Institute
and Faculty
of Actuaries

Regulating defined benefit schemes

IFoA response to The Pensions Regulator

Consultation Response

10 February 2014

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Institute and Faculty of Actuaries

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7 February 2014

Dear Mouna

IFoA response to the Pensions Regulator's ("tPR's") defined benefit consultation: setting a balanced approach

The IFoA welcomes the opportunity to respond to tPR's defined benefit consultation on setting a balanced approach. This response has been prepared by the IFoA's Pensions Board many of whose members advise trustees and sponsors of defined benefit pension schemes. The IFoA appreciated the opportunity for some of the Pensions Board members to attend the recent workshop on the consultation and we would welcome a further opportunity to meet with tPR staff to discuss some specific aspects of the consultation.

We have included some broad headings under which we would be grateful to have further discussions. The comments below summarise the main issues we have highlighted in our response that could cause difficulties in the successful implementation of the replacement Code.

Principles based guidance

As discussed further in our response to question 3, the IFoA supports the move to principles based guidance, rather than having an explanation of the legislation. In particular, we support the use of risk management techniques, although we would encourage tPR to consider carefully how to monitor their use, particularly for smaller schemes.

Documentation length

We would encourage tPR to consider the opinions of trustees and sponsors, particularly of smaller schemes, in regard to the length of the documents. Many such trustees and sponsors are not able to spend significant time on pension scheme matters; therefore, we would encourage tPR to consider setting out a shorter principles based Code, with additional information provided by means of guidance or case studies. We would also welcome an Executive Summary to identify the key points for stakeholders.

Proportionality

Again, principally in relation to smaller schemes, we would encourage tPR to apply proportionality to the implementation of the measures in the Code. We have referred in a number of places to ensuring that much resource is not dedicated to an outcome of limited benefit.

tPR's new objective

As suggested at the workshop, "sustainable growth" can be interpreted in different ways by different types of sponsor. We would welcome greater clarity in defining the term in order to avoid unhelpful discussions between sponsors and trustees, but recognising the breadth of meaning it could have. In addition, we would welcome clarification on the use of the word “any” in the new objective, as this could obviously be used by sponsors to minimise the extent of actions trustees could adopt.

Greater clarity between the Code and the governing legislation

In a number of places, the tension between tPR’s new objective (in addition to the current objectives) and trustees’ duties is apparent. We would welcome further clarification of this tension, recognising that it results in ambiguity in a number of places in the documentation. This is highlighted by omissions of legislative requirements, both primary and secondary, applying to trustees. This could generate future difficulties if courts judge trustees against the Code.

Actuaries’ responsibilities

We specifically reference the responsibilities of actuaries’ in our response to question 5f. We would encourage tPR to reconsider the specific references to actuaries and to ensure that the Code reflects the actual responsibilities of actuaries.

Small schemes

If tPR does not devote sufficient resource to trustees and sponsors of smaller schemes adhering to the Code, this could encourage less appropriate behaviours.

Should you want to discuss any of the points raised please contact Philip Doggart, Policy Manager (Philip.doggart@actuaries.org.uk/ 01312401319) in the first instance.

Yours sincerely,

Nick Salter

Nick Salter
President-Elect, Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries

Response to the consultation document "Regulating defined benefit pension schemes"

New objective on sustainable growth

1. Is our new objective on sustainable growth adequately reflected in the approach outlined in the draft consultation documents? If not, what more could we do to reflect the new objective?

The consultation documents make significant mention of the new objective on sustainable growth. Since the objective is new, we expect that it will take time for views on sustainable growth to evolve and practice to develop.

As we indicate later in this response, some parts of the documents, when read in isolation, do not reflect the balance provided by the documents in entirety. This may be applicable to the new objective. Given the length of the documentation, we recognise a temptation for trustees, sponsors and/or their advisers not to become sufficiently familiar with the documents in full and, consequently, they may be selective in their interpretation. We would recommend the inclusion of an executive summary in the documentation to mitigate this risk.

2. Is our interpretation of sustainable growth appropriate?

We welcome the emphasis on trustees and sponsors working collaboratively, but we would caution about conflicts of interest. The approach advocated (correctly in our view) is that the sponsor should supply all of the necessary information, but that it is the trustees who make the final decision on covenant and affordability. It is possible that information presented by sponsors to trustees may favour towards a preferred outcome, so the sponsor may have undue control, or influence, in funding negotiations. We would identify this risk as more likely to arise with smaller schemes rather than larger schemes.

"*Sustainable growth*" is not defined; therefore, the interpretation of sustainable growth is open to question and will undoubtedly mean different things to different entities. As an example of this, not all businesses will be growing, so sustainable growth could mean a well-planned, phased wind-down, but one that takes account of the scheme's cash needs.

There may also be a broad range of views as to what "sustainable growth" might be, with the "funnel of doubt" widening over lengthening periods of time. There may be a challenge in coming to a platform as to what sustainable growth is for a particular sponsor/scheme.

We would encourage considering the "true" lifetime of the scheme against the context of the sponsor's sustainable growth. This should take account of de-risking programmes in place. For a sponsor with an expected finite lifetime because of a phased wind-down, the expected length of that wind-down period is clearly important in the context of funding the pension scheme. It is also important to recognise how the covenant would change during the phased wind-down so that risks to the pension scheme can be adequately understood. It may also be helpful to observe the dangers of trustees and advisers using undefined terms, such as "self-sufficiency", in this context.

