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PENSION SCHEME FUNDING AND SPONSOR COVENANTS

A Discussion Meeting

[Held by the Institute of Actuaries, 30 October 2006,
and by the Faculty of Actuaries, 14 February 2007]

Introduction

Under the new regulatory regime, it is a requirement that the trustees and the sponsors of pension schemes negotiate scheme funding according to a defined process. For some schemes these negotiations have already started; for many they are due to start shortly. What is clear is that the outcome of the first funding negotiation is critical, as it will set the benchmark for the future.

This Sessional Meeting covers pension scheme funding negotiation, with an emphasis on:
— the ways in which actuaries, trustees and sponsors can, or should, take account of the credit quality of the sponsor;
— the lessons on negotiation drawn from other areas of finance; and
— the role of the regulator.

The meeting takes the form of presentations by three speakers, taking stock of the current situation, and the discussion follows.

ABSTRACT OF THE DISCUSSION
HELD BY THE INSTITUTE OF ACTUARIES

Mr T. J. Gordon, F.I.A. (introducing the discussion from the funding point of view)**:** I am here with the intention of generating discussion, so that we, as a profession, can get to grips with sponsor covenants and the new funding regime in a better way. The key point is that the sponsor covenant is a critical component of funding advice under the new regime.

I shall give a short resumé of what has happened over the years since scheme specific funding was introduced, with a new GN9 and the report of the Sponsor Covenant Working Party. Then I will give a view on scheme funding. Ms Mills, who works for Ernst & Young, will talk about assessing the sponsor covenant, and Mr Redmayne will give you the Pensions Regulator's viewpoint.

First, here is a quick recap on what was said by the Sponsor Covenant Working Party:
— The actuary's role does not include assessing the covenant itself, unless the actuary is otherwise qualified, but the actuary should be able to advise on the need and the options available to trustees to assess it.
— Actuaries cannot continue to ignore the sponsor covenant and funding advice.
— It is quite important that, where actuaries are giving advice on funding and a third party is giving advice on assessing the covenant, the two sets of advice need to be combined at some stage. The fact that they interact cannot be ignored.

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— Actuaries should distinguish companies which are in distress. For these companies, the focus is not about funding for the long term — the focus should be about maximising the recovery from the company.
— Actuaries should look at the overall risk, rather than focusing narrowly on the risks which relate purely to the pension scheme.

I now give a quick summary of the new regulatory regime. The Regulator starts with a weak hand, if you compare it to the Financial Services Authority (FSA). Not only does it have to cope with poorly funded pension schemes, but the powers which it has under the law are relatively weak. It has compensated for this, to some extent, by using secondees from commercial institutions, who have, not only brought expertise to the Regulator, but also a different attitude.

In the summer of 2005 the Regulator came out on clearance, and was a lot stronger than we expected. On funding, my impression is that the Regulator has turned out to be a little weaker than expected. However, it is a key point that the Regulator has, fairly and squarely, and much more powerfully than we could as a working party, put the focus on the sponsor covenant.

We now also have the Pension Protection Fund (PPF), with a risk-based levy, which also makes reference to the sponsor covenant. Unfortunately, there are issues with the application of the Dun & Bradstreet ratings.

We have a Board for Actuarial Standards. Responsibility for pension standards has, in part, moved from the Actuarial Profession to the Board for Actuarial Standards. The Board has adopted the new version of GN9 (v8.0) as it stands, and is looking to develop common actuarial principles, which will be an interesting challenge.

There have been various market developments over the past year. There has been a huge growth in the use of swaps by pension schemes. You can tell by the exodus of clever actuaries to banking institutions that there is a great deal of business being done, or expected to be done. Liability driven investment (LDI) has really taken off. There seem to be two types of LDI. There is LDI in the sense that we match our investments, but this seems to be very much the minority. As I note from a recent article in *The Actuary* (2006), using slightly Orwellian language, there is also 'enhanced LDI', which is where you may offset one risk, but you take on another at the same time. My experience is that this version is the more common.

Longevity continues to be a thorn in the side of the Actuarial Profession. We have made limited progress. We now have tables which make reference to occupational pension scheme mortality, and we seem, slowly, to be developing some sort of stochastic approach. However, its emergence is slow, and it is difficult for the average actuary to access. It is still uncommon for pensions actuaries to separate their base mortality table and their future improvement factor in practice, and it is extremely uncommon for them to cost or to reserve for longevity uncertainty.

Probably the most obvious development is the bulk annuity market. We have had a new entrant stampede. Where there were only two players, we now have about ten. Prices have fallen, although not dramatically, and there is a potentially huge increase in implied market capacity. Also, bear in mind that schemes which, previously, would have ended up with bulk annuity insurers, are now going to the PPF. So, this implies an even greater potential market capacity.

I now turn to scheme investment strategies. With the focus on LDI, have they moved towards being lower risk? My impression is that, despite the publicity, changes are slow. There are strong systematic pressures for investment mismatching by pension schemes. Companies can report higher profits if pension schemes take risk. Technical provisions can be lower if they take risk. Both of these aspects are attractive to companies. Regarding amortisation of deficits, there is an asymmetric risk, which means that you may be more happy to take the bet, and you can amortise deficits more slowly if you take the risk inside your pension scheme. I am not making a value judgement, I am just observing that these pressures exist.

There continue to be very strong convictions about investment returns and how these should be incorporated into funding. Alpha, or active investment management, is widely assumed to exist, and I like the phrase 'harvesting alpha'. You assume that it exists, and then you go out and

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harvest it. Bond yields are widely thought to be 'low', and I have heard the phrase 'they cannot fall further' quite a few times in the past few years.

Equities will probably outperform, but 'will outperform' is a statement which you cannot prove. I notice that an actuary was recently quoted in *The Times* — maybe he was misquoted — as saying that equities are better in the long term, because they 'will', unqualified, 'outperform'.

There have also been developments in the services which are available to trustees to assess the sponsor covenant. A year ago, in the Sponsor Covenant Working Party Report, we summarised all the services available. Essentially, we had large accountancy firms, and some not so large, and one credit rating agency, making quite a big play for giving advice.

Since then we have observed new features to the advice given and some new players. There have been some tie ups between consultancies and the people who can give this advice, either within their groups or externally. Some consultancies are developing an in-house capability, and there are some advisers with an investment banking background making small inroads into the area, although this latter group is not vast.

I would like to remind you what the new GN9 says, admittedly being very selective in what I quote. The actuary must:

— provide information about solvency, on what technical provisions mean in terms of solvency and the solvency level;
— advise on how the funding strategy will affect the evolution of scheme solvency for the next three years; and
— advise on the potential impact on scheme solvency of the sponsor not being able to continue to pay contributions or to make good any deficits.

In broad terms, what this means is that, even if the Regulator had not put the sponsor covenant fairly and squarely on the agenda, you would still have to look at it.

So, let us move to the meat, which are the technical provisions. This is the linchpin measure under the law, but it is undefined. Technical provisions must be 'chosen prudently', taking account of any 'margin for adverse deviation', which, again, is undefined. This is Government policy. Any change must be justified by a change of legal, demographic or economic circumstance. This is really important. It means that, when you set technical provisions the first time you are stuck with them. Unless you can point to something external which has changed, it is going to be difficult for you to change the provisions. So, the first time when you and your clients negotiate on technical provisions is very important.

The Regulator code of practice is treading a fine line, trying to avoid stepping outside the boundary and actually providing any specification. It has clarified a few points. Equity outperformance is all right if trustees have taken account of the sponsor's ability to cope with adverse experience. I am curious to see how many schemes will be incorporating equity outperformance in their funding bases. My guess is that it will be quite a few. Changing the sponsor covenant qualifies as a change of economic circumstance. I had not appreciated that, because it would not have been my interpretation of the legislation, but it is very helpful. However, the key flaw in the system remains, which is the reliance on trustee governance.

