TPR consultation "setting a balanced approach"

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The Pensions Regulator has opened consultation on a revised policy and strategy framework, including a revised Code of practice regarding the funding of DB pension schemes. The revised Code is expected to be in place by July 2014 and will apply to schemes undertaking valuations from that time, though the approach expressed in the consultation is expressed to be consistent with the 2013 annual funding statement; schemes with valuations completing before the new Code comes into force are urged by TPR to "bear in mind" its messages.

TPR has now formally to balance its new statutory objective (to minimise the impact on employers' sustainable growth) with its existing DB funding objectives, and has also reflected on experience in this area since 2005. A number of key themes emerge from the consultation documents discussed below.

There is a distinct change in tone and regulatory approach: there is an emphasis on notions of balancing risks, using flexibility, and the need for trustees and sponsors to work collaboratively together "to manage risks and reach appropriate funding solutions". TPR acknowledges that its own approach has evolved since 2005; it is looking to be more consistent in approach, "more principle-based and outcome-focused". For many years TPR stressed that it was an umpire not a referee, so it remains to be seen what this will mean in practice. The Regulator is also looking to be more proactive and focused in its interventions, so in place of the "trigger" based approach it is using a broader range of indicators to identify the (mainly larger) schemes on which it will focus direct engagement, while the focus for the rest will be though education and influencing behaviour. As a regulatory tool to do so, TPR is designing a "balanced funding outcome" model, based around covenant strength in various scenarios, scheme assets, maturity and funding position.

Integrated risk management: trustees are expected to understand and manage the balance of employer covenant, investment and funding risks within acceptable parameters. Whereas back in 2005 these risks were viewed in separate silos, TPR now stresses how these risks affect each other and need to be understood and managed - not necessarily eliminated. The concept of the employer covenant is now the "cornerstone" which "underwrites scheme risks and underpins the trustees' investment and funding strategies". TPR encourages the use of risk assessment tools, their value not being in predicting outcomes, but in helping appreciate the order of magnitude of all scheme risks, trade-offs and options to manage them. So ongoing monitoring of these risk areas, and contingency planning to restore risk to acceptable levels, are important.

Covenant assessment: a full, proportionate, employer covenant assessment should be undertaken at each actuarial valuation, and should take these risks into account. The draft Code sets out the areas that an assessment should cover, including "sustainable growth", and also recognises that trustees can focus on areas where they are not already confident of the position or able readily to discover the position for themselves. Trustees can carry out this work themselves, but if they elect not to retain independent advisers, they should document why they consider themselves equipped and sufficiently experienced to do so to an appropriate standard. For larger and more complex schemes, the draft Code suggests that more sophisticated approaches are appropriate when assessing the ability of the covenant to support investment risk, the degree of prudence in discount rates and recovery plans, for example using stochastic and/or scenario modelling approaches.

We consider that, to a great extent, the draft Code reflects evolving best practice already being pursued by leading schemes with their advisers. For instance, Gazelle’s quantitative covenant risk modelling techniques integrate covenant and funding risk with investment risk over the life-span of the pension scheme and already take into account the sustainable growth of the employer. The world has moved on since 2005 and it makes sense for TPR to re-assess the current Code, though it remains to be seen whether, in practice, this marks a shift to a more consistent or proactive regulator.

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