

Review of pensions institutions

Memorandum by the Pensions Regulator

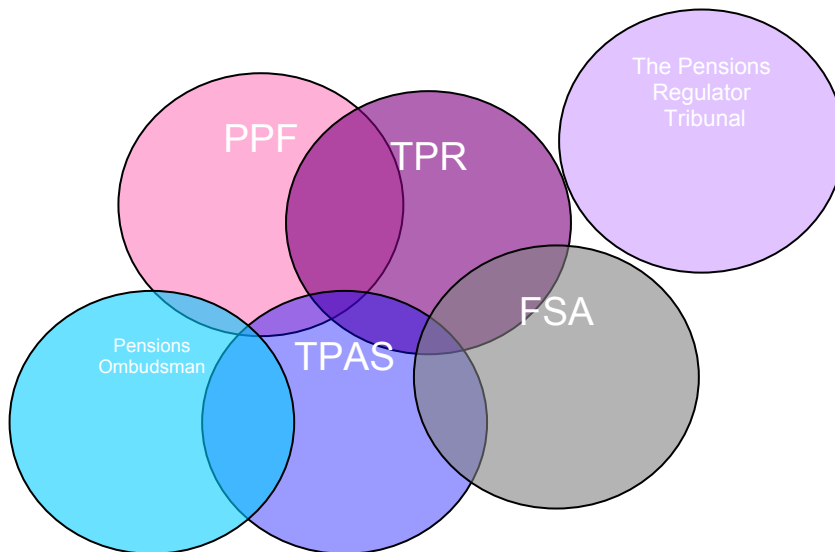
1. *The Pensions Regulator: functions and achievements*

The Pensions Regulator is the regulator of work-based pensions. Since our establishment in April 2005 our key achievements have been:

- scheme funding framework defined, established and implemented. We expect 3,000 recovery plans in the next year;
- clearance process for corporate transactions established and implemented. We received 250 applications last year;
- to have consulted on regulatory priorities for DC schemes; and we will do likewise shortly on the governance of pension schemes;
- issuing 10 codes of practice giving practical guidance to trustees and others;
- on-line learning for trustees via the ‘trustee toolkit’;
- a regulatory approach which is proactive, risk-based and flexible. For example, we have consulted on the regulatory implications of new developments in the management of risk in relation to pension schemes, such as the ‘abandonment’ of schemes by employers;
- building a credible organisation quickly: there are high levels of awareness and trust of the regulator among those we regulate.

2. *What are the other institutions with which the Pensions Regulator (TPR) interacts?*

The diagram below shows those other bodies in the pensions institutions review with which we interact.



Our greatest interactions are with the Pension Protection Fund (PPF) and the Financial Services Authority (FSA).

3. *Future developments*

The options for change we recommend below have regard to future developments. Two which we highlight in particular are personal accounts and the possible extension of the EU's solvency II framework from insurance to occupational pensions.

