



# The Pensions Regulator

## **Seminar on Reforming Pension Benefit Protection Schemes**

**How protection schemes interact with regulation  
and regulators**

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# How protection schemes interact with regulation and regulators

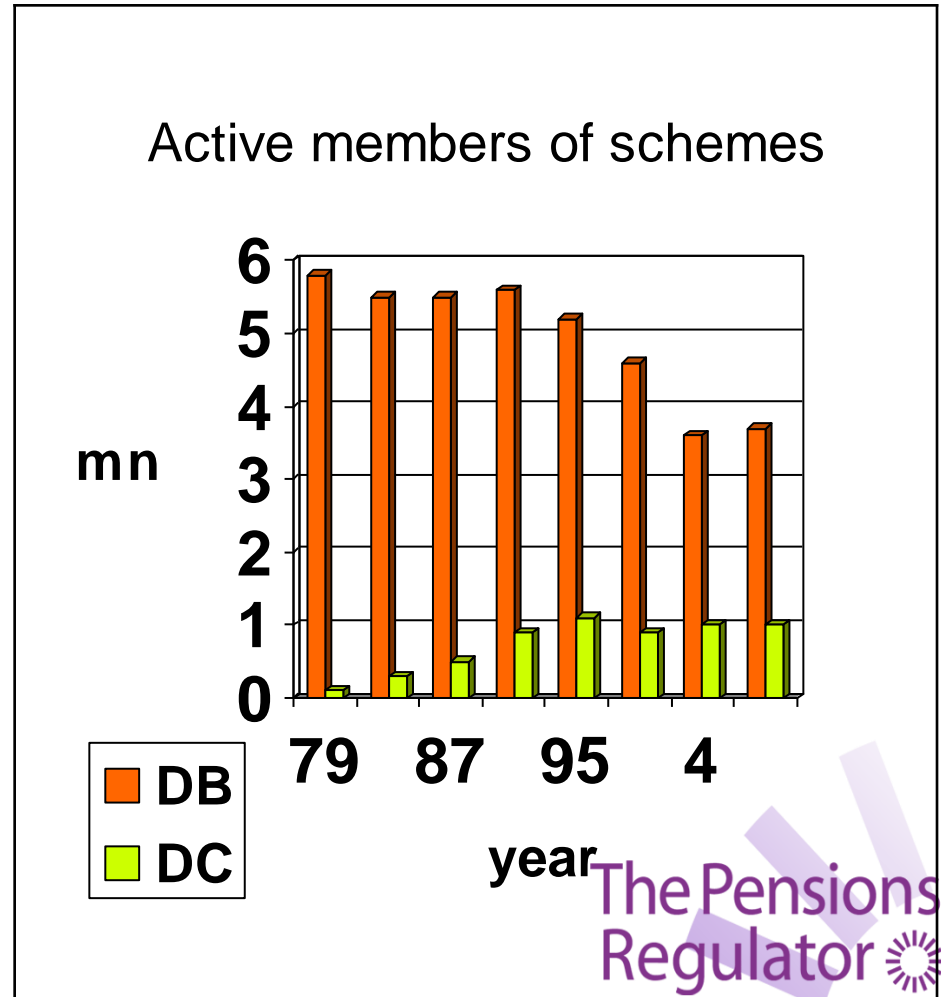
- UK context
- How this influenced legislation and PPF design
- Moral hazard
- Impact on the regulation of funding

# Defined benefit (DB) pensions in the UK

- A typical defined benefit pension scheme provides:
  - a pension of  $1/60$  of final salary for each year of service, with an option to give up some of the pension for a lump sum
  - payable from a Normal Pension Age between 60 and 65
  - with a survivor's pension, as well as ill-health pensions before retirement and perhaps an option for retirement before NPA
  - with indexation of the pension in some way related to inflation, probably with a cap of 5%
  - and pensions for people who leave employment before retirement indexed to NPA
- There is however a wide variety of all these parameters – the accrual rate and definition of final salary, NPA, indexation

# Private sector DB pensions in the UK

Scheme size (members)	Number of schemes
10,000+	200
5000-9999	180
1000-4999	930
100-999	3640
12-99	2400
2-11	5000
total	12300



