NEW PENSIONS REGULATOR CODE OF PRACTICE ON FUNDING DEFINED BENEFITS

The Pensions Regulator issued its latest draft code of practice no.3, "Funding defined benefits", on 10th June. The key messages of the code remain broadly the same as in the consultation draft but the new version has some important changes particularly on the Regulator's approach to its new objective around "sustainable growth". Happily, the new code is now some 20 pages shorter.

Why now?

The code addresses the experience and understanding the Regulator has gained since Part 3 of the Pensions Act 2004 came into force, and seeks to draw out any benefits from that experience and understanding.

The Regulator wishes to explain how funding risks should be identified and assessed, with suitable contingency planning, using an "integrated approach to risk management" – meaning an approach that seeks to recognise the interaction between the three key component elements of risk being employer covenant, investment strategy and funding position. The Regulator's revised text seems to prefer the softer terms "contingency planning" and "risk management" to "mitigation of risks" and the Regulator has moved away from the emphasis in the earlier draft on repaying deficits as quickly as possible, in favour of setting out a more balanced approach.

The code has been laid before Parliament and is expected to come into force "in the next few months", subject to Parliamentary approval.

The Regulator's New Objective – A New Balance?

The Regulator's statutory objectives will include (when implemented by the Pensions Act 2014) a new objective "to minimise any adverse impact on the sustainable growth of an employer".

The new code now much more closely follows the terminology of this new objective, which is a welcome change for employers and a response to the consultation comments that the language used in the previous draft was less favourable to employers than the objective required. The Regulator's key word is "balance" – recognising the interaction between the different risk elements and seeking to find the appropriate balance between them.

The Regulator reports that some respondents to the consultation had suggested the previous draft code underplayed the extent to which the new objective should be taken into account. In response to these suggestions, the Regulator has stated that "sustainable growth" is the Regulator's objective rather than the objective of pension plan trustees. Trustees must still, and always, comply with their fiduciary and legislative duties (not forgetting any contribution requirements stated in pension plan rules). "Sustainable growth" in this context is likely to be interpreted by the Regulator to mean that trustees should make sure that their principal asset – the employer covenant – is not devalued, and continues to serve as one of the pension plan's main support mechanisms.

In the earlier draft of the code, the Regulator had stated that a consideration of the employer's plans for sustainable growth should form a part of the trustees' covenant evaluation. Consistent with the Regulator's point that sustainable growth is an issue for the Regulator not the trustees, this element of the covenant review process has been removed from the trustees. Rather, the trustees are directed to seek "balance" and to concentrate upon the employer's resilience to cope with downside outcomes and its ability to repair any likely deficits. The trustees are asked to use any flexibility within the funding system to reflect the employer's position, but without compromising what the trustees would believe to be an appropriate outcome for the needs of the pension plan.

Specifically, the Regulator cautions trustees against allowing their covenant review to be a "critique" of the employer's business plans, saying that the employers themselves are best placed to take key decisions on those business plans, including those for sustainable growth.

The Regulator sees "balance" as a way of increasing the likelihood that the needs of all parties will be met. But the Regulator expects this "balance" to be found in a way that does not compromise the trustees' basic obligation to ensure that the pension plan is appropriately funded so as to provide the pensions which are deferred pay.

Note that the new statutory objective to minimise any adverse impact on the sustainable growth of an employer applies only in relation to Part 3 of the Pensions Act 2004 – it won't apply to such matters as enforcement of employer debts resulting from the application of Section 75 of the Pensions Act 1995, or other regulatory activity involving detrimental events.

Key Funding Principles

The new code of practice opens with a statement of the key funding principles that should apply to all trustees who seek to comply with their obligations under Part 3 of the Pensions Act 2004. They are as follows:

- Trustees and employers are to work collaboratively, in an open and transparent manner.
- Trustees should integrate the management of covenant, investment and funding risks, identifying, assessing, monitoring and addressing those risks effectively. A previously stated requirement, to have trigger points for key actions, has been removed from the latest draft code.
- Trustee risk taking should be discussed with the employer to establish the employer's risk tolerance and assess the employer's ability to address a range of likely adverse consequences over an appropriate period. The previously stated requirement, to mitigate risk taking by having contingency plans, has been removed.
- Trustees should take a long-term view of the employer covenant, funding and investment targets.

