# The governance revolution

Proactive governance as the game-changer in the new era of pension provision

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The considered choice of master trust

# Power to the people

## Why the new industry standard should focus on enhancing, rather than simply protecting, member outcomes

We live in the age of creative disruption. Pension provision is set to be transformed by radical innovation in the approach to governance. Members of those schemes which embrace this paradigm shift will benefit from greatly improved retirement outcomes.

This revolution is predicated on a powerful idea whose time has come: that effective, proactive and relevant governance, which focuses as much on enhancement as it does on protection, is the critical driver of improved member outcomes and value creation.

It is the keystone of successful and effective pension provision and the much-needed driver of enhanced member outcomes.

Those schemes which invest in and embrace the optimisation of the governance function, placing it at the very heart of the scheme's operation will be at the forefront of tackling the current governance deficit and driving significantly improved member outcomes. These schemes will allocate a significant governance budget and spend that budget as much on improving the member outcome as they will on minimising downside risk.

Good enough is no longer enough when it comes to building the governance framework for a DC pension scheme. Governance can no longer be dismissed as an overhead, an inconvenience or even a step in a sign-off process.

It must be positioned at the very heart of the scheme, driving it forward and constantly seeking improvement. If DC pension provision is going to succeed and deliver the outcomes that the UK population requires then the governance revolution is both timely and essential.

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GOOD ENOUGH IS NO LONGER ENOUGH WHEN IT COMES TO BUILDING THE GOVERNANCE FRAMEWORK FOR A DC PENSION SCHEME

# Betrayal of trust: tackling the governance deficit

ONLY 23% OF PEOPLE SURVEYED TRUSTED LONG-TERM SAVINGS PRODUCTS SUCH AS PENSIONS

Trust is the new battleground in business, finance and pension provision. In an era of fake news, alternative facts and post-truth, confidence in politicians, corporations and institutions – including pension schemes – is being eroded. Savers need confidence that their pensions and retirement savings are safe. However, a recent study by Which? discovered that only 23% of people surveyed trusted long-term savings products such as pensions, compared to 40% who trusted retail banking[i].

Restoring and building trust is therefore a key issue for UK pension schemes which currently have over £2 trillion under management[ii] and which have never really recovered from the damning scandals that first came to light in the 1980s and are still a feature of the pensions landscape. As a society we place our trust in those who have earned it: we trust airline pilots; we trust Amazon. The most trusted professions in the UK are nurses, doctors and teachers – all with trust ratings of well over 90% according to the latest *Ipsos Mori Veracity Index*[iii].

Restoring trust and enhancing reputation is the defining issue for the future success of pension adequacy. In order to achieve adequate pension incomes, scheme members need to increase their personal contributions, supplementing those of their employers. However, they will do so only if they trust the scheme to which they belong.

In the past, the defining issues for pension schemes and providers have been variously; the shift from defined benefit (DB) to defined contribution (DC); scheme membership recruitment (auto enrolment); adequate investment/pot size; and pension freedoms.

However, governance failures and inadequacies have been a key factor in all the challenges that pension provision has faced over the years. Nothing short of a revolution in scheme governance is required now to build the foundation of successful pension provision in the future.

In this paper we argue that the new battleground lies in trust, openness and accountability. Governance is the critical factor in determining a pension scheme's success in providing good member outcomes and is the foundation underpinning everything else.

# Box-ticking versus proactive governance

The pensions industry has undergone a revolution in recent years but the disruption of old models has scarcely touched the sometimes cosy, complacent and cumbersome world of scheme management. We argue that first-class governance – innovative and fit-for-purpose – not only provides effective risk management but is the crucial missing element in delivering superior returns and better outcomes for members.

Governance of occupational pension schemes in the UK is currently characterised by a strong focus on process, rather than people; box-ticking and compliance rather than continuous improvement and value-enhancement. There must be recognition that simply having a board of trustees or obtaining, for example, master trust authorisation doesn't necessarily equate to good member outcomes. Indeed, master trust authorisation risks a deeper obsession with box-ticking and compliance. Schemes must embrace the full potential of proactive governance in order to really add value to members – the vast majority of whom are neither engaged nor equipped to successfully manage their own retirement savings.

The current focus of governance can be considered analogous to health and safety; it is driven by accident prevention and avoiding illness (which are clearly important) rather than on increasing fitness, health and well-being – leading to sub-optimal decisions and behaviours.

