

Draft code of practice no. 3

# Funding defined benefits

June 2014

The Pensions  
Regulator



Draft code of practice no. 3

## **Funding defined benefits**

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# Purpose of this code of practice

This second version of code of practice no. 3 replaces the version published in 2006.

The code has been developed in light of the regulator's objectives which were introduced by the Pensions Act 2004 and applied in the 2006 code of practice as well as a further objective 'in relation to the exercise of its functions under Part 3 only, to minimise any adverse impact on the sustainable growth of an employer' introduced in 2014.

The code has been developed by us to meet our objectives but recognises:

- **trustee objectives:** to comply with their fiduciary duties and ensure that scheme benefits can be paid as they fall due, and
- **employer objectives:** to run their businesses and grow them as appropriate while ensuring that they are able to provide the pensions they have promised.

In particular, the code recognises that a strong, ongoing employer alongside an appropriate funding plan is the best support for a well-governed scheme.

It therefore stresses the importance of trustees having a good understanding of the employer's position and plans (including how any plans for sustainable growth enhance the employer covenant). This is because the trustees' ability to fulfil their key duty to pay promised benefits as they fall due will be enhanced if the employer supporting the scheme is successful.

The code encourages trustees and employers to use the flexibilities in the funding regime and work collaboratively. This greatly increases the likelihood of reaching an appropriate scheme funding outcome that reflects a reasonable balance between the need to pay promised benefits and minimising any adverse impact on an employer's sustainable growth; which in turn helps the trustees to achieve their key funding objective. Collaborative working helps to foster understanding of the challenges facing the trustees and the employer and the options for addressing them. Trustees and employers are encouraged, therefore, to engage openly and transparently with one another.

The code also recognises that trustees may take some risk in achieving their objectives while stressing that they should understand and manage that risk effectively. In particular the code encourages trustees to adopt an integrated approach to risk management across the key risk areas to funding plan success – employer covenant, investment and funding related risks.

The code encourages trustees to act proportionately in carrying out their functions given their scheme's size, complexity and level of risk.

# Introduction

1. This code of practice is issued by The Pensions Regulator (the regulator), the body that regulates occupational pension schemes.
2. The regulator's statutory objectives<sup>1</sup> are:
  - to protect the benefits of pension scheme members
  - to reduce the risk of calls on the Pension Protection Fund (PPF)
  - in relation to the exercise of its functions under Part 3 only, to minimise any adverse impact on the sustainable growth of an employer
  - to promote, and improve understanding of, the good administration of work-based pension schemes, and
  - to maximise compliance with the duties and safeguards in the Pensions Act 2008.
3. The regulator has a number of regulatory tools, including issuing codes of practice, to enable it to meet its statutory objectives.
4. Codes of practice provide practical guidelines on the requirements of pension legislation and set out standards of conduct and practice expected of those who must meet these requirements<sup>2</sup>.

## Northern Ireland

5. A version of this updated code including references to corresponding legislation in Northern Ireland will be brought forward in due course.

## Status of codes of practice

6. Codes of practice are not statements of the law and there is no penalty for failing to comply with them. It is not necessary for all the provisions of a code of practice to be followed in every circumstance. Any alternative approach to that appearing in the code of practice will nevertheless need to meet the underlying legal requirements and a penalty may be imposed if these requirements are not met. When determining whether the legal requirements have been met, a court or tribunal must take any relevant provisions of a code of practice into account<sup>3</sup>.
7. If there are grounds to issue an improvement notice, the regulator may issue a notice directing a person to take, or refrain from taking, such steps as are specified in the notice. These directions may be worded by reference to a code of practice issued by the regulator<sup>4</sup>.

<sup>1</sup>  
See section 5(1).

<sup>2</sup>  
See section 90(1).

<sup>3</sup>  
See section 90(5).

<sup>4</sup>  
See section 13(3).

## This code of practice

8. Publication of this code is a statutory requirement. It provides practical guidance and sets out standards of conduct for complying with Part 3<sup>5</sup>. In addition it:

- provides guidance to trustees in the discharge of their duties under the legislative provisions concerning the disclosure of information requirements linked to Part 3<sup>6</sup>
- sets out what are regarded as reasonable periods for trustees to provide certain information, and report certain issues, to the regulator<sup>7</sup>
- details what the regulator considers to be adequate trustee knowledge and understanding for the purposes of Part 3<sup>8</sup>
- sets out when to report materially significant breaches of the law to the regulator<sup>9</sup> and
- sets out the regulator's expectations for adequate internal controls and approach to investment issues for the purposes of Part 3<sup>10</sup>.

5  
See section 90(2)(d).

6  
See section 90(2)(d) and also under the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 (SI 2013/2734) and Schedule 3.

7  
See section 90(2)(a).

8  
See section 90(2)(f).

9  
See section 90(2)(c).

10  
See section 90(2)(k) and the Occupational Pension Schemes (Internal Controls) Regulations 2005 (SI 2005/3379).

11  
These are benefits accrued independently of the contributions payable to and investment returns achieved by the scheme. Most commonly, the benefits are related to members' earnings when leaving the scheme or retiring and the length of pensionable service completed.

12  
See section 221 and regulation 17.

## At whom is this code directed?

9. This code applies to trust based occupational pension schemes providing defined benefits<sup>11</sup> and is primarily for these schemes' trustees, who must comply with the funding requirements of Part 3<sup>12</sup>, and their employers. Certain aspects also apply to actuaries. Other professional advisers will also find it of interest.

## Terms used in this code

10. In this code, legislative requirements are indicated by 'must' and code guidelines by 'should'.
11. Unless stated otherwise, all references to:
  - an 'actuary' are to the actuary appointed by the trustees and who fulfils the statutory functions under Part 3
  - an 'actuarial report' are to a report commissioned by trustees to provide an update of the scheme funding position at a time between full actuarial valuations
  - an 'actuarial valuation' are to a comparison by the actuary of the value placed on scheme assets with the technical provisions and an assessment of any future contribution requirement which meet the Part 3 requirements
  - 'contingent assets' are to those assets on which a claim by a scheme would exist on the occurrence of one or more specified future events. Unless the events occur these assets are not included as scheme assets for the purposes of assessing compliance with the statutory funding objective
  - the 'effective date' in relation to an actuarial valuation or actuarial report are to the date as at which the scheme's assets and technical provisions are measured. It will be earlier than the date on which the calculations are carried out.
  - an 'employer' are to an employer as defined in section 124(1) of the Pensions Act 1995 as extended by section 125(3) of that Act to former employers by paragraph 3 of Schedule 2
  - the 'funding documents' are to the actuarial valuation, statement of funding principles, recovery plan and schedule of contributions for a scheme
  - 'schemes' are to defined benefit schemes and include the trustees of these schemes
  - 'regulations' and 'Schedules' are to those from the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (SI 2005/3377)
  - 'sections' and 'Parts' are to those from the Pensions Act 2004
  - the 'technical provisions' are to the measure used for the purposes of actuarial valuations under Part 3 which is calculated by the actuary
  - 'trustees' include a scheme's trustees or managers or, where applicable, directors of corporate trustees.
12. Terms used in this code not otherwise defined should be read consistently with Part 3 and the regulations.

## Other relevant codes of practice

13. Trustees reading this code are expected to have appropriate knowledge and understanding of the funding regime. For more information on what is expected, please refer to **Code of practice no. 7 – Trustee knowledge and understanding (TKU)** and its associated guidance.
14. **Code of practice no. 1 – Reporting breaches of the law** sets out expectations in respect of reporting matters of material significance to the regulator.
15. **Code of practice no. 2 – Notifiable events** explains the duty of trustees and employers to notify the regulator about certain scheme-related and employer-related events.
16. **Code of practice no. 9 – Internal controls** sets out the regulator's expectations on adequate internal controls.

## Other guidance

17. We have published, and will continue to publish, guidance which complements areas covered in this code.

## Key funding principles

18. Paying the promised benefits is the key objective for scheme trustees. This code sets out the standards and guidance for how trustees and employers should seek to put in place an appropriate funding plan and comply with the scheme funding requirements to achieve this aim.
19. In doing so, the following principles are applicable to all schemes<sup>13</sup>. Implementation will depend, however, on the specific circumstances of the scheme and employer.

### Principles

**Working collaboratively:** Trustees and employers should work together in an open and transparent manner to reach funding solutions that recognise the needs of the scheme and the employer's plans for sustainable growth.

**Managing risk:** Trustees should implement an approach which integrates the management of employer covenant, investment and funding risks; identifying, assessing, monitoring and addressing those risks effectively.

<sup>13</sup> For example, no different principles apply where the employer is a charity or a regulated utility.

**Taking risk:** Before trustees take funding or investment risk they should, in discussion with the employer, establish the employer's risk tolerance and assess the employer's ability to address a range of likely adverse outcomes over an appropriate period.

