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Pensions briefing

TPR's new guidance on setting and monitoring investment strategies for defined benefits

Briefing

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Introduction

The Pensions Regulator (TPR) published new investment guidance, 'Investment guidance for trustees and advisers running schemes that offer defined benefits', on March 30, 2017.

It is aimed at trustees who run schemes which offer defined benefits, their advisers and the sponsoring employers of such schemes. It should be noted that TPR is increasingly taking a broader approach to encouraging good pension scheme governance. With its '21st Century Trusteeship' initiative being aimed at improving the standards of governance across all occupational pension schemes, both defined benefit (DB) and defined contribution (DC), TPR has indicated that it intends to consolidate the current governance regime into key overarching pieces of guidance to cover the principles or issues common to all pension schemes.

In the current guidance, TPR sets out practical information and examples of approaches trustees could take in formulating their investment strategy, along with factors for them to consider when investing scheme assets for DB funding purposes.

In addition, TPR has helpfully provided a five-page summary of the guidance, which is a good starting point, and which sets out the principal points for DB trustees to consider.

View the full guidance.

The aim and structure of the guidance

According to TPR, the guidance aims '*to provide [trustees] with practical information, examples of approaches [they] could take and factors to consider when investing scheme assets to fund defined benefits. Often the methods and approaches [trustees] choose to adopt will depend on the nature of [their] scheme*'.

As in some previous publications, TPR has used phrases such as 'you need to' or 'you should' to indicate to trustees which approaches it views as good practice. It indicates matters which trustees could consider by using phrases such as 'we would encourage you to' and 'you may wish to'. In contrast, legislative requirements are clearly identified, with the regulatory references being provided in footnotes.

The six main sections of the guidance are prefaced by an introduction which includes a section on understanding trustees' legal investment duties and a glossary. It also recommends that trustees who have not done so should first read the DB funding Code of Practice and, where the scheme offers multiple benefit types (such as a DC additional voluntary contribution section as well), the guidance on DC investment management.

Each section provides links to other relevant publications as well as to the related modules in TPR's online trustee toolkit. The sections are easy to navigate, with links being provided to each sub-topic covered. Detailed practical examples are given to illustrate the various concepts, as are clear pointers for trustees on what they need to do in each case. In addition, 'learning points' and 'things to consider' are highlighted throughout.

The six key sections

The guidance is divided into the following six sections.

DB investment governance

Unsurprisingly, the need for effective governance structures is emphasised. This section includes the trustee board's role in investment governance, and sets out key considerations for working with investment advisers and preparing the statement of investment principles. TPR also stresses that it anticipates better outcomes will be achieved where trustees, employers and their respective advisers adopt a collaborative approach with regular communications.

Investing to fund DB

This section, at 21 pages, is the most substantialin the guidance and includes sub-sections on setting an appropriate investment strategy, understanding investment risks and using models to help with setting the investment strategy. TPR states that, in setting investment objectives, trustees need to identify how and when those objectives need to be achieved. As TPR considers the scheme's investment strategy to be a key part of an integrated risk management approach, it should be considered alongside the employer covenant.

There is also a section on 'journey planning'. This is TPR's description of how the evolution of asset allocation and risk mitigation could be considered over the life-span of a scheme. Trustees are encouraged to take into account the changing profile of the membership and how they propose to meet any long-term objectives and interim milestones.

Matching DB assets

This section looks at the trustees' legal obligation to invest DB assets in ways which are appropriate in terms of the scheme's aim to meet the expected future benefit liabilities. The focus is on the use of matching assets, understanding the associated risks, and the requirement for such assets to be properly diversified. TPR expects trustees to manage properly any risks related to matching assets and encourages them to consider how the use of derivatives can introduce investment and operational risks which require careful oversight. A detailed example is provided on the use of liability driven investment.

DB growth assets

This section sets out how trustees are expected to understand the use of growth assets, the aim of which is to provide positive investment returns to meet the scheme's funding obligations (in contrast to those held to match liabilities). TPR outlines how diversification may provide greater stability of investment returns, while reducing risk. Trustees are encouraged to consider how diversified the scheme's assets are from the employer, since the overall risk may be increased if the same factors significantly affect both the employer covenant and the scheme assets.

Implementing a DB investment strategy

In this section, TPR focuses on the need for trustees to understand the risks associated with implementing an investment strategy. This includes the risks relating to the management of scheme investments which can potentially arise from the operations of a custodian, investment manager, derivative counterparties or scheme administrators. Trustees should obtain appropriate advice before appointing any such third party, and in relation to document negotiation where possible. The trustee duty to ensure the security of the scheme's investments is flagged, together with the importance of undertaking due diligence on the extent and effectiveness of any third party's operational risk framework.

Monitoring DB investments

Trustees need to focus on the key factors affecting the scheme's funding level and investment performance, monitor performance in a timely manner and take appropriate action when necessary. Trustees should identify the information required to achieve this and ensure that it is provided to them clearly so that well-informed decisions can be taken. As part of an integrated risk management approach, the scheme's investments should be monitored in the context of monitoring the employer covenant and the funding level.

Comment

While is it fair to say there is nothing new or surprising in this publication, trustees may find it comforting to have such a wealth of information on what TPR sees as the key areas of focus gathered together and readily available.

The guidance will undoubtedly be helpful to newly appointed lay trustees needing a grounding in increasingly complex pensions investment matters. However, its usefulness for existing trustees should not be underestimated. We would encourage all DB trustees to read the guidance – possibly not at one sitting, as it is quite long at 76 pages – if only to reassure themselves that their investment duties are being carried out in the way TPR expects. It helps clarify how trustees should approach their investment strategy in line with what TPR sees as good scheme governance standards.

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Some have called the guidance unnecessary, and criticise it for simply re-presenting information already available from TPR in various other forms/guidance notes and adding to the increasingly unmanageable amounts that trustees are expected to read. However, we feel that this criticism is slightly unfair. The guidance is useful if viewed as a starting point for access to the various codes of practice and guidance which are linked throughout.
Diligent trustees will already be familiar with the contents of this guidance but could use it as an opportunity to review their existing investment and governance practices.
Overall, the guidance is likely to be useful to trustees as TPR has done a good job of focusing on the prime issues and gathering a great deal of information into one place.

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