

Regulation of Pension Schemes in the United Kingdom

The following issues arose in connection with the regulation of pension schemes in the United Kingdom. They may be relevant to the development of policy on pension fund governance, regulation and supervision in China.

1. Is there a need for a Pensions Regulator?

Until the implementation of the Pensions Act 1995, the United Kingdom did not have a pensions regulator, as the Government had not been considered necessary to have one. This was because:

- i) The Government believed (wrongly as it transpired) that those responsible for the administration of pension schemes and the management of pension fund assets would always act honestly, professionally, competently and effectively. In practice, the vast majority did act in that manner, but a major scandal (the “Maxwell affair”) demonstrated that it was possible to act criminally and defraud pension scheme members.
- ii) Legislation was in place to impose statutory requirements on the operation of pension schemes and on those who administered them. (However, there were no statutory restrictions on the investment of pension scheme assets on the basis that fund managers would act in the interest of pension fund beneficiaries and that, if their performance was inadequate, the trustees would choose other fund managers to replace them.) The statutory requirements were enforceable through the Courts. However, to take action through the Courts was costly and long-winded and, even if successful, could in practice prove to be of little assistance to the scheme members and beneficiaries if scheme assets had already been dispersed or otherwise lost. Furthermore, many pension scheme members could not afford to take legal proceedings, unless their trade union met the cost.
- iii) Among the legislation was a requirement for information about the operation of the pension scheme, its annual accounts, actuarial reports and annual report to be made available to the members and their trade unions. It was considered rightly that members and trade unions should and would take an active interest in the operation of their pension scheme and that they would take action where there was any suggestion of negligence, incompetence or inappropriate activity by the scheme trustees, administrators or fund managers. Although members might not themselves have detailed technical knowledge to understand the financial arrangements, trade unions would have that knowledge and would therefore act on behalf of their members. It is still considered essential that detailed information should be provided to members and

trade unions and that they should take appropriate action, when necessary. The current Regulator has powers to enforce the disclosure requirements.

- iv) The statutory “Occupational Pensions Board” (OPB) was established to advise the Government on pensions regulations, but also produced guidance material to explain to pension schemes how statutory requirements applied. It could also be consulted by pension schemes to determine whether their rules complied with the statutory requirements. However, the OPB did not have powers to enforce compliance and so was unable to act as a formal Regulator, nor did it have the role to identify whether scheme rules complied in relation to schemes that did not themselves seek its opinion. This contrasted with the Irish Pensions Board, which not only advises the Irish Government on pension issues and pension reform, but also has regulatory powers in respect of Irish pension schemes.
- v) The Government had established the Securities and Investments Board (SIB) to monitor the operation of financial services. The SIB authorised the establishment of a number of “self-regulatory” institutions to monitor financial services. For instance, the Life Assurance and Unit Trust Regulatory Organisation (LAUTRO) monitored life assurance companies and unit trusts, the Investment Managers Regulatory Organisations (IMRO) regulated investment managers; the Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA) monitored brokers and the Securities and Futures Authority monitored stock markets. (Subsequently LAUTRO and FIMBRA were merged to form the Personal Investment Authority (PIA)). The legislation required any undertaking providing financial services, including providing financial advice, in the relevant field to be affiliated to the appropriate self-regulatory organisation and to comply with its rules. Failure to comply could lead to a fine by the organisation or expulsion, which prohibited the undertaking from continuing its activity in the field. Exceptionally members of certain professions, eg solicitors (lawyers) and actuaries, were exempt from the requirement to affiliate to a self-regulatory organisation as a condition of providing financial services or advice, but had to comply with the profession’s codes of conduct. However, the self-regulatory organisations did not monitor the non-investment activity of pension schemes.
- vi) Before the establishment of the SIB and the self-regulatory organisations, the question arose as to whether these would be suitable supervisory bodies for financial services or whether there should be one or more independent regulators. The first alternative was chosen because the financial services community convinced the Government that it would be preferable. The justification was that those responsible for operating the self-regulatory organisations would be people who worked in the financial services field and would therefore better and more quickly be able to identify and recognise inappropriate, negligent or criminal activity than a regulator appointed by the Government who had not been directly involved in the financial services sector and so would be less able to identify fraud, deception or other rogue activity. The Government considered that the operation and rules of the self-

regulatory organisations would safeguard the interests of pension scheme members by monitoring the financial institutions responsible for the investment of pension scheme assets and for providing annuities. In the event, the self-regulatory organisations were not better able to identify financial misconduct, thus allowing some scandals to occur, nor were their powers sufficient to impose adequate sanctions of wrongdoers.

