

REVIEW OF PENSIONS INSTITUTIONS – RESPONSE TO CONSULTATION DOCUMENT BY THE BOARD OF THE PENSION PROTECTION FUND

Introduction

1. We welcome the opportunity to make further input to this review, in the light of the consultation document. This response is divided into three main parts:
 - (i) Section I sets out key aspects of the Pension Protection Fund (PPF)'s position given the consultation document's suggestion of a potential merger between the PPF and the Pensions Regulator;
 - (ii) Section II assesses how a proposed merger would measure up against the consultation document's "*key factors which need to be considered in weighing up proposals for change*";
 - (iii) Section III is an extract from a letter sent by the Chief Executive of the PPF to the external reviewer. This letter relates to our concern that the Regulator's evidence contains substantive misunderstandings about the nature of our functions and the basis of our operations. Because of this, we cannot accept the Regulator's conclusions on the future of the two bodies.
2. The consultation document asks 3 main questions:
 - is there a good case for bringing tPR and PPF closer together?
 - is there a good case for bringing FSA and tPR closer together?
 - is there a good case for bringing the Pensions Ombudsman and the Financial Ombudsman Service closer together?
3. The Board's primary concern is clearly with the first question, and this response deals solely with that: other respondents will no doubt offer views on the other questions.

I PPF Key issues

4. **Financial Institution, not regulator**. It is essential to realise that the PPF is a compensation provider and (in order to fulfil this role while maintaining solvency) a financial institution. It is not a regulator, and has no regulatory functions. The Board's initial evidence set out its key functions and activities as including:
 - investment management and strategy – strategic asset allocation of a portfolio currently around £1bn and likely to grow to £5bn+ by end 2008/9;
 - corporate finance and debt recovery – securing recoveries through creditor negotiations, which already exceed £330m;
 - pricing the risk to the Fund represented by the universe of final salary pension schemes and designing levy strategies to cover that cost;
 - preparing and publishing complex financial statements, similar in scope to an bank or insurer;

- receivable management – calculating, invoicing and collecting the pension protection levy;
- balance sheet management – managing the solvency of the Fund;
- transition management, as scheme asset portfolios are moved into the PPF’s investment portfolio;
- managing back-office functions specific to our role – custody of assets, etc.
- project-managing around 150 schemes, with about 100,000 members, through the assessment process;
- making monthly direct compensation payments. 7,000 members have now transferred to PPF, of whom we are already paying about 1,450 - this is expected to rise steeply to about 30,000 payees by end 2008/09;

5. **Additional timing concerns.** While we believe that the flaws in the case for merger are fundamental rather than transient, we also believe that if a merger were nonetheless proposed, the Regulator’s contention that this would be timely in view of the two bodies now moving to “steady state” simply does not apply to PPF. Figure 1 shows the expected growth and scale of some of the activities listed in paragraph 4 within the current 3 year strategic plan horizon:

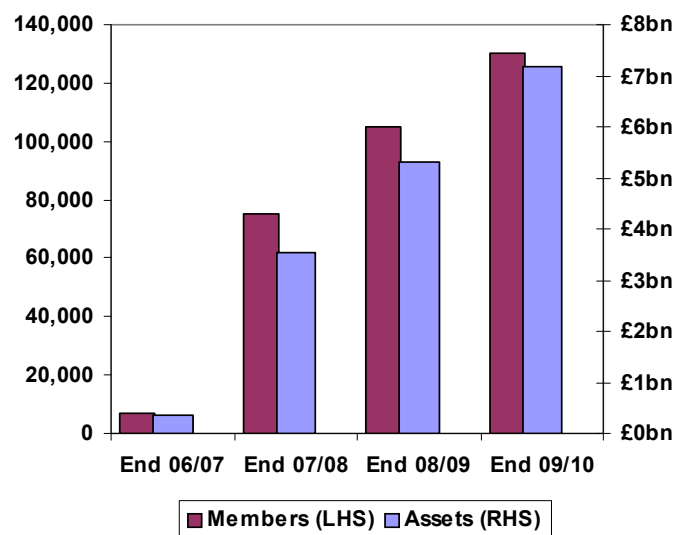


Fig 1: projected scheme members and assets transferred to PPF

6. By end 2009/10, the PPF expects to be:
- A retirement compensation provider large enough to rank in the UK’s top 30 pension schemes;
 - The equivalent of a medium-sized bank in terms of its risk transfer programme;
 - One of the top 5 buyers of inflation swaps;
 - One of the largest carriers of annuity risk in the UK;
 - Transferring in 60 pension schemes a year with associated transitioning of assets etc.

