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COMPTROLLER AND
AUDITOR GENERAL

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5 FEBRUARY 2010

Department for Work and Pensions

Pension Protection Fund

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Department for Work and Pensions

Pension Protection Fund

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

28 January 2010

The Pension Protection Fund (PPF) was established by the Pensions Act 2004. It provides compensation to members of UK private sector defined benefit pension schemes (most of which are commonly known as final salary) where an employer is insolvent and the scheme itself has insufficient funds to pay more than the Fund will pay in compensation.

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Summary

1 The Pension Protection Fund (PPF) was established by the Pensions Act 2004. It provides compensation to members of UK private sector defined benefit pension schemes (most of which are commonly known as final salary) where an employer is insolvent and the scheme itself has insufficient funds to pay more than the Fund will pay in compensation. The Fund protects some 12.4 million pensions in around 7,100 pension schemes. Of the people whose pensions are protected, 4.5 million (36 per cent) are already pensioners, 2.6 million (21 per cent) have not yet retired and are still accruing benefits, and 5.3 million (43 per cent) have not yet retired and have ceased to accrue benefits. The Fund is managed by the Board of the Pension Protection Fund, a public corporation.

2 In December 2009, the Fund was paying £7 million a month to some 15,000 pensioners (on average, about £450 a month each). The Fund is responsible for the future pensions of another 18,000 people who have yet to retire. As at December 2009, 109 pension schemes had transferred to the Fund. The Fund is assessing whether it needs to take over a further 268 pension schemes of insolvent employers, affecting 203,000 people.

3 The Fund's assets at 31 March 2009 were worth £3.2 billion. At the same date, the Fund estimated the current value of its existing liabilities, which fall due over the next 100 years, at £1.7 billion. The Fund bases this estimate on assumptions about life expectancy and current yields from investments, such as gilts. The Fund's balance sheet also included provisions for those schemes whose employers have experienced a qualifying insolvency event and which are likely to transfer to the Fund. The liabilities outweighed the assets of these schemes by £2.7 billion. The Fund therefore had a balance sheet deficit of £1.2 billion at 31 March 2009 (a funding ratio between assets and liabilities of 88 per cent), significantly more than the £0.5 billion deficit at 31 March 2008 (a funding ratio of 91 per cent). The deficit rose as pension schemes whose sponsoring employers have become insolvent entered assessment by the Fund and falling asset values and bond yields increased scheme deficits. The Fund's long term objective is to pay appropriate and timely compensation to all eligible recipients. The Fund seeks to manage the risk that its deficit is so great that it cannot achieve this objective.

4 The Pension Protection Fund is self-financing. Its income comes from compulsory levies paid by defined benefit schemes (£651 million collected in 2008-09) and investment returns from any assets it receives from transferred pension schemes (£257 million in 2008-09). If necessary, the Board can reduce any deficit by lowering the level of compensation the Fund pays or increasing the levy the Fund charges protected schemes (within statutory limits). The Fund benefits from the Pensions Regulator's responsibility to encourage employers to eliminate the funding deficits of their schemes within reasonable timescales so that, if a company becomes insolvent, any pension deficit is minimised.

5 Less than three years after the Fund was set up in 2005, it has been exposed to the consequences of a severe economic downturn. Our report examines whether the Fund, under the stewardship of the Department for Work and Pensions, is effectively managing its assets and the risks posed by its potential future liabilities. We have not examined whether the Fund will ultimately be able to meet all its liabilities, the appropriateness of the asset allocation within the investment strategy or how much it should raise through its levy.

Main findings

Investments

6 The Fund has not been exposed to severe losses resulting from the stock market decline in the current recession. The Fund's investment strategy is to hold a higher proportion of low risk investments by comparison with the average asset allocation of UK pension funds. In 2008-09, the Fund's investments, taken in aggregate, increased in value by 13.4 per cent. This outcome represents the combined return from gains or losses on the Fund's standard assets plus gains or losses from additional financial deals, known as swaps. The Fund's standard investments, excluding the additional financial deals, achieved a slightly better return (-3.4 per cent) than the market average for the same combination of asset classes (-3.6 per cent) in 2008-09. The Fund's approach to offsetting changes in the value of its liabilities as a result of changes in inflation and interest rates proved effective, adding £318 million to the Fund in 2008-09.

7 The Fund's investment operation is well placed to manage the assets it currently holds. Aspects of the Fund's management of its investments are exemplars of best practice. But, as the Fund's assets grow in size and complexity, the investment operation will require additional skills and more developed processes for managing and monitoring its external investment managers. The Fund is currently recruiting additional staff to its investment team.

Assessing potential future liabilities

8 The Fund's deficit has increased during the current recession. The deficit has grown from £500 million in March 2008, to £1.2 billion in March 2009. The deficit could grow further if more firms become insolvent and the Fund takes over under-funded schemes. The median output of the Fund's risk modelling, however, projects the deficit as falling to zero in 2013. The short term 'going concern' risk – that the Fund will not be able to pay compensation over the next 12 months – is negligible, as the value of its assets is many times greater than its current compensation obligations.

9 The Fund has developed a suitable means with which to assess its potential future liabilities. To gauge the extent of its likely future deficit, the Fund faces the difficult task of modelling how the economy might perform and what effect this might have on both employers' solvency and pension scheme assets and liabilities. The Fund's Long Term Risk Model to assess the effect on its balance sheet, mainly over five years, considers a very wide range of economic and insolvency situations. The Model has proved resilient to a range of sensitivity tests. The Model's long term projections, however, are sensitive to a number of important assumptions, particularly those relating to scheme closure or changes to investment strategies. The introduction of a formalised framework for explaining the effects of such assumptions could significantly improve understanding of the uncertainty around such projections.

10 The probability distribution of possible futures generated by the Model is an adequate reflection of past variation in market performance and includes extreme economic scenarios. During, or in anticipation of, times of economic stress, however, the Model should examine in greater detail the impact of severe economic scenarios. In December 2008, the Fund adapted the Model to provide a detailed assessment of the risk presented by a range of specific forward-looking recessionary scenarios. Since December 2008, the Fund has regularly adapted the Model to enable it to examine in greater detail the potential impact of specific severe economic scenarios. Such analysis is a useful component of the Fund's risk monitoring apparatus and one which might valuably be expanded.

11 The Fund and the Department have considered how to address the potential risks facing the Fund but have not set any simple trigger points to prompt potential mitigation. The complexity and long term nature of the risks facing the Fund, such as movements in asset prices, interest rates and insolvency rates, preclude such an approach. In the circumstances, regular review and discussion, with the Department and the Regulator, of key metrics, such as the ratio of the Fund's assets to its liabilities, is a better alternative.

Oversight of the Fund

12 The Department has set up a clearly articulated stewardship structure in line with available government guidance. The Department has increased its involvement in monitoring the risks to the Fund in the current downturn and has played a central role in directing the Fund's Board's assessment of the risks of the current recession. Since October 2008, the Fund, the Department, the Pensions Regulator, the Financial Services Authority, HM Treasury and the Department for Business Innovation and Skills have met regularly to monitor the impact of the economic downturn on pension provision and the UK pension protection regime.

Value for money conclusion

13 For the Fund to represent value for money, it must manage the balance of its assets against its liabilities to provide an adequate level of protection while minimising the cost of the levy. To achieve this balance, the Fund must invest efficiently and have suitable means to assess and respond to the potential impact of future claims. Against these criteria, the Fund has delivered value for money thus far. It managed its investments satisfactorily to achieve an aggregate return in 2008-09 of 13.4 per cent, after taking into account deals to manage the impact of inflation and interest rate changes. The Fund has also developed a suitable model for assessing the impact of potential future claims. Nonetheless, the Fund needs to take steps to maintain value for money in future, in particular, adapting its investment processes to reflect the growing value of its assets, continuing regularly to audit its risk model and establishing a framework for illustrating the sensitivity of its longer term risk modelling projections.

Recommendations

14 The value of assets transferred to the Fund is expected to reach at least £4 billion by April 2010. For its investment operation to continue to operate efficiently in the light of an increasing portfolio of assets, the Fund should:

a complete its review of the roles and responsibilities of its Investment Committee and Asset and Liability Committee. This should consider increasing the delegation of responsibility to the Asset and Liability Committee, particularly with regard to the replacement of investment managers. [paragraph 2.14]

b fully develop objective procedures for actively responding to ratings decline among Fund Managers and appointing replacements. [paragraph 2.15]

c further develop, in line with best practice, capability for detailed analysis of the prospective performance of managers to minimise the risk of counter-productive investments. [paragraph 2.16]

15 The Fund has developed a suitable model for assessing its potential future liabilities. For the Model to be more responsive to changing circumstances, the Fund should:

a review the transition matrix, which models how probability of default against credit can change over time, in light of recent experience. [paragraph 3.6]

b continue to audit the Model regularly, and at least once every five years to review the cumulative effect of small structural changes, or when large model changes occur, to continue to provide assurance that the methodology and outputs are reasonable and robust. [paragraph 3.4]

c model routinely over the truly long term (15 to 30 years). [paragraph 3.8]

d continue to improve the documentation of the Model in line with emerging best practice. [paragraph 3.11]

e establish a framework for illustrating to a wider audience the sensitivity of modelling results to all key assumptions, such as the specific circumstances of recessionary scenarios. [paragraph 3.10]

f consider further consultation on the operation of the Model to make it more accessible to employers paying the levy on behalf of schemes. [paragraph 3.9]

16 The recession could increase the Fund's deficit considerably as it takes on the under-funded schemes of a growing number of insolvent employers. To guard against the prospect of an unmanageable deficit, the Fund regularly discusses key metrics, such as the ratio of the assets to liabilities, with the Department and the Regulator. The Fund and the Department should review these metrics each year to confirm their suitability. [paragraphs 3.20 and 4.6]

Part One

Pension protection arrangements in the UK

1.1 The Pension Protection Fund provides compensation to members of UK private sector defined benefit pension schemes where an employer is insolvent and the scheme itself has insufficient funds to pay benefits above the level of compensation provided by the Fund.[1] There are 12.4 million members of defined benefit pension schemes protected by the Fund. Some 36 per cent are already pensioners; 21 per cent have not yet reached retirement and are still accruing future benefits; and 43 per cent have not yet reached retirement but have ceased to accrue benefits (for example, because they are no longer employees).

