

# Regulating work-based defined contribution pension schemes

NEST Corporation response

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## Introduction

We're grateful for the opportunity to respond to The Pensions Regulator's (TPR) consultation on the regulation of work-based defined contribution (DC) pensions. NEST is a new scheme but we anticipate gaining a measure of scale over the course of staging. How the trust-based sector develops and is regulated is therefore of the utmost importance to us.

This response seeks to respond to the specific questions asked by TPR in the consultation document, and also, where we have felt it is appropriate, we have made a series of comments about the pensions landscape and potential regulatory challenges. In particular, we have sought to highlight a number of issues about the differences between the various types of multi-employer schemes and what those differences could mean for the regulatory approach to them.

The NEST Trustee is not afraid of tougher regulation of the NEST scheme and we see a case for tougher regulation of the workplace pensions market. We feel, though, that regulation that adds cost without driving quality improvements in workplace pension products will not generally prove value for money. As such, there is a fine balance to be struck between the two issues.

## Market context and the need for regulatory intervention

The workplace pensions market is not like regular product and service markets. The end customer or member does not select the product and typically does not engage significantly with the product after being enrolled. Furthermore, information asymmetries are significant and stacked against the member and the quality of the product is observed only over a very long period of time. For these reasons, competitive pressure may not result in the same levels of improved product quality as it does in regular product and service markets. We believe that there is a case for a regulatory drive to improve the quality of supply of workplace pensions across both trust- and contract-based sectors. The creation of a new breed of multi-employer master trust arrangements blurs the boundaries between these two segments and makes a joined-up regulatory approach all the more important.

### **1. Since publishing the draft features in June 2012, we have made some drafting improvements to make the DC quality features clearer. What further changes could we make to improve the DC quality features?**

We have provided our view of the quality features in the attached Annex but make a few general points here. While we agree with the direction the quality features are heading in and with the rationale for them, we feel that they would benefit from further redrafting and reorganisation.

In respect of their organisation, we feel that the current arrangement of the quality features underneath the principles is potentially confusing and leads to duplication. Currently, each quality feature is tiered underneath one specific principle. This means that there is often another, similarly worded quality feature covering similar ground underneath another principle. We suggest that where there is common ground between the quality features, they are combined into a single one which could support multiple core principles.

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**2. Do the DC code and DC regulatory guidance, together with the DC regulatory approach, sufficiently address risks to members within the different segments of the DC market, for example those relating to master trusts? Please comment on coverage by segment.**

We have responded to this question with reference to master trusts.

### **NEST and master trusts, an overview**

We note that TPR has taken a wide definition of what a master trust is. Almost all trust based multi-employer schemes would be categorised as a master trust using TPR's definition. At this level, NEST is clearly a master trust and there are some risks that apply to all multi-employer schemes. But there are wide variations between master trusts, and any regulatory response should be based on the identification of which risks apply to which master trust. One central issue in regulating the master trust sector will be fishing out which risks apply to which schemes and regulating each scheme in a manner proportionate to the risks it poses.

### **The NEST Trustee's view of the master trust segment**

We feel that all multi-employer schemes are not alike and the potential nature of the risks to members varies within the sector. Multi-employer schemes categorised as master trusts may be fully trust-based or may operate a hybrid trust-based and contract-based arrangement. Some may also have a tie to a particular provider, for instance where the tie is written into the scheme rules.

TPR and some consumer stakeholders have made a range of criticisms of these structures, citing two potential problems. Where there is a hybrid trust or contract-based arrangement, there is the potential for regulatory arbitrage. Where there is a theoretical or practical tie to a particular provider, there is the potential for conflicts of interest, especially where the provider has a binding obligation towards shareholders.<sup>1</sup> The NEST Trustee has no particular point of view on these and notes that for now, these remain potential rather than real problems. At the moment, there is no published evidence that either of these issues has had detrimental effects in practice.

Both risks, though, are products of structure rather than products of culture, behaviour or conduct. They are identifiable from a scheme's rules and frequently from its marketing literature. If TPR believes that certain structures are more prone to regulatory arbitrage or serious potential conflicts then it would make sense to identify and regulate those structures in a different way to the multi-employer sector as a whole.