7. It should be emphasised that every one of these functions is integral to the PPF; all will need to be carried out in the future; and none could be reduced in scale or removed as a result of a merger with the Pensions Regulator.
8. This has major implications for the cost-benefit expectations of any merger proposal (see paragraphs 9-11 below and Annex A). However, the difference between the PPF and the Pensions Regulator is arguably even more fundamental than this. In some of the areas listed in the Regulator's evidence, initial attempts to share services like levy collection and early warning of employer/scheme risk failed because the functions, data requirements and activity timetables of the two organisations were too different. For example, the actual experience of combining the 2005/06 Initial (PPF) Levy on the same Regulator invoice as other scheme levies was that the complexity associated with sorting out the different levies actually damaged collection performance - separate structures subsequently had to be established and are now working acceptably both individually (levy calculation and collection) and in collaboration (analysis of scheme universe risk profiling through the PURPLE book). It would therefore be dangerous to assume that combining functions and services in a single body would necessarily lead to improved efficiency and reduced costs – the opposite would be more likely.
9. **Major growth expected over next 5 years.** The PPF remains on course for strong balance sheet growth over the next 3-5 years. The scale of this is set out in more detail in figure 1. This clearly shows that we have *not* reached a “business as usual” position in the transition from start-up to “normal running” which is assumed in the Regulator's evidence. We believe the PPF's ability to meet these demanding increases in business (and to operate successfully in capital markets) over the next 3-5 years could be jeopardised by merging to become of a regulatory body.
10. The Regulator, too, faces major challenges over this period. Evidence to the review so far has consistently identified areas such as personal accounts, the emergence of secondary markets and Solvency II as key emerging factors in pensions over the next few years; to which can be added taking forward the DWP's pensions simplification review and a raft of more minor related initiatives such as changes to transfer values. Not one of these would in any way be moved forward by the time, effort and resource needed to change the operational processes and legislative structure of the current pensions institutions.
11. **Conflicts of interest.** We are seriously concerned at the prospect of a single body having responsibility for the full range of regulator and compensation functions. We believe it would be inappropriate for an industry regulator to take a direct financial stake in the sponsoring employers of the entities it regulates; or to have direct responsibility for running a scheme which will eventually become one of the largest such entities in the UK. It would also contradict the Regulator's aim to be seen as a “referee not a player” in the pensions arena.¹ Further, it would constitute a serious breach of the Hampton principle that “Regulators should be of the right size and scope”².

¹ Eg “the regulator intends to act as a referee rather than a player” (Tony Hobman – Outer Temple Chambers Conference Arundel House, London Tuesday 20 September 2005)

² Reducing administrative burdens: effective inspection and enforcement – Report by Philip Hampton (March 2005) , p.13.

12. The provisions of the 2004 Act which lay down clear requirements for two bodies and prohibit combined governance are, in our view, appropriate to the realities of operating within the framework established by the Act. We have seen no evidence at all to suggest that this structure is flawed.
13. Key conflicts of interest exemplify the problems of combining a regulator with a financial institution. They would include the following:
- Conflict between scheme regulator and institutional shareholder. Unlike the regulator, the PPF performs a number of the functions of a pension scheme. These include investment in a range of asset categories, which in turn involves PPF acting as an institutional shareholder. As part of a single body, the PPF could not exercise its shareholder vote if it also acted as regulator, making decisions on funding, clearance and other issues that might involve the same companies potentially leading to sub-optimal financial returns for the investment fund;
 - Conflict between scheme regulator and corporate creditor. PPF acts as a contingent creditor in insolvency proceedings such as a CVA (we have received £330m via this route on behalf of scheme members and levy payers). The regulator then needs to “clear” the settlement. For the referee to operate as one of the players in these arrangements would be a clear conflict.
 - Conflict between “referee” role in scheme funding and active intervention in schemes in assessment. As already noted, a frequently-stated principle of the Regulator is not to intervene directly in scheme funding and investment decisions – for obvious reasons, given its powers in respect of clearance, CNs and FSDs. In a single body, this would be in conflict with powers of direction which enable PPF to protect itself against the actions of schemes in assessment.
14. The regulator’s evidence acknowledges that conflict may exist in a single body, but suggests that, if this were the case, it could be solved by a “Chinese wall”. In our view, the extent and complexity of separation or “Chinese Wall” arrangements required to mitigate even the more obvious potential conflicts between the regulator (the “referee”) and a financial institution established as a “player” in the pensions industry would more than cancel any theoretical benefits of the merger, and to be incompatible with normal standards of effective public service.
15. **No perceived cost benefit in a merger.** The Board believe no financial case exists for the merger, given that it could:
- result in significant transition costs, which could only be recouped as a direct burden on business
 - at best only produce modest savings since no key functions can be reduced or abolished;
 - further increase burdens on business if efficiency of the single body was compromised by having to perform disparate functions (eg a 20% fall in asset recoveries caused by regulator and creditor functions being unable to
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operate in a fully independent way would add £60m to scheme protection levy costs over 2 years).