There is an important distinction between the sustainable growth (or otherwise) plans of the legal sponsor and that of the sponsor's wider group. We would encourage making this distinction more prominent in the Code.

Since sustainable growth (and indeed sponsor covenant) varies between organisations, there is a risk that reviews of sustainable growth and sponsor covenant could become too codified. The level of investigation undertaken will depend on many factors, including trustee skills and the nature of the sponsor. To avoid resources being used up in unnecessarily complex exercises measuring sustainable growth and assessing sponsor covenant, we would encourage tPR to take a balanced and proportionate view in each case. We are not certain that the message of a balanced, proportionate approach is sufficiently clear from the documents.

Code of practice

3. Does the practical guidance set out in the revised funding code reflect your experience of what good practice looks like? If not, why not?

We recognise the need for the Code of Practice to be updated and we fully support the change in focus from detailed explanation of the legislative process and requirements to principles based guidance. However, we do have concerns over a number of areas of the revised code. Due to the nature of the consultation questions, some of these concerns are repeated in our responses to more than one question.

The key themes to our comments are:

- The practicalities of applying integrated risk management and contingency planning in a proportionate manner, particularly for smaller entities;
- How the implementation of tPR's proposed new statutory objective affects trustees through the Code of Practice; and
- Whether tPR's expectations of trustees and sponsors in relation to funding and investment are sufficiently clear and whether these expectations are reasonable relative to current practice.

The revised Code emphasises the value to trustees (and sponsors) of agreeing contingency plans with clear triggers for action, so that action can be taken as and when identified future events occur. Our members advise a number of trustee bodies who started to draw up contingency plans in response to the introduction of the concept of the financial management plan in the 2012 annual statement. However, our members' experience suggests that even where sponsors have expended significant time and thought on developing plans, the plans may be relatively simple. We understand tPR's desire for trustees to have plans that go beyond an agreement to talk when a trigger has been sprung. We would question whether the types of action-based plans that are envisaged by the draft Code could be achieved in a proportionate manner for a significant proportion of pension schemes.

In relation to the concept of proportionality, we observe that this could be interpreted in two ways:

- Complying with a particular aspect of the tasks expected of the trustees (e.g. assessment of investment risk) but in a 'light touch' manner; or
- Deciding not to carry out a particular task at all.

It would be helpful if tPR could clarify, either in the Code itself or through supporting case studies, how it envisages the implementation of such a proportional approach. For example, where a very well funded scheme with a low risk investment strategy is very small relative to the sponsor, a proportionate approach to risk management could involve the use of a risk register rather than quantitative analysis.

Whilst contingency planning is a useful and helpful process, the ability to bring forward the next formal valuation appears to have been downplayed in the revised Code – it is first mentioned in paragraph 183 on the penultimate page of the main body of the Code.

As pointed out elsewhere in this document, we have some concern that the Code is diverging from the legislation applying to trustees. The existing Code is well aligned with the Pensions Act 2004 and Scheme Funding Regulations; whereas, the draft Code introduces issues which are absent from the Act/Regulations.

"Good practice" does not necessarily mean "best practice" and this brings us back to the concept of proportionality. It would be unhelpful if trustees or sponsors of small/medium sized schemes felt obliged to adopt practices appropriate for large entities, for whom the cost/benefit analysis is advantageous. The potential benefit for smaller schemes implementing such practices may be disproportionate to the potential outcome.

4. Is the approach to risk management set out in the code useful? If not, why not?

We support the concept of integrated risk measurement in relation to the funding of pension schemes. Trustees and sponsors should consequently be in a much better position to govern the scheme, with up-to-date information on the risks being run and understanding the impact of any changes in these risks on the likelihood on benefits being paid. However, we would again emphasise proportionality in understanding how to embrace the concept.

The Code, as drafted, may encourage trustees to look for sophisticated risk management techniques that are disproportionate to the benefits they will bring, or may simply not be appropriate to the particular situation of the scheme, or sponsor. We also have concerns (as indicated), that unlike scheme funding, integrated risk management is not a concept that is captured by legislation. This might make it more difficult to persuade stakeholders to implement integrated risk management, even where there are techniques which would be useful to the scheme specific situation.

The "Principles" section in paragraph 24 refers to trustees taking risk where "*they should be confident that the sponsor is able to mitigate adverse outcomes with appropriate contingency plans"*. In paragraph 102 (contingency planning), the Code gives several examples of such plans, but there is no mention of the sponsor's ability to increase future contributions if risks have not been rewarded.

This might suggest that risks should only be taken where they can be fully mitigated. We are not certain that this is the message tPR wishes to convey. In practice, pension schemes accept risks where all potential outcomes are not, or cannot be, fully mitigated. We would note the following examples:

- Investment in return-seeking assets may be deemed a reasonable risk even in the knowledge that extreme events (such as a collapse in equity markets) are possible.
- The sponsor is paying the maximum affordable contributions and the sponsor covenant is weak. The draft Code suggests that all other risks (including investment risk) should be eliminated. We are not certain this is required by the Scheme Funding regime, or intended by the legislators. It may be that, in order to sustain the scheme benefits, some investment risk needs to be taken (i.e. the statutory funding objective would be met through a combination of contributions and investment growth).

