Introduction

We welcome the opportunity to provide written evidence to the Committee as it considers defined benefit pension funds, including regulation and the Pension Protection Fund (PPF). We were grateful for the opportunity to provide both written and oral evidence to the inquiry into the position of BHS. We trust that this provided suitable reassurance via the Committees to members of the two BHS pension schemes that at a minimum they would receive PPF levels of compensation.

The BHS situation has rightly contributed to a developing debate on pension scheme funding, regulation and protection. The settlement introduced by the Pensions Act 2004 which created the Pensions Regulator and Pension Protection Fund has brought many benefits and the system remains broadly appropriate; from the PPF perspective, the pre-April 2005 position where pension scheme members might be left with nothing if their employer went bust is now rightly unimaginable given the protection we provide. The previous regime where member benefits were based on a sharing out of often hugely insufficient scheme assets with significant impact on members puts the current regime in important perspective. That PPF compensation is now the minimum members should receive provides certainty and reassurance to members.

We believe that the PPF model has proven itself to be robust. However in the face of public concern about whether some employers are seeking to sidestep their pension promises, new business models which may serve to weaken member protection and stubbornly high deficit levels, this wider inquiry is timely. We hope to assist the Committee as they consider these issues and trust that our experience and analysis will be of assistance to the inquiry.

Summary

The PPF plays a vital role in the UK’s pensions landscape. Without it, the 11 million members of defined benefit schemes would have no protection should their employer fail. The service, security and reassurance that the PPF provides to its pension members in unsettling times should not be underestimated.

Compensation becomes payable from the PPF where an employer becomes insolvent and a defined benefit pension scheme is insufficiently funded to pay at least PPF levels of compensation. Our main risks are therefore the likelihood of employer insolvency and the potential scale of any claim (something reflected in how our levy, payable by the schemes we protect, is calculated).

We have a strong interest in the position of the defined benefit pension schemes we protect. We don’t believe radical changes are necessary but think that improvements to the current system would ensure the PPF can continue to run in the most efficient way and be robust enough for the future. The areas raised by the inquiry in respect of the PPF, our sustainability and the fairness of the levy system, while under our stewardship, relate closely to the wider considerations.

We therefore offer in this evidence a number of areas which the Committee may wish to focus on in considering how the system might be improved. We believe that for many schemes in our universe, which carry the bulk of pension liabilities, and their sponsoring employers, the pension promises made to current and former employees are affordable. We believe that deficits on a PPF basis are a real risk to members of those schemes and our levy payers given that in the event of employer insolvency poorly funded schemes will pass to us. In our view, more could be done to ensure that schemes are sufficiently funded and employers continue to stand behind their promises. To help achieve this,
targeted improvements to the powers available to the Pensions Regulator may be needed. We recognise however that there are a number of schemes and employers where promises may now be unaffordable and a specific regime, with suitable safeguards would be appropriate.

Our previous evidence

This written evidence is intended to sit alongside the evidence we provided to the BHS inquiry. We include updates on our current financial position, our latest view on our long term financial position and our work with industry on the development of our levy. We also provide information on how the environment is evolving and the implication of recent developments.

We provided written evidence which provided an overview of the PPF and details of our performance to date in May 2016 (PPF0001 attached at Appendix 1). At the request of the Committee, we also provided more detailed evidence on how overall levies are set and individual levy bills are assessed in July 2016 (attached at Appendix 2).

Developments since our previous written evidence

We provided the Committee with an overview of our financial position and performance in our May written evidence. This was based on our 2014/15 Annual Report and Accounts published in July 2015. We published our 2015/16 Annual Report and Accounts updating on our position as at 31 March 2016 on 21 July 2016. This showed that despite the continuing economic uncertainty, our invested assets grew to over £23 billion. Our funding position strengthened to 116.3 per cent, with a surplus of £4.1 billion. These figures included the impact of 47 new claims during the year (including the two BHS schemes) which meant the number of claims remained relatively low. We had recovered nearly £2 billion from insolvent employers or as a result of corporate restructurings since inception. Our total compensation paid to members since inception rose to £2.4 billion with over £616 million paid out during the year.

