LCP on point

The PPF and Covid-19 – Can the lifeboat sail to calmer waters?

August 2020

Contents

01 Executive summary

- The Pension Protection Fund ("the PPF") is the "insurance policy" for defined benefit ("DB") pension schemes where the sponsoring employer becomes insolvent.

- As at 31 March 2019, the PPF reported a £6.1bn surplus of assets over expected liabilities to pay compensation. The PPF's longer term goal is to reach a position of "self-sufficiency" whereby it has no need to rely on significant future levy payments or investment returns from growth assets. It calculates that its chances of successfully reaching that goal by 2030 were 89% as at 31 March 2019.

- We have considered two scenarios to assess how the PPF could cope with a Covid-19 driven downturn creating additional insolvencies and additional liabilities entering the PPF where:

    - **Scenario 1: "Insolvencies Double"** - the increase in PPF entrants is doubled to rates similar to those following the 2008 global financial crisis, but based on the higher level of average claims seen in recent years. We have assumed additional deficits of £10bn enter the PPF over the next 6 years in this scenario; and

    - **Scenario 2: "Deeper Downturn"** - assumes that the post Covid-19 recovery is much slower and / or insolvencies are significantly biased towards businesses in sectors that support large DB schemes. We have assumed additional deficits of £20bn enter the PPF over the next 6 years in this scenario.

- We have also considered the effect of some non-Covid-19 factors facing the PPF, such as the move from RPI inflation to CPIH and the effect of recent court cases such as *Hughes* on PPF compensation.

- Given its current robust financial position, the PPF seems well set to cope with the Insolvencies Double scenario with the funding hole potentially being filled solely by future investment returns, albeit accepting a lower probability of achieving their self-sufficiency target by 2030.

- Should the Deeper Downturn scenario unfold, the PPF would potentially have to look to do more than just rely on investment returns, and raising levies alone wouldn't solve the issue. But lengthening the time horizon to the PPF meeting self-sufficiency for another roughly four to five years could help to give the required breathing space to make up the additional deficit in full, again without raising levies. Should the PPF choose to raise levies as well, that timescale would reduce.

- An even more significant downturn, which could lead to some of the larger schemes with the largest deficits entering the PPF, could lead to the need to consider more extreme measures.

- Given the heightened risk of insolvency, many schemes face the prospect of potentially falling into the PPF. Trustees and sponsors of schemes with distressed employers, which may include those which are attached to employers in “at risk” sectors, should focus their attention on what actions are possible in order to ensure that stakeholders are treated fairly and that members benefits are protected to the greatest extent possible.

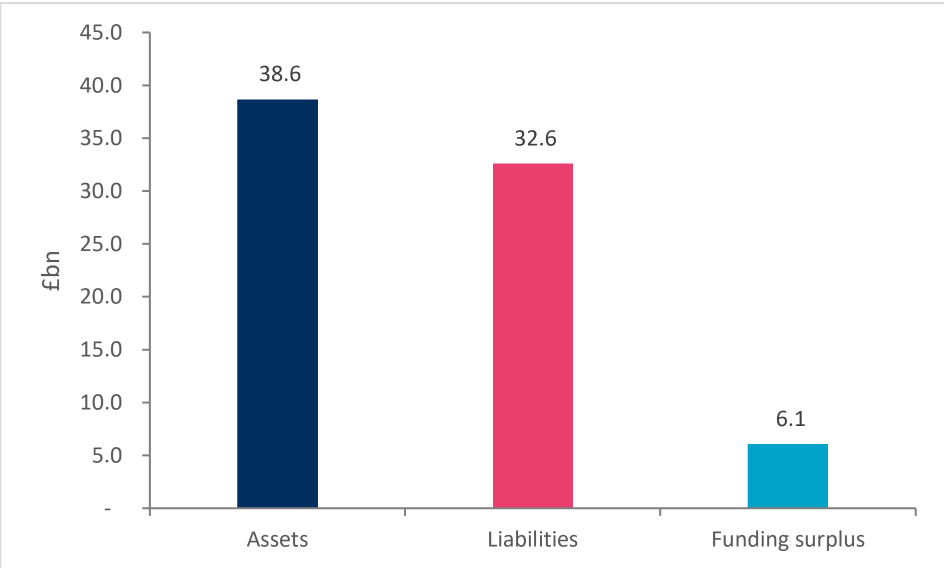
02 Introduction

The PPF is a lifeboat for DB pension members. It is designed to provide a reasonable level of retirement income where a scheme's employer has become insolvent and there is still a large pensions deficit. Although this usually means a reduction in benefits for individuals compared to their previous expectations, the PPF provides an important "insurance policy" to prevent much more significant reductions in retirement income, should the worst happen.

The PPF is funded by annual levies on all eligible UK DB schemes, the assets of schemes where the employer has become insolvent and the investment income that is generated on its overall asset base.

As at 31 March 2019 the PPF had a healthy surplus of assets over liabilities, including allowance for schemes that have not yet completed their PPF assessment period but are expected to enter the PPF, as illustrated in the chart below.

Summary of the PPF's funding position as at 31 March 2019



Source: PPF's 2018/2019 annual report, figures do not cast exactly due to rounding

It is inevitable that some businesses will become insolvent. This can be for a myriad of reasons, not simply linked to the state of the economic environment. Common causes may include changing consumer trends, technological innovations leading to obsolescence, weak management teams, fraud, or over stretching a business financially to the extent it can no longer afford to service its debt.