**Taking a long-term view:** Trustees' decisions should be consistent with their long-term funding and investment targets and their view of the employer covenant.

**Proportionality**<sup>14</sup>: Trustees should act proportionately in carrying out their functions given their scheme's size, complexity and level of risk.

**Balance:** Trustees should seek an appropriate funding outcome that reflects a reasonable balance between the need to pay promised benefits and minimising any adverse impact on an employer's sustainable growth.

**Well governed:** Trustees should adopt good governance standards in relation to the scheme's funding.

**Fair treatment:** Trustees should seek to ensure that the scheme is treated fairly amongst competing demands on the employer in a manner consistent with its equivalent creditor status.

**Reaching funding targets:** Having agreed an appropriate funding target, trustees should agree funding to eliminate any deficit over an appropriate period.

14  
See paragraph 20.

## Proportionality

20. The concept of proportionality is an important one to which we refer throughout the code. Factors that trustees should take into account in deciding what is proportionate for their scheme include:
- the size of the scheme (both in absolute terms and its size relative to the size of the sponsoring employer) and the strength of the employer covenant
  - the funding level of the scheme
  - the complexity of the proposed investment strategy, the investment related risks undertaken and the reliance placed on the employer covenant
  - the likelihood that employer covenant, investment or funding risks will crystallise and their impact if they do
  - the potential costs and benefits of any proposed approach; and
  - the complexity of scheme design and employer relationships (as, for example, with non-associated multi-employer schemes).

## Approaching funding

21. The trustees' approach to scheme funding cannot be implemented in isolation from their fiduciary and other duties (under both the rules of their scheme and legislation or trust law). The circumstances of both the scheme and employer are also crucial.
22. The trustees' key objective is to pay promised benefits as they fall due. They may also have additional aims: for example, maintaining the relationship between the scheme and employer, de-risking or (where required, with employer agreement) the preservation of ongoing benefit accrual.
23. Trustees must have appropriate knowledge and understanding of the principles which relate to scheme funding<sup>15</sup> to understand the possible funding approaches for their scheme.
24. Part 3 provides the statutory framework for how the trustees must assess their scheme's liabilities and determine the pace and period over which these liabilities must be funded. Part 3 sits alongside the scheme's own funding rules<sup>16</sup>. As there is no single typical scheme, the funding solution under Part 3 will always be scheme-specific.

15  
See sections 247(4)(b) and 248(5)(b) and **Code of practice no. 7 – Trustee knowledge and understanding**.

16  
To the extent there is any conflict between the scheme's provisions and Part 3, then Part 3 overrides. See sections 306(1) and 306(2)(h).

## The responsibilities of trustees and the employer

25. Whilst it is the trustees who take the decisions on a scheme's funding position and who must be comfortable that certain statutory tests are met<sup>17</sup>, agreement must normally be reached with the employer on the contents of the funding documents<sup>18</sup>.

## Collaborative working

26. Trustees and employers should therefore work together in an open and transparent manner to reach funding solutions that strike the right balance between the needs of the scheme and those of the employer. They should engage early and often. This engagement will be valuable even where not mandated. Where negotiation is necessary, it is important to work together as partners to explore whether it is possible to reach agreement.

27. To form their views, the trustees should engage with and obtain relevant information from the employer at an early stage in the valuation process. In turn the employer must provide the trustees with the information they or their professional advisers reasonably require to perform their respective duties<sup>19</sup>. This includes information reasonably required to assess the employer covenant. Employers will appreciate the value of volunteering information about their plans (including those for growth) so that these can be considered when reaching funding decisions.

28. Trustees should not be refused information to which they are otherwise entitled because of concerns over stock exchange requirements or other confidentiality issues<sup>20</sup>. They should, however, be aware of the potentially sensitive nature of the information and any constraints on disclosure by the employer. Potential employer concerns can be overcome by the trustees entering into a confidentiality agreement with the employer and/or using trustee sub-committees. Where constraints on disclosure exist, trustees should co-operate with the employer in taking steps to overcome those restraints where possible.

17  
See paragraph 112.

18  
See section 229(1).

19  
See regulation 6(1)(a) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715).

20  
See regulation 6(1) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715).

## Managing conflicts

29. Managing conflicts of interests and duties properly is vital. Trustees should have a process in place which effectively identifies, documents, monitors and manages conflicts and potential conflicts.
30. Given the importance and sensitivity of funding negotiations, trustees need to understand when actual or potential conflicts arise. Where conflicted, a trustee should consider withdrawing from negotiations. Where there are acute or pervasive conflicts or tensions associated with the trustee's role (for example where the trustee is also the finance director) it is likely to be inappropriate for the trustee to continue to be involved in those negotiations. Not all conflicts are employer-related. They can also arise for trustees who, for example, are members of the scheme or who hold trade union representative roles.
31. Trustees also need to be aware that their service providers and advisers could also have conflicts. Where a conflict is identified to the trustees they should understand how it is being managed.

## Agreeing a funding solution

32. It is important that trustees are always able to demonstrate that they have acted in line with their fiduciary duties in an impartial, independent manner when complying with the requirements of Part 3. In the unlikely event that those requirements are not met (even after engagement and collaborative working between both parties) then the trustees should not agree the actuarial valuation as they would be compromising the scheme's funding position.
33. A limited number of schemes may not be able to put in place an adequate scheme funding solution (ie one which is appropriate in the context of the employer covenant without an unacceptable level of investment risk being run). The trustees of these schemes should be prepared to address the implications of this for paying benefits. Continued future accrual of benefits is unlikely to be appropriate. Other consequences might include consideration of whether the scheme should be wound up or how the scheme's interests in the employer are protected or realised.
34. Trustees should document their considerations and reasons for decisions. They should be in a position to be able to explain the decisions based on the interplay of the different information and advice strands they have received.
35. When performing their duties under Part 3, trustees should not take into account the potential for the PPF to provide compensation to members of the scheme.

# An integrated approach to risk management

36. It is not necessary to eradicate risks completely. Trustees may wish to embrace a degree of risk in seeking opportunities to capture potentially significant associated rewards for both the scheme and employer. Accepting appropriate risk can significantly help to minimise any adverse impact on the employer's sustainable growth which in turn helps the trustees to meet their key funding objective to pay promised benefits.
37. Risk should be understood and managed appropriately. Trustees should understand the likely upsides and downsides of proposals and be comfortable with the extent to which the employer can address the likely adverse outcomes over an appropriate period. Trustees should engage with the employer to establish its appetite for risk and tolerance to downside events. Trustees should note that it is not necessary for the employer to be able to cover all conceivable risks or that those it is covering be repaired immediately should they crystallise.

## Assessing risk

38. If they are not already doing so, trustees should adopt a proportionate<sup>21</sup> integrated approach to risk management when developing an appropriate scheme funding solution. The resources committed to this should be commensurate with the benefits the approach is expected to deliver for the scheme and employer.
39. Schemes face many risks to achieving their funding plans. These broadly fall into those which are:
  - employer covenant-related
  - investment-related and
  - funding-related.

As part of a risk management approach, trustees should understand the risks across all of these strands and define acceptable parameters for each within which they seek to manage the scheme. This understanding also helps the trustees to strike the right balance between these risk parameters.

40. In general, employer covenant, funding and investment decisions interact so that a material change to one affects the other two. Trustees should proportionately<sup>22</sup> monitor key indicators so that, where such a change occurs, they can make timely adjustments (if appropriate) designed to preserve the scheme's funding balance.

<sup>21</sup>  
See paragraph 20.

<sup>22</sup>  
See paragraph 20.

41. An integrated approach does not need to be expensive or standalone. Some aspects may already be, and continue to be, recorded within either or both of the statement of funding principles and the statement of investment principles for the scheme. The focus should not be on paperwork or excessive quantification. Instead the approach should be embedded within the trustees' governance framework. Emphasis should be placed on the actions trustees should take when risks begin to crystallise.

## Risk management in the funding landscape

42. Effective integrated risk management is an internal control for the scheme and represents an appropriate scheme risk management cycle<sup>23</sup>. Once they have set objectives for scheme funding, trustees should:
- understand the employer covenant, investment and funding risks to those objectives and the interaction between these risks
  - have a funding and investment strategy to achieve these objectives
  - set an appropriate risk appetite
  - agree appropriate management actions and contingency plans; and
  - establish a framework to assess, monitor and control:
    - scheme risks
    - progress against the trustees' strategy; and
    - any changes required.

## Integrated risk management steps

### Understanding risks

43. Trustees should seek to understand the risks across the employer covenant, investment and funding strands. In particular trustees should understand the extent of the scheme's reliance on the employer covenant over time on the basis of a range of plausible future scenarios. These scenarios should capture investment risk, the impact of potential or actual maturing of the scheme and the impact of the contribution patterns which are proposed for the scheme (and the risks to those contribution patterns) compared to the employer covenant available under various scenarios. This is because the employer underwrites both the short- and long-term risks to which a scheme is exposed.