- vii) Eventually in 1997, Legislation was passed under which the self-regulatory organisations were abolished and the SIB was replaced by the Financial Services Authority (FSA) which is a single financial services regulator with far stricter powers than its predecessors and the power to impose more effective sanctions. The FSA acts as regulator of all activity in the financial services sector, including in respect of the investment of pension fund assets and personal pensions (3rd pillar pensions). It became a criminal offence to conduct business in the financial services sector without authorisation by the FSA.

2. Establishment of a Pensions Regulator

Following a financial scandal that resulted in members of pension schemes sponsored by companies operated by a man called Robert Maxwell potentially losing their occupational pensions, the Government was advised by a Commission, specifically established by the Government for the purpose, to establish both a pension regulator and a compensation scheme for persons who lost their pension rights as a result of fraud or other criminal activity.

- i) **Should there be a separate pensions regulator or should pensions come within the jurisdiction of the existing financial services regulator?** When the Commission recommended that that the Government should establish a regulator to regulate pension schemes, the question arose as to whether there should be a separate pensions regulator or whether regulation of 2nd pillar pensions come within the scope of the overall financial services regulator. It was decided that the functions of regulating the operations of a pension scheme were different in character from the regulation of financial services. Accordingly legislation to establish a separate “Occupational Pensions Regulatory Authority” (Opra) was adopted in 1995. A factor in deciding to have a separate pensions regulator was that there were over 150,000 schemes to be supervised. The legislation required all schemes to register and update their information, but there was no requirement for a licence to be issued before a scheme could be established and operated.
- ii) **Opra’s functions and powers.** Opra was given powers to suspend individuals from acting as pension scheme trustees during investigations of breaches of statutory requirements and, if the breaches were proved, to prohibit the individual from acting as trustee. They could also, where necessary, appoint trustees to replace existing trustees. In addition, Opra could impose financial penalties of up to £5,000 on an individual or £50,000 in other cases where trustees, employers or others were in

breach. Opra's powers extended to the following areas:

- ♦ Opra could wind up (ie close) a pension scheme if they considered it should be replaced by another scheme, it was no longer required, or winding up was in the interest of the generality of members.
- ♦ Opra could apply to the courts to prevent an individual from taking action where there was a likelihood that the individual would misuse or misappropriate pension scheme assets.
- ♦ Opra could apply to the courts to order restitution of payments made to a sponsoring employer except in the restricted circumstances permitted by legislation.
- ♦ Opra could direct trustees to take action to establish a separate bank account where an employer failed to hold sums towards pension payments in a separate bank account.
- ♦ Opra could direct that scheme rules could be modified (or themselves modify the rules) in appropriate specified circumstances.
- ♦ Opra could impose penalties or prohibit individuals from acting as a trustee where, for instance:-
 - ◆ Trustees did not take reasonable steps to provide for the election of scheme members to at least $\frac{1}{3}$ of the members of the trustee board;
 - ◆ Trustees failed to produce and maintain a statement of investment principles covering the kinds of investment to be held, the balance between different kinds of investments, risk and the expected return and realisation of assets, and/or failed to obtain professional advice before producing it.
 - ◆ Trustees failed to produce and disclose to members an annual report, audited annual accounts, an actuarial valuation at least every 3 years and to disclose to members the rules of the scheme and details of their individual rights under the scheme.
 - ◆ Trustees failed to appoint a scheme auditor and scheme actuary or took advice from an actuary, legal adviser, fund manager or other professional adviser other than one formally appointed as such..
 - ◆ An auditor or actuary who failed to "whistle blow" (ie who failed to report to Opra any breach that they had discovered). Other persons connected with the pension scheme, eg trustees, members, fund managers or scheme administrators, could "whistle blow", but they were not under an obligation to do so and so could not be penalised for failure.
 - ◆ Trustees failed to have a separate bank account or to keep records or minutes of meetings and accounts of transactions.
 - ◆ Trustees failed to adopt a procedure for resolving disputes with individual members.
 - ◆ Trustees failed to obtain an actuarial valuation within the prescribed time or to produce a schedule of contributions stating when and at what rate contributions must be paid into the scheme by the sponsoring employer and, where applicable, the members.
 - ◆ Trustees failed, when a scheme was winding up in deficit, to allocate the