The PPF is designed in the expectation that there will be a number of insolvencies of employers with DB schemes in any given year, and that it will need to pay compensation to an increasing number of individuals over time.

Sponsoring employers going insolvent and entering the PPF do not create an immediate cash flow problem for the PPF. In fact quite the opposite, as it receives all the assets of the relevant scheme when it enters the PPF. However, the PPF then has to pay compensation over the next 50 to 90 years, and the challenge arises in ensuring it will continue to have sufficient assets to pay that compensation many years into the future.

In Section 3 we will set out some trends for historic claims on the PPF in a “crisis period” and a “business as usual” period, then investigate how the current crisis might see a different pattern of company insolvencies to previous experiences. In Section 4 we will also highlight some of the protections that the PPF itself has in place to ensure it can continue to support its scheme members.

The key question is to what extent these protections can cover the effects of potential “black swan” events which could materially increase the level of liabilities the PPF needs to underwrite, through both an increased rate of insolvencies and / or stresses on its assets and liabilities?

At the end of 2019, no one could have expected that a global health pandemic would arise and have the far-reaching economic impact that we have seen from Covid-19. Many sponsors are in crisis management mode, taking measures to protect liquidity and ensure work can continue in as efficient a manner as possible. Pension scheme advisers and trustees are focusing on their scheme’s funding levels and in some cases responding to requests from sponsors to defer deficit repair contributions.

In the face of such tough and unprecedented economic conditions, a reasonable hypothesis may be that the rate of insolvencies will spike in the near term and that this will put significant pressure on the PPF.

But should anyone be panicking that the pensions lifeboat could get inundated and ultimately sink? This paper aims to consider both the potential stresses that could be placed upon the PPF, and how it is set up to cope with them.

03 Covid-19: A spike in insolvencies to come?

3.1 What do statistics tell us about the current insolvency rates?

It is currently too soon to see the full impact of Covid-19 on insolvencies, as the effects of the pandemic are still emerging and because available Government support plans are providing a much-needed safety valve across the short term.

Indeed, a release[1] from the Office of National Statistics ("the ONS") on 14 July 2020 showed that company insolvencies in England and Wales decreased by half in June 2020 compared with the same month last year, with the reduction in the rate appearing to coincide with the start of the pandemic.

The ONS's 14 July report comments that this trend was likely to be in part driven by the range of Government packages put in place to provide financial support to companies in response to Covid-19. It is also likely to be assisted by the Government announcement in late April that it would temporarily prohibit the use of statutory demands and certain winding-up petitions from 27 April to 30 June 2020 (which was further extended to 30 September 2020 under the Corporate Insolvency and Governance Act 2020).

The ONS's report additionally notes that compulsory liquidations require a winding-up order obtained from the court by a creditor, shareholder or director. Since the UK lockdown was applied on 23 March 2020, the HM Courts & Tribunals Service has reduced the operational running of the courts and tribunals.

However, as a counter to this recent ONS data, Moody's has recently issued a report to show that global default rates are at the highest level in a decade, which shows that companies are beginning to feel the squeeze of the Covid-19 crisis[2].

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/899920/Monthly_Insolvency_Statistics_June_2020.pdf
[2] Moody's default trends and rating transitions section, issued on 10 August 2020

In addition, on 5 August 2020, Charles Counsell (Chief Executive of the Pensions Regulator ("TPR")) issued a blog which suggested TPR is bracing itself to deal with a significant uptick in insolvencies over the coming months, with a reference to employers in potentially vulnerable sectors:

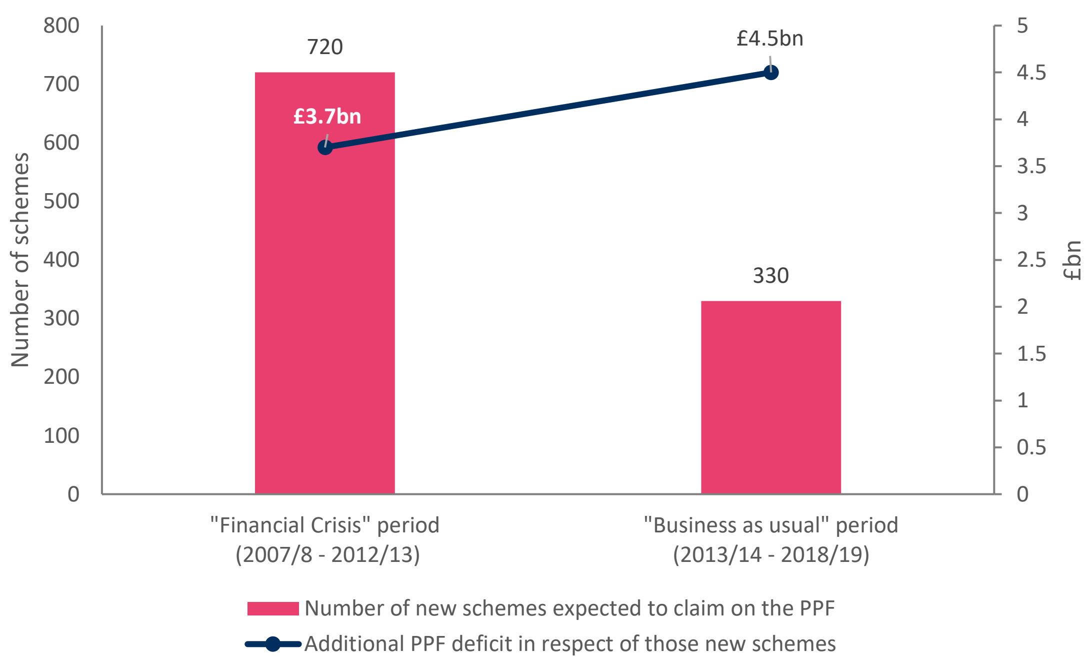
- *"Since March, we have received 108 revised recovery plans. Of these, almost 86% (92) have seen schemes agree to defer their employer's deficit repair contributions allowing some room for manoeuvre. The majority were from small schemes and relate to sectors under increased strain from the impact of COVID, such as the manufacturing, retail and airline industries."*

