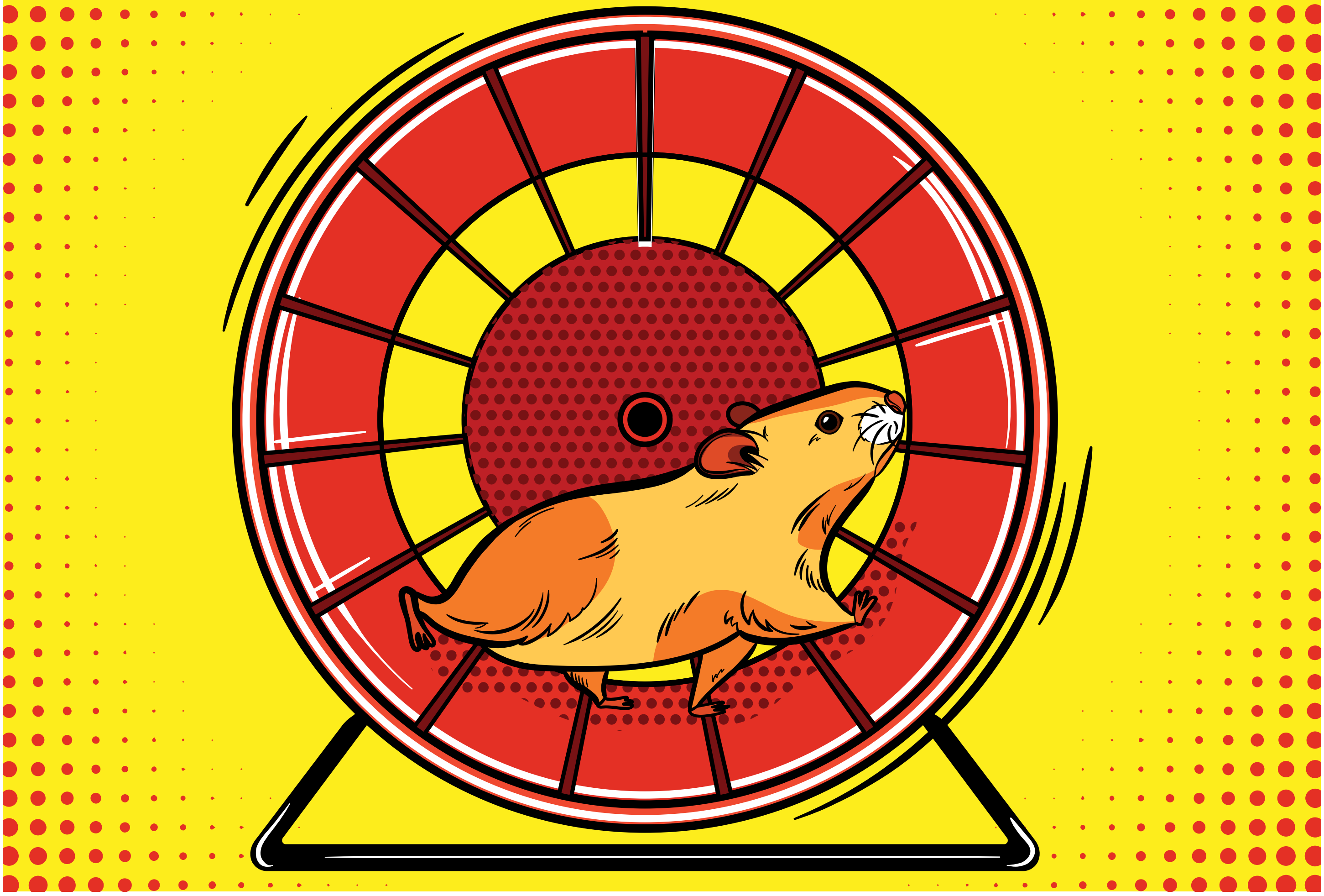

Spinning faster

Laura Blows explores the pace of reform within the pensions industry and whether trustees are struggling to keep up

Summary

- The pace of policy and regulatory reform has been 'breathless' in recent years, with criticism that some regulatory developments are short term in their outlook.
- There are concerns around the time and costs of complying with reform, along with unintended consequences, such as companies moving away from trust-based schemes.
- Trustees may struggle to balance between what the law requires, what the regulator suggests and the fundamental interests of their scheme when implementing change.
- Regulation can sometimes be too prescriptive, with tension between small schemes who may want or need more direction, and larger schemes that want and can manage flexibility.
- Policy and regulation focusing on the 'big picture' is desired, with scheme allowed to find apply their own methods of achieving goals.