We argue that this obsession with procedure and box-ticking should not be at the expense of engaging with the important strategic decisions shaping the long-term success of schemes and providing much needed improvement to member outcomes.

SIMPLY OBTAINING MASTER TRUST AUTHORISATION DOESN'T NECESSARILY EQUATE TO GOOD MEMBER OUTCOMES

# The governance dividend

Corporate governance reform and the introduction of the corporate governance code has had a huge beneficial and transformational impact on the performance and ethical behaviour of UK companies. Principles-based and widely-copied internationally, it has made UK companies world leaders in governance.

It is now more than a quarter of a century since the launch of the UK's first governance code – The Combined Code on Corporate Governance. Its timeliness was emphasised by a series of high-profile corporate scandals around that time including Polly Peck, BCCI, Robert Maxwell's companies, and Guinness.

While the Pensions Regulator has done much to promote and strengthen governance and member protection over recent years, we argue that it is time to take things to the next level.

We advocate an equally rigorous commitment to governance excellence in DC pensions with the promise of a similar beneficial impact on levels of trust and performance in pension schemes.

We now need to focus as much governance effort on enhancement as we do on protection if we are to truly deliver the financial futures which the UK population deserve and aspire to.

Strong proactive governance leads to better decisions and better strategy. This in turn leads to:

- Higher levels of trust amongst members
- Positive innovation and development
- Optimising investment risk budgets and return opportunities
- Reducing and optimising costs
- Improved overall scheme risk management
- Clearer, more helpful and more effective communication and support to members (proactive, understandable, focused, accessible and relevant)
- More rewarding service experience for members
- Better engagement, increased understanding and better decisions in relation to saving and decumulation options
- Greater anticipation of future developments and optimising of responses.

The bottom line: better outcomes for members across every key performance indicator.

Research indicates that schemes with robust governance structures outperform their peers by between 1 and 2 per cent a year[iv]. Another recent study identified that funds which adopt best practice in governance have a performance margin of 2 per cent per annum or more over their benchmarks[v].

WE NOW NEED TO FOCUS AS MUCH GOVERNANCE EFFORT ON ENHANCEMENT AS WE DO ON PROTECTION

# Calibre and composition of governance teams

The governance revolution will transform the selection and composition of trustee boards. Far from being passive sinecures, or a collection of industry grandees, many trustee boards will become active and independent centres of value creation for members.

The most successful sports teams exploit their players' complementary skills and expertise – attack and defence, power and speed, technical control, tactical vision – to outperform at the highest levels. That serves as a model for best practice in governance, ensuring that the board (or team) is greater than the sum of its parts.

An optimised strategic governance team must comprise the following essential skillsets:

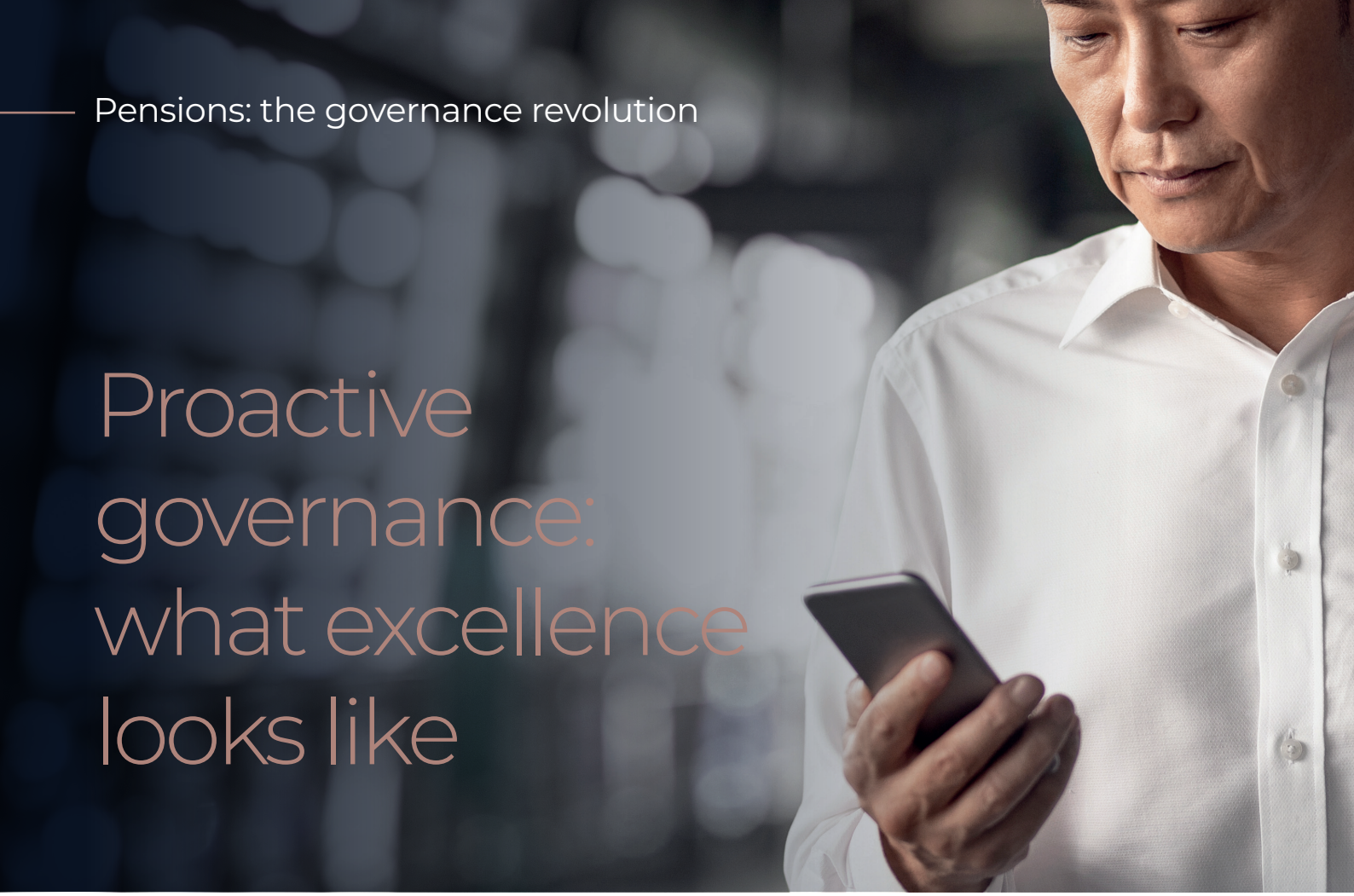
- Leadership expertise
- Strategy formulation and execution oversight
- Commercial management
- Operational skills
- Risk management expertise
- Service excellence know-how
- Investment experience
- Customer engagement experience

A board of trustees must function as a dynamic, cohesive team, not a group of individuals, with a spectrum of essential skills, all adding value in clearly defined ways. The culture should allow robust challenging of viewpoints during discussions, while retaining collective cabinet-style responsibility

- Trustees need expertise and understanding of their role
- They need to be suitably qualified and experienced
- They should be diverse in terms of knowledge and skills.

Trustees should have a clear, mutually-agreed and widely-understood vision, objectives and set of beliefs. They will dedicate significant time and effort to understanding the strategic issues that affect governance, performance and member outcomes. Sub-committees – covering areas such as investment or engagement – will hold joint meetings that integrate different areas of oversight seamlessly and effectively. This creates a holistic approach to investment decision-making and delivering member experience. This approach should be shared across the full spectrum of support and delivery partners and advisers.

A BOARD OF TRUSTEES MUST FUNCTION AS A DYNAMIC, COHESIVE TEAM WITH A SPECTRUM OF ESSENTIAL SKILLS, ALL ADDING VALUE IN CLEARLY DEFINED WAYS



# Proactive governance: what excellence looks like

Simply exhorting trustees to raise their game is not sufficient. It is important that boards gain an appreciation of what is required to drive next-generation level governance. Here we profile each of three core characteristics of successful governance teams – effectiveness; proactivity; and relevance – and provide examples of best practice.

## Effectiveness

Effective governance teams are collegiate, operate as one and are capable of making swift decisions. With an emphasis on dynamism rather than bureaucracy, they maintain continuous oversight of processes and investment performance rather than deferring consideration until the next scheduled quarterly governance meeting. Effective teams ensure that all materials and communications are comprehensive, clear and well-documented.