- *"With the government's coronavirus job retention scheme ending in October, and other support being unwound, employers will continue to experience significant financial challenges and some, sadly, will fail. Despite figures showing corporate insolvencies declined between April and May, insolvency and restructuring trade body R3 argue this is the "calm before the storm"."*[3]

3.2. What can we glean from past experience?

This is not the first global financial crisis the PPF has lived through since its inception in 2005, with the chart below depicting how the 2008 global financial crisis impacted the number of claims made on the PPF. The figures below are the cumulative changes the PPF made to reserves in their annual accounts each year during each time period for expected new claims during the year – this includes companies that became insolvent and were expected to have a PPF deficit, but also with some provision for other newly "at risk" schemes. The deficits are measured on the PPF's funding (or reserving) basis.

Historic claims on the PPF



Source: Figures taken from PPF annual report and accounts where available. New claims information from 2007/08 and 2008/09 estimated from information on PPF website.

[3] Charles Counsell blog, issued 5 August 2020.

Can this historic data help us form any views on how Covid-19 could impact the level of future claims on the PPF?

In order to analyse trends, we have split the historic data into two discrete time periods:

- 2007/8 – 2012/13 ("Financial Crisis" period): Impact years during and following the global financial crisis, resulting in an estimated 720 new claims on the PPF (120 per annum on average), with a corresponding aggregate deficit on the PPF's reserving basis of £3.7bn[4].

- 2013/14 to 2018/19 ("Business as Usual" period): 'Business as Usual' levels of insolvency returning following the global financial crisis, resulting in around 330 new anticipated claims on the PPF (an average of around 55 pa), with a corresponding deficit of around £4.5bn.

Note: For the purposes of this analysis, we considered the end of the Financial Crisis period to occur in the 2012/2013, the financial year during which UK GDP returned to pre-crisis levels.

When comparing the claims on the PPF in a period impacted by the global financial crisis to a period after the recovery, the trends suggest that the number of entrants in the last six years of "Business as Usual" stability was under half the amount of entrants in the six years which followed the 2008 financial crisis. That is a decrease of nearly 400 schemes.

However, the deficit suffered by the PPF in the Business as Usual period was actually £0.8bn larger than that of the Financial Crisis period, even with less than half the number of schemes claiming on the PPF.

So, what is this showing us? Despite clearly a higher number of insolvencies during the Financial Crisis period, it is the size of the schemes which enter the PPF rather than the volume that is more impactful. A perfect illustration of this conclusion is the 2018/19 financial year where, despite having the lowest number of new expected claims on the PPF (23), the deficit from claims during the year peaked at £1.7bn. This was mainly driven by the claim of the Kodak Pension Plan No.2 ("KPP2") on the PPF, which had a deficit of around £1.5bn.

3.2. Where does the risk lie? - Vulnerable sectors

Our analysis of the PPF's historic trends shows that it was able to weather the insolvencies that followed the global financial crisis, and also absorb the impact of the occasional very large scheme entering the PPF with a substantial deficit. This is evidenced by its surplus of around £6bn[5] as at 31 March 2019.

However, how similar will the profile and financial impact of insolvencies arising from Covid-19 be, compared to the aftermath of the 2008 crisis?

The 2008 crisis was initially concentrated within global financial markets, stemming from mis-sold real estate loans in the US, which eventually had a knock-on effect on several industries. But LCP's covenant team has outlined several key differences to the current situation, including:

[4] As for the graph, figures taken from PPF annual report and accounts where available. New expected claims information from 2007/08 and 2008/09 estimated from information on PPF website.
[5] From the PPF's 2018/19 Annual Report and Accounts

