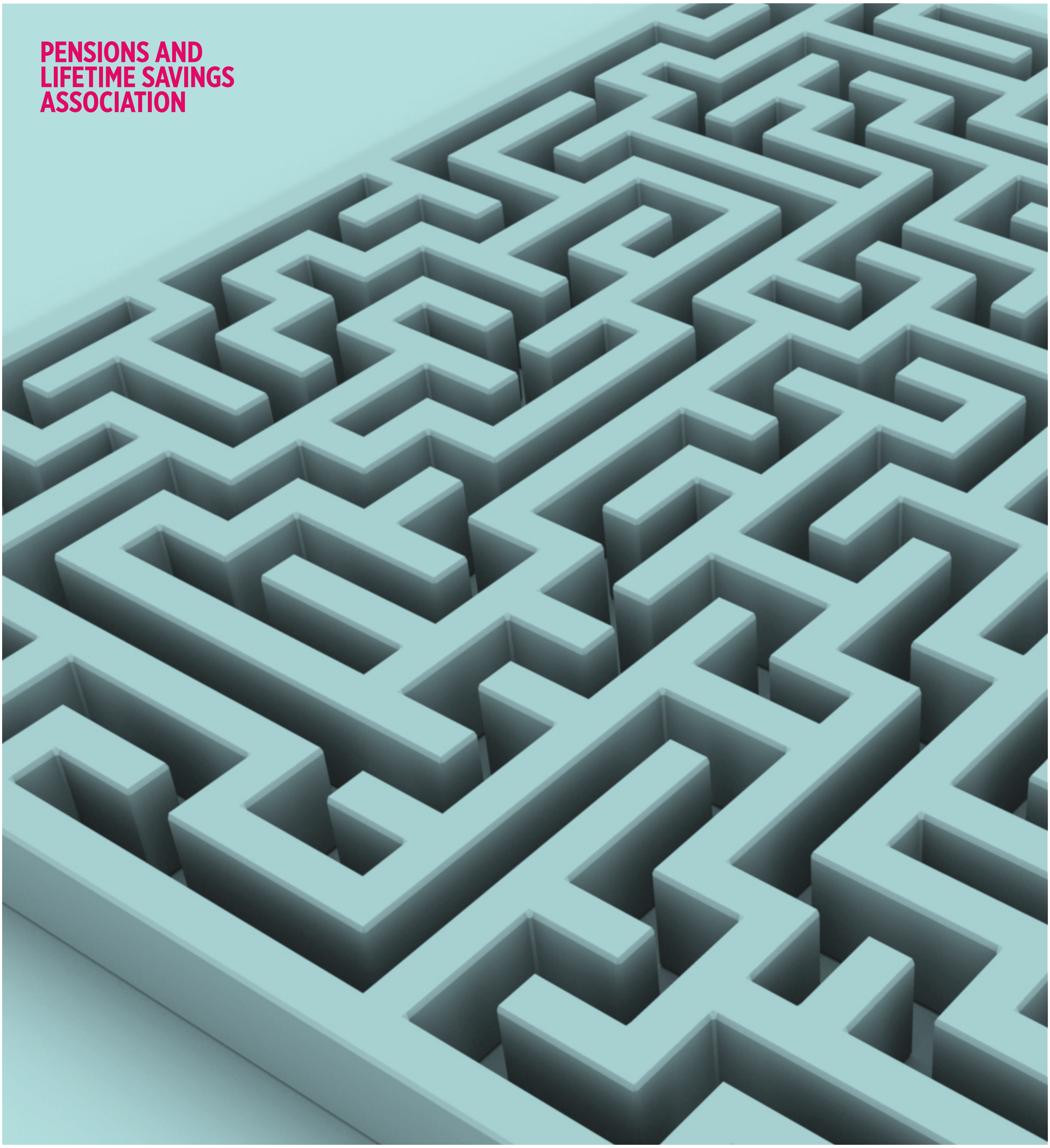
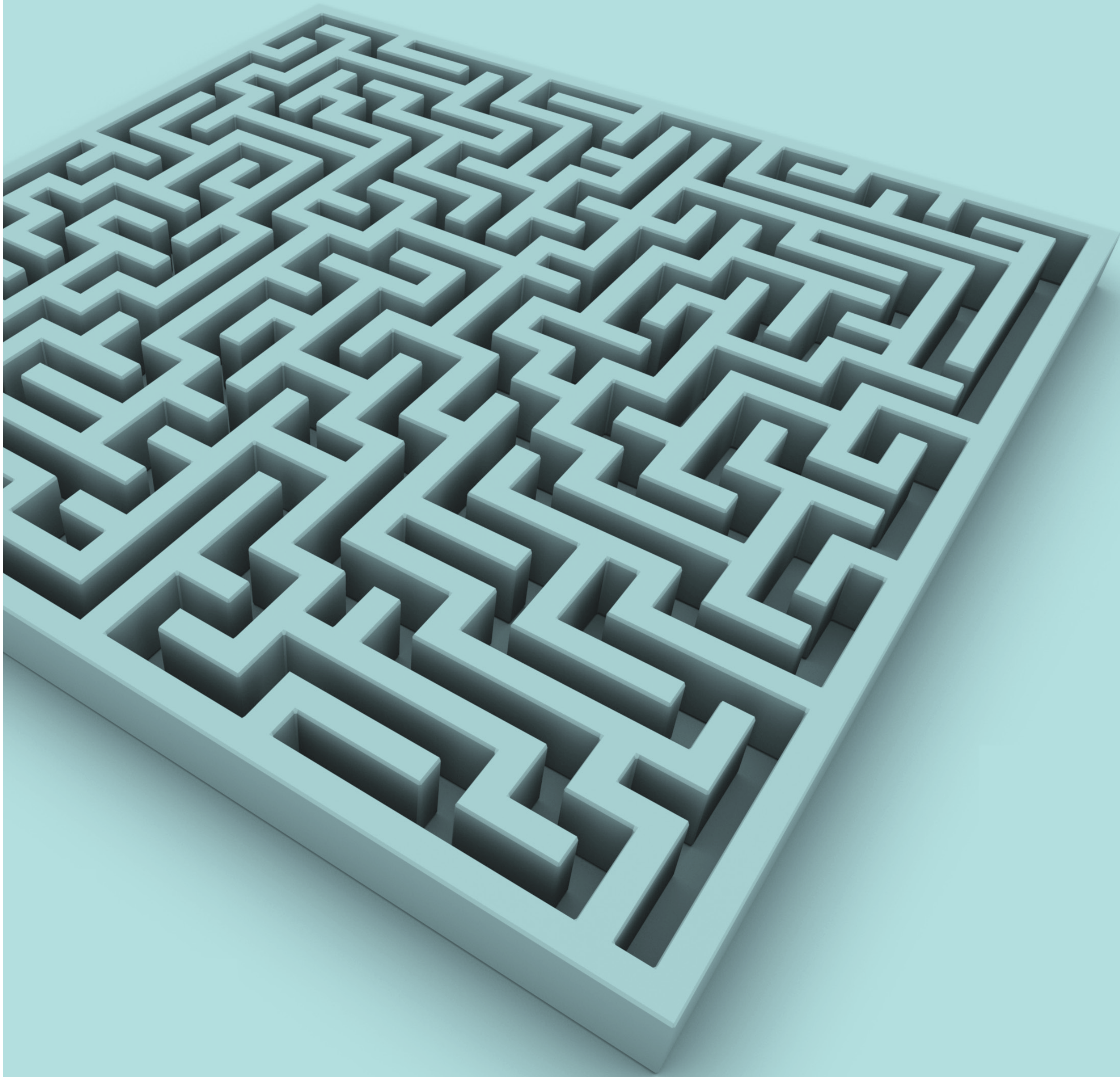
PENSIONS AND LIFETIME SAVINGS ASSOCIATION



