

Financial Conduct Authority



Consultation Paper

CP14/16***

Proposed rules for independent governance committees

August 2014



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We are asking for comments on this Consultation Paper by 10 October 2014.

You can send them to us using the form on our website at:

www.fca.org.uk/your-fca/documents/consultation-papers/cp14-16-response-form

Or in writing to:

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Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

You can download this Consultation Paper from our website: www.fca.org.uk. Or contact our order line for paper copies: 0845 608 2372.

Abbreviations used in this paper

ABI	Association of British Insurers
AMD	active member discount
AUM	assets under management
CBA	cost benefit analysis
DWP	Department for Work and Pensions
FCA	Financial Conduct Authority
FSMA	Financial Services and Markets Act 2000
GAA	governance advisory arrangement
GPP	group personal pension
ICAEW	Institute of Chartered Accountants in England and Wales
IGC	independent governance committee
IMA	Investment Management Association
MiFID II	Markets in Financial Instruments Directive II
MIR	market investigation reference
NEST	National Employment Savings Trust
OFT	Office of Fair Trading
PRA	Prudential Regulation Authority
PRIIPs	Packaged Retail and Insurance-based Investment Products Directive
SIPP	self-invested personal pension scheme
TPR	the Pensions Regulator
WPC	with-profits committee

1. Overview

Introduction

- 1.1** The UK has an aging society with many people not saving enough for their retirement. Automatic enrolment of employees into workplace pension schemes began in July 2012, as part of the government's policy response to this challenge. By 2018, the time automatic enrolment applies to all companies, it is estimated that between eight and nine million people will be newly saving, or saving more, in a workplace pension scheme.¹ Many of these will be on low incomes and will not have made any active choice about how their pension savings are invested.
- 1.2** Automatic enrolment means that it is even more important to ensure that workplace pension schemes deliver the best possible value for money. However, the recent Office of Fair Trading (OFT) market study highlighted problems with the market, including a very weak buyer side and the potential for conflicts of interest.
- 1.3** The Financial Conduct Authority (FCA) has been working with the Department for Work and Pensions (DWP) and the Pensions Regulator (TPR) to design a package of reform measures that will help ensure that all workplace pension schemes are high quality and offer value for money. These measures include new governance standards, a proposed charge cap on default funds, the banning of certain charging practices, and measures to improve the disclosure of costs and charges.
- 1.4** This consultation paper sets out our proposed rules that will require the providers of workplace personal pension schemes to set up and maintain independent governance committees (IGCs). IGCs will have a duty to act in the interests of scheme members and will operate independently of the firm. They will assess and, where necessary, raise concerns about the value for money of workplace personal pension schemes.
- 1.5** We will consult later in the year on rules relating to a charge cap on default funds and on the banning of certain charging practices in workplace pension schemes. The FCA will be responsible for rules to implement these measures for the firms that we regulate. The DWP will be responsible for regulations on the trust side of the market.

Who does this consultation affect?

- 1.6** This consultation paper affects the providers of workplace personal pension schemes. Workplace personal pension schemes include personal pension schemes and stakeholder

¹ *Transparency data – DWP business plan transparency measures*, July 2014, DWP
<https://www.gov.uk/government/publications/dwp-business-plan-transparency-measures/dwp-business-plan-transparency-measures#rate-of-pensioner-poverty>

pension schemes which employers either use for automatic enrolment or otherwise make available to their employees.

- 1.7** In 2013, our data indicated that there were over 20 firms or groups that sold workplace personal pension schemes to employers in the UK. In addition, there are a number of other firms or groups which operate group pension schemes which are no longer being actively marketed to employers. Our proposed rules will affect these as well.
- 1.8** This consultation paper is likely to be of interest to employers and their advisers in relation to the selection and ongoing monitoring of workplace personal pension schemes. It is also likely to be of interest to fund managers and other third parties providing services to firms operating workplace personal pension schemes.

Is this of interest to consumers?

- 1.9** IGCs are proposed to act in the interests of relevant scheme members by challenging firms on the value for money of workplace personal pension schemes. Therefore, this consultation should be of interest to consumers who are scheme members of workplace personal pension schemes, both employees actively contributing to a pension and deferred members. It is also likely to be of interest to consumer groups seeking better protection for consumers with workplace personal pensions.

Context

- 1.10** In 2013, the OFT conducted a market study on defined contribution workplace pension schemes. The study covered both trust and contract based schemes, since employers can choose either type of scheme for their employees.
- 1.11** In its report², published in September 2013, the OFT found that the buyer side of the market was ‘one of the weakest that the OFT has analysed in recent years’. Employers make most of the key decisions but may lack the capability and/or the incentive to ensure that members of their schemes receive value for money in the long term. Many employees are not interested in their pension saving and, with the advent of automatic enrolment, may be enrolled into the default fund of their employer’s scheme without making any active choice. Neither employers nor employees can be expected at this time to drive effective competition between firms.
- 1.12** The weaknesses identified by the OFT may result in poor value for money workplace pensions, or result in them becoming poor value for money over time. Therefore, the effective governance of workplace pension schemes is particularly important to mitigate the risk of consumer detriment.
- 1.13** On the trust side of the market, which is regulated by TPR, the DWP intends to introduce regulations for minimum governance standards and to ensure the independence of trustee boards of mastertrusts.

² *Defined contribution workplace pension market study* – <http://webarchive.nationalarchives.gov.uk/20131101164215/http://www.of.gov.uk/OFTwork/markets-work/pensions/>

- 1.14** On the contract side of the market, which we regulate, scheme members lack any direct agent to represent their interests. On behalf of its members, the Association of British Insurers (ABI) agreed with the OFT that firms would establish and maintain IGCs to assess and raise concerns about the value for money of workplace personal pension schemes.
- 1.15** As the regulator of workplace personal pension schemes, the FCA has been working with the DWP to develop minimum standards, under which IGCs will provide governance oversight of the schemes operated by firms that the FCA regulates. The FCA's principles and rules already place a number of requirements on the conduct of firms, including a requirement to treat customers fairly and to manage conflicts of interest between the firm and its customers.
- 1.16** In this paper, we propose new FCA rules to require firms operating workplace personal pension schemes to establish and maintain IGCs. We consider that our proposals will advance the following statutory objectives of the FCA.
- **Securing an appropriate degree of protection for consumers:** IGCs will protect the interests of relevant policyholders by assessing the value for money of their schemes and raising concerns where necessary.
 - **Promoting effective competition in the interests of consumers:** IGCs will report on the value for money of their firm's schemes. This will increase the quality of information which employers and employees have access to and may improve competition between firms providing workplace personal pension schemes.
- 1.17** We have been working with the DWP and TPR on consistent minimum standards. Our proposed rules and the DWP's proposed regulations are aligned to ensure similar expectations for contract and trust based workplace pension schemes.

Summary of our proposals

- 1.18** Our proposed rules will require the creation of IGCs within firms and ensure that they act in the interests of scheme members to provide credible and effective challenge on the value for money of workplace personal pension schemes. We propose setting minimum requirements for the format and operation of IGCs, as well as their role within a firm's governance framework.
- 1.19** The key duties of the IGC would be as follows:
- to act in the interests of relevant policyholders
 - to assess the value for money of the firm's workplace personal pension schemes
 - where the IGC finds problems with value for money, to raise concerns (as it sees fit) with the firm's board
 - to escalate concerns to the FCA, alert relevant scheme members and employers, and make its concerns public, and
 - to produce an annual report of its findings.

- 1.20** We propose a “comply or explain” duty on firms, so that the firm must address the IGC’s concerns or explain to the IGC why it does not intend to do so. Our objective is for firms to take actions that will ensure the value for money of workplace personal pension schemes on an ongoing basis.
- 1.21** We propose allowing firms with smaller and less complex workplace personal pension schemes to establish a governance advisory arrangement (GAA), as an alternative to an IGC. A GAA would involve the firm appointing another independent firm (a third party) to take on their IGC responsibilities. The third party may provide GAAs to multiple firms, with the potential for economies of scale and lower costs per firm.

Equality and diversity considerations

- 1.22** We have assessed the likely equality and diversity impacts of the proposed rules and do not think they give rise to any concerns. We consider that the proposed rules for IGCs should ensure that the interests of potentially vulnerable members are represented and that concerns are raised on their behalf.

Q1: We would welcome views on the likely equality and diversity impacts of the proposed rules.

Next steps

- 1.23** Please send us any comments you have on the new rules by 10 October 2014.
- 1.24** Please use the online response form on our website or write to us at the address on page two of this paper.
- 1.25** We will consider your feedback as we finalise the new rules. We intend to publish the rules in a Policy Statement in January 2015.
- 1.26** Our proposed rules for IGCs, if made following consultation, will come into force in April 2015. Firms will be expected to comply from that date. Firms that already have IGCs in place will also need to ensure that they meet these rules from April 2015.

2. Requirement for an IGC

- 2.1** In this chapter, we set out the proposed scope of IGCs and which firms will be required to establish and maintain an IGC. We propose that all firms operating workplace personal pension schemes will be required to set up and maintain an IGC to act in the interests of both active and deferred members. Personal pensions set up on an individual basis, without employer involvement, would not be in the mandatory scope of IGCs, although firms may choose to include them.
- 2.2** In defining workplace personal pensions, we propose that our rules should apply to any firm operating a personal or stakeholder pension scheme with direct payment arrangements in place covering two or more employees of the same employer. For a group with a number of firms to which our rules would apply, we propose allowing a single IGC to operate at group level. Occupational workplace pension schemes are out of scope of our proposed rules and will be covered by separate regulations to be made by the DWP.

Workplace personal pensions

- 2.3** Workplace personal pensions are personal pension contracts between individual (including past) employees and the providers of personal pension schemes. When employees join a personal pension scheme through the workplace, a contractual agreement is established directly between the scheme provider and the employee. While the employer selects the pension provider and scheme, and possibly the default fund within the scheme, the employer is not party to this agreement. The agreements collectively within a workplace are commonly referred to as the employer's workplace personal pension scheme.
- 2.4** Many employers have offered access to personal pensions through the workplace for a number of years. Requirements on employers to automatically enrol employees into a workplace pension scheme are being introduced between 2012 and 2018, and employers may use personal pension schemes to comply with these requirements.
- 2.5** Employees will generally only receive employer contributions if they join and remain in their employer's workplace pension scheme. As such, employees typically have an incentive to join the scheme selected by their employer. The employer facilitates the employee's contributions through deductions from payroll. In addition, under automatic enrolment, employers are required to pay minimum contributions to the scheme. Even prior to automatic enrolment, it was usual for employers to pay employer contributions into personal pension schemes provided through the workplace.
- 2.6** Under automatic enrolment, eligible employees who do not express a choice are enrolled into the default option of their employer's workplace pension scheme. Employers therefore need to agree a default option with the pension scheme provider, taking into account the

likely characteristics and needs of their workforce. The large majority of employees will be automatically enrolled into the default option (typically a default fund) of their employer's workplace pension scheme.

Deferred members

- 2.7** Deferred members are scheme members who no longer contribute to their pension. In workplace personal pension schemes, individuals who are no longer employed by a particular employer are generally deferred members of the relevant pension scheme.
- 2.8** Analysis by the DWP suggests that the average person works for 11 employers during their career.³ Without further reform, the DWP estimates that by 2050 automatic enrolment will create up to 50 million dormant pots of pension assets. The government's "pot follows member" initiative is intended to address the problem of dormant pots across both occupational and workplace personal pension schemes.
- 2.9** While this may mitigate the problem, deferred members of workplace personal pension schemes are likely to continue to need protection. Individual deferred members may have built up substantial pension assets, which may continue to grow through investment returns. Despite this, deferred members are often disengaged and poorly informed, with less interest in their pension because they are no longer actively contributing.
- 2.10** Further, employers have less incentive to protect the interests of scheme members who have left their workforce, and some traditional charging practices in effect penalise deferred members. In particular, active member discounts (AMDs) in some schemes have resulted in active members being charged less than deferred members.
- 2.11** In consideration of the above, we believe that IGCs should act in the interests of deferred members of workplace personal pension schemes as well as active members. Therefore, we propose that deferred members be within the mandatory scope of IGCs.

Q2: Do you agree that deferred members of workplace personal pension schemes should be within the mandatory scope of IGCs?

Individual personal pensions⁴

- 2.12** Individuals may choose to invest in personal pension schemes as part of their financial planning. These individual customers generally receive advice and/or undertake research before selecting the pension provider and scheme that they want to join.
- 2.13** Such customers can be expected to take more active interest in their pension scheme, including post sale, and the value for money that it delivers. If not satisfied with the performance of the provider and/or scheme, they can transfer their savings, as with other forms of long-term saving product.

