

**BRIGHTONROCK**

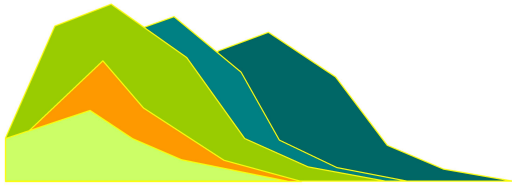
## **Pension Guaranty Insurance**

**Should or can trustees and their advisers consider alternative or supplementary approaches to protecting members' interests in the event of sponsor failure?**

**Association of Consulting Actuaries**

London, October 2008

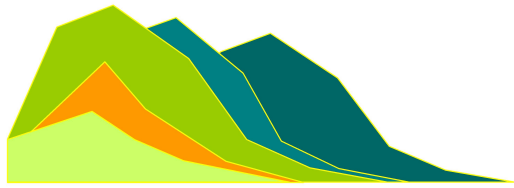
**Con Keating**



Yes !!

BRIGHTONROCK

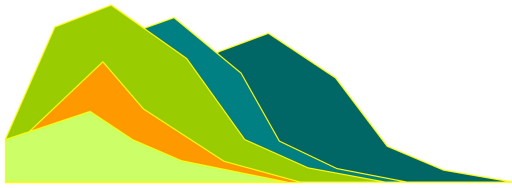
- This answer is unequivocal, because...
- The PPF is part of the problem rather than any part of a solution.
- Correctly designed indemnity assurance lowers the cost of pension provision,
- Enabling sponsors to capitalise their covenant, without incurring any sunk costs
- While providing total security and full benefits for scheme members.
- This cannot be achieved by a Government sponsored enterprise.