We note that the wording overlooks the importance of the formal valuation process, when the funding strategy can be reviewed, typically on a triennial basis. The draft Code could be read as downplaying the relevance of the valuation process (note our reference in our response to question 3 to out of cycle valuations) which again we do not believe to be tPR's intention.

We have a concern around the expectation that trustees are expected to react to a change in one of the covenant/investment/funding positions by adapting one, or more, of the other positions (covenant/investment/funding) to maintain the same risk balance. Such an approach could potentially involve constant adjustment and, therefore, lead to increased costs (governance, advisory and investment), so we would again encourage the recognition of proportionality. We also believe that the word "*ensure*" conveys a stronger message than is appropriate.

The draft Code also refers to understanding risk "*by reference to key quantitative indicators*" (paragraph 48) and that trustees "*should understand the risks across all of these strands and define acceptable parameters for each within which they will seek to manage the scheme*" (paragraph 43). We would question whether quantification of all the key factors is realistic, as many of the key risks might be qualitative, or unquantifiable in practice. An example of this would be the risk of change in ownership of the sponsor.

Finally, we note that some of the wording in the revised Code is looser than desirable for a Code of Practice. It switches between the words “managing” and “mitigating” risk. For example, paragraph 23 refers to risks being “*identified, assessed and mitigated*”, whereas paragraph 41 has, in our view, more balanced language and states that “*it is not necessary to eradicate risks completely but a prudent trustee approach to scheme funding entails understanding those risks, managing them*…”.

5. Does the revised Code provide sufficient practical guidance for trustees in relation to:

a. Working with sponsors and advisers?

We support the desire for a collaborative approach between trustees and sponsors and the messages given in paragraphs 71 – 75 inclusive. In particular, we support the message that trustees should appoint advisers with the necessary expertise, ensure that they understand the information the advisers need to fulfil their roles and they allow advisers to work together where this produces a more efficient outcome. We also support the view that trustees should document their reasons for not retaining an independent adviser.

We welcome the removal from the Code of the paragraphs around conflicts of interest for actuaries. The process for managing conflicts of interest for pension actuaries put in place by the IFoA last year is appropriate and can work well in the collaborative process envisaged.

We agree that trustees need to act in an impartial and independent manner; however, we are not sure how trustees can demonstrate that they have acted in such a manner. We would encourage the publication of guidance to illustrate how trustees might achieve this.

b. Assessing and monitoring the employer covenant?

The covenant advisory market has developed significantly since the advent of the scheme specific funding regime. We expect the messages since the 2012 funding statement on integrated risk management will provide further impetus. However, almost inevitably, the forward time horizon of a typical covenant review is materially shorter than the forward period used for pension scheme analyses, such as asset liability modelling exercises. We cannot see that the draft recognises the practical difficulties in getting a medium, or longer, term view on the sponsor covenant in order to develop an integrated risk management analysis. This would undermine one of the key principles set out in paragraph 24.

The revised code also suggests that trustees should understand how the sponsor covenant changes in different investment/funding scenarios. Whilst we support tPR in its desire to encourage trustees to carry out scenario planning, we are unsure how feasible it would be to get this analysis prepared (in a proportionate manner) and to have an appropriate length of time to which the analysis relates.

c. Assessing reasonable affordability, including understanding the impact on sustainable growth?

We accept tPR’s interpretation of its new objective (i.e. to focus on sustainable growth that supports the scheme) as a reasonable way of balancing its objectives.

However, our main concern is the way in which tPR’s proposed new statutory objective has been passed on to trustees through the revised Code, albeit in a slightly modified form. The new objective has been set for tPR, but it is not reflected in the statutory framework applying to trustees (or to scheme sponsors).

d. Their investment strategy?

This is another area where we draw attention to the divergence of the Code from the legislative framework applying to trustees. We recognise, however, that investment strategy and risk are inextricably linked to funding risk and covenant risk.

Funding and investment strategies for pension schemes have evolved over time. There will inevitably be some influence from previous legislative regimes which, it could be argued, provided more incentive to take investment risk (for example, in order to provide discretionary increases). Those strategies will also reflect schemes' difficulty in adapting to the significant changes in investment markets and longevity expectations over the last 20 years. Consequently, the level of risk being run in some pension schemes may be greater than either the trustees or sponsor would ideally want. Both trustees and sponsors would also prefer to have a greater probability for the payment of full benefits to members. This does not necessarily mean that a pension scheme's funding strategy is inappropriate; however, it does mean that immediate pressure to de-risk the investment strategy might make it more difficult to meet the benefit promises.

We would make some observations about specific phrases used in this section:

- Paragraph 111 refers to trustees being satisfied that their investment strategy is consistent with their "*assessment of the employer's needs*". It would be helpful if this concept were explained more clearly. We understand that this may be an indirect reference to sustainable growth, but we are not sure that it is helpful to use different phrases to reflect similar, but undefined issues.
- There is a suggestion that trustees should not be taking "unnecessary risks". We would encourage further explanation of this, given the potentially significant consequences for investment and funding strategies if applied literally and, of more concern, if used in evidence in a court of law. For example, where the sponsor is very strong and has sufficient resources to fund the scheme immediately to a solvency level it could be argued that no investment risk is necessary. However, this conclusion is not consistent with the statement in paragraph 12 of the funding policy document - ."*our statutory objectives do not require us to see elimination of all risks*

e. Technical provisions and recovery plans?

We welcome the wording on assumption setting and, with regard to discount rates in particular, the wording reflects our understanding of the requirements of the Scheme Funding regulations.

