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Comparison of the regulatory frameworks for DC pensions

Executive Summary

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Executive Summary

The implementation of automatic enrolment and the introduction of new pension flexibilities have meant an increased role for regulators to ensure that new policies work to the benefit of pension savers. At the same time, the challenges for regulators have increased. For example, automatic enrolment means that a greater number and wider range of employers are offering pensions to their employees, and the new pension flexibilities have brought about increased possibilities for pension scams.

In order to address some of these concerns, Scottish Widows commissioned research to explore the advantages and disadvantages of the two main regulatory regimes for pension saving. This research provides an independent assessment of the Financial Conduct Authority (FCA) and the trust-based regime for pensions, implemented by The Pensions Regulator (TPR), in terms of supporting good member outcomes in retirement.

The PPI conducted 13 interviews with representatives from different organisations, including pension providers, legal experts, advisers and employers' organisations, around the effectiveness of the respective regulators. This report draws on discussions with these interviews as well as desk research.

Particular aspects of workplace pensions mean that there is a need for regulation

Complexity of pension arrangements, the need for specialist management and the fact that outcomes may not be apparent for some years mean that it is difficult for members to assess whether they are receiving value for money.[1] This results in the need for external regulators to ensure that members are treated fairly and have access to strategies that best suit their needs.

Broadly, trust-based Defined Contribution (DC) pensions are regulated by TPR and contract-based DC pensions are regulated by the FCA

- **TPR** regulates workplace trust-based pension schemes. The activities regulated include administration and employers' duties, trust and trustee activity.[2]

- The **FCA** regulates the firms and individuals that promote, arrange or provide contract-based schemes, including Group Personal Pension schemes (GPPs) used in workplaces. Bodies regulated by the FCA in relation to pensions can include financial advisers and investment/asset managers.[3]

Pension trustees are also subject to trust law that applies to areas such as investment powers, while contract-based pensions are subject to contract law that covers areas such as disclosure and fairness. The regulators, in turn, reflect these laws.

[1] Office of Fair Trading (2013)
[2] House of Commons library (2014)
[3] House of Commons library (2014)

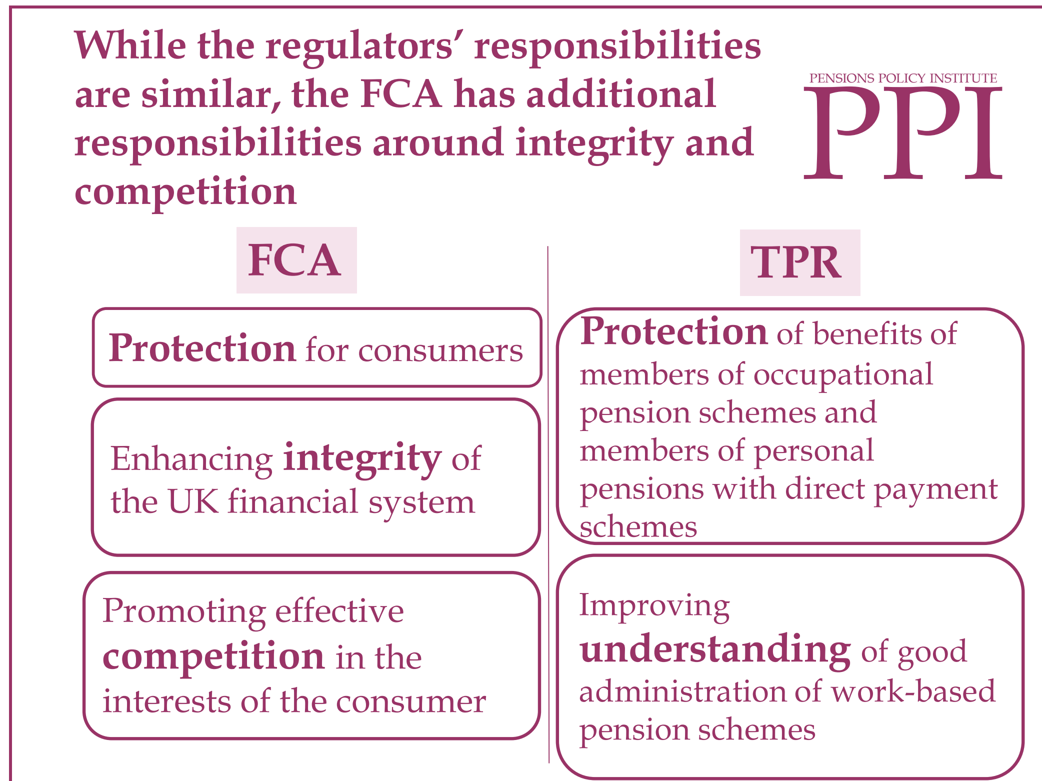
Large financial service organisations, such as insurers, are jointly regulated by the FCA (for conduct) and the Prudential Regulation Authority (for solvency).

