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Pension Protection Fund (PPF) Iceberg or Lifeboat?

Cliff Speed and Simon Banks

Aim

- Pensions Bill
  - To restore confidence in pensions
- PPF
  - Increase protection for members to ensure they are confident in saving for retirement

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PPF: What Protection Will Be Provided?

Partial Protection Fund

Level of protection
- 100% of protected benefits for pensioners
- 90% protected benefits for non-pensioners

Protecte
- Pens
- No p
- Revaluation in deferment LPI(5%)
- For “non-pensioners” cap on benefits (~ £25k pa including tax free cash increasing with NAE)

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When Does the PPF Get Involved?

- Notification to the PPF when
  - Employer is insolvent

  or
  - “Employer unlikely to continue as a going concern”
- In assessment period need actuarial valuation
- After assessment period, transfer notice
  - PPF takes over assets and responsibility
  - …unless, buy-out, scheme rescue or fiddling

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How Will It Be Paid For?

Levy comes in two parts
- risk factors – deficits, insolvency risk?, asset allocation?
- scheme factors - #members, pensionable pay, etc

Principles for setting the levy
- predominantly risk-related (80:20?)
- a flat-rate component
- aim for consistent costs over time, regardless of economic cycle

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How Much Will Be Raised?

- £300m per annum, but
- Initial levy set by the Secretary of State (up to 2 years)
  - £150m in the first year
  - Based only on scheme factors
- Risk based levy introduced
  - “in a way that suits schemes best”
  - stay with scheme levy for until next valuation?
- An under-capitalised insurance company allowing selection against itself

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Restrictions on the Levy

- Must not increase by more than 25% year on year
- Levy ceiling set by Government
- Risk based levy must be 50% of the total levy

- These do not apply in the initial period
- Ceiling could be lower
- 50% for risk levy

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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

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Will the Levy be Sufficient?

- What is the theoretically correct levy?
- Levy = PV [deficit given insolvency]
- Levy = PV (E_Q[max(L_p – A, 0) & insolvency])
- Levy = function of
  - Deficit
  - Pr{insolvency}
  - Asset allocation
  - Correlation (insolvency, capital markets)

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How to Measure the Deficit

- Choice of basis is key
- Best guesstimate is a buy-out proxy
  - GN9 gilts -½%
- Need to take account of all the features of Protected Liabilities

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How do Protected and FRS17 Liabilities Compare?

Different interest rate – 1.1%	+20%
Future salary increases	–9%
No pre-97 increases	–15%
Post-97 increases at LPI (2½%)	–4%
90% limit for those below NPA	–6%
Benefit cap of £25,000 pre-NPA	–5%

Protected Benefits are approx 20% below FRS17 Liabilities, but…

…individual schemes will differ substantially

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Why Charge for the Risk of Insolvency?

Assume £50m deficit & Pr Insolvency 1%

→ £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

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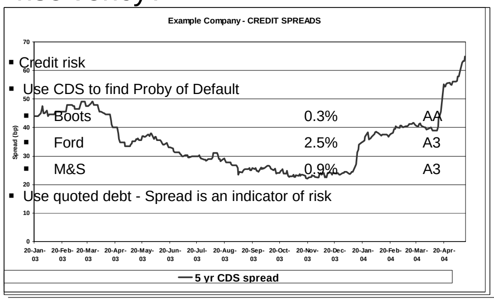
How to Measure the Probability of Insolvency?



- Credit risk
- Use CDS to find Proby of Default

Boots	0.3%	AA
Ford	2.5%	A3
M&S	0.9%	A3

- Use quoted debt - Spread is an indicator of risk

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Probability of Insolvency for Smaller Companies

- Credit scoring is standard banking practice
  - Many models already exist to do this
- Will the PPF just assume unquoted companies are high risk?

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Asset Allocation and Correlation

- Need a simple method for asset allocation
- Could use “haircuts”
- Prefer to use matching and other assets
  - Assess the correlation between liability and assets
- Intuitive to expect more insolvencies when the markets are “down”
  - Difficult to substantiate
  - Not true for corporate debt defaults
  - # of insolvencies related to recession, but markets are forward looking

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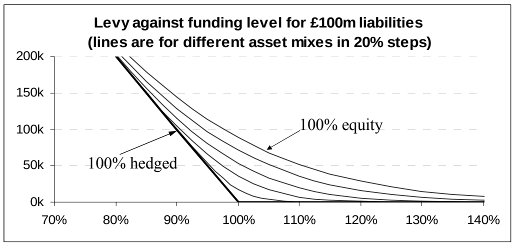
So What is the “Right” Levy?