16. We have set out some thoughts on possible costs and benefits at Annex A. We have based this on 2 alternative assumptions:
 - (i) a single, merged body remains located on 2 sites, at Croydon and Brighton. This would produce only very limited staff savings, since support functions are sized to support the number of core operational staff at the two locations, and some (eg Finance) are structured in a unique way to the individual body.
 - (ii) a single-site merged body. Staff savings – though still limited - are doubled, but costs escalate massively, because of lease termination and staff turnover.
17. In the event that no clearly favourable cost-benefit analysis could be produced for the merger, it would interesting to see whether PPF/Regulator levy-payers, or their representative organisations like the NAPF, are prepared to accept the risk of higher costs to themselves in order to justify any other perceived benefits of merger.
18. **Increased balance sheet risk to government.** The two organisations have different classifications within the types of “arms length bodies” and the implications this has for the Government Accounts. The Regulator is constituted as an executive Non-Departmental Public Body and so lies within the boundary of the Whole of Government Accounts (WGA). PPF is classified as a Public Corporation and consequently its assets and liabilities, including its investment portfolio and its long-term actuarial liabilities to meet compensation obligations, lie outside the WGA boundary. This avoids any potential confusion or implications that the Government might in any sense guarantee or underwrite a deficit in the PPF. [The deficit on the Protection Fund stood wef 31 March 2006, at £343 million.] A merger of the two organisations risks passing this deficit onto the Government’s statements of public accounts.

II - Measuring Proposals for change – “Key Factors” assessment

17. The consultation document sets out, in paragraph 12, “key factors” which “*need to be considered in weighing up proposals for change*”. The Board has assessed the proposal for a merger of the Regulator and PPF against each of these as shown – where possible, using statistics and external evidence to probe below the broad (and unsupported) generalisations which appear to characterise the case for a merger:

- a) **Encouragement of good pension provision.** In terms of encouraging or discouraging pension provision, the NAPF wrote in their initial response to the review that: *“For employers, the existence of two regulators with responsibilities for different aspects of pensions, TPR and the FSA, may be one reason why so many employers say that they do not want to have anything to do with pensions other than contributing to Personal Accounts in the future. The complexity of the current regulatory environment is often cited as a reason by employers for not wanting to provide pensions to their employees. This does not fit well with Government policy aimed at increasing and encouraging more people to save for retirement”*. This, together with other evidence, suggests that jurisdictional rather than administrative issues, may be the key aspects of the pensions institutional “map” which need to be examined here;
- b) **Maintenance of confidence in the pensions system.** The primary objective of the 2004 Act is to increase confidence in occupational pensions. A very good start has been made on this by both the PPF and the Pensions Regulator, and there is no evidence that this is compromised by there being two bodies involved rather than one – indeed, there is Parliamentary (including Ministerial) recognition that focus and accountability may have been improved by two separate bodies each concentrating on its core functions. As a stand-alone, independent body, the PPF has so far received a high degree of confidence from its key stakeholders – eg the SPC note that *“we consider that the Pension Protection Fund has made an impressive start. It generally communicates well, makes efforts to maintain good working relationships and genuinely consults.....”*, while the ABI state that *“The Pensions Protection Fund (PPF) has taken a pragmatic approach, for example being very helpful in its interpretation of the timing of payment of increases on annuities, and has taken an open approach involving wide consultation and thorough research”*. We believe that a Government decision, within 2 years of its introduction, to opt for a major restructuring of such a body, can only reduce confidence in the PPF’s own future, and will not benefit general confidence in pensions protection, given that merger with the Regulator would tend to complicate and confuse PPF’s solvency position – the one issue that *did* concern the SPC (*“There are clearly question marks about the longer-term financial viability of the fund as currently constituted, but the resolution of these questions lies in the political field”*.)
- c) **An effective and comprehensive approach to risk.** The risk context of the Regulator and the PPF are significantly different. In essence, the Regulator monitors the risks arising from poor standards of regulatory compliance (eg, lax administration, training and competence of trustees, failure to fund technical provisions appropriately etc). The PPF builds up an overall risk

