

Defined benefit regulatory strategy

June 2014

The Pensions
Regulator

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Introduction

1. The Pensions Regulator ('the regulator') is a non-departmental public body which regulates work-based pensions^{1,2}.
2. This regulatory strategy sets out our approach to regulating trust-based defined benefit (DB) occupational pension schemes (DB schemes)³.
3. Our approach to regulating work-based pensions⁴ is set out on our website.
4. Our current Corporate plan⁵ sets out, under this regulatory strategy, our objectives, key priorities and key performance indicators for the current business year.

1
Under section 5(3) of the Pensions Act 2004 work-based pensions are occupational pension schemes, personal pension schemes where direct payment arrangements are in place or stakeholder pension schemes.

2
All references to the law that applies in Great Britain should be taken to include corresponding legislation in Northern Ireland.

3
References to schemes, unless the context indicates otherwise, are to trust-based DB schemes and include trustees and managers of these schemes.

4
www.tpr.gov.uk/regulate-and-enforce.aspx

5
www.tpr.gov.uk/plan

Our strategic objective

Our task and statutory objectives

5. There are approximately 6,200 DB schemes providing pension benefits for around 11 million people. Upon retirement under a DB scheme, a member receives a level of benefit usually determined by length of service and salary. Delivery of that promise is underwritten by the scheme's employer. In the event of employer insolvency⁶, the Pension Protection Fund (the PPF) may pay the members compensation.
6. In setting our own strategic objective and our approach to DB regulation, we are guided by four of our six statutory objectives⁷:
 - to protect the benefits of members of occupational pension schemes
 - to reduce the risk of situations arising which may lead to compensation being payable from the PPF
 - in relation to the exercise of our functions under Part 3 only, to minimise any adverse impact on the sustainable growth of an employer⁸, and
 - to promote and to improve the understanding of the good administration of work-based pension schemes⁹.
7. These objectives shape our approach. We have discretion over how we achieve them and do not prioritise one over another.
8. Improving a scheme's funding and employer support reduces risk to the members, employers and the PPF. Our objectives recognise that risks to members and the PPF cannot be completely eradicated despite the efforts of trustees, employers and us. It is acknowledged that some schemes will be underfunded, some employers will fail and some schemes will enter the PPF.
9. For regulating the statutory funding framework¹⁰ we also have a specific objective to minimise the adverse impact on employers' sustainable growth. We explain our approach to this in more detail in our funding policy¹¹.
10. Good governance is likely to improve member outcomes. It should also improve the efficiency of schemes and be cost effective for employers. We consider how funding, avoidance and other risks may be mitigated by interventions which improve scheme governance. In regulating schemes we are more likely, therefore, to intervene in respect of administration breaches and poor governance that risk materially poorer outcomes for members.

6

It must be a qualifying insolvency event in respect of an employer to an eligible scheme (see PPF guidance at www.pensionprotectionfund.org.uk/About-Us/eligibility/Pages/insolvencyevents.aspx)

7

See section 5(1) of the Pensions Act 2004.

8

This objective refers to the statutory funding regime detailed under Part 3 of the Pensions Act 2004 and comes into force in July 2014.

9

See footnote 1.

10

Under Part 3 of the Pensions Act 2004.

