

# Consultation report

May 2006

How the Pensions Regulator will  
regulate the funding of defined benefits

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## 1. Introduction

On 31 October 2005 we issued a consultation document entitled *How the Pensions Regulator will regulate the funding of defined benefits* containing our proposed statement on this matter, to provide an opportunity for early discussion about how we propose to regulate the implementation of the new legislation to improve scheme funding.

The relevant legislative provisions are contained in Part 3 of the Pensions Act 2004 and the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (SI 2005/3377). Guidance to trustees is provided in the Pensions Regulator's code of practice No 3, *Funding defined benefits*.

The consultation period ended on 26 January 2006. We received 67 responses from representative bodies of employers and pensions professionals as well as from trustees, trade unions and individual employers.

As a result of the consultation we have revised our draft statement to reflect the comments received.

## 2. What the consultation document said

The consultation document set out the background to the funding of defined benefit schemes in the UK and the new scheme funding framework introduced by the Pensions Act 2004. It then explained our proposals for how we would regulate in this new environment and included a draft statement on this approach. It also included a summary of analysis we commissioned from PricewaterhouseCoopers on the impact on the economy and employers of paying off FRS17 shortfalls.

The consultation document explained that, in order to meet our statutory objectives of protecting members' benefits and reducing risks to the Pension Protection Fund (PPF) we needed to ensure that trustees and employers were meeting their responsibilities in relation to the funding of defined benefits. By publishing the statement we aimed to give those whom we regulate a degree of certainty about how we were going to do this to help them take informed decisions on ways to improve protection for members' benefits.

This section provides brief outlines of the issues and proposals we consulted on, listing them in the order of consultation questions, for ease of reference.

### ***The key risks associated with scheme funding***

- The employer goes out of business leading to the scheme winding up while there are insufficient funds to meet the pension promise.

- Any resulting claim on the PPF would be a potential burden on all schemes and sponsoring employers.
- Trustees may set technical provisions too low or recovery periods too long to adequately mitigate the risks to members' benefits and to the PPF.
- The regulator may be drawn in as the arbiter on funding for many schemes thus having to take a much larger role than envisaged with significantly higher associated costs.

### ***Underlying regulatory principles guiding our approach***

*Protecting members* – we will support trustees and employers working to maximise protection of the benefits that the employer has promised to pay and that members are expecting.

*Scheme specific* – it is not our role, nor is it consistent with government policy, to set a funding standard, because each scheme needs to take account of its particular circumstances.

*Risk-based* – regulatory intervention should be focused on the schemes that pose the greatest risk to their members or the PPF. While it is never possible to eliminate all risk, those in a position to do so should seek to mitigate those risks wherever it is reasonable to do so.

*Proportionate* – trustees should aim to correct any shortfall as quickly as the employer can reasonably afford. We intend to distinguish between those schemes where rapid elimination of the shortfall would have a serious adverse impact on the employer's viability and those where employers could potentially afford to pay off the shortfall more quickly.

*Preventive* – we need where possible to act before risks materialise.

*Practicable* – we need an approach that can be operated within the constraints of the information and resources available to us.

*Referee not player* – the responsibility for ensuring that schemes are fully funded rests with trustees and employers with the help of their advisers – the regulator will not interfere with this responsibility where it is discharged consistently with their own duties.

As a means of implementing these principles we proposed to apply a filtering mechanism to scheme recovery plans and scheme returns in order to decide which schemes we needed to look at more closely in the light of the risks they posed.

To ensure that any scheme funding arrangements put in place by trustees complied with legislation in the light of the code of practice, we

proposed to focus on the technical provisions and recovery plans agreed by trustees and employers along with the cases where agreement had not been achieved. We proposed to consider challenging those arrangements that appeared to us to provide insufficient protection when taking into account the specific circumstances of the scheme, particularly its maturity, the strength of the employer and the employer's ability to pay off the shortfall.

### ***Filter mechanism***

We recognised the potential for our proposals to have a strong behavioural impact. Therefore, we aimed at designing a framework that would allow us to achieve the right outcomes – a prudent level of funding and, where relevant, appropriate recovery plans – but which would also be sufficiently flexible to serve as a prioritisation tool for the regulator and allow trustees and employers to make scheme funding decisions that best suit the particular circumstances of their scheme. We wanted to avoid our triggers becoming rigid targets to which schemes would aspire.

Our proposed solution was a trigger mechanism based on readily available information and supported by a scheme specific secondary assessment process to identify schemes posing the greatest risks. Once a scheme had triggered, we would prioritise these schemes we judged posed the greatest risk in order to decide whether we should intervene and, if so, how.

Two triggers were suggested, one relating to the prudence of a scheme's technical provisions, and the other to the appropriateness of any recovery plan.

We recognised that although our attention could be drawn to a scheme initially by either of the triggers, we could not treat them in isolation – the level of security of scheme benefits would inevitably be determined by the interaction between the two triggers.

We indicated that we would look carefully at the circumstances of a scheme that triggered before deciding whether or not to intervene. This was in recognition of the fact that there would be circumstances where, as a result of further investigation, we could judge that trustees had agreed a reasonable approach to funding in the light of the specific circumstances of their scheme.

### ***Technical provisions trigger***

For the technical provisions trigger we proposed a range based on the funding levels for a typical scheme required to secure PPF compensation benefits and FRS17 liabilities as reported in company balance sheets, both expressed as a percentage of full buy-out (solvency) cost. Our understanding was that such a range would lie between 70% and 80% of buy-out cost for a typical scheme. Funding

targets below the range would attract the regulator's attention. For those falling within the range, the strength of the employer's covenant and the scheme's maturity would determine whether the scheme triggered.

### ***Recovery plan triggers***

For recovery plans we proposed to focus our attention on schemes with recovery periods longer than ten years or with significantly back-end loaded schedules of contributions. We proposed to look at periods shorter than ten years only in circumstances where we considered that the financial position of the employer was such that it could reasonably clear the shortfall in a shorter period, bearing in mind the strength of the funding target and/or the employer's ability to pay.

In situations where it would be a struggle for an employer to pay off a shortfall at all, we proposed to look for other actions to minimise the risks to members and the PPF, such as the modification of future accrual of benefits, recognising the importance of allowing a scheme to continue wherever possible.

### ***Use of contingent security***

We were in principle attracted to finding a mechanism to enable us to take into account contingent assets, and we welcomed risk management by employers and pension schemes. We also sought to understand the scope of guarantees provided by the market and by group companies and said we would determine the practicalities of recognising these instruments explicitly, for example where a back-end loaded recovery plan was proposed.

### ***Impact of improving scheme funding***

We recognised that our statement was likely to become an additional driver encouraging improved scheme funding levels. Others already in existence included:

- the requirement on companies to disclose FRS17 pension shortfalls on their balance sheets;
- the PPF risk-based levy;
- the legislative requirement for trustees to set scheme technical provisions on a prudent basis; and
- the legislative requirement for trustees to disclose the funding position of the scheme to scheme members.

We acknowledged that improving funding levels through paying off shortfalls, though beneficial in many respects, had the potential for less welcome consequences for the wider economy. To help us understand

these wider implications we commissioned a report from PricewaterhouseCoopers to assess the impact on company behaviour, share prices and macroeconomic performance of companies paying off their shortfalls over various periods of time.

The report found that for around 65% of the sample of employers used for modelling purposes, the increased payments to the pension scheme needed to clear FRS17 shortfalls within ten years would represent less than a quarter of free cash flows, and that for the sample of employers modelled for the report around 75% of the FRS17 shortfall was already factored into their share prices.

### ***Factors we would consider before deciding to intervene***

We said that our proposed regulatory framework was designed to ensure that we identified schemes that presented the greatest risk to their members' benefits and to the PPF, taking account of the strength of technical provisions and the length of recovery periods as well as other variables such as the strength of the employer's covenant and the scheme's maturity.

