

Medium term strategy

April 2006

Table of contents

Foreword	3
Chapter 1 – Executive summary	4
Part 1 The challenges for the regulator	7
Chapter 2 – What the regulator was set up to achieve	8
Chapter 3 – The pensions environment	11
Chapter 4 – Our principal challenges.....	19
Part 2 How we will address these challenges	24
Chapter 5 – Our approach to regulation.....	25
Chapter 6 – Scheme funding	33
Chapter 7 – Scheme governance	39
Chapter 8 – Risks to members of DC schemes	42
Chapter 9 – Delivering the strategy.....	46
Appendices	48
Appendix A: Our risk-based approach to determining priorities for intervention.....	49
Appendix B: Examples of poor governance	52

Throughout this document ‘DB’ refers to defined *benefit* schemes,
‘DC’ refers to defined *contribution* schemes and ‘GPP’ refers to group
personal pensions (usually contract-based).

Foreword

The Pensions Regulator recently completed its first year of operation. Significant achievements over the period have included:

- the establishment of a new clearance process for corporate transactions involving employers with defined benefit schemes;
- issuing a number of statutory codes of practice giving practical guidelines to trustees and others;
- developing a regulatory framework for the funding of defined benefit schemes; and
- starting the development of an overall organisational and regulatory approach which is proactive, risk-based and flexible.

This document is intended to provide a medium-term strategic overview as the context for the annual cycle of operational and business plans. It aims to help the reader to understand our overall approach and priorities for the next three years and to provide more of the background to the individual issues that are likely to arise.

David Norgrove
Chairman

Tony Hobman
Chief Executive

Chapter 1 – Executive summary

This strategy document is in two parts. Part 1 sets out the challenges for the Pensions Regulator (‘the regulator’) and Part 2 how we will address those challenges.

The outcomes the regulator is seeking and the steps it intends to take in respect of our challenges can be found in the second halves of chapters 6, 7 and 8. The key performance indicators for each challenge are in the same chapters and in chapter 4.

Our risk-based approach to regulation and our working in partnership with bodies such as the Pension Protection Fund is set out in chapter 5.

The regulator’s objectives

The Pensions Regulator is the regulator of work-based pensions. Our statutory objectives are to protect the benefits of members of work-based pensions; to reduce the risk of situations arising which may lead to calls on the Pension Protection Fund; and to promote and improve the understanding of the good administration of work-based pension schemes.

Our objectives are not ranked in importance; nor is there a statutory requirement to give priority to any particular work-based pension arrangement such as defined benefit schemes.

The challenges for the regulator

In pursuit of these objectives our three principal challenges over the next three years are:

- (i) to strengthen the funding of defined benefit schemes;
- (ii) to improve the governance of work-based pension schemes;
- (iii) to reduce the risks to members of work-based defined contribution pension schemes.

Our key performance indicators are that during the course of the next three years:

(i) Scheme funding

DB schemes will have completed scheme specific funding valuations, and those with deficits will have agreed recovery plans. These will be based on:

- *prudent assumptions for valuing the assets needed to cover the liabilities as they fall due; and*

- *an appropriate recognition within the recovery plan of the risks to members taking account of what is reasonably affordable for employers.*

(ii) Governance

There will be year-on-year improvement in the extent to which trustees demonstrate knowledge and understanding of the governance requirements for their schemes (as evidenced by surveys of knowledge and understanding and key aspects of governance).

(iii) Risks to members of DC schemes

Trustees and others involved in running DC schemes (such as providers, administrators and employers) will have a clear understanding of the significant risks inherent in such arrangements, especially in relation to administration, member awareness and investment, and how they should be mitigating them.

How we will address these challenges

Our approach to regulation

There are four components to our regulatory approach, which are in line with the principles of regulation set out by the Better Regulation Task Force and the recommendations of the Hampton Review:

1. *Working with individual schemes to reduce risks.* We will take a risk-based approach to priorities, focusing interventions more intensively on those schemes with more than 1,000 members.
2. *Working with other bodies with similar responsibilities.* We believe we will be more effective through working in partnership with the Pension Protection Fund and others. We have agreed a tripartite Memorandum of Understanding with them and the DWP which sets out the responsibilities of each organisation and the information flows between them.
3. *Helping the regulated community understand what is expected of them.* We believe that working in partnership with trustees, employers and their advisers, and providers is key to meeting our challenges and delivering our intended outcomes. We will inform the regulated community what is expected of them, and help further through provision of education and information. All schemes regardless of size will have access to our codes of practice and our guidance via printed literature and our website. All trustees will be able to access our free e-learning programme.
4. *Analysing the risks in the pensions environment.* This will inform our priorities for helping the regulated community to understand what is expected of them, and increase the effectiveness of our scheme-specific interventions.

Strategic framework

Our strategic framework for the next three years is summarised below.

2005/06	2006/07	2007/08	2008/09
Establishing the regulator	Addressing challenges	Sustaining progress	Review and look forward
Start to demonstrate a proactive and proportionate response to risk	Fully embed risk-based regulatory approach	Refine the risk-based regulatory approach	Refine the risk-based regulatory approach
Draft and launch codes of practice and supporting guidance	Complete the programme of codes of practice and supporting guidance	Review and refine codes of practice and supporting guidance	Review and refine codes of practice and supporting guidance
Develop scheme funding framework	Implement scheme funding framework as the first schemes undertake their triennial valuations	Continue to strengthen scheme funding as schemes reach their triennial valuation dates	Continue to strengthen scheme funding as all schemes complete their first triennial valuations by the end of 2009
Develop trustee knowledge and understanding and e-learning framework	Trustee knowledge and understanding becomes a statutory requirement: disseminate guidance and e-learning	Continue to work towards improved scheme governance	Continue to work towards improved scheme governance
Work with other bodies on developing strategy on risks to DC members	Understand and address risks to DC members	Complete implementation of strategy to reduce risks to DC members	Continue to work to reduce the risks to DC members, keeping the strategy under review

The Medium Term Strategy and the Corporate Plan

This strategy forms part of the Pensions Regulator's Corporate Plan to be agreed with the Department for Work and Pensions. The Corporate Plan also covers a three year period and reflects the Pensions Regulator's statutory duties and, within those duties, the priorities set from time to time by the Secretary of State. In particular, the plan should reflect the Pensions Regulator's key objectives and associated key performance targets for the three forward years, and its strategy for achieving those objectives. The first year of the Corporate Plan, amplified as necessary, takes the form of the annual Business Plan, which will be published in due course.

Part 1

The challenges for the regulator

Chapter 2 – What the regulator was set up to achieve

Introduction

In 2002 the Pickering report¹ called for simplification of the regulatory framework for pensions.

This was followed in December 2002 by the Quinquennial Review of the Occupational Pensions Regulatory Authority (Opra) and in June 2003 by the pensions Green Paper *Simplicity, security and choice: working and saving for retirement*. Both these documents, and the National Audit Office's report on Opra, supported the Pickering report's recommendation for change in pensions regulation and the establishment of a 'new kind of regulator': outcome and customer focused; and transparent, proportionate and risk-based in its approach.

What is the Pensions Regulator?

The Pensions Regulator was launched on 6 April 2005. We regulate work-based pensions. Our vision is to improve confidence in work-based pensions by protecting the benefits of scheme members and encouraging high standards of good practice in the running of schemes.

What are the regulator's objectives?

Our objectives are in the Pensions Act 2004. They are to protect the benefits of work-based pension scheme members; to reduce the risk of situations arising which may lead to calls on the Pension Protection Fund; and to promote the good administration of work-based pension schemes.

Our objectives are not ranked in importance; nor is there a statutory requirement to give priority to any particular work-based pension arrangement.

Interpretation of our objectives

Our statutory objectives set the framework for what we focus on, but we have discretion over how we achieve them. The objectives, and having a range of discretionary powers in addition to prescribed activities, enable the regulator to take a more flexible, proactive and risk-based approach to pensions regulation.

Subject to a base level of administration required by statute, we have discretion over which activities we should undertake in order to meet our objectives. As part of our annual business planning we will identify themes which are consistent with our objectives and statutory obligations, and which enable us to plan specific activities. In 2005/06 our themes were:

- (i) demonstrating a proactive and proportionate response to risk;

¹ *A simpler way to better pensions* was published in June 2002.

- (ii) becoming an authoritative voice in the industry;
- (iii) working with the Pension Protection Fund to protect scheme members from employer default;
- (iv) supporting the strengthening of scheme funding;
- (v) strengthening the Pensions Regulator and its people.

The 2005/06 themes were developed for a year of transition while we established the new organisation, and we recognised that they would change thereafter. Our themes for 2006/07 are:

- (i) to strengthen scheme funding;
- (ii) to improve the governance of work-based pensions;
- (iii) to understand the risks to DC schemes, within the risk-based regulatory environment;
- (iv) to deliver effective risk-based regulation relevant to our environment and stakeholders.

Our themes will be reviewed annually to ensure they continue to reflect developments in work-based pensions, for example the shift from DB to DC arrangements; as well as wider developments such as increased longevity. Any changes will be consistent with the medium term strategy.

Limits to our objectives

We will pursue all our objectives. There are, however, practical limits to this.

We do not regard, for example, our objective of reducing the risk of situations which may lead to calls on the Pension Protection Fund as meaning that this risk should, or could, be reduced to zero. The diversity of causes of calls on the Pension Protection Fund, particularly those relating to employer insolvency, means that it is not possible for the regulator to achieve this.

Even for those situations relating to calls on the Pension Protection Fund which the regulator can influence, zero risk would be undesirable. It might lead the regulator to take an excessively risk-averse approach to scheme funding, for example by requiring all defined benefit schemes to be funded at all times at a level significantly above that required to buy out the level of benefits provided by the Pension Protection Fund. That would lead to excessive burdens for employers and would also require intensive policing. Such an approach would require the regulator's activities to be significantly more costly than planned, leading to greater expense for levy payers.

In pursuing our objectives we will consider whether it is possible to secure changes to behaviour without regulatory intervention by, for example, using market-based mechanisms.