³ *Making automatic enrolment work* – Cm 7954 October 2010 – <https://www.gov.uk/government/publications/making-automatic-enrolment-work-a-review-for-the-department-for-work-and-pensions>

⁴ For the purposes of this paper, we refer to personal pensions accessible outside the workplace and without employer involvement in selecting the scheme as individual personal pensions.

- 2.14** We believe these individual customers are provided with sufficient protection under the current regulatory regime and, therefore, do not propose including individual personal pensions within the mandatory remit of IGCs. However, an IGC's terms of reference may be extended on a voluntary basis to include individual personal pensions, subject to the IGC being appropriately resourced and supported.
- 2.15** As proposed, firms operating schemes with a mix of workplace and individual personal pensions will be required to operate an IGC. While the IGC will act in the interests of workplace personal pension policyholders, individual personal pension policyholders may also benefit. We would not expect individual personal pension policyholders to be disadvantaged by actions taken by the firm in response to concerns raised by its IGC.
- 2.16** It is important to note that some firms may classify the policies of deferred members of workplace schemes as individual personal pension policies. These policies would be within the mandatory scope of IGCs.

Q3: Do you agree that individual personal pensions, other than those that originated as workplace personal pensions, should not be in the mandatory scope of IGCs?

Employer contributions to individual personal pensions

- 2.17** Some employers may contribute to personal pensions arranged on an individual basis, accessible outside the workplace and without employer involvement in the original selection of the scheme. This includes situations where employers facilitate the payment of member contributions through payroll to such pensions.
- 2.18** We do not intend for our new rules to apply to firms operating schemes into which employers pay contributions but where the individual has made the final decision over the selection of their pension provider and scheme. For example, our rules would not apply to an executive's self-invested personal pension scheme (SIPP) or other personal pension arrangement, even where an employer has agreed to make or facilitate contributions into this.
- 2.19** However, we do propose that our rules apply to providers of group SIPPs used in the workplace and set up by employers for their employees. In this situation, the employer has selected the arrangement and the employees are less likely to be engaged with the administration and investment of their pension savings.
- 2.20** In consideration of the above, we propose that firms will not be required to establish an IGC where they can clearly demonstrate that their schemes have been set up by individual members for their own benefit and where any employers contributing to the schemes were not involved in the selection of the scheme.

Q4: Do you agree that individual personal pensions should not be in the mandatory scope of IGCs, even where the employer contributes or facilitates payments?

Which firms will be required to establish an IGC

- 2.21** It is our intention that IGCs should represent the interests of active and deferred members of workplace personal pension schemes. As such, we propose that firms operating a personal pension scheme or stakeholder pension scheme for which there are, or have been, direct payment arrangements in place to cover two or more employees of the same employer, will be required to establish and maintain an IGC.
- 2.22** Direct payment arrangements are defined in the proposed rule as arrangements under which employers pay contributions directly to firms for the benefit of employees. This includes both employer and employee contributions.

Q5: Do you agree with our proposals for which firms will be required to establish and maintain an IGC?

IGCs established at a group level

- 2.23** We recognise that there may be more than one provider of workplace personal pension schemes within the same corporate group. In such situations, we do not consider it proportionate to require each provider to establish its own IGC. We see no reason why a group level IGC cannot act in the interests of all the scheme members of workplace personal pension schemes operated by providers within the group, if appropriately resourced and supported.
- 2.24** We propose that IGCs may be established at a group level for use by providers of workplace personal pensions under common ownership. We would expect the separate providers operating workplace personal pension schemes within the same corporate group each to ensure that all relevant scheme members have their interests represented by an IGC.

Q6: Do you agree that IGCs may be established at a group level?

Quality standards for occupational pension schemes

- 2.25** Occupational pension schemes are set up under trust, with trustees appointed to run the scheme. Trustees are required to operate schemes in accordance with the provisions contained within a scheme's trust deed and rules, and are also under a fiduciary duty to act in the best interests of members of the scheme. Trustees are responsible for appointing (in some cases) and holding to account (in all cases) those parties who are responsible for the day-to-day running of the scheme.
- 2.26** The FCA does not regulate occupational pension schemes. As such, our proposed rules in this consultation will not apply to occupational pension schemes.

- 2.27** In the DWP's Command Paper⁵, published in March 2014, the government outlined its intention to introduce new regulations later this year introducing minimum governance standards for occupational pension schemes. The trustees of occupational pension schemes will be required to ensure that the minimum standards are met. TPR will be responsible for regulatory oversight of trustees' compliance with these regulations.
- 2.28** We have been working closely with the DWP and TPR to ensure that our proposed requirements for workplace personal pension schemes are consistent, as far as possible, with the proposed minimum governance standards for occupational pension schemes and that they achieve the same outcome.

⁵ *Better workplace pensions: further measures for savers* – https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf

3. Establishing and maintaining an IGC

- 3.1** In this chapter we set out our proposed requirements on firms for establishing and maintaining an IGC, including the recruitment process for IGC members and the proposed duration of appointments.
- 3.2** We propose requiring firms to establish IGCs with sufficient expertise and experience to assess the value for money of workplace personal pension schemes. In addition, we propose that the IGC must have a majority of members independent of the firm, including an independent Chair. We consider that an IGC with too few members may not have the breadth of views to be effective. Therefore, we propose that an IGC must have a minimum of five members.
- 3.3** While firms may choose to indemnify IGC members, we do not believe it necessary to make this a requirement under our rules. Nor do we propose making any role on the IGC a controlled function at this time. We propose requiring an open and transparent appointment process for independent IGC members to help ensure their independence of the firm.

Our regulation of IGCs

- 3.4** Our proposed rules require firms to establish committees to provide independent oversight of the firm's workplace personal pension schemes. While established as a committee of the firm, the IGC will have a clear duty to act independently of the firm.
- 3.5** Since we are not able to regulate IGCs directly, we propose requiring firms to make contractual arrangements for IGCs, with mandatory content to be included in the IGC's terms of reference. This content would include minimum duties on the IGC, with a duty to act in the interests of relevant scheme members and a duty to assess the value for money of relevant schemes. The terms of reference for IGCs are covered in more detail in Chapter 4.
- 3.6** We believe that this approach, in conjunction with requirements on firms to support the effective operation of IGCs, will be sufficient to ensure that IGCs operate in line with our intentions.

Composition of an IGC

- 3.7** An effective IGC needs members with the understanding and knowledge of workplace personal pensions to be able to assess and make judgements on value for money. Schemes may be complex, with differing benefits and services, and a variety of charges and costs that are often opaque. The IGC also needs to be independent of the firm, so that it can act solely in the interests of members in raising concerns about value for money.

- 3.8** We propose requiring firms to establish IGCs with sufficient collective expertise and experience such that they are competent to make judgements on the value for money of potentially complex schemes. In addition, we propose that an IGC must have a majority of members independent of the firm.
- 3.9** A firm may appoint one or more employees to the IGC, subject to the requirement that the majority of IGC members be independent, because of the firm-specific, in-depth knowledge they may bring. However, we would expect firms to have arrangements to ensure that any employees appointed to an IGC act independently of the firm in their capacity as IGC members. Employee IGC members would be required to act in accordance with the IGC's terms of reference and, in particular, in the interests of relevant scheme members.
- 3.10** Given the importance of the IGC Chair to the work of the IGC and in providing credible and effective challenge, we propose requiring that the Chair must always be independent of the firm.

Q7: Do you agree that an IGC must have a majority of members independent of the firm and that the IGC Chair must always be independent?

IGC members

- 3.11** In the DWP's Command Paper, the government originally proposed that IGCs must have at least seven members.
- 3.12** We have subsequently agreed with the DWP that this minimum requirement may be too high. While an IGC with seven members may be appropriate for large firms, the burden on other firms may be disproportionate to the benefit to members. Nonetheless, we consider that an IGC with too few members may not have the breadth of views to be effective, regardless of the expertise and experience of individual members.
- 3.13** Therefore, we propose that an IGC should have at least five members. We believe that this strikes the right balance between burden on the firm and benefit to members.
- 3.14** Along with the earlier requirement for a majority of independent members, a five member IGC implies at least three independent members, including an independent Chair. An odd number of members also ensures a majority in voting.
- 3.15** For smaller firms, we believe that a requirement to establish an IGC may be disproportionate. In Chapter 6, we propose an alternative arrangement for firms with smaller and less complex schemes.

Q8: Do you agree that an IGC should have at least five members?

Definition of independence

- 3.16** The definition of 'independence' in the DWP's Command Paper required that an independent IGC member must not:
- be an employee of the provider or scheme or paid by them for any role other than that which they fulfil on the trustee board/IGC,
 - have been an employee of the provider or group within the last five years, and
 - have, or have had within the last three years, a material business relationship with the company.
- 3.17** A number of firms have represented to us that these proposed requirements are too restrictive, in the context of a limited pool of candidates with sufficient expertise and experience to be on an IGC.
- 3.18** Firms have suggested that a trustee of a firm's mastertrust should be able to serve as an independent member of the firm's IGC and could provide valuable read across, and vice versa. In addition, firms have suggested that non-executive members of other committees within the firm, such as a with-profits committee or investment committee, should be similarly available for the role of independent IGC member.
- 3.19** We do not consider that being a trustee of the firm's mastertrust should compromise an individual's ability to act independently of the firm in the interests of workplace personal pension scheme members. A trustee of a mastertrust operated by the firm must also act independently of the firm.
- 3.20** However, we consider that membership of other committees within the firm, such as a with-profits committee, may present difficulties for the independence of the member. There is a potential for conflict of interest between roles, especially where an individual may be called upon to review decisions that they have made in other roles within a firm.
- 3.21** We propose modifying the definition of independence to allow firms to appoint trustees of the firm's mastertrust to the IGC as independent members. We do not propose extending this to allow firms to appoint individuals to the IGC as independent members when they are also members of other committees within the firm, even if acting in a non-executive capacity on those other committees.
- 3.22** We propose that the same person may serve on more than one IGC as an independent member. We consider that there may be valuable read across between IGCs operated by different firms. This would include the situation where firms within the same corporate group each have established an IGC, rather than using a group-level IGC.

Q9: Do you agree with our proposed definition of independence that would allow trustees of a firm's mastertrust to be independent IGC members?

Indemnification of IGC members

- 3.23** We have considered whether there should be a requirement on firms to indemnify individuals against liabilities incurred in their capacity as IGC members. This would give firms an incentive to ensure that IGCs are set up to be effective. In addition, firms might otherwise find it hard to attract suitable candidates.
- 3.24** We have discussed the potential for indemnification of IGC members with the Law Commission. In its report on the Fiduciary Duties of Investment Intermediaries⁶, published on 1 July 2014, the Law Commission recommended that firms should be required to indemnify IGC members.
- 3.25** We can see merit in firms indemnifying IGC members against liabilities arising from actions that the firm takes, following concerns raised or recommendations made by the IGC. This is despite scheme members being more likely to pursue the firm than the IGC, since the firm remains responsible for any actions taken. Persons seeking appointment to an IGC may request such indemnification, and firms may choose to offer it.
- 3.26** We propose guidance that firms should consider indemnifying IGC members against any liabilities incurred while fulfilling their duties as IGC members. However, we do not believe it necessary to make this a requirement under our rules.
- 3.27** We note that non-executive members of firms are generally indemnified against liabilities resulting from, for example, fraud and negligence. These are standard terms within contracts of insurance indemnifying non-executives.

Q10: Do you agree that we should not require firms to indemnify IGC members?

Approved persons

- 3.28** We have considered whether one or more members of the IGC should be approved persons, to increase our regulatory control over IGCs. In particular, we have considered whether the Chair of the IGC should be an approved person.
- 3.29** If one or more persons carrying out an IGC were approved persons, this would provide the following benefits:
- allow the FCA to determine whether a candidate is a fit and proper person to carry out the function for which they are proposed, and
 - give the FCA increased powers to intervene, where an IGC is not acting in line with our rules or its terms of reference.
- 3.30** However, some stakeholders have expressed concerns that making IGC members and/or the IGC Chair approved persons may deter some potential candidates from seeking appointment, because of the additional responsibilities. Further, the cost to firms may be higher because the compensation of IGC members may need to reflect their additional responsibilities.