In considering whether any intervention on our part would be a cost-effective use of our resources we proposed as follows:

- to scrutinise the decisions the trustees had made and the actuarial and other advice provided to them;
- to consider the specific circumstances of the scheme and its employer, in particular the employer's strength;
- to consider any further independent advice that trustees may have taken in relation to the wider circumstances of the scheme; and
- to consider whether the trustees or employer had taken any other steps to mitigate the funding risk.

We proposed that, when intervening, we would not seek to overturn past decisions by the trustees where they acted reasonably.

### ***Failure to comply with the requirements of Part 3 of the Pensions Act 2004***

This section of the consultation document and draft statement considered our approach in circumstances where there might be:

- failure by trustees and the employer to agree technical provisions, a recovery plan, the content of the statement of funding principles or the content of the schedule of contributions;
- failure to obtain funding documents within prescribed time limits; or

- failure to pay contributions in accordance with the schedule of contributions.

We proposed, that, as a risk-based regulator, in the first instance we would seek more information to help us understand the reasons for the failure and offer help and guidance. We would consider intervention and the use of our more formal powers only when judged necessary, appropriate and cost effective.

### ***Treatment of schemes still subject to MFR***

We proposed a trigger of 110% MFR for the purpose of deciding whether to intervene before schemes had embarked on their first Part 3 valuation. We explained that if a scheme in this category triggered we would consider examining whether the trustees had taken all appropriate actions to improve funding in advance of an actuarial valuation under Part 3, or have considered bringing forward such a valuation where they had the power to do so.

## **3. The outcome of consultation**

### **Key themes**

There were 67 responses to the consultation. Our proposed approach was broadly welcomed, particularly in relation to having a trigger approach and on the underlying principles. Key themes concerning our proposed statement to emerge from the consultation were:

- there was broad support for the concept of filters to help us manage our workload;
- concern was expressed that triggers would become targets;
- there was broad agreement that there should be technical provisions triggers but no agreement on which methodologies could best be used – particular concern was expressed about reference to buy-out costs;
- there was no consensus on recovery plan triggers although some respondents felt that more latitude should be provided, particularly for strong employers;
- concern was expressed that the proposed trigger points for recovery plans might influence trustees to set low technical provisions;
- triggers should reflect scheme circumstances such as employer strength and scheme maturity;

- the use of contingent assets was strongly supported, with a few suggestions as to the circumstances in which we might reasonably take account of them;
- there was some concern that our proposals placed undue emphasis on the security of accrued benefits relative to employer profitability or future pension provision;
- some employers were concerned about the inability to obtain a refund of surplus in the event that the scheme becomes over-funded, reflecting the 'one-way valve' in legislation that requires employers to fund their schemes on the basis of prudent assumptions but makes it difficult for the schemes to repay money that may not be needed.

### **Summary of the changes**

These are all important points which we have considered carefully. We have made some changes in our proposed approach, and the drafting of the statement, as a consequence. The changes we have made in revising the statement that arise from these comments are detailed in section 4 of this document. In summary, we have:

- sought to make clearer those matters that caused confusion or uncertainty, along with changes to align the text to the final version of our code of practice No. 3, *Funding defined benefits*, that came into force in February 2006. Where possible we have also sought to make the text more succinct;
- given additional emphasis to the fact that a healthy ongoing business will be in the best position to ensure its pension obligations are met in the long term;
- sought to make it clearer that triggers are not targets, but just the first filter in our process for identifying the schemes which may need regulatory attention;
- reduced the role of the solvency valuation in determining whether or not a scheme triggers by removing the references to a range of 70-80% of full buyout;
- made it clear that trustees should not compromise technical provisions in the interests of achieving a shorter recovery plan;
- indicated that our primary focus will not be on recovery plans with a duration of ten years or under;
- recognised that the investment return assumptions in the recovery plan can allow for equity outperformance and added a specific trigger to help us identify cases where the return assumed may be inappropriate;

- provided more information on what we may do when a scheme triggers; and
- provided a clearer indication of how we may take account of contingent assets. During May 2006 we will publish on our website ([www.thepensionsregulator.gov.uk](http://www.thepensionsregulator.gov.uk)) separate guidance on the approach we expect trustees to take when considering the use of contingent assets as part of a scheme's funding strategy.

We outline below the impact of these changes in our approach on schemes in general, and schemes with strong employers in particular.

## **Schemes in general**

### *Risks and principles*

The consultation responses broadly supported our analysis of the risks that we should take into account and the general principles underlying our approach. We recognise that we could have mentioned other risks or expanded further on the principles but are happy that they were implicit in our thinking to the extent that they are relevant.

The principle of affordability suggested by some respondents was indeed central to our approach – although we have called it proportionality. It would not be proportionate for us to take action to improve scheme funding that would put at risk the employer's ability to support the scheme on an ongoing basis. It is not part of our role, however, to promote one form of pension provision over another, especially where doing so might put accrued benefits at greater risk.

In developing our proposals we were conscious of the importance of reducing uncertainty, and undertook research on the potential impact on the wider economy of encouraging a fairly rapid elimination of funding shortfalls. The report indicated that the likely impact on the economy and jobs from eliminating shortfalls measured on the FRS17 basis was not likely to be great.

### *Trigger approach*

The consultation responses supported the application of a dual trigger approach to filter schemes. Therefore, we have decided to retain triggers for both technical provisions and recovery plans. We recognise that they are interlinked and intend to place greater emphasis on schemes' setting prudent technical provisions, which means that we are prepared to be more flexible in considering schemes that trigger because of their recovery plan.

### *Triggers not targets*

Many respondents recognised the strong behavioural impact of our triggers and raised concerns about the potentially negative impact of

triggers becoming targets. We share these concerns and have sought, through the statement, to make it clear that the triggers we have set are only one of the tools in our regulatory toolkit and not the standards against which we will measure DB pension schemes. They will be used to prioritise and manage our work and should by no means be considered targets for pension schemes to aim at.

### *Summary of triggers*

We have noted the extensive comments about potential problems with using the buy-out funding level as a first line trigger for technical provisions, particularly the 70%-80% range, and, as a consequence, we have decided to modify our approach. Rather than looking at a range relating to average values for section 179 and FRS17 liabilities in relation to buy-out, we have chosen to concentrate on the values themselves. Although not free from drawbacks, they satisfy our need for a pragmatic solution.

We now intend to use a range between the actual section 179 value of PPF liabilities and the FRS17 measure of liabilities (IAS19 where available) for the scheme in question, irrespective of which of the two is higher, as the trigger range for technical provisions. Whether a scheme triggers where its funding target falls within the range would depend on its maturity and the employer's strength. As part of the filter we will apply a sense check to the FRS17 and section 179 figures using other available information, including buy-out valuations.

We have also considered carefully comments relating to recovery plans, but continue to believe that a ten-year trigger strikes an appropriate balance between the risk of significant deterioration in the employer's covenant and our regulatory objectives. We have therefore retained the ten-year trigger, alongside a trigger to monitor back-end loading of recovery plans, which was not contentious. However, we do not intend to focus our attention on recovery plans of ten years or under and would only want to consider intervention where we had reason to believe that assumptions used, for example in relation to mortality or investment returns, might be inappropriate.

### *Relationship between technical provisions and recovery periods*

We have noted the concerns that the proposed trigger points for recovery plans might influence trustees to set low technical provisions in order to achieve a shorter recovery period, and have made it clear that we would not wish to see the level of technical provisions compromised in the interests of achieving a shorter recovery period.

If a scheme triggers, whichever trigger is the reason, our primary focus will be to ensure that the technical provisions have been calculated using a method and assumptions that are prudent given the scheme's circumstances.

We will be prepared to be more flexible when considering the appropriateness of the recovery plan, giving full regard to the viability of the employer, its ongoing ability to fund the scheme and its long-term health.