GOOD GOVERNANCE – HOW TO GET THERE

A PLSA DISCUSSION PAPER

August 2017



WE NEED A BOLD SHIFT IN THE WAY WE REGULATE GOVERNANCE

FOREWORD

Through our roles at the PLSA and our day-to-day work, we are aware of many of the challenges that make great governance so vitally important in managing UK pension schemes.

The increasing individualisation of pension provision and the move from Defined Benefit (DB) to Defined Contribution (DC); the uncertain economic outlook; and the ongoing stream of new policies and regulations designed to safeguard member outcomes in this new world have combined to add further intricacies to the already demanding role of running a pension scheme.

In dealing with this complex subject matter, governance bodies have little margin for error. Poor decisions can have serious consequences for members. For UK defined benefit schemes, it can be shown that a significant proportion will not be able to pay all of the promised benefits to scheme members. The PLSA's DB Task Force found that there are 3 million people in the schemes categorised by The Pensions Regulator (TPR) as most at risk of being unable to fulfil their commitments to members.

When DC schemes fail to achieve good value for members because of poor investment returns, excessive costs and charges or poor administration performance as a result of poor governance, savers also suffer. Both of these scenarios lead to lower incomes and a lower quality of life in retirement than ought to have been the case.

It is, therefore, vital that governance bodies are properly equipped to fulfil their responsibilities. So we were pleased to be asked by the PLSA to form a working group for the development of this discussion paper, setting out ideas about how to raise and maintain standards of pension scheme governance.

As a group, we have focused in particular on the key 'inputs' to good governance – populating governance bodies with an appropriately qualified group of people, able to draw upon a diverse range of backgrounds and perspectives and the support of an appropriately resourced executive so that trustees are able to play the 'non-executive' role. To run pension schemes effectively we need expertise in technical areas such as financial, legal and actuarial matters, as well as more general skills such as commercial acumen and communication skills.

To achieve this, we need a bold but not implausible shift in the way we regulate governance, from process to people, achievable within the existing legislative framework and capable of bringing about a real and necessary improvement in standards. We look forward to seeing our ideas debated and welcome feedback from all stakeholders.

Lesley Williams
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EXECUTIVE SUMMARY

DEFINING GOVERNANCE

Governance is about the resources, structures and processes which support decision-making – for pension funds, this means having a skilled board or committee, with a good balance of knowledge and experience and the cognitive diversity which that brings, supported by a properly-resourced executive function. These are the key ‘inputs’ into scheme governance. The ‘outputs’ are the processes that governance bodies implement, determining the quality of management of the scheme and the outcomes experienced by scheme members.

The regulation of pension fund governance should focus on these inputs – if governance bodies are populated by the right people, situated within an appropriate and accountable structure, this maximises the likelihood of good decision-making, leading to good outcomes for scheme members.

CURRENT REGULATORY OVERSIGHT

Currently, however, the regulation of occupational pension schemes in the UK remains characterised by a strong focus on outputs rather than inputs, on process, rather than people. There is a wide range of different regulations setting out expectations of boards and committees, largely concerned with dictating specific procedures that schemes must follow rather than ensuring that appropriately qualified individuals are appointed to governance bodies and empowering them to act in the way most suitable to the circumstances of their particular scheme.

The existing approach is illustrated by the 22 pieces of regulatory guidance; 14 codes of practice; and 7 pieces of code-related guidelines currently hosted in TPR's online library.[1] It is confusing for scheme governance bodies and can lead to mis-direction of energies towards compliance with procedural requirements and away from the important strategic decisions shaping the long-term success of their scheme.

This approach has been unsuccessful – and while welcome steps have been taken towards clearer, simpler governance guidelines, further progress is needed. Scheme governance standards remain highly varied. Only half of schemes surveyed by TPR say all their trustees meet the standards set out in the Trustee Knowledge and Understanding (TKU) Code of Practice.[2] 24 per cent say they never disagree with external advisors and 58 per cent say they 'rarely' do so, hinting at a lack of capacity to challenge expensive advice.[3] Research on quality features of DC schemes indicates that only 22 per cent of small DC schemes have an investment strategy that is 'suitable to the needs of their membership' (the figure rises to a still-concerning 46 per cent and 72 per cent for medium-size and large schemes respectively).[4]

LESSONS FROM CORPORATE GOVERNANCE

These varied standards contrast with those achieved by the principles-based, input-focused approach to governance in the corporate sector. The Corporate Governance Code for listed companies sets out expectations in relation to five key themes of leadership, effectiveness, executive remuneration, accountability and shareholder relations, with considerable emphasis on board appointments and the balance of skills, diversity and independence of the directors. Similarly, the Financial Conduct Authority's (FCA) 'fit and proper' benchmark focuses on the honesty; competence and capability; and financial soundness of the individuals appointed to key roles in the financial services sector.

Corporate Governance in the UK is well-regarded internationally and the high profile scandals that pre-dated the Corporate Governance Code have become much less common. We believe that pension funds could similarly gain from a move in regulatory focus towards governance inputs.

A BETTER APPROACH TO PENSION FUND GOVERNANCE

In order to improve pension fund governance **a rebalancing of TPR's regulatory priorities is necessary, putting greater focus on scrutiny of board appointments and effectiveness.** This is in contrast to the current approach of concentrating regulatory resources on attempts to manage each individual process that the governance bodies undertake.