Sponsor covenant is a binary event. I am glossing over some complexities here, but, in broad terms, you are either ongoing or you have failed. There is a messy bit in between, but you have either entered the PPF or you have not. This is demonstrated in Figure D.1. The key issue is that there is no point in averaging the two outcomes, because it is a meaningless way to analyse that sort of event. The average does not exist in a useful sense. In the okay scenario, everything is fine by definition. In the bad scenario, the key number in which you are interested is how well benefits are covered. So, we should be looking at, and we should be telling our clients how, benefit coverage is likely to progress over time.

Figure D.2 shows the graph of a scheme funding target, re-expressed in terms of benefit coverage. Assume that you start with a scheme which is 100% funded on a technical provision basis, which assumes equity outperformance and makes no allowance for potential cost of longevity risk. Although it is 100% funded on a technical provision basis, it may be about 75%

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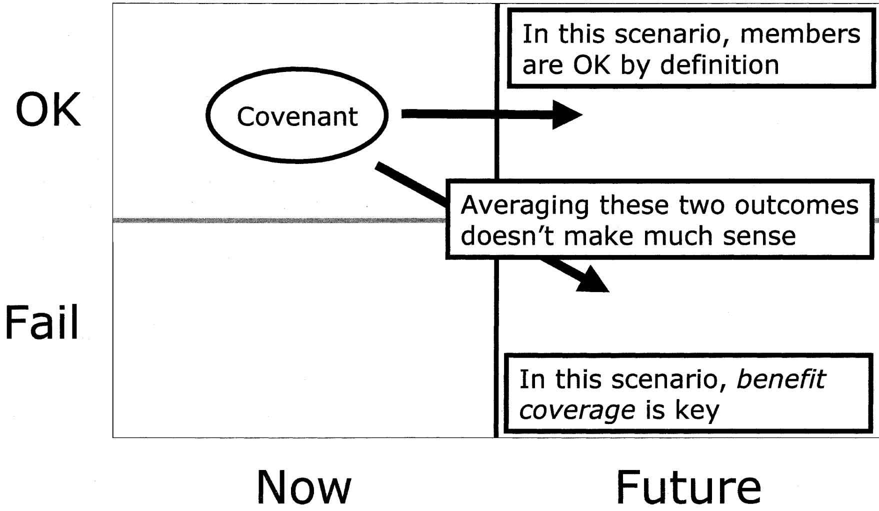

Figure D.1. Sponsor covenant is binary

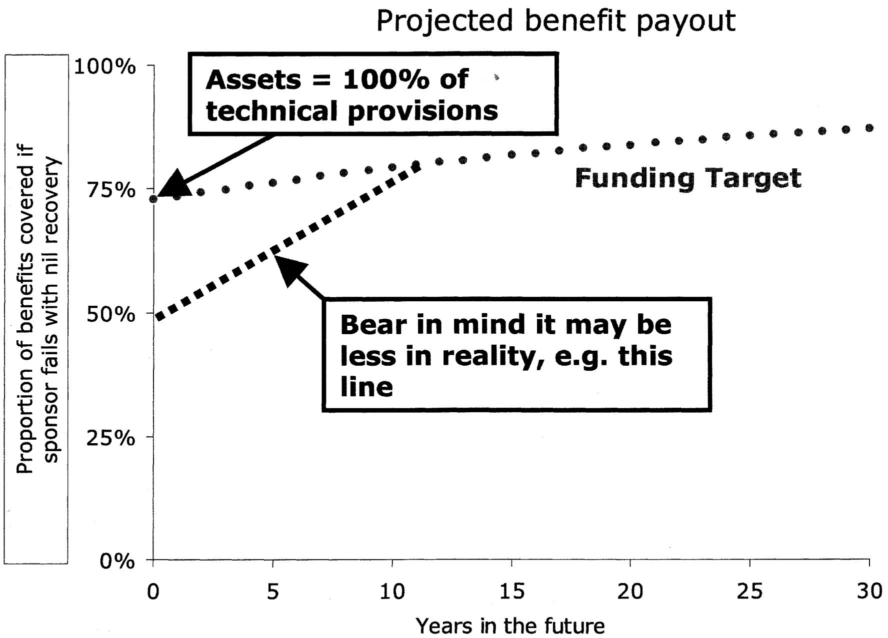

Figure D.2. Sponsor covenant exposure (1)

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funded on the cost of securing the benefits. This is not unusual. Bear in mind that the reality may be that it is underfunded on the funding basis.

It sounds great. Clients have these assets, and that is how they are advised as to how they are going to progress in the future. The problem is that they have a persistent and material exposure to the sponsor covenant, as shown in Figure D.3. Are your clients aware of that when you are advising them on technical provisions? Have they really taken on board what that exposure means? It means that the company fails. Have they taken on board that, if you get the returns which you are expecting, you expect that exposure to remain pretty much for ever until the last pound is paid out of the scheme? It is quite important that we do get that across. I am not convinced that we do so at the moment.

Figure D.4 is quite complicated, but is worth seeing. The dotted line across the graph is the 'expected' (as in mathematical expectation) line of scheme funding. The fan of different grey shades is the probability distribution. In effect, this does not allow for scheme prudence, but, in practice, people probably do not allow for some of the risks which really do apply, such as longevity risk, and so I do not think that this is, necessarily, an unfair representation. However, what is important is that the risk expands.What is going on here is that there is a pool of assets invested riskily.The funding position, looking forward, is equal to the current liabilities less the liabilities which are certain. So, there is all that asset risk, and in ten or 15 years time it is being divided by a smaller pool of liabilities. In effect, there is gearing, looking forward.

It is not obvious to me that, as actuaries, we are clear in advising this. We make the assumption that the expected return, as shown by the dotted line across Figure D.4, is sufficient. We do not advise that, over the long term, there is a gearing effect.

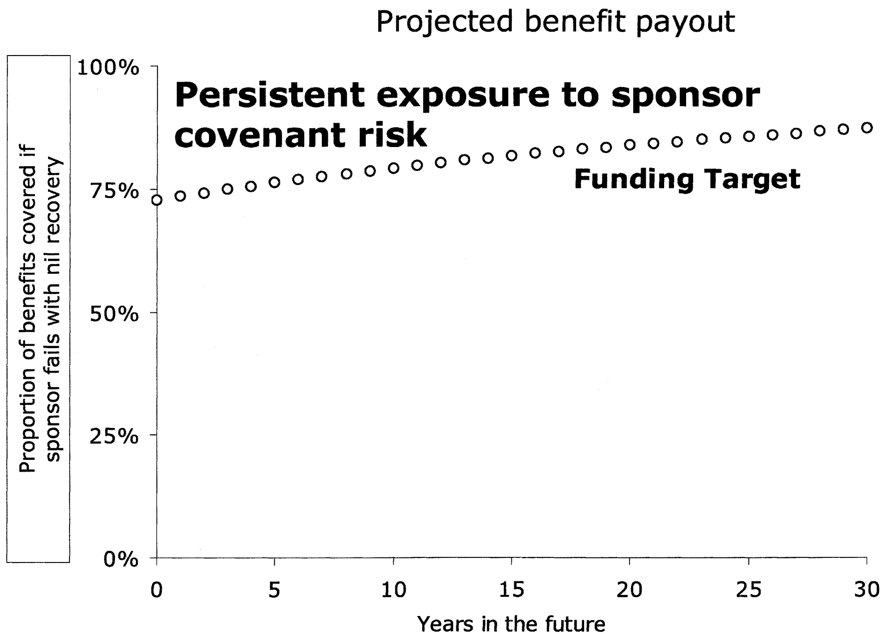

Figure D.3. Sponsor covenant exposure (2)