#### *Secondary assessment*

We appreciate the need for better understanding of what happens when a scheme triggers and have sought to provide more information in the revised statement about the process we may follow and the actions we may take. However, there is a limit to what we can say at this stage bearing in mind that few, if any, schemes have completed the valuation process and we have not yet received any recovery plans. Both the triggers and our assessment model are essentially prioritisation tools to help us decide whether our intervention would be appropriate, and the scheme specific nature of the funding framework means that our processes could vary widely from scheme to scheme. We will keep the situation under review and provide more guidance as appropriate.

#### *Contingent assets*

Our proposal for recognising the use of contingent assets in a scheme's funding strategy has met with overwhelming support. Although we would generally prefer to see the money being put directly into the scheme, we recognise that there are circumstances where the use of contingent assets can provide valuable flexibility. Therefore, we have decided to take account of contingent assets used to support recovery plans or, alternatively, in some restricted circumstances, technical provisions, but subject to strict criteria relating to duration and enforceability. As already mentioned, we will set out the approach we expect trustees to take in separate guidance which will be published on our website in May 2006.

#### *Additional issues*

Consultation responses brought to our attention a number of specific issues relevant to the regulation of scheme funding in the context of not-for-profit organisations and employers subject to economic regulation, such as utilities or rail companies. This list can in fact be extended to cover multi-employer schemes and cross-border schemes operating within the European Union. We do not consider that there is a need to change our general approach for these schemes. We will still use a filter mechanism based on technical provisions and recovery plan triggers where appropriate, but will take account of the schemes' unique circumstances during the secondary assessment process.

#### *Surpluses*

We are aware of the risk that if employers fund their schemes prudently there may be an eventual surplus which they could have no guarantee

of recovering. Unless the legislation is changed we can do little about this other than be prepared to take account of assets that are made available to the scheme on a contingent basis. We have been in discussion with DWP about this issue, who have confirmed that they intend to keep the situation under review as the new requirements for the funding of defined benefit schemes are put into practice, and will consider the need for consultation on changes to current legislation in due course.

### **Schemes with strong employers**

A theme running through many of the responses has been the importance of our giving due weight to the strength of covenant provided by strong employers, especially in relation to recovery plans. We recognise that statistically most strong employers will be strong for some years to come and pose a smaller risk to members' benefits and the PPF than the generality of employers. Our code of practice provides guidance on how the trustees can take comfort from the employer covenant in setting the assumptions for technical provisions.

On the other hand, any pensions shortfall may still form part of a potential debt on the employer and must be made good regardless of employer strength. The longer this funding gap remains outstanding the greater the risk that the employer will cease to be strong enough to close it without putting its viability at risk. We therefore need to strike a balance and believe that our approach, as revised, does this by:

- retaining a trigger range for technical provisions, which means that a stronger employer's technical provisions can be lower than those of other employers, other things being equal, without triggering. However, even strong employers will trigger if their technical provisions fall below the range;
- taking account of employer strength in a more scheme specific way than triggers can in our secondary assessment process where schemes trigger on technical provisions; having looked at such schemes in more detail we may conclude that the technical provisions look reasonable in the context of the scheme without contacting the trustees for further evidence;
- being less likely to look further at schemes that have used recovery plans with investment return assumptions that differ from the prudent assumptions used for technical provisions where the employer appears to the trustees strong enough to make good any under-performance during the period of the plan;
- being less likely to look further at recovery plans that trigger on grounds of length or back-end loading where there is a contingent security in place that is fit for purpose – such contingent security is most likely to be readily available to strong employers, including not-for-profit organisations with unencumbered assets.

We will, however, expect trustees who take significant comfort from the strength of the employer covenant to keep it under close review and to be prepared to take action should the covenant deteriorate. Indeed, trustees may find it attractive to take such comfort through securing some form of contingent asset.

## **4. The responses in detail – by consultation question**

This section provides a full analysis of comments made under each of the consultation questions, together with our views on these comments and how we have changed our approach in response.

Additional issues highlighted in the consultation are covered at the end of this section.

**Question 1: Do you agree that the key risks caused by scheme funding are that:**

- **schemes could close with insufficient funds to meet their liabilities;**
- **the resulting claims on the PPF would be a potential burden to all schemes and sponsoring employers;**
- **trustees may set technical provisions too low or recovery plans too long to adequately mitigate risks;**
- **the regulator may be drawn into actions as the arbiter of scheme funding for many schemes, causing the regulator to take a much larger role with significantly higher associated costs;**

**and that**

- **these are the risks which the regulator should seek to address.**

### ***Summary of comments received***

*None of the responses disagreed with the risks we identified. A few other risks were identified:*

- *of the excessive burden being placed on trustees and employers through uncertainty leading to incorrect decisions or documentation which may need to be redone, or to excessive enquiries from the regulator;*

- *of reduction in future benefit provision or further exit from DB provision, and so reduction in members' benefits from what was expected or what would otherwise have accrued to them;*
- *to jobs and the wider economy resulting in increased unemployment or UK companies losing their share of world markets;*
- *of over-funding leading to employers having capital unnecessarily tied up in the pension fund rather than employed in the business, so inhibiting growth of the business; and*
- *of asset-liability mismatching leading to the volatility of deficits and a significant risk of a deficit from which recovery was not possible.*

### ***Regulator's response***

We recognise that each of the additional risks suggested has some relevance to our approach, but consider that they are already implicit in the approach we are taking, so far as they are appropriate.

#### *Uncertainty as to regulatory approach*

We hope that the statement, published alongside this consultation report, coupled with our regulatory code of practice No. 3, *Funding defined benefits*, should go some way towards reducing uncertainty about the implications for trustees and employers of the new scheme funding framework. We have supplemented this information with an extensive national programme of roadshows and workshops to maximise the understanding of the funding framework and the key role that trustees play in making it a success. We hope that this will provide sufficient certainty about our regulatory approach to avoid any unnecessary burden being placed on trustees and employers.

#### *Reduction in future benefit provision or further exit from DB provision*

The level of pension benefits that employers provide is informed by their assessment of the benefits to be obtained in the market place from making pension provision and their approach to securing good relations with their staff. Many employers have taken the view that defined contribution provision or some form of risk-sharing hybrid meets their needs in a way that is better balanced with their future prosperity. The trend towards the closure of DB schemes started some years before the new scheme funding framework came into force, influenced by the increasing reluctance of employers to bear the costs and volatility inherent in funding a potentially open-ended promise.

We consider that our approach may make these costs and risks more visible, but it will not change them. It is not part of our objectives to encourage one form of pension provision above any other. Our remit is to seek to ensure that whatever provision is made, be it DB or DC, members' benefits are protected.

### *Jobs and the wider economy*

We have taken very seriously the risk that our proposals could have adverse effects on jobs or the wider economy. We therefore commissioned PricewaterhouseCoopers to undertake research into these risks before we published our proposals.

We asked PwC to base their assessment on two key parameters: FRS17 measure of pension fund deficits, and the pay-off periods of five to ten years. The analysis was conducted by reference to a specific date using a sample of 550 companies, skewed towards FTSE 350 constituents, which between them are responsible for over half the aggregate shortfall.

The research showed that the likely impact on the economy and jobs from eliminating shortfalls measured on the FRS17 basis was not likely to be great. In essence, the research showed that the corporate world may already be moving in the direction of eliminating FRS17 shortfalls and is, for the larger part, well able to do so. In particular:

- their survey of 550 individual employers<sup>1</sup> to examine the impact on companies of filling their FRS17 deficit in ten years showed that, depending on the measure used, 65-80% of the sample would be required to make contributions of less than 25% of their free cash flow; 10-15% would make contributions worth between 25% and 100% of their free cash flow, while some 10-20% of companies would face a cash call greater than their cash flow. This last group includes all those with negative free cash flow;
- around 75% of the FRS17 shortfalls are already factored into share prices for listed companies, indicating that the scope for any further negative impact is limited;
- the effect on Gross Domestic Product of paying off the shortfalls over ten years would be limited (an estimated reduction in GDP would peak at 0.2% after 2.5 to 5 years) unless a significant proportion of companies sought to fund these payments by cutting employment costs and raising prices.