We note that paragraph 146 states the following:

"*When considering discount rate prudence a medium to long term assessment is possible, recognising that scheme funding is a long term activity; however, trustees should understand that it is difficult to be certain of employer covenant strength over that longer term*."

It is unclear to us what this means in practice when setting discount rates. One option would be to read it as suggesting that because covenant is uncertain in the longer term, any reliance placed on it should only be in the shorter term. We are not certain this is the intention. If this is an indirect reference to the desirability (or otherwise) of assuming reducing levels of investment risk over time, it may be preferable for this desire to be stated clearly

Unlike the current Code, the draft Code makes no reference to regulation 5(4)(d) of the scheme funding regulations. Given this is a legal requirement and, hence, an important aspect of the assumption setting process, we question this omission.

Paragraph 158 raises the idea of trustees attempting to recover contributions that were not made to the extent that they could have been paid where a risk strategy has not paid off. It may be desirable for trustees to try to agree such downside contribution mechanisms as part of the process of agreeing recovery plans. However, in reality at that point, unless there has been a contingency plan agreed in advance, the future funding will depend on the reasonable affordability of contributions from that point onwards, regardless of how any deficit arose in practice. In other words, there will be instances where the trustees believe it appropriate to take some risk without a contingency plan in place to mitigate the impact of the risk not being rewarded.

We are pleased that the problems associated with long recovery plans and higher assumed asset performance assumptions have been highlighted in paragraph 161.

Finally, we would note that it is becoming more common for trustees to adopt longer term funding objectives that are stronger than shorter term targets, such as their technical provisions target. The longer term objective may be based on a form of low-risk position as a proxy for buy-out, self-sufficiency or, for stronger sponsors, a sustainable long-term low-risk funding target.

It is also common for trustees (and sponsors) to accept that this higher, long-term target will be met through a combination of contributions and investment returns. These longer term funding objectives might not be formalised (e.g., because the sponsor wishes to retain some flexibility in its business) but may still be in the best interests of the scheme. We suggest it would be helpful for the Code to include some reference to this type of funding approach. In particular, with the shift in focus from technical provisions to the proposed Balanced Funding Objective (BFO), such long term targets will assume greater significance over time as the mechanism for encouraging closed mature schemes to move to the low-risk positions that are in the trustees', sponsors' and tPR's best interests.

f. Any other issue not mentioned above?

We note that several items from the current Code are no longer mentioned, for example, summary funding statements and the form of certification for the schedule of contributions. We would welcome a summary of legislative requirements to be included in the Code to encourage all stakeholders to use the Code appropriately. We also note that the requirement in paragraph 41 of the current Code (for the actuary to advise the trustees on any matter considered relevant) has also been removed.

In connection with actuarial reports (for an interim valuation), paragraph 181 of the revised Code states that "*this should be aligned with the rest of the inter-valuation risk monitoring and assumptions adjusted as necessary to ensure the trustees see an estimate of the outcome of a full actuarial valuation were it to be conducted*". However, this is inconsistent with the legislation which requires the actuary to report on developments in the technical provisions since the last actuarial valuation and; therefore, to use assumptions that have been set consistently with the trustees' latest statement of funding principles. This does not reflect the outcome that would result from a full valuation process, since a full valuation process may result in changes to the statement of funding principles. The wording in the Code, as drafted, is therefore more onerous than the legislative requirements and we encourage tPR to amend the wording.

It should also be noted that under the legislation actuarial reports need not be quantitative; a narrative on the developments of the technical provisions will satisfy the legislative requirements and this may well be the approach taken for smaller schemes. The Code does not reflect this point.

Paragraph 134 of the Code requires the actuary to provide a report to tPR if the trustees instruct him/her to certify the technical provisions and/or schedule of contributions using an approach that is considered "*unsound*". The wording used in the Code places a significantly wider responsibility on the actuary than the actual requirements set out in s70(2)(b) and we do not support such a wide interpretation of the actuary's duties. We suggest that the wording in paragraph 134 should be amended to more accurately reflect the actual responsibilities placed on Scheme Actuaries.

While fully understanding tPR's desire to draw sponsors more fully into the funding process, we note that in a number of areas the Code actually places specific requirements on sponsors, using phrases such as "the employer should". We wonder whether the wording of such requirements should be amended and possibly captured in guidance sitting alongside, but outside of, the Code.

6. What, if any, significant additional administrative cost does the revised Code impose on schemes and sponsors?

The wording of the question suggests that the impact of the revised code is not expected to be significant. This conclusion could be a result of either:

- A view that the actions expected of trustees and sponsors are not intended to be significant; or,
- If the Code is applied in a proportionate manner; the costs of implementation are not expected to be significant.

The extent to which trustees interpret tPR's expectations on how to apply the Code in a proportionate manner will become clearer in due course. Until then, our view on the impact can only be based on how we interpret the Code. Our initial view is that a greater focus on risk management would inevitably require more risk management information and advice e.g. scenario and affordability analyses. This would lead to an increase in costs especially for small schemes. Again, we would welcome the use of additional guidance and case studies in order to avoid trustees incurring excessive costs in attempting to satisfy the Code. However, even large schemes will not be doing everything envisaged by the Code and, therefore, there are also likely to be cost implications for these schemes.

These additional costs would be deemed worthwhile if the end result is the creation of a framework which provides adequate security for members' benefits while meeting the objective of not hindering sustainable growth of the employer. The danger is that significant costs are involved which are disproportionate to the outcome.

