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Response to The Pensions Regulator Discussion Paper on 21st Century Trusteeship and Governance

The CFA Society of the UK (CFA UK) welcomes the opportunity to respond to the questions raised in The Pensions Regulator's discussion paper on 21st Century Trusteeship and Governance. CFA UK is the professional body for the UK investment sector and is a member society of CFA Institute, the world's largest association of investment professionals.

CFA UK's mission is to educate investment professionals, to promote high ethical and professional standards and to explain the profession to our stakeholders. The society has more than 11,000 members, most of whom work in institutional investment management firms. However, an increasing number work within the in-house investment teams at pension schemes and – as noted within the research supporting your discussion paper – a number of our members serve as trustees.

The publication of your discussion paper (and the preceding quantitative and qualitative research reports) is timely. Pension schemes are challenged to deliver returns to beneficiaries and trustees are faced with an array of difficult choices and tasks. It is important that they are equipped to undertake those tasks and to make those decisions. Furthermore, they need to operate within governance structures that allow them to do so effectively.

We note the knowledge gaps identified in relation to trustees' understanding of pension scheme investments and concerns among trustees about their ability to challenge advisors' views and to assess advisor value for money. We also note with interest the view from half of respondents that not all trustees had the level of knowledge and understanding required by the regulator. These areas have a direct impact on trustees' capacity to oversee investments on beneficiaries' behalf and to control the costs of managing those investments. In order to meet long-term return objectives, it is important that costs are appropriately managed and that trustees are confident that their investment approach matches their objectives.

We were also interested in the perceived difference between governance and knowledge practices at large and smaller funds and the greater perceived ability of trustees at larger firms to challenge their advisors including their investment managers. Similarly, we were concerned by the poor governance reported by the trustees of DC-only schemes. Given that assets held in DC schemes (where more than a third of trustees meet just annually or less frequently) will soon surpass those held in DB schemes, there is clearly an urgent need to ensure appropriate governance of those schemes. The market for investment management services won't deliver the best outcomes unless it benefits from informed clients working within the right governance structures.

CFA Institute and CFA UK focus on educating investment managers and providing them with standards and guidelines to help them behave ethically and professionally. We have engaged with trustee education, guidance and governance, but have done so infrequently. These topics though are of increasing interest because of the impact that they have on investment managers' ability to deliver value to clients over time.

There are a number of services and tools that CFA Institute has developed to support trustee knowledge and understanding. Among these are the pension trustee code of conduct, a primer for investment trustees and an educational programme designed to help trustees and others to understand how investment markets and the investment sector work (CFA Institute Investment Foundations). We list more information about these products in the appendix to this response.

In addition to these products, CFA Institute and CFA UK have facilitated and made comments about the pressures on pension scheme trustees and the challenges they face: retirement security is a key focus area for CFA Institute's Future of Finance initiative; a recent edition of the Financial Analysts Journal was dedicated to this topic; and CFA UK's recent publication on the 'Value of the Investment Profession' commented on the need for improvements to professionalism and governance within pension trusteeship.

<u>Response to questions</u>

1. There are currently no barriers to entry for professional trustees. Should there be? For example, should all professional trustees be required to be qualified or registered by a professional body?

Yes, we believe that all professional trustees should have an appropriate qualification and be registered with a relevant professional body. It is clear from your quantitative research that many professional trustees already hold such qualifications. We do not propose that current professional trustees should be required to attain a qualification if they have demonstrated their competence through experience, but we believe that membership of a professional body (that can support continuing professional development) should be required within a reasonable transition period.

All trustees will bring different skills and expertise to the board. We would expect that professional trustees i.e. those that are paid for their services, would bring a particular, identifiable skill to the board. We would expect that they would hold a relevant professional qualification such as the CFA Charter or another qualification relevant to their professional field. It is not unreasonable to expect professional trustees to be a member of a professional body. The advantages of such membership are that there would be an independent verification of trustees' knowledge and skills. Most professional bodies will expect members to sign up to a Code of Ethics and Standards of Professional Conduct.

