National Audit Office

The Pensions Regulator: Progress in establishing its new regulatory approach

LONDON: The Stationery Office
£13.90

Ordered by the
House of Commons
to be printed on 23 October 2007

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 1035 Session 2006-2007 | 26 October 2007

SUMMARY

1 Some 20 million people in England and Wales have private sector work-based pension schemes. The Pensions Regulator (TPR) was established on 6 April 2005 to regulate these schemes, of which there are some 84,000.[1] TPR's statutory objectives are to protect members' benefits, promote improved governance of such schemes, and to reduce the risk of compensation being paid out by the Pension Protection Fund (PPF).[2] TPR is not responsible for regulating whether individuals are making adequate provision for their retirement. The Department for Work and Pensions is responsible for pensions policy while the Financial Services Authority is responsible for regulating the sale of financial products and for promoting public understanding of financial services and products.

2 TPR replaced Opra[3], on which the National Audit Office (NAO) and the Public Accounts Committee (PAC) published reports in 2002 and 2003.[4] These reports found that the regulatory arrangements at that time addressed only some of the risks to pensions provision, and Opra had not focused on the greatest risks to pension scheme members.

3 This report evaluates the progress of TPR in establishing its new regulatory approach. Since TPR has been in existence for only two years it is too early to conclude on its impact on long term pensions issues. This report therefore focuses on evaluating whether TPR has put in place appropriate processes to meet its statutory objectives in a risk-based manner and whether deficiencies in Opra's approach have been remedied.

Overall conclusion

4 The issues facing pensions are long term but subject to a great deal of ongoing short term volatility. For example, movements in the stock market on a single day in February 2007 added some £11 billion to the value of pension scheme deficits taking the total deficit to some £35 billion.[5] Drawing conclusions on the effectiveness of pensions regulation must therefore be set in the long term context rather than based on shorter term fluctuations. Our conclusion is based on the regulatory approach that TPR has taken and whether this addresses the key risks.

5 We found that TPR has made good progress in establishing a risk-based approach to regulation. It has focused on those areas that currently appear to present the greatest systematic risks to pension scheme members and the Pension Protection Fund (PPF). This stands in contrast to Opra, which had not distinguished adequately between trivial and high risks. TPR has also developed an appropriate regulatory approach which focuses on influencing those actors who make decisions on pensions such as scheme trustees and professional advisers. As TPR matures, it has the scope for a presumption of further transparency in its approach, and is taking steps to increase the information it makes available to the pensions sector. TPR initially focused on final salary pension schemes, where it has had to implement two substantial new areas of regulation, but during 2007 it also clarified its intended approach to money purchase schemes.[6] Money purchase schemes present very different risks to members and many have very different governance arrangements to final salary schemes. Since employers are increasingly shifting provision from final salary to money purchase schemes this will be an important and challenging area for TPR in the future.

Detailed findings

- **The Pensions Regulator's statutory objectives provide a sound framework for pension regulation and it has established clear links between these objectives and its operational approach.** The 2002 NAO and 2003 PAC reports found that a lack of clear objectives had prevented Opra from articulating how it would protect pension scheme members. TPR was given four broad strategic objectives by the Pensions Act 2004 which it interpreted in the context of the prevailing risks in the pensions environment. Seventy eight per cent of TPR's stakeholders believe that risks to members would increase in TPR's absence.[7]

- **TPR has a broader range of powers than the previous regulator.** The 2002 NAO and 2003 PAC reports found that Opra had inadequate powers, for example in terms of enforcing compliance or gathering information. TPR has been granted additional powers to remedy these inadequacies. Seventy three per cent of TPR's key stakeholders consider that TPR has adequate powers[8] although some of the key new enforcement powers remain untested.

- **TPR has developed a risk-based approach to focus its activities.** In its 2003 report the PAC found that Opra had not taken a risk-based approach to regulation and had therefore failed to protect members from the greatest risks. TPR has set itself up to take a risk-based approach. It has processes in place to identify and assess generic pension risks and to categorise individual schemes to reflect this assessment. It has also implemented a range of IT systems to enable more sophisticated risk analysis. In future, TPR is planning improvements in its systems that will allow it to test and refine further the approach.

- **TPR draws on a wider range of data than the previous regulator and has refined its approach to data collection; data quality and completeness remains a priority.** TPR inherited unreliable and incomplete data from Opra. In conjunction with the Pension Protection Fund (PPF), TPR is gradually cleansing this data and has created a return to be filled in by all schemes. This return is web-based and has built in checks to help ensure data credibility. TPR now has data on 99 per cent of final salary schemes and 32 per cent of money purchase schemes by membership. It is currently collecting scheme data for the remaining money purchase schemes and expects by March 2008 to have requested all such schemes to complete a return.