Objectives restricted to work-based pensions

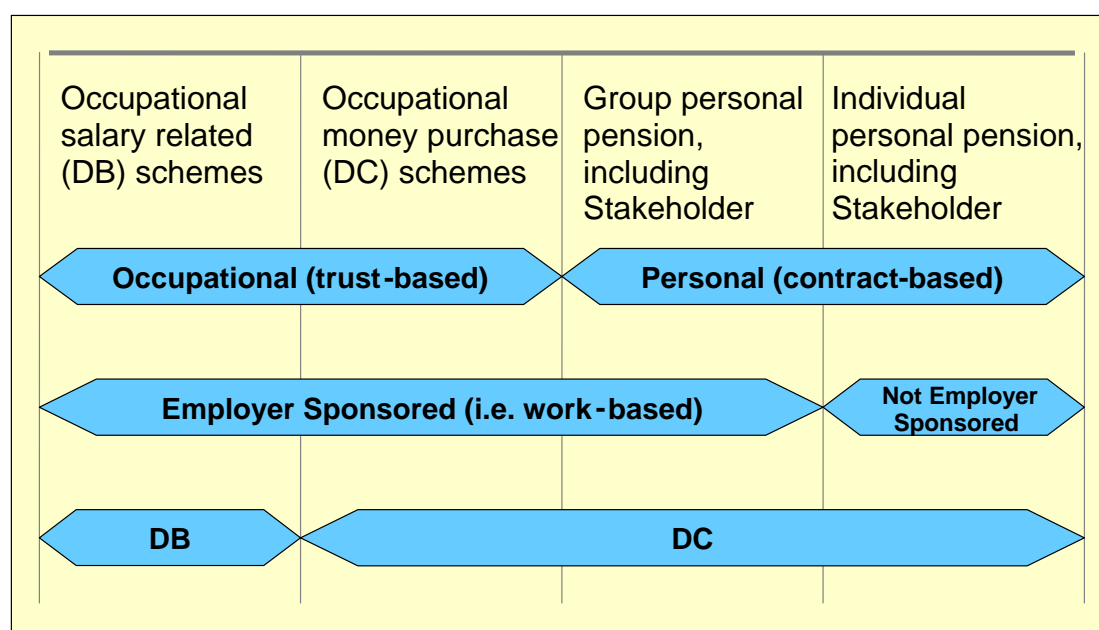
Our objectives are limited to work-based pensions. They do not include other sorts of pension. Nor do they extend to wider issues such as the promotion of competition or addressing poverty in retirement, although we have an interest in issues of this sort where they impact on the effective regulation of work-based pensions.

Chapter 3 – The pensions environment

Work-based pensions are part of a wider pensions landscape comprising the basic state pension, the state earnings-related scheme (SERPS/S2P) and individual personal pensions.

Employer sponsored or work-based schemes comprise both trust-based and personal arrangements (see figure 3a below). Occupational schemes are governed by trustees; GPPs are an individual contract between the employee and the provider (typically an insurance company).

Figure 3a: Types of pension arrangement



Source: Based on diagram on page 80 of Pensions Commission, *Pensions: Challenges and Choices, The First Report of the Pensions Commission*

Profile of scheme membership

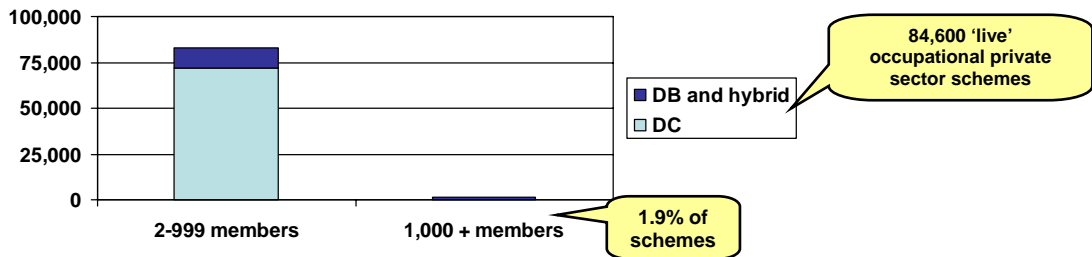
Most members of pension schemes (whether active, deferred or pensioner) belong to a small number of schemes.

At 31 March 2005 there were approximately 17.3 million members of 84,600 private sector occupational schemes (see figure 3b below). Of these members over 85 per cent belonged to 1,600 schemes that had 1,000 or more members. These 1,600 schemes comprise just 1.9 per cent of all schemes; 1,300 were DB or hybrid and 300 were DC schemes.

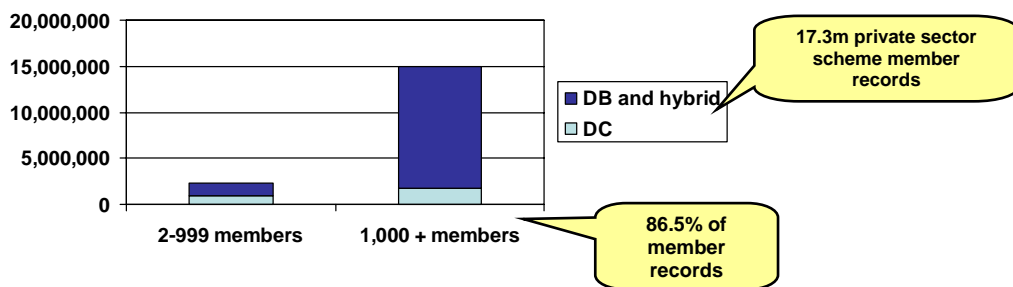
Of the approximately 83,000 schemes with fewer than 1,000 members, approximately 72,000 were DC schemes and 11,000 were DB or hybrid. Of these 72,000 DC schemes, over 56,000 had between two and four members only.

Figure 3b: The number of pension schemes and the number of members of pension schemes

Number of 'live' private sector schemes, by registered benefit type as at 31 March 2005



Number of members, by registered private sector scheme benefit type as at 31 March 2005



Source: The Pensions Regulator
(Pension schemes in the UK, 2005)

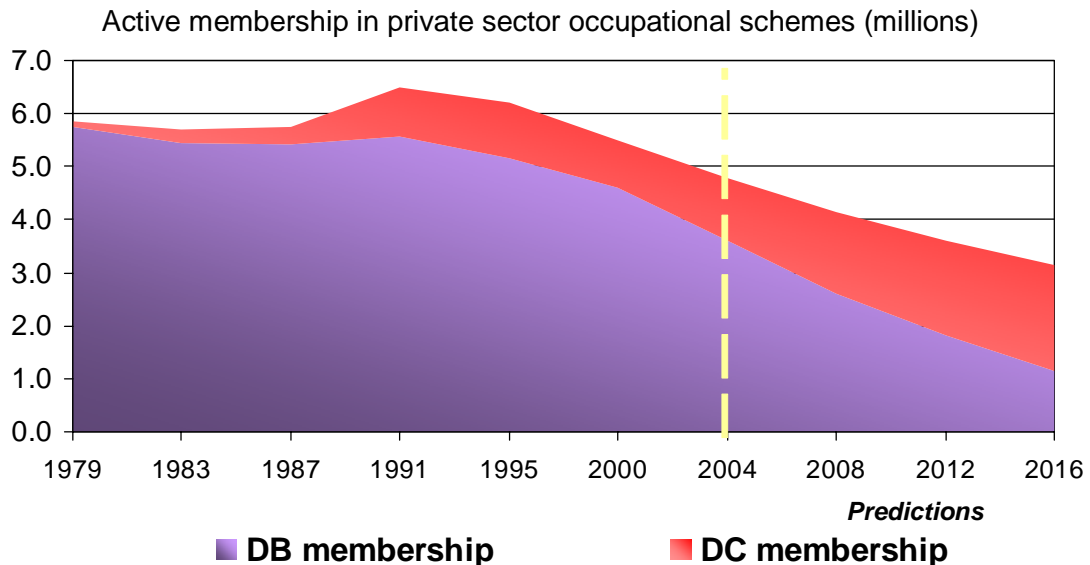
The changing environment

The shift from DB to DC

One of the most well-known developments has been the closure of many defined benefit schemes to new members. An estimated 54 per cent of such schemes closed to new members between the end of 2001 and the end of 2004.² By October 2005 only 24 per cent of FTSE 100 companies offered DB schemes to all new employees and 67 per cent did not offer DB schemes to any employees.³ Of those 67 per cent, 74 per cent provided instead a trust-based DC scheme, and 14 per cent a contract-based GPP scheme.

As figure 3c below shows, the number of active members of DB schemes is in decline, and if trends continue at current rates there will be equal numbers of active members of DB and DC schemes by 2012.

Figure 3c: Trend for fewer active members in occupational schemes and shift in balance from DB to DC



By 2012 active members of occupational schemes split 50/50 DB/DC?

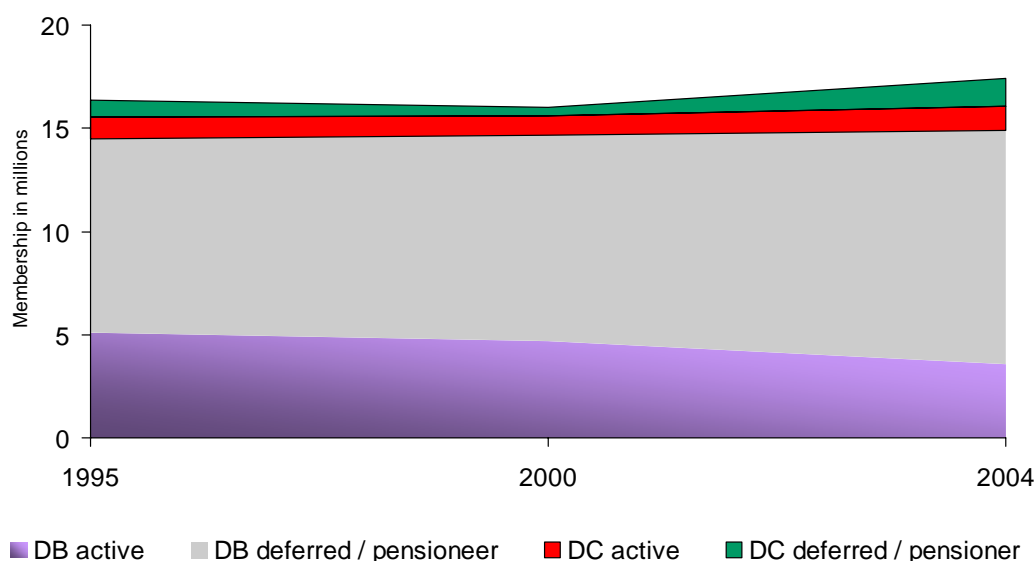
Source: Data GAD Survey / DWP "Shifts in the Pensions Landscape"
 Predictions added based on rate of change from 2000 to 2004

² NAPF survey figures 2005.

³ *Sunday Telegraph* survey of FTSE100 companies, October 2005.

Even however with a continuation of the current rate of decline of active members, DB schemes will remain prominent for many years to come. Many active members remain; moreover deferred members have built up substantial rights. Figure 3d below shows that there has been little change in the overall membership of DB schemes over the last ten years. By contrast, many DC schemes are relatively new and their membership drawn only from new employees.

Figure 3d: Breakdown of membership of occupational pensions (1995-2004)



Sources: GAD Occupational Pension Schemes Survey

A second development in the shift away from DB schemes is the recent growth in GPP contract-based, as opposed to trust-based DC, arrangements. Recent research estimates that GPP arrangements cover eight per cent of working people.⁴ There is also some evidence that this trend may accelerate: one survey said that, while only two per cent of trust-based DC schemes intended to switch to GPP or stakeholder arrangements in the next year, 11 per cent were undecided whether to do so.⁵ Several large employers that have recently closed their DB pension schemes have replaced them with contract-based schemes.

While we expect hybrid schemes (i.e. schemes with DB and DC components) to continue to make up a relatively small proportion of schemes, it is possible that this will change if employers look to provide members with risk sharing alternatives to DB schemes.