2. **Do you think it is the role of the chair of trustees to support trustees and use their leadership skills to improve the likelihood of appropriate scheme processes being put in place? Given the crucial role played by chairs, do you think more needs to be done to raise the standards of trustee chairmanship? For instance, do you think that chairs should be required to meet a minimum standard through having minimum qualifications or experience or belonging to a professional body?**

We agree that the role of the chair is critical in the effective functioning of a board of trustees. The role of the chair should include strong leadership to ensure that the board and its members work to achieve the best outcomes for the pension scheme members and employers. It is not immediately obvious that specific qualifications would help to raise standards, but chairs should have experience of chairing other boards or committees or relevant experience as a member of several committees or boards. Board evaluation should be conducted on a regular basis.

3. Should the requirement to appoint a chair and report on compliance with governance standards be introduced for DB schemes?

Yes, we believe strongly that the governance of DB schemes should be similar to the regime for DC schemes. TPR's research suggests that governance standards are stronger among DB schemes. It is important that governance is strong across both DB and DC schemes and it would be odd to introduce a higher governance standard for DC schemes than required of DB schemes.

4. How can we help trustees to be aware of, understand and apply the TKU framework?

The Trustee Landscape Research indicates that trustee knowledge and skills are pretty strong. However, we note the apparent disparity between large and small schemes and between schemes made up largely of professional trustees and others. We also note the large perceived knowledge gaps between perceived knowledge and perceived importance relating to pension scheme investments and assessing value for money in investment costs.

We appreciate the difficulty of raising awareness of the Trustee Knowledge and Understanding (TKU) framework for trustees and Boards, but believe that it is essential that trustees adhere to the framework. As noted on The Pensions Regulator's website, the law requires that trustees have knowledge and understanding of, among other things, the law relating to pensions and trusts, as well as the principles relating to the funding of pension schemes and the investment of scheme assets.

The requirement for knowledge and understanding applies equally to all trustees. We recommend that all trustees should attest to their understanding of the framework, and their commitment to meeting its requirements, as a condition of their appointment or reappointment. Chairs of trustee boards should be required to acknowledge the importance of ensuring that each trustee has an appropriate level of knowledge and understanding and should ensure that the Board collectively has the required range and depth of knowledge and understanding.

We would be pleased to talk to The Pensions Regulator about potential approaches to bridging the knowledge gaps with regard to investments.

5. Do you have any views as to how we can help new trustees bring their knowledge and skills up to the required standard within the statutory period? For instance, would it be useful to make completion of the Trustee toolkit or other equivalent learning tool within six months mandatory? Or would the introduction of a six month probationary period for new trustees help to meet standards of TKU? What are the difficulties associated with these options and how could these be solved?

A six months' deadline to complete the trustee toolkit (or equivalent programme) seems reasonable, but it might also be helpful to encourage individuals standing for election as a trustee to complete the trustee toolkit. A probationary period provides the flexibility required to encourage MNTs to stand or for a serving trustee to be replaced, but we're unsure about the legal status of a 'probationary' trustee. Trustees should commit to attaining an appropriate level of knowledge and understanding before they take up their role or within six months. Chairs should be required to confirm that trustees have met this commitment.

6. How can trustees demonstrate they have the minimum level of competence required to fulfil their role? For instance, do you think holding relevant qualifications is the right way to demonstrate competence? What are the difficulties associated with this option and how could these be solved? Are there other options?

Qualifications are clearly a good way to verify an individual's knowledge. It is important to have a blend of knowledge and skills on a board so a "one size fits all" approach will not be appropriate. We were interested to read that many trustees and boards felt that their knowledge of investments was deficient.

The issues that we foresee arising would be the time taken to achieve the knowledge and study for qualifications. Employer support would be vital to encourage trustees to undertake this learning. It would also be important to explain this before individuals put themselves forward or are nominated to be trustees. The direct cost of studying, whilst not high, would need to be accommodated and employers would need to provide sufficient time for studying.