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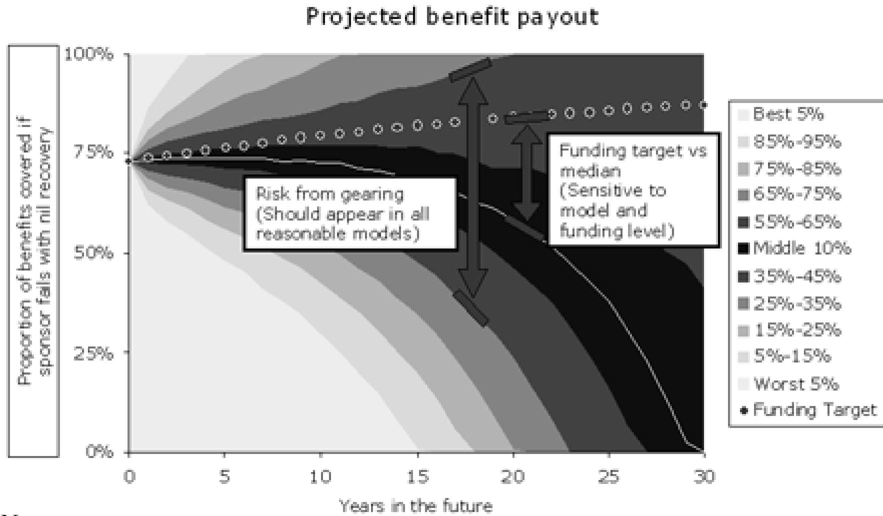

Notes
1. Funding Target has same expected return as scheme assets.
2. Simple risk model — no allowance for yield curve or longevity risk.

Figure D.4. Sponsor covenant exposure (3)

So, here are my observations. Conventional funding advice can create persistent exposure to the sponsor covenant. This is implicit in the funding plan. I am not saying that that is an illegitimate approach. It is Government policy. It says: "Do not expect schemes to be 100% funded on a buy-out basis." I just ask: "Are your trustees aware that, not only are they underfunded now, but this is what you say will be the expected position in 15 years' time, if everything goes to plan?" I also say that, unless you think about how you present long-term risk, you may be disguising the risk.

If we look towards the life industry, we note that they have 'run off' plans. The implicit run off plan in this scheme is to wait for the last member to die, it is hoped, on time. Is that really a run off plan? Are the trustees aware of the risks? Are the members aware of the risks? Would it be good practice for trustees to define a run off plan for their pension scheme?

The paper by Campbell *et al.* (2006) tried to apply some lessons from running closed life companies over to pension schemes. While we are not talking about closed schemes, many of the schemes which we are talking about are large compared with the sponsors. They have that closed feel about them, so that this approach might be worth considering.

One of the items which people tend to avoid in funding advice, because it is difficult, is taking account of the PPF. In theory, it has added a great deal of protection. We are very unsure about advising on it, because is it going to be 100% of what it holds itself to be at the time when schemes will need it. Maybe the PPF will have had to reduce benefit payments, but, clearly, it must be adding some protection. Let us take an extreme case, where you have a poorly funded pension scheme plus a weak sponsor covenant. This means that it is likely that the scheme will end up in the PPF. Is it not a sensible option, instead of adopting an approach which guarantees that you find yourself in the PPF, for the trustees to conspire with the sponsor to run on as long as possible? In such a case, members might benefit from more accrual of benefits in the PPF, since more of them reach normal retirement age, which results in better benefit

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coverage. Also, the trustees and the sponsor might create some optionality in the members' favour by taking a considerable bet on pension scheme strategy.

With a very mismatched investment strategy: if it comes off, then members benefit and the benefits are more than from the PPF; and if it does not, then the PPF benefits are still received. My impression is that clear advice on the impact of the PPF is unusual.

I trust that these comments will stimulate discussion, and here are some questions to think about.

(1) How would you incorporate the sponsor covenant into your funding advice? Has your funding advice changed under the new regime compared to what it was three years ago? Have you just added a new section called sponsor covenant at the back of your valuation report and that is it, or have you gone further than that?
(2) Is it reasonable for technical provisions to be less than 100% of benefit coverage for ever? Do you ever plan to exit or do you plan to run on until the last man or woman dies?
(3) Do you give quantitative risk advice? It is very easy to say qualitative things like 'it is risky', but do you actually give any statistics with which one can get to grips? Maybe you are leaving it to investment consultants. That is quite an effective strategy.
(4) Should pension schemes have run off plans? Do you think that it would be a good idea if they had such things?
(5) Should the PPF be taken into account in funding?

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Ms M. Mills (a visitor; introducing the discussion from assessing the sponsor covenant point of view)**:** Before I start on the subject of assessing the employer, or sponsor, covenant, we should recap on why we are looking at this subject. This might explain why anyone would ever think that a corporate finance or corporate restructuring adviser should be involved in the matter of covenant assessment for pension fund trustees. My background is in corporate finance and corporate restructuring. Pensions are moderately alien to me, but I am learning fast.

Trustees of a pension fund are creditors of the sponsoring employer of the participating employers. They are involuntary creditors, in that they have no payment plan and no terms of trade. They also have no equivalent triggers to the likes of banking covenants, which allow them to negotiate their repayment. That last point has changed, and it is being rectified by the need for a recovery plan to settle the deficit: but at what rate; over what period; and how do we go about it? That is one of the main areas into which the accounting profession has come.

Why not just look at the credit rating? Mr Gordon referred to Dun & Bradstreet, but you also have Standard & Poor's, Moody's and Fitch. To start with, not all companies are rated. Then, if a company has a rating, it is a snapshot. This is not the way forward, as it does not give the trustees all the information which they need to be able to negotiate paying off the deficit or to deal with any other of the situations which may present themselves in the form of transactions.

To date, my experience, and that of many others, has been on transactions, in the form of mergers and acquisitions activity, disposals, as well as restructuring and pure insolvency, which are drivers for the assessments required. However, that is changing, and it is changing quite fast.

The questions being asked are the ones which we are accustomed to. When we advise lenders in either a pre-lending review, before they lend their precious funds to corporates, or if they are in distress situations with insolvency on the horizon, or even just a restructuring, each of the situations will require different levels of analysis and different levels of challenge. Fundamentally, the questions are: "Will I get repaid?", "How will I get repaid?" and "When will I get repaid?"

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So, the Regulator used a correct analogy by looking at this whole scenario as one of the lenders might, as a major creditor to the corporate.

At what do we look and with what do we start? First, there is the publicly available information in the form of accounts. This gives you a view of where the business has come from, but it will not necessarily give you a view of the future ability to repay the deficit, although it can give some hints.

So, the trustees, if we are acting as their advisers, need to be privy to companies' forecasts. This is sensitive, as many corporates do not see the need for it. However, if you are looking to the future, you need to understand that that is what the equity analysts price in when they are looking at businesses. You need to ask: "How does the corporate see its market?", "How does the company fit into that market?", "What is its strategy?" New products, technological change and market obsolescence of products all come into play.

There is also the need to consider geographic spread, given globalisation. Is everybody getting adventurous, and are they venturing out into areas for which they are ill-prepared?

I can paint that picture, and you will tell me that it is far too complex, and that you do not need to delve that deeply in many scenarios. However, however small or large the company, trustees have to be aware of, and have to have a view on: where the company is heading; what it thinks that it is actually doing to its business; and how that will affect profitability. Profitability provides the cash, and cash is the source of the repayment of any deficit. However, there are no guarantees, so that the trustees also need to understand the risks involved with that strategy. What could go wrong? What effect will that have on cash flows? Will it be a deferred effect? Will it be an absolute effect? Trustees need to see this, even if it is just to understand why a company thinks that it needs time to repay. What is its headroom? What is its banking covenant? The last situation which you need is for banks and bonds to go into default, because that will defeat the objective of having a company which is operating within the market's expectations. Trustees need to be able to see what the constraints are on the company before they start making demands.

I have spoken as though the trustees are the only party needing advice. The sponsoring employer also needs advice, but not, it is to be hoped, on its plans and its strategy. If it does, then we may have a bigger problem than we thought!

Companies need to factor in other stakeholders, including the trustees of the pension fund. Most of my profession first interfaced with pension funds and the new regime through being restructuring advisers. Our job is to look at the propositions for our clients, very often the corporates themselves. A restructuring plan which should resolve a problem is being put forward, taking into account all of the parties' needs and agendas.