assets in accordance with a statutory priority order.

- ♦ Opra was given the power to demand the production of any document relating to the pension scheme and to send an inspector to business premises to make necessary enquiries and examinations of persons and documents if they believed that members of the scheme were employed there, the scheme was administered there or documents relating to the scheme were held there.

- iii) At the same time as establishing Opra, the legislation made it a criminal offence for:
- ◆ a pension scheme to invest more than 5% of scheme assets in the sponsoring employer;
 - ◆ an employer not to pay contributions deducted from an employee's wages to the pension scheme trustees within a specified time; and
 - ◆ a person to refuse to provide a document demanded by Opra, to provide false or misleading information to Opra, or to obstruct an inspector acting on behalf of Opra.

Existing criminal offences of fraud, theft and misappropriation of funds continued to apply. A statutory requirement also imposed on insolvency practitioners a requirement to appoint an independent trustee if the sponsoring employer became insolvent. Scheme members were given powers to take legal action in the courts to force the insolvency practitioner to do so if he had failed to do so.

- iv) When Opra was established, the question arose as to who should fund it. Pension schemes pressed for it to be funded by the Government. However, the Government decided that it could not afford to pay for the cost of the regulator. Instead they adopted the principle that it should be funded by a levy on pension schemes according to the number of members. Scheme objections that well-administered schemes and their members would have to pay for the regulation of badly administered schemes were disregarded by the Government. To avoid undue cost to schemes by setting the levy too high, Opra was designed to operate on a reactive, rather than a pro-active, basis. Thus, although it had powers to inspect premises, it operated on the basis that auditors and actuaries would be required to, and others involved with pensions might, "whistle blow" and so notify Opra of any potential or actual breach. Opra would then investigate and take whatever action it thought appropriate.

3. **The Pensions Compensation Board**

- i) Following the Maxwell scandal, the Government had set up a fund to provide for the cost of current and future pensioners of Maxwell schemes. However, they decided that it was impossible to fund every scheme that became insolvent as a result of criminal activity. Instead the legislation establishing Opra also established The Pensions Compensation Board to administer a scheme that provided funds to support pension schemes that had lost funds where the sponsoring employer was insolvent (and so could not make additional contributions), there were grounds for believing

that the reduction of funds was due to a criminal offence and that following the reduction the value of scheme assets was less than 90% than the amount of its liabilities. The cost of the Pensions Compensation Fund was also to be met by levies of pension schemes. The introduction of Opra, its supervision of pension schemes and the penalties it could impose were intended to reduce the possibility of criminal activity affecting pension schemes. In practice, there were few demands on the Fund because of the very few occasions on which the conditions for payment under the scheme arose.

- ii) The Pension Compensation scheme operated on the basis that small interim payments were made to the scheme to ensure that pensions in payment could continue, but after a certain period when all scheme assets had been identified and realised, a lump sum payment was made to meet the deficit between the value of the assets and the amount of the liabilities.

