Financial Reporting Council

Alistair Elliott
The Pensions Regulator
Napier House
Trafalgar Place
Brighton
BN1 4DW

28 March 2013

Dear Alistair,

The Pensions Regulator's Consultation Document 'Regulating work-based defined contribution pension schemes'

I am pleased to respond to the above consultation on behalf of the FRC. The FRC considers that the consultation document with its three annexes enhance the debate on the regulation of defined contribution (DC) pension schemes and is timely as the DC market is in a period of significant change with the introduction of automatic enrolment.

The FRC is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. Our remit includes corporate governance, notably the UK Stewardship Code (the Code) and setting technical actuarial standards including AS TM1, which details the methods and assumptions to be used when producing SMPIs for members of DC schemes.

We have not addressed the questions posed in the consultation but have commented on specific maters in the documents that relate to our remit. Our detailed comments relating to the Stewardship Code and AS TM1 are set out in the appendix to this letter. In summary, these are:

On the Code of Practice:

- We would like to see a greater recognition of the importance of the stewardship role undertaken by Trustees (e.g. in paragraphs 100 and 119);
- We question whether the phrase "socially responsible investment" is appropriate in the context of paragraph 133 or whether "social, environmental or governance factors" might be more widely understood;
- We welcome the recommendation that trustees put in place robust conflicts of interest processes.

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On the Regulatory approach

- We welcome the recommendation that master trusts obtain independent assurance;
- We recommend that consideration be given to the monitoring of compliance with AS TM1.

On the Regulatory Guidance:

- We suggest that consideration be given to the communication to members of the risks and uncertainties around their pension.

The scope of the consultation is limited to the "proposed approach to regulating occupational DC trust-based pension schemes" but we are pleased that the Pensions Regulator and the Financial Services Authority are working closely to achieve consistent standards and levels of protection across the DC provision. We would like to see reference to, and suggested ways to address and mitigate, any "governance and regulatory gap" in the forthcoming analysis of work-based personal pensions due later this year.

Should you wish us to expand on any aspect of this response, please do not hesitate to contact me.

Yours sincerely

M McLaren

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Appendix

Issues relating to the Stewardship Code

The Code aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders. It is designed to improve investment decision-making and assist pension schemes and other owners in protecting the interests of their beneficiaries. The Code is directed in the first instance to institutional investors, namely asset owners and asset managers with equity holdings in UK listed companies. Given the demographics of the individuals participating in automatic enrolment, it is expected that these investors will choose to have a significant exposure to UK equities. Signatories to the Code include trustees and investment managers of both DB and DC Pension Schemes, including NEST.

We welcome the emphasis that the consultation document places on governance, especially within the six Principles described in the regulatory approach document. We note the list of considerations in the section "Setting an investment strategy" but would suggest this be extended to include recognition of the trustees' policy on stewardship. The National Association of Pension Funds (NAPF) has recently produced a Stewardship policy[1] which states that: "There are three simple actions which can be expected of pension funds as the owners and providers of capital:

(1) Include a section on 'stewardship' within the fund's Statement of Investment Principles;

(2) Include stewardship criteria in manager searches; and

(3) Incorporate monitoring of stewardship activities into manager reviews."

The current list includes the extent to which the trustees take account of social, environmental or ethical considerations when taking investment decisions and their policy regarding using the rights (including voting rights) attached to investments if the trustees have them, but these do not adequately cover the breadth of activities included within the Stewardship Code,[2] such as signatories' willingness to undertake collective engagement.

Including stewardship criteria in manager searches (as recommended by the NAPF in action 2 above) could also be added to the list of topics in Paragraph 100 of the Code of Practice. Several of the largest investment consultancies, including Mercer, Towers Watson and Aon

[1] http://www.napf.co.uk/PolicyandResearch/Policy_topics/~/media/Policy/Documents/0272_Stewardship_policy_NAPF_2012.ashx
[2] http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx

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Hewitt, are signatories to the Stewardship Code, and the capability exists in the market to advise trustees on how to include stewardship criteria in manager searches. Likewise, the NAPF's recommendation on incorporating the monitoring of stewardship activities into manager reviews (action 3) could also be added to the list of topics in Paragraph 119 of the Code of Practice.

One additional possibility to consider would be the introduction within Paragraph 100 of the Code of Practice of a recommendation that those who issue mandates to asset managers to manage the savings of others demonstrate that they have made a considered decision that takes account of the needs of their beneficiaries. The mandate would need to be clearly consistent with the time horizon of the beneficiaries, and the degree to which the manager was expected to act as an owner of the companies in which it held stakes on behalf of clients. It should further be expected of asset owners that they monitor expenditure on dealing commissions and can justify the expenditure in terms of value. A more considered approach to mandates should enable asset owners to require asset managers to deliver what they as customers actually want.

On a minor point of terminology, we would question whether "social, environmental or governance factors" may be a more generally understood phrase than "socially responsible investment issues" in the context of Paragraph 133 of the Code of Practice.

We welcome the recommendation that trustees put in place a robust conflicts of interest process, as this is an area we have previously highlighted as a priority in our 2012 monitoring report on the effectiveness of the Stewardship Code[3]. The disclosures made by a scheme's managers under Principle 2 of the Code[4] should be consulted as part of the overall review process.

Issues relating to AS TM1 and SMPIs

Our actuarial standard, AS TM1 sets out the methods and assumptions to be used to determine the projected pension shown on members' annual statutory money purchase illustration (SMPIs).

As you are aware, SMPIs are issued to a very large number of pension scheme members and contain information which might inform member decisions. We are concerned that compliance with AS TM1 should be adequately monitored. The FSA monitors compliance with its Conduct of Business Sourcebook (COBS) projection rules for certain products and in

[3] http://www.frc.org.uk/getattachment/47293b70-bd65-485c-bbcd-d9a63688b87d/Developments-in-Corporate-Governance-in-2012.aspx
[4] Principle 2 of the Stewardship Code states that "So as to protect and enhance the value that accrues to the ultimate beneficiary, institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed."

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principle SMPIs should also be monitored for compliance with its “clear, fair and not misleading” rules. We consider it desirable for some form of review of compliance with AS TM1 to be carried out for trust-based pension schemes not within the FSA’s remit. In developing its DC regulatory approach on enforcement, in particular in relation to monitoring (section 8.2); we would encourage the Pensions Regulator to consider how compliance with TM1 might be monitored for trust-based schemes.

We welcome the reference to a requirement of AS TM1 in paragraph 140 of the Regulatory Guidance. We would note that in the latest version of AS TM1 (version 3.0 which is effective from 6 April 2013), the requirement to use an accumulation rate appropriate to member’s investment strategy and market conditions has been supplemented by the requirement to disclose the rationale for their assumption to members, on request. In the same paragraph it is noted that consideration should be given to the provision of additional information to accompany the SMPI.

Our Supplementary Information document (not AS TM1 itself) gives examples of information, not required by legislation, which providers may wish to consider providing on their statements. We consider providing additional information on the risks and uncertainties associated with the projected pension on an SMPI may serve the aim, articulated in paragraph 123 of the Regulatory Guidance, of persuading members of the benefits of giving active attention to their pension pots. We also suggest that the Regulator covers the communication of risks in the Regulatory Guidance.

Issues relating to audit and assurance

It is helpful that the consultation sets the expectation that master trusts will obtain independent assurance that will provide an additional layer of rigour and enable schemes to demonstrate that they are credible and viable. The model that is proposed sets out high-level guidance. However, there are other models that could be explored and the FRC would be pleased to contribute to this discussion.

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