What matters are the incentives operating within the governance structure of the scheme and the extent to which those incentives are solely aligned to the interests of scheme members. As such, we recommend a more granular approach to the multi-employer sector, recognising that there are multi-employer structures in which the Trustee is subject to the full weight of trust law alongside hybrid structures, which have different arrangements and incentives. These are unlikely to present the same risk and regulatory challenges as one another.

### **General comments on risks to members**

TPR outlined four potential risks to members in the regulatory approach. With one exception, these seem the right risks to identify, although we note that these do not apply evenly throughout the master trust sector. Taking each in turn these are:

*Conflicts of interest as a result of the relationship between the provider and trustees*

and

*Decision-making powers vested with the provider rather than trustees*

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<sup>1</sup> <http://touchstoneblog.org.uk/2012/11/wake-up-call-from-the-fsa-on-conflicts-of-interest-in-investment/>  
<http://www.moneymarketing.co.uk/pensions/pensions-regulator-investigates-master-trust-conflicts-of-interest/1059964.article>

These risks do not manifest themselves in the NEST scheme. Decision-making powers in respect of running the NEST scheme are vested in the scheme Trustee. There is no decision-making power vested in a provider. Without the presence of a provider, that is not controlled by the Trustee, it is not possible to have a conflict of interest between the Trustee and the provider. NEST is not unique and we believe that this line of reasoning applies to other master trusts within the sector. If TPR feels that certain multi-employer structures feature power imbalances between trustees and a provider that threatens member benefit then we believe it needs to state this clearly and develop a regulatory approach targeted at the issue.

*A lack of independent oversight in some master trusts – unlike traditional occupational DC schemes, member and employer representatives are unlikely to be involved in important decision-making processes*

We think that TPR is right to identify this as a potential issue. NEST has member and employer panels that form a part of our governance structure. We anticipate these growing further in stature as NEST acquires more members and employers over the course of staging. In particular, the creation of our Members' Panel was a response during the government's policy development phase to the fact that it would be difficult in a large multi-employer occupational pension scheme such as NEST to have member-nominated trustees as part of its corporate structure but that some form of member representation was nonetheless important.

NEST's member and employer panels are established under section 69 of the Pensions Act 2008 and in accordance with articles 6-9 of the NEST order and rule 5 of the NEST rules. Broadly, the Pensions Act 2008 mandates the existence and maintenance of the panels and their composition as part of a general duty on the Trustee to maintain arrangements for consulting the members and participating employers on the operation, development or amendment of the NEST scheme. Without prejudice to the generality of the Trustee need to consult employers and members, there is a specific duty on the Trustee to consult the panels in respect of the statement of investment principles or other changes in the operation and development of the scheme.<sup>2</sup> Over the course of 2011-12 the member panel influenced the development of NEST's research approach, NEST's statement of investment principles and the scheme order and rules.<sup>3</sup>

*Complex and opaque investment structures*

We do not recognise this risk as a description either of NEST's approach or of the approaches of others within the segment with which we are familiar. Moreover, it is not clear why this risk is seen as potentially manifesting in the master trust segment and not in any other. If TPR feels this is a serious potential risk then it would be helpful to outline further the dimensions of the issue such that those involved can evaluate it and comment further.

## Summary

As such, we note that while NEST could, using TPR's definition, be categorised as a master trust, many of the risks that TPR outlines as applying to the master trust sector do not apply uniformly across this sector.

For this reason we're cautious about an approach that identifies this sector as homogenous under the current set of descriptions. In practical terms, from a NEST Trustee point of view there is little member benefit in NEST or other similarly structured master trusts complying with regulation intended to mitigate risks to which they are not prone as a result of their structure and incurring the additional costs involved. After all, it is not possible for compliance costs to manifest in NEST as reduced profit. All compliance costs will ultimately fall on the membership. We believe that there should always be a clear rationale for the imposition of those costs tied back to a potential risk in the target scheme. NEST operates the three lines of defence model, and therefore subscribes to the importance of independent assurance.

<sup>2</sup> <http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/NEST-Order-and-Rules,PDF.pdf>

<sup>3</sup> <http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/NEST-members-panel-annual-report-2011-2012,PDF.pdf>

**3. Do you agree that voluntary disclosure of consistency with the principles and features is a suitable approach for trustees to demonstrate the presence of DC quality features contained in the DC code and DC regulatory guidance? If not, why not? When responding to this question, it would be helpful if you could outline what you envisage trustees disclosing to demonstrate their accountabilities to members.**

We feel that voluntary disclosure of consistency with the principles and features is a suitable approach. We would anticipate summarising how we comply with the finalised quality features with the obvious location of the summary being the annual report and accounts.