You may think that restructuring or insolvencies are a minor point, so that you do not have to worry about them. They are an exception, not the rule. However, what they do demonstrate is how you can use that scenario in negotiating the position, and thereby in understanding the dynamics of what needs to happen.

The parties need to know where they stand relative to the other stakeholders in the pecking order. The trustees of the pension fund will generally start as unsecured creditors. However, are all the creditors unsecured? Are some of the financiers secured? What is their security? Over what are they secured? Are they at a holding company level or can they get right down into the operating companies? Is there a structural subordination? Ideally, the trustees of the pension funds will go down to operating level. Doing this will give them some leverage, because this is where cash flows originate, rather than at the top level.

It may come as a shock to some of the bondholders and, possibly, the financiers, when they face a situation where they find that the trustees have already negotiated security at a lower level, which they may not have taken into account.

Again, this sounds as though I am over-complicating matters, but it is safe to say that, if you look at any corporate structure which has been in existence for five years, there will be mergers and acquisitions activity. You will find that trade and activities have moved round the group, perhaps for tax or restructuring purposes. Companies will report on a divisional basis. They will report on a product line basis. Even if all these components are sensible and commercial and

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'correct', the trustees need to be able to look at an entity on a legal entity basis, because, if the balloon goes up, that is where their risks will lie.

Again, this is not just if it all fails. There are many mergers and acquisitions in business. There will be takeovers, sales of non-core businesses and cost-cutting or rationalisation. All these need to be considered, because the trustees need to know the implications for the covenant on which they are relying. Change will occur, and the trustees need to know how to react.

So, covenant assessment gives the trustees knowledge. It gives them information so as to understand the cash flows of the company and the risks inherent in achieving those flows, which gives them the basis for negotiating their constituency's share of the cake. There is not a large amount to be shared, or, even if there is, how much of it is going to be there for their party?

Also, they have to understand the dynamics of the business and to identify the risks involved with the strategy. They can run scenario analyses and prepare for the eventualities, so that they will not be behind the curve. They will be able to react immediately and protect their position in a constructive way. To date, there has been some bad press, with some trustees being perceived as blockers. Therefore, the more trustees are informed, the easier it is for them to be constructive, as well as to defend their position.

It also gives them an ability to understand the key performance indicators of the business and to monitor them on an ongoing basis. If performance is within certain parameters, then they can feel comfortable. Once it starts to get near a level which they do not like, then they can take action. If trustees have based their assessment of a good covenant on recovery plan A, or performance at a certain level, and it is not happening, they need to re-think. Again, trustees need to build this aspect into a new agreement with the company on covenants. As with a bank, they need to know that, if performance is weak, they have the right to be heard and to reopen discussions.

It is worth noting that there are a number of tools available in the form of guarantees, which can allow trustees to reach a level of comfort and security which they would not have had otherwise. We have seen several securitisations take place in this context.

Trustees should be up to speed, not just on their own positions, but on the positions of others. You do need to understand the agendas of others if you are going to come up with a win-win situation. These are the kinds of skills which a financial adviser can bring to the table, and, as Mr Gordon pointed out, he or she is one of the team. The team advising the trustees has to come from all angles, whether it is investment, actuarial, legal or financial. All are needed.

Moreover, it is not just the trustees who are asking for this advice. Increasingly, I am finding that corporates are pushing the trustees to make sure that they are up to speed. With all the activity in the marketplace, companies want to know that their trustees will not be the blockers, and will be able to react quickly.

One last issue to mention is that, in looking at the clearing banks or the traditional financiers, you are looking at a position which has exhibited, one might say, moderately gentlemanly conduct. However, if the rating agencies have downgraded a major company, it will bring that debt into play on the debt markets. There will be hedge funds, the 'affectionately' known distressed debt funds, and other investment parties, which, suddenly, will become creditors, alongside the trustees. They have totally different agendas. They are slightly more daring, perhaps, in some of their strategies, and you will find that you do need to know, as a trustee, exactly what your position is and how you can protect it, because those parties have no respect whatsoever for the pensioner, and will take what they can get out of the situation. It is a position for which trustees need to be prepared, and you need to be advising your trustee clients in that way.

Mr D. Redmayne (a visitor; introducing the discussion from the Regulator's point of view)**:** I am on secondment to the scheme funding team of the Pensions Regulator, a secondee from an investment bank. I am a director of Close Brothers, an investment bank which focuses on a number of things, including financial restructurings.

I shall speak about some perspectives on the employer covenant from a regulatory standpoint. The agenda which I propose is revisiting some topics:

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— Why the employer covenant is an important matter.
— What is meant by covenant as a concept, introducing the whole scheme funding regime.
— I shall touch on the interrelation which we see between the covenant, technical provisions and recovery plans.
— I shall talk about our role and your role.

Why is the employer covenant important? There are two angles which I should like to consider. First, there is the context of it codifying a relationship which exists between an employer and an underlying scheme. The scheme is the provider, supported by the employer, of member benefits, and, although defined benefit schemes over time are moving increasingly to defined contribution schemes, a large number of employers still see benefit in providing such arrangements. The obvious and clearest point is the funding provision. Perhaps a less obvious point, not to this audience maybe, is that the employer is a provider of longstop longevity risk, by being the counterparty in the transaction.

The second point is the scheme specific funding process standpoint: setting technical provisions; agreeing a recovery plan; and the ongoing monitoring of covenant for significant change after a recovery plan has been submitted. We are in the early days of the first wave of recovery plans which have been received, given the time provided for recovery plans to be submitted. It is very early for anybody to draw conclusions on behaviours at this point.

What is meant by covenant? In the code (Paragraph 57) we have explained the covenant in these terms: "an objective assessment of the employer's financial position.'' That is, you could say, the 'now'. Its prospects are important too, and there is a non-financial aspect which we cite at this point: the employer's willingness to fund benefits.

So, there are financial and non-financial aspects to covenant. We see it very much as an essential building block by which trustees assess covenant, and seek, where they need it, appropriate professional advice so to do.

I want to give some examples of factors which go into assessing covenant. It could be a very long list: management; willingness; sector prospects; what is happening in casual dining versus retail; what is happening in automotive manufacturing versus specialist instruments for healthcare; business models. Is it capital intensive or not? On access to capital, is it a quoted business? Does it have access to the bond markets? On capital structure, is it a weak covenant employer, but with a strong covenant parent? On a competitive position, there are many factors. The point which I want to make, as well as analysis of the present and the future and of factors such as those above, is that there is a professional judgement to be made. It is very difficult from publicly available documents to have 'a feel' for the relationship between trustees and the employer. However, to reiterate — the concept of willingness is a very important part of covenant.

Moving on to the balancing act between the covenant, technical provisions and the recovery plan, the code and the final statement make it clear that there is no precise answer. There is a range of appropriateness, and our intervention will occur where there are inappropriate technical provisions, inappropriate recovery plans, and where we feel that our intervention is needed. You may see situations where these matters could get off balance. A weak employer covenant, one might infer, could result in higher technical provisions than otherwise. That might, ordinarily, all other things being equal, lead to greater cash contributions than would otherwise be the case. However, if those cash contributions are larger than the employer can reasonably be expected to afford under an analysis of affordability, that could further weaken the covenant of the employer. What matters is that these components are balanced, and that the work and the judgements have been made by the professionals, the trustees, and their advisers.

These are new challenges. It is a new environment, which is why I said that it is early days to be drawing behavioural conclusions. There is a negotiation between trustees and employer, and you and other advisers are involved in that. Conflicts come to the fore. How those conflicts are managed is important. Where appropriate, we encourage independent financial advice. There are very clear cut situations where financial advice may not be needed. What it comes down to is an assessment, which the trustees need to make, about their own capabilities to perform such a

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task within the team as it stands, and their comfort in so doing. If they feel uncomfortable in performing the role, or are lacking the expertise and the capabilities to perform that role, then financial advice is necessary.

