Funding For The Future

- a long-term funding strategy for the PPF

Pension
Protection
Fund

Protecting People's Futures

THE BACKGROUND

Since we opened our doors for business as the Pension Protection Fund five years ago, we have become an established part of the pensions landscape, with many achievements under our belt.

As at 30 April 2010, we had:

- paid out a total of £156 million in compensation
- transferred more than 46,000 scheme members into the PPF
- built up an investment portfolio worth almost £4.5 billion, and
- a further 200,000 members whose schemes we are assessing for eligibility and are currently receiving benefits at PPF levels of compensation.

We now want to build on those achievements.

That is why we have revised our strategic objectives to reflect how we are developing for the future.

Many of the challenges remain the same but we now face them with the benefit of our experience during the last five years. The continued development of our thinking on, for instance, the pension protection levy all builds on the work we have carried out to date.

One of the most important areas of policy development is on our funding for the future. This has resulted in us publishing our first formal funding strategy.

WHY DO WE NEED A FUNDING STRATEGY?

This strategy crystallises the work we have been doing behind-the-scenes since we were set up.

We want to show that we are intent on:

- having the financial resources required to pay existing levels of compensation to current and future members of the PPF, and
- becoming self-sufficient by the time the level of risk to the PPF from future insolvencies has reduced substantially.

We will use the strategy to assess the impact that certain events will have on our ability to meet our long-term obligations.

WHAT ARE WE AIMING FOR?

We aim to be fully-funded by 2030.

Why?

- The liabilities that we have taken on will have matured by then.
- The fund will have grown substantially in relation to the levy we charge.
- The number of schemes will have reduced and the risk that they pose will be much lower.

This makes it difficult to charge a significant levy beyond 2030, so we need to be in a strong financial position before this happens.

By this point, we also aim to have:

- only limited exposure to interest rate, inflation and other market risks, and
- built up a reserve or entered into agreements with third parties to protect ourselves against other risks such as our members living longer than we have estimated.

HOW WILL WE ACHIEVE THIS?

1. We will continue to collect the annual pension protection levy while aiming to make sure it is fair and affordable.

   The levies we receive will be invested alongside
   - the assets of schemes that transfer to us, and
   - our own accumulated investment returns.

   This will give us enough money to pay compensation as it falls due, maintain stakeholder confidence in reaching our long-term funding target, and allow us to continue our low-risk approach to investments.

2. We will also continue to work closely with the Pensions Regulator (the regulator) and others to reduce the level of risk in the UK's defined benefit pension schemes.

WHAT WILL STOP US ACHIEVING OUR AIM?

There are a number of factors which put our ability to achieve our funding target at risk.

1. **Scheme underfunding** - the more schemes that don't have enough assets to cover PPF levels of compensation, the greater the risk that PPF liabilities will increase.

   The regulator, through its scheme funding regime, makes sure that schemes work towards improved funding levels over agreed periods of time.

   Scheme investment strategies also influence underfunding risk.

2. **Investment** - our investments may not always achieve their target returns.

   We have an in-house team, plus specialist fund managers, dedicated to maximising the returns on our investments, while maintaining an overall low-risk approach.

   As 2030 approaches, and we are in a strong funding position, we will look to reduce the effect of market movements on our funding position through relevant financial agreements and low-risk investments in government bonds and cash.

3. **Insolvency** – the more employers with eligible schemes that go bust, the more pressure is placed on the PPF.

4. **Longevity** – the longer that PPF members live beyond our expectations, the more we have to pay out.

   While we have no direct control of either insolvency or longevity risks, we can ease these uncertainties by buying protection from a third party, eg longevity insurance, but only where it is possible and cost-effective.

   Where this isn't possible, we will look to cover these risks by building up a reserve. We estimate that a reserve of 10 per cent of PPF liabilities in 2030 will provide adequate protection against insolvency and longevity risk in nine out of 10 scenarios.

There are also other risks which we do not believe should be considered as part of our funding strategy:

1. **Legislative** - the Government could pass legislation that changes the way the PPF works.

   Government intervention is outside our control.

2. **Liquidity** - our investments might have to be redeemed at an inappropriate time to provide cash to pay compensation.

   A core part of our portfolio will be in high-quality, liquid government bonds.

HOW WILL WE MEASURE PROGRESS?

Progress to achieving our funding target will be measured by the modelled probability of us meeting the target. This is calculated by our internal risk model that projects future economic conditions, claims on the fund and investment returns.

We will also monitor the key risks which affect this probability, including:

- our own funding level
- the performance of our investment strategy, both in the past and in the future
- the total funding of eligible pension schemes
- the total level of risk in the investment strategies of eligible schemes
- the prospects of insolvency among employers of eligible schemes
- the length of time over which schemes plan to achieve improved funding levels, and
- the outlook for the UK economy.

We will review the funding objective on an annual basis and, if things are not going according to plan, we may:

- adjust the funding objective itself
- review our investment strategy, and/or
- consider an increase, or decrease, in the pension protection levy in the medium term.

If, having done all this, we still believe we will not meet our objective, we may consider triggering other powers we have under the Pensions Act 2004 such as reducing indexation of compensation.

WHAT DOES THIS ALL MEAN FOR LEVY PAYERS?

When making decisions on the amount of levy we should charge, we take into account a range of factors. Our progress towards achieving our funding target is one of them.

- If we are likely to meet our target quicker than we thought, we may reduce the levy – but the opposite applies if we think we will not meet our target in time.
  - It is important to remember that, by taking a long-term view on our funding for the future, we are less likely to suddenly discover that we are experiencing difficulties.
- We should always have a clear idea about what we need to do to meet our ultimate obligations which means that, all things being equal, any changes in the levy are likely to be smoother, and more predictable, than if we had no funding strategy.
  - But, progress towards the funding target will not be the only consideration in setting the levy. Economic and affordability considerations, for instance, will also be taken into account, as always.
- Our funding strategy helps us to set the overall amount of levy required. It does not tell us how that amount is to be distributed between different levy payers.

COMMENTS AND QUESTIONS

We welcome any comments and questions regarding our funding strategy.

Please contact Richard Hunt in Communications on 0208 633 5931 or richard.hunt@ppf.gsi.gov.uk