in practice – perhaps precisely because of the contrast with the high level of control they can exercise over internal managers – insurers view their relationship with external managers as much more ‘arms length’, and do not see close oversight as reasonable or practicable. This leaves a potential accountability gap which could result in less client pressure on these managers to improve their stewardship and investment governance practices.

Consumers will generally have no direct relationship with the asset managers looking after their money, either in law or in practice. Their contract is with the insurance company. If insurance companies do not oversee the asset managers on their platform on consumers' behalf, this leaves a potential vacuum of accountability.

2.3 Insurance companies

Insurance company governance was repeatedly described by participants at our roundtable as a ‘black box’. Participants with long experience of working on investment governance, including with insurance companies, repeatedly said that they simply did not know what went on inside the ‘box’. This was contrasted with trust-based governance, where – notwithstanding the obvious fact that the quality of governance varies in practice – the duties and accountabilities of key decision-makers are clearer. There was also a general feeling that the consumer is ‘on their own’ to a much greater extent in a contract-based than a trust-based scheme, where the trustees are explicitly and solely charged with looking after beneficiaries’ best interests.

“ Consumers will generally have no direct relationship with the asset managers looking after their money. If insurance companies do not oversee the asset managers on their platform on consumers' behalf, this leaves a potential vacuum of accountability. ”

Like asset managers and other investment intermediaries, insurance companies may also be subject to conflicts of interest which could potentially damage consumers. Such conflicts may arise at an institutional level between policyholders and shareholders, or at an individual level through activities such as personal share-dealing. According to a recent OECD paper, “conflicting interests are at the heart of many of the complaints often heard about defined contribution plans, from high fees to unsuitable investments and poor performance.”¹⁸

But does the absence of trustees matter? Our research on shareholder engagement practices offers a case study. Our recent survey of the top ten commercial providers¹⁹ found that they lagged behind large occupational pension schemes in this area: only one company (Aviva) was a signatory to the UK Stewardship Code, and only one (AEGON) had a publicly available responsible investment policy. There was a general sense that many respondents regarded themselves simply as a platform or ‘fund supermarket’, rather than as an asset owner with stewardship responsibilities or fiduciary-like duties to protect savers’ interests by monitoring and overseeing asset managers’ engagement activities. This suggests that the absence of anyone charged solely with protecting savers’ interests may indeed be associated with a ‘governance gap’ in practice: insurance companies cast themselves in a fundamentally different role to that of trust-based pension schemes in relation to both savers and asset managers.

This was particularly apparent in the different approaches to monitoring internal versus external asset managers. One recurring theme of responses to the survey was a tendency for any monitoring to be restricted to internal asset managers: only one company (Legal & General) said that it monitored the voting activities of external asset managers. Respondents also frequently relied on the stewardship policies and procedures of internal asset managers as a substitute for having their own separate policies.

“ *The economic relationship is the same in all DC pension saving, whether trust- or contract-based: savers entrust their money to someone to invest on their behalf in order to provide them with a retirement income.* ”

There appears to be an assumption that savers will have exercised an active choice to invest in an externally-managed fund, and that the insurance company’s role is limited to facilitating that choice. However, in a world of auto-enrolment, this assumption may not hold (see section 2.4 below). In any case, it is difficult to see how this relationship between consumer, provider and external asset manager is fundamentally different to a trust-based scheme. Here, the law is clear that trustees are responsible for monitoring and overseeing external managers on behalf of their beneficiaries, and bear ultimate responsibility for managers’ actions if they have not done this.²⁰ This obligation is not affected if members have made an active choice of fund, as indeed they do in some DC schemes.

Most participants in our roundtable agreed that the economic relationship is the same in all DC pension saving, whether trust- or contract-based: savers entrust their money to someone to invest on their behalf in order to provide them with a retirement income. Yet the legal and regulatory framework for these two types of saving, as we have seen, is entirely different. The trust-based framework is built on the fact that savers are entrusting their money to a third party. The contract-based framework is built on the fact that savers are, at least nominally, making consumer choices about their money. Yet neither of these facts is unique to one type of pension or the other. There was general agreement that, while it might not be desirable to *replicate* the trust-based framework in a contract-based setting, there was a need to ensure that levels of protection were *equivalent*.

2.4 The role of employers

Employers have two potential roles in ensuring that work-place pension savers are protected by good investment governance: first, in choosing the provider and product; second, in ongoing monitoring through governance arrangements at the firm level. This role will only grow in importance with the advent of auto-enrolment. It is therefore worth examining employers as a link in the investment chain in their own right.

Choosing providers and default funds

As the Work and Pensions Select Committee noted in its recent report on auto-enrolment, *“It should be borne in mind that the employer will choose the pension scheme but the consequences of that choice ... will fall on the employee.”*²¹ Under auto-enrolment, the employer effectively acts as a proxy for the consumer in most key decisions about the fund: the choice between trust- and contract-based, the choice of provider, the choice of product proposition, and so on. This is already true to an extent of all workplace pensions. At present, though, the saver does make one key active choice: to join the scheme. Under auto-enrolment, this is no longer the case. Of course, employees do have the chance to opt-out. But the premise of auto-enrolment is precisely that most will not do so - not because they have carefully weighed the costs and benefits and reached an active decision, but out of simple inertia. Harnessing inertia to increase pension saving is at the heart of public policy.

Most consumers will neither make active choices, nor be in a position to evaluate the choices made on their behalf. If they are in a trust-based scheme, this vulnerability will be recognised in law through the imposition of fiduciary duties on those entrusted with their money. But if they are in a contract-based scheme, they will be treated as a consumer, protected by FCA rules subject to the principle

that ‘consumers should take responsibility for their decisions’ (see section 3 below). Serious questions should be asked about whether this framework is appropriate in the context of auto-enrolment.