CFA Institute would be pleased to share details of the CFA Institute Investment Foundations with the Pensions Regulator. Investment Foundations is a comprehensive global education certificate programme that provides a clear understanding of investment industry essentials. The certificate programme is designed for all professional disciplines outside of investment roles, including IT, operations, accounting, administration, and marketing. There is no education or experience requirement and the exam can be taken at a candidate's convenience at available test centres around the UK. The complete curriculum will shortly be available online (via free access to PDF versions) so anyone can access and learn the content.

7. Do you have a view as to whether a CPD framework would assist trustees to meet the challenges of scheme governance? What are the difficulties associated with this option and how could they be solved?

A CPD framework is a good way of encouraging trustees and boards to keep their knowledge up to date. Pension law and regulation as well as the investment management industry are fast-moving and so knowledge needs to be updated constantly. Changes to the scope guidance should be communicated to trustees and chairs should be encouraged to recommend CPD to trustees. In time, we would recommend standardisation of a CPD requirement, but we believe that, initially at least, it is more important to ensure that all trustees attain the appropriate base level of knowledge and understanding.

8. What further education tools and products would you find useful to receive from us?

We encourage the Pensions Regulator (TPR) to focus on communicating the importance of the TKU framework and on the supervision of trustees' awareness of the framework and their attainment of its requirements. TPR should not necessarily seek to develop products and services itself, but might play a role in reviewing and recommending products offered by others.

As we noted earlier, we were impressed with the quality of the research undertaken by TPR around these issues. We believe that it might also be useful for TPR to commission academic research into the correlation between trustee boards' levels of knowledge and understanding and the outcomes achieved for beneficiaries.

9. What do you think is the best way of managing conflicts of interests? How could the system be improved to reduce the likelihood of conflicts arising in the first place?

There are a number of apparent conflicts that may need to be managed. A representative from the finance function at the scheme sponsor may want to pursue a more aggressive asset strategy to reduce a scheme deficit and diminish the need for additional contributions. Similarly, a Member Nominated Trustee (MNT) may feel that they have a constituency to serve (other union members) when considering benefits changes. And a professional trustee may be privy to investment decisions being made by a number of different schemes. Management of these conflicts falls within the trustees' overall fiduciary obligation to act in the members' overall best interest. We are aware that these conflicts can be difficult to manage.

Appropriate recruitment and induction processes and proper management of the Board by the chair should reduce the opportunity for conflicts to arise and improve their management in the cases where they do. Article 4 in our own code of conduct for members of a pension scheme body deals with this issue.

10. What do you think are the key challenges faced by trustees in engaging effectively with administration and investment governance and third party providers and advisers? What could we do to help them in addition to what we outline above?

The challenges faced by trustees in these areas arise from lack of knowledge, lack of time and resource and the difficulty of assessing long term performance over the short term. Trustees might find it helpful to draw on others' experience in these areas of engagement. It might be helpful for trustees to be able to communicate with and learn from others that have recent experience of dealing with these issues. Some form of informal mentoring scheme might be appreciated by trustees. The difficulty for trustees is knowing when to challenge and why to challenge. The asymmetry of information between trustees and their advisers needs to be diminished. It would be helpful for TPR to provide examples of situations where others have challenged and what happened as a result. It would also be good for TPR to recommend that boards appoint trustees with a range of skills and knowledge such that the board feels more confident in addressing these issues.

11. What should be done with those schemes that are unwilling or unable to deliver good governance and member outcomes? In particular, should small schemes be encouraged or forced to exit the market or to consolidate into larger scale provision? Is regulatory intervention required to facilitate this or can it be achieved through existing market forces?

Good governance is controllable. Member outcomes are not. Some firms that take all of the right actions may deliver poor outcomes through ill fortune. However, on the whole governance should be a reasonable predictor of outcomes because it should cause schemes to pay attention and to act appropriately.

