Briefing

BURGES SALMON

Pensions

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Funding: A risk-based approach

The Regulator's (TPR) revised materials on funding show it will be taking a more flexible approach to assessing the risk a scheme is running than originally proposed. This is the main change from the consultation drafts.

Instead of testing a scheme against a standard actuarial basis (the "balanced funding outcome" or BFO), TPR will consider a range of risk indicators. This broader assessment was part of the consultation proposals but was secondary to the BFO. The materials identify the fifteen risk indicators but do not say where the threshold for concern will be on any of them.

The change responds to observations that the BFO could have acted as a new "minimum funding requirement" and become a target even for schemes that could do better. That said, it may be that a form of BFO will still be part of TPR's internal procedures.

New objective

The revision of the Code of Practice on funding follows the introduction of a new statutory objective for TPR in relation to funding from 14 July 2014. The objective is "to minimise any adverse impact on the sustainable growth of an employer".

This competes to some extent with TPR's existing statutory objectives to protect members' benefits and the PPF. The funding documents set out how TPR sees this tension being resolved in practice.

Action points

Trustees and employers should familiarise themselves with the new documents (see the list at the end of this briefing) as soon as they can, and with the Code in particular. This is most pressing for a scheme that has a valuation date in the months after mid July this year.

Wider picture

The funding regime will be more employer friendly and flexible than it has been in the past.

Balance, appropriateness, flexibility, proportionality and risk management are among a dozen or so concepts that run through the documents. For example:

- "trustees can use the flexibilities available in the funding regime to set funding strategies that are appropriately tailored to the scheme's and employer's circumstances and which represent a balanced outcome",
- believing its approach "reflects a balanced view of all [its] objectives", TPR aims to ensure "trustees reach appropriate funding outcomes that reflect a reasonable balance between the need to pay promised benefits and minimising any adverse impact on an employer's sustainable growth",
- it also aims to help trustees "ensure the funding plan is appropriate given the context of the circumstances of the scheme and employer" and
- trustees are urged to "implement an approach which integrates the management of employer covenant, investment and funding risks".

What is balanced, appropriate or proportionate for a particular scheme is left to be contested by the trustees and the employer. When agreement is hard to reach, trustees cannot expect the same backing from TPR that they may have had in the past.

The same also goes where, because of the balance of power in their rules, trustees are required only to consult the employer rather than reach agreement.

Other repeated themes in the documents include TPR acting in a "risk-based" fashion and regulation being "principle-based" and "outcome-focused".

Risk management

Risk management and the need for an integrated approach to it is the central idea in the Code.

The main risks TPR is concerned about relate to covenant strength, funding arrangements, investment and the overarching issue of scheme governance.

Trustees are encouraged to recognise and work with a holistic view of risk composed of these four elements. In general, they are asked to assess and manage these risks rather than try to eliminate them. This is significant change in the way TPR expects them to behave.

TPR will prioritise schemes for engagement according to their general risk profile.

As outlined in the consultation, it will begin profiling by putting schemes into one of four segments according to the strength of the employer's covenant.

It will then test valuations and recovery plans against a non exhaustive list of, currently, fifteen risk indicators. It says the list is likely to develop in future. For now the indicators include:

- bespoke covenant assessment,
- funding risk,
- investment strategy risk,
- mortality,
- back end loading of any recovery plan,
- reductions in contributions,
- actions taken that weaken covenant,
- PPF funding risk,
- governance,
- specific, known risks and
- asset backed funding arrangements.

There is more detail in the *Defined benefit funding regulatory and enforcement policy.*

TPR does not identify the point where it would begin to show concern on any of the indicators.

A scheme's size can also affect its priority. Larger schemes have some priority because they represent a particular concentration of risk to TPR's objectives. On the other hand, in a change of emphasis from the consultation, TPR confirms it will continue to engage with small and medium sized schemes and will not be relying exclusively on education. It points out that in 2012/13 about half its interventions were with such schemes.

TPR's "risk appetite" will also influence whether and how it engages. It will issue an annual statement on its risk tolerance. We await the initial statement.

Guiding principles

The Code is the most detailed and practical of the documents. Addressed to employers and trustees, it starts from a set of principles that apply in all cases:

- **working collaboratively:** trustees and employer to collaborate in finding an approach that recognises the needs of the scheme and the employer's plans for sustainable growth,
- **managing risk:** trustees to integrate the management of their covenant, investment and funding risks,
- **taking risk:** before taking funding or investment risk, trustees to establish the employer's risk tolerance and its ability to address adverse outcomes over an appropriate period,
- **taking a long-term view:** trustees' decisions to be consistent with their long-term funding and investment targets and their view of the employer's covenant,
- **proportionality:** trustees to act proportionately given the size, complexity and level of risk of their scheme,
- **balance:** trustees to seek an appropriate funding outcome that reflects a reasonable balance between the need to pay benefits and minimising adverse impact on the employer's sustainable growth,
- **well governed:** trustees to demonstrate good governance in relation to funding,
- **fair treatment:** trustees to ensure the scheme receives fair treatment from the employer equivalent to other creditors of comparable status and
- **reaching funding targets:** trustees to aim to have any shortfall eliminated over an appropriate period. (It is interesting that the consultation draft called for elimination "as quickly as the employer can reasonably afford". The final version has moved in the employer's favour.)

The Code is well organised as a working document. It starts by explaining what it means by an "integrated approach to risk management". It then sets out the main considerations trustees and employers should work with in the key risk areas of covenant, investment and funding.

Transition

TPR's new objective comes into force on 14 July this year. The new Code is expected to come into force at the same time.

The Code will apply to all schemes with valuation dates from the day it comes into force.

Trustees of schemes with earlier valuation dates are encouraged to take the new Code into account as far as they can depending on how much work they have already done. TPR says it will be pragmatic about this.

TPR's materials

Compared to the consultation drafts, the use of language is more consistent within each document and between them. This makes the picture clearer. In another plus, the Code is substantially shorter than the draft.

The set of documents is:

- *Defined benefit regulatory strategy* - explains at a high level how TPR will approach regulation,

- *Defined benefit funding regulatory and enforcement policy* - explains what TPR means by risk and how it will assess it,
- *Code of Practice no. 3: funding defined benefits* - the key working document for trustees in particular,
- *Essential guide to the Code* - a brief, high level introduction to the new regime,
- *Consultation response: regulating defined benefit pension schemes* - for those who want more detail, this explains some of the thinking behind the changes from the consultation documents and
- *Annual defined benefit funding statement.*

They are available at: **http://www.thepensionsregulator.gov.uk/press/pn14-18.aspx**

More information

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