Long-Term Funding Strategy Review 2022

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What we do and why it matters

The Pension Protection Fund (PPF) is a statutory public corporation established by the Pensions Act 2004. Our purpose is to pay compensation to members of eligible defined benefit pension schemes, following sponsoring employer insolvency, where there are insufficient assets to cover PPF levels of compensation. The levels of compensation we pay are set out in legislation. Our work has a real impact on people's lives, so whatever we do, we strive to do it well, with integrity and with their future in mind.

Executive summary

- Our funding strategy to date has served us well – our investment excellence, along with levy collection and reduced risks, mean we currently stand in a strong financial position.
- Recognising our financial strength and changes in risk, we've concluded we are entering a new phase in our funding journey, called our 'Maturing' phase.
- In this phase, our focus will increasingly move from building to maintaining our financial resilience.
- We've redefined our funding objective to 'Maintaining our Financial Resilience' and set out funding priorities to guide our future approach.
- Given our financial strength and in line with our funding priorities, the levy can now be actively reduced without risking the long-term security of current or future members.
- As we reduce the levy, we will also reform the way it is calculated.
- We have launched our consultation on the 2023/24 levy rules, which seeks to begin the journey towards our longer-term levy aims.

We are here to pay compensation to members of eligible defined benefit pension schemes, following sponsoring employer insolvency, where there are insufficient assets to cover PPF levels of compensation. To enable us to provide financial security to current and future members our approach to funding has always been to build reserves to protect against adverse future experience.

So far, our strategy has been successful. Our investments have performed consistently ahead of target and, combined with our levy collection and risk reduction strategies, we have built up reserves of £11.7 billion (as at 31 March 2022). Our current modelling shows these reserves provide a high degree of confidence that we will be able to pay compensation to our members in the future.

Funding in the universe of schemes we protect has been more volatile and they have experienced long periods of persistent underfunding. However, in recent years this risk has reduced as many trustees switch to assets that provide a better match to their liabilities and funding levels have started to improve. Despite this, there are still schemes that remain very underfunded and will likely present a risk to us for many years. Our expectation therefore is that whilst the risks we face are reducing, we will need to build our reserves (at a reduced pace) and retain them for some time yet.

Executive summary continued

Recognising our own financial strength and the changing profile in our universe we believe we are entering a new phase in our funding journey, which we have called our maturing phase. During this phase our revised funding objective will be **"Maintaining our Financial Resilience"**.

To help us evolve our strategy during this phase, the Board has defined a set of funding priorities and expects that the strategic decisions they take will be guided by how reserves compare to these priorities. To meet the *Financial Resilience* test, reserves must provide a high level of confidence of being able to pay compensation to both our current and future members in full, without relying on investment returns and levy. Therefore, when we are funded above this level, we can expect that any further growth in reserves will come primarily from our investment returns. Our investment strategy may in time evolve to place more emphasis on protecting reserves from investment losses.

Our current level of reserves means that funding is close to what we expect to need to meet the *Financial Resilience* test and we are now able to take active steps to bring the levy we charge down. Over the next few years, the level of our reserves will be very sensitive to actual claims experience and investment return, but so long as we continue to make progress towards our *Financial Resilience* target we expect our reliance on the levy will continue to reduce.

As we take steps to reduce the levy we charge, we will also reform the way it is calculated. Our future levy system must support the new funding strategy and remain appropriate as our universe of levy payers changes. An overarching principle will also be one of simplification for both the schemes we protect and for our own internal processes. This will ensure the costs associated with charging a levy remain proportionate to the amount charged.

We have now commenced our consultation for the 2023/24 levy rules. As well as reducing the levy we charge, we expect to make some changes to our methodology that will begin the journey towards our longer-term levy aims.

Recognising our own financial strength and the changing profile in our universe, we believe we are entering a new phase in our funding journey, which we have called our maturing phase. During this phase our revised funding objective will be 'Maintaining our Financial Resilience'.

Recapping our Long-Term **Funding Strategy**

Our ultimate funding objective is to have enough funds to enable us to pay all our members, both current and future, their compensation when it falls due.