4. **Replacement of the Occupational Pensions Regulatory Authority by the Pensions Regulator**

- i) Although the legislation establishing Opra and the Pensions Compensation Board had been passed as recently as 1995, new legislation was passed in 2004 to replace Opra and the Pensions Compensation Board. The 2004 legislation replaced Opra with “The Pensions Regulator” and the Pensions Compensation Board with the Pensions Protection Fund Board (PPF Board).
- ii) Experience of the operation of Opra had shown that its operation was defective. Because it acted when potential breaches were brought to its notice under the “whistle-blowing” arrangements, there could be occasions when breaches came to its notice too late, ie after the assets had been dispersed. While it could impose penalties on wrong-doers – and these were intended to act as a deterrent – to impose a penalty did not benefit scheme members if the scheme assets had all disappeared.
- iii) The Pensions Regulator was given statutory objectives, which included: to protect the benefits under 2nd pillar and certain 3rd pillar pension schemes of scheme members, to reduce the risk of situations leading to compensation under the PPF and to promote, and improve understanding of, the good administration of such schemes. Apart from not being permitted to borrow money, the Regulator was given the right to do anything calculated to facilitate exercise of its functions or incidental or conducive to their exercise. The new legislation was designed to give the Regulator a pro-active role in supervising schemes and not simply to react to whistle-blowing. The Pensions Regulator was given the powers previously operated by Opra, but its powers were extended additionally to the following areas:
 - ◆ It may issue an “improvement notice” where it considered that someone (including a legal person) was contravening a provision of pensions legislation or, having done so in the past, was likely to do so in the future. Such a notice

would order the person concerned within a specified period to take, or not take, specified steps to remedy or prevent the recurrence of the contravention;

- ◆ It may issue a “third party notice” where it considered that someone (including a legal person) was contravening a provision of pensions legislation or, having done so in the past, was likely to do so in the future, but the contravention was at least partly due to someone else’s failure, eg trustees could not publish the auditor’s report because the auditor had not completed the audit. In such cases a third party notice could order that third party to take, or not take, specified steps to remedy or prevent the recurrence of the contravention;
- ◆ It may apply to prevent an individual from taking action where there was a likelihood that the individual would misuse or misappropriate pension scheme assets.
- ◆ It may apply to the courts to order restitution of payments made to a sponsoring employer except in the restricted circumstances permitted by legislation.
- ◆ It may take action against a sponsoring employer who had failed to pay contributions to the scheme to recover the amount of unpaid contributions.
- ◆ It may apply to the courts to issue a “restraining order” and “repatriation order” under which, if funds are about to be, or have been, taken from a pension fund and used for an unauthorised purpose, to prevent them from being so used and/or to order them to be paid back.
- ◆ It may issue a “freezing order” directing that no further benefits may accrue under the scheme, the scheme may not start to wind up (close), no payments may be paid to the sponsoring employer and no transfers may be made in or out of the scheme during the period of the order without the authority of the Regulator.
- ◆ It may issue a “contribution notice” stating that a person is under a liability to make a payment to the scheme if:
 - The person was party to an act (or deliberate failure to act) to prevent recovery of a debt due from the employer to the scheme, or to prevent or reduce the debt becoming due; and
 - The person was the sponsoring employer or an associate.
- ◆ It may issue a “clearance statement” to confirm in advance that a person would not be party to an act (or deliberate failure to act) if he continued to act as described in an application.
- ◆ It may issue a “financial support direction” where the sponsoring employer is a service company or insufficiently resourced. The direction requires the person to whom it is issued (who will be the employer or an associate) to secure financial support to the scheme within a specified period and thereafter. (This was designed to ensure that a scheme could not become insolvent because the sponsoring company had minimal resources when an associate company (eg of joint venture) had the necessary resources.)
- ◆ It may issue a “restoration order” following a transaction at undervalue in respect of scheme assets to restore the position to what it would have been but for the transaction.

- ◆ It took over responsibility for the register of pension schemes with the power to require scheme trustees to provide specified information.
 - ◆ It was required to establish a register of persons prohibited from acting as trustees and on request to provide such information to schemes.
 - ◆ It may specify information that schemes must provide to it.
 - ◆ The whistle-blowing function is replaced by a statutory requirement for trustees, scheme administrators, sponsoring employers, professional advisers and other persons involved with the scheme to report to the Regulator to notify to the Regulator any duty relevant to scheme administration that is not being complied with. In addition the Regulator may issue a “report notice” requiring the trustees, sponsoring employer or other person connected with the scheme to provide a report on a specified matter. Provisions comparable to those of Opra apply in relation to the requirement to produce documents and inspect business premises.
 - ◆ It may issue codes of practice containing practical guidance in relation to pensions legislation and standards of conduct expected from persons exercising functions under such legislation.
- iv) The additional powers given to the Pensions Regulator were designed to ensure that action can be taken before a pension scheme becomes insolvent, instead of imposing penalties afterwards.