There is, perhaps, an additional party at the table than has been the case previously, be it an accountant or an investment adviser, with very much a set of corporate finance, banking, accounting and financial skills.

Our role in all of this, and your role, is that we have said very clearly that we are referees, not players. There are many schemes and recovery plans. Trustees seeking advice where necessary, negotiating sensibly with well advised employers, is what we encourage. There will be times when negotiation does not work. There will be times during negotiations where there may be issues which come up, and we are very happy to discuss them. It is scheme specific, though. When we consider matters in the scheme specific funding team, and when we are approached for views, we do not do so on a no names basis. We are, of course, highly professional, and will treat everything in absolute confidence, but we cannot be scheme specific and apply a generality. We need to understand some of the specific factors in order to give a view on an issue.

If negotiation fails and there is a failure to agree, as we have said in the code and final statement, we will investigate. We will look at the negotiations which were held, where the professional or less formal mediation services were sought, and check, very closely, whether independent advice was taken. We have said that we would also be concerned if all options were not explored. We will intervene if necessary. Our powers are available, if we need them.

Mr C. G. Lewin, F.I.A.: I do understand the complexities which previous speakers have mentioned, and their remarks are entirely sound. Although I shall be doing some gross simplification in what I say, it is not meant to be, in any way, critical of what has been said.

When one faces a difficult issue, what does one normally do? One normally thinks where one would like to be, ideally, in, say, ten years' time, and then considers: "How do we get from where we are now to there?"

I am not sure that the actuarial profession has yet given a great deal of thought to where trustees of defined benefit schemes would like to be, ideally. The duty of the trustees is to do their utmost to make sure that the pensions are paid. If the actuary is advising the trustees, as opposed to the company, then it is the duty of the actuary to advise the trustees in such a way that they can have the maximum possible chance of getting the pensions paid in full to all their members. That may seem obvious, but what is the implication of that for funding policy? Remember, I am talking about ideals here.

Even if you have a good sponsor covenant, the company may become insolvent in some years' time. Clearly, if you have a poor company covenant, the chance of that is higher. However, in either case it can happen. The controversial target, which I would like to suggest, for trustees in an ideal world, is 125% solvency on an ongoing funding basis. In other words, the assets should be 125% of the liabilities, which may not be too far from a buyout basis, but I am not talking about a buyout basis. I am talking about a basis which is ongoing and related to the liabilities.

Why do I suggest 125%? What is the magic of that figure? It is because I have seen actuarial calculations, based on stochastic modelling, which suggest that, if you have somewhere around 125% or 130% of liabilities as your assets for a fund with a 70% equity content in its investment portfolio, even if things go quite badly wrong you will not experience too much disaster in the short term. There would then be time for recovery to take place.

If the fund has significantly less than 125% solvency, then there is a great deal of risk for the members, and I am not sure that we are yet pointing that out to them in sufficiently clear terms.

So, what should the actuary do? Clearly, that target may appear to be beyond reach for many companies at the moment. My first suggestion is that the actuary should report on a range of solutions to the trustees, not just one, and that that range should include the ideal. In other words, the actuary should say: "I think that, in ten years' time, you should be aiming to get 125% solvency if you possibly can, and this is the implication of that on the deficiency payments."

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The actuary may then continue to recommend alternative solutions, and certainly some solutions which take account of information about the sponsor's ability to pay.

However, the actuary may have to hand back to the trustees the responsibility for determining where the final recommended figure should be. It may be that the actuary would not want to take that on board for himself.

How do we get from where we are now to where we would like to be? I suggest that, if the company has a good covenant now, then getting to the 125% level over a ten-year period or less may not be too difficult. There is the possibility of bond issues. There is the worry that the company may have that putting in too much money may result in it not being able to get it back if the scheme runs into surplus. There are various technical ways of coping with that: escrows, repayable loans, contingent asset charges, and other ways. However, I do not think that that is a real issue. Many companies with good covenants might well be able to issue bonds to get to a good level of funding quickly. If they do that, then one advantage will be a greater degree of certainty surrounding the company in the eyes of investors, and also a greater degree of flexibility for the company if it has to go for clearance of some kind of corporate transaction in the future. Moreover, interest payments on bonds may be less of a cash flow burden than deficiency payments.

If, on the other hand, the company now has a poor covenant, what should the answer be? So far as the actuary is concerned, the ideal solution would be to pay off the deficit in a lump sum straight away. For a company with a poor covenant that may not be possible, but, nevertheless, the actuary should report on it and what the lump sum would be. The responsibility for dealing with that situation should be very definitely placed on the trustees in arriving at a suitable compromise with the employer.

One other aspect which was put forward in the discussion was the PPF. The reality is that the PPF will provide very poor benefits for some members, particularly, for example, middle management, who may well not have alternative resources. I do not think that it is appropriate for actuaries to rely on the PPF in their recommendations. It is a safety net which may help to deal with the worst aspects of a collapse, but not something which should be built into the calculations.

Mr J. Ralfe (a visitor)**:** Most of what we have heard has focused on the trustees and how they should view the sponsor covenant. Mr Gordon mentioned, and Mr Lewin picked up, the peculiar position of the PPF. This is something which needs more thought, not necessarily in the way in which actuaries should advise trustees, but on a broader scale. It is illogical for pension scheme trustees to be too worried about the sponsor's covenant, funding plans or deficit contributions, or any of the things which we have heard about, if they are well below the level of the PPF compensation — the position of many pension schemes in the United Kingdom.

The danger is — and Mr Gordon alluded to this — that the trustees realise that, whatever happens, they do not stand a chance of getting more than the PPF compensation, so it is in the interests of members to continue to accrue new benefits and to have more members reaching normal retirement age, etc. It is also in the interests of the sponsor to do exactly the same. The danger is the degree of connivance which goes on between the sponsors and the trustees. Where does this leave the PPF? If the PPF is not represented at this meeting, perhaps it should be. It seems to me that the PPF will not intervene to make sure that this does not happen, and, probably, as a matter of law, it cannot, because the Pensions Act does not give the PPF the powers to intervene.

What is important, on the practical level, is for the PPF to have the power to appoint its own trustees. I do not know the circumstances in which it currently has that power, but the PPF should have the ability to appoint trustees where it is in the final firing line, because the level of funding and sponsor covenant means that there is a real risk of the scheme ending up with the PPF.

As an example, consider the Coal Board pension scheme. My understanding is that one or more of the trustees of the two big Coal Board pension schemes are appointed by the Government, because the Government provides the guarantee. We already have a model.

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It is also worth mentioning my experience of practise in the United States of America. We have had the Pension Benefit Guaranty Corporation (PBGC) operating for 30 years or so. In the early days there was a huge amount of game playing, trying to exploit the PBGC 'put'. There was a whole series of legal cases which the PBGC undertook, and some of them went to the Federal Supreme Court, to make sure that clever trustees and clever companies could not exploit loopholes.

What we have now in the U.S.A., (and I certainly would not like to see it happen in the U.K.) is institutionalised moral hazard. I have had conversations with U.S. trustees, who do not necessarily articulate it like this, but their attitude is: "We need not worry too much about asset allocation, we need not worry too much about our covenant, we need not worry too much about contributions, because the worst which might happen is that the company goes bust and Uncle Sam picks up the bill, and perhaps some senior managers, including some of the trustees, lose out."

The moral which I should like to take out of this is that the focus on the company covenant, the sponsor's covenant — when it really matters, i.e. where that covenant is a bit dodgy — is a focus, not for trustees, but for the PPF, and the PPF needs to get directly involved. That probably involves changing the legislation.

