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5 February 2014

Mouna Turnbull
Defined Benefit Regulation
The Pensions Regulator
Napier House
Trafalgar Square
Brighton, BN1 4DW

Dear Mouna

REGULATING DEFINED BENEFIT PENSION SCHEMES

I am writing on behalf of the Association of Consulting Actuaries (ACA) in response to the consultation document dated December 2013 on "Regulating Defined Benefit Schemes" and in particular your new Defined Benefit (DB) regulatory strategy, funding policy and revised Code of Practice.

We broadly welcome your proposed approach and the updated Code. However, trustees and employers are likely to have differing views on the Code and in particular on how your growth objective has been reflected in it and other documents.

Overall we have found the documents to be well-written and thought-through and, in general, a welcome step-forward in your documented approach (albeit, the approach is not materially different from the way in which, in practice, our members have recently found you to be operating). In particular, we welcome the change in policy to become more principles-based and outcome-focused.

However, parts of the draft Code are both over-detailed and over-aspirational. Whilst the Code sets out a lot of good practice behaviours that are par-for-the-course for many larger schemes, the expectations will be much harder to meet for trustees in other situations – for example multi-employer schemes (particularly with overseas parents or non-associated employers) and small schemes.

If the Code had remained a principles-based guide, then trustees in these more complex cases could decide what was 'proportionate' for their circumstances. Because the draft is so detailed, it is hard to know exactly what is required to meet the higher level principles.

Arguably, setting policy is the easy part and the challenging test is how you implement your new approach.

We welcome your stated intention to be more targeted when intervening in DB schemes' funding matters; to focus on the greatest risks and where they can have the most impact; and to move away from a one-size fits all approach.

Your intention to establish "internal panels" to review case decisions will help to maintain consistency across casework – something that is generally felt to have been lacking from your previous approach. When an actuarial peer review process was in place, this tended to focus on the minutiae, and it was felt that nobody was ensuring that your key messages were consistent from case to case. It will be important to achieve consistency.

Finally, the acknowledgement (in paragraph 176 of the Code) that in some cases it may not be possible for trustees to agree to sign off the actuarial valuation is helpful. However, we are concerned that the onus is being placed on trustees to make drastic decisions about the future of their scheme, and by extension, the sponsoring employer. We would like to see the emphasis in this section of the Code changed accordingly, perhaps setting out the role of the employer in such a situation and the options available to trustees.

Our responses to your specific questions as well as our detailed comments on the above points and some further issues are set out in the appendices to this letter.

We hope that you find our comments of assistance and would be happy to discuss them further if that is helpful. You can contact me on 020 7432 6635 (david.everett@lcp.uk.com), or my colleagues Tyron Potts on 01527 300027 (tyron.potts@barnett-waddingham.co.uk) or Peter Williams on 01372 733 763 (peter.williams@aonhewitt.com) who both helped prepare the response.

Yours sincerely

David Everett

David Everett
Chairman
ACA Pension Schemes Committee

Sent by e-mail to DBConsultation@thepensionsregulator.gsi.gov.uk

APPENDIX

ACA'S RESPONSES TO SPECIFIC QUESTIONS

A. New objective on sustainable growth

> ***Question 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?*

From a trustee perspective, it is important that the new statutory objective is seen to be for *the Regulator* in carrying out its functions under Part 3 – i.e. it is directed at how the Regulator regulates, not at how *trustees* carry out their statutory funding valuations. Whilst it is acceptable for the Regulator to make suggestions about how trustees should act following the adoption of its new objective, trustees might consider that it is not appropriate for the Regulator to require them to take sustainable growth into account when considering appropriate funding outcomes.

This is because trustees have no duty or obligation to take sustainable growth into account. They have to consider employers' interests as a beneficiary under trust law for example, but they don't have to act as an investor, which is what appears to be proposed in the Code.

From an employer perspective, there are some significant differences between the wording used in the Pensions Bill and the references to growth in your draft documentation.

In particular, the Pensions Bill provides for an objective for the Regulator *"to minimise any adverse impact on the sustainable growth of an employer"*. The concept of growth is mentioned several times throughout the consultation document but, other than in the introductory section in which the regulatory objectives are set out, there is no mention of *"minimising any adverse impact"* on growth. Instead, references to growth considerations are often mentioned in the context of enhancing the employer covenant.