Whilst the research provides a valuable indication of the potential impact on companies and the economy of eliminating FRS17 shortfalls over the agreed timescales, we recognise that we need to exercise caution in extrapolating the findings to the actual impact of our proposed regulatory approach.

Therefore, where schemes with employers that would find it hard to pay off shortfalls quickly (or at all) trigger, we would seek to avoid action which would threaten the viability of the employer, and would be

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<sup>1</sup> All figures are based on averages over the past five years.

flexible about recovery periods. Our position is that the best means of delivering the members' benefits is usually for the scheme to have the continued support of a viable employer and that recovery plans can be expected to take this into account.

### *Over-funding*

We do not believe that our approach should result in schemes being over-funded in the sense of having more assets than it is prudent to hold against future risks that the scheme will not be able to meet liabilities as they fall due. The triggers are not targets which trustees and employers should base their decisions on but should enable us to identify most schemes that have been insufficiently prudent.

However, we recognise that, by definition, prudent technical provisions may result in a possibility that the scheme will eventually have surplus assets, particularly for schemes closed to future accrual or very mature schemes where future accrual is insignificant relative to accrued liabilities. We appreciate concerns from employers about the difficulties involved in recovering any surplus assets. We have been in consultation with the DWP about this issue, who have confirmed that they intend to keep the situation under review as the new requirements for the funding of defined benefit schemes are put into practice, and will consider the need for consultation on changes to current legislation in due course.

In the meantime, in looking at the sufficiency of technical provisions agreed by the trustees, we will take account of appropriate contingent security provided, which could be used to supplement the fund where the technical provisions prove to be insufficient, or released back to the employer if assets exceed those needed.

### *Asset-liability mismatching*

While we recognise that asset-liability mismatching could potentially increase the risks to schemes, this is a complex issue. In particular, there is a balance to be struck between the degree of certainty provided by matching assets with the cost of obtaining such assets. There is also a lack of consensus as to what constitutes a prudent approach where matching assets are unavailable. However, our statement makes it clear that the use of a prudent discount rate for technical provisions does not necessarily require trustees to adopt the same assumptions for their investment strategy, so long as they are comfortable with the employer's covenant and have allowed for the risk that the employer may not be able to cope with any adverse experience. Trustees are required to take advice before setting or revising their investment policy and mismatching risks can be expected to be addressed in that advice. We are not currently giving priority to developing a response to the asset-liability mismatching risk, but may turn our attention to it in due course.

**Question 2: Do you agree that the following principles are those on which the Pensions Regulator should base its approach to scheme funding?**

- **protecting members**
- **scheme specific**
- **risk-based**
- **proportionate**
- **preventive**
- **practicable**
- **referee not player**

**If you believe there are other principles we should follow please make suggestions.**

### ***Summary of comments received***

*Respondents generally agreed with the principles we identified, but some additional suggestions were put forward, such as the need for clarity and consistency in our approach as well as affordability. Respondents appeared, understandably, to want to be able to anticipate the regulator's decisions without apparently fully appreciating the scheme specific nature of the new scheme funding framework.*

### ***Regulator's response***

We accept the thinking behind the suggested additional principles and indeed the points raised were very much implicit in our thinking as we developed our approach.

#### *Clarity*

The published code of practice sets out clearly our expectations of trustees and provides considerable guidance as to how these might be discharged in practice. In the revised statement we have sought to simplify the explanation of how triggers will operate and to provide more information on what we may do once a scheme triggers. This will be followed by further guidance as our experience develops.

#### *Consistency*

We have also sought to ensure that our approach to regulating other related areas, such as clearance, withdrawal arrangements for multi-employer schemes or cross-border schemes, is consistent with our approach to scheme funding. There is, however, a tension between consistency of regulation and being scheme specific and proportionate. We will therefore seek to be consistent in as far as our processes should ensure that two identical schemes in identical circumstances would be treated equally. In practice, however, we may need to treat

differently similar schemes in different circumstances, for instance where the strength of the employer differs.

### *Affordability*

We have always intended that the principle of proportionality should encompass affordability. In particular, where a scheme triggers and we decide that we need to take a closer look (or if we decide to investigate for another reason), the extent to which the employer can afford to pay more to the pension scheme will be one of our primary considerations in reaching our conclusions as to whether to question or accept trustees' judgement on the level of technical provisions or the structure of any recovery plan. When considering the reasonable practicability of recovery plans we will pay particular attention to the future viability of the sponsoring employer, on the grounds that the best protection of members' benefits is usually an ongoing scheme with an ongoing employer. We place additional emphasis on this point in the revised statement.

**Question 3: Do you agree that building a filter using distinct triggers for funding targets and recovery plans is the best way for the regulator to identify funding risks?**

### ***Summary of comments received***

*The need for some sort of filtering was accepted widely, as respondents recognised that we need to prioritise our work and be risk-based. There was also considerable agreement that separate triggers for technical provisions and recovery plans were appropriate, although there was no consensus as to where they should be pitched. Some emphasised the importance of a dual approach because of a clear interaction between the two components.*

*Some respondents argued that strong employers should have more latitude and that triggers should only serve to manage the regulator's workload, with the second stage assessment being the crucial one.*

*Some respondents had misunderstood the triggers as targets and had not appreciated that they were intended as management tools to prioritise workload.*

### ***Regulator's response***

We are heartened that there is general support for an approach that uses triggers to help filter our workload. Within the responses there is also recognition that triggers are likely to shape behaviour. This is clearly beneficial if it helps trustees take a view on prudence and appropriateness in the circumstances of their particular scheme that is consistent with the way we intend to look at schemes. It should also help trustees act with greater confidence and reduce the number of schemes we need to look at. What we need to avoid is the triggers

becoming unthinking targets regardless of circumstances, which is clearly not the intention. As some of the responses blurred this distinction and raised concerns about the impact of triggers becoming targets we have made it even clearer in our statement that triggers are not targets.

We have decided to retain the filter approach using triggers relating to technical provisions and recovery plans (see questions 4 and 5 below), while recognising that there are linkages between them and that a careful balance needs to be struck between increasing the security of accrued benefits and maintaining the viability of the employer. The aim of the triggers is to identify, from readily accessible data, schemes where technical provisions appear to have been set at a level that might prove, on further examination, to be too low or schemes where the recovery plan appears to have been set too long or otherwise inappropriately.

There is an inevitable tension between designing triggers that are practicable to operate on the basis of information that schemes will be providing us as a matter of course, and reflecting the specific circumstances of each scheme. Our code of practice explains in some detail the processes that trustees should go through in preparing and agreeing their funding plans. These processes, which will include assessments of risk and the strength of the employer covenant, will be considerably more complex and detailed and call on a much wider range of inputs than we could possibly replicate in designing triggers. We do not see this as a serious problem as the triggers are an initial prioritisation tool for the regulator to manage its workload. They do not predetermine where we are likely to decide to intervene and hence cannot be targets.

As our own and trustees' experience of the new pension scheme funding regime develops, the triggers will be kept under regular review taking into account scheme behaviour and market conditions.

The triggers will be supported by a scheme specific secondary assessment process which will use more detailed information and a much wider range of criteria to determine for each scheme we decide to look at whether our intervention is necessary or would add value. During this secondary phase we will consider any special or unique circumstances of the scheme including, for example, whether the scheme sponsor is in a regulated industry or whether the sponsor is a not-for-profit organisation. We have explained our approach to this process in the revised statement to help emphasise the message that triggers are not targets.

We believe that our approach provides greater latitude for schemes with strong employers, for the reasons given in the previous section.

