

**Transcript of the speeches by
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director for strategic development***

Pensions regulation

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David Norgrove

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Good morning and thank you for coming to this workshop, which is the second in London, and it is the seventh in the series of our nationwide tour. We have been all over the country with well over one thousand people registered, which is another clear signal of the scale of the challenge that we are all facing together. It reinforces for me the critical point that working in partnership is the way to tackle this. What is 'this'? It is to fund, to protect and administer UK pension schemes.

This is a real opportunity for us as a regulator to work with you face-to-face, and that is what we should be doing; to engage openly, to listen and to communicate. Let me encourage all of you to do that, and there are facilitators on every table. What we want is for everyone to be prepared to talk openly. We are not precious, so if you want to say anything which is critical or questioning, the more the merrier.

The workshops so far have been rewarding and the feedback that I have had is that people have enjoyed it and found it valuable, and I certainly believe we have found that from our point of view. I have just had an interview with a journalist with a number of colleagues, and they were able to talk to him about all the very valuable lessons that we have learned over the last week or two.

My hope, therefore, is that the regulator can help you through what is the worst downturn and the worst economic difficulties that we have seen certainly in my lifetime and probably since the war: those two things are more or less coterminous. For the hard work, the positive contribution and for being here today, thank you very much, because I know how busy you all are in these difficult times.

Most of all, I hope that today will be interactive, because we hope you will draw on the experience of those around you and engage with the problems proposed by the case study that we shall have with that well-known company, I think it is called, Ace Widget Manufacturing, or something like that. Soon I shall hand over to Bill who will cover scheme funding in a little more detail but, before I do that, I would like to say a few words on the key principles that underpin our approach.

The scheme funding framework has, of course, been in place for a few years now. While most of that time has been economically stable, we are confident that it is flexible enough to cope with the impact of the current downturn. Both our economic modelling and the dialogue we are having with live schemes leave us under no illusion about the scale and complexity of the challenges that are faced by trustees, by sponsors and by their advisers. Equally, it reaffirms our belief that the principles of our approach are sustainable and hold good today: prudence, reasonable affordability, flexibility, these are the foundations of the UK approach and they are fundamental. By the way, they are also principles that seem to be holding up well in an international context. We have been criticised in the past by some of our colleagues overseas but, in many cases, they are in worse trouble than we are, and I take no great schadenfreude in that. However, it is a tribute to the structure that was put in place in 2004.

What are those foundations? I translate them into a few key statements. Setting appropriate technical provisions is paramount, and these funding targets must be set prudently. There must be no aiming off the funding targets to make the scheme look apparently more affordable, so prudent technical provisions. The technical provisions must take into account the strength of the covenant, and then there is reasonable affordability and the flexibility that is available with that. This lies in areas such as recovery plan shape and length, and further security through the possible use of contingent assets or a future share of profits but, brutally, and let me say that again, not in a compromise of the scheme funding targets or the assumptions that underpin them. There is real temptation now to choose assumptions that are weaker than they should be, and this simply is not acceptable.

Turning to flexibility, much has been written and said about triggers and, in particular, the 10-year recovery plan trigger. I would like to take this opportunity to emphasise once again that these triggers are not targets, they are exactly what they say they are. They are triggers to help focus our attention and dialogue with schemes and sponsors over their recovery plans, and they are scheme-specific. I want to assure you that all plans are looked at on a case-by-case basis and, to date, we have seen and considered appropriate recovery plans ranging in length from less than one year, in fact tomorrow, so to speak, to more than 20 years. Therefore, I hope that is helpful to understand, and I do acknowledge that with cash constraint and increased uncertainty, we are likely to see more recovery plans above 10 years and, yes, that means more scrutiny. Of course, in a downturn, you would expect us to want to scrutinise more plans. That is why we at the regulator have been committed to doing more for less, streamlining our processes and equipping our front line. That is the right way for us to regulate at this time as we strive continually to better regulate.