The role of the employer as a proxy for the consumer adds another potential layer of misaligned interests which could impede the market from working for

consumers. Several participants in our roundtable from both industry and consumer groups noted that, when it comes to auto-enrolment, insurance companies’ clients are employers and advisers: product ranges will therefore be tailored to meet these clients’ needs, which may not always coincide with employees’ needs. Which? have expressed concern that this could result in *“limited market pressure to keep charges low for employees, particularly for ex-employees”*²² – whether through actively misaligned incentives (for example, privileging active members at the expense of deferred members – while trustees have a duty to treat all members impartially, employers have little incentive to protect ex-employees) or simply because employers have weaker incentives to get a good deal overall.

It has been suggested that employers could be given explicit fiduciary duties when making decisions on behalf of employees.²³ The idea of placing additional burdens on small employers may be neither feasible nor politically palatable. If so, it is all the more vital that the implications for the regulatory regime of employers’ role as proxy consumers are explored and clarified.



“It should be borne in mind that the employer will choose the pension scheme but the consequences of that choice ... will fall on the employee.”



Work and Pensions Select Committee

Ongoing monitoring and governance

In the case of single-employer trust-based pension schemes, the employer's ongoing role can be collapsed into that of the board of trustees: by setting up the scheme, the employer undertakes to maintain these governance arrangements and to appoint employer-nominated trustees.

However, employers are not obliged to have any ongoing role in overseeing contract-based funds: joint guidance from TPR and the FSA merely notes that they “*may wish to put in place some form of ongoing monitoring on a voluntary basis*”.²⁴ TPR has also published guidance on what this might entail, which notes that “*as the selector of the pensions provider, you have an interest in keeping this service, as with other services, under ongoing review to ensure that it is still meeting the need it was designed to fill*”.²⁵

“ **Once a member leaves employment the contract becomes an individual personal pension with no employer involvement** ”

Interestingly, many employers have sought to fill the gap left by the absence of a board of trustees by setting up new governance structures. Recent research by TPR found that around half of employers had established ‘management committees’, although these were often informal with limited clarity over their role.²⁶ TPR’s guidance on employer engagement admits that “*a management committee generally has no legal definition and is a term used to cover a diverse and often not clearly defined group of arrangements set up by employers*.”²⁷ Many do not even have terms of reference, and they have no formal powers or duties. Anecdotally, some employee representatives who were previously trustees of their firm’s now-closed DB scheme have said that they felt much clearer on their role and responsibilities as a trustee than they do as a management committee member. Neither the

DWP’s default fund guidance nor the Investment Governance Group (IGG)’s principles for DC governance directly address this confusion.

Employers would benefit from greater clarity and definition on the role of management committees from DWP or TPR. Formalising these committees and their relationship with providers could help to ensure that they play a genuine oversight role. However, there are limits to this approach. Auto-enrolment will bring 1.3 million employers under an obligation to enrol their employees into a pension scheme,²⁸ many of them small businesses who may lack the skills or capacity to take on this paternalistic role and would be likely to resist additional obligations.

In addition, as TPR has noted, management committees only have a role in relation to the protection of active members: “*once a member leaves employment the contract becomes an individual personal pension with no employer involvement*”.²⁹ This still leaves a gap in protection compared to trust-based schemes, where ex-employees remain members of the scheme and trustees’ duties are owed equally to all beneficiaries. Focussing on the role of the employer, while important, does not remove the need to address the governance of pension providers themselves.

2.5 Employee benefit consultants

In preparing to fulfil their duties under auto-enrolment, employers are highly likely to call on the advice and support of employee benefit consultants (EBCs). EBCs will help employers choose providers, either by making a straightforward recommendation, presenting a shortlist or organising a ‘beauty parade’. They may also assist with the establishment of governance arrangements and with any ongoing monitoring or oversight. These services will likely be provided by major consultancy firms or by Individual Financial Advisors (IFAs).

This relationship presents similar problems to that between pension fund trustees and investment consultants, explored in detail in our original report.³⁰ Like trustees, employers – particularly smaller ones – may lack expertise and be heavily reliant on consultants’ advice. Meanwhile, it may not always be in consultants’ interests to help schemes control costs: on the contrary, they may benefit from advising towards complexity, since this increases the need for further costly advice. There is evidence of a trend towards complexity in trust-based pension schemes’ investment approaches: while this has driven up the costs of intermediation, it is questionable whether it has delivered better consumer outcomes.³¹ Although the decisions on which EBCs will be advising are not exactly parallel, similar issues could arise.

Which? has also expressed concerns that EBCs’ charging models may introduce further conflicts of interest.³² The dominant model seems likely to be ‘consultancy charges’ agreed by employers but borne by members in the form of deductions from their contributions. These charges may lack transparency, cross-subsidies may be hidden, and additional services (such as individual financial advice) may be provided on an opt-out rather than opt-in basis. The role of employers as proxy consumers is problematic in this context.

“ A model which treats pension savers as individual consumers making informed decisions is fundamentally at odds with the mechanics of auto-enrolment. ”

One of the key mechanisms which appears to be envisaged for ensuring charges are reasonable is *“comprehensive and clear disclosure of the consultancy charges an employee will bear ... so that he or she can make an informed decision before being committed to joining the scheme.”*³³ Yet under auto-enrolment, most employees are not expected to make ‘informed decisions’ at all. Some consumer advocates have suggested that consultancy charging should therefore only be allowed where consumers actively opt into additional consultancy services, and where informed consent can be demonstrated. Again, a model which treats pension savers as individual consumers making informed decisions is fundamentally at odds with the mechanics of auto-enrolment.