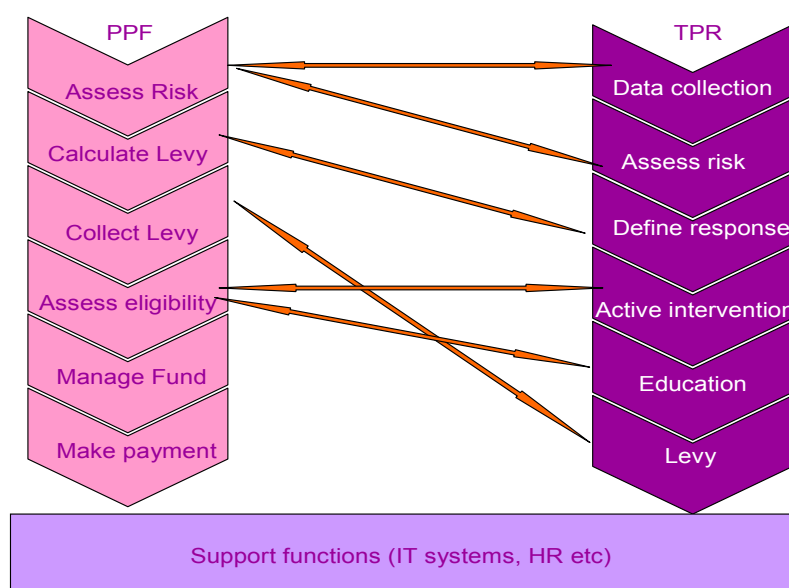
4. *The PPF*

TPR has a statutory objective to avoid the risk of situations which may lead to calls on the PPF. That creates many interactions with the PPF, particularly in relation to funding of DB schemes and clearance of corporate transactions.

Among the areas of overlap are:

- **Analysis of data.** Both organisations currently undertake risk analysis of data but with different approaches reflecting different objectives. Both use a mix of data obtained by TPR and PPF.
- **Insolvency.** Both organisations assess the risk of employer insolvency.
- **Strategy development.** Both organisations aim to reduce the extent of funding risk in the DB pensions universe in order to meet their objectives, albeit focusing on different tools.
- **Risk of entry to the PPF.** The PPF can ask TPR to use its powers where it perceives that there is a risk of entry to the PPF. TPR takes its own view of the perceived risk in determining whether to use its powers.
- **Levy.** Both organisations impose separate levies with PPF making some use of TPR for this purpose.
- **Support functions.** IT systems, HR, finance and others.

Supply chain crossovers and links



What is the quality of TPR's interactions with the PPF?

Relationships with the PPF are generally good. There has been a lot of successful cooperation, for example appointments by TPR of trustees when a scheme is entering the PPF assessment period. The Purple Book (an analysis of DB schemes in the UK) was a successful joint production between the two organisations.

But there are areas where tensions between the organisations' objectives and operations have impacted adversely on interactions between them.

Structural issues

There may be circumstances where to reflect different objectives in separate organisations would result in a more explicit and better balanced result. This is not the case here.

The regulator has protection of the PPF as one of its key objectives so such separation does not exist even in principle. Moreover the existence of two organisations makes it difficult for either body to consider all the risks facing pension schemes and their members. Tensions arise between TPR's wider objective of protecting the benefits of scheme members and the PPF's focus on reducing risks to the amount of compensation that it pays. Where those tensions exist, the fact that there are two organisations in place can act to institutionalise differences of view rather than create an incentive to resolve them. There have not yet been any key issues that fall into this category, but we believe that is in spite of rather than because of the existence of two organisations.

One determinant of TPR's interventions is whether it can make a material difference to the outcome. This approach has led to concern within the PPF that insufficient attention is paid to schemes with the highest risk of entering the PPF. In addition, TPR pays less attention than the PPF might wish on issues not directly related to funding levels but which do impact on PPF risks, such as investment volatility. Concerns by both organisations have been raised over whether PPF levies are being used optimally to drive behaviours in respect of scheme funding, and vice versa.

The existence of two organisations, and the consequent 'tripartite' stewardship arrangements, also affects the way in which the government is able to meet its objectives. Because there is no single organisation accountable for overall strategic priorities or for balancing government objectives in relation to pension protection, stewardship by DWP is made more complex.

Operational issues

Some difficulties have arisen at operational level. There are concerns in TPR about how thinly PPF resources are spread on corporate transactions and that this has led to inconsistent approaches to schemes at risk of entering the PPF.

There are also concerns that both organisations' customers face duplication, at a time (insolvency or a corporate transaction) when pressures are already intense. For example, during clearance transactions there are separate negotiators for TPR and the PPF. There have also been occasions when the same information has had to be provided twice in different ways in order to meet each organisation's requirements. This is consistent with one of the Hampton Report's criticisms that "There are too many interfaces between businesses and regulators."¹

TPR and PPF: options for change

The functions of TPR and PPF could be combined into a single body.