TPR should ensure that boards and committees collectively possess appropriate expertise across the relevant technical areas as well as a functional working dynamic based on a diverse range of backgrounds and perspectives, and an appropriate balance of softer skills, then concentrate on making sure these standards are met and maintained.

To operate effectively and efficiently, governance bodies also require executive support. Schemes should therefore seek to implement a **governance structure involving a board or committee carrying out strategic oversight and an executive body responsible for day-to-day running of the scheme,** based on the corporate model of a board and an executive committee. The focus on inputs that we envisage for the regulator should include assessment of whether governance bodies have access to adequate executive support. In practice, for many smaller pension funds, resourcing an executive may necessitate **consolidation into or with larger entities.**

Taken together, we believe that these reforms will deliver the highest possible standards of governance, giving the best possible chance of good outcomes for scheme members.

1 Details taken from TPR, Online '*Documents Library*', as of July 2017
2 TPR, *Trustee Landscape Quantitative Research: A report on the trustee landscape research*, 2015 (Figure 3.8.7)
3 Ibid (Table D5)
4 TPR, *Defined Contribution (DC) Quality Features Quantitative Research A data report on the 2015 DC Quality Features research* (Table 2.7.3)

INTRODUCTION

Governance is a critical factor in determining a pension fund's success. This paper sets out our view on what constitutes good governance and how to achieve it.

UK pension funds are responsible for over £2 trillion worth of assets under management.[5] Their investment and administration practices affect millions of people's financial security and aspirations in later life.

5 Willis Towers Watson, *Global Pensions Asset Study*, 2016

The importance of governance has been brought into sharp focus recently by developments affecting the UK pensions sector such as:

- the funding challenges facing Defined Benefit (DB) schemes;
- the large number of workers introduced to pension savings through auto-enrolment;
- the growing government, regulatory and public interest in the efficiency and wider socio-economic value of investment industry processes;
- the increasing individualisation of pension provision and the transfer of risk from employers to individuals.

The skills, experience, resources and functionality of scheme governance bodies will be key to the effectiveness of UK pension provision in the face of these changes.

While pension funds' influence over the volatility of the wider economy or the fortunes of their sponsoring employer is limited, they can ensure that the management and oversight of every aspect of their operation is robust. Thus, governance is the most important factor within the control of a scheme that shapes outcomes for scheme members..

Research indicates that governance of pension funds is highly varied. The standards underpinning it also lack the focus and prominence of other sectors, most obviously corporate governance and the corporate governance code.

It is not surprising therefore that pension fund governance has become a key concern for policymakers and regulators. In 2015, the Financial Conduct Authority (FCA) introduced new rules for Independence Governance Committees for workplace personal pension schemes, and The Pensions Regulator (TPR) is looking in detail at governance of trust-based schemes as part of their 21st century trusteeship programme. As of 2013, TPR is also responsible for the governance of public service pension schemes. Concerns over the quality of governance lie behind the Financial Conduct Authority (FCA)'s recommendation of pooling of pension fund assets, while the Pension Schemes Act 2017 seeks to transform the quality of master trust governance.[6]

The PLSA welcomes this interest in such a vital topic. This discussion paper puts forward our views on how to improve governance across the sector. We hope the paper represents a useful and challenging contribution to a broad and vigorous debate about how pension fund governance can ensure the best possible outcomes for members.

THE PLSA WELCOMES THIS INTEREST IN SUCH A VITAL TOPIC

6 Financial Conduct Authority, *Final report of the Asset Management Market Study*, 2017

SECTION 1: GOOD GOVERNANCE

For Pension funds, good governance requires oversight by capable boards or committees who are subject to robust accountability structures. This leads to better decision-making and improves the chance of achieving good outcomes for members. The key 'inputs' to good governance are the collective skills and experience of the individuals that comprise scheme governance bodies and the structures in which they are situated. These inputs should be the focus of regulatory attention.

DEFINING GOVERNANCE

Governance is about the resources, structures and processes that support decision-making.[7] Good governance leads to better decisions and, in the specific context of pension schemes, can enable:

- a long-term investment strategy which maximises return within an appropriate risk budget;
- a positive member experience – including clear communication with beneficiaries, prompt and helpful responses to enquiries and the efficient operation of payment systems - leading to heightened member engagement with their pension and, where applicable, an increased understanding of their saving and decumulation options;
- full compliance with all legal and regulatory requirements and a reduced need for regulatory intervention;
- good value on scheme costs (administrative and investment costs and costs of external services);
- effective risk management, minimising the risks to members, sponsors and other stakeholders.

Research supports the intuitive argument that good governance has a substantial effect on pension fund investment performance. Keith Ambachtsheer, of the Rotman International Centre for Pension Management, has estimated that schemes with robust governance structures outperform their peers by between 1 and 2 per cent a year.[8]

When Gordon Clark and Roger Urwin of Oxford University and Willis Towers Watson sought to identify a selection of pension funds with the characteristics that they associated with good governance, they found that:

"While performance was not our principal selection criteria, almost all of our best-practice funds have a performance margin of 2 per cent per annum or more over their benchmarks"[9]

Further studies looking at economies of scale in pension funds have also concluded that the reason larger schemes tend to achieve better returns stems in part from the fact that they are usually better governed, as noted by the interim report of the PLSA's DB Task Force:

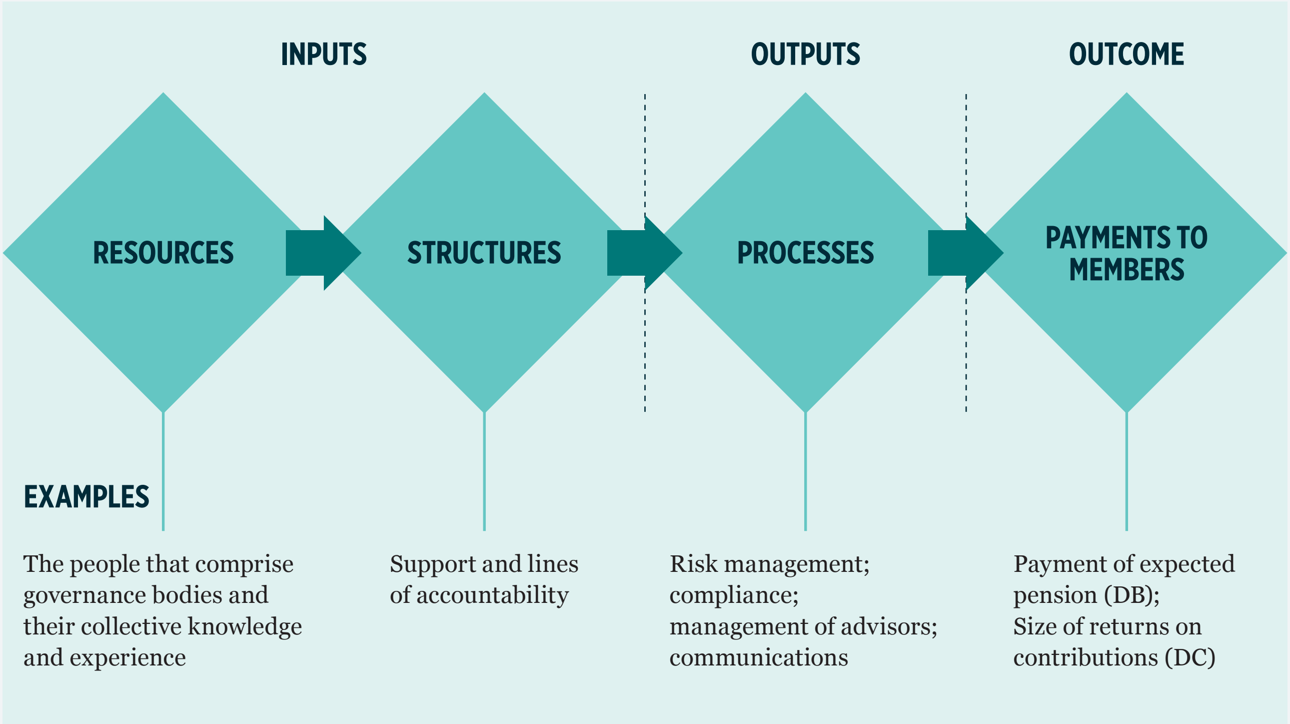
"Bikker and De Dreu; the Ontario Government's Report of the Expert Commission on Pensions; and Dyck and Pomorski all assert that weaker bargaining power is one of the main reasons smaller schemes fail to achieve the same value as larger counterparts. They emphasise a lack of expertise, resource and access to certain asset classes, all of which would have an impact on scheme bargaining power"[10]

7 Gordon Clark and Roger Urwin of Oxford University and Willis Towers Watson describe good investment governance as 'the capacity of a pension fund to create value derived from the resources, structures and processes employed in the fund's investment arrangements' in Gordon Clark and Roger Urwin, *Investment Governance: an overview of an underestimated subject* – extracts from the Clark and Urwin research papers, Towers Watson, 2010
8 Keith Ambachtsheer, *Pension Revolution: A Solution to the Pensions Crisis*, p. 130, 2007
9 Gordon Clark and Roger Urwin, *Best-practice pension fund governance in Journal of Asset Management*, Vol 9 issue 1 p2-21, 2008
10 PLSA, *DB Task Force: Interim Report*, 2016

CHARACTERISTICS OF GOOD GOVERNANCE

As Figure 1 illustrates, the resources, structures and processes that constitute scheme governance are interlinked.

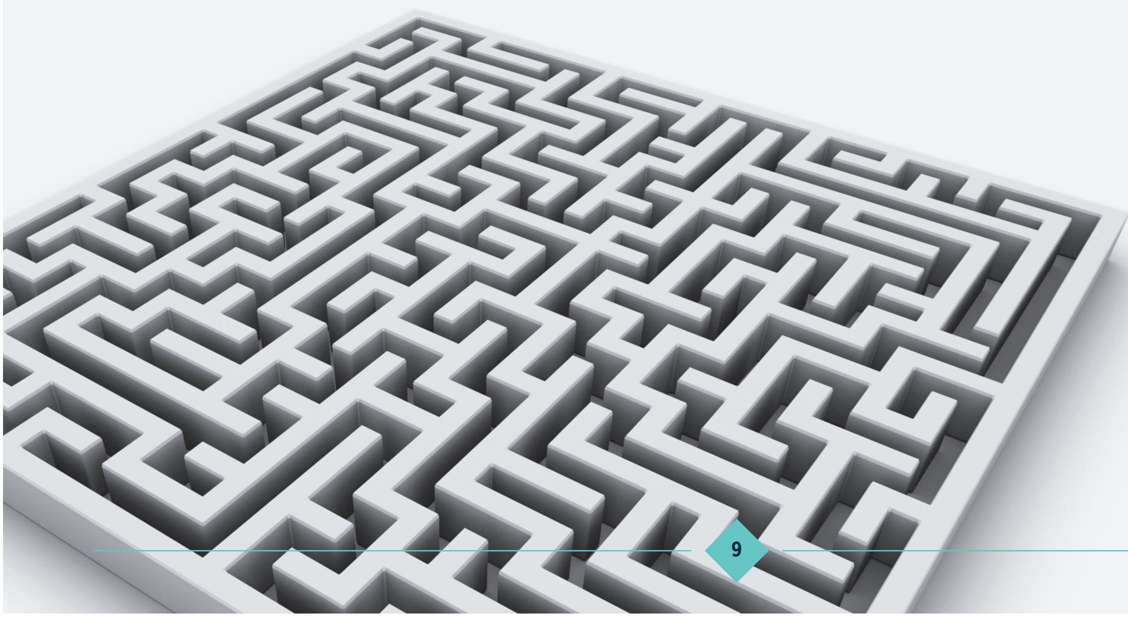
Figure 1: Factors affecting governance quality



This suggests that the resources and structures of governance bodies are the key inputs which determine governance quality. Skilled trustee boards, with a rounded set of collective knowledge and experience and the cognitive diversity that this brings, supported by a properly-resourced executive function, are the foundation of good governance.

Processes are the scheme's 'output' – the actions they undertake, which in turn lead to the 'outcomes' they achieve. Outputs and outcomes should be monitored and reported on, but are largely determined by the quality of the inputs.

We would argue there is a clear case for focussing regulation on inputs rather than outputs, on people rather than processes. The regulation of occupational pension schemes in the UK, however, remains characterised by a strong focus on outputs.



SECTION 2: TWO APPROACHES TO GOVERNANCE

There are currently a wide range of different regulations setting out expectations of pension fund boards and committees. These tend to focus on process rather than on ensuring that governance bodies are appropriately skilled. Research suggests that governance quality remains highly varied. This contrasts with the inputs-focused approach to corporate governance regulation, which has helped to raise standards.