1.2 The Fund was set up under the Pensions Act 2004 in April 2005, along with a new regulatory framework for private sector pensions. The creation of the Fund was prompted by a number of cases – such as that of Allied Steel and Wire – in which, following an employer's insolvency, employees had lost most or all of their expected pension benefits.

1.3 As at December 2009, the Pension Protection Fund had taken over 109 pension schemes with around 32,000 members in total. Of these members, 15,000 are pensioners receiving on average £450 a month. The Fund is assessing whether to take over a further 268 schemes with 203,000 members.[2]

1.4 In addition to the assets from transferred pension schemes (£616 million in 2008-09), the Fund's income comes from compulsory levies on eligible companies (£651 million in 2008-09) and investment returns from any assets it gets from transferred pension schemes (£257 million in 2008-09). Under the legislation, the amount by which the Fund can increase the levy estimate in any one year is restricted to 25 per cent of the previous year's estimate. The total charged may not exceed the levy ceiling. For 2009-10 this ceiling is set at just over £863 million. The Fund can also alter the rates at which compensation is revalued and indexed.

1.5 In 2008-09 the Fund paid out £38 million in compensation to pensioners.[3] The Fund predicts this compensation will rise to over £100 million in 2009-10 as it takes over further schemes. Payments will increase over the next 30 years as the number of retired members of pension schemes increases and life expectancy continues to rise. The Fund estimates

1 There are two main types of private sector pension scheme. Defined benefit schemes typically pay members a proportion of their final salary on retirement. The risk that scheme assets are worth less than the liabilities is borne largely by the scheme sponsor. Defined contribution schemes typically build up a fund which allows members to purchase an annuity on retirement. The risk of the fund performing poorly is borne by the scheme member.

2 Position at 31 December 2009.

3 While a scheme is being assessed as to whether it should be transferred to the Fund, members of the scheme receive, or can start receiving, benefits paid from the scheme's assets.

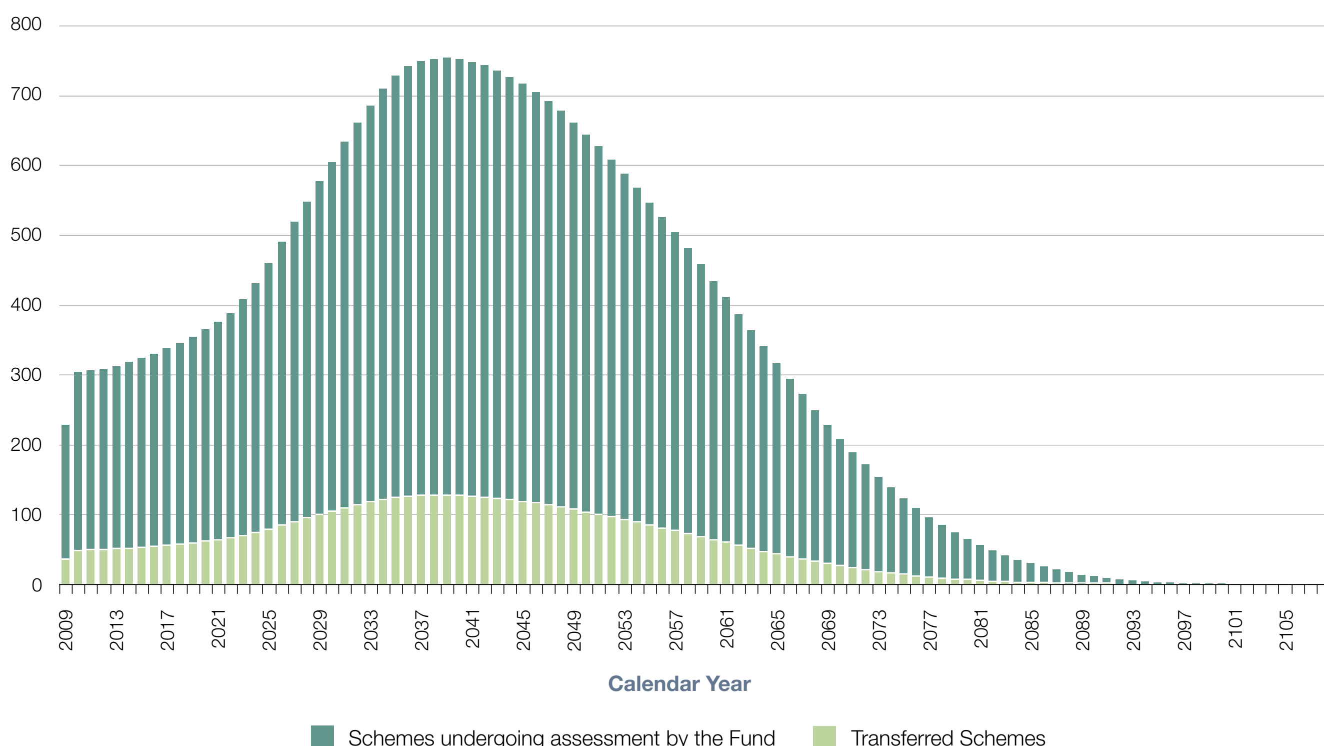
the amount of compensation it pays each year will peak in the 2040s (**Figure 1**). It bases this estimate on current schemes and those schemes it is assessing for potential takeover where an employer has become insolvent. The Fund could continue to have compensation obligations from these schemes a hundred years from now as payments may still be due, at this point, to scheme members and their dependants.

1.6 Once a scheme transfers to the Fund, those members who are already receiving a pension and are above normal retirement age at the time of their employer's insolvency will continue to receive their full pension. Those members who have not yet reached the normal retirement age of the scheme, or are yet to start receiving pension payments, receive compensation paid at the rate of 90 per cent of their accrued pension at the point of insolvency, revalued to normal retirement age. The total the Fund will pay as compensation to an individual below normal pension age at the date of their employer's insolvency is subject to a cap. The cap is applied at the point of reaching normal retirement age. Between April 2009 and March 2010, the cap at the age of 65 equates to £28,742. The cap is actuarially adjusted for people taking their compensation at ages other than 65.

Figure 1

The Pension Protection Fund's projected pattern of compensation obligations shows a peak in the 2040s

Projected annual payments to members of eligible schemes currently in the Fund or in assessment



Source: Pension Protection Fund

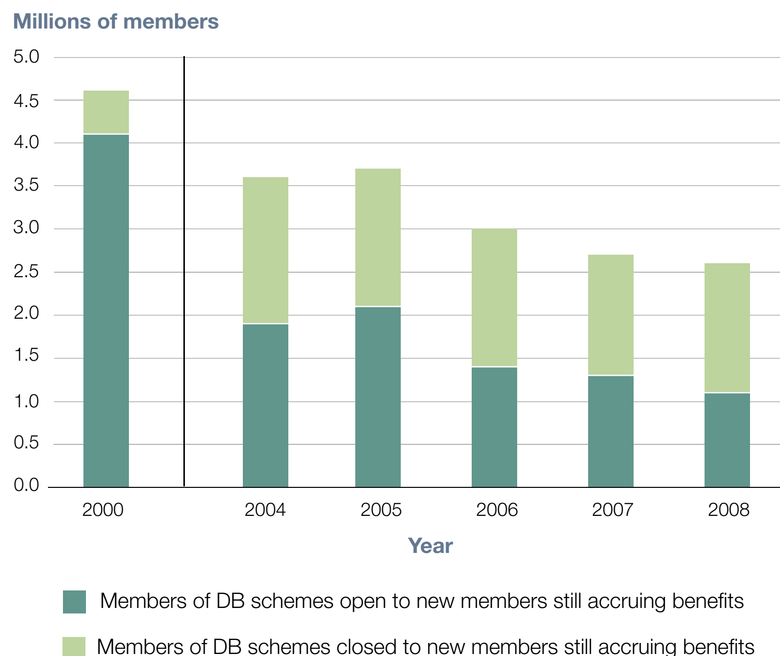
1.7 The number of people accruing benefits in private sector defined benefit schemes in the UK has been steadily declining over the last decade (**Figure 2**) as the number of employers offering defined benefit schemes to new entrants has fallen. A number of employers, having closed their schemes to new and current members, have paid insurance companies, regulated by the Financial Services Authority, to take on the remaining pension liabilities. In these cases, the Fund no longer provides protection and can no longer charge a levy. The number of schemes paying the levy has fallen from 7,300 in 2008 to 7,100 in 2009.

Pension Protection Fund structure

1.8 The Board of the Pension Protection Fund is a public corporation under the stewardship of the Department for Work and Pensions. The Department covers the Fund's administration costs (£18 million in 2008-09). This amount is recovered through a levy collected from protected defined benefit schemes by the Pensions Regulator (**Figure 3** overleaf). The Fund benefits from the Pensions Regulator's responsibility to encourage employers to eliminate the funding deficits of their schemes within reasonable timescales so that, if a company becomes insolvent, any pension deficit is minimised.

Figure 2
Declining membership of defined benefit schemes

Number of members of private sector defined benefit pension schemes 2000 to 2008[1] still accruing benefits



Source: Office of National Statistics Occupational Pensions Survey 2008

NOTE
1 Comparable data are not available for 2001-2003.

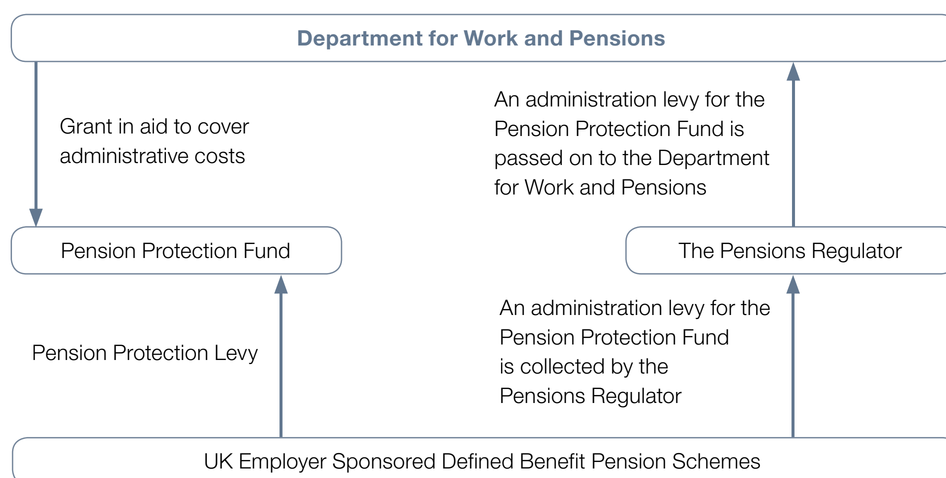
To preserve its political independence, the Fund is run at arm's length from Government. The Board has a majority of non-executive members drawn from a range of professional backgrounds and with experience and expertise in the field of pensions.

