

Pension Protection Fund

“The Pension Bill will establish the Pension Protection Fund to protect members of private sector defined benefit schemes whose firms become insolvent with insufficient funds in their pension scheme so they can be reassured they will still receive most of the benefits which they were expecting.

We will make sure that in future individuals in final salary schemes will never again face the injustice of saving throughout their lives only to have their hard-earned pension slashed just before they retire. The Pension Protection Fund will allow individuals to save with confidence.”

Andrew Smith, Secretary of State for Work and Pensions, 12th February 2004

Current situation

People join occupational defined-benefit (sometimes known as “final salary”) pension schemes rightly expecting that they will receive the pension they have been promised. While the overwhelming majority do see that promise fulfilled, there are some who, in exceptional cases, do not.

This can leave workers with a significantly reduced pension because there is insufficient money left in the pension scheme to pay out pensions as promised. In some cases workers have been left losing out very heavily – there are cases where people have paid into a pension for their full working life, only to find its value dramatically reduced in the immediate run-up to retirement. This has shaken trust in pensions in general - trust which the Government and its partners are taking action to restore.

What is changing

The Government wants to increase protection for scheme members to ensure that they are confident in saving for retirement, as well as to give employers the reassurance they need to carry on providing valuable pension provision.

We will establish a brand new compensation scheme called the **Pension Protection Fund (PPF)** run by an independent board to protect the pension promise. It will provide compensation in two areas:

1. Firstly the new organisation will ensure that where a company with a defined benefit pension scheme becomes insolvent, and its pension fund is not sufficiently funded, members can be reassured they will still receive the core of the benefits to which they are entitled, by providing compensation covering:
 - 100% of the original pension promise for people who have reached the schemes pension age,

- 90% for people below that age, subject to an overall benefit cap, calculated using a mixture of the schemes individual rates and standardised rules, linked to earnings.

It will also include:

- Indexation of pensions in payment on rights built up after '97 in line with RPI capped at 2.5%, and revaluation of all deferred rights in line with RPI capped at 5% to ensure the PPF compensation retains its value over time and provides a meaningful level of retirement income.
- Survivors' benefits for married and civil partnerships, in most cases.

This approach strikes a balance between providing a high level of compensation and maintaining administrative simplicity to help keep costs down

Compensation will be funded by taking on the pension assets of insolvent employers, and through a levy on schemes.

2. The PPF Board will also take over the existing responsibilities of the Pensions Compensation Board and compensate members of both defined-benefit and defined-contribution schemes in cases of fraud and misappropriation.

How will the Levy work?

The levy will be charged to all private sector defined-benefit or hybrid occupational pension schemes and collected by The Pensions Regulator. The costs of the Levy are offset by other measures the Government is taking to reduce costs and burdens on schemes. This means that overall the Pension Bill will produce net savings for employers.

The levy has been designed drawing on US experience. As a result, we are ensuring that risk-based factors will be the major component of our levy, so that costs are minimised for good employers with well funded schemes. The Bill specifies a number of factors that can be considered in assessing risk – scheme underfunding, credit-rating and investment strategy – and also leaves flexibility for the PPF board to add more.

The Levy will be split into three parts:

- **Pension Protection levy**
 - One element will be based on **scheme factors**, such as number of members and the balance between active and retired members;
 - The other element will be based on **risk factors**, linked to the level of under-funding and other risk factors. The risk-based element will constitute **at least 50%** of the total charge;

- **Administration** levy, covering the set-up and on-going costs of the PPF;
- **Fraud compensation** levy (this replaces the existing Pensions Compensation Board levy), to cover and be paid by both defined-benefit and defined-contribution schemes, if and when a case of fraud occurs.