As we made clear in our May evidence, given the need to balance the interests of our levy payers and those eligible for compensation, together with the uncertainties we face, we annually review our Long-Term Funding Strategy. This provides the framework to ensure that we are sustainable and have the financial resources required to pay existing levels of compensation to current and future members of the PPF. The Funding Strategy considers the risks to which we are exposed, and is the framework we use for setting the level of levies and our investment strategy.

Alongside our Annual Report and Accounts we published our latest Funding Strategy Update. At 31 March 2016 our modelling indicated a probability of reaching our funding target of 93 per cent (known as our ‘probability of success’). While this had primarily improved for technical reasons, it remained ahead of the PPF’s target.

Given our low risk approach we do not believe our funding level and probability of success have moved significantly in the period since March, despite the wider economic volatility and uncertainty.

Chart 1 overleaf is an updated version of that provided on page 4 of our May 2016 written evidence. It shows the history of our funding level as well as a projection beyond 2016. There has been speculation that given current scheme funding and a cohort of very weak employers, the PPF faces a very significant level of claims (perhaps over £40 billion) in the near term; while our model does consider extreme scenarios such as this, our model indicates this would be at the most extreme tail of the claims distribution. To illustrate this, Chart 2 below shows the range of cumulative deficits of schemes that make a claim on the PPF, measured at the point at which they enter the PPF.
The overall levy that we seek to collect is reflective of the need to keep on track toward our funding target and is therefore shaped by the risks to which we are exposed. To support this analysis we also published an updated version of the chart on page 5 of our previous written evidence (see Chart 3 overleaf). This chart shows how our modelling, anticipates that the amount of our levy will develop over time. There is clearly uncertainty but our funding model is such that we do not anticipate a greater burden falling over time on surviving levy payers; rather our levy is likely to fall over time as a percentage of pension scheme liabilities.

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1 This assumes no changes in our levy parameters and is based on a number of wider assumptions being borne out by experience.
Our expectations around the future direction in the overall level of levy we seek to collect are reflected in the draft levy rules for 2017/18. We confirmed on 22 September 2016 our intention to maintain our approach of setting the shape of the levy rules on a three year cycle to provide consistency and stability (2017/18 marks the third year of the current levy triennium). In addition, we announced that our levy estimate for 2017/18 is £615 million, the same as that for 2016/17. Maintaining a stable basis for calculating levies gives helpful context about the immediate implications for levy payers, not just of the current wider economic uncertainty but also of the BHS schemes requiring PPF protection.

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. The 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 at least 80% of the levy calculation, in practice it currently makes up around 95% of the levy collected.

We welcome the engagement we have had from levy payers, through both formal and informal consultation, around continuing to develop the levy rules, and the Experian model in particular\(^2\). We recognise that given it arrives as a single annual invoice, the levy is a visible cost to schemes and their sponsoring employers (albeit as shown in the chart above aggregate levies are small in relation to total scheme liabilities). Given the bulk of the levy is risk-based, individual bills differ depending on individual risk. In addition as scheme risk changes, despite the stability provided by our setting rules on a three year basis, bills can potentially be volatile.

We publish aggregate information on levy bills and how they vary by different groups of scheme and employer in the annual ‘Purple Book’\(^3\). This data also informs our wider work on levy. Most strikingly this shows that the top 100 levy payers, reflecting the level of risk they pose, paid 42 per cent of levies in 2014/15 (we estimate that for the most

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\(^2\) Since the 2015/16 we have assessed the risk of insolvency of the scheme sponsor or any guarantor using a PPF specific model developed by Experian

recent levy year the top 500 levy payers paid 2/3rds of levies). For 2014, manufacturing accounted for 26 per cent of total pension liabilities and paid 37 per cent of total levy in 2014/15 reflecting the highest average insolvency probability of any industry.

