

The Pensions Regulator

DB consultation
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Dear Minister

Response from the Pensions Regulator to the February 2017 Green Paper - Security and Sustainability in Defined Benefit Pension Schemes

1. The recent Green Paper provides considerable evidence about the key challenges facing DB pensions and seeks views from all interested parties on various suggested options for improving confidence in the system.
2. Our analysis of DB schemes shows that the vast majority of employers supporting them should be able to repair their deficits and meet their long-term financial obligations to their scheme members. Our view remains that the DB funding regime is working largely as Parliament intended. We are encouraged by the strong consensus from DWP's informal 2016 consultation that, on the whole, the regulatory regime is satisfactory and that the funding regime sets a fair balance between the interests of the members and those of sponsoring employers.
3. However, we agree with Government that it is right to examine the evidence in detail. We also agree that any changes to pensions should be subject to a thorough test to ensure that the case for change is well made and that the consequences are explored and understood. We welcome the Green Paper.
4. In April we published our Corporate Plan for 2017-2020 which set out our priorities for the next three years. Together our priorities show how we are already evolving to become a clearer, quicker and tougher regulator – one which intervenes faster, in a more focused way and more frequently – and our programme of work in this area, known as TPR Future, is already taking some of these priorities forward.
5. However, the pensions landscape is continually changing and so are the risks and challenges we are facing as a regulator in pursuing the objectives given to us by Parliament. It is

The Pensions Regulator

important that we have a regulatory framework which can adapt to these risks and challenges and which can support our vision for our regulatory approach.

6. While we do not intend to offer responses on the detailed questions posed within the Green Paper, we do wish to comment on a number of key points and possible changes which we feel would support our vision for the future. In particular, changes to our scheme funding powers, information gathering powers and the introduction of a DB chair's statement would, as a package, support the journey we outlined in our 2017 corporate plan. Being able to set clearer standards and to shift our dynamic with all of our regulated community so that we can monitor against those standards on an ongoing basis, not just when a breach is detected, is essential to our being a more proactive regulator. The remainder of this letter concentrates on these points.

We will not be publicising our response prior to the General Election on 8 June 2017 but we understand that our response will form part of a wider Government response in the coming months. We plan to publish our response on our website in due course.

Suitability of the Part 3 Pensions Act 2004 approach to valuations

7. The current scheme funding regime allows trustees and employers a great deal of flexibility in agreeing funding levels for their scheme. We consider these flexibilities to be essential in achieving a balance between protecting members, reducing risks to the PPF and minimising burden on sponsoring employers. However, the absence of clear definitions around 'prudence' or 'appropriateness' in relation to scheme funding strategies and recovery plans leads to a divergence of approaches across schemes and represents a challenge for trustees and TPR alike.
8. Although some flexibility will always be needed to take account of scheme-specific circumstances and sponsor affordability, it is our view that there would be benefits in greater clarity over what we expect schemes to do with regard to funding, through more defined standards and requirements.
9. There are two ways to achieve greater clarity. The requirements could be set out explicitly in legislation or, alternatively, we could be given the power to set binding standards in this area. We prefer this second route.
10. Under this second option, we would articulate the standards we expect to be met in the form of detailed codes or guidance, supported by a legally enforceable "comply or explain" regime requiring trustees and sponsors to explain why they have not complied with our code and to demonstrate to us why they think their approach is prudent and appropriate. This would require a smaller legislative change, but would provide for a clearer, quicker and

The Pensions Regulator

tougher regulator who is able to respond to emerging risks faster than would be the case if requirements were set out explicitly in legislation. We also favour such an approach having wider application, for example to DC and public service pension schemes, as this would allow us to be more responsive, flexible and adaptable to changing risks, contexts and priorities across our whole regulatory remit.

Trustee investment choices

11. We support changes that will enable trustees to take advantage of a wide range of investment opportunities. We acknowledge that not all trustees will be in a position to fully understand the risks associated with investments that are less familiar, such as those involving infrastructure projects. Good governance can go a long way in helping trustees manage the growing complexity of scheme investments more effectively by ensuring that trustees understand and are able to procure the skills and knowledge needed both on their board and through advisers. It also helps trustees to structure board operations in a way that best utilises those skills and facilitates investment decision-making (e.g. through the use of an investment sub-committee). We recently published investment guidance for DB schemes and will provide further support to trustees through our 21C trusteeship and governance initiative. It is possible that greater scheme consolidation, concentrating trustee expertise and improving adviser support, could contribute towards optimising investment choices and that is one of the reasons for our support of steps to facilitate and remove unnecessary barriers to consolidation of all scheme types

Employer contributions, affordability and reducing sponsor burden.