We believe that additional scrutiny is likely to take place for master trusts through pressure from intermediaries and employers and that this process will take place without external intervention over time. Indeed, the NEST Trustee is already being asked by employee benefit consultants to show how it complies with the draft quality features. For master trust schemes over the course of staging, we think that pressure from EBCs to demonstrate compliance could potentially lead to high levels of disclosure, especially if other master trusts see marketing advantages deriving from compliance.

We are dubious about the potential benefits of disclosing this information directly to members. Based on our extensive research on communications with the target group for automatic enrolment, we anticipate engagement with schemes (not just NEST) being low and feel that little member benefit would arise from the exercise. Of course this does not mean that the information should not be available for those who wish to read it, and should therefore be easily available on our website. We of course recognise the importance of disclosing such information to allow proper scrutiny of pension schemes by not just interested members, but others such as advisers and other intermediaries, consumer groups, employers and the media. What matters, therefore, is disclosure to bodies that may offer a high degree of scrutiny and there is evidence that the intermediary market may provide that alongside the interest that TPR will no doubt take.

**4. Do you agree that independent assurance will help provide another layer of rigour to help improve standards of governance and verify accountabilities of trustees of master trusts? If not, what other sources of assurance can trustees of master trusts use to demonstrate the presence of DC quality features and operational effectiveness of related control processes?**

We feel that the independent assurance proposal has much to recommend it but believe that the proposal needs further refinement and detail. Independent assurance could be a major undertaking and we would urge TPR to be certain that the costs of assurance will be met by a proportionate increase in the quality of supply of workplace DC pensions. NEST itself has recently undertaken an audit of its governance through an external company that acts as our internal auditors.

We suggest that there is a need for greater clarity in three areas.

## **Rationale**

We think that a clearer articulation of the rationale for the proposed assurance framework would be helpful. Currently, the regulatory approach makes reference to a need for master trusts to be subject to an additional layer of rigour and articulates a perceived need for master trusts to demonstrate credibility and viability. Given the proximity of the four characteristics that TPR outline as potentially preventing master trusts from delivering good outcomes (section 9.5.3 of the Regulatory approach document) and the introduction of the independent assurance proposal (at section 9.5.6) it's implied that this proposal is intended to mitigate these risks. It would be helpful if TPR tied the proposal more tightly to these risks – if that is, indeed, the intention of the proposal. We do not feel that the four master trust risks set out in the regulatory approach apply to NEST and similarly structured multi-employer schemes in the way that they might apply to other hybrid trust/contract-based multi-employer schemes. We do, though, feel that independent assurance could have a beneficial impact on the market as a whole.

## Cost

At first glance, the costs of the proposal seem lower than might be expected in reality, although without further detail about the proposal, it is not possible to say how low. NEST, though, is likely to be at the upper end of the cost scale. As we noted in the beginning of our response, NEST is sensitive to issues of cost. As a non-profit scheme, all cost incurred by NEST will eventually fall on the membership. We see the potential costs of an independent assurance scheme as worthwhile if assurance leads to an overall increase in the quality of supply of workplace pension, and a consequent increase in public trust in pension schemes.

## Nature of the assurance

We feel that TPR could develop the proposal further before seeking further views. This is for several reasons. Firstly, there are conflicting signals in the documentation as to how significant an exercise the assurance exercise might actually be. The cash amounts in the impact assessment suggest a fairly light touch exercise, the volume and nature of the guidance suggests something more substantial.

In respect of demonstrating credibility and viability, this objective could have some overlap with the exercise undertaken by NEST's scheme auditor. If this turns out to be the case then the potential cost of compliance would be comparatively low and hence the impact on the member of the cost of compliance would also be relatively low. If not, then, the reverse is likely true.

In respect of auditing NEST against the quality features, a full audit of all of the quality features would probably be quite complicated. We assume it would not be simpler for other master trusts. The features are frequently qualitative and sometimes loose in their description of quality. Assessment of them would be bound to be subjective. While this allows for their application in different contexts. It also allows for substantial variation between auditors' own interpretations of them. Potentially this also throws into doubt the level of assurance provided.