While the new Experian model of insolvency risk exhibits a high predictive power, no model based on a small number of financial variables can be expected to perfectly reflect the exact circumstances of individual employers. We recognise that in seeking to set levy rules that most closely charge individual schemes for the risk they pose of making a claim, while maintaining a system that can produce an annual assessment of insolvency risk (“score”) for around 16,000 employers, we can continue to improve the levy system. While as noted above, levy receipts are weighted toward a small number of schemes, we regard it as important to ensure that individual levy bills are properly reflective of risk across all eligible schemes regardless of size or industrial sector.

While the framework adopted for 2015/16 onwards, including the Experian model, has worked well, we have been working to consider improvements to the rules. We provided an update in July 2016 which highlighted a number of areas where work for the levy rules for 2018/19 and beyond has already started. We are investigating the case for using credit ratings, where available, and industry specific scorecards for regulated financial services entities. We are reviewing the employer segmentation underpinning the model including separating out parent companies according to size, so that SMEs are not on the same scorecard as some of the largest employers in our universe; and we are exploring whether – now we have additional years of data - we can improve predictiveness on some scorecards by using different variables.

We also considering the potential for simplifying requirements for smaller schemes. From our engagement with SMEs we recognise that engaging with what can be a necessarily complex levy model can often be a challenge. This does raise issues around balancing any simplified approach with a proper reflection of risk, and we will therefore be considering this further as part of our work for the next levy triennium. We also believe that this is something that could be considered alongside the scheme consolidation we discuss below.

An evolving pensions landscape

We have seen a number of changes in the pensions landscape over the last six months.

Most striking has been the worsening of pension scheme deficits. There are a number of different bases which are used to measure deficits. That which matters to us is the deficit on a PPF (known as ‘section 179’) basis; this is the cost to a scheme of having an insurer pay on their behalf at least what we would provide. Broadly, if a scheme shows a deficit on this basis that would result in a claim on the PPF in the event of employer insolvency. While this means members are protected, there would be an impact on them and also a cost to our levy payers. This is therefore an appropriate basis for measuring risk and targeting a funding level of at least 100% on this basis would be a reasonable requirement for most schemes, to ensure members will receive benefits that are equal to PPF compensation or are closer to their original pension promise.

On this basis, aggregate deficits of the schemes that the PPF protects reached £459 billion at the end of August 2016. This was around double the level of a year previously. There has been a particular worsening in scheme funding since June given the economic uncertainty and volatility.

We have however seen evidence of the ability of many employers to close these deficits. While median recovery plan lengths in the most recent tranche of schemes (Tranche 9) are almost unchanged to the comparable tranche three years ago, employer dividend policies would indicate an opportunity to close deficits more quickly. This is, in part, reflected in the continued growth in cash retained on employer balance sheets. Indeed our modelling projections would indicate that given the strength of employers in the median case the vast majority of schemes should be sufficiently funded to pose little risk of making a claim on the PPF by 2030 (with less than 700 schemes falling into the PPF in the median case by that time as against around 850 to date).

Our modelling and assumptions about future levies and our future financial position are though based on employers continuing to stand behind their schemes, deficits falling (we assume in our modelling that gilt yields will increase toward historic norms over time, assets on average outperform liabilities and deficit-reduction contributions either are at least maintained or increase if deficits widen) and effective regulatory interventions where required. These assumptions not being borne out would increase the risks to the PPF and hence the costs to levy payers.

Alongside our concern to see deficits reduced as quickly as possible, we are concerned by discussions of new business models which would also challenge these assumptions. We are strongly of the view that new models which consider allowing schemes to continue without a substantive sponsoring employer are unacceptable. This includes the recent consultation on the future of the British Steel Pension Scheme where running on the scheme without a substantive employer was floated; we believe this type of arrangement would constitute an inappropriate ‘one-way bet’ against PPF levy payers.