BRIGHTONROCK

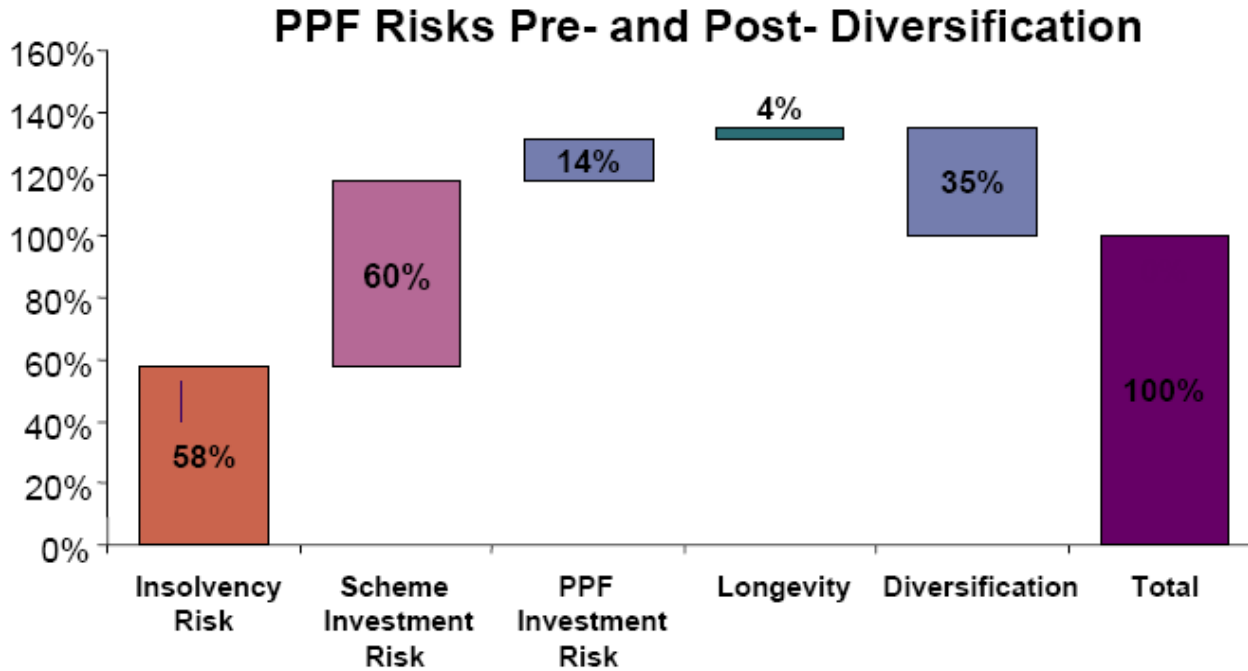
# The UK DB Pension Problem

- There is only one problem for members – sponsor insolvency
- The debt on employer legislation ensures the enforceability of the debt
- And unless a sponsor is insolvent pensions will be paid on time and in full
- This removes “willingness” as a dimension to covenant analysis leaving just
- “Ability”, and that is well conditioned for quantitative analysis.
- This also renders redundant most of the regulation concerned with scheme funding
- The question which should now be asked is:
- If the risks in DB provision are as high as the regulations imply,
- Why is Government content to allow these risks to be borne by the individual in DC arrangements?



BRIGHTONROCK

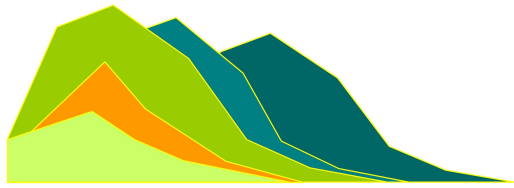
# PPF Risks



This PPF graphic shows a “risk” decomposition.

But the reality is that there is just one, sole risk to members,

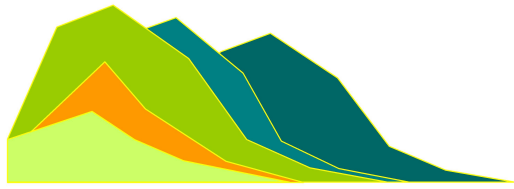
**sponsor insolvency**



BRIGHTONROCK

# Pension Risk Analysis

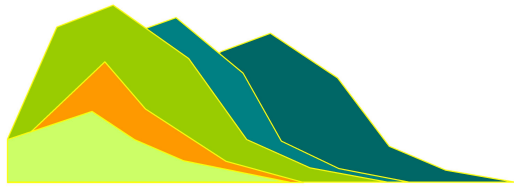
- Risk to a member is the product of the insolvency likelihood and the consequence, any deficit at insolvency
- There is a temporal order – any deficit is immaterial until insolvency has occurred
- Risk management should focus on insolvency before scheme funding status
- Focus on scheme status is secondary, and inefficient, and costly
- This is all that is available to the PPF & TPR
- Sponsor insolvency is a matter of private sector corporate finance
- And unnatural for any government sponsored enterprise



BRIGHTONROCK

# Some Technicalities

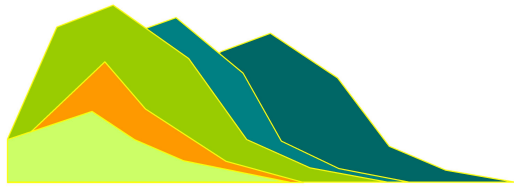
- Most Government pension publications fail to distinguish between error and risk, but errors add while risks diversify
- Error is variation **of** the expectation, while risk is variation **from** the expectation
- Funding ratios and Deficits have unfortunate statistical properties
- Rendering risk management a very hard problem indeed.
- Even the significance of a deficit varies with the discount rate under which it was derived.
- The use of “market consistent” valuations as the basis for decision and action is inefficient, by virtue of the induced path dependency,
- Unless that valuation is relevant to the likelihood of paying members their pensions in the future, on time and in full.



BRIGHTONROCK

# Voluntary Pension Provision

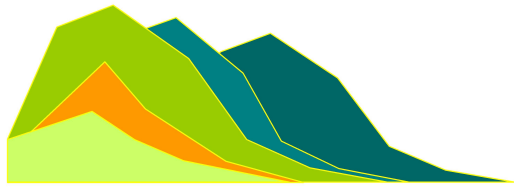
- DB provision is a voluntary act by the sponsor.
- DB is superior for the member to DC.
- DB provision can also be superior for the sponsor.
- Government should provide incentives to the sponsor firm to provide it,
- Not costly and redundant regulation enforceable only because of the creation of an ex-post barrier to exit – annuitisation.
- Private sector indemnity permits the affordable provision by sponsors of secure high quality pensions.
- The form and status of a scheme is not a barrier to private sector indemnity assurance,
- Including risk-sharing approaches such as proposed by the ACA