# A very simplified history of requirements on funding and insolvency

- Until 1989 no overall funding requirements. Maximum funding rules introduced. Funding generally relied on the rules of the individual pension scheme and the trustees' decisions, based on actuarial advice. Actuaries had to certify (since 1978) that the scheme was adequately funded to provide for the level of benefits which the scheme was providing in place of the social security system, although in general that was materially less than the full scheme benefit.
- 1992
  - When a pension scheme winds up there is a debt due from the employer in relation to the scheme equal to an actuarial estimate of the level of underfunding relative to insurance buy out for pensioners and transfer values for non-pensioners.
- 1995
  - The Minimum Funding Requirement (MFR) introduced targeting the amount needed to insure pensions in payment and pay equity based transfer values to non pensioners with 10 years and to meet that level if underfunded.
  - Details of methodology and assumptions in professional guidance.
    - On winding up (termination), the debt is based on the MFR underfunding
- 2004
  - The debt is based on the amount needed to insure annuities and deferred annuities

# The reason for action in 2003-04

- Falling nominal and real interest rates increased liabilities.
- Falling equity values reduced asset values.
- Concern about significant increasing in funding needed to provide for a realistic estimate of improvements in mortality.
- Leading to dramatic falls in typical funding levels
  - many schemes moved from being in surplus or reasonable balance to large deficits
  - this was publicly evident in a number of high profile insolvencies which crystallised the issue of members' losses

# The reaction to the emergence of significant underfunding

- For ongoing schemes:
  - scheme funding requirements were introduced to replace the out-of-date and inflexible minimum funding requirement, with a requirement for a prudent target level of funding and a realistic recovery plan to correct any underfunding;
  - a stronger and more flexible role for a new Pensions Regulator.
- Where schemes terminate and wind up:
  - Full insurance based debt owed to trustees from company for solvent employers who wind up a scheme;
  - Pension Protection Fund (PPF) underpins the position where the employer is bankrupt.

# PPF : Lessons from international experience

- A Pension Insurance fund needs as much financial freedom as possible.
- Flexible process for setting the levy
  - need for risk-related levy
  - need ability to take a long term view
- Financial importance of a few large claims.
- Do not guarantee full scheme benefits.
- Ensure the members of pension schemes are not affected by delays in rescuing their scheme.
- Moral hazard must be addressed both in relation to the rules of the pension scheme and corporate operations.
- Operate like a pension scheme to enable annual claims to be smoothed over time and avoid large changes between years in the levies on employers.
- Strong scheme funding required to protect the Insurance arrangement.

# Moral hazard (1)

- There is a significant moral hazard in introducing pension insurance
- Three types of moral hazard
  - pension scheme benefits may be manipulated before entry into the PPF to maximise the level of compensation increasing the COST of claims
  - increasing NUMBER of claims by employers dumping scheme liabilities on the PPF
  - increasing the COST of claims by employers organising their affairs so that the pension scheme has a reduced claim on the employer in the event of insolvency

# Moral hazard (2)

- Avoiding the manipulation of PPF compensation levels are dealt with in a number of ways
  - admissible rules and recent discretionary increases: all recent rule changes will be disregarded if the effect is to increase PPF compensation
  - review of recent ill-health awards to ensure there was no abuse
  - benefit cap: ensures decision-makers have no personal incentive to let their scheme fall into the PPF
  - to ensure that a scheme can not manipulate itself to become eligible (eg a 2 member scheme taking in an additional member). The PPF must refuse entry to schemes where such manipulation has occurred in the 3 years prior to the insolvency event

# Moral hazard (3)

- Measures to stop employers reducing the potential effect of the debt on the employer on insolvency are included as new powers of the regulator
  - the regulator may impose a requirement that contributions are made to the scheme by a person who was a party to an act (or fails to act) where the main purpose was to avoid the recovery of any pension scheme debt on insolvency (Contribution Notice)
  - the regulator may impose a financial support requirement on a participating employer or associated or connected parties where the employer in relation to the scheme is 'insufficiently resourced' to support the scheme. (Financial Support Directive)

But only where it is 'reasonable' for the regulator to impose this direction

# Impact on the regulation of funding

- Statutory objective for the regulator
- Facilitates reliance on the employer covenant
- Informs the scheme funding objective
- Relationship with recovery plans
- Necessitates processes for pre-empting moral hazard

