Defined benefit funding regulatory and enforcement policy

June 2014

The Pensions Regulator

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Introduction

1. The Pensions Regulator ('the regulator') is a non-departmental public body which regulates work-based pensions.

2. This document sets out our approach to regulating the statutory funding requirements (DB funding) as set out by, and under, Part 3 of the Pensions Act 2004 ('the Act')[1] for trust-based defined benefit (DB) occupational pension schemes ('schemes').

3. This document sits under our approach to regulating work-based pensions and our DB regulatory strategy[2].

Approach to DB funding

Understanding sustainable growth and our new objective

4. Our DB regulatory strategy sets out how we balance all our statutory objectives[3] when it comes to the regulation of DB schemes. In addition to our objectives to protect members' benefits, reduce risks to the Pension Protection Fund (PPF) and promote and improve understanding of good administration we have a new additional objective relating to our functions in respect of the DB funding framework: 'in relation to the exercise of its functions under Part 3 only, to minimise any adverse impact on the sustainable growth of an employer'[4].

5. This new objective makes it explicit that our approach to regulating DB funding should seek to minimise any adverse impact on an employer's sustainable growth plans alongside our existing objectives.

6. Striking this balance between the needs of the employer with those of the scheme is essential to allow employers to invest in the growth of their business. Supporting employers to achieve their business objectives and strengthen the covenant that underwrites the benefits promised and scheme risks is, therefore, also of benefit to the scheme and reduces risks to the PPF. This also supports the wider growth of the economy.

7. A strong and ongoing employer provides vital support for a scheme, and there should be no presumption of conflict between the scheme's needs and that of the employer. However, we expect trustees and employers to be aware of the potential for such conflicts and to recognise and address them when they do arise. Our focus is on ensuring trustees and employers work together in these instances to secure the best and fairest outcome.

1
All references to the law that applies in Great Britain should be taken to include corresponding legislation in Northern Ireland.

2
www.tpr.gov.uk/regulate-and-enforce.aspx; www.tpr.gov.uk/dbstrategy

3
See section 5(1) of the Act.

4
Section 5(1)(CZA) of the Act, coming into force in July 2014.

8. Trustees should explore the flexibilities within the scheme funding framework to ensure that the funding plan they agree minimises any adverse impact on the employer's plans for sustainable growth whilst still ensuring adequate protection for members in line with trustee fiduciary duties.

9. Trustees should take account of the employer's plans for sustainable growth in their assessment of the employer's covenant strength (including the employer's current position, its future prospects and affordability)[5].

10. Employer investment can take differing forms. We encourage trustees in our funding code of practice to take a proportionate approach to assessing and understanding the employer's plan for sustainable growth and the nature of any proposed investment. This helps trustees to understand how they fit in with the employer's long-term business plans. We ask trustees to bear in mind the extent to which others with an interest in the employer share or contribute to that employer investment. We also encourage trustees to consider the extent to which the scheme is expected to benefit from additional support from employer growth.

11. Our approach is to seek to ensure that the trustees have carried out the appropriate due diligence (bearing in mind the employer's plans for sustainable growth) and have balanced the needs of the scheme with those of the employer to reach an acceptable outcome.

12. We apply the principles behind our approach consistently across different employer types. However, we are mindful that growth can be very dependent on circumstances and can, therefore, mean different things to different employers. For some, growth is a real prospect while for others it may be more about maintaining their position or slowing a business decline. Growth can also have a different meaning for employers in the not-for-profit sector compared to, say, employers in a purely commercial environment. We, therefore, seek to understand the context of an employer's circumstances, including its investment aims and what constitutes success for its business. We interpret our statutory objective on sustainable growth broadly to reflect this diverse range of circumstances.

5
www.tpr.gov.uk/code3

DB funding policies

13. The significant shifts in the DB pension landscape in the last few years, as well as difficult economic conditions, have posed particular challenges for many DB schemes and their employers.

14. The significance of schemes and their deficits to their employers varies. For some schemes, their deficits are easily manageable in the context of the strength of the employer; however, for others, the level of employer support needed and the extent to which it is available can be a material consideration for both the scheme and the employer.

15. There continues to be a material level of claims on the PPF and, therefore, members receiving less than the full benefits to which they were entitled under their DB scheme. A greater value of claims on the PPF also results in higher levy payments from other PPF eligible schemes and so the impact of insolvencies are wider than just for those schemes and members with insolvent employers.

16. While we recognise that there are differences between the benefits members have been promised and the compensation levels offered by the PPF, we believe that increasing the protection of members' benefits generally reduces the risk of claims on the PPF.

17. However, risk is part of the DB funding regime and we do not believe it to be pragmatic or proportionate, in light of our statutory objectives, to seek the elimination of all risks. Despite these risks, we believe that most DB schemes should be capable of paying their promised benefits in full. The DB funding regime is flexible enough to encompass both risk-taking and risk-mitigating strategies. However, it is important that DB schemes are adequately funded and supported and that any risk taken is understood and managed appropriately.

18. Given this context, our approach is focused on the following aims:

    - encouraging **trustees and employers to work collaboratively to use the flexibilities** in the system appropriately to best suit their needs and those of the employer
    - ensuring that trustees reach **appropriate funding outcomes** that reflect a reasonable balance between the need to pay promised benefits and minimising any adverse impact on an employer's sustainable growth
    - ensuring that trustees understand and manage risks effectively through a proportionate application of an **integrated approach to risk management**

