The Pension Protection Fund (PPF)
and the Fraud Protection Fund (FPF)

Cliff Speed & Phil Page

30 November 2004

The PPF - questions

- Why?
- What is the PPF?
  - How will it operate?
  - When will this happen?
- What can we learn from the PBGC?
- What questions remain about the PPF?
- How *should* the levies be set?

2x 50 min sessions

The PPF - questions

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- What questions remain about the PPF? (Phil)
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2x 50 min sessions

Aim

Pensions Bill

- To restore confidence in pensions

PPF

- Increase protection for members to ensure they are confident in saving for retirement

Pension Protection Fund

Who will run it?

- **Board of the PPF**
  - Chairman, Chief Executive and at least 5 "ordinary members"
  - Majority to be non-executives
- **Chairman to be appointed by Secretary of State**
- **Appointment of Chief Executive and first 5 ordinary members initially by Secretary of State, subsequently by Board**

PPB will also be responsible for the Fraud Compensation Fund (FCF)

Pension Protection Fund

Protected liabilities

- **Members over NPA (and ill-health pensioners)**
  - **100% of benefits payable under scheme**
- **Members under NPA (including early retirement pensioners)**
  - **90% of benefits payable, subject to 'compensation cap'**
  - **options of**

Partial Protection Fund

- **Improvements due to rule changes and discretionary increases within last 3 years excluded**

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Pension Protection Fund

How will it be funded?

- **Levies in respect of "eligible schemes" (excludes pure money purchase schemes and others to be prescribed in regulations)**
- **Assets of schemes for which PPB assumes responsibility**
- **Investment returns (bonds + some equities?)**
- **Borrowing**

NO GOVERNMENT FUNDING

How much will be raised?

- **£300m per annum (??), but**
- **Initial levy set by the SoS (for 12 months)**
  - — £150m in the first year
  - — Based only on scheme factors (liabilities plus others e.g. no of members)
- **Risk based levy introduced during "transitional period" (Totalling £300m pa ??)**
  - — 3 years?

How much will be raised?

- **Final risk-based levy arrangements will apply after "transitional period" (£300m pa)**
  - — e.g. 1 April 2009

Summary

- **An under-capitalised insurance company (does it allow selection against itself?)**
- **….or penalising the stragglers.**

Pension Protection Fund
Calculation of Levy (1)

Ultimately

- **Based on both 'risk' and 'scheme' factors**
- **Must be at least 80% 'risk-based' (see below) (Note: was 50%)**
- **'Levy ceiling' applies – increased annually in line with earnings (unless PPB recommends and HMT approves larger increase)**
- **Estimated amount must be no more than 25% higher than that raised in previous year**
- **Different bases could apply for different types (or sizes) of scheme**

nb Regulatory Impact Assessment (RIA) includes "80% risk-based" illustration

Pension Protection Fund
Calculation of Levy (2)

During 'initial period' (12 months)

- **Normal rules do not apply**
- **Based on 'scheme factors' only for first year**

During 'transitional period' (unspecified duration, but perhaps 3 years)

- **May be less than ultimate 'risk-based' proportion of 80%**
- **Lower 'ceiling' may apply**
- **Flexibility for schemes to choose whether risk-based assessment applies to them??**

Calculation of levy (3) - Issues in transitional period

— Govt suggested PPF Board may wish to "encourage" schemes to move to risk-based sooner rather than later

— Implies higher scheme-based than risk-based

— Stay with scheme levy until next (PPF) valuation?

Possible timeline

Preliminary	Initial	Transitional	Ultimate
•statutory priority order: protected liabilities	•Levy based on “scheme factors” only	•There may be flexibility on risk-based assessment	•Levy at least 50% risk-based

2004 — *Apr2005* — *Apr2006* — *Apr2009*

6Apr05: PPF open for business

Pension Protection Fund
Calculation of scheme factors Levy

‘Scheme factors’ include

- **number of members,**
- **pensionable earnings**
- **liabilities, + other prescribed factors**

Possible scale

• **Actives £16pa (may be higher in initial and transitional period)**

• **Non-actives £8pa (ditto)**

•**Plus £1 Fraud levy per member**

Pension Protection Fund
Calculation of risk factors Levy

‘Risk factors’ must include:

- **funding position**
- **chance of employer insolvency**

may include

- **investment strategy (mismatching)**
- **other matters to be prescribed**

Pension Protection Fund
How much will the levy be?