12. In considering DB scheme sustainability, the Green Paper examines the case for altering the current balance between the protection of members and the demands on sponsors. The paper confirms that Government is not persuaded that there is a case for across the board change and we support that view. However, we acknowledge that a wide range of circumstances apply to different schemes and their sponsors and there may well be a case for treating schemes whose sponsors can readily afford contributions differently from those where there is significant underfunding alongside sponsor financial constraint.

13. Our own research and casework and the evidence presented in the Green Paper have indicated to us that there are a number of sponsors who could afford higher deficit repair contributions. We have also seen schemes where the opportunity to enhance scheme contributions has been missed, leading to poorer member outcomes and greater risk to the PPF when sponsor finances have subsequently deteriorated. Profitability can deteriorate quickly, for example through increased competition or technological change, along with an employer's ability to meet its funding obligation even for those with a strong financial track

The Pensions Regulator

record. In our view there is a case for measures, including clarification of our funding powers, to encourage employers with significant resources to repair deficits more quickly when they can afford to do so.

14. In contrast we understand the difficulties that limit business development opportunities available to a number of employers and the stresses that result from their efforts to repair the deficits within their schemes.
15. As well as posing risks to member benefits and to the sponsor's future prospects, stressed schemes pose a risk to the PPF as its exposure increases over time as scheme benefits continue to accrue/crystallise. Given this risk, we agree that options for change in this area should be considered. However, it would be unrealistic to believe that outcomes can be improved for all parties. Any change would transfer some of the risk and potential positive or negative outcomes from one party to another. For this reason careful controls would be needed to ensure that a scheme in these circumstances is treated fairly and that inappropriate transfer of wealth from the members to the sponsor's shareholders and other creditors is avoided. A failure in this area could significantly weaken confidence in the pension system to deliver the promises upon which both current and future generations rely.
16. One option discussed in the Green Paper is the potential for indexation to be cut in order to reduce the burden on employers. We do accept that some schemes have been prevented from adopting CPI as their inflation measure by a "scheme rules lottery," committing them to RPI when their intention had simply been to protect against inflation in general terms. Trustees and sponsors of such schemes might reasonably expect to be able to operate on a level playing field alongside schemes whose rules had simply adopted the statutory inflation measure in place from time to time. We also accept that there may be a case for suspension of indexation in specific situations where an employer is stressed and its scheme is underfunded.
17. However, given the available evidence as discussed in the Green Paper and considering that some indexation promises may have been intentionally introduced as part of a deal incorporating a sponsor contribution holiday to manage historic surpluses, we do not believe that a move to reduce member pensions across the board could be justified on grounds of affordability nor on the grounds of rationalization or simplification of benefit structures.

Section 11 wind-up power

The Pensions Regulator

18. We currently have limited powers where it becomes clear that a scheme may never be able to meet its funding plans, which is our s11 or 'winding up' power. TPR's power to wind-up a scheme was originally set out in the Pensions Act 1995, and thus focuses solely on the interests of scheme members. However, the Pension Act 2004, which brought TPR into being, gives us a wider set of objectives which includes reducing risks to the PPF in addition to protecting members' benefits. Further changes have since given us an additional objective in respect of DB funding to minimise any adverse impact on the sustainable growth of employers.
19. Given the evolution of the current framework since this power was first introduced, we think it would be helpful to revisit the winding-up power to allow us to take into account all our objectives which are relevant to DB when considering whether to exercise it. We consider that this may provide a route to dealing with the minority of schemes whose sponsors are in persistent difficult financial circumstances, but where the trustees are unwilling to act themselves, and where risk to the PPF continues to increase steadily over time.
20. It may also be worth exploring whether, in addition to our wind-up powers, there is room for a separate mechanism allowing for the separation of the employer and scheme on the basis of scheme viability rather than on employer insolvency.