It would seem to us that the quality features would need to be underpinned by a framework of some sort that would allow for an even-handed assessment of the quality features with little room for personal interpretation on the part of auditors. This framework would then become the document that scheme providers use to measure their compliance. We would see this as being likely to be more prescriptive and necessarily offering less room for trustee discretion and personal judgement on the part of an auditor.

## Summary

In short, we feel that the assurance proposal has merit but feel that it would benefit from further development. The NEST Trustee, in particular would like to see greater clarity around the likely cost and scale of the exercise, how TPR envisages assurance addressing risks in the master trust segment and the overall impact on the market. We remain positively disposed to any measures which promote a flight to quality.

### **5. Should requirements outlined for disclosure and independent assurance outlined above be incorporated in pensions legislation? Please give reasons.**

We believe that the independent assurance proposal should be outlined in more detail prior to further discussion. Once that matter has been settled, it will be possible to have a discussion about the merits of legislation. Our instinctive response is, however, that we do not believe that requirements for disclosure and independent assurance should be outlined in legislation.

### **6. Does the DC code sufficiently address the standards of trustee practice necessary to evidence compliance with pensions legislation? If not, why not?**

Yes, we believe that the DC code sufficiently addresses standards of trustee practice.

**7. Does the level of guidance included in the DC code in relation to internal controls and trustee knowledge and understanding provide sufficient detail to enable trustees to comply with pension legislation and undertake their role effectively?**

Yes, we believe that the level of guidance in the DC code is sufficient.

**8. Are there any other legal requirements which you think should be brought within the scope of the code?**

We think that an explanation of fiduciary duty would sit well within the code. At points, the regulatory package makes reference to the 'best interests of members' and the 'needs of the membership' among other terms. We feel that the use of these terms would sit well with a summary of a Trustee's legal obligation. Otherwise, we do not feel that there are other matters that should be brought within its scope.

**9. Are there any other key actions that you believe trustees must take in order to meet the legal requirements set out in the code?**

No, we do not believe that there are other actions trustees should take.

**10. Do you agree that the regulator should issue a code of practice in order to clarify the standards it expects in occupational DC trust-based pension schemes? If not, what other vehicle could we use to provide further education and enablement tools to trustees, and why?**

We feel that a code of practice would be a useful development.

**11. Do you agree that we have targeted the DC code at the right schemes?**

So much depends on how the market develops over the course of staging that this is a hard question to answer. It will only become apparent in retrospect whether or not the code targets the right schemes.

We feel that the focus on the master trust segment is appropriate. As we have noted earlier, we feel that the main new proposal in respect of master trusts would benefit from further development and discussion. It may be that TPR has not yet arrived at the right regulatory mix for the management of the master trust segment.

**12. Do you agree that we have correctly identified the key components we should take into account when assessing fitness and propriety? If not, why not?**

Yes, we believe that the key components have been identified correctly.

**13. Do you agree that we have set out clearly what actions are expected of trustees in relation to risk management and internal controls?**

Yes, we feel that guidance in respect of risk management and internal controls is sufficiently clear.

**14. Certain activities or events may call into question the ability of a DC scheme to deliver a good member outcome. Should we develop a DC notifiable events regime that could require and enable certain events to be reported to us, for example a change in administrator as a result of poor quality service? If yes, what should the list of events include?**

We are not, in principle, opposed to a notifiable events regime.

Achieving a good regime will not be easy. The main challenge is in designing a regime that does not contain perverse incentives. In the example given in the above question, a scheme would potentially have an incentive to continue with a poorly performing administrator in order to avoid generating a notifiable event. While such foot-dragging would not be justifiable, it is easy to spot the temptation. This would be doubly the case if a notifiable event were to trigger regulatory sanction.

The challenge, therefore, is to design a regime that is rooted in schemes' performance and not in any remedial action they might take in order to correct poor performance. While this might be simple in a world with only a handful of very large schemes, we do not operate in that world and the difficulties of designing something that operates equally and fairly across all schemes seems formidable.

We feel that the first step here would be to understand whether some form of reporting framework based upon the scheme provider's understanding of their own performance is feasible. From this, it would be possible to understand what the commonalities are and, from that, how difficult it would be to achieve a sufficient degree of harmonisation.

We would be happy to explore this area further in discussions with TPR.

### **15. Does the DC code include sufficient practical guidance on the design and governance of default strategies?**

The DC code includes high-level guidance to cover the basic elements of the design and governance of default strategies.