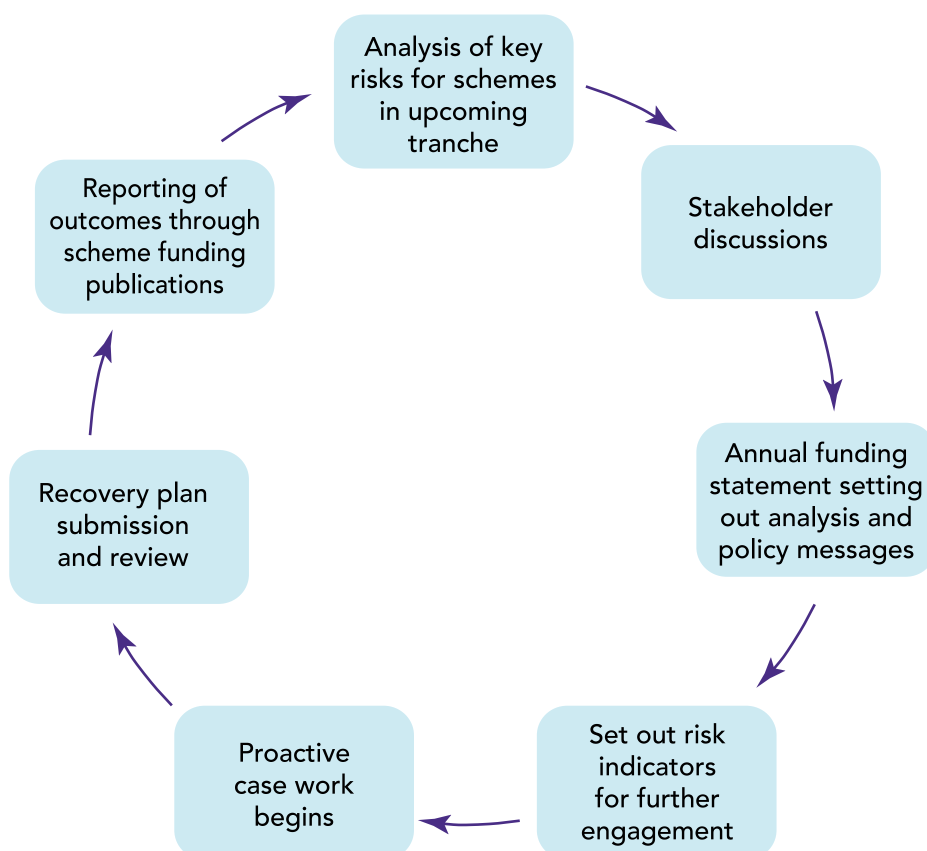
- ensuring that trustees focus on the importance of understanding the employer's covenant and give full consideration to their **employer's affordability, growth and investment plans**
- ensuring that we implement our regulatory approach to **balance** the needs of schemes and employers in an appropriate way.

Regulating across the three-year funding cycle

19. Our DB regulatory strategy explains how we implement our approach to regulating schemes. We follow this process in our approach to regulating DB funding.

20. It is grounded in the three-year funding cycle which applies to most schemes (the total number of valuations is broadly spread evenly in each year of the three-year cycle or 'tranche'[6]), so that we can direct our communications at schemes at their important junctures. This process is illustrated below.

The three-year funding cycle process



6
We describe a set of schemes with valuation dates between 22 September and 21 September of the following year as a 'tranche'. Each three-year valuation cycle therefore covers three tranches.

21. The following table explains the three phases in the valuation cycle that schemes will be at in any one year of the three-year funding cycle together with the steps we typically take for each tranche.

Funding cycle approach (October to September)		
Year 1: Valuation process	Year 2: Finalise and submit plans	Year 3: Prepare for next valuation
• Undertake initial modelling of the impact of market conditions to form a view on what the key emerging issues may be for these schemes • In relation to these emerging issues and our views of appropriate behaviours, provide policy messages for these schemes as they undertake their valuations • Begin proactive engagement with selected schemes.	• Undertake modelling to determine how we set our risk indicators for prioritising schemes for further engagement • Take into account any relevant information from scheme proactive work when these were Year 1 schemes.	• All recovery plans should have been submitted and reviewed • Report the outcomes in light of our communications to these schemes when they were in Year 1 and 2.

22. We discuss the results of our modelling and policy messaging with a variety of stakeholders (including actuarial firms, covenant and investment advisers, trustees and employers) to ensure our approach is reasonable and appropriate.

23. We use our annual funding statement to communicate these messages and outcomes. This is normally published in the spring as around half of the valuations in any year are completed with effective dates of 31 March and 5 April. We seek to reflect our understanding of the actual market conditions facing schemes and employers at those dates to provide guidance to all of those schemes and employers whose valuation date falls within that tranche.

Assessing risk

24. A sound understanding of the risks across the DB landscape is key to meeting our objectives for DB funding and underlies all our activities from policy development to the design of our operational processes. Our risk assessment framework is informed by the risk appetite statement set by our Board which is reviewed on an annual basis. This section explains:

    - the factors that we consider in developing an overall risk profile for the DB landscape and for assessing risk associated with individual schemes, and
    - how and why we segment the DB landscape to enhance our understanding of risks and focus our polices and operational practices.

Areas of risk focus

25. Our approach to understanding risks to DB schemes focuses on the key risk areas which influence the overall chance of schemes paying benefits in full: employer covenant strength, schemes' funding plans, and investment risks. These are the three broad areas of risk we expect trustees to manage as part of good governance and an integrated risk management process.

26. Focusing on areas of risk in isolation is a poor indicator of overall risk. Our modelling and casework suggests that the funding plans schemes have in place do not always properly link risks in an integrated way. This is why an integrated approach to risk management is a guiding principle and key component of our code of practice on scheme funding and is at the core of our risk assessment. Our understanding of the overall risk profile is, therefore, informed by analysing funding risk, covenant risk and investment risk just as we expect trustees to analyse these risks.

Covenant strength

27. Understanding the employer covenant strength and the potential impact of short and long-term scenarios for the scheme demands is a central tenet in understanding the scheme's risk profile.

28. Our approach focuses on understanding the strength of the covenant (including any contingent assets), the impact of the scheme on sustainable growth and the risks of this support reducing or being insufficient when it may be needed by the scheme.

29. We consider the employer's affordability and its plans for sustainable growth and how this improves the covenant to the scheme.

30. We only consider those employers with legal obligations to the scheme for the purpose of understanding covenant strength. However, we do consider the position of the wider group where this has the potential to add benefit or risk to the covenant of the scheme.

Funding plans

31. An appropriate funding plan has three main elements which are common to all business planning processes: firstly, the objectives the plan seeks to achieve; secondly, the approach taken to meeting these objectives; and thirdly, identifying the risks to achieving a successful outcome and how these risks are to be managed.

32. Our approach aims to assess these elements and ensure the funding plan is appropriate given the context of the circumstances of the scheme and employer.

