Regulating defined benefit pension schemes

RESPONSE FROM ICAS TO THE PENSIONS REGULATOR

7 February 2014
Introduction
The ICAS Pensions Committee welcomes the opportunity to comment on The Pensions Regulator’s (TPR’s) consultation on regulating defined benefit pension schemes.

Our CA qualification is internationally recognised and respected. We are a professional body for over 20,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, financial services, industry, the investment community and the public and charity sectors.

Our Charter requires ICAS committees to act primarily in the public interest and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members’ views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount. For example, the ICAS Pensions Committee has published two high profile reports on pensions in an independent Scotland in the context of the Referendum debate. Our reports which have been published under the banner “Scotland’s pensions future” have successfully raised important issues on the implications of independence for the State pension, public sector pensions and private pensions.

Key points
• We would recommend that TPR re-considers its approach to scheme funding. We believe that the balance sheet approach to funding means that insufficient emphasis is placed on the importance of cash flow to meeting scheme liabilities as these liabilities fall due.
• A greater emphasis on the importance of cash flows would enable the TPR to achieve a better balance across all its objectives. Under these proposals the balance of power remains with the trustees and therefore TPR’s new objective to minimise the adverse impact on sustainable growth of the employer is not adequately reflected.
• We also believe that TPR’s objective which is designed to protect the Pension Protection Fund conflicts with its objective on the protection of member benefits. We believe this is driving TPR’s approach to scheme funding and why we believe a review of this approach is needed.
• TPR has a responsibility to protect the benefits of members of smaller schemes. The revised approach disadvantages smaller schemes for which the cost of complying with the code will be significant relative to the cost to larger schemes. There is also a risk that smaller schemes will not receive the attention of TPR. We recommend that material produced by TPR is more succinct so that it is accessible to all trustees, including those of smaller schemes. We also recommend that a sample of smaller schemes do receive direct attention from TPR as a matter of routine.
• The Balanced Funding Outcome (BFO) is proposed as the primary risk indicator. However, there is insufficient detail about this model to enable our Pensions Committee to comment. This is a concern given that the revised code is due to be implemented in July 2014.
• The consultation period of just over two months, including Christmas, is insufficient given the length and complexity of the consultation documents. We recommend that TPR follows the UK Government’s consultation principles in future.

Any enquiries should be addressed to Christine Scott, Assistant Director, Charities and Pensions, at cscott@icas.org.uk.

Consultation questions

Question 1
Is TPR’s new objective on sustainable growth adequately reflected in the approach outlined in the draft consultation documents? If not, what more could TPR do to reflect the new objective?

Answer 1
We do not agree that TPR’s new objective on sustainable growth is adequately reflected in the consultation document.

We believe that TPR’s approach to scheme funding means that the balance of power remains with the trustees. Until there is a greater recognition and emphasis in TPR’s approach that cash flow is key to a scheme’s ability to meet its liabilities as these fall due, we do not believe that it will be possible to achieve the correct balance across all TPR’s objectives.

For many employers sustainable growth is more hope than reality and a more balanced approach to scheme funding would likely be welcomed by companies and other employers.
**Question 2**  
Is TPR's interpretation of sustainable growth appropriate? If not, why not?

**Answer 2**  
We do not believe TPR's interpretation of sustainable growth is appropriate.

The proposed new objective to “minimise the adverse impact on sustainable growth of the employer” is different, for example, to taking “account of an employer’s plans for sustainable growth” as referred to in paragraph 6 of the draft funding policy. It is important that references in TPR material to its statutory objectives and to other matters of law use the same terminology as the law. This will ensure that, as material is developed, there is no regulatory creep.

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

**Answer 3**  
We agree that some good practice is reflected in the draft documents. However, there are examples of earlier good practice which have been excluded from these latest proposals.

The 2006 version of Code of Practice 3 includes references to integrated risk management and the option of preparing a combined statement of funding and investment principles as opposed to having two separate statements. This aspect of good practice has been lost in the revised code. We believe that having a combined statement of principles facilitates integrated risk management which in our view is more effective and indeed necessary.

TPR’s 2012 Annual Funding Statement refers to the preparation by trustees of a financial management plan: most trustees do not have one. We believe that trustees should have a financial management plan supported by strong governance structures. A financial management plan would support the management of scheme cash flows. In TPR’s 2013 Annual Funding Statement there is no mention of financial management plans.

We recommend that TPR develops a mechanism for ensuring that all significant relevant aspects of good practice are retained within the latest guidance.

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

**Answer 4**  
We are not convinced that the approach to risk management set out in the revised code is as useful as it could be.

This brings us back to our earlier comments on the lack of sufficient emphasis on the importance of cash flows. The balance sheet approach to scheme funding has led to the following statement in paragraph 110 of the draft code with which we do not agree: “The long-term ability of the scheme to meet its benefits is likely to be more affected by the attention given to the identification of risk and appropriate asset allocation than to investment manager selection and monitoring...”

We are concerned that TPR’s continued emphasis on the balance sheet approach means that it appears to be giving additional weight to its statutory objective “to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund (PPF)” rather than to its statutory objective “to protect the benefits of members of occupational pension schemes”. The existence or at least the perception that there is a direct conflict between these two objectives, in our view, should prompt a review by TPR of its approach to scheme funding.
**Question 5**
Does the revised code provide sufficient practical guidance for trustees? If not, why not?