⁴ National Association of Pension Funds, *Pension Scheme Governance – fit for the 21st century*, page 9.

⁵ Capita Hartshead, *The 12th Pension Scheme Administration Survey 2005*, page 33.

The level of scheme underfunding

The driving force for the closure of DB schemes has been the increasing recognition of the extent to which such schemes expose the sponsoring employer to non-business related, and in some cases uncontrollable, risks, particularly in relation to investment volatility and increasing longevity. Some key risks have materialised in recent years resulting in substantial deficits. Figure 3e shows estimates based on different methods of calculation of the deficit.

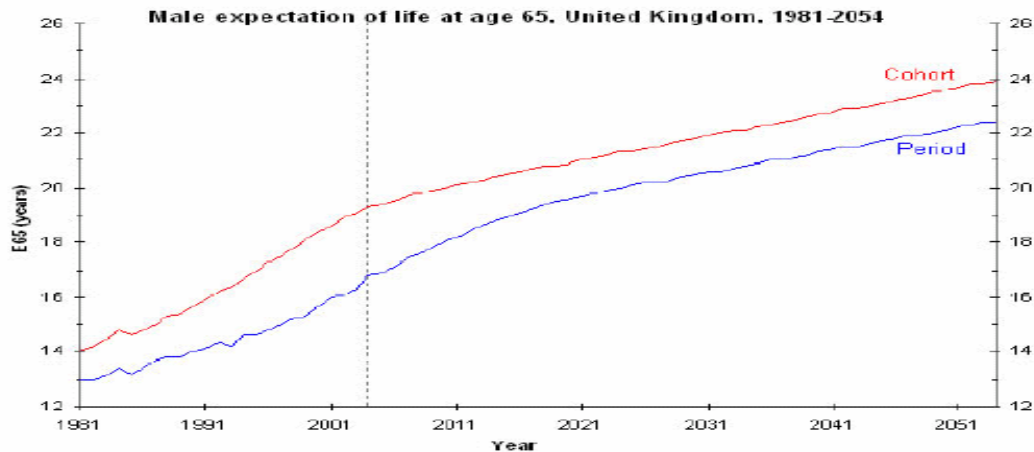
Figure 3e: Scheme funding deficits of all DB schemes (£bn)

	Assets (£bn)	Liabilities (£bn)	Resulting funding deficit /(surplus) (£bn)
MFR liabilities	650	500-540	(110-150)
FRS17 liabilities	650	740-780	90-130
Pension Protection Fund liabilities	650	780	130
Full buy-out liabilities	650	950-1050	300-400

Source: TPR estimates (made in August 2005) based on Mercer HRC Retirement Financial Management Statistics (April 2005)

All other things remaining equal, continued increases in longevity are expected to cause these deficits to remain significant. Figure 3f on the next page shows the longer term male longevity trend.

Figure 3f: Male expectation of life at age 65. United Kingdom, 1981-2054



Source: GAD, 20 October 2005. Note: Expectations of life can be calculated in two ways: 'period life expectancy' or 'cohort life expectancy'.

Poor governance of many schemes

Our experience is that the standard of governance of many schemes, particularly smaller ones, is poor. Appendix B shows some examples of poor governance taken from our casework.

Our in-house research⁶ shows clear evidence of low standards of trustee knowledge and understanding, particularly in schemes with under 1,000 members. Of all our respondents, trustees:

- are at the lowest position both with regard to their knowledge and their access to information;
- provide the greatest opportunity for improving scheme governance; and
- are the least in touch with the regulator and the most anxious for the regulator to be in direct contact.

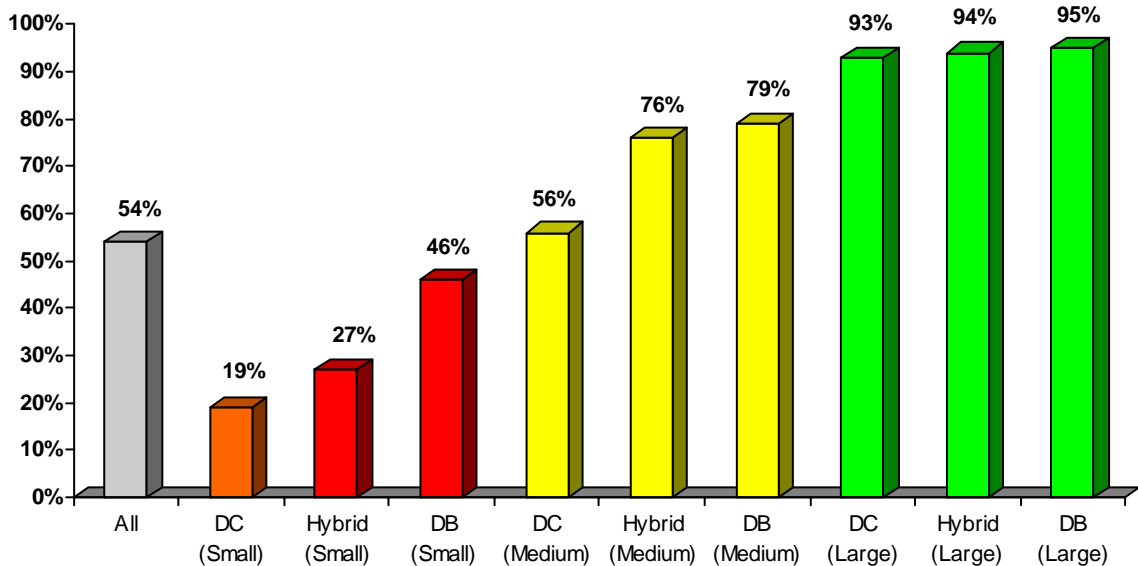
Trustee conflicts of interest are also a concern, especially in DB schemes with funding difficulties.

Earlier research by Opra⁷ showed that trustees of schemes with fewer than 1,000 members receive little training – see figure 3g.

⁶ Audience needs-based segmentation research, prepared by NOPWorld Financial in February 2005.

⁷ OPS Regulatory Survey 2004, sample of 424 respondents.

Figure 3g: Proportions of schemes where one or more trustees attended at least one from a list of five trustee training courses in the past three years



'Small' 12-99 total members
 'Medium' 100-999 members
 'Large' 1,000+ members

The 2001 Myners Review of Institutional Investment in the UK similarly indicated the low level of expertise of trustees. Among its findings were that:

- more than 50 per cent of trustees received less than three days' training when they became trustees;
- 44 per cent of trustees have not attended any courses since their initial 12 months of trusteeship; and
- 49 per cent of trustees spend three hours or fewer preparing for pension investment matters.

Recent developments

Key recent legislative, regulatory and accounting developments include:

- the creation of the Pension Protection Fund;
- the powers of the regulator to impose sanctions on employers which seek to avoid their liabilities to their pension scheme and a voluntary mechanism for clearance of certain business transactions;
- the requirement for trustees to have knowledge and understanding of the law relating to pensions and trusts, and the principles relating to the

funding of occupational pension schemes and investment of the scheme assets;

- the IORP directive⁸ which set a standard for funding requirements for all EU-based schemes;
- adoption of the FRS17 standard for pensions accounting; and
- the forthcoming review of pensions disclosure (including FRS17 and IAS19) by the Accounting Standards Board⁹ in which the regulator is taking part.

Future developments

The pensions environment will continue to change. At the time of writing, three recent or forthcoming legislative changes are expected to impact on our strategy within the next three years:

- pensions simplification;
- the Pension Commission's Reports and the Government's forthcoming White Paper; and
- the proposed EU directive on portability.

There will also be wider developments, for example ongoing increases in longevity and financial markets-driven changes.

Key issues and observations

From the analysis above some key conclusions are:

- (i) many defined benefit schemes require stronger funding;
- (ii) the standard of governance in many, especially smaller, schemes is variable and in many cases poor;
- (iii) DC schemes are becoming increasingly important.

⁸ Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision.

⁹ Research Project into Accounting for Pensions. For further details see <http://www.frc.org.uk/asb/technical/projects/project0065.html>

Chapter 4 – Our principal challenges

The main risks to our objectives arise in respect of the financing and governance of work-based pension schemes.

These risks need however to be kept in proportion. Despite the challenges we set out below, most scheme members are paid the pension they were promised.

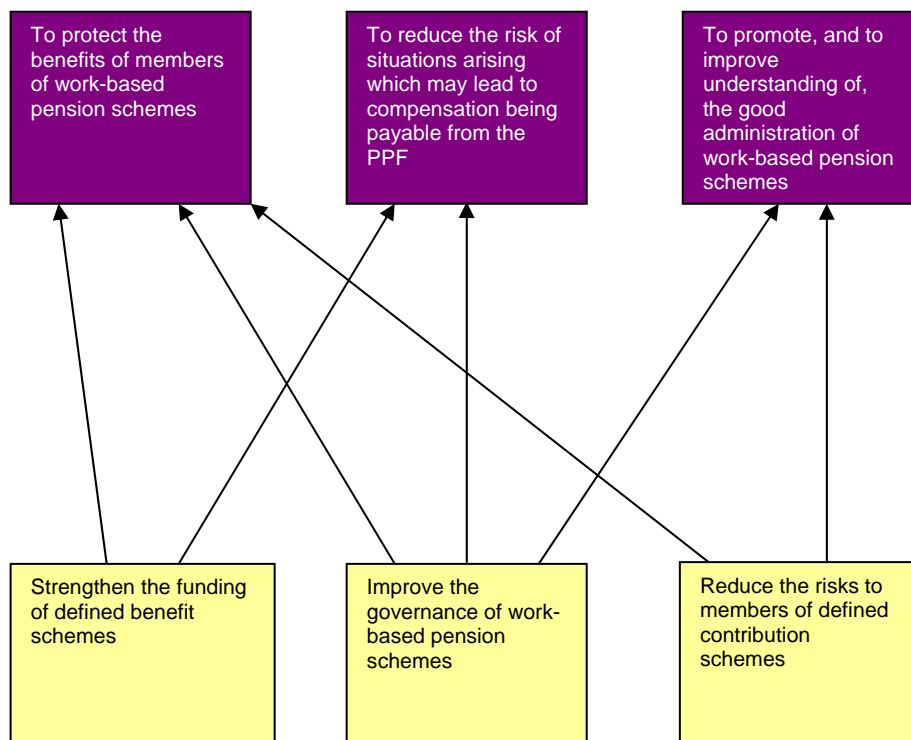
Our principal challenges over the next three years are:

- (i) to strengthen the funding of defined benefit schemes;
- (ii) to improve the governance of work-based pension schemes;
- (iii) to reduce the risks to members of work-based defined contribution pension schemes.

The challenges are consistent with developments in the pensions environment such as the deterioration in scheme funding, the increased importance given to governance issues both in the pensions environment and more widely, and the growing number of members of defined contribution arrangements.

The challenges support our statutory objectives as shown in figure 4a below.

