

REVIEW OF PENSIONS INSTITUTIONS – SUBMISSION BY THE BOARD OF THE PENSION PROTECTION FUND

1. The Board of the Pension Protection Fund (PPF) welcome the opportunity to offer evidence to the review of pensions institutions.
2. **General**

The Board notes apparent expansion in the intended scope of the review. The initial announcement of the review, in the May 2006 White Paper *Security in Retirement*, indicated that it would cover only those bodies established by the 2004 Pensions Act. However, the reference to the review in the October 2006 *Summary of Response to the Consultation* document, and subsequently the review's terms of reference also cover a range of other bodies involved in pensions regulation and protection, including the Financial Services Authority, Pensions Advisory Service, Pensions Ombudsman and Financial Services Compensation Scheme.

The terms of reference also indicate the need for the review to take into account a range of developments, not simply limited to those – principally the pensions reform programme – within the government's control.

The Board welcomes these changes. Those bodies specifically created by the Pensions Act 2004 are inevitably still at a formative stage of operation. In the case of the main bodies concerned (Pensions Regulator, Pension Protection Fund), they are still in the process of developing key powers and functions. For example, the PPF only made its first direct payments to scheme members on 1 December 2006, and is still in the process of collecting its first full, risk-based Protection Levy, while the Regulator is understood only to have rejected two or three of the clearance applications it has received from companies wishing to restructure in ways which may affect their pensions schemes, and has yet to use a number of its key powers¹ in respect of employer debt and scheme funding. Other, smaller 2004 Act creations like the PPF Ombudsman or Pensions Regulator Tribunal have not yet – as far as we are aware - undertaken any substantive case work.

The Board feels that a review which was limited to these bodies would therefore not be in a position to draw conclusions or recommendations backed by substantive evidence; and moreover might not be able to

¹ In particular, Contribution Notices (S38 *et seq*); Financial Support Directions (S43 *et seq*.)

take properly into account a number of important developments in the pensions and savings area, in particular:

- recent announcements about the Personal Accounts structure and the extent to which this national system of occupational defined contribution pensions will further influence the shift from DB to DC arrangements;
- the new proposed Delivery Authority and subsequent Personal Accounts Board – the relationship of these bodies with the existing players, and the resulting advisory, regulatory and compensatory requirements;
- the current rapid developments in so-called “secondary markets” as employers, insurance providers and financial intermediaries adapt to the existing legislative requirements on employers in respect of their pension schemes; also the issues these developments are raising on DB regulation and the interfaces between DB and trust and contract-based occupational DC;
- continued legal and political pressure on the compensation regimes for pensions and savings generally, including the Financial Services Compensation Scheme, the Financial Assistance Scheme, and the PPF;
- linked in part to this, continuing developments in EU and global (OECD) legislative and regulatory requirements on occupational pensions in the UK.

3. Suggested Principles of Pensions Institution Reform

The Board welcomes the inclusion of robust governance, efficiency/effectiveness, affordability and the avoidance of duplication and conflicts of interest in the revised draft terms of reference for the review. The recent and still-developing nature of the institutional landscape to be covered by the review (see above) creates risk of the exercise being less valuable than it should be. The Board feels that this risk is reduced if the review is based on clear principles determining an optimal outcome, and suggests the following:

- (i) Strategic vision – the outcome should if possible seek to envisage a suitable institutional layout going forward towards the Personal Accounts world of 2010 and beyond. As noted above, the review will be of less value if, at this intermediate stage, it concentrates on simply rationalising the 2004 Act settlement.
- (ii) Good Governance. Achievement of efficiencies of scope and scale are important. They need to be balanced with the need to maintain good governance, avoid conflicts of interest, and the separation of powers where necessary. In the light of recent history, the pensions area is not one where conflicted authorities or weak governance can be lightly risked.
- (iii) An effective structure. As indicated below, a number of the PPF functions are unusual and indeed novel, particularly in a public sector body. The same is likely to apply to other bodies in this

area. If restructuring is proposed, it is important that the resulting institutions are structured to carry out their functions within their competent capacity.