A better balance might be achieved if the Code provided less specific instruction about what trustees and sponsors should do, but rather concentrated on the general principles and behaviours that tPR expects them to follow. Then, trustees and sponsors could determine what was appropriate for their circumstances, understanding that they might have to justify their decisions to tPR.

Regulatory strategy

7. Does our strategy, focused on "protecting accrued rights to benefits through adequately funded and supported and well governed DB schemes", with risks identified and mitigated in a proportionate and balanced way, reflect the proper balance of all our objectives?

We note that, where possible and desirable, the identification and mitigation of risks is important, however, we note that mitigation will not be possible in all cases. For example, market, or longevity, risk cannot be fully mitigated without fully securing the benefits with an insurer (and even then some risk remains, since essentially this is an exchange of longevity risk for counterparty risk). In these cases, we expect tPR to encourage a robust risk monitoring plan so that the risks can be understood even if not fully mitigated. Again, case study examples might help trustees and sponsors understand this issue.

Given tPR's reliance on education, particularly for smaller schemes, we suggest also that this should also be reflected in this section on Regulatory Strategy.

8. Where risk has already crystallised, should our focus be on managing the impact of that risk to achieve the fairest and best possible outcomes in the circumstances?

We would be interested in exploring further what particular focus tPR has in mind. For example, there are companies, seemingly on the brink of failure, which have been turned around and have been able to settle creditors and pay dividends to shareholders. Our understanding of the legislation is that not all risks need to be eliminated, or even mitigated. It may be a difficult judgement call as to when a risk is deemed to have crystallised to the extent that intervention is required. There is a danger that the fear of crystallisation and/or intervention leads to behaviour which is not in the best interest of members and/or inhibits sustainable growth.

In particular, there is no mention of who is responsible for coming up with solutions and who makes these happen. It is important to note that there will be different objectives for different parties; the objectives of tPR, trustees and sponsor (or administrator) will differ.

For example, for a pension scheme where the level of the sponsor's affordable contribution appears to be inadequate to finance a deficit in a pension scheme, the employer may be viable as a continuing entity if the pension scheme liabilities were removed. It is very difficult to assess who is in a position to determine an appropriate solution that correctly balances the interests of the various stakeholders. This appears to be key to the successful fulfilment of tPR's new objective; whereby if deficits can be met over the longer term, sponsors may carry on in business whilst still sufficiently supporting the pension scheme to pay benefits.

Funding policy

9. Do you agree with our priorities for the regulation of DB schemes? (Paragraph 14)

Paragraph 14 of the funding policy provides a description of tPR's current focus in the form of four bullet points. This is a reasonable way to draw attention to tPR's (proposed) new statutory objective. However, the new objective introduces (or reinforces) a potential conflict between tPR's other objectives (in particular, protecting benefits and reducing risk to the PPF), as illustrated by bullets one and four. As the new objective applies to how tPR regulates pension schemes, it would seem appropriate for its funding policy to address how it proposes to reconcile any conflict that may arise.

We note that the wording in these bullets recognises the demarcation between the statutory objectives of tPR and the legislation applying to trustees by the use of "*encouraging*" in bullets 1 and 4 and "*ensuring*" in bullets 2 and 3. We are not sure that this demarcation comes through clearly elsewhere, so trustees and sponsors may be confused about the statutory requirements that apply to them.

For schemes' aspirations in a perfect world, the specific bullet points seem to be reasonable objectives and they will be familiar to the trustees of many large schemes. We think it would be preferable if there were an additional focus on proportionality. For example:

- Under bullet one, it is suggested that the trustees should, on an informed basis, ensure that deficit reduction contributions are reasonably affordable and set in the context of the scheme's needs. It is our understanding that, in many cases, this currently forms part of the recovery plan negotiation process. Accordingly, it is not clear what further value is gained from bullet one. However, it is likely that trustees of smaller schemes, and also trustees of larger multi-employer schemes, may have difficulty in becoming fully informed on their sponsors' affordability, growth and investment plans.

- Under bullet two, the suggestion of an integrated approach to risk management, whilst desirable, may be more difficult to achieve for smaller schemes, where resources (including financial) are likely to be limited.
- Under bullet three, it may be difficult for trustees, and in particular of smaller and/or multi-employer schemes, to be confident that they are as fully informed on these matters as they would need to be. Whilst they may be aware of the importance of covenant related issues, trustees may not have sufficiently detailed information.
- For bullet four, it is expected that the collaboration described will be currently in place for many schemes, so there may be limited achievable further gain. However, the comments made in respect of bullet one also apply here.

10. Is our risk assessment approach, focussing on key areas of covenant, funding, investment and governance risks, useful? If not, what other areas of risk should we focus on? (Paragraphs 21 -30)

Given the proposed new statutory objective, we understand why tPR has proposed this approach. However, as commented previously, there is a difference between tPR's objectives and the legal framework under which trustees operate. We can foresee some difficulties with this approach.

Even if we set aside those difficulties, there are potential problems with the proposed approach. The information available to trustees may be limited and, the risk is that, for some schemes, the trustees may not have a full grasp of the true underlying position. Indeed, it is important to remember that all these areas, in particular the future assessment of covenant, rely to some degree on assumptions and subjective assessments, so the information available can never be complete. In particular, trustees are likely to have difficulty in reaching an informed decision on the true worth of the employer's plans for sustainable growth, the extent to which this will improve the covenant and the timescale over which this is expected to be delivered.

