

A faint, stylized world map is visible in the background, showing continents and major cities. The map is rendered in a light gray tone against a blue gradient background.

Impact of the Pensions Bill The Pension Protection Fund (PPF)

27 October 2004

You are listening to:



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- Cliff Speed

Agenda

- What is the PPF
- What happens in the US? The PBGC.
- How should the levy be set?
- What might happen – case studies
- 2x 50 min session

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 (PPB) to be established under Pensions Act**
- **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

PPB must

- **Appoint at least 2 fund managers and an actuary**
- **Prepare and maintain Statement of Investment Principles**
- **Submit annual reports including accounts, and actuarial valuation**

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'

Partial Protection Fund

- options of £100,000 on full or part of a pension
- **Improvements due to rule changes and discretionary increases within last 3 years excluded**

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**
- **Borrowing**

NO GOVERNMENT FUNDING

How much will be raised?

- **£300m per annum, but**
- **Initial levy set by the SoS (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**

Pension Protection Fund

Calculation of Levy (1)

Ultimately

- **Based on both ‘risk’ and ‘scheme’ factors**
- **Must be at least 50% ‘risk-based’ (see below)**
- **‘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’ (could be up to 2 years)

- **Normal rules do not apply**
- **Fact sheet says to be based on ‘scheme factors’ only for first year**

During ‘transitional period’ (unspecified duration)

- **May be less than 50% ‘risk-based’**
- **Lower ‘ceiling’ may apply**
- **Flexibility for schemes to choose whether risk-based assessment applies to them??**

Pension Protection Fund

Calculation of Levy (3)

‘Scheme factors’ include number of members, salary roll, liabilities

‘Risk factors’ must include funding position

may include

- chance of employer insolvency**
- 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

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”**

How to measure the deficit

- **Choice of basis is key**
- **Best guesstimate is a buy-out proxy**
 - GN9: gilts $-1/2\%$
- **Need to take account of all the features of Protected Liabilities**

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

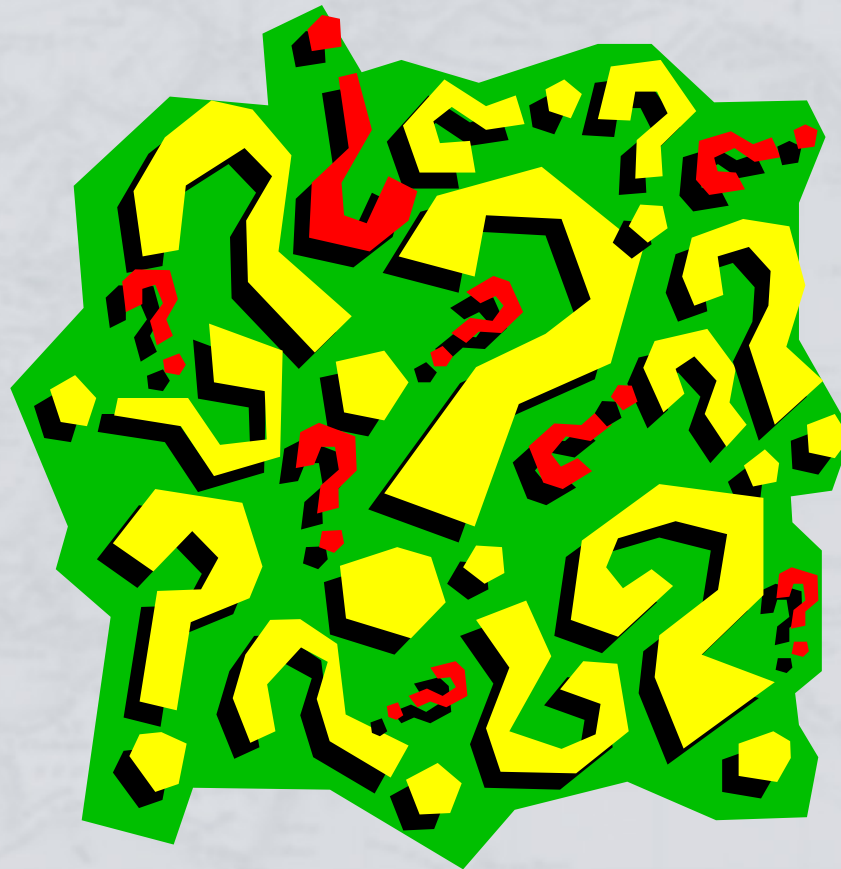
These are nuclear options – self-defeating