⁶ *Fiduciary Duties of Investment Intermediaries* – http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties.pdf

- 3.31** Our proposed rules will require firms to ensure that IGCs are established with sufficient expertise and experience to be able to perform the duties in their terms of reference. We also expect firms anyway to assure themselves of the integrity and good standing of persons that they appoint to their IGCs.
- 3.32** Further, we recognise that the timetable for implementing IGCs is tight. Requiring persons sitting on IGCs to be approved persons may not be conducive to firms meeting the new rules from April 2015.
- 3.33** Therefore, on balance, we do not propose making any role on the IGC a controlled function at this time. If, in the future, we believe that IGC members, and in particular IGC Chairs, are not suitably qualified or performing their duties correctly, we may consider requiring that one or more members of IGCs be approved persons.

Q11: Do you agree that members of the IGC, including the IGC Chair, should not be approved persons at this time?

Appointment of IGC members

- 3.34** An IGC's independence is crucial to its ability to challenge the firm effectively on value for money issues. We recognise the potential for conflicts of interest in the appointment process; for example, firms might seek to appoint 'independent' members who may not put the interests of scheme members first.
- 3.35** To mitigate this risk, the government proposed, in the DWP's Command Paper, that the appointment process must be open and transparent. In particular, firms must use either an external search consultancy or open advertising to appoint independent members, including the IGC Chair. The DWP also proposed that the IGC Chair should be involved in the recruitment of other IGC members.
- 3.36** We agree that the appointment process must be open and transparent, and propose making this a requirement. We propose guidance that firms can meet this requirement through the use of an external search consultancy or open advertising. We would expect the firm to involve the IGC Chair in the appointment of other IGC members, both independent members and employees of the firm.
- 3.37** We have considered the possibility of scheme members directly electing IGC members to represent their interests. There are practical difficulties, given the low level of scheme member engagement, so we do not propose requiring at this time that prospective IGC members be put to a vote. Nonetheless, we would encourage firms to consider how to involve scheme members in future appointments of IGC members.

Q12: Do you agree that we should require firms to recruit independent IGC members through an open and transparent recruitment process?

Duration of appointment

- 3.38** In the DWP's Command Paper, the government proposed that independent IGC members should be appointed for terms of no more than three years, and should be eligible for re-appointment twice. This would mean that an independent member could be in post for a maximum period of nine years.
- 3.39** We agree that the overall duration of appointment should be capped, with a limit to each term of appointment. This would help ensure that independent IGC members do not become too "close" to the firm. It would also allow new appointments and fresh challenge.
- 3.40** However, a fixed term of no more than three years may be too short. It will take time for a new IGC member to become fully effective and, towards the end of the term, the member may have less incentive to challenge the firm if seeking re-appointment.
- 3.41** We propose that independent IGC members be appointed for fixed terms of no longer than five years, with a cumulative maximum duration of ten years, unless that member is a corporate person (see below). Individual independent IGC members would not be eligible for reappointment to the IGC until five years have elapsed, after having served on the firm's IGC for the cumulative maximum duration of ten years.
- 3.42** We also propose that firms must manage appointments to maintain the continuity of the IGC's expertise and experience, for example through staggered terms of appointment. We would expect firms to replace any vacancies that arise within IGCs as soon as possible and in any event within six months.

Q13: We would welcome views on the proposed duration of appointment of IGC members.

Corporate persons as IGC members

- 3.43** Some organisations that provide independent trustee services are considering offering their services as a corporate IGC member. In discussion, firms have said to us that they may wish to appoint such organisations to their IGC.
- 3.44** We believe there may be benefits to allowing corporate persons to be appointed as IGC members, including the following:
- high levels of professionalism and consistency where corporate persons provide similar services in their normal course of business (for example, as corporate trustees sitting on mastertrust boards)
 - improved access to research and insights from across the pensions market, where corporate persons have central resources, and
 - continuity, since individuals representing a corporate person can be more readily replaced if they are no longer able to be the representative on an IGC.

- 3.45** We propose that firms should be allowed to appoint corporate persons to an IGC, including as Chair, provided that the corporate person is independent of the firm. The firm should consider the circumstances of the corporate person and ensure that any potential conflicts of interests are managed effectively and do not affect the corporate person's ability to represent the interests of scheme members.
- 3.46** We propose that the appointment of a corporate person to an IGC count as a single appointment, and that more than one corporate person may be appointed to an IGC. We would expect each corporate person to nominate the individual responsible for representing them on the IGC. A named individual will help ensure continuity and the accumulation of firm-specific experience.
- 3.47** We do not consider that there should be an overall cap to the duration of a corporate appointment, because the named individual can be changed. Further, we would not want to prevent firms from accessing a limited pool of organisations capable of acting as IGC members by being overly restrictive on their reappointments.
- 3.48** Therefore, we propose that, where a corporate person is appointed as an IGC member, the firm should ensure that the corporate person's representative is named and is rotated at least as frequently as would be required for an independent individual IGC member, but with no restriction on the duration of the corporate appointment.

Q14: Do you agree that we should permit the appointment of corporate persons to IGCs, including as the IGC Chair?

Q15: Do you agree that there should be no restriction on the duration of a corporate appointment?

4.

Terms of reference for an IGC

- 4.1** In this chapter we consider the terms of reference that set out the duties and powers of an IGC. We propose duties to act in the interests of scheme members and to assess the value for money of the firm's workplace personal pension schemes on an ongoing basis. We set out, at a high level, what we mean by assessing value for money, including the key elements of scheme quality and the costs and charges that IGCs will need to consider.
- 4.2** We propose that IGCs raise concerns with the boards of firms. Where not satisfied with a firm's response, IGCs would have the power to escalate concerns to the FCA, to alert relevant scheme members and employers, and to make their concerns public.

Duty to act in member interests

- 4.3** We propose that the terms of reference for an IGC must require the IGC to act in the interests of relevant scheme members. Whereas under FCA rules the firm has a duty, in relation to investment business carried on for its client, to act honestly, fairly and professionally in accordance with the best interests of its client, it also has a duty to its shareholders to act commercially. The IGC would be responsible for acting in the interests of relevant scheme members only.
- 4.4** We recognise that there may be situations where conflicts of interest may be present across different groups of scheme members. Rather than prescribing how an IGC should address conflicts of interest, we would expect the IGC to manage any conflicts that arise. This would include how the IGC prioritises its work, across potentially very many schemes and diverse groups of members.

Duty to assess value for money on an ongoing basis

- 4.5** As outlined in previous chapters, the primary purpose of an IGC is to act in the interests of members in assessing and raising concerns about value for money. We expect IGCs to consider in particular the value for money received by individuals enrolled in default funds⁷, because most scheme members are likely to be invested in the default fund and most of these are unlikely to have made any choice.
- 4.6** An assessment of value for money involves weighing the quality of the scheme against its cost to members. The key elements of scheme quality include the:

⁷ both value for money of the default fund and of scheme administration

- design and execution of the investment strategy
- administration of the scheme including communication with members, and
- governance of the scheme, including regular assessment of its value for money.

4.7 The key elements of cost to members include the:

- costs and charges for scheme and investment administration, and
- direct and indirect costs of transactions and other activities in the managing and investing of pension assets.

4.8 In discussion with us, some firms have asked whether IGCs would be expected to consider the non-default funds of workplace personal pension schemes, given that scheme members must actively choose to invest in such funds.

4.9 In our view, IGCs should have a wide remit to consider all the choices available to scheme members, to help protect against the possibility of members making poor decisions. Non-default funds have the potential to be poor value relative to the default, since they may have high fund management charges and transaction costs, in particular where actively managed, and the proposed charge cap relates to default funds only.

4.10 We propose that, at a minimum, IGCs must assess whether the characteristics and net performance of all investment strategies (including non-default investment strategies) are regularly reviewed by the firm, to ensure alignment with the interests of scheme members. Beyond this minimum requirement, we believe that IGCs should determine their own priorities, subject to their terms of reference and having regard to the interests of workplace personal pension scheme members.

4.11 We have also been asked whether IGCs would be expected to consider the value for money of each employer's scheme individually, given that some firms may operate schemes for many thousands of employers.

4.12 We recognise that it may not be practical or cost effective for the IGC to assess the value for money of each employer's scheme individually. An IGC may want to consider grouping schemes with similar characteristics, and assess value for money at the level of groups of similar schemes together. The IGC would still be able to drill down to the level of individual schemes.

4.13 We do not intend to prescribe in rules how IGCs should go about assessing value for money. Firms will have schemes with different characteristics and it will be for each IGC to determine how best to undertake its assessment.

4.14 Over time, we would expect greater consistency in how IGCs go about assessing value for money. While we do not propose to mandate a one-size-fits-all approach, we expect IGCs to have regard to any common standards developed by government and/or regulators. One example is the voluntary mastertrust assurance framework, developed by the Institute of Chartered Accountants in England and Wales (ICAEW) in association with TPR.

Q16: Do you agree that IGCs should consider in particular the value for money received by individuals enrolled in default funds?

Q17: Do you agree that, at a minimum, IGCs must assess whether the characteristics and net performance of all investment strategies are regularly reviewed by the firm?

Q18: Do you agree that, rather than mandating a particular approach, we should allow individual IGCs to determine how best to assess value for money?

Scheme quality and minimum governance standards

4.15 There are some aspects of scheme quality which we believe are fundamental to members receiving adequate protection. Based on our experience of supervising firms, and our work with the DWP, we believe that good governance must include an assessment of whether:

- default investment strategies are designed in the interests of scheme members, with a clear statement of aims, objectives and structure appropriate for scheme members
- the characteristics and net performance of investment strategies (including non-default strategies and/or funds made available to scheme members) are regularly reviewed by the firm to ensure alignment with the interests of scheme members, and action taken to make any necessary changes, and
- core scheme financial transactions are processed promptly and accurately.

4.16 We propose that the terms of reference must require IGCs, as a minimum, to assess these three aspects of the services provided to members of workplace personal pension schemes.

4.17 We recognise that firms may provide additional services, guarantees, bonus payments or other benefits, to differentiate their proposition to employers and scheme members. Further, the various schemes of an individual firm may differ in the terms and conditions of services offered.

4.18 Since IGCs should be able to assess the overall value for money of services provided to members of workplace personal pension schemes, we do not believe that they should be restricted in the range of services they review. Instead, we propose that IGCs should be able to determine which other services they consider, having regard to:

- whether scheme members need or value the additional services, in particular where these relate to default investment strategies
- the views received from scheme members
- the reports and other information produced by IGCs and mastertrusts, and
- changes to legislation or guidance issued by the government, the FCA or other regulators, such as TPR.

Q19: Do you agree that IGCs should be required, at a minimum, to review the three aspects of scheme quality proposed, and should consider other aspects as appropriate?

Costs and charges

- 4.19** To assess overall value for money, the services provided must be weighed against all costs and charges borne by scheme members. IGCs will need to obtain from firms the costs and charges associated with the workplace personal pension schemes that they operate.
- 4.20** The proposed 75 basis point charge cap will help protect scheme members invested in default funds. However, the cap is not intended to set a market price, and we expect many schemes to charge at levels beneath the cap. IGCs will need to consider whether charges are appropriate relative to the services provided to scheme members.
- 4.21** Where a member chooses a non-default investment strategy, higher costs and charges often apply. We would expect IGCs assessing the value for money of non-default investment strategies to ask firms to provide them with details of relevant costs and charges.
- 4.22** All funds, including default funds, are subject to varying levels of explicit and implicit transaction costs. These are considered later in this chapter, under the heading ‘improving transparency of all costs and charges’.
- 4.23** We propose that IGCs must assess the level of charges borne by scheme members and all costs (direct and indirect) incurred in relation to transactions and other activities in managing and investing the pension assets of scheme members.

Q20: Do you agree that IGCs should consider all costs and charges, as proposed? If not, what would you suggest?

With-profits funds and legacy schemes

- 4.24** For some types of fund, such as with-profits funds, firms may have difficulty allocating costs and calculating the charges borne by pension scheme members. However, if such funds are used as defined contribution default funds, firms will still have to comply with the proposed charge cap.
- 4.25** We already require firms managing with-profits funds to establish a with-profits committee (WPC) or, where appropriate, an alternative advisory arrangement, to represent the interests of all with-profits policyholders. As part of their remit, WPCs should already assess the charges incurred by the with-profits fund. We would expect IGCs to work with the arrangements already in place for with-profits funds, rather than seek to replicate what they are doing.
- 4.26** We propose that IGCs should have the flexibility to decide how to work alongside existing arrangements for with-profits funds. The characteristics and cost allocations of with-profits funds will differ between firms. Therefore, individual IGCs are best placed to decide how to assess the costs and charges of the funds for which they provide oversight, on behalf of pension scheme members.