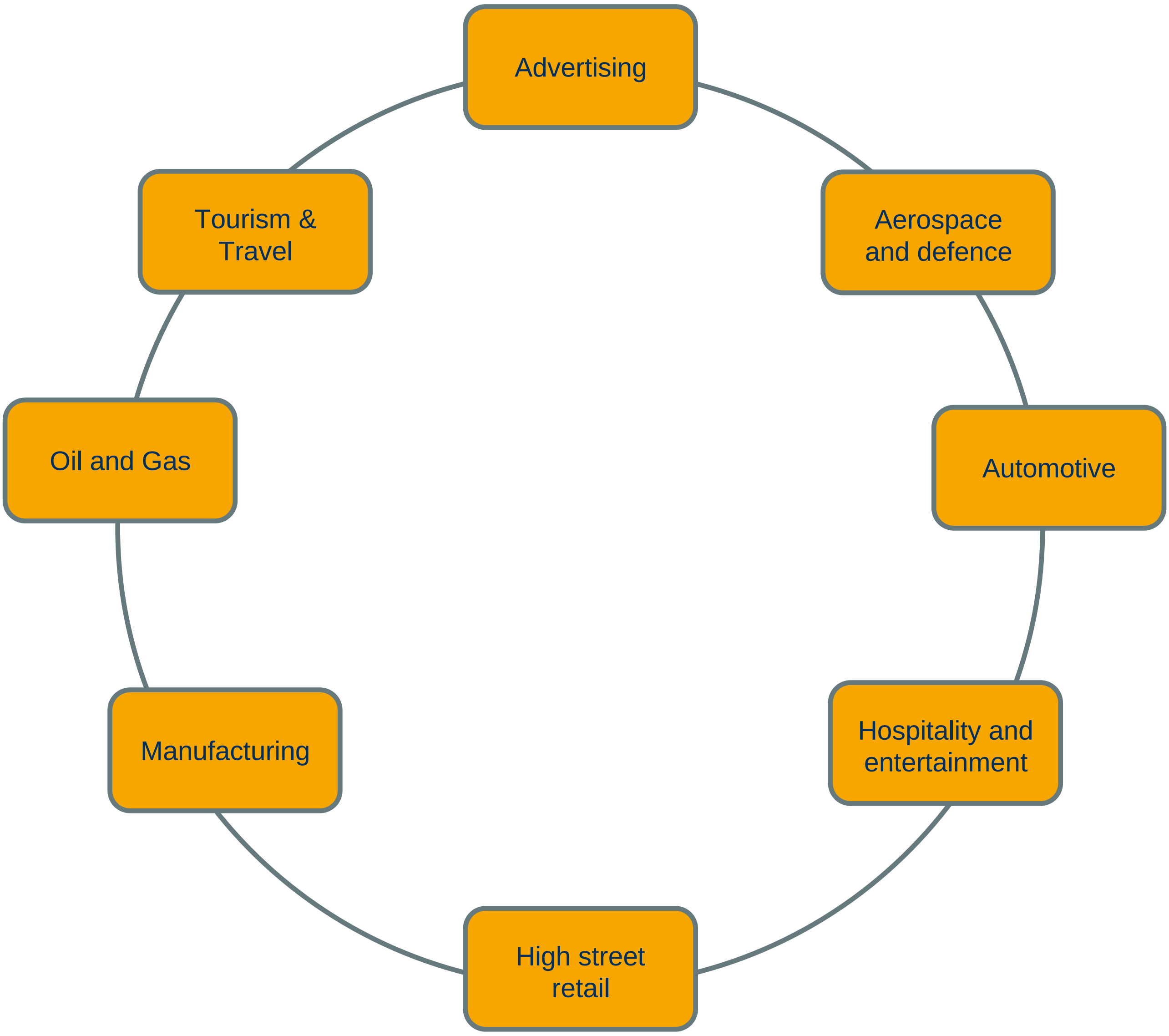
- The speed of the impact of Covid-19, which many companies will have had a matter of days to prepare for.

- The global financial crisis caused a demand-side shock to the economy (eg due to lack of available credit), whilst the lockdown has directly impacted both the supply side of the economy (eg factories and other workplaces prevented from opening due to lockdowns) and the demand for goods and services (eg businesses and consumers being physically unable to go to market where face to face interactions were essential).

- The scale of the industries which are detrimentally affected appears far greater.

- The sectors most severely affected (eg high street retail, tourism, manufacturing) are typically the 'older' industries, which are in turn more likely to have DB pension schemes.

Examples of sectors which appear more severely impacted by Covid-19 than the global financial crisis



The notion that the sectors above may be at higher risk from Covid-19 is also supported by research to date by credit rating agencies, with Moody's reporting that, between March and July

2020, amongst the industries mostly impacted by Covid-19 were leisure & entertainment, transportation, retail, automotive and energy[6].

In addition, when analysing European non-financial corporates, Moody's research noted that, as at Q4 2019, 66% of publicly rated debt issuances were considered speculative grade, compared to 46% in Q4 2009 (ie during the 2008 financial crisis)[7]. This suggests that, on average, these corporates were already more vulnerable to financial shocks ahead of the Covid-19 pandemic than they were during the last financial crisis, and may have had a lower level of financial flexibility to deal with liquidity needs.

3.4. Large scheme analysis

Illustrative scale of largest schemes versus other schemes in deficit in the DB universe

Source: PPF Purple Book 2019

Schemes in the DB universe with over 10,000 members are responsible for around 61% of the overall DB liabilities, despite only representing 193 schemes (4% of total schemes)

So why is this chart significant? This shows that, despite the possibility that many of the larger schemes are well funded, the PPF may be more concerned with the size and type of company which is exposed to the pandemic rather than the quantity of individual insolvencies which may occur. When you consider that KPP2 is the largest claim on the PPF to date and it only just sneaks into the "scheme with more than 10,000 members" category, you can imagine the impact one of the biggest schemes could have on the PPF's funding level if it were to be in deficit when its employer became insolvent.