5. **Replacement of the Pensions Compensation Board by the Pension Protection Fund Board**

- i) The Pensions Compensation Board and Pensions Compensation scheme operated only in the event of criminal activity, and did not assist if the reduction in scheme assets resulted, not from fraudulent activity, but from negligence, mismanagement or incompetence. Nor did it operate if the reduction had resulted from a loss in the value of scheme assets due to the reduction in market values or from insufficient contributions at a time when the sponsoring employer was becoming insolvent. Between 1995 and 2004, these had become major causes of pension scheme insolvency. It was for this reason that the Pensions Compensation Board was replaced by the Pension Protection Fund Board (PPF Board) and the Pension Protection Fund (PPF).
- ii) The PPF operates in a different way from its predecessor. It operates whatever the cause of the insolvency of the pension fund and so is not restricted, as was the Pension Compensation scheme, to cases of reduction of scheme assets due to criminal activity. If an insolvency event occurs in relation to the sponsoring employer of a pension scheme or the scheme trustees make an application, the PPF Board must assume responsibility for the scheme if the scheme’s assets are less than its protected liabilities (ie the majority of its liabilities). The PPF Board may itself also take action where it becomes aware that the employer is unlikely to continue as a going concern.

If after a period of at least 12 months during which the PPF Board administers the scheme and no additional liabilities may accrue, the scheme's assets still remain less than its protected liabilities, the assets and liabilities of the scheme are transferred to the PPF and the scheme is wound up (closed). (If at that time the scheme's assets are sufficient to meet its liabilities, the PPF Board ceases its involvement.) If the scheme assets and liabilities have been transferred to the PPF, former pension scheme members will receive payments from the compensation payments from the PPF at a rate similar, but not identical to their previous entitlement under the wound up scheme.

- iii) The PPF is funded by the assets of scheme that it takes over, investment of its assets and a levy on pension schemes. In determining the amount of the levy payable by each scheme, account is taken, not only of the number of members of the scheme, but also of the risk involved, determined on the basis not only of the funding of the scheme, but also the likelihood of the employer becoming insolvent. A well funded scheme with an employer with little likelihood of insolvency will pay a lower levy per member than an underfunded scheme or a scheme whose employer is at risk of insolvency.
- iv) The new arrangements ensure that, where an individual would otherwise lose a pension, or receive it at a reduced rate, because of insolvency of both the pension scheme and sponsoring employer. (Where the sponsoring employer is not insolvent, the legislation places a liability on the employer to make good the shortfall.)
- v) The PPF Board also has responsibility for the "fraud compensation scheme", which is a continuation of the previous Pension Compensation scheme and operates under analogous conditions.

6. **The Pensions Ombudsman**

- i) Separately from issues relating to the regulation and supervision of pension schemes, the question arose as to how complaints against pension scheme should be dealt with. The Occupational Pensions Board (OPB) recommended that to avoid the cost to members and the delay of going to the courts, a cheaper and quicker alternative should be provided. The OPB recommended the establishment of pensions tribunals for different parts of the country, with three members of each tribunal: a legally qualified chairman and two other members with pensions experience. However, this recommendation was rejected by the Government on the grounds firstly of cost and secondly that there were insufficient sufficiently qualified people to stake part in tribunals if persons with an interest in, or involvement in the parties to, a particular case, eg lawyers, actuaries, trade union representatives, etc. had to be excluded. Instead the Government decided to introduce legislation establish in 1990 the office of Pensions Ombudsman.