Figure 4a: Mapping of our principal challenges onto our statutory objectives



The challenges are also consistent with our role as the regulator of all work-based pensions. It would not be appropriate to focus only on one category of scheme e.g. the funding of defined benefit schemes or risks to members of defined contribution schemes. Nor however are we seeking to do everything: hence our focus on three principal challenges and our risk-based approach to regulation (see chapter 5).

In many cases our challenges will require us to work with groups such as trustees and advisers. We are however mindful that protecting the benefits of individual scheme members is at the heart of much of what we do.

The nature of our principal challenges

There are differences in the nature of these challenges:

- *Scheme funding*: the challenge has already arisen; our response is therefore to remedy what has already happened and to ensure that existing deficits are properly factored into recovery plans and other corporate activity.
- *Governance*: our regulatory response needs to be varied. Some of our interventions will be to prevent risks arising but, as with scheme funding, there are also interventions which will focus on risks that have already crystallised.
- *Risks to members of DC schemes*: not all the risks have yet arisen on a large scale; our approach is therefore more preventative. As with governance we intend to use a variety of regulatory tools.

What would meeting our principal challenges look like?

Scheme funding

Our long term objective is to strengthen scheme funding through the effective implementation of the scheme specific framework which replaces the minimum funding requirement (MFR). This will mean that schemes will be fully funded to the level of their technical provisions on the basis of prudent assumptions specific to the scheme, or will be on an agreed, well defined and achievable course towards reaching this level. We therefore expect that schemes will become progressively better funded over time. This in turn should have the effect of reducing the estimation of total risk that the Pension Protection Fund uses to calculate its annual levy.

We fully recognise, however, the need to be sensitive to the needs and circumstances of those sponsoring employers who cannot readily afford to eliminate their deficits within a reasonable timescale, or at all. Furthermore, we recognise that there may be other influences, affecting the value of assets or liabilities, that could push scheme funding levels off course.

Schemes are only required to start the valuation and recovery plan agreement process at the first triennial valuation after September 2005, and have generally 15 months to complete the process. By the end of 2009 all schemes should have completed, but some only just. In this timeframe, therefore, we can expect to see only modest overall improvements in scheme funding levels arising from our support for the implementation of the new scheme funding legislation.

Other factors such as FRS17 deficits appearing on corporate balance sheets and the Pension Protection Fund's risk-based levy should accelerate the improvements in funding; as will the need to improve funding where corporate transactions reduce the strength of the employer's covenant.

What we will be seeking to achieve is for all schemes to be moving in the right direction by the end of the period, and our key performance indicator is that during the course of the next three years:

DB schemes will have completed scheme specific funding valuations, and those with deficits will have agreed recovery plans. These will be based on:

- *prudent assumptions for valuing the assets needed to cover the liabilities as they fall due;*
- *an appropriate recognition within the recovery plan of the risks to members taking account of what is reasonably affordable for employers.*

Governance

Our long term objective is that the governance of occupational pension schemes is of a sufficiently high standard that trustees, without regulatory prompting, understand and address effectively the risks relevant to their schemes. In view of the size of the assets and liabilities involved, and the difficult judgements to be made by trustees, including negotiating with employers, it is vital that high standards are achieved and sustained. Trustees will need high quality support from their advisers and administrators. It will also be important for there to be a continuing supply of people willing and able to take on the demanding duties placed on trustees.

Our understanding is that the extent to which trustees currently understand and apply governance standards varies considerably. Raising the standards of the generality of schemes to a sufficiently high standard will take time.

Raising standards while considering the supply of trustees and the cost of regulation will require sensitivity and obliges us to ensure, for example, that the right training materials are available. The first stage is to ensure that trustees at least understand what is expected of them, especially in relation to the requirements on trustees to have appropriate knowledge and understanding which came into force in April 2006.

Within this context our key performance indicator over the next three years is:

There will be year-on-year improvement in the extent to which trustees demonstrate knowledge and understanding of the governance requirements for their schemes (as evidenced by surveys of knowledge and understanding and key aspects of governance).

Risks to members of work-based DC schemes

Members of DC schemes face a greater number of risks than members of DB schemes. Moreover, the number of members facing these risks is increasing rapidly, reflecting the DB to DC shift.

Our long term objective is that action is taken by trustees and others involved in running DC schemes to mitigate the risks to members. For this to happen those responsible for running DC schemes need to understand the key risks, which we consider to relate to administration, member awareness and investment; and to have a clear appreciation of what they can do to mitigate these risks.

Our key performance indicator over the next three years is therefore that:

Trustees and others involved in running DC schemes (such as providers, administrators and employers) will have a clear understanding of the significant risks inherent in such arrangements, especially in relation to administration, member awareness and investment, and how they should be mitigating them.

The longer term

We would expect new regulatory challenges to arise during the period of this medium term strategy, and beyond, not least as the Government responds to the recommendations of the Pensions Commission's reports. These should not change our aspirations and goals for the next three years but they could add new tasks or priorities.

We expect the current trends in pensions provision to affect the balance and direction of our work in the longer term. For example:

- the expected continuing increase during the next three years in the number of members of DC and GPP schemes and, within that, the shift towards GPP rather than DC, could increase the emphasis we place on both DC and GPP provision;
- a greater decoupling of employers from their pension schemes as, if current trends continue, deferred and pensioner members become an increasing proportion of overall membership. According to a recent survey 43 per cent of companies perceive closed defined benefit schemes as an unwanted legacy; that figure rises to almost 60 per cent

when a scheme has been closed for at least five years.¹⁰ The possible development of new vehicles for taking on defined benefit pension liabilities is also relevant in this context.

Chapters 6, 7 and 8 describe our principal challenges in more detail.

¹⁰ Aon Consulting survey of 130 UK companies operating closed defined benefit schemes April and May 2005. Data accuracy not checked.

Part 2

How we will address these challenges

Chapter 5 – Our approach to regulation

A key characteristic of our approach to regulation is that it is risk-based.

Other characteristics include working in partnership with other bodies with similar responsibilities and with trustees, employers, advisers and providers; and being clear what we expect, what success would look like and to use appropriate forms of influence to secure acceptance of this approach.

We consider our approach to regulation to be consistent with the five principles of good regulation set out by the Better Regulation Task Force:

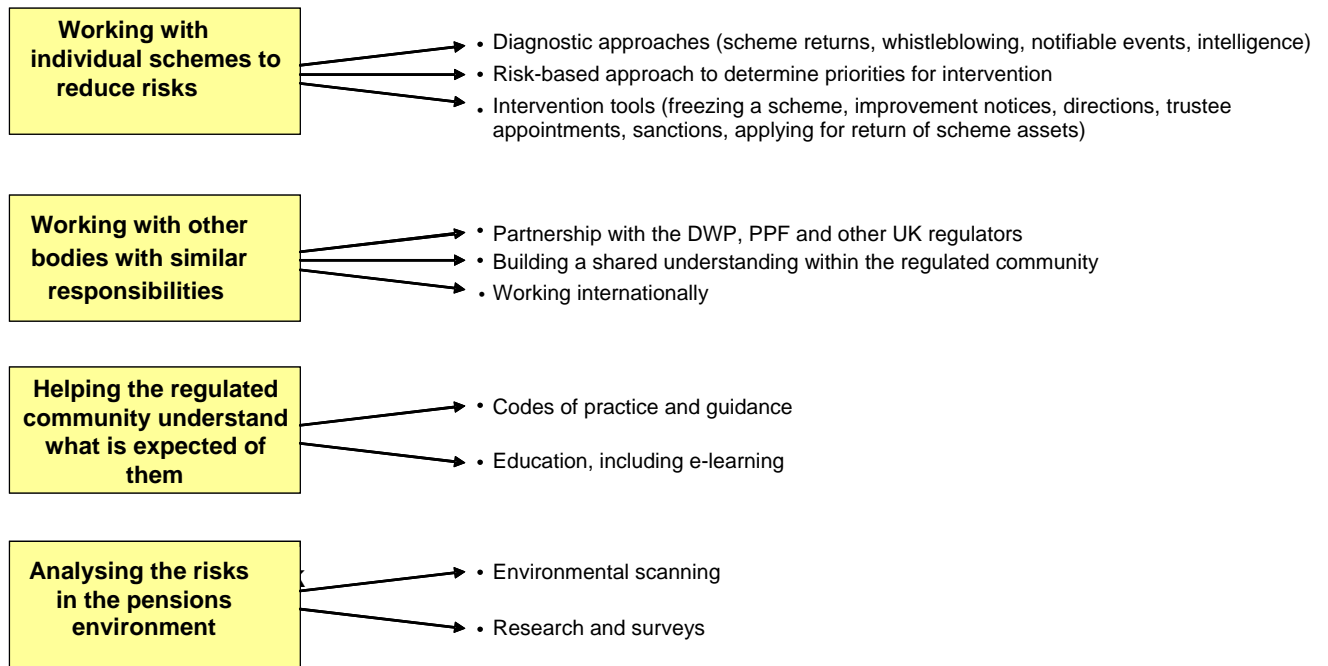
- **proportionate** – we will intervene on a specific basis only where necessary and any remedies we impose will be appropriate to the risks identified;
- **accountable** – we will publicly justify our decisions as we consider ourselves accountable to government and other stakeholders;
- **consistent** – we will apply our regulation consistently and in a way that minimises uncertainty about our likely response;
- **transparent** – we will be open about what we intend to do, communicate our intentions and actions clearly and consult where possible on new and changed approaches. Where appropriate we will provide a regulatory impact assessment of new codes of practice; and
- **targeted** – we will focus our regulation on those schemes posing the most serious risks to our objectives, consistent with meeting all of our statutory obligations.

There are four components to our regulatory approach:

1. Working with individual schemes to reduce risks;
2. Working with other bodies with similar responsibilities;
3. Helping the regulated community understand what is expected of them;
4. Analysing the risks in the pensions environment.

This is shown diagrammatically in figure 5a below.

Figure 5a: Our regulatory approach



Working with individual schemes to reduce risks

Our approach is to prioritise our resources according to the risk to our objectives, and not devote resources unnecessarily to ‘tick box’ supervision. This is consistent with the approach recommended by the Hampton Review.¹¹

The case for this risk-based approach is:

- *the number of schemes which we regulate and the distribution of their members.* As shown in chapter 3, there are around 84,600 private sector occupational pension schemes. These comprise a small number of large schemes and a large number of small, and very small, schemes. The 1,600 largest schemes comprise fewer than two per cent of the number of schemes but contain over 85 per cent of scheme members. We can thus seek to meet our objectives in respect of a large proportion of members by focusing in particular on a relatively small number of schemes;
- a risk-based approach is consistent with our being a *proportionate and cost-effective regulator*. These are desirable principles for any regulator but are of particular importance for us given that the provision of work-

¹¹ ‘Risk assessment is an essential means of directing regulatory resources where they can have the maximum impact on outcomes... On the basis of this information, regulators can direct their resources where they can do most good. They can end unnecessary inspections or data requirements on less risky businesses, identify businesses who need more inspection, and release resources to improve broader advice services.’ *Hampton Review – Reducing administrative burdens: effective inspection and enforcement – Executive summary paragraph 8.*

based pensions by employers, and the participation of most trustees, is voluntary. We do not want the cost of our regulation to lead unnecessarily to withdrawal of work-based pensions or lack of supply of trustees of pension schemes;

- *a number of reviews have called for the regulator to adopt a risk-based approach*: ‘The Pickering report, the quinquennial review of Opra and the National Audit Office study of Opra all recommended that any regulator should target its resources on the cases in which members’ benefits are at greatest risk’;¹²
- any regulatory approach and fulfilment of our statutory obligations must be based on a *realistic assessment of our capacity*. The regulator currently has around 250 staff; there are around 84,600 private sector occupational pension schemes. While both these figures may change, the orders of magnitude are unlikely to during at least the next three years.

