MACFARLANES

A NEW CODE FOR DEFINED BENEFIT FUNDING

PENSIONS

NEW CODE OF PRACTICE FOR FUNDING DEFINED BENEFIT PENSION SCHEMES

The Pensions Regulator is consulting on a new draft Code of Practice on the funding of defined benefit pension schemes to replace the current Code of Practice originally issued in 2006.

The revision is prompted by the Pensions Regulator's new statutory objective for scheme funding "to minimise any adverse impact on the sustainable growth of an employer". Optimists hoping this might give employers a breather and a bit more balance between the pension scheme and current employees may be disappointed.

The list of principles includes balance, proportionality, taking risk and taking a long-term view. However, the detailed recommendations require all risk to be effectively covered by the employer covenant or contingent asset arrangements. They also require increased professional analysis.

Complexity and cost

The Pensions Regulator itself anticipates that the impact of the revised Code on the cost of scheme governance and administration activities is likely to be significant. The level of monitoring and analysis of both the employer and the scheme is likely to require significant levels of advice.

Who runs the business?

Trustees are advised to recognise the importance of an employer investing to maintain or grow its business. However, trustees are asked to test whether the employer's investments are "necessary" and how they strengthen the employer covenant before allowing them to take priority over scheme funding. This seems to require trustees to check the employer's business decisions. If an investment does not proceed, the resources are to be redirected to the scheme. Employers with defined benefit schemes may find themselves constrained in taking normal business risk and competing in their own industries.

According to the draft Code, trustee access to employer information is not to be restricted by concerns over confidentiality or stock exchange requirements.

Unequal balance

Trustees are directed not to take funding or investment risk unless the employer can fund the gap if those risks materialise. To strike a "balance", trustees may accept greater funding and investment risk but only if it is adequately mitigated by the employer. In effect, the funding and investment risks of the scheme are re-allocated to the employer. If the trustees accept investment risk not adequately hedged by the employer's resources, they are encouraged to adjust actuarial assumptions to create a greater deficit.

Is this Solvency II and the "holistic balance sheet"?

Surprisingly perhaps, the draft Code seems significantly inspired by the European Commission's now abandoned proposals to extend Solvency II[1] rules to pension schemes by using a "holistic balance sheet".

The draft Code advocates a risk-free investment and funding policy unless the employer covenant or contingent assets cover any risk. While this might be sensible in an ideal world, this fails to recognise that the purpose of the trustees' investment powers is to part-fund the scheme benefits from investment returns, not just to provide security. Some impact on equity investment may also be expected.

The long-term view?

Trustees are directed to put in place contingency plans and to respond promptly to risks crystallising in relation to funding, investment or the employer covenant. The emphasis on continuous monitoring and rapid response plans seems at odds with the long-term view advocated elsewhere in the draft Code. In effect, only where the covenant is sufficiently strong to absorb investment and discount rate volatility can a long-term view be taken.

Not all bad

Like a curate's egg, the draft Code is good in parts and much of it is not contentious. Who would argue with the need for good governance or an integrated approach to risk management? The only debate is how good, how integrated and at what price?

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[1] Solvency II is the European directive that sets the capital requirements for insurers.

What is being consulted on?

The Regulator has a statutory duty to produce a Code of Practice in relation to the funding regime under Part 3 of the Pensions Act 2004. This is subject to default approval by Parliament. This Code of Practice is being revised and the three draft documents released are:

- **The Code of Practice on Scheme Funding**: the code is not law but sets out the Pensions Regulator's expectations on funding for trustees and employers.
- **Our Defined Benefit Funding Policy:** this sets out the Pensions Regulator's approach to the regulation of the funding regime in particular situations.
- **Our Defined Benefit Regulatory Strategy:** this sets out the Pensions Regulator's high level strategy in relation to its regulation of the funding regime.

Macfarlanes will be responding to the consultation which closes on 7 February 2014.

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