33. We are focused on the overall outcome of the funding plan and the balance struck between reliance on investment returns and employer contributions. This involves considering the amount of risk the scheme is running and whether it is appropriate in the context of the employer's covenant.

Investment approach

34. The investment approach is a key part of a scheme's strategy and is a major factor in influencing the overall outcome and chances of success of the funding plan, both in terms of the potential risks and rewards. Our risk assessment focuses on judging whether the approach to the investment strategy is appropriate given the needs of the scheme and the strength of the employer's covenant, including how the scheme's plans for risk-taking strategies may impact on the employer's sustainable growth in the future.

35. We are focused on two key elements, whether:

    - the level of prudence adopted and the downside risk being run in the investment strategy is consistent with the ability of employer covenant to realistically cover it over an acceptable period taking into account the potential impact on the employer's plans for sustainable growth
    - the current and planned future investment strategy is appropriate for the characteristics of the scheme's membership both now and in the future.

Scheme governance

36. Good governance is essential in managing the risks to the scheme. Therefore, we consider indicators relating to the governance of the scheme and are interested in on any areas where material poor governance indicates improperly managed risks. When we engage with schemes, because we have identified potential funding risks, we consider to what extent improving scheme governance would be expected to address those risks.

Covenant segments and policy approach

37. In our regulatory strategy we explain that we may segment the DB landscape by scheme and employer characteristics to help us understand risks and develop targeted policies and interventions.

38. In the funding context, we segment the DB funding universe on the basis of the employer covenant. The covenant underwrites scheme risks and trustees' investment and funding strategies. It should, therefore, be one of the key determinants in the behaviours of trustees and employers when agreeing funding outcomes.

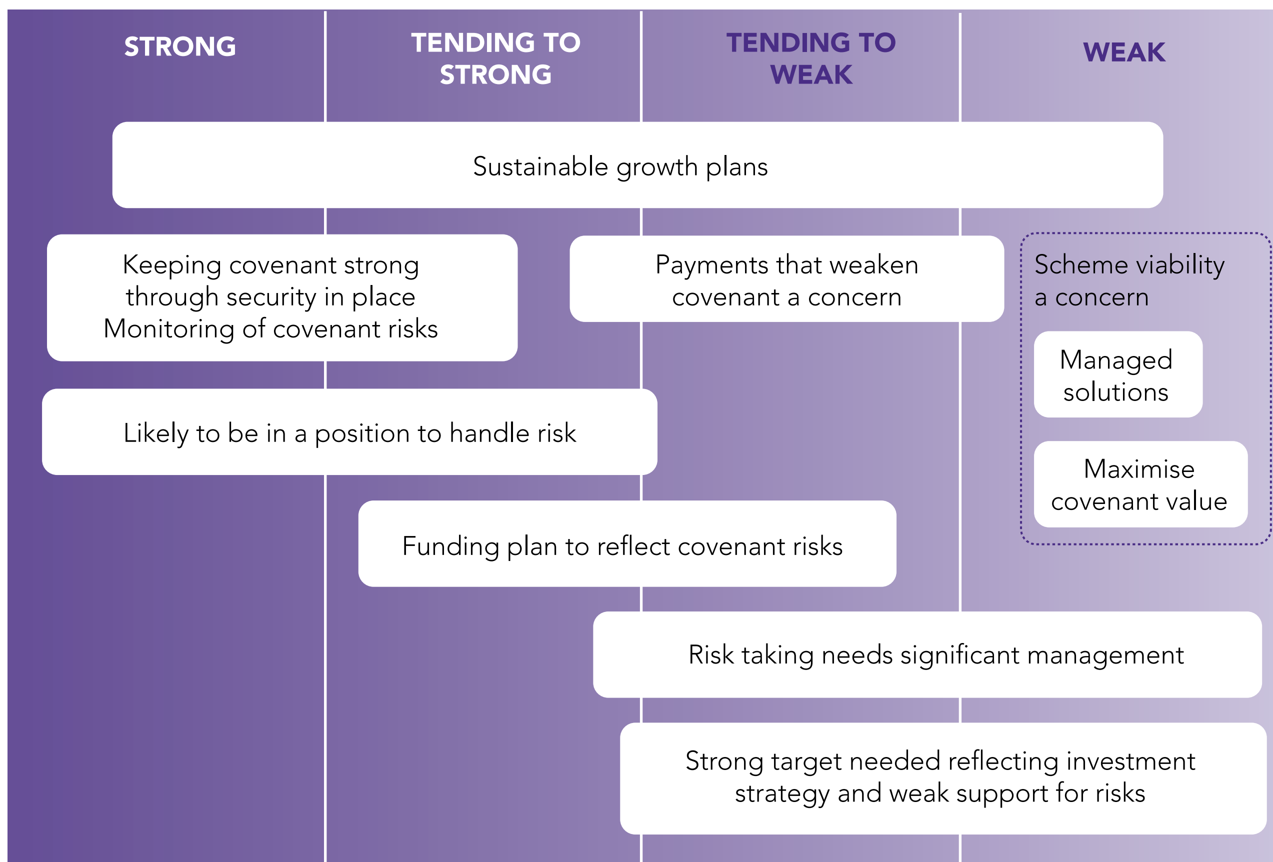
39. We use four employer covenant segments: strong; tending to strong; tending to weak; and weak. In practice, we recognise that there are no 'cliff edges' or dramatic changes in covenant strength and the range of covenant strengths is a continuum along a spectrum of covenant strength. In our engagement with individual schemes we look at their particular circumstances in a much greater level of detail. Appendix A explains how we assess the strength of the covenant.

40. Segmenting by covenant allows us to develop an initial, high-level and consistent view of what an appropriate outcome for schemes with certain characteristics might look like. We use this to help us assess the overall risk and outcomes for the scheme. In our further engagement with schemes we focus on the behaviours and outcomes which we expect for each segment in line with an integrated approach to managing risk and how the flexibilities have been used.

41. Our approach is to check that scheme outcomes appear consistent with the principles that we think are appropriate for them but there is flexibility in how schemes apply these principles and each scheme will be in a different place on the continuum, meaning there is no 'one-size-fits-all' answer.

42. The following diagram illustrates how our focus changes with covenant strength and Appendix B explains the different covenant categories in greater detail and outlines some of the implications for schemes and the principles underpinning our policy focus for each segment.

