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Re-examining pensions guaranty insurance

The UK's Pension Protection Fund is a good illustration of poor institutional design. Full cover insurance of pensions is both feasible and theoretically sound, argues **Con Keating**

One of the declared objectives of this UK government is the maintenance of good DB pension schemes. This may be considered sound policy as in principle they are far superior to alternatives such as DC schemes. Unfortunately the value-for-money proposition associated with these schemes is now so low that many sponsor enterprises wish to curtail their commitment.

This is a cumulative effect of government action over time, including legislation that has progressively added further benefits to the liability burden. Simultaneously, government concessions in the form of tax and social security treatments have been progressively reduced. This has been accompanied by a near halving since the 1970s of the corporation tax rate to 28%, which raises the effective cost of a pension contribution to a shareholder.

Curtailment was a simple and usually inexpensive process until the 2003 enhancements to the 'debt on employer' legislation and the Pensions Act 2004. The introduction of the Pensions Regulator and the Pension Protection Fund (PPF) have added significant cost to curtailment, and to sponsors who wish to continue offering this voluntary form of benefit to their employees. Effectively the only way to achieve full curtailment now is to engage in a bulk annuity purchase, a process which requires the scheme to close, cease all benefit accrual and wind up. It typically costs some 20-30% more than the FRS17/IAS19 accounting liability – an exit expense introduced expost for voluntary schemes.

At the same time, still-contentious revisions to accounting standards have focussed attention on pension issues and arguably have increased the pressure on DB schemes to close.

For ongoing schemes the costs of PPF membership are an additional scheme expense. Moreover levy costs, funding level expenses and compliance costs, such as the S179 valuations have burgeoned. In addition, the PPF has recently suggested that it may adjust its levy income to reflect scheme asset allocation and increase it to build up reserves – as if it were an insurance company rather than the compensation fund that it is.

The level of over funding that the PPF requires for exemption of a scheme from the risk-based levy, it has just been raised to 140% of the S179 valuation, may be used to indicate the potential long-run cost of the levy. With interest rates at 5%, this is an annual premium equivalent cost of greater than 2%.

The PPF is an example of poor institutional design. It promises to pay, at best,

90% of the entitlements of the members of schemes whose sponsor has failed. In individual cases the compensation offered by the PPF may be as little as 60% of the entitlement. At first sight this appears to be a form of deductible with which we are all familiar from our household and motor insurances. The rationale for a deductible is that it mitigates the problem of moral hazard – namely, that we may not be as diligent and careful after insuring as we were before; it is recognised as an optimal form of risk sharing. However, in the case of pensions insurance, the situation is different. As the insurer (the sponsor/scheme) and the beneficiary (the member) of the insurance are not the same person the deductions from full entitlement no longer function to modify behaviour but are simply another device to lower the consequence to the PPF of a failure.

Full cover insurance of pensions is both feasible and theoretically sound. But the PPF has stated that it covers just one-fifth of the full risk DB schemes face from their sponsor's failure.

Sound risk management principles can help with understanding pension guaranty insurance. The risk of an event is the product of the likelihood of the event and its consequence. So to reduce risk we may take action either to reduce the chance of the event or to mitigate its consequences, or both. There is a sequential order here; if we eliminate the possibility of the event then we have no concern with mitigation of the consequence of the event.

This distinction also helps us understand why it would be inappropriate for the EU to subject many pension funds to the same solvency regime as insurance companies. The regime is indeed appropriate for insurers as it results in a reduction of the likelihood of insolvency. But for pension funds, where it serves solely as a risk mitigant of the consequence of insolvency, it does nothing to reduce the likelihood of insolvency and, indeed, it may even increase it.

The distinction also enables us to see why the Pensions Regulator and the PPF are operating inefficiently, both from their own standpoint and from that of the corporate sector. There is little that they can do with respect to the likelihood of insolvency of a private sector company. They must consider this risk as exogenously given and focus solely upon the consequences. The economically correct approach would be to consider scheme and sponsor finance jointly – and that can lead to different results (and costs) from those resulting from the current regulatory regime.

The PPF is principally concerned with the protection of its financial position and the limitation of its own liabilities. It has just two tools at its disposal – the amount of the levy and scheme funding. It has already altered the amount of the levy quite markedly, but has never achieved its mandated target that 80% of revenues be risk based. The volume of alterations has been criticised by scheme sponsors and trustees.

The use of excess funding as a risk mitigant is a blunt instrument that results in higher risk to both beneficiaries and shareholders.

Private sector insurance of pension schemes against sponsor insolvency is intrinsically superior to the current regime. For an insured scheme to be granted exemption from both the risk- and scheme-based PPF levies, the current regulatory position requires it to be closed and in wind-up. Surprisingly, the guidance notes that accompanied the draft of the relevant statutory instrument indicate a far broader intent than the final text. At present, the best that can be achieved for an ongoing privately insured scheme is exemption from the risk-based levy under the PPF contingent assets regime.

This is an economic nonsense since once fully insured the scheme represents no risk to the PPF.

BrightonRock recently discussed with the UK minister for pension reform, Mike O'Brien, the possibility of amending the regulations to reflect the intent of the guidance notes so that insured schemes avoid unnecessary expense. O'Brien declined to advance such amendments at this time. The expressed reason was protection of the PPF due to its relative youth.

Unfortunately, the passage of time is unlikely to increase confidence in its security and sustainability, since its structure and method of operation is intrinsically short term and volatile, as may be seen from the fact that its levy is based, inter alia, upon scheme deficits – a difference statistic. Like all such figures, the difference between two large, varying amounts (scheme assets less liabilities) is very volatile.

Subsequently, the minister requested a short report on how an insurance policy, such as that to be offered by BrightonRock, might assist in prolonging the provision of defined benefit schemes in the UK.

Both this and a report dealing with the related question of 'cherry picking' are available for download from www.brightonrockgroup.co.uk