We recognise that you have several competing objectives and there is a balance to be struck between minimising any adverse impact on growth and, for example, protecting the benefits of members and reducing PPF risks. However, by focusing on growth that enhances the employer covenant you are potentially restricting the types of investment that trustees might agree to – such as investments in companies in the wider corporate group that have no legal obligation to support the scheme but would contribute to the financial health of the wider group and deliver potentially significant growth. We suggest that this scenario should be discussed in the Code and not necessarily prohibited, given the new regulatory objective.

In one case (paragraph 89) the Code goes further by suggesting that trustees consider whether investment in the business *"is necessary and how this strengthens the employer where this is needed"*. We question whether the addition of the words "where this is needed" results in a balanced interpretation of the regulatory objectives. It appears to suggest that, where the employer covenant is already considered to be sufficiently strong, growth considerations should not be applied.

We also note that the Code contains no mention of the potential impact of investment strategy on employer growth. A low risk investment strategy would generally be expected to lead to a higher employer contribution requirement which could impact on growth prospects. There is a question mark over whether a Code of Practice on Part 3 of the Pensions Act 2004 should include comment on setting investment strategy. However, if you conclude that it is appropriate to comment on setting investment strategy in the Code, it would also appear appropriate to include commentary on growth considerations.

Question 2*: Is our interpretation of sustainable growth appropriate? (Paragraph4-9 of funding policy)*

Sustainable growth as a concept is difficult to define – not least, as you point out in paragraph 9, because it will have a different meaning for different employers.

It is evident that you have put your own slant on what "sustainable growth" means, and it is difficult to see how this interpretation can be criticised. In our view the interpretation is "reasonable", but we cannot say with certainty that it is "appropriate".

In paragraph 8 you state that you will seek to ensure that the trustees have balanced the needs of the scheme with those of the employer to reach an acceptable outcome. In practice, except in those cases involving regulatory intervention, we do not think you will have sufficient information to assess whether the trustees have adopted a balanced approach. In particular, although there are checks in place to cope with a scenario where you do not believe trustees have gone far enough in protecting the scheme, there are no corresponding checks in the system to protect against trustees taking an extreme view, at the expense of the employer's growth prospects.

From an employer perspective, this does not appear to be consistent with the new set of more rounded regulatory objectives. One possibility is to consider schemes at both ends of the spectrum rather than only those for which you consider the contributions to be too low.

B. Code of practice

Question 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?*

Yes. In general the guidance reflects our members' experience of well-run schemes.

Whilst the Code recognises that investing for sustainable growth will need to be interpreted in different ways in the not-for-profit sector, our members' trustee clients would appreciate further, specific guidance for charities and institutions such as universities which, whilst not-for-profit, have very different needs to other charitable institutions.

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

The approach set out in relation to risk-management is generally expected to be very helpful, although implementing it will be very challenging for smaller schemes because of their typically limited budgets.

However, we question whether the approach should be set out in separate guidance rather than being included in this Code of Practice on scheme funding under Part 3 of the Pensions Act 2004. For example, it is not clear that guidance on setting investment strategy is directly relevant to Part 3. In our view, although it is closely related to funding and should be integrated, the investment strategy is a driver in scheme funding considerations rather than strictly being an output from those considerations (although we recognise that, in practice, the approach to funding will have implications for investment strategy).

***Question 5**: Does the revised code provide sufficient practical guidance for trustees in relation to:*

a. Working with employers and advisers?
b. Assessing and monitoring the employer covenant?
c. Assessing reasonable affordability, including understanding the impact on sustainable growth?
d. Their investment strategy?
e. Technical provisions and recovery plans?
f. Any other issue not mentioned above?

If not, what further guidance would you find useful?

Our understanding is that your policy in relation to the Code was that it should be "principles-based". If it was intended for the Code to offer "practical guidance", then the current draft would not be "sufficient" as the guidance is necessarily generic and high-level. However, we feel it is better that the guidance be principles-based and that the practical guidance is provided by advisers. The Code as drafted is not sufficient as a practical guide for most trustees, without the help of advisers, although it does provide very helpful ideas around a high-level framework and an extremely useful starting point.

