Pensions Bulletin – New Objective, New Guidance
July 2014

The Pensions Regulator has recently published a revised Code of Practice on Funding for defined benefit schemes, which will come into force later this year.

The new Code coincides with a new statutory objective for the Regulator, effective 14 July 2014, which is to ensure that funding plans “minimise any adverse impact on the sustainable growth of the employer”.

In line with this new objective the new Code stresses that “a strong, ongoing employer alongside an appropriate funding plan is the best support for a well-governed scheme”. We believe that the new Code, and the industry’s application of it, will lead to a more employer-friendly environment for DB scheme funding, albeit with an increased need for trustees to evidence their understanding of risks and their approach to managing them.

Key Points

The Code recognises the following key objectives of the trustees and the employer and the need to achieve a balance between them:

- Trustees – to ensure benefits can be paid as they fall due (and comply with all other fiduciary duties)
- Employer - to run their businesses and grow them as appropriate while ensuring that they are able to provide the pensions they have promised

The key aspects of the Code are:

- trustees should have a good understanding of the employer’s position and plans, working collaboratively with the employer
- trustees may take some risk in achieving their objectives but they should understand and manage that risk effectively
- trustees should adopt an integrated approach to risk management, combining the employer covenant, investment and funding aspects
- trustees should act proportionately given the scheme’s size, complexity and risks
- it is vital that trustees can demonstrate that they have managed conflicts of interest and acted impartially.

Integrated Risk Management

The new Code stresses the need for trustees to understand and manage their risks, across the three strands of investment, funding, and employer covenant. The Code states that:

- Trustees may wish to embrace a degree of risk to seek rewards for both the scheme and employer, because accepting appropriate risk can help to minimise any adverse impact on the employer's sustainable growth which in turn helps the trustees to meet their key funding objective to pay promised benefits.

BUT

- Risk should be understood and managed appropriately. Trustees should understand the likely upsides and downsides of proposals and be comfortable with the extent to which the employer can address the likely adverse outcomes over an appropriate period.

Trustees should engage with the employer to establish its appetite for risk and tolerance to downside events, but should note that it is not necessary for the employer to be able to cover all conceivable risks or that those it is covering be repaired immediately should they crystallise.

A trustees' risk assessment should include analysis of:

- what risks are controllable and what are not
- the likelihood and consequences of each of these being realised
- what risks they are prepared to take
- what risks would they like to mitigate in full or in part
- proposed risk controls and volatility of results; and
- the vulnerability of the scheme and the employer covenant.

The Code encourages trustees to use a variety of qualitative and quantitative approaches (for example, scenario testing and stress testing) to assess the impact of adverse events on potential employer covenant, investments and funding plans.

Once a risk assessment has been done trustees should decide how risks need to be managed and monitored, and have in place appropriate management and contingency plans.

Covenant

Trustees do not necessarily need to have an external covenant assessment. However, if trustees elect to undertake the analysis themselves, they should document why they consider themselves sufficiently equipped, independent and experienced to undertake the work to a standard appropriate to enable them to discharge their duties. They should then ensure they perform the task to that appropriate level and record their analysis.

There is a list of specific items that the Regulator expects to see addressed within a covenant assessment, which includes:

- The employer's forecast profit and cash generation, business plans, growth prospects, need for investment, levels of debt and ability to service this from cash generated,

- The employer’s ability to pay contributions to the scheme and its ability to address any adverse experience compared to that assumed in the scheme’s investment and funding plans.
- An estimate of the value that might flow to the scheme on insolvency of the employer or scheme wind up as well as the likelihood of such an eventuality, based on the employer’s current position and prospects.
- The employer’s position within the group and the wider group structure

Employers are expected to notify the trustees of any event or development that could have a material impact on the scheme. Covenant monitoring should include a review of key business performance indicators and should be done at least annually.

Investment

- A scheme’s investment strategy should be consistent with the funding objectives and the level of risk that trustees are willing to take in the light of the covenant, as well as the scheme’s liquidity needs and the employer’s plans for growth.
- The more risk that is taken, the more attention that needs to be paid to the covenant available to support that risk.
- The identification of risk, expected reward and appropriate asset allocation, is more important than the selection of manager and performance monitoring (although trustees still need to monitor performance)
- Trustees should discuss with the employer how potential strategies may affect them, and the employer’s ability to repair the funding if the risks materialise
- Diversification is important (the Code comments that this includes diversification away from the employer’s industry sector)
- Trustees must ensure that they have the cash available to pay benefits

Funding

- Assumptions must be chosen prudently.
- However, the assumptions made for the relative returns of different asset classes may rise or fall from preceding actuarial valuations reflecting changes in market conditions and the outlook for future returns. This is a key change in the Regulator’s approach – whereas previously the Regulator expected discount rates to be some constant margin above the gilt yield they now acknowledge this may not necessarily be the case.
- The more sensitive the results are to a particular assumption, the more the margin for prudence may need to be.
- Particular attention needs to be paid to discount rates and mortality assumptions.
- Decisions should be consistent with the long-term funding and investment targets.
- Trustees should not compromise the technical provisions to result in lower contributions.
- Trustees should use the solvency valuation as a key reference point for the prudence or otherwise in their Technical Provisions.

- If Trustees choose not to follow their Actuary's advice the Actuary is under a duty to report that fact to the Pensions Regulator.

Contributions

The Regulator's previous stance was that "deficits should be paid as soon as the employer can reasonably afford" with the implication being that if a given level of contributions were deemed affordable in the past then the trustees' starting position should be that this level of contributions should be at least maintained going-forward.

In the new Code, the requirement for "reasonable affordability" has been re-phrased as "deficits should be paid off over an appropriate period". The Code states that although affordability of deficit repair contributions is a factor to consider, this does not mean that an employer should be expected to pay deficit repair contributions at a particular level simply because it would be able to afford to contribute at that level or because it has previously been paying at that level.

When deciding upon an appropriate Recovery Plan, trustees should consider:

- forecasts of the employer's cashflow after essential business expenditure
- the employer's plans for sustainable growth
- the employer's debt structure, capital structure and resources
- the employer's dividend policy
- the value, terms and enforceability of any contingent security
- the benefits available to scheme members if there is an insolvency
- expected changes to the scheme's membership profile
- anticipated PPF levies

It is possible for the trustees to consider an employer's request to reduce contributions if:

- the employer's money is being used to enhance its sustainable growth, and
- the scheme is being treated fairly alongside other creditors of the employer

The draft new Code can be found at:

http://www.thepensionsregulator.gov.uk/docs/code-03-funding-defined-benefits.pdf

If you have any queries on the above or would like to discuss further, please do not hesitate to contact us.