What have we been doing to help in these challenging times, and what do we ask of you? Of course, we are holding this series of workshops around the country, and we shall be producing a webcast version of the key messages to broaden access even further. We have produced some statements over the past year clarifying our position through the downturn such as that of trustees last October and for employers this February. More recently still, we felt it right to alert our regulated community to the need for vigilance in the downturn, because we must be all aware of and guard against those kind of risks, which I am afraid we shall continue to see and read about.

Let me emphasise that these are minority incidents of fraud, the vast majority of people play by the rules and do a great job. It is our role to ensure that level playing field and to protect benefits, and be assured that we are committed to continue to do so.

Today, we are publishing six scheme funding case studies that were previously reported in our *Orange Book*. We thought that perhaps our *Orange Book* was not quite as widely read as it should be, so we are repeating them, and these are to be followed shortly by a new module on buy-outs and buy-ins for our *Trustee toolkit*, which I hope you will find useful. We shall publish later today a statement on valuations and the role of the employer covenant in the scheme funding process, consolidating the messages you will hear today.

Finally, how can you maximise the value of your input to the funding challenges of your scheme? Perhaps that is a question better posed at the end of today rather than at the beginning but here are my starters for 10. First, aim not just to understand clearly the position of the scheme but also the sponsor and the current and likely future strength of the covenant. If you are a trustee, ask the right questions of the sponsor and your advisers, regardless of how straightforward or difficult that process may have been in the past, and provide and demand open communication between all parties. Remember that there are tried and tested processes that can ensure that confidentiality is respected. Start the processes as early as you can. Negotiations, covenant reviews and agreeing arrangements for additional security can all take much longer than you might think.

I do hope that this workshop will give you some food for thought and help you to understand or, at the very least, reinforce your view of your role in the scheme funding process. We hope it will help you to prepare a robust and durable funding arrangement for your own scheme, better understanding our approach at this time. Thank you for joining us, do enjoy your day.

Bill Galvin

executive director, strategic development, the Pensions Regulator

This is my third workshop – I have also done Bristol and Edinburgh – and they have been very well received to date. The feedback we have from trustees and advisers who have been at the other workshops is that it is the right material, it helps us to put some of the previous guidance and advice in the context of where we are now in the downturn, the time of falling asset values and reduced employer affordability. From that perspective, there won't be a whole lot new in what we are saying. It will be a matter of helping us to put all the pieces of the jigsaw together as we go through the day, and relating it back to what we have previously said about messages like prudence, flexibility, affordability. As David said, it is also a chance to hear from you and to get your views on where we are. Certainly, audiences in other venues have not been slow about coming forward, and I look forward to hearing from you as well.

Let me move forward a little to show you the view of the world that we have in Brighton. It is a rather complicated view of the world, but let me talk you through it a little. If you take 7,000 schemes or so and divide them into three tranches, you have the orange boxes up there on the slides which are three equal tranches of schemes starting with valuations about a year apart, starting in around 2005 and building up to the valuation of tranche three between September '07 and September '08. Fifteen months then for each of those to produce their recovery plan and submit it to us. Those are the white boxes on the slide.

The dotted line up there is where we are today, so down in Brighton, as we speak, we are receiving recovery plans from tranche three schemes. It will become obvious from this slide that, though the recovery plan is based on valuations when probably things were a little bit better in terms of asset values, what we are seeing right now in Brighton are the issues around affordability, cash flow constraints on employers but not necessarily some of the more significant falls in asset values.

However, these things come around again, as I am sure you know, with inevitability and the blue box up there is where tranche one schemes are currently going through their second triennial valuation, and we are seeing some early input from that activity down in Brighton at the moment.

We expect, as we go through the next period between now and Christmas, to be dealing directly with many of the issues that you are dealing with at the moment. This session is about making it clear how we shall see the issues, and getting some feedback from yourselves about your experience of going through this process at the moment.

It is probably worth saying that we have not seen a huge amount of out-of-cycle revaluations. For those tranche two schemes in particular, there are not many people coming back to us saying, hold on a second, we thought this was a good idea but it is not quite working out. It is sticking at about previous experience. Most of the revaluations that are coming into us – or the revised recovery plans that are coming into us – are, for a variety of reasons, not necessarily in order to revise the payment schedules.