Pension Protection Fund

Possible Timetable for Introduction

2004/5	Statutory priority order amended to prioritise ‘protected liabilities’
6/4/2005	PPF ‘open for business’
2005/6	Initial period – levy based on ‘scheme factors’ only
2006/9	Transitional period – may be flexibility on introduction of risk-based assessment?
2009-	Levy at least 50% risk-based

Questions and comments



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

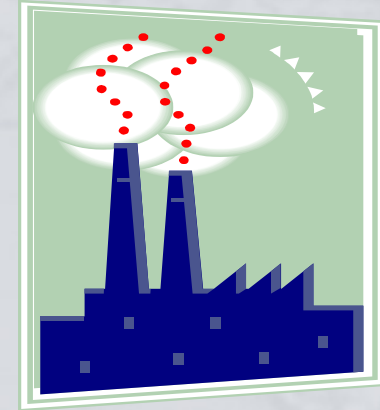
PBGC – Funding

- 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**

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

Some similarities

Politicians can meddle - eg by capping premiums

Confusion over security

Pension – scheme style (ie equity) approach to investment

Will *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 ($E_Q[\max(L_p - A, 0) \text{ \& insolvency}]$)

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

(if insolvency independent of capital markets)

Will *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 $-1/2\%$

arguably unfeasible for it to be anything else!

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

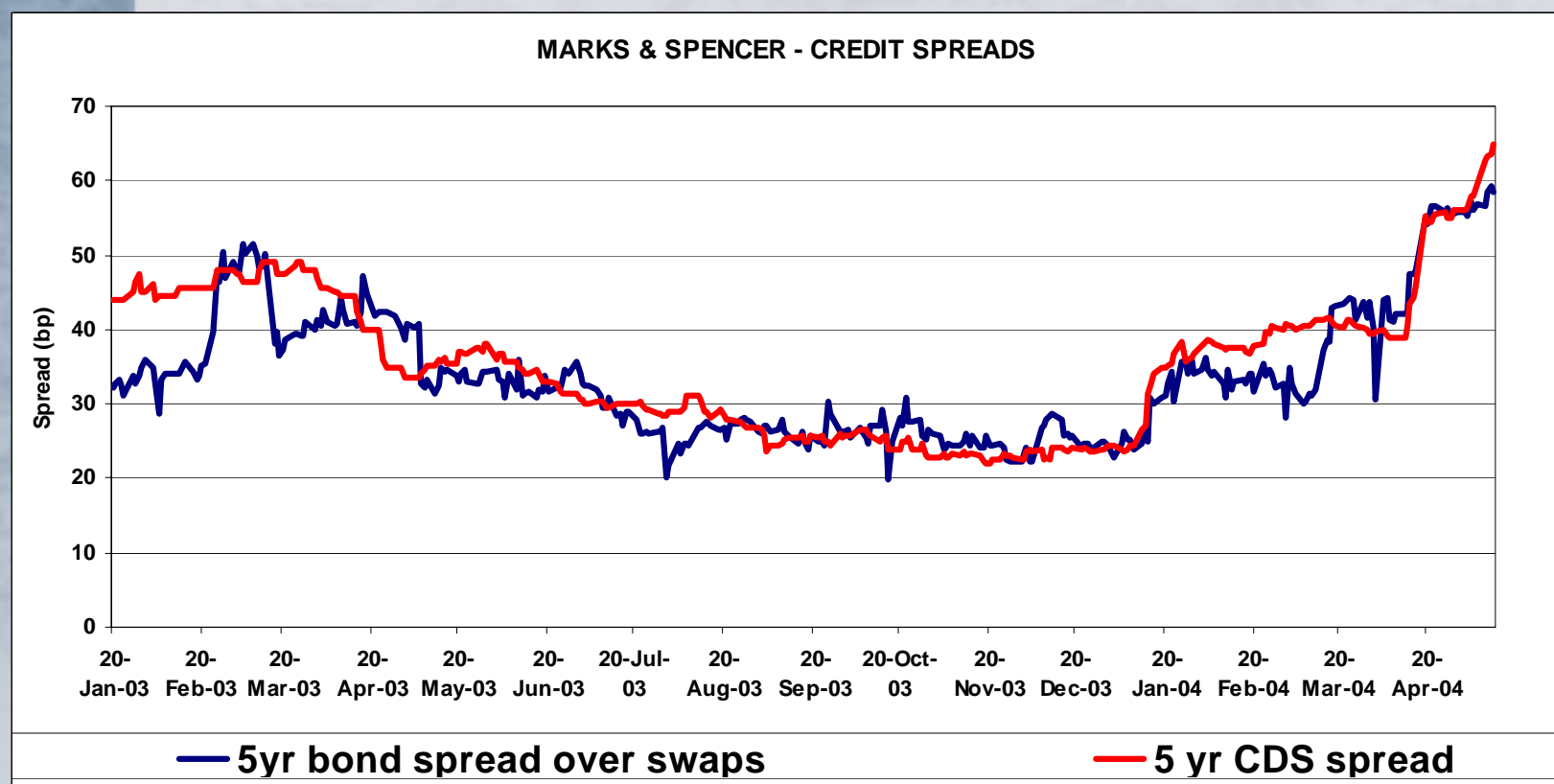
Why Charge for the risk of insolvency?