Scope

1.9 This report examines whether the Fund, under the stewardship of the Department for Work and Pensions, is effectively managing its assets and the risks posed by its potential future liabilities. We examined whether the Fund followed good practice in its management of its assets. We also examined the suitability of the Fund's approach to modelling risk and whether these risk assessments have adequately informed the Fund's decision making. We have not sought to form a view on whether the Fund will ultimately be able to meet all its liabilities, the Fund's choice of asset allocation, the size of the levy, the assessment process or compensation levels. This report does not examine the work of the Pensions Regulator, on which we reported in 2007.[4] Our audit methodology is set out in Appendix 1.

1.10 The Board of the Pension Protection Fund manages two other compensation schemes which fall outside the scope of this report. The Fraud Compensation Fund provides compensation to members of occupational pension schemes which suffer a loss that can be attributed to dishonesty. It is funded by a Fraud Compensation Levy, and is managed separately from the Fund. In broad terms, the Financial Assistance Scheme helps people who have lost out on their pension because they were a member of an under-funded defined benefit scheme that started to wind up after 1 January 1997 but before the Pension Protection Fund was created. The Pension Protection Fund took over the management of the Scheme in July 2009. The Financial Assistance Scheme is government funded.

Figure 3
Funding the pension protection regime



Source: National Audit Office

4 *The Pensions Regulator: Progress in establishing its new regulatory approach*, National Audit Office, HC 1035, 2007.

Part Two

Investments

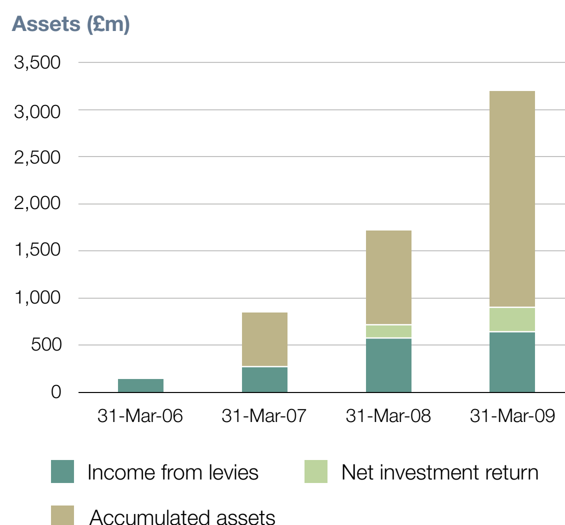
2.1 This part of the report examines how well the Pension Protection Fund manages its assets compared to good practice. In particular, it addresses investment performance, with the context of the Fund's investment strategy, and governance arrangements.

Investment performance

Assets and investment strategy

2.2 The value of the Pension Protection Fund's assets has risen rapidly since it was set up in 2005. The assets were valued at £141 million at 31 March 2006, and could be worth at least £4 billion by April 2010 (**Figure 4**). The Fund's assets are accumulated from transferred schemes, the return on its own investments and the levy. As the assets received from transferred schemes grow, investment returns will make up an increasingly significant part of the Fund's income. The size of the Fund's assets, and the rate of growth, require a sound approach to investment management.

Figure 4
The Sources of the Pension Protection Fund's assets



Source: Pension Protection Fund Annual Report and Accounts 2005-06 – 2008-09

2.3 The Pension Protection Fund invests the assets it receives from transferred pension schemes, and its levy income, in a range of assets such as cash, bonds and stock market shares. Cash and bond investments offer relatively low returns but are low risk. Other types of investment, such as shares, offer potentially higher returns but have a greater risk for loss in value. The Fund makes investments in line with a strategy which is low risk compared to UK private sector pension funds. Some 70 per cent of the Fund's investments are in low risk asset classes such as bonds and cash (**Figure 5**). The remaining 30 per cent is invested in assets with growth potential: mainly equities (i.e. shares) and property. The average asset allocation of UK defined benefit pension funds is 46 per cent in bonds and cash, and 54 per cent in equities and other growth assets.[5]

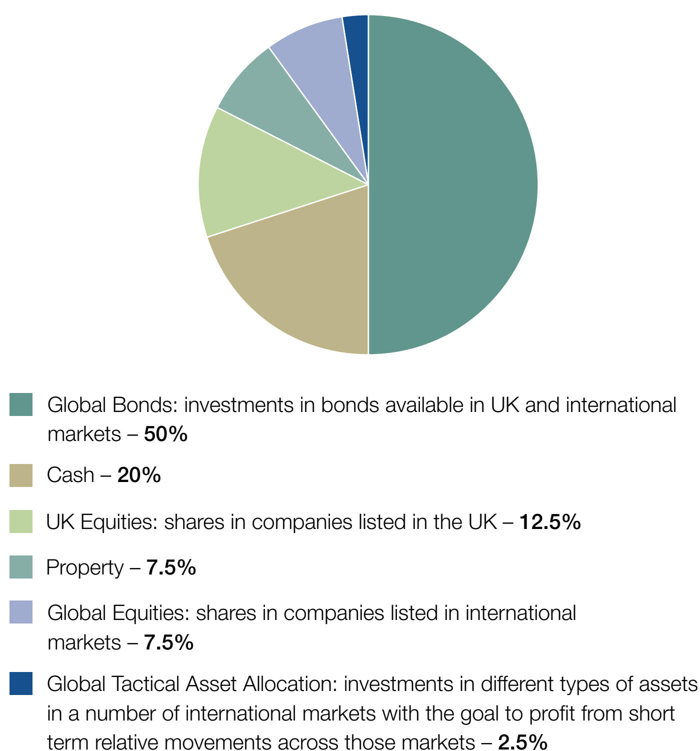
2.4 The Fund's investment strategy is more risk-averse than that adopted by the United States Pension Benefit Guaranty Corporation in 2008. The Corporation is the counterpart to the Fund and was set up in 1974 to protect members of defined benefit pension schemes in the USA. Between 30 September 2007, and 30 September 2008, the value of the Corporation's total investments fell by 6.5 per cent. This was largely due to a 23.2 per cent ($4.8 billion/£2.9 billion) fall in the value of its equities, which represented 27 per cent of the Corporation's total invested funds in September 2008. In 2009, the Corporation invested 37 per cent of its total invested funds in equities. These equities fell in value by 1.6 per cent over the financial year. Nevertheless, if the value of its investments in equities recovers, the Pension Benefit Guaranty Corporation could achieve much greater returns in the future.

Implementation of investment strategy

2.5 Our review of the Pension Protection Fund's processes for implementing its investment strategy found that they are broadly robust and carried out with competence and diligence compared with best practice in institutional fund management.[6] In 2008-09 the Fund employed seven firms to manage its asset investments: two to manage its UK equities; two to manage its global bonds; and three to manage its property, UK bonds and global equities.[7] The firms were all 'active' managers whose aim is to select investments to outperform the general market. Active managers carry a risk of underperformance, when compared with 'passive' managers, whose aim is to replicate the market. In February 2009, the Fund employed Legal & General as a passive UK equity manager. The number and style of investment managers chosen by PPF is appropriate to the investment strategy which the Fund has adopted. The rest of this section analyses performance against Fund benchmarks and the areas where individual gains and losses arose.

5 European Asset Allocation Survey, Mercer 2009.
6 Russell Investments provided to the National Audit Office an assessment of the Pension Protection Fund's implementation of its investment strategy against a model investment framework, the Russell Fiduciary Ladder.
7 The investment firms were Aviva, Goldman Sachs Asset Management, Insight, Lazard, Newton, Pacific Investment Management Company and State Street Global Advisors.

Figure 5
The Pension Protection Fund's investment strategy asset class allocation



- Global Bonds: investments in bonds available in UK and international markets – **50%**
- Cash – **20%**
- UK Equities: shares in companies listed in the UK – **12.5%**
- Property – **7.5%**
- Global Equities: shares in companies listed in international markets – **7.5%**
- Global Tactical Asset Allocation: investments in different types of assets in a number of international markets with the goal to profit from short term relative movements across those markets – **2.5%**

Source: Pension Protection Fund

2.6 In 2008-09, the Fund's investments, taken as a whole, increased in value by 13.4 per cent. This outcome represents the combined return from gains or losses on the Fund's standard assets plus gains or losses from additional financial deals, known as swaps. In 2008-09, the Fund made a 3.4 per cent loss on standard asset investments and a 16.8 per cent gain from swaps.

2.7 The Fund monitors the performance of its standard asset investments against a strategy benchmark. This benchmark represents the return that would have been achieved if investments had reached the market index return within each asset class, having invested in each class in proportion to its weight in the strategy. The Fund's investments outperformed the strategy benchmark in 2008-09. In this period, the Fund's assets lost 3.4 per cent of their value while the strategy benchmark dropped by 3.6 per cent. The similarity of the results over a period of great market turbulence suggests investments were managed well and with low risk. The performance of the Fund's investments is summarised in **Figure 6** overleaf.

Figure 6

Summary of performance of the Pension Protection Fund's standard assets (excluding gains or losses from additional financial deals, known as swaps)

	2007-08 (%)	2008-09 (%)
Return on standard assets	+3.6	-3.4
Fund Strategy Benchmark for return on standard assets[1]	+3.7	-3.6
Performance against Fund Strategy Benchmark	-0.1	+0.2
Fund target for return on standard assets[2]	+7.7	+6.2
Performance against Fund target	-4.1	-9.6

Source: Mercer/Pension Protection Fund

NOTES

1 Based on a return against the market generally.

2 1.4 per cent above the 3-month London Interbank Offered Rate (LIBOR).

2.8 The Fund also monitors the performance of its investments against the 3-month London Interbank Offered Rate (LIBOR) benchmark. This is the rate of return which would be achieved if the Fund was lending to commercial banks in the London wholesale money markets. The Rate is a useful comparator against which to measure how well the Fund's standard investments are keeping pace with its liabilities as they increase in line with inflation and interests rates over the longer term (five to 10 years). The Fund has set a target of outperforming this benchmark by 1.4 per cent. The Fund has not achieved this target in either of the last two years, falling short by 4.1 per cent in 2007-08 and by 9.6 per cent in 2008-09 (Figure 6). Given the severity of the recent stock market downturn, failure to meet this target in the last two years does not necessarily indicate poor investment management. To help achieve the targeted return through greater diversification, the Fund has nevertheless amended its investment strategy to include a 2.5 per cent global tactical asset allocation.[8] The allocation of a small percentage of the Fund to a variety of investments in a number of global markets is intended to allow the Fund increased flexibility.