Concerns have also been expressed that consultancy charges may create conflicts of interest in relation to choice of provider, since EBCs will be incentivised to recommend firms which facilitate the charging models they want to impose. Five of the largest commercial pension providers recently published a ‘Shared Approach to Adviser and Consultancy Charging’, billed as an attempt to make advisers’ lives simpler by reassuring them that certain charging structures would be facilitated by all these major providers.³⁴ This raises the question of how likely advisers are to recommend other providers who may not share this approach – potentially including NEST.

“ Despite their significant influence on key decisions and the potential for conflicts to arise, employee benefit consultants are essentially unregulated ”

Despite their significant influence on key decisions and the potential for conflicts to arise, EBCs, like investment consultants, are essentially unregulated. While the FSA regulates advice to individuals, advice to businesses is not covered by its rules.³⁵ This was identified as a regulatory gap in the National Audit Office's recent report.³⁶ Moreover, while giving investment advice is legally recognised as a fiduciary function in the US,³⁷ it does not appear to be widely regarded as such in the UK.

This continuing regulatory vacuum is particularly surprising given the key governance role regulators appear to envisage for consultants: TPR guidance tells employers that “the adviser's professional knowledge of pensions and their potential commercial influence over the provider (as a provider of potential new business) can make them a valuable contributor to the governance process.”³⁸ Government should urgently reconsider whether the current approach to regulation of advice is viable and should ensure that the FCA is empowered to ensure the quality of advice offered in relation to auto-enrolment.

KEY POINTS

- The key decision-makers in contract-based pension provision are employers, employee benefit consultants, insurance companies and asset managers.
- There is a lack of clarity over the respective roles and responsibilities of each of these parties, creating the potential for an oversight deficit at each stage of the investment chain.
- Misaligned interests may cause consumer detriment. Employers and consultants are the customers who exert commercial pressures on providers, but their interests are not identical with those of savers themselves. Providers may be subject to conflicts of interest, but are not subject to fiduciary duties which exist to prevent such conflicts from harming savers.
- It is also not clear that anyone is incentivised to perform key functions that affect consumers, such as the oversight of stewardship activities.
- The consumer themselves is unlikely to make any active choices about their retirement savings, or to be in a position to scrutinise choices made on their behalf. A regulatory model which treats savers as informed consumers making active decisions is fundamentally at odds with the mechanics of auto-enrolment.

3. Fiduciary duty or consumer responsibility?

Most participants in our roundtable agreed that consumer empowerment and regulatory intervention to correct market failures were complementary, not mutually exclusive, approaches to improving standards. We share this view.

However, there is also a need to address an underlying inconsistency in the way savers are treated by the current framework. If the economic relationship between saver and provider is indeed broadly the same whether the pension happens to be trust- or contract-based, then why is one saver cast as a vulnerable beneficiary in need of protection by a system of fiduciary obligations, and the other as a consumer capable of making, and taking responsibility for, their own decisions?

“ If the economic relationship between saver and provider is indeed broadly the same whether the pension happens to be trust- or contract-based, then why is one saver cast as a vulnerable beneficiary in need of protection by a system of fiduciary obligations, and the other as a consumer capable of making, and taking responsibility for, their own decisions? ”

To be clear, this is not to imply that consumers in the contract-based world are entirely on their own: of course, FSA rules and regulations exist to protect consumers from bad practice. The point is that these are two fundamentally different approaches to the relationship between provider and saver. Moreover, the distinction is largely an artefact of the UK legal system rather than a reflection of fundamental differences in the facts of that relationship. In countries where the trust does not exist as a legal form (such as Spain,³⁹ Germany,⁴⁰ Italy⁴¹ and South Africa – see box on p28), pension providers are generally all subject to fiduciary-like obligations.

Indeed, the UK Law Commission has identified the key criteria defining a fiduciary relationship as “discretion, power to act, and vulnerability”: i.e. the fiduciary has discretion in a matter affecting the beneficiary’s interests, and power to act on their behalf, in circumstances which make the beneficiary vulnerable and dependent on their skill and good faith. On the basis of these criteria, the Commission concludes that investment agents “advising customers or making purchases on a customer’s behalf” are performing fiduciary functions.⁴² It seems to us that this applies to contract-based pension provision just as it does to trust-based. This is in line with the Kay Report’s recommendation that “all participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers”, and its observation that “caveat emptor is not a concept compatible with an equity investment chain based on trust and stewardship.”⁴³

Financial services: a special case?

The principle of ‘caveat emptor’ is uniquely inappropriate to long-term retail financial products like pensions. Firstly, finance is subject to massive asymmetries of information and expertise between provider and consumer. Moreover, the nature of these asymmetries is such that it is difficult to resolve them fully through disclosure: the vast majority of consumers will struggle to interpret the information disclosed, or to use it to make informed decisions. As a 2008 OECD paper put it: “While improving members’ financial education and enhancing disclosure can help overcome some of the more blatant cases of abuse, it is highly unlikely to eliminate the massive information gap between private pension providers and individual plan members.”⁴⁴

Secondly, pensions are by nature a one-off purchase. As Howard Davies, former Chairman of the FSA, observed in an essay written before the financial crisis, this makes them different from many other financial products: *“there is little that investors can do by way of withholding their business, and, by the time the effect of [conflicts of interest] is evident, it is likely to be too late for investors to act.”*⁴⁵ In other words, even once consumers are in a position to know whether their pension has delivered for them, they are in no position to translate this knowledge into market pressures.