There will nevertheless be ‘no abandonment’; we aim to meet all our statutory obligations and to reach all schemes, for example through activities to improve governance. Regulating different schemes at different levels of intensity is not the same as failing to regulate all areas for which we have responsibility, or failing to meet our statutory obligations such as requiring a scheme return.

Further detail on our risk-based approach is in Appendix A.

The risks of a risk-based approach

A risk-based approach does itself contain risks.

First, we may misjudge the riskiness of a scheme. In particular, we may classify a scheme as being of low risk when it is, in fact, of high risk. For example we may not identify significant risks early enough for a scheme-specific intervention to make a difference. Hence we may fail to intervene when we should do.

Second, even when we assess the riskiness of a scheme correctly, we may not be able to avoid that risk crystallising. For example, we may assess accurately the chances of a scheme entering the Pension Protection Fund, but be unable to do anything about the sponsoring employer becoming insolvent and triggering this.

Neither possible nor desirable to eliminate all risks

The risks of a risk-based approach will materialise in respect of some schemes.

Our role is to minimise the number of occasions on which the risks materialise; it is neither possible, nor indeed desirable, to eliminate all occasions on which they do so. Any attempt to reduce these occasions to

¹² Malcolm Wicks MP, Standing Committee B, Tuesday 9 March 2004 (morning).

zero would lead to most schemes having a disproportionate level of regulation compared with the risks they pose to scheme members and the Pension Protection Fund. In considering our risk-based approach to regulation, we have also been very conscious of the significant limitations of a non risk-based approach.

In other words not all members' benefits will be protected, not all situations which lead to a call on the Pension Protection Fund will be prevented, and not all schemes will be well administered.

Other regulators have reached the same conclusion about the possibility and desirability of zero failure in respect of their objectives.¹³

Consequences of a risk-based approach

Two consequences of a risk-based approach are, first, the need for an element of '*co-regulation*'. All those involved in work-based pensions should take responsibility for compliance including those who manage, advise on and administer schemes. It is neither possible nor desirable for the regulator to take on all this responsibility. The information we receive through channels such as whistleblowing and notifiable events therefore remains vital for our effectiveness.

Second, in order to make correct assessments of risk we need accurate information. That is one reason why the information we require in our scheme return is important.

Individual schemes: diagnostic approaches

Trustees of schemes with five or more members have to provide annual scheme returns. Those connected with a scheme (whether a trustee, an actuary or other adviser, or a member) have to provide us with a whistleblowing report or a notifiable event notification when circumstances require.

We use this information, together with that from external sources such as credit rating agencies, to determine a risk profile and hence our priorities for intervention.

We are conscious of regulatory burdens and therefore put substantial effort into ensuring intelligent information collection and using information we already have. We aim only to ask for something once, to ask only for those items that we need for determining priorities for intervention, and only to collect data as frequently as is reasonable.

We have therefore simplified the scheme return in the light of experience, and will be working in partnership with DWP to review the notifiable events procedures.

¹³ Financial Services Authority *Reasonable expectations: Regulation in a non-zero failure world*, September 2003.

For schemes which demonstrate over time that they are consistently well run (and well funded in the case of DB schemes), and hence perceived to constitute a low level of risk to their members and to the Pension Protection Fund, we wish to explore opportunities for them to achieve 'earned autonomy' – a lower level of regulatory interaction. For such schemes we might, regulations permitting:

- issue a less detailed scheme return and/or issue it less frequently;
- be more reactive, relying on accurate notifiable event and whistleblowing reporting, and external credit scoring information; and
- be less likely to ask for further information about recovery plans than is permitted by law.

It may also be possible, through benchmarking, to provide greater information on some schemes in order to help others see what standards are being set elsewhere.

A further diagnostic approach is 'intelligence' or 'horizon scanning' using alerts, media feeds, intelligence sources, etc to inform us of problems which may occur for an employer or scheme. It is 'entity specific' in that it searches for risks caused by trustees, companies, managers, administrators, advisers or other individuals common to multiple schemes. It allows us to pre-empt risks which may otherwise occur, allocate resources, make scheme-specific interventions, and provide early warning to the Pension Protection Fund.

Regulatory tools

We will consider for particular schemes whether reference to tools of general application, such as our e-learning material, is sufficient to change behaviour, or whether our intervention needs to be more specific, and whether it needs to be more formal.

In the event of non-compliance the regulator will take account of indications of effort to meet regulatory requirements and will seek to encourage trustees in this direction. Formal intervention will, nonetheless, be necessary in schemes where there are no indications of effort producing improvement.

Working with other bodies with similar responsibilities

Partnership with the DWP, the Pension Protection Fund and other UK regulators

One means of securing our objectives will be by working in partnership, and influencing, other bodies involved in work-based pensions. We therefore attach importance to productive relationships with these bodies.

We have put in place, or are developing, memoranda of understanding where the relationship is sufficient to justify them.

DWP

Our sponsoring Government department is the DWP, with whom we work closely in a number of areas.

We help the DWP in their task of developing policy and regulations by sharing our regulatory experience, for example:

- on initiatives to improve take-up of work-based pensions (the 'Informed Choice' initiative);
- on the implications and potential government response to the Pensions Commission's reports which have proposed a National Pension Savings Scheme (NPSS). We are actively contributing to consideration of the regulatory implications of NPSS and the various alternatives that have been proposed;
- by using our perspective as a risk-based regulator to contribute to the DWP's simplification plans. Simplification is part of the Better Regulation agenda to reduce the administrative burdens on business, with each department submitting simplification plans for its areas of regulation to the Better Regulation Commission. We are currently concentrating on:
 - identifying areas of regulation which offer poor return in terms of reducing risks to members' benefits where regulation could be lifted altogether;
 - identifying areas of law which could be simplified or re-drafted;
 - looking at smarter ways of gathering and using information to reduce the amount sought from schemes and employers; and
 - contributing to DWP's thinking around major regulatory issues.

We are required to provide an annual Corporate Plan to DWP. The information which the Plan must contain is set out in a Management Statement and Financial Memorandum between the regulator and DWP. This medium term strategy forms part of the regulator's Corporate Plan.

Pension Protection Fund

We place particular importance on our relationship with the Pension Protection Fund. We have shared interests in action that reduces funding deficits and the risk of employers avoiding their liability for these deficits. We also have a shared interest in schemes in the Pension Protection Fund assessment period and in data on the funding and solvency position of pension schemes and employers. We also act as the Pension Protection Fund's agents in collecting its levies from pension schemes.

We will continue to build our relationship to ensure that our strategies and policies are aligned as closely as is compatible with our respective objectives. For example, we will consider jointly with the Pension Protection Fund how

pension scheme investment allocation should affect the way we assess risks to schemes and the Pension Protection Fund calculates its risk-based levy.

FSA

The main area of common interest between the FSA and the regulator is in relation to work-based personal pension schemes. The FSA also has an indirect interest in occupational schemes as it regulates firms which provide investments and other financial services to occupational schemes.

Where the regulator or the FSA acquires information which may be relevant to the other, information gateways are in place to permit its exchange.

The FSA and the Pensions Regulator have a signed Memorandum of Understanding in place,¹⁴ which describes our areas of responsibility and establishes procedures for addressing areas of common interest, such as administration of pension schemes by FSA-authorized firms.

Other public bodies

We liaise regularly with bodies such as HMRC, the Pensions Ombudsman, The Pensions Advisory Service and HM Treasury.

Building a shared understanding with the regulated community

We work closely with organisations representing pension schemes, employers and others. By doing so we are able to understand those whom we regulate, have effective feedback on the impact of our actions, and are able, if appropriate, to revise our approach. In addition we have an Advisory Panel, which brings together representatives from a wide range of stakeholders.

Working internationally

Regulation of work-based pensions in the UK is increasingly influenced by developments in European law. For example, the 'technical provisions' which form the basis of the scheme funding framework arise from a European Union directive on occupational pensions. We will therefore play an active part in influencing, in partnership with DWP, developments in this area. We are members, along with the FSA, of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

Internationally, we will continue to participate actively in the International Organisation of Pension Supervisors (IOPS) to share good practice and help encourage the development of effective pension regulation world-wide.

Helping the regulated community to understand what is expected of them

Our research shows lack of awareness of requirements by many pension scheme trustees, particularly of smaller schemes. We therefore devote substantial effort to educational approaches. From a scheme trustee

¹⁴ See www.thepensionsregulator.gov.uk/pdf/mouFsa.pdf

perspective, our actions start, other than in the most serious cases, at 'educate', move through 'advise' and 'order', and finally to 'punish' where the regulator sees no other way of securing appropriate behaviour.¹⁵

Among the tools which we will use to help the regulated community understand what is expected of them are codes of practice and guidance, and education and information.

Finally, we will publish some details about how we use our powers, as an encouragement to other schemes with similar issues to address these before the regulator needs to intervene.

Analysing the risks in the pensions environment

We routinely monitor the pensions landscape to understand the wider risks that are common across many schemes. We do this through environmental scanning, and through our own research and surveys (many of which we publish in the interests of transparency and of highlighting important issues).

The purpose of monitoring the risks in the pensions environment is to inform our regulatory priorities and to help the regulated community understand what is expected of them.

Environmental scanning

Environmental scanning is part of proactive regulation. Without it, we would only become aware of risks that have already materialised. We would also be unable to keep Ministers and Parliament informed of likely developments.

Our scanning is through a combination of relationship-based meetings (for example with economists, City analysts and other regulators), desk research using externally available information and the regulator's own information about schemes, and primary research and surveys of which we undertake a wide range, many using external market research firms in order to secure independence. Some of these are 'one off' surveys to research specific issues (for example research was recently commissioned to explore the information and education needs of employers), and others are annual tracking surveys to measure changes over time. These include the perceptions tracker survey and the governance survey.

¹⁵ This is consistent with the Hampton Review: 'Numerous surveys have found small businesses unaware of particular regulations ... The review believes that this lack of knowledge is less a mark of failure by business, and more a failure by regulators to communicate their message.' Moreover, 'better advice leads to better regulatory outcomes, particularly in small businesses,' paragraph 2.53 and paragraph 29 of the executive summary.

Chapter 6 – Scheme funding

Our most immediate challenge is to strengthen the funding of defined benefit schemes.

Background

In recent years many defined benefit schemes have developed bigger funding shortfalls, for reasons ranging from adverse market movements to increasing longevity of scheme members.

