

UK - Update

Pension Regulator's Defined Benefits Funding Statement 2013: a more flexible approach?

The Pension Regulator has recently issued its second Defined Benefit Annual Funding Statement. This is aimed at schemes with effective valuation dates between 22 September 2012 and 21 September 2013 (and which are due to be completed between December 2013 and December 2014).

The Statement notes that the Regulator is due to be given a new objective and the day after the Regulator published its statement the Pensions Bill was published. The new objective is:

"... in relation to the exercise of its functions under Part 3 [of the Pensions Act 2004] only [Scheme Funding], to minimise any adverse impact on the sustainable growth of an employer."

The Statement frequently refers to "flexibility" which hints at the shift in approach that the new statutory objective may bring. The Regulator also announced that it will be consulting on revisions to its Code of Practice on Scheme Funding which was first published in February 2006. Codes of practice are not the same as legislation and there is no penalty for failing to comply with them. However, any approach which deviates from a code of practice still needs to meet the underlying legal requirements and a court or tribunal can take account of the relevant provisions of a code of practice when deciding whether the legislation has been met. In the case of the Scheme Funding Code of Practice the revision is overdue. The Regulator has issued much guidance on scheme funding since 2006 and, in particular, its view of the "employer covenants" has changed so that the latest guidance is at odds with the use of the term in the code.

The Statement reiterates some of the points made in its first statement last year but there are some interesting differences. In the 2012 Statement, the Regulator emphasised that it would not be prudent when setting valuation assumptions to assume that gilt yields would improve. However, in this year's Statement it emphasises that discount rates in valuation assumptions must be chosen prudently to take into account either:

- the yield and assets held by the scheme and the anticipated future investment returns and/or
- the market redemption yields on government or high quality bonds

This reflects the requirements of the Scheme Funding Regulations, but it then goes on to say:

“Trustees can use the flexibility available in setting the discount rates for technical provisions and investment return assumptions for recovery plans to adopt an approach that best suits the individual characteristics of their scheme and employer.”

At one level this is simply reflective of scheme specific funding: the circumstances of each employer and each scheme will be unique and the funding regime allows different approaches to be taken. However, it is interesting to see the emphasis on flexibility; albeit it then goes on to state that trustees should document the reasons for changes in assumptions from preceding valuations and take account of any increase in risk that this might bring. In any event, changes to assumptions must, under the Scheme Funding Regulations be justified by changes to legal, demographic or economic circumstances.

When looking at recovery plans, the Statement – as with last year – says that when there is a tension between contributions to the scheme and investment for the employer’s business it is important that the solution neither damages the employer covenant nor benefits other stakeholders at the expense of the scheme. However, whereas in 2012 the Regulator said that it would expect recovery plan payments to be maintained in real terms, this year it states that “as a starting point, trustees **should consider** whether the current level of contributions can be maintained” (our emphasis).

The Statement again encourages trustees to take an integrated approach to addressing covenant, investment and funding risks and that they should be able to evidence how this has been done. The Statement then goes on to say that this evidence “need not be an undue burden or additional exercise, but could be part of the development of good governance whilst demonstrating a sound risk management approach for the scheme”. Professional covenant assessment is encouraged by the Regulator, but there is sometimes a reluctance on the part of trustees to obtain such advice and this might be a tacit recognition of such reluctance. However, it is important that trustees ensure that they have a proper framework in place for monitoring the covenant and that where they do need to take external advice it is properly focussed and proportionate to the size of the scheme and the employer (Appendix B of Pension Regulator’s Guidance on Monitoring Employer Support sets out some considerations when appointing a covenant assessor <http://www.thepensionsregulator.gov.uk/docs/employer-support-consultation-document.pdf>). That proper employer covenant assessment is important is made clear by the Regulator stating that, where it does engage with a scheme over funding, the key area of focus will be the link between the strength of the employer covenant, the investment strategy and the discount rates compared to expected investment returns. The Regulator is also proposing to consult on the approach to integrated risk management as part of its consultation on the new Code of Practice.

Finally, the Statement reiterates that the Regulator has moved away from the approach of comparing valuations against FRS17 or IS19 accounting figures or that a recovery plan greater than ten year is a trigger for their investigation. The Regulator is now using a series of risk indicators which require further investigation. These include:

- whether contributions and investment risk appropriately reflect the employer covenant strength and the affordability of contributions

- any specific issues or concerns relating to deterioration in the employer covenant
- the shape of recovery plans – this also suggests the Regulator is more prepared to accept “back end loaded” recovery plans
- investment performances assumed are the duration of any recovery plan
- any significant issues that the Regulator has had with previous valuations

The 2012 Scheme Funding Statement is available at <http://www.thepensionsregulator.gov.uk/docs/pension-scheme-funding-in-the-current-environment-statement-april-2012.pdf>. It will be interesting to see how the Regulator further adjusts its approach once the new statutory objective becomes law and following the consultation about the revised Code of Practice.

Further information

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