Written evidence from the Pension Protection Fund (PPF0001)

Introduction

We welcome the opportunity to provide the Committee with written evidence in advance of their session with our Chief Executive, Alan Rubenstein, on 9 May 2016.

Any major corporate insolvency and the circumstances leading up to it will understandably draw attention. Given the 20,500 or so members of the main BHS Pension Scheme and the substantial deficit in the scheme, much of this attention has rightly focused on the pension aspects of the BHS administration. The reassurance for members is that the Pension Protection Fund (PPF) is ready, willing, and able to ensure that those members are protected; the BHS Pension Schemes are currently being assessed for entry to the PPF.

The PPF was established to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover PPF levels of compensation.

Who do we protect?

We protect the members of around 6,000 mainly private sector defined benefit (typically final salary) pension schemes in the UK. These schemes have around 11 million members in total.

Overall these schemes do not currently have sufficient assets to pay what their members have been promised. Nearly 5 in 6 schemes that we protect are currently in deficit. The aggregate deficit, on a PPF basis, at the end of March 2016 was around £300 billion; while the schemes had combined assets of c.£1.2 trillion, they had combined liabilities of c.£1.5 trillion. On a ‘buy out’ basis, the cost to secure full benefits for all members through a commercial insurer, the liabilities of schemes are much higher. Scheme funding has varied significantly during the eleven years that the PPF has been in operation.

The chart overleaf shows the historical aggregate balance and funding ratio of the eligible pension schemes in the PPF universe.

Until the PPF opened for business in April 2005, if an employer became insolvent leaving an underfunded pension scheme, members simply received their share of what was available in the scheme. This meant many would receive significantly less than what they were promised, and in many cases no pension at all. While these pension scheme members have received retrospective assistance from the Financial Assistance Scheme, their pensions received less protection on employer insolvency than their holiday had if their tour operator went bust.

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1 Comparing the assets of the scheme with the value of liability to pay at least what the PPF would pay
The role of the Pension Protection Fund

The Pension Protection Fund was established by the Pensions Act 2004 to address this issue. The Pensions Regulator, with new powers, was created as part of the same reinforcement of the protection regime. Now when the employer of an eligible scheme becomes insolvent and the scheme cannot afford to pay at least PPF levels of compensation, the PPF takes over the assets of that scheme and pays compensation to members.

The PPF makes up the funding shortfall by: charging a statutory levy on eligible schemes; through its own investment returns; and by claiming in the insolvencies of failed scheme employers. The PPF is not tax payer funded and there is no Government guarantee for compensation payments.

Our last published funding position is as at 31 March 2015. The PPF was 115.1 per cent funded with a surplus of £3.6bn, which places us on track towards our funding target discussed below. At 31 March 2015 the PPF had invested assets of £22.6bn managed according to our Statement of Investment Principles. The investment strategy is designed to match current estimates of the Board’s liabilities and provide some outperformance over the estimated liabilities. Any outperformance should contribute to the long-term sustainability of the Fund and therefore reduce the burden on the levy payer. The day to day fund management of the assets is performed both by external professional fund managers and an in-house team of investment professionals. During 2014/15, our return seeking assets returned 7.0 per cent; our total return including the Liability Driven

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2 Further information on the PPF 7,800 Index and more detailed number can be found here: http://www.pensionprotectionfund.org.uk/Pages/PPF7800.aspx
Investment part of our portfolio was 25.9 per cent over the year as our matching assets have grown in line with our liabilities.

As at 31 March 2016, the PPF had 225,000 members (with 120,000 currently receiving compensation), with a further 100,000 members in schemes in the PPF Assessment Period.

The PPF Funding Strategy

Given the need to balance the interests of our levy payers and those eligible for compensation, together with the uncertainties we face, the PPF in 2010 published its Long-Term Funding Strategy which is updated annually. The Funding Strategy provides a framework to ensure we have the financial resources required to pay existing levels of compensation to current and future members of the PPF, and for us to become self-sufficient by the time the level of risk to the PPF from future insolvencies has reduced substantially. We therefore use the Funding Strategy as the framework for setting levies and our investment risk.

The PPF aspires to become self-sufficient by 2030. By this point the liabilities that we have taken on will have matured, the fund will have grown substantially in relation to the levy we charge and the number of eligible schemes will have reduced, with the risk that they pose being much lower. Assuming the scheme funding regime has resulted in lower deficits, we would need a levy only for a remaining tail of claims and would look to reduce our risk exposure, particularly interest and inflation rate risks, substantially. 2030 is not a fixed date but driven by our assessment by how risk will decline over time.

