

DB research response

September 2018

The Pensions
Regulator

DB research response

We aim to ensure that all pension schemes we regulate are well run, provide good value and are well-funded, so their members get the benefits they expect.

To understand the extent to which trustees and employers meet the expectations we set out in our defined benefit (DB) funding code of practice and related guidance, and what barriers trustees face in running their schemes, we undertook a survey of DB schemes in spring 2018. As well as assessing compliance with the principles set out in the DB code, the survey covered our expectations on scheme governance and tested awareness, and the action trustees took as a result of our 21st century trusteeship campaign.

The survey follows a similar study carried out in 2017, meaning it has been possible for us to compare results across both surveys and identify trends.

The survey results show some improvements in DB governance and administration and increased levels of understanding of, and compliance with, the DB code principles. It appears that the majority of members with DB benefits are in relatively well-run schemes. This is particularly true for those in larger schemes, but results for individual small and medium schemes are mixed.

Smaller schemes:

- ▶ tend to display poorer governance standards, with trustees placing less emphasis on assessing fitness and propriety of new trustee board members and their arrangements for managing conflicts of interest, and
- ▶ generally score lower than larger schemes on their trustees' adherence to the DB code principles (particularly around taking and managing risk)

The survey does reveal a positive picture in relation to the majority of the DB funding code principles. Highlights include that:

- ▶ nearly all trustees (92%) and 87% of employers interviewed had read the DB code, or a summary of it
- ▶ the large majority of trustees (between 88% and 98%) and employers (between 87% and 98%) met each of our expectations under the 'Working collaboratively' principle
- ▶ the vast majority of trustees (94%) are clear about which employers are legally liable to support their scheme, helping to inform their decision making in accordance with the 'Long term view' principle

The survey results on trustee actions taken after the 21st century trusteeship campaign also contain some positive indications. We asked the same questions to trustees of defined contribution (DC) schemes in a separate survey, and trustees of DB schemes performed better.

Across the seven questions we asked both DB and DC trustees, on average 77% of DB trustees responded positively, compared to only 43% of DC trustees. Some areas of concern did arise in relation to DB schemes, however. Particular areas of weakness included:

- ▶ a failure by some trustees to include appropriate contingency planning within their risk management frameworks
- ▶ a reluctance by some trustees to assess employer business investment plans robustly
- ▶ a significant increase in the percentage of trustees reporting that they take no actions to ensure their scheme is treated fairly among competing demands on the employer
- ▶ that fewer than half of the trustees of small schemes (48%) had a documented process to assess the fitness and propriety of new trustees, compared with those of large schemes (62% and 82% respectively), and
- ▶ that a third of all trustees had no documented conflicts policy and no register of interests for the trustee board

Where results are less encouraging we highlight some key findings from the survey and reiterate our expectations across these particular themes in Annex A. In the section below, we set out what we will do over the next year to address these issues.

Next steps

We are using findings from this survey and our regulatory experience to target schemes that are less likely to be meeting the standards we expect, and also to broaden our reach across the DB pensions landscape.

We have already contacted the trustees of a number of smaller schemes earlier this year to explain how we rate their covenant and highlighting the particular issues we want them to address before their 2018 valuation is finalised. These areas include covenant, investment, funding, and risk management. We have asked the trustees of these schemes to explain, when they submit their 2018 valuation, how they have addressed the issues we raised. For all other schemes, we will carry out comprehensive risk assessments and engage where appropriate after trustees submit their valuations.

We also intend to address potential issues of schemes not being treated fairly by identifying schemes where:

- ▶ recovery plan end dates are being extended unnecessarily (for example where the recovery plan end date has been extended but there is sufficient affordability to increase contributions to the scheme) and
- ▶ we believe funding plans are not ambitious enough and yet dividends, or other distributions to shareholders, are many times the level of contributions that have been paid to the scheme

We expect trustees to seek advice where they perceive there is a lack of skills on their board, or there is a risk to objectivity in funding discussions from conflicts of interest. They are entitled to expect their advisers to find proportionate and cost-efficient ways of helping, delivering advice in a manner they can understand, and should challenge advisers where this is not the case. When we engage with trustees we will ask for documented evidence of the advice they receive and their rationale for the decisions they make.