Covenant strength



Risk-based prioritisation

43. The most effective and proportionate way of regulating DB funding is to provide a framework where we explain, based on our understanding of the DB landscape, what we see as the key risks, how they can be managed and what the features of a good outcome look like. We do this through our code of practice, annual funding statement and other educational material.

44. It is for trustees and employers to ensure that schemes are appropriately funded, in the light of our information and guidance, taking into account the needs of both the scheme and employer, and we do not seek to engage further in every valuation and recovery plan submitted to us.

45. We aim to target our resources on the subset of those schemes which pose the greatest risks to our aims and where we believe we can have the most impact.

46. We decide whether further engagement is justified through a process that combines quantitative and qualitative risk indicators with expert judgment. For each valuation and recovery plan submission we:

    - test the scheme against our suite of risk indicators for further engagement
    - apply expert judgment as to whether any further action or engagement is justified.

Risk indicators

47. We consider a broad range of risk indicators to allow for a rounded view of scheme characteristics before making a judgment on the overall risk the scheme presents. Appendix C outlines our existing risk indicators but we constantly review risks across the landscape to inform and develop this list. We combine our assessment of the covenant strength, funding plan, and investment approach to inform our judgment as to whether the funding outcome for the scheme looks appropriate.

48. The factors we take into consideration when deciding on whether to engage further include:

    - the **position of the scheme compared to our risk indicators**
    - the **size of the scheme's liabilities**
    - the potential complexity and resource intensity of our engagement compared to the **impact** and the value we can add through further engagement
    - the overall **resources** we have available.

Smaller schemes

49. We recognise that by using the size of liabilities as a factor in determining which schemes to engage further with, we may not engage directly with a large number of smaller schemes, although in practice, nearly half of the schemes we engaged with in 2013 related to small and medium-size schemes.

50. We expect the same standard of behaviour from all schemes irrespective of size, although how they seek to comply with these standards will be proportionate to their risk and resources.

51. As well as direct engagement with individual schemes, we use other approaches and communication channels (such as our annual funding statements) to target our messages to reach trustees, employers and advisers of schemes of all sizes. We may also carry out specifically targeted campaigns in order to help smaller schemes to understand our messages or engage with advisers who may be best placed to reach out to a larger number of smaller schemes.

A flexible view of risks

52. We recognise that the use of data and models has limitations. For instance, the data that we have from valuation submissions and publically available financial information is likely to be significantly less detailed than that available to schemes. Our risk assessment framework enables us to broadly assess scheme risks and decide on our engagement with schemes on an indicative basis.

53. Selecting a scheme for further engagement does not imply that the valuation and recovery plan are not appropriate. Similarly choosing not to engage further does not imply that we have determined that the funding outcome is appropriate. Our direct engagement enables us to explore in greater depth the issues identified and understand the scheme's specific circumstances, including those of the employer and its future plans for sustainable growth. We may decide in the light of that engagement that trustees and employers are doing all they can and that the outcome is reasonable given the circumstances.

54. We start from the position that we have assessed the scheme against our risk indicators. However, the behaviour and outcome changes we are seeking to achieve through our engagements and policies are scheme specific in nature. Therefore, our view varies of what is an appropriate outcome for a scheme with which we have engaged. We recognise that there is more than one funding outcome that may be appropriate for schemes in similar circumstances. For example, appropriate outcomes for some may be an increase in the contributions while for others it may be non-cash solutions such as strengthening of the employer covenant through a credible sustainable growth plan or use of contingent asset or wider group support.

55. Our risk assessment and engagement approaches recognise and encourage this flexibility.

Proactive engagement

56. We use our risk assessment framework to identify a group of schemes to approach proactively before they have submitted their valuation. For this assessment we project their funding position from the previous valuation to the current valuation date and consider this against the outcome of their previous valuation. Our selection of schemes for proactive engagement is based on a broad range of factors; in line with our risk-based approach we aim to target schemes which pose the greatest risks and where we believe we can have the most impact.

57. Proactive engagement gives us an opportunity for discussion and input early in the valuation process so that all parties are able to discuss and address any issues in real time before the valuation is completed, potentially reducing the need for more protracted engagement after the valuation has been submitted. Early engagement enables us to better influence outcomes as our aim is for an appropriate funding agreement to be reached with which all parties are comfortable.

58. The process also allows us to understand how schemes and employers are incorporating our messages and guidance into their funding plans and the specific issues and challenges faced by them, particularly in the light of prevailing market conditions. This helps us refine our guidance to the industry (for example, through our annual funding statements) and make sure it is relevant and fit-for-purpose.

Schemes in surplus

59. We also review schemes that have reported a surplus and have, therefore, not submitted a recovery plan. In doing so, we use the same principles for risk assessment. This recognises that these schemes could be posing similar risks as those that have submitted recovery plans.

Implementing our regulatory interventions

60. We have a range of regulatory tools from education to enablement and enforcement to mitigate the risks we have identified. Our preference is for education. This limits the need for detailed engagement, including enforcement. However, engagement is a necessary and effective tool.

61. The following sections describe the standard steps we take when using these regulatory tools. However, for those circumstances where we believe it is appropriate, we may deviate from these standard steps. Where we do so we generally aim (time permitting) to explain the reasons to the parties involved. In certain circumstances (for example, using powers under the special procedure[7]), this explanation phase may not be appropriate.

Educate

62. We recognise the complexity of trustees' roles and place great emphasis on education, including through:
    - the code of practice[8], which provides practical guidance on DB funding, and supporting guidance
    - the DB regulatory strategy[9] and this funding policy, which outline our key considerations in assessing risks and defining good outcomes
    - our annual funding statement[10] where we provide up-to-date messages and explain our approach in setting our risk indicators for that year
    - providing guidance on particular matters of importance to funding and educating trustees through the provision of online training in the Trustee toolkit[11].

Enable

63. This section describes how we undertake our funding casework following our risk assessment and prioritisation. We consider this type of intervention to be educational and enabling.