11

www.tpr.gov.uk/dbpolicy

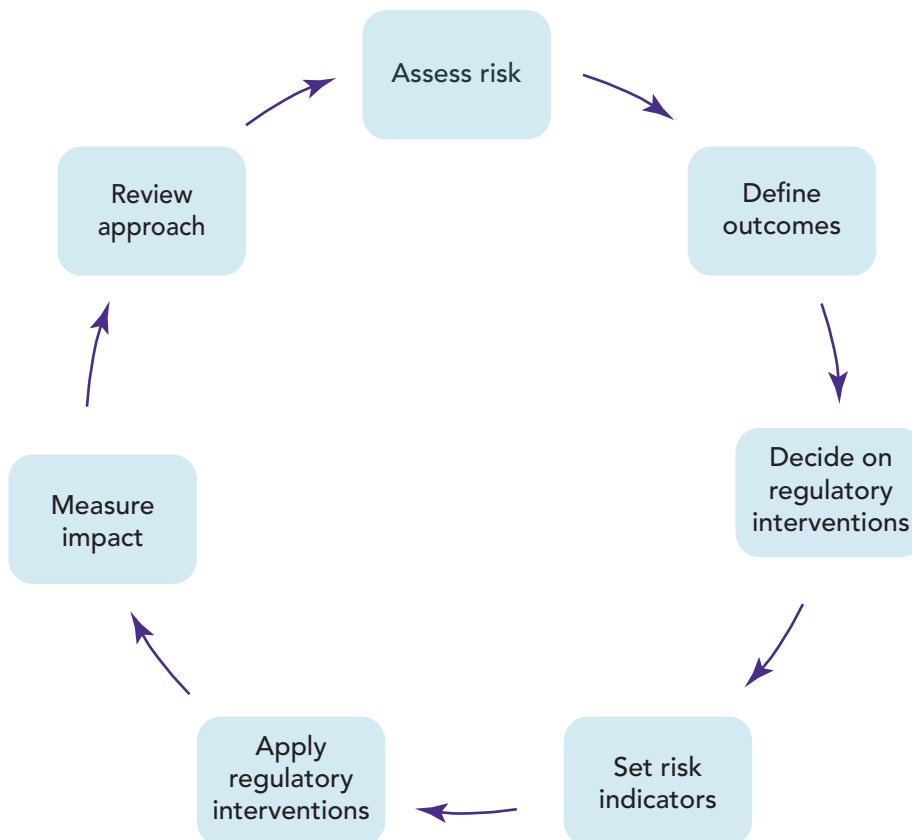
Balancing our objectives: our strategy

11. We balance our objectives by implementing a strategy focused on protecting accrued rights to benefits through adequately funded, supported and well governed DB schemes. We believe that this is best achieved by a strong and ongoing employer and effective and engaged trustees implementing an appropriate funding plan.
12. We use risk assessment to identify the key factors or behaviours that could affect this goal. We mitigate these risks in a proportionate and balanced way by defining good outcomes and developing targeted policies and efficient operational practices. We rely on trustees and employers working together (helped by our education and support) in order to ensure that members receive their promised benefits.
13. In situations where risks have already crystallised, for instance where the employer is at material risk of insolvency or where the scheme is likely to enter the PPF, our focus is on managing the impact of these risks by working with schemes (and their employers) and the PPF to achieve the best and fairest possible outcome under the circumstances.

Implementing our strategy

14. We implement our strategy by:

- understanding risks across DB schemes and how they impact on our objectives
- developing and communicating policies setting out good outcomes and what schemes should do
- determining how best we can use our regulatory tools, from education to enforcement, to mitigate the risks and achieve our desired outcomes
- setting our risk indicators for engagement annually to target the schemes with the greatest risks and where we can have the most impact
- applying our regulatory tools
- measuring the effectiveness of our policies and interventions, and
- reviewing and developing our approach to ensure it is effective.



15. We aim to be transparent in our expectations and actions. We publish policies setting out the risks as we understand them, our desired outcomes and our intended approach. We publish section 89 reports¹² on specific case interventions, which may provide more detail on our policies and approach.
16. We are keen to work in partnership with the regulated community to inform our understanding of risk and understand the likely impact of our policies on schemes and employers. We also maintain a secondment programme to augment this understanding. These steps and the outcome of our casework, interventions and the analysis of the impact of our approach feed into our policy development and risk assessment processes.

Assessing risk

17. A sound understanding of the risks to our objectives, in particular those we can influence, is key to the success of our strategy and drives all our activities from policy development to the design of our operational processes.
18. We aim to consider risk both at the macro and micro level to:
 - identify and assess emerging risks and trends proactively to inform our understanding of the landscape, which then informs our policy and operational development, and
 - identify schemes (or other parties) for further investigation; we do this proactively and reactively following reports and submissions made to us.
19. Our understanding of risk is informed by our experience of regulating schemes and our assessment of how the landscape could develop and relies upon fit-for-purpose data and modelling capabilities.

