



National Audit Office

# Pension Protection Fund

## Methodology

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**FEBRUARY 2010**

# Methodology

The Pension Protection Fund (PPF) was established to provide compensation to members of UK registered private sector defined benefit (e.g. final salary) pension schemes where the employer is insolvent and the pension scheme has insufficient funds to meet its liabilities. Of key importance to the effective functioning of the Fund is the monitoring of and response to financial risks. Against the backdrop of the wider economic downturn the financial risks to the Fund have been brought into sharper focus.

In light of this, we examined:

- 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;
- whether the Fund followed good practice in its management of its assets; and
- 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.

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

Selected Method	Purpose
<p><b>1 Semi-structured interviews with commercial stakeholders</b></p> <p>We interviewed:</p> <ul style="list-style-type: none"> <li>• Professional Pension Trustees</li> <li>• Employers Groups</li> <li>• Pension Advisors</li> </ul>	<p>To inform our understanding of the pensions' landscape and establish stakeholders' views on the key risks to the Fund.</p>

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<p><b>2 Evaluation of secondary data</b></p> <p>We analysed:</p> <ul style="list-style-type: none"> <li>● ONS occupational pensions survey data;</li> <li>● The Pensions Regulator and the Fund's Purple Book of Pensions Data;</li> <li>● PPF 7800 Index of Defined Benefit Pension Scheme Deficits;</li> <li>● PPF Top 500 index of long term risks;</li> <li>● The Fund's data on schemes which have completed assessment; and</li> <li>● The Fund's data on scheme recoveries.</li> </ul>	<p>To identify trends in the status of defined benefit pension schemes.</p> <p>To follow the pattern of the Fund's exposure to possible claims in the current recession and its analysis of the risk presented by individual employers.</p> <p>To identify the Fund's capacity to minimise exposure through the assessment period thus far.</p>
<p><b>3 Literature Review of key academic research</b></p> <p>We reviewed a number of papers on the affordability of defined benefit pensions and the problem of modelling future liabilities.</p>	<p>To inform our understanding of the complexities of modelling potential future liabilities for a pension compensation scheme; and to inform our understanding of the landscape in which the Fund operates, in particular the rate of withdrawal and 'buy out' of defined benefit schemes.</p>
<p><b>4 Semi-structured interviews with responsible individuals within the Pension Protection Fund</b></p> <p>We interviewed:</p> <ul style="list-style-type: none"> <li>● Director of Financial Risk</li> <li>● Chief Investment Officer</li> <li>● Chief Actuary</li> <li>● Head of Modelling</li> <li>● Head Economist</li> </ul> <p>and other relevant team members.</p> <p>Non-executive members of the Fund's board:</p> <ul style="list-style-type: none"> <li>● Chair of the Fund's Audit Committee</li> <li>● Chair of the Fund's Investment Committee</li> </ul>	<p>To understand the structures and processes in place at the Fund to manage the financial risks. To understand the practical measures taken to manage the risks posed by the current recession.</p> <p>To understand the operation of the Board and its use of information to reach key decisions on funding and management of the recovery of any deficit.</p>

Selected Method	Purpose
<p><b>5 Semi-structured interviews with responsible individuals within secondary audited bodies</b></p> <p>We interviewed:</p> <p><b>Department for Work and Pensions</b></p> <ul style="list-style-type: none"> <li>● Head Pensions Protection Policy</li> <li>● Head of Private Pensions Analytical Team</li> <li>● Head of the Economy Unit</li> <li>● The Steward</li> </ul> <p><b>The Pensions Regulator</b></p> <ul style="list-style-type: none"> <li>● Executive Director for Strategic Development</li> <li>● Head of Strategic Research and Analysis</li> </ul>	<p>To understand the structures and processes in place at the Department for Work and Pensions (DWP) to oversee the routine operation of the Fund and manage the arms-length relationship. To understand the Department's response to the economic downturn.</p> <p>To understand the structures and processes through which the Fund and the Regulator work together to manage and model risks and collect data.</p>
<p><b>6 Review of documentation</b></p> <p>We conducted an extensive review of documentation relevant to the Fund's governance arrangements, management of risk, risk modelling and management of investments, including:</p> <ul style="list-style-type: none"> <li>● Green Paper: Simplicity, security and choice: Working and saving for retirement, December 2002;</li> <li>● White Paper: Simplicity, security and choice: Informed choices for working and saving, February 2004;</li> <li>● Regulatory Impact Assessment of the Pension Protection Fund, 2004;</li> <li>● Pensions Act 2004;</li> <li>● Management Statement and Financial Memorandum;</li> <li>● Terms of Reference of the Fund's Board and Committees;</li> <li>● The Fund's Business Plans, Annual Reports, Board papers, Risk Registers, Investment and Asset &amp; Liability Committee minutes and papers and its Statement of Investment Principles;</li> <li>● Modelling Uncertainty - An Introduction to the Fund's Long Term Risk Model; and</li> <li>● External Reviews of Long Term Risk Model commissioned by the Fund.</li> </ul>	<p>To understand the terms on which the Fund was established and the assessment of risks to the fund at an early stage.</p> <p>To understand the governance arrangements established for the Fund and the extent of its powers to mitigate the risks posed to the fund.</p> <p>To plot the evolution of the Fund's approach to managing the risks it has faced; and the development of the information available to the Fund's Board, its assessment of this information and responses to it. To assess the effectiveness of the processes through which the Fund manages its investments against good practice. To understand the process through which the Fund developed its Long Term Risk Model and assess whether this model is fit-for-purpose.</p>

