

Mouna Turnbull
Defined Benefit regulation
The Pensions Regulator
Napier House
Trafalgar Place
Brighton BN1 4DW

By email: DBConsultation@thepensionsregulator.gsi.gov.uk

7 February 2014

Dear Madam

Defined Benefit consultation: setting a balanced approach

I am writing in relation to the Pensions Regulator's 2 December 2013 consultation on a revised code of practice for DB scheme funding and specifically your invitation for comments on the questions set out in the consultation document.

The comments in this letter are given on behalf of Gazelle Corporate Finance Ltd ("Gazelle"), which specialises in covenant assessment and related advisory work in relation to some of the UK's largest DB pension schemes.

New objective on sustainable growth

1. *Is our new objective on sustainable growth adequately reflected in the approach outlined in the draft consultation documents? If not, what more could we do to reflect the new objective?*

We welcome the overall approach presented in the draft strategy, policy and code documents which reflect a more nuanced and integrated regulatory framework than previously.

We note that the additional objective "to minimise any adverse impact on the sustainable growth of an employer" is presented in the draft consultation as a matter of clarifying what already happens in practice - "The new objective makes it explicit that we will consider the impact on employers' sustainable growth plans alongside members in our approach to regulating DB funding" (funding policy para 5). The Government's presentation of the impact in the current Pensions Bill similarly refers to it "refin[ing] the existing regime by making explicit something that is implicit in existing legislation...the existing objectives mean that the Regulator implicitly needs to take account of impacts on the sponsoring employer, given that a strong employer is in the best interests of scheme members. However, the new objective will ensure that the Pensions Regulator must explicitly consider minimising any impact on the sustainable growth of sponsoring employers."¹

If therefore this is not intended to introduce a new factor that did not already exist, then it is adequately reflected in the draft consultation documents. However, we make further comments on this in 2 below.

¹ Pensions Bill Impact Assessment: Annex G – Other measures in the Pensions Bill

2. *Is our interpretation of sustainable growth appropriate? (paragraph 4-9 of funding policy)*

It will be important that pension trustees and sponsors understand how the Pensions Regulator expects the sustainable growth objective to be brought into funding discussions in terms of: what the concept means and to what extent (if any) it should change the balance of discussions.

What does “sustainable growth” mean?

The new objective is stated in the draft consultation (e.g. at funding policy para 4) but it is not an easily defined concept, as is recognised in draft Code para 93: “sustainable growth will mean different things to employers in different circumstances. The key is to understand the context...including its investment aims and what will constitute success for its business”, and in funding policy para 9. Pension schemes are supported by a wide variety of companies, across a spectrum ranging from the high growth (organically or through M&A), the mature and the declining, and growth is not constant or linear, being affected by economic cycles and transformational changes. There is also a potential paradox - that growth per se might not be consistent with sustainability of the sponsor over the long-term. A study carried out by Gazelle² indicates that even the most “blue chip” sponsors can change dramatically over a generation. Yet even when closed to new entrants or to future accrual the sponsors’ formal pension liabilities may extend out for decades. It is intrinsic to Gazelle’s approach towards the modelling of covenant risk that covenant risk needs to be looked at through cycles and over long periods by reference to the long-dated nature of pension liability cash flows. Equally, as major investors in UK companies, pension schemes need to take account of the long-term success of the companies in which they invest.

Considerable work being carried out by research bodies, asset management groups and academics supports the view that a longer-term view should be taken of corporate sustainability and behaviour of participants through the value chain. We suggest that it would therefore be appropriate for there to be express recognition and clarification in the draft consultation (either in the policy or Code paper) that long-term value creation by the employer is consistent with the sustainable growth objective – making it clear that trustees can take account of the very long-term and variable business dynamics beyond the next 3-5 years. Indeed it is inherent to Gazelle’s quantified approach to covenant risk assessment, drawing from our collective corporate finance, capital markets and business experience, that longer term corporate performance looking out many years should – just like investment performance - be assessed stochastically rather than deterministically.

A further issue which we feel needs to be addressed explicitly in the interpretation of sustainable growth is the extent to which employers may be tempted to give deficit recovery contributions lower priority than dividends. There are references to employer resources being used to pay dividends rather than to pay off pension liabilities in paras 97 and 98 of the draft Code but it would be helpful for trustees to have clearer guidance from the Regulator as to how they should judge the reasonableness of the balance between investment for growth, dividends (special or normalised) and pension deficit recovery contributions in making allowance for sustainable growth.