The wording on "Contingency Planning" (paragraphs 57, 59-60 and 101-105) is not particularly helpful. Our members have seen situations where pension scheme trustees have" worried themselves down a rabbit hole" over a particular issue under the banner of "contingency planning" – which serves only to be destructive to the relationship with the employer, can waste a great deal of time and detracts from the main focus of funding. It would therefore be helpful if the Regulator could give more specific detail on proportionality in this area.

On a related note, we believe the Regulator should be ensuring that trustees and covenant advisers think very carefully about broader business risks which can rapidly impact on the covenant. Our members have seen several recent examples of catastrophic incidents effectively wiping out the sponsor's business overnight. There was no contingency planning in these cases and now the PPF is left to pick up the pension scheme deficit.

With regard to reasonable affordability, the wording here is somewhat unhelpful (and this has been the case ever since the original Code in 2005). Paragraph 89 says "Trustees should form their own view of what an employer can reasonably afford to pay to the scheme when considering the employer covenant." In practice, once a certain level of contributions is agreed via a Recovery Plan then, unless the employer's covenant has worsened, this level of contributions is by definition affordable. Where the funding position has subsequently improved relative to the funding plan, trustees (and advisers) have used the fact that the current contributions are perceived as being affordable to justify deficit reduction contributions carrying on at the same rate. In effect, the affordability principle is used to justify shortening the length of the Recovery Plan which is at odds with the Regulator's new growth objective.

We welcome the Regulator setting out minimum requirements for employer covenant review. This will support the pensions industry in ensuring all trustees document their processes. We would urge the Regulator, however, to recognise the conflict between the importance of understanding wider corporate structures and the difficulty of obtaining adequate information.

Question 6: *What, if any, significant additional administrative cost does the revised code impose on schemes and employers?*

Where schemes have previously been adopting a minimum-compliance approach to funding, the additional cost of implementing 'best practice' is likely to be significant. For example there would be adviser costs associated with developing a risk management and monitoring framework, contingency planning, taking a more holistic approach to triennial valuations, and additional risk and outcome modelling.

However, many schemes are already doing these things to a proportionately appropriate level and therefore we would expect minimal or no costs would be incurred by these schemes and their employers. We expect this is the case for many larger schemes who already consider the integration of covenant, funding and investment. But our members often find it difficult to persuade smaller schemes to consider all of these items in appropriate detail in isolation, let alone in combination. To the extent that these smaller arrangements have the will to comply, they will therefore face significant additional cost.

C. Regulatory strategy

Question 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? (Paragraphs 5-13)*

No. In isolation, focussing on "protecting accrued rights…" appears to favour the member at the expense of sustainable growth for the sponsoring employer (where relevant) and minimising claims on the Pension Protection Fund (PPF).

Nevertheless, the detail in paragraphs 5-13 is a little more balanced.

***Question 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? (Paragraph 13)*

Yes, subject to achieving a reasonable balance between any competing objectives.

D. Funding policy

***Question 9**: Do you agree with our priorities for the regulation of DB scheme funding? (Paragraph 14)*

Yes. These priorities look reasonable to us.

The Regulator should use the policy document to explain how it will balance its objectives, rather than using the suite of documents being consulted on to try to get trustees to reach balance.

The Regulator also appears to continue to push a de-risking agenda. In many cases this may well be appropriate, but not always, and over the long-term it may not be the optimum solution.

In fact, the extent to which it is realistic (or even desirable) for schemes with weaker covenants to de-risk their investment approach and fund as prudently as is suggested, could be questionable. Whilst we understand why the Regulator would not encourage risk-taking in weak covenant, underfunded schemes, we note that the policy documentation does suggest the current extent of investment risk and valuation prudence does not vary significantly in practice by strength of covenant, reflecting a pragmatic 'real world' outcome.

***Question 10**: Is our risk assessment approach, focusing 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)*

Yes, the risk assessment approach is useful. It is key that the approach to assessing and managing the risks is integrated, but you will need to acknowledge that implementing such an approach in any detail will be disproportionate for many smaller schemes.

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

Separating the DB universe into homogenous sub-groups seems to be an efficient way to proceed – bearing in mind that one-size-does-not-fit-all.

