Impact of the Pensions Bill
The Pension Protection Fund (PPF)
27 October 2004

You are listening to:
• Simon Banks
• 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)

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’ (cap of £25,000 pa assumed in RIA)
- 50% spouses’ pensions
- statutory revaluation and 2.5% LPI (post ‘97 only)
- options of 25% commutation and early retirement
- Improvements due to rule changes and discretionary increases within last 3 years excluded

Pension Protection Fund

How will it be funded?
- Levis 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 a scheme with £900m in assets:

<table>
<thead>
<tr>
<th>Members</th>
<th>Assets</th>
<th>Funding Level</th>
<th>Levy</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,000</td>
<td>£1m</td>
<td>80%</td>
<td>£52k</td>
</tr>
<tr>
<td>20,000</td>
<td>£90m</td>
<td>90%</td>
<td>£480k</td>
</tr>
<tr>
<td>50,000</td>
<td>£2m</td>
<td>80%</td>
<td>£1.8m</td>
</tr>
</tbody>
</table>

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 -½%
• 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) & 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 -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

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

How to measure the proby of insolvency?

- Credit risk
  - Use CDS to find Pr of Default
    - Boots 0.3% AA
    - Ford 2.5% A3
    - M&S 1.0% A3
  - Use quoted debt - Spread is an indicator of risk

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?
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

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

<table>
<thead>
<tr>
<th>Assets</th>
<th>Annual premium</th>
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</thead>
<tbody>
<tr>
<td>£250m</td>
<td>£1.6m</td>
</tr>
<tr>
<td>£275m</td>
<td>£1.0m</td>
</tr>
<tr>
<td>£300m</td>
<td>£0.6m</td>
</tr>
<tr>
<td>£325m</td>
<td>£0.3m</td>
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</table>

Scheme 1 – investment

<table>
<thead>
<tr>
<th>Matching assets held</th>
<th>Annual premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>£50m</td>
<td>£1.57m</td>
</tr>
<tr>
<td>£100m</td>
<td>£1.52m</td>
</tr>
<tr>
<td>£150m</td>
<td>£1.50m</td>
</tr>
<tr>
<td>£200m</td>
<td>£1.50m</td>
</tr>
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</table>

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

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**Scheme 2 – funding**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Annual premium</th>
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</thead>
<tbody>
<tr>
<td>£350m</td>
<td>£152,000</td>
</tr>
<tr>
<td>£375m</td>
<td>£71,000</td>
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**Scheme 2 – investment**

<table>
<thead>
<tr>
<th>Matching assets held</th>
<th>Annual premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>£50m</td>
<td>£152,000</td>
</tr>
<tr>
<td>£100m</td>
<td>£89,000</td>
</tr>
</tbody>
</table>
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

<table>
<thead>
<tr>
<th>Assets</th>
<th>Annual premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>£250m</td>
<td>£212,000</td>
</tr>
<tr>
<td>£275m</td>
<td>£112,000</td>
</tr>
<tr>
<td>£300m</td>
<td>£12,000</td>
</tr>
<tr>
<td>£325m</td>
<td>£12,000</td>
</tr>
</tbody>
</table>
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?