Regulation Impact Assessment provides illustration based on

- £300m overall (80% risk-based)
- £4 per £1,000 for first 20% underfunding
- £8 per £1,000 for rest of underfunding

Assuming £4 per member scheme factor would give

Members	Assets	Funding Level	Levy
1,000	£30m	75%	£52k
20,000	£900m	90%	£480k
50,000	£2,000m	80%	£1.8m

This is an illustration.
Handle with care!

Pension Protection Fund
What triggers PPB involvement?

- Insolvency Practitioner notifies PPB that ‘insolvency event’ has occurred in relation to employer and whether a ‘scheme rescue’ is possible
- Trustees must apply to PPB if the employer “is unlikely to continue as a going concern”
- Regulator must notify PPB if it becomes aware that the employer “is unlikely to continue as a going concern”

Pension Protection Fund
Assessment Period (1)

- Begins with employer’s insolvency or application/notification to PPB
- Actuarial valuation carried out to determine whether ‘protected liabilities’ are covered
- PPB will pursue debt on the employer
- Restrictions apply to accrual and payment of benefits, contributions, transfers, investment
- Ends (usually at least 12 months later)….

Pension Protection Fund
Assessment Period (2)

ENDS ***when***

- **PPB approves valuation and 'assumes responsibility' - transfer notice issued and trustees discharged**

OR

- **Valuation shows scheme assets sufficient to cover protected liabilities - trustees must proceed to wind-up**

OR

- **PPB ceases to be involved because 'scheme rescue' occurs or scheme was not 'eligible' or was set up or amended to exploit the PPF – withdrawal notice issued**

Safety valves

If necessary the PPF Board can

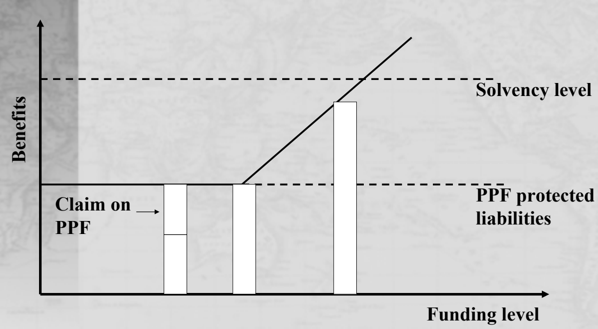
- Adjust the rate of revaluation
- Adjust the rate of increases in payment

If both reduced to zero then

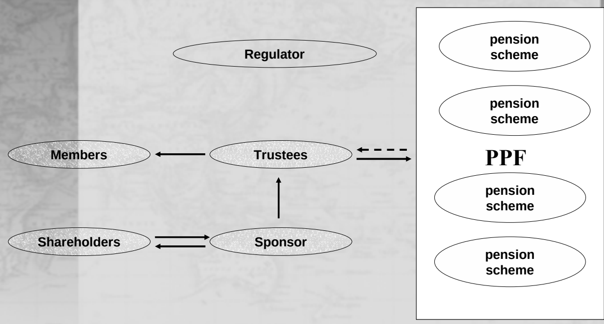
- SoS may reduce the 90%/100% rates of compensation

These are nuclear options – self-defeating

Picture of the PPF protection



Picture of the stakeholders



Moral Hazard

- **Avoid “debt-on-the-employer”**
  - ie Corporate structuring, asset stripping etc
  - Pay a “contribution” to scheme (or PPF)
  - Post 27/4/04 actions, 6 year time limit
- **If an employer is “insufficiently resourced”**
  - Financial Support Direction
  - Joint and several liability, or bank g’tee
  - Not limited to after 11/6/03

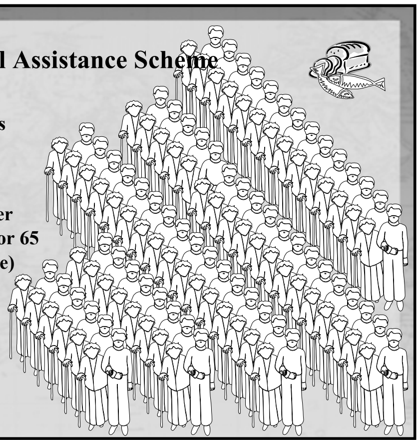
Will the PPF be retrospective?