<sup>23</sup>  
See Code of practice no. 9.

## Tools for understanding risks

44. It is important for trustees to appreciate that all the risk assessment tools only illustrate possible outcomes. They do not predict how a scheme's assets and liabilities will behave. Their value lies in helping trustees to appreciate the order of magnitude of the scheme risks, the broad trade-offs and the options available for managing these risks. Trustees should assess and weigh the inputs they receive relative to the various other inputs. They are encouraged to use a variety of qualitative and quantitative approaches (for example, scenario testing and stress testing) to assess the impact of adverse events on potential employer covenant, investments and funding plans. The approaches used should be proportionate<sup>24</sup> to scheme and employer circumstances.

## Approaching risks

45. When approaching the assessment of risk, trustees should remember that pensions are deferred pay. If the funding strategy is unsuccessful and the employer is unable to make up the shortfall this deferred pay will not be delivered.
46. It is useful for trustees to consider how other organisations, which find themselves in a position of being creditors (such as banks), seek to protect themselves against the risk of the non-payment of money owed by counterparties. Applying some of these techniques to the scheme's circumstances could result in the provision of adequate and risk-controlled collateral or guarantees (the scheme's actual and contingent assets) and/or the use of controls around employer behaviour (for example, negative pledges and monitoring).

## Setting strategies

47. Strategies set by the trustees should be specific, measurable, appropriate, realistic and time-bound. Setting acceptable strategies involves establishing the balance between the risks which they consider to be appropriate for the scheme given its and the employer's circumstances. Trustees should consider a wide range of questions and issues such as:

- what risks are controllable and what are not
- the likelihood and consequences of each of these being realised
- what risks they are prepared to take
- what risks would they like to mitigate in full or in part
- proposed risk controls and volatility of results; and
- vulnerability of the scheme and the employer covenant.

<sup>24</sup>  
See paragraph 20.

48. This analysis should enable trustees, in discussion with the employer, to identify material risks and set parameters within which they seek to manage the scheme risks. The ability of the trustees to take different levels of risk dependent on their appetite should be informed by their assessment of the employer's own tolerance to risk. The trustees' ability to manage and address these risks, is a key flexibility which can be used to minimise any adverse impact on an employer's sustainable growth. The level of tolerable risk and the flexibilities set by the trustees should be consistent with their key objective to pay promised benefits.

## Monitoring risk

49. Effective risk management should be an ongoing process. Material changes can occur between actuarial valuations.
50. This is why trustees should have a framework in place to apply proportionately<sup>25</sup> when it comes to on-going monitoring. This should enable them to quickly identify changes in the environment and balance of risks.
51. Employer covenant, investment performance and scheme funding levels can change rapidly and changes can be very different in their nature. Some employer covenant changes may be significant and expected to be permanent, others may not. Similarly, investment values fluctuate constantly with market changes but not all fluctuations will endure or have a lasting adverse impact. Trustees should exercise judgment about the materiality and permanence of changes.

## Contingency planning

52. Trustee risk management plans should identify the potential steps they may take to preserve an appropriately balanced<sup>26</sup> funding strategy and when to take those steps.
53. Trustees should have a view on the range of likely adverse outcomes that could apply and have an adequate and flexible strategy and governance structure to address these outcomes. This planning should be proportionate<sup>27</sup>. It may be as valuable to the employer as it is for the scheme because potential volatility can be damaging for both. In simple form, it can involve the identification of triggers for provision of information and review and discussion by both trustees and employer of how matters might be addressed.

<sup>25</sup>  
See paragraph 20.

<sup>26</sup>  
See paragraph 39.

<sup>27</sup>  
See paragraph 20.

54. Where trustees agree with the employer to accept more risk than can be supported by the available employer covenant, contingency plans will need to be more definitive as they can provide additional support for the scheme. The plans should be aimed at preventing risk from escalating to levels which the trustees would not find acceptable. They can also be used in anticipation of an improved position (so that, for example, employer concerns over potential scheme funding surplus can be addressed). Options available include:
- provision of contingent assets
  - transfer of non-cash assets
  - contingent cash funding
  - negative pledges
  - improving the insolvency priority of the scheme
  - scheme rule changes
  - wider group support
  - third party guarantees; and
  - use of escrow accounts.
55. Trustees need to consider the value that is likely to flow to the scheme from a contingent asset in the circumstances likely to be prevailing when it is needed, taking appropriate legal, covenant, investment and actuarial advice to understand the associated risks. This advice informs their view on the appropriateness of any arrangements provided to support the scheme's funding strategy.
56. Where the contingent asset is in the form of a guarantee, trustees should understand how the guarantee is to be funded and what other claims might arise on the guarantor and the relative priority of those claims. They should also understand the impact that employer or guarantor insolvency would have on the guarantor's ability to meet the terms of the guarantee together with the likelihood of employer or guarantor insolvency occurring.

## Working with advisers

57. Trustees should have the right people to help them run their scheme. Where appropriate trustees should seek professional independent analysis and advice across the employer covenant, investment and funding strands to support their decision-making. This may extend beyond those circumstances in which they are required to take advice under Part 3. If trustees elect not to retain independent advisers (for example, to assess the employer covenant) and instead undertake the analysis themselves, they should document why they consider themselves sufficiently equipped, independent and experienced to undertake the work to a standard appropriate to enable them to discharge their duties. They should then ensure they perform the task to that appropriate level and record their analysis.
58. Trustees should ensure that their advisers and personnel have the skills, knowledge and expertise necessary for the proper discharge of the responsibilities allocated or delegated to them. Professional conduct rules may apply to advisers. For example, the professional standards (including the Technical Actuarial Standards of the Financial Reporting Council) underpinning actuarial information and advice which apply to actuaries.
59. When appointing an adviser, trustees should ensure that they understand the information the adviser needs to fulfil the assigned role.
60. Trustees have the best vantage point from which to identify the risks their scheme faces. They should do so taking account of the advice they receive across the employer covenant, investment and funding strands in an integrated way and ensuring that their advisers have access and regard to the analysis of the other advisers as necessary or appropriate.

# Employer covenant considerations

## Understanding employer covenant impact

61. The employer covenant to a scheme represents the extent of the employer's legal obligation<sup>28</sup> and financial ability to support the scheme now and in the future. Trustees should understand the strength of the employer covenant. This involves forming a view of the covenant now and how it could grow and develop in the future.
62. This view should encompass the employer's resilience to cope with downside outcomes (for example, should the scheme's investment strategy underperform and/or its funding deteriorate) and its ability to repair any likely deficits over a reasonable period. It should help the trustees decide how much risk it may be appropriate to take (ie when they set their technical provision assumptions and investment strategy as well as put in place any recovery plan). These views will also enable the trustees and the employer to explore how prudent funding plans, to pay promised benefits, can be supported by and balanced with minimising any adverse impact on the employer's sustainable growth. Additionally, if there is a deficit, the trustees' view of how the employer can afford to meet the scheme's funding needs is an important consideration in recovery plan design.
63. An employer covenant assessment should be proportionate<sup>29</sup> and undertaken as part of each actuarial valuation. The trustees' assessment of the employer covenant (including affordability) should be used consistently for different purposes. So, for example, a low value for technical provisions based on a strong employer covenant assessment would be inconsistent with a long back-end loaded recovery plan, as this type of recovery plan would be more consistent with a weak employer covenant assessment.
64. Trustees should ensure that the employer covenant which supports the scheme is only accounted for once. For example, a guarantee provided to the scheme to enhance the employer covenant strength in support of low technical provisions should not also be counted as support for an extended recovery plan. Similarly, if an asset backed contribution (ABC)<sup>30</sup> arrangement is implemented, the assets transferred to that arrangement should not be double counted by taking them into account in the employer covenant assessment.

28  
Legal obligations can flow from a number of sources, most commonly under legislation and the scheme rules.

29  
See paragraph 20.

30  
An ABC arrangement is a contractual funding arrangement under which an income stream is provided to a scheme, usually via a special purpose vehicle. The income stream derives from an asset which is transferred to the vehicle. Sometimes, that income stream is given a net present value by the trustees, thereby reducing or eliminating the scheme's funding deficit. This code does not provide guidance on the appropriateness of entering into an ABC.

65. It is unlikely that trustees will be able (with any degree of certainty) to assess the employer covenant too far into the future, as projections are less precise. Assessments should, therefore, be based primarily on the short to medium term for which business plans are provided. In the longer term, the assessment should be based on a range of plausible scenarios and any strategic developments which the trustees or covenant adviser are aware of and consider plausible.