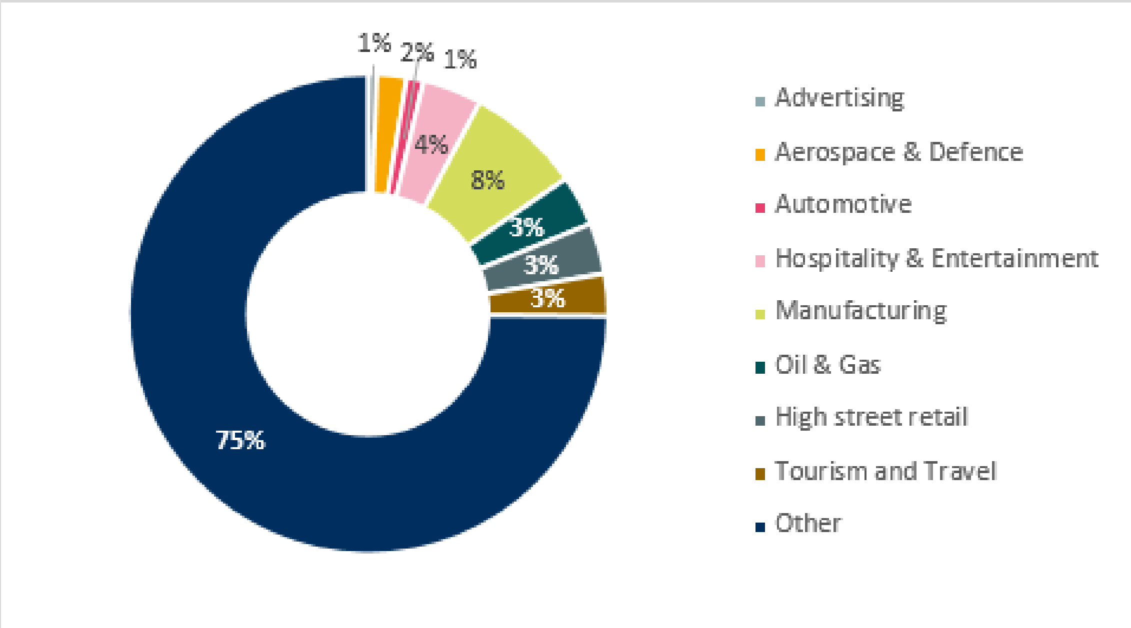
[6] Moody's – Coronavirus effects section.
[7] Moody's

3.5. Large schemes in vulnerable sectors

But how concerned should the PPF be at the possibility that a number of employers sponsoring large DB schemes in deficit face insolvency simultaneously? In this regard, it is important to consider where bigger schemes are also potentially more vulnerable as a result of Covid-19, given the sectors their employers operate in.

PPF deficits by scheme are not publicly available, so it is not straightforward to identify specific schemes which both have large PPF deficits and are in at risk sectors. However, we have prepared some illustrative analysis to try to quantify the possible exposure to the PPF from the sponsors of large schemes in deficit becoming insolvent as a result of the pandemic.

FTSE 350 companies split by 'at risk' sectors



Source: https://www.fidelity.co.uk/shares/ftse-350/

LCP's covenant team considers that around 25% of FTSE 350 companies are in sectors which are considered to be at a high risk as a result of Covid-19, which forms the basis for our assumption that 25% of large schemes in deficit could be attached to employers in vulnerable sectors.

The graph in section 3.4 showed that there are 193 "large" schemes, ie those with more than 10,000 members, that account for 61% of aggregate PPF liabilities[8].

The PPF's August 2020 monthly update[9] noted that the aggregate deficit of the 5,422 schemes in the PPF 7800 Index is estimated to have been £200bn at the end of June 2020. If we assume that the 193 largest schemes also account for 61% of that deficit, then those of the large schemes that are in deficit will have an aggregate deficit of around £122bn.

[8] Note that these figures are on what is known as the PPF's "Section 179" basis which is slightly different to the funding basis used in the PPF's annual report and accounts and in the later analysis sections of this paper. These figures are intended to indicate an order of magnitude rather than directly relate to the later discussed deficits.
[9] From the PPF's 7800 Index.

If we then assume that the proportion of sponsors that support the large schemes have a similar spread of sectors to the FTSE 350, we can estimate that of the largest schemes in deficit on a PPF basis, deficits of around £30bn are attached to around 40 to 50 companies in sectors which are most adversely affected by Covid-19 (ie applying the 25% vulnerable sector ratio to the both the £122bn of deficits calculated above and the 193 large schemes with more than 10,000 members).

Of course, we have had to prepare this analysis on an "average" basis given that we don't have PPF deficits on a scheme by scheme basis, and our workings have not taken account of the fact that the size of the large schemes which enter the PPF over coming years will not necessarily be "average" in size.

But this analysis helps to put an illustrative figure on the additional deficits the PPF might need to support following Covid-19 related insolvencies, noting that the figure is highly sensitive to the number and distribution of large companies with large DB schemes that fail. For example, if say half of the 40 to 50 large companies hypothesised above went bust, on average it could imply an additional c£15bn of deficits for the PPF to cover, whereas if only 10% went bust it would imply additional deficits of only c£3bn.

Finally, it should be noted that, although certain sectors may not be considered as 'at risk' in this section of our paper, it is also very likely that other businesses with large DB schemes in other sectors will also suffer from the knock-on effects of Covid-19.

3.6. So how could all this impact upon the PPF? Scenarios to consider

It is difficult to accurately predict much about the future at present. In our work as covenant advisers to many pension schemes, which range from having both large and small employers and from within organisations which are solely UK based or are part of complex global groups, a common trend has been that management projections have been changing month-by-month as more information comes through on the impact of Covid-19 on the business.

It also appears that current government support schemes are stemming the tide for now, as evidenced by the ONS data in section 3.1.