Improving transparency of all costs and charges

- 4.27** Because of their impact on the returns delivered to investors, it is important that all costs and charges are identified and quantified so the full costs of investment services can be made clear. In the DWP's Command Paper, the government outlined a vision for workplace pension schemes that will involve full transparency of all costs and charges throughout the value chain in a way that enables pension scheme managers, and IGCs or trustees, to compare value across the market and identify the best deal for scheme members. Disclosure will include member-borne deductions relating to scheme and investment administration costs, and transaction costs associated with buying and selling investments held within the pension scheme wrapper.
- 4.28** If pension scheme operators are not aware of all the costs, including transaction costs, they will be required to obtain the information from the other suppliers in the value chain for the assets in which pension scheme monies are invested, as so much market data is now readily available.
- 4.29** Although some costs will be predictable, many costs are expected to vary, especially costs incurred for transactions and other activities in managing and investing pension assets. These will include, but are not limited to:
- dealing charges, such as brokerage commission and fees
 - bid-offer spreads
 - transaction taxes (including stamp duty)
 - research costs,
 - foreign exchange commissions
 - fees relating to stock lending or stock borrowing
 - initial charges, and entry and exit fees for investment in underlying funds (for funds of funds), and
 - transaction costs relating to investments held in underlying funds (for funds of funds).
- 4.30** Our proposed rules will require public disclosure by firms of their IGC's assessments in the IGC Chair's annual report, to enable IGCs to compare their assessments with those of other IGCs.
- 4.31** We plan to consult in 2015 on rules outlining the way cost information is to be disclosed by firms. This will take into account industry efforts to improve transparency of transaction-related costs and charges, including the comparative table recently developed and consulted on by the Investment Management Association (IMA) to show the direct costs and charges of authorised collective investment schemes.⁸ The IMA approach drew a number of critical responses, stating that the comparative table did not go far enough. Respondents to the IMA consultation gave examples of transaction-related costs which they said would not be disclosed through the IMA mechanism and they suggested that, as a result, the table would mislead investors. However,

⁸ The comparative table is set out in the IMA's Statement of Recommended Practice which was re-issued on 14 May 2014 and can be found here: <http://www.investmentfunds.org.uk/policy-and-publications/sorp-0314/>

The FCA is consulting on referring to IMA's Statement of Recommended Practice in chapter 4 of the FCA's Collective Investment Scheme sourcebook. Our consultation paper (please see chapter 7) can be found here: <http://www.fca.org.uk/static/documents/consultation-papers/cp14-08.pdf>

although this table in its current form does not reflect all the costs identified in the Command Paper, it may provide a template for disclosing the costs of a wide range of funds in an easily understandable way.

- 4.32** We have asked asset managers to do further work to address the deficiencies of the IMA's comparative table so that it presents the full cost of investing in authorised funds more accurately. Such work will be a pre-requisite if the table is to be adapted for disclosure of pension scheme costs to IGCs and trustees. Our objective is to require firms to ensure IGCs receive standardised cost information relating to workplace personal pension schemes.
- 4.33** Our proposed approach takes into account the timetable of relevant EU legislation for the Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs) and the Markets in Financial Instruments Directive II (MiFID II), as well as the need to test consumer understanding of information about costs and charges. Implementation of PRIIPs is expected in late 2016 and MiFID II in early 2017.

Q21: We would welcome views on how best to improve the disclosure of all costs and charges, and how we could transpose the industry standards for authorised funds to pensions.

Raising and escalating concerns

- 4.34** IGCs must present a credible challenge to firms on value for money issues. Where they identify poor value for money, IGCs must be able to raise concerns and make recommendations as they see fit. We propose that the terms of reference require that the IGC raise its concerns with the firm's governing body, typically its board. The firm's board must be given a right to respond before the IGC takes its concerns further.
- 4.35** We expect firms to consider concerns raised by IGCs and address them or explain to the IGC why they do not intend to do so. We outline this proposed "comply or explain" duty on the firm in Chapter 5.
- 4.36** Where an IGC has raised concerns to the firm's board which, in the IGC's opinion, have not been addressed satisfactorily, we propose that the IGC be able to escalate its concerns directly to the FCA. Where appropriate, we may require the firm to take action. We also propose that the IGC may alert relevant scheme members and employers, where the IGC sees fit, and make its concerns public.

Q22: Do you agree that IGCs should be able to escalate concerns directly to the FCA, alert relevant scheme members and employers, and make their concerns public?

Requirement to publish an annual report

- 4.37** We propose that the terms of reference for an IGC must require the IGC Chair to produce an annual report on the IGC's work. The firm would be required to make this annual report publicly available.

- 4.38** The annual report would include, among other things, the value for money delivered by schemes, and in particular an assessment of how the firm has performed against the aspects of scheme quality outlined at paragraph 4.15. It would also set out how the IGC has complied with its duty to act in member interests.
- 4.39** The requirement for annual reports should increase transparency and encourage comparison between schemes provided by different firms. In addition, it would enable interested scheme members, employers and consumer groups to scrutinise what an IGC is doing.
- 4.40** We would expect IGCs to report on the level of direct and indirect costs incurred for transactions and other activities in managing and investing the pension assets of scheme members. Where IGCs have not been able to obtain the information, we would expect them to explain why not in their annual report and what steps will be taken to allow them access to the information in the future.

Q23: Do you agree that the IGC Chair should be required to produce an annual report and that the firm should be required to make this report publicly available?

Priorities for IGCs

- 4.41** An immediate priority for IGCs is likely to be actions arising out of an audit of high cost and legacy schemes ('legacy audit') carried out by the ABI and those of its members that provide workplace personal pensions.⁹ The legacy audit is overseen by an independent project board and is due to conclude in December 2014. IGCs will need to consider whether actions taken by firms are sufficient to address any recommendations for industry-level actions made by the independent project board.
- 4.42** The legacy audit does not consider deferred members (scheme members who have stopped contributing to their pension) with workplace personal pensions that have been reclassified as individual personal pensions. ABI members have committed to a sampling exercise of individual personal pensions to identify such cases, since these may face higher charges. IGCs will provide oversight of this sampling exercise.
- 4.43** As outlined in the DWP's Command Paper, the Government intends to ban active member discounts from April 2016, which are charging practices that result in charge increases for deferred members. IGCs will need to consider whether deferred members are getting value for money and ensure that firms comply with the proposed ban.
- 4.44** Similarly, IGCs will have a role in ensuring that firms comply with the proposed charge cap on default funds and proposed bans on adviser commissions and consultancy charging.
- 4.45** We would expect IGCs increasingly to be in a position to challenge firms on the value for money offered by fund managers, brokers, and other third-party providers. To date, the firms providing and administering pension schemes may have lacked any strong incentive to negotiate down the direct and indirect costs of transactions and other activities in managing and investing pension assets. The ability of IGCs to challenge firms and report publicly may change this.

⁹ A cross-industry audit of pre-2001 schemes and schemes established since then with charges higher than an equivalent of one per cent total expense ratio. This audit was agreed between the ABI and OFT in the context of the 2013 OFT market study on defined contribution workplace pension schemes. <http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.of.gov.uk/OFTwork/markets-work/pensions/>

- 4.46** The problems with value for money that an IGC might identify are likely to depend on the characteristics of the firm's schemes. For example, closed-book schemes are likely to have different issues than schemes still open to new members.
- 4.47** More generally, IGCs may need to take into account the employer's workforce in assessing value for money. Employers with smaller, more transient and lower paid workforces may cost more per member to service. Costs and charges are likely to reflect this and may not necessarily indicate a problem with value for money in all cases.
- 4.48** IGCs cannot assess value for money without some basis for comparison. They will need to look across the market in benchmarking value for money, including the National Employment Savings Trust (NEST) and other mastertrusts, as well as workplace personal pension schemes provided by other firms.
- 4.49** Some problems will be particularly difficult for firms to address. These include:
- Problems to do with the scale of the firm's schemes, where reducing charges and/or raising quality to a competitive level may result in losses, and
 - Poor service and/or poor value for money schemes operating on legacy IT platforms, where the cost of upgrading the platform or transferring members to a more up-to-date platform may be substantial.
- 4.50** While such problems may be difficult for firms to address, we would still expect IGCs to raise concerns on behalf of relevant scheme members and to push firms to take appropriate action.
- 4.51** The priorities of IGCs are likely to change over time. While we recognise that an early focus for IGCs will be any recommendations made by the independent project board overseeing the legacy audit, we do not propose to mandate what individual IGCs should prioritise.

Q24: We would welcome views on where IGCs should focus their attention.

5.

Ensuring the effectiveness of IGCs

- 5.1** In this chapter we focus on what firms must do to ensure that IGCs are effective. Firms will need to provide information and make resources available so that IGCs are able to fulfil their duties. We propose that firms be required to provide all information reasonably requested and sufficient resources to enable IGCs to carry out their duties.
- 5.2** While IGCs may assess value for money and raise concerns, firms must respond to the concerns raised if IGCs are to be effective. We propose a “comply or explain” duty on firms, whereby firms are required to address the concerns raised or to explain to IGCs why they do not intend to do so.
- 5.3** Finally in this chapter, we outline our supervisory approach and how this may apply to IGCs and firms.

Duty to provide all information reasonably requested

- 5.4** For a comprehensive assessment of value for money, IGCs will need detailed information about the benefits and services of a firm’s workplace personal pension schemes and about the costs and charges borne by scheme members. We expect IGCs to consider what they need to assess value for money, and whether particular schemes or aspects of schemes may be poor value for money, and request the information they need from firms.
- 5.5** There are two broad categories of information that IGCs will need for a comprehensive assessment of value for money. First, information about the scheme and investment administration, and all related charges. This information will almost certainly be known by the firms operating workplace personal pension schemes, since they provide these services and/or the charges are explicit and known in advance.
- 5.6** Second, information relating to the management and investment of pension assets, and all related costs and charges, including transaction costs. Since these services are typically provided by third parties, the firm operating the pension scheme may not currently have information about service quality and all the costs and charges that apply. We would expect firms to seek such information from fund managers and other third parties, so that they can provide it to IGCs.
- 5.7** We recognise that there may be a tension between what an IGC wants and what a firm may be willing to provide. There is a cost to the firm in obtaining data and carrying out analyses on the IGC’s behalf. Ultimately, there is a risk that this cost may be passed on to scheme members, or that firms may withdraw schemes from the market.

- 5.8** To strike the right balance, we propose that the firm must provide all information ‘reasonably requested’ by the IGC for the purposes of carrying out its role. The firm and the IGC would need to agree what constitutes a reasonable request, having regard to proportionality and the interests of scheme members. We also expect firms to ensure the quality of the information.
- 5.9** If the firm cannot agree with the IGC what constitutes a reasonable request, we would expect the IGC Chair to raise a concern with the firm’s board. If the IGC Chair is not satisfied with the response of the firm’s board, the IGC Chair should escalate the concern to us.
- 5.10** We consider that IGCs are likely to need information that may be confidential and/or commercially sensitive to carry out their duties. Firms must ensure that mechanisms are in place for sharing confidential and commercially sensitive information with IGCs.
- 5.11** Where a corporate group chooses to have a single IGC at the group level, it should ensure that this does not lead to restrictions on the sharing of information which would not otherwise be in place if there were firm-level IGCs.

Q25: Do you agree that we should place a duty on the firm to provide the IGC with all information that it reasonably requests for the purposes of carrying out its duties?

Duty to provide sufficient resources

- 5.12** In addition to information, an IGC is likely to need administrative and analytical support from the firm to fulfil its duties effectively. Where schemes are large and/or complex, considerable data processing and analysis may be needed before information can be provided to the IGC in a form that is useful.
- 5.13** The IGC will also require other support to carry out its duties effectively. This would include independent advice, funded by the firm, to the extent necessary and proportionate and not inconsistent with the firm’s duty to act in members’ interests. For instance, funds should be available to engage advisers who are independent of the firm, such as an independent investment adviser and an independent lawyer, where specialist or legal input is required.
- 5.14** We propose that a firm must provide the IGC with sufficient resources as are reasonably necessary for the purposes of carrying out its role independently. The firm and the IGC would need to agree what constitutes ‘sufficient resources as are reasonably necessary’, having regard to proportionality and the interests of scheme members.
- 5.15** Some consumer groups have suggested to us that there is a risk that some firms provide biased or inadequate administrative support to IGCs, and thereby weaken their ability to provide effective challenge. To mitigate this risk, we propose that firms should agree arrangements for the IGC secretariat and other administrative support with the IGC Chair.
- 5.16** As with information request, if the IGC has concerns about the resources offered or provided by the firm, we expect the IGC Chair to raise the concerns with the firm’s board. If the IGC Chair is not satisfied with the response of the firm’s board, the IGC Chair should escalate the concerns to us.