Back in 2010, we published our first Long-Term Funding Strategy. At this stage the PPF was still in its relative infancy and the funding strategy was designed to help us grow our reserves and build our financial resilience. This set out our objective to be "self-sufficient by our funding horizon".

Our *funding horizon* was defined as the point in time when the risk from future claims on the fund was low. This was expected to be in 2030.

Self-sufficient was defined as holding sufficient reserves to protect the fund against adverse future longevity and claims experience. To be 'self-sufficient', we estimated we needed to be at least 110 per cent funded by 2030.

The expectation back then was that, at the funding horizon, the fund would then charge a levy equal to expected claims, utilise the reserves held if experience was worse than expected, and no longer need to rely on investment returns to provide a high chance of paying compensation to members.

The Board agreed that the reserves held should aim to be sufficient to cover adverse experience in 90 per cent of modelled scenarios.

The best-known measure we have used to monitor progress against our funding objective is what we call our 'Probability of Success'. This measures our chance of being self-sufficient at the funding horizon.

To measure this statistic, we use an internal stochastic modelling tool which we call our 'Long-Term Risk Model' (LTRM). This model runs a million different scenarios to project what the future may look like, allowing for future claims, levies, investment returns and changes in economic conditions – this generates a range of different outcomes.

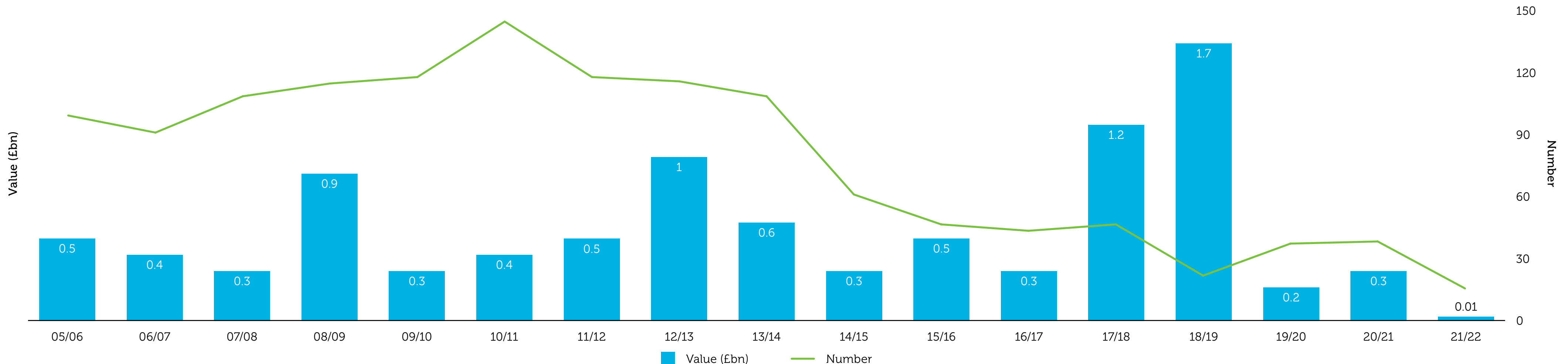
How we've progressed against **our funding strategy**

Since 2010 the PPF has grown significantly. Back then, we paid around £82 million in compensation a year, had 47,000 members and reserves of £400 million. We now pay £1.1 billion in compensation each year, have 295,000 members and £11.7 billion reserves (as at 31 March 2022) to protect current and future members.

The claims received over this period have been quite varied. Individual large claims have had a big impact on the cost of claims in each year. Specifically:

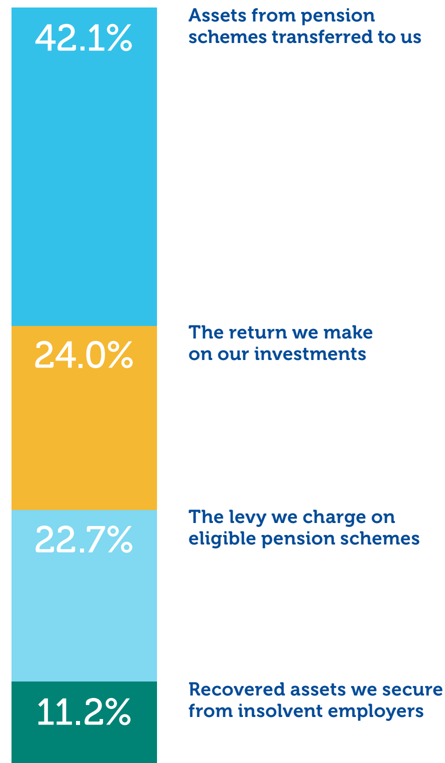
- Following the 2008 financial crisis we experienced high numbers of smaller claims.
- Between 2014 to 2017 claim numbers fell to around 50 schemes per year.
- In the years 2017/18 and 2018/19 our claims experience was dominated by a few medium to large schemes entering assessment; this meant claim numbers fell but claim amounts rose.
- Over the Covid-19 pandemic to date, we've experienced relatively low numbers of claims as corporate sponsors have received unprecedented government support.

Cost of new claims since inception



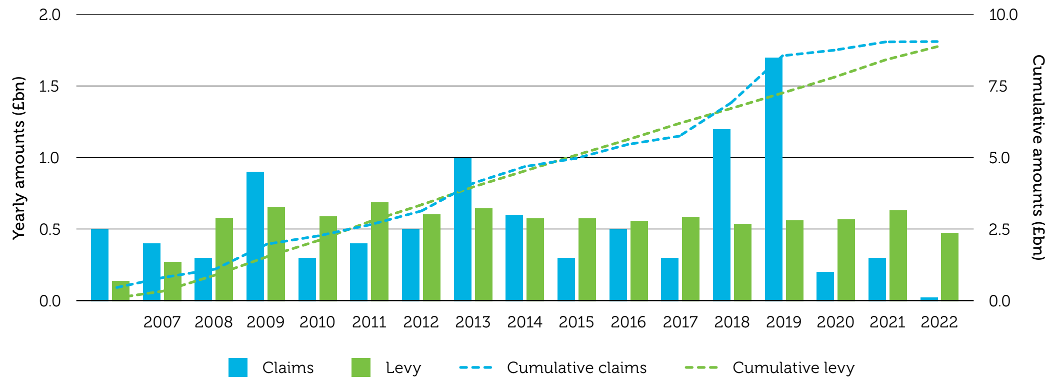
How we've progressed against our funding strategy continued

Our assets have grown to £39 billion, as at 31 March 2022. Our main sources of income have been from transferring schemes, followed by investment returns and levies from the eligible Defined Benefit (DB) universe.



Split of funding sources from income received to date, as at 31 March 2022.

The reported cost of new claims and levies collected



Our levy strategy throughout this period has focused on stability. Changes in the amount collected each year have mainly been driven by shifting risks in the universe. The chart above compares the levies collected with the reported cost of new claims in each year.

Our investment strategy has been successful in providing protection against changes in interest rates and inflation, while also generating income using return-seeking assets to build our reserves, thereby reducing our reliance on future levies.

At 31 March 2022, our Probability of Success was 96 per cent, or in other words, we expect to be 110 per cent funded or above in 2030 in 96 per cent of our modelled scenarios. This compares with our Probability of Success of 83 per cent back in 2010.

Back in 2010 we expected that over time the risk from claims would fall as:

- The PPF would grow in size and scale so that the impact of individual claims would be less material. Also, our ability to generate investment returns and accumulate reserves was expected to increase meaning we'd be better able to absorb claims when they occurred.
- We anticipated improvements in scheme funding alongside reducing recovery plan lengths. We also expected that continued scheme closures and movement to more de-risked investment strategies would mean fewer schemes would claim on the fund following corporate insolvencies, with schemes instead securing benefits above PPF levels.

How we've progressed against our funding strategy continued

We've achieved the first of these expectations as we have grown and built our financial resilience through the accumulation of reserves, but the wider universe's funding hasn't progressed as quickly as we might have expected. There has been persistent underfunding in the universe, as indicated by the chart on the right, with the aggregate deficit remaining volatile, having in recent years been significant relative to the reserves we hold.