Given that sponsor covenant strength is the key factor driving the level of risk that trustees can afford to take, segmenting by covenant is sensible.

Nevertheless, you appear to be mindful that covenant strength can be a reasonably subjective term – hence we do not feel it necessarily appropriate to segment the employer universe into more than four groupings.

There is little detail in the documentation at this stage how you will in practice go about assessing covenant strength and allocating into one of the four groupings. Appendix A describes the approach but further clarity will avoid a great deal of time and effort spent dealing with disputes over the allocated covenant segment (particularly where the Regulator's assessment is lower than that of the external covenant assessor and/or the trustees' view).

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

We have a number of minor concerns with the diagram at paragraph 37 which explains how your focus changes with covenant strength.

- The diagram could be misinterpreted. For example material *"payments that weaken covenant"* should be a concern to trustees even where the covenant remains strong.
- The diagram also implies only strong and tending to strong employers are *"likely to be in a position to handle risk"*. This is not necessarily true. Some schemes with weaker employers may also be in a position to handle risk, albeit to a lesser extent. Whilst we appreciate that you expect such schemes' funding plans to reflect covenant risks, the diagram does not make it clear that in some cases, taking on the risks may be appropriate.
- Consideration of sustainable growth plans is not going to be appropriate for the weakest covenants. It is difficult to see from the diagram that, for the very weak employers, the focus should shift from sustainable growth to staving off insolvency and / or managing transition to the PPF.

The explanation given in paragraphs 34-37 and Appendix B, however, do make the approach clearer.

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

Yes, this approach is preferable to the rigidly imposed "triggers" used for tranche 6 valuations (and earlier). Whilst, in adopting this approach, there will be a lack of certainty for trustees as to whether you will become involved in the scheme's funding negotiations, the proposed approach avoids the pit-fall where triggers were clearly influencing trustee behaviours.

Anecdotally, we heard of many cases where trustees were reluctant to take what may have been the best decision for the scheme to avoid "triggering".

Appendices C and D of the document therefore signal a significantly improved approach.

The only additional risk indicator we would suggest you consider would be one relating to your new growth objective. It is not clear the best way to do this given the information you will have available. One option might be to consider some schemes at the opposite end of the BFO risk spectrum – where contributions are significantly higher than you might expect. Another might be to focus on schemes for which the trustees have unilateral power to set contributions.

Question 14: *Do you think that our proposed 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 Annex C)

In general, the BFO indicator is likely to be useful.

We note that you are also considering overlaying scheme size (see Q15) to determine which schemes to prioritise for further investigation (which would appear necessary to avoid investigating mainly small schemes, as we understand happened in Tranche 6).

It is not clear how you will assess an employer's need to invest for future growth from the information initially collected and, as a result, we note that this aspect does not feature in the BFO. From an employer perspective, we would question whether this achieves a balance between the competing regulatory objectives.

Once the BFO indicator is being used in practice, our members have expressed concern that employers and their advisers will be trying to pinpoint where the BFO is for their scheme and then negotiating a Recovery Plan around this. There is therefore a risk of a descent to the lowest possible Recovery Plan outcome in some cases, which cannot be the best result for members.

Question 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? (Paragraphs 52-53)

It is difficult to see how a regulator who sets out to be risk-based and proportionate can avoid taking account of the level of risk posed by schemes and their size.

However, whilst it is appropriate for resources to be focused on larger schemes, we think there is a danger that this message suggests that significantly lower standards are acceptable for smaller schemes. Rather than stating that smaller schemes can fall short of their BFO by a greater amount before being investigated, we suggest that you acknowledge that a smaller proportion of small schemes will be investigated.

This should ensure both large schemes and small schemes face an appropriate prospect of regulatory intervention if they fall short of the BFO. We do not think the comment in paragraph 52, that you expect the same standard of behaviour from small schemes as you do of large schemes, is sufficient to achieve this on its own (and we question whether it is even correct, given the principle of proportionality you have set for trustees in the Code).