The wheels of pension reform have been spinning ever faster for many decades, but the past few years has seen it really increase in speed.

Making changes

"Pensions policy and regulation has never stood still," Sackers partner, Peter Murphy, says. "Many will regard the Maxwell scandal as a particularly pivotal event, which drove many of the initiatives in the early to mid-1990s with the aim of better securing members' benefits. But the pensions landscape has continued to evolve in a multitude of quite fundamental ways since then, driven by changing policy and backed by increased regulation."

Aon partner and head of UK retirement policy, Matthew Arends, agrees that the pace of regulatory change to UK pensions in the past few years has been "breathless".

"Think of the existential crisis caused by freedom and choice, the advent of DB consolidators or the Code of Good Practice on Incentive Exercises," he says. "And for DC schemes, there have been, for example, the introduction of the charge cap, DC chairs statements and increases to minimum auto-enrolment contribution rates. Each of these developments has caused deep and widespread implications for every occupational pension scheme. And further change is coming in the form of the Code of Practice on Scheme Funding, further environmental, social and governance, (ESG) requirements and the dashboard, to name just three."

Whether new regulation is needed or whether existing structures – many of which are quite new – should be left to bed down is a question posed by State Street Global Advisors head of pensions and retirement strategy, Alistair Byrne. He references the charge cap consultation as a case in point *[for more information see page 40]* as most large schemes are already below the charge cap price, "so it is not clear that further legislation is required".

Changes to policy and regulation can be a reaction to high-profile cases, "on the perceived weaknesses in the system shown by these unusual cases", DLA Piper legal director, Craig Looker, says. "Changes are made to address those weaknesses and rolled out to every scheme, but those changes may be unnecessary for most schemes."

Ultimately, for Arc Pensions Law partner, Rosalind Connor, the pace of reform is "inevitably both too fast and too slow".

"Some changes are proposed with very little warning," she explains, "whereas others, such as the treatment of DB consolidators, seem to drag behind the movement of the markets."

The Pensions Regulator (TPR) is aware of the many reforms that have occurred in the industry in recent years.

"We acknowledge the pensions landscape has been through a prolonged period of change, and we are committed to driving all trustees to constantly review and develop their knowledge and skills, and to improve diversity and inclusion on trustee boards," its spokesperson says.

SEI head of institutional group, EMEA and Asia, Ian Love, sympathises with trustees and the various regulatory bodies "for the sheer amount of changes they have had to respond to or shepherd through".

TPR's spokesperson highlights the sheer volume of work itself has gone through as an organisation, having made "significant progress in transforming our organisation so we are a modern and 21st century regulator, fit for the challenges we face, delivering on a growing remit and changing risk landscape, and protecting workplace pensions most effectively with the resources we have".

On the trustee side, "I've never heard a trustee or employer suggest there is too little pensions regulation. But I've heard lots of complaints that there is too much," Isio partner, Mike Smedley, adds. "Individual policy changes may be well-intentioned, but in practice layers upon layers of complexity have been added over the years. Promises of simplification have not been fulfilled."

Love states that "when you consider the vast array of regulatory developments, they all have clear merits in isolation", citing the master trust authorisation process as an example that most would agree has the right intentions as a standalone regulation.

"What causes concern," Love says, "is both the cumulative effect of the many regulations that trustees and schemes are having to keep pace with, and the unintended consequences that each regulation may bring. The old adage 'not seeing the forest for the trees' rings true here."

Consequences

One knock-on effect for regulators to be aware of is that of 'regulatory capture' Love advises, whereby regulation "favours large, established market participants and erects impossibly high barriers" to entry for potential new entrants.

"This is not unique to pensions, but as the recent CMA review demonstrated, the pensions industry is one that cannot afford to close itself off to innovation and fresh competition. The sector is afflicted by many challenges that need new solutions. The regulators and the industry should welcome novel ideas if members can receive greater outcomes and increased security," he says.

Not only is red tape risking creating a barrier to new entrants, it may also be driving others out of the industry.

PTL managing director, Richard Butcher, wonders whether increased consolidation may drive schemes towards consolidation. "I am not against consolidation per se but I'd rather it be for the right reasons. Some schemes may not need to consolidate but end up having to do so because of the pace of regulatory change, which I think is a shame."