That said, over the last few years we have seen funding trending upwards and average recovery plan lengths are starting to fall. Many schemes are taking actions to reduce their funding risk and, as a result, the risk profile of the schemes we protect is now reducing. But there still exists a number of schemes which are underfunded and/or investing in a high proportion in equities and other more volatile assets. These schemes still pose a risk to us today and we expect, based on current funding plans, that this may continue for some time into the future. As a result, we are not yet confident that future claims on the PPF will be low.

Historical s179 deficit for schemes in deficit and surplus for schemes in surplus

Source – 7800 as at 31 March 2022, PPF

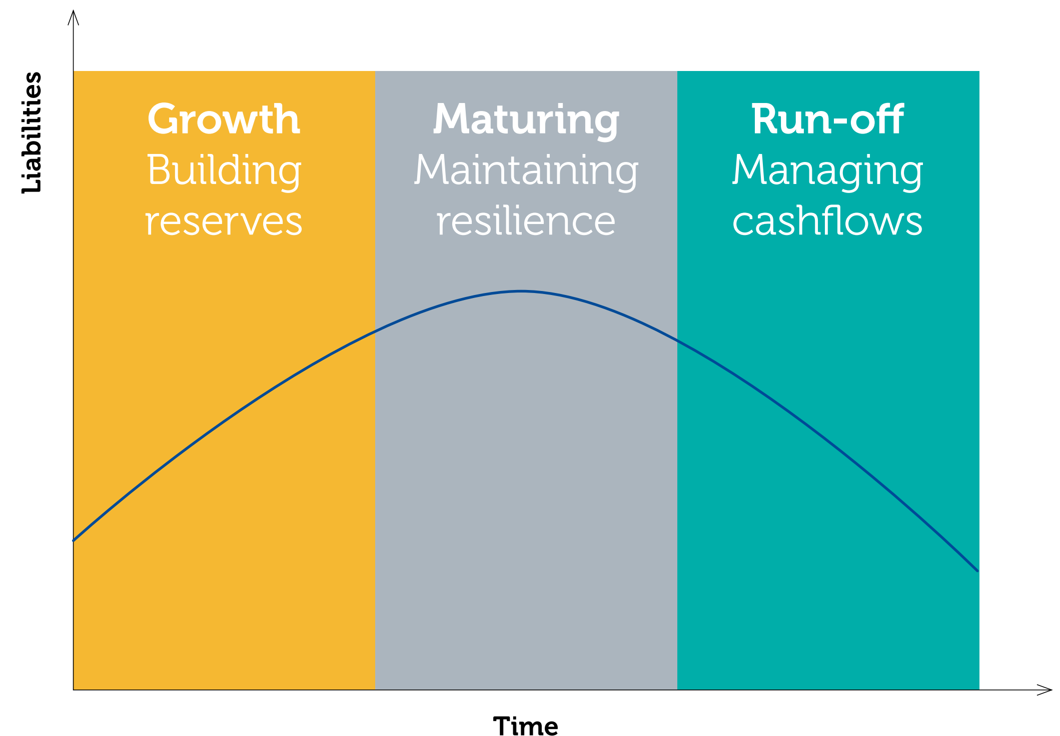
The different phases of the PPF's journey

The PPF's characteristics will change dramatically over its lifetime. In comparison to a standard scheme in the universe, our journey is likely to be bumpier and will change at a different pace given there will be periods where new claims dominate our progression.

The trajectory between the phases is unlikely to be as smooth as indicated in the picture below. We may even move back into a phase depending on the characteristics of new schemes entering the PPF or if actual experience is significantly different to assumed.

Broadly speaking, we can classify the PPF's journey into three parts:

- **The growth phase**
  As we are small to begin with, new claims drive a rapid growth in our liabilities.
- **The maturing phase**
  Once we reach a certain size, the impact of new claims reduces, and our liabilities stabilise.
- **The run-off phase**
  Our liabilities fall as our membership matures.



The different phases of the PPF's journey continued

During each of these phases, we expect our strategic funding objectives to change.