The first thing I would like to say is just a little reminder of our triggers, which David mentioned earlier. We have two key triggers, one on technical provisions and the robustness of technical provisions, and the other on recovery plans. The technical provisions trigger is a point that our algorithms give us between FRS17 Section 179, influenced by the strength of the covenant and the maturity of the scheme. That trigger tells us whether we need to take a closer look at the technical provisions of the scheme to ensure that we are comfortable with the levels of prudence that have been built into it.

The recovery plan trigger then looks at the appropriateness of the recovery plan in those circumstances and, as you know, it has been well documented that we look at recovery plans of over 10 years in length. We also look at recovery plans that are significantly back end loaded and where there are other assumptions about which we would like to ask some questions.

Our message is that the technical provisions must be robust and, as David said, they need to reflect the situation as it really is and not as we would like it to be, but that the recovery plans that are about filling that deficit, filling that funding gap, can show some flexibility. I shall talk a little more about how that framework can work as we go forward.

What have we seen in tranches one and two of the valuations that have come in from my last slide? The first tranche that came in, we had about 50% of schemes that triggered on a technical provision basis, and just over 40% of schemes that triggered on a recovery plan basis. Of course, those two groups are not mutually exclusive. About 30% of schemes did not trigger at all. In the second tranche, as they came through, about 50% of schemes did not trigger at all, so we had less work to do, which we thought was quite good. We took that as evidence that the system was beginning to be understood.

We are sitting in Brighton now looking at the recovery plans that are coming in in tranche three, and we do not know yet whether they are going to come out to look more like tranche one or tranche two, but we hope that the improvements we have seen in the levels of prudence and in the recovery plans will hold true as we go through the next six months.

In aggregate, as far as the prudence of technical provisions, there is one measure that we like to look at, which is the Section 179 measure, which, as most of you know, is the proxy for the buy-out of PPF level benefits. So it is a reduced benefit level but prescribed assumptions that are a proxy for buy-out assumptions that go into measuring it. From our perspective, that is a very useful benchmark in aggregate to look at, because it gives us a relatively stable measure against which we can see where technical provisions are sitting in aggregate. Indeed, in the first tranche we saw 107% of Section 179 being set as the aggregate level of technical provisions. In tranche two, it was 119% which, again, we saw as progress, people understanding our system.

The section 179 measure, of course, also gives us a view of how successful we are being in protecting the PPF, which is one of our statutory objectives. A key point: because we look at this in aggregate and use it as a rough measure of the prudence affecting the provisions, it does not mean that in the context of an individual scheme, a section 179 level of funding is appropriate. There are wide variations around this at the individual scheme level, depending on issues around maturity etc.

We are, of course, in more difficult economic times and we are not yet seeing that in Brighton, as I have said already, but we have modelled a variety of scenarios to see what the affordability and situation of employers is, and what we would expect to see as a result. That tells us that, although there are some employers who will find it difficult to fill the funding gap from current cash flows in a reasonable time, for the majority there is not yet a significant issue of affordability, and we have gone beyond looking at the current scenarios and modelled further significant falls in cash flows from employers. We are comfortable that our regime and the way we approach it is robust enough to deal with the situation that employers will find themselves in, based on these principles of let us get the target in the right place, and then, where appropriate, let us be flexible about how we fill that.

Everything that I have said so far is predicated on having a good understanding of the employer covenant, and that is the unique aspect of the UK regime. Our message to our European colleagues is that our system in the UK is not less prudent or less secure than other systems where there is a solvency buffer involved. It is different. We have a level of funding in the scheme and an employer provides against residual risk. Clearly, for trustees an understanding of that employer covenant is a critical part of the sums that need to be done around the funding equations.