We are continuing with our work to develop and implement our new regulatory target operating model. This new model will enable us to have a greater impact on the behaviour of schemes and employers and drive up standards by interacting with a larger proportion of schemes and employers on a wider range of priority risks. The model will enable us to:

- ▶ systematically prioritise risk and use our existing powers more effectively
- ▶ give a clearer steer to trustees and employers on what we expect them to do
- ▶ make better use of data to enable us to target the right schemes as early as possible
- ▶ use a wider range of communications, oversight and enforcement tools to engage with and influence scheme behaviour

Setting greater clarity on funding standards through a revised DB funding code

Following the recent publication of the government's DB white paper **Protecting defined benefit pension schemes**, we welcome the DWP's support for TPR to set clearer funding standards through a revised DB code of practice. This will provide trustees and employers with support in agreeing successful funding outcomes and help put DB funding on a sustainable footing for the long term.

The new code will set clearer parameters around prudent technical provisions and appropriate recovery plans within the existing scheme specific funding regime. As part of a more explicit 'comply or explain' regime, trustees and sponsoring employers will need to demonstrate to us the effectiveness of their funding and investment strategies and risk management plans in delivering the long-term funding objective for the scheme.

This increased clarity around prudence and appropriateness and, potentially, improvements to a range of our powers, will strengthen our ability to take effective and efficient action where the standards in our funding code are not met.

We are looking to engage extensively with our regulated community – trustees, employers, advisers and their representative organisations – throughout this review of the DB funding framework to ensure our revised code is based on expert input, industry consensus (to the extent possible) and provides clear and useful guidance to trustees and sponsoring employers on funding their scheme for the long term. We plan to consult formally on options for a clearer funding framework early next year and undertake a consultation on a revised code later that year. As part of our ongoing engagement, we welcome thoughts and comments on this initiative at: DBchange@tpr.gov.uk.

Annex A: Key research findings and messages

1. Compliance with our funding code principles

The main aim of the survey was to provide a performance measurement against seven of the nine principles within the DB funding code of practice among trustee boards and employers of DB and hybrid schemes.

Managing risks

Our DB funding code states that we expect trustees to implement an approach which integrates the management of employer covenant, investment and funding risks, identifying, assessing, monitoring and addressing those risks effectively. As in the survey in 2017 we asked both trustees and employers whether they took five actions in relation to managing risks within their scheme and to rate their scheme's performance against this risk management principle.

Managing risks: the five actions

1. Investment strategy and funding plans based on an updated view of the risk that can be backed by employer covenant
2. Risk taking in the investment strategy and funding plans is set following agreement of a risk appetite discussed with the employer
3. Funding and investment performance are monitored to defined tolerances
4. Clear plans for action when tolerances are breached or on some other trigger
5. Trustees able to evidence how they have taken an integrated approach to risk management

As was the case in last year's survey, the integrated risk management activity which was least likely to be carried out by trustees was having clear plans for action when tolerances are breached or on some other trigger. In 2018 the trustees of nearly a quarter of small schemes did not report having such plans in place.

We have reiterated our expectations on this in our 2018 annual funding statement. Trustees should analyse the impact if key risks were to materialise, and consider how they would respond to put their funding position back on track. Contingency planning should not just be about managing poor outcomes. Trustees should also be mindful of opportunities that may help to put their scheme on a more solid footing and relieve the employer of future strain from the scheme.

Seeking balance

The DB code states that trustees should seek an appropriate funding outcome that reflects a reasonable balance between the need to pay promised benefits and minimising any adverse impact on an employer's sustainable growth.

Four factors for trustees to consider when considering employer investment proposals for its business are:

1. The likely benefit to the employer or group both in terms of value and timing
2. The degree of risk involved in the new investment and the employer's track record
3. How the new investment is to be financed
4. How the employer intends to share any increased value from the new investment with the scheme

The survey showed that more than a quarter (29%) of trustees did not consider any factors when an employer proposes an investment, a significant increase from the 20% of trustees who did not consider any factors in 2017.

When questioned further, some trustee boards admitted that, although they felt well engaged with employer investment plans, they relied on briefings from trustees who were also employer decision makers. Among trustees who felt they were poorly informed, some felt they had no legitimate reason to ask the employer for information while others had asked but had encountered opposition.

Our DB code is clear that where an employer proposes to prioritise the investment it wishes to make in its business over making funding available to the scheme, the trustees should understand how this impacts on the employer covenant. The approach adopted should be appropriate to the circumstances. Where there is a constraint on the employer's covenant which results in greater risk taking in setting and reaching funding targets, the degree of trustee consideration and discussion with the employer should be proportionate, bearing in mind that level of constraint.