profile scheme by scheme in order to price the inherent risk across the DB universe and thus to set a risk premium (the Protection levy) to be collected from the insured population. The crucial issue is the ability to share and jointly use scheme universe data, and this has already been demonstrated through PURPLE. The Regulator has suggested that tensions exist between the risks to scheme members and the risk to the PPF's funding position, but notes that "*There have not yet been any key issues that fall into this category...*". In so far as there remain unanswered questions about the Regulator's use of its powers to fulfil its objective of reducing calls on the PPF, these would be unaffected by a merger, since all the main functions of the PPF would continue.

d) Clear accountability & effective governance. This is also achieved by the current structure, which has enabled a complex set of powers and functions under the 1995 and 2004 Acts to be carried out with no complaints about accountability or impartiality. In our initial evidence, we drew attention to the potential governance problems which would be created by merging a sector regulator with an organisation which, in certain key respects, acts and operates like one of the entities under regulation. In our view, there are three areas of risk:

- i) the need to prevent the single body's solvency, investment and actuarial strategies for the invested assets from being seen as *de facto* industry norms;
- ii) accountability issues for the Chair, Board and Chief Executive in attempting to respond to internal and external pressures created by the conflicts of interest described elsewhere;
- iii) reduced efficiency, effectiveness and economy resulting from internal Chinese Walls needed to separate certain Board and sub-committee functions, e.g. general regulation and specific insolvency/creditor rights decisions.

e) Avoidance of gaps, conflicts of interest or unhelpful overlaps between the various institutions. We are unaware of any evidence to the review which indicates specific gaps between PPF functions and operations and those of the Pensions Regulator (or indeed, of any other body). Our initial evidence, and paragraph 13 of this note, have already drawn attention to the potential for conflicts of interest in the event of a merger. We are seriously concerned at the prospect of a single body having responsibility for the full range of Regulatory and financial functions. We believe it would be inappropriate for an industry regulator to be able to take a direct financial stake in the sponsoring employers of the entities it regulates; and to have direct responsibility for running a scheme which in a few years is likely to constitute one of the largest such entities in the UK. The Board believe this would constitute a serious breach of the Hampton principle that "*Regulators should be of the right size and scope*".

f) We believe it is easy to overstate the degree to which Regulator and PPF functions interact, and thereby create potential for overlap. The Regulator's own evidence notes that "*entry of pension schemes to the PPF has relatively few consequences for TPR*" and in practice the Regulator has only felt itself able or required to involve PPF in about 10% of clearance applications, and not at all in other "early warning" areas (notifiable events, letters of comfort

etc). We note that although some external stakeholders mention a perception that there may be overlap or duplication of function between the two organisations, the only specific example raised is the presence of both at negotiations in the small percentage of clearance involving PPF – a dual involvement which we regard as essential for demonstrating that there is no conflict between the clearance and the creditor roles of the respective negotiators.