At 31 March 2015 our modelling indicated the ‘probability of success’ in reaching that target was 88 per cent, ahead of the PPF’s target. This is based on our Long Term Risk Model which models one million potential future scenarios based on our current funding position, the position of the schemes we protect (including their current deficits) and different economic conditions.

Our current position is a strong one given that at the end of March 2009 we were £1.23bn in deficit. The PPF continues to face a significant degree of risk given the universe it protects. The PPF, in line with the legislative framework, is also not capitalised like a commercial insurer would be. It should be noted that solvency arrangements, if applied to the PPF, would have significant implications on the cost of providing protection. As a consequence, the path to 2030 will not be smooth and may well involve periods when the PPF builds up substantial surplus and/or goes into deficit.

The fan chart overleaf shows the history of our funding level as well as a projection beyond 2015. It is based on modelling and the assumption that there is no change to levy or investment strategy in scenarios where the funding level is high or low. This is because the model is used to inform current strategy rather than predict future strategy.

3 Further information about the Funding Strategy can be found here: http://www.pensionprotectionfund.org.uk/About-Us/Pages/About-Us.aspx
As set out in the Pensions Act 2004, the PPF charges a compulsory levy on eligible pension schemes to help fund the compensation we provide. This annual levy is payable by the scheme, although in many cases it will be passed to the sponsoring employer. The Pension Protection Levy has two elements:

- Scheme based – which is calculated based on the liabilities of the scheme; and
- Risk based – which is calculated based on the risk of insolvency of the scheme sponsor and funding position of the scheme. This must by statute make up 80% of the levy calculation, in practice it makes up around 95% of the levy collected.

Each year the PPF must publish an estimate for next year’s collection – for 2016/17 this is £615m (compared to £635m in 2015/16 and £695m in 2014/15 reflecting changes in risk). Parliament has set an upper limit to the levy that the PPF could seek to collect; in 2016/17 this is £981.7m. The estimate is set on the basis of the amount we aim to collect given the risks we face and the individual position of the schemes we protect.

The PPF annually publishes the rules by which the levy is calculated; the PPF aims for stability and predictability in levy bills and therefore the intention is that the rules remain broadly unchanged for three year periods (the latest runs from 2015/16 to 2017/18). Actual collection will vary from the estimate to an extent, as the data on which the levy is charged is not fully available at the point the estimate is made. Schemes can also take steps to reduce their risk which will reduce their levy bill.

While the levy is not set in relation to any particular sets of claims, the below is illustrative of how the levy has remained broadly stable in a volatile claims environment.

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This chart is taken from our 2015 Funding Strategy Update
The chart below shows how our modelling anticipates that, while there is clearly uncertainty, our levy is likely to fall over time as a percentage of pension scheme liabilities.

The funding position of each scheme is assessed using a standard valuation that schemes have to produce every three years. This is then rolled forward to a common date of the start of each levy year (the same data is used to produce our regular review of pension scheme funding). The funding position of the scheme is then ‘stressed’ to reflect that a claim on the PPF might arise when investments have performed poorly; different types of asset are stressed in different ways.

The levy billed in 2015/16 used a new model to assess insolvency risk. The new model has been developed by the PPF with Experian and with input from the pensions industry and those with a wider interest. It is a statistical model based on company financial data and experience of insolvency amongst sponsors of eligible pension schemes. It is substantially more predictive than similar commercial models. It takes financial information for each of the employers which sponsor a pension scheme, uses a formula applied across different types of employer and provides a one year probability of how likely that company is to

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5 This chart is taken from our 2015 Funding Strategy Update
become insolvent. These probabilities are tracked on a monthly basis, and the average of the twelve probabilities used to place the employer in a band. This band is then used in the levy calculation.

The individual levy bill of a particular scheme may therefore vary substantially year on year if their funding level or employer strength varies significantly. Employers, and related companies, can provide guarantees and pledges on assets to a scheme, which in turn reduce their risk of making claims, and is therefore reflected in a reduced levy bill.

The individual levy bill payable by any scheme is capped at 0.75 per cent of the scheme’s PPF liabilities. The costs of this cross subsidy reflected by this cap is met through the scheme based levy payable by all schemes.

**PPF Assessment and Compensation**

Should the company sponsoring an eligible pension scheme have an insolvency event, the scheme will enter a PPF assessment period. A scheme will only then transfer to the PPF if it is not rescued by a new employer and does not have enough assets or money to buy at least PPF levels of compensation from an insurance company (a 'buy-out'). While assessment takes place, the pension scheme trustees remain in day-to-day control of the scheme and members continue to be paid albeit at PPF compensation levels. Members can also retire during this time but not transfer out of the scheme.