- **The quality of governance of pension schemes varies widely and TPR is working to improve standards.** To meet its statutory objectives TPR must rely on good governance by those individuals, both lay and professional, who govern pension schemes, in particular trustees. Opra and TPR research shows that there is a strong link between trustee knowledge and understanding and good governance. TPR has several activities aimed at improving governance, ranging from codes of practice to guidance and an e-learning toolkit for trustees. Stakeholders we spoke to commented that the Trustee toolkit in particular is an innovative approach to raising governance standards and by September 2007 there were some 20,000 registered users. Seventy eight per cent of TPR's key stakeholders consider that TPR is a trusted source of information.
- **TPR cannot have close direct contact with all 84,000 pension schemes and therefore must influence behaviour indirectly by signalling to the market its expectations.** To do this effectively a regulator should have a presumption towards transparency in its regulatory expectations and decisions. TPR has developed a range of approaches to communicate its expectations and provides much information on its regulatory approach, for example through codes of practice, guidance and statements of regulatory approach. Historically TPR has not routinely published its findings and determinations. This is because it is required by statute to ensure that funding is scheme specific and it is concerned that publishing this information will encourage all schemes to adopt similar funding approaches. As of September 2007 TPR has adopted a presumption towards publishing its future determinations and it is keeping its policy on case examples under review. TPR also does not publish case examples where it considers that the case may set misleading precedents or where there are commercial confidentiality issues.
- **TPR initially focused on final salary schemes and governance issues where the need for action was most urgent and the risks to members greatest.** TPR's focus on final salary schemes was due to two major new regulatory requirements of the Pensions Act 2004, and the pressing need to secure appropriate funding levels for schemes covering some 14 million members. Recent third party research and the initial scheme valuations provided to TPR[9] indicate that most companies are planning to reduce deficits over shorter timescales than previously, are giving attention to their obligations to support schemes, and are setting higher levels of funding. At the same time TPR has given priority to legislative requirements regarding scheme governance such as issuing codes of practice.
- **TPR's approach to money purchase schemes initially had a lower priority.** This lower priority reflects the smaller membership of these schemes, at some 5.5 million members, the absence of major legislative change, the different nature of the risks and the longer timescale available to tackle them. TPR research from 2006 shows that TPR generally had a lower profile with money purchase than final salary schemes and that governance standards were lower in money purchase than for equivalent sized final salary schemes. Following its consultation document of November 2006 TPR clarified its approach in April 2007, which focuses on raising awareness of its role and giving greater focus to smaller schemes. In money purchase schemes, it is important that individual members understand the risks they face and the need to ensure they are making adequate arrangements for their retirement. However, TPR has no formal role in the financial education of individuals. The Financial Services Authority (FSA) leads the national strategy for financial capability which aims to improve the public awareness and understanding of the financial system, including public understanding of pensions.

Recommendations

6 TPR has made good progress in establishing its regulatory approach. Risks in the pensions environment can change quickly and the following recommendations are framed with this in mind.

a The impact and nature of the long term risks to pensions will change over time. For example, if TPR is successful in reducing or eradicating pensions deficits this risk, which is high at the moment, will diminish. One of the key shortcomings of the former regulator was its inability to respond appropriately to the emergence of new risks. TPR has built a framework that has demonstrated flexibility in responding to the risks identified and to new risks emerging. In order to remain effective it must ensure that it retains this flexibility into the future, for example by setting up new specialist business units or changing its organisational design as appropriate.

b One of the key risks to money purchase schemes is a lack of member understanding. In order to regulate these schemes TPR has built a relationship with the Financial Services Authority (FSA) as the responsibility for improving the public awareness and understanding of the financial system, including their understanding of pensions, rests with the FSA. TPR should build on this relationship to ensure that it inputs at the appropriate time into the FSA's development of strategic priorities for financial capability work.

c It is best practice for a regulator to be transparent in its decision-making so that the regulated entities are clear on the regulator's expectations. TPR provides information on its regulatory approach, for example in codes of practice, guidance, and regulatory statements, and does now have a presumption towards publishing its determinations. It does not publish the outcomes or reasoning for its decisions in relation to specific individual cases unless they are subject to formal determination. This is because funding levels are required to be scheme specific and it does not want to publish information which may be perceived to set a target, discourage schemes from approaching the regulator, or is commercially sensitive. As the market matures TPR should have a presumption towards greater transparency with a view to publishing more individual cases.

d TPR has greatly improved the quality of its regulatory data, particularly in relation to final salary schemes. The compendium report of final salary scheme data produced with the PPF[10], and the report on the first 1,300 recovery plans[11] are examples of this. As the regulator collects more data on money purchase schemes it should look to publish a similar body of evidence.