Overall, these shortfalls are substantial: the reported FRS17 shortfall for FTSE 350 companies alone was some £54bn at the end of March 2006 based on estimated assets of £415bn.¹⁶ The figure for the whole sector may be nearer £90-£130bn, on assets of around £600-650bn. The shortfalls where scheme assets are compared with the buy-out value of liabilities are substantially higher than this, and are likely to be between £300-400bn for the whole sector.¹⁷

Where employers have wound up their schemes there have been instances of employers becoming insolvent leaving insufficient funds in the scheme to meet the pensions promise. In some well-publicised cases members received only a small fraction of the benefits due. These cases, and the increasing availability of information on shortfalls, have dented confidence in defined benefit pensions, and indeed in pension saving more generally.

The establishment of the Pension Protection Fund reduces the potential adverse consequences of underfunding for members by providing compensation for most, but not all, benefits, in the event of employer insolvency. It does this, however, by spreading the risks across the whole defined benefit sector by means of a levy, which means that employers ultimately have to provide the funding to cover the risks to the Pension Protection Fund arising from the funding shortfalls.

We do not expect the shortfalls to diminish without a substantial increase in funding. Our analysis shows that rises in equity prices are unlikely by themselves to eliminate shortfalls measured on the FRS17 basis. It is just about conceivable, although not very likely, that favourable movements in both equity and bond markets might do so, all other things being equal. Bond yields have stayed relatively low for some years, however, so that changes in market conditions are unlikely to make much if any impact on overall deficits. Furthermore, the continuing increase in longevity is liable to cancel out much of the effect of any foreseeable improvement in the markets.

¹⁶ Watson Wyatt Pension Deficit Index. Estimated deficits as at 31 March 2006 based on disclosures reported in the year ending 30 June 2005 and assuming continuation of the same level of employer contributions.

¹⁷ The Pensions Regulator's extrapolation.

Why is scheme funding important to the regulator?

Part 3 of the Pensions Act 2004 has introduced a new funding framework for defined benefit pension schemes. The new framework, which replaces the minimum funding requirement (MFR), is being phased in, as scheme valuations fall due, over the period September 2005 to December 2009.

It is our responsibility under the Act to ensure effective implementation of the new framework, having regard to our statutory objectives which include protecting the benefits of members of occupational pension schemes and reducing the risk of situations arising which may lead to calls on the Pension Protection Fund.

In order that these objectives are achieved in relation to scheme funding, it is important for us to address the risk that trustees and employers set a funding objective that is inadequate in the circumstances of their scheme or agree to make up any funding shortfalls over a period that is too long or otherwise inappropriate.

Given the scale of the funding involved it is important that our regulatory approach balances the need for benefit protection with the needs of business and the wider economy, considering that the best means of delivering the members' benefits is usually for the pension scheme to have the continued support of a viable employer.

What outcomes is the regulator seeking?

As stated in chapter 4, our long term objective is to strengthen scheme funding through the effective implementation of the scheme specific funding framework. We therefore expect that schemes will become progressively better funded over time. This in turn should have the effect of reducing the total risk to members' benefits and the Pension Protection Fund. This should also reduce the Pension Protection Fund's estimation of total risk used to calculate the annual levy and reduce costs to levy payers.

During the period of this strategy DB trustees will be implementing the new framework. Our key performance indicator is that they will have completed scheme specific funding valuations, and those with deficits will have agreed recovery plans. These will be based on:

- prudent assumptions for estimating the value of assets needed to cover the liabilities as they fall due; and
- an appropriate recognition within the recovery plan of the risks to members taking account of what is reasonably affordable for employers.

While we have powers to intervene in particular schemes, where this does not happen our aim is that trustees and employers will be able to make the new framework effective without any formal scheme specific intervention. Our priority is that agreements do enough to protect members' benefits and the Pension Protection Fund while taking account of affordability constraints.

We also prefer to see trustees and employers working together and treating the pension creditor appropriately rather than having to use our avoidance powers. Appropriate treatment of the pension creditor will happen once it is treated as a key material stakeholder by an employer.

What steps does the regulator intend to take?

Approach to scheme funding

Our broader approach is to:

- promote, through our code of practice and other forms of communication, good understanding among trustees, employers and their advisers of the matters they should consider when they agree their scheme's statutory funding objective and any recovery plan needed to raise funding to that level;
- influence key parties through the forthcoming regulator's statement on our regulatory approach to scheme funding. The statement will indicate how we intend to focus our resources on schemes that are likely to pose the greatest risk;
- ensure that the messages are widely spread through a communication programme, including workshops, speaking engagements etc; and
- intervene in specific schemes where the funding objective or recovery plan is (or may be) agreed at an inappropriate level or duration in respect of our objectives to protect members' benefits and reduce risks to the Pension Protection Fund.

We are currently considering a range of comments made by the regulated community following our consultation on scheme funding. Our forthcoming regulatory statement will set out our proposals in more detail.

Our broader approach is underpinned by the following guiding principles that derive from the legislation, code of practice and our overall regulatory approach:

1. ***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.
2. ***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.

3. **Risk-based.** Specific regulatory interventions should be focused on the schemes that pose the greatest risk to their members or the Pension Protection Fund.
4. **Proportionate.** Trustees should 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 seriously adverse impact on the employer and those where employers could potentially afford to pay off the shortfall more quickly.
5. **Preventive.** We need where possible to act before risks materialise.
6. **Practicable.** We need an approach that can be operated within the constraints of the information and resources available to us.
7. **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 its own duties.

To ensure that appropriate scheme funding arrangements are put in place in line with these principles, we intend to focus in particular on the technical provisions and recovery plans agreed by trustees and employers along with the cases where no agreement has been reached. We will consider challenging those arrangements where the technical provisions are not prudent or the recovery plan is inappropriate. In particular, we will consider the specific circumstances of the scheme, especially the strength of the employer and its ability to pay off the shortfall, and the scheme's maturity.

To help us focus our attention on those schemes that pose the greatest risk, we will use a filter mechanism based on triggers to identify schemes whose funding plans seem more likely to be based on imprudent or inappropriate assumptions. This will enable us to focus our attention on schemes that might merit scrutiny to determine whether the trustees have made appropriate judgements.

The triggers relate separately to the technical provisions and the recovery plans, recognising that they are interlinked. Our intention is that the triggers can be operated from the information that schemes already need to produce for other purposes, such as recovery plans and scheme returns, and therefore do not create an additional burden.

As our 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.

All schemes that trigger will be subject to some form of further assessment process to help us decide whether our intervention would be appropriate. The

criteria which will inform this assessment will be derived from some, or all, of the following:

- the likelihood that the trustees did not set prudent technical provisions or prepare an appropriate recovery plan;
- the potential impact on both members' benefits and the Pension Protection Fund; and
- an assessment of how likely intervention is to protect those interests.

The purpose of our further assessment of the scheme will be to identify those schemes where the trustees have made either imprudent or inappropriate funding decisions, so that we can intervene, whether informally or by using our statutory powers, and achieve an improvement in the outcome. Our assessment will be made in the light of what we know, more broadly, about the scheme, the sponsoring employer and the economic environment in which they are operating.

We will keep our guidance and regulatory approach under review as experience of operating and regulating the new framework grows. We will also, through environmental scanning, build a clearer picture of where the most serious risks lie, to help us focus our efforts and help the Pension Protection Fund assess its risks. Finally, we will consider and as appropriate respond to wider developments in the pensions landscape, such as the development of new vehicles for taking on defined benefit pension liabilities.

Approach to corporate events

We wish to ensure that trustees are vigilant to the need to mitigate any negative impact that corporate events may have on the pension scheme. Our corporate risk management (CRM) practice aims to minimise the risk of no mitigation occurring when it is needed. It focuses on those corporate events that have the greatest potential impact. The corporate risk that the CRM practice seeks to manage falls broadly into five categories outlined below:

- change in creditor preference;
- reduction in capital;
- weakening in employer covenant;
- withdrawal and compromise; and
- insolvency.¹⁸

A key principle that influences our scheme funding activity is that the pension scheme is a material creditor of the employer and therefore stands alongside all the other creditors, subject to its preference standing. As such the pension scheme must protect its position and exercise its rights in much the same way as any other creditor. In the past trustees of pension schemes were not as a matter of course consulted on corporate transactions and were often bypassed in the negotiations. An overriding objective of the CRM practice is to

¹⁸ The regulator cannot manage insolvency risk or stop businesses from going insolvent. The regulator becomes involved when there is doubt over whether the business is a going concern and there is a transaction e.g. pre-packaged sale.

encourage effective negotiations between scheme trustees and employers, where independent advice is taken as necessary to support the outcome that is in the best interests of all parties.

The CRM practice also investigates instances where an employer may be seeking to avoid its pension scheme liabilities. These instances come to our attention from a variety of sources, both proactively and reactively, for example from notifiable events, and we aim to improve the targeting of the events that need to be notified. The emphasis in looking at such instances is on understanding creditor preference issues and the use of the relevant powers to make good the scheme funding shortfalls.

Our first year's experience of working with those involved in corporate transactions has shown that our involvement is not a barrier to the successful completion of those transactions. Trustees, employers, investors and the regulator are all on a learning curve, and the challenge going forward is to share this learning so that those involved in corporate transactions give due regard to the pension creditor as a matter of course. We will keep our working practices under review so as to maximise the benefits to schemes and ease the process for those involved in transactions.

Chapter 7 – Scheme governance

Background

Over the last 10 to 15 years there has been an increased emphasis on the importance of good corporate governance, for example the 1992 'Cadbury Code' and, in the pensions environment, the Myners Review of Institutional Investment in the UK (March 2001), and the Morris Review of the Actuarial Profession (March 2005).

Chapter 3 and Appendix B describe the often low standards of governance, particularly within smaller schemes.

Why is governance important to the regulator?

Improving governance will contribute in particular to the regulator's objective of promoting and improving understanding of the good administration of all work-based pension schemes.

It will also contribute to important initiatives by the pensions industry such as Raising Standards of Pension Administration.¹⁹

Well-governed pension schemes are likely to be better administered, have greater awareness of financial risk, and to represent better the interests of scheme members. The situations described in Appendix B would have been unlikely to arise in well-governed schemes.

Meeting the challenge of improving governance should also therefore contribute to meeting our challenges of improving scheme funding and, in particular, addressing risks to members of DC schemes.

¹⁹ The Raising Standards of Pensions Administration project began in January 2002 as a voluntary initiative by the pensions profession and continues to operate on a voluntary basis. The objects of the initiative are the advancement of knowledge and learning in respect of pension administration, in particular through the creation and maintenance of a collection of guidance notes, case studies, tools and checklists, with the aim of improving the standard of service delivered to members of pension arrangements in the UK.

What outcomes is the regulator seeking?

The desired longer term outcome is to have in place well informed, capable trustees acting in the best interests of their members.

As indicated in chapter 4 our key performance indicator over the next three years is:

There will be year-on-year improvement in the extent to which trustees demonstrate knowledge and understanding of the governance requirements for their schemes (as evidenced by surveys of knowledge and understanding and key aspects of governance).