- 5.17** Some firms may want to extend the scope of their IGC beyond its mandatory minimum duties, for example, to include oversight of individual personal pensions set up outside the workplace. We consider that this would be for the firm to agree with the IGC. If the scope is extended, we would expect the firm to provide additional resources and support, so that the IGC's ability to fulfil its minimum duties is not compromised.

Q26: Do you agree that we should place a duty on the firm to provide sufficient resources to the IGC as are reasonably necessary for it to carry out its duties?

Duty to ensure that member views are directly represented to the IGC

- 5.18** IGCs have the challenge of representing scheme members who may not be interested in the management and administration of their pension assets, especially members who have been automatically enrolled into the default fund of their employer's scheme. Nonetheless, IGCs have the potential to be more effective if there are arrangements in place for interested members to make their views known.
- 5.19** While we do not seek to prescribe the mechanism, we propose that firms must make arrangements to ensure that relevant scheme member views can be directly represented to IGCs. By 'directly', we mean without intervention by the firm as to which views are put forward. We note that some mastertrusts already have arrangements to ensure that members' views are represented; for example, NEST has a members' panel.
- 5.20** We have considered whether to require firms to appoint scheme members to IGCs, but recognise that individual scheme members may not be impartial in representing member views. For instance, an individual scheme member may have interests or concerns that do not correspond to those of scheme members generally. Further, the firm may operate multiple schemes with diverse member groups.
- 5.21** While not ruling out scheme members as IGC members, we do not at this time seek to require firms to appoint scheme members to IGCs.

Q27: We would welcome views on possible arrangements to ensure that member views are directly represented to the IGC.

Duty to make annual report and terms of reference publicly available

- 5.22** The annual report of the IGC Chair would, as proposed, include information about the value for money and governance of the firm's schemes and about how the IGC has complied with its duty to act in members' interests. This information should be of interest to other IGCs. It may also stimulate greater interest from scheme members and employers, and encourage engagement with firms on the value for money of schemes.
- 5.23** Publication of an IGC's terms of reference would allow interested scheme members and employers to understand what is required of the IGC and hold it to account.

- 5.24** We propose making the firm responsible for making publicly available both the annual reports of the IGC Chair and the IGC's terms of reference. The firm could do this by placing the documents on its website and providing them on request to scheme members and employers.

Q28: Do you agree that the firm should make the IGC's annual report and terms of reference publicly available?

"Comply or explain" duty

- 5.25** For IGCs to be effective, firms must listen and respond to their concerns. IGCs are not able to make changes directly to pension schemes to improve value for money, since the firm remains responsible for any changes to its schemes.
- 5.26** We propose that a duty be placed on the firm to take reasonable steps to address concerns raised by an IGC under its terms of reference, or to explain in writing to the IGC why it does not intend to do so. To ensure that concerns are given due weight and attention, we propose that IGCs raise their concerns directly with the boards of firms.
- 5.27** We expect executive management to consider the IGC's concerns and inform their board on proposed actions to address the concerns. Where the IGC is at group level and the concerns relate to pension schemes of a subsidiary of the group, the executive management of the subsidiary may be best placed to consider concerns and propose actions to address them.
- 5.28** Where an IGC seeks to escalate its concerns, we expect the firm to take all necessary steps to facilitate the escalation of the concerns raised by the IGC under its terms of reference. This operates alongside the proposed mechanism for raising and escalating concerns, as outlined at paragraphs 4.34 to 4.36.

Q29: Do you agree that we should place a duty on the firm to address concerns raised by the IGC or explain to the IGC why it does not intend to do so?

Our supervisory approach

- 5.29** Our supervisory approach comprises three 'pillars,' which take into account the scope of our remit and are designed to support our statutory objectives. These pillars are as follows.
- Pillar 1: proactive firm supervision, which assesses whether the firm is run in a way that results in the fair treatment of customers, through identifying and addressing the drivers of conduct risk at the firm level.
 - Pillar 2: event supervision, which addresses significant crystallising or crystallised conduct risks at the firm level that occur outside the firm assessment cycle.
 - Pillar 3: issues-based supervision, which addresses specific conduct risks across a sector and, as such, will be the main way we address our conduct priorities.

- 5.30** We propose that IGCs are captured within our existing supervisory three pillar framework while we monitor their set up and implementation. We will use our full range of supervisory tools; for example, we may take firm-specific action on concerns escalated to us, or a thematic review of IGCs to assess their effectiveness. We would expect IGC Chairs to escalate concerns to the firm's usual supervisory contact.
- 5.31** Our supervisory approach will be kept under review to ensure that concerns are dealt with consistently and, where appropriate, acted upon.

6. Alternative arrangements to IGCs

- 6.1** We recognise that an IGC may not be a proportionate approach for firms with smaller and less complex workplace personal pension schemes. Therefore, we propose allowing governance advisory arrangements (GAAs) as an alternative, with firms to decide whether a GAA would be proportionate and appropriate for them, having regard to a number of factors that we outline below.

Governance advisory arrangements

- 6.2** As an alternative to an IGC, we propose that firms with smaller and less complex workplace personal pension schemes should be able to appoint another firm, as an independent third party, to take on their IGC responsibilities.
- 6.3** The third party would provide a group of individuals (including individuals independent of the third party and the firm) to carry out these responsibilities. This group may serve multiple firms, with the potential for economies of scale and resulting lower cost solutions for smaller firms.
- 6.4** We refer to this as a governance advisory arrangement (GAA). We recognise the risk that GAAs may not provide as effective governance as IGCs. In particular, and unless minimum standards are specified, we believe there is a danger that:
- individuals responsible for providing GAAs will not be held personally accountable for performing their duties
 - commercial interests of a third party may conflict with effective challenge, and/or
 - the third party would lack and not be able to obtain sufficient in-depth knowledge of a firm's schemes.
- 6.5** To mitigate these concerns, we propose that firms seeking to establish GAAs must ensure that their GAA performs the same functions that an IGC would have done. In particular, firms should ensure that the mandatory requirements in the terms of reference for an IGC apply to the GAA.
- 6.6** We would expect any third party providing GAA services to set up a GAA committee that is independent of the firm(s) using its services. We propose requiring firms seeking to establish GAAs to do this on terms that secure the independence of the GAA committee and its Chair from the appointing firm. We would expect the majority (or all) of the members of the GAA committee, including the Chair, to be independent of the firm(s) using its services.

- 6.7** We believe these minimum features will help ensure the independence and effectiveness of GAAs, while allowing the market some flexibility in how GAAs are delivered.
- 6.8** Some stakeholders have discussed with us the possibility of a third party setting up an arrangement replicating the full IGC structure for use by multiple firms. If set up in a way which meets the above conditions, we consider that this would be an acceptable form for a GAA.

Q30: Do you agree that GAAs should be allowed as an alternative to IGCs for firms with smaller and less complex workplace personal pension schemes?

Threshold for use of a GAA

- 6.9** As outlined above, it is our intention that GAAs should be available as an alternative governance arrangement for firms with smaller and less complex workplace personal pension schemes.
- 6.10** We have considered whether we should determine a threshold below which a GAA will be allowed as an alternative to an IGC. However, we believe setting a threshold based simply on number of members, or funds under management, would not be appropriate, because different firms may have schemes with very different characteristics. For example, firms may have closed and open schemes, different types of legacy scheme, workforces with different characteristics, or schemes with additional benefits or services.
- 6.11** Therefore, we propose allowing firms to determine whether or not it would be appropriate for them to establish a GAA rather than an IGC. In making this assessment, we would expect firms to consider:
- their market share of workplace personal pensions, and
 - the complexity of their workplace personal pension schemes.
- 6.12** While we do not seek to prescribe a threshold, we recognise that firms will receive comfort from having guidance on the level of market share below which a GAA may be considered appropriate. We propose that for firms with less than a five per cent market share of two or more of the following measures, a GAA may be considered appropriate:
- funds under management in relevant schemes
 - number of relevant scheme members, and
 - number of employers contributing to relevant schemes.
- 6.13** We also expect firms to consider the complexity of their schemes in determining whether a GAA would be appropriate, since the more complex a firm's schemes, the greater the need for the in-depth and firm-specific knowledge that an IGC can provide. One or more of the following features might indicate complex arrangements:

- schemes operated on multiple IT systems
- schemes with multiple charging structures
- schemes offering with-profits funds, where costs are allocated to members and conflicts of interest may arise, and/or
- schemes with funds managed by firms within the same group, i.e. the fund management is vertically integrated.

6.14 The majority of members of workplace personal pension schemes are concentrated within a small number of providers. If firms adopt the above guidance on where a GAA may be considered appropriate, we believe that the large majority of members of workplace personal pension schemes will be represented by an IGC.

Q31: Do you agree with our proposals for the types of firm that can use GAAs?

Annex 1:

Market failure and cost benefit analysis

1. The Financial Services and Markets Act 2000, as amended by the Financial Services Act (2012), requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as 'an analysis of the costs together with an analysis of the benefits' that will arise if the proposed rules are made. It also requires us to quantify these costs and benefits, unless they cannot reasonably be estimated or it is not reasonably practicable to produce an estimate.

Summary of costs and benefits

2. The table below summarises the costs and benefits of our proposals. It provides estimated one-off and ongoing costs and benefits. For each of one-off and ongoing costs, we show an estimated range, based on responses from firms on the costs to them, and our central estimate.

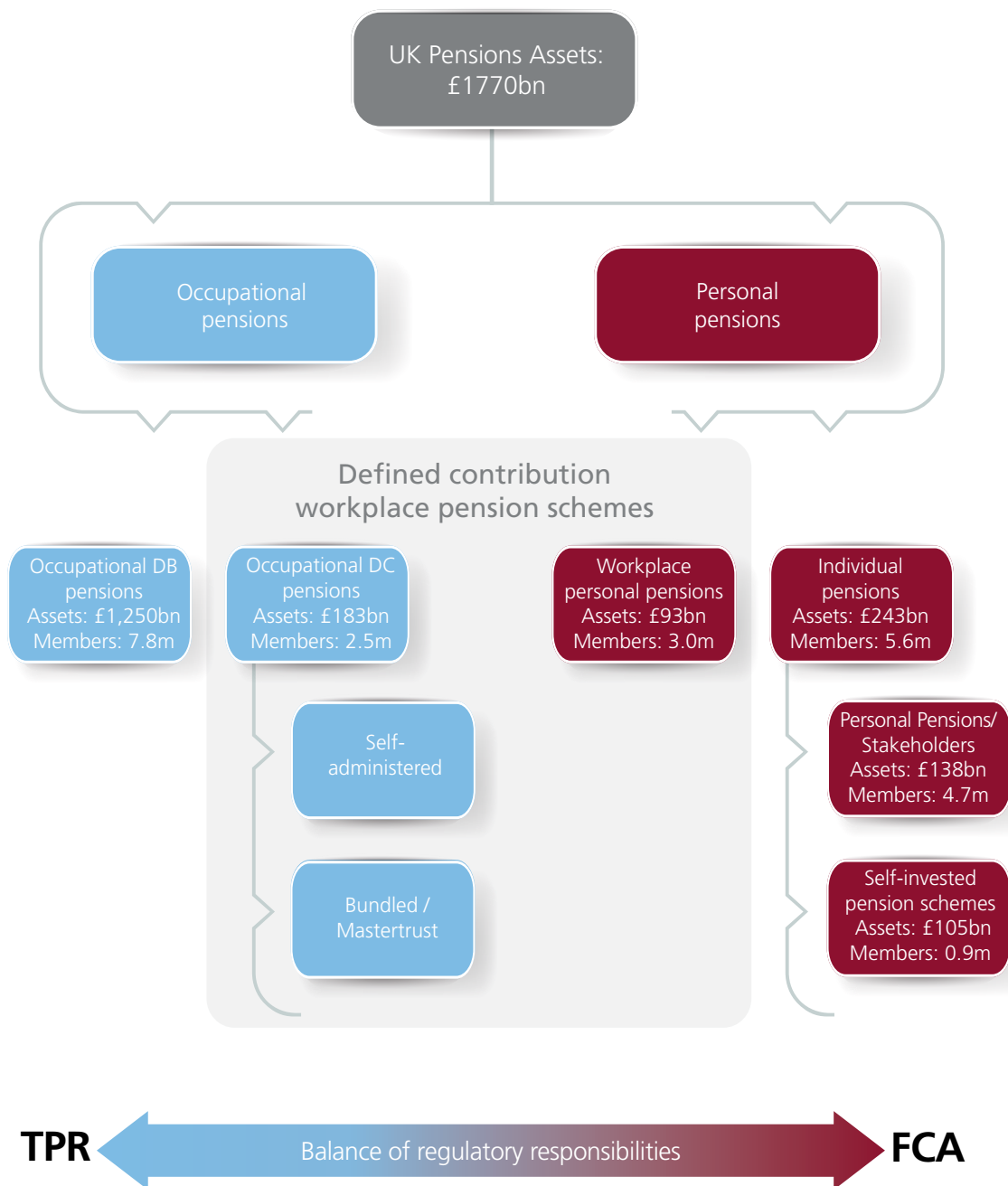
	One-off		Ongoing	
	Range	Central estimate	Range	Central estimate
Firm costs (£m)	0.8-10.9	2.0	5-13.8	8.5
FCA costs (£m)	Negligible	0.0	Negligible	0.0
Benefits (£m)			10-15.0*	10.0

*Benefits are expected to rise significantly beyond this level over time

The market and affected firms

3. Chart 1 below illustrates the size of the overall UK pensions market in 2012. The market for workplace personal pensions, which is the relevant market for IGCs, had £93bn in assets under management and 3 million members.
4. FCA data from 2013 suggested that 21 firms, or groups of firms, set up workplace personal pensions in the UK in that year. These firms will be affected by the proposed new rules outlined in this consultation. The total premiums received by these firms totalled approximately £2bn in that year. There are likely to be a number of other firms who operate group pension schemes in the market, despite making no sales in 2013. We estimate that there may be as many as ten further groups in this category.