PENSION SCHEME GOVERNANCE

TPR's approach to regulating pension scheme governance is characteristic of the challenge of regulating a fragmented sector. Governance standards vary widely across the thousands of pension schemes, regulation seeks to fill the gap by prescribing in minute detail what governing bodies should be doing.

TPR's online document library currently hosts 22 pieces of regulatory guidance; 14 codes of practice; and 7 pieces of code-related guidelines.

Table 1: TPR's regulations, codes and guidance[11]

REGULATORY GUIDANCE		CODES OF PRACTICE		CORE-RELATED GUIDANCE
Abandonment of DB pension schemes	Mortality assumptions	Reporting breaches of the law	Dispute resolution – reasonable periods	A guide for trustees of DC Occupational Pension Schemes
Assessing and monitoring the employer covenant	Multi-employer schemes and employer departures	Notifiable events	Circumstances in relation to the material detriment test	A guide to managers of personal pension schemes
Asset-backed contributions	Record-keeping	Funding defined benefits	Governance and administration of occupational trust-based schemes providing money purchase benefits	Complying with the duty to report breaches of the law
Clearance	Relations with advisers	Early leavers	Governance and administration of public service pensions schemes	The notifiable events framework
Conflicts of interest	Scheme funding and clearance case studies	Reporting late payment of contributions to occupational pension schemes		Member-nominated trustees and member nominated directors
Corporate transactions	Scheme funding FAQs	Reporting late payment of contributions to personal pension schemes		Internal controls
Cross-border schemes	Transfer values	Trustee knowledge and understanding		Material detriment test
DB to DC transfer conversions	Trustee guidance	MNT/MND putting arrangements in place		
Incentive exercises	Trustee knowledge and understanding	Internal controls		
Integrated risk management	Winding up	Modification of subsisting rights		
Lump-sum death benefits				

11 Details taken from TPR, Online '*Documents Library*', as of July 2017

Not all of these documents are applicable to every UK pension fund. Some relate to particular types of schemes (for example, DB or DC), while others are only relevant in certain circumstances (for example, when a sponsoring employer is taken over, or a scheme is wound up). Even so, this is a confusingly large number of guidelines for governance bodies to adhere to, and there is a risk that so many codes and regulations may dilute the message of the most important ones or be ignored altogether.

Regulators and policymakers have taken a number of steps in recent years to simplify and improve governance, with different approaches applied to different types of pension fund. For example:

- **The DC Code and the Public Sector Codes** for trust-based occupational DC schemes and public sector schemes set out requirements for appointments to scheme governance bodies in their opening sections, before outlining expectations of the skills and competences of those appointed. They then go on to make more extensive requirements in terms of mandatory procedures and the timeframes in which they should be undertaken. Many of the codes' provisions are legal requirements, so it is useful for these to be collated in a single document;
- **Master Trusts and private sector multi-employer DB schemes** are governed by a new authorisation and supervision regime outlined in the 2017 Pension Schemes Act. The regime stipulates that schemes will have to meet new standards in terms of 'fitness and propriety of key staff', as well as financial sustainability of the scheme; financial sustainability of the scheme funder; systems and processes that allow the scheme to run effectively; and an adequate continuity strategy. The Act also sets out requirements on trustees on how to act in the event of wind up or closure.

These are welcome developments with the potential to raise governance standards. However, outside the master trust sector, they still leave the regulation of pension scheme governance focussed on outputs. The evidence on current standards of governance suggests a new approach is overdue.

EXISTING GOVERNANCE STANDARDS

TPR's 'Trustee Landscape Research' identifies major variations in the capabilities of current scheme trustees.

For example:

- Only half of surveyed schemes with non-professional trustees felt that all their trustees had a level of understanding that met the standards set out in the TKU, indicating that significant numbers of trustees have fundamental gaps in their understanding of their role;[12]
- A large minority (24 per cent) said they 'never' disagreed with external advisors and a further 58 per cent said they rarely do so, suggesting many schemes lack the expertise to understand and critique the advice they receive;[13]
- Only 66 per cent of schemes said they possessed a professional qualification for finance or investment, while the figure was just 25 per cent for law and 27 per cent for pensions. Not every trustee needs a professional qualification, and qualifications are not guarantees of capable administration. However, they do provide some indication of knowledge of the subject matter, giving confidence to scheme stakeholders. These are low numbers for such complex topics;[14]
- Separate research on diversity suggests that pension funds record on diversity is poor. Just 28 per cent of trustees responding to a PLSA survey said their board was diverse in terms of ethnicity while only 49 per cent thought it was diverse in terms of gender. The PLSA's annual survey has previously found that around 83 per cent of scheme trustees are male.[15]

12 TPR, *Trustee Landscape Quantitative Research: A report on the trustee landscape research*, 2015 (Figure 3.8.7)
13 Ibid (Table D5)
14 Ibid (Figure 3.3.2)
15 PLSA, *PLSA Annual Survey*, 2017

These variations in trustee capabilities (ie resources, or inputs) are reflected in differences in the quality of scheme management. Two-thirds of small DC schemes and over one quarter of medium DC schemes, for example, do not meet any of the governance standards monitored by TPR in tracking use of the DC Code.[16] In particular:

- only 22% of small DC schemes and 58% of medium DC schemes have used member research or analysis to inform development of their default investment strategy;[17]
- Only 16 per cent of small schemes have administration systems that are able to cope with their current scale, underpinned by adequate business and disaster recovery arrangements. This also applies to 41 per cent of medium-sized schemes, 49 per cent of large schemes and a healthier 95 per cent of Master Trusts;[18]
- The FCA's Asset Management Market Study highlights a 'long tail of smaller institutional investors, typically pension funds, who find it harder to negotiate with asset managers.'[19] The study suggests that these schemes are failing to achieve value from the substantial costs they are charged by their asset managers;
- The PLSA annual survey found a significant variation in DB schemes' advisor costs, noting that the total cost per member of advisory services at surveyed schemes was over 70 per cent higher at the 75th per centile of respondents than at the 25th.[20] This may in part relate to different priorities resulting in different advisory needs, but could also result from differing capacities to control costs.

Therefore, there is a strong case for saying that the broad approach to governance of all types of scheme requires reform. Too many scheme governance bodies lack key capabilities, and too many are characterised by poor administration. This contrasts with other industries, where different approaches to governance have achieved better outcomes.

THE COMPARISON WITH CORPORATE GOVERNANCE

The rules-based approach to pension fund regulation differs from regulatory approaches to governance applied in other sectors.