**Question 4: Have we set the technical provisions triggers appropriately? If not, please provide suggestions.**

**Summary of comments received**

*There was no clear consensus on the trigger mechanism. The main arguments advanced were:*

- *buy-out costs are not a universal benchmark as current legislation, actuarial guidance notes and limitations in the insurance market leave significant discretion to the individual actuary. Some respondents considered that the perceived 70%-80% trigger range was set too high given current market conditions and a few noted that the link to buy-out which is an inappropriate standard for ongoing employers could be presentationally difficult;*
- *whilst some respondents supported the use of the section 179 valuation as being aligned to our objective of PPF protection, others argued that it is of little direct relevance to the determination of technical provisions because it does not relate to all benefits and is purely gilt-based;*
- *some respondents argued that FRS17 calculation is inappropriate because it is bond-based or based on assumptions chosen by the employer and hence susceptible to manipulation. A few questioned whether most employers look at FRS17 as the right measure of their pensions liabilities. Others, on the other hand, supported the use of FRS17 to inform an initial trigger, particularly given the presence of this liability on the employer's balance sheet;*
- *an argument was also put forward that a more scheme specific approach should be used, for instance by applying a matrix of the main discount rate assumptions that could be used in practice to derive a prudent actuarial basis. This might enable the trigger to reflect scheme maturity, sponsor strength and allow for some equity exposure if appropriate and prudent. For example, a suggestion was made that a discount rate of 1.25% (measured in real terms relative to gilts) could be applied to a mature scheme with a weak sponsor, but an immature scheme with a strong sponsor could use a rate of 2.25%;*
- *many respondents sought greater clarity in framing the trigger and in explaining what form our subsequent intervention would take, including scenario-based guidance on what could happen.*

**Regulator's response**

*Alternative approaches*

We have carefully considered the alternative approach suggested by a few respondents of using the more direct approach of setting triggers

relating to specific elements of the actuarial basis underlying technical provisions, such as the discount rate – in particular a suggestion for a matrix of discount rates to model what might be prudent technical provisions in different circumstances.

We can see that such an approach would be attractive in as far as it would relate to the types of decisions trustees will be taking and could reduce the number of schemes with prudent technical provisions that trigger. There are, however, serious drawbacks that have led us to conclude that it would not be desirable or practicable:

- Triggers of this nature would look more like targets, which is not the intention. By replicating, albeit crudely, the types of decisions that trustees take there would be a serious risk that we would be inadvertently setting a new funding standard like the MFR. This would conflict with the Government's intention that the new funding framework should be scheme specific.
- There is a particular risk in our publishing what would be taken as views on appropriate discount rates in particular circumstances. There is no guarantee that they would prove to be prudent and they could become rapidly outdated. It could, therefore, undermine the role of trustees in considering prudence in the context of the specific circumstances of the scheme.
- More generally, the use of discount rates might be taken to imply that this is necessarily the appropriate way for trustees and actuaries to calculate prudent technical provisions. In practice, there are several methodologies they could use which are not based on simple discount rates.
- It would be less practicable for us than the simpler triggers we have proposed as more information would need to be identified and processed to provide us with an answer for each scheme. With over 10,000 DB schemes to regulate this is a serious consideration.

In fact, we have been unable to identify any possible approaches to setting triggers for technical provisions that we could operate without asking schemes for more information and hence increasing their costs, other than what we have proposed. As trustees and employers are already required to prepare valuations on four bases, we consider it would be unreasonable, at this time, for us to mandate a fifth one. However, we may look at the discount rates set by trustees as part of our secondary assessment for schemes which trigger, because at this stage we are likely to have more information to validate the basis on which they have been calculated.

*Our proposed primary triggers (s179 and FRS17)*

We recognised in the consultation document that there are conceptual problems with using s179 or FRS17 as a trigger. This is why we

decided against using either as a trigger in isolation. Many of the arguments in favour of this approach have been reflected in the responses:

- The s179 valuation has the strength of being calculated on a consistent basis, including, uniquely, a consistent approach to mortality assumptions. It is also an accurate representation of the risk exposure that the PPF assume in determining the amount of levy that should be charged to all DB schemes. Schemes with technical provisions valued below this level may represent a perennial risk to the PPF which will be shared across all schemes. We should therefore be failing in our statutory objective of protecting the PPF if we did not consider this figure in deciding whether a scheme should trigger. In addition, although it does not value the totality of members' benefits, it does provide a more prudent valuation of a substantial part of those benefits (on average around 75%) than most ongoing schemes with ongoing employers would wish to use;
- The FRS17 valuation has the strength of being available in many instances,<sup>2</sup> applies to all the benefits and has a consistent, and in the circumstances of most schemes, prudent discount assumption. We recognise that the other assumptions are best estimates, chosen by the employer. It does nonetheless provide a rough approximation to the level of technical provisions that would result from using a complete set of prudent assumptions. It also has the merit of being a potential driver of behaviour for employers who are concerned about the impact on their business of having an FRS17 shortfall reported on their balance sheet. Furthermore, because all the key assumptions including, increasingly, that for mortality, do need to be disclosed, the likelihood of these assumptions deviating significantly is in practice less than some respondents might fear. The assumptions are more likely to converge than diverge as greater attention is applied to these disclosures.

We are not, therefore, convinced that the arguments against these measures are sufficient to render them unsuitable as triggers. They would not be suitable as targets – but triggers are not targets. Even as triggers they may not be perfect but, as indicated above, we do not believe that there are any alternatives that would not either increase the information provision burden on schemes or be somewhat arbitrary in nature.

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<sup>2</sup> Listed companies will be increasingly moving to the IAS19 accounting standard. In most circumstances this produces similar figures to the FRS17 standard, so that we will be able to use IAS19 figures in their place. IAS19 does allow a range of options for reporting on changes in values from year to year, but the inconsistencies that potentially arise from such smoothing can, if necessary, be removed by recourse to notes to the accounts. References to FRS17 in this document should be taken as applying also to IAS19.

### *Our proposed trigger relating to 70-80% of the buy-out valuation*

We have taken very seriously the extensive comments that there are potential problems with using the buy-out funding level as back-up measure for a trigger for the technical provisions. When we issued the consultation paper we hoped that the scheme funding regulations would provide a clear, workable and consistent means for actuaries to measure the buy-out debt. The actuarial profession issued a new version (v 8.0 of their GN 9) from 30 December 2005 to refer to the new Part 3 requirements. The section on estimating buy-out costs was substantially altered from the draft version and was made less prescriptive. In addition, as we stated in the consultation document, we recognise from our own modelling work that the 70-80% buy-out range would be too high for some types of scheme, especially less mature schemes with a strong employer. This view was supported by some of the responses to consultation.

We have therefore decided to remove the trigger relating to buy-out and focus our attention on the triggers relating to s179 and FRS17 liabilities. Our original proposal for the technical provisions trigger was in any case focused on the valuation of scheme liabilities on a s179 and FRS17 basis. But rather than looking at a range relating to average values for these numbers in relation to buy-out we shall concentrate on the numbers themselves.

We now intend to use a range between the s179 liabilities and the FRS17 liabilities (IAS 19 liabilities where available) as the trigger range, irrespective of which of the two is higher. Whether a scheme triggers if it falls within the range would depend on its maturity and the employer's strength. As a guide to how this will apply, the trigger point for a relatively mature scheme with a weak employer is likely to be set towards the higher of the two values, whereas the trigger point for a relatively immature scheme with a strong employer is likely to be set towards the lower of the two values.

We may still look at the information available on the buy-out position of schemes, along with any other available information, as a reasonableness check on the s179 and FRS17/IAS 19 figures available to us. In doing so, we recognise that neither s179 nor FRS 17 can be more than a rough approximation of prudent technical provisions and that there may be circumstances where using triggers based on these values could lead us to ignore technical provisions that may be imprudently set.