## Covenant assessment

66. Employers are best placed to take key decisions on their business plans including those for sustainable growth. This is not the job of the trustees. Therefore, a covenant assessment by or for the trustees should not be designed to critique an employer's business. It is an assessment of the employer's strength relative to the scheme.
67. The starting point is for the trustees to understand the legal robustness of an employer's obligations<sup>31</sup> to the scheme and its ability to meet them.
68. Where a scheme has an overseas employer, trustees will need to consider how this may impact on the scheme's ability both to access ongoing funding and to enforce debts in the overseas employer's jurisdiction.
69. The trustees' approach to covenant assessment should be proportionate<sup>32</sup> to the circumstances of their scheme and the employer. In depth analysis may not be required, for example, if there has been no material change since the covenant was last assessed or the scheme is very small in comparison with a strong employer.
70. Advice on the employer covenant should enhance the trustees' understanding and can be focussed on those areas where the trustees are not already confident of the position or able to readily understand the position for themselves.
71. Although historical evidence may be informative, evaluation of likely future performance is key to the assessment of employer covenant. The future is never certain and forecasting events over a long period is always more difficult than taking a view about how things will develop in the short-term. When taking a view, trustees should take account of the extent to which they anticipate needing to rely on the employer covenant as time passes.

31  
Legal obligations can flow from a number of sources, most commonly under legislation and the scheme rules.

32  
See paragraph 20.

72. The scope of a covenant review should reflect the employer's circumstances and may involve different considerations from those set out in this paragraph in relation to some employers (for example those in the not-for-profit or charity sectors or those under a non-associated multi-employer scheme). Generally, however, areas that trustees might consider to be within the scope of an employer covenant review may include the following:

- The employer's position within the group and the wider group structure, including inter-company relationships, reliance and policies (for example, inter-company trading), transfer pricing, dividend policy and group cash pooling.
- The employer's trading and balance sheet position and financing strategy. This should include looking forward to material forthcoming events (for example, debt refinancing and financial covenant compliance tests) and understanding the impact of the employer's and group's financing arrangements on the scheme's priority as a creditor (for example, the impact on the creditor priority ranking of any inter-creditor agreement, both in terms of the ranking in an insolvency and in priorities against cash generation and asset realisations on a going concern basis).
- The employer's forecast profit and cash generation, business plans, growth prospects, need for investment, levels of debt and ability to service this from cash generated, ability to provide support for: (i) ongoing benefit accrual (if applicable) and (ii) deficit repair contributions, and its ability to address any adverse experience compared to that assumed in the scheme's investment and funding plans.
- An estimate of the value that might flow to the scheme on insolvency of the employer or scheme wind up (taking account of the extent to which the trustees are able to limit the development of uncontrolled insolvency and so maximise value), as well as the likelihood of such an eventuality, based on the employer's current position and prospects. Alternatively, trustees might decide that a more high-level consideration of insolvency outcome is appropriate where they consider insolvency risk to be low.
- The nature of the industry in which the employer operates and its position in that industry. This would include the key drivers of demand in the sector, likely future trends and other factors that may affect the resilience of the employer's business (for example, corporate governance, ownership and management structures).
- If the employer is subject to any price control regulation, for example a regulated utility, and how this affects the employer<sup>33</sup>.

33

Other regulators often develop models for factoring in the cost of the schemes when applying price controls. Trustees should not place direct reliance on these models and their outputs in funding negotiations. However, they may form part of the assessment of the employer's covenant and when assessing reasonable affordability for the employer in formulating the scheme funding plan.

73. The position of the wider corporate group, other than those employers with legal obligations, can be important as this may provide strength or introduce risks to the employer covenant.
74. If the wider corporate group draws benefit from the employer, which can be through cross guarantees, cash pooling, transfer of intellectual property, transfer pricing bias etc, then the trustees should consider asking for the group to provide formal support which reflects this.
75. Trustees might be told that banking covenants prevent guarantees and/or contributions to the scheme. They should be conscious that these were entered into voluntarily and can be modified over time, so this argument should be considered in that context. Sometimes they will have been entered into in a way which did not respect the scheme's equivalent creditor status, in which case mitigation should be sought.

## Investing for sustainable growth

76. Trustees should recognise that employers often need to invest in their businesses to enable them to grow and/or fulfil their obligations which should, in turn, help the trustees to achieve their key funding objective<sup>34</sup>. Trustees should understand the employer's plans. This should allow them to explore how to use flexibilities under Part 3 that can minimise any impact on the employer's sustainable growth, when putting in place plans to pay the promised benefits.
77. Where an employer proposes to prioritise the investment it wishes to make in its business over making funding available to the scheme the trustees should understand how this impacts on the employer covenant. The approach adopted should be appropriate to the circumstances. Where there is a constraint on the employer's covenant which results in greater risk taking in setting and reaching funding targets, the degree of trustee consideration and discussion with the employer should be proportionate bearing in mind that level of constraint. However, in cases where the employer covenant is unconstrained or the employer covenant would not be significantly altered as a result of the investment, the trustees should recognise that the employer is free to pursue its investment plans without trustee scrutiny.
78. In responding to the employer's investment plans, trustees should consider the impact of their decisions on both scheme funding risks and the employer covenant. For example, trustees should recognise that the servicing of other debts and raising of additional equity may contribute significantly to business success and be in the long-term interests of the scheme.

<sup>34</sup>  
See paragraph 22.

79. Where trustees have agreed to accept more risk to facilitate planned investment which does not then take place, the trustees should ask the employer to present to them any alternative plans it has for the contributions foregone. If no alternative plans are presented or the trustees do not agree to accept the risk associated with the plans, the trustees should expect additional funding to be made available to the scheme.
80. Sustainable growth will mean different things to employers in different circumstances. The key for trustees is to understand the context of an employer's circumstances, including its investment aims and what will constitute success for its business.
81. Sustainable growth should be interpreted so that it is capable of being applied to all types of businesses. Therefore, it will look different in different sectors such as not-for-profit and for businesses at different points in their life cycle.
82. The employer's investment can take differing forms; therefore, where appropriate and proportionate<sup>35</sup>, trustees should look to understand:
- the nature of any proposed investment (in assets or projects) including the distinction between maintenance and growth projects
  - how this fits with the employer's long-term business plans
  - the likely benefit to the employer (or group), both in terms of value and timing
  - whether additional support can be made available to the scheme from this increased value in employer covenant
  - the extent to which other stakeholders share in and contribute to the employer investment. Where investment in growth constrains<sup>36</sup> the employer's ability to support the scheme, trustees should explore the extent to which shareholders can share in providing this support (for example through formally agreed reduced or suspended dividend payments).
  - when investment is to be funded by new equity rather than from existing employer assets which would otherwise be available to the scheme. Where equity provides new funding, they may have a reasonable expectation that reasonable dividends will be paid on this equity subject to business performance at an appropriate time.

35  
See paragraph 20.

36  
See paragraph 77.

## Dividend payments

83. Payment of dividends by an employer is a normal business activity which can be consistent with both the employer's sustainable growth plans and the trustees' funding objective to pay benefits as they fall due. While an employer's dividend policy might be significant for scheme trustees where the employer's covenant is already constrained<sup>37</sup>, it should not generally be a material concern where the employer covenant is already strong and will remain so after the proposed dividend has been paid. Significant trustee scrutiny of employer dividend policy would be disproportionate and unnecessary in the latter circumstances. Trustee scrutiny can be limited to those situations where the covenant strength is a concern, where the timing of proposed dividends is unusual or where exceptionally large dividends are proposed. This is because trustees will need to know if particular dividend payments will result in the covenant becoming weaker than that on which they have relied when taking their most recent scheme funding and investment decisions and be satisfied that the payments will not constrain the employer's ability to support the scheme without the acceptance of excessive risk within it.
84. Where dividend payments will result in the employer covenant becoming weaker and to address any resulting material impact, trustees should consider obtaining additional security or a share of any upside from the success of the employer's growth.

## Covenant monitoring

85. As the strength of the employer covenant can change rapidly due to internal and external factors, trustees should regularly and proportionately<sup>38</sup> monitor the employer covenant.
86. Covenant monitoring should include a review of key business performance indicators and corporate events which may materially impact the employer covenant. As a minimum an annual review of the employer's performance and other areas which have changed significantly (or may be expected to do so) should be conducted.
87. An employer must notify the trustees when it becomes aware of a materially significant development to the employer covenant, as this will have an impact on the scheme<sup>39</sup>.

