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Department for Work and Pensions

Pension Protection Fund

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]