### **The value of member research**

We would make one specific point. The code makes references to the 'suitability' of the investment approach and periodically to the 'needs of the member'. The NEST Trustee has a very good idea of the nature of the needs of the automatic enrolment target group based on extensive market research and data analysis, most of which we have published. At points, this has led us to some unexpected or controversial conclusions, mainly relating to how target group members tend to misunderstand the investment component of DC and also to prize certainty and frequently fear investment risk. These conclusions perhaps seem less surprising with the passage of time.

As such, we would like to take this opportunity to restate the value of market research and data analysis in the setting of a default investment strategy and to point out that it offers an excellent and empirical way of judging whether or not a default approach meets the needs of members or is otherwise suitable.

As an aside, we noted with interest the OECD's comments on the performance of UK pension funds in aggregate in international perspective.<sup>4</sup> As TPR will be aware, the UK ranks comparatively poorly when placed against the rest of the OECD. TPR rightly notes that the quality of investment performance and, especially, the performance of the default fund will be critical in determining member outcomes. Our research suggests that the quality of the default fund is an important but not a critical factor in scheme selection. Furthermore, our research suggests also that parts of the advisory community associate quality with the extent of choice of funds or merely recent return performance, without considering the nature of risks or the appropriateness of strategies for beneficiaries. That may be an appropriate view in other parts of the financial services market but jars with our understanding of what is desirable for most people most of the time under automatic enrolment.

With an end-customer group that is largely passive and an actor choosing the product that does not always share in its success or failure, there is the heaviest burden on trustees and on TPR to defend the interest of the member. In this context we would urge TPR to begin developing an evidence base seeking to understand the links between regulatory action and improvements in the quality of default funds offered by schemes.

<sup>4</sup> <http://www.oecd.org/finance/private-pensions/50560110.pdf>

**16. Do you agree that the practical guidance adequately addresses the risks of the different types of conflicts of interest which may occur within different segments of the DC market?**

Yes, we feel that the issue of conflicts of interest are addressed appropriately.

That said, we feel that sections of the regulatory guidance in respect of value for money are disquieting. In particular, the guidance to trustees intended to tackle situations where the trustees perceive value for money but a master trust provider fails to act to expose a suboptimal situation. We are keen to emphasise that not all master trust providers are so circumscribed. In NEST, as with other similarly structured master trust providers, the scheme Trustee is not so limited in its decision-making ability as the scheme rules do not preclude taking such action as might be required.

In that spirit, we feel that paragraph 62 of the regulatory guidance exposes the weakness of the trustee model in a situation where the freedom of the trustees to act to secure value for money is constrained. We feel that TPR needs to consider how far seeing the trustee as the primary engine of quality improvement is the way forward in situations where the trustee has limited power to act.

**17. Does the DC code include sufficient practical guidance on the standards of administration that we expect?**

We have no comments to make on this question.

**18. We have set out practical guidance for trustees on assessing the value for money of their scheme. Do you have any comments on this guidance?**

We believe that the value for money guidance is quite prescriptive. Where it is prescriptive, it generally prescribes sensible things. However, in certain places it could be read as being overly prescriptive. For example, is it absolutely necessary to prescribe recording 'failure to achieve value for money' as a risk on the scheme risk register?

**19. We have set out practical guidance for trustees on deciding how to disclose costs and charges to members. Do you agree with the approach that we have suggested?**

We agree with the approach suggested.

**20. We have set out practical guidance for trustees on helping members to optimise their retirement outcomes. Do you agree with the approach that we have suggested?**

We agree with the approach suggested.

**21. We have set out practical guidance for trustees on communicating with members. Do you agree with the approach that we have suggested?**

We feel that the approach suggested will help compliant schemes towards communicating effectively with their members.

**22. Do you agree that the DC regulatory approach document, DC code and DC regulatory guidance do not place additional regulatory burden on trustees? If you do not agree, please explain and quantify additional costs.**

We have no comments to make on this question.

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**23. In the Impact assessment statement, we have outlined indicative costs for the voluntary 'comply or explain' regime and independent master trust assurance framework. Do you agree with our initial assessment of these likely costs?**

We believe that the cost estimates associated with the 'comply or explain' regime are lower than the costs NEST would face were this regulatory package to come into force. We believe that the costs associated with the data maintenance proposal (paragraph 193 of the code) would be substantial once NEST is at scale and higher than the figures in the impact assessment. We also believe that the costs associated with the 'maintaining contributions' proposals would also be much higher than stated, as we set out in our submission to that consultation.