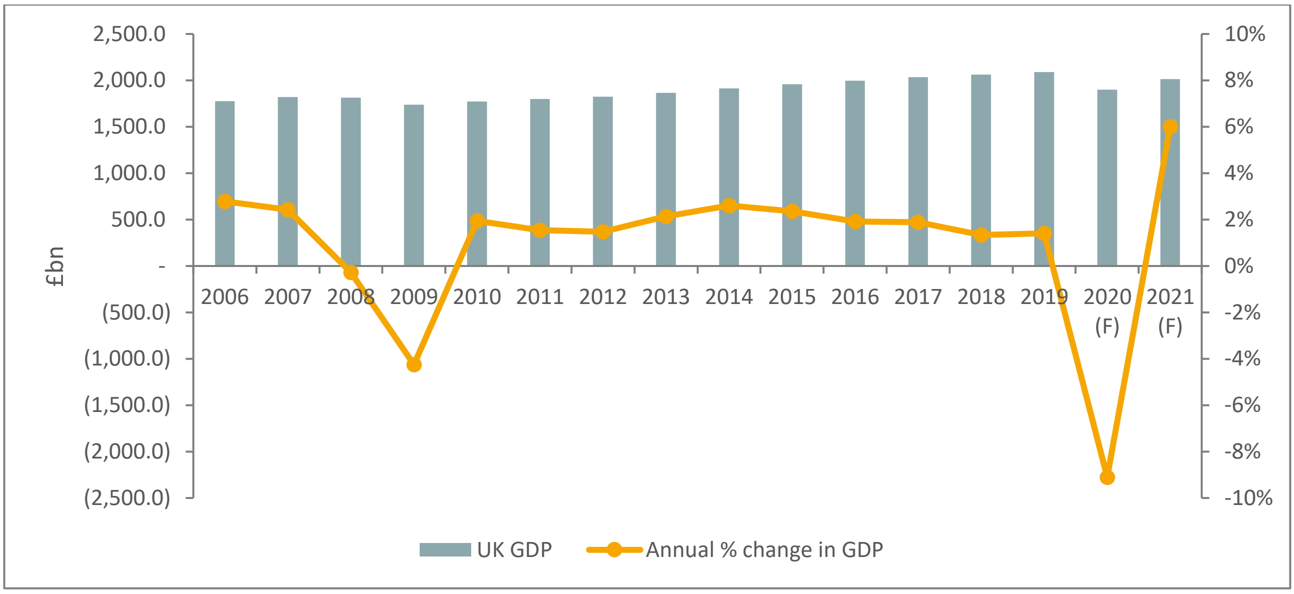
However, it is useful to create some numerical parameters around which scenarios can be created, in order to illustrate the PPF's ability to weather the potential financial storm.

As noted in section 3.2, our analysis suggests that the Business as Usual period recorded around half the amount of claims on the PPF than were experienced during the Financial Crisis period, but the average claim was much higher during the Business as Usual years. Based on the this, the first scenario we have considered is:

- **Scenario 1 – Insolvencies Double:** this assumes a reasonably swift partial recovery of the economy so that the overall number of insolvencies is similar to the 2008 financial crisis, but based on the relatively higher claims profile experienced during the Business as Usual period. This reflects the potentially greater impact of Covid-19 on the sponsors of larger DB pension plans compared to the 2008 financial crisis. With claims of around £4.5bn over the past 6 "Business as Usual" years, we will illustrate the impact of claims with combined deficits of around £10bn over the next 6 years under this scenario.

UK GDP

Simple economic indicators suggest that the Covid-19 downturn in 2020 could be more material compared to the global financial crisis. However, the speed of recovery is expected to be quicker, as the UK economy begins to exit lockdown.



Source: Reuters.

The above chart highlights the progression of the UK's historic GDP between 2006 and 2019, with a sharp recession forecast for 2020 before a projected recovery in 2021.

The forecast data shows that in 2020, UK GDP is expected to shrink by 9%, compared to a GDP growth of around 1% in 2019 which was slightly lower than previous years. Assuming that GDP growth in a 'normal' year over the recent past has been around 2%, the scale of the forecast reduction in GDP for 2020 in percentage point terms appears to be around twice that of the 2008 financial crisis.

Assuming that the current downturn is twice as bad as that following the global financial crisis, we have also considered:

- **Scenario 2 - Deeper Downturn:** this assumes that the impact of a deeper recession is that significantly more insolvencies occur and / or insolvencies are significantly biased towards businesses in sectors that support large DB schemes. If the currently anticipated adverse impact on GDP being around double that immediately following the global financial crisis resulted in a further doubling of the insolvencies we have allowed for in Scenario 1, or if the insolvencies were more focussed on the sponsors of the largest pension schemes, we could easily see twice the level of claims. So for the Deeper Downturn scenario we have illustrated the effect of £20bn of deficits in new scheme claims on the PPF over a six-year period.

To conclude Section 3, our analysis shows that, although the PPF has already weathered a serious financial crisis in its reasonably short existence, the forthcoming recession we are expecting will potentially have a greater impact on large, historic industries which are more likely to have large DB schemes.

If this recession causes simultaneous insolvencies for numerous large sponsors with material DB schemes, it is possible that the PPF will experience an unprecedented strain on its finances.

Only time will tell in relation to the actual number of insolvencies that occur, and the size of the schemes that may go into the PPF is uncertain. In particular, if the implications of Covid-19 topple any sponsors with extremely large DB schemes it is possible that our £20bn Deeper Downturn scenario will be understated and the strain on the PPF's resources may actually be far greater than this.

And the key question to follow up on is, does the PPF have sufficient levers and flexibilities to be able to weather the storm?

Case study – Covenant advice where PPF entry was a possible outcome

We are the covenant adviser to a set of Trustees whose Scheme is sponsored by a business which operates in the construction sector.

An Escrow Account was in existence with funds ringfenced for payment into the Scheme upon certain downside events, for example Employer insolvency.

The Employer had been experiencing liquidity issues for a number of years and was considering an urgent redundancy exercise in order to remove unnecessary layers of management and administration, and to close trading divisions which were loss making.