Chart 1: Current UK pensions market (figures 2012, ONS)¹⁰



¹⁰ Excluding DC decumulation assets; total UK pension assets including DC decumulation assets equates to c.£1960bn

Market failure analysis

5. In its 2013 market study report¹¹, the Office of Fair Trading concluded that the market for defined contribution workplace pensions is not working well and that competition alone cannot be relied upon to drive value for money for all scheme members in the market. The buyer side of the market was one of the weakest that the OFT had analysed in recent years.
6. As a consequence, we believe that the operators of workplace pension schemes (both trust and contract based) are not under sufficient competitive pressure to deliver good value for money pensions or to ensure that pensions remain good value over time.
7. To illustrate the potential for poor value for money, the OFT noted that around £30bn of contract and bundled trust-based assets (approximately one quarter of total assets in workplace pension schemes) remain in schemes with charges at risk of being poor value for money. The average annual management charge (AMC) on schemes sold before 2001 (so-called “legacy schemes”) was around one-quarter to one-third higher than on those sold after April 2001.
8. There are a number of features of the market that contribute to significant buyer side weaknesses and market failure. The key features include:
 - Product complexity and information asymmetries
 - A lack of alignment of incentives between employer and employee, and
 - Barriers to switching pension provider.
9. We consider each of these key features in turn below.

Product complexity and information asymmetries¹²

10. There is evidence that customers (employers and scheme members) do not sufficiently engage with workplace pension products.¹³ In particular, scheme members rarely scrutinise fees charged to their fund, finding it difficult to assess the impact of charges on their net returns. This is due to a number of factors:
 - pensions are complicated products,¹⁴ both their costs and quality are hard to observe and outcomes may not be apparent for some years, making decision making on value for money very difficult¹⁵
 - the complexity of charging structures makes it challenging for employers/scheme members to compare offerings across pension providers effectively

11 *Defined contribution workplace pension market study* – <http://webarchive.nationalarchives.gov.uk/20131101164215/http://www.of.gov.uk/OFTwork/markets-work/pensions/>

12 More detail on information asymmetry is included in FCA’s Occasional Paper 1 – <http://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-1.pdf>

13 Only one third of employers are aware that members paid any charges on the pension – see https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193451/rrep804.pdf

14 There is evidence that often when faced with complex decisions, individuals tend to procrastinate making a decision or accept the status quo, where decisions are made, they are often aided by simple rules that result in sub-optimal outcomes – see Occasional Paper 1: Applying behavioural economics at the FCA

15 Occasional Paper 1: Applying behavioural economics at the FCA describes this as ‘present bias’ see page 17

- the lack of transparency of charges, and of transaction costs in particular, makes it difficult for employers/scheme members to assess whether funds are good value for money
 - scheme members may rely on the employer to ensure value for money, despite employer incentives often not being aligned with those of the individual scheme members (see below), and
 - scheme members are unable to switch to another, better value provider without losing employer contributions
- 11.** The product complexity and information asymmetries contribute to the potential for poor market outcomes. These outcomes include scheme members being subject to higher charges (which impact on net returns) and worse service standards (e.g. financial transactions not being processed promptly and accurately) compared to a market which worked well.¹⁶

Lack of alignment of incentives

- 12.** The role of the scheme members' employer is to choose an appropriate workplace pension scheme, scrutinise costs and service, and switch provider where value for money is poor. Employers have an incentive to minimise the costs that they bear, including the cost of setting up the scheme and some ongoing administration costs. However, employers do not have sufficient incentive to ensure that the ongoing charges falling on scheme members (both active and deferred members) are minimised.
- 13.** In addition, a lack of transparency of costs and charges means that scheme members may not be aware of the levels of charges and/or their impact on their future pension pot and may not sufficiently scrutinise decisions, made on their behalf by employers, that affect the charges incurred or returns achieved.
- 14.** As a consequence, there is a risk that such charges are excessive (i.e. they do not reflect costs associated with the ongoing costs of running a pension scheme) and that decisions are made that are not in the best interest of scheme members.
- 15.** Further, employers have an incentive to favour current over past employees, with the pension as part of a remuneration package aimed at attracting and retaining staff. Lower charges for existing staff may be subsidised by higher charges for deferred members no longer employed by the firm.

Barriers to switching

- 16.** Employers face significant barriers to switching because of the costs of setting up a new scheme. These costs may include paying for external advice to select an appropriate scheme and the administrative resource required for set up.

¹⁶ http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.offt.gov.uk/shared_offt/market-studies/oft1505

17. Whereas in the past, the cost of advice could be charged against the pension pots of scheme members, the proposed bans on adviser commissions and consultancy charging will prevent this practice. Other initial costs will continue to be absorbed by the employer and/or passed on to current employees, in the form of lower salaries or pension contributions.
18. To the extent that employers bear set up costs, not least of external advice, this will act as a disincentive to switching to a scheme offering better value for money for their employees. Scheme members themselves are generally unable to switch to an alternative and better value pension scheme without losing their employer's contributions.
19. These barriers mean that the threat that employers and/or scheme members may switch pension provider is weak and does not act as a strong constraint on the level of fees or quality of service offered by pension scheme providers.

Cost benefit analysis

20. Our proposals are to introduce IGCs in line with the expectations of the DWP's Command Paper, to provide a sufficiently resourced (in expertise and experience) consumer voice to challenge providers where issues arise that threaten value for money. In trust-based schemes, regulated by TPR, this consumer representation is present in the guise of the trustees, who have a fiduciary duty to scheme members (although actual effectiveness inevitably varies). IGCs should replicate some of these features already present in the trust-based world.
21. When assessing the costs and benefits of our proposed intervention, we consider these against the case were no intervention to take place (the baseline). We note that, in the absence of intervention, the DWP's Command Paper outlined a number of other proposals aimed at ensuring the quality of schemes used for automatic enrolment.

Nature of benefits

22. We expect IGCs to mitigate the negative impact on the market of the buyer side weaknesses and market failures summarised above. In particular, we expect IGCs to hold firms to account on the value for money delivered by their schemes and to ensure that value for money, relative to other providers, does not deteriorate over time. We believe that this will result in affected firms taking action to minimise costs where possible and deliver pension products that more closely match scheme member needs. We expect our proposals to achieve the following outcomes:
 - greater consumer confidence in pension savings, increasing the savings rate, preparedness for retirement and retirement income
 - higher pension saving, increasing industry income
 - greater employer confidence in selecting and maintaining a workplace personal pension scheme
 - more information for advisers to employers to allow them to improve their recommendations
 - pressure on fund managers to reduce transaction costs, increasing investment returns to individuals
 - increased competition, as IGC reports improve the transparency of scheme information heighten the pressure on employers to move away from poor value schemes – this, in turn, will provide firms with incentives to innovate, provide improved service, and lower fees

- pressure on providers to reduce charges and/or improve service quality, or move scheme members, where outdated pension schemes no longer reflect best practice or value for money
 - pressure on providers to avoid “levelling up” to the 75 basis point cap on default funds
 - pressure on providers to remove costly extras that add cost with little practical benefit to the majority of scheme members
 - better designed pension schemes to help scheme members choose funds that match their risk tolerance, and
 - a reduction in charging practices that may discriminate against less active members or against past relative to current employees.
- 23.** Inevitably, providing a robust estimate of the value of benefits is challenging, particularly when looking at benefits such as increased consumer confidence. We have focused on considering the impact of potential falls in charges, since these benefits are more readily quantifiable. However, we consider that the other benefits, while less practicable to estimate, are likely to be at least as significant. While IGCs will consider in particular default funds in qualifying schemes, we expect benefits across the whole of the workplace personal pensions market. These wider benefits would occur both from IGCs considering better value for money and appropriateness from funds, but also from changes to acceptable practice emerging from IGCs’ analyses.
- Scale of benefits**
- 24.** Given the size of this market, and the expectation that it will grow significantly over the next ten years, the potential scale of detriment to end-investors, absent IGCs, could be large and widespread. For example, assets held in defined contribution funds are expected to increase six fold over the coming decade.¹⁷ As summarised above, there is likely to be significant detriment to scheme members as a result of the buyer side weaknesses and market failures. In particular, scheme members could be subject to higher charges, poorer service and more limited choices.
- 25.** To illustrate the potential scale of the benefits, if charges reduced by as little as one basis point as a result of the IGCs, averaged across all assets held (where total charges on default funds will be capped at 75 basis points), the potential cost savings to scheme members could be around £10m per year¹⁸, based on currently affected assets under management. A 1.5 basis point reduction would deliver savings of £15m per year.
- 26.** Going forward, with forecast growth in assets under management (AUM) of 11.6 per cent per annum (see Spence Johnson), and assuming an average one basis point reduction in charges across all assets held, this could result in annual savings to scheme members of as much as £50m¹⁹ per annum. These figures illustrate the relatively small change in charges needed, as a result of IGCs, to generate significant benefits from charges alone. If IGCs have a larger impact on charges, savings would be even higher.

¹⁷ Spence Johnson, Broad Brush, Number 14, December 2012

¹⁸ This is based on £100bn funds under management (a cautious assumption given IGCs will commence in 2015) and an assumed average current charge rate of 50 basis points (where one basis point is 0.01%). This assumes the presence of IGCs maintains this benefit and in the absence the charge rate would return to its previous level. This impact on charge rates – averaged across funds does not seem an unreasonable expected level of saving. IMA data 2012, Latest available data (2012) shows that total funds under management for workplace personal pensions were £93bn.

¹⁹ If affected AUM increase to £500bn

27. Given the range of wider benefits expected from IGCs, we believe actual benefits will be substantially higher, which further strengthens our case for the introduction of IGCs. Given that these estimated benefits exceed our expected incremental compliance costs to firms, we do not consider it proportionate to provide an estimate of the other benefits.

Benefits to the FCA

28. We expect to see some benefits arising from the presence of IGCs improving the consumer focus of providers (thus reducing the need for supervision) and improving the information available to supervisors on the firms they are supervising.

Direct costs to the FCA

29. We expect the direct costs to the FCA to be low. The supervision of IGCs would be within our existing supervisory framework while we monitor their set up and implementation. There may be some additional costs to the FCA, in particular if we undertake a thematic review of IGCs or have direct discussions with IGCs. Any enforcement action on firms would result in further costs but would be in the context of our overall enforcement budget.

Compliance costs to firms

30. We estimate that the one-off incremental costs to firms that require IGCs to comply with our proposed rules could be between £0.8m and £10.9m in aggregate, with ongoing costs of around £5m to £13.8m.²⁰ Costs vary significantly in the start-up phase, with some firms estimating significant initial recruitment costs. Ongoing costs are driven by a mixture of external advice costs and providers' own costs in supporting IGCs. The estimates we have received have given a wide range of potential costs.
31. However, we expect industry costs for those setting up IGCs to be towards the lower bounds of these estimates (i.e. one-off costs of £1.5m and ongoing costs of £6.5m) for a number of reasons. We expect providers to benefit from efficiency savings through using data from existing sources, leveraging benefits of scale, grouping services through external providers (some may operate smaller IGCs) and by managing external costs. Furthermore, the principles-based approach adopted by the FCA (e.g. allowing greater flexibility over the recruitment process) is likely to significantly lower the cost of the IGCs when compared with a more prescriptive approach.
32. Smaller providers are likely to operate governance advisory arrangements (GAA) with a range of less costly alternative arrangements. While we do not have specific data, we estimate the costs could be between one third and one half of those faced by larger providers. Set-up costs involved in contracting out the GAA function would be minimal, while ongoing annual costs might be expected to be in the range of £80,000 to £295,000. Translating this to total market costs for those operating GAAs would equate to £1.2m to £4.4m per annum. Again, as with larger firms, we would expect the majority of those operating GAAs to have costs towards the lower end of our estimates, for ongoing industry costs of £2m.
33. The types and per firm amounts of incremental compliance costs are summarised in the table below. We expect most firms will incur costs in line with the lower-end estimates. However, where IGCs are dealing with specific challenges in securing value for money, more IGC member time is likely to be needed, the firm may need to provide more support, and external expertise may need to be procured. In such cases, the higher-end estimates may be more appropriate and we would expect the benefits to be proportionately higher.