We suggested earlier in this submission that the proposed independent assurance has much to recommend it but would benefit from further sharpening and perhaps cost-benefit analysis.

That said, we believe that the cost of a full audit of NEST by an external auditor against the proposed quality features would considerably exceed the cost estimates given. This is based on our current use and experience of audit firms. The quality features have some subjective elements that are open to a degree of discussion and interpretation.

**24. We consider that the DC regulatory approach document, the DC code and DC regulatory guidance help trustees in complying with their obligations to not discriminate against people with protected characteristics under the Equality Act 2010. Do you have any further comments on this area?**

No, we have no comments to make.

## Addendum

### Trustee qualifications

We have one substantive point to make in respect of trustee qualifications, in reference to paragraph 55 of the draft regulatory guidance. We believe that the standards for professional trustees are open to discussion and the definition of 'professional' would benefit from some sharpening. From our perspective, members of the NEST Trustee, while not full time employees of the organisation, receive a fee for their services. This is, though, a small proportion of NEST's overall scheme costs. They could be considered 'professional' for that reason.

NEST's Trustee contains a number of individuals who have many years of experience in the pensions industry and a number with expert level investment knowledge. It also contains a number of individuals whose expertise is in fields other than pensions who contribute other skills and experience. We find the presence and challenge of long-standing consumer advocates to be of immense value, especially as other sectors of the economy usually engage better with their customer base than the pensions industry. Member-nominated trustees are widely recognised as making a positive contribution to employer based DB and DC schemes. Where there is less community and common interest between members in multi-employer master trusts, particularly those covering a range of sectors, we think it's valuable to include trustees who can perform a similar consumer advocacy role even though different means of recruitment may well be necessary.

We do not believe that all of the members of the Trustee should hold a PMI qualification prior to being appointed. This seems to be an unsuitable yardstick for members of the Trustee who have had long careers in the pensions industry. It also seems to be an unsuitable yardstick for those of our trustee members who offer an external perspective following a career outside the pensions industry. From our position, the important thing is the level of expertise in the trustee as a whole and we feel that this should be judged in aggregate.

## Annex – NEST Corporation comments on draft quality features

This annex contains NEST Corporation's comments on the draft quality features. As we noted in the main body of our response, we feel that the quality features read well and address the right issues. We have made a handful of drafting suggestions set out below and suggest also that the quality features could be further rationalised to avoid the appearance of duplication.

### Principle 1 – essential characteristics

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#### 1.1 All members receive value for money.

We have no comments to make on this quality feature.

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#### 1.2 All costs and charges borne by members are transparent and communicated clearly at point of selection to the employer to enable value for money comparisons to be made and to assess the fairness to members of the costs and charges.

We are unsure why there are separate quality features for the disclosure of charges to employers and the disclosure of charges to members. We also do not see why disclosure of charges to employers falls under principle one and disclosure of charges to members under principle six – especially as principle one is titled 'essential characteristics'. This seems suggestive of a hierarchy with disclosure to employers being seen as more important. We feel that it would be sensible for these quality features to be merged to avoid duplication and for the new quality feature to support both relevant principles.

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#### 1.3 Those running schemes understand and put arrangements in place to mitigate the impact to members of business and/or commercial risks.

We have no comment to make on this quality feature.

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#### 1.4 Those running schemes seek to predominantly invest scheme assets with entities regulated by the Financial Services Authority (FSA) or similar regulatory authorities. Where unregulated investment options are offered, it must be demonstrable why it was appropriate to offer those investment options.

We have no comments to make on this quality feature.

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#### 1.5 Those running schemes understand the levels of financial protection available to members and carefully consider situations where compensation is not available.

We have no comments to make on this quality feature.

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#### 1.6 Schemes offer flexible contribution structures to members and/or employers (over and above minimum scheme qualifying thresholds).

We have no comments as to how this quality feature is worded.

We would make two points here. The first is that there are potential compliance costs to flexibility – we would envisage more flexible structures being more complex to administer and harder for an employer to get right. Consequently we would expect employers using more complex contribution structures to experience more difficulties in complying with the regulations than those that are choosing simpler structures.