Unfortunately, whilst the need to significantly reduce its cost base was urgent, this was also coinciding with a low point in the Employer's seasonal cash flow cycle.

The Employer was concerned that if it did not undertake the redundancy exercise immediately it would become insolvent within the next few months, but as neither its existing bank nor any other lender was willing to extend additional facilities to the business, it was not clear how the exercise could be funded.

As a final option, the Company requested that part of the funds in Escrow were paid to the business to fund the exercise, before being returned when the redundancy program was complete and the Employer could afford to do so.

The Trustees were very concerned that these monies would be permanently lost from the Scheme's reach if they agreed and the Employer could not pay them back over time. In addition, no additional contingent asset security was feasible.

Against this background, we were asked to assess the viability of the proposition. Our work fell into two areas: considering the potential outcome on insolvency and considering the reasonableness of the business plan and forecasting going forwards.

Our insolvency analysis showed that the Scheme, which had a very large deficit, would already have had a significant shortfall against both its PPF and buy-out deficits if it was to become insolvent, and retaining the monies in the Escrow Account would only have a marginal impact on the outcome.

Our review of the Employer's business plan, in which we discussed the assumptions at length with the management team, showed that there was cause for optimism – the cost reductions would make the business achieve higher margins and higher earnings, and a new government backed contract had been won which would provide additional revenue streams over a number of years into the future. The cash flow forecasts also appeared robust and suggested that the business could trade with a good degree of headroom on its existing borrowing facilities over the short to medium term if the Escrow Funds were advanced.

Our overall conclusions were that there were no “risk-fee” options for the Trustees, but that the impact of their agreement on the insolvency outcome was low and the chances of the Employer’s success if they did agree appeared reasonable in terms of its ability to trade on and support the Scheme in improving its funding position over time. Alternatively, if they disagreed, insolvency and entry into the PPF appeared inevitable.

On the basis of our advice, and in return for certain other points of conditionality, the Trustees agreed to the Company’s proposal.

On the back of successfully executing the redundancy programme, the business was able to trade on, the Scheme has stayed out of the PPF and the Employer has since paid the monies back into the Escrow Account.

Given the distressed situation of many sponsoring employers due to Covid-19, LCP’s covenant team has been involved in various bespoke requests from both trustees and sponsors over recent months. By working collaboratively with all stakeholders, our aim is to consider all viable options that may be appropriate given the heightened risk of insolvency.

04 The PPF: Sources of funding and how it could be impacted by Covid-19

4.1. How is the PPF funded?

The PPF has three main sources of funding, all of which are potentially impacted by the Covid-19 crisis:

- The assets of schemes that fall into the PPF – as such schemes are in deficit, those assets, which include recoveries from insolvent employers and any contingent assets the scheme held, will not be sufficient to cover the PPF's liability to pay compensation to former scheme members. To the extent that the assets have been impacted by adverse market movements as a result of Covid-19, the deficits for the PPF to pick up will be even higher.

- Investment returns on the assets already in the PPF – the PPF has a history of achieving good investment returns in a relatively low risk manner. In 2018/19 this equated to a net investment return of over £1.5bn. It seems likely those investment returns from return-seeking assets will fall in the short term as a result of Covid-19. The PPF estimates that a 10% drop in its non-LDI assets would see its funding position deteriorate by about £2bn[10]. We have seen drops in UK equity asset values due to coronavirus of the order of around 10%, but smaller drops in other returns-seeking assets, so a deterioration of around £1.5bn seems a reasonable estimate.

- Levies on eligible schemes – clearly a big focus for levy payers (particularly as this can be another drain on sponsor resources at a time when liquidity is under pressure), but not as crucial to the PPF as you might expect with £565.5m paid in levies during 2018/19. Worsening insolvency scores (as a result of Covid-19 hitting company accounts) and worsening funding levels would, all other things being equal, lead to higher levies in future years. But currently there are legislative limits to the extent that levies are allowed to increase. One year's levy is not allowed to increase by more than 25% of the previous year's expected levy, and the total annual levy take is also subject to a ceiling of currently around £1.1bn. If the PPF did ramp up the levies to the maximum possible over each of the next ten years it could see an additional c£4bn in revenue. It is worth noting that the available pool of levy payers is declining, so any increase in PPF levy will have a proportionately bigger effect on individual scheme sponsors.

There are other, non-Covid related items that are also likely to affect the PPF's future levels of income. Most notable is Government issued index-linked bonds changing coupon and redemption payments from being linked to RPI to being linked to CPIH from some point in the future, expected to be no later than 2030, which could reduce the PPF's future income by c£1.5bn[11].

[10] See Annex S7 of the 2018/19 PPF Annual Report and Accounts.
[11] Based on the effect on PPF assets of a 0.5% drop in inflation in Scenario 3 on page 168 of the 2018/19 annual report and accounts, assuming CPI is around 1% lower than RPI and it would affect 75% of invested assets.

4.2. How else could Covid-19 impact the PPF?

The current pandemic doesn't just affect the assets of the PPF, it also impacts the amounts it is likely to have to pay out (or liabilities) as well. Those impacts may work to either improve or worsen the PPF's funding position:

- As outlined in Section 3, we are expecting more schemes to enter the PPF as a result of the pandemic. We will analyse the potential effects of this under the "Insolvencies Double" and "Deeper Downturn" scenarios in section 5.