- Trustees should act proportionately, taking into account their pension plan's size, complexity and level of risk.
- Trustees must seek an appropriate funding outcome that reflects a reasonable balance between the need to pay promised benefits and minimising any adverse impact on the employer's sustainable growth. The requirement, stated in the previous draft, that there should be no "excessive or unnecessary risks" has been removed. There may be a very fine distinction between seeking a funding outcome that reflects sustainable growth, as opposed to accepting that sustainable growth is part of the trustees' objectives – presumably, the employer is expected to argue its case.
- Trustees should adopt good governance standards in relation to funding.
- Trustees should ensure that the pension plan is treated fairly amongst competing demands on the employer in a manner "consistent with its equivalent creditor status".
- Having agreed an appropriate funding target, trustees should aim for any funding shortfall to be eliminated "over an appropriate period". The requirement, stated in the previous draft, that the deficit should be eliminated "as quickly as the employer can reasonably afford" has been removed, which many employers will welcome.

Approaching Funding

The Regulator gives us some preliminary thoughts about the way in which trustees should approach their funding responsibilities under Part 3 of the Pensions Act 2004. There is not much that is new here, but it is helpful to have the Regulator's thoughts codified.

As one would expect, the key thoughts from the Regulator are:

- The trustees' key objective is to pay the benefits from the pension plan as they fall due.
- They have to have sufficient knowledge and understanding to be able to manage this responsibility.
- Significantly, the trustees' responsibilities under Part 3 cannot be approached in isolation from their fiduciary and other duties under the law and under their trust deed and rules: meaning they must be aware of any wider powers they might hold.
- Part 3 provides a statutory framework for the way in which trustees must assess their liabilities and determine the pace and period over which these liabilities must be funded. Beyond that framework, every pension plan is different and trustees must reach a solution that is appropriate to the context of their own plan.

Under Part 3, most matters have to be discussed and agreed with the sponsoring employer. Generally, the trustees must reach an agreement with the employer in relation to the actuarial methods and assumptions, the statement of funding principles, the recovery plan and the schedule of contributions. These principles are adjusted to a requirement to consult with the employer where a pension plan's rules already give the trustees, or the pension plan's actuary, greater powers, such that a statutory requirement to reach agreement with the employer would in effect be a statutory dilution of trustee power. The legislation, therefore, needs to be checked quite carefully against the pension plan rules whenever approaching a funding discussion.

Integrated Risk Management

A critical aspect of the code of practice (and a product of the last 8 years' experience) is the Regulator's greater emphasis on the links between (1) employer covenant, (2) investment strategy and (3) funding.

Starting from the premise that pensions are deferred pay, the trustees must take an integrated approach to risk management, and one that manages the links between these three key areas.

For example, it would represent an unacceptable risk for trustees to enter into a high-risk/high-reward investment strategy if the pension plan was already poorly funded and the employer covenant insufficiently strong to pay additional contributions should that investment strategy fail to deliver. The risks to which these trustees have exposed their pension plan benefits would be regarded as unacceptably high.

This builds upon the Regulator's experience since Part 3 of the Pensions Act 2004 was introduced, and recognises the significance of the employer covenant.

The Regulator will expect trustees to identify and assess their risks, and set investment and funding strategies around those risks, considering such questions as:

- What risks are controllable and what are not.
- The likelihood and consequences of particular risks being realised.
- What risks are they prepared to take.
- What risks should they mitigate in full or in part.
- Proposed risk controls (not "risk mitigations", as in the previous draft) and volatility of results.
- Vulnerability of the pension plan and the employer covenant.

The Regulator will also expect contingency planning around the risks, where the risks are regularly monitored and potential contingency plans (not "potential mitigation steps" as in the previous draft) identified in advance, to preserve the appropriate balance as and when, or if, risks are realised.

When considering risks, and developing funding plans under Part 3, trustees are not permitted to consider that the Pension Protection Fund might be available to rescue benefits of failed pension plans.

Contingency Planning

As is clear from the code, and Part 3 of the Pensions Act 2004, cash payments into the pension plan are preferred.

If, however, the trustees agree with the employer to accept more risk than can be supported by the employer covenant, the Regulator indicates that there have to be definite contingency plans. These plans can include:

- Some form of parent or group company guarantee.
- Situations where an employer might be concerned about "trapped surplus" (meaning funds that the employer may never be able to recover after the pension plan eventually becomes fully funded) and the trustees can be persuaded to accept assets held in a fund (usually an escrow account) outside the plan.
- Transfers of non-cash assets.

Trustees are asked to make sure they consider the value that is likely to flow from these contingent assets. Where trustees are offered an asset-backed contribution structure, they are required to "unpack" the structure and identify the extent to which they will have enforceable claims against the underlying asset. Also, recognising that these structures could potentially breach employer-related investment restrictions, the structure must contain appropriate underpinning arrangements against this contingency of illegality.

Action

Any trustees who are in the midst of reviewing their funding and investment strategy, and/or assessing the employer covenant should consider how, if at all, the code of practice affects the approach they should adopt.

Employers should also become familiar with the code, particularly where it impacts their own approach to funding and risk.

Contacts

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