The PPF aims to complete the assessment period for the majority of schemes within two years (this is significantly shorter than the time taken to wind-up pension schemes before the PPF came into being). Where there are complex circumstances or ongoing legal action the assessment period can be prolonged.

The levels of compensation that the PPF provides are set out in the Pensions Act 2004. Members who have reached their scheme’s normal pension age will generally receive the same amount in compensation as the pension they were receiving from their scheme at the time their employer went bust. The PPF also generally pays 100 per cent compensation to those who have retired on legitimate ill-health grounds, regardless of age, and those receiving a pension in relation to someone who had died at the time that the employer went bust.

Those members who have not yet retired will generally receive 90 per cent compensation on reaching the normal pension age of their scheme. Members who have retired but have not reached their normal pension age will also receive up to 90 per cent compensation. These 90 per cent calculations are subject to a cap. But the vast majority of members are not affected by this cap.

Annual increases in compensation may be different to the increases that members were getting from their pension schemes. Compensation payments rise in line with inflation each year, subject to a maximum of 2.5 per cent. But this will only relate to pensionable service

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6 We’ve used the word ‘generally’ as there will be some more complex member specific circumstances
dating from 5 April 1997. Payments relating to pensionable service before that date will not increase.

Our relationship with the Pensions Regulator

The Pensions Regulator (TPR) was created alongside the PPF by the Pensions Act 2004 and we work closely with them at all levels within our respective organisations, the Chief Executives of the two organisations regularly attend each other’s Board meetings.

Alongside its statutory duties to protect the benefits of members and minimise any adverse impact on the sustainable growth of employers, the Pensions Regulator has a duty to ‘reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund’.

We therefore work with them in two broad areas: supporting their overarching work to improve levels of pension scheme funding and where appropriate their case specific investigations and interventions. The Regulator of course has much broader responsibilities than just defined benefit pension schemes, including defined contribution schemes, pension scams and auto enrolment compliance.

Given that pension scheme deficits represent a significant part of our risk exposure we are understandably focused on the Regulator’s work to improve scheme funding. In specific areas we engage intensively – for instance we are dependent on information from the TPR scheme return process for our levy calculations – and more broadly around the overall shape of the defined benefit pension scheme universe and each tranche of recovery plans. In respect of specific cases we share intelligence, work closely on restructuring cases or other cases of concern and regularly liaise on how each are approaching particular issues.

A common misconception is that the Pension Protection Fund has a role in supervising the behaviour of employers or scheme trustees. The legislative framework makes a clear distinction between the organisations to ensure the Regulator is focused on supervision whilst the PPF is focused on compensation.

Specific Engagement with the BHS Pension Schemes

Prior to 2016 we had engagement with the employer relating to the protection levies payable. We are often asked to engage with employers and/or scheme trustees to discuss their levy calculation.

Since the start of 2016, we were actively engaged in specific discussions with the company, Regulator and other interested parties about whether there was an appropriate solution which would secure more for the pension schemes than administration of the company. These continued after the Company Voluntary Arrangement (CVA) proposals were lodged on 3 March 2016, and we abstained in the CVA vote having agreed a six month period within which they would need to be concluded. These discussions ended when the company entered administration on 25 April 2016. We are now working with the trustees of the schemes to progress them through the assessment process. This has included a successful
move of all the member records to a provider with experience of making pension scheme member payments.

Our current role with the BHS Pension Schemes

The two BHS Pension Schemes are currently in PPF assessment periods which started from the date the CVA was lodged (3 March). Members are protected and receiving benefits at PPF compensation levels. This is exactly what we were set up to do.

The schemes are the BHS Pension Scheme and the much smaller BHS Senior Management Scheme. The aggregate deficit on a PPF basis for the schemes is estimated at £275m (as at 31 March 2016) with an aggregate deficit on a ‘buy out’ basis, the amount needed to secure full benefits from an insurer, of £571m. There are 20,462 members (6,774 pensioners and 13,688 deferreds) in the BHS Pension Scheme with a further 233 members (128 pensioners and 105 deferreds) in the management scheme. While the schemes are in the early stages of the assessment process, we would expect that, absent significant recoveries from the insolvency process and/or the Regulator using its powers, the BHS Pension Scheme will eventually transfer to the PPF.

May 2016