What does that mean? At the most basic level, the employer stands behind all of the liabilities and potential liabilities of the scheme, it stands behind payments to cover any deficit repairs, it stands behind any risk that is taken in the scheme in terms of investment, longevity or other issues, and underpins any residual risks that the scheme is taking. It is very important that trustees in approaching funding are clear that the employer is able to underpin the risks that are inherent in the funding strategy of the scheme.

For companies that have a weaker covenant, the risk level of the assumptions in the scheme funding process must be reduced, because the employer will not be able to stand behind a significant level of risk in that scheme. In other words, the prudence levels that are built into those assumptions must increase. That is a fundamental precept of our funding regime.

It is important for trustees to understand what we call here the self-sufficiency level of funding. That should be obvious from what I have said before. The starting point should be to understand if this scheme were standing on its own, what level of funding, what level of resources would this scheme need to have to cover our accrued benefits, the investment strategy that we are undertaking to fund those and any residual risks that remain. The self-sufficiency level of funding is a scheme that is de-risked and where there is a residual buffer against any unhedged risks. Many trustees will use a buy-out level of funding as a proxy for this. Buy-out quotations can depend on market pricing, that is not always appropriate but in many cases it will be.

This graph on the screen here indicates how trustees in a particular scheme might go about ensuring that they have covered the levels of security that are required by that self-sufficiency level of funding. In this graph here, you can see that they have set technical provisions at a level where they have understood the best estimate. In other words, if everything works out well, what level of resources is required. They have added a margin for prudence as they are required to do, and they have set technical provisions at a level that they felt was appropriate.

This is then made up by the assets of the scheme and a debt called on the employer in the form of the recovery plan. The trustees have then reassured themselves that, in terms of the residual risk that the employer is required to underwrite, their confidence in the robustness of the employer and the ability of the employer to underwrite it means that they are comfortable with the technical provisions set at this particular level.

Were a covenant is weaker, trustees have a more difficult equation because, in these circumstances, the trustees are clear that the employer cannot stand behind the very significant level of underperformance in the scheme, and they have decided that, as a result, they must set technical provisions at a level significantly higher than the trustees in the previous example, even though this has created a much more significant funding gap in this scheme. These can be difficult discussions between employers and trustees, we know, and from our perspective it is critical that we are setting the funding target at the right level. At the extreme, where the employer covenant is non-existent or very weak, perhaps from a very highly leveraged company that is taking a lot of risk in its daily business, trustees may decide that they need to set technical provisions at a level equivalent to a self-sufficiency level of funding. In some cases, this can be very difficult. It does not mean that the scheme in every case will push the employer into bankruptcy; that is probably not in anybody's interests. It does mean in circumstances like this that trustees need to be very sure about where they sit and, in the event of an insolvency, they probably need to be in contact with the other creditors of that company.

Here are some figures, which you will see later on together with a lot more figures, because, as you work through a case study, the challenge will be to put this framework into practice. What we have up here is a scheme that has assets of £38.5 million and, unfortunately, under any method of calculating the liabilities, they stay at £38.5 million. The trustees in this circumstance have used the buy-out assessment as a proxy for a self-sufficiency level of funding, and have come up with a deficit of £20 million, a funding level of 60%. The actuary has advised, on his or her best estimate, the liabilities are about £37.9 million, in this case giving a surplus of about £600,000. This, of course, is predicated on everything working out, on the investment strategy coming through and on all of the other risks coming in within the anticipated parameters. That is not a prudent basis on which to fund the pension scheme.

The task for the trustees here is to determine where in between those two points of best estimate versus fully self-sufficient this scheme needs to set its funding target and, of course, they will need to take into account the strength of the employer covenant, its ability to underpin these risks and that is what I am sure you are looking forward to having a look at a little bit later.

Before that, let me say a word on the assessment of employer covenant. As it has probably become clear, we see it now as a very critical task for trustees. It requires a number of things to be in place. The first is absence of conflict, and trustees need to address these up front. The second is an open flow of communication, which very often means addressing confidentiality issues up front as well. Then the trustees need to decide within the board whether they have the necessary skills and the required objectivity to carry out this task.