“ Someone who buys a pension will generally have at best a limited grasp of what they are buying, and will not know whether it has performed as expected until it is too late to do anything about it. ”

The mechanics of the market for pensions are therefore fundamentally different from those of the market for, say, cars – and competitive pressures cannot be expected to operate in the same way. Someone who buys a car can reasonably be expected to have at least a basic grasp of what they are buying – and, if the car doesn’t perform as expected, they can ditch it or complain to the seller. Someone who buys a pension will generally have at best a limited grasp of what they are buying, and will not know whether it has performed as expected until it is too late to do anything about it. As the OECD paper concluded: *“Given the complexity of investment matters and the long horizon of pension matters, expectations [that market forces will lead to efficient outcomes] may seem unwarranted.”* In other words, pension savers are vulnerable in a way which fiduciary obligations exist precisely to address.

The key argument to the contrary appears to be that the consumer has made an active choice to enter into a contract with the provider, and their relationship should therefore be governed by the terms of this contract rather than by fiduciary principles. But, as we have seen, this is not always the case under auto-enrolment. Moreover, many trust-based DC pension schemes offer their members a choice of investment funds without this affecting the trustees’ fiduciary obligations.

Policy implications: the Financial Services Bill

In relation to retail savings, the shortcomings of market forces have long been recognised. The 2002 Sandler Report presented considerable evidence demonstrating that *“the functioning of the retail savings market was unlikely to apply effective competitive pressure on investment decision-making.”*⁴⁶ Yet, ten years on, the Financial Services Bill – which establishes the new regulatory regime for financial services – currently persists in treating savers as consumers like any other. The new Financial Conduct Authority (FCA), which will replace the FSA, will be required to have regard to *“the general principle that consumers should take responsibility for their decisions”*.⁴⁷

Consumer groups expressed concern about this during pre-legislative scrutiny, and the Joint Committee on the Draft Bill recommended that the Bill should *“place a clear responsibility on firms to act honestly, fairly and professionally in the best interests of their customers”*⁴⁸ – in other words, a quasi-fiduciary obligation. The Bill now includes a principle that providers *“should be expected to provide consumers with a level of care that is appropriate”*.⁴⁹ However, this leaves open the key question of what the ‘appropriate level of care’ might be.

Since fiduciary obligation is a common law concept, there is currently some confusion over the extent to which the FSA can or should act to uphold fiduciary standards. Thus, even where fiduciary obligations clearly do apply, they can only be enforced if the beneficiary is in a position to bring a court case. Both FairPensions and the Financial Services Consumer Panel (FSCP) have, separately, proposed amendments to the Financial Services Bill which would explicitly empower the FCA to have regard to firms' fiduciary duties to consumers.⁵⁰ Similar provisions were recently introduced for the US Securities and Exchange Commission under the Dodd-Frank Act.⁵¹

An article in CityAM, accusing the MPs tabling the amendments of trying to “ambush” the Bill, protested that the imposition of fiduciary duties would “*fundamentally transform the relationship between financial firms and their customers*”.⁵² This would seem to give the lie to claims that embedding fiduciary standards would make no practical difference. Indeed, it is worth asking why much of the industry is so implacably opposed to the idea of being required to put their customers first. This may indicate not that the proposal is unworkable, but rather that it poses a challenge to prevailing cultures and practices which privilege firms' interests at the expense of consumers.

The government has thus far opposed efforts to write fiduciary obligation into the Bill, with Financial Secretary to the Treasury Mark Hoban arguing that “*customers should not have to dust down the old statute books and dig out their dictionaries to understand common law and to identify what standards they can expect from providers. It is far better for the FCA to set out, via rules, a specific, clear, focused and transparent set of duties on firms.*”⁵³ But a reference to fiduciary obligation is not an alternative to FCA rules: it is a guiding principle to inform the content of those rules and the standard of care they seek to achieve.

Moreover, as the recent history of financial regulation amply demonstrates, rules do not always have the desired effect if the underlying culture remains at odds with their objectives. One way of dealing with this is to prescribe ever more detailed rules to reduce firms' room for manoeuvre. Another is to try and address the cultural issue head-on by reasserting the appropriate nature of the relationship between provider and consumer.

“ In the NAPF's Spring 2012 survey, mistrust of the industry overtook affordability as the number one reason for planning to opt out of auto-enrolment. ”

Fiduciary obligation, with its emphasis on the intermediary serving the consumer rather than the other way around, provides an extremely helpful way of articulating this. It may therefore have a vital role in combating the perception that finance has become inherently self-serving. The reputation of the financial sector remains at rock bottom following the financial crisis, and has been further damaged by the recent LIBOR-fixing scandal. Of course, pension providers are not banks – but it seems clear that they have suffered by association from this general loss of trust. In the NAPF's Spring 2012 survey, mistrust of the industry overtook affordability as the number one reason for planning to opt out of auto-enrolment.⁵⁴ Reviving the “*ethos of fiduciary duty*”, as Michael Johnson puts it in his recent paper for the Centre for Policy Studies,⁵⁵ is clearly in providers' long-term commercial interests.

It may be that, as Mark Hoban argues, fiduciary duty is not *“the right standard to impose across the board between providers and consumers.”*⁵⁶ However, that certainly does not mean that it is never the appropriate standard. In relation to pension provision, where intermediaries are charged with investing other people’s money over the long-term, we continue to believe that it is appropriate. As the Financial Services Bill continues its passage, and subsequently as the FCA develops its regulatory approach, we hope

that government and regulators will engage constructively with the debate over when fiduciary standards of care are appropriate and how they can be achieved in practice. We also hope that the Department for Work and Pensions, in taking forward its own work on regulatory differences between trust- and contract-based pension provision, will take a holistic approach, drawing on the experience of jurisdictions where this distinction is not a feature of the regulatory landscape.