- ii) The Pensions Ombudsman is a person appointed by the Government under the relevant legislation to:
- ♦ Investigate and determine any written complaint made to him by a scheme member, survivor or person claiming to be, or to be entitled to be, a member who alleges that he has sustained injustice as a result of maladministration in connection with any act or omission by pension fund trustees or managers;
 - ♦ Investigate and determine any dispute of fact or law arising in relation to a pension scheme between trustees or managers and a member, survivor or person claiming to be, or to be entitled to be, a member.
 - ♦ This was later extended to apply to allegations of maladministration by other persons and to disputes between trustees of more than one pension schemes

However, the Pensions Ombudsman cannot investigate and determine cases already before the Courts. Because of the pressure caused by increased workload in 2005 a Deputy Pensions Ombudsman was appointed to supplement the Pensions Ombudsman in determining complaints and disputes.

- iii) The issue was raised as to who should fund the Pension Ombudsman and his office. Pension schemes suggested that this should be the Government, but the Government rejected this proposal. Secondly it was suggested that complainants should have to pay for cases, or either complainants or those complained about according to whether the complaint was accepted or rejected. The Government rules that this would discourage poor pensioners from complaining. Finally the Government decided that the Pensions Ombudsman should be funded by a levy on pension schemes.
- iv) Maladministration was ruled to be wider than criminal activity. A pension scheme that had failed to answer a letter might be held to have caused maladministration. Similarly failure to take account of all the factors in reaching a decision was held to be maladministration. The Pensions Ombudsman invited the person against whom the complaint was made to respond and then the complainant could comment on that response. Finally the Pensions Ombudsman would give a determination and, if he did not reject the complaint, could order the pension scheme trustees to take specific action within a specified time and order compensation for the injury suffered.
- v) Because the number of complaints to the Pensions Ombudsman increased at a high rate, an organisation called the Occupational Pensions Advisory Service (OPAS), recently renamed The Pensions Advisory Service (TPAS), was brought in to deal as a “gatekeeper”. OPAS had earlier been established as a charity, but subsequently it additionally received funds provided out of the levy to fund the Pensions Ombudsman. OPAS had been established to deal with queries from pension scheme members and others and to clarify issues, especially where members had been under a misunderstanding, and to act as a mediator between

members and the scheme. To reduce the Pensions Ombudsman's workload, he decided that complaints should be referred firstly to OPAS to avoid the need for a formal investigation and determination in simpler cases. If OPAS could not resolve the issue or the member insisted on a formal determination, the complaint was referred to the Pensions Ombudsman for formal determination.

- vi) Although it has from time to time been suggested that the Pensions Ombudsman and the Pensions Regulator should be merged, the Government has recognised that they perform very different functions and there seems little likelihood of any merger.

7. Possible merger of organisations

- i) The British Government has established an enquiry to consider whether the Pensions Regulator and the Financial Services Authority (FSA) should be merged, with pensions supervision and regulation being taken over by the FSA. Both organisations have recently expressed the view that they should not be merged, but the Government will decide the issue later this year.
- ii) An alternative suggestion is that the Pensions Regulator should merge with the PPF Board. Both organisations have stated that their functions are very different and that a regulator should not be the organisation that provides compensation in the event of failure. The government will again decide the issue later this year, but it is unlikely that the two organisations will merge.
- iii) It is expected that at some date in summer 2007 the enquiry will report and consider the advantages and disadvantages of a merger of regulatory bodies. It is expected that the Government will consider the recommendations of the enquiry report and will decide on the future structure later this year.

8. Conclusions

It is clear that the good operation of pension arrangements in the United Kingdom has required an effective Regulator to supervise the operations of pension schemes and to safeguard the interests of members. This is in addition to the requirement to provide to members sufficient information about the scheme to enable them to take action themselves to protect their own interests. Although the vast majority of British pension schemes operate efficiently, effectively and honestly, there remain a limited number that operate negligently and very occasionally fraudulently. Experience has shown that the Regulator needs to have sufficient powers to be able to adopt a pro-active policy as regards the supervision of pension scheme to prevent illegitimate activity before it has any detrimental effect on member's rights under the scheme. Similarly it needs to have sufficiently strong powers to take action if a breach occurs.