37  
See paragraph 77.

38  
See paragraph 20.

39  
See regulation 6(1)(b) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996.

# Investment strategy considerations

## Purpose and impacts of investment strategy

88. An important purpose of scheme assets is to provide collateral and security for the promised benefits. They also enable scheme benefits to be funded in part by investment returns rather than solely by future contributions.
89. The trustees' investment strategy should be consistent with their key funding objective to pay promised benefits. They should engage with the employer as they develop and implement their investment strategy even where this is not required by law, as this should allow them to explore how to use flexibilities under Part 3 that can minimise any adverse impact on the employer's sustainable growth so helping them to achieve that key funding objective.
90. The trustees' investment strategy is a potential source of volatility in the employer's balance sheet and profit and loss account. The performance of the scheme's assets will also influence the amount of the future contributions the employer may have to pay to the scheme and the timings of those payments. The investment strategy will, therefore, affect the way in which the employer is able to plan and manage its cashflow. A low risk investment strategy might result in the need for higher employer contributions immediately. Conversely a high risk investment strategy may lead to higher and potentially unexpected contribution requirements in the future. The trustees and employer engagement should cover how these strategies may affect each of the scheme's funding position, the employer's plans for sustainable growth and its covenant.
91. The investment strategy will also likely impact on the assumptions used for setting technical provisions prudently (for example, the discount rate used when valuing assets and liabilities) and for setting an appropriate recovery plan.

## Determining the investment strategy

92. When managing scheme assets, trustees should place emphasis on setting investment principles that are appropriate to the scheme and employer's situation (now and in the future) and also on ensuring the effective implementation of the chosen principles. The long-term ability of the scheme to meet its benefits is likely to be more affected by the attention given to identification of risk, expected reward and appropriate asset allocation than to investment manager selection and monitoring. Focus and resources should be allocated accordingly.
93. The trustees should be satisfied that the investment strategy is consistent with:
- their funding objectives
  - their risk appetite as informed by their understanding of the scheme's risk profile and based on their approach to risk management (and so consistent with their objectives for the scheme and the level of employer covenant supporting the risks)
  - the scheme's liquidity needs (for example trustees should bear in mind potential liquidity risks when considering the introduction of contingent assets or another related reduction in contributions); and
  - the trustees' assessment of the employer covenant and its plans for sustainable growth.
94. As fiduciary stewards of scheme assets, trustees have a duty to invest them prudently in accordance with the scheme's provisions and the legislative framework<sup>40</sup>. Trustees should be mindful of the impact that downside underperformance has on the likelihood of members receiving their promised benefits and any strain it would place on the employer covenant. Trustees should seek to understand the impact on the scheme's funding plan and contributions in the event of any adverse or better than expected investment outcomes.
95. Diversification is important<sup>41</sup>. For example, if investments are concentrated in the same or a related industry to the employer, the risk increases that value will not be available to the scheme when needed should there be a downturn in the employer's sector.
96. Trustees should have sufficient and appropriate knowledge and understanding to enable them to provide sound and prudent oversight of the investment strategy. This may require having investment and/or risk management expertise within the trustee board in order to critically evaluate and oversee the investment strategy and associated risks, particularly where more complex investment strategies or risks are undertaken.

40  
See section 36 of the Pensions Act 1995 and regulation 4 of the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378).

41  
See regulation 4(7) of the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378).

97. As a scheme matures, the increasing net outgoings tend to increase the potential for crystallisation of the risks in the investment strategy. Running investment risk during this time may be appropriate but it is vital that trustees and the employer understand and manage the risk this brings.
98. Virtually all investment strategies involve an element of risk: however, as a general approach, if trustees accept investment risk, the higher the level of investment risk held within the scheme the greater should be the trustees' focus on the level of employer covenant available to support it. The more complex the investment strategy, the greater will be the level of governance needed to monitor it.

## Taking advice

99. Trustees must obtain and consider investment advice when setting and reviewing their investment strategy<sup>42</sup>. Complex strategies should be analysed more thoroughly than straightforward ones. An adviser should be expected to demonstrate and explain the balance of risks and rewards that would justify the particular strategy recommended in light of the trustees' assessment of the employer covenant. Trustees should be circumspect about claims that market outperformance can always be achieved.

## Asset-backed contributions

100. ABCs may help employers meet their obligations to schemes and can, in certain circumstances, improve a scheme's security by providing access to valuable assets or cashflow which were previously out of reach.
101. Capitalisation of the payment stream due to a scheme under an ABC structure may, however, give a distorted view of the scheme's funding position and overall risk profile.
102. When making decisions about a scheme's funding and investment strategy trustees should 'unpack' the elements of an ABC structure by disregarding the net present value attributed to the ABC in the scheme's accounts, and instead recognise the ABC as a funding stream. This 'unpacking' process will enable trustees to clearly identify the extent to which the scheme's future funding flow depends on payments being made from the ABC, the period over which those payments will be made and whether they are back-end loaded. Trustees should carefully consider whether any reliance should be placed on those future payments. This will be informed by the likelihood of the ABC continuing together with the value and enforceability of claims against the underlying asset in relevant scenarios (particularly employer insolvency, since this is the situation in which the asset will be relied upon).

42

See section 36 of the Pensions Act 1995 and regulation 2(2)(a) of the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378).

103. Trustees should recognise the risk that the ABC could, in future, be found to breach employer-related investment restrictions<sup>43</sup> and be unwound. As a contingency they should, therefore, put in place appropriate underpinning arrangements.

## Assessing investment risk

104. Trustees should understand the size and likelihood of risk (for both the scheme and employer over time) inherent in a proposed investment strategy. Risk should be assessed relative to the employer's ability to support the likely adverse outcomes identified.

105. Trustees should understand:

- the complexity of the proposed strategy and asset allocation
- the financial exposures (both current and evolving) underlying the proposed strategy
- the scheme's potential reliance on the employer over time on the basis of a range of future scenarios capturing investment risk, the maturing of the scheme and the impact of the proposed contribution patterns, compared to the employer covenant strength available under various scenarios.

106. To assist their understanding, trustees can adopt a deterministic approach considering a range of future investment, contribution and covenant combinations (including stressed assumptions). Before taking any decisions on approach, the trustees should discuss the most appropriate and proportionate<sup>44</sup> approach with their advisers.

107. For larger schemes and those with more complex investment strategies, a more sophisticated approach involving additional techniques such as stochastic asset and liability modelling (ALM)<sup>45</sup>, tail risk assessment, scenarios and contributions at risk may be appropriate to prudently assess and monitor the risks they are undertaking. Techniques used should be proportionate<sup>46</sup> and realistic in the assessment of likely adverse outcomes and how the trustees might address them. The timescale for modelling should be relevant to the needs of the scheme. In general longer-term risks are the most important although short-term models may provide useful indicators of long-term risk.

108. Where more complex investment or hedging strategies are envisaged, trustees should be mindful of additional risks such as agency, credit, counterparty, liquidity, pricing and model risks and be confident that these additional risks are proportionate<sup>47</sup> to the relative size of the scheme, the anticipated benefits of the strategy and the employer's ability to support them.

43

See section 40 of the Pensions Act 1995.

44

See paragraph 20.

45

ALM models many simulations of the future generated by computer using a mathematical model with random elements to illustrate the variability of outcomes and their relative likelihood.

46

See paragraph 20.

47

See paragraph 20.

109. Trustees should be alert to the fact that many factors can impact the effectiveness of their investment strategy. These can be external to the scheme (for example, general economic changes which can affect both the scheme and the employer covenant) or internal (for example, the quality of the advisers and any investment personnel the trustees employ).

## Monitoring investment performance and ongoing management

110. Trustees should monitor investment performance and continue to review the appropriateness of their investment strategy in light of the employer covenant, scheme funding level and liability profile, and any changes to economic circumstances. Trustees should also regularly review expected investment returns to see if they are still appropriate to the economic environment, both current and anticipated.

111. Ongoing management of the investment strategy should be proportionate<sup>48</sup>, reflecting the nature, scale and complexity of the scheme, the trustees' funding objectives and the employer's covenant and its plans for sustainable growth. The costs of any changes adopted should be weighed against the benefits they are likely to provide. In line with their contingency planning<sup>49</sup>, if the level of investment risk becomes excessive relative to the strength of the employer covenant, the trustees should:

- explore options to provide additional funding to the scheme
- explore options to strengthen the employer covenant, for example by improving access to employer assets or through legally binding support from other entities
- consider whether a change to the investment strategy is required to re-align the level of risk to the employer covenant; and
- recognise that it may be appropriate to accept a higher level of risk in the scheme's investment strategy to allow for the employer covenant to strengthen (improving its ability to support adverse outcomes).

48  
See paragraph 20.

49  
See paragraphs 52 to 56.

# Funding considerations

112. Every scheme that provides defined benefits<sup>50</sup> is subject to the statutory funding objective which is to have sufficient and appropriate assets to cover its technical provisions<sup>51</sup>. Under Part 3, trustees must commission actuarial valuations periodically<sup>52</sup> and prepare and revise both a statement of funding principles<sup>53</sup> and a schedule of contributions<sup>54</sup> for their scheme. Where a scheme does not meet the statutory objective, a recovery plan must be put in place<sup>55</sup>.

