



## **Design and Implementation of the Jobsworth Box: Selected issues from UK defined benefit regulation**

Andrew Slater & Con Keating

Last month we dealt with issues associated with the DWP's risk sharing consultation which fails to recognise that DB scheme members face only a solitary risk – sponsor insolvency. Indemnity assurance was offered as a complete and efficient resolution of the real problems faced by both employer and scheme member. We also made the observation that that the 2003 Debt on Employer legislation rendered redundant the majority of the scheme and funding regulation now in effect and that its continued application could be costly and counter-productive. This article is concerned with a number of specific examples of such otiose regulation.

At first sight the PPF might be considered to fulfil the role of an indemnity assessor but it is actually a mutual compensation fund. This is a design which falls far short of that required. The PPF by its own calculation covers just 83% of scheme benefits and 20% of scheme risk; many schemes have reported much lower levels of average coverage.

It is usual for an insurance policy to contain a deductible, a first loss which is paid by the insured in each claim; this is a contractual device for the optimal reduction of the adverse selection and moral hazard issues that arise from the asymmetry of information between specific policyholder and insurer. Perhaps the designers of the PPF were thinking of this benefit reduction as a form of deductible. However, participation in the PPF is compulsory for schemes, which means that questions of selection can not arise. Moreover, as the rules are the same for all, such general reductions of benefits would fail badly as a screening device for any adverse selection problems, were they to exist.

This, of course, leaves problems of moral hazard; the misbehaviour of the insured after a policy has been effected: smoking in bed after the fire policy has been bought, or leaving the doors unlocked after household contents cover has been acquired. However the risk here is sponsor insolvency, and moral hazard in this case does not arise from the actions of the scheme members but from the actions of sponsor management and shareholders. The lowering of member benefits is next to useless in



modifying the behaviour of those latter groups. Properly designed indemnity assurance will pay members their full entitlements under the scheme rules.

The principal risk faced by the PPF is, in lieu of members, sponsor insolvency, and this is a matter of corporate finance, which is not a natural field of activity for Government or any of its agencies. It is, of course, subject in a European context to competition and subsidy regulation. In any event, there should be concerns as to competence; remember that for the past thirty or so years, privatisation has been avidly pursued precisely because productivity and productivity growth in the private sector exceeds that of the public sector. For some, non-involvement is also an article of political dogma. The PPF risk management toolkit is mis-specified; it can only operate on the scheme when the problem arises with the sponsoring employer.

The position of a private sector indemnity assessor is unique in this regard. When a company is in distress, it has an imminent loss, but also a positive incentive to participate in rescue and recovery prior to the costs of administration, receivership and liquidation being incurred. A bank, by contrast, is seeking recovery, of monies already long spent by the sponsor, from the assets of the business. The proposals of the Leader of the Opposition, David Cameron, for the introduction of a US chapter 11 style insolvency process, with super-senior status for advances made in these situations look to be a very positive development.

The PPF levy structure is misconceived. It is based upon a difference statistic – the difference between the discounted present value of liabilities and the current market price of assets. Difference statistics are intrinsically volatile. Under this arrangement there is no reason to expect the levy ever to stabilise or become predictable. Equally important is the fact that the significance of a deficit itself is a function of interest rates; any deficit when interest rates are 3% admits a far longer period for recovery funding to be organised than when interest rates are 15%. Moreover, risk management should not, in general, be limited to the immediate. This is clearly problematic for the Pensions Regulator's scheme specific funding regime.

Pension accounting has been widely and often heatedly discussed in recent times. As was noted in the previous article, the small liquidity requirement of DB pensions reduces the relevance of such calculations to very low levels indeed. These issues are covered more extensively in our response to the Accounting Standards Board's consultation on pension accounting – available from [www.BrightonRockGroup.co.uk](http://www.BrightonRockGroup.co.uk).



This low liquidity requirement is a source of one of the fundamental strengths of DB arrangements, their long length to benefit from time diversity. Basing levies and other actions upon the immediate serves to deny this and make the costs of provision arbitrarily high; technically this introduces path dependency into the process and it is trivial to show that path dependent processes are in general inefficient and costly.

The PPF introduces the requirement for recurrent S179 valuations. With some 8,000 schemes at an average of, say, £25,000 per valuation this amounts to £200 million pounds in additional costs for schemes and their sponsors; not an insignificant sum. If a scheme is funded at 140% of this valuation, it may be exempt from the risk-based levy and this may be used to gauge the PPF's implicit view of risk. Forty per cent of excess funding considered as in perpetuity with interest rates at 5% implies a 2% annual premium cost; never in history has such a loss-by-value rate been incurred by the DB pensions market. Schemes using this would be funded well in excess of 100% of the full accounting liability, and that is harmful to the sponsor company, increasing the likelihood of their insolvency. With PPF cover at 83% of scheme accounting liabilities and 140% funding, the scheme is funded at 116% of the FRS17 level. At this level most schemes could not effect full annuitisation of all member benefits in the bulk annuity market. The effect here is to increase the likelihood that members receive less than their entitlements under the scheme rules – a classic Jobsworth result.