12
Under section 89 of the
Pensions Act 2004.

Areas of risk focus

20. As covenant, investment and funding risks influence the overall member outcomes and, when regulating the statutory funding framework, the impact on employers' sustainable growth, our consideration of risk across the DB landscape focuses on these three areas of risk. We also consider governance risks, as poor governance is often a factor in poor outcomes. Our main considerations are:
- **Covenant:** the support that an employer (and its group) is able to give to the scheme and the risk of this support being withdrawn, reduced, or otherwise unavailable now or when the scheme needs it. When regulating the statutory funding framework, we also seek to ensure that guidance on standards, practices and any interventions minimise any adverse impact on the sustainable growth of an employer.
 - **Funding:** the trustees' and employer's plans to ensure the scheme is adequately funded to provide benefits and the risks to these plans.
 - **Investment:** the risk in the overall investment strategy in relation to the employer's covenant and how this is managed.
 - **Scheme governance:** the extent to which poor governance (for example, unmanaged conflicts of interests or inadequate internal controls) increases the risk of schemes not achieving good member outcomes.
21. These risks are interlinked, and so focusing on isolated elements of risk is a poor indicator of overall risk. We therefore consider these 'in the round' to inform an overall judgment as to whether further action is necessary.

Segments and portfolios

22. Segmentation is a means of identifying mutually exclusive subsets of schemes with similar characteristics (for example, size, covenant strength, or employer type) which are drivers of risk or have significant implications for the way these particular schemes should behave. We consider whether to segment the whole DB landscape to help us understand risks to schemes and employers and develop more effective and better targeted policies and interventions.
23. Segmentation can also help achieve the right balance between maintaining consistency of approach to schemes in similar circumstances and adapting our regulatory approach, including our communications and educational material, to reflect specific circumstances.

24. We may also group those schemes that display a common behaviour-related risk, including a new or emerging issue, into portfolios so that we are consistent in how we assess them. These portfolios are a subset of the overall DB landscape, cut across segments and are not mutually exclusive – a scheme may be in several portfolios (or none) at the same time depending on the risks exhibited.
25. Taken together, segmentation and portfolios inform our understanding of risk and the development of our policy and operational approach, communications and educational material.

Setting policies

26. Having understood the risk presented we seek to define our desired outcomes, informed by the need to balance all our objectives. These may be universally applicable to all schemes or be different for different segments, subject to an individual scheme's and/or employer's circumstances. At the highest level this represents our policy for that particular risk or issue.
27. Our policies are principle-based and outcome-focused (rather than prescriptive) because we believe that while compliance with form and process is important, focusing on the substance of issues promotes flexibility and innovation and encourages adoption of best practice, thereby increasing the likelihood of achieving our objectives.

Setting priorities and interventions

28. We have a range of regulatory tools from education through enablement to enforcement to achieve our policies. We describe how these are implemented below.
29. Our primary focus continues to be on education and enablement as the best means of supporting those within our industry but we take enforcement action where we consider it necessary. We rely on trustees and employers working together to ensure members receive their promised benefits.
30. How we deploy our regulatory tools depends on the nature of risk. For instance, a risk posing a significant threat may potentially be mitigated using all our tools while low risks may be mitigated principally by education. We aim for our interventions to be consistent and proportionate and take into account the circumstances of, and likely impact on, the party subject to our interventions.