²⁰ Assuming that large providers will introduce a full IGC and a further 15 a GAA.

Table 2: Estimated incremental compliance costs per firm²¹

Type of cost	Larger providers (16 firms)		Smaller providers (15 firms)	
	One-off costs per firm	On-going costs (annual) per firm	One-off costs per firm	On-going costs (annual) per firm
Costs of setting up an IGC	£35,000 - £465,000	N/A	Minimal	N/A
Five members, three independent including an independent chair	N/A	£75,000-£155,000	N/A	N/A
Costs of purchasing external advice necessary for committee business	N/A	£30,000 - £140,000	N/A	£70,000-£170,000
Costs faced by the provider in working with the IGC and supplying necessary information	N/A	£30,000-£250,000	N/A	£10,000-£125,000

Source: 5 firms representative of larger providers

The impact on the market

34. We expect the establishment of IGCs to lead to a market that better matches the pensions provided by the market with the needs of consumers. Given that IGCs were introduced to address buyer side weakness in the market, we do not expect the IGCs to have a direct impact on consumer behaviour. However, it is possible that successful IGCs will have an indirect impact on the market. In particular:

- lower charges should lead to higher savings rates in pension schemes, and
- better matching of investment funds to the risk profile of scheme members should lead to better matching of investment outcomes, again encouraging increased savings rates in pension schemes.

²¹ We contacted a range of providers who attended a workshop at the FCA on 30 April. We asked them to estimate the costs of running an IGC based on the model included in the DWP's Command Paper. These figures were then adjusted to take account of the likely smaller size of IGCs in practice.

Annex 2: Compatibility statement

Compatibility with the FCA's general duties

1. We are required by section 138I(2)(d) of the Financial Services and Markets Act 2000 (FSMA) to explain why we believe our proposed rules are compatible with our strategic objective, advance one or more of our operational objectives and have regard to the regulatory principles in section 3B of FSMA. We are also required by section 138K(2) of FSMA to state whether the proposed rules will have a significantly different impact on mutual societies, as opposed to other authorised persons.
2. This annex also sets out our view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way that promotes effective competition in the interests of consumers (section 1B(4) of FSMA). This duty applies in so far as promoting competition is compatible with advancing our consumer protection and/or integrity objectives.

Compatibility with the FCA's regulatory objectives

3. The proposals in this consultation paper are compatible with our strategic objective of ensuring that the relevant markets function well, since they are designed to ensure that scheme members' interests are effectively represented within firms.
 4. Our proposals are intended to advance of our operational objective of consumer protection. IGCs will protect the interests of relevant consumers by acting on their behalf in assessing and raising concerns about the value for money of workplace personal pension schemes. This will help counter low levels of consumer understanding and engagement with how their pension assets are managed and invested.
 5. Our proposals are also intended to advance our operational objective of promoting effective competition in the interests of consumers. IGCs will report on the value for money of their firm's schemes. This will increase the amount of information available to employers and employees and may improve competition between firms providing workplace personal pension schemes.
 6. In preparing the proposals set out in this consultation, we have had regard to the regulatory principles set out in section 3B FSMA.
- The need to use our resources in the most efficient and economical way**
7. Our proposed approach is to capture IGCs within our existing supervisory framework while we monitor their set up and implementation. We believe that the resource costs to the FCA are small compared with the benefits of responding to concerns raised by IGCs.

The principle that a burden or restriction should be proportionate to the benefits

8. We believe that the additional costs to the sector of establishing and maintaining IGCs are proportionate to the benefits. This consultation paper makes provision for a proportionate alternative approach for firms with smaller and less complex workplace personal pension schemes. The cost-benefit analysis set out in Annex 1 provides more detail.

The desirability of sustainable growth in the economy of the United Kingdom in the medium or long term

9. Our proposals support the government's policy objective of people saving more for their retirement and thereby relieving the tax burden on future generations. Automatic enrolment is likely to drive significant growth in pension assets under management in the medium to long term, which will be available to invest in the UK economy. The success of automatic enrolment depends on consumers being confident in saving for their pension which, in turn, depends on the ongoing value for money delivered by the pension scheme into which they invest.

The general principle that consumers should take responsibility for their decisions

10. While we believe that consumers should take responsibility for their decisions, in this instance consumers may be automatically enrolled into the default fund of their employer's scheme without making any decision. In addition, information asymmetries and the complexity of assessing value for money may deter consumers from making choices about how their pension assets are invested.
11. Since many scheme members are unlikely to be willing or able to take responsibility for decisions about how their pension assets are managed and invested, our proposals are for independent bodies that will act in their interests.

The responsibilities of senior management

12. Our proposals place obligations on the senior management and governing bodies of firms to ensure that IGCs are effective and act independently in the interests of members. We consider these obligations necessary to ensure that the interests of policyholders are properly represented within firms.

The desirability of exercising our functions in a way that recognises differences in the nature and objectives of businesses carried on by different persons

13. We recognise that different firms may operate workplace personal pension schemes with very different characteristics. Therefore, our proposals seek to give IGCs the flexibility to assess value for money in the way most appropriate to the characteristics of the workplace personal pension schemes operated by the firm. We have developed GAAs as a proportionate alternative approach, recognising that some firms may have smaller and less complex schemes.

The desirability of publishing information relating to persons

14. We believe that our proposals do not undermine this principle. Our proposed rules would promote greater transparency of information and provide an independent view on value for money. In addition, our proposals give IGCs the power to make public, to relevant scheme members and employers, their concerns on particular value for money issues. However, our proposals do not require IGCs or the firm to publish, or make publicly available, confidential or commercially sensitive information.

The principle that we should exercise our functions as transparently as possible

15. IGCs have been widely discussed. Our proposed rules broadly follow the proposals in the DWP's Command Paper published in March 2014. During the course of developing our proposed rules we have met with firms and held an industry workshop on IGCs in April 2014. We have also met with consumer groups and other interested stakeholders. We have taken into account input from stakeholders in advance of our formal consultation on our proposed rules.

Compatibility with the duty to promote effective competition in the interests of consumers

16. In preparing the proposals as set out in this consultation, we have had regard to our duty to promote effective competition in the interests of consumers under section 1B(4) FSMA. This duty applies in so far as promoting competition is compatible with advancing our consumer protection and/or integrity objectives.
17. The OFT market study concluded that the buyer side of the market was one of the weakest that they have encountered in recent years. Further, automatic enrolment will bring disengaged and potentially vulnerable consumers into pension saving for the first time. Many of these consumers will not express any choice in how their pension savings are managed and invested.
18. Our proposals for IGCs are designed to ensure that the interests of relevant consumers are protected. In addition our proposals will increase the amount of information available to employers and their advisers, and to interested scheme members. We believe that over time this will result in more engaged and informed customers, promoting more effective competition between firms in the interests of consumers.
19. Our cost-benefit analysis in Annex 1 of this consultation paper provides further explanation on how our proposals may impact on effective competition.

Expected effect on mutual societies

20. Section 138K of FSMA requires us to state whether, in our opinion, our proposed rules have a significantly different impact on authorised persons who are mutual societies, in comparison with other authorised persons.
21. We see no reason why our proposed rules would impact a firm differently based on the structure of the provider. However, mutual societies tend to be smaller, which means that the cost of establishing and maintaining an IGC for mutual societies that operate workplace personal pension schemes may be high relative to scheme assets under management. As such, our proposed rules allow for a proportionate alternative approach, available to all firms with smaller and less complex schemes.

Annex 3: List of questions

Overview

- Q1:** We would welcome views on the likely equality and diversity impacts of the proposed rules.

Requirement to establish an IGC

- Q2:** Do you agree that deferred members of workplace personal pension schemes should be within the mandatory scope of IGCs?
- Q3:** Do you agree that individual personal pensions, other than those that originated as workplace personal pensions, should not be in the mandatory scope of IGCs?
- Q4:** Do you agree that individual personal pensions should not be in the mandatory scope of IGCs even where the employer contributes or facilitates payments?
- Q5:** Do you agree with our proposals for which firms will be required to establish and maintain an IGC?
- Q6:** Do you agree that IGCs may be established at a group level?

Establishing and maintain an IGC

- Q7:** Do you agree that an IGC must have a majority of members independent of the firm and that the IGC Chair must always be independent?
- Q8:** Do you agree that an IGC should have at least five members?
- Q9:** Do you agree with our proposed definition of independence that would allow trustees of a firm's mastertrust to be independent IGC members?

- Q10:** Do you agree that we should not require firms to indemnify IGC members?
- Q11:** Do you agree that members of the IGC, including the IGC Chair, should not be approved persons at this time?
- Q12:** Do you agree that we should require firms to recruit independent IGC members through an open and transparent recruitment process?
- Q13:** We would welcome views on the proposed duration of appointment of IGC members.
- Q14:** Do you agree that we should permit the appointment of corporate persons to IGCs, including as the IGC Chair?
- Q15:** Do you agree that there should be no restriction on the duration of a corporate appointment?

Terms of reference for an IGC

- Q16:** Do you agree that IGCs should consider in particular the value for money received by individuals enrolled in default funds?
- Q17:** Do you agree that, at a minimum, IGCs must assess whether the characteristics and net performance of all investment strategies are regularly reviewed by the firm?
- Q18:** Do you agree that, rather than mandating a particular approach, we should allow individual IGCs to determine how best to assess value for money?
- Q19:** Do you agree that IGCs should be required, at a minimum, to review the three aspects of scheme quality proposed, and should consider other aspects as appropriate?
- Q20:** Do you agree that IGCs should consider all costs and charges, as proposed? If not, what would you suggest?
- Q21:** We would welcome views on how best to improve the disclosure of all costs and charges, and how we could transpose the industry standards for authorised funds to pensions.
- Q22:** Do you agree that IGCs should be able to escalate concerns directly to the FCA, alert relevant scheme members and employers, and make their concerns public?

- Q23:** Do you agree that the IGC Chair should be required to produce an annual report and that the firm should be required to make this report publicly available?
- Q24:** We would welcome views on where IGCs should focus their attention.

Ensuring effectiveness of IGCs

- Q25:** Do you agree that we should place a duty on the firm to provide the IGC with all information that it reasonably requests for the purposes of carrying out its duties?
- Q26:** Do you agree that we should place a duty on the firm to provide sufficient resources to the IGC as are reasonably necessary for it to carry out its duties?
- Q27:** We would welcome views on possible arrangements to ensure that member views are directly represented to the IGC.
- Q28:** Do you agree that the firm should make the IGC's annual report and terms of reference publicly available?
- Q29:** Do you agree that we should place a duty on the firm to address concerns raised by the IGC or explain to the IGC why it does not intend to do so?

Proportionate alternative arrangements

- Q30:** Do you agree that GAAs should be allowed as an alternative to IGCs for firms with smaller and less complex workplace personal pension schemes?
- Q31:** Do you agree with our proposals for the type of firms that can use GAAs?

Appendix 1: Draft Handbook text

**PERSONAL PENSION SCHEMES (INDEPENDENT GOVERNANCE
COMMITTEES) INSTRUMENT 2014**

Powers exercised

- A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137A (General rule-making power);
 - (2) section 137T (General supplementary powers); and
 - (3) section 139A (Guidance).
- B. The rule-making powers listed above are specified for the purpose of section 138G (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on [*date*].

Amendments to the FCA Handbook

- D. The Glossary is amended in accordance with Annex A to this instrument.
- E. The Conduct of Business sourcebook (COBS) is amended in accordance with Annex B to this instrument.

Citation

- F. This instrument may be cited as the Personal Pension Schemes (Independent Governance Committees) Instrument 2014.

By order of the Board of the Financial Conduct Authority
[*date*]

Annex A

Amendments to the Glossary of definitions

In this annex, underlining indicates new text, unless otherwise stated.