### *Using bond-based measures as triggers*

A number of responses expressed concern that all our proposed triggers use the rate of return on bonds to measure scheme liabilities, and that by linking the valuation of technical provisions to these measures we would inadvertently increase the pressures on schemes

to move their investments from equities into bonds so as to reduce the volatility against the valuations. We understand this concern.

However, we do not consider that, taken in isolation, there is evidence that our proposals have contributed to the historically low yield in the long bond market. The trend for pension schemes, and indeed insurers, to switch from equities into bonds has been apparent for several years and pre-dates the Pensions Act 2004, let alone our proposals.

There are clear reasons for the longer-term trend towards bonds. They include closure of pension schemes, and the effect of that in helping to crystallise liabilities, the sharp fall in equity prices in 2000, and the increasing use of asset and liability studies which have brought out the potential effects of asset price volatility.

There is, nonetheless, a case for suspecting that a combination of factors, including the increasing visibility and importance of (corporate bond-based) FRS17 figures may have encouraged some employers to press for a closer match to bonds to reduce balance sheet volatility. We recognise that to the extent that our proposals focus even more attention on FRS17 and (gilts-based) s179 they could place further incentives on trustees to avoid volatility in deficits relative to the technical provisions.

Such reduction in volatility may be appropriate or indeed desirable in some circumstances. However, we did not set our triggers to influence trustees' investment decisions. We want to emphasise again that we set the triggers primarily to help us manage our workload. We do not view them as funding targets against which to measure a scheme's technical provisions and do not expect anybody else to view them as such. Just because a scheme triggers does not mean that its technical provisions have been set too low. We have already made it clear in the code of practice, and reiterated this point in the statement, that trustees can assume some equity out-performance in setting technical provisions where they believe that the employer is strong enough to make good under-performance against this assumption. If they do, the scheme may trigger but in our assessment process that will follow we will consider more carefully the technical provisions in the light of what we know about employer strength and may decide not to look further at schemes where a higher than bond-based discount rate has been used. Our assessment of whether the employer appears strong enough to support under-performance will draw on a range of factors and could not easily be replicated in a simple trigger.

In fact, we are already working on the assumption that trustees of all schemes are able to allow for out-performance against gilts in their scheme's funding strategy. A scheme that invested totally in gilts would in practice need to be funded close to the buy-out level if it were to make prudent allowance for longevity, inflation risks and the cost of

administering the scheme. Our triggers and subsequent assessment criteria aim to ensure that the levels of technical provisions are prudent enough in the particular circumstances of the scheme to allow the scheme to pay benefits as they fall due. This in most cases means funding levels that fall short of the buy-out level of funding and implies that trustees can prudently assume investment returns higher than those provided by gilts. The forthcoming guidance on the use of contingent assets in scheme funding strategy will indicate that their existence can be another reason for trustees to allow some equity exposure in technical provisions.

Both the statement and the code make it clear that trustees can, if they consider the employer's strength justifies it, use less prudent assumptions in any recovery plan. And the statement makes it clear that we are not requiring any particular allocation between bonds and equities.

#### *Further guidance*

We agree with the respondents who made this point that we should give a clearer indication of what would happen where a scheme triggers, and have sought to provide some material in the revised statement. We have not included scenarios, however, as to do so would run a serious risk that trustees or employers would seek to apply them to their schemes and therefore, use them as the basis for creating targets. Each scheme's circumstances are different and it could be misleading to try to apply them to another scheme without understanding the full circumstances. We have, however, taken groups of trustees and advisers through an example as part of our recent scheme funding workshops and could consider placing such examples on our website in due course. These workshops have been attended by about 500 trustees, employers and professional advisers and were very well received.

#### **Question 5: Have we set the recovery plan triggers appropriately? If not, please provide suggestions.**

#### ***Summary of comments received***

*As with technical provisions, there was no clear consensus over the right trigger for recovery plans and a variety of views on whether ten years was the right trigger. There was little dispute about triggering for back-end loaded recovery plans. The main arguments advanced were:*

- *ten years is shorter than much current practice for funding deficits and could have an adverse impact on business costs, investment, jobs and international competitiveness. Some respondents suggested 12 to 15 years or the average future service lifetime of active members as being more appropriate;*

- *strong employers should have longer to pay off their deficits than weak employers and should not have to pay off their deficit in less than ten years because they should be able to plan how to invest their own funds and reduce their pension deficit in a way that fits their financial position and business plans;*
- *we should not seek to intervene in recovery plans of ten years or less;*
- *the ten-year trigger could create pressure from employers to weaken technical provisions because they are likely to seek an affordable recovery plan which will not trigger;*
- *ten years is only a trigger and is reasonable for that purpose because it strikes the right balance between the risk of significant deterioration in the employer's covenant and the regulator's objectives, and allows to make it clear that there are circumstances in which a longer period may be deemed reasonable;*
- *ten years may be reasonable if realistic asset return assumptions are used;*
- *price-regulated industries may present special problems because they can only raise their prices at predetermined times with their industry's regulator's permission.*

### **Regulator's response**

We have thought carefully about the use of a ten-year trigger, bearing in mind that the trigger is not a target. In setting recovery plans the trustees will have to agree with the employer a recovery period that is reasonably affordable in the employer's circumstances. Some will be shorter than ten years, others longer. Wherever we set the trigger is to some extent arbitrary. But we do need a trigger that will highlight those recovery plans where, for good or bad reasons, the risk that the employer will not be strong enough to deliver the plan is significant, bearing in mind the available evidence about the progressive deterioration in employer credit ratings. As we stated in paragraphs 4.2.2 and 4.2.3 of the consultation document:

*...to be useful, credit ratings should discriminate between high-risk and low-risk entities by means of a reasonably granular scale and should show good stability over time so that, for example, an entity rated very low risk (or AA) in year 1 does not suddenly become high risk (BB) in year 2. A study by Standard & Poor's<sup>3</sup> of AA rated entities showed that over a five-year period 50.5% of the entities maintained AA credit strength, 1.8% strengthened to AAA, 23.9% weakened to A, 0.3% defaulted to D and 18.5% became non-rated.*

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<sup>3</sup> *Credit ratings and their relevance to pensions trustees, 2005.*

*The ten-year data shows a higher level of relative change. Broadly over this period no more than a third of credit ratings have remained the same. Equally, non-rated cases increased quite significantly.*

*These figures highlight the significant differences in lifetimes between scheme sponsors and pension schemes. Over a ten-year period there can be a significant change in the circumstances and financial strength of a sponsor. In contrast, the pension obligations extend over a significantly longer timeframe.*

Furthermore, we note that a ten-year trigger is reasonably consistent with that taken by financial institutions in a similar position to a pension scheme of being owed substantial sums of money. It would be unusual for a financial institution to contemplate loan repayments over a period significantly longer than ten years. We consider that the pension debt is analogous to an unsecured creditor.

For weaker employers there is a relatively high risk of default within ten years. Indeed the risk of default in ten years is such that we would expect trustees to press for quicker recovery where they believe this to be possible. But affordability constraints would make it fairly pointless to shorten this trigger for the generality of weak employers. We would, however, consider looking at schemes in this category even though the recovery plan has not triggered on grounds of length where we become aware that the employer could afford to pay more quickly.

We recognise that there might be a case for extending the length of the recovery period that might trigger for strong schemes, as the risk to members and the PPF is less. Nonetheless, any pensions shortfall still needs to be eliminated regardless of employer strength, and the longer the funding gap remains outstanding the greater the risk that the employer will cease to be strong enough to make good the shortfall without putting its own viability at risk. A strong employer should have no difficulty paying off the shortfall over the ten-year period. These principles are reflected in our code of practice which states that employers should pay off shortfalls as soon as reasonably practicable.

