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PENSION SCHEME FUNDING

NEW CODE CAN BRING YOU GREATER CONTROL

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On 10 June 2014 the Pensions Regulator published its new Code of Practice on defined benefit pension scheme funding

The 50-page Code replaces the Regulator's previous code, which was issued back in 2006 when the Regulator was in its infancy. Whilst Codes of Practice are not legally binding, they reflect the Regulator's interpretation of pensions law, and compliance with these Codes can be taken into account by courts when determining whether pension schemes have been managed in accordance with relevant laws.

This is a wider emphasis than the 2006 Code, which focussed more on funding risk, and less on investment risk. Indeed, **risk** is a major theme of the Code – the word appears 142 times in total.

Key principles

The Code focuses on three key pillars, for trustees and employers to get to grips with, which are underpinned by nine principles:

1 INTEGRATED FUNDING

Deficits no longer need to be repaid as quickly as possible – instead, the Regulator simply talks about an "appropriate" recovery plan length. This would appear to allow **longer recovery plans**, in cases where sponsors can demonstrate that the resulting lower levels of pension funding will improve the sponsor's prospects for growth.

2 ASSESSMENT OF THE EMPLOYER COVENANT

Unsurprisingly, the Regulator makes it clear that an assessment of covenant is an integral part of determining ongoing scheme funding. However, there is an acknowledgement that assessing **long-term** covenant risk is very imprecise, and therefore covenant assessments should focus on the short-to-medium term.

3 INVESTMENT RISK MANAGEMENT

The new Code is less prescriptive than the previous version, and less focussed on process. Reflecting the Regulator's new statutory objective – namely to ensure that funding agreements are compatible with the sustainable growth of a sponsor - the Code is arguably slightly more employer-friendly than the 2006 version. However, the Code places far more emphasis on considering **investment risk**, with the possible implication that the Regulator is concerned that some schemes are taking more investment risk than they should.

The nine key principles:

1. **Working collaboratively** – trustees and sponsors should work together in an open way; sponsors should share relevant business information with trustees.
2. **Managing risk** – funding, covenant and investment risks should be identified, measured, managed and monitored.
3. **Taking risk** – trustees should determine the sponsor's risk tolerance, and the sponsor's ability to cope with adverse outcomes.
4. **Long-term view** – trustee decisions should be consistent with long-term investment and funding targets, and reflect the covenant of the sponsor.
5. **Proportionality** – trustee decision making should be proportionate to the size and complexity of the scheme.
6. **Balance** – funding agreements should be an "appropriate balance" between the need to pay benefits and the sponsor's need to grow in a sustainable way.
7. **Well-governed** – trustees should adopt good governance standards in relation to funding.
8. **Fair treatment** – trustees should ensure that schemes are treated fairly compared to other stakeholders such as other potential creditors.
9. **Reaching funding targets** – funding targets and recovery periods should be "appropriate".

Comment – Good news for Trustees and Employers

Understanding and using the Code of Practice to fully recognise the risks associated with running your Defined Benefit pension scheme will give you the control you need to manage the costs.

The Regulator has changed tack, and no longer wants to push the employer under in order to bring money into the pension scheme. Instead, the focus is on affordablity and managing risk which means that trustees and employers can be more flexible in their discussions.

The covenant area is also an important one, and, discussing and deciding how you meet the Regulator's requirement to appropriately and proportionately assess the strength of the employer covenant is a key topic. However, this need not be a prohibitively expensive exercise and properly recognising the employer's strength may well work in the employer's favour when discussing next steps in setting contributions.

What next?

Dealing with the new Code is an imperative task for trustees and employers and understanding these risks should begin sooner rather than later.

The Code requires trustees to understand the size and likelihood of investment risk over time. This may range from deterministic approaches to complex asset and liability modelling. This should form an integral part of the trustees' approach to scheme funding generally and in particular to the triennial actuarial valuation process.

The Code, when fully implemented by the trustees and employers, will go a long way to improving the way your pension scheme is managed.

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Actions for Trustees and Employers:

1. Start discussions on funding early in the valuation process so that trustees and Scheme Actuary are able to take into account all the relevant information that the employer would want to be considered in formulating view on affordability.
2. Ongoing employer discussions, not just for the triennial valuation. Agree a process, format, and a suite of financial and management information for regular discussions between the employer and trustees.
3. Discuss the new Code with your Scheme Actuary to ensure that he or she is open to the new focus and flexibilities that the Code presents. This will avoid additional time and expense of having to build these in later on, and also ensure that your scheme is treated in the best way for your particular circumstances, rather than being just given the house standard.
4. If you do not have an Investment Consultant, appoint one.
5. Discuss the new Code with your Investment Consultant to ensure that he or she is ready and able to provide the required risk analysis information into the valuation process.
6. Work with your investment consultant to ensure that trustees and employer fully understand and evaluate the short and medium term downside risk of the investment strategy being followed and consider whether this is affordable. Showing that this 'back-up plan' issue has been properly considered will allow more flexibility in the funding approach and contribution plans that might be adopted.
7. With a new 'integrated' focus on looking at the funding of the scheme, it is now even more important to ensure your scheme advisers are also working in the same integrated way. It is vital to tie in the actuarial funding strategy with the investment strategy.
8. Employer, trustees and advisers to start to discuss the ultimate long term exit plan for the scheme, if the scheme is now closed. This destination could be a long way off, but having an agreed broad plan ensures both the trustees and employer understand what they are working towards, the likely risks along the way, and reduces the surprises from valuation to valuation.

Contact us

BROADSTONE has an integrated actuarial and investment consulting team with the expertise to assist trustees in navigating through the complete process.

Contact us to see how we can help.

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