Society of Actuaries in Ireland

Regulation of defined contribution master trusts

Response to Consultation Document issued by the Pensions Authority

October 2018

Preface

The Society of Actuaries in Ireland ("Society") is the professional body representing the actuarial profession in Ireland.

We welcome the opportunity to submit this response to the Pensions Authority's consultation document on the Regulation of defined contribution master trusts.

We would be happy to respond to any questions on this response – please contact Philip Shier, Actuarial Manager, at Philip.Shier@actuaries.ie.

Introductory comments

The Pensions Authority issued a consultation document on the Regulation of defined contribution master trusts on 26th July 2018, with a deadline for submission of responses of 5th October 2018.

The Society welcomes the publication of the consultation paper and notes that the proposals outlined reflect some of the recommendations which the Society put forward in response to the Authority's consultation on "Reform and simplification of supplementary funded private pensions" in 2016. We recognise and support the concept of there being a regulatory regime in place for master trusts which recognises their specific characteristics and which will ensure that they operate effectively, securely and provide good outcomes for members.

This is one of three interrelated consultation processes that are underway, the other two being:

1. Interdepartmental Pensions Reform and Taxation Group —encompassing three main strands:

    A. simplification measures, removing inconsistencies and reduction in the number of pension savings vehicles

    B. reviewing the cost of supplementary pensions to the Exchequer (i.e. structure of tax incentives)

    C. broad review of the utilisation of the ARF option (potentially opening up possibility of in-scheme group ARF/drawdown solutions)

2. Automatic Enrolment (AE) strawman proposal consultation document issued by the Department of Employment Affairs and Social Protection which, while aimed at those currently not saving for retirement, will have very significant implications for all private sector retirement provision in Ireland.

Together with the imminent transposition of the IORP II Directive, the combined conclusions of these consultation processes are likely to materially influence and shape a much-changed Irish pension system, and the place and role of master trusts.

Two particular challenges that we identified in formulating our response are the overlapping impact of the aforementioned developments and also the relatively limited detail set out on how some of the topics addressed in the consultation paper might be implemented in practice.

Before turning to comments under the key headings set out in the master trust consultation document, we would highlight the following key points:

- The Authority's expectation is that the increased governance requirements under IORP II will make small schemes non-viable and employers will be attracted to master trusts, which we accept should improve the overall standards of governance and will facilitate the Authority in discharging its supervisory responsibilities.

- It is our expectation that master trusts will primarily be established by commercial entities rather than on a not-for-profit basis and that the structure of the regulatory regime should reflect this (as in UK). It is our impression that the approach set out in the consultation paper is reliant on the ability of the trustee DAC directors to be able to concurrently serve multiple masters (e.g. shareholders and members). We suggest that there is much that could be gained through leveraging the UK master trust authorisation framework in establishing a more robust framework for master trusts, which would then lead to greater consumer confidence in the system.

- Capital requirements along with greater governance standards will add a layer of cost – one which we believe it is necessary to add in the interest of creating confidence in the system – and in the short term these costs may be significant relative to the capital provided and the funds invested. This will be a challenge to the feasibility of master trusts.

- It would seem that master trust sponsors will be challenged to develop a proposition that will prove both attractive to employers and members, whilst also being capable of delivering a commercial return on the set-up investment and ongoing capital requirements. The proposed requirements around independence and conflicts of interest may be a barrier for some commercial entities in providing the capital.

- The consultation document defines a master trust as "a funded scheme, the members of which are persons who are employed or were previously employed by unrelated employers". Has the Pensions Authority considered whether it should bring schemes promoted by a particular provider that share a number of common features/components into the master trust regulatory framework, as appears to now be the case in the UK with tPR's definition of "cluster schemes"? Not considering this point may give rise to unintended regulatory arbitrage which might undermine the Authority's goal.

- Whilst we recognise that ARFs are the subject of a parallel consultation exercise, we suggest that it would be useful if the Pensions Authority would elaborate on what role it expects master trusts will have in the group post-retirement ARF/drawdown space. There is no reference to this in the consultation document, but it would seem reasonable to expect that master trusts may have a valuable role to play in this.