TPR should commission research to identify optimal and minimal governance practices and levels of knowledge and understanding. If schemes cannot demonstrate adherence to minimal governance standards, then they should be required to consolidate. We recognise though that, while this can be relatively easily done on the asset side of the balance sheet through common investment funds, it is extremely difficult to do on the liability side of the balance sheet as it produces winners and losers due to different benefit security outcomes amongst members and likewise for their sponsors. Nevertheless, regulatory intervention may be required as scheme members might only become aware and take action to try and resolve governance issues too late in the day.

TPR should continue to play a role in setting standards for governance, knowledge and understanding and should then supervise schemes' adherence to those standards. Where TPR is concerned that a scheme is unable to act in beneficiaries' best interest, it should intervene.

12. Would you find it useful to see overarching guidance covering issues common to all schemes, with more specific issues being covered in technical guidance?

We expect that the proposed approach would be helpful.

13. Do you have any other thoughts on the issues raised in this paper or on how standards of trusteeship and quality of governance can be improved?

CFA UK is the local member society for CFA Institute. As professional bodies working in the investment management sector, CFA UK and CFA Institute share a mission to promote the highest standards of ethics, education and professional excellence for the ultimate benefit of society.

Our focus has been on educating those working in investment management, but we also have a strong interest in ensuring that our clients (such as trustees) have the skills and experience to hold us to account. We are pleased that TPR has undertaken this consultation and has conducted valuable research about standards of trusteeship and governance. Trusteeship and governance need to be strong if market discipline is to be maintained and client outcomes optimised.

We recommend that TPR continues to emphasize the value of trustee training – both in relation to general and specific duties – and might work with potential providers to consider how levels of knowledge and understanding might be acknowledged and celebrated. We encourage TPR to consider ways to broaden the market for training and, as mentioned in our response to Q11, it would be helpful for TPR to research the relationship between scheme governance and outcomes.

Last, we note that the Trustee Toolkit does not currently cover ethics. Ethics has been a core component of the CFA Program since it was first launched more than 60 years ago. Given the potential conflicts of interest that a trustee may have to tackle and the critical importance of the trustee's role, we recommend that TPR consider the addition of a module on ethics or the encouragement of some other form of study specific to ethics.

We trust that these comments are useful and would be pleased to discuss them in person.

Yours,

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About CFA Institute and CFA UK:

CFA Institute's mission is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. We believe that:

- Investment professionals contribute to the ultimate benefit of society through the
- sustainable value generated by efficient financial markets and by effective investment institutions.
- Good stewardship and high ethical standards are necessary for trust and confidence to be secured and for society to be served.
- Financial markets should afford every investor the opportunity to earn a fair return.
- Financial markets are more effective when participants are knowledgeable.
- High ethical principles and professional standards are essential to positive outcomes; rules and regulations, while necessary, are not sufficient by themselves.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 135,000 members in 150 countries and territories. In addition, more than 240,000 CFA Program candidates took the CFA Program exams in FY 2016 in one of our 250+ test centres around the globe.

CFA UK is the local member society for CFA Institute and shares CFA Institute's mission and beliefs. Founded in 1955, CFA UK represents the interests of approximately 12,000 investment professionals

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession.

All members of CFA Institute and CFA UK abide by the CFA Institute Code of Ethics and Standards of Professional Conduct. The Code and Standards serve as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. The Code and Standards are fundamental to the values of CFA Institute and its societies and are protected by CFA Institute through its Professional Conduct Program.

The CFA Program: As part of its portfolio of educational programs, CFA Institute offers the Chartered Financial Analyst® (CFA®) charter, which is a global, challenging, and widely respected graduate-level investment management credential. Earning the CFA charter requires passing its three, demanding, six-hour examinations. Successfully doing so demonstrates a commitment to the highest ethical and professional standards as well as a mastery of a comprehensive range of advanced investment principles needed to successfully practice in the investment industry.

