



Information
for trustees and
employers

The essential guide to the DB code

June 2014

The Pensions
Regulator

Defined benefit (DB) schemes are complex. **Code of practice no. 3 – Funding defined benefits** helps trustees understand how they should approach scheme funding. The full version of the code can be viewed at www.tpr.gov.uk/code3. This essential guide provides an overview of the code and gives details of where you can go to find out more. It can help you use the code but is obviously not exhaustive and it's not a substitute for reading the full code – which we expect all trustees to do.

What is a code of practice?

Codes help trustees fulfil their legal duties. They aren't statements of the law, but they outline an approach that trustees can take to complying with their duties. The courts have to take account of codes when considering whether trustees have fulfilled their responsibilities, and we may refer to them when we issue an improvement notice to trustees.

Code of practice no. 3 – Funding defined benefits (the DB code) was updated in summer 2014.

The DB code

This code balances trustees' objectives to comply with their duties and ensure they pay benefits when due, with employers' objectives to grow their business while ensuring that pension promises are kept.

Fundamental principles of the code

There are many moving parts associated with the ongoing maintenance and funding of a DB scheme. These can be complicated by the specifics of the scheme, its members and its employer. But there are some broad principles that will apply to all schemes:

- Trustees and employers should work together in an open and transparent manner
- Trustees should manage funding, covenant and investment risks in a way which takes account of how they interact with each other
- Trustees should assess their employer's ability to help their scheme if risks materialise
- Individual decisions in a scheme should be consistent with the trustees' long term targets and their view of the employer's strength
- The approach trustees use should be in proportion to the size, complexity and level of risk in their scheme
- Trustees should seek appropriate funding which reflects a reasonable balance between the need to pay promised benefits and minimising any adverse impact on an employer's sustainable growth
- Trustees should run their scheme in line with good governance standards
- The scheme should be treated fairly when compared to other creditors of the employer
- Any deficit should be paid off over an appropriate period.

Risk

It's not necessary to remove all risks from DB schemes. Accepting an appropriate amount of risk can help a scheme improve its own situation, meaning it needs to rely less on employer support.

Trustees have to understand the possible upsides and downsides to taking risks. Where the downside might result in the employer having to make up a shortfall, it's important that trustees have assessed whether this is feasible.

Just because an employer couldn't write a cheque big enough to cover the shortfall straight away if all risks materialised together, it doesn't mean that taking those risks is inappropriate. However trustees should explore over what period and how the employer could potentially deal with the scheme's position deteriorating.

Trustees need to manage risks in an integrated way as one risk materialising could result in changes being needed in other areas. They should recognise how risks that can change the strength of the employer's support will interact with the scheme's investment risks and funding assumptions.

Trustees must put contingency plans in place, making sure that their management structures are flexible enough to monitor multiple risks simultaneously, and respond quickly where risks materialise.

See the chapter of the DB code entitled 'An integrated approach to risk management' for more detailed information.

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Trustees should manage funding, covenant and investment risks in a way which takes account of how they interact with each other.

Employer covenant

The employer covenant is the employer's legal obligation to the scheme and financial ability to support the scheme now and in the future. The covenant provides an important backstop for the scheme.

Trustees should assess the employer's covenant and how it may change in the future. This can help them make decisions about how much risk to take. They may commission an external adviser to assist in this assessment.

Employers will often need to invest in order to run and grow their business. Trustees should therefore understand what plans the employer has and whether calls on the employer's resources could affect its sustainable growth and, therefore, its ability to support the scheme.

Paying dividends is a normal business activity. However, trustees may be legitimately concerned about dividend payments which weaken the employer covenant, or where the covenant is already weak. In these circumstances, trustees will need to revisit their funding plans and might consider obtaining security.

The covenant can change quickly, so trustees should monitor it regularly. The employer should notify trustees of any event or development that will have a material impact on the scheme.

See the chapter of the DB code entitled 'Employer covenant considerations' for more detailed information.



Individual decisions in a scheme should be consistent with the trustee's long term plans.

Investment strategy

The investment performance of a DB scheme has an impact on the employer. A low risk strategy will tend to mean higher contribution payments at first but at a more stable level. Whereas a high risk strategy can create volatility, potentially requiring large, unexpected contributions from the employer to repair the resulting deficit. Trustees should discuss with the employer how potential strategies may affect scheme funding and the employer's growth plans and covenant.

The trustees' investment strategy should be consistent with their funding objectives and the level of risk they are willing to take in light of the employer covenant. Trustees must ensure that they have cash available to pay benefits when needed.

Nearly all investment strategies involve risk. Trustees should understand the likelihood and impact of this risk materialising and the employers' ability to repair this. Ongoing monitoring is important.

See the chapter of the DB code entitled 'Investment strategy considerations' for more detailed information.

Funding

All DB schemes need to have enough money to pay the benefits that have been promised to their members.

To establish how much money is needed, trustees must commission an actuarial valuation at least every three years. They should take advice from their actuary on what method and assumptions to use when calculating the amount of money they need, taking the employer covenant into account, to pay the benefits already promised. This amount is called the technical provisions.

Trustees should not compromise the technical provisions to result in lower employer contributions. Trustees should choose assumptions prudently because technical provisions will be sensitive to changes in the individual assumptions like yields on government securities or wage inflation, and mortality assumptions.

The valuation will include the actuary's estimate of the scheme solvency (commonly called the 'buy-out' level). This is a useful reference point for trustees, as it will show how much money the scheme would need if it had to pay all benefits at one time.

As part of the valuation process the trustees will need to draw up a schedule of contributions for ongoing payments to the scheme from the employer and the active members. This should be clear enough to be easily monitored, and not rely on onerous cross-checking of other scheme documentation to establish who pays what and when.

See the chapter of the DB code entitled 'Funding considerations' for more detailed information.



Trustees and employers should work together in an open and transparent manner.

Recovery plans

If a scheme's assets fall short of its technical provisions then the trustees need to put in place a recovery plan. The recovery plan will set out what employer contributions will be made and when in order to fill the deficit.

The recovery plan can be tailored to meet the needs of the scheme and the employer but it should be appropriate when the risks the scheme faces are considered. Employer payments should be affordable and recognise both scheme needs and the employer's plans for sustainable growth.

See the chapter of the DB code entitled 'Recovery plans and intervaluation actions' for more detailed information.

Between valuations

Typically, schemes will undergo a valuation once every three years. In between valuations trustees will receive reports from their actuary with updates on the scheme's funding position.

Between valuations trustees should be alert to any significant changes to the scheme, its members, the economic conditions or the employer, and whether these might affect the investment or funding assumptions that they made at the last valuation.

Trustees can bring forward their next actuarial valuation if they feel it is necessary. However, given the cost of carrying out a valuation, trustees should give careful consideration to whether this is an effective use of their resources.

Members must receive a summary funding statement from the trustees every year. This sets out the financial position of the scheme to the members.

Trustees must monitor contributions to their scheme and report materially significant late or non-payments to us.

See the chapter of the DB code entitled 'Recovery plans and intervaluation actions' for more detailed information.

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