KEY POINTS

- All forms of pension saving involve essentially the same economic relationship: one person entrusts their money to another to be invested with the aim of providing them with a retirement income.
- Yet savers are cast in a fundamentally different role depending on whether their pension happens to be trust- or contract-based: one as a vulnerable beneficiary in need of protection through a system of fiduciary obligations, the other as an informed consumer making active decisions in a well-functioning market.
- Long-term savings vehicles are fundamentally unlike other consumer products: there are irresolvable information asymmetries between consumers and providers, and there is no ‘repeat business’ for consumers to bestow or withhold. This suggests that market mechanisms alone are unlikely to deliver optimal consumer outcomes.
- This makes savers vulnerable in precisely the fashion which fiduciary obligations exist to address. The Law Commission has defined a fiduciary relationship as one where there is ‘discretion, power to act and vulnerability’. It seems to us that this applies to all pension savings, whether trust- or contract-based.
- The FCA should therefore be empowered to uphold these standards among asset managers and insurance companies. Its starting point should be that anyone entrusted with someone else’s money has a duty to act in their best interests.
- The promotion of the fiduciary principle would also help to restore trust in finance – an increasingly urgent commercial imperative for the industry.
- The parameters currently set for the FCA by the Financial Services Bill are based on a view of the consumer which does not match the reality, particularly in the context of auto-enrolment.

4. Achieving fiduciary standards in practice

If the responsibilities of the various intermediaries are unclear, and if fiduciary responsibilities represent the appropriate standard of care in relation to long-term savings, the next question is how this standard can be achieved? This is about more than the legal framework: it is also about creating structures that effectively align interests, and about the incentives created by government policy. This section explores these various possible approaches.

4.1 New governance structures

Participants at our roundtable generally agreed that the lacuna in insurance companies' investment governance needed to be filled – although they were less clear on what this might look like in practice, and held differing views on whether the change could be driven by the industry's enlightened self-interest or would have to be imposed by regulators.

Concerns over whether insurance company governance adequately protects policyholders are not new. The FSA's review of with-profits funds in the early 2000s identified various potential problems arising from companies' high degree of discretion over key decisions affecting policyholders' interests. In particular, it noted that there was *"potential for conflicts of interest to arise in a number of ways"* – between policyholders and shareholders, between different groups of policyholders, and between management and policyholders.⁶¹ Options considered for dealing with these problems included a statutory duty on directors to have due regard for policyholders' interests, direct representation of policyholders on company boards, and introducing beneficial ownership of assets by policyholders.⁶²

'SUPER TRUSTS'

There appears to be surprisingly little UK research comparing the relative outcomes of trust- and contract-based pension provision. Research from the US, Canada and Australia suggests that governance models may indeed affect consumer outcomes. For instance, the performance advantage of pension funds over mutual funds (a distinction similar to that between trust- and contract-based in the UK) has been estimated at 2.8% per year in the US and 3.8% per year in Canada.⁵⁷ This may be due to the governance structures themselves, the underlying business models (for-profit vs not-for-profit), or both.

In any event, scale is clearly crucial: there is now overwhelming evidence that the UK's long tail of small trust-based schemes is not in members' best interests. Costs per member are more than twice as high for schemes with less than 2,000 members as for those with more than 10,000;⁵⁸ TPR has also found that *"the smallest schemes are less likely to benefit from good governance."*⁵⁹

The NAPF's proposal for 'Super Trusts' – which envisages a landscape of large, not-for-profit, multi-employer trust-based schemes – therefore has many advantages. In some ways, NEST illustrates the potential of this idea: it has market-leading good governance and low charges, and performed highly in our survey of stewardship and responsible investment practice compared to its contract-based competitors.⁶⁰ Much more work is clearly needed to establish how this would work in practice, including how existing small schemes could be helped to consolidate.

All these options were ultimately rejected. Instead, the key features of the new regime were:⁶³

- Requirement to prepare and publish a ‘Principles and Practices of Financial Management’ document, setting out how the firm’s discretion would be exercised, and to report annually to policyholders on how this had been complied with, including how policyholders’ interests had been considered and how any conflicts had been managed;⁶⁴
- Guidance encouraging larger firms to set up a ‘with-profits committee’, made up of non-executive directors and independent persons, to oversee and advise the board and to defend policyholders’ interests; and
- Replacement of the Appointing Actuary with a general actuarial function and a dedicated With-Profits Actuary; the new requirements were intended to address potential conflicts of interest in the performance of this role.

These requirements were revisited and strengthened in 2011-12, following a damning FSA review which found that *“the majority of firms did not satisfactorily demonstrate that their practices were consistent with well run with-profits businesses ... potentially exposing a very significant number of with-profits policyholders to risk.”*⁶⁵ In particular, the review found that many with-profits committees were under-resourced and did not have a meaningful role in holding management to account. In one extreme case, *“all members of the with-profits committee also sat on the board, and it was difficult to see how the entities were in fact operating separately or as an effective challenge function.”*⁶⁶ There were also significant and pervasive structural conflicts of interest in the role of the With-Profits Actuary – exactly what the new regime had hoped to avoid.

The role of the with-profits committee has now been formalised in detailed FSA rules.⁶⁷ However, its function of ensuring policyholders’ interests are ‘balanced’ with those of shareholders still falls short of the fiduciary duty of undivided loyalty owed to beneficiaries of trust-based schemes. The history of with-profits regulation raises the question of whether conflicts of interest between policyholders and shareholders can ever be satisfactorily resolved, or whether there is a need to explore alternative business models (see section 4.3 below). It also illustrates the cultural and practical barriers faced by new governance structures which are ‘bolted on’ to an underlying framework in which conflicts of interest are pervasive and difficult to avoid. Time will tell whether the FSA’s new, more prescriptive framework has been successful in overcoming these barriers – and whether this approach could usefully be extended beyond with-profits business.