## Role of the scheme actuary

113. Trustees must take advice from the actuary on the assumptions to be used<sup>56</sup>.

114. The actuarial valuation must incorporate the actuary's certification of the technical provisions calculation and the schedule of contributions<sup>57</sup>. The actuary is not responsible for choosing the method and assumptions or certifying that they are appropriate.

115. Trustees should have good reasons if they decide not to follow the actuary's advice. They should recognise that if they instruct their actuary to certify the technical provisions and/or schedule of contributions using an approach which the actuary considers would be a failure to comply with Part 3, the actuary would have to report that certification to the regulator<sup>58</sup> as the regulator considers such certification to be materially significant.

## Technical provisions – method

116. Trustees must choose an accrued benefits funding method for calculating the scheme's technical provisions<sup>59</sup>. This is a value placed on benefits accrued to a particular date. Trustees must take advice from the actuary on the differences between the accrued benefits funding methods available and the impact on the scheme of changing the funding method<sup>60</sup>.

50  
See footnote 11.

51  
See section 221(1).

52  
See section 224(1).

53  
See section 223(1).

54  
See section 227(1).

55  
See section 226(1).

56  
See section 230(1)(a).

57  
See sections 225(1)  
and 227(5).

58  
See section 70(2).

59  
See regulation 5(2).

60  
See section 230(1)(a).

## Assumptions used in calculating technical provisions

117. Technical provisions should represent a target reserve to hold against a scheme's future liabilities calculated using assumptions that have been chosen prudently, taking into account the degree to which the employer covenant can support a range of likely adverse outcomes.
118. Trustees are responsible for prudently choosing the assumptions to be used for the calculation of technical provisions<sup>61</sup>. They should choose individual assumptions the prudence of which is consistent with the overall level of prudence required of the technical provisions. They must<sup>62</sup> consider whether, and if so to what extent, account should be taken of a margin for adverse deviation when choosing prudent economic and actuarial assumptions.
119. The actuarial valuation must include the actuary's estimate of the scheme's solvency<sup>63</sup>. The actuary's estimate of the solvency position, and the assumptions underlying the calculations, are useful reference points for trustees and the employer when considering the adequacy of the technical provisions. The trustees should discuss whether the actuary considers there are any material implications for the scheme. In particular they should discuss the relationship between their technical provisions assumptions (particularly investment return and mortality) and the assumptions which the actuary will use in the estimate of the scheme's solvency.
120. It is essential for trustees to understand from the actuary how sensitive the technical provisions are to changes in the value of each financially material assumption. The greater the sensitivity, the greater the importance of choosing an appropriately prudent value for that assumption. This does not mean that detailed calculations are needed in each case, rather that the trustees should ask the actuary to identify the assumptions to which the technical provisions are particularly sensitive.
121. Assumptions should be evidence-based. This usually involves considering current conditions and expected future trends. Past experience may be relevant to the extent that it has predictive value for the future, for example when it relates to member behaviour, but care is required to recognise when changing circumstances make it a poor guide to the future. It is important to relate more general data, such as occupational or geographic groupings, to the situation of the particular scheme. This will be especially relevant to the choice of demographic assumptions (such as mortality<sup>64</sup> and early leaver rates) where there is wide variation of observed rates within the population or between employers.

<sup>61</sup>  
See regulations 5(1), (3) (a) and (4).

<sup>62</sup>  
See regulation 5(4)(a).

<sup>63</sup>  
See regulation 7(4)(b).

<sup>64</sup>  
See paragraph 131.

122. Technical provisions should not be compromised to make a recovery plan appear affordable.
123. At subsequent valuations trustees may choose a different method or assumptions to those previously adopted where justified by a change of legal, demographic or economic circumstances<sup>65</sup>.

## Economic assumptions

124. Economic assumptions are used to discount the expected cashflow from the scheme. Related assumptions, for example on the rates of future inflation and pay increases, will impact on the expected cashflow. The factors which need to underlie these assumptions are almost entirely independent of the scheme. They are driven by:
- the current yields on United Kingdom government securities of appropriate terms which informs the expected return on low risk investments and other parameters (for example, price inflation), and
  - broader economic and financial factors (for example, economic growth and wage inflation, and the expected returns on, and risks associated with, asset classes other than UK government securities).
125. Discount rates used in setting technical provisions must be chosen prudently<sup>66</sup>, taking into account either:
- the yield on assets held by the scheme to fund future benefits and the anticipated future investment returns; and/or
  - the market redemption yields on government or high quality bonds.
126. Trustees should seek a funding outcome that reflects a reasonable balance between the need to pay promised benefits and minimising any adverse impact on an employer's sustainable growth. They may use the flexibility available in setting the discount rates for technical provisions to reach the balance that best suits the scheme's circumstances. When considering any flexibilities in setting discount rates trustees should take account of any expected future changes to their investment policy.
127. The assumptions made for the relative returns of different asset classes may rise or fall from preceding actuarial valuations reflecting changes in market conditions and the outlook for future returns.
128. Asset and liability measures should be consistent. Smoothing of the discount rates is inconsistent with the requirement to measure assets at market value.

65  
See regulation 5(4)(d).

66  
See regulation 5(4)(b).

## Assessing prudence in discount rates

129. Discount rate prudence needs to be considered by reference to the likelihood and scale of the funding needs which could emerge if the expected investment return is not achieved. When considering discount rate prudence a medium- to long-term assessment is possible, recognising that scheme funding is a long term activity; however, trustees should understand that it is difficult to be certain of employer covenant strength over that longer term.

## Assessing funding risks

130. Any assessment techniques adopted should be proportionate<sup>67</sup> to scheme and employer circumstances. Trustees should discuss with the actuary the possible approaches to illustrating variability. One approach is stochastic modelling (ALM<sup>68</sup>). A simple, less costly approach could be to carry out the valuation using a few different sets of assumptions simply to illustrate the width of the potential outcome range and the sensitivity of results to particular assumptions. Discussions with the actuary would centre on the choice of appropriate assumption sets and the interpretation of results. Such scenario-based work can, where appropriate, usefully replace or supplement stochastic modelling since it may give a more readily understandable picture.

## Mortality assumptions

131. Trustees should pay particular attention to assumptions about future mortality bearing in mind that:

- wide variability is observed between individuals
- there is variability year-on-year in the whole population
- long-term trends can be observed in age-specific mortality of cohorts; and
- historically, experts have usually underestimated the rate at which mortality will reduce (longevity increase).

## Other actuarial valuation Issues

132. The cost of future benefit accrual for active members should be assessed on a basis consistent with that being used for the technical provisions. If the employer pays contributions determined on a different basis, this needs to be reflected in the schedule of contributions and any recovery plan required so that at the end of any recovery plan period the additional accrual can be expected to be fully funded on the assumptions made.

<sup>67</sup>  
See paragraph 20.

<sup>68</sup>  
See footnote 45.

133. Allowance should be made for likely changes in the scheme membership's demographic profile, in particular if the scheme is closed to new members.
134. The trustees should discuss with their actuary any concerns they or their actuary have over the quality of the actuarial valuation data.
135. Where the actuary includes, in the actuarial valuation, the value of any insurance policies held as scheme assets<sup>69</sup>, the trustees should ensure that they understand the explanation given by the actuary of the approach used to value such assets and the implications for the scheme's funding strategy.

## Schedule of contributions

136. The trustees should apply the following principles when preparing or revising the schedule of contributions:
  - It should be sufficiently clear to enable them to monitor payments and for the scheme auditor to audit those payments (for example, profit related contributions would not meet this principle).
  - It should be drafted so as to avoid, as far as is possible, the need to refer to other scheme documents. If the scheme's rules provide for different contribution rates, the schedule of contributions should set out those rates. However, where contributions are expressed as percentages of pay, a cross reference to other documents could be appropriate.
  - It should avoid showing any due date for member contributions later than the 19th (or 22nd if payments are made electronically) day of the month following the month of deduction from pay. This is because, to comply with the legislation, these are the latest dates by when the employer must pay these contributions to the scheme<sup>70</sup>.
  - It may contain deficit repair contributions as an additional percentage of pensionable pay. If the trustees have doubts as to the stability of pensionable pay or if aggregate pensionable pay is small compared to the funding shortfall, they should express these additional contributions as monetary amounts. These monetary amounts can still be linked to a price or pay index or to the employer's pay increases.
  - It should not refer to the contributions covering individual augmentations or general benefit improvements, unless these were planned and due to be paid when the schedule of contributions was certified.

<sup>69</sup>  
See regulation 7(3).

<sup>70</sup>  
See regulation 16 of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715).