Mr M. H. D. Kemp, F.I.A.: I found some of the comments which Mr Lewin has just made very interesting, in particular the desirability of providing a full range of advice. I suggest that actuaries advising trustees do include in their thinking the possibility of buying protection from the capital markets against the risk of the sponsor defaulting. It seems to me that the trustees may be unusual as 'creditors', in that they may be able to alter the size of the exposure which they have to the sponsor covenant, and thus, in effect, to get the sponsor to pay for this protection. For example, if they spend their money by buying protection, and this protection does not get triggered, then, over time, they will have made the funding position worse, which, ultimately, will be paid for mainly by the company. However, they will have gained something in the meantime, i.e. protection against the sponsor defaulting.

I raised this idea when I was presenting a sessional paper here in 2005 (Kemp, 2005), and the then President, Mr Pomery, alluded to the similarity between buying protection in the capital markets and the protection which the PPF offered. I assume that some of us believe that the PPF is a sensible way to try to protect against the risk of sponsor default, which suggests that the use of the capital markets may also be a sensible way for trustees to protect against sponsor default risk.

Reference

Kemp, M.H.D. (2005). Risk management in a fair valuation world. *British Actuarial Journal*, **11**, 595-725.

Mr M. A. Pomery, F.I.A.: Sponsor covenant is a critical issue regarding future funding and investment advice for defined benefit plans, although I am going to come to that conclusion from a slightly different angle than that from which Mr Gordon did.

One of the biggest challenges faced by pensions actuaries at the present time is the tension between the long-term approach to funding and investment and the need to measure against short-term solvency and solvency type requirements. Historically, pension funds were treated as a very-long-term set of liabilities. That was partly justified by the fact that they were very immature. We ended up in the early 1990s with a situation where many large pension funds in this country had 80% or 90% of their assets in equities.

About ten years ago we started a period of dramatic change, partly because pension schemes became more mature, but also because of the minimum funding legislation introduced in April 1997 and the new accounting standard which came in shortly afterwards. These required snapshots were to be taken every year, which went against the grain of our previous views about the long-term nature of pension funds.

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Today we still have a considerable tension between the long term and the short term. Many employers, asset managers, trustees and some actuaries want to continue taking a long-term approach to funding and investment. The regulators and the standard setters, however, still require their short-term snapshots.

So, how are we going to square this circle? We need to make the role of the employer even more explicit. The employer must stand firmly behind the scheme's liabilities. If an employer believes that investing a large part of the pension scheme's assets in equities is good for its business and its shareholders, then it should, as a *quid pro quo*, be prepared to provide some form of risk capital, not necessarily inside the pension fund, to cover both the short-term fluctuations in asset values and the long-term underfunding between the funding level and the solvency level, to which Mr Gordon referred.

If there is to be a future for defined benefit plans in the U.K., we need an even clearer and more explicit role for the company as a provider of risk capital to resolve the tension between the long term and the short term. For this reason, I think that the employer covenant is absolutely central to the future of actuarial work in this field.

Mr T. W. Keogh, F.F.A.: I start with a question. I am not quite sure whether it is for the Board for Actuarial Standards, the Actuarial Profession or the Pensions Regulator (and perhaps the uncertainty is my point), but: "What is the present position as to whether actuaries are required to take into account covenant information in carrying out actuarial valuations?" In particular, is it acceptable to say: "There is no covenant information, but here is a range of results — over to you, the trustees"? I apologise if the answer is somewhere in the guidance notes, but, when talking to colleagues, I am not sure that it is, or that it is certainly not clear. This needs resolving, at least in terms of some indications.

Just to set out my own position, there should be a requirement for the Scheme Actuary to consider covenant, and for that to influence the advice to the trustees. My reasoning is because I despair when I see actuaries trying to escape from the important decisions in relation to pension schemes and to pass them to the trustees. It does not seem acceptable to say: "This is not for me, I am a mere actuary, I do not understand these things." If I want to have a useful role, I should go and learn about them.

On the liabilities side of the balance sheet there is less work to do, as more schemes are closed. There is some longevity uncertainty. Otherwise, it is all in the two investments: one is the 'physical' investment held; and the other is the investment which constitutes the sponsor's covenant, and which should get as much analysis as the 'physical' investment. As for the trustees, I would want the regulatory system to insist that there was someone who could pull the various strands together, rather than leave the trustees, who may have the lowest level of expertise relative to all these expensive advisers, having to put the pieces together. I hope that this will continue to evolve.

One specific aspect which we can learn from those who work in the insurance sector is this. It seems to me to be well developed that, if you have an undercapitalised insurance company subsidiary, there are various mechanisms by which capital can be injected or made available to that subsidiary without necessarily putting money in. That is well codified and understood in the regulatory system. The way in which we currently talk about employer covenant is the beginning of a similar journey. I suspect that, in five years' time, what acceptable employer capital looks like will be well established and, perhaps, rather as Mr Pomery is suggesting. That is a mechanism by which there is a formal making available of capital which may or may not be inside the scheme, but is well defined and appears in the accounts, and everyone knows about it.

Mr J. G. Spain, F.I.A.: What I say here is said personally, and is not held against my employers.

We have heard comments from Mr Lewin about 125% solvency being equivalent to buyout, but we need to have a consistent idea of what solvency means. Solvency probably means buyout. Let us be very clear about that.

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Next, the idea that a very low covenant implies that we need more money is, perhaps, slightly difficult from an old fashioned with-profits perspective. There was a very well regarded text book on pension scheme valuations which stated that, if you could not quite afford the contribution rate required by the funding basis, weaken the funding basis a little and hope to put it right later. Such an approach, perhaps, is no longer acceptable. However, the idea that a poorer covenant means that you need more money just when more money is not going to be available needs to be squared a little better.

How does one square the short term with the long term? It cannot be done. There is no way in which you can invest money for the short term and the long term. What the trustees have to decide, having taken advice from all their advisers, whoever they are, is how long do they have before they really need to make sure that they have the money for a buyout, whatever it is: whether it is going to be through the PPF; whether it is going to be through one of the newest waves of buyout specialists; or whoever. How long have they got? Within that time, do they then have the room for manoeuvre to buy anything but bonds, which are less volatile?

Let me not seem to advocate bonds at all times. I do not, but neither do I suggest that equities will always be the right option. Trustees need, most of all, to know how long they have before they are going to be sacked.

Mr P. J. Sweeting, F.I.A.: One view of the value of the sponsor's covenant might be to look at the size of the deficit, and then just deduct the cost of removing the risk of company defaults from the pension scheme. As Mr Kemp has already mentioned, there are instruments available in the market to remove the risk of default from the pension scheme, so that it should be fairly straightforward to come up with a price. Even if a market price is unavailable, provided that you can approximate a probability of default, it is not too complex a calculation to work out that risk for yourself.

However, an important point to note is that, in relation to the pension scheme, the value of the sponsor's covenant is not just a function of the credit worthiness of the company. Company health is related to stock market health, to a greater or a lesser extent. Given that most pension schemes are heavily invested in the stock market, you have to look at the link between each sponsoring employer and the level of the stock market if you are to come up with a value for the employer's covenant.

Mr P. M. Greenwood, F.I.A.: I have never been a great fan of the Treasury fudge which was the concept of scheme specific funding. It has done great harm, because it stops the real issues being addressed, the real issues being: "Can we afford the accrued pension liabilities which had been promised previously on a guaranteed basis?'' It has probably stopped the Government being forced into doing some compromise on schemes with normal pension ages to solve the longevity issue. We should have an urgent call for this to be re-addressed.

Having said that, I agree with much of the individual comments which have been stated. I will put a slight emphasis on them. I agree with Mr Lewin that we need to look to the future. The future which I see is that most defined benefit pension liabilities will be separated from the economic activity under which they were promised, and, certainly in 15 or 20 years' time, that that is definitely going to be the case. The issue is how we manage over the next 15 or 20 years to wind up those schemes and possibly move them to new 'providers'.

I worry that, if the business plans of those providers succeed, then now will never have been a better time to buy index-linked gilts and fixed gilts, because of the fundamental issue not being addressed. That is, given the supply of fixed and index-linked investments and longevity improvements, can we afford the existing level of U.K. accrued occupational pension rights delivered on a nearly guaranteed basis? It is the duty of this profession to make sure that this issue is addressed. I am afraid that the failure to address it has been one of the failures of the profession as well as of the Government.