The consequential risk of trustees agreeing to an employer's request to support sustainable growth is that the growth does not materialise and the security for members' benefits is diminished. It is quite possible that aggrieved members may challenge the trustees for the previous actions taken.

It is important, as pointed out elsewhere in this response, that a proportionate approach is taken. We are not sure that the message of proportionality comes across adequately in the document. The danger is that trustees spend too much effort searching for information that may not be available; which may have limited value, or, alternately, reverting to the relative safety of taking a more prudent approach than might be justified.

Given that the current legislative requirements continue to apply to trustees and that trustees are required to act in the best interest of their members, it might be expected that the current requirements would continue to drive the trustees in how they discharge their duties. Trustees may have great difficulty in knowing how to address the new tPR objective, which they could interpret as conflicting with their legal and fiduciary duties.

11. Is our approach to segmenting the landscape by covenant, in order to tailor our policy and operational approach appropriate? Is not, what would be a useful way of segmenting the landscape? (Paragraphs 31-33 and Appendix A)

Appendix A sets out how tPR will assess covenant strength: the information listed in paragraph 89 could be quite considerable and we agree that the areas for consideration are valid ones. We would be interested in how tPR plans to obtain all of this information in order to decide the allocation of a scheme to a segment and how it determines the extent to which the scheme exceeds the risk bar (or, in other words, how tPR will decide how to allocate its resources). It appears that some of the information will not be easy for the trustees to obtain and some of the information is unlikely to be in the public domain. We can envisage tPR asking for further information as part of its investigation into a selected valuation, but we are struggling to see how the information will influence the initial risk assessment. The first item (business plans provided to the trustees) is a good example of useful information for tPR, but which will not be readily available for initial risk assessment purposes.

If tPR expects to collect sufficient information to reasonably assess covenant for risk assessment purposes, there may be value in sharing this information with the trustees, with each party acting in partnership and in members' best interests (rather than being in conflict as might sometimes be inferred). The sharing of such information with trustees of small schemes might help to drive the covenant-focussed behaviour tPR seeks to promote. The current system, where each party analyses covenant, using similar but different information and sets a recovery plan, with a subsequent comparison of the two without knowledge of each party's starting point (the covenant assessment), seems difficult to justify when the resources of both tPR and schemes are scarce.

An alternative approach could be to simply require trustees to submit their assessment of covenant rating (which they could reach based on the description in Appendix B) along with their valuation results. This would seem to us to be a pragmatic approach, not least because in our view the covenant itself is not necessarily the crucial risk factor. In many cases, it is the interaction of covenant with the funding assumptions, recovery plan structure and investment strategy that matters.

For example, assessing covenant as strong, when it is not, does not matter if the assumptions reflect a weaker covenant; investment strategy is cautious and the technical provisions are assessed prudently. Similarly, a weak covenant is much less of a concern if the funding is strong; the recovery plan is short and investment strategy cautious. If tPR is made aware of the trustees' covenant rating, its judgment of the trustees' view of the covenant assessment would be simpler. It would also be simpler to judge if there is a potential risk that the trustees have not been sufficiently "prudent" or (given tPR's proposed new objective) whether they have been "over prudent".

In terms of the direct question, we agree that segmenting by covenant must be part of the process for assessing risk, but looking at the interaction of covenant, funding assumptions, recovery plan structure and investment strategy would be more enlightening. We also note that if tPR expects shortfalls to be met as soon as reasonably affordable (as it appears to do), segmentation by covenant strength will not flag up the risk that this is not happening.

We would also indicate that segmenting by covenant will not necessarily give the right outcome for valuation purposes. We must remember that covenant is not a well-defined concept. Its assessment is at least partly subjective and not necessarily indicative of the correct outcome, merely a possible one. We must not lose sight of the fact that tPR's objectives, including the objective of assessing risk for resource allocation purposes, are very different to the trustees' objectives. Thus measuring risk in the context of tPR's objectives is not necessarily appropriate for the trustees' measurement of risk for valuation purposes.

As a slightly separate point, it would be helpful if Appendix A could shed more light on how tPR plans to take the various areas into account. As drafted, it just set out the typical factors which a covenant assessor might consider.

12. Is our proposed policy focus for the different covenant strengths appropriate? If not, why not? (Paragraphs 34-37 and Appendix B)

We note the proposal that tPR will segment its behavioural expectations by covenant strength, as set out in paragraph 37. However, we have some difficulty understanding how this segmentation enables tPR to use the BFO to check that contributions and risk are consistent with affordability (as is suggested in the following section). We also have some difficulty understanding how the segmentation will help flag whether the outcomes adversely affect sustainable growth (or whether they are restricted in order to avoid such an adverse effect). If tPR does not plan to provide information on how it will "*tailor*" its risk assessment, much of the information in paragraphs 34-36 and Appendix A may be of limited use for trustees and sponsors.

We also note that it is not clear how much of the risk assessment mentioned in this section is intended to be used for the initial high-level determination of which schemes in the population merit further examination, and how much is only intended for the intervention stage (where tPR decides if the selected valuation's outcome and the trustees' behaviours are actually within its tolerance levels). As already mentioned, an assessment that is suitable for allocating resources will not necessarily be adequate for valuation purposes (or for considering whether a valuation outcome is appropriate). For example, we could envisage a situation where the outcome trustees have achieved does not meet tPR's BFO, but the trustees can demonstrate that they have taken appropriate advice and reached a solution that is consistent with their duties under the Pensions Act and trust law.