We are recently reiterated our commitment to charging schemes an appropriate levy to reflect the additional risk such an arrangement might pose should it arise, not least to ensure there is no cross subsidy from other levy payers. While it raises wider issues, we would also be concerned where proposals to reduce scheme benefits above PPF compensation levels enabled employers to slow or weaken their commitment to properly fund to at least PPF compensation levels.

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5 Pensions Regulator Scheme Funding Statistics June 2016  

6 Pensions Regulator Annual Funding Statement May 2016  
Our confidence in the future ability of the PPF to continue to protect members is dependent on the wider framework within which the PPF sits. Our sustainability and the levy which we charge are dependent on the wider defined benefit pensions landscape. We think there are therefore a number of areas that the Committee may wish to consider.

**Scheme Funding**

Broadly our view is that for certain categories of scheme we would support a regime for scheme funding that was more interventionist. The PPF would welcome changes to the scheme funding regime in order to more effectively tackle risks to member benefits and PPF levy payers. In particular, schemes with strong employers should be required to target shorter recovery plans as opposed to being allowed longer recovery plans or to take greater risks as is the case under the present system. We know from experience that even the strongest sponsors can deteriorate rapidly, and where this happens it can pose an unnecessary risk to member benefits. We believe restrictions on the permitted length of recovery plans, and on plans that are “back-end loaded”, may be appropriate. This approach, particularly if targeted on schemes with the largest deficits could substantially reduce downside risks to the PPF and ultimately our levy payers.

**Stressed Schemes**

We recognise that there are schemes where the above is not achievable and this would provide the trigger that the scheme is demonstrating particular stress. For stressed schemes, those with poor funding and weak employers, we believe a period of intensive scrutiny would be appropriate. This might include the appointment of an independent trustee, consideration of a restructuring of the sponsoring employer or that winding up the scheme might represent the best outcome for all parties (including the PPF). There could be a case for the Regulator to have a new and broad power to require the wind up of pension schemes, which could be triggered at the request of either the trustee or ourselves. New or revised legislation may need to be considered in order to support this approach.

**Anti-Avoidance**

Reflection of recent cases would also suggest improvements could be made to improve oversight of corporate transactions and support timely action to prevent avoidance or weakening of the employer covenant. The Pensions Regulator’s anti-avoidance processes (and the supporting regulation) should be reviewed to ensure effective targeting and much faster implementation. Duties on employers and trustees to engage with the Pensions Regulator around transactions may also be appropriate. It may be appropriate for Contribution Notices (CNs) and Financial Support Directions (FSDs) to be substantially increased to provide for a ‘fine’ element where there isn’t such engagement. The current process for CNs and FSDs requires the presenting and arguing of the case at an independent panel with any challenge being heard from first principles. This process should be streamlined, perhaps allowing action to be taken where the Pensions Regulator is satisfied there is a case with affected parties subsequently able to appeal decisions.

**Scheme Efficiency**

While it would, as it does so at present, create challenges, we believe that a regime of this sort could remain compatible with the Regulator’s objective ‘to minimise any adverse impact on the sustainable growth of an employer’
There are wider issues which the Committee may wish to consider; in our view there are a number of issues preventing scheme assets being used as effectively as possible. Chief amongst these is the lack of scale across a large number of small schemes and we believe options for scheme consolidation should be considered.

We have a strong working relationship with our colleagues at the Pensions Regulator, who face a range of challenges in delivering their statutory objectives. They are best placed to indicate the capacity, capability and resourcing that they would require to deliver a changed regime. This would be particularly so if the regime were to become more pre-emptive, requiring greater engagement, with a resultant greater focus on DB given the Regulator’s other regulatory responsibilities.

The situation that existed before the creation of the PPF and the penury it created for some members was clearly unacceptable. We believe that through our performance to date we have demonstrated the value of the protection we provide. We believe however that changes to the regime as outlined above would increase our sustainability, reduce risk to the PPF (and hence hopefully levies), and therefore provide clear benefits to members and levy payers.

*September 2016*