That said, as a risk-based regulator:

- we will not focus on schemes where the recovery plan is no longer than ten years, unless they come to our attention for other reasons such as a corporate event or if we believe that some of the key assumptions may be inappropriate;
- we may take account of any contingent security put in place to reduce the risks to the scheme during the recovery period;
- we would be less likely to look further at a scheme with what we believe to be a strong employer which, in its recovery plan, uses investment return assumptions less prudent than those for technical provisions, as long as these are reasonable. Consequently there is

some latitude for trustees and employers to assume that scheme assets will perform better over the course of the plan than is assumed when calculating technical provisions themselves. However, recovery plans that do not appear to be realistic (from the disclosed assumptions) will trigger.

We therefore continue to believe that a ten-year trigger should provide an appropriate balance, and intend to retain it. The use of a trigger relating to back-end loading of the recovery plan was not contentious and we intend to retain this trigger as well, alongside a new trigger relating to unrealistic investment return assumptions in the recovery plan.

#### *Relationship between technical provisions and recovery periods*

A few respondents raised concerns that the proposed trigger points for recovery plans might influence trustees to set low technical provisions. We recognise this concern and as a result make it clear in the statement that we would not wish to see the level of technical provisions compromised in the interests of achieving a shorter recovery period.

We stress in the statement that, if a scheme triggers, whichever trigger is the reason, our primary focus will be to ensure that the technical provisions have been calculated using a method and assumptions that are prudent given the scheme's circumstances. Trustees must still choose prudent technical provisions regardless of the extent to which the employer's ability to make good a shortfall is constrained.

However, we will be prepared to be more flexible when considering the appropriateness of the recovery plan. We will give full regard to the impact any alteration to the recovery plan may have on the employer's viability, including its ongoing ability to fund the scheme and its long-term health.

Where a scheme's recovery plan triggers, we will expect trustees and employers to be able to demonstrate that they have taken appropriate advice and all available steps to minimise the risk of the funding position deteriorating further.

#### *Price-regulated industries*

We refer to concerns raised by regulated industries under *Additional issues* at the end of this section.

**Question 6: Do you consider that employers should be able to use contingent assets to lengthen recovery periods? Which contingent assets should the regulator take into account in deciding how it deals with a scheme and how should it do this?**

## **Summary of comments received**

*The recognition that contingent security has a part to play in scheme funding was enthusiastically welcomed and we were urged to provide further guidance. Whilst it was recognised that contingent security would be useful in managing the length or back-end loading of recovery plans and could warrant a more risky investment strategy, it was not generally considered appropriate for offsetting technical provisions.*

## **Regulator's response**

In view of this response, the remaining issues involved in our taking account of contingent assets used to support a recovery plan relate to technical details such as enforceability and duration.

We recognise that the arguments for using contingent assets to support technical provisions are more finely balanced. We state in the code of practice that trustees may agree to technical provisions assuming a degree of equity exposure if the employer is strong enough to bear the potential consequences of equities underperforming. A similar argument can be advanced if a contingent security of appropriate value and duration is in place. Although we would generally prefer to see the money being put directly into the scheme, particularly where the employer is strong, we recognise that the current restrictions on paying money back to the employer where it proves not to be needed could make employers understandably reluctant to pay the money in. Until or unless there is a change to the legislation on surpluses we consider that it would be unreasonable for us to ignore a contingent security that may be put in place.

The revised statement therefore states that:

- where trustees have agreed to the use of a contingent asset to support the recovery plan, in determining whether we consider it appropriate we may take into account the security provided by the contingent asset, bearing in mind a range of criteria relating to duration and enforceability; and
- where trustees have agreed to the use of a contingent asset to support technical provisions, in determining whether we consider it appropriate, we may take into account how the contingent asset, taken together with the trustees' assessment of the employer's covenant, allows them to agree a lower level of technical provisions than would otherwise be prudent, again bearing in mind duration and enforceability.

In May 2006 we will be publishing separate guidance on the approach we expect trustees to take when considering the use of contingent assets as part of a scheme's funding strategy.

**Question 7: Do you agree that the impact of the regulator’s proposals is likely to balance its duty of protecting members and the PPF with a need to take a proportionate approach for employers?**

***Summary of comments received***

*Some respondents felt that the proposals placed too much emphasis on the security of accrued benefits to the detriment of employer profitability and future pension provision, especially as a few respondents were not convinced by our analysis of the likely impact on business. Some also commented that the regulator could expect a heavy workload under its current proposals. Other respondents, however, thought that trustees might respond by seeking to avoid their scheme triggering so the regulator’s workload should not be excessive.*

***Regulator’s response***

***Security of accrued benefits***

Our statutory objectives require us to focus on protecting members’ benefits and reducing risks to the PPF. They give us little choice but to take appropriate action to ensure that there is prudent and appropriate funding of benefits that have already accrued, so far as this is possible. In doing so, we need to be mindful, as we have already emphasised, that we should not do anything that increases the risk that a scheme sponsor cannot meet its obligations.

We consider that to shift the balance towards greater provision of future benefits would be inequitable to those with accrued rights and to pension schemes in general because it would increase the overall risk to the PPF and hence the cost to all schemes and employers, including those who wish to be more prudent in protecting accrued benefits.

***Workload***

We recognise that the comments about the potentially heavy workload that the proposals are likely to generate have some validity. In particular, our modelling work suggests that some schemes using what might appear to be prudent assumptions in their circumstances may trigger if they use these assumptions. We hope that our subsequent assessment process will enable us to filter out some schemes that have triggered, by using a wider range of factors than could be included in a practicable set of initial triggers.

We also recognise that there may be delays before we investigate some of the ‘at risk’ schemes. We would ask the trustees to raise any concerns with us if they believe that a delay in analysing their scheme may be problematic.

**Question 8: Do you agree that we have proposed reasonable factors to consider how to intervene? If not, please suggest alternatives.**

***Summary of comments received***

*Very few comments were made in answer to this specific question. The main issue that emerged was a call for more information on what the regulator would do if a scheme triggered.*

***Regulator's response***

The revised statement provides some further information on the processes we may follow and the action we may take if a scheme triggers. There is, however, a limit to what we can say at this stage, bearing in mind that few if any schemes have completed the valuation process and we have received no recovery plans as yet. We will keep our statement under review and provide more information as appropriate. That said, the scheme specific nature of the funding framework means that our processes could vary widely from scheme to scheme, and it will not be possible to describe in detail the steps that will be taken in each case.

**Question 9: Do you have any comments on how we propose to regulate when there is a failure to agree, failure to obtain funding documents, contribution failure or modification of future accrual?**

***Summary of comments received***

*Very few comments were made under this specific heading. There were calls for clear guidelines on how we will act, calls for realistic risk assessment as opposed to box ticking, and a warning that there might be more failures than we anticipated. Concern was expressed as to how quickly we will be able to deal with these.*

***Regulator's response***

Given the low number of responses to this specific question, we do not propose to change our approach when the specific situations listed in this question arise.

Other comments received under this question are addressed in our response to feedback on other questions.

**Question 10: Do you have any substantive (as opposed to drafting) comments on the regulator's proposed statement?**

***Summary of comments received***

*There were very few substantive comments specific to this question, mainly on the grounds that the statement covered the same ground as*

*the preceding chapters of the consultation document. Those who responded stated that it was too long, it needed to explain clearly how we would be using our powers and it should be kept under regular review.*

### **Regulator's response**

We accept these concerns. We have made the statement more succinct and sought to explain our general approach to applying regulation, including the use of powers, as well as explaining more clearly how we will use our powers. We also intend to keep our approach and the statement under regular review.