Mr A. D. Smith: I would like you to imagine that you are in the position of giving funding advice on a plan, and that, as an actuary, you already have an evaluation of the sponsor

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covenant. So far, I do not think that anybody has indicated what you might do with it. I do not know myself, but I do know what I would do with it if somebody owed me money and I had an evaluation of the covenant. I would look at the kind of rating which the organisation is given and I might look at the yield on quoted bonds issued by other similar organisations. I might use that to give some value to myself as to how much I thought that their obligation was worth to me. The ropier a third party believes that organisation to be, the lower value I will place on the debt.

However, what I have heard here is something which works in the reverse direction, which is that, if you get an adverse indication of a sponsor covenant, then you might want to increase the pace of funding, and you will presumably do that by coming up with a valuation which gives a larger liability. That strikes me as a rather 'strange' valuation. To my mind, the pace of funding is a negotiation between two parties. I am not sure that negotiation is very much informed by having a strange valuation which moves in the opposite direction in relation to credit spreads than any valuation which is used elsewhere in the financial world. That element needs further thought. It is all very well to say: "We can push this question of covenant to experts in sponsor covenants." We do have to imagine what we would do with the answer if those experts were to propose it.

Mr Redmayne: Covenant is not a precise answer in that sense. Affordability and the setting of technical provisions may characterise a greater debt for a weaker employer. Then there is the debate and the negotiation between the parties of what is appropriate in the context of the demand on the employer for cash, be it cap-ex, equity dividends or the pension scheme, and what is appropriate in terms of a recovery plan, in terms of its length and of its shape.

One of the things, even from the earlier behaviours which we, as an organisation, are seeing, is that recovery plans are becoming more complicated. We are all going to be involved in more complicated plans which involve addressing specific issues and objectives between schemes and trustees. Escrows, on occasions, are a way through that. Security, how that impacts risk, and how that impacts views on the level of contributions over a time frame, all comes together in a balance.

If the answer was a score — and it is not — this goes back to Mr Sweeting's comment on taking a deficit and subtracting the cost of removing the risk of default, and how you price willingness. Pricing of willingness is something which is a very important part of covenant to consider. So, there are several matters which come together. Speaking as a banker, what it comes back to are the views on covenant affordability and the competing demands for cash which go to funding risk and to funding long-term benefits.

Mr C. Keating (a visitor)**:** I have heard much in this discussion about covenants, complexity, more advisers and more fees. It is extremely attractive if one is in the business of selling advice, but there is a very simple way to remove a great deal of this complexity, because it is not that complicated a situation for the overwhelming majority of people. This, I suppose, could be taken as advice to trustees.

Covenants are just codes for credit worthiness, and credit worthiness is about both willingness and ability. The simple way to check whether or not you are in good shape before you go to professional advisers is to call your bank manager and to ask him if he will lend to your sponsor entity, or, to be more precise, the terms on which he will lend the amount of the deficit to your sponsor entity. Add a little to it for prudence, if you want. If he comes back to you and says: "I will lend it on these terms ...", you know two things. You know what a professional's assessment of the current situation is and the situation going forward, and only if the bank will not lend you the money do you need to resort to advisers and fees.

Ms L. Inward (a visitor)**:** I was previously at the Pensions Regulator and prior to that at the Department for Work and Pensions, working on some of this legislation. It was about two years ago, when we were in the final run-up to what was then the Pensions Bill becoming law. What a huge amount has happened in those two years!

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When we started, the trustees were nowhere. They did not sit at the table. They did not negotiate for contributions, which we might think were reasonable now. They did not get involved in transactions. The Regulator took the view then that it really needed to give trustees a kick to make them get into play. We started talking about pensions behaving as a material unsecured creditor and we started talking about the employer covenant.

What I have seen over the past two years is trustees stepping up to the mark, and many advisers doing that as well, which is commendable. I have also seen people going beyond the mark now, and thinking that the trustees really are material unsecured creditors. It was an analogy. Trustees are not material unsecured creditors, because the pension debt is a contingent debt. The only way in which that debt is going to become due, and members are going to lose out, is if the employer becomes insolvent and the scheme has to go into the PPF. That is something which trustees and advisers have to take into account.

I agree with some of the speakers who have been talking about employers who have a bad covenant. What you cannot do, if the employer does not have the money, is to demand it now, because that is the only way in which your members are going to lose out. That is not something which you should be advising clients to do because there is a weak covenant. Pension schemes and employers have a symbiotic relationship. If you do not have a job, you cannot have a pension. It is that simple. We all need to recognise that, and to ensure that trustees and employers work together in a symbiotic relationship, and we should not, as advisers, say: "You must behave as a bank. You must take security." You are not a bank. You cannot lend money. You are not in the same situation. Everybody should pay attention to that.

There was talk about the PPF and people conniving to increase the call on it. Clearly, the Pensions Regulator is there to protect the PPF. That is one of its objectives, and it has powers to do that. I am sure that you, as statutory whistle blowers, would let the Regulator know if you thought that trustees were conniving in this way.

Mr Keogh made a comment that actuaries should not escape from the important decisions and should not leave them to the trustees. Two years ago I felt that actuaries and lawyers were running pension schemes, and that was not right, it should be trustees. I continue to think that. You should not be taking the important decisions. It is the trustees who run the scheme. What you should be making sure of is that you give them the correct advice to do that, and that might include telling them that they need advice on the employer covenant. It might involve telling them that they ought to phone the bank and get that advice much cheaper.

Mr M. R. Kipling, F.I.A.: I am a life actuary. As some contributors have been speaking, particularly Mr Keogh, who referred to the employer covenant as if it were an asset of the scheme, it struck me that pension funds, which, in their normal investment practices, take great care to diversify, so as not to have significant counterparty exposure, effectively have a huge counterparty exposure to one counterparty, namely the employer.

We may look to the PPF to provide some kind of security. In some cases we may look to the credit default swap market to find some protection, but it also struck me that every pension fund with a large counterparty exposure to the sponsoring employer is probably sharing 75% to 80% of the same risk. The employer covenant, in most cases, will probably be driven by longevity risk. While there are scheme specific elements, there is a huge commonality of population mortality improvement risk. There is also interest rate risk, equity and property market risk, inflation risk, much of which is not portfolio or employer specific.

If there was some way in which the employer covenant, or a large part of it, could be converted into forms of tradeable securities, which were contingent, not upon scheme specific risks, but upon changes in national longevity, changes in the equity market and in interest rates, and so on, perhaps quite a large proportion of the employer covenant could become tradable. This would also provide a neat solution to the problem of putting a price on the employer covenant, as there would be, in effect, a market for it. Clearly, this market would put a low value on the counterparty risk from weak employers and a reasonably high value on that from solvent ones. Indeed, in the short term, it would be difficult for a weak employer sponsor to find any market for its securities.

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We do not know who are going to be the weak sponsors in ten years' time, and who are going to be the strong ones. If there was some way in which all the participating schemes could trade these securities among themselves, each would find that they have the same protections against the common risks, but a much greater diversification of exposure to sponsor insolvency.

Mr Keogh: I refer to the remarks of Mr Keating about saving advisory fees. There is a simpler way still, which is just to put some more money in. I say that not entirely tongue in cheek. You could argue that, for the majority of companies which can afford to fund their schemes to higher levels, all these advisory costs are just an elaborate agency cost. The difficulties which arise for those employers who cannot afford to fund the schemes are important, but they are not the majority.

There is a lesson there for the regulatory authorities. It seems well-established that we can tell our clients that, if there is a strong covenant, you can go easy on the technical provisions, because that is the signal which has been sent. In five years' time, when the first currently AA rated company does go into the PPF, there may be those who will ask whether the actuary said to the trustees: "Why aren't you going to grab the money while the going is good?'' I would want to make sure that *I* had seen that question asked.