- g) **Ability to cope with future developments**. Evidence to the review so far has consistently identified areas such as personal accounts, development of the buy-out market and Solvency II as key emerging factors in pensions over the next few years; to which can be added taking forward the DWP's pensions deregulation review and a raft of more minor related initiatives such as changes to transfer values. Not one of these would in any way be helped by the time, effort and resource needed to change the operational processes and legislative structure of the current pensions institutions. In addition, the Board are concerned that the resulting displacement and disruption could adversely affect PPF's ability to deal with current developments – for example, DWP have indicated that agreed improvements to the 2004 Act intended for the next Private Pensions Bill may need to be re-prioritised in the event of urgent legal work flowing from a proposed merger.
- h) **Clarity**. We are not aware of any evidence that lack of clarity between Regulator and PPF roles creates significant problems in practice – for example, the SPC note that: *“On a day to day level, our experience suggests that the roles of the Regulator and the Pension Protection Fund are sometimes subconsciously merged into one among practitioners, although there is no evident support within SPC for actually merging the two organisations”*. The PPF's initial perception audit – carried out when the PPF itself and the Regulator (as distinct from Opra) were less than a year old – showed that only 4% of stakeholders questioned thought that PPF carried out regulatory functions. More recently, from April 2006 to February 2007, only 0.9% of calls to the PPF's Stakeholder Support Team (which includes the enquiry point and Helpline) needed to be re-routed to the Regulator under a standing Service Level Agreement. We see no reason why any confusion in stakeholders' minds as to the respective functions of the Regulator and the PPF would be helped by a merger, since all the key functions would continue in different parts of the single body.
- i) **Customer Focus**. We have already noted the strong indication of customer satisfaction shown for PPF by respondents to this review. We believe there is no quantifiable (and very little anecdotal) evidence to suggest that our (and tPR's) external customers and stakeholders want or are interested in any major restructuring of the 2004 pensions institutions, including the PPF and tPR. Given the points on the absence of savings mentioned below (*Costs and benefits of change*), this is hardly surprising. Moreover, since – in the light of timescales and resource constraints – it is inevitable that any institutional changes will compete for legislative priority with simplification changes and technical improvements to the 2004 Act that are likely to be a high concern for industry and scheme member interests, we have concerns that this outcome will be seen as pushing an internally-driven agenda at the expense of other stakeholder priorities.
- j) **Costs & Benefits of Change**. We note, in section I, our surprise at the lack of any cost-benefit analysis of merger; an attempt to make good this omission

is set out in Annex 1. Since PPF has no regulatory functions, no significant savings of any sort are therefore likely to result from a merger – all PPF's key functions of scheme assessment, compensation, levy calculation and invoicing, investment and financial management would simply continue, as presumably would the Regulator's. There would be no noticeable reduction in the amount of legislation/regulation required, and there would be no compliance savings to employers or to schemes. Any cost savings that resulted would relate to relatively minor aspects of the administration levy; our initial thoughts on costs and benefits at Annex A reflect this.

k) Control over the cost of levies to payers. By far the largest levy costs to payers result from the risk-based Protection Levy. The PPF has been rigorous in devising measures to give levy payers more flexibility over their costs in respect of this levy. These have included:

- recognising various types of contingent assets in the levy calculation;
- recognising special contributions made since the last valuation, in the levy calculation
- progressively reducing the levy as an incentive to well-funded schemes
- these measures have been widely welcomed – by the CBI among others (*“there is much for business to be pleased about in today's announcement”*) and have been key in helping the PPF acquire a very strong record for consulting and listening to stakeholders.

By contrast, we are concerned that the potential conflicts of interest inherent in a merged body which might inhibit unfettered pursuit of the PPF's objective of maximising returns to schemes in insolvency situations could result in extra costs to levy payers (see paragraph 15 in Part I).

Other, far smaller levies – in particular the administration levy which the Regulator collects on its own and the PPF's behalf – are based on a straight amount per scheme member basis. Clearly, that amount may increase or reduce depending on the overall costs of the two organisations, although the PPF already seeks to achieve maximum value for administration levy payers, for example:

- (i) a public commitment, through our first Strategic Plan, to a 30%+ unit cost decrease for each transferred member over the 3 years until 2008/09 ;
- (ii) current overall pensions administration costs which, at £16pa per scheme member, are only 40% of the pensions industry average

There is in any case no scope within the existing legislation for incentivising administration levy payers by giving them greater control over how much they pay. It is, accordingly, very difficult to see how a merged organisation would be able to give schemes greater control over their levy costs than is being done at present.

III – Extract from a letter from Chief Executive of the PPF to Paul Thornton

Date: 08 March 2007

Dear Paul

REVIEW OF INSTITUTIONAL BOUNDARIES

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I attach, in the light of the issues surrounding the respective evidence of ourselves and the Regulator, some commentary on tPR's evidence, which you may find useful background in further discussions with, or about, the two organisations.....