Another example is the continued drive for better security of members' DB pensions leading to changes to employer debts on exit, as well as to employers' funding obligations, Murphy says. "This has come at a huge and unexpected cost to many employers, both directly and indirectly through payment of levies for the PPF to provide an ultimate safety net for members. It has perhaps also come at a significant cost to members, with the offering of DB pensions accrual well and truly on the decline," he suggests.

On the DC side, it has resulted in companies exiting their trust-based DC scheme, to pass on its increased governance, risk and cost burden, Isio partner and head of DC pensions, Richard Birkin, adds.

The money aspect is a significant one for pension schemes. According to a Pension Management Institute (PMI) survey in January, 34 per cent of pension professionals believe that the cost of regulation is too high and are concerned about its increasing cost. However, 39 per cent thought that the cost of regulation was "about right".

TPR's spokesperson states that it committed to meeting its statutory duties effectively, while providing value for money for stakeholders.

However, pension schemes are shouldering an incredible cost burden to comply with the raft of regulations, Love says. And beyond the direct costs, there is a fair amount of opportunity cost involved as well. "Schemes could have deployed the same amount of pounds and pence to other key, strategic and potentially transformative initiatives – or simply having more of that money remaining in the scheme," he explains.

Trustee response

Scheme trustees also face that issue of resources being pulled in different directions.

As Butcher says, "regulators and the Department for Work and Pensions (DWP) forget that pension trustees answer to many different paymasters, so we could do with joined-up governance."

Efforts have been made to improve this though, with TPR's spokesperson noting that working with industry stakeholders and government partners is a "firm priority" for the regulator, particularly with the Financial Conduct Authority (FCA).

"For example, we engaged extensively with the FCA throughout 2019-2020, including on a very successful joint campaign highlighting the threat of pension scams, and published a joint statement (also with the Money and Pensions Service) to increase awareness of scams during Covid-19," they add.

Arends usually sees trustees responding to change in one of three ways. They either 'get busy' and rise to the challenge, 'get help', where they outsource some or all of the responsibility for change to a third party, such as a master trust or fiduciary manager, or they 'get simple' by complying in the minimum way possible in order to manage the cost and time required to comply.

"This is perhaps where the unintended consequences of rapid policy change begin to emerge," he adds.

"The biggest challenge for pension schemes is the constant change and tinkering with policies," Smedley says. "It's difficult and expensive for trustees to keep up with moving goalposts. And even worse it can distract trustees from more important issues. GMP equalisation is a great example of a regulatory burden that adds significant work with very limited benefit. Trustees would much rather use that time and money to do something more meaningful. Increased disclosure is hard to argue with, but does it add value if no-one reads it?"

According to Connor, trustees are caught between what the law says, what the regulator or other interested parties suggest they should do, and the fundamental interests of their scheme. "These are all competing for their time and attention, and time and money is spent sorting out the competing positions, before even starting to implement."

Whether spending that time and effort complying with a certain regulation will even generate a benefit to the scheme is sometimes subject to debate.

"A lot of the proposals and ideas are of course good ones, and many well-run pension schemes look at a lot of what is presently required of schemes and think firstly that they are already quite compliant, and secondly that they are glad that others are being required to do this too," Connor says.

"However, there are problems and challenges even for the best run schemes with compliance from time to time, and other, perhaps smaller and less well-resourced schemes can find it a significant challenge."

There is always tension between small schemes who may want or need more direction, and the larger ones that want and can manage flexibility, Smedley agrees. There also needs to be more consideration to applying regulation equally across small schemes and large schemes, he adds.

Connor also notes that there is a great deal of scepticism on whether the schemes that can best benefit from direction and guidance, those without regular advice and input from experts, will be at all compliant, "leaving a risk of over-engineering for schemes that are already in the right direction, whilst those most in need of guidance remain oblivious to what is asked of them".

To counteract this 'obliviousness' has arguably been to make policy and regulation more rigid.

"A fundamental issue with pensions policy and regulation is that it is always highly prescriptive," Looker says. "The concept of setting out principles and guidance for schemes to follow and then leaving it to the schemes and their advisers to work out the best way to achieve that in practice seems never to form part of our pensions policy. This results in lengthy and complex rules to be followed, which dampens enthusiasm for change. These rules risk becoming just a list of boxes to be ticked at great expense to schemes in terms of both time and adviser costs."