The UK's 'Corporate Governance Code' is the most prominent iteration of good governance principles in this country. At 32 pages in length, the code is a concise document when compared with the various governance regulations affecting pension funds, applying to all companies with a premium listing of equity shares in the UK on a 'comply or explain' basis.

The Code sets out expectations of company boards in respect of five different criteria: leadership; effectiveness; executive remuneration; accountability; and relations with shareholders. While it does mandate particular processes, the principles-based, 'comply or explain' approach of the Code enables flexibility, with a focus on communicating outcomes in relation to the five criteria.

The Code's emphasis on the people appointed to listed company boards and the accountability structures to which they are subject is also significant. For example, there are requirements for boards to maintain an appropriate 'balance of skills, experience, independence and knowledge of the company' and to be 'collectively responsible for the long-term success of the company', as well as more specific provisions on the appointment and induction of board members.

Similarly, directors and employees working on internal controls or regulatory compliance issues (termed controlled functions) at firms regulated by the FCA are subject to a 'fit and proper' benchmark.

As with the Corporate Governance Code, the benchmark takes a principles-based approach focused on the key themes of:

- Honesty (including openness with self-disclosures, integrity and reputation);
- Competence and capability;
- Financial soundness.

Again, the regime focuses on ensuring the right inputs - the character, experience and judgement of the individuals – rather than attempting to dictate all the decisions and processes that these individuals might implement.

The FCA approves all 'fit and proper' persons, but regulated firms are also expected to ensure that appointments to controlled functions comply with these standards on an ongoing basis.

16 TPR, *Defined contribution trust-based pension schemes research A summary report on the 2016 research survey* (Figure 3.2.2.1) The research defines small schemes as having 12-99 members and medium-size as having 100-999 members
17 Ibid (Table 3.2.9.1)
18 TPR, *Defined Contribution (DC) Quality Features Quantitative Research A data report on the 2015 DC Quality Features research* (Table 2.7.3)
19 Financial Conduct Authority, *Asset Management Market Study: Final Report*, 2017
20 PLSA, *DB Task Force: Interim report*

CONTRASTING APPROACHES, CONTRASTING OUTCOMES

The Corporate Governance Code and the Fit and Proper benchmark are more reflective of the focus on inputs that we argue is currently lacking in pensions, despite welcome steps in this direction through the Pension Schemes Act and the DC and public sector codes.

While they are not the only regulations governing listed companies and the financial services sector, the Corporate Governance Code and the Fit and Proper regime do enjoy a higher level of prominence as guidance on appointments to key governance positions than any equivalent guidelines for pension funds. This is demonstrated by public and media interest in (and scrutiny of) breaches of the corporate governance code at large companies or appointments to leading positions in the financial services industry.

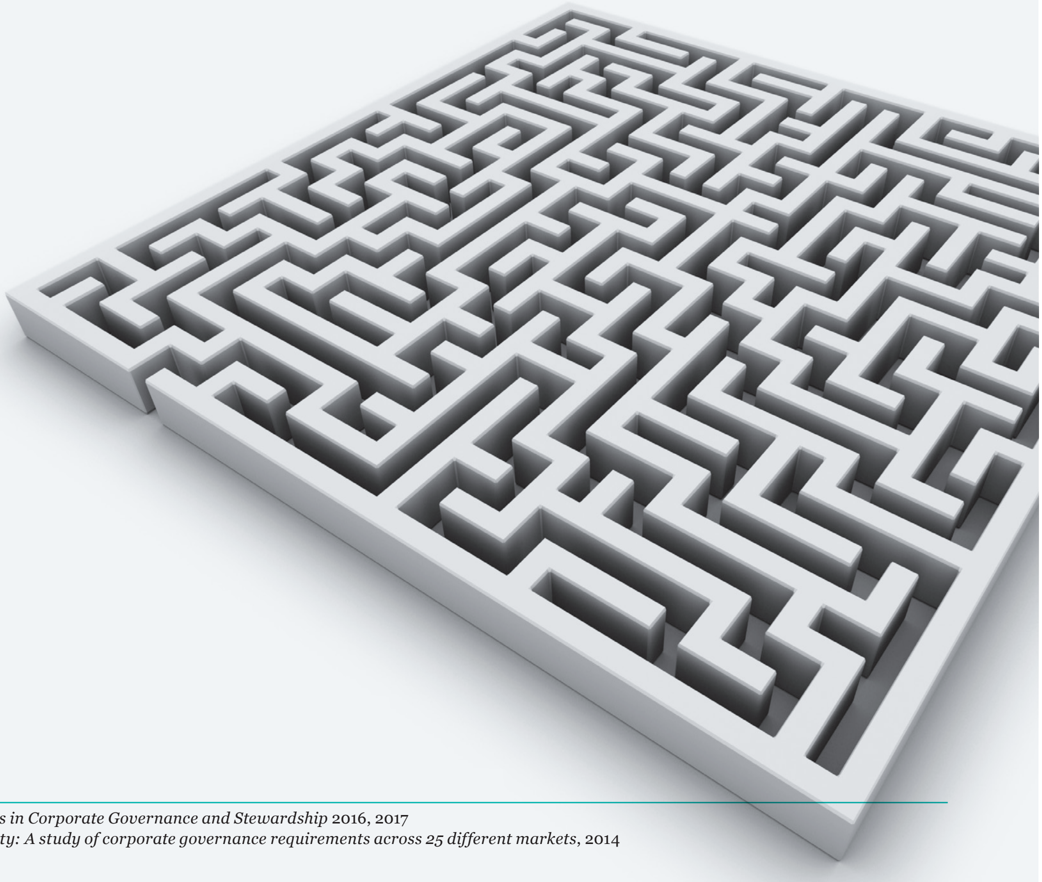
In the pensions fund sector, breaches of TPR's codes and guidance and appointments to governance positions attract little public attention (although the quality of governance personnel is debated retrospectively if a major failing occurs). Yet the assets under management of the largest pension funds and the number of people dependent on them are similar to major corporations and financial services firms.

This approach to governance does not guarantee successful outcomes for listed companies and the financial services sector but it does increase their likelihood and reduce that of major failure. It is unsurprising that corporate governance and the fitness and propriety of the individuals overseeing financial services firms have become much more prominent in public debate since the global financial crisis.