You are of course aware of the serious concerns of our Board about the idea of a merger with the Regulator. In brief, these are:

- (i) Undermining rather than building confidence. The primary objective of the 2004 Act is to increase confidence in occupational pensions. A very good start has been made on this by both the PPF and the Pensions Regulator, and there is no evidence that this is compromised by there being two bodies involved rather than one. Early machinery of government changes will give the impression that HMG is not content with the progress made so far and will tend to reduce industry and scheme member confidence that the system is working properly;
- (ii) Conflicts of interest. Our Board are seriously concerned at the prospect of a single body having responsibility for the full range of Regulator and PPF functions. They believe it would be unprecedented and inappropriate for an industry regulator to be able to take a direct financial stake in the sponsoring employers of the entities it regulates; and to have direct responsibility for running a scheme which in a few years is likely to constitute the largest such entity in the UK. The Board believe this would constitute a serious breach of the Hampton principle that "*Regulators should be of the right size and scope*";
- (iii) Meeting the Needs of Future Challenges. Evidence to the review so far has consistently identified areas such as personal accounts, the emergence of secondary markets and Solvency II as key emerging

factors in pensions over the next few years; to which can be added taking forward the DWP's pensions simplification review and a raft of more minor related initiatives such as changes to transfer values. Not one of these would in any way be affected or progressed by the time, effort and resource needed to change the operational processes and legislative structure of the current pensions institutions;

- (iv) Different functions. While we appreciate the need for DWP to ensure it is making an appropriate contribution to the Government's Better Regulation targets, we cannot see a link through from this to the merger proposals in the way that the Regulator's evidence implies. We are not a regulator (nor for that matter are TPAS, where similar tPR arguments are deployed). We have no regulatory functions, and therefore no significant savings of any sort are likely to result from a merger – all our key functions of scheme assessment, compensation, levy assessment and invoicing, investment and financial management would simply continue. There would be no noticeable reduction in the amount of legislation/regulation required, and there would be no compliance savings to employers or to schemes;

- (v) Poor service to customers and stakeholders. We believe there is no quantifiable (and very little anecdotal) evidence to suggest that our (and tPR's) external customers and stakeholders want or are interested in any major restructuring of the 2004 pensions institutions, including the PPF and tPR. Given the points on the absence of savings mentioned above, this is hardly surprising. Moreover, since – in the light of timescales and resource constraints – it is inevitable that any institutional changes will compete for legislative priority with simplification changes and technical improvements to the 2004 Act that are likely to be a high concern for industry and scheme member interests, we have concerns that this outcome will be seen as pushing an internally-driven agenda at the expense of other stakeholder priorities.

Our Board will in due course be responding formally to the review's consultation document. In the meantime, I hope these thoughts are helpful. I look forward to seeing you next week.

**MERGER BETWEEN THE PENSIONS REGULATOR AND THE PPF:
INITIAL THOUGHTS ON POSSIBLE COST-BENEFIT**

Assumptions

- No reductions in core functions carried out by either body are possible: most senior staff up to Director level would still be needed. PPF functions (levies, investment and financial risk management, assessment, compensation) would need Managing Director oversight at around current CEO level
- Some staff reductions in adjacent work areas (eg corporate risk management / financial risk / strategy & policy) may be possible. In the event of co-location, additional savings may be made by reductions in support functions – HR, IT, Stakeholder Support / Helpline, Payroll).
- Marginal savings to schemes may be possible if the billing and collection of the Administration and Protection levies are combined. A failed attempt to do this in 2005/06 suggests there will be costs involved in making this work.
- No other savings to schemes or employers are assumed.

Summary

From the costs and benefits shown below, the expected pay back period of a merger would be in the 10-15 years range, depending on whether early co-location was adopted.

A. Costs / Savings (continued twin-site working):

• Abolish one Board (but 50% offset by additional work for remaining Board to oversee merged body)	£0.1m	
• staff reductions (up to 10 staff, mid-point)	£0.3m	
• scheme savings on levy collections	£0.2m	
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	£0.6m	pa
• costs of merger (to include additional staff turnover, travel costs, IT convergence, establishment of new Board and organisational processes and protocols; culture change programme)	£5.0m	³
Pay back period for savings	=	c. 9.5 years

B. Costs/ Savings (co-location)

• Savings as for A, but 2 x staff reductions	£0.9m	pa
• costs – as for A, but add £10m to cover cancellation of existing leases in Croydon or Brighton, transfer of 100-200 staff to other site, additional recruitment as necessary	£15.0m	⁴
Pay back period for savings	=	c. 16.5 years

³ Annex note A - published cost of Opra – Pensions Regulator culture change programme in 2005/6 was £4.94m. Merger would affect rather fewer staff directly, but would have to take place over 2 geographically remote sites rather than over a series of sites in the same town.

⁴ Annex note B – published cost of setting up PPF and locating it in Croydon is around £9m. We have assumed about the same amount, netting off reduction for an established organisation rather than a start-up cost against increases created by the disruption to existing lease arrangements etc.