To enter the PPF must have after 5 April ‘05

- **Scheme must not have started to wind-up before 5th April ‘05**
- **Insolvency event**
  - receiver appointed, enters administration, creditor winding-up, court ordered winding-up
  - Not voluntary insolvency

This does <u>not</u> bar companies that have entered insolvency proceedings before April 05

Financial Assistance Scheme

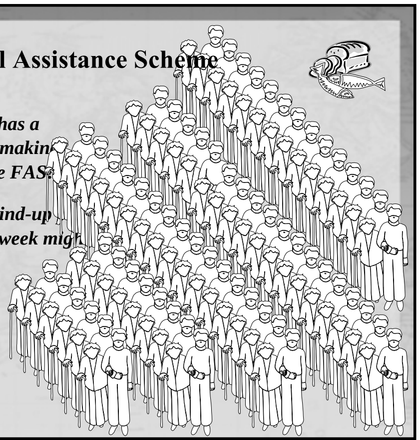


£ *400m* over 20 years
÷ 65,000 affected members

= £ 6,150 per member
÷ 20 (annuity rate for 65 year old, 50% spouse)

= £ 308 per year
= £ *6 per week*

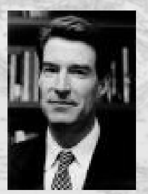
Financial Assistance Scheme



- *The private sector has a “strong interest in makin contributions to the FAS*
- *If other schemes wind-up April 2005, £6 per week mig be optimistic*

Questions and comments

Pension Benefit Guarantee Corporation (PBGC)



What can we learn?

PBGC – the US inspiration for the PPF

Set up in 1974 to:

- Encourage the continuation and maintenance of DB plans
- Provide timely and uninterrupted payment of pension benefits
- Keep pension insurance premiums to a minimum (!)

In many respects it is the model for the PPF

PBGC – Governance

- No statutory guarantor
- US Treasury denies it would bail out the PBGC
- Commentators believe it would have to
  - E.g. Savings & Loans scandal

UK Government has stated taxpayers' money will not be used to bail out the PPF

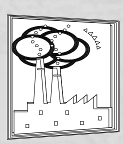
PBGC Premiums

- Flat per-member basis until 1988
- Capped risk-based element 1988 – 1994
- Cap phased out 1994-1997
- Choice over liability calculation
- Premiums reflect underfunding but not sponsor risk

PBGC – Funding

- Has been in deficit for most of its life
- Current deficit around $11bn – to be paid by ongoing schemes
- In 2003, the PBGC had to take over the pension obligations of 152 plans covering 206,000 workers
- In total, the agency estimates pensions nationwide are underfunded by $450 billion.

PBGC Beneficiaries



US Steel Industry

- 3% of those protected
- 52% of all claims by value

US airline industry

- 2% of those protected
- 17% of all claims by value

Their employees and customers

PBGC's experience

•Analysis of the largest claims on PBGC, representing over 50% of the amount of all claims, shows,

- —10 yrs out over 85% of sponsors were sub-investment grade status
- —3 yrs out 100%

Differences between PBGC and PPF

PPF will use risk based premiums from the start (almost)

PPF has differing objectives – emphasis on protection rather than encouraging provision

Regulator has a role

PBGC – successes?

- Currently pays >500,000 pensioners
- Has reserves of $34 billion
- Number of DB schemes has fallen
  - – from 112,000,
  - – to 31,000

in the past 20 years.

What questions remain about the PPF?

FAQ1

Q1 Should the risk based levy depend on:
- strength of employer (we know it will)
- investment strategy?
- other factors?

Q2 What proportion of the total levy should be risk based? (Note: will be at least 80%)

Q3 What basis (discount rate) should be used to measure the deficit for the PPF?

Q4 Should the Government stand behind the PPF?

Q5 How should the PPF invest?

FAQ2

Q6 How will the PPF affect funding strategy for a scheme:
- poorly funded (below PPF liability)?
- well funded (above PPF liability)?

Q7 How will the PPF affect investment strategy for a scheme:
- poorly funded (below PPF liability)?
- funded up to PPF liability?
- well funded (above PPF liability)?

Does the strength of the employer covenant make a difference?

Q8 Will the employer cover the levy in addition to the contributions?

Q9 What moral hazards exist? How should the regulator react?

Q10 Is £ 300m the right total amount for the PPF to levy?

Q Should the risk based levy depend on:
- strength of the employer?
- investment strategy?
- other factors?