64. Appendix D outlines in greater detail how we approach specifically late valuation and failure to agree cases.

7 See sections 97 and 98 of the Act.

8 **www.tpr.gov.uk/code3**

9 **www.tpr.gov.uk/dbstrategy**

10 **www.tpr.gov.uk/funding2012**, **www.tpr.gov.uk/funding2013** and **www.tpr.gov.uk/funding2014**

11 **www.trusteetoolkit.com**

No further engagement

65. We undertake a risk assessment of all the valuations that we receive. For the vast majority, we decide not to engage further. We send the trustees of these schemes a valuation submission acknowledgement letter. This acknowledges that we have received their valuation submission and we have no further questions. This does not mean we consider the valuation and recovery plan to be appropriate. We aim to issue this letter within three months of the valuation submission or the statutory timeframe, whichever is later.

Further engagement

66. Where we decide that, following our risk assessment, direct engagement with a DB scheme is warranted, we may open a case in order to gain a better understanding of the scheme's circumstances.

67. An opened case is allocated to a case team. The size of the case team and its composition depends on the issues under consideration but it generally includes a case manager, an actuary, a business analyst and a lawyer. The degree of engagement with the scheme depends on the nature and complexity of the issues.

68. In all our interactions with schemes, regardless of the phase, we aim to be consistent, fair, open and transparent and for the process to be as constructive as possible for all parties.

69. We are clear from the outset as to why we wish to engage, our assessment of the scheme and employer's position and what we see as the key issues and risks, the purpose of our actions and what parties can expect from the process. Depending on the circumstances of the scheme some of the things we are likely to wish to discuss include:

    - the trustees' decisions in relation to any particular risk we have identified
    - the trustees' decision-making process
    - the trustees' qualitative and quantitative analysis underpinning their decision-making process including their assessment of the employer's plans for sustainable growth and the impact of the scheme on these.

70. We communicate in advance what issues we seek to discuss; however, our views on what the key issues and risks are may change as we gain a better understanding of the schemes' circumstances. It often suffices to discuss these with the trustees alone. At other times the employer may need to be involved based on our assessment of the scheme's circumstances. Where we determine that it is useful to involve the employer we will engage with them as early as possible to prevent delays.

71. Our preference is to highlight issues and risks, indicating the broad principles underpinning a range of appropriate funding solutions while being clear on what we consider to be more acceptable. We remain mindful of the scheme's specific circumstances, including those of the employer and their future plans for sustainable growth.

72. If we do not consider the explanations provided to adequately address the issues we have raised, we explain why and give the parties an opportunity to address our issues. In these instances, the focus of further engagement is to enable trustees and employers to agree what we consider to be more appropriate funding solutions given the issues and risks we have identified. However, where there is a wider range of issues than those associated with DB funding, these issues are also considered.

73. To support their engagement with the scheme the case team may gather further information through various means including telephone calls, written requests, face-to-face meetings or, in rare cases, by issuing a formal notice compelling production[12]. We may also request that trustees receive further expert advice but only in scenarios where we believe this adds value to the scheme.

74. We understand that schemes and employers are often working to tight deadlines. We seek to understand any scheme and employer timescales and try to meet those as far as it is reasonable to do so.

75. Engagement does not presuppose that the trustee's funding plan is inappropriate. A consequence of any regulator's interaction with their regulated community will be that sometimes it has to have difficult conversations with that community, for instance where there is disagreement between respective views and analyses. We will continue to remain open and transparent in our approach even though the context of our engagement may be challenging[13].

Outcomes from our engagement

76. Once our initial engagement with the trustee and/or employer is complete we write to them to let them know the outcome and potential next steps. These are broadly:

    - If we have no outstanding concerns and are satisfied that the funding plan is appropriate, we close our investigation
    - If we have identified issues and risks in the course of our engagement but we do not consider that it is reasonable and proportionate to use our funding powers, we may close our investigation, outlining our expectations for the next valuation and explaining how we consider those issues and risks should be addressed

12 See section 72 of the Act.

13 See paragraph 68.

- In some cases where the issues and risks we have identified have not been adequately addressed, we may decide that it would be reasonable and proportionate to take enforcement action.

These steps are outlined in greater detail in Appendix E.

Enforce

77. When we consider enforcement action, we not only consider action under our funding powers[14] but also whether the use of other powers is appropriate[15].

78. Our consideration of whether to use our powers is informed by the scheme's position relative to our risk indicators. This will be informed by how our views have developed regarding what an appropriate funding outcome for the scheme looks like following more detailed assessment of the scheme and employer's position.

79. We may consider that it is appropriate to seek a skilled persons report[16] to assist us in the exercise of our functions. The cost of that report is likely to be at the expense of the scheme and/or employer.

80. Enforcement is, amongst other things, subject to the Case team procedure and the Determinations Panel procedure[17].

Measuring impact

81. We monitor the success of our approach to the regulation of scheme funding by:

    - using surveys to assess the understanding of our messaging and the perception of our effectiveness
    - engaging regularly with our stakeholders to sense-check our understanding of the key risks against their experiences and to assess how our messages are perceived, understood and applied
    - evaluating the outcome of valuations submitted to us against the analysis and policies we set at the start of the funding cycle and how these evolve over time.

14
See section 231(2) of the Act.

15
For example, appointing a trustee under section 7(3) of the Pensions Act 1995, issuing an Improvement Notice under section 13 of the Act or Financial Support Direction under section 43 of the Act.

16
See section 71 of the Act.

17
www.tpr.gov.uk/procedures

82. In particular we seek to measure:

    - the impact of our policies and engagement with schemes, including:
        - the level of scheme risk, and
        - the position of employers and how we have taken into account their plans for sustainable growth
    - the approach and level of consistency in our engagement with schemes and employers
    - understanding and awareness of our policy messages.

83. Our risk indicators help to inform our understanding of risk and impact of our approach.

84. We keep our approach to regulating DB scheme funding under review to ensure that it remains effective. This is informed by our assessment of impact and our ongoing engagement with the regulated community. We communicate how we adjust our approach every year to take account of this evaluation and of specific circumstances in our annual funding statements.

Appendix A

Assessing covenant strength

85. The strength of the employer covenant is an important element in scheme funding and a key part of our risk assessment process. It informs our risk indicators and also allows us to look for specific events or circumstances which increase the risks to the scheme – such as potential avoidance of scheme liabilities.