We need to get the PPF in place as soon as possible, even though some of the data needed for the risk-based levy will not be available. So, **for the first year**, only the scheme-factors based part of the Pension Protection levy will be collected. Well run schemes will not lose out as the Pension Protection levy will be set to raise just **half** what the levy will raise in later years. We will be enabling the Board to introduce a risk-based component from the second year, so that the risk-related factors can be added in **in the way that suits schemes best**. If they think it is in their interest to have an early valuation done, then they can do this as soon as they like; alternatively, they can wait until their next tri-annual valuation is completed. So, schemes face a low levy in the first year and the flexibility to move towards a more risk-based system as it suits them.

It is likely that the levy will be simpler for small employers so that they will not be forced to incur disproportionate administrative costs in providing information on which the levy will be based.

The aim is to set the levy so that it can be maintained at a steady level in order to allow employers to plan ahead financially with confidence.

How do scheme members enter the PPF?

A scheme will become eligible to enter the PPF and its members receive compensation when triggers in the employer's **insolvency** procedure occur, and where the scheme has insufficient assets to buy out the PPF level of benefits with an insurance company.

Who will run the PPF?

The Board will consist of a chairman (to be appointed by Secretary of State) and directors drawn from relevant sectors of the pension and financial markets, who will be responsible for:

- paying pension compensation;
- paying fraud compensation (the PPF Board will take over the functions of the current Pensions Compensation Board);
- managing the calculation and application of the three levies (pension compensation, administration, and fraud compensation); and
- setting and overseeing the investment strategy.

In line with good corporate governance guidelines, the PPF will have a majority of non-executive members.

It must provide an annual report and accounts describing the activities of the Board in that financial year, which the Secretary of State must then present to Parliament.

The Pension Protection Fund has been designed so that Government funding is not required. The Fund can control its own income (through the levy) and its own liabilities, as well as being able to borrow on the market to smooth these over time. This will avoid the costs falling ultimately on taxpayers, the vast majority of whom will not be members of defined benefit occupational pension schemes.

How will the fund/assets be managed?

The Pension Protection Fund's investment strategy is the responsibility of the Pension Protection Fund Board, who must appoint at least two independent fund managers. The Pension Protection Fund Board may borrow commercially on a short-term basis should cash-flow difficulties arise.

Why should well run company schemes pay a levy?

The US experience shows that good firms participate because "you never know what's around the corner", especially 30, or even 60 years down the line. Pensions are a long-term commitment, which is why the PPF is taking a long-term view.

However, the PPF will reduce cross-subsidy by charging a risk-based levy so that schemes that pose a higher risk pay more for the PPF compensation cover, and costs are kept down for good employers with well-funded schemes. This effect is guaranteed to be significant because the levy must be **at least 50% risk-based**.

Won't this reform discourage firms from running Defined Benefit (DB) schemes?

The levy represents only a very low percentage of the flow of contributions into DB schemes.

It greatly increases the value of DB pensions to firms, as they will be more useful to recruit and retain the best once the workforce have confidence that pensions paid will be pensions delivered.

The Pension Protection Fund is part of a balanced overall package which protects the interests of scheme members but also minimises the burden on employers. The overall impact of the Bill measures on business at

introduction is an estimated saving of £130 million per year. This excludes savings from proposals for simplification of taxation of pensions.

When will the PPF open for business?

Member protection is a Government priority, and so the PPF will open its doors as soon as possible after the relevant legislation is in place. We are still aiming for the first part of next year, though this timetable remains very challenging.

This is a major new reform, and we must make sure that we engage thoroughly with all our partners to get it right.

What about those who are at risk of losing out before PPF comes in?

We are taking urgent steps which will help in advance of the PPF. We have already published draft regulations which will prevent solvent employers from walking away from their responsibilities.

We will shortly publish draft regulations which will change the priority order where a scheme winds up, giving more protection especially to people who have been in the scheme for the longest.

These urgent measures will increase protection significantly in advance of the Pension Protection Fund.

We have enormous sympathy for the difficulties faced by former workers who have already missed out, and these have highlighted the need for the Government to take urgent action. The PPF, however, is an insurance scheme and no insurance scheme can cover against events that have already happened.