- (iv) Perceived fairness to levy payers and scheme members. The Board's ultimate customers – schemes that pay levy; their sponsoring employers and scheme members receiving compensation – are in a relationship with the Board through force of circumstances and not through choice. We regard it as important that the outcome of the review should not result in a negative impact on them.
- (v) Functional or product-based rationalisation? The Board notes that functional rationalisation is already well-advanced in the financial services area (where both the FSA and the FSCS were created from a number of bodies carrying out comparable functions across smaller product areas). This approach may be worth considering in the pensions area. The Board would see it as likely to be more promising – and more likely to avoid problems of governance and conflict mentioned above – than an approach which attempts to combine the different functions of bodies (e.g. regulation, compensation payment) operating in the same product market.

4. The Pension Protection Fund – Functions and Achievements

Although the Pension Protection Fund exists to compensate scheme members and its Vision and Mission statements² concern ensuring fairness and increasing confidence in pension provision through protection, its key functions are essentially those of a financial institution, rather than of a “protection” mechanism *per se*, or of a regulator. Its key activities – calculating and raising levy, investing assets and paying compensation – are primarily financial in nature. An issue of key underlying importance is that, in contrast to other bodies performing public roles in respect of pensions and savings, Government does not guarantee these activities by underwriting the Fund: indeed, its refusal to give any commitment to stand in as guarantor of last resort is well-documented in Parliamentary debates and other public occasions. The Government has been clear that that the Board has to remain solvent through its own abilities to raise and invest sufficient funding to meet its ongoing liabilities. This means that, although there is a “solvency safety valve” in the provisions of the 2004 Act (schedule 7) which enable the Board to adjust certain aspects of the compensation provision subject to safeguards, ultimately the Board must remain a financially going concern in order to fund the necessary compensation payments on a year on year basis.

This financial emphasis can be briefly illustrated through the Pension Protection Fund's activities in 2006/07, which have so far included:

² PPF Strategic Plan 2006/07 – 08/09 (June 2006) pp1-2.

- publishing our initial financial statements – acknowledged by the NAO as unique and unusually complex for a public body, with closest comparators from the insurance and pension industry areas
- receivables management – calculating, invoicing, collecting and credit control management for the pension protection levy - £675m in 2007/08 - the first such levy in the world to be based on the risk posed by schemes, rather than simply on the number of their members or level of funding
- balance sheet management – managing the solvency of the Fund, determining the appropriate levy strategy, investment strategy and the application of hedging techniques to manage the insurance, financial and demographic risks we face
- transition management – the transfer of asset portfolios and their reorganisation from the existing scheme investment strategy to the PPF's investment strategy, hedging the risk as appropriate using financial instruments during assessment and at the point of transition
- investment management and strategy – strategic asset allocation of a portfolio of levy money and transferred scheme assets. Expected asset exposure is c. £4bn by end 2006/07. Likely to grow to £10bn+ within 3 years. Selection, monitoring and evaluation of external fund managers
- corporate finance / debt recovery - negotiation as a creditor to secure recoveries from insolvent employers and involvement in restructuring of solvent and insolvent entities – recoveries to date exceed £330m
- project-managing a current portfolio of 144 schemes through the PPF assessment process, with a strong emphasis on actuarial valuation of liabilities
- making monthly direct compensation payments to scheme members
- development of back-office functions – custody of assets, banking and compensation payments.

Other important activities include:

- long-term risk modelling and management of the DB Pensions universe (we have developed the most sophisticated model of that universe available using credit ratings and econometric scenario planning and, with the Regulator, have published the most comprehensive analysis yet developed of the UK DB pensions system);
- stakeholder management – we have published five consultation documents, held stakeholder workshops on levy, administration and assessment issues, and dealt with nearly 6000 calls and about 2500 letters/emails from members of the public. In this context, our organisational culture is shaped by our direct accountability to levy payers who fund us, and to the scheme members who we protect.

In the context of the functions covered by the Review of Pensions Institutions, it is worth noting that:

- Except for some very specific powers in respect of adjusting compensation awards, the Pension Protection Fund does not have any powers or functions which could be described as regulatory;
- The PPF does not in any way act as a general advisory service on pension issues. Although the volumes of queries dealt with are significant, the work of the Stakeholder Support Team, with its in-house Helpline function, deals largely with calls from pension scheme advisers and other professionals. Its work is therefore highly specialised and relates very closely to the Board's functions and activities (e.g. levy invoice calculation).

5. Relationship with the Pensions Regulator [“The Regulator”]

Although as already noted the Pension Protection Fund does not undertake regulatory functions, it shares a number of business interfaces with the Regulator, and close working links exist with the Regulator at a number of levels.