2.9 The Fund assesses the performance of its managers in individual investment classes against benchmarks to reflect the rate of return which might be reasonably expected for those classes. The benchmarks are appropriate proxies for the average investor's experience (**Figure 7**). Individual fund managers are appointed in accordance with EU regulations. The Fund draws on information provided by its Investment Adviser, Mercer, in setting the mandate for new managers. Remuneration of managers is typically performance related, and reflects standard practice within the investment industry.

8 This allocation represents a flexible portfolio of investments in different assets classes and markets with the aim of profiting from short term relative market movements.

2.10 The performance of the individual managers has been variable, as is typical of active investment management, but broadly within expected bounds. **Figure 8** presents the performance of the individual managers for 2008-09.

Figure 7
The performance benchmarks for the Pension Protection Fund's investments

Asset Class	Strategic Allocation (%)	Asset Benchmark
Cash Collateral	20.0	3-month London Interbank Offered Rate
Global Bonds	50.0	JP Morgan Government Bond Index (hedged to sterling)
UK Equities	12.5	FTSE All-Share Index
Global Equities	7.5	FTSE All-World Index (hedged to sterling)
Property	7.5	Investment Property Databank Index
Global Tactical Asset Allocation	2.5	3-Month London Interbank Offered Rate

Source: Pension Protection Fund

Figure 8
The Fund's investment managers' performance in 2008-09

Investment Manager	Asset Class	Portfolio Return (%)	Benchmark Return (%)	Performance against benchmark (%)
Newton	Global Equity	-35.4	-36.2	0.8
Insight	UK Bonds	8.3	7.7	0.6
Lazard	UK Equity	-29.2	-29.3	0.2
Aviva	Property	-27.2	-25.6	-1.7
Goldman Sachs Asset Management	Global Bonds	5.9	8.1	-2.2
State Street Global Advisors	UK Equity	-31.6	-29.3	-2.3
Pacific Investment Management Company	Global Bonds	1.3	8.1	-6.8

Source: Mercer/Pension Protection Fund – Performance Report March 2009

2.11 In 2008-09, the Fund's investments, taken as a whole, increased in value by 13.4 per cent. This was achieved primarily as a result of a gain from financial deals known as swaps. These deals are designed to minimise the impact of changes in the value of liabilities through changes in interest rates and inflation. The deals should provide a financial gain when liabilities increase in value, but lead to a loss where liabilities decrease. This approach – known as 'liability driven investment' – aims to allow asset values to keep pace with the value of liabilities. The increase in the Fund's liabilities in 2008-09 was partially offset by gains of £318 million (16.8 per cent) from swaps deals. These gains turned a 3.4 per cent loss on standard asset investments, as shown in Figure 6, into a 13.4 per cent gain on assets as a whole. The Fund uses one of its investment managers, Insight, to manage these deals. Deducting the growth in the liabilities in 2008-09, through falling interest rates and rising inflation, the net gain to the Fund from these deals was £103 million.

2.12 One consequence of the Fund's swap deals, however, is the need to hold sufficient money as collateral to pay out if interest rates rise and the Fund's liabilities fall in value. If interest rates were to rise very sharply, accessing sufficient collateral could disrupt the Fund's other investments. In August 2009, new arrangements were put in place to manage the Fund's exposure to this risk. But as liabilities, and the size of the related collateral requirements, continue to grow, the Fund will need to check that its arrangements for managing increased collateral requirements are adequate. The Fund encourages schemes it is assessing, prior to a potential transfer, to manage their exposure to changes in interest rates and inflation to reduce the strain on amounts held as collateral.

Fund governance

2.13 **Figure 9** shows how the Fund oversees its investments. The Board is responsible for the investment strategy; the Investment Committee oversees the implementation of the strategy and appoints and terminates investment managers; the Asset and Liability Committee monitors the implementation of strategy, reviews the performance of investment managers and manages risks. The Investment Committee currently carries both oversight and more direct management responsibilities.

2.14 Pension funds best practice suggests the delegation of investment management matters to an investment sub-committee.[9] In the case of the Pension Protection Fund, the Asset and Liability Committee should carry out the 'managing' role of an investment sub-committee, while its Investment Committee carries out the 'governing' role. The Fund has not rigorously maintained such a division of responsibilities since it set up the Asset and Liability Committee. As the complexity of investment operations grows, there is consequently a risk that the work of the Committees will overlap unprofitably.

2.15 The Fund's management of its current investment managers largely reflects best practice for pension funds. The first requirement of investment managers is that they should be judged likely to deliver superior returns. Falls in managers' ratings, which suggest the possibility of lower returns in future, are not rare events.[10] Over the course of a year, between 10 per cent and 30 per cent of top-rated managers in a given class

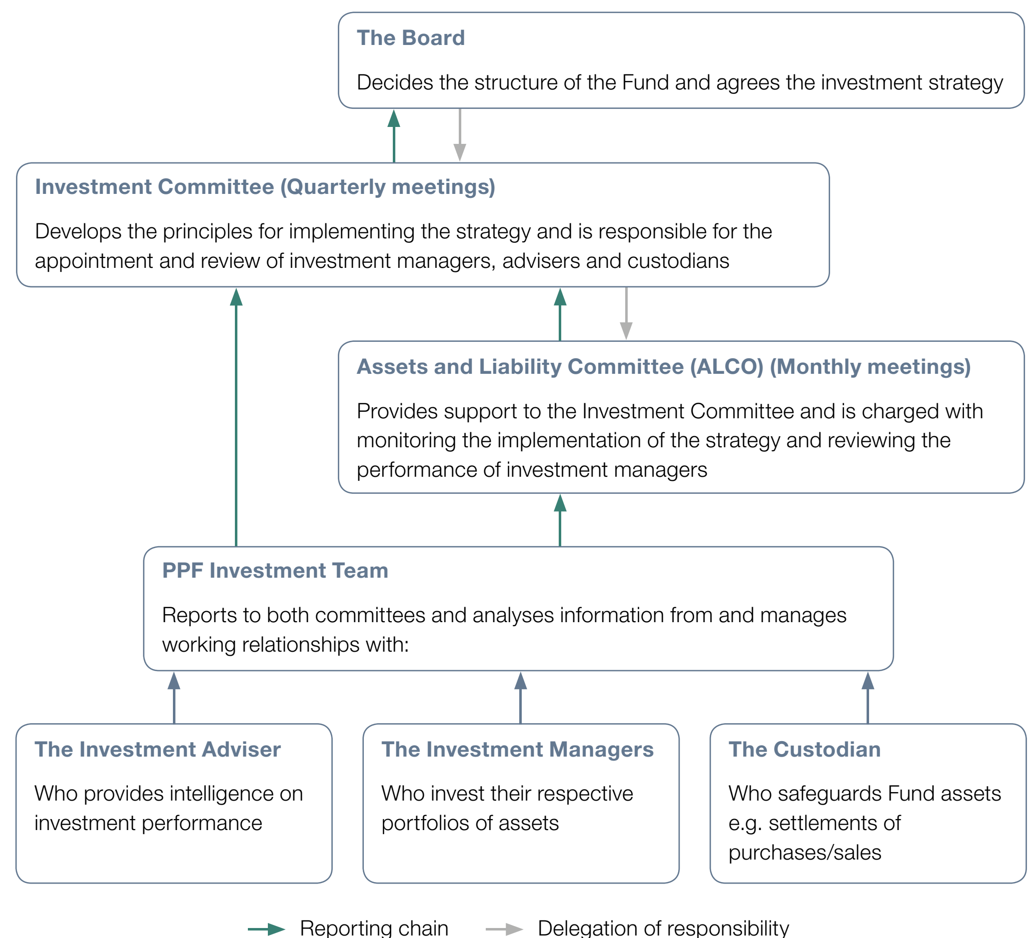
9 Ezra, D. & Ambachtsheer, K. *Pension Fund Excellence* (1998); Ilkiw, J. *The Portable Pension Fiduciary* (1997).
10 Ratings are determined by a financial advisory company (Mercer) on the basis of an assessment of a manager's prospective future performance.

may be expected to suffer a drop in their rating. It is, therefore, important for the Fund to regard this as normal and to have rigorous procedures for dealing with it. The Fund has not fully developed an objective procedure for responding to a drop in rating given to an investment manager (e.g. triggering a replacement process or by defining a timetable for other action).

2.16 The Fund employs a number of different investment managers to balance the risk of underperformance by any one manager. As its assets grow, the Fund will need to use a larger number of investment managers. The skills of the Fund's investment team will therefore need to be developed to handle and monitor the additional managers. For example, the Fund could develop, in line with best practice, further capability for detailed analysis of the prospective performance of managers to minimise the risk of counter-productive investments. The Fund has nearly completed a recruitment programme to address the capacity of its investment team.

Figure 9

The Pension Protection Fund's Investment Operation



Source: National Audit Office

Part Three

Managing the risks of potential future liabilities

3.1 This part of the report assesses how well the Pension Protection Fund manages the risks posed by its potential future liabilities. In particular it covers:

- short and long term risks;
- the impact of the recession;
- responding to the risks;
- risk management approaches; and
- the process of taking over transferred pension schemes.