What steps does the regulator intend to take?

The first stage is to ensure that trustees understand what is expected of them, starting with, but not restricted to, the requirements on trustees to have appropriate knowledge and understanding. This came into force in April 2006 with a six month lead time for trustees to meet the requirements.

Specific issues include the management of conflicts of interest and disclosure of information by trustees to members, for example through the scheme's annual report and accounts.

A continuing research programme will enable us to expand our knowledge of governance issues. Examples include:

- an annual governance tracker survey, with over 50 questions being put to scheme trustees on topical governance issues; and
- Paul Myners' ongoing work, which will include further research into trustees' expertise in 2007.

Our approach to governance is based on education and support, through providing and promoting:

- codes of practice and guidance;²⁰
- e-learning (see box 7a); and
- trustee knowledge and understanding scope guidance.²¹

²⁰ Codes of practice on trustee knowledge and understanding, member-nominated trustees and directors, modification of subsisting rights, internal controls, reasonable periods for the purposes of occupational pension schemes and funding defined benefits; as well as web-based guidance on managing conflicts of interest.

²¹ This articulates what trustees need to know, understand and be familiar with in order to comply with the requirements of the Pensions Act 2004. The Financial Services Skills Council will use this to maintain its syllabus for the new 'Award in Trusteeship' qualification that will be launched by the Pensions Management Institute in summer 2006.

Box 7a: the regulator's free e-learning programme for trustees

This provides a means for trustees to acquire the knowledge and understanding they need to run schemes effectively and helps them comply with the trustee knowledge and understanding requirements of the Pensions Act 2004.

The fully interactive programme comprises a series of standalone modules based heavily on real-life case studies designed by e-learning and pensions experts.

A 20-hour programme is being delivered between January and September 2006.

Scheme specific intervention will, nonetheless, be necessary in schemes where we find that education and support activities are proving to be insufficient, for instance where there has been a significant breakdown in governance, or we have identified risks that are sufficiently serious in the context of the number of members concerned or the gravity of the consequences should the risk materialise.

Specific interventions may include:

- continued use of powers to remove trustees and appoint independent trustees (75 independent trustees appointed between 1 April 2005 and 31 March 2006);
- suspending and prohibiting trustees; and
- issuing of improvement notices and third party notices, and use of the power to obtain a report by a skilled person.

We acknowledge that in seeking to improve the professionalism of trustees there may be an unintended consequence of discouraging well informed and capable individuals from becoming or continuing to serve as trustees, though we have yet to see any significant evidence of this. We are not complacent, however, and will monitor the situation.

Contract-based schemes

These schemes do not require any mechanism to represent the collective interests of members. There is instead a contractual relationship between the member and the provider. Our objectives cover all work-based pensions and hence issues which derive from weak governance arrangements, such as poor administration, are of concern in contract-based schemes. In comparison with trust-based schemes this might need to be addressed to a greater extent through working with others such as the FSA, industry representative bodies and the providers themselves.

Chapter 8 – Risks to members of DC schemes

Our third principal challenge is to reduce the risks to members of work-based defined contribution²² schemes.

Background

As shown in chapter 3, there has been a major shift by employers from DB to DC schemes. For most new employees joining a private sector employer the pension on offer is a DC or GPP scheme.

Members of DC schemes face a greater number of risks than members of DB schemes. Moreover, the number of members facing these risks is increasing rapidly, reflecting the DB to DC shift.

Why are risks to members of DC schemes important to the regulator?

Reducing the risks to members of DC schemes will contribute to our objectives of protecting members' benefits and promoting good administration.

The risks facing members of DC schemes

The main risks for members of DB schemes are the funding position of the scheme and the financial strength of the employer.

In a DC scheme there is a more varied range of risks. One of these is the quality of administration:

- it involves complex banking/accounting processes, where the timeliness and accuracy of the payment and allocation of contributions is essential in order to ensure that the correct fund value is attributed to individual members, as it is this fund value which is used to provide their retirement benefits; and
- if there are administrative errors in the processes, e.g. the contribution is paid at the wrong rate due to a change in salary not being notified to the scheme administrator, or an incorrect unit price is used, then these can be very costly and time-consuming to rectify, especially if the error has persisted for some time and many members are involved.

This contrasts with DB schemes where there is generally no requirement to allocate contributions to individual members and benefit entitlement is calculated by reference to a formula.

Other significant risks to members of DC schemes are in the areas of member awareness and investment.

²² Hybrid schemes are not covered specifically but many of the issues will be applicable to the money purchase element of hybrids.

What outcomes is the regulator seeking?

Our key performance indicator over the next three years is that:

Trustees and others involved in running DC schemes (such as providers, administrators and employers) will have a clear understanding of the significant risks inherent in such arrangements, especially in relation to administration, member awareness and investment, and how they should be mitigating them.

The longer term outcomes which the regulator seeks in respect of DC schemes are:

1. *To secure good standards of administration and record-keeping*
 - Accurate and timely payment of contributions
 - Regular reconciliation
 - Accurate and timely payment of benefits (annuities/transfers)
 - Accurate and timely disclosure of information
2. *Better member understanding*
 - Good disclosure of information by trustees and others where appropriate
 - Realistic opportunity to make appropriate fund choice
 - Realistic opportunity to make appropriate choices at retirement
 - Members consider that they have a better understanding of their scheme and have greater confidence in it
3. *Effective choice of retirement options*
 - Open Market Option is exercised by members where appropriate
 - Members choose appropriate type of annuity
4. *Cost-effective delivery of defined contribution arrangements*
 - Costs borne by members are justified
 - Transparency of costs and less variation in equivalent costs between schemes
5. *Good practice in investment management processes*
 - Rigorous process for selection of investment manager(s)
 - Rigorous process for review of investment managers/fund performance
6. *Improved standards of governance (see chapter 7)*
 - Engaged trustees
 - Appropriate knowledge and understanding

Trustee behaviour will be key to achieving all these outcomes as will working in partnership with the FSA, e.g. in respect of stakeholder pensions. Providers and administrators also have key roles in achieving outcomes 1 to 4.

What steps does the regulator intend to take?

The regulatory issues are more diverse than in respect of DB schemes and require a different regulatory response. Some areas are clearly within the regulator's remit, e.g. administration and disclosure, but some are not, e.g. annuity rates and contribution levels.

Furthermore, the differences between occupational and contract-based arrangements mean that the regulatory strategy needs to be tailored according to the legal structure (employer-sponsored trust or individual contract) and key parties (trustees or managers and product providers). On a number of issues, especially for GPP arrangements, we will work closely with the FSA.

If the Government's response to the Pensions Commission's reports leads to a new type of work-based DC pensions product, our regulatory strategy may need to differentiate between this and existing work-based DC schemes.

As we address this challenge over the coming year, we will develop a detailed plan of action. In doing so we need to work in partnership with among others the DWP, the FSA, and trade bodies such as NAPF and ABI, in order to:

- clarify who will deliver what against each desired outcome and explore opportunities for market-based solutions; and
- identify and prioritise the key issues which the industry should focus on resolving.

Our focus will be on:

- effective dissemination of good practice to particular audiences: employers, trustees, managers, administrators;
- codes of practice: for example, internal controls; reporting breaches; trustee knowledge and understanding;
- providing guidance to trustees and managers to encourage good practice across the full range of issues which pose risks to our objectives, e.g. administration; extent and clarity of information for members; processes for choice by trustees of investment manager, investment options, and for review of investment performance; and control of costs borne by members;
- evidence-based material on particular issues e.g. where research or whistleblowing highlights specific problem areas.

Much of our work will involve helping the regulated community to understand what is required of them and, in our areas of regulatory responsibility, influencing rather than enforcement activity. Nevertheless serious breaches will require an appropriate risk-based and scheme specific response by the

regulator; and, where we do make significant formal interventions, we will back them up with publicity to communicate that breaches will be dealt with seriously, to encourage better standards across all schemes.

During the course of 2006/07 the regulator will consult publicly on its proposed approach towards reducing the risks to members of work-based DC schemes. We expect to include stakeholder forums and workshops, and conference speeches and presentations by the regulator, as well as the more formal route of issuing consultation documents.

Chapter 9 – Delivering the strategy

We need an organisation which can deliver this strategy.

Human resources

Our strategic human resources plan is designed to facilitate the regulator's vision.

The desired outcomes are:

- a high calibre and diverse workforce is attracted and utilised effectively, through initiatives such as the flexible resourcing model (see box 9a below);
- organisational and individual capability is developed and rewarded;
- our ability to change and improve is sustained;
- a high commitment culture is in place, emphasising the importance of enhancing mutual commitment; and
- value added human resources services are aligned to strategic priorities and are professionally delivered.

Box 9a: The flexible resourcing model

The key elements of the model are:

- developing an organisational infrastructure to support the flexible resourcing model (e.g. recruiting from a wider range of sources, and refining contractual and reward approaches);
- providing opportunities for staff from one area of the business to move on a temporary basis to another team to gain a wider and more flexible skill set;
- establishing secondments into the organisation of high calibre individuals;
- refining our workforce planning and monitoring, and succession planning for business critical posts, to ensure resourcing is fully aligned with our business planning horizon;
- establishing systematic approaches to harvesting knowledge, and ensuring knowledge transfer when staff leave.

Processes and IT systems

We have four workstreams within our integrated development programme designed to ensure that the regulator has in place the IT infrastructure required for it to operate effectively and efficiently. These are:

- Move to commercial off-the-shelf solutions – for the regulator’s systems and its managed services.
- Develop efficient core operations – to improve processes which collect core data about schemes and companies for the levy, scheme return and the Pensions Tracing Service.
- Knowledge management – to put in place the knowledge and information to support case management and development of new codes of practice.
- Customer contact development – to review the contact channels appropriate to different customer/stakeholder groups (web, telephone, etc).

Premises

In January 2006 we rationalised our office space, moving from Opra’s three premises to a single dedicated site at Napier House in Brighton, with an overall reduction in rental costs. Our new premises provide a modern environment that is conducive to efficient and effective working, and to attracting the calibre of staff that the regulator requires.

Controls

The regulator has put in place a comprehensive set of controls to comply with the Orange Book²³ and the effectiveness of these together with the wider management of organisational risks will be monitored regularly by the regulator’s Audit Committee.