Insert the following new definitions in the appropriate alphabetical place. The text is not underlined.

governance advisory arrangement (in COBS 19.5) an arrangement between a *firm* and a third party under which the third party establishes a committee to represent the interests of *relevant policyholders* in the *firm's relevant schemes*.

IGC (in COBS 19.5) an independent governance committee established by a *firm* with terms of reference which satisfy COBS 19.5.5R whose purpose is, in summary, to represent the interests of *relevant policyholders* in the *firm's relevant schemes*.

relevant policyholder (in COBS 19.5) a member of a *relevant scheme* who is or has been a worker entitled to have contributions paid by or on behalf of his employer in respect of that *relevant scheme*.

‘Worker’ has the same meaning as in section 88 of the Pensions Act 2008, that is, in summary, an individual who has entered into or works under (a) a contract of employment, or (b) any other contract by which the individual undertakes to do work or perform services personally for another party to the contract.

Amend the following as shown.

relevant scheme ...

(3) (in COBS 19.5) a *personal pension scheme* or *stakeholder pension scheme* in respect of which direct payment arrangements are, or have been, in place, under which contributions have been paid in respect of two or more *employees* of the same employer.

‘Direct payment arrangements’ has the same meaning as in section 111A of the Pension Schemes Act 1993, that is, arrangements under which contributions fall to be paid by or on behalf of the employer towards the scheme (a) on the employer’s own account (but in respect of the employee); or (b) on behalf of the employee out of deductions from the employee’s earnings.

Annex B

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, all the text is new and is not underlined

In COBS 19 (Pensions supplementary provisions) insert the following new section after COBS 19.4.

19.5 Independent governance committees (IGCs)

Application

- 19.5.1 R This section applies to a *firm* which operates *relevant schemes* in which there are at least two *relevant policyholders*.

Requirement to establish an IGC

- 19.5.2 R (1) Subject to COBS 19.5.3R, a *firm* must establish an *IGC*.
- (2) This *rule* does not apply to a *firm* ('Firm A') if another *firm* in Firm A's *group* has made arrangements under this section for an *IGC* to cover *relevant schemes* operated by Firm A.

Governance Advisory Arrangements

- 19.5.3 R (1) If a *firm* considers it appropriate, having regard to the size, nature and complexity of the *relevant schemes* it operates, it may establish a *governance advisory arrangement* instead of an *IGC*.
- (2) Where a *firm* has decided to establish a *governance advisory arrangement* rather than an *IGC*, this section, other than COBS 19.5.9R(2), COBS 19.5.9R(3), COBS 19.5.10G, COBS 19.5.11R and COBS 19.5.12G, apply to the *firm* as if references to the *IGC* are read as applying to the *governance advisory arrangement*.
- (3) A *firm* must establish a *governance advisory arrangement* on terms that secure the independence of the *governance advisory arrangement* and its Chair from the *firm*.
- 19.5.4 G (1) *Firms* with large or complex *relevant schemes* should establish an *IGC*. For the purposes of this section, a *firm* may determine whether it has large *relevant schemes* by reference to:
- (a) the number of *relevant policyholders* in *relevant schemes*;
- (b) the funds under management in *relevant schemes*; and
- (c) the number of employers contributing to *relevant schemes*.
- (2) Examples of features that might indicate complex schemes include:

- (a) schemes that are operated on multiple IT systems;
- (b) schemes that have multiple charging structures;
- (c) schemes that offer a *with-profits fund*; and
- (d) the *firm* offers *relevant policyholders* access to investment funds it operates or which are operated by an entity with the same ownership.

Terms of reference for an IGC

- 19.5.5 R A *firm* must include, as a minimum, the following requirements in its terms of reference for an *IGC*:
- (1) the *IGC* will act in the interests of *relevant policyholders*;
 - (2) the *IGC* will assess the ongoing value for money for *relevant policyholders* delivered by *relevant schemes* particularly, though not exclusively, through assessing:
 - (a) whether the *firm's* default investment strategies are designed in the interests of *relevant policyholders* with a clear statement of aims, objective and structure appropriate for those *relevant policyholders*;
 - (b) whether the characteristics and net performance of investment strategies are regularly reviewed by the *firm* to ensure alignment with the interests of *relevant policyholders* and action taken to make any necessary changes;
 - (c) whether core scheme financial transactions are processed promptly and accurately;
 - (d) the levels of charges borne by *relevant policyholders*; and
 - (e) the direct and indirect costs incurred in relation to transactions and other activities in managing and investing the pension savings of *relevant policyholders*;
 - (3) the *IGC* will raise with the *firm's governing body* any concerns it may have in relation to the value for money offered to *relevant policyholders* by a *relevant scheme*;
 - (4) the *IGC* will escalate concerns as appropriate where the *firm* has not, in the *IGC's* opinion, addressed those concerns satisfactorily or at all;
 - (5) the Chair of the *IGC* will produce an annual report setting out:
 - (a) the *IGC's* opinion on the value for money delivered by *relevant schemes*, particularly against the matters listed under

- (2);
- (b) how the *IGC* has considered *relevant policyholders'* interests;
 - (c) any concerns raised by the *IGC* with the *firm's governing body* and the response received to those concerns;
 - (d) whether the membership of the *IGC* has sufficient expertise, experience and independence to act in *relevant policyholders'* interests;
 - (e) each independent member of the *IGC*, together with confirmation that the *IGC* considers these members to be independent, having taken into account those matters set out at *COBS 19.5.12G*;
 - (f) the arrangements put in place by the *firm* to ensure that the views of *relevant policyholders* are directly represented to the *IGC*.
- 19.5.6 G (1) An *IGC* is expected to act in the interests of *relevant policyholders* both individually and collectively. Where there is the potential for conflict between individual and collective interests, the *IGC* should manage this conflict effectively.
- (2) The primary focus of an *IGC* should be the interests of *relevant policyholders*. Should a *firm* ask an *IGC* to consider the interests of other members, the *firm* should provide additional resources and support to the *IGC* such that the *IGC's* ability to act in the interests of *relevant policyholders* is not compromised.
- (3) Where an *IGC* is unable to obtain from a *firm*, and ultimately from any other person providing relevant services, the information it requires in order to assess the matters in *COBS 19.5.5R(2)*, the *IGC* should explain in the annual report why it has been unable to obtain the information and how it will be granted access to that information in the future.
- (4) If, having raised concerns with the *firm's governing body* about the value for money offered to *relevant policyholders* by a *relevant scheme*, the *IGC* is not satisfied with the response of the *firm's governing body*, the *IGC Chair* may escalate concerns to the *FCA* if that would be appropriate. The *IGC* may also alert *relevant policyholders* and employers and make its concerns public.
- (5) The *IGC Chair* should raise with the *firm's governing body* any concerns that the *IGC* has about the information or resources that the *firm* provides or about the arrangements that the *firm* puts in place to ensure that the views of *relevant policyholders* are directly represented to the *IGC*. If the *IGC* is not satisfied with the response of the *firm's governing body*, the *IGC Chair* may escalate its

concerns to the *FCA* if appropriate. The *IGC* may also make its concerns public.

- (6) An *IGC* should assess whether all the investment choices available to *relevant policyholders*, including default options, are regularly reviewed to ensure alignment with the interests of *relevant policyholders*.

Duties of firms in relation to an *IGC*

- 19.5.7 R A *firm* must:
- (1) take reasonable steps to ensure that the *IGC* acts and continues to act in accordance with its terms of reference;
 - (2) take reasonable steps to provide the *IGC* with all information reasonably requested by the *IGC* for the purposes of carrying out its role;
 - (3) provide the *IGC* with sufficient resources as are reasonably necessary to allow it to carry out its role independently;
 - (4) put arrangements in place to ensure that the views of *relevant policyholders* can be directly represented to the *IGC*;
 - (5) take reasonable steps to address any concerns raised by the *IGC* under its terms of reference;
 - (6) provide written reasons to the *IGC* as to why it has decided to depart in any material way from any advice or recommendations made by the *IGC* to address any concerns it has raised;
 - (7) take all necessary steps to facilitate the escalation of concerns by the *IGC* under *COBS* 19.5.5R(4) and *COBS* 19.5.6G(5); and
 - (8) make the terms of reference and the annual report of the *IGC* publicly available.
- 19.5.8 G
- (1) A *firm* should fund independent advice to the *IGC* if this is necessary and proportionate.
 - (2) A *firm* should not unreasonably withhold from the *IGC* information that would enable the *IGC* to carry out a comprehensive assessment of value for money.
 - (3) A *firm* should ensure arrangements are in place for sharing confidential and commercially sensitive information with the *IGC*.
 - (4) A *firm* should provide the *IGC* with information on the costs incurred in relation to transactions and other activities in managing and investing the assets of *relevant schemes*, as well as information about costs and charges more broadly, so that the *IGC* can properly

assess the value for money of *relevant schemes* and the funds held within these. A *firm* should use best endeavours to obtain information about the costs incurred in relation to transactions and other activities in managing and investing the assets of *relevant schemes* so that it can provide this information to the *IGC*.

- (5) If a *firm* asks an *IGC* to take on responsibilities in addition to those set out in *COBS 19.5.5R*, the *firm* should provide additional resources and support to the *IGC* such that its ability to fulfil its responsibilities as set out in *COBS 19.5.5R* is not compromised.
- (6) A *firm* should provide secretarial and other administrative support to the *IGC*. The nature of the support, including how it is provided and by whom, should not conflict with the *IGC's* ability to act independently of the *firm*.
- (7) A *firm* can make the terms of reference for the *IGC* and the annual report of the *IGC* publicly available by placing them on its website and by providing them on request to *relevant policyholders* and their employers.

Appointment of IGC members

- 19.5.9 R
- (1) A *firm* must take reasonable steps to ensure that the *IGC* has sufficient collective expertise and experience to be able to make judgments on the value for money of *relevant schemes*.
 - (2) A *firm* must recruit independent *IGC* members through an open and transparent recruitment process.
 - (3) A *firm* must appoint members to the *IGC* so that:
 - (a) the *IGC* consists of at least five members, including an independent Chair and a majority of independent members;
 - (b) *IGC* members are bound by appropriate contracts which reflect the terms of reference in *COBS 19.5.5R*, and on such terms as to secure the independence of independent members;
 - (c) independent *IGC* members who are individuals are appointed for fixed terms of no longer than five years, with a cumulative maximum duration of ten years;
 - (d) individuals acting as the representative of an independent corporate member are appointed to the *IGC* for a maximum duration of ten years;
 - (e) independent *IGC* members who are individuals, including those representing independent corporate members, are not eligible for reappointment to the *IGC* until five years have elapsed, after having served on the *firm's IGC* for the

maximum duration of ten years;

- (f) appointments to the *IGC* are managed in such a way that continuity in terms of expertise and experience of the *IGC* is maintained.

- 19.5.10 G (1) An individual may serve on more than one *IGC*.
- (2) A *firm* should replace any vacancies that arise within *IGCs* as soon as possible and in any event within six months.
- (3) A *firm* should involve the *IGC* Chair in the appointment of other members, both independent members and employees of the *firm*.
- (4) A *firm* should consider indemnifying *IGC* members against any liabilities incurred while fulfilling their duties as *IGC* members.

IGC members who are independent

- 19.5.11 R The *firm*, in appointing independent *IGC* members, must determine whether such a member is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, that member's judgment.
- 19.5.12 G (1) An *IGC* member is unlikely to be considered independent if any of the following circumstances exist:
- (a) the individual is an *employee* of the *firm* or of another company within the *firm's group* or paid by them for any other role other than as *IGC* member, including participating in the *firm's* share option or performance related pay scheme;
- (b) the individual has been an *employee* of the *firm* or of another company within the *firm's group* within the five years preceding his appointment to the *IGC*;
- (c) the individual has, or has had within the three years preceding his appointment, a material business relationship of any description with the *firm* or with another company within the *firm's group*, either directly or indirectly.
- (2) A *firm* may appoint a corporate person to an *IGC*, including as Chair. The corporate member should notify the *firm* of the individual who will act as the member's representative on the *IGC*. A *firm* should consider the circumstances of a corporate *IGC* member and any representative of the corporate member with the objective of ensuring that any potential conflicts of interest are managed effectively so that any conflicts do not affect the corporate *IGC* member's ability to represent the interests of *relevant policyholders*.
- (3) There may be benefits to an independent *IGC* member also being a trustee of a mastertrust, should the *firm* or another company within

the *firm's group* operate a mastertrust. If such circumstances exist, an individual or a corporate member might still be suitable to be an independent *IGC* member.

- (4) A *firm* should review on a regular basis whether its independent *IGC* members continue to be independent and take appropriate action if it considers that they are not.

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