While the FCA makes rules for financial services providers and reports to Her Majesty's Treasury (HMT), TPR's role is to regulate according to the rules put in place by the Department for Work and Pensions (DWP). DWP and Her Majesty's Revenue and Customs (HMRC) are responsible for putting in place rules around registration conditions for schemes.

While the regulators' objectives are similar, the FCA has additional responsibilities around competition and regulation of the market

The emphases of the two regulators reflects the different models of pension provision of trust and contract-based pensions, with the FCA focusing on the market and having responsibilities that also cover products other than pensions (Chart A).

Chart A



The respective approaches of the regulators reflect the different underpinnings of contract and trust-based pensions, as well as the regulators' different expectations of trustees and providers:

- TPR regulates the body of law that relates to trustees who are responsible for overseeing assets on a collective basis, and optimising outcomes at the collective rather than at an individual level.[4]
- The FCA expects providers to optimise each individual's outcomes.

[4] www.thepensionsregulator.gov.uk/press/mark-boyle-professional-pensions-2015.aspx

While both regulators have identified similar types of risk, their approaches are different with TPR focusing on enablement and education. It is also less prescriptive than the FCA in terms of its guidance, particularly around communication to pension savers. In contrast, the FCA is more pro-active in monitoring pension schemes' activities. This difference reflects the fact that it is the trustees who are responsible for playing a supervisory role in the trust-based regime.

Both regulators have identified risks, particularly, around the pensions freedoms but with only a finite amount of resources, both regulators have to target these at the areas of greatest risk

Both regulators address the risk that sub-optimal investment decisions and high fees will erode the value of members' DC pension pots. In addition, both have identified risks brought about by the new pension flexibilities, including:

- Individuals using their DC pots at retirement in a way that is not aligned to the individuals' objectives.
- Pension scams, where individuals are encouraged to withdraw their pension savings and place these in a fraudulent product.

In order to address these, both regulators have brought in 'the second line of defence' rules whereby pension schemes have to provide risk warnings to members when they wish to withdraw their pension savings. However, while FCA regulations mean that contract-based pension providers have to give tailored risk warnings, trust-based pensions only have to provide generic warnings. TPR has pointed out that it is the differences between trustees' and providers' responsibilities that account for these (with trustees overseeing a scheme's assets on a collective basis and providers having a direct commercial relationship with each member).[5]

TPR's role in ensuring that employers make contributions should not be under-estimated, with interviewees rating its communications with employers as good

As inadequate pension savings constitute the highest risk to adequate retirement income, TPR's role in ensuring that employers make contributions is a large, complex and valuable one. Both employers and advisers rate TPR's communications as good in this area.

Both regulators have strengths that could helpfully inform approaches taken by the other regulator

TPR's strengths lie in its pragmatic approach that makes it relatively easy for trustees to comply with the regulations, and the leeway that the legislation allows pension schemes in terms of communication with members.

The FCA's regime is more rigorous and designed to prevent adverse events. This approach may be particularly valuable in terms of emerging priorities, under the Master Trust regime, around the prevention of adverse events.