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 probby of insolvency?



Proby of insolvency for smaller companies

- Credit scoring is a standard practice in banking
- Could use 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

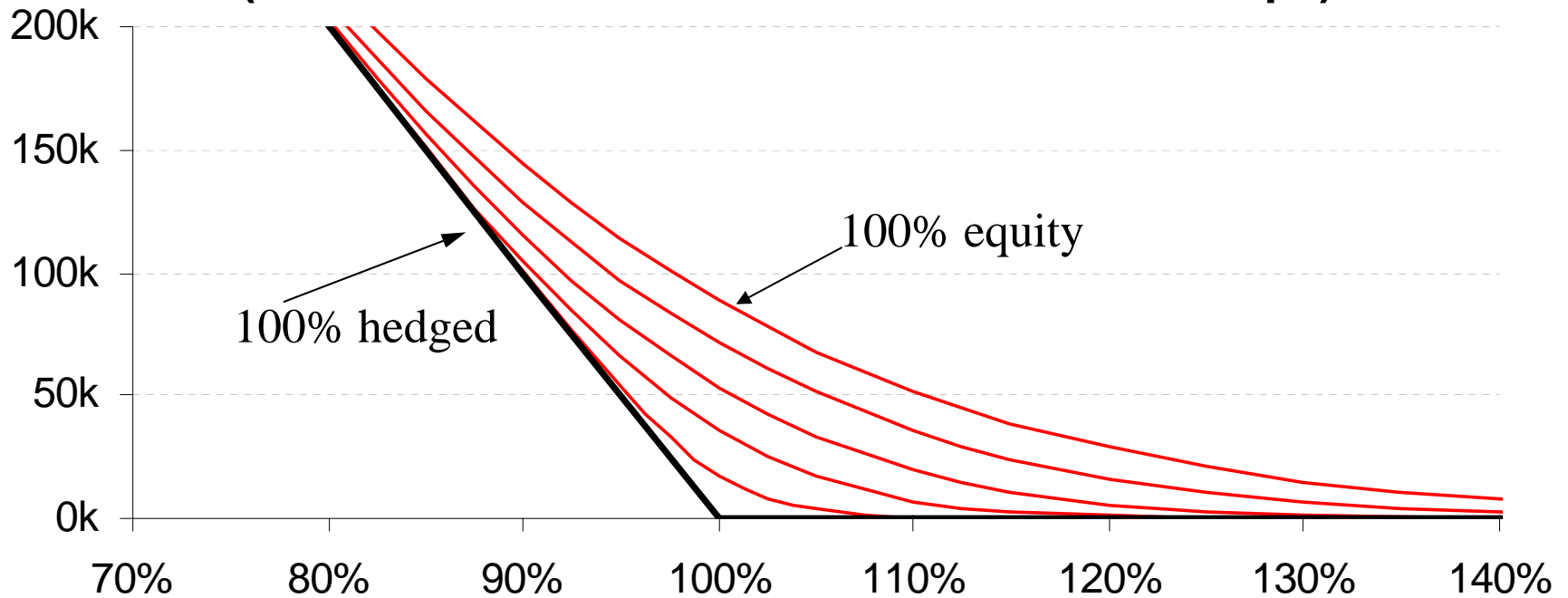
Company represents a bigger risk to the insurer.