In the **growth phase** the main focus of our funding strategy is to build our financial resilience by growing our reserves. This can be a challenging aim given new claims can be material, meaning our experience in the short term might be volatile. So, we set a Long-Term Funding Strategy designed to target a level of funding in the future that would ensure we have sufficient money to protect both our current and our future members.

Once we have grown and move into the **maturing phase**, our focus shifts to ensuring we remain financially resilient ahead of our run-off phase. Our main levers to amend our reserves are our investment strategy and levy collection. We would expect that, in general, our investment lever will be the most dominant source of income during this phase. Of course, if experience is worse than we expect, we may need to amend our approach to increase the pace that reserves accumulate.

In the **run-off phase**, the majority of our membership will be pensioners and the amount of compensation paid to members each year will be a material percentage of our liabilities. Our investments will need to focus on generating sufficient liquid income to pay compensation, potentially changing our investment strategy and the level of investment risk we are willing to take.

The population of closed schemes in the wider pensions universe will also be maturing, meaning the overall size of the universe may be in decline and it may be difficult to raise a material levy. With this is mind, it is important that we are financially resilient as we enter this phase since any deterioration in funding may be difficult to restore.

Moving into a new phase

We believe we are entering the maturing phase in our funding journey.

The improving outlook for many of the schemes in our universe alongside our fast-growing pensioner membership means that we expect our liabilities will soon start to stabilise – a characteristic of the maturing phase.

We are entering this phase from a position of significant financial strength; the performance of our investment strategy has been particularly helpful in this regard, increasing reserves by around £5.5 billion over the last two years alone.

It is therefore important that we consider how our strategy should change in this new environment.

We are entering our maturing phase from a position of significant financial strength.

Evolving our funding approach

Whilst it is clear our reserves already provide us with a good level of protection against future experience being materially worse than we expect, the current level of risk in the universe means that it will be some time yet before we are confident the risk from further claims is low.

As a result of this, we have decided to move away from the explicit funding horizon of 2030 and have redesigned our funding strategy to better guide strategic funding decisions during this next phase of our journey, our maturing phase.

Our funding objective during this phase will be **"Maintaining our Financial Resilience"**. We define *Financial Resilience* as having a high level of confidence of being able to pay compensation to both our current and future members in full, with no support required from investment returns and levy. The strategic decisions the Board will take will depend on how our reserves compare with the level required to meet the *Financial Resilience* test.

To meet this objective, we will seek to:

- Fully hedge the inflation and interest rate risk in respect of our current members.
- Build and maintain a reserve to protect against longevity risk for our current members.
- Build and maintain a reserve to cover the potential cost of future claims.

Our aims for stakeholders

We recognise the interests of our various stakeholders, and in particular those of our members and levy payers. We seek to balance the interest of these two groups by holding a level of reserves that is sufficient to pay out compensation with high certainty without burdening levy payers with a disproportionate share of the costs of doing so.

We also plan to adopt a levy strategy that makes explicit consideration of the level of reserves that we already hold. So, if our funding becomes sufficiently high, the levy will be reduced to a lower level.

