Thoughts and insights

Adam Cadle talks to PPF CFO Andy McKinnon about levy proposals, pre-pack sales and investment decisions

What is the thinking behind the PPF's latest levy proposals and how have you reached these proposals?
We are currently consulting on the levy for the third triennium 2018/19. The consultation closes on 15 May. The proposals have been developed in partnership with Experian following engagement with stakeholders over the last three years, most recently through an industry steering group, and they seek to improve the way we calculate levies for the next three years, beginning in 2018/19.

The current levy framework is working well and overall, feedback is supportive of our approach, therefore in an effort to maintain stability we have only proposed changes where there is a compelling case to do so. To ensure the best possible assessment of insolvency risk for some of the largest levy payers we are suggesting new scorecards, adoption of credit ratings for some of the largest employers and a specific methodology for regulated financial services entities. We believe the outcome of these proposals will result in SMEs and 'not-for-profits' paying levies that better reflect their risks.

In addition to consulting on the third triennium, we confirmed our levy rules for 2017/18 in March this year following consultation and feedback from stakeholders. The final rules confirmed the levy estimate of £615 million and outlined some other small changes. This includes a proposed mechanism for stakeholders to notify Experian, our insolvency risk services partner, where the move to new UK accounting standard FRS102 would cause an artificial movement in their rating.

The levy determination also included the new approach for schemes with no substantive employer. This is new and evolving terrain for us – these types of schemes were not envisaged at the time of the Pensions Act 2004 which set up the PPF. We recognise that these arrangements change the nature of the risks we face. Simply put: in the absence of a genuine sponsor, PPF levy-payers would be directly exposed to the risk of failure of a scheme's investment strategy.

Therefore, as specific propositions have been put forward, we have necessarily developed our thinking with regard to the challenges these schemes pose to us and as part of this, have developed a new charging methodology and rules as to how we would charge a levy to any such a scheme without a substantive sponsor that meets our criteria. The new proposed charging methodology for these schemes is based on a commonly-used pricing model for valuing options, which has then been adapted to the PPF's particular circumstances. The methodology recognises that a scheme with no sponsor will always pose a bigger risk than an identical scheme which has a sponsor, however weak and should, therefore, always pay at least the same levy.

Concerning deficit recovery periods, the industry has argued that there should not be an indefinite term in which a firm can stretch out funding arrangements? Should there be a cap on deficit recovery periods?
We would welcome changes to the scheme funding regime in order to more effectively tackle risks to member benefits and PPF levy payers. In particular, schemes with strong employers should be required to target shorter recovery plans as opposed to being allowed longer recovery plans or to take greater risks as is the case under the present system.

We know from experience that even the strongest sponsors can deteriorate rapidly, and where this happens it can pose an unnecessary risk to member benefits. Restrictions on the permitted length of recovery plans, and on plans that are 'back-end loaded', particularly if targeted on schemes with the largest deficits, could substantially reduce downside risks to the PPF and ultimately our levy payers.

How much of a concern are pension schemes entering the lifeboat fund under pre-pack sales?
Pre-packs themselves are sometimes

entirely appropriate in the given circumstances. There have only been a small number which have been cause for concern, and in recent years we have been educating insolvency practitioners on the need to engage before any pre-pack insolvency. The number of pre-packs has dropped significantly in the last few years and there is not believed to be a widespread issue.

The PPF has strong controls in place to take action if a scheme comes to the PPF through a pre-pack insolvency without prior engagement or where there are concerns. In such circumstances The Pensions Regulator would be alerted, who have a range of regulatory powers available to them, and can seek to protect the interests of our levy payers by appointing an independent liquidator.

Do you think that the number of BHS-type situations is going to increase in the future and if so what impact will this have on the PPF's resources?
An increase in claims often follows political uncertainty and economic weakness and we are structured to withstand unexpected events and an increase in claims. Our investment strategy aims to generate a return over and above that required to match existing liabilities in order to enhance the fund's capacity to absorb schemes that may transfer to the PPF in the future. We have a clear view of the risks we face and our funding strategy assumes that large schemes will enter the PPF from time to time.

Looking at the PPF's investment portfolio, how has this changed over the last few years and how is the investment portfolio decided and structured?
The PPF currently has more than 225,000 members who will rely on us to pay compensation for the rest of their lives. The investment strategy is therefore low risk, and combines a liability-driven investment portfolio and a return-seeking portfolio. The key change over the last few years is the work we are doing to insource part of our investment management capability, allowing us greater control and flexibility to manage our assets.

In terms of our investment approach, about half of our assets are in the LDI portfolio, including gilts, inflation swaps, and other long duration assets. The return-seeking portfolio is roughly evenly divided between illiquid assets such as real estate farmland and private equity and a second, tactical subset including publicly-traded equities, credit, and government bonds.

Since July 2014 we have also been building our exposure to hybrid and alternative assets in line with our evolving asset allocation strategy. This provides a number of diversification benefits, as well as an attractive risk adjusted return to benefit our members and levy payers.

Infrastructure is a key component of our long-term alternative strategy. In 2015 we were part of a consortium investing £4.2 billion in the Thames Tideway Tunnel, one of the biggest infrastructure projects in Europe, and in 2016 we partnered with Legal and General Retirement to provide £400 million of financing for the London Gateway port at Tilbury. As the PPF continues to grow its investment capabilities we will continue to work with other pension providers and institutions on innovative investments where we see collaborative opportunities.

What are the PPF's aims and ambitions for 2017?
We are here to continue to protect our members by pursuing our funding target and providing excellent service.

We are of course living through a forever-changing political and economic landscape and while our assets under management currently stand at a healthy £23 billion, with a surplus over £4 billion, we are not complacent.

We are currently in the process of insourcing some of our investment capability, giving us more flexibility and control over our assets. This project will continue over the coming year.

Written by Adam Cadle

Pension Protection Fund