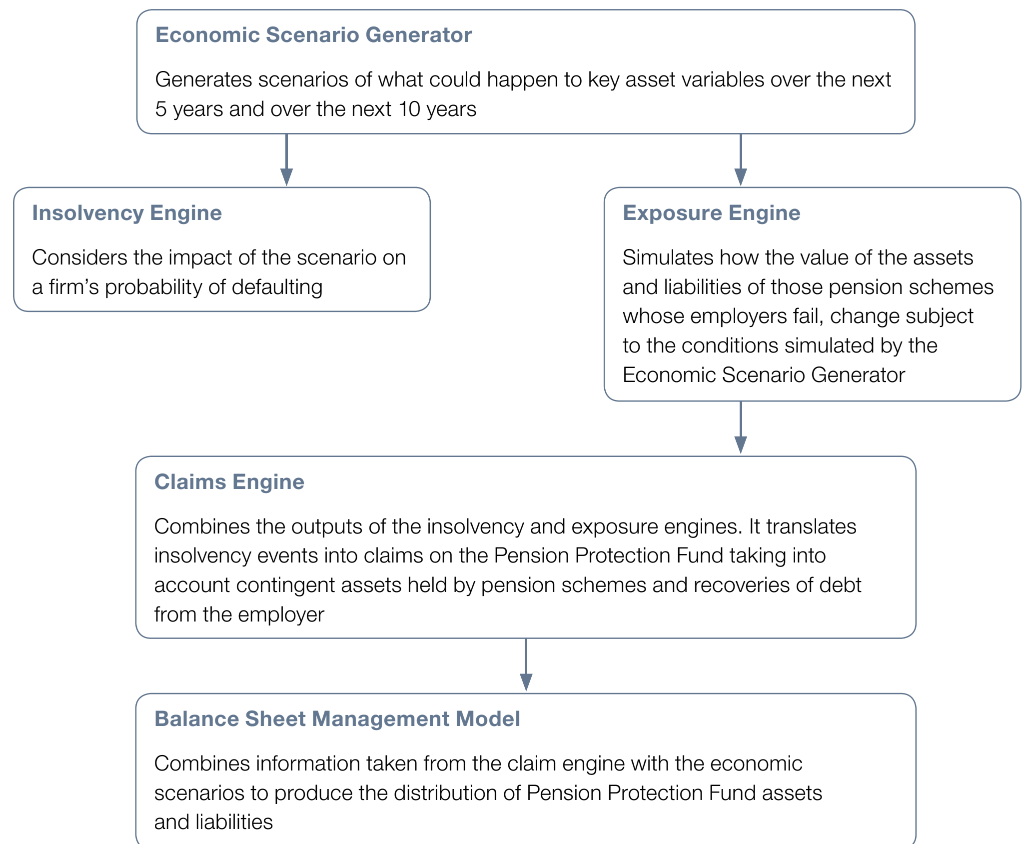
Short and long term risks

3.2 The 2008-09 Accounts note that there is "a reasonable expectation that the Fund will have adequate resources to continue in operational existence for the foreseeable future".[11] Although liabilities have increased considerably as a result of the recession, they fall due over many years. In the short term, compensation costs, £70 million in 2009[12], are not expected to exceed £150 million in the coming year, whereas the Fund's assets are worth £3.2 billion. Furthermore, as more employers become insolvent and schemes transfer to the Fund over the next two years, the value of its assets is expected to exceed the yearly payments by still greater amounts.

3.3 Over the longer term, the Fund must manage the risk that the deficit between its liabilities and assets becomes too great (i.e. that future compensation becomes unaffordable). To address this, the Fund seeks to assess the potential scale of future claims to inform decisions on how much levy to raise and how much is needed from its investments. The Fund does this through its Long Term Risk Model (**Figure 10**). The Model generates a range of economic scenarios and assesses the impact in each scenario on the Fund's balance sheet, usually over a five-year period. The Model calculates the level of the claims on the Fund in 500,000 scenarios by combining 1,000 economic scenarios with 500 credit risk scenarios. From this, the Model constructs a probability distribution of the level of claims.

11 Pension Protection Fund Annual Report and Accounts 2008-09 p.32.
12 Compensation payments were £70 million in calendar year 2009 and £38 million in financial year 2008-09.

Figure 10
The Fund's Long Term Risk Model



Source: National Audit Office

3.4 The Model is particularly sensitive to starting assumptions about the funding position of pension schemes, tending towards positive outcomes when starting from a good funding position, and negative outcomes when starting from a bad funding position. Such volatility is driven by defined benefit pension schemes' exposure to fluctuations in asset prices. Care must be taken to ensure stakeholders are aware of the capacity of the Model's risk assessments to shift in line with scheme funding.

3.5 The Fund's Model provides a reasonable prediction of company insolvencies on the basis of the probability of default against credit. For companies not publicly listed, this assessment is made on the basis of Dun & Bradstreet failure scores. The Fund has undertaken detailed research into the strengths and weaknesses of Dun & Bradstreet scores as a measure of insolvency probability. These scores are currently seen by the Fund as the most comprehensive and effective set of indicators available for non-publicly listed companies. For publicly listed companies, the Fund uses analysts' credit ratings

and market implied ratings from KMV Moody's and Fitch Solutions. All these ratings models are widely used by businesses as a means of assessing the probability of default against credit. The limitations of credit ratings as indicators of company solvency were highlighted by the rapid and not widely foreseen onset of the economic downturn in the US and UK. Nonetheless, we have not identified more effective alternatives with the breadth and consistency of coverage necessary for the Fund's purposes.

3.6 To match the probability of insolvency in one year to the term of the Model, the Fund employs a transition matrix which models how probability of default against credit can change over time. The transition matrix has not been updated since it was developed in 2005. The Fund should consider reviewing the matrix in light of recent experience.

3.7 The Model relies on up-to-date information on pension schemes. The Fund works with the Pensions Regulator to collect appropriate data from all eligible pension schemes. A 2007 National Audit Office report on the Pensions Regulator noted significant improvements to the completeness and timeliness of data collection since 2005.[13] Coverage is not yet complete, however, with full data unavailable for approximately 6 per cent of schemes eligible for the Fund. These schemes only represent 4 per cent of defined benefit pension schemes' liabilities and the insertion of actual data would not have a significant effect on the Fund's projections of its balance sheet deficit. Nonetheless, full coverage of scheme data could result in a marginal improvement in the Model's accuracy, especially when modelling outcomes for smaller schemes.

3.8 The Model is not routinely used to assess potential future liabilities over the truly long term, although such projections have been used in the most recent Annual Report and Accounts. The Fund currently routinely models over five years and over ten years. Routine, rather than *ad hoc*, assessments over the longer term (15 to 30 years) may enhance the Fund's perspective on the financial risks to the protection of future pensioners.

3.9 Despite the publication of an explanatory paper in August 2007, stakeholders continue to suggest that the workings of the Model are not transparent. Major levy payers argue that the Fund should provide more detailed information on the operation of the Model, in particular, the methodology for deriving insolvency risk over five years. The Fund has consulted widely on the inclusion of 'long term' risk in the determination of individual levies. But further consultation exercises to make the operation of the Model more transparent to stakeholders could help both to satisfy levy payers and identify potential improvements to the Fund's capacity to assess risk over the longer term.

13 *The Pensions Regulator: Progress in establishing its new regulatory approach*, National Audit Office, HC 1035, 2007.

3.10 The Model's long term projections are sensitive to a number of important assumptions, particularly those relating to future scheme behaviour. The complexity of decision processes shaping future scheme investment strategy and scheme closure, for instance, leads to the use of assumptions to plot their future development. At present, the Fund does not routinely and consistently explain the potential impact of these assumptions on modelling output. The Fund should establish a formalised framework for highlighting these sensitivities to stakeholders as part of its reporting protocol.

3.11 The Fund has not yet fully documented the workings of the Model and the methodology for adjusting it to reflect specific circumstances of recessionary scenarios, such that they are fully accessible and open to scrutiny and replication by others, e.g. the Department for Work and Pensions. The Fund is aligning the Model's documentation with the standard set for insurers under European Regulations scheduled to come into force in 2012.

Assessing the effect of the current downturn

3.12 The Fund's deficit has increased during the current recession. The deficit has grown from £500 million in March 2008, to £1.2 billion in March 2009 as the Fund has taken over more pension schemes. The Fund has identified scenarios in which the deficit could grow further over the next two years as the recession makes more companies insolvent and worsens pension schemes' deficits. However, it currently expects its deficit to diminish to zero in 2013.[14] The Fund takes a number of sensible steps to assess how it might be affected by the recession.

3.13 To assess its potential exposure, the Fund measures each month the assets and liabilities of defined benefit pension schemes, eligible for protection.[15] At the end of December 2009, the deficit was £32.6 billon, with the ratio of assets to liabilities at 96 per cent (**Figure 11** overleaf).[16]

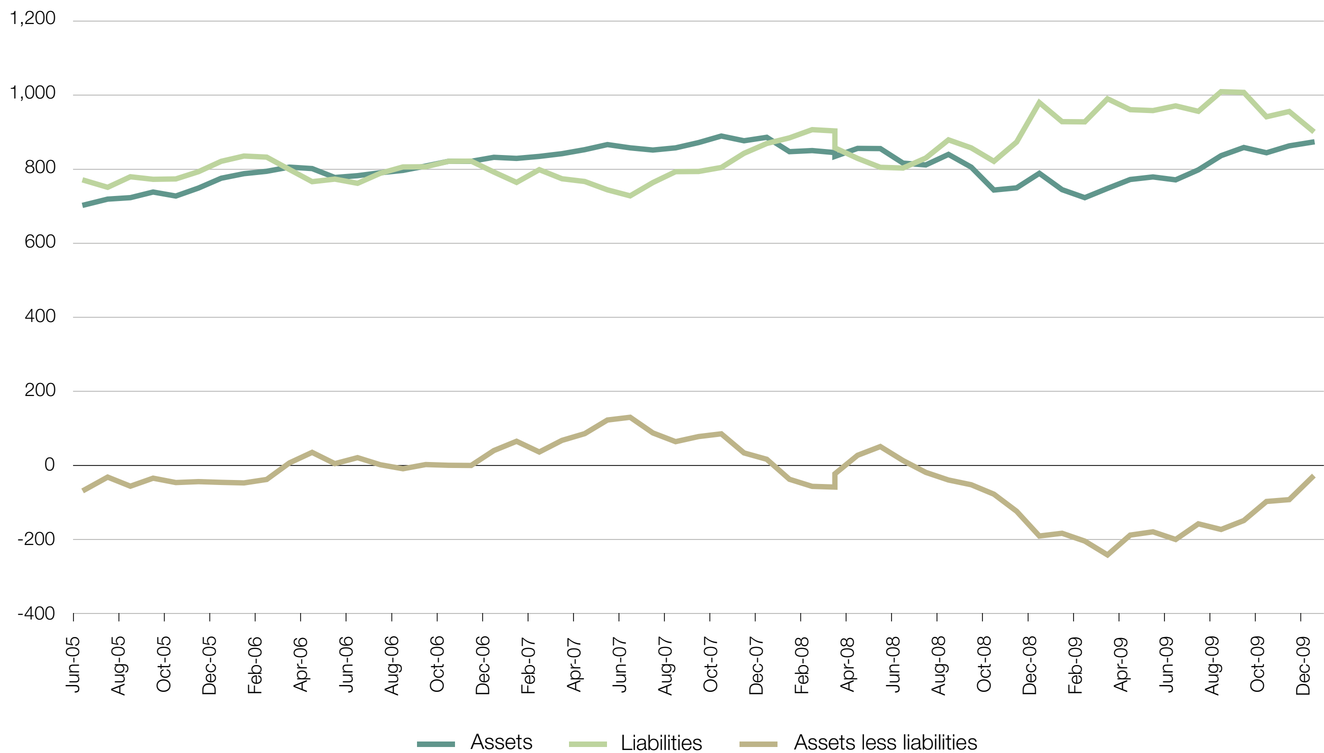
14 This projection is based on a levy estimate of £700 million indexed to future earnings and asset return, and insolvency projections consistent with historical observation.