- **Should T&N and BP pay the same levy per £1m deficit?**
- **Consider a scheme with assets = protected liabilities**
- **Can these factors be practically incorporated?**
- Small sponsors/schemes require different treatment
- Consider insurance under-writing?

Q What proportion of the total levy should be risk based?

Lower the risk based levy the greater the cross-subsidy

- **Cross subsidy bad**
  - Companies paying for promises from competitors
- **Cross subsidy good**
  - Worst situation schemes not able to pay full for the risk they contribute in full, so need to be subsidised
  - Is this economics or politics?

Q What basis (discount rate) should be used to measure the deficit for the PPF?

What happens when sponsor goes bust?

Are there "sufficient" funds to meet protected liabilities?

If this is on a different (weaker) basis to insurance Co

- PPF says you have enough money
- Insurance Co says you do not

PPF basis must be a proxy for insurance buy-out

Gilts – ½ %??

Q Should the Government stand behind the PPF?

No

- Then companies are in a mutual insurance arrangement
- Cross-subsidy between competing companies

Yes

- Tax-payers pay for company promises
- Members of company pensions have above average pension provision. Should those with lower pensions subsidise the pensions of those with higher provision?

Behavioural effects on the PPF Board?

Q5 How should the PPF invest?

I don't think we will be too different from [the average pension fund] in our investment.

PPF Board required to consider interests of levy payers and current/potential beneficiaries when setting investment policy

Steven Kandarian: You do not invest in Florida beach front property

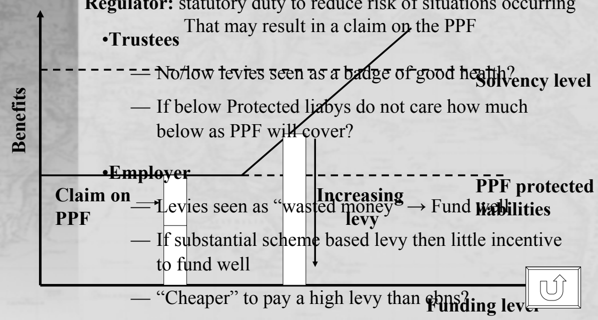
Q How should the PPF invest?

- **PPF Board required to consider interests of levy payers and current/potential beneficiaries**
- **How are the interests of levy payers best served?**

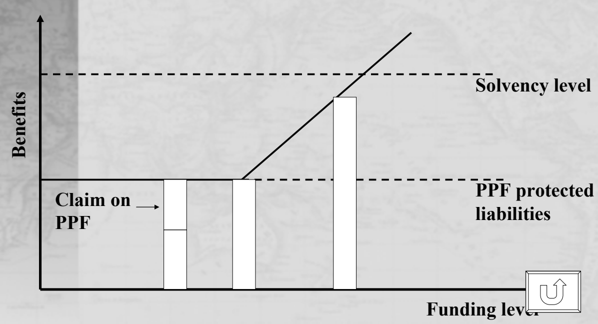
Q How will the PPF affect funding strategy?

Regulator: statutory duty to reduce risk of situations occurring That may result in a claim on the PPF

- **Trustees**
  - No/low levies seen as a badge of good health?
  - If below Protected liabys do not care how much below as PPF will cover?
- **Employer**
  - Levies seen as "wasted money" → Fund well
  - If substantial scheme based levy then little incentive to fund well
  - "Cheaper" to pay a high levy than cbns?



Q How will the PPF affect investment strategy?



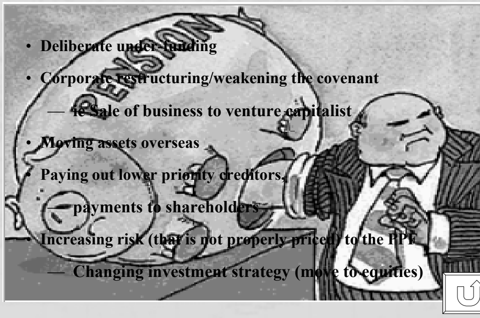
Q Will the employer cover the levy in addition to the contributions?

E'er pays the "balance of cost" – so yes, but when?

If PPF does not reflect the risk the scheme brings

- Levies paid from the scheme reduces FL
- Effectively scheme borrowing more from the PPF
- The levy (interest) may be a subsidised loan to the sponsor
- What is the role of the regulator here?