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Furthermore, we note that there are costs to providing flexibility that may not be compatible with a desire to be low cost. There may be a point at which the ability to cater for a high degree of individual variation in contributions negatively affects other ambitions a scheme might have – such as the achievement of value for money through low charges. These will directly trade off against one another.

There is also an obvious conflict here with NEST's contribution cap. NEST cannot offer some levels of flexibility in its product owing to limitations imposed by the NEST constitution.

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**1.7 A default strategy is provided which is suitable for the needs of members.**

We note that there are several quality features that pertain to investment. We believe that these could be rationalised further as noted later in this document. We would suggest this quality feature could read:

'Those running schemes take reasonable steps to understand the needs of the membership and provide a suitable default strategy'.

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**1.8 The number and risk profile of investment options offered reflects the needs of the membership.**

We feel this is a well-drafted quality feature. Note, though, that the 'needs of the membership' is a different statement to 'the needs of members'. The former suggests suitability in aggregate for a group, the other personal suitability. We feel these are different concepts with the former much easier to achieve than the latter.

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**1.9 Investment objectives for each investment option are identified and documented in order for them to be regularly monitored.**

There are several investment quality features, which are substantially similar. We see the need for two or at the most three pertaining to the establishment of an investment approach that suits the needs of members/the membership (including the legal obligation for automatic enrolment schemes to offer a default fund) and then the ongoing maintenance of that investment approach.

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**1.10 A process is provided which helps members optimise their income at retirement.**

We feel that this quality feature could be merged with quality feature 6.5. We would word this as 'A process is provided to help members to make appropriate decisions before and at retirement'.

## **Principle 2 – establishing governance**

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**2.1 Sufficient time and resources are identified and made available for maintaining the ongoing governance of the scheme.**

We feel that this is well-drafted but also feel that this would be one of the harder quality features to assess objectively by an external auditor providing assurance. It gives room for trustee discretion but is highly subjective. Whether or not sufficient time and resources have been made available is probably only observable in retrospect from the quality of decisions made by trustees. As such, it is a good example of the potential complexity of an assurance framework.

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**2.2 Those running schemes support employers in understanding their responsibility for providing accurate information, on a timely basis, to scheme advisers and service providers.**

In the main part of our submission and in our submission on 'maintaining contributions' we comment at some length that there are tensions between running a low-cost scheme, providing value for money for members and engaging in activities that support regulatory activity and enforcement. As such, we believe that this quality feature should be subject to a 'reasonableness test'.

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We are also concerned about how this situation may develop. It will not be sustainable for further responsibilities in this area to be loaded onto those running schemes across the course of staging.

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**2.3 Accountability and delegated responsibilities for all elements of running the scheme are identified, documented and understood by those involved.**

We have no comments to make on this quality feature.

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**2.4 Those running schemes establish and maintain procedures and controls to ensure the effectiveness and performance of the services offered by scheme advisers and service providers.**

We have no comments to make on this quality feature.

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**2.5 Those running schemes establish and maintain adequate internal controls which mitigate significant operational, financial, regulatory and compliance risks.**

We have no comments to make on this quality feature, although we note that it is similar to the one we have numbered 1.3. (and could therefore potentially be merged with it).

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**2.6 Arrangements are established to review the ongoing appropriateness of investment options.**

We feel that this could be incorporated into another investment quality feature. This overlaps substantially with quality features 1.8 and 4.3. Please see the general note on the investment quality features in our comment under quality feature 1.9.

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## **Principle 3 – people**

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**3.1 Those running schemes understand their duties and are fit and proper to carry them out.**

We have no comments to make on this quality feature, although we note its similarity to the one we have numbered 4.1. (and could therefore potentially be merged with it).

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**3.2 Those running schemes act in the best interests of all beneficiaries.**

We note that the quality features and the rest of the regulatory package refer to the best interests of members and the best interests of all beneficiaries. These are worthwhile sentiments but they're not quite in line with the legal position.

There is, though, for trustees of occupational pension schemes:

- 1) a fiduciary obligation to act in the interests of beneficiaries
- 2) a statutory obligation to act in the best interests of beneficiaries on matters of investment
- 3) a fiduciary obligation to act in the 'best financial' interests of beneficiaries on matters of investment.

We feel that two things would be helpful here. As we've suggested in the main body of our response, the first would be to codify the fiduciary responsibilities of trustees in the guidance. The second would be a broader discussion about the nature of the member/beneficiary interest. We would suggest that the interests of the member will vary over time and will come into tension with aspects of the regulatory package. We would also note that at points the interests of the membership in aggregate will differ from the interests of the individual member and that this also must be balanced in a sensible manner.