137. Administrative expenditures such as professional fees which are due to be met directly by the employer need not appear on the schedule of contributions. Where this is the case, the trustees should look to include in the schedule of contributions a statement covering this point and satisfy themselves that the employer will pay those expenses.
138. Trustees should treat the PPF levy as an annual expense item. Even where this expense item is included in the employer's overall contribution rate, the schedule of contributions should look to include a note to this effect indicating the assumed annual amount incorporated for this purpose. Where the employer pays the levy directly, the trustees should be satisfied that the employer can take this step and obtain proof of discharge for their records.
139. Trustees should understand that a section 75 debt<sup>71</sup> is a discontinuance debt due from a departing employer. It is distinct from the ongoing funding obligations of the remaining employers under a schedule of contributions. Trustees should avoid situations where one payment is treated as discharging both obligations.

## Recovery plans and intervaluation actions

### Recovery plans

140. Where the scheme does not meet the statutory funding objective, a recovery plan must be put in place in order to return the scheme to full funding on that measure<sup>72</sup>.
141. A recovery plan should be appropriate<sup>73</sup>. Its structure is fundamental. Length is only one aspect of its structure. When setting the plan structure trustees should recognise that the time taken for the scheme to meet its technical provisions represents a period over which the trustees and employer may have agreed to accept a risk level higher than that of the technical provisions. The level of risk accepted should depend on the overall funding and security arrangements agreed.

71  
A debt under section 75 of the Pensions Act 1995.

72  
See section 226.

73  
See section 226(3).

142. Although affordability of deficit repair contributions is a factor to consider, this does not mean that an employer should be expected to pay deficit repair contributions at a particular level simply because it would be able to afford to contribute at that level or because it has been paying them at that level. Instead, trustees can use the flexibilities available in recovery plans to ensure that they are appropriately tailored to both scheme and employer circumstances. They should recognise, for example, that a longer recovery plan period may be appropriate where technical provisions reflect a particularly low risk approach. Conversely, the impact on scheme risk of adopting weaker technical provisions may result in the need for a proportionately shorter recovery plan period.

143. When considering the affordability of deficit repair contributions the following are some of the relevant factors:

- the forecast cashflow of the employer after essential business expenditure and investment
- the employer's plans for sustainable growth – its proposed use of its free cashflow after essential spend and investment
- the difference between temporary factors restricting cash availability and longer-term structural trends
- the employer's debt structure and debt service obligations
- the employer's capital structure and resources, and
- the employer's dividend policy.

144. In assessing the impact of actual or proposed deficit repair contributions, the trustees should consider the impact of these contributions on the range of likely future scheme funding levels relative to the employer covenant, following the same proportionate<sup>74</sup> approach used to determine the technical provisions<sup>75</sup>. Again, stochastic and/or scenario modelling (ALM)<sup>76</sup> as appropriate can be used to assess this impact.

145. It is generally helpful for the level of deficit repair contributions to be settled for a period so that the employer can budget and trustees can plan in expectation of the cash flow. Short-term fluctuations in circumstances may often be dealt with by changing the recovery plan period rather than by adjusting the level of deficit repair contributions.

146. If the deficit repair contributions have previously been set at a low level for affordability reasons, trustees should consider whether the reasons for this persist or whether changed circumstances mean that an increased level is appropriate.

74  
See paragraph 20.

75  
See paragraph 130.

76  
See footnote 45.

147. The simplest approach to setting contributions is to consider whether assets and contributions will be sufficient to meet the statutory funding objective (based on the technical provisions and, therefore, informed by their discount rate).
148. In some situations, it may be appropriate to assume a higher investment return for the recovery plan than the discount rate used to calculate technical provisions. The extent to which this is appropriate will depend on the level of risk associated with the assumptions used in the technical provisions calculation and investment strategy and the employer covenant risks applying. Stochastic/scenario modelling (ALM)<sup>77</sup> techniques used to inform the technical provisions can be helpful in this context. The period over which outperformance is assumed should be appropriate.
149. When considering the structure of a recovery plan (in particular the level of deficit repair contributions), the trustees should take into account the following matters:
- the value, terms and enforceability of any contingent security provided by the employer
  - the likely benefits available from the scheme to members should the employer be subject to an insolvency event in the short term
  - whether any changes are expected to the membership profile which could significantly affect funding, such as major retirements or bulk transfers (in or out)
  - the impact on the employer and its plans for sustainable growth
  - the impact of any or all of the assumptions used when setting the recovery plan not being borne out in practice, and
  - the anticipated level of the PPF levy over the course of the recovery plan period.
150. Trustees should include in the recovery plan the assumptions they have used when determining how to eliminate the shortfall.

77  
See footnote 45.

## Intervaluation actions

### Actuarial Reports

151. Appendix 1 sets out the circumstances and frequency for actuarial reports. The purpose of the actuarial report is to provide an update of the funding position of the scheme since the last actuarial valuation<sup>78</sup>. Actuarial reports prepared using a quantitative or a purely narrative approach may be acceptable to the trustees. In either case, trustees should question the actuary to understand the factors taken into account in preparing the report.

### Changes in circumstances

152. Trustees should be alert to material changes which may lead them to review and, if necessary, revise their scheme investment or funding strategies. Where, having taken advice from the actuary, it seems to the trustees that these material changes make it unsafe to continue to rely on the chosen assumptions used in the funding documents, they should review and, if necessary revise, those documents (bearing in mind that they would usually need to agree a revised recovery plan with the employer). Commissioning an early actuarial valuation is one technique for doing this, but may lead to unnecessary cost and delay when a revision of the existing recovery plan can achieve the necessary results. Trustees should adopt a proportionate<sup>79</sup> approach when deciding how to proceed.

### Summary funding statements

153. Trustees must issue a summary funding statement to all members and beneficiaries of their scheme (who are neither excluded persons nor persons whose only entitlement to benefits under the scheme is, or will be, to money purchase benefits) within a reasonable period following the date by when the trustees must receive each actuarial valuation or actuarial report<sup>80</sup>. The reasonable period is three months from the date by when valuations or reports must be obtained.

78  
See section 224(2)(c).

### Reporting of breaches

154. Trustees have duties and obligations to:

- monitor the payment of contributions payable under the schedule of contributions for the scheme; and
- report materially significant payment failures to the regulator and to members within a reasonable period<sup>81</sup>.

79  
See paragraph 20.

80  
See regulation 15 of, and schedule 4 to, the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 (SI 2013/2734).

155. Appendix 2 (Reporting breaches) contains further detail on these duties and obligations.

81  
See section 228(2).

# Appendix 1

## Key documents and reporting requirements

156. This appendix does not include the late payment reporting requirements or requirements for provision of information to members<sup>82</sup>.

157. For the purposes of submitting any of the funding documents to the regulator or reporting to the regulator:

- any failure by the trustees and employer to agree an appropriate actuarial valuation of the scheme and deficit recovery plan, in line with the scheme funding requirements contained in Part 3 (ie technical provisions, a recovery plan, the content of the statement of funding principles or the content of the schedule of contributions) or
- any failure by the actuary to certify technical provisions or a schedule of contributions

the reasonable period is usually ten working days from the relevant submission, agreement or certification deadline.

82  
See Appendix 2.

Document/ action	Responsible parties	Deadline	Frequency and circumstances	Reporting requirements
Actuarial valuation	Trustees	Within 15 months of effective date.  Effective date to be no more than three years from the effective date of previous actuarial valuation, where actuarial reports obtained for intervening years. If no actuarial report is obtained for an intervening year, then the effective date will be no later than the anniversary of the effective date of the last completed actuarial valuation <sup>83</sup>	Triennially where actuarial reports are obtained for intervening years. Otherwise may be more frequent	N/A
Certifying the calculation of the technical provisions	Actuary	Within 15 months of actuarial valuation effective date	Depends on frequency of actuarial valuation	Any failure to certify by 15 months of actuarial valuation effective date must be reported by the actuary to the regulator within a reasonable period <sup>84</sup>

continued...

83

The effective date of a scheme's first valuation must be no later than one year after the scheme's establishment date (section 224(3)(a)).

84

See section 225(3).

Document/ action	Responsible parties	Deadline	Frequency and circumstances	Reporting requirements
Actuarial reports	Trustees	Within 12 months of effective date  Effective date is no more than one year from that of the last actuarial valuation or, if more recent, the last actuarial report	At trustee choice but usually for the years between actuarial valuations	N/A
Review and revise statement of funding principles	Trustees	Within 15 months of actuarial valuation effective date	Depends on frequency of actuarial valuation if other circumstances do not apply	N/A
Review and revise recovery plan	Trustees	Within 15 months of an actuarial valuation effective date	Depends on frequency of actuarial valuation if other circumstances do not apply	Trustees to submit recovery plan to the regulator within a reasonable period <sup>85</sup> after: (i) its preparation or revision together with the valuation summary; or (ii) its revision between actuarial valuations with an explanation for the revisions <sup>86</sup>

continued...