Since its introduction in the early 1990s, the Corporate Governance Code has also helped to reduce the likelihood of a corporate governance failure on the scale of the Maxwell, Polly Peck or BCCI scandals that predated it. The Financial Reporting Council (FRC) estimates that over 90 per cent of listed companies are compliant with all but one or two of the Code's provisions and it is also well-regarded internationally.[21] The Japanese corporate governance code, introduced in 2015, was heavily influenced by the UK template, while a survey for KPMG and ACCA ranked the UK top of 25 different markets for the clarity and completeness of its corporate governance regulations.[22]

Therefore, we believe there is much that pension fund members could gain from a move in regulatory focus towards governance inputs.

In the final section of this paper, we set out our ideas for governance reform, which take into account the successful innovations from other sectors.



21 Financial Reporting Council, *Developments in Corporate Governance and Stewardship* 2016, 2017
22 KPMG/ACCA, *Balancing rules and flexibility: A study of corporate governance requirements across 25 different markets*, 2014

SECTION 3: RE-THINKING GOVERNANCE

The quality of governance is determined by the people that provide it and the structures in which they are situated. Raising standards in this respect necessitates a regulatory body with a remit focused on scrutiny of board appointments and the resources available to scheme governance bodies, rather than attempts to manage each individual process that the governance bodies undertake.

Regulators should ensure that schemes possess appropriate collective expertise across the relevant technical areas as well as a functional working dynamic based on a diverse range of backgrounds and perspectives, and an appropriate balance of softer skills.

To operate effectively and efficiently, governance bodies also require executive support as part of a structure involving a board or committee carrying out strategic oversight and an executive responsible for day-to-day scheme management, based on the corporate model of a board and an executive. In practice, for many smaller pension funds, resourcing an executive may necessitate consolidation into fewer, larger entities.

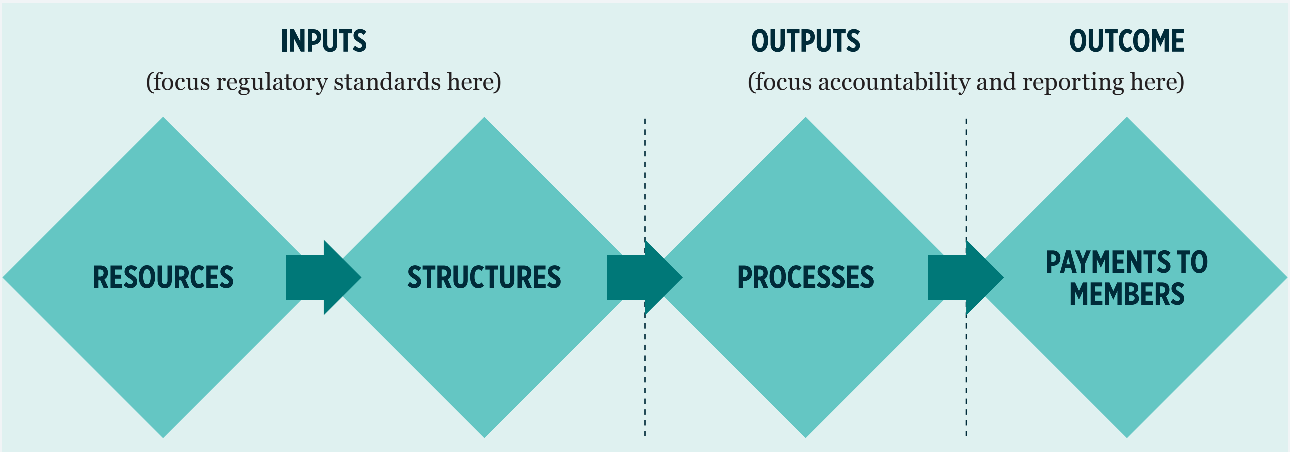
Governance standards must improve. In both DB and DC, too many scheme members are at risk of a sub-optimal outcomes and too many sponsoring employers are at risk of overpaying for the running of their schemes for substandard governance to be tolerable. The existing prescriptive, process-based approach to solving this problem is a well-intentioned response to the challenge of overseeing the UK's fragmented pensions sector. However, it does not appear to be raising the quality of either the outputs or the inputs which sit behind them to a sufficient extent.

It's time to think about a different approach to governance.

A SHIFT IN REGULATORY FOCUS

This paper sets out our argument that, without ensuring that the inputs into scheme governance are of sufficient quality, it is impossible to have confidence in that governance. The potentially-confusing array of existing regulations; the comparison with the regulatory approach to corporate governance; and the evidence of highly-varied standards of pension fund governance all suggest that current approaches to scheme governance are not working.

Figure 3: Governance oversight



A regulatory approach more focused on governance inputs – the individuals that comprise governance bodies and the structures in which they are situated – is needed. While the regulation of some schemes, Master Trusts in particular, is moving towards a greater emphasis on inputs, more focus is needed across the pensions sector.

A focus on inputs would involve the dedication of TPR's resources to oversight of appointments to boards and committees and the structure of governance bodies, and then making sure standards are met and maintained. This would represent a bold and significant shift in the regulator's focus, but at the same time, would not require a major programme of legislative reform (for which there is little appetite) as opposed to a managerial reconfiguration of TPR priorities. We believe that such a change would make a positive difference to the fundamental ingredient of good governance – the people charged with delivering it.

BOARD/COMMITTEE CHARACTERISTICS

Regulating in this way would start with oversight of the appointments to governance bodies. Collectively, boards and committees should possess an adequate understanding of the technical issues relevant to a pension fund's work such as investment affairs, the legal regime and actuarial matters.

More qualitative characteristics, such as the interpersonal skills necessary for working with fellow board members; a hunger to learn; probity; commercial acumen in negotiating with external parties; or the communication skills needed to engage with members and sponsors are also vital. While these capabilities are harder to measure, they are as important as more formal qualifications and experience, and should be treated as seriously by regulators.

Key characteristics that we believe ought to be mandatory for every board, and overseen and enforced by regulation are detailed in Figure 4.

Figure 4: Key characteristics of good governance

The role of scheme Chair is particularly important in creating an effective working dynamic, in terms of setting the scheme's strategic direction, ensuring appropriate prioritisation and encouraging frank but open and constructive discussion at meetings. A reflective and challenging culture is critical to board effectiveness and a diverse board, able to draw upon a range of different backgrounds and perspectives, is likely to have a more challenging culture, ultimately leading to better decisions.[23] Therefore, the authority of the Chair and the diversity of the wider governance body should be a consideration as part of the appointments process and a priority for regulatory monitoring.