- The AE consultation paper envisages that Registered Providers may be established as master trusts, but it is not expected that AE will be in operation until 2022. If the Authority intends that a new framework for master trusts be introduced before that date, it would be desirable to ensure that it is consistent with the (expected) requirements of the AE regime.

Overall there is a lot still to be clarified in turning the thoughts set out in the consultation paper into an operable regulatory framework that will be able to deliver on the Authority's objective.

In the remainder of this response we have set out comments under the main headings of the consultation paper.

Master trust requirements - Trustees

The Consultation Paper states that master trusts should be run by a trustee structured as a single purpose Designated Activity Company (DAC). The majority of directors of the DAC are required to be "independent".

We are in broad agreement with the proposal that each master trust would be governed by a single purpose DAC.

We would challenge the proposed requirement that the majority of the trustee DAC directors must be independent, with independent meaning that the director "is not connected or associated with the shareholder of the trustee company or the service providers to the scheme other than in their capacity as trustee". If a commercial entity is to put forward the necessary capital, we are of the view that, while there should be a requirement for an independent chair and/or other independent non-Executive directors, it is a step too far for there to be a requirement for the majority of the directors to be such.

Under the proposed structure, it will be difficult for the directors of the master trust DAC to reconcile their responsibility to the shareholders under commercial law with their duty to serve the membership to the best of their ability under trust law.

We suggest that the objectives of the Authority in relation to both the independence and functional role obligations would be better addressed by the Authority regulating a wider group of key role holders that will be inherent in the running of a master trust. The UK master trust regulations helpfully call out the following key roles in addition to that of the trustee:

- Scheme funder
- Scheme strategist
- Persons who can appoint or remove trustees
- Persons who have the power to vary the terms of the trust
- Promoter or marketer

We would consider that the persons who have a material influence on the governance and operations of a master trust be subjected to fitness and probity requirements along the lines of the Central Bank PCF regime.

We would also suggest that the definition of "independent" could be usefully clarified further – what if for example there was a past employment or other connection? Given the size and structure of the Irish market, it is likely that many individuals who are "fit and proper" to act as independent directors would be excluded if the independence requirements were overly restrictive.

Master trust requirements – Business Plans

The Authority expects that the trustee must revise and update a business plan for review by the Authority that is "sufficiently detailed and comprehensive for the Authority to understand and be satisfied as to its reasonableness and robustness". This task goes well beyond the level of input that would be expected of a pension trustee in a stand-alone scheme and may in any event be delegated to a scheme management function.

We note that the business plan will have to "outline how the scheme can be expected to grow" yet the consultation paper states that trustees of master trusts "may not have responsibility for the marketing of the scheme”. This seems to us to be somewhat of a contradiction. We would suggest that in reality much of the work in shaping the business plan and the ongoing marketing of the scheme would be undertaken by the Scheme Strategist and Scheme Funder roles as envisaged in the UK regulations.

Where a master trust is viewed as a self-funding / self-supporting entity, we agree with the high-level requirements mentioned in the consultation document around financial projections and would be happy to engage / comment on more detailed requirements when they emerge. We would suggest that the following details are also captured in the plan:

- Business strategy to include commercial objectives and growth strategy
- Expected income sources
- Commentary on the degree of certainty around costs
- Potential sources of capital / future funding if required and any conditions attaching
- Details of third parties relied upon and any key individuals
- Details of any circumstances in which member accounts could be negatively affected

The consultation document is silent on the responsibility for and governance of the administration (e.g. record keeping, member transactions and operational reporting) of the master trust, or the Authority’s supervision of this aspect, which is fundamental to the successful operation of a master trust. Poor administration is the rock upon which many schemes could easily founder. We therefore recommend that administration capabilities and performance be a substantive factor in the Authority’s assessment of the viability of a master trust.

It is likely that some master trust sponsors will be financial institutions that are already regulated by the Central Bank of Ireland. The Pensions Authority should give some thought as to how its proposed regulatory oversight will interact with that already undertaken by the Central Bank and, in particular, seek to identify potential synergies that can reduce unnecessary/duplicate regulatory costs which will ultimately be borne by the members.