Fair treatment

Our funding code states that trustees should seek to ensure that the scheme is treated fairly amongst competing demands on the employer and in a manner consistent with its equivalent creditor status. The survey asked about four actions that could be taken by trustees to secure fair treatment. These were

1. Establishing whether other creditors to the employer are contributing fairly
2. If the employer is paying dividends checking that the return to shareholders is proportionate
3. Checking whether the employer is maintaining or increasing dividends
4. Establishing if and how the employer intends to cover risk, if needed

One in six trustees (14%) said they undertook all four actions (lower than the 24% in 2017), 27% take two or three (31% in 2017), 21% (19% in 2017) take one of them and 38% don't take any of these, a significant increase on the 27% who reported not taking any of the actions in 2017.

There were significant decreases in the proportions establishing whether other creditors to the employer are contributing fairly (36%, down from 51% in 2017) and checking whether the employer is maintaining or increasing dividends (38%, down from 47% in 2017).

We discovered that there were particular issues for small schemes with a large international sponsor company - here some trustees reported they felt a small scheme should not (or could not) challenge the employer's wider activities.

Other trustees felt that where the employer had generally been co-operative in making requested payments in the past, it was unnecessary to draw a link to dividends.

In other cases where the employer was felt to be in a long-term strong financial position, closing the pension deficit quickly was sometimes seen by some trustees as unnecessary.

In our 2018 annual funding statement we have made clear that where distributions appear unreasonable relative to scheme contributions we expect trustees to negotiate robustly with the employer to secure a fair deal for the pension scheme. We are concerned about the growing disparity between dividend growth and stable payments towards any scheme deficit.

Recent corporate failures have highlighted the risk of long recovery plans while payments to shareholders are excessive relative to deficit repair contributions. Trustees should assess the impact of dividends on the employer's covenant and whether the scheme is being treated fairly in light of what it needs to pay the promised benefits. While dividends may be the most common form of distributions, trustees should also be alert to other forms of covenant leakage when considering what contributions are affordable and whether the scheme is being treated fairly.

2. Scheme governance

Fitness and propriety of trustees

A trustee board comprising a diverse mix of individuals with appropriate motivation, knowledge, experience and skills will contribute significantly to efficient and effective scheme management. To help maintain the board's competence and integrity, succession planning, recruitment and selection need to take account of the strengths and weaknesses of the existing board and look to address any gaps in knowledge, skills and relevant experience.

We expect trustees to establish and maintain a clear policy for assessing the fitness and propriety of individuals appointed to the trustee board and asked those we surveyed whether they operate such a policy. Disappointingly, only 58% of all trustees confirmed that they do, the position for trustees of small schemes being less encouraging still at 48%.

25% of those who do not meet the expectation to have a policy to assess trustee fitness and propriety did not consider it to be required or relevant.

Conflicts of interest policy and register of interests

Actual or potential conflicts of interest may arise for trustees of DB schemes, eg when they are involved in funding negotiations.

There may be acute or pervasive conflicts associated with a trustee's role (eg where they are also the finance director of an employer) and the trustee board may need to take advice on how to manage that type of situation. Not all conflicts are employer-related – they can also arise for trustees who, for example, are scheme members or who hold trade union representative roles.

We expect trustee boards to operate a process to identify, monitor and manage any potential or actual conflicts of interest for those involved in running their DB scheme. This includes trustees, advisers and service providers. The process should include the following controls:

- ▶ agreeing a conflicts policy setting out the approach to dealing with conflicts. This should cover the process to identify and monitor conflicts and outline options for managing them
- ▶ register of interests for recording all actual or potential conflicts
- ▶ declarations when trustees, advisers and service providers are appointed, ongoing declarations by advisers and service providers as soon as they arise, and declarations at the start of trustee and sub-committee meetings
- ▶ advance planning to identify conflicts that may occur in the future and available options for managing them

The survey asked trustees whether they operate a conflicts of interests policy and register of interests. While 88% of trustees reported operating a conflicts policy and 82% maintain a register of interests, one third of trustees reported that they do not do both. 34% of those who do not meet the expectation to have a conflicts policy and register of interests did not consider these to be required or relevant.

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Free online learning for trustees

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