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BBS briefing note

Consultation on new Code of Practice for DB Scheme Funding

The Pensions Regulator has recently published for consultation a revised Code of Practice 3 covering the funding of defined benefits, along with associated documents setting out how the Regulator will regulate the defined benefit funding regime in the future. These documents will be of great interest to trustees, employers, advisers and other parties involved with DB schemes.

This *BBS briefing note* provides a summary of the draft documents.

BACKGROUND

The existing Code of Practice on defined benefit funding was originally issued in 2006 to accompany the new funding regime introduced by the Pensions Act 2004. The existing code was largely concerned with the process of completing valuations and was supplemented by various notes and statements setting out the regulatory approach to monitoring funding plans, including the hitherto reliance on explicit “triggers” when considering whether further intervention was required.

Last year, it was confirmed that the Regulator would be given a new statutory objective in relation to scheme funding “to minimise any adverse impact on the sustainable growth of an employer”. Whilst the wording of this new objective has yet to be finalised, the new Code and associated documents take it into account and will replace the original documents in due course. The revised documents also reflect the Regulator’s experience of the operation of the new funding regime since 2006.

DRAFT CODE OF PRACTICE

The key focus of the draft Code is that trustees should take an integrated approach to risk management when developing a funding strategy.

The three key areas of risk are identified as:

- Employer covenant-related;
- Investment-related; and
- Funding-related.

These risks are clearly interdependent and the Code stresses that trustees should seek to fully understand the risks under each strand and define acceptable parameters for each within which they will manage the scheme.

Where significant changes are made or occur in one risk area, it follows that it may be necessary to adjust the level of risk in another area so as not to increase the overall level of risk. The risk management approach should be embedded within the trustees’ governance framework, with emphasis placed on the resulting actions to be taken when risks begin to crystallise.

Once trustees have identified and assessed the risks, they will be able to set their investment and funding strategies consistently with the level of risk they are prepared to hold within the scheme. The strategies should be specific, measurable, appropriate, realistic and time-bound.

Risk management is an ongoing process and trustees should have a framework in place for the ongoing monitoring of employer covenant, investment and funding risk levels. Contingency plans should identify the mitigation steps to be taken to redress any imbalance in the risks considered to be acceptable.

The draft Code stresses the importance of understanding the employer covenant, particularly in conjunction with the employer’s plans for sustainable growth, and the competing calls on the available assets. The trustees should seek to ensure that the scheme is treated fairly as a creditor in the employer’s financial dealings.

Trustees are encouraged to work collaboratively with employers, recognizing that a strong, ongoing employer alongside an appropriate funding strategy is the best support for a well-governed scheme.

Trustees are encouraged to keep the employer informed as they develop and implement their investment strategy, even where not strictly required by law.



Trustees should be cognisant of the investment strategy risks on both scheme members and the employer, including the impact volatility has on the employer's growth plans. Investment risk should be supported by the employer covenant.

In terms of funding, the Code stresses that the trustees are responsible for setting assumptions and determining what constitutes prudence. Trustees will rely heavily on the scheme actuary in this regard. The Code repeats that technical provisions should not be compromised to make a recovery plan more affordable, and trustees should ensure that any shortfall is eliminated as quickly as the employer can reasonably afford.

THE REGULATOR'S FUNDING POLICY

In conjunction with the Regulator's new statutory objective and the consequent move away from trigger-based monitoring of funding plans, the Regulator has issued a draft document setting out its DB funding policy.

The Regulator intends to segment the DB funding universe by employer covenant to develop its policies for intervention, using four categories of "strong", "tending to strong", "tending to weak", and "weak". The Regulator will then determine the risks and potential outcomes for each segment, recognising that there is no "cliff edge" between the segments, and develop a risk tolerance threshold for intervention for each segment.

For this purpose, the Regulator will adopt a new risk indicator known as the Balanced Funding Outcome ("BFO"), which is an indicator assessed for each scheme within each covenant segment. The BFO indicator does not set a minimum level of funding or contributions, but provides a model of the characteristics of what a BFO for a scheme might look like based on an assessment of the risks.

In practice, the BFO will be set by calculating a notional level of assets, taking into account the covenant strength and maturity of the scheme, at which the Regulator considers it acceptable for no further contributions to be paid. The shortfall relative to this notional level of assets is then assessed to determine the contributions required over the "medium term", which are then compared with those actually agreed under the recovery plan.

A scheme's departure from the BFO will be the primary risk indicator, but there will be a range of other risk indicators used by the Regulator.

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Schemes will then be selected for intervention on a proportionate basis. In particular, the size of the scheme will be taken into consideration so that the Regulator's resources are focused on those schemes presenting the greatest risk. This means that a smaller scheme will have to fall short of their BFO by a proportionately greater amount than for a larger scheme. The Regulator acknowledges that, going forward, most of its case-specific resources will be directed to larger schemes.

TIMESCALES

The consultation runs until 7 February 2014 and the new Code of Practice is expected to be in force by July 2014. However, trustees submitting valuations in the meantime are encouraged to bear the new policy in mind.

BBS VIEW

Whilst many of the key themes underpinning scheme funding remain, there is a clear shift in approach under the new Code of Practice and the way in which scheme funding will be monitored in future, with the focus now being on integrated risk management. This shift was inevitable given the Regulator's new statutory objective to reflect the employer's interests, but it is likely to take a period of time for the new regime to be fully understood by trustees, employers and advisers.

Perhaps the greater shift is that the new monitoring regime will differentiate on scheme size, and it will be interesting to see in what circumstances the Regulator will intervene on smaller schemes.

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