In response to Ms Inward, for the avoidance of doubt, I am not suggesting that actuaries should carry on taking all the decisions, but they should have opinions, and present options in these areas to trustees, rather than shying away.

Mr Keating: Picking up on something which Mr Keogh said, I do not advocate sending signals, because, to be credible, signals have to be costly, otherwise anyone can send them if they are free. So, let us not send signals. That is a waste of money.

More importantly, there is the question of markets and market solutions. I hear repeatedly that the investment bank round the corner is going to come up with a market solution. I see and listen to this more often than I care to think. The plain and simple fact of the matter is that there are many things which markets cannot do. Markets cannot make credible promises at 50, 60 or 70-year time horizons. There is no structure which a market can have which does that, other than by becoming an institution. That is why financial institutions exist. This is why we have banks, this is why we have insurance companies, this is why we have pension funds.

Most of the market solutions which we see, the so-called market solutions, are not market solutions at all. They are alternate institutional structures. If you have looked at the SPVs and the trusts which lie at the heart of those sorts of solutions, then what you are actually looking at are some very poor alternative institutional forms.

Mr T. Hobman (a visitor, from the Pensions Regulator)**:** One of the points which I want to make is that these are really first thoughts, and that we should not worry too much that we do not have all the answers. It seems to me that one of the fundamental precepts of scheme funding is that there is not one answer. What is required is that the trustees, who are our first line of defence on behalf of scheme members, have the real support of a team, actuaries included, who seek to understand all the issues and to be part of a wider dialogue, which gives trustees the context in which they need to make complex decisions.

It is too early, at this stage, to start saying that the Regulator is too weak or too strong on a particular matter, or that its powers are too weak or too strong.

None of that is true. We are all going through this process together, and we will play our role in it. I hope, having heard the comments of Mr Redmayne and Ms Inward, that you will realise that the people who currently work for, and who have worked for, the Pensions Regulator are bright, intelligent, engaged people, who understand the subtleties of this process and who do not see it in black and white terms. If you, as individuals, or from your firms, would like to discuss issues with us which you are finding problematic, or contentious, then come and talk to us. You will find us willing and able partners in that dialogue.

Mr C. Daws (a visitor)**:** I am from the Board for Actuarial Standards, and am grateful for the

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opportunity to have listened to the discussion. The two areas about which I am still wondering both centre on what the trustees do when they have paid their adviser's fees, received all the information, and perhaps discovered that the employer covenant is not all that it might seem. Perhaps my first area of concern is whether one might see a great increase in the complexity and detail of agreements between trustees and sponsors. I am told that bankers are past masters at this. They have things like significant adverse change and what happens in those circumstances. What happens if the company decides to triple its dividend or to repay half the share capital to its shareholders or to go on an acquisition spree? I do not think that it is yet the practice for trustees to enter such agreements with their sponsors to guard against the covenant becoming worse, and, indeed, to prevent such changes occurring in the sponsor's covenant. Maybe there is a huge untapped field, or maybe it is a field of which I am not yet aware.

The second group of reactions which trustees might have is much shorter and sharper. These centre on saying to the sponsor: "Your covenant is weak. The deficit is large. In this situation there comes a point at which we are not prepared to accrue any more defined benefits, because they will merely increase the risk on those pensions which have already been accrued.''

These are the two areas which I should be very interested to hear developed on some future occasion.

Mr Redmayne: I touched on that earlier. Recovery plans are becoming more complex. All those points are becoming more typically used as part of the debate between the trustees and the employers. Responding to Mr Daws, there is another party at the table — the financial adviser. Depending on the complexity of the situation, the added value of that role will vary. The covenant is a building block of the recovery plan. There will be specific items identified in the covenant assessment which will consider, not just the notifiable events which we have as an organisation, but other events, like dividend policy, strategy change, and management change.

We, of course, encourage trustees to look for ways to assess covenant, for example by having conversations with the secured lenders. That is going to be helpful, but the trustees are not secured lenders. If they were to provide credit approval: they would want to do so with diligence; they are going to require company forecasts; and they are going to want an accountant to look at these. You are going to be incurring costs by a different route. Do you need a conversation with a banker? Absolutely! Bankers are going to be looking at it as a secured lender which can be refinanced out, not as a contingent obligation which may be viewed as a creditor from time to time and which cannot be refinanced out.

So, you have to look at these aspects as part of the role. Covenant assessment has been seen as a great opportunity for accountants, advisers and others. There is another complexity in the whole scheme funding process, which is a financial advisory element, which: in certain cases, will be quite limited in scope, and trustees will be tied in the definition of what they can ask people to do; and in other cases will be very broad and complex, but will also feed very directly into the recovery plan. We are seeing that already.

Mr S. A. Carne, F.I.A.: I thank Ms Inward, because, until she spoke, I thought that I had bought a dud copy of the Pensions Act 2004. The comments from the floor do not seem to bear much relationship to the new regulations.

The role of the actuary is changing. The role, historically perhaps, was to hand down an answer to a grateful client. The future role of the pensions actuary is to advise a party involved in negotiations. Debating how to come up with a 'value' of the liabilities is missing the point about the actuary's role under the new regime.

Mr A. G. Sharp, F.F.A. (closing the discussion)**:** The thought of a discussion such as this would have been unlikely as little as ten years ago, as Mr Pomery said. In an ideal world it would still be unlikely, if we had full funding of pensions promises, but we are where we are today in the funding of schemes, and so the subject is both timely and relevant.

Mr Gordon told me, in advance of his presentation, that he might be a little controversial. I was surprised that more attention was not paid to his waterfall of probabilities going forward. It

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has all the obvious caveats of being just one model and dependent on the assumptions going in. I think that the picture which can come out of it was almost, in some scenarios, too frightening for people to think about. More work on that kind of projection would be useful.

Ms Mills talked about three basic questions for the trustees in terms of: will they get repaid; when; and how much. She gave us some helpful descriptions of how corporate restructuring advice can work. One of the most relevant points, which we should take away, was about how trustees might go about monitoring the sponsor covenant on an ongoing basis in a way which means that they might actually have the time and the opportunity to react to changes and to do something about it.

Mr Redmayne gave us the view from the Regulator's point of view, and, not surprisingly, has still very limited practical experience of recovery plans and negotiations flowing from them. So, inevitably, he will have disappointed many of you who came along to this discussion hoping for some more definitive position statements on funding from the Regulator. He did go on to talk about processes between trustees and employers. That, indeed, is consistent with the Regulator's often-repeated statement that he will be a referee rather than a player.

I had hoped that I might be able to draw together the themes of the discussion by looking back at the five questions which Mr Gordon posed. I am afraid that I have admitted defeat on three of them. There were two fairly strong themes coming through from questions 4 and 5. Question 4 was: "Should pension schemes have run off plans?" I agree very strongly with at least part of what Mr Greenwood said in terms of looking to the longer-term future, and what we are actually going to see in terms of the relationships between pension schemes and sponsoring employers, or lack of them, and I think that more work and more attention to the idea of run off plans would bear very useful fruit.

Question 5 was: "Should the PPF be taken into account in funding?" I picked up at least three or four speakers who, for different reasons, all said that it should not, either because of moral hazard against the PPF, because it is something which should be a whistle blowing event, or, indeed, because of general connivance against the PPF, and so the PPF should be more proactive in stopping it. I think, for the moment, that what is probably true is that, in practice, things may be a little different until something more specific on this comes out.

The other theme which I have drawn up is, perhaps, linked to run off plans in terms of the different ways in which pension trustees can seek to have protection for their deficit. Whether that is by looking at buying credit default swaps, looking at assets in escrow, or simply assessing the overall creditworthiness of employers, what it comes down to is trustees trying to find ways of getting a measure of full funding of pension schemes in a way which does lead to the pension benefits which have been promised being delivered.

The President (Mr N. J. Dumbreck, F.I.A.): It remains for me to express my own thanks and the thanks of us all to our three presenters, to our closer and to all who have participated in this discussion.

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