“ Insurance companies could do more both to embed policyholder interests into decisions and to render themselves accountable to policyholders for those decisions. ”

FairPensions has previously suggested that insurance companies could do more both to embed policyholder interests into decisions (for instance, through standing policyholder committees) and to render themselves accountable to policyholders for those decisions (for instance, through policyholder AGMs). This mirrors our view that trust-based pension schemes must become far more accountable to their beneficiaries – particularly in DC schemes, where beneficiaries bear the investment risk. Another possible approach would be the establishment of trustee-like boards with duties to act in policyholders’ interests, as is required in jurisdictions like South Africa (see box below).

CASE STUDY – SOUTH AFRICA

When considering how contract-based investment governance could look different, short of eradicating the distinction between trust and contract, it is useful to look at the experience of jurisdictions without these parallel legal frameworks.

In South Africa, pension funds are not established under trust but are legal persons in their own right. Save for a few specific exceptions, all South African pension funds are subject to the same legislative regime. This requires them to have a board of members whose object is to administer the fund, and who are required by legislation to:

- take all reasonable steps to ensure that the interests of members are protected;
- act with due care, diligence, skill and faith;
- avoid conflicts of interest; and
- act with impartiality in respect of all members and beneficiaries.⁶⁸

These obligations closely mirror the fiduciary obligations of UK pension fund trustees.

This demonstrates that it is technically possible to apply fiduciary-like standards of care and trustee-like governance structures outside the framework of trust law. The next question is whether these duties and structures are effective in a commercial setting. Some in South Africa have questioned the genuine effectiveness of boards' conflicts management. We are not aware of any comparative research to show whether the South African regime is more or less effective than the UK regime in this respect: such cross-jurisdictional comparisons are clearly an area for further work.

4.2 Alternative business models

Participants in our roundtable held differing views as to whether shareholder-driven institutions could ever be effective fiduciaries. In legal terms, as we have seen, this is perfectly possible. Whether fiduciary-like duties and governance structures can operate as effectively in the context of an intrinsic and unavoidable conflict between shareholders and customers is another matter. Perhaps, as the Kay Report observed, we need to explore *“the establishment of market structures which provide appropriate incentives”*, rather than simply the *“attempt to control behaviour in the face of inappropriate commercial incentives.”*⁶⁹

This should not lead us to conclude that imposing fiduciary standards is useless in commercial settings: it should indeed represent an improvement on the status quo. But it would be

wrong to imply that either fiduciary duties or trust-based governance structures are a panacea for market failures: there is a need to examine the economic structures, as well as the legal frameworks, that deliver the best outcomes for consumers.

In our original report, we emphasised that *“existing practices or organisational structures must not be regarded as sacrosanct... If fiduciary standards of care are judged to be important for the protection of savers, it may be necessary to structurally eliminate [organisational] conflicts – whether by regulatory changes to the aggregations of services permitted within a single entity, or by encouraging alternative business models such as financial mutuals.”*⁷⁰ This raises the broader question of what sort of retirement provision can best align the interests of providers and consumers.

This is about far more than the distinction between trust and contract. For instance, Master Trusts can be set up and managed by anyone – including by commercial providers – and are increasingly competing for auto-enrolment business. The trustees of Master Trusts have the same fiduciary duties as any other trustee. But concerns have been expressed about whether the governance of some such schemes truly delivers fiduciary standards in practice, particularly where the trustee board is effectively accountable to the commercial provider and lacks independence.⁷¹ Like the South African example, this illustrates that trust-based governance frameworks may be insufficient to achieve fiduciary standards if the underlying economic drivers are working in the opposite direction.

“ Trust-based governance frameworks may be insufficient to achieve fiduciary standards if the underlying economic drivers are working in the opposite direction. ”

Conversely, the nature of these economic drivers varies considerably between contract-based providers. It may be possible to 'design out' some key conflicts of interest within a contract-based framework, by encouraging models of provision that are non-profit, or non-shareholder-driven, or both. B&CE – one of the UK's largest stakeholder pension providers, existing primarily to serve the construction industry – is an example of a non-profit contract-based provider. Its governance and approach is strikingly similar to that of many trust-based pension schemes. The insurance company board is made up of equal thirds employer representatives, trade union representatives and industry experts. The absence of shareholders removes a key layer of potential conflicts of interest, which the company says allows it to focus on the interests of members.

Mutuals and other non-shareholder models are by no means immune from conflicts of interest: conflicts may arise between different groups of policyholders, or between policyholders and management. However, these are arguably more manageable. When companies are owned and controlled by policyholders there should be a closer alignment of interests, and this is reflected in governance structures. Having said this, further work is clearly needed to establish whether mutuals deliver better outcomes for consumers in practice than their shareholder-driven competitors. Policymakers should give serious attention to this question, and should consider whether mutuals and non-profit models offer a starting point for the development of new business models and governance structures which can truly put savers first.

4.3 Auto-enrolment: standards and guidance

Qualifying criteria for auto-enrolment

Schemes must meet only minimal requirements to be eligible for employers to use under auto-enrolment. The criteria focus on the practicalities of ensuring that members can be automatically enrolled without having to make any active choices, and that minimum contribution levels are met. There are no criteria relating to scheme governance, charges or transparency: the legislation requires only that the scheme be an occupational or personal pension scheme.⁷² This contrasts with the preceding system of 'stakeholder' schemes, which contained some requirements as to governance, albeit still fairly minimal (see table below). It also contrasts with the approach of other jurisdictions, such as Australia (see case study on p31).