15 The calculation uses a valuation of liabilities which reflects what would have to be paid to a private insurance company for it to take on the obligation to pay pensioners compensation at the same level as Pension Protection Fund. The terms are in Section 179 of the Pensions Act 2004.

16 Valued on a Section 179 basis, PPF 7800 Index: January 2010.

Figure 11

Estimated aggregate assets and liabilities of defined benefit schemes paying the Pension Protection Fund levy (June 2005 – December 2009)



Source: Pension Protection Fund

3.14 The probability distribution of possible futures generated by the Model is an adequate reflection of past variation in market performance and includes extreme economic scenarios. During, or in anticipation of, times of economic stress, however, the Model should examine in greater detail the impact of severe economic scenarios, based on plausible characterisations of adverse economic circumstances. Following the collapse of Northern Rock, the Pension Protection Fund and the Department carried out, in November 2007, a detailed assessment of how the Fund might be affected by the recession based on August 2007 outputs from the Model. The assessment indicated that the probability of the Fund carrying a deficit of £5 billion (a ratio of assets to liabilities of 83 per cent) after five years was 1 in 40, consistent with the consensus economic forecast of the time.[17]

17 Forecasts for the UK economy, A comparison of independent forecasts, HM Treasury, November 2007.

3.15 In June 2008, the Fund produced an updated assessment of the risks, in the light of the indications of potential severe recession then evident, such as the erratic and then falling FTSE 100 from early to mid-2008, a key indicator for the Fund. Given such signals, the production of additional forecasts on the basis of lower asset return assumptions may have furnished the Fund with a fuller picture of the potential effects of a strong downturn on its balance sheet.

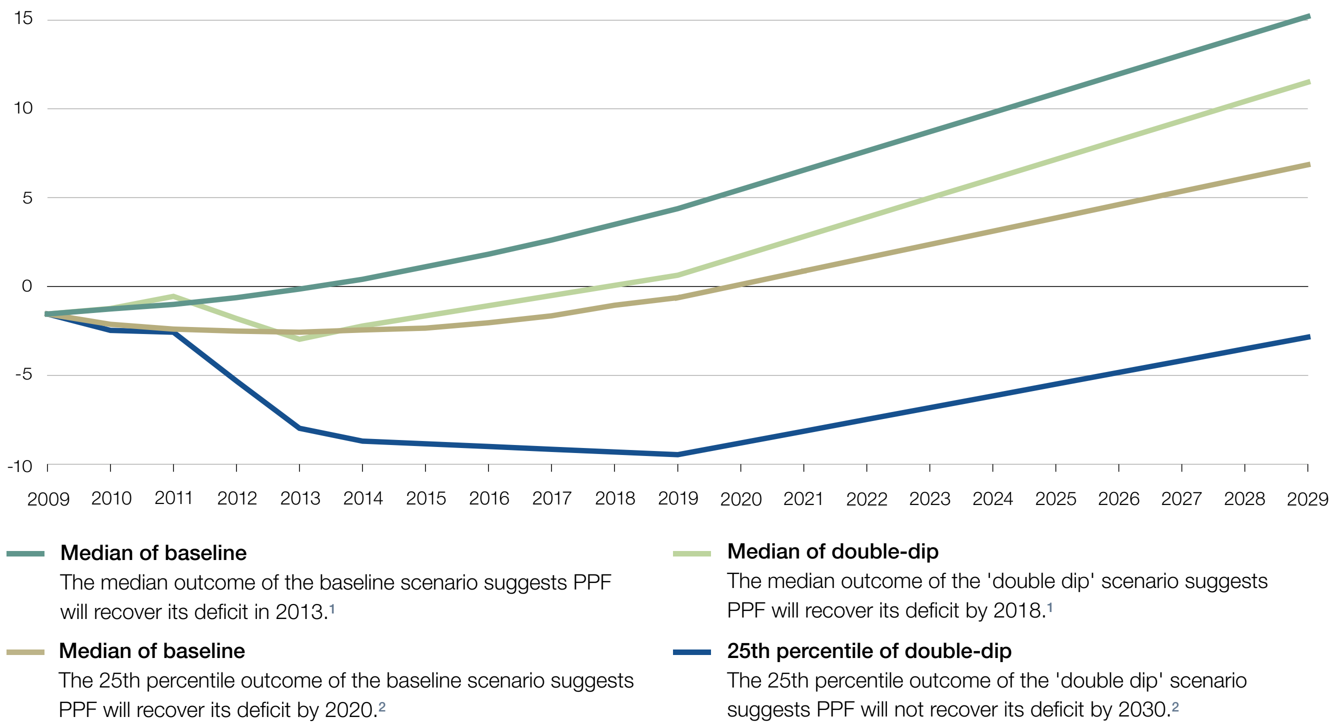
3.16 In December 2008, the Fund considered a wider range of detailed forward-looking analyses (stress tests) of the potential impact of specific recessionary economic scenarios. These tests highlighted the probable capacity of the Fund to recover from recessions similar to that experienced in the UK or in Sweden following their banking crisis in the early 1990s. The tests also examined the impact on the Fund's deficit of a sustained severe recession, akin to that experienced by Japan during the 1990s and 2000s. In such a scenario, the Fund predicted that its deficit could grow to £15.7 billion (a ratio of assets to liabilities of 80 per cent) over 10 years and would be effectively irrecoverable without some alteration to the way it funds compensation.

3.17 In June 2009, the Fund modelled the impact on its balance sheet deficit of six further recessionary scenarios, including a variant based on the Treasury's economic forecast and a strong, 'V-shaped' recovery. In September 2009, the Fund updated the results relating to two scenarios (one using baseline assumptions and one using more adverse 'double-dip' assumptions), for publication in its Annual Report. The median outcome of these two scenarios highlight the Fund's potential to recover its deficit by 2018 (**Figure 12** overleaf). The predictions of the deficit in the worst 25 per cent of possible outcomes under the baseline scenario also suggest the Fund could require 11 years to recover a deficit.

3.18 The results of these scenarios are a useful indication of possible outcomes. They are, however, sensitive to the starting economic position: using slightly earlier data (from March 2009 rather than September), the outcome at the 25th percentile of the baseline scenario suggested the Fund would take over five years longer to recover its deficit (**Figure 13** overleaf). This shift is in part reflective of the dramatic recovery in asset prices over the period. Nevertheless, the Fund should clearly explain to stakeholders the sensitivity of the Model to underlying data. There may be scope in future for expanding the range of economic and wider developments that are modelled to enable the Fund to assess the potential impact of unusual events with significant economic consequences, such as a major disease epidemic.

Figure 12
The Fund's recovery scenarios as modelled in September 2009

Pension Protection Fund Deficit/Surplus £ billions



Source: Pension Protection Fund

NOTES

1 Median outcome – the deficit in 50 per cent of possible futures computed by the Fund's Model under this particular scenario.

2 25th Percentile outcome – the smallest deficit in the worst 25 per cent of possible futures computed by the Fund's Model under this particular scenario.

Figure 13
Possible dates when a deficit will be recovered, as estimated by the Fund

Scenario	Baseline Median	Baseline 25th Percentile	'Double-Dip' Median	'Double-Dip' 25th Percentile
Deficit recovery date based on March 2009 dataset	2015	2025	2016	2030
Deficit recovery date based on September 2009 dataset	2013	2019	2017	2030 +

Source: Pension Protection Fund

Responding to the risks

3.19 The main way for the Fund to recover its deficit is through its levy on existing pension schemes. But the Fund must balance two competing factors: the need to raise sufficient funds through the levy from a diminishing number of eligible schemes; and the need to avoid putting too much strain on existing schemes, which risks reducing further the number of live schemes. The Fund aims to collect a total levy of £700 million in 2009-10 and £720 million in 2010-11. The levy is shared between all 7,100 schemes eligible to pay. The Fund is currently consulting with levy payers on how to make apportionment of the levy as fair as possible.

3.20 The Fund and the Department have considered how to address the potential risks facing the Fund but have not set any simple trigger points to prompt potential mitigation. The complexity and long term nature of the risks facing the Fund, such as movements in asset prices, interest rates and insolvency rates, preclude such an approach. In the circumstances, regular review and discussion, with the Department and the Regulator, of key metrics, such as the ratio of the Fund's assets to its liabilities, the rate of schemes entering assessment and the effectiveness of levy collection is a better alternative. The Department and the Fund need to keep this set of metrics under continual review to best inform action on risk mitigation.

Minimising the risks facing the Fund

3.21 The United States Pension Benefit Guaranty Corporation, established in 1974, with a similar function to the Pension Protection Fund, faces many of the same risks. The Corporation has already experienced a number of severe financial tests following the insolvency of major steel manufacturers and airline companies, and has also been affected by company insolvencies and the falling stock market as a result of the recent economic downturn. At 30 September 2009, the Corporation had a deficit of $22 billion (£13.5 billion), up from $11 billion (£6.8 billion) at 30 September 2008. The size of the deficit is one of the primary reasons that the Corporation is considered 'high risk' by the United States Government Accountability Office.[18] The Corporation has limited practical options to recoup such a large deficit. According to the Government Accountability Office, after many years of charges which do not fully reflect the risk of claims on the Corporation[19], increases in the levy charged on remaining eligible schemes to recoup the deficit could penalise surviving companies unfairly and encourage more companies to close their defined benefit pension schemes. By comparison with the Corporation, the Fund is in a position to recoup its deficit.

18 The United States Government Accountability Office identifies areas as 'high-risk' due to their 'greater vulnerabilities to fraud, waste, abuse, and mismanagement' or due to the need for 'broad-based transformation to address major economy, efficiency, or effectiveness challenges.' United States Government Accountability Office, High Risk Series Update January 2009, p.1, p.87.

