An tÚdarás Pinsean
The Pensions Authority

Defined benefit engagement programme findings report

Introduction

The Pensions Authority recently met with the trustee boards of a number of large defined benefit (DB) pension schemes as part of its 2020 engagement programme. The engagement forms part of the Authority's move to a risk based and forward-looking approach to supervision.

The aim of the engagement was to examine the trustee board's governance practices, particularly in relation to the management of scheme risks. In addition, the Authority was keen to examine how well schemes were equipped to meet the enhanced governance and risk management requirements soon to be transposed into law under the IORP II Directive (the **Directive**).

The purpose of this report is to share observations on the key findings identified during the engagement process. While the details of the findings set out are not exhaustive, the Authority expects all trustee boards and their advisers to fully consider these findings and evaluate their own practices to establish if any improvements are required.

Please note that any future supervisory engagements carried out by the Authority will have regard to the considerations given by trustee boards to the matters raised in this report.

Overview

As would be expected of the cohort of large schemes engaged with, many of the trustee boards were able to demonstrate robust governance, management and oversight arrangements, and resourcing and operational structures focused on delivering good member outcomes.

Examples of arrangements that were in line with the expectations of the Authority for schemes generally, irrespective of size, included:

- Trustee boards that included dedicated, informed and earnest trustees of sufficient quality and combined expertise;
- Clear written policies on governance, conflicts of interest, internal controls, data protection etc., albeit with some falling short of the full requirements set out under the Directive. Some initial gap analysis in that respect was also evident;
- A disciplined approach to risk management, which reflected considerations of the employer covenant, the investment strategy and funding;

- Long term self-sufficiency targets on a prudent ongoing valuation basis and some within a specified timeframe;
- Regular engagements with the employer on covenant, funding and investment matters;
- An investment de-risking plan; and,
- Key performance indicators in place with service providers together with regular reporting against these KPIs.

However, in a number of cases, the Authority was concerned at the level of incompleteness of risks identified, poor identification of controls, failure to implement controls, and a general lack of risk awareness.

Risk governance practices that were found lacking included:

- A lack of an active engagement policy with their employer sponsor by some trustee boards and a general lack of consideration of the consequences of employer risk;
- Weaknesses in the oversight and management of third-party service providers including failure to put in place appropriate contractual arrangements supported by service level agreements (SLAs);
- The management of the conflict between the employer and the trustee board. In some instances, it appeared that the trustee board was merely ratifying the employer's preference with their own decision making rather than making their own independent decision;
- A lack of independence of mind and challenge by trustee boards to their advisers; and,
- No evidence that trustee boards assessed the readability or the level of understanding of their member communication material.

1. Risk identification / mitigation

Most trustee boards were able to evidence the establishment of a risk register, some of which were reasonably comprehensive. Risk registers are an important source of information, but they must be used as a dynamic tool to drive action: specifically, action around mitigation of the identified risks. It is important that the mere establishment of such a register does not provide a false sense of security.

The better risk frameworks demonstrated a holistic, integrated approach to risk management. Risk registers need to be reviewed using sources of information such as experiences of service contracts, complaints, and administration reports to help to keep information updated and relevant.

In summary trustee boards should be constantly risk-aware and actively look at ways to mitigate their schemes' risks.

2. Employer covenant

For many schemes, the greatest determinant of risk capacity is the strength or otherwise of the employer covenant. The issue of employer covenant was identified as a key concern by the majority of trustee boards. Many trustee boards had an active engagement policy with their employer sponsor, but this was not evident in all cases. A sound understanding of the employer's ability to support the scheme should inform investment and funding decisions.

The Authority views the lack of an active engagement policy or a general lack of consideration to the consequences of employer risk as a key weakness in the management of a DB pension scheme.

3. Management of outsourced services

The use of third-party service providers in areas such as administration, investment management and custodianship, is an accepted practice in the management and operation of pension schemes. However, the Authority saw deficiencies in trustee board awareness and understanding of their responsibility for the management of the resultant risks. In particular, weaknesses were identified in relation to the governance and risk management controls and processes in place.

Key weaknesses include:

- Failure to put in place appropriate contractual arrangements supported by SLAs and key performance indicators;

- Failure to conduct and/or refresh periodically, appropriate due diligence, both financial and operational, in respect of third-party providers;

- Failure to seek and assess evidence of business continuity arrangements; and,

- Failure to devise, document and test effective 'exit strategies' or repatriation contingency plans.

Trustee boards are accountable for all activities undertaken by third-party service providers. Trustee boards must ensure the security and resilience of a scheme's data and services. While the outsourcing of activities or services may be a necessity, the responsibility, including that of managing the resulting risks, remains with the trustees. It was not always evident that trustees carried out regular reviews and assessments of how well service providers were performing, which is an essential element of managing risks connected to the employment of third-party service providers.

4. Conflicts of interest

All trustee boards confirmed that they had a conflicts of interest register and they regularly reviewed any potential conflicts during meetings. However, it was clear that in many cases the trustee board had failed to appreciate the potential conflicts in the use of service providers connected to the employer or in relation to the relationship between the employer and /or service providers and individual trustees.