[5] www.thepensionsregulator.gov.uk/press/mark-boyle-professional-pensions-2015.aspx

Table A summarises the strengths and areas where one regulator may learn from the other in terms of impact on the pension schemes, including members that they regulate. These are then discussed in more detail after the table.

Table A: Respective strengths of the contract and trust-based regimes

<table>
<tr><th>Activity</th><th>Contract- based regime (FCA)</th><th>Trust-based regime (TPR)</th></tr>
<tr><td>Rigour of regulatory regime</td><td>Requirement to meet threshold conditions to conduct regulated activities. Ongoing monitoring including:
• Supervision
• Thematic reviews.</td><td>It relies on trustees and other professionals to report any breaches and to comply with their statutory whistleblowing duties.</td></tr>
<tr><td>Communication with members</td><td>Requirement for communications that reflect where individuals are on the retirement journey.

Prescriptive around the information provided to members – in some cases, this may make it more difficult for organisations to present information in the most useful way (e.g. if they are required to provide information that will not be used by the member).</td><td>Schemes able to tailor their communications to their members.

Communications may be designed at the level of the scheme membership and may not reflect an individual's position on their retirement journey.</td></tr>
<tr><td rowspan="2">Compatibility with workplace pensions</td><td colspan="2">Employees do not typically have a choice of pension scheme, this is down to the employer.</td></tr>
<tr><td>FCA's requirement to promote consumer choice of their pension provider is not as relevant under automatic enrolment where it is the employer who chooses the pension scheme.

This suggests that some of the information (such as the provision of information to help members make choices) provided may not be used and that this may distract</td><td>Schemes have the leeway to provide information relevant to the members' situation – that can reflect the fact that the employer chooses pension schemes under automatic enrolment.</td></tr>
</table>

Activity	Contract- based regime (FCA)	Trust-based regime (TPR)
	members from other important information.	
Cost (including monetary costs and time) of managing pension schemes	Compliance entails a higher volume of work and cost than required by the trust-based regime. Pension providers must receive authorisation for certain activities.	Compliance requires lower volume of work – for example, lower levels of contact with the regulator. Trustees have the freedom to make decisions if they judge these to be beneficial to members.

The trust-based regime is particularly effective in terms of compatibility with workplace pensions and places a lower cost burden on managing schemes. The FCA provides a more rigorous regulatory regime overall in terms of preventing adverse events.

There is an obvious trade-off between rigour on the one hand, and cost and flexibility on the other.

Authorisation and monitoring by the FCA are more stringent than conditions around a Master Trust. The FCA regime is designed to prevent negative events while the trust-based regime addresses these after the event

The FCA is a supervisor of entities while TPR oversees trustees; e.g. the FCA will undertake particular activities, such as interviews with staff at all levels and analysis of management information, in order to regulate organisations such as insurers. The FCA regime includes the following requirements:

- Meeting threshold conditions, such as an appropriate level of resources to be authorised to conduct regulated activities.
- Supervision entailing on-going engagement between the firm/individual.

Much of the FCA's approach, such as threshold conditions around adequacy of resources for investment managers, is driven by European legislation.

Under the HMRC and DWP rules, that determine TPR's approach to regulation, the requirements are:

- A Master Trust can be set up with a minimum of only three trustees, provided that the majority are independent of the provider of the scheme.
- Trustees are responsible for the supervisory function, including protection of members' assets.

Trustees have a legal duty to put in place internal controls,[6] and the regulator would expect to receive a 'whistleblowing' report where the implications of inadequate controls are materially significant. Trustees are personally liable and may face action where a breach has occurred. However, there is a concern

[6] TPR *Code of practice no.9*

that, under the trust-based regime, action takes place only once members' assets are at risk.

Interviewees felt that TPR recognises the limitations of its less pro-active regime, particularly in the context of automatic enrolment.

Concerns around lack of conditions to entry and active supervision centre on the possibility of the winding up of some Master Trusts, in particular where they do not achieve the necessary scale for automatic enrolment

The lack of conditions to entry, such as threshold conditions around solvency requirements, in particular, are judged to make it more likely that those Master Trusts without the sufficient scale to profitably operate under automatic enrolment will enter the market – and that these Master Trusts will either wind up or merge.