19 United States Government Accountability Office, Testimony before the Committee on the Budget, House of Representatives: The Pension Benefit Guaranty Corporation and Long-Term Budgetary Challenges, June 2005.

3.22 Having consulted extensively with US Pension Benefit Guaranty Corporation staff and learned from the Corporation's experience, the Department drafted the Pensions Act 2004, to minimise the risks the Fund could face:

- The Fund apportions at least 80 per cent of the levy to reflect scheme risk.
- The Pensions Regulator was established with an explicit objective to reduce the risks to the Fund and has powers to ensure schemes potentially eligible for protection take steps to manage their deficit.
- The compensation paid by the Fund is limited to mitigate the risk of being perceived by employers as a means of shedding responsibility for under-funded schemes.

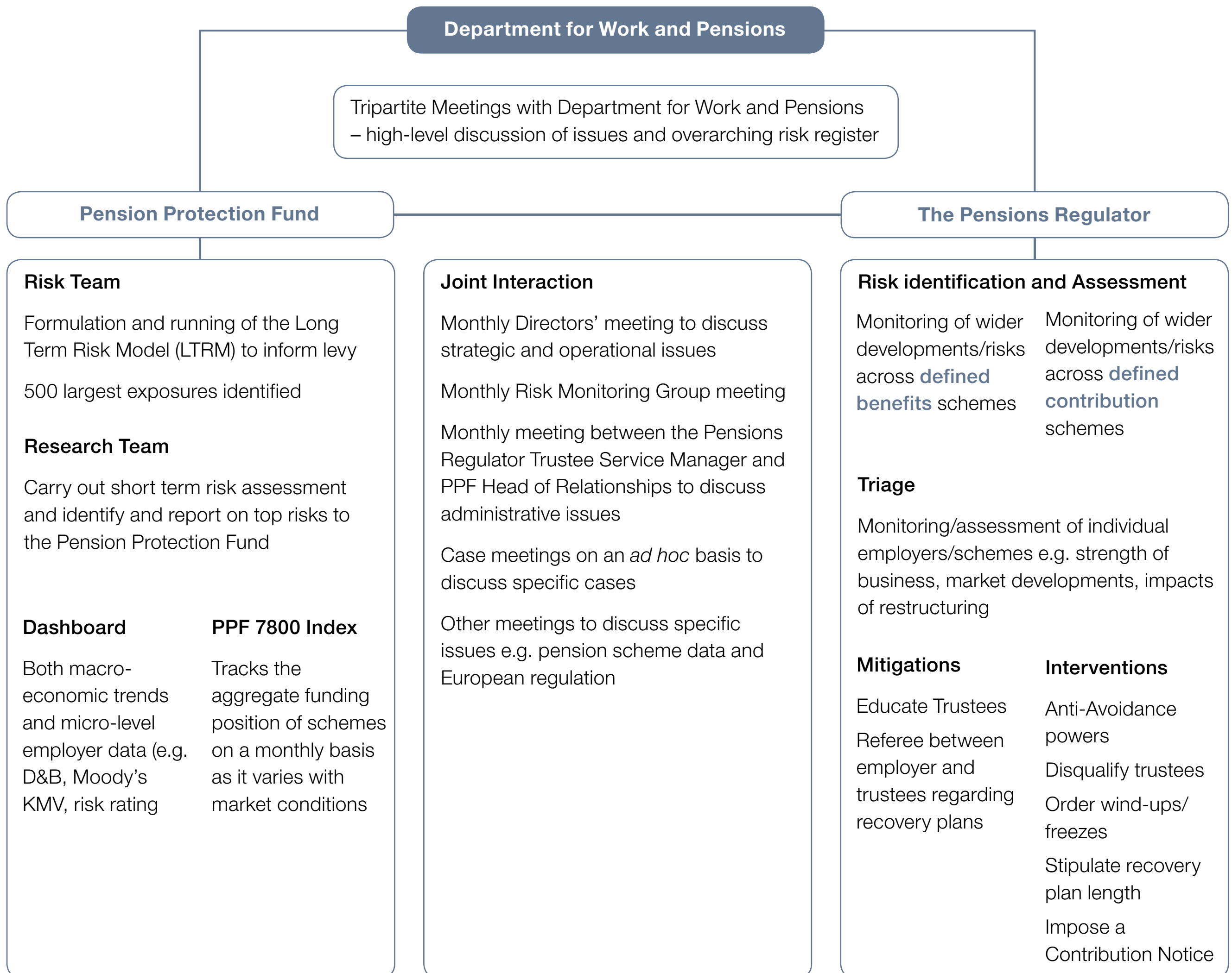
3.23 The Fund uses a formula for apportioning the risk-based element of the levy between schemes to reflect the insolvency risk of each sponsoring employer and the underfunding of each pension scheme. The Fund also imposes a scheme-based levy charge as a fixed proportion of the scheme's liabilities. To avoid charging those companies at high risk of insolvency a levy great enough to force them into administration, the Fund places a cap on the levy as a proportion of those liabilities. Those companies which fund their pension schemes adequately can expect to pay a smaller levy than a similar company which allows their scheme to be under-funded.

3.24 The Pensions Regulator's explicit task is to "reduce the risk of situations arising which may lead to compensation being payable from PPF."[20] The Regulator must ensure that employers fund their pension schemes sufficiently such that, should insolvency occur, the burden on the Pension Protection Fund is minimised. But the Regulator must also consider whether the demands of the pension scheme on the sponsoring employer are so onerous as to undermine the company's solvency and therefore encourages the scheme trustees to act responsibly towards the company. Where the Regulator believes that an employer is not fulfilling its duties to the pension scheme, it can take legal action to secure contributions through a recovery plan, thereby protecting the Pension Protection Fund.

3.25 The Fund actively supports the Regulator's efforts to minimise potential claims, collaborating on operational matters (e.g. data collection and data analysis) and management of key risks (**Figure 14**). Each month, the Fund produces a list of the top 500 schemes whose sponsoring employers are considered most at risk of insolvency. A list of the top 50 is discussed with the Pensions Regulator at monthly risk monitoring meetings. This risk assessment highlights where the Regulator can act in the short term to minimise risk to the Fund. It also allows the Fund to prepare to take over schemes from potentially insolvent employers.

20 Pensions Act 2004, Section 5(1)(c).

Figure 14
The Pension Protection Fund and the Pensions Regulator's frequent interactions



Source: National Audit Office

3.26 Consideration of the risks facing the pension protection regime by the Department, the Regulator and the Fund has led to further legislation to strengthen the powers of the Pensions Regulator and the Fund:

- the Pensions Act 2008 strengthened the Regulator's anti-avoidance powers allowing it to require a contribution to a scheme where an act or failure to act has detrimentally affected, in a material way, the likelihood of members' benefits being received; and
- the Pension Protection Fund (Entry Rules) (Amendment) Regulations 2009 enabled it to prevent retrospective changes to scheme rules that would increase liabilities.

The process for transferring pension schemes into the Fund

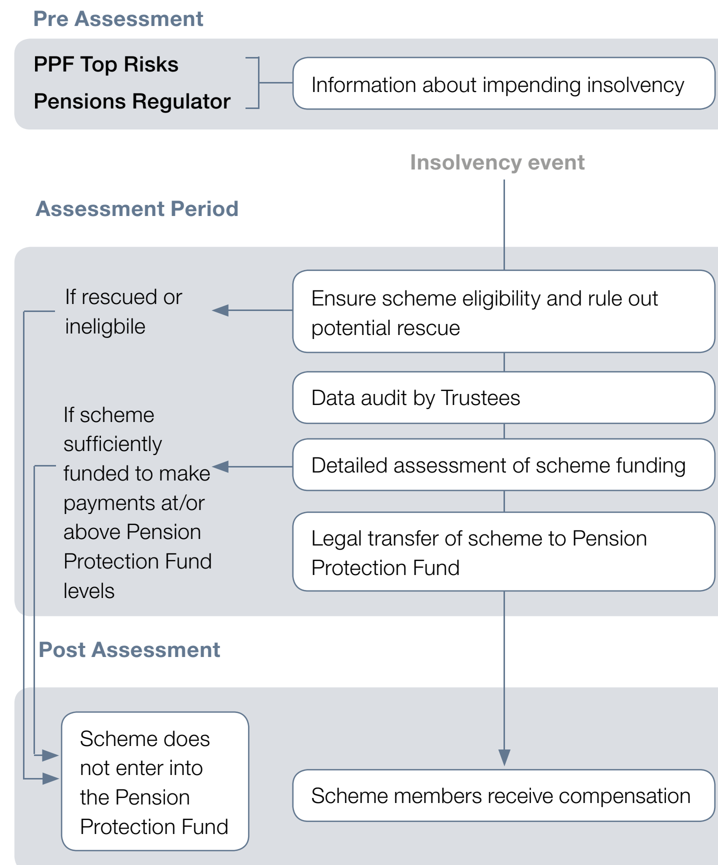
3.27 After an employer has become insolvent, but before it is transferred to the Fund, a scheme must undergo a period of assessment lasting no less than a year. The assessment period currently lasts over two years for 50 per cent of schemes. At 31 December 2009, there were 268 schemes in the Fund's assessment period.

3.28 Prior to the assessment period, the Fund's recoveries team may help to diminish the scheme's deficit by seeking recoveries from the insolvent firm. During the assessment period, the investment team seeks to minimise the risk of an increased scheme deficit by working with the trustees to align assets with the Fund's investment strategy. The assessment process is summarised in **Figure 15**.

3.29 Where a scheme is deemed to have sufficient assets to secure levels of pension above the Fund's compensation level, it will not be transferred. UK Can is one of the 72 cases where a pension scheme has completed assessment and has not needed to be transferred to the Fund (see **Box 1**).

3.30 Where an employer becomes insolvent, the Fund becomes a creditor and acts on behalf of the scheme trustees to recover as many assets as possible. Since its establishment, the Fund's recovery team has secured a total of nearly £73 million as a creditor of insolvent companies. The Fund estimates that it is due a further £194 million from dividends.

Figure 15
The Fund's Assessment Process



Source: National Audit Office

Box 1
UK Can Pension and Assurance Plan

Scheme wound up outside the Pension Protection Fund

UK Can Ltd a tin can manufacturer based in Merthyr Tydfil in Wales entered administration in October 2006, and in December 2007 the Company went into voluntary liquidation. As a result of these events, the company's defined benefit pension scheme entered the Pension Protection Fund's assessment process to determine how best to secure the pension benefits of members of the scheme.