Disadvantages

There are benefits to having two organisations. Each can develop expertise. TPR staff can focus on regulatory issues without for example developing the systems required to make payments to members from the PPF.

Nor does the number of organisations remove the need for the choice to be made on occasions between entry to the compensation fund or other steps as the best means of protecting members' benefits.

There would be transitional costs to combining functions. Management time would need to be devoted to merger issues, which might coincide with other significant challenges such as an increase in activity due to the introduction of personal accounts. Management time is however more likely to be available than previously since each organisation is firmly established after two years of operation.

New legislation would be required (the objectives of an organisation with merged functions would have to be changed from TPR's current ones). Having said that, a decision to merge functions would, in practice, be at least two years from actual merger. Moreover, the case for taking the decision to merge now is strengthened because the only firm opportunity for legislation arises in the next parliamentary session.

There might be a conflict of interest within a single organisation between its regulatory role and its asset management role. We consider this unlikely: the asset management role is not running a pension scheme so the regulatory function would not be making decisions which impacted on itself. Nevertheless the continued separation of the asset management role which the PPF already adopts might be desirable within a merged organisation.

Advantages

The nature of work-based pensions means member confidence is vital. Securing confidence requires awareness of all the risks facing members, employers and schemes and striking the right balance between them, for example between improving security for members and maintaining affordability for employers.

¹ Hampton Report - page 4, para 7, last bullet.

Our view is that securing member confidence via two separate organisations is not optimal. There are overlaps between the organisations and some difficulties on operational matters. A single organisation would be better placed to focus on the needs of members, employers and schemes. The benefits of a single organisation would be:

- a structure which would enable all the risks to pension schemes and their members to be considered rather than specific consideration of risk to the compensation fund;
- clearer responsibility for managing the trade-offs between objectives. Currently entry of pension schemes to the PPF has relatively few consequences for TPR: it is the PPF which makes the payments and raises the levy to finance them. A single organisation would itself have to raise the levy to finance the cost of those schemes which enter the compensation fund. It would therefore have more immediate incentives to consider any alternatives to this option;
- better communication of the approach to regulation and compensation;
- a single point of contact for those affected by pension regulation and compensation issues;
- levies and other requirements would come from a single body which would increase the chances of them being imposed in a coherent fashion;
- clearer accountability to government for who was responsible for mitigating risks to work-based pensions; and to customers over for example the size and distribution of the risk-based levy in relation to overall objectives for scheme funding;
- easier stewardship for central government.

A further advantage would be cost savings at a time when financial pressures on schemes and their sponsors are intense. In our view it would be possible to merge nearly all of the functions of the two organisations. These include the board and its support, levy collection, data collection and analysis, staff working on corporate transactions and scheme funding, communications, IT, HR, finance, research, strategy and policy, customer support, and facilities. Many systems and processes could be scaled to accommodate the other organisation's functions. Co-location could offer further savings.