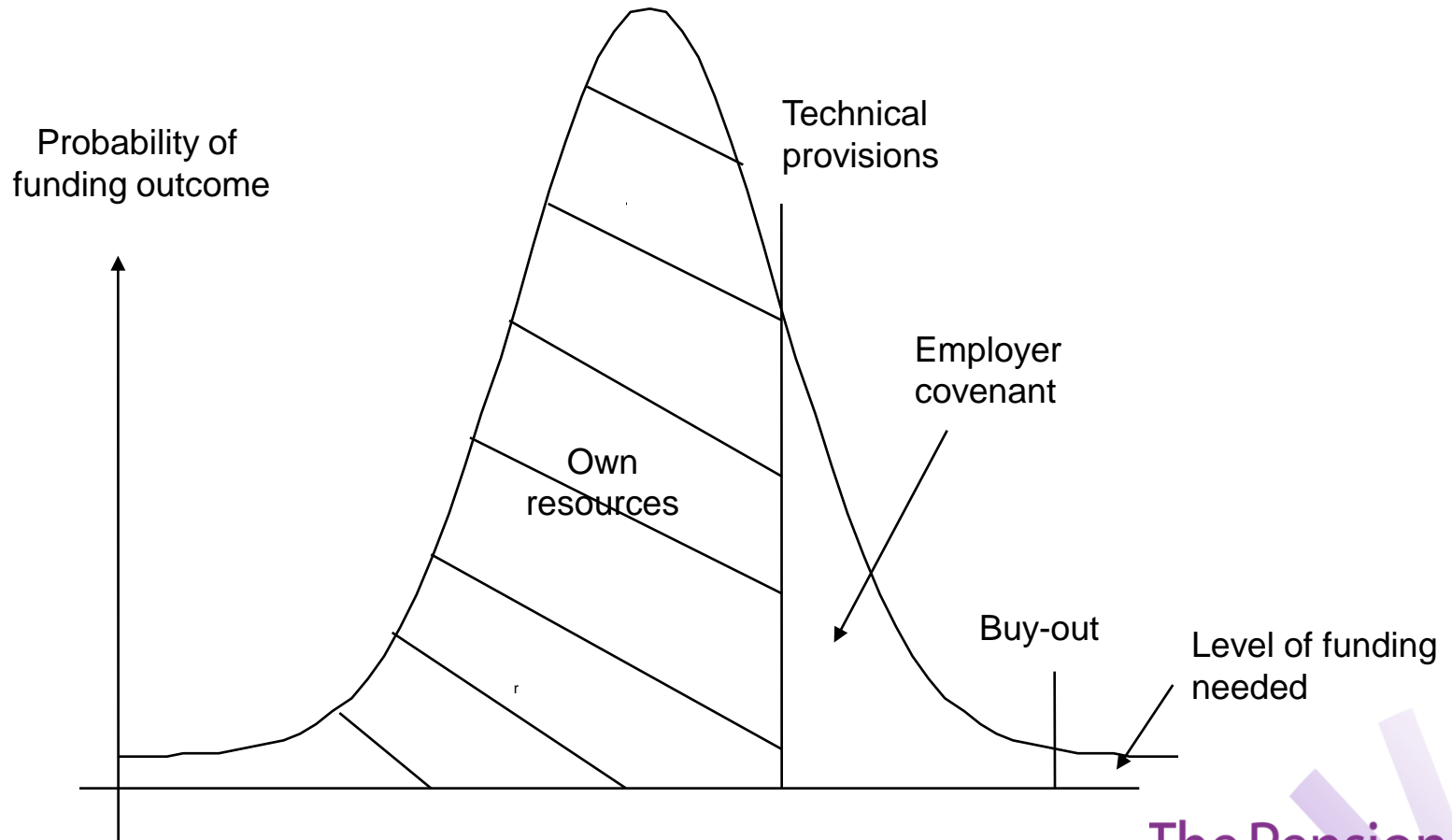
# The Pension Regulator's statutory objectives

- (a) and (b) – protect benefits of, or in respect of, members of work-based pension schemes
- **(c) – reduce the risk of situations arising which may lead to compensation from the PPF**
- (d) promote and improve understanding of good administration of work-based pension schemes

# Relevance on the employer covenant

- Schemes have to be funded to meet their liabilities as they fall due (technical provisions)
- Technical provision based on scheme specific assumptions determined by **trustees**
- Assumptions to be prudent (not defined in legislation)
- Technical provisions will not (usually) suffice to cover all risk
- Residual risk covered by the employer covenant, backed by PPF
- Prudence depends (in part) on employer covenant

# The role of employer covenant



# Relationship with the scheme funding objective

- The regulator's published approach
- Triggers not targets
- PPF trigger set to minimise not eliminate situations requiring PPF compensation
- Experience shows most schemes setting objective above PPF level

# Relationship with recovery plans

- Key driver is affordability
- 10 years – trigger not target
- Employer strength the key driver
- Investment return assumptions important
- Transitional risk for PPF

# Processes for pre-empting moral hazard

- Clearance process
- Hard line on abandonment
- Raising the trustees' game
- Using the moral hazard powers
- Needs unusual skill sets for a pensions regulator

# Conclusions

- Protection fund enables security with affordability
- But introduces novel risks for a regulator to tackle:
  - rigour of assessing employer covenant
  - employer avoidance activity