86. We use a number of metrics relating to employers to look for trends and risks. However, we recognise that this is highly complex and that a one-size-fits-all approach to looking at the employer covenant would miss the many complexities and nuances of individual employers. We, therefore, combine the use of metrics with expert judgment.

87. Our assessment of covenant seeks to understand the ability of the employer to provide funding to the scheme if required and how the scheme may affect the employer. The principles below set out at a high level some of the factors we take into account, although we recognise that for different types of employers the application of these principles may differ (for example not-for-profit employers and multi-employer schemes).

88. The outlook for the employer and the plans for sustainable growth as set out in any business plans provided to the trustees, taking account of the factors below:

    - The strategic outlook for the sector and the position of the employer within the industry including the age, brand and public profile of the employer (ie its intellectual property)
    - The income streams, cash generation and profitability of the employer, and the trends in these over time. The ability to fund future increases in pension contributions and any adverse impact this may have on these
    - The level of reinvestment of profits/cash/income within the business to ensure sustainability.
    - The level of debt of, or secured by, the employer, and the ability to service this comfortably from income streams and cash generation within the business
    - The strength of the balance sheet and its ability to withstand trading shocks or decreases to its income streams
    - The size and value of the balance sheet and assets in comparison with the size of the pension liabilities and deficit and their availability to reduce deficits, including, where the employer is considered weak, the likely asset cover in insolvency

- Any restrictions on income, assets or reserves
- The level and sustainability of dividends (or other analogous distributions, for example distributions to members of limited partnerships), as a proportion of profitability and cash generation.

Appendix B

Segmentation

89. We use four broad categories to rank employers from strong to weak according to how well they are able to support the scheme. This is used as an initial assessment of the covenant for the purpose of segmenting our universe, prioritising our resources and targeting our policies. Where we engage further with schemes we will be transparent about our views. These will be refined further as they are informed by our more detailed understanding of the scheme's and employer's circumstances from our engagement.

90. The categorisation below is not intended to define our expectations for the exact nature of trustees' own covenant assessments. Our funding code of practice gives guidance for trustees in this respect.

91. We recognise that this approach differs from that of the PPF when looking at employer strength for risk and levy purposes. The following definitions of the categories are not designed to be rigid descriptors, but are indicative of the employer's place on a continuum of covenant strength.

Covenant grade 1 (CG1) – Strong

92. Very strong trading, cash generation and asset position relative to the size of the scheme and the scheme's deficit. The employer has a strong market presence (or is a market leader) with good growth prospects for the employer and the market. The scheme has good access to trading and value if the employer is part of a wider group. Overall low risk of the employer not being able to support the scheme to the extent required in the short/medium term.

Covenant grade 2 (CG2) – Tending to strong

93. Good trading, cash generation and asset position relative to the size of the scheme and deficits. Operates in a market with a reasonably positive outlook and the employer has a stable market share. Outlook is generally positive but medium-term risk of employer not being able to support the scheme and manage its risks.

Covenant grade 3 (CG3) – Tending to weak

94. Concerns over employer strength relative to the size of the scheme and deficit and/or signs of significant decline, weak profitability or balance sheet concerns and/or high vulnerability to economic cycle. No immediate concerns over insolvency but potential risk of decline.

Covenant grade 4 (CG4) – Weak

95. Employer is weak, to the degree that there are concerns over potential insolvency, or where the scheme is so large that, without fundamental change to the strength of the employer, it is unlikely ever to be in a position to adequately support the scheme.

Outcomes and behaviours

96. The following table shows our initial focus when opening an investigation into schemes depending on where we rate the employer covenant: from CG1 to CG4. It highlights the likely key issues and risks we will be discussing with the trustee and employer and asking them to address by explaining the reasons behind their funding decisions[18]. Again, we recognise that there are no cliff edges or dramatic changes in covenant strength or the types of behaviour appropriate to them but rather a shift along the spectrum.

97. Where we believe that the scheme's position warrants our involvement, we consider the range of options from education through enablement to enforcement. In doing so, we do not only consider action under our funding powers[19] but also whether using other powers is appropriate.

98. Our engagement with schemes will be on a scheme-specific basis and considered based on the relevant facts and circumstances. Therefore, this is not an exhaustive list and should not be taken as the only issues and risks we consider that the trustee and employer should focus upon during funding negotiations.

18
See paragraph 69.

19
See section 231(2) of the Act.

Covenant grade 1 – Strong	Covenant grade 2 – Tending to strong
• Strong covenant means that the scheme is likely to be in a position to take investment risk in order to clear deficits or reduce the need for higher contributions. We check that where the scheme chooses to accept risk, the funding outcome is balanced and that risk-taking is consistent with the covenant • Deficits in schemes with funding targets that fully reflect the risk taking capacity of the covenant can support should be cleared over a reasonably short period of time • For schemes looking to target a stronger or less risky overall outcome (for example, through de-risking, although this is not the only situation in which a stronger target may be desired), a longer period of time may be appropriate • Where a longer period is preferred, this is consistent with the overall level of risk the covenant is considered strong enough to support and therefore this does not increase the scheme risks • The level of affordability is likely to mean that the employer can afford contributions without adversely impacting on the employer's plans for sustainable growth • Trustees understand and monitor the covenant risks and are able to demonstrate that if the covenant deteriorates the position could be recovered without putting members' benefits at risk (for example, through contingent assets).	• Tending to strong covenant means that the scheme is likely to be in a position to take investment risk. Risk-taking should be commensurate with the medium-term risk of the employers' ability to manage scheme risks. The funding outcome is appropriate and that risk-taking is consistent with the covenant • Deficits in schemes with funding targets that fully reflect the risk taking capacity of the covenant can support should be cleared over a short to medium period of time • High affordability generally means employers are mainly able to afford contributions to fund the scheme without impacting on their plans for sustainable growth • Trustees have considered the impact on employers' sustainable growth plans and where contributions are constrained through higher employer investment to support business growth, the trustees have taken a proportionate approach to working with employers to: – understand how the investment plans to strengthen the covenant are credible – put in place appropriate and robust mitigations and protections, and – considered if other stakeholders may be reasonably expected to contribute towards these plans • Trustees understand and monitor the covenant risks and recognise that if the covenant does deteriorate, the capacity to support the scheme will increasingly be stretched and trustees have appropriate mitigations in place (for example, through contingent assets).