13. We use a broad range of risk indicators to assess scheme risks in the round. Is this the right approach? If not, why not? (Paragraphs 38-43, 48-49, Appendices C and D)

We agree that, to be able to meet its objectives, tPR needs to understand the nature of the risks inherent in defined benefit provision and those which are most material. However, some of the statements in connection with the actions trustees and sponsors should take to address the risks they face may require some further consideration. We make some observations in this regard.

Specifically, in relation to the sections of the Funding Policy document covered by this question:

- The section on "*defining balanced outcomes in practice*" (paragraph 38) opens with the statement "*the level of contributions and amount of risk schemes should take should be consistent with the affordability and strength of the employer covenant…*". Whilst we agree that the overall risk taken should be viewed in the context of the employer covenant, it should be acceptable for particular aspects of the risk, which include the pace of funding, to be permitted to offset one another. For example, if a scheme has access to a strong covenant, and does not take excessive investment risk, or has agreed other risk mitigating actions, then a slow pace of funding might be acceptable. For this reason, whilst we agree it is reasonable to segment schemes by covenant, we would view contribution income as just another risk indicator, rather than as a 'top level' measure.
- The actuarial profession has always supported the view that the primary role of an actuarial funding valuation is to act as a budgeting exercise for a scheme, rather than as an economic valuation of the liabilities. The key outcome of a budgeting exercise is agreed levels of expenditure, or, in the case of funding valuations, the contributions that will be payable to the scheme over the short to medium term. It is those contributions, and the scheme's investment performance over time that will ultimately determine whether members' benefits can be paid in full (not the technical provisions assumptions). From this perspective, the contributions agreed for a valuation are the key valuation outcome and, therefore, tPR's focus on the BFO (defined as the level of contributions payable in the medium term) as the key metric for its policy intervention is, in our view, sensible.
- In paragraph 103, it is implied that, as schemes mature, the more conservative trustees should become in relation to their statutory funding objective and pace of funding. Whilst this should certainly be a consideration, we do not agree that it is a necessary conclusion. Our view is that the strength of the sponsor covenant is a more material consideration than the maturity of the scheme. If the scheme continues to have access to a strong covenant, then it could continue to be funded at similar risk levels to less mature schemes. It is possible the phrase "*all else being equal*" is supposed to address this point, but as it stands, the paragraph gives a very strong message to trustees to de-risk as schemes mature, which we do not think would always be necessary, nor is it required by the legislative regime.
- We comment more generally on paragraph 104 in our reply to the next question. However, the explanation of the process for developing the BFO implies that tPR will take a view as to the "appropriate" investment risk to be taken for each covenant level and also the relationship between its categories of covenant and company longevity. We appreciate tPR would be reluctant to publish these relationships, since doing so might inadvertently introduce new

minimum funding standards. However, as time passes, actuaries will be able to deduce much of the detail and this could have a significant impact on behaviour.

- For paragraph 108, overall we agree that the risk indicators listed are appropriate, although we have some reservations about how they might be used. In particular, but not exhaustively:

  - Investment strategy risk: As explained above, our view is that, whilst maturity is a relevant consideration for the trustees when setting investment strategy, the risk they take should be measured relative to covenant. Having a two stage process seems likely to impose unnecessary de-risking on trustees.
  - Back end loading and reductions in contributions: We mentioned earlier that we thought contributions should be included as a risk indicator, rather than part of the BFO. Whilst we agree that these could indicate increased risk, the possible justifications given (affordability or covenant improving) seem narrow (particularly if covenant improvement does not include measures just to maintain, or limit reductions in, covenant). In addition, temporarily low contributions could also be justified if other risk mitigating measures are taken (for example, escrow accounts).

- In paragraph 22, the draft document states that tPR's understanding of the risk profile is "*informed by following the same considerations as those we expect of trustees*". We do not think this is necessarily appropriate, for several reasons:

  - Trustees' objectives are not the same as tPR's objectives;
  - Trustees have access to different information than tPR; and
  - Trustees' resources are different from tPR's resources.

14. Do you think that our Balanced Funding Outcome indicator is useful to:

a. Measure risk in the system?
b. Inform our approach to prioritising schemes for further investigation?
c. Inform our approach to measuring our impact? (Paragraphs 38-43 and 48-49, Appendix C and D)

As we mentioned in our response to question 13, we agree that tPR needs certain metrics to help manage how it resources the actions it takes to the statutory funding regime. Although we have some reservations about the proposed BFO we agree it could be useful for this purpose.

However, because the BFO does not take into account any of the risk mitigating aspects inherent in the structure of occupational pension schemes (for example, access to parent company guarantees) and also does not take many of the material risks faced by schemes into account (for example, investment risk), the extent to which it provides a meaningful measure of the risk may be limited.

For similar reasons, it may be a limited measure of tPR's impact.

15. Our policy for targeting our resources where we can have the greatest impact takes account of the level of risk, including scheme size. A greater proportion of our interventions will, therefore, be in larger schemes, with smaller schemes generally being regulated through education and other targeted approaches such as portfolio reviews.

a. Is it right that our risk bar for intervention takes account of the level of risk posed by schemes and their size?
b. Is education the most effective and proportionate way of regulating across a diverse landscape?