Selected Method	Purpose
<p><b>6 Review of documentation continued</b></p>	
<p>We also reviewed documentation relevant to the Fund's relationship with the Pensions Regulator and the Department for Work and Pensions, including:</p>	
<ul style="list-style-type: none"> <li>● Pensions Regulator – Pension Protection Fund Joint Board Meetings Papers and Minutes;</li> </ul>	<p>To assess the effectiveness of the partnership working between the Pensions Regulator and the Fund.</p>
<ul style="list-style-type: none"> <li>● Pensions Regulator – Pension Protection Fund Risk Monitoring Group Minutes;</li> </ul>	
<ul style="list-style-type: none"> <li>● Department for Work and Pensions – Pension Protection Fund Quarterly Accountability Review Minutes;</li> </ul>	<p>To assess the extent of the Department's oversight of the Fund and the effectiveness of this oversight for managing risks to the Fund in the recession, and the compliance of the stewardship relationship with available guidance on Non Departmental Public Bodies.</p>
<ul style="list-style-type: none"> <li>● Department for Work and Pensions – Pension Protection Fund Performance Monitoring Papers (Balanced Scorecard); and</li> </ul>	
<ul style="list-style-type: none"> <li>● Department for Work and Pensions Risk Assurance Division Audit of Stewardship.</li> </ul>	
<p>and other Government Departments:</p>	
<ul style="list-style-type: none"> <li>● Government Actuary's Department Review of the Fund's Actuarial Assumptions; and</li> </ul>	<p>To gain expert assurance on the adequacy of the Fund's use of assumptions to assess its liabilities.</p>
<ul style="list-style-type: none"> <li>● Pensions and Economy Senior Group Meeting Actions.</li> </ul>	<p>To assess the Department's role in coordinating a cross-government approach to pension protection in the current downturn.</p>

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<p data-bbox="453 443 627 465"><b>7 Consultancy</b></p> <p data-bbox="453 488 884 568">We engaged Russell Investments to carry out a review of the implementation of the Fund's investment strategy, analysing:</p> <ul data-bbox="453 591 820 824" style="list-style-type: none"> <li data-bbox="453 591 751 613">● the governance framework;</li> <li data-bbox="453 636 820 689">● the appointment and monitoring of investment managers;</li> <li data-bbox="453 712 715 734">● transition management;</li> <li data-bbox="453 757 687 779">● liability hedging; and</li> <li data-bbox="453 801 667 824">● operational issues.</li> </ul> <p data-bbox="453 846 903 981">Their methodology consisted of meetings with key members of the Fund's investment staff, as well as a selection of four of the Fund Managers (Insight Investment, PIMCo, Newton and State Street Global Advisors).</p> <p data-bbox="453 1003 842 1142">In addition, Russell reviewed a range of documentation including the Investment Management Agreements, Statement of Investment Principles and the Investment Committee Papers.</p> <p data-bbox="453 1164 852 1276">Benchmarking was based upon Russell's extensive experience of investment fund management and published best practice, including the Myners Review.</p>	<p data-bbox="943 488 1442 658">To assess the Fund's management of investments by comparison with best practice in institutional fund management. To identify any areas where the Fund could improve its processes for implementing its investment strategy to ensure efficient and effective deployment of its assets.</p>
<p data-bbox="453 1317 632 1339"><b>8 Case Studies</b></p> <p data-bbox="453 1361 906 1464">We selected six employers from different economic sectors sponsoring defined benefit pension schemes and constructed case studies using desk based research and a questionnaire.</p> <p data-bbox="453 1487 906 1688">We selected four further schemes which had recently completed the Fund's assessment period. We constructed case studies using the Fund's data on scheme funding before and after assessment and any recoveries or rescues secured, in addition to Companies House information on employer insolvency history.</p>	<p data-bbox="943 1361 1458 1496">To illustrate the range of considerations of employers in different sectors, sponsoring schemes with different statuses, eligible for the Fund's protection, regarding the future of defined benefit pension schemes and their concerns regarding the Fund.</p> <p data-bbox="943 1518 1458 1599">To illustrate the extent to which the Fund can minimise the impact on its balance sheet and the role it plays in safeguarding pensions where necessary.</p>

Selected Method	Purpose
<p data-bbox="405 436 718 470"><b>9 International Comparison</b></p> <p data-bbox="405 481 877 683">We compared approaches to risk management and investment with that of the Pension Benefit Guaranty Corporation (PBGC) in the USA. In addition to desk based research on PBGC's risk modelling and investment, meetings were held with key experts and institutions operating in the US system including:</p> <ul data-bbox="405 694 877 952" style="list-style-type: none"> <li data-bbox="405 694 877 728">● Pension Benefit Guaranty Corporation;</li> <li data-bbox="405 739 877 772">● Government Accountability Office;</li> <li data-bbox="405 784 877 851">● Employee Benefit Security Administration, Dept. of Labour;</li> <li data-bbox="405 862 877 896">● Brookings Institute; and</li> <li data-bbox="405 907 877 940">● American Benefits Council.</li> </ul>	<p data-bbox="877 481 1439 627">To assess the extent to which the Fund learned from the experience of the United States. To identify any additional steps the Fund could take to ensure it is well prepared to manage a growing deficit in the current downturn.</p>
<p data-bbox="405 963 877 1030"><b>10 Assurance on the Fund's valuations and financial data</b></p> <p data-bbox="405 1041 877 1243">In June 2009, the Government Actuary's Department undertook a detailed review of the Fund's actuarial valuation of its assets and liabilities at the year end. The National Audit Office has taken assurance from this review for this report and for its audit of the Fund's accounts.</p> <p data-bbox="405 1254 877 1397">Assurance on the Fund's year-end assessment of levy and investment income was gained from the National Audit Office's audit of the Fund's accounts in August and September 2009.</p>	<p data-bbox="877 1041 1439 1131">To gain assurance on the prudence of the Fund's actuarial assumptions and calculations determining the value of its assets and liabilities.</p>