These concerns do not relate to all Master Trusts, but centre on those Master Trusts not deemed to have the scale for the mass market of automatic enrolment (with some exceptions around smaller Master Trusts designed for the top end of the market) and/or effective governance.

Other concerns linked to the lack of supervision relate to issues around poor management of Master Trusts leading to poorer outcomes for employees.

It is not yet possible to know the exact implications of negative events, such as being wound up, for Master Trusts. However:

Pension members

- Where investments have been mismanaged or internal controls are not in place, this can lead to lower values of pension assets.
- Where a Master Trust winds up trustees would be required to cover the administration costs and, as such, these would be taken from the pension scheme funds.

Employers

- Where an employer enrols their employees into a pension scheme that is not managed effectively, they may have the burden of moving their employees into a different pension scheme (but has no recourse to move existing funds).

The Financial Services Compensation Scheme (FSCS) can pay compensation to consumers when an authorised financial services firm is unable, or likely to be unable, to satisfy claims against it, due to its financial position. There are a number of conditions that must be met for the FSCS to be able to pay compensation, including that the firm is unable, or likely to be unable to satisfy claims itself, that the firm owes the claimant a civil liability and that the claimant is a person who is eligible to claim compensation. Trustees of occupational pension schemes, including schemes set up under Master Trusts, may be eligible to claim compensation, subject to the conditions in the rules being met. More information is available on the FSCS website.[7]

[7] www.fscs.org.uk/what-we-cover/products/pensions/?gclid=CJbmyZa3vcgCFSnkwgodNU8EXg

New regulations and the introduction of the Master Trust Assurance Framework (although not mandatory) represent a move towards a more stringent approach for trust-based pensions

The Master Trust Assurance Framework (MTAF), introduced in April 2015, was developed to help trustees to assure the quality of their scheme and to address some of the concerns around the quality of pension schemes. However, it is not currently mandatory for Master Trusts to complete this although it has been reported that TPR is considering making it mandatory.[8]

As part of the MTAF a charge cap and governance regulations were introduced for trust-based pensions, although the charge cap applies only to the default funds in both GPPs and trust-based pensions used for automatic enrolment. This cap limits charges to 0.75% for default funds and brings in new requirements for trustees such as reviewing operational processes and considering whether charges represent good value for money.[9,10]

There is a concern that a lack of transparency may lead to worse outcomes for some pension savers, under both regimes, and that TPR, in particular, has no remit to protect the integrity of the market

Interviewees noted a move towards services, including advice, administration and fund management, being bundled via a Master Trust. While this may result in efficient provision of services in some cases, there were concerns that this might lead to conflicts of interest, for example, where advisers promote more than one product or service. A 'bundle' also makes it more difficult for employers to assess the value provided by the Master Trust's product, potentially adversely affecting value for money for the individual.

There is a concern that some boards of trustees will not feel able to appoint investment managers other than those linked to the adviser or provider that has sponsored the Master Trust. While a recent change in regulations by DWP was introduced to ensure that trustees are not locked in by providers or advisers to in-house administration or investment services, some trustees may not choose to exercise this choice.

The issue of bundling has also been noted for contract-based schemes. The assessment of value for money is one of the responsibilities of Independent Governance Committees (IGCs) that have recently been introduced.

Another issue for the trust-based regime, raised during interviews, is around unregulated advisers setting up some Master Trusts, something that may have an adverse impact on the market in terms of transparency and competition. This was seen as something that might not be effectively addressed under the trust-based regime, as TPR does not have a remit to promote competition and protect the integrity of the market.

[8] www.engagedinvestor.co.uk/Story.aspx?storyCode=14746697&utm_source=Adestra&utm_medium=email
[9] DWP (2015)
[10] This does not include 'transaction charges' – charges related to the buying and selling of assets in a pension scheme

It should be emphasised that these are potential risks and it remains to be seen whether members are affected adversely by these arrangements. Moreover, there are some Master Trusts with extremely effective governance arrangements. In particular, these issues may be more likely to arise where profit is an over-riding objective for the organisations that sponsor the Master Trust.

