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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

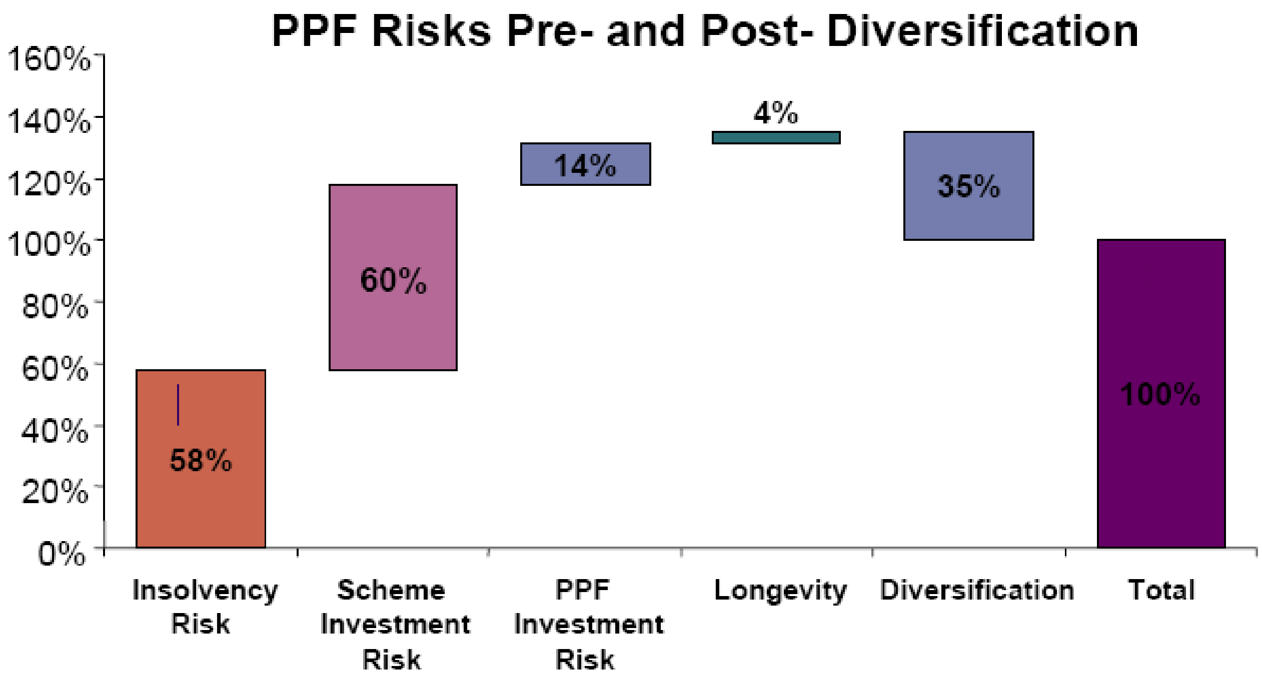
Yes !!

- 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.

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?

PPF Risks



This PPF graphic shows a "risk" decomposition.

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

sponsor insolvency

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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

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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.

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

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

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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

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

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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 assuror 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 assuror guarantees, in the event of sponsor insolvency, to procure individual annuities for all members paying their full entitlements under scheme rules.
- The assuror may issue these annuities – this removes the point in time, sponsor insolvency, dependence on market annuity prices lowering costs
- The assuror takes possession of all scheme assets upon sponsor insolvency, including the S75 debt
- Some minor covenants are also advisable

Optimal Policy Concerns

- The **indemnity assuror** 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 assuror to maintain a very high credit standing or face material lapse
- Lapse incidentally stabilises the indemnity assuror balance sheet.

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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

Covenant Capitalisation

- If the sponsor pays the annual premium, it will show in its accounts a liability for future premiums payable
- The indemnity assuror 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.

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.

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

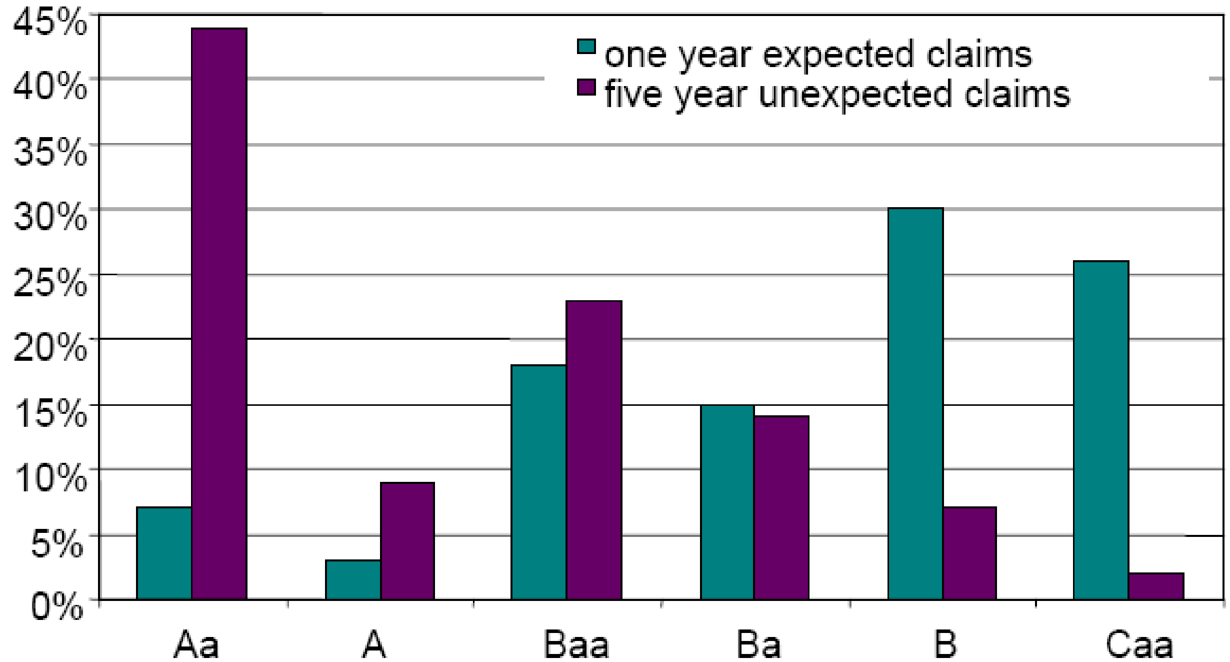
- Contingent asset rules are overkill
- *"Guarantors must be EU regulated and members of the OECD"*
- This breaches EU single market rules
- Schemes with indemnity assurance would enter the FSCS not the PPF
- Such schemes should be **ineligible** for the purposes of the PPF
- Not just subject to an annual 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

“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" ?

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)

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