Regulator powers to enhance member protection

Our responsibility and aims

21. The Green Paper recognises that a strengthening of our powers in some areas would contribute towards appropriate member protection. Alongside this we acknowledge our responsibility to ensure that we use our powers in a timely and effective way.
22. We have mentioned our ongoing regulatory approach review, TPR Future, where we are looking at all aspects of our regulatory remit, our operational practices, how we get our messages across and how we use our powers with the aim of ensuring sustainable and robust regulation for the next decade. We are committed to being a modern, responsive regulator that is able to act with more clarity, speed and force in order to regulate more efficiently, reducing the burden both on us and our regulated community. To do this, we feel the most important change to the current regime is around our relationship with our regulated community and how it provides information to us. Changes may also be worth considering around planned corporate activities in certain circumstances.

Our relationship with our regulated community

The Pensions Regulator

23. Our current information gathering powers can be extremely effective in carrying out some of our specific functions. However, there are instances where we are not able to engage our s72 powers or where we are limited in the exercise of certain powers to specific types of schemes, or their advisers, depending on their structure and type. They also require a significant amount of TPR time and resource to exercise.
24. We have mentioned previously that the Financial Conduct Authority has a very helpful principle requiring firms¹ to cooperate with them. A similar approach has been taken in the new Master Trust authorisation regime where TPR's ongoing supervision of Master Trusts and the threat of de-authorisation means it is in the interest of schemes and their advisers to cooperate with us, and to provide us with information to our satisfaction, in order to avoid engaging our formal powers. This is an important shift in dynamics between us and our regulated community. We would like to see this dynamic extended beyond the Master Trust regime such that we have a single set of regulatory tools at our disposal, to exercise when and where appropriate across all aspects of our casework, including the ability to request information regularly and on an ad hoc basis. This shift in dynamics, combined with the existing requirements for schemes to notify us of certain events, will support our evolution towards becoming a quicker, more effective regulator.
25. The Green Paper considers changes to our scheme funding powers and considers extending the requirement for a chair's statement beyond DC schemes to DB schemes as well. Changes in these two areas would already go some way in shifting the dynamics in our engagement with DB schemes, by addressing how we set standards around scheme funding, governance and transparency. We believe there are two specific changes to our information gathering powers which would further facilitate this shift, and enable us to hold schemes to these standards:
- **Interviews and inspections.** We currently have no general power under section 72(1A) of the Pensions Act 2004 to compel parties to submit to an interview where we believe they have information that could assist our casework. We do have a unique power in relation to our automatic enrolment function but this is limited to very specific circumstances only. The lack of an interview power in other cases, and the very limited

¹ FCA handbook principle 11: "a firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice."

The Pensions Regulator

nature of our power related to automatic enrolment, has, in some cases, hampered our ability to take swift action and achieve a timely outcome.

We have found that, in the rare instances where individuals have voluntarily submitted to an interview, we were able to progress the case more quickly than would otherwise have been the case. For example, some of our recent avoidance cases were significantly assisted when key parties agreed to be interviewed on a voluntary basis early on. Without this co-operation, and in the absence of a power to require interview, our investigation would have been significantly delayed.

A more comprehensive interview power across our regulatory remit would facilitate the more timely resolution of cases across a number of areas including avoidance cases and pension scams. It would also assist the production of skilled persons reports as our ability to interview relevant parties would expedite their completion.

Separately we are prevented from using our section 73 Pensions Act 2004 inspection powers in relation to avoidance functions unless there has been non-compliance with a section 72 information request notice. An extension of the power to allow earlier inspection would also help us to establish underlying facts in a quicker, more proactive way and would better inform the direction of an investigation.

- **Civil penalties in addition to criminal penalties.** Our sanction for non-compliance with information requests under section 72 of the 2004 Act is limited. We can pursue a criminal prosecution but this requires us to satisfy a high standard set by a ‘beyond reasonable doubt’ burden of proof test. Although we have successfully fined individuals for breaching s72, the cases took 18 months to progress and required recourse to the Courts, followed by a criminal conviction, with associated costs. An additional civil/administrative power to impose fixed and escalating civil penalties (akin to what we currently have in relation to our automatic enrolment work) requiring a lower burden of proof would enable us to take action more quickly and effectively.

26. These specific powers, combined with other tools such as a DB chair’s statement, would drive greater accountability and transparency. They would allow us to target our interventions across a wider range of circumstances rather than just at specific points in the valuation cycle and may reduce burden on our regulated community where they lessen the need for us to use our burdensome formal powers.