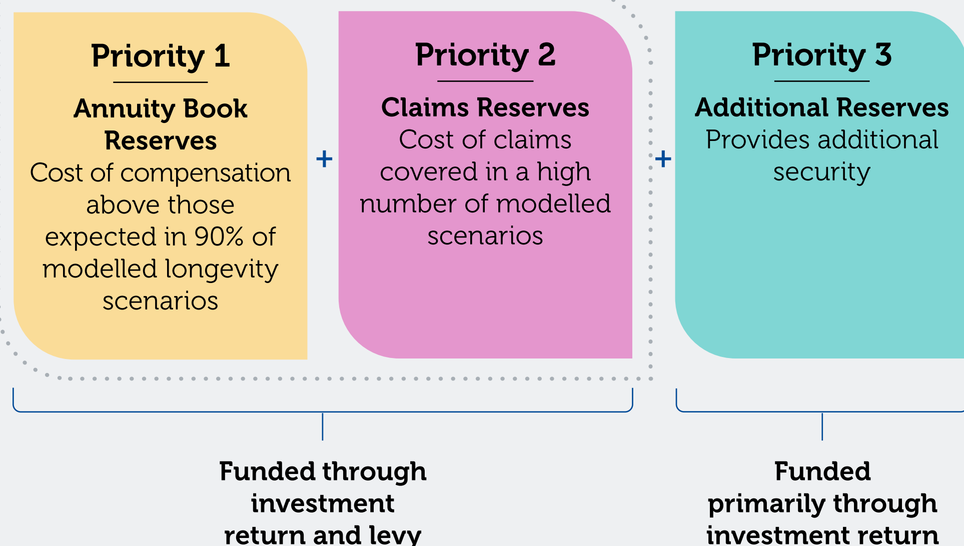
Evolving our funding approach continued

Our target reserves

It is important for us to hold reserves to protect our current and future members regardless of future changes to the economy, insolvency rates or longevity.

To understand the potential range of outcomes for the PPF, we will continue to model our future funding using our internal stochastic modelling tool, the LTRM. No model can perfectly predict the future, and the LTRM is no exception. The projections are based on a series of assumptions, which we will continually refine to reflect how experience and expectations develop over time.

At a high level, we have three main priorities for our reserves during our maturing phase which are summarised in the diagram below.



The Annuity Book Reserves and Claims Reserves are designed to cover all but the worst longevity and claim scenarios. These reserves will be funded through both investment return and levy. Any Additional Reserves built up will be funded primarily through investment return.

During our maturing phase we consider ourselves *Financially Resilient* when we have sufficient reserves to cover both Priority 1 and Priority 2 reserves, i.e. longevity reserves for our current members and reserves for future claims. However, our aim is to achieve additional reserves, above those needed to meet the *Financial Resilience* test, to provide better protection for both our current and future members. As the universe we protect matures and declines, it will be difficult to raise a material levy. By building additional reserves – through our investment returns – our aim is to reduce the risk of having to go back to ask levy payers to contribute more in the future.

We recognise that this approach means the most likely outcome for the PPF is that we may end up with more money than we ultimately need. However, given we anticipate a reasonable level of underfunding in the universe for some time, we will need to hold these reserves to ensure we have sufficient funds to pay for current and future members' compensation.

Although it may be some time before we know the eventual funding outcome of the PPF, we appreciate the growing interest in this scenario among our stakeholders, particularly members and levy payers. We also recognise that, in the absence of an existing legislative framework governing what to do with any excess funds, there will be an important role for government.

We will work with the Department for Work and Pensions (DWP) over the period of our Strategic Plan 2022–25 to agree an approach for utilising any excess reserves when the level of risks we are exposed to reduces sufficiently. The views of stakeholders will be important in considering this scenario, and we fully expect there to be further engagement with stakeholders on this in the coming years.

How our strategy will change depending on funding

Depending on where our funding lies relative to our Priority levels, our levy and investment strategy is expected to change.

We believe it is unreasonable to ask sponsoring employers to pay a levy to cover the potential extreme tail scenarios – these are the low probability but high impact scenarios where we could receive significantly higher claims. Instead, any build-up of Priority 3 reserves should be achieved through our own investment return.

We expect the transition to a lower levy environment to happen over several years and will commence as the level of reserves approaches those needed to meet the *Financial Resilience* test.

The implications for the PPF levy

Our current level of reserves are close to what we expect to need to meet the *Financial Resilience* test. Given this, and a lower expectation for future claims, we believe it is appropriate to reduce the rate at which we collect levy. Our levy consultation document confirms our proposal to reduce the levy we expect to charge in 2023/24 to £200 million, which compares to a targeted collection of £390 million for 2022/23.

The prospect of charging a much lower levy in the future means it will be important to ensure that the cost and complexity of operating the levy remains appropriate for schemes and for us. At the same time, we also need a levy system that can flex to the different funding positions we might face. Developing our longer-term levy design will take time and may need legislative change. We plan to work closely with stakeholders and DWP over the next year to inform our proposals.

In the meantime, we expect to propose some changes to levy design next year that will more closely align the calculations to our longer-term aspirations.