Master trust requirements - Capitalisation

The Consultation Paper states that master trusts should be required to demonstrate sufficient capital to cover running costs for two years, along with any wind-up costs that might arise, to ensure that in the event of the scheme having to wind up, members could be transferred to another arrangement without suffering additional costs.

It seems reasonable to us that there should be a capital requirement for master trusts. Master trust funders should be required to demonstrate their commitment to supporting the master trust. Moreover, an appropriate capital requirement will act as a deterrent for practitioners without the scale or financial resources necessary to adequately support a master trust over the long term.

The level of capital proposed by the Pensions Authority is liable to grow significantly as membership increases. Economies of scale should arise in respect of governance and perhaps investment charges. However, the economies of scale related to the administration of master trusts are limited, as the work in maintaining payroll feeds from each of the multiple employers, handling member records and providing sectional reports to the employers will still exist at a not too dissimilar level to that involved in servicing the same population through multiple single employer trusts. Furthermore, there are barely any economies of scale when it comes to wind up as DC wind up costs are highly dependent on the number of members in the scheme.

We agree that it is desirable that master trust funders should be required to show commitment to the master trust by providing capital to cover the cost of wind-up in the event that they decide to walk away from the master trust. At the same time, it is not sensible to force the master trust's members to bear the full cost of capital to provide for an event that might never happen, or that might be readily arranged by other means.

Assuming capitalisation is required against two years' running costs and wind up, then we believe that allowances should be made for factors that would in all likelihood be available to reduce or offset the cost of a wind-up exercise. For instance:

- Master trusts should be allowed to offset a prudent estimate of the income which is reasonably certain to arise such as the portion of annual management charges, or administration fees normally invoiced to participating employers, which would typically be used to pay for ongoing operations
- A way should be found to deliver economies of scale for master trusts as they grow by means of a limit on the escalation of capitalisation requirements. This could take the form of a sliding scale of capitalisation per member after membership reaches certain trigger points.

Master trust funders should be permitted to examine any other capital they are obliged to set aside, and where there is effectively crossover between the requirements relating to master trusts and other regulatory requirements, they should be permitted to make use of those amounts.

Master trust requirements – Risk assessment

The Consultation Paper states that risk assessments for master trusts must be prepared annually and take account of risks that are specific to master trusts. It identifies the specific risks to be:

1. Master trusts are likely to be bigger
2. Multi-employer makes contribution and data collection more complicated
3. Conflicts of interest
4. Employers less involved

Size of itself should not be a particular risk factor for members – larger schemes tend to have better governance and oversight, and may deliver some economies of scale.

Contribution and data collection across multiple employers will indeed be more complicated and hence we recommend that the Pensions Authority pay significant attention to administration capabilities in assessing the viability of master trust business plans.

The consultation paper includes sections that address risk relating to conflicts of interest and employers being less involved (communications and charges). We have set out our comments in relation to these aspects in the respective sections.

We question why master trusts would have to produce an Own Risk Assessment annually when this may not be required for large Defined Benefit schemes where there is more risk to be assessed? Would a triennial approach make more sense?

Master trust requirements – Conflicts of Interest

Inherent in the landscape of Irish pensions provision there are numerous conflicts of interest for trustees. They may be current members of their own plan, pensioners, senior executives of the sponsoring employer or a trustee who receives remuneration for service. These types of conflicts are accepted on the basis that the trustee should know that their decisions may not be coloured by the effect that the decisions would have on their interests. There may however be conflicts that are so great that the ability for the trustee to act impartially would be questionable by any common-sense review. In such a case the trustee would be expected to recuse from taking part in the decision-making process.

The prohibition of there being “any contractual conditions binding the master trust to particular service providers” combined with the DAC independence requirements would seem to limit the willingness of commercial providers to put up the of the necessary capital and other resources underpinning a master trust.

Furthermore, the requirement that the master trust must be “unambiguously run in the best interests of the members” is difficult to reconcile with the provision of a return on capital invested by the scheme funder.

We are of the view that it would be strongly preferable to have a clear and transparent view on the scheme governance structures rather than there being various opaque (behind the scene) measures being put in place by the parties putting up the necessary capital backing for a master trust to protect their interests.