BRIGHTONROCK

# The Real Corporate Finance Problem

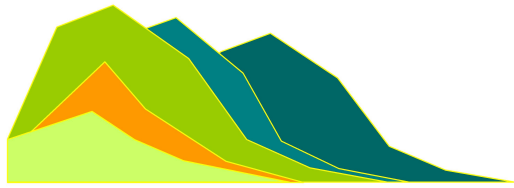
- Prior to insolvency no FD should fund any liability at greater than 100% of its fair accounting value
- But post insolvency 100% funding may be insufficient for a scheme, faced by uncertainty and risk for the residual life of the scheme
- Capital buffers are one way of coping with this, and
- The Bulk Annuity Market indicates the size – 125 -130% liabilities.
- But if we over-fund any scheme, we increase the likelihood of sponsor insolvency – and that is the primary risk event.
- The correct solution of this problem lies with insurance
- Not a mutual compensation fund like the PPF
- The optimal solution is indemnity assurance for the pension scheme



BRIGHTONROCK

# Assured Benefits

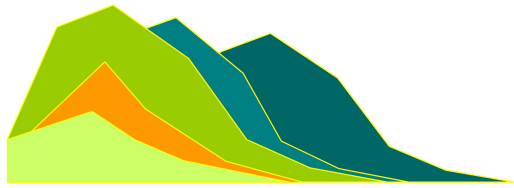
- Paying members reduced benefits post insolvency, such as the PPF's 83%, is not justified by any adverse selection or moral hazard concern
- There is no adverse selection – membership is compulsory
- And general rules wouldn't do it anyway – scheme specific is required
- Members can't influence scheme status – no potential from them for moral hazard – that's management and shareholders.
- Moral hazard concerns are dominated anyway by economic hazard concerns
- Partial benefits payments bring with them material additional costs – S179 and S143 valuations are just two examples
- Correct indemnity assurance pays members their full entitlements



BRIGHTONROCK

# Levies and Pricing

- Under the PPF arrangements schemes bear the costs of other scheme failures, not their own risk.
- Pricing is based upon a scheme's own risk contribution to the estimated overall risk in any year
- But the PPF's covered population is declining, not ergodic
- The best and longest to survive schemes will bear outrageously high costs under this arrangement
- The levy will increase inexorably
- A risk based / scheme based mixed levy structure is also inevitably flawed if risk pricing is intended.
- Correct pricing would be of the marginal contribution of a sponsor and scheme's risk to the written book of indemnity assurance



BRIGHTONROCK

# Pricing Basis

- The PPF levy is based upon scheme deficits
- A difference statistic, which is inherently unstable and volatile
- But the risks arise from liabilities –
- Longevity and inflation affect total pension liabilities
  
- The correct basis for levies or premiums is as a function of liabilities
- This can be fixed for life with indemnity assurance
- This is “whole of corporate life assurance”
- And of course unlike “whole of human life”, resurrection is possible
- But that is corporate finance; the land of rescue and recovery
- Offering the assurator some control over the incidence and timing of failure
- Feeding back into optimal marginal risk contract pricing



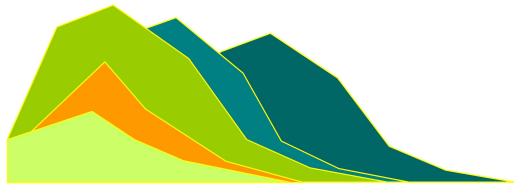
# The Optimal Contract

- Is **indemnity assurance**:
- In exchange for an annual premium, fixed as a proportion of scheme liabilities for as long as the scheme and sponsor exist
- The indemnity assurator guarantees, in the event of sponsor insolvency, to procure individual annuities for all members paying their full entitlements under scheme rules.
- The assurator may issue these annuities – this removes the point in time, sponsor insolvency, dependence on market annuity prices lowering costs
- The assurator takes possession of all scheme assets upon sponsor insolvency, including the S75 debt
- Some minor covenants are also advisable



# Optimal Policy Concerns

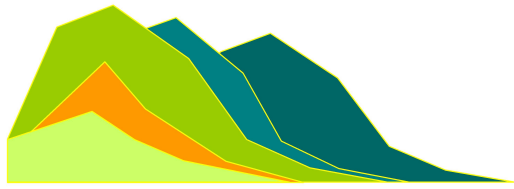
- The **indemnity assurator** cannot resile from the contract
- Even breach of covenant or non-payment of premium will not result in cessation of scheme cover.
- The sponsor & trustees, by contrast, may achieve cessation of cover at any time by GN16 transfer of the scheme liabilities and assets
- This disciplines the assurator to maintain a very high credit standing or face material lapse
- Lapse incidentally stabilises the indemnity assurator balance sheet.