Looker states ESG regulation as a good example of this. "The prescriptive rules and laborious process set out for schemes around ESG distract from the genuine benefit of considering these issues as part of pension scheme's investment decisions," he says.

Since last year, trustees must meet new UK regulations from the DWP to explicitly consider climate change and ESG in investment decision making, and as of October this year, develop implementation statements that show how they have achieved what they have set out to do.

"Many trustees are still building their knowledge in what is a rapidly developing area *[ESG]*," Columbia Threadneedle Investments senior analyst, responsible investment policy, global research, Chris Anker, comments. "Combined with the associated costs in addressing these issues concurrently in a relatively short timeframe, there is a risk of sub-optimal implementation," he adds.

For Butcher, the implementation statement may be too prescriptive, as a small scheme may have to spend time and cost to fill it in, "when the reality is that small schemes can do very little to influence what their fund manager does, but they still have to comply with this".

However, in contrast, he highlights the flexibility in other regulations, such as the DB funding code, with its bespoke and fast-track options.

The more prescriptive regulations are, "the more you end up with churn out like a sausage factory", he warns, "as opposed to trustees thinking about strategic objectives and how to achieve them".

We may already be at 'sausage factory' stage, Butcher adds, with too much regulatory focus currently on the 'output' instead of the 'input' and 'outcomes' of good governance – "by which I mean providing legislative and regulatory framework to ensure that governance is of a high quality and continues to be so to deliver good member outcomes. Let's not worry about the bit in the middle, 'are they complying with that schedule, have they produced that statement in these words etc', as that just ties people up in knots".

Looker agrees that all schemes would benefit from a wider review of what is expected of pension scheme governance as a whole and then a policy change toward setting schemes free to find their own path to achieving it. "The regulatory regime should sit behind this to police the few schemes that do not comply, rather than seeking to impose specific actions on schemes at every stage."

TPR's spokesperson notes that its consultation and response to its *Future of Trusteeship and Governance* work "saw a record 114 responses and showed broad support for our view that all savers should benefit from efficient and well-run pensions, with the right people in place to make good investment decisions and deliver value for money".

However, Connor thinks that there is not enough recognition of trustees' efforts generally.

"There is a growing suggestion that pensions regulation puts no store by the duties of trustees, and how seriously those duties are adhered to, or by the professional expertise or judgment of advisers," she says. "Regulating on specifics may of course do something to prevent those specific problems, but in practice, ensuring that trustees and their advisers look at the big picture and do the right thing for their schemes and the schemes' beneficiaries leads to much better outcomes. This message seems increasingly lost in the current regulatory climate."

Focus and direction of reform

A challenge to seeing the bigger picture is possibly the increased focus on short-term issues.

"The problem is that pension schemes are pushed to focus on the latest issue, and it is easy for them to lose sight of the overall objective – providing members' benefits – in the scrum to keep up with the latest campaign," Connor says.

Love describes the timing mismatch that has arisen as "one of the key challenges with modern pensions regulation".

"The nature of many of the regulatory developments is highly short term. Pensions, by their very nature, need to have a long-term perspective," he says.

"Trustees understand that their guardianship must reflect their long-term and, in some cases, 50-year obligations to members, but they are increasingly judged quarter to quarter. They have quarterly meetings, annual funding updates, three-year valuation cycles, and may have the regulator looking over their shoulders on a regular basis. This creates a mindset where short-term incentives can dominate."

The regulator "explicitly and directly providing guidance that emphasises the importance of long-term outlooks" may help with this, he suggests, as "trustees may feel more empowered to give primary consideration to longer horizons".

Looking to longer horizons may be needed – if not always enjoyable. In June, PMI's *Pulse* survey found 60 per cent of pensions industry respondents remain "pessimistic" about the direction of future pension policy following the current pandemic, (particularly clause 107 of the Pension Schemes Bill, and whether this could criminalise normal DB scheme management and consultancy services).

However, Butcher does think the wheel of regulatory change is broadly heading in the right direction; the only issue is the speed of the spin.

"The concern is that we may spend a lot more time dealing with regulatory compliance, which distracts from the strategic work that could improve member outcomes," he explains.

"Therein lies the problem," Arends adds. "Not so much the direction of travel, because that will always be debated, but if the pace and breadth of change is too fast, it will discourage schemes and the industry as a whole from doing anything other than the minimum. Policymakers beware!"

Written by Laura Blows