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The Pension Protection Fund (PPF) is a government-sponsored insurance scheme established by the 2004 Pensions Act with the aim of protecting members of private sector defined benefit schemes whose sponsoring firms become insolvent and have insufficient funds in their pension scheme to pay to the pensions promised to members in full. The PPF came into operation in April 2005 and has so far been a great success.

However, the PPF will live under the permanent risk of insolvency as a consequence of the moral hazard, adverse selection and, especially, systemic risks that it faces (see Blake et al (2007)).

Moral hazard is one of the classic risks facing all insurance providers: people become more careless once they are insured and also have an incentive to play ‘games’ against the insurer. Wallace (2016, Tables 2 and 3) shows the enormous range of ways in which scheme sponsors can game against the PPF. In particular, the PPF provides scheme sponsors with an incentive to underfund their schemes and invest in assets with higher expected returns and risks. If the assets perform well, the deficit will be reduced, but if the assets perform badly and the scheme becomes insolvent, the PPF will take over the pension liabilities. The PPF can respond by increasing the risk-based levy for an underfunded scheme, but this might not solve the problem and might actually make matters worse for a sponsoring company that is already in financial difficulty – and might actually trigger the insolvency that the PPF wants to avoid. For an employer, near to insolvency, there is a pronounced trade-off between pensions and jobs. In short, the PPF is not able to charge the appropriate risk-based levy for the schemes most likely to end up in the PPF.

Another classic risk that the PPF is exposed to is adverse selection: only those most likely to claim take out insurance. As with all forms of insurance, strong schemes subsidise weak schemes. The PPF is exposed to this risk because the levies charged by the PPF provide a strong incentive for financially strong employers to close down their DB schemes, leaving only the schemes of financially weak sponsors participating in the PPF. Although participation is mandatory if an employer has a DB scheme, there is no requirement for an employer to operate a DB scheme in the first place; and over the last 7-8 years, many of the strongest schemes have bought out their liabilities with insurance companies. This trend is only going to increase over the next few years. This could have a dramatic impact on reducing the total levy received by the PPF.

The PPF faces a very serious systemic risk because insolvencies are cyclical. Claims arise when firms become insolvent and the claim size depends on the level of underfunding. Since pension funds still have a heavy equity exposure, under-funding is therefore worst after sharp falls in stock markets and this is just when corporate insolvencies are likely to peak. Even if one accepts the PPF’s claims that claims will be low on average and hence manageable, the PPF is likely to experience years when the claims will be very high which will occur when prolonged weakness in equity markets coincides with widespread corporate insolvencies.

Harrison and Blake (2015) estimated that up to 1,000 DB schemes at serious risk of falling into the PPF. Of this, members of 600 schemes may only receive PPF compensation; many sponsors are expected to become insolvent in the next five-to-10 years. The remaining 400 sponsoring employers might initially survive, but may eventually fail if they are not able to off-load their pension obligations. The authors challenge the PPF’s assumption that, in time, the majority of these sponsors
will meet their pension promises in full. The PPF believes that it could deal with these insolvencies if they were spread out over the next 15 years. They would not be able to do this if the insolvencies were all bunched together as will happen in a recession.

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