Despite this, the recent introduction of the charge cap and new governance standards indicates recognition by the DWP of the need for protection of members' interests in the context of the pensions market.

The extent to which one of the regulatory regimes is more likely to be effective depends on providers' motivations in making available a pension scheme

Where the primary motivation is around providing a benefit to workers, such as in a single employer trust-based pension scheme or large not-for-profit scheme, the trust-based regime may well be effective. According to this type of model, trustees are responsible for supervising administrators and investors for the benefit of members and are motivated to do so. Moreover, the trust-based regime allows trustees the leeway to adapt their approach to the needs of employees. However, where there may be conflicting commercial objectives, such as profit-making, the FCA regime may be more effective, in terms of working towards better outcomes for the pension member, by ensuring that organisations do not pursue other objectives at the expense of scheme members.

The FCA's prescriptive approach to member communications may not be as appropriate for workplace pensions, where the member is typically not able to choose to change pension scheme

There is some leeway around how trust-based pensions communicate with members. In contrast, the FCA is prescriptive around the information that pension schemes have to provide to members, reflecting its commitment to treating customers fairly and in promoting competition. The FCA's requirement to promote consumer choice may not be as relevant for workplace pensions, including automatic enrolment, where it is the employer who chooses the pension scheme and therefore the provider.

This suggests that some of the information (such as the provision of material to help members make choices) may be unnecessary and may distract the reader from key communications on other points.

While competing views exist around whether there should be a single regulator, there was a consensus among research interviewees that combining the regulators would not be straightforward

The issue of regulatory arbitrage – where a pension scheme is set up in a particular way so that it is regulated under one of the regimes rather than the other – was touched upon in interviews. However, it is not clear that having a single regulator would address this to a greater degree than bringing in line some of the main causes of regulatory arbitrage such as the threshold conditions for starting a pension scheme. A further barrier would be the volume of contract, tax, trust and pension law needing to be changed to accommodate a move to a single regulator.

The interviews generated some objections to or questions around having a single regulator:

- It was felt that the burden on employers should not be increased at a time when they are experiencing a high regulatory burden, due to the implementation of automatic enrolment.
- It was not clear where a single regulator should sit – whether this would be in the Department for Work and Pensions (DWP) or Her Majesty's Treasury (HMT).

There are concerns around individuals, organisations and products that are not regulated, and it was felt that any failure in pensions regulation would be felt by the whole of the pensions industry

Both desk research and interviews with experts drew attention to risks brought about by those individuals, organisations and products that either fall outside the regulatory regimes or have not applied for authorisation when they should be regulated. An area that has received concern in the press is the role of international advisers, not regulated in the UK, and their potential role in recommending unsuitable investments.[11]

If one of the regulatory regimes were not successful in preventing member detriment, it was felt that the reputation of the pensions industry as a whole would suffer and, for this reason, the effectiveness of both the regulators is important across the board.

Conclusions

Particular aspects of workplace pensions mean that there is a need for regulation.

TPR's role in ensuring that employers make contributions should not be underestimated, with interviewees rating its communications with employers as good and appreciating its pragmatic approach.

Both regulators have strengths that could helpfully inform approaches taken by the other regulator.

Concerns around lack of conditions to entry and active supervision centre on the possibility of the winding up of some Master Trusts, in particular where they do not achieve the necessary scale for automatic enrolment.

New regulations and the introduction of the Master Trust Assurance Framework (although not mandatory) represent a move towards a more stringent approach for trust-based pensions.

There is a concern that a lack of transparency may lead to worse outcomes for some pension savers, under both regimes, and that TPR, in particular, has no remit to protect the integrity of the market.

While competing views exist around whether there should be a single regulator, there was a consensus that combining the regulators would not be straightforward.

[11] www.ftadviser.com/2015/06/05/investments/unregulated-advisers-under-fire-YyFN0ZnWNuXYjK7K7l8qiK/article.html