Balancing interests

While we have noted above the implication that the new objective is to be read as clarificatory, the wording refers to minimising “any” adverse effect on sustainable growth, which could imply a priority to this objective over “adequate” scheme funding?

² Sponsor covenant risk highlighted: the past 25 years covenant experience of the FTSE 100 constituents, a pensions research paper by Gazelle Corporate Finance April 2012

Code of practice

3. *Does the practical guidance set out in the revised funding code reflect your experience of what good practice looks like? If not, why not?*

The comments here reflect Gazelle's experience in this area since 2005 which has mainly been in relation to larger schemes supported by global corporations (typically assets in excess of £1bn). The current drivers of good practice derive from the Pensions Regulator (codes, guidance and statements etc.), evolving practitioner market practice and thought leadership.

To a great extent, the draft Code reflects some "catch-up" with evolving best practice already being pursued by leading schemes and advisers - for example, Gazelle's quantitative covenant risk modelling techniques which integrate covenant and funding risk with investment risk over the life-span of the pension scheme and which already takes into account the sustainable growth of the employer. The draft funding code is a significant advance on the existing body of (sometimes inconsistent and not integrated) regulatory codes and practice in this area (e.g. funding code 2006, monitoring employer support 2010).

The emphasis on notions of balancing risks, using flexibility, and the need for trustees and sponsors to work collaboratively together "to manage risks and reach appropriate funding solutions" is welcome, as is the stress on addressing how these risks affect each other and need to be understood and managed, and that risk cannot necessarily be eliminated.

In our experience with leading schemes, it is recognised that covenant, funding and investment risk cannot properly be understood, assessed and monitored in isolation from each other. This requires a co-ordinated approach in terms of governance and increased constructive and open engagement between trustee and sponsor boards. In these respects therefore the revised code reflects our experience of good governance.

We note the stated intention to be a "more principle-based and outcome-focused" regulator, which is welcome.

As a general point, we welcome the approach towards covenant taken in the code and consultation documents which subtly reshapes the concept, integrates it and makes it more dynamic: we read the code as setting out the key areas to be addressed (para 81-89), rather than a checklist, stressing the need to address covenant, funding and investment together in terms of "risks" and "issues", and not just at the triennial valuation stage.

4. *Is the approach to risk management set out in the code useful? If not, what not?*

Conventionally, trustees and practitioners have tended to assess the employer covenant in terms of how "strong" or "weak" it is (for example by reference to a label or a numerical rating) as at a reference point in time (for example the effective date of the triennial valuation for the purpose of informing the scheme actuary's advice on the prudence of assumptions when setting the Technical Provisions or the date of a corporate transaction). Practice varies considerably however, depending on the individual actuary and consulting firm's approach as to how a view of covenant "strength" is incorporated into the TPs, and furthermore it is unclear how covenant strength is taken into account in setting investment strategy.

The characterisation of covenant in terms of "strength" or "weakness" can sometimes be overly simplistic, produce inconsistencies across valuation cycles (for instance where advisers or methodologies have changed) or seriously damage the trustee-sponsor relationship. A risk-based approach is an

improvement as it allows for a more sophisticated assessment, allows for consistency of approach, and promotes the more transparent and “collaborative” relationship sought by the draft Code.

The approach to integrated risk management in the code is useful therefore. It represents a welcome change of emphasis away from pure risk reduction towards an appreciation that no financial liability can be riskless and a more nuanced exposition of risk balance.

The risk management cycle is also a helpful way for trustees to address this. The wording of para 50 is in line with Gazelle’s “Mousetrap” approach which is a covenant “risk assessment tool” which is “not meant to be predictive in nature” and whose value also lies in “helping to appreciate the order of magnitude of the scheme risks and the broad trade-offs and options that will be available in managing these risks”. We therefore welcome the encouragement of both qualitative and quantitative approaches in the code; our quantified risk assessment approach builds on a qualitative financial risk assessment and has been used to good effect in a number of contexts for several of the UK’s leading pension schemes in 2013.

The quantitative approach has the potential for both improving the efficiency of covenant assessment and integrating it with other pension risks, particularly investment. It therefore offers a “win-win” of greater value-added with much reduced assessment time.

Our only specific comment on this section relates to the risk management steps (paras 48-60) which we assume track the cycle represented in para 47. Presumably item d “agreeing the appropriate risk appetite” should precede rather than follow “setting the funding and investment strategy”. This would merit expansion in that section of the code.