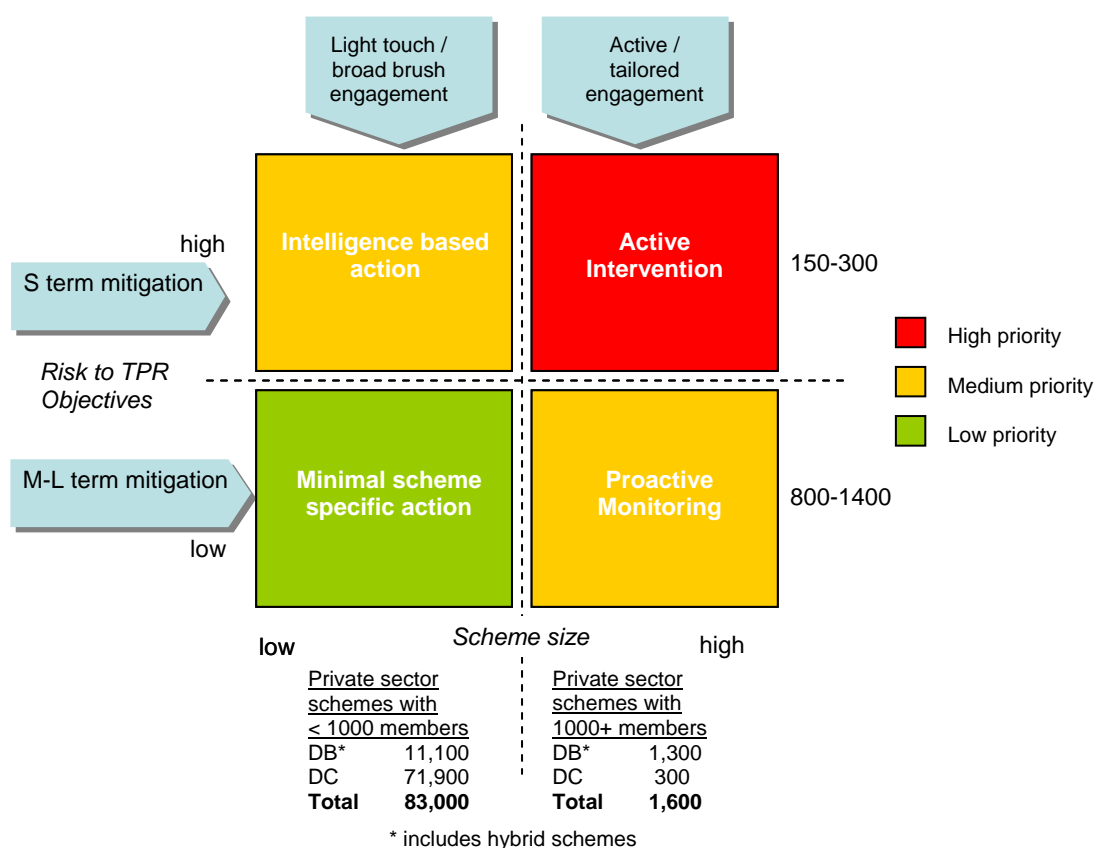
²³ *The Orange Book: Management of Risk – Principles and Concepts*, October 2004.

Appendices

Appendix A: Our risk-based approach to determining priorities for intervention

For both DB and DC schemes we will focus our most resource-intensive interventions on private sector schemes with over 1,000 members (covering over 85 per cent of members), and those smaller schemes that pose a significant risk to the regulator’s objectives. Figure Aa shows this conceptually:

Figure Aa: Risk and intervention model



- The horizontal axis of this 2 x 2 matrix is scheme size. Schemes with 1,000 or more members (1,300 DB and hybrid schemes, and 300 DC schemes) are the main priority for the regulator. The approach to the remaining 83,000 smaller private sector schemes (11,100 DB and hybrid schemes, and 71,900 DC schemes) will be less resource intensive.
- The vertical axis of this 2 x 2 matrix represents the severity of the risk to the regulator’s statutory objectives.

Explanation of risk and intervention model

Taking each quadrant in turn:

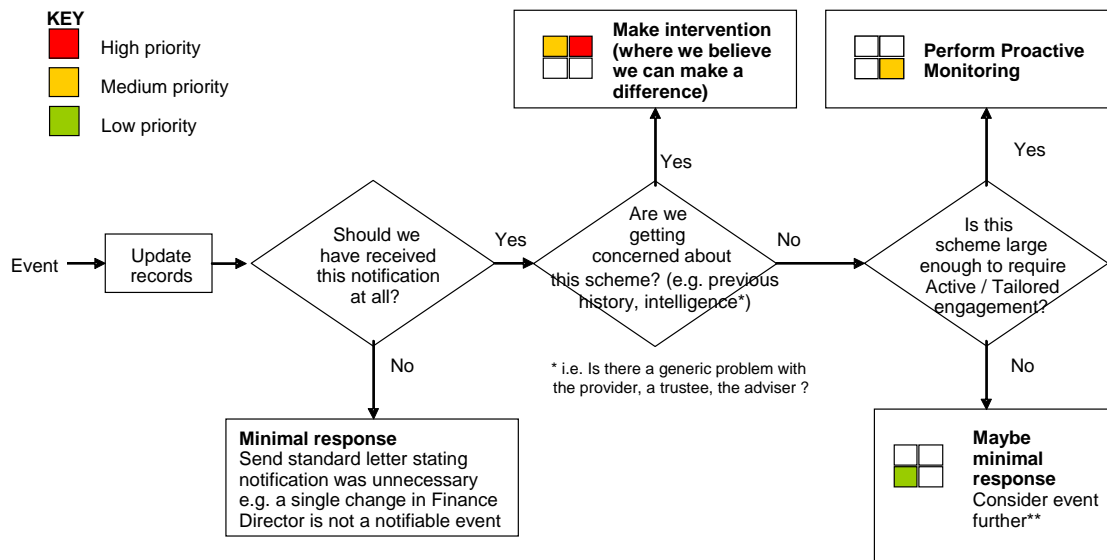
- **Active intervention** The 150-300 schemes in this quadrant are the regulator's highest priority because:
 - number of members impacted is high;
 - amount of money at risk is high; and
 - risk to the regulator's future effectiveness is high (the risk is that we may be perceived as, for example, not making a difference).Schemes in this quadrant have cases open against them and resource intensive intervention is underway, often for substantial periods of time
- **Proactive monitoring** The 800-1,400 schemes in this quadrant are a medium priority for the regulator as the number of members that would be impacted if anything were to go wrong would be high. Hence they are monitored proactively.
- **Intelligence-based action** The schemes in this quadrant are a medium priority for the regulator because:
 - risk to the regulator's ability to influence behaviour in future is high – the schemes in this quadrant are those small schemes where fraud, other gross mismanagement or other misconduct is taking place;
 - the effect on individual members is high. An event that is likely to lead to potential loss to any number of members should have a response from the regulator. However, in this quadrant the number of members impacted is low in any one scheme and hence the level of the regulator's resources being devoted to that scheme should be low, unless there is a systemic risk.
 - These schemes are usually hard to identify, hence the reference to 'intelligence'. To be successful in identifying these, the regulator has to spot common denominators such as a suspect trustee, adviser or employer across multiple schemes. A key challenge for the regulator regarding small schemes is to identify which of the 83,000 small private sector schemes belong in this quadrant, early enough for the regulator's scheme-specific interventions to make a difference.
- **Minimal scheme specific action** The schemes in this quadrant are the regulator's lowest priority as they represent the lowest risks to pension scheme members as a whole. The intention is therefore to take minimal action for as long as the regulator is confident that a small scheme
 - is not moving into the 'intelligence based action' quadrant; and
 - has not grown above 1,000 members (e.g. a recently opened DC scheme at a FTSE 100 employer may grow to above 1,000 members within 12 months) and hence into the 'proactive monitoring' quadrant.

Where the scheme size is small and the risk to the regulator’s objectives is low, we will only take minimal action. We have defined ‘minimal action’ as being:

- no targeted interventions *that are aimed specifically at small entities* (though these can access the global education and support that the regulator provides), e.g. no more work place access surveys;²⁴ and
- minimal responses, *where we have already determined* (through filtering incoming events²⁵ as shown in figure Ab below) that the risks to the regulator’s objectives are low.

Medium and high severity risks are always followed up. Low priority risks will receive a minimal response wherever possible, in order to conserve the regulator’s resources for the more severe risks.

Figure Ab: Incoming event filters



** The event will receive a minimal response if:

- it has been defined as being low priority (after passing through these three filters); and
- a random ‘inspection’ is not due, as part of the regulator’s ‘no abandonment’ policy

²⁴ Note that the regulator will continue to provide website information, literature, telephone support and attend HMRC events. We will also continue to respond to whistleblowing reports; we are simply ceasing the mailing of workplace access surveys.

²⁵ ‘Events’ can be triggered by the regulator itself (e.g. following receipt of a scheme return or a changed credit reference agency score), or by a stakeholder (e.g. a whistleblowing report, a notifiable event, a separate notification, a process complaint, or other professional concern).

Appendix B: Examples of poor governance

All the behaviours in these examples have occurred but should not be attributed to particular cases.

Example 1

Scheme details

- The scheme is a DB scheme in wind-up with about 50 members. It is currently underfunded by approximately £0.3 million.
- There are three trustees. Of these, one is the Managing Director/majority shareholder, one is a retired ex-director, and the other is an employee.
- In 1999 the employer commenced winding up the scheme and stopped making regular contributions.
- In 2003 the employer issued a special dividend of £0.4 million.
- Later in 2003 the company claimed it could not afford to make good the underfunding, and persuaded the other two trustees that this was the case.
- Opra never received the 2003 and 2004 scheme accounts, despite numerous requests.

The trustee behaviours observed

- Did not appear to understand Section 75 of the 1995 Pensions Act.
- Did not ensure that a statutory determination and calculation of the debt due was made when winding up commenced.
- Did not at any time take independent advice to understand either the resources available to the company or on what level of settlement they should aim.
- Argued with the scheme actuary over the wind-up priority within the pension scheme, causing the actuary to whistleblow.

Impact

- The Managing Director/majority shareholder does not appear to be acting in the best interests of members.
- The other two trustees are proving ineffective in minimising the level of underfunding.

Example 2

Background

- The scheme is an underfunded paid-up DB scheme with about 25 members.
- The employer is the corporate trustee, and there are no other trustees in place.
- The Managing Director is also the majority shareholder.
- There is only an out of date schedule of contributions in place, and no contributions have been paid in recent years.
- The auditor failed to whistleblow, and has been reported to his professional body.

The trustee behaviours observed

- The Managing Director is unaware of pensions issues, and of the role and responsibilities of pension scheme trustees.
- Has ignored communications to date from the regulator, and its predecessor Opra.

Impact

- The Managing Director has failed to manage a conflict of interest in an effective fashion and, with the scheme neither having a current schedule of contributions in place nor being in wind-up, the scheme would continue to be severely underfunded.

Example 3

Background

- The scheme is a DB scheme with about 100 members, which is funded well below the MFR.
- The employer claims that it can only afford a schedule of contributions of under £5,000 a month, whereas to bring its pension fund up to the MFR would require over £10,000 a month. The regulator believes that it can afford this upper figure, using available financial information.
- It has five trustees, of whom three are from the employer and two member-nominated trustees (MNTs).
- The Directors have a separate SSAS, into which generous contributions continue to be made.

The trustee behaviours observed

- The employer trustees have persuaded the trustee Board to apply for an MFR extension, rather than seek a compliant schedule of contributions from the employer.

Impact

- The trustee Board is not acting to minimise the level of underfunding, with the MNTs not asserting their influence with the employer trustees.
- As a result, the scheme would continue to be severely underfunded.