31. Where our assessment indicates that a scheme may pose significant risks, we may decide that direct engagement through enablement and enforcement is the most appropriate way of addressing those risks. Direct engagement allows us to gather more information on which to base our decision-making. We aim to intervene in a risk-based and proportionate manner. We do not seek to eliminate risk completely or to engage with all schemes. Instead we focus our engagement on those schemes posing the greatest risks to our objectives and where we can have the most impact.
32. Being risk-based enables us to operate more effectively as a value for money regulator. This ensures that our interventions are proportionate to the scale of the risks identified and that we make the best use of our limited resources. Targeting our intervention in this way is intended to minimise the regulatory burden on trustees and employers.
33. Decisions as to when, and where, to engage with schemes are informed by a risk tolerance threshold. The factors we take into account in setting our risk indicators include (but are not limited to) the nature of the risks posed and the complexity and resource intensity of our engagement. Our risk assessment framework is also informed by the regulator's risk appetite statement, which is reviewed on an annual basis.
34. We set different risk indicators for different types of risk and sometimes for different segments of the landscape. This can help define outcome-based interventions which are in line with our policies and are more applicable in one segment than another.
35. Our approach to understanding and intervening on risks is integrated; therefore, whilst a scheme may come to our attention for a particular risk or issue, we look across all our key risk areas (covenant, investment, funding and governance) to understand the overall risk profile of the scheme and determine whether further engagement is warranted.
36. We use a wide range of information to assess risks posed by schemes and decide whether to engage with them. However, we recognise the limitations inherent to data and models, and, therefore, expert human judgment continues to play a central role in our decision-making.
37. Schemes cover a wide range of sizes ranging from tens of thousands of members to single member schemes. Our risk assessment identifies a greater proportion of large schemes than small schemes for engagement as they contain the greatest overall risk to our objectives but we do nevertheless engage with a substantial number of small and medium-size schemes. In addition, we may use broader interventions to influence the behaviour of a greater number of small schemes (for example, through targeted guidance or education campaigns).

38. We have zero tolerance for some types of behaviour, for example, misappropriation of scheme assets by trustees.
39. Identifying a scheme for further engagement does not imply that the scheme is non-compliant. Instead, based on the information we have, we have assessed these schemes as those exhibiting the greatest risks. Equally, where we receive information on a scheme and do not intervene, this should not be interpreted as meaning that we have no issues with the scheme's circumstances but rather that the level of risk does not meet our risk assessment criteria.

Implementing our interventions

Education

40. Trustees play the central role in ensuring that DB schemes are governed effectively. We expect trustees to carry out their role competently and have sufficient skills, knowledge and understanding¹³ to be able to do so. We acknowledge the increasing complexity of trustees' roles as well as the fast-changing and challenging conditions trustees and employers face.
41. We, therefore, place great emphasis on education as we believe this is the most efficient means to reach the widest audience. We provide guidance and support to help trustees and employers to work together.
42. Our educational materials and communications are tailored to the needs and circumstances of our audiences. We aim to be clear about when a particular piece of guidance applies and ensure that guidance is clearly signposted on our website.

Enablement

43. We target support to those specific schemes and their employers where risk is the greatest and where we consider we can have the most impact. We do this through direct engagement with those schemes and employers and sometimes through the use of our powers.
44. Generally, the key focus of our casework is to support and enable schemes and employers to deliver better member outcomes without having to resort to using our powers.
45. We also assist schemes and employers through processing applications on a range of issues (for example, clearance applications or pension sharing order extension applications). In order to deal with applications promptly and efficiently we expect trustees and employers to comprehensively prepare these applications.

13
Under sections 247 and 248 of the Pensions Act 2004.

Enforcement

46. Enforcement is usually only an option when education and enablement have proved unsuccessful. When considering enforcement action, important factors include:
 - the range of powers available
 - the evidence
 - the grounds for the use of powers
 - whether action is reasonable and proportionate (for example, past conduct and mitigation steps), and
 - the impact of action on the parties affected and the wider impact within the regulatory framework.
47. We may go straight to enforcement action in those instances where, for example:
 - there is sufficient evidence of a breach
 - there is an immediate and material risk or it has already crystallised, and/or
 - a delay arising from our engagement process would cause a material risk.
48. In addition to any enforcement action that we may take we may also refer matters to other regulatory bodies where appropriate.

Measuring impact and reviewing our approach

49. We primarily measure our impact against our statutory objectives. In our annual report and annual funding statement we report on:
 - the risk to members' benefits
 - the risk to the PPF, and
 - the impact on employers.

This includes looking at key indicators such as pension contributions or scheme funding targets and employer covenant strength indicators.

50. We seek to measure the impact of our approach on the regulated community and effectiveness of our guidance through perception surveys, research on understanding and awareness, and regular engagement.
51. We keep our regulatory approach under review to ensure that it remains effective, informed by our assessment of impact and our ongoing engagement with the regulated community.

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