More importantly, the management of the conflict between the priorities of the employer and the trustee board was not always apparent.

5. Independence / challenge

Good governance is not just about compliance; it is also about implementing and demonstrating good behaviours and practices to ensure good member outcomes. Evidence of good governance will be found in the records of trustee discussions which show consideration of all appropriate issues and all trustees actively taking part in decision making and discussion.

In some cases, it was clear to the Authority that there was insufficient independence of thought process or challenge by trustees; in fact, on questioning some trustees, it appeared to the Authority that the trustee board was being led or influenced without challenge by advisers and third-party service providers. In other cases, the addition of a professional trustee to the trustee board was clearly helpful in providing direction and guidance. However, it was noted that on occasion, the presence of a professional trustee could create a sense of disenfranchisement for the non-professional trustee members, and trustee chairs should ensure that all trustee views are considered and evidence of such recorded.

Pension schemes are complex financial arrangements. The Authority supports the non-professional trustee role and is keen to ensure that they demonstrate an independence of mind and challenge to professional advisers. Regular trustee training is a requirement, and trustee chairs should consider whether such training should incorporate behavioural elements as well as technical knowledge.

6. Member communication

The objective of the work of the trustee board is to deliver the member benefits set out in the scheme rules. It is important that members are kept advised on progress in delivering these benefits and this is mainly achieved through the regular member communication materials which are required under regulation. However, there was very little evidence that trustee boards assessed how comprehensive or readable their member communication material is.

In many cases, member communication appeared to be simply at the level and frequency prescribed in regulation. DB pension scheme members need to understand not only the pension benefit they can expect to receive at retirement, but also how secure their benefits are. Explaining actuarial valuations and scheme funding in a clear, straightforward way can be a challenge for scheme trustees.

It was apparent to the Authority from the engagement that trustee boards should consider how they might improve member communication by providing additional detail and explanation of the issues facing the scheme and the risks thus created for benefit outcomes.

Conclusion

The matters raised in this report should not be taken as exhaustive but rather as an overview of the main issues identified during the recent engagement programme. The Authority expects all trustee boards, and their advisers, to fully consider these findings and evaluate their own practices to establish if any improvements are required.

In the future, trustee boards will be asked to prepare and examine a much wider range of financial and actuarial data than they do at present. They should focus on what might happen in the future; not just on what has happened to date. To achieve this, many trustee boards will need to improve their understanding in the areas of risk quantification, risk management, risk interdependencies and scenario planning tools.

The Authority will continue to actively engage with the trustees of DB schemes. In addition to the issues referenced in this report, the Appendix outlines a sample of the potential information that the Authority is likely to request when carrying out such future engagements.

As set out in the information notice to trustees of DB schemes published by the Authority on 7 October 2020 [Important information for trustees of defined benefit schemes], the level of supervisory attention given by the Authority to a DB scheme will depend on the likelihood of the scheme meeting the benefit obligations set out in the scheme rules. Schemes will be categorised on this basis and we are currently working on the criteria to underpin this categorisation. Schemes will be notified in due course of which category they have been assigned to. The Authority will not be engaging with schemes to discuss their classification in advance.

Appendix

Information likely to be sought by the Pensions Authority as part of future engagement with the trustee boards of DB schemes:

- A description of the risk management system in place to identify, measure, monitor, manage and report on the risks to which the scheme and member benefits could be exposed;
- Any process to assess the likelihood and extent of reliance on the sponsoring employer and the form and regularity of any related discussions with the sponsoring employer;
- Any separate legal agreements outside the scheme rules (e.g. funding agreements, contingent assets etc.) that the trustee board considers provides an increased level of assurance on the sponsor covenant;
- Any process followed for developing, reviewing and approving the statement of investment policy principles (SIPP);
- Any future intended de-risking of the scheme's assets, including any related detail on the criteria for the intended de-risking;
- How the trustee board monitors the investment performance and other objectives for the scheme's assets;
- Any interaction and input the trustee board has with the Scheme Actuary in the actuarial valuation process for funding valuations e.g. assumptions, discount rate, amortisation period, recommended contributions etc;
- How the trustee board satisfies itself that the valuation of the liabilities and the recommended contributions in an actuarial valuation for funding purposes reflect an appropriate level of prudence, taking account of the potential variability of future experience outcomes;
- How the trustee board considers the particular risks for active and deferred pensioner members as arising from the lower settlement priority in the event of a scheme wind up;
- How the trustee board integrates the risk considerations of sponsor covenant, investment strategy, funding, and the variability of potential experience outcomes into their risk management of the scheme;
- How the trustee board assesses its risk tolerance and how this is factored into their risk management of the scheme;
- The extent that any risk related assessments carried out to aid decision making by the trustee board are quantitative or qualitative assessments and whether any stochastic modelling or sensitivity analyses are undertaken;

- Information on any risk management or risk reducing measures that have been or are being implemented by the trustee board i.e. through investment strategy, liability management, insurance or by any other means; and,

- The process, method and regularity by which the trustee board and sponsoring employer engage to ensure an aligned understanding of the sponsor covenant, investment strategy, funding requirements and the risks for the scheme.