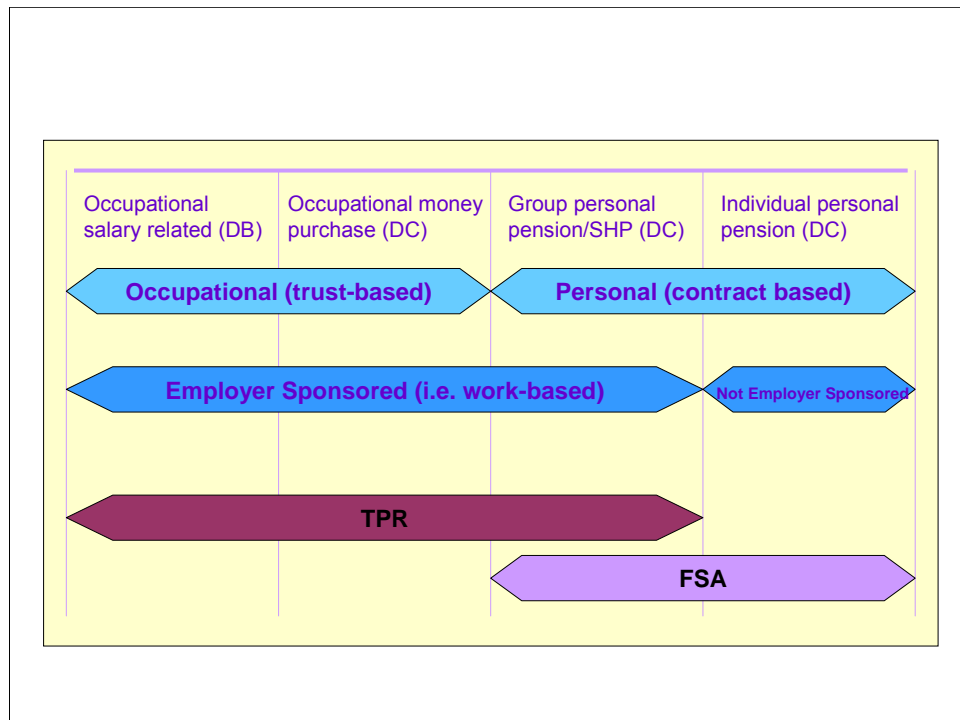
Finally, two organisations are in our view very vulnerable to the point made by Hampton: "It is more difficult and more expensive to have a comprehensive risk assessment system if data is split across several regulators with similar areas of responsibility. In such circumstances, a holistic view of business risk becomes difficult, if not impossible. Small

regulators are also more expensive. Regulators with fewer than 200 staff are on average more than £8,000 per staff member more expensive than regulators with more than 200 staff members.”²

In conclusion, our recommendation is the merger of the functions of TPR and the PPF.

5. The FSA

The diagram below shows TPR’s and FSA’s responsibilities with respect to private sector pensions.



Personal pensions which are arranged through the workplace is the most significant area of overlap³.

On the other hand each regulator’s approach is very different, reflecting its objectives and powers. To take just one example, the FSA requires authorisation of firms which wish to carry out the activities it regulates; TPR has no equivalent power.

Relations between TPR and FSA are set out in a Memorandum of Understanding agreed in April 2005 and reviewed in 2006. TPR regards the relationship as strongly co-operative with both regulators working together well on issues such as pensions liberation. There is also co-operation at the international level: both regulators represent the UK at the Committee of European Insurance and Occupational Pensions Supervisors.

² Hampton Report - page 6, para 20.

³ There is also some overlap on stakeholder pensions generally.

Notwithstanding the area of regulatory overlap, the different approaches to regulation mean that duplication of activity does not in practice occur.

TPR and FSA: options for change

Options include allocating sole regulatory responsibility for work-based personal pensions to one regulator or the other. It is also possible to envisage either regulator taking on new responsibilities beyond the overlap e.g. the FSA to become responsible for the regulation of all DC pensions or TPR responsible for all personal pensions. It is even possible to conceive of FSA regulation of all work-based pensions.

Advantages of change

The principal advantage to removing the area of regulatory overlap would be greater clarity on who regulates what.

The future development of personal accounts might also strengthen the case for redrawing the boundary between the two organisations. Presently, the number of members of occupational DC and work-based personal schemes is similar. The potential membership of personal accounts means however that in the medium term i.e. after 2012 the number of members of occupational pensions could be far greater (see table below). In that environment it may not be optimal for TPR to maintain resources and expertise on contract-based schemes if it is the regulator of all occupational pensions including personal accounts.