### Governance examples:

1 The board ensures that all external advisers and service providers are aligned and onboard with the aims of the scheme. They cannot be left to pursue their own agenda.
2 Discussions and meetings are well-structured and focused with a clearly understood objective and required outcome.
3 In the event of any shock to the economy, there will be a mechanism in place to decide immediately on the strategic response.

## Proactivity

The essence of proactive governance is striving constantly to do things better - adhering to absolute standards of excellence rather than merely benchmarking against relative performance. Its perspective on issues is through the front windscreen rather than the rear-view mirror.

The emphasis is on enhancing what already works to make it better rather than merely fixing what is broken. This can be likened to the Japanese concept of kaizen or continuous improvement.

Delivering proactive governance requires:

- An agile and empowered governance team
- A clearly articulated vision of success
- A road map that is shared with all service providers

Apple's iterative approach to excellence is a useful role model. Apple's first iPhone, launched in 2007, worked extremely well. It had a 3.5 inch screen, 2 megapixel camera and did not offer 3G connectivity[vi]. Had Apple adopted a typical pensions trustee mentality, everyone would still be using the original iPhone.


Today, however, after continuous enhancement, the iPhone X series is much faster and more powerful, offering a 6.5 inch screen, 12 megapixel camera and 5G connectivity[vii]. Apple's slogan for the original iPhone launch was "This is just the beginning". Such cultural attitudes should inform the new pensions governance.

The analogy of Amazon is also appropriate. The world's largest internet retailer regularly tops the customer satisfaction charts on both sides of the Atlantic. Amazon claims that it is guided by four principles: customer obsession, passion for invention, commitment to operational excellence, and long-term thinking[viii].

These principles are in line with our thinking on proactive pensions governance.

### Governance examples:

1 The board already has a good investment default structure but constantly tasks itself to improve it by monitoring all alternative options and innovations in the market and making the necessary changes.
2 In addition to the regular quarterly trustee meeting cycle, the board convenes once or twice a year to focus exclusively on strategy and innovation.
3 While service delivery might be deemed adequate due to the low level of customer complaints, proactive trustees will constantly seek to enhance customer satisfaction and move towards customer delight.

## Relevance

Empathising with members' hopes and fears while understanding and responding to their needs is a fundamental aspect of the new governance. Knowing your customer base requires the use of profiling and segmentation, focus groups and member surveys. Specifically, communication should be clear and simple, focusing on serving the needs of the members rather than the regulatory criteria.

### Governance examples:

1 Members already provide trustees with a wealth of actionable data every day through their behaviours, their actions, their online activity and their inquiries to the helpline. Boards should ensure that this data – the effective 'voice of the member' – is captured, processed and integrated into future strategic decision-making.
2 Communication with members should reflect member needs and not rely solely on timetabled annual summaries. Taking into account the lessons of behavioural economics, proactive boards will respond to adverse economic events by reassuring members, reminding them of the long-term nature of the investment horizon and advising them not to over-react.

# From commodity to value-add: not all governance is the same

Achieving improved outcomes for members will in part derive from selecting the best governance framework. There are several governance models for workplace DC: contract; own trust; and master trusts. Each has its respective regulatory framework but more importantly each has a differing type and level of fiduciary overview in terms of, for example, trustee experience, cognitive diversification, resources and sponsor support.

We contend that master trusts have a compelling advantage in that their scale permits a significant governance budget and their trustees not only have direct fiduciary duties to act in the best interests of scheme beneficiaries, but are generally very experienced, independent, expert professionals with real power and control to drive change, innovation and improvements. By contrast, we argue that contract-based schemes, run entirely by a pension provider, with Independent Governance Committee (IGC) oversight, are relatively governance-light and less effective in enhancing member outcomes, by comparison.

Furthermore, individual master trusts vary substantially in terms of the degree to which the governance role adds value. We believe that the governance structure, and the extent to which the master trust's governance board adds value, should be one of the most important factors in selecting a master trust.

While the pursuit of financial return on behalf of the members is the main concern and duty of the trustees, the governance revolution also embraces future sustainability and ESG (environmental, social and governance) factors, as well as ethical considerations. This is not just in terms of good corporate citizenship but a recognition of the fact that longer-term financial risks from climate change, pollution, natural resource depletion and unsustainable business practices will have a significant impact on investment portfolio performance, scheme operations and, ultimately, member outcomes.