5. *Does the revised code provide sufficient practical guidance for trustees in relation to:*
- a. *Working with employers and advisers?*
 - b. *Assessing and monitoring the covenant?*
 - c. *Assessing reasonable affordability, including understanding the impact on sustainable growth?*
 - d. *Their investment strategy?*
 - e. *Technical provisions and recovery plans?*
 - f. *Any other issues not mentioned above?*

If not, what further guidance would you find useful?

In many cases, pension trustees and sponsors have worked through the covenant assessment, valuation and recovery plan funding negotiations over a number of cycles now and the level of guidance is broadly sufficient. Para 83 is helpful in setting the overall scope.

In relation to investment risk, the draft Code suggests (para 123-4) a deterministic approach as a minimum but that for larger schemes and those with more complex investment approaches a more sophisticated approach involving additional techniques such as stochastic asset and liability modelling (ALM), tail risk assessment, scenarios and contributions at risk may be appropriate. Given the importance ascribed to covenant risk in the code, logically the same should apply to assessing covenant risk: for larger schemes and those where the interaction of risks is more complex, a more sophisticated scenario based or stochastic approach should equally be taken – and this is the inference from para 123. However, the draft Code does not make this explicit in paras 88-4 where it would also make sense to reference such approaches and we suggest this is included.

6. *What, if any, significant additional administrative cost does the revised code impose on schemes and employers?*

We are not in a position to assess the cost impact and note that the parliamentary impact assessment was equally unable to do so. However, based on our own experience, we would suggest that the flexibility inherent in the revised Code and the support given for focused and quantitative approaches could reduce overall costs somewhat by focusing resources on "value-added" assessment rather than "compliance".

Regulatory Strategy

7. *Does our strategy, focused on "protecting accrued rights to benefits through adequately funded and supported and well governed DB schemes", with risks identified and mitigated in a proportionate and balanced way, reflect the proper balance of our objectives?*

We believe so.

8. *Where risk has already crystallised, should our focus be on managing the impact of that risk to achieve the fairest and best possible outcomes in the circumstances?*

In such a situation, we would agree that this should be your focus given your statutory objectives. It would, though, be helpful for you to provide guidance as to the balance of factors and stakeholder interests which you would take into account to achieve such "fairest and best possible outcomes".

Funding policy

9. *Do you agree with our priorities for the regulation of DB scheme funding?*

Yes.

10. *Is our risk assessment approach, focusing on key areas of covenant, funding, investment and governance risks, useful? If not, what other areas of risk should we focus on?*

Yes, though we note that your limitation (in para 25) only to consider those employers with legal obligations to the scheme as part of your risk assessment approach will inevitably raise attention to the extent (if any) of parental support structures and inter-group relationships which can be more complex in large, financially or commercially integrated corporations.

11. *Is our approach to segmenting the landscape by covenant in order to tailor our policy and operational approach appropriate? If not, what would be a useful way of segmenting the landscape?*

As we understand paras 31-33, funding outcomes are to be screened by reference to covenant, broadly defined on a four "bucket" covenant strength scale. As a way of identifying where to focus attention and resources, given the cornerstone role of covenant, some form of scale is useful. Of course, with differences in methodologies and approaches, it is to be expected that trustees' and covenant advisers' assessments of covenant strength may well differ from those of TPR. That in itself is not a problem and it is made clear (Appendix B para 91) that your segmentation methodology is simply a screening tool and that the trustees or advisers may well have a different assessment of covenant - which implies a potentially different funding outcome from that taken by individual schemes.

Charts 3.1, 3.2 and 5.1 in the Draft Defined Benefit Funding Policy imply that strength of covenant has had limited effect on the level of investment risk taken or level of prudence adopted in technical provisions assumptions, whilst funding level appears to have had limited effect on the level of deficit recovery contributions relative to liabilities. This rather indicates that the quality of risk management in

pensions has been quite poor and provides a strong case for an objective methodology to allow *quantitatively* for covenant risk in setting investment and funding policy, as we do in the Gazelle Mousetrap model.

12. Is our proposed policy focus for the different covenant strengths appropriate? If not, why not?

Following on from the points made in Q11 above, trustees may reasonably have assessed that a different risk based funding outcome is appropriate from that which might be apparent to the Regulator from its high level covenant based screening. We have a concern for instance that Section 34-37 is headed "desired outcome", which may give rise to behaviour from trustees, employers and practitioners that sticks rigidly within the table in para 100 which may not in all cases be appropriate. (For instance, a strong covenant does not necessarily allow a high level of investment risk). It would be helpful for the funding policy document to make clear that trustees may reasonably come to a different view on risk from the Regulator.