Work-based DC pension landscape

	Live occupational DC	Live personal (work-based personal pensions and stakeholder pensions)
<i>Existing position</i>		
Number of employers ⁴	75,000	140,000
Number of schemes	72,000 ⁵	134,000 ⁶
Number of members	2,700,000²	2,580,000³
<i>After introduction of Personal Accounts⁷</i>		
Number of employers	1,060,000	140,000
Number of schemes	72,000 ⁸	134,000
Number of members⁹	10,925,000¹⁰	2,805,000

⁴ Number of employers are estimated figures slightly higher than the number of schemes on the basis that a proportion of schemes have more than one participating employer.

⁵ Based on Opra registry data, March 2005. This probably understates the number of members of DC schemes.

⁶ Extrapolated from data provided by seven of the top ten providers of personal pensions, August 2006.

⁷ The figures assume that all existing schemes are unchanged after Personal Accounts are introduced.

⁸ As Personal Accounts is expected to constitute a single occupational scheme the approximate number of occupational schemes does not change.

⁹ We use the middle figure (8 million) in the 6 to 10 million range of new members of Personal Accounts estimated by DWP.

Disadvantages

The clarity achieved by moving the current regulatory boundary would be likely to lead to different areas of uncertainty about the new boundary. For example, if the FSA had sole responsibility for regulation of all personal pensions, an employer which offered both a group personal pension and a trust-based DB scheme would be regulated by the FSA in respect of the former and TPR in respect of the latter.

Moving the boundary might also prove difficult to reconcile with each regulator's different approaches and powers.

Finally, complete merger would make it harder to justify distinct approaches to the regulation of insurance and work-based pensions. That would undermine the UK's approach to regulation at the European level where we support different regulatory frameworks for occupational pensions and insurance, reflecting the different nature of these activities, particularly in the context of the possibility of extending the solvency II framework.

In conclusion, there are overlaps between TPR and the FSA, particularly in respect of DC schemes. Nevertheless, it remains appropriate to define TPR's scope of regulation as pensions which are arranged through the workplace. The role of the employer in particular is more suited to TPR's regulatory approach. Our recommendation is therefore the status quo. This depends however on the future development of personal accounts.

6. *The Pensions Advisory Service/Pensions Ombudsman/Pensions Regulator Tribunal*

Communications with these organisations are fairly infrequent. There is some: for instance TPAS influenced the decision to issue TPR guidance (in January 2007) on inducements and provided comments. Nevertheless, TPR's customer support team estimate that only one per cent of the 2,500 pension enquiries which they receive each month are passed on to TPAS. Only two cases have been referred to the Pensions Regulator Tribunal (with a third pending).

TPAS: options for change

An option would be to merge the functions of TPAS with TPR.

Advantages

There would be advantage for some members in having a single point of contact for advice and regulatory issues. The criticism made by Hampton of too many interfaces between business and regulation is also relevant here.

Merger would improve TPR's knowledge of member concerns. It would moreover facilitate feedback between member concerns and regulatory

¹⁰ DWP estimate that approximately 664,000 employees not currently in existing schemes (including DB) could join their employer's exempt scheme. It is assumed that of these approximately $\frac{2}{3}$ rds (450,000) are DC. We have assumed that this is split evenly between occupational and contract-based.

priorities. Both these could enable TPR to be more proactive and wide-ranging in its relationships with members and trustees, for example communications on issues such as scheme governance or e-learning could reach a wider audience using TPAS's channels of communication.

Finally, there would be cost savings from merging infrastructures.

Disadvantages

Advising members is often not the same as regulation. Issues which affect individual members may not require regulatory attention. This is particularly so for a risk-based regulator.

The voluntary basis for provision of TPAS advice would have to be reconciled with becoming part of a larger paid organisation.

In conclusion, we see arguments for the merger of functions as well as for the status quo.

Pensions Ombudsman/Pensions Regulator Tribunal: options for change

The procedures by which the ombudsman adjudicates disputes are very different from how TPR uses its powers. Even within a single body it would be hard to envisage how these functions could be merged.

The Tribunal is an independent body to which TPR's determinations can be referred. On that basis we cannot conceive it as possible to merge any functions.

In both cases we recommend the status quo.