The key areas of interaction are:

- i. The Regulator's work under Section 5(1)(c) of the 2004 Act [*“to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund.”*]. This includes, in general terms, the Regulator's approach to scheme funding requirements and its use of PPF compensation levels (“Section 179” valuations) as a trigger for technical provisions and, more specifically, the Regulator's decisions on whether to give clearance for corporate restructuring proposals and when appropriate, to issue Contribution Notices (CNs) or Financial Support Directions (FSDs);
- ii. The need for negotiations by both bodies with companies in trouble and with prospective bidders for them, to ensure the best possible outcome for the pension scheme, irrespective of whether it continues as an ongoing scheme or, following the insolvency, enters a PPF assessment period. The two bodies work to secure a shared outcome ensuring regulatory compliance (Regulator) and creditor leverage (PPF); but their separate involvement helps avoid accusations of conflict of interest between the two roles ;
- iii. The treatment of schemes which have entered a PPF assessment period. Still run by their trustees, these remain subject to the Regulator's intervention through CN or FSD decisions, while now also being subject to

- Board oversight and requirements to pay benefits at PPF compensation levels³;
- iv. Data sharing, particularly scheme data through the scheme returns made to the Regulator;
 - v. Some of the broader, longer-term risk identification and management work based on this data, which recently culminated in the first issue of the joint DB pension universe risk profile (PURPLE). Both organisations have a direct interest in the general state, and future prospects of, the DB pensions universe, and in key risk measures such as longevity, corporate solvency etc;
 - vi. The collection of administration expenses through the Administration Levy to defray the annual grant-in-aid made to the two bodies. Collection is carried out by the Regulator, and the collected sums are passed to the DWP, from which the bodies draw down funding as appropriate.

It is however worth noting that important limits to the practical extent of joint working and cross-provision of services have been encountered. In particular, although the Regulator was responsible for collecting the Initial Levy (the first substantive funding levy for the PPF, in 2005/06 only), the Board's specific data needs and invoicing requirements led to a mutual agreement not to continue this arrangement as the simple, headcount-based Initial Levy was replaced by a full risk-based Protection Levy in 2006/07. Instead, the Board decided to undertake the full process of levy estimating, billing and collecting in-house due to the significant differences in complexity of calculation and support needed, and in the size of payments (that determines follow-up and credit collection techniques).

To help ensure the interfaces operate satisfactorily, numerous mechanisms for co-operation and co-working between the Regulator and the PPF also exist already. These include:

- a Tripartite Memorandum of Understanding governing the formal relationships between both bodies and between each and the DWP;
- Service Level Agreements covering provision of services by one body to the other, and a Letter of Agreement at Chief Executive level committing each body to early consultation with the other on proposals on policy, operational and organisational development;
- bi-annual meetings of the two Boards ;
- regular scheduled meetings between the two Chairs; the two Chief Executives, Executive Directors; and others with broadly corresponding roles (eg Regulator Head of Strategy / PPF Head of Policy);

³ It should be noted that this shared responsibility ends when schemes transfer into the PPF; the schemes (as opposed to their former members) no longer exist and the regulatory regime ends

- very close co-operation over the handling of clearance cases where sponsoring employer insolvency is an issue and the two bodies need to secure the best results for pension scheme creditors
- operational workshops to examine and resolve issues around handling of individual schemes;
- collaboration on specific joint projects – the development and publication of PURPLE being the main example.

Co-operation with the Regulator, as a key PPF stakeholder, is kept under constant review. Further joint or co-operative measures may be worth considering, for example improved mechanisms to share progress and information on individual schemes, or more systematic exchanges of staff (either individual swaps, or outplacement of small teams with the other body).

6. Merger of the Regulator and the Pension Protection Fund?

The Board is aware that an issue which may confront the review, is whether there should be a wholesale restructuring of the post-2004 Pensions Act settlement, through a merger of the Regulator and the PPF into a single body.