Master trust requirements – Member/employer communications

We broadly agree that trustees should have a policy for communication with employers and members. Trustees may, in practice, delegate much of this communication to service providers with trustee sign off on documentation issued on their behalf.

It is reasonable that the consultation document notes that, in a master trust structure, the employer is expected to have less direct involvement with trustees which will impact communication channels. Nonetheless the employer continues to have certain obligations in relation to communication, in particular, to ensure that all eligible employees are advised of the opportunity to join the scheme.

We would question the viability of the trustees holding an annual meeting to which members and employers are invited. Potentially there are better, timelier and more cost-effective means (e.g. social media, live streaming, webinars, etc.) that could be put in place to proactively communicate with and obtain feedback from both members and employers.

Master trust requirements – Charges transparency

We agree with the Authority’s view that it is particularly important that members and adhering employers can understand the master trust charges and are able to move to another provider if they are not satisfied that they are receiving value for money. However, we believe that to achieve transparency of charges, disclosure needs to go further than trustees having a written policy.

Given the relative size of the Irish market and as a result the relatively high degree to which various insurance companies / benefit consultancies / trustee companies / individual trustees are intertwined there is potential scope for material conflicts arising. However, by the nature of the arrangements, master trusts are commercial entities working in a competitive market, therefore you would expect that charges/costs would be minimised due to competition. A key driver in managing this will be transparency and disclosure of information.

One example of how this could be managed is if all entities are required to disclose charges in a standard manner and these were held in a central, publicly available database. Master trust providers could be required to disclose their administration charges to members against market benchmarks. Similarly, stringent requirements on trustees to monitor investment options should assist in reducing potential conflict of interest issues. We recommend that a review of international best practice (e.g. New Zealand, Mexico) in the area of the communication of summary cost / service level information would potentially be helpful.

There should be a requirement for clear benchmarking of costs and services from each master trust, including member investment costs being incurred (e.g. Total Expense Ratio by fund). This will encourage competition within the master trust system to drive the best value for money. A policy of controlling charges does not necessarily lead to better outcomes and market competition/disclosure is likely to lead to a more efficient approach e.g. PRSAs are often more expensive than BOBs. Any benchmarking of costs must align with the services being provided in order to allow easy comparison between low cost/low service arrangements with higher cost arrangements providing broader services like communications, advice and diverse fund options.

That said, we have concerns that moving to a single standard pricing structure for each master trust could have adverse consequences. Recognising the challenge in delivering low charges to members and the contribution that many employers currently make towards the running costs of their pension arrangements and/or the cost of advice, we are very much of the view that it is appropriate to allow for different charges between different sections / employers within a master trust. This would facilitate employers who want to pay some or all of the administration costs for their staff. Policy should not discourage this.

Different sections/employers may also have different charges due to the size of the employer. For example, a large employer with 1,000 staff would expect lower charges than an employer with 5 employees. If the charges for a particular master trust were set purely based on the costs associated with having smaller employers participate in the master trust, it would not attract larger employers which would limit the master trust's ability to achieve economies of scale and which in turn would be to the detriment of smaller employers.

The consultation also proposes that increases in charges can only be made by giving 12 months' notice to members. While we agree that members should be given advance notice of increases, we note that there may be circumstances where 12 months' notice is too long (e.g. increases arising from changes in legislation) and may not be in the members' best interest (e.g. delaying a change of investment manager or default asset allocation strategy).

The provision of advice to members at or approaching the point of retirement (and potentially thereafter should in-scheme ARF like drawdown structures be facilitated) could be an optional value-added service provided by some master trusts. While any such optional member charges should be fully transparent, we are not of the view that they should be subject to a 12-month variation restriction as they may in practice be both member and service specific.

For master trusts to be able to have the ability to transfer member assets in or out without charge, we suggest that the process for transferring from existing schemes or between master trusts needs to be simplified as has recently been done in the UK in the light of practical experience. The current Bulk Transfer regulations contain information that is not necessarily appropriate for 'defined contribution only' transfers.

