KPMG commentary on the Regulator's new approach to DB regulation

The Pensions Regulator (tPR) has launched its consultation on a revised code of practice and regulatory approach to funding defined benefit (DB) schemes. The consultation period closes on Friday 7 February 2014 and we anticipate that the new code will be in force by July 2014. This short summary highlights our key observations from reviewing the consultation documents.

Overview – From short term lender to long term investor

Given its objectives to protect members' benefits and reduce the risk of calls on the PPF it was not surprising that tPR's focus from inception has been to push trustees to act more like professional lenders of money; considering their sponsors' covenant, looking for repayment as quickly as possible and seeking security as a contingency. The tPR's new statutory objective, along with their experience of having to regulate under the existing funding code of practice, looks to have shifted their focus to consider the relationship between trustees and sponsors more symbiotically. The emphasis will now be on trustees to act more like long term investors; considering the sponsors' long term business plans, the requirements of other stakeholders and the balance between investment and distributions.

The Code of Practice – how trustees should approach funding

The revised code of practice emphasises the importance of pension trustees and sponsors working collaboratively to establish viable, long-term funding plans, and encourages trustees to take an integrated approach to managing key scheme risks: namely funding, investment and the employer's ability to meet its obligations to the pension scheme. We expect sponsors to welcome the explicit references to supporting growth plans and will be rewarded for investing time explaining these in detail to the trustees. For trustees, "squaring the circle" of pulling together the various components of the funding and understanding how they interact, both now and in the future, will increase the requirements for co-ordinated and insightful advice.

1. Balancing act

Unsurprisingly, the biggest change to the existing code of practice, which has been in force for the last eight years, has been the effect of the Regulator's new statutory objective to "minimise any adverse impact on the sustainable growth of an employer". This has resulted in 'balance' being the buzzword; with explicit expectations on trustees to work collaboratively to balance their pension scheme's needs with those of the sponsor. There is clear recognition of the value of a strong sponsor and that valuation agreements should suit both parties, using the flexibility that exists in the system where appropriate. Helpfully, the Regulator is interpreting "sustainable growth" broadly to include sponsors that may be investing to stand still, and non-profit organisations.

2. Accountants: two – Actuaries: one

The code of practice makes it clear that the trustees' assessment of their sponsor's covenant should form the bedrock for all considerations in relation to the funding of their scheme. There is a significant focus on this throughout the funding code of practice, particularly when you compare it to the level of detail on any technical points around the calculations involved in the actuarial valuation. It is interesting to note that there are twice the numbers of references to "covenant" compared to "actuary" in the code of practice. As a result, we expect to see the level of input from covenant advisers increase over time, both as part of the valuation process and in regular monitoring between valuations.

3. Sponsors to set out their stall

We expect the code of practice will push sponsors to engage more proactively with trustees to clearly articulate their plans for the future of the business. To allow trustees to properly assess the strength of their covenant and help avoid protracted valuation negotiations, sponsors should provide them with enough information to understand "the employer's plans for sustainable growth". For example, detailed financial performance and forecasting information, particularly around levels of free cashflow, areas of investment and distributions to other stakeholders. This may prove to be a challenge for those sponsors that have, to date, been reluctant to share more than high level information. Sponsors who are able to present a compelling and robust business strategy to their trustees are likely to benefit from valuation results that are more closely aligned to supporting their plans. This could include a reduction in current deficit contributions even for cases where the employer is not stressed.

4. Joining it all up

Trustees will need to have a good grasp of the interaction between sponsor covenant, investment strategy and funding. The Regulator expects the approach adopted by the trustees in all areas to be consistent, e.g. trustees with a weak covenant should not be pursuing an aggressive investment strategy. In order to develop their understanding trustees are expected to carry out modelling to see how different strategies will perform under various conditions. This modelling may take the form of detailed stochastic asset-liability studies, scenario analysis and reverse stress testing. We expect to see sponsors and trustees increasingly move to use interactive modelling tools, such as KPMG's Fusion, to bring all the various complex strands together in an intuitive and efficient package.

5. The dangers of lines in the sand

The Regulator wants trustees to undertake pre-emptive planning around the risks to their objectives being met and to have adequate monitoring systems in place with "clear triggers for action". While specific automatic trigger mechanisms may sound appealing in theory, it is difficult to achieve in practice without restricting the flexibility to deal with the reality of actual experience. We believe that sponsors and trustees should look for greater insight and expertise in considering how to respond to real-world developments rather than mechanistic triggers.