- The "discount rates" used to place a value on payments made in the future are likely to change. At this stage it looks like the PPF's existing liabilities are well hedged and its assets would move largely in line with liabilities should discount rates change[12]. The same might not be true for the PPF's future liabilities, as pension schemes not currently in the PPF might not be as well hedged as the PPF itself, but for the purposes of this paper we will assume any changes in the funding levels of future claims are enveloped within the £10bn (Insolvencies Double) and £20bn (Deeper Downturn) claims scenarios.

- Future payments are also affected by how long members live. The pandemic is having a tragic human cost, but the effect of members potentially living for a shorter amount of time could see the PPF's funding level improve. We should note that whilst the pandemic is expected to worsen life expectancy, the effect will vary for different sub-groups of the population. There are also drivers that could improve life expectancy (such as improved air quality as a result of lockdown). We are not expecting the current Covid-19 wave to have the biggest impact on PPF funding – LCP's "Charting Mortality Trends" report suggested the impact on pension scheme funding could be a saving of lower than 0.25%, which for the PPF would equate to a figure of less than £100m. However, subsequent waves and repercussions could have a bigger impact.

- Covid-19 could cause other non-financial difficulties, such as in terms of the practicalities of administering particularly large and complicated schemes or the sheer volume of schemes that might require attention. We have not allowed for any financial impact as a result of this in our analysis.

There are also other, non-Covid related issues that are currently impacting PPF finances. These include the application of EU and UK pensions law in recent times, which has seen the amount of compensation the PPF pays certain members increase. In particular the *Hughes* case published in June 2020 ruled that the application of the compensation cap (which limits the amount of compensation available to those under Normal Pension Age) is unlawful. Disapplying the compensation cap is expected to add around 1% to the PPF's liabilities (a cost of around £350m). The earlier *Hampshire* case, which broadly prevents the PPF from cutting back a member's benefits to below 50% of their original scheme benefits, added around £230m to the PPF's liabilities[13].

For the purposes of the analysis in this paper, we will assume that the effects of any discount rate changes would be broadly cancelled out by equivalent moves in the hedged assets, and small gains that might be expected from mortality changes would be broadly cancelled out by PPF compensation adjustments so we can focus on the impact of future insolvencies.

[12] See Scenario 1 on page 168 of the 2018/19 annual report and accounts
[13] See page 142 of the PPF's 2018/19 Annual Report and Accounts

4.3. The PPF's strategy and targets

The PPF's main ambition as stated in the 2018/19 annual report and accounts is "to pay the right people the right amount at the right time" – essentially paying its current and future members their compensation as it falls due. To achieve this, it has a target of reaching "self-sufficiency" at a future point in time called the "time horizon", and it models the probability of reaching that state. It's worth taking a moment to properly understand that target, as it affects the ways the PPF could deal with the financial pressures it is currently facing.

Self-sufficiency – for these purposes the PPF considers self-sufficiency to be having accumulated sufficient assets to protect against adverse experience with little reliance on future levies or return-seeking assets to build up further reserves. In its 2018/19 report and accounts, the PPF targets a margin of at least 10% of its liabilities at the funding horizon as a sufficient asset buffer.

Time horizon – For many years the PPF aimed to meet its self-sufficiency targets by 2030. There is nothing in latest annual report and accounts to suggest that has changed.

Probability of meeting the self-sufficiency target – Each year the PPF models the probability of meeting the self-sufficiency target. Good news increases its chances of meeting it, whilst bad news reduces it. In the 2018/19 accounts the chance of meeting the self-sufficiency target was assessed at 89%.

As we saw earlier, when it became clear that the KPP2 was going to fall into the PPF this hit the PPF's funding level over the 2018/19 year. It was mitigated to some extent with other good news, so over the year the PPF's surplus dropped from £6.7bn to £6.1bn. The effect of that reduction in buffer was to reduce the PPF's probability of reaching its self-sufficiency target from 91% to 89%[14].

4.4. How could the PPF deal with additional pressure on its finances?

There are various ways the PPF can deal with the changes in circumstances it is seeing.

- **Raising Levies** – If the PPF continued charging around £600m per year it would raise about £6bn in levies by 2030. We saw in 4.1 that increasing levies to the legislative maximum could increase that by around another £4bn. Whilst increasing levies would clearly help the funding position, there is likely to be pressure to not increase levies substantially to allow companies to recover after Covid-19. As such, the PPF is not likely to be able to consider this as the only action to mitigate any funding gaps that open as a result of increased employer insolvencies.

- **Allowing probability of success to decrease** – there is scope to deem any bad experience as simply that, and see the probability of success decline. However, that could see the PPF lose an element of credibility if it is seen as having a significant chance of "failing" to pay benefits. Whilst this is an option in years where the experience isn't too bad, it may not on its own deal with the full potential fall-out from the pandemic.

- The PPF could choose to **reduce the 10% liability buffer** it has allowed itself in a steady state.

- **Lengthening the time horizon** – the PPF could allow itself more time to reach self-sufficiency. With an ever-decreasing pool of levy-paying schemes it is unlikely that the additional levies would make a substantial difference to the funding position, but the extra time

[14] See the PPF's 2018/19 annual report and accounts

invested in a balanced portfolio of return-seeking assets could help to address any deficits that the coronavirus pandemic may cause. We estimate that delaying the time horizon by a year could create an additional buffer in the region of c£2bn per year of delay (calculated as an additional year's excess returns plus an additional year's levy assuming levies continue at similar levels).

- **Changing investments** – A shift to more return-seeking assets could allow the PPF to hope for higher future returns to meet some of the deficits that might be faced