BRIGHTONROCK

# The BrightonRock Policy

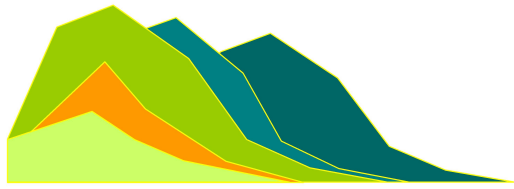
- Sets, for the life of scheme and sponsor, an annual premium at inception as a fixed proportion of scheme liabilities.
- Liabilities are the functional determinant of post-insolvency risk buffer needs
- Reduces the premium to a nominal sum in the event that a scheme is funded at or above 115% of liabilities.
- This is equitable – at or above this level BrightonRock faces no risk
- Over-funding the scheme increases the likelihood of sponsor insolvency
- Will credit all premiums received (but not the investment income arising from) against the cost of any elective annuitisation of the scheme.
- This sets a strictly increasing minimum value to the policy as an asset of the scheme
- There are no sunk costs, unlike the PPF levy
- There is an element of the sponsor covenant worth considering in more detail



BRIGHTONROCK

# Covenant Capitalisation

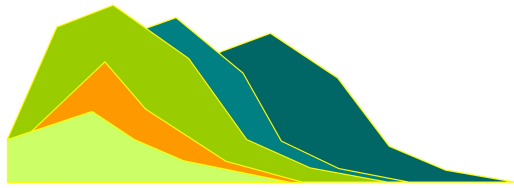
- If the sponsor pays the annual premium, it will show in its accounts a liability for future premiums payable
- The indemnity assessor is a long term creditor of the sponsor
- The pay-off of the policy is an asset of the scheme
- The sponsor company has capitalised its covenant as an asset of the scheme
- This lowers the cost of pension provision
- This asset has a strictly increasing minimum value
- The policy will usually have positive net present value to the scheme and sponsor combination - Recoveries alone will usually ensure this
- The policy is a contra-cyclical asset of the scheme
- If scheme funding declines or sponsor insolvency likelihood increases, the value of the policy as a scheme asset increases
- Accounting volatility greatly reduces.



BRIGHTONROCK

# Time and Capital

- Pensions fund investment is both long term and multi-period.
- Single period and short-term operations are sub-optimal.
- If I plan to consume a hamburger in every day of my future life (God forbid), I want the price of hamburgers to remain low or fall, not rise.
- The final value of future contributions relative to the final value present fund is the critical concern
- The spurious risk of the “animal spirits” of markets is removed by multi-period investment
- By using indemnity assurance to cover post-insolvency risks, the sponsor is capitalising the value of the long term, multi-period nature of pensions
- And reducing both current funding costs and accounting volatility.



BRIGHTONROCK

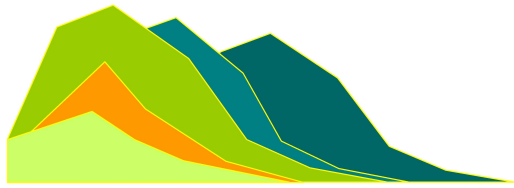
# Redundant Regulation

- With private sector indemnity assurance available
- Member security is fully assured
- And sponsor costs, direct and indirect, are lowered
- Redundant valuations and costs are eliminated
- Spurious, inefficient and expensive path dependencies, such as funding rules based upon market consistent valuations, are eliminated
- Freeing the scheme and sponsor to develop the benefits structures they desire
- While having the freedom to fund and allocate assets in the manner which best suits their risk and return preferences and objectives,
- leaving incentives for the sponsor to offer DB provision