Question 16*: Is proactive engagement an effective way of engaging with schemes and targeting our resources in order to achieve balanced outcomes? (Paragraphs 58-60)*

The efficacy of "proactive engagement" will depend on both the caseworker assigned and the group of trustees / employer. Feedback from our members suggests it was very helpful in some cases and added value to the scheme funding process (for example, the trustees were able to get an early view from you regarding a particular course of action before they went too far down a particular road). In other cases, it was felt that you added little or no value. Anecdotally, improvements have been made over time.

We agree with the proposal that such forms of engagement can only really be justified for the largest schemes.

Question 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. (Paragraphs 82-85)*

Again, the proposed approach appears reasonable (although we are not able to say that it is "appropriate") and our members look forward to engaging with you to regularly inform your view and share experiences.

We expect that measuring success against the new objective will be particularly challenging for you.

It is not clear how you will measure *"the position of employers and how we have taken into account their plans for sustainable growth",* given our comments above about the collection of information relating to this objective.

E. Any additional comments

Question 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?*

In our opinion, the documents are well-structured and easy to understand.

At 75 pages, the Code is very long. Perhaps all the detailed guidance could be taken out (for example, the section on investment strategy is unnecessary – see comments above) as well as the guidance on covenant analysis, the section on asset backed contributions and comments on double counting for example. This would leave a manageable, principles-based code, with specific guidance directed at particular audiences provided separately.

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

Appendix 6

Our understanding is that Appendix 6 is intended as a statement of the legislation (in particular how the requirements of Part 3 are modified in particular circumstances).

However, where a scheme's rules give the Scheme Actuary a role in setting the contribution rate, you say: "When undertaking this function, the actuary should approach it as if stepping into the shoes of the trustees for this purpose".

We are concerned that this might be read as suggesting a legal requirement where there is none. Moreover, the approach suggests that the actuary effectively acts as if he or she was one of the trustees that had been engaged in the valuation negotiations. This is also unhelpful as there could be circumstances when the actuary does not feel that he or she can bring him or herself to agree the schedule of contributions. In short, it is not clear that the actuary should "step into the shoes of the trustees" and legal advice might be required.

The actuary has different professional requirements and responsibilities than the trustees have, which would be tested if things go wrong. It is important that the actuary's role is seen in the framework of the legislative requirement on the actuary and distinct from the trustees. In our view, Appendix 6 should simply state the legislative requirements.

We note that a similar comment appears in the FAQs on the Regulator's website (with suitable caveat the comment is the Regulator's opinion) and suggest that it can be retained there, with the caveat.

Paragraph 134

We have concerns with the comment in paragraph 134 of the draft Code that where trustees "are intent on proceeding to instruct the actuary to certify the technical provisions and/or schedule of contributions using an approach the actuary considers unsound, the actuary is required to report this to the regulator". Whilst there is arguably a professional duty for actuaries to report such instances, we do not believe there is a legislative requirement.

In fact, the suggested requirement could have unwelcome consequences – it may be used by trustees or employers to push boundaries with their actuary (e.g. by asking the question, "at what point would you need to report this to the regulator as unsound?").

General Comments

In relation to the other documentation, broadly speaking we welcome the following aspects of the proposals:

- Your change in policy to become more principles-based and outcome-focused.

However, setting policy is the easy part. Implementing the strategy will be the challenge. We wait to see whether case teams will change their behaviour to focus more on the key issues, rather than on the minutiae.

- The intention to be more targeted when intervening and to focus on the greatest risks and where you can have the greatest impact.

- The aim to be more transparent.

  We hope this will also be reflected at case team level, where written communications in the past often obfuscated the main issues.

- The intention to set up internal panels to review case decisions.

  We hope this will lead to consistency across casework (something which may have been lacking in the past).

- The helpful additional material provided in the appendices to the policy document.

- The move away from a "one-size-fits-all" approach and the use of a set range of tailored comments in letters.

- The acknowledgement that in some cases it may not be possible for trustees to agree to sign off the scheme funding valuation.

  It is a concern that pressure is being placed on trustees to take drastic decisions about the future of the scheme, and by extension the employer. We feel that this section of the Code could usefully include an explanation of the employer's role in situations where agreement cannot be reached on funding, and a list of some of the options that may be available to the trustees.

About the Association of Consulting Actuaries (ACA)

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes.

The ACA is the representative body for UK consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

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5 February 2014