### **Question 11: Do you agree to the funding trigger we propose for reviewing schemes subject to the MFR?**

#### **Summary of comments received**

*Views here ranged from not targeting schemes subject to the MFR until the first Part 3 valuation was due on the basis that we had no power to intervene and should only take action when trustees failed to move quickly to the new funding regime, through suggesting lower triggers, down to 80%, on the basis that a trigger set at 110% would catch too many schemes, to the acceptance that 110% trigger was reasonable or even too weak.*

#### **Regulator's response**

After considering the feedback in relation to this question, we have concluded that setting a specific trigger point for schemes which, for the time being, remain subject to the MFR is not desirable in the light of our powers and objectives. It is in the interest of both trustees and employers to start increasing funding levels gradually in the run-up to the first actuarial valuation under Part 3 of the Pension Act 2004, and trustees should start discussing options with the employer at the earliest opportunity.

Where the employer cannot immediately adopt a scheme specific approach to scheme funding, or is struggling to fund the scheme to MFR level, we would encourage trustees to consider alternative options to improve the funding level or to ensure that the deficit does not continue to grow.

Any reduction in the funding deficit will also have the benefit of reducing the level of the risk-based levy paid to the Pension Protection Fund.

**Question 12: Do you have any other comments on the regulator's proposals contained in this consultation document?**

***Summary of comments received***

*Schemes should not be prohibited from investing in risk capital.*

*Concern was expressed over the costs of compliance including adviser fees and continuous employer health checks, with the burden falling disproportionately more heavily on smaller companies.*

*Some employers are regulated by the FSA and we should liaise to avoid inconsistencies between scheme funding regime and the FSA's prudential rules.*

*An excessively stringent funding regime may prejudice the ability of non corporate entities, particularly charities, to fulfil their objectives and could, in some cases, threaten their very existence.*

***Regulator's response***

It is not our role to prohibit or encourage investments in any particular asset class or classes. The responsibility for the choice of scheme investments lies with the scheme's trustees. It is up to the trustees to decide how much investment risk they are comfortable with, and therefore what asset classes to invest in, after taking into account the scheme size, maturity and the strength of employer covenant. Trustees must take advice before setting or revising their investment policy.

We do not consider that monitoring employer covenants will be as costly for schemes as feared. A lot of this information is likely to come directly from the employer who is obliged by law to provide, on request from trustees, information reasonably required by them to assess the employer's covenant. There will be information about the employer that is in the public domain, and trustees can always ask the employer to keep them informed of matters which are likely to have a material impact on the scheme. For the majority of small pension schemes this may be all that is required for trustees to do their job.

We have discussed with the FSA their approach to prudential regulation and the treatment of scheme deficits for that purpose to ensure that there are no inconsistencies between their prudential rules and the scheme funding regime. We are satisfied that both regimes can work effectively alongside each other.

We comment on our approach to regulating scheme funding in the not-for-profit sector under *Additional issues* below.

## **Additional issues**

Consultation responses brought to our attention a number of specific issues relevant to the regulation of scheme funding in the context of not-for-profit organisations and employers subject to economic regulation such as water, electricity or rail companies. We have considered the comments very carefully and concluded that, while some practical considerations may differ depending on the nature of the sponsoring employer or the type of scheme, there is no need for us to change our general approach.

Therefore, we will still use a filter mechanism based on triggers to identify schemes whose funding plans seem more likely to be based on imprudent or inappropriate assumptions. We will take account of the nature of the sponsoring employer, the scheme type and any other relevant factors during the secondary assessment process.

We outline below some of the specific factors we may consider. For completeness, in addition to not-for-profit organisations and employers subject to economic regulation, we cover multi-employer and cross-border schemes as well.

### ***Not-for-profit organisations***

For not-for-profit employers, the specific factors we would consider include:

- the degree of reliance of the sponsor on voluntary income, including legacies;
- whether the employer has any other available funds (whether part of the unrestricted income funds or restricted funds the employer may have) which can be used to meet the pension scheme shortfall;
- the opportunity to use unencumbered assets as a contingent security for the purposes of a recovery plan. Such security is often in the form of land and buildings which may currently be used for operational purposes, but which would become available for sale if the not-for-profit organisation were to cease operating; and
- whether the employer has flexibility in determining the level of commitments it makes to beneficiaries.

### ***Employers subject to economic regulation***

For sponsoring employers subject to economic regulation, the specific factors we would consider include:

- whether they are subject to periodic price reviews – because when formulating a recovery plan, trustees may need to consider how the

periodic price reviews will impact on the employer's ability to eliminate the shortfall; and

- the existence of franchise agreements, such as in the rail industry. If the term for an existing franchise holder is coming to an end and the industry regulator would require the new franchise holder to seamlessly take on the pension scheme liabilities, then we would not necessarily require the existing franchise holder to remove any pension scheme shortfall before the end of the term of their franchise.

### ***Multi-employer schemes***

For multi-employer schemes we would take into account such factors as the type of scheme, ie whether an industry-wide one or one for associated employers, and the way in which scheme assets are invested, ie whether pooled or segregated.

### ***Cross-border schemes***

We will apply the same general principles, as far as possible, to the regulation of the funding of cross-border schemes operating within the European Union. Cross-border schemes are schemes which have one or more European employers who make contributions in respect of qualifying members located in a member state other than that from which the scheme is operated.<sup>4</sup> They must first be authorised and approved to operate cross-border and will provide evidence of their funding position on application.

Once approved to operate as a cross-border scheme, such schemes are required to be fully funded within two years of the valuation which revealed the shortfall<sup>5</sup> and submit annual funding valuations to the regulator. This means that recovery plans of the type envisaged for domestic schemes do not apply and therefore the recovery plan trigger cannot be used. However, we will operate the technical provisions trigger in the same way as for domestic schemes.

We will take account of the specific requirements for cross-border schemes in the secondary assessment process.

Further guidance on the regulation of cross-border schemes can be found at [www.thepensionsregulator.gov.uk/trustees/crossBorder](http://www.thepensionsregulator.gov.uk/trustees/crossBorder).

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<sup>4</sup> 'European employer' and 'qualifying person' are defined in regulations 2 and 3 of the Occupational Pension Schemes (Cross-border Activities) Regulations 2005 (SI 2005/3381).

<sup>5</sup> Recovery plans as modified for cross-border schemes: s226 of the Pensions Act 2004 as modified by para 6(2)(b) of Schedule 2 of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (SI 2005/3377).

## **Annex A**

### **List of respondents to our consultation**

Association of British Insurers  
ABN-Amro  
Association of Consulting Actuaries  
Association of Chartered Certified Accountants  
Alchemy Partners LLP  
Amicus  
Anglian Water  
Aon Consulting Limited  
Ashurst  
AstraZeneca  
Aviva  
British Airways Pensions  
Balfour Beatty plc  
British Air Line Pilots Association  
Barclays plc  
Barnett Waddingham LLP  
British Chambers of Commerce  
BT Group plc  
Confederation of British Industry  
Chiltern Group  
Electricity Supply Pension Scheme  
Ernst & Young  
Ferguson McIlveen  
Friends Provident  
GMB  
Gordon Consulting LLP  
Graham Cox (financial economist)  
Hewitt  
The Hundred Group of Finance Directors  
Hymans Robertson  
Institute of Chartered Accountants of Scotland  
Interlek plc  
Institute of Directors  
Jardine Lloyd Thompson  
John Lewis Partnership  
Kelda Group  
Lane Clark & Peacock  
Law Debenture  
Law Society of Scotland  
Mercer  
Morgan Stanley  
National Association of Pension Funds  
National Grid plc  
Nestle UK Ltd  
The NG Bailey Organisation Limited  
Ofwat

Pearson plc  
Pensions Management Institute  
Pension Protection Fund  
Prudential plc  
Punter Southall  
Punter Southall for a client  
Royal Bank of Scotland  
SBJ Benefit Consultants  
Scottish Widows  
South East Water  
The Society of Pension Consultants  
Standard Life  
Tesco PLC  
Unquoted Companies Group  
Water UK  
Watson Wyatt  
Wessex Water  
Western Power Distribution  
Yattendon Investment Trust plc