# Contingent Asset Status

- Contingent asset rules are overkill
- “*Guarantors must be EU regulated and members of the OECD*”
- This breaches EU single market rules
- Schemes with indemnity assurance would enter the FSCS not the PPF
- Such schemes should be **ineligible** for the purposes of the PPF
- Not just subject to an annual waiver of the risk based levy
- This places assured schemes at the mercy of the caprices of the PPF
- Ineligibility would greatly reduce the costs of regulation, much of which exists solely to protect the PPF



BRIGHTONROCK

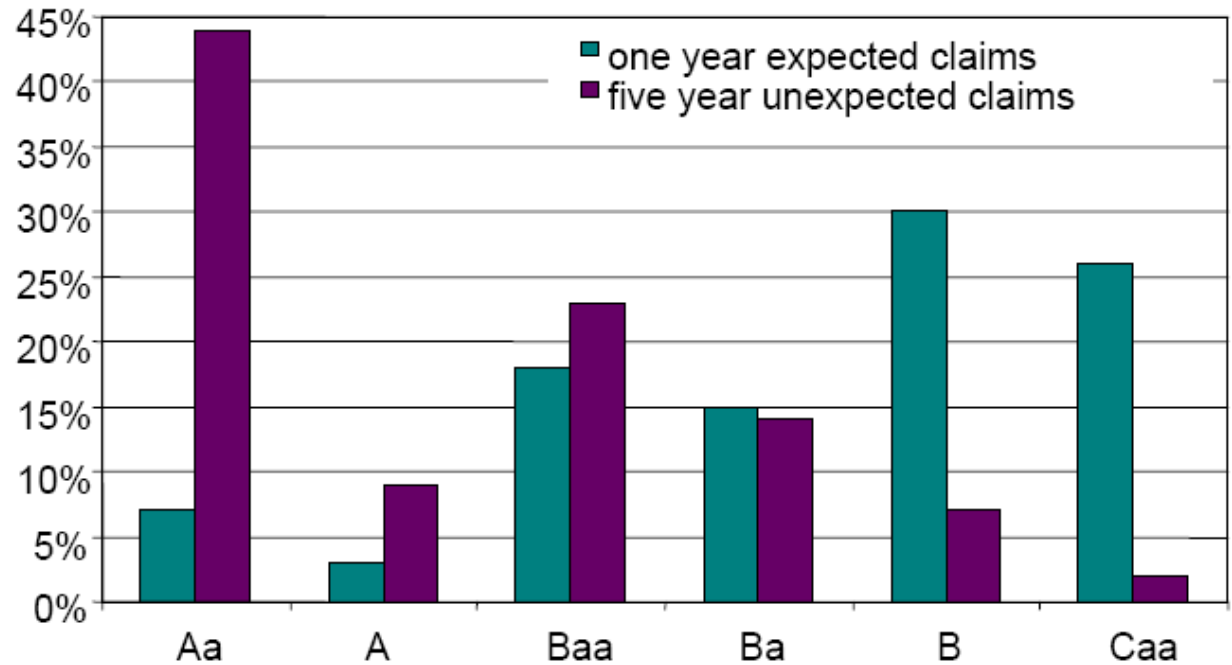
# “Cherry-Picking”

- Government has expressed concerns that private sector indemnity assurance will “cherry-pick” risks, harming the PPF
- This is a spurious concern
- The evaluation of credit at the required level of precision is not feasible
- The rewards, even if it were feasible, are not material
- Given the size of other markets where credit evaluation is central.
- In fact the risks removed by indemnity assurance from the PPF’s universe exceed the benefits of levies payable by those risks to the PPF under current and foreseeable arrangements.

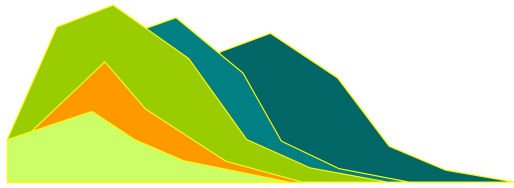


# “Cherry-Picking”

PPF “Risk”  
graphic



The question that really should arise is what could even constitute “Cherry-Picking” ?



BRIGHTONROCK

# Conclusion

- With indemnity assurance DB pension provision is once again affordable
- **And the provision of good DB is a stated Government objective**
- *Because things are the way they are, things will not stay the way they are.*
  - Bertolt Brecht (1898 - 1956)
- [Con.Keating@BrightonRockGroup.co.uk](mailto:Con.Keating@BrightonRockGroup.co.uk)