

Self-regulation guidance for defined benefit schemes

As the Pensions Regulator publishes documentation that could indicate the contents of its funding code of practice, trustees are discovering just how much training they will need to advise their schemes on how to avoid intervention, says **Aaron Punwani**

The Pensions Regulator published a 90-page consultation document on 31 October 2005 on how it will regulate the funding of defined benefit (DB) schemes.

It is good to see the regulator finally declaring its hand by describing the proposed triggers that determine when it will take an interest in a scheme's funding policy.

After months of uncertainty, it is helpful for companies to know what they have to do to run their businesses relatively free from regulator intervention, and for trustees to have more of an idea of the degree of funding the regulator is expecting them to negotiate. But what will it all mean in practice?

The regulator is taking a keen interest in the level of funding needed for schemes to stay out of the Pension Protection Fund (PPF), and in a company's FRS 17 deficit.

Taking the view that these measures typically amount to 70% to 80% of the cost of buying out all the benefits with an insurance company, the regulator is proposing to scrutinise schemes that set funding targets

below 70% of buy-out.

It will also look at schemes with funding targets between 70% and 80% of buy-out where it has particular concerns arising from the employer's financial strength or the scheme's maturity.

So the regulator is creating a new minimum funding requirement (MFR) by the back door – an inevitable outcome given the regulator's statutory objective to minimise calls on the PPF. This is despite all the rhetoric about the new funding standard being scheme-specific.

The main difference between the old MFR and the new trigger levels is that the new ones are much higher and less well defined. The only way to know how much it costs to buy out a scheme's benefits is to buy them out, but buy-out costs are highly sensitive to commercial considerations affecting the two insurers writing business in this limited market. Indeed, some larger pension schemes have assets that are several times the capacity of the buy-out market.

The regulator also proposes a trigger

relating to the recovery period over which a scheme's deficit is to be cleared. It wants to look at schemes with a recovery period of more than 10 years and, significantly, those less than 10 years where it believes the employer's strength is such that faster funding is affordable.

As drafted, this implies (in the extreme) that an employer that could afford to fill the deficit immediately, without a material detrimental effect on its business, may have to do so. The trustees would need to be presented with a sound business case to agree to a longer period without facing criticism from the regulator.

Perhaps the most revealing part of the document is the apparent sneak preview of the scheme funding code of practice, expected in December.

It indicates that setting a funding target that anticipates equity outperformance relative to bonds – currently common practice in pension scheme funding – would need to be justified by the ability of the employer to top up the scheme if the equity investments do not deliver.

This is the clearest indication so far that trustees will need explicitly to factor the company's financial strength and prospects, rather than just the pension scheme's financial position, into their funding strategy.

As they go through their next actuarial valuations, trustees will have a challenging new dimension to their decision making, and they will quickly need to ensure they have the necessary knowledge and advice in place to meet this challenge.

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