The skills can be quite broad-ranging. Assessing a covenant requires a view of the legal link between the sponsor entity and the scheme, a clear understanding of exactly which legal entity stands behind the scheme, which can be quite complicated in some group structures. Assessing the credit risk of covenant requires trustees very much to assume the position of unsecured creditors and assess the nature of the sector, the industry, the entity and the future prospects that stand behind that scheme. That can be quite a significant exercise.

It need not always be so, of course. We are not suggesting here that every trustee board needs to go out and commission a Rolls-Royce version of covenant assessment. Very often, trustees just need to reassure themselves that what they see on the surface in terms of the size and scale of the company backing the scheme is actually the case. Trustees just need to make sure that they have gone through asking those critical questions.

Trustees also need to understand, regardless of the position of the sponsor, their place in an insolvency scenario. This is even if insolvency is not seen as being on the horizon and it is important because it provides trustees with a view on what level of security is backing the scheme in extremis, but also on what assets might be available to provide security for the scheme in the shorter term as far as underpinning a recovery plan etc.

On the topic of recovery plans, we have been clear, I believe, that we expect to see recovery plans of a slightly different shape to the ones that we have seen in the past. It is an inevitable result of the current difficult times, cash constraints, reduced affordability. We are also clear that many employers can continue to fund their deficit on a straight line payment from current resources, and that there is no need to renegotiate the terms. However, there are employers that are significantly cash-constrained and, in those circumstances, trustees can look to be flexible in terms of how they provide that level of security to the scheme.

We expect to see perhaps longer recovery plans: from the average of seven years that we have seen in the past tranches, we would not be surprised if it is pushed out longer due to real concerns on affordability. As far as our previous concerns about back end loading, we understand if, due to real and significant concerns about affordability, plans are back end loaded. In these circumstances, we would have to make sure that the trustees have taken every opportunity to secure other forms of security, perhaps contingent assets, perhaps parental guarantees to support the assumptions in the recovery plan. Perhaps if the trustees agree with the employer that we are going through a period of tightness at the moment but that things will improve in the near term, they can look to agree for the scheme a stake in any profit levels above target.

These recovery plans we expect to see will probably of a different shape than the ones that we have seen in better times. We expect trustees, however, when they are looking for this additional level of security for just contingent assets such as parental guarantees, to make sure that they are asking the right questions. Some of the guidance that we have put out on these issues asks some important questions such as, in the case of contingent assets, have we properly valued these assets, are we sure that they can be crystallised when the scheme would require them to be crystallised. In the case of parental guarantees, the issue of enforceability is important, and an understanding of what would happen if the parent were to go insolvent is clearly something that the trustees need to think through.

We have an example of that flexible recovery plan here, which lays out some of the content of what I have just said. In this particular situation, in order to recover a deficit of £14 million where there are cash constraints, but the company is expected to recover in year four, trustees have agreed an escalating recovery plan. In addition to that, they have built in an agreement for a profit share should things get better faster, or much better than was anticipated.

In summary, we believe our current regime is flexible enough to cope with the current scenario and circumstances. We are very clear that, from our perspective, technical provision must be set robustly, it must reflect the situation as it really is and the ability of the sponsor to underwrite any risk that is taken in setting those technical provisions. Recovery plans must reflect what is possible and must be reasonably affordable for the sponsor. What we ask of you is to ask the right questions, and many of those will come out from what you go through today, and to start early, as David said, because these things take time, particularly where the negotiations are more difficult and the level of complexity around the recovery plan can take some time to work through. Where you have questions or issues, please come and talk to us. It is probably worth mentioning that none of us is today in regulatory case mode, so while we are very happy to talk to you about specific issues or principles, if you want to take us aside and talk us through the particulars of a case, it is probably not the best time to do it. However, please come to us as soon as possible through the usual channels in Brighton, and we shall keep today free to allow us to talk through the issues and principles.

That is all from me. I hope you have a good day and that you enjoy putting this framework into practice. I do not think we have time for any questions right now but there will be plenty of time during the day to ask about any of the concepts that we have just gone through. Thank you.

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