“ Schemes must meet only minimal requirements to be eligible for employers to use under auto-enrolment. There are no criteria relating to scheme governance, charges or transparency. ”

Some participants in our roundtable suggested that the qualifying criteria should be strengthened to ensure that employees could only be auto-enrolled into schemes which met certain minimum governance requirements and/or in which members were protected

against excessive charges. FairPensions has also suggested elsewhere⁷³ that it would be consistent with the principle of joined-up government for eligible schemes to be required to sign up to the UK Stewardship Code.

	Stakeholder⁷⁴	Auto-enrolment⁷⁵
Charges	Maximum 1.5% annual management charge for the first ten years, 1% thereafter.	No charge caps (govt has reserve powers)
Flexibility	No charges for transferring to another provider or for stopping or changing contributions.	No charge caps (govt has reserve powers)
Governance	The scheme must be run by trustees or by a stakeholder manager authorised by the FSA; for trust-based schemes, at least a third of trustees must be independent of the provider.	Must be an occupational or personal pension scheme, regulated either in the UK or (if administered outside the UK) by relevant home authorities within the European Economic Area.
Contributions	No minimum contributions.	In DC schemes, the total contribution rate must be at least 8% of earnings, of which employers must contribute at least 3% of earnings.
Default options	The scheme must have a default fund and must not require the member to make any active choices to stay enrolled.	The scheme must have a default fund and must not require the member to make any active choices to stay enrolled.
Transparency	Like trust-based occupational pension schemes, stakeholder schemes are subject to various disclosure requirements including the publication of a written Statement of Investment Principles.	Personal pension schemes are subject to some disclosure requirements; there are no additional requirements for schemes eligible for auto-enrolment. There is no requirement to publish a Statement of Investment Principles.

CASE STUDY – AUSTRALIA

The Australian pensions landscape differs markedly from the UK's, being dominated by a relatively small number of large, trust-based 'industry funds' run by employer associations and/or unions. Only trust-based schemes are eligible for employers to use under the Australian equivalent of auto-enrolment, although this can include master trusts and other for-profit trustee entities.⁷⁷ Australian policymakers are alert to the governance challenges associated with the trust-based investment chain, with the recent 'Super System Review' examining issues such as trustee competence and the management of conflicts of interest between asset managers and beneficiaries.⁷⁸

The most important reform to emerge from the Super System Review is the introduction of 'MySuper', a simplified product to replace the default funds currently offered by employers. The requirements for MySuper products will be more stringent than current criteria and are likely to include:

- enhanced duties for trustees to avoid conflicts and act in members' interests,
- limits to the type of fees which can be charged, and
- parameters within which trustees should negotiate other types of fee (namely performance-related asset management fees).⁷⁹

The thinking behind these reforms offers various useful insights for the UK debate. Firstly, the Super System Review Panel emphasised that the reforms aim to strengthen the *"trusteeship that MySuper members ought to expect from their product providers"*, and are *"designed to ensure that the trustee is truly accountable to members, that the trustee is unfettered in its pursuit of the best interests of members and that the costs of delivering MySuper are contained."*⁸⁰ This objective should be placed at the heart of UK policy debates, including the 2017 review of auto-enrolment.

Secondly, the strategy of improving the quality of default funds is based on the recognition that the vast majority of savers will have neither the willingness nor the capability to make active decisions: unlike the UK's regulatory approach, "MySuper would not depend on notions of informed choice and disclosure". The government has characterised the purpose of the reforms as providing *"a better deal for the many Australians who choose not to take an active role in managing their superannuation, but who instead rely on superannuation funds to act in their best interests"*.⁸¹ However, crucially, the new regime protects the rights of those engaged members who do wish to make decisions by ensuring that comprehensive comparative information about products is available online.

Default fund guidance

There seemed to be general agreement amongst both industry and consumer representatives at our roundtable that the DWP's default fund guidance could usefully be strengthened. The present guidance⁷⁶ is extremely broad-brush in relation to investment governance and does little to fill the gap left by the qualifying criteria.

For example, it states that roles and accountabilities at each 'stage' (design, monitoring, review) *"should be clearly defined and available to members on request"*. However, there is no elaboration as to what the role of providers, intermediaries and employers might be. Clarification on this point is limited to a general statement that *"the ongoing responsibility for the default option may vary between provider, adviser, fund manager, employer and governance committee in different situations and for different aspects of a scheme"*. Likewise, there is no indication of the kind of governance structures that might be desirable or appropriate to ensure that savers' interests are protected. Governance committees are mentioned as one party to whom the guidance might be relevant, but there is no discussion of the circumstances under which it might be appropriate to establish one, or of best practice in their composition, terms of reference or operation.

Possible improvements to the default fund guidance could include greater clarity on:

- the **key roles and responsibilities** of different actors in the chain;
- the **substantive issues** for which roles and responsibilities need to be agreed (e.g. ensuring the risk/return profile of the fund is appropriate to the needs of scheme members; considering the fund's stewardship approach; etc);
- best practice in terms of **governance structures**, including basic principles for the operation of management committees if they are established;
- the **governance standards** that should be met (e.g. providers to demonstrate that mechanisms are in place to effectively manage conflicts of interest, including in relation to internally managed funds);
- the **types of charges** that may be appropriate (see Australian example on p31);
- the **key information that should be disclosed**, including the Statement of Investment Principles and its implementation, comprehensive disclosure of charges, etc.



Members should not have to be interested, financially literate, or investment experts to get the most out of their super. If members want to engage and make choices, then the system ought to encourage and facilitate them doing so. If members are not interested, then the system should still work to provide optimal outcomes for them. The super system should work for its members, not vice versa.