The CFA program curriculum is grounded in the practice of the investment profession. CFA Institute, through the oversight of the Educational Advisory Committee, regularly conducts a practice analysis survey of investment professionals around the world to determine the knowledge, skills, and abilities (competencies) that are relevant to the profession. The results of the practice analysis define the Global Body of Investment Knowledge and the CFA program Candidate Body of Knowledge. The topic areas covered by the CFA program range from ethical and professional standards, investment tools, all asset classes, and portfolio management.

The CFA Program curriculum comprises about 1,000 hours of study material spread over three levels of examinations across a comprehensive set of investment topics including Financial Reporting, Valuation, Portfolio Management, Economics and Ethics.

The CFA Institute Investment Foundations (formerly the Claritas Investment Certificate): In addition to the CFA charter, CFA Institute also offers a certificate programme in Investment Foundations. The certificate programme is intended for those working in support roles in the investment sector and who need to have a clear understanding of how financial markets and the investment business work. It is a self-study programme which requires approximately 100 hours of study. To earn the certificate, candidates must pass a two hour, multiple choice exam. There will be free online access to PDF versions of the curriculum.

The Certificate in Investment Performance Measurement: Finally, the Certificate in Investment Performance Measurement (CIPM) is focused on performance measurement, attribution, appraisal, and manager selection. In addition, 30% of the CIPM program is devoted to investment performance and reporting standards and ethics. To earn the CIPM designation, candidates must pass two, three hour examinations, each of which requires approximately 150 hours of study.

Comments on scheme governance and professionalism from CFA UK's Value of the Investment Profession report:

There's broad agreement that scale is valuable and that clients might work with the investment profession more effectively if demand for investment management was less fragmented and there was a small number of larger, better informed clients.

The development of occupational schemes at employer level has meant that the UK has a very large number of schemes. Some of these are large and benefit from professional in-house investment support, but many are small. While some of these are thought to be more than capable of identifying and managing good investment partners, not all have these skills.

The situation may improve as the balance of assets shifts from DB to DC with consolidation under Master Trusts (multi-employer schemes), but even here there is considerable proliferation. In the UK, there are roughly 6,000 DB schemes, close to 35,000 DC schemes and there are estimated to be roughly 70 Master Trusts.

Where asset owners operate with scale, they are able to diversify more effectively by accessing a broader range of investment opportunities and have more leverage with which to negotiate the costs of their investments. The converse is true for smaller schemes. As noted in a 2015 Financial Analysts' Journal article 'The ideal pension-delivery institution is expert, has scale, and acts solely in the best interests of plan participants'[1].

Large asset owners can also benefit from being able to afford their own investment professionals. These individuals, working directly for the asset owner, might manage some or most of the asset owner's own money or they may support the asset owner's work with external managers. They will likely have sufficient experience and expertise to select and monitor managers (by understanding their investment managers' processes and interpreting their performance, both relative to benchmarks and in absolute terms) and are also well placed to review fees and to investigate the relative cost of similar exposures and risk profiles.

However, most observers believe that asset owners only obtain the benefit of in-house expertise where they have appropriate governance structures in place. It is reckoned that in too many instances the asset owner's trustees retain control over operational decision-making and that this only takes place following occasional, relatively brief meetings.

Most of those that contributed to this report suggested that it would be better for trustees to set the appropriate reference and policy portfolios and then, where possible, to leave the implementation of the investment portfolio to an in-house investment team. That would leave the trustees with more of their governance budget to spend on the areas that would have the greatest impact on outcomes and would leave tactical issues to informed, aligned employees[2].

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[1] Why we need a pension revolution', Keith Ambachtsheer, FAJ January/February 2015 | Vol. 71

[2] CFA Institute's primer for investment trustees (2011) is a useful guide to how trustees can work with and challenge investment professionals (http://www.cfapubs.org/doi/pdf/10.2470/rf.v2011.n1.1)