6. You get what you pay for

The Regulator recognises that its new code of practice and regulatory approach will mean more work for trustees with an associated increase in adviser fees – "the impact of the revised funding code on the cost of scheme governance and administration activities is likely to be significant". Having an adviser that can help sponsors and trustees develop their integrated risk management plan, pulling together the various strands around covenant, investment and funding, in a consistent and efficient manner will help to mitigate the increased budget pressures.

The funding policy – how tPR will regulate

The Regulator has set out details on how it proposes to develop its approach to overseeing the funding of DB schemes and protecting the PPF. There appears to be a shift in focus to what really matters: the cash contribution outcome, rather than the level of the Technical Provisions or funding liabilities. The Regulator will also be hoping that the changes to its approach will result in greater correlation between covenant strength, levels of investment risk and cash contributions.

1. If it is broke – fix it

If the current regulatory approach was working satisfactorily from tPR's perspective, they would expect to see schemes with weak covenants have strong technical provisions and low levels of investment risk. However, as part of the supporting analysis in the consultation documents (Appendix G), the Regulator has shown that the strength of covenant (as measured by tPR) has little impact on either in practice – "our modelling and casework suggests that covenant, funding and investment risks are not always being properly linked up".

2. Cash is king

The Regulator has proposed that its key indicator for assessing whether to intervene in the funding arrangements for a scheme will be a comparison with its Balanced Funding Outcome ("BFO"). Although there is little detail provided around the exact derivation of the BFO, the most significant point to note is that BFO is focussed on the agreed level of cash being paid by the sponsor. This is a material shift in approach from the Regulator, which used to place most focus on the value placed on the liabilities (i.e. the level of the Technical Provisions). The Regulator expects to get actively involved with c10% of funding cases each year. Developing the BFO that helps to identify these with a single cash measure, taking account of all the scheme specific factors that go into setting a Recovery Plan (e.g. payment term, contingent payments, lump sums, asset backed funding and security, etc) will be challenging.

3. Maturity: not always a good thing

The Regulator expects the BFO to be set in relation to two factors, the strength of covenant and the maturity of the scheme. While the cashflow profile of the scheme is important, we are not convinced the proportion of pensioner liabilities should be a major factor in the BFO. If you have a strong covenant, why should having a more mature scheme result in a lower acceptable risk budget?

4. The Regulator as covenant assessor

As noted above, the key driver of the BFO measure will be strength of covenant. The Regulator has proposed using 4 bands ("Strong", "Tending to strong", "Tending to weak" and "Weak") and their supporting analysis shows that the majority by number (and vast majority by liabilities) of schemes will fall into the "Strong" and "Tending to strong" bands. It will be interesting to see how the approach of covenant advisers in the market will develop in light of this system as we don't believe that any adopt a similar approach. It is also worth noting that the Regulator's analysis attributes about 80% of all liabilities to companies with either a "Strong" or "Tending to strong" rating. We suspect that there will be some interesting conversations to be had when the trustees' covenant advice and tPR's assessment differs.

5. The bigger they come the harder they fall

As a resource constrained organisation it is perhaps unsurprising that the Regulator will take account of the scheme size when considering whether to intervene or not. However, this explicit acknowledgement may result in trustees of smaller schemes finding that they come under greater pressure in their discussions with sponsors as both parties will have limited expectations of any regulatory involvement.

6. Last orders

There is recognition that in certain cases it is unlikely that the sponsor will ever be able to provide adequate funding for their pension scheme. We expect to see the Regulator putting increased pressure on the trustees who find themselves in this situation to take more immediate action – "considering whether it is appropriate to crystallise the scheme's position".

7. Through the looking glass

The Regulator has acknowledged the frustrations that are caused to sponsors and trustees by a lack of transparency and consistency in their dealings with individual case teams. It hopes the new funding approach will improve matters, with greater transparency provided by the BFO assessment approach and a clear commitment to providing all schemes with timely confirmation on whether it proposes to take further action following their initial review of the valuation results. Also, they expect to see the level of consistency improved by aligning their assessment of risks with how they expect schemes to operate, as set out in the code of practice.

The 163 pages released by the Regulator contains a lot of positive sentiment on greater balance, flexibility and transparency within how the new framework for funding DB schemes will work but, as always, the proof will be in how trustees, sponsors and their advisers interpret it in practice.

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