13. We used a broad suite of risk indicators to assess scheme risks in the round. Is this the right approach? If not, why not?

Please see our response to Q14 below.

14. Do you think that our proposed Balanced Funding Outcome indicator is useful to:
- Measure risk in the system?
 - Inform our approach to prioritising schemes for further investigation?
 - Inform our approach to measuring our impact?

In principle we are supportive of the use by the Regulator of a broad suite of risk indicators to assess risks in the round, which should reduce the behavioural issues associated with previous narrow suite of indicators. The BFO indicator should be useful for the stated purposes. It is not entirely clear yet though how the Regulator proposes to use operate this in practice: it appears that you will segment schemes according to your 4 covenant strength buckets, apply the Balanced Funding Outcome (BFO) indicator to each covenant bucket, and then determine the extent of divergence from the BFO indicator (Appendix D para 107) and take into account the other risk indicators in para 108. The BFO appears to have characteristics of the EIOPA "holistic balance sheet" model overlaid onto one of the 4 covenant strength buckets. This approach has its merits, but that model suffers from subjectivity and it does not address constrained affordability (as recognised in para 41). Gazelle's Mousetrap model does address these and also specifically the sustainable growth objective; and we endorse the quantified approach to assessing risk now being pursued by the Regulator. Clearly the specific design of the BFO indicator will be critical and we look forward to the further consultation on this.

15. Our priority for targeting our resources where we can have the greatest impact takes account of the level of risk, including scheme size. A greater proportion of our interventions will, therefore, be in larger schemes, with smaller schemes generally being regulated through education and other targeted approaches such as portfolio reviews.
- Is it right that our risk bar for intervention takes account of the level of risk posed by schemes and their size?

Size of liabilities bears no inherent relation to level of risk - there are of course strong sponsors supporting large schemes which present little risk to the PPF - but it is quite reasonable to expect the Regulator to be concerned with identified BFO risk "shortfall" where the liabilities are large, given the other factors in para 50 – impact of intervention and resources available to you.

- Is education the most effective and proportionate way of regulating across a diverse landscape?

Realistically, many schemes with small liabilities are currently either unable or unwilling to carry out resource-intensive covenant and funding risk assessment. While education is clearly a worthwhile way of regulating, we are not in a position to know the extent to which education is the most effective way of reaching this universe of schemes.

16. Is proactive engagement an effective way of engaging with schemes and targeting our resources in order to achieve balanced outcomes?

Proactive engagement from the Regulator can be an effective way of engaging with schemes, but has hitherto often been inconsistent and unclear in its approach, in its objectives and in implementation.

17. Is our regulatory approach to measuring the impact of our regulatory approach appropriate? If not, do you have any suggestions? We are particularly interested in your views on how we should be measuring success against our new objective on sustainable growth.

Yes.

Any additional comments

18. Are the documents structured and drafted in a way that makes it easy for you to understand the key messages and issues? How could they be improved?

No comments.

19. Are there any other comments which you would like to make on the proposals contained in these consultation documents?

We would raise two related aspects of the current framework which the consultation has not openly addressed: the appropriate level of investment risk for a given level of covenant strength and the reliance which schemes should place on the PPF.

Should covenant strength be used to take more investment risk or to de-risk? This is left to individual schemes to decide according to their individual circumstances and different schemes seem to end up in very different places. We are preparing a paper on this specific topic which we will submit to the Regulator separately in due course.

Should covenant weakness lead schemes to de-risk to the greatest extent affordable, or to them carrying a level of risk which could potentially put the scheme into the PPF? We would draw attention to the statement in Code s76 that trustees should not take into account the potential for the PPF to provide compensation to the scheme. This has been a long-standing position adopted by the Regulator and we appreciate that given the Regulator's existing statutory objective to "to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund (PPF)", this was necessary in the early years of the PPF. Now that the PPF is well-established and has a target of self-sufficiency by 2030 however, the question arises whether it might not be more appropriate for the PPF to be taken into account by schemes to justify higher levels of investment risk in the expectation of higher levels of investment return, resulting in higher overall levels of funding across the sector and hence resulting potentially in lower demands on the PPF. This would be consistent with the way in which a board of trustees, would regard it as appropriate to take into account any other contingent asset, to support a higher risk investment strategy.

Yours sincerely

A handwritten signature in black ink that reads "Donald Fleming". The signature is written in a cursive style with a large, sweeping initial 'D'.

Donald Fleming
Managing Director
Gazelle Pensions Advisory