The Board has considered this possibility. We perceive a number of significant drawbacks:

- real and/or perceived conflicts of interest – for example, between making clearance decisions and taking asset recovery stakes in company rescues – created by combining regulator and creditor functions⁴
- the acute reputational risk to the merged body, were its former PPF elements to become insolvent – a situation which would then directly affect the Regulator
- confusion created by a Regulator (in part) mimicking its regulated entities – for example, the need to prevent the new single body's solvency, investment and actuarial strategies for its invested assets from being seen as *de facto* industry norms
- the political and presentational difficulties of putting the Parliamentary case for abolishing the 2004 Act provisions which specifically separate the Regulator from the PPF (for example, Sections 2 and 108 prohibiting the same person from chairing both bodies)
- the removal of a challenge function, inherent in a structure where one body (the Regulator) has a statutory duty to minimise calls on another (the PPF)
- potential adverse reaction from employers and pension schemes, which would see such a move as likely to lead to result in a more risk-averse, regulation-dominated protection regime

⁴ The US PBGC, which combines similar functions, has been criticised for this reason – see eg *re UAL Corporation et al, Illinois Bankruptcy Court chapter 11 Hearing, 9 May 2005*

- the diversion of time and effort from more pressing priorities and potential far-reaching changes to the pensions regulatory regime (for example Solvency II and the capital adequacy standards of occupational schemes; further developments in secondary markets; the new regulatory regime for Personal Accounts).

A number of these drawbacks could of course be reduced or resolved by the creation of Chinese walls within the new, single body. But this would inevitably reduce the merger's value as a way of removing functional interfaces between the two bodies.

For these reasons, the Board would be strongly opposed to the idea of a full-scale merger of the Regulator and the PPF.

7. Relationship with other protection and compensation bodies

The Board notes that three organisations exist, all or part of whose functions are to pay compensation to pension scheme members or investors in pension plans in the event of insolvency – the PPF itself, the Financial Assistance Scheme (FAS) and the Financial Services Compensation Scheme (FSCS). In addition, both the PPF and the FSCS have a role in compensating individuals where fraud has taken place. However, there are significant differences in governance and funding arrangements between all three bodies.

The similar purpose (though not necessarily key functions) of the PPF and the FAS causes some apparent confusion in the public and sometimes in the media's understanding of their identities and roles. In practice however, cases where there has been actual doubt about whose jurisdiction applies to a specific scheme have been few, and – so far – resolved without recourse to the Ombudsman or courts. Given that FAS's jurisdiction does not apply to schemes which began winding-up after 5 April 2005, such cases should become increasingly rare.

There are no direct boundary issues between the PPF and the FSCS. There are however some potential points of indirect interaction, for example in the event of PPF assuming responsibility for a scheme which had had to apply to the FSCS in respect of annuities purchased from a provider who had subsequently become insolvent.

8. Wider institutional issues

The Board are aware of a number of areas of work-based pension regulation and compensation where responsibilities are unclear or where there are gaps – for example, where Independent Financial Advisers are involved in advising individuals transferring between occupational schemes. In some cases, it would appear that such gaps might materially reduce a scheme member's pension entitlement or protection (the Board notes that, by contrast, the PPF's own interfaces

with other organisations involved in work-based pensions are essentially administrative or process-based: they do not involve issues of over- or under-lapping statutory jurisdictions) – see above.

The Board notes that the review will seek to establish how the organisations set up by the 2004 Act will fit with the Government's pension reform proposals. It is understood that the proposed new Personal Accounts are to be treated as occupational DC pensions. This would appear to indicate a potential role for the Regulator, although the money purchase nature of the Accounts means there is unlikely to be any direct interface with the PPF's responsibilities.

The Board do however note that the proposed Delivery Authority (or, ultimately, the Personal Accounts Board) is expected to have a similar status (public corporation) to the PPF's, and the recent White Paper *Personal Accounts: a New Way to Save* suggests that the Personal Accounts Board is likely to have key functions in terms of asset management and investment, where the PPF's existing experience could be both directly relevant and helpful.

9. Conclusion

The Pension Protection Fund has been in operation for less than 2 years. While it remains premature to make any long-term judgment about its success, the Board believes that its ability so far to implement its core functions of raising risk-based levies on schemes and compensating scheme members represent a real and substantial achievement – the more so since many commentators doubted that this would be possible without doing irreparable harm to UK occupational pensions or even to the wider economy. The Board is in no doubt that these achievements have been made possible by the PPF's status as an independent body able to combine the disciplines and expertise of a financial institution with its knowledge and analysis of the pensions scheme universe, working in conjunction with the DWP and the Pensions Regulator as necessary. While the twenty months or so experience of operating the 2004 Pensions Act may indicate work areas where marginal adjustments may be worth considering, the Board strongly believes that continued independence, together with the freedom to pursue its mission without the disruption of early organisational upheaval, is essential if the PPF is to build successfully on its initial achievements.