Covenant grade 3 – Tending to weak	Covenant grade 4 – Weak
• Tending to weak covenant means that risk-taking should be appropriately limited given the limited ability of the covenant to support this and the impact that calling on this support would have on the employer's business plans • Affordability constraints likely to be a concern. Contributions are at a level that reduces the deficit at an appropriate rate • As there is a need to balance contributions with the employer's plan for sustainable growth and improving the covenant to the scheme, the trustees and employers have engaged and discussed the employer's plans for sustainable growth to improve the covenant and how this interacts with the scheme risks • Trustees have discussed the appetite for risk with the employer and have firm contingency plans in place. They recognise that if the covenant does deteriorate further then the capacity to support the scheme will increasingly be inadequate and that poor scheme investment performance compounds stress on the employer • Trustees and employers have sought to maximise the support available to the scheme including obtaining formal group support • Where contributions are limited to support investment in growth, the covenant does improve and the value of that growth is protected for the scheme. Trustees have considered whether equity holders also support investment in the employer by restricting or postponing dividends	• While a level of risk taking may be appropriate and have potential reward for the scheme, the trustees recognise that the weak covenant means that the employer is unlikely to be able to make good significant reductions in funding level due to investment losses or, by doing so, risks damaging the covenant. Investment risk should be appropriately limited in this context • Trustees and employers understand and monitor the covenant risks and are able to demonstrate that they are aware of the lack of capacity of the employer covenant to recover poor scheme investment performance • Trustees and employers have engaged and discussed the employer's plans for sustainable growth to improve the covenant and the interaction with the scheme risks • Contributions are dictated by affordability • Trustees and employers have sought to maximise the support available to the scheme by: – limiting the flow of value away from the employer (for example, through dividend restrictions) – preventing detriment to the scheme's claim on the covenant caused by the employer's debt financing – improving the scheme's security (for example through contingent assets being provided to the scheme by the employer), and – obtaining formal group support.

continued...

<table>
<tr><th>Covenant grade 3 – Tending to weak</th><th>Covenant grade 4 – Weak</th></tr>
<tr><td>Trustees understand and monitor the covenant risks and are able to demonstrate that they are aware that further deterioration of the covenant is likely to put members’ benefits at significant risk
Trustees have considered the sustainability of future accrual in the context of difficulties with supporting existing benefits.</td><td>Trustees and employers have sought to limit the risks of the scheme’s position deteriorating by:
– adopting an appropriate investment strategy
– considering whether future accrual remains appropriate, and
– considering whether it is appropriate to crystallise the scheme’s position.</td></tr>
</table>

Appendix C

Our suite of risk indicators

99. Our risk indicators include, but are not limited to:

    - **Bespoke covenant assessment** – we carry out a high level assessment focusing on those employers with legal obligations to the scheme based on publicly available information. The focus of this exercise is to assess the likely ability of the employer to support the scheme, including its ability to afford contributions, support scheme risks now and in the future, prospects for sustainable growth and the risks of insolvency. This assessment also feeds into our other indicators (eg funding risk indicator and investment risk) and we also check for materially detrimental events and how this may change the overall balance of covenant, funding and investment risk
    - **Funding risk indicator** – we assess the appropriateness of the planned contributions by looking at the scheme's maturity, level of assets relative to a standardised liability measure and the strength of the covenant. Our focus is to judge whether the planned contributions look appropriate given the position of the scheme and the strength of covenant
    - **Investment strategy risk** – we assess the level of investment risk the scheme is running having regard to the scheme's maturity based on the most recent information we have on the scheme's asset allocation. We then test whether this level of investment risk can be supported by the employer covenant over an appropriate period of time. In general, schemes which hold a higher proportion of growth seeking assets, have a greater proportion of pensioner members or are supported by weaker covenants are more likely to show a higher level of risk under this indicator
    - **Mortality** – we check if the scheme's mortality assumptions have been set prudently. For this assessment we look at the two parts of the assumptions: the base table of current mortality rates and the expectations for future improvements in mortality. If significantly higher than average mortality rates (and hence lower life expectancies) are being used in the base table, we consider whether such an adjustment is justified based on the characteristics of the membership of the scheme, for example, industry sector and liability per member. For the future improvements we check that the expected improvements in life expectancies are not significantly lower than prevailing industry practice

- **Back end loading** – an important indicator of short/medium-term risk is the concentration of contributions in the later years of the recovery plan – for example, recovery plans where the deficit reduction contributions over the period until the next valuation are materially lower than subsequently
- **Reductions in contributions** – where contributions have reduced from the previous recovery plan, we check that this may be justified by a material improvement in the scheme's position, a reduced level of affordability or that employer resources are being used to improve the employer covenant balanced with the scheme's needs
- **Avoidance issues** – we review the recent transactions of the employer(s) to check if they could indicate possible avoidance activity
- **Actions taken to weaken the covenant** – we identify any specific issues and/or concerns relating to a deterioration in the strength of the employer's covenant (for example, excessive dividends in the context of the covenant strength and contributions needs of the scheme)
- **PPF funding risk** – we review the deficit on the 's179 valuation basis'[20] (if any) with covenant strength to provide an indicator of the risk to the PPF
- **Reliance on investment outperformance in the recovery plan** – we assess how much reliance is being placed on investment outperformance to make good the deficit in the recovery plan and check if this appears excessive
- **Governance** – we consider reports of material poor governance (for example, conflicts of interest, inadequate internal controls, inadequate exchange of information between employers and trustees, or failure to commission adequate professional advice proportionate to the scheme) which indicate improperly managed risks
- **Specific risks** – such as the presence and underlying risks such as late payments [21] or 'section 75 double-counting'[22]
- **Asset-backed contributions (ABCs)**[23] – we will evaluate the nature of the scheme's interest in the ABC and assess the proportion of the scheme's assets made up of the net present value attributed to the payment stream. Where we consider that the valuation of the payment stream is material we will 'unpack' the effect of the ABC. In other words, when considering the valuation and the scheme's funding plans, we will look behind the net present value attributed to the ABC and consider the aggregate funding stream provided under any recovery plan and the ABC and the value of the contingent security provided

20
Valuation of PPF compensation benefits under Section 179 of the Act, for PPF levy purposes. Liabilities are based on the scheme benefits taking into account key features of the levels of compensation paid by the PPF as set out in Schedule 7 of the Act.