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KEY POINTS

- Achieving fiduciary standards of care is clearly not as simple as imposing fiduciary duties, although we continue to believe that this is a useful starting point.
- Insurance companies should establish new ***governance structures*** which embed policymaker interests into decision-making in the same way that trustee boards do in trust-based schemes; this process could be industry-led or mandated.
- There is also a need to explore the ***institutions and business models*** that might structurally eliminate conflicts of interest and align firms' interests with those of savers.
- Consideration should be given to strengthening the ***qualifying criteria*** for schemes eligible for auto-enrolment, to ensure that minimum standards of good governance are met. The UK regime is out of step with other jurisdictions such as Australia in this respect.
- The ***default fund guidance*** should also be strengthened to provide greater clarity on the core responsibilities of each player in the investment chain, or at the very least the key issues on which responsibilities must be agreed.

5. Conclusions and Recommendations

Our analysis of the contract-based investment chain suggests that, at each level, there is the potential for an oversight deficit which could harm savers' interests. Insurance companies do not seem to regard themselves as having an obligation to oversee asset managers; employers have little incentive and no obligation to oversee the providers they appoint, and are being left largely on their own to devise governance structures for doing so; employee benefit consultants are entirely unregulated. The saver is the only one of these actors who exercises virtually no influence over any key decisions - and, under auto-enrolment, may well not make any active decisions about how their money is invested. Yet the regulatory system will treat these savers as consumers making informed decisions in a well-functioning market - in stark contrast to the treatment of comparable savers who happen to be enrolled into trust-based pension schemes.

It does not seem reasonable to expect that the individual saver can take responsibility for ensuring that this web of relationships is working in their interests. Promoting consumer engagement and empowerment is of course welcome; indeed, it is a key part of FairPensions' mission and philosophy. But it cannot be a substitute for greater clarity about the roles and responsibilities of each player in the investment chain, and the duties they each owe to the savers whose money they are entrusted with. We remain convinced of the basic principle that, if you are looking after someone else's money, or are making decisions about it on their behalf, you should owe them a fiduciary obligation. The aspiration towards fiduciary standards of care - protecting savers' interests and avoiding conflicts of interest - should be the thread that runs through the whole system. The below recommendations set out a range of possible approaches which we believe could help to achieve this in practice.

Recommendations

1. **Fiduciary-like duties** should apply consistently across the market to all those exercising discretion over other people's money. This should include insurers and asset managers. It could also theoretically cover employers and employee benefit consultants in relation to certain key decisions.
2. **New governance structures at insurers** should be explored with a view to ensuring that policyholders' interests are fully embedded in decision-making - for example, standing policyholder committees or policyholder AGMs. As participants at our roundtable observed, the insurance industry has a clear interest both in being well-governed and being seen to be well-governed. The ABI may therefore be well placed to take a lead in developing industry thinking on robust and transparent governance processes. If firms prove reluctant to engage with this agenda, the FCA should consider developing new mandatory requirements.
3. Government should consider whether more could and should be done to **promote and facilitate alternative business models** which help to structurally eliminate conflicts of interest.
4. Employers would benefit from greater clarity over the **role and status of employer-led management committees**, and more support in putting robust governance structures in place for auto-enrolment. DWP or TPR would seem to be the appropriate bodies to provide this.

5. **Advice to businesses**, including advice to employers from employee benefit consultants, should be regulated by the FSA/FCA in the same way as advice to individuals.
6. The **qualifying criteria for auto-enrolment** should be strengthened to include minimum governance requirements. The **default fund guidance** could also be improved to give greater clarity about roles and responsibilities in relation to key investment governance issues.
7. The Financial Conduct Authority should consider undertaking a **fundamental review** to investigate whether pensions markets are operating in the interests of underlying savers, and to reassess whether its regulatory approach remains appropriate to the economic relationships at play, particularly under auto-enrolment.

AREAS FOR FURTHER WORK

Further research is urgently needed to inform this debate and help to determine the most effective approach to protecting savers' interests. Some key areas for further work are:

- Cross-jurisdictional comparisons of legal regimes and governance structures and how they affect practice in key areas such as conflicts management
- Empirical research on relative consumer outcomes associated with different forms of provision (trust vs contract, for-profit vs not-for-profit, etc)
- Thought-leadership work on the type of institutions which could help embed savers' interests in decision-making and align incentives effectively.



USD	7,12	7,87	1,4582
DKK	0,85	0,92	0,8813
GBP	108,48	122,48	112,61
JPY	3,46	4,85	3,9964
PLN	1,14	1,23	1,1720
CHF	7,75	12,15	9,6099
ZAR	20,44	26,84	24,...

Appendix 1: List of roundtable attendees

Mike Axton	Department for Work and Pensions
Christine Berry	FairPensions
Yvonne Braun	Association of British Insurers
Sarah Brooks	Consumer Focus
Baroness Jeannie Drake	House of Lords
Caroline Escott	UK Sustainable Investment & Finance Association
Philip Goldenberg	
Chris Hewett	Finance Innovation Lab
Brian Hill	Former Partner, Towers Watson
Emma Hunt	Towers Watson
Howard Jacobs	Universities Superannuation Scheme
Alexandra Kitching	National Association of Pension Funds
Dominic Lindley	Which?
Lucy Malenczuk	Age UK
John Mellor	Foundation for Governance Research & Education
David Metz	Formerly of the Financial Services Consumer Panel
Peter Montagnon	Financial Reporting Council
Peter Morris	
Martin Palmer	Friends Life
Louise Rouse	FairPensions
Charles Scanlan	Former Partner, Simmons & Simmons
Andy Tarrant	Office of Gregg McClymont MP
Simon Wasserman	Department for Business, Innovation & Skills
Simon Wong	Governance 4 Owners

Organisational affiliations are given for information only. All participants attended in a personal capacity and the event was held under Chatham House Rules.

The opinions expressed in this paper are those of FairPensions and are not necessarily endorsed by roundtable participants.

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