Following assessment by the Fund, the company's defined benefit pension schemes' assets were valued at £44.4 million and the liabilities at £38.1 million. With sufficient assets to pay a commercial pension insurance company to take on payment of the scheme's liabilities, the Fund deemed it unnecessary to take on the scheme itself.

The Pension Insurance Corporation subsequently took on the running and payment of pensions, securing for the members a higher pension entitlement that would have been the case had the scheme entered the Pension Protection Fund.

Source: National Audit Office/Pension Protection Fund

3.31 In some circumstances, the Fund participates in the restructuring of an insolvent business. This can secure better assets on behalf of the scheme than if the business was allowed to fail in the standard way. The Fund has been involved in 29 such restructuring deals and equity is held in 13 companies as a result. The Fund estimates that it has gained £365 million from such deals. The Sheffield Forgemasters Pension Scheme is an example of one such restructuring deal (See **Box 2**).

Box 2
Sheffield Forgemasters Pension Scheme

In 2003, Sheffield Forgemasters Engineering Limited went into administration following the liquidation of its US parent company.

Before the company entered the insolvency process, the Fund was asked to support a rescue deal whereby it took over the pension scheme and the business was sold to a new company, unburdened by pension obligations.

The Fund estimated that it might recover up to £1 million for the pension scheme if the company went through the normal insolvency process and the scheme entered the Fund. Under the rescue deal, however, the Fund was able to negotiate a stake in the new, unburdened company of 26 per cent, and a cash contribution of £1.3 million for taking over the pension scheme. In 2008, a newly formed company, Sheffield Forgemasters International, bought back the 26 per cent stake for £1.75 million. The Fund thereby secured a total of £3 million to add to the assets of the pension scheme, over £2 million more than it may have received had the company not been rescued.

This additional source of assets is a worthwhile contribution to reducing the Fund's deficit. Nonetheless, it represents only a small proportion of the compensation costs associated with the pension scheme. The Fund now has responsibility for paying compensation to the 3,429 members of the transferred pension scheme, of which over 2,100 are existing pensioners, resulting in a current annual compensation bill of £6.5 million.

Source: National Audit Office/Pension Protection Fund

Part Four

Oversight of the Fund

4.1 The Pension Protection Fund is a statutory fund, managed by the Board of the Pension Protection Fund, a public corporation. The Fund was set up to be self-funding through compulsory levies on schemes potentially eligible for its protection. The Fund has not been underwritten by the Government. The Board is expected to report its performance each year to the Department for Work and Pensions.[21] The Department is expected to "respect the operational independence of the Board of the Pension Protection Fund and its independent statutory status."[22] This part of the report reviews the arrangements for oversight of the Fund's operations.

4.2 Since the Fund was set up in 2005, the Department has made steady progress in establishing a clearly articulated stewardship structure in line with available government guidance on sponsorship of non-departmental bodies.[23] There are numerous arrangements in place to allow interaction between the Department and the Fund (**Figure 16** overleaf). Since December 2008, the Department has initiated an additional layer of oversight of risks to the Fund – the Pensions and Economy Senior Group. The Group meets to discuss systemic issues presented by the recession across government. These meetings are in addition to the long established risk monitoring meetings between the Department, the Fund and the Pensions Regulator.

4.3 The Department monitors the Fund's operation and administration; investment and liability management; and governance. The Department monitors performance each quarter partly through the Fund's Executive Dashboard which classifies areas for remedial action using a red/amber/green designation. The review of the Fund's performance in March 2009 highlighted the following areas as 'red' over the year:

- Performance of the Fund's investments against its internal target of outperforming the 3-month LIBOR benchmark (see paragraph 2.8).
- The Fund's solvency ratio (79 per cent) against the short term target of reaching 100 per cent by April 2010.
- The Fund's progress at completing the assessment of schemes within two years.

21 Pensions Act 2004, Section 119.
22 Framework document: Management Statement and Financial Memorandum between the Board of the Pension Protection Fund and the Department for Work and Pensions April 2009 p.9.
23 Public Bodies: A Guide for Departments, Cabinet Office June 2006.

Figure 16
Departmental interaction with the Pension Protection Fund

	Senior Level	Stewardship Level
Annual	The Chairs of the Fund and of the Regulator meet with the relevant Ministers at least once a year and attend a meeting of senior Departmental officials twice a year.	Annual Accountability reviews are held between the Departmental Steward of the Fund and the Chief Executive of the Fund.
Quarterly	The Chief Executive of the Fund meets senior Departmental officials – Pensions Client Director General and the Private Pensions and the Cross Cutting Analysis Director quarterly.	Accountability reviews are held between the Chief Executive, Executive Directors and Finance Director of the Fund and the Departmental Steward each quarter; Quarterly 'tripartite' meetings are also held between representatives of the Department, the Fund and the Regulator.
Monthly	Pensions and Economy Senior Group (PESG) chaired by the Department's Pensions Client Director General, including representatives of the Treasury, Financial Services Authority, Department for Business Innovation and Skills, and the Chairmen and Chief Executives of the Fund and the Pensions Regulator has met monthly since December 2008.	Monthly meetings are held between the Fund's finance staff and the Departmental Stewardship team.
Weekly	Weekly telekits including discussions of insolvencies that could affect the Fund and the latest economic indicators are held between representatives of the Treasury, Department for Business Innovation and Skills, Financial Services Authority, the Fund and the Regulator at a working level.	

Source: National Audit Office

4.4 The Executive Dashboard for the second quarter of 2009-10 noted an improved investment performance of 3.6 per cent above the Fund's targeted return of 1.4 per cent above 3-month LIBOR. Against a revised short term target of 84 per cent, the Fund's solvency was also rated green, having improved significantly to 93 per cent. The Fund's progress against the target of completing assessment of schemes within two years remained red.

4.5 The Fund agrees its operational targets, set out in its Business Plan, with the Department each year. The Business Plan sets out the milestones through which the Board's strategic objectives are to be achieved. This includes annual targets, such as for levy collection and the length of the assessment period for pension schemes, against which the Department assess operational performance.

4.6 The Department has played a central role in directing the Fund's approach to assessing the risks of the current recession. The Department has not, however, established any objective criteria to identify when it might be called on in future to take action to avert risks to the Fund or consider what the most appropriate action might be in different circumstances. The Department considers that a combination of regular accountability review meetings, and discussion of these issues, is more appropriate than a pre-defined trigger system based on quantified objective indicators. This approach reflects the limits of the responses currently appropriate and the long timeframes available to consider alternatives.

4.7 The Department has also taken assurance on the adequacy of the Fund's assessment of risks from several reviews of the Risk Model conducted by external consultants. Work by the Fund to improve the documentation of the Model should allow the Department to undertake more detailed scrutiny of the quality of risk assessment.

4.8 Despite the large volume of interaction, there are nevertheless, some limits to the Department's oversight of the risks to the Fund. Although it receives audit committee papers, and discusses issues arising directly with the Fund, the Department does not have a representative on the Fund's audit committee nor does it attend audit committee meetings as an observer. To ensure the Department has a better awareness of the risks under discussion, additional meetings before each audit committee have recently been established between the Fund's Chief Operating Officer and the Department. This step should provide the Department with the necessary additional oversight of key risks.

Appendix One

Methodology

The main elements of our fieldwork, which took place between June and September 2009, were:

Selected Method	Purpose
1 Semi-structured interviews with commercial stakeholders	
• Professional Pension Trustees (3) • Employers Groups (2) • Pension Advisers (7)	To understand the pensions' landscape and establish major stakeholders' views on key risks.
2 Evaluation of secondary data	
• ONS occupational pensions survey data • The Pensions Regulator and the Fund's Purple Book of pensions data • PPF 7800 Index of Defined Benefit Pension Scheme Deficits • PPF Top 500 index of long term risks • Fund data on schemes which have completed assessment • Fund data on scheme recoveries.	To identify trends in the status of defined benefit pension schemes. To follow the pattern of the Fund's exposure to possible claims and its analysis of risk. To identify the Fund's capacity to minimise exposure through the assessment period.
3 Semi-structured interviews with responsible individuals within the primary audited body	
• Director of Financial Risk • Chief Investment Officer • Chief Actuary • Head of Modelling • Head Economist Non-executive members of the Fund's board: • Chair of the Fund's Audit Committee • Chair of the Fund's Investment Committee.	To understand how the Fund assesses and responds to financial risks.

Selected Method	Purpose
4 Semi-structured interviews with responsible individuals within secondary audited bodies	
Department for Work and Pensions	
• Head Pensions Protection Policy • Head of Private Pensions Analytical Team • Head of the Economy Unit • The Steward	To understand the Department's approach.
The Pensions Regulator	
• Executive Director for Strategic Development • Head of Strategic Research and Analysis.	To understand how the Fund and the Regulator work together.
5 Review of documentation	
This included: • Board papers on risk assessments and modelling • Risk Registers • Unpublished model specification and business plans • External reviews of the Model commissioned by the Fund • the relationship with the Pensions Regulator, the Department for Work and Pensions and others.	To assess the Fund's approach to risks, investment management, the model and the governance arrangements.
6 Professional Consultancy Advice	
We engaged Russell Investments to review the implementation of the Fund's investment strategy, based upon their extensive experience of investment fund management and published best practice.	To assess the Fund's management of its investments and identify possible improvements.
7 Case Studies	
Using desk-based research and a questionnaire, we selected : • six employers from different economic sectors sponsoring defined benefit pension schemes	To illustrate the considerations of employers regarding the future of defined benefit pension schemes.
• four schemes which had recently completed the Fund's assessment period.	To illustrate how far the Fund can minimise the impact on its balance sheet.

Selected Method	Purpose
8 International Comparison	
We compared approaches to risk management and investment with that of the Pension Benefit Guaranty Corporation (PBGC) in the USA.	To identify any additional steps relevant to the Fund.
9 Assurance on the Fund's valuations and financial data	
We took assurance from: • the Government Actuary's Department June 2009 review of the Fund's actuarial valuation of its assets and liabilities at the year end • our audit of the year-end assessment of levy and investment income in the Fund's accounts.	To gain assurance on the prudence of the actuarial assumptions and calculations determining the value of the Fund's assets and liabilities.

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