So what is the “right” levy?

Outperformance option

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

Levy against funding level for £100m liabilities
(lines are for different asset mixes in 20% steps)



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?**

Case studies

A faint, light blue map of the United States serves as the background for the slide. The map shows state boundaries, major cities, and a grid of latitude and longitude lines. The title 'Case studies' is overlaid on the upper left portion of the map.

Scheme 1

Scheme liabilities £400m

PPF liabilities £300m

Assets £250m – equities £200m

Risk of sponsor insolvency 3% p.a.

Overall levy £1.6m

Scheme 1 – funding

Assets	Annual premium
£250m	£1.6m
£275m	£1.0m
£300m	£0.6m
£325m	£0.3m

Scheme 1 – investment

Matching assets held	Annual premium
£50m	£1.57m
£100m	£1.52m
£150m	£1.50m
£200m	£1.50m

Scheme 1 - perspectives

Trustees

- may decide to 'go for broke'

Sponsor

- better to reduce scheme deficit and borrow more

Members

- better security.

PPF (other schemes)

- incentives for the employer are working well, but
- less well for the Trustees,
- hence the need for the regulator to be involved.

Scheme 2

Scheme liabilities £400m

PPF liabilities £300m

Assets £350m – equities £300m

Risk of sponsor insolvency 3% p.a.

Overall levy 150k

Scheme 2 – funding

Assets	Annual premium
£350m	£152,000
£375m	£71,000

Scheme 2 – investment

Matching assets held	Annual premium
£50m	£152,000
£100m	£89,000

Scheme 2 – perspectives

Trustees

- protect downside - some changes to investment strategy

Sponsor

- supports changes to investment strategy

Members

- expect better coverage than PPF anyway

PPF (other schemes)

- Not concerned (at the moment) about this scheme
- Levy should cover combined investment and employer insolvency risk

Scheme 3

Scheme liabilities £400m

PPF liabilities £300m

Assets £250m – equities £200m

Risk of sponsor insolvency 3% p.a.

1000 actives, 1,750 inactives

Overall levy £200,000

Scheme 3 – funding

Assets	Annual premium
£250m	£212,000
£275m	£112,000
£300m	£12,000
£325m	£12,000

Scheme 3 – investment

Investment strategy has no impact on premiums

...but PPF insures the downside...

Scheme 3 - perspectives

Trustees

- PPF insurance encourages aggressive investment strategy

Sponsor

- business as usual

Members

- better security.

PPF (other schemes)

- Left supporting other Scheme 3 stakeholders,
- At the expense of stakeholders in other schemes
- Is overall levy sufficient?