We suggest that the key risk here is that tPR will concentrate much more on larger schemes, with smaller schemes being dealt with through the education process. This could create a divergence in the method of regulation. It should be recognised that the level of perceived scrutiny by tPR will influence behaviour.

At present, part of the incentive for smaller schemes to act in line with the Code is the knowledge that the trustees may have to answer to tPR if there is a perception that a better outcome could have been achieved. We believe that it is important this incentive is not lost, particularly since the potential support of tPR can be helpful for trustees of smaller schemes who may not have access to the same level of advisor support as larger schemes.

The perceived level of scrutiny may also influence the behaviour of advisers.

One possible way to deal with this would be to intervene by "sampling" the approach taken by smaller schemes and publishing the outcome of the sampling exercise. The possibility of being one of the schemes chosen in the sample may well influence behaviour and the lessons learned from the sampling exercise could be educational for trustees and sponsors of smaller schemes.

As resources will not be available for investigating every scheme, we believe that it is correct that scheme size should be one of the factors taken into account. Other factors could include:

- size of scheme relative to sponsor;
- trustees' and sponsors' past practice in the valuation process;
- distance from BFO compared with covenant; or,
- availability and/or affordability of advisers?

Similarly, some proactive engagement should be expected with smaller schemes where the process at the last valuation was less than ideal and where the closure letter noted issues to consider/address. If the proactive engagement envisaged were to be directed less towards smaller schemes, fewer schemes with less than ideal processes will be indentified.

From the perspective of the member, members of small pension schemes may not view regulatory activity as "fair", if a lower level of scrutiny resulted in greater risk that their benefits would not be met in full in comparison to members of larger pension schemes.

In summary, we agree that education is effective, but it should be supported by both reactive and proactive engagement, even for small schemes. The education materials will need to be accessible and we would advocate the development of case studies.

16. Is proactive engagement an effective way of engaging with schemes and targeting our resources in order to achieve balanced outcomes?

Our members' experience is that proactive engagement can be effective.

We suggest that it is critical that tPR does give a view as an outcome of proactive engagement so that valuations become more streamlined following the use of tPR resources.

17. Is our proposed approach to measuring the impact of our regulatory approach appropriate? If not, do you have any suggestions? We are particularly interested in your views on how we should be measuring success against our new objective on sustainable growth.

Since the outcome of tPR's regulatory approach will be specific to each case, it is difficult to derive a set of metrics which clearly show its impact. However, a range of metrics and real-life case studies could be useful to help the regulated community.

In particular, it would be helpful to show in case studies how tPR decided whether to open up a case or not. The metrics suggested seem reasonable, but others could also be used, including:

- time spent on cases where proactive engagement is used;
- number of enforcement cases in relation to valuations;
- publication of investigation outcomes (categorised by outcome) and timescales;
- entry to PPF following tPR investigation;
- use of determination panel on valuations; and
- number of expert reports commissioned.

Any additional comments

18. Are the documents structured and drafted in a way that makes it easy for you to understand the key messages and issues? How could they be improved?

We have a significant concern about the length of the documents. Many trustees and sponsors (particularly of smaller pension schemes) have limited time to spend on pension issues and may find maintaining familiarity with all aspects of the documents challenging, particularly as some of the requirements will not apply to their circumstances. This could lead to particular aspects not being understood in their full context. For example, if paragraphs 4-9 of the draft funding policy document are read out of context, or by trustees/sponsors who are not familiar with all of the documents, there is a danger that it will be assumed that the sustainable growth of the sponsor is paramount.

In summary, our view is that a principles based Code, setting out the behaviours tPR expects to see, rather than explicit actions it would like trustees to take, would be more appropriate. If tPR wished to publish more directional guidance that applies to particular groups of trustees, it could do so in separate documents, which could include a clarifying statement about the target audience.

a. Are there any other comments which you would like to make on the proposals contained in these consultation documents?

- Transitional provisions (p15 of consultation document))

We are not convinced it is helpful to urge trustees and sponsors to take into account the contents of such a significant volume of documents which are still at a consultation stage. As is clear from our response, our view is that there are some areas in the draft consultation documents that require further consideration.

19. Are there any other comments which you would like to make on the proposals contained in these consultation documents?

Although many detailed points are made in the Funding Policy document, we think that there are some aspects of the approach that tPR intends to take which should be more explicit.

In relation to the Statutory Funding regime, tPR's statutory objectives generate a conflict of interest, particularly once its (expected) new statutory objective ("in relation to its functions under Part 3 only, to minimise any adverse impact on the sustainable growth of an employer") is brought into force. We are conscious that the word "any" in this regard has already attracted material comment and could give some difficulty in practice. Clarity from the DWP on how the word "any" should be interpreted would be welcome. The disparity between the scheme funding regime as it applies to trustees and the proposals set out in the draft Code could create difficulties which may impact on the ability of tPR to meet all of its statutory objectives.

We would like to explore further with tPR how the BFO and the associated risk indicators are intended to address the new objective. For example, the risk indicators listed in Appendix D of the Funding Policy could influence trustee behaviour with the result that risk taking is reduced. We do not understand this is the Government's purpose in introducing the new objective in relation to a funding regime that explicitly permits taking risk.

We would also be interested in exploring further with the Pensions Regulator how it intends reconciling the conflicts of interest imposed by its statutory objectives.