**Answer 5**
In general terms, we believe that the sheer length of the revised code issued as part of this consultation is out of proportion to the messages that need to be conveyed to trustees. We recommend that the code is stripped back and the use of jargon reduced: the aim should be to produce more succinct guidance for trustees. TPR indicated (at an NAPF South group meeting in Reigate on 9 December 2013) that it plans to produce a series of “Quick Guides” in April and May. While we welcome this approach it may still be necessary for TPR to revisit its approach to more detailed material.

The guidance also needs to work for small schemes and there is a sense throughout the consultation papers, either directly or implied, that TPR’s focus on protecting the benefits of members of smaller schemes in not sufficient. Succinct guidance would be accessible to smaller schemes without recourse to expensive consultants.

We believe that the revised code of practice 3 should cross-refer to code of practice 9 on internal controls. This would be particularly helpful for smaller schemes.

We support the material available in the revised code around the administration of member data.

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

**Answer 6**
We expect the additional costs for smaller schemes will be significant, for example, trustee training will be required, new actuarial advice, covenant assessment advice and new investment-for-funding advice.

**Question 7**
Does TPR’s strategy…. reflect the proper balance of all our objectives?

**Answer 7**
We do not feel we can answer this question in full on the basis that “adequately funded and supported” may be interpreted in different ways. While we agree that it may be appropriate for employers to inject capital into schemes, we are not convinced that TPR’s approach to scheme funding is striking the correct balance.

We also believe that small schemes may struggle to meet the requirements of the revised code due to the significant additional costs we believe that they would need to incur.

**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?

**Answer 8**
Yes. However, TPR is less interested in small schemes which need the most help. In reality, in small schemes inertia can set in with trustees continuing to keep schemes open when this is no longer the appropriate approach.

**Question 9**
Do you agree with TPR’s priorities for the regulation of scheme funding?

**Answer 9**
We agree to some extent. However, we believe that the funding policy should recognise more clearly the need to maximise opportunities in addition to managing risks.

We would also recommend that the bullet points are re-ordered to refer to the order in which the key areas of risk are referred to earlier in the consultation papers. The first bullet point would therefore be on the employer covenant followed by funding, investment and then governance.
**Question 10**
Is our risk assessment approach .... useful? If not, what other areas of risk should we focus on?

**Answer 10**
We believe that the correct risks have been identified. However, we believe that a cross-reference to code of practice 9 on internal controls should be included in paragraph 14. We would also like to see a reference to integrated risk management included in order to reflect good practice.

**Question 11**
Is our broad 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?

**Question 11**
We do not feel we can answer this question as it is worded using jargon.

**Question 12**
Is our proposed policy focus for the different covenant strengths appropriate? If not, why not?

**Answer 12**
We believe that four ratings are probably not sufficient and we are not convinced that ‘strong’ is clearly defined in this context.

**Question 13**
We use a broad suite of indicators to assess scheme risks in the round. Is this the right approach? If not, why not?

**Answer 13**
While we agree that a broad suite of indicators should be used, we are concerned that in practice TPR’s approach towards individual schemes may not be sufficiently tailored to individual circumstances.

This issue was highlighted by DWP in its recently published three yearly review of the Pensions Regulator, Pensions Advisory Service, Pensions Ombudsman and the Pension Protection Fund Ombudsman.

**Question 14**
Do you think that our proposed Balanced Funding Outcome (BFO) indicator is useful?

**Answer 14**
There is insufficient detail about the BFO in the consultation. We would have expected the BFO to be finalised prior to this consultation and well in advance of the implementation of the new code in July 2014.

**Question 15**
(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?

**Answer 15**
We agree with these assertions up to a point. However, we believe that smaller schemes are in danger of being ignored and that a sample of small schemes should be looked at as a matter of course. Education about the new code will be particularly important for the trustees of smaller schemes.

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

**Answer 16**
Yes, provided smaller schemes are not ignored. Also, see our response to question 15.
**Question 17**
Is our proposed approach to measuring the impact of our regulatory approach appropriate? If not, do you have any suggestions?

**Answer 17**
We believe TPR’s approach focuses too much on short term risk reduction by focusing mainly on the balance sheet approach to funding. This could have the effect of diverting resources to DB schemes which are closed to future accrual and reducing the cash resources available to offer a good DC pension for current staff. In general terms, this could impact on the effectiveness of pensions arrangements established to deliver auto-enrolment.

**Question 18**
Are the documents structured and drafted in such a way that makes it easy for you to understand the key message and issues? How could these be improved?

**Answer 18**
We touch on this topic earlier on in our response.

The four consultation documents amount to 168 pages, which is excessive and inconsistent with a principles-based approach to regulation. It is difficult to understand the purpose of each document and to identify and comment on key matters.

We are also disappointed in the lack of detail about the BFO indicator which is a major feature of the consultation.

We are aware that TPR has actively engaged with pension schemes in England (for example, the NAPF South group meeting in Reigate on 9 December 2013) on this consultation but we are not aware of any events being arranged in Scotland. This is something we would welcome in future.

**Question 19**
Are there any other comments you would like to make?

**Answer 19**
We do not believe that TPR has followed the UK Government’s consultation principles. We do not consider that a consultation period of just over two months, including Christmas, is sufficient to respond effectively to such complex and lengthy documents.