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**3.3 Those running schemes are able to effectively demonstrate how they manage conflicts of interest.**

We have no comment to make on this quality feature.

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## Principle 4 – ongoing governance and monitoring

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### 4.1 Those running schemes regularly review their skills and competencies to demonstrate they understand their duties and are fit and proper to carry them out.

We have no comments to make on this quality feature.

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### 4.2 Those running schemes take appropriate steps to pursue and resolve all late and inaccurate payments of contributions.

The NEST Trustee has commented on the matter of late payments in our submission to the 'maintaining contributions' consultation. We do not see the resolution of all late payment events as practicable and do not feel that the costs of enforcement of the automatic enrolment legislation should fall on NEST's membership.

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### 4.3 Those running schemes monitor the ongoing suitability of the default strategy.

We feel that this overlaps with quality feature 1.7 and the two could potentially be merged.

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### 4.4 The performance of each investment option, including the default, is regularly assessed against stated investment objectives.

We feel that this overlaps with quality feature 1.9. Please see the general note on investment quality features under quality feature 1.9.

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## Principle 5 - administration

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### 5.1 Member data across all membership categories is complete and accurate and is subject to regular data evaluation.

We believe that this should be reworded to read 'Providers should be able to effectively demonstrate good data handling practices in compliance with data protection legislation'.

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### 5.2 Core scheme financial transactions are processed promptly and accurately.

We have no comments on this quality feature.

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### 5.3 Administrators maintain and make available their complaints process.

We note that this quality feature has been deleted. While we feel that this list would generally benefit from fewer and not more quality features, we feel that this deletion is not the right course of action. Complaints procedures are of great importance to the membership and the quality of the scheme. | For this reason we believe that this feature should be retained.

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### 5.4 Administration systems are able to cope with scale and are underpinned by adequate business and disaster recovery arrangements.

We believe that this feature should be reworded to read 'administration systems are able to cope with appropriate scale and are underpinned by adequate business and disaster recovery arrangements'. This form of words recognises that scale will vary from scheme to scheme and what is appropriate will vary in a similar manner.

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## Principle 6 – communications to members

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### 6.1 All costs and charges borne by members are disclosed to members.

We note that there are two quality features addressing the matter of charges (6.1 and 1.2), dealing with disclosure to individuals and disclosure to employers. We feel that these could be merged.

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### 6.2 Members are regularly informed that their level of contributions is a key factor in determining the overall size of their pension fund.

We have no comments on this quality feature.

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### 6.3 Scheme communication is accurate, clear, understandable and engaging and addresses the needs of members from joining to retirement.

We believe that this could be reworded to read 'scheme communications are designed with consideration for clarity, accuracy and member understanding'.

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### 6.4 Members are regularly informed of the importance of reviewing the suitability of their investment choices.

We feel that this quality feature could better reflect current thinking on member engagement and member choices. While we have designed a communications approach and materials that are engaging and easy to understand, we anticipate low levels of engagement with the NEST product. As such, NEST is designed to operate and provide a good member outcome in the absence of financial advice and with little or no member input in respect of the investment choice. We feel that this is in tune with the way that those automatically enrolled will actually behave, based on similar international experience. We also feel it can protect members from common mistakes made by inexperienced investors.

Our members will, in the main, not be investment specialists. We feel that there are potential risks in encouraging people to take investment decisions for which they may not be well equipped. The investment research literature is full of examples of common investor errors, notably performance chasing, a tendency to ride losses and to buy at the top of the market and then sell at the bottom. We know that it is not the intention of TPR to encourage these behaviours but feel it important to note that member engagement in the investment aspect of the product carries potential risks as well as potential benefits.

As such, we would suggest amending this quality feature to read: 'Members are regularly made aware of their current investment strategy, what this means for them, and what alternatives are available'. We feel this shifts the balance of the quality feature towards the provision of useful information to the member and lets the member choose whether or not to exercise a choice, rather than encouraging them to become actively involved with the investment of their pension fund.

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### 6.5 Those running schemes clearly communicate to members the options available at retirement in a way which supports them in choosing the option most appropriate to their circumstances.

We feel that this could be merged with quality feature 1.10.

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