Q What moral hazards exist? How should the regulator react?



- Deliberate under-funding
- Corporate restructuring/weakening the covenant
  - ie sale of business to venture capitalist
- Moving assets overseas
- Paying out lower priority creditors,
  - payments to shareholders
- Increasing risk (that is not properly priced) to the PPF
  - Changing investment strategy (move to equities)

Q Is £ 300m the right amount in aggregate for the PPF to levy?

Who has the data to tell?

Lessons from DB schemes

- Can not set the benefits AND the cost
- If the costs are set does this mean the benefits are flexible (ie not guaranteed)?

True cost will depend on market conditions

- Size of deficits, strength of employers, asset allocation

How *should* the levy be set?

If an insurer offered this protection how would it be priced?

Claim = Deficit at insolvency

Levy = PV [deficit at insolvency]

Levy = PV (E_Q[max(L_p – A, 0) & insolvency])

Levy = Fn(Deficit,
Pr[insolvency],
Asset allocation)

(if insolvency independent of capital markets)

How *should* the levy be set? (2)

Need to assess the following

- **Deficit**
- **Pr[insolvency]**
- **asset-liability mismatch**

How to measure the deficit

- **Choice of basis is key**
- **Best guesstimate is a buy-out proxy**
  - — GN9: gilts -½%

arguably unfeasible for it to be anything else!

- **Take account of all features of Protected Liabilities**

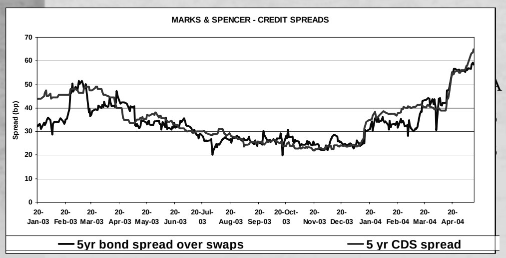
Why Charge for the risk of insolvency?

Assume £50m deficit & Pr Insolvency 1%

hence charge each scheme → **£0.5m levy**

Sponsor	Deficit £m	Pr[insolv]	Fair Levy £m	Overpayment / Subsidy £m
AAA	50	0.2%	0.10	0.40
AA	50	0.2%	0.10	0.40
A	50	0.5%	0.25	0.25
BBB1	50	0.6%	0.30	0.20
BBB2	50	3.7%	1.85	1.35
BB	50	6.0%	3.00	2.50

How to measure the proby of insolvency?



Reminder - PBGC's experience

- **Analysis of the largest claims on PBGC, representing over 50% of the amount of all claims, shows,**
  - — 10 yrs out over 85% of sponsors were sub-investment grade status
  - — 3 yrs out 100%

Proby of insolvency for smaller companies

- Credit scoring is a standard practice in banking
- For example S&P Credit Default tracker
  - — Wisdom Toothbrushes
  - — Harris & Sheldon
  - — Prym Newey (UK)
- Will the PPF just assume unquoted companies are high risk?

Asset-mismatch risk

Will the deficit be stable?

Assessing the correlation between Assets and the interest rate sensitive liabilities.

Consider 2 companies both with assets of 105% of the protected liabilities,

— Co. A has all pension assets in equities

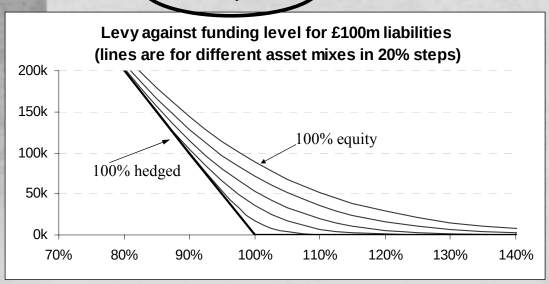
— Co. B has all pension assets in bonds

Company represents a bigger risk to the insurer.

So what is the "right" levy?

Out-performance option

Proby Insolv x $E_Q[\max(L_p - A, 0)]$



Why is this approach unlikely?

- Too complex?
  - For most schemes
  - But for those that represent largest risk
- Political pressure
  - No "disincentive" for equity investment
- Lobbying from weak schemes
  - Need for subsidy

What will happen?

- **Deficit must be included**
- **Rough risk rating for sponsors**
  - More accurate assessment for large schemes
  - Where bonds/CDS are traded?
- **Asset mismatch phased in over time?**

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