The legislation also requires that the PPF levy is at least 80% risk based in aggregate – an objective the PPF has yet to achieve. Many believe, erroneously, that this implies that their levy should follow this formula – in fact, as some 9% or so of schemes pay no risk-based levy, it is evident that this cannot be the case. When we add the cross subsidy of the levy for schemes with very weak sponsors, it becomes obvious that an individual scheme's risk-based levy may far exceed this.

Variation in the aggregate level of riskiness of schemes, as might reasonably be expected from the economic cycle, would also suggest that the scheme based levy would vary with this. A numerical illustration is appropriate here: suppose we have one year when the aggregate risk of schemes collectively is £1 billion and this is divided as to £200 million scheme-based and £800 million risk-based and the next year the aggregate risk declines to just £500 million. Then we may divide this as to £400 and £100 million, which makes the scheme levy also entirely risk-based or we might choose, among many possibilities, to maintain the scheme-based levy at £200



million and have just £300 of risk-based levy, which of course exaggerates the volatility of the riskiness of pension schemes in aggregate, and of schemes paying risk-based levies in particular. The Jobsworth box is getting crowded.

Sponsor insolvency risk has a pronounced term structure as is evident from corporate bond markets. We observe the credit spread payable by high-quality issuers or sponsors increases with the term of the security, but the credit spread for low quality issuers or sponsors declines. This raises significant questions as to the risk horizon and today's fair price for that risk to an individual scheme. Using the current short term insolvency likelihood favours the high quality to the detriment of the low. At first sight this may be thought to lend support to the concept of cross-subsidy in the PPF levy. However, this is not the case.

The losses when one scheme fails are collectively paid for by other surviving schemes under the PPF structure. When subsidy of the levies payable by weak schemes is introduced and justified by the immediate enhancement of the weak sponsor's insolvency likelihood, the effect is to increase the aggregate risk exposure of that weak sponsor; having a sponsor limp along, paying the costs of other scheme failures as it does so, hurts that sponsor in the long term. The conclusion is that risk subsidy in a mutual setting is a very poor idea.

Surviving schemes pay the costs of other scheme failures; the longest surviving will pay the most. Notwithstanding the proportional cost sharing among schemes based upon that scheme's contribution to aggregate risk, the fact is that the PPF costs are not those of the scheme but those of the failures. A scheme's levy (the cost of cover) under the PPF arrangements explicitly do not reflect that scheme's riskiness. Private sector indemnity assurance would, in line with sound risk theory and practice, price the cover provided explicitly in terms of the riskiness of the scheme to the assurator.

The annual nature of the PPF levy is also problematic; it is an explicit, highly variable expense to be borne and accounted for annually- a deadweight cost. By contrast indemnity assurance, by virtue of its long term nature, is properly accounted for as a long-term liability of the sponsor and an asset of the scheme. This makes obvious the fact that this is a form of corporate finance and also of considerable value to the scheme. The partial benefits payable under PPF arrangements further serve to ensure that the cover provided has no ongoing positive value to a member scheme. There are also many ancillary benefits to indemnity assurance arrangements – see [www.BrightonRockGroup.co.uk](http://www.BrightonRockGroup.co.uk).



Much of the legislation being administered by the Pensions Regulator is concerned with the reduction or avoidance of risks to the PPF. Inasmuch as this is ultimately borne by schemes collectively (and disproportionately among them) as a cost, this should, perhaps, be laudable. However, too much of the detail is micro-management and grossly inefficient in consequence. Scheme specific funding has already been criticised for failing to consider its interest rate sensitivity, but problems abound with this micro-management. Applying a set of common minimum longevity assumptions, as the Pensions Regulator (the PPF's guardian) proposes, will only serve to introduce error into many schemes' funding contribution costs; there is considerable natural and correct variation among the life expectations of scheme populations. Applying an asset allocation criterion to a scheme's fund to reduce its short-term variability can only be counter-productive in the long term. The relation between risk and return in financial markets may be complex but few would deny that on average higher risk is associated with higher returns – this is a basic tenet of finance. Any scheme's asset allocation is rightly considered in the joint context of scheme and sponsor finances; any consideration for PPF levy is restricted to just the scheme. In general, reducing the variability of a scheme's assets will lower its returns, increasing the costs to the sponsor, decreasing its financial strength and increasing the likelihood of sponsor insolvency: reducing scheme asset volatility lowers member security.

A recent study published by the US National Institute on Retirement Security entitled "*A Better Bang for the Buck*" concludes that DB offers significant, economically superior value to DC. The benefits in this study arise principally from longevity pooling and the investment strategy followed. The UK's Jobsworth box now looks to be overflowing.

If Government really does wish to see continuing good quality DB provision in the private sector, then a thorough root and branch analysis and revision of the regulations is necessary. The acceptance of private sector indemnity assurance is part of this and clearly overdue.