21
See Appendix 2 of the funding code of practice on scheme funding at **www.tpr.gov.uk/code3**

22
See paragraph 139 of code of practice on scheme funding and statement at **www.tpr.gov.uk/counting**

23
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.

- **Any issues raised at previous valuations** – where we have raised significant issues at previous valuations we are more likely to investigate than otherwise
- **Other interactions with us** – to extent that we have engaged with schemes or employers in relation to other matters we take them into consideration.

Appendix D
Late valuations and failure to agree

100. If we receive advance notification that the trustees are likely to fail to complete their valuation within the statutory fifteen-month timeframe, we generally do not engage at that point if work is underway. In those instances, we urge the parties to continue to engage to try to complete the valuation process a quickly as possible while reminding the parties that agreement should still be appropriate and not 'at any cost'.

101. Where schemes and employers have failed to agree to all of the funding requirements[24] within the statutory deadline, this must be reported to us[25].

102. Obtaining regular actuarial valuations is not just a legal requirement[26], it is a good discipline for schemes and their employers to assess the financial health of the scheme, even for schemes that may be in surplus. We have little tolerance for outstanding actuarial valuations. Our key focus, therefore, is to help a scheme in this situation reach an appropriate outcome as soon as possible.

103. We seek to understand the reasons for the delay and the likely date of completion so as to assess the risk of prolonged non-compliance. This enables us to determine the most appropriate course of action. In our assessment we also consider any other relevant factors such as whether there are any other issues or risks relating to funding, investment or covenant support, concerns about governance or evidence of avoidance.

104. This may involve meetings with the parties to try to explore whether agreement is possible. In our discussions with the trustees and the employer we seek to understand the reasons for the delay, the nature of the parties' position and the extent of the work done so far. We also consider the extent to which the trustees and employer have sought to put mitigating actions in place in view of their failure to agree. Our objective is to facilitate discussions between parties and encourage the trustees and the employer to engage in a meaningful dialogue and to agree an achievable timetable within which they can agree an appropriate outcome.

105. Where the delay is likely to be short or the deadline has just passed or we are confident that good progress is being made, we are unlikely to take action. However, in the absence of progress, if delays are significant or we have identified other material risk factors we consider the use of our powers[27].

24
Under Part 3 but will generally be completing the actuarial valuation and revising the schedule of contributions as well as updating (or putting in place) a recovery plan.

25
See Appendix 1 of the funding code for details on these reporting requirements under Part 3 of the Act.

26
See section 224(1) of the Act.

27
See paragraphs 77 to 80.

Appendix E

Outcomes from our engagement

106. Once our initial engagement with the scheme's funding is complete we write to the relevant parties to let them know of the outcome and any next steps.

107. Where we decide not to take action, we reserve the right to revisit that decision where we receive information which is materially different from that provided. A material change in circumstances after that decision may lead to a new investigation.

No further action

108. If we have identified no concerns warranting further investigation, we issue a valuation investigation closure letter (VIC letter).

109. This confirms that we do not intend to carry out further investigations and do not propose to exercise any of our funding powers[28] in relation to the valuation in question. In the VIC letter we may give some bespoke feedback to the scheme and the employer.

Inadequate response but no further action

110. Where we have identified concerns but we do not consider that it would reasonable and proportionate to use our funding powers (for example, due to the parties' agreement to meaningful improvements at the next valuation), we may issue a VIC letter communicating the issues outstanding; explaining why we are closing the case; outlining our expectations for the next valuation; and outlining what steps we could take should we still have issues with the next valuation (including the extent to which we can take into account those issues with the current valuation when doing so). The letter will also confirm any agreement reached by parties for the next valuation in the light of our concerns.

111. Not using our funding powers in relation to the current valuation does not preclude us from considering the use of our other powers or taking other actions.

28
Under section 231(2) of the Act.

Inadequate response and further action

112. In some cases we may decide that the concerns we have outlined to trustees have not been adequately addressed, or where an agreement remains outstanding, that it would be reasonable and proportionate to take enforcement action.

113. In this case we explain to the parties our next steps and the reasons for them[29].

29
See paragraph 72.

Appendix F
Glossary

Work-based pensions
Occupational pension schemes, personal pension schemes where direct payment arrangements are in place or stakeholder pension schemes.

Tranches
'Tranche' refers to the set of schemes which are required to carry out a scheme specific funding valuation within a particular time period. Schemes whose valuation dates fell between 22 September 2005 and 21 September 2006 were in Tranche 1, between 22 September 2006 and 21 September 2007 were in Tranche 2, etc. Because scheme-specific funding valuations are generally required every three years, schemes whose valuations are in Tranche 1 will also be likely to carry out valuations in Tranches 4, 7 and 10.

Technical provisions (TPs)
The funding measure used for the purposes of Part 3 valuations. The 'technical provisions' are a calculation undertaken by the actuary of the assets needed at any particular time to make provision for benefits already considered accrued under the scheme using assumptions prudently chosen by the trustees – in other words, what is required for the scheme to meet the statutory funding objective. These include pensions in payment (including those payable to survivors of former members) and benefits accrued by other members and beneficiaries, which will become payable in the future.

Reference liabilities
An estimate of liabilities which enables a consistent comparison between schemes by removing the impact of varying degrees of risk between schemes.

Recovery plans (RPs)
Under Part 3 of the Pensions Act 2004, where there is a funding shortfall at the effective date of the actuarial valuation, the trustees must prepare a plan to achieve full funding in relation to the technical provisions. The plan to address this shortfall is known as a recovery plan.

Recovery plan length
The recovery plan length is the time that it will take for a scheme to recover any shortfall at the effective date of the actuarial valuation, so that by the end of the recovery plan it will be fully funded in relation to the technical provisions.

Deficit repair contributions (DRCs)
DRCs are contributions made by sponsors to the scheme in order to address any asset to technical provisions deficit, in line with the schedule of contributions and the recovery plan.

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Defined benefit funding regulatory and enforcement policy

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