INDIVIDUAL MASTER TRUSTS VARY SUBSTANTIALLY IN TERMS OF THE DEGREE TO WHICH THE GOVERNANCE ROLE ADDS VALUE

MASTER TRUST:
## Mastering the hard facts

**9.9m**
people enrolled in multi-employer pension schemes at start of 2018

**0.2m**
Up from 0.2 million members in 2010

**43%**
of all UK employees pay into a DC pension in 2017 – up from 17% in 2012

**£29bn**
of assets invested in 74 master trusts

**£300bn**
UK master trust assets are projected to be over £300 billion by 2025

*Sources: Department of Work and Pensions; Office of National Statistics; The Pensions Regulator*

MAJOR QUOTED COMPANIES IN THE USA ARE CURRENTLY THE SUBJECT OF LAWSUITS ALLEGING BREACHES OF FIDUCIARY DUTY

# Governance failure: why the revolution matters

The pressing need for the governance revolution is confirmed by the evidence of the disastrous consequences of governance deficit. Events in the USA – where an increasing number of 401(k) retirement plan members are suing plan sponsors in legal class actions – serve as a cautionary tale.

Major quoted companies there are currently the subject of lawsuits alleging breaches of fiduciary duty including: self-dealing; excessive fees; inappropriate investment options; poor due diligence; inadequate record keeping; and failure to disclose information.

Beyond these shortcomings, there are numerous potential areas where failure to enhance will become problematic, including the following examples:

- Changing the investment default fund for new members but leaving existing members in the old structure
- Launching new platforms or products but failing to make these available to current members
- Earning relatively poor returns for members by taking insufficient investment risk and not adjusting for relevant time horizons
- Not making decisions in a timely manner

## Conclusion

In DC schemes, investment risk and responsibility for the retirement outcome will always ultimately reside with the member – although the vast majority of members simply do not have the skills, knowledge or time to respond effectively.

The governance revolution is therefore critical and hugely valuable in filling the void left by member inertia and inexperience, enhancing member outcomes, managing realistic expectations and ensuring that no member is ever surprised by their retirement outcome.

By restoring trust and confidence in the management of pension schemes, focusing on enhancement as much as protection, and driving better returns and outcomes, governance will truly prove to be the new killer application in the industry.

# Summary: the perfect ten

**1**
Proactive governance focuses as much on enhancement as it does on protection

**2**
Governance in future will abide by the three core values: effectiveness; proactivity; and relevance

**3**
Governance will emerge as the critical factor in determining a pension scheme's success in terms of reputation, engagement and delivery of member outcomes

**4**
The mindset of governance teams will shift from a focus on compliance with procedure to strategic decision-making in members' best interests

**5**
DC pension schemes will look to the positive impact of the UK's code of corporate governance for companies as a model for the benefits of proactive governance, building on TPR's existing guidance

**6**
Schemes with proactive governance structures can expect to outperform their peers by between 1 and 2 per cent a year – driving significantly better outcomes for their membership

**7**
Funds which adopt best practice in governance should experience a performance margin of 2 per cent per annum or more over their benchmarks

**8**
Core governance team composition will be optimised to ensure it comprises all the requisite skillsets

**9**
A culture of continuous improvement, in line with the examples of Apple and Amazon, will replace the culture of adequate

**10**
The master trust model of governance and regulatory framework offers compelling structural advantages in delivering optimised outcomes for members

## REFERENCES


i Which? Survey, quoted in *Financial Times*, August 2017

ii Financial Conduct Authority, Data Bulletin, September 2018

iii *Ipsos Mori Veracity Index*, 2018, published November 2018

iv Keith Ambachtsheer, of the Rotman International Centre for Pension Management

v Gordon Clark and Roger Urwin of Oxford University, research conducted in association with Willis Towers Watson

(Sources iv and v both quoted in *Good Governance: How To Get There*, PLSA Discussion Paper, August 2017)

vi Apple Inc.

vii Apple Inc.

viii Amazon Inc.

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The considered choice of master trust

Atlas is the trustee-led Master Trust representing the considered choice for employers who want their people to have the financial futures they choose.

Atlas' core belief is that no member should be surprised by their outcome, giving people control of their financial future. It gives them the reassurance that their best interests, and hard-earned money, are being proactively looked after by a board of independent trustees.

Atlas' open structure drives quality, supported by people-experts Capita, daily administrators of British life, and the investment expertise of Schroders.

Together, we create financial futures from working lives so our members are the masters of the life they choose.

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