Our journey through the maturing phase is unlikely to be a straight path as it's possible for our funding to worsen or the level of reserves needed to meet the funding priorities to become higher. Therefore, it is a possibility that we might need to increase levy at a future date having cut it to a low level in the past. It is important to stress that our modelling suggests there is a low probability of this situation arising. We appreciate the desire for stability and predictability within the levy and therefore we will endeavour to avoid adjusting our strategy based on short-term volatility in our funding unless we see a material deterioration in our funding position and a challenge to our ability to pay those who rely on us.

> "Our levy consultation document confirms our proposal to reduce the levy we expect to charge in 2023/24 to £200 million, which compares to a targeted collection of £390 million for 2022/23."

Next steps

We have now published our consultation on the 2023/24 levy rules. As well as setting our Levy Estimate – how much we will look to collect in levy in 2023/24 – it also describes our proposed initial changes to our levy methodology to move us towards our long-term aims.

In order to support further reductions in levy in future years, we are working with DWP to enable legislative change so that we have the power to raise the levy again more freely if future claims experience meant it were needed. The current cap of 25 per cent on year-on-year increases in levy is a barrier to reducing levy by materially more at this stage.

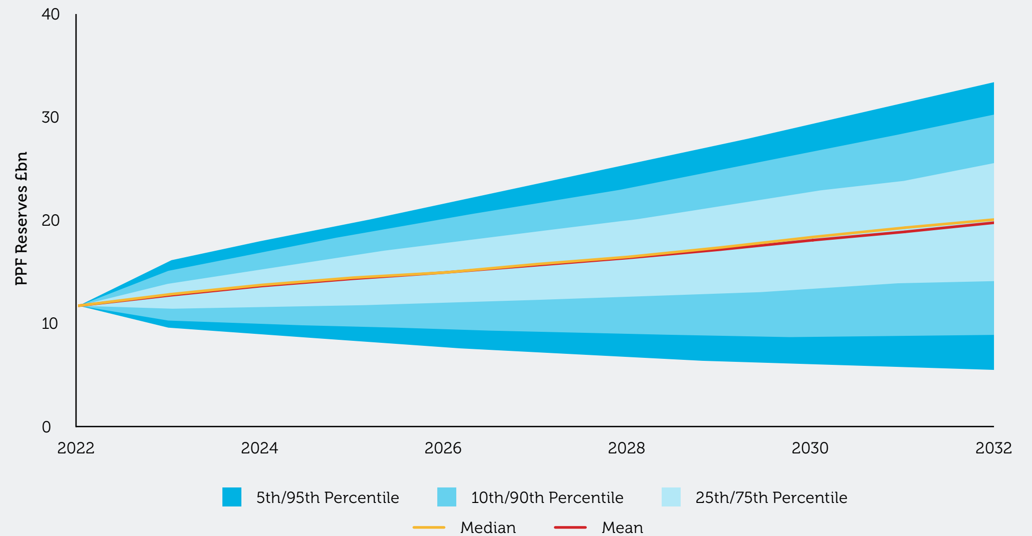
Our analysis of our investment strategy shows that the level of risk remains appropriate, having reduced somewhat already in recent years.

We will keep this approach under review to ensure that the risk of our *Financial Resilience* being eroded as a result of investment losses over the medium to long term is sufficiently low.

When setting our strategy, our primary aim is to ensure a very high chance of paying compensation in full. We therefore have a very low risk appetite for our funding position to dip below 110 per cent funded; this being our best estimate of the cost of providing compensation to our existing members at any time plus the margin needed to cover our Priority 1 reserves.

Our modelling shows that based on our proposed strategy the probability of us having funding below this level as we enter our run-off phase is around five per cent. This rate reduces materially once we allow for the modest management actions that we may take if funding does deteriorate.

A projection of how our reserves may change over the next 10 years based on our funding approach



We plan to monitor and report on our funding position, and where we stand against our funding priorities, each year in our Annual Report and Accounts. Although we expect our revised funding objective and approach to remain appropriate for some time to come, dependent on our progress and how risks evolve, we plan to evaluate our strategy on a regular basis (every three years). We will conduct an out-of-cycle review should we find ourselves either significantly ahead or behind projections.

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