Probability of Insolvency x Margrabe Option



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Is the Levy Level Correct?

- FTSE100 as at 31 December 2003
  - Assets £223bn
  - Liabilities £249bn → deficit of £26bn
  - Protected liabilities ~ £200bn → surplus of £23bn
  - With 70% unmatched assets → Option value £4bn
  - Taking account of Pr {insolvency} 1% → £40m
- But differences between schemes
  - Some individual schemes would have levies > £50m
- How much of total UK liabilities are in the FTSE100?

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Recent Developments

- Amendments to the Pensions Bill
  - Mainly to address “moral hazard” through capital re-structuring
- Lawrence Churchill to chair the PPB
  - Ex Zurich Financial Services’ UK Ins chief
- Retrospection, £400m bailout from Government
  - ~£6,666 pp or £350pa
- Directors and Owners liability
  - Required to make payments by regulator?

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Effect on Pension Scheme Behaviour

Why fund a pension scheme?

- Security for members
- Tax
- Reduced PPF levy

Why not fund?

- Prefer to invest in own business / cost of borrowing
- Agency costs
- Benefit leakage

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Tilting the Playing Field in Favour of Funding

Other factors too, eg

- Greater transparency
- Greater understanding of tax benefit
- Other requirements of Pensions Bill

So

- Higher funding
- Better matching

Results could be perverse if "risk based" levy not very risk based

- Potential arbitrage

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Wider Implications

Short term upheaval?

- Shift from equities to bonds
- Resources diverted from worthwhile investment to pension funding

Further decline in DB (short term)?

- PPF is extra cost

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Wider Implications

Resurgence in DB (longer term)?

- PPF works!
- Higher "value" placed on DB benefits as a result

More (cautiously funded) executive schemes

- No protection past £25k
- Lower priority order

What If We Get More Fudge?

- Gamble could pay off … initially …
  - Stores up trouble for later (à la PBGC)
- … or may not pay off
  - Chaos?
  - Bail out by taxpayers?

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Public Subsidy in Question

- Already suggested that some US industries that compete globally (… Steel, Airlines …) have been effectively subsidised by PBGC
- PPF may create similar industrial subsidies
- What happens if WTO decides these are illegal?

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Other Problems

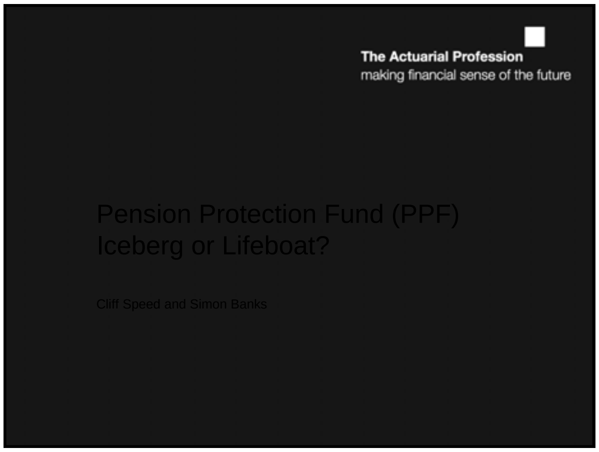
- Calculating a fair levy for private companies, with no public finance
  - Requirement to disclose terms of private borrowing?
- Allowing markets to develop their own solutions. How to allow (for example) for
  - Charges on company assets
  - Schemes entering into credit default swaps
  - Employers giving preferential creditor status to schemes

Investment Strategy for PPF

- No perfect match
- Equities
- Bonds, ILGs, FIGs
- Short equities?
- Credit default swaps
- Supply / demand issues
- Increases demand for long dated ILGs?
  - Treasury benefits!?

Other Thoughts

- Is the levy enough?
- Why not have done with it and make pensions a preferential creditor?
- Insurance company Regs – why not use these?
- Large initial claims
- Selection against PPF
- Disclosure
- PPB have an incentive to keep levy high (unlike PBGC Board)
- No (official) Govt backing encourages good governance
- Too complex…. If you want to pay pensions…..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