85  
See section 226(6).

86  
See regulation 8(7)(a).

<b>Document/ action</b>	<b>Responsible parties</b>	<b>Deadline</b>	<b>Frequency and circumstances</b>	<b>Reporting requirements</b>
Review and revise schedule of contributions	Trustees	Within 15 months of an actuarial valuation effective date	Depends on frequency of actuarial valuation if other circumstances do not apply	Trustees to submit schedule of contributions to the regulator within a reasonable period <sup>87</sup> after its preparation or revision
Certifying the schedule of contributions	Actuary	Within 15 months of actuarial valuation effective date.	Depends on frequency of actuarial valuation	Any failure to certify by 15 months of actuarial valuation effective date must be reported by the actuary to the regulator within a reasonable period <sup>88</sup>
Reporting failure to agree	Trustees	N/A	N/A	Any failure to agree by 15 months of actuarial valuation effective date must be reported by the trustees to the regulator within a reasonable period <sup>89</sup>

87  
See section 227(7).

88  
See section 227(9).

89  
See section 229(5).

# Appendix 2

## Reporting breaches

158. This Appendix sets out how trustees of schemes should meet their obligations and duties to:
- monitor the payment of contributions to be paid under the schedule of contributions; and
  - report payment failures of material significance to the regulator and to members within a reasonable period.
159. It is not intended to prescribe the process for every scenario. It does, however, provide principles, examples and benchmarks to help trustees understand their duties and obligations.
160. The legislation requires that if the trustees have reasonable cause to believe that a failure to make a payment is likely to be of material significance in the exercise by the regulator of any of its functions then they must give notice of this failure to the regulator and the members within a reasonable period<sup>90</sup>. These payments are referred to as 'material late payments'.

## Monitoring contributions

161. Trustees have a duty to check that the contributions are paid into the scheme in accordance with the schedule of contributions. Trustees should, therefore, have processes in place to check the contributions that are paid into the scheme and to reconcile these with the schedule of contributions. This can be a risk-based process. It is up to the trustees to set up and operate appropriate procedures for their scheme.
162. To do this, the trustees may need information from the employer. Where the necessary payment information is not supplied by the employer automatically and trustees decide they need it to carry out risk-based monitoring, they should request the additional information they need from the employer<sup>91</sup>. Trustees may not need to obtain payment information as a matter of course, only where it is needed for effective monitoring.
163. The regulator considers that a reasonable period for employers to provide trustees with payment information will be within seven working days of the date of the trustees' request.
164. Trustees should report to the regulator where payment information requested is not supplied by the employer within this reasonable period. The regulator considers that a reasonable period for trustees to report non-receipt of this payment information will be within ten working days of the date of the request.

90  
See section 49(9)(b) of the Pensions Act 1995 and section 228(2). Only one report is required in respect of the same payment breach, see regulation 12.

91  
See regulation 6 of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715) as amended.

165. Trustees should have good record-keeping and adequate internal controls in place to ensure that the scheme and the schedule of contributions are administered, maintained and managed in accordance with the scheme rules and legal requirements. Trustees must also record and retain information on transactions, which will support them in their administration and monitoring responsibilities including:

- any amount received in respect of any contribution payable in respect of an active member of the scheme, and
- payments of pensions and benefits<sup>92</sup>.

## Payment dates

166. Employer contributions must be paid by the due date set out under the schedule of contributions for paying them to the scheme<sup>93</sup>. At the latest, member contributions deducted from pay must be paid to the scheme by the 22nd day (or 19th day if the payment is not made electronically) of the month following deduction<sup>94</sup>. These dates do not override any earlier due date set out in the schedule of contributions. There are special rules for the first deduction of contributions on automatic enrolment under the Pensions Act 2008<sup>95</sup>.

## Taking action to resolve overdue contributions

167. Where a payment failure occurs trustees should contact the employer promptly to alert them to the failure and to seek to resolve the overdue payment. Where necessary, trustees should try to find out and record the causes and circumstances of the payment failure.

168. Trustees have flexibility to design their own processes so that they can obtain overdue payments from the employer and rectify administrative errors in the most effective and efficient way for their particular scheme.

92

See regulation 12(2) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715).

93

See section 227 and regulation 9.

94

See regulation 16(1) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715).

95

See regulation 16(2) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715).

## Reporting material late payments to the regulator

169. Trustees must report a material late payment to the regulator and members within a reasonable period. A material late payment is where:

- contribution payments and other amounts under the schedule of contributions are not paid to the scheme by the due date(s), and
- there is 'reasonable cause to believe' that this failure is likely to be of material significance to the regulator in the exercise of its functions<sup>96</sup>.

170. Having 'reasonable cause to believe' means more than an unsubstantiated suspicion. Trustees should make enquiries and use their judgment when deciding whether to report to the regulator. While they are not expected to undertake a full investigation to establish materiality or investigate whether an employer has committed fraudulent behaviour, the trustees should seek to enquire of the employer:

- the cause and circumstances of the payment failure, and
- what action has been taken by the employer as a result of the payment failure.

171. The trustees may choose to take an employer's response to their enquiries at face value if they have no reason to believe it to be untrue or where their risk-based process indicates that there is a low risk of continuing payment failure. Where no response is received the trustees may infer that an employer is unwilling to pay the contributions due.

172. Below we set out the circumstances which are likely to be of material significance to the regulator. This list is for illustrative purposes only and is not exhaustive.

## Material payment failures that need reporting

173. Trustees must report material late payments to the regulator and members within a reasonable period after the due date<sup>97</sup>. Circumstances which are likely to be material and which the trustees should report include:

- where trustees have reasonable cause to believe that the employer is not willing or able to pay the outstanding contributions

<sup>96</sup>  
Under sections 228(1) and (2) of the Pensions Act 2004.

<sup>97</sup>  
Under section 49(9) of the Pensions Act 1995 and 228(2) of the Pensions Act 2004.

- where the trustees' reminder and recovery process has been exhausted without response from the employer or without them having obtained the outstanding payment, in which event they may assume this indicates an employer's unwillingness to pay
- where there is a payment failure involving possible dishonesty or a misuse of assets or contributions. For example, trustees may have concerns that the employer is retaining and using contributions to assist cashflow difficulties or where trustees have become aware that the employer has transferred contributions elsewhere other than to the scheme.
- where the information available to the trustees may indicate that the employer is knowingly concerned in the fraudulent evasion of the obligation to pay employee contributions
- where the trustees become aware that the employer does not have adequate procedures or systems in place to ensure the correct and timely payment of contributions due and the employer appears not to be taking adequate steps to remedy the situation, for example where there are repetitive and regular payment failures
- where there is an immediate risk to members' benefits (such as where pensions in payment are normally met by the employer's contribution), and
- in any event where contributions have been outstanding for ninety days from the due date (unless the payment failure was a one-off or infrequent administrative error, which is discovered after the ninety days and had already been corrected when discovered or is thereafter corrected as soon as reasonably practicable).

174. Trustees should not normally report to the regulator where one of the following circumstances applies:

- Where all the members of the scheme are directors of the employing company or family members of the directors
- Where a claim has been submitted to the Redundancy Payments Service of the Department of Business, Innovation and Skills for the outstanding contributions
- Where trustees have entered into a payment arrangement with the employer for the recovery of the outstanding contributions and the employer is paying in accordance with that arrangement

- Where there are infrequent one-off payment failures or administrative errors (resulting from, for example employees leaving the scheme or employment, new employees joining, or changes in salary not being notified promptly to the trustees), and those occasional failures or errors have been corrected within ninety days of the due date; and
- Where payments are made in excess of the contributions due under the schedule of contributions

## Reasonable period for reporting to the regulator

175. A reasonable period for reporting to the regulator will be within ten working days of the trustees having reasonable cause to believe that a material late payment exists. For example, the regulator should receive a report within ten working days of the trustees having received verbal or written confirmation from an employer that it does not intend to pay.

176. Exceptionally, where there is a current or imminent danger to members' and/or the employer's payments unless immediate preventative action is taken, trustees should report the failure to the regulator by telephone as soon as they become aware of the occurrence. The trustees should confirm telephone reports in writing, for example by letter or email, as soon as reasonably practicable and in any event within ten working days.

## Reasonable period for reporting to members

177. Once the trustees have reasonable cause to believe that a material late payment exists they should report to members within thirty days of having reported to the regulator.

178. The regulator believes that members should be made aware of outstanding payments and have the opportunity to discuss these with their employer at an early opportunity, as this may assist in the resolution and recovery of overdue payments. For this reason, trustees should consider whether to report to the affected members around the same time as their initial contacts with the employer to pursue outstanding payments. If the trustees have already notified the members at an earlier point in their contacts with the employer, they may choose whether to notify the member again at the point of reporting to the regulator.

## Method of reporting to the regulator

179. Reports should be made in writing (preferably electronically) except where a telephone report is made in exceptional circumstances<sup>98</sup>.

98

See paragraph 176.

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