STRUCTURES

Regulation should also seek to drive improvements in the structures that support the effective application of the board's knowledge and experience. Key characteristics include:

- **Accountability to members**, through a named Chair and clear, concise and timely reporting on scheme developments;
- **Clear objectives**, enabling a tangible basis for assessing scheme performance. Trustees should have a clearly-expressed strategic objective, backed by a plan to achieve that objective and a process for reviewing it at appropriate intervals;
- **Executive support** – full-time support staff, able to advise and execute the decisions of the governance body, are essential. An executive focused on day-to-day administration of the scheme enables the board or committee to fully concentrate on strategic decision-making.[24] The adequacy of executive support should therefore be as much of a consideration for TPR as the board or committee itself.

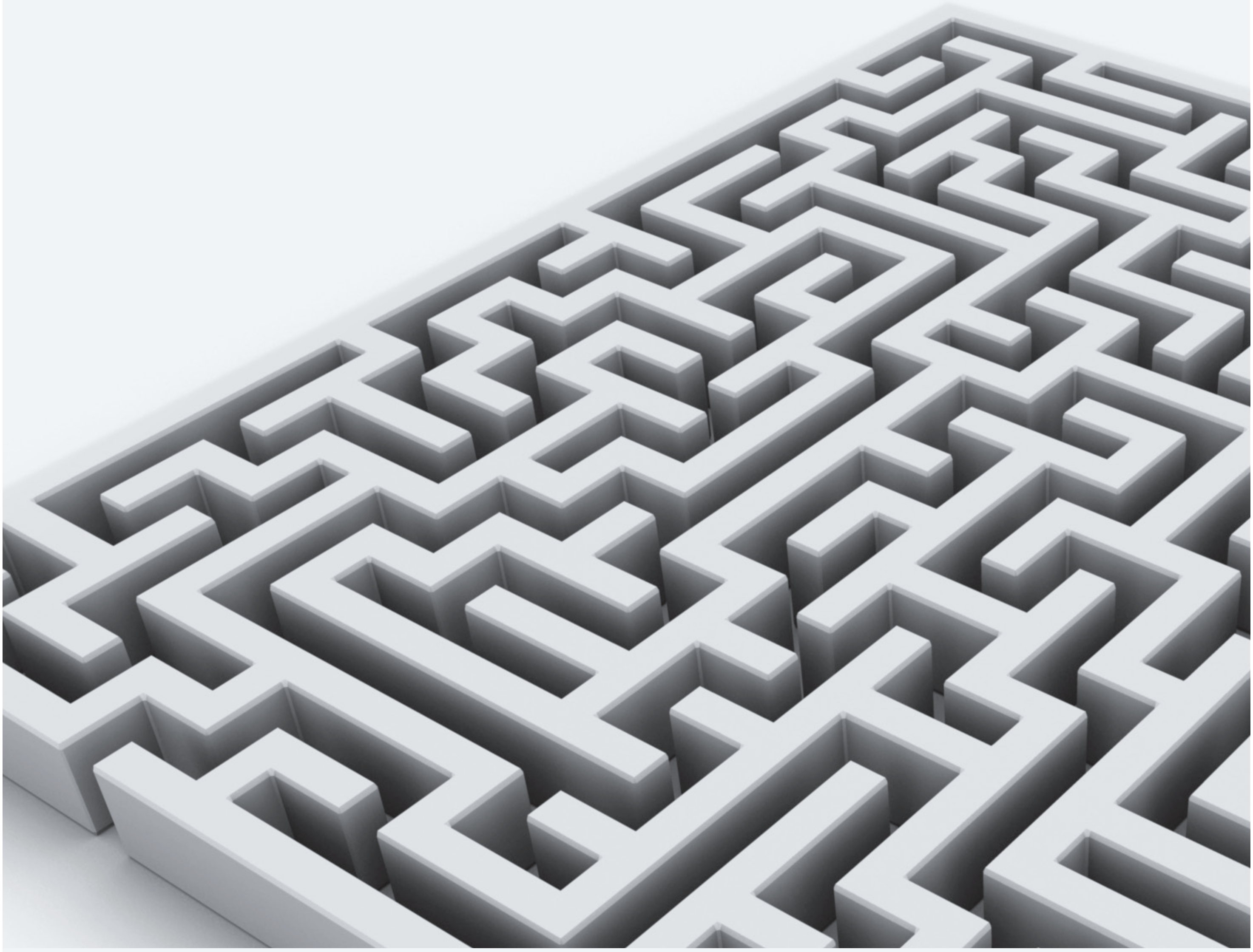
23 See McKinsey, *Why Diversity Matters*, 2015
24 PLSA, *DB Task Force: interim report*

ENCOURAGE CONSOLIDATION

A strong trustee board and a well-resourced executive may be beyond the means of smaller schemes – for many, consolidation with other pension funds into larger entities will be the best way of equipping such schemes with the appropriate governance capacity. From a regulatory point of view, oversight of fewer, larger schemes would also be more manageable and would facilitate greater scrutiny of appointments to governance bodies.[25]

The second report of the PLSA DB Task Force recommends that regulatory agencies develop 'nudges' that could encourage smaller schemes to assess and raise performance standards and consider consolidating. In Australia, the number of private sector DB schemes has been reduced to just 232 (compared with circa 6,000 in the UK), driven in part by a requirement for schemes to explain on an annual basis why their existing scale is appropriate.[26]

A similar explanation could be required within a 'statement of governance principles', to be published annually by scheme governance bodies. The DC Code already requires DC schemes to issue a 'Chair's Statement' detailing certain governance disclosures including how they meet the standards in the TKU. If this requirement were extended beyond the DC sector, together with an Australian-style requirement to explain the scheme's scale, this would renew the focus on the resources needed to deliver good governance and improve accountability. Schemes that are well-governed and operating successfully would be able to continue regardless of size.



25 TPR's submission to the Work and Pensions Select Committee makes the same point regarding the benefits of consolidation and the targeting of resources on a smaller number of schemes – see Work and Pension Select Committee, *Written Evidence: The Pensions Regulator*, 2016

26 PLSA, DB Task Force: interim report

SUMMARY AND NEXT STEPS

This paper identifies what we believe to be the key characteristics of effective governance bodies; the weaknesses of the existing regulatory regime; and measures that could enable improvements. However, we recognise that a number of stakeholder bodies are currently undertaking work on pension fund governance. Our proposals are intended to further these discussions, rather than be the definitive word on the subject of governance reform.

We would welcome views from all stakeholders on our suggestions, as well as other ideas on what constitutes good governance and how to achieve it. We believe that a robust and lively debate on this topic, characterised by bold thinking, can deliver better outcomes for scheme members.

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