



And Pigs Might Fly Some lessons in institutional design

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Many hope that the PPF levy will stabilise. Some even expect it. They will all be disappointed. . The final cost will become unbearable for the DB schemes which continue to exist. The recent announcement that the PPF has commissioned Oliver Wyman to develop a new levy formula cannot prevent the PPF levy from inexorably rising as time passes.

The PPF levy is based in part upon a difference statistic: the scheme deficit. As this is the difference between the discounted present value of the future pension cash flows and the market value of assets at a point in time, it will remain volatile. To believe otherwise is to believe that bond and equity markets will become risk-less and unchanging – something that belongs with free lunches and fairies at the bottom of our gardens.

The PPF has estimated that it covers in aggregate just 83% of member benefits. We have a situation where there is much cost for rather little benefit – the scheme's assets will support the majority of that 83%.

There is a popular misconception that the levy payable reflects the risk of a scheme to the PPF. The reality is that the levy meets the costs of other scheme failures and is apportioned among schemes according to the PPF's assessment of a scheme's contribution to the aggregate risk faced by the PPF in a particular year. If the compensation fund had a constant membership through replacement for every failure and departure then this structure could satisfy the misconception, and be equitable among schemes. The PPF membership is declining; there are fewer and fewer DB schemes in the PPF universe. Would anyone really choose to bet on new schemes being created in this regulatory (and cost) environment?

The consequence of a declining population is to increase the costs of surviving schemes. A numerical example can illustrate this well. Suppose we have 100 schemes which are all identical in size and risk and we then allow just one scheme to fail by chance in each year (strictly the sponsor fails, not the scheme) with a loss of 50% of scheme liabilities; then the actuarially fair levy for any scheme in year one is 0.005%, but by year 99 the actuarially fair scheme levy for the sole survivor must be 50% of its liabilities.



More alarming still is the cumulative cost. For the first to fail this is just 1% of its realised loss whereas for the strongest scheme it is a staggering 519% of its realised loss. Under such an arrangement the strong become very weak.

The use of risk assessment in the apportionment of the total levy can mitigate these effects to some degree. However, even if the PPF universe was fully refreshing, it would still need perfect foresight at all times in its risk assessment for the arrangement to be equitable among schemes and not to create an increasing cumulative cost. Of course, a policy of levy subsidy among schemes, as we have at the current time, exacerbates such problems.

Some believe that the volatility problem can be resolved by de-risking their scheme: choosing an asset allocation that is very similar to the discount function that is used to calculate the present value of liabilities. This really does not help – the costs incurred increase the costs of provision, weakening the covenant of the employer sponsor.

On a number of occasions the PPF has suggested it should raise capital resources to enable smoothing of the year by year variability of the levy; this amounts to no more than prepaying the next few years' levies. The incentives for the PPF to fulfil its monitoring and risk assessment roles are not good in this situation. The question of ownership of the surplus could also become important, particularly for schemes whose sponsor is distressed.

Against this background of ever increasing costs some might argue that over-funding a scheme to avoid the risk based levy is a good idea. But for schemes with strong sponsors, funding at 140% (s179) is equivalent to paying an annual risk based levy of 2% (this perpetual annuity calculation uses a 5% p.a. discount rate). A loss-by-value rate that high is unprecedented in the UK pension universe. It also weakens the sponsor covenant, putting at risk current employees' jobs and prospects; quite what HMRC would do if it were to occur at scale is another matter – total corporation tax receipts are only in the £30 - £40 billion range.

The central problem is one of corporate finance, not a natural activity for any government sponsored enterprise. Their risk management toolkit, operating in the immediate or near term on scheme and fund, is highly inefficient and costly. Private sector assurance indemnifying the scheme against sponsor insolvency is the answer.

In these times of scarce and expensive credit, the scale of the finance offered to the corporate sector under indemnity assurance is material. For BrightonRock alone it will



be some £11 billion but for the pension market as a whole it would be of the order of £100 billion. This approaches 20% of all bank lending to private non-financial corporations in the UK, but is far longer in term. Government reluctance to facilitate the advent of indemnity assurance by removing redundant external regulatory costs is, in these times, simply incomprehensible.

The PPF levy has two components: the scheme based levy and the risk based levy. No formula for the risk based levy can be fair based on long-term risk as long as the scheme based levy exists. The scheme based levy had a purpose in the very early days of the PPF, it brought administrative ease, but that time has passed. Under the Pensions Act 2004 the risk based levy has to be at least 80% of the total PPF levy each year in aggregate. Let us hope that Oliver Wyman recommend that it is 100% for all schemes.

The heart of the matter is that the institutional design of the PPF is badly flawed, bringing costs which are sufficient to ensure the demise of the best form of employment-related pension ever devised – defined benefit.