It could be expected that there would be regular movements of funds from one master trust to another (e.g. where an employer decides that they wish to change arrangement) and this needs to be easily facilitated both in the transfer rules and by setting protocols around how such transfers would be managed across the industry as the practical difficulties of changing providers currently acts as a barrier to movement from one provider to another.

Master trust requirements – Marketing of the scheme

It is likely that the marketing of a master trust will be carried out by the scheme funder or one of their appointed agents, rather than the trustees. We agree that marketing content should not be misleading. However, we are less sure if explicit Trustee consent should be required for all marketing material.

It may be, depending on the entities involved behind the master trust, that marketing material would need to comply with the relevant Central Bank regulation/code in relation to the marketing of financial products and services. This is an area where we suggest the Pensions Authority should have a joined-up approach with the Central Bank.

Master trust requirements – New members

It would be helpful if the Pensions Authority could clarify the circumstances in which the granting of consent by Trustees for new members would operate:

- Is it intended that trustee consent would be required only when new plans/employers join the master trust?
- Would this consent extend to new members enrolling in existing plans in the master trust as well?
- Would trustee consent only be required if the number of new members enrolling in the master trust each year exceeds a certain limit (perhaps linked to the business plan submitted)?

We agree that Trustees should be aware of potential new members entering the plan, where members are taken to be employers. We do not think the trustees need to be aware of each individual enrolee. A pragmatic approach should be taken. We would suggest that the escalating capital requirements represent a mitigation against the risk of there being too many enrolees.

Master trust requirements – Wind-up procedure

We agree that all master trusts should have written procedures which they can implement in the event of a wind-up. The procedures should include clear timelines for each step and the entire process should be capable of being completed in a timely manner.

The procedures should include details of member and employer communications plans, the legal and regulatory processes which need to be followed and the role of the registered administrator and funder/sponsor/founder as well as any third party providers. The plan should be costed and capital held to fund it so that member accounts are not charged.

The needs and expectations of both active and deferred members as well as employers should be considered separately so that interruptions to the members' pension saving journeys are minimised.

The procedure should consider different potential triggering events which could result in the scheme winding up, how the wind up (and specifically member outcomes) might differ depending on the triggering event and the extent to which other alternative resolutions to winding up might be considered. To ensure all options are available to trustees when faced with a wind up or potential wind up scenario, it would be helpful if the bulk transfer regulations were reviewed in the context of master trusts.

The procedure should be reviewed annually to ensure it reflects current pension regulations and is appropriate to the scale of the master trust and should be approved by the funder/sponsor/founder.

Wind up represents a challenge for members, participating employers and the master trust funder, but it will inevitably represent an opportunity for somebody else: an alternative pension provider will acquire significant business as a result of the wind up. It would seem logical that master trusts should be allowed to construct living wills, whereby an alternative provider agrees in the event of a trustee decision to wind up the master trust to contribute to the cost of the wind up in return for acquiring the relevant member accounts. The master trust would be allowed to offset a prudent estimate of the amount of funding available against the capitalisation requirement relating to the event of wind up.

Master trust requirements – Reporting to the Pensions Authority

We are broadly in agreement that a different and enhanced approach to authorisation and supervision of master trusts over that currently applying to individual employer occupation pension schemes is appropriate. (This is also consistent with the Society's response to the 2016 consultation – "We agree that the introduction of a pre-establishment authorisation process would lead to a more robust pensions system.")

More detail in relation to the supervisory process is required prior to being able to comment in detail. For example, will the reporting requirements take the form of a three-strand approach – required annual documents/reports to statutory deadlines, event driven notification to the PA and ad hoc/ongoing requests for information by the PA? Further detail and guidance is required in relation to notifiable events and the relative reporting timelines and structures of such reporting.

An important consideration is whether reporting and information requests will always be at master trust level or will there be a drilling down to employer level reviews/audits as currently?

In designing the appropriate set of master trust reporting requirements, the Pensions Authority should set out why it needs the various information and what it will actually do in response to what it may find in the reports. The Authority should consider whether a principle led approach would be more effective rather than a tick-box set of detailed compliance hurdles which will have little direct benefit to the master trust member.

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