Preventing certain planned corporate actions

The Pensions Regulator

27. The Green Paper considers whether it would be more effective for us to have powers in some limited circumstances to intervene proactively to prevent certain corporate activities, rather than deploying our retrospective anti-avoidance powers.
28. Our view remains that a blanket requirement on parties to obtain clearance ahead of any planned corporate actions would be disproportionate both for the UK economy and for TPR and our levy payers.
29. We remain open to proposals that would seek to strengthen our clearance powers and allow us the opportunity to prevent activity that is not accompanied by measures to alleviate negative scheme impact before it happens. Requiring clearance in some defined circumstances could help to achieve this. There may also be some value in exploring further the alternative approach identified at paragraph 320 of the Green Paper providing for a fining system to deter poor behaviours and nudge employers to engage with us earlier.
30. Careful consideration would still be needed to identify those transactions which should attract enhanced sanctions and the approach would not enable TPR to stop unmitigated activity that is detrimental to an affected DB scheme before it happens. However, we believe that the risk of later punitive enforcement activity would be an effective deterrent, encouraging employers to seek up-front clearance where they perceive a risk that we might exercise our anti-avoidance powers.
31. In any event we will continue to look closely at our existing anti-avoidance powers to ensure that they, and the processes we adopt around them, are as efficient and effective as possible. It may be that amendments to the legal definitions of, and the processes surrounding the use of, our specific anti-avoidance powers could allow us to be clearer, quicker and tougher in this area.

Governance and Scheme consolidation

32. It is clear from our 21st Century Trustee research, and our engagement with schemes, that the quality of governance and administration remains inconsistent across our landscape. These concerns extend across all the types of schemes we regulate, including the DB sector. We see no justification for there to be two classes of pension scheme members, those who benefit from what we can see is the premium of good governance and those who do not. Therefore we remain determined to drive up standards and tackle non-compliance.. In particular we are looking to make our expectations clearer and will be launching a targeted and segmented communication campaign focused on the fundamentals of good governance

The Pensions Regulator

to support trustees running their scheme more effectively. It was also very clear from the research that an effective chair of trustees and the presence of a good professional trustee have a marked positive impact on board effectiveness. We are therefore working with industry to develop fitness and propriety protocols.

33. We continue to believe that consolidation of all scheme types could yield tangible benefits and in the DB context is one of the key areas in the Green Paper worth exploring further. In particular we can see that DB scheme consolidation, in the right circumstances, could lead to better governance and achievement of value for money driven by greater trustee expertise, availability of advisers and delivery of a wider range of investment opportunities.
34. Considering our member and PPF protection objectives, an important driver for us would also be to see improved scheme funding positions. This suggests it could be beneficial to focus on schemes supported by weak employer covenants that may struggle to recover a substantial deficit and ultimately fall into the PPF. Our view is that a further consolidation option targeted at schemes in this position may improve outcomes over the longer term through efficiencies and by limiting downside risks (including a further deterioration in funding deficit).
35. Our preference would be for steps that encourage and enable voluntary consolidation rather than a compulsory consolidation regime. However, in our view extension of the compulsory chair's statement to include DB and hybrid schemes as noted in paragraph 391 of the Green Paper along with a legislative requirement for trustees to explicitly update on what they are doing to achieve value for money and control costs would provide a significant impetus.
36. We acknowledge that consolidation is not a simple matter. The Green Paper itself acknowledges a number of difficulties which may even be more acute for non-associated employer DB schemes where links with multiple sponsoring employers adds considerable complexity.
37. It is also important to be clear about the objectives of any consolidation solutions that are adopted. Key questions to consider include a) the entry criteria for consolidating, b) how the entry criteria would affect member benefits and c) who carries the risks. For example a consolidation vehicle permitting a sponsor to limit its exposure by payment of a joining premium and which results in some rationalisation of member benefits might lead to benefit reductions while allowing the employer to discharge its obligations at a reduced cost. This might represent an inappropriate transfer of risk to members where the sponsor is well resourced and could have supported full benefits under its original scheme.

The Pensions Regulator

38. We will continue to engage actively with DWP and industry to identify the best approach to encouraging consolidation where appropriate and to overcoming barriers.

We very much appreciate the opportunity to respond to this important and wide-ranging Green Paper and we remain committed to working closely with you as we seek to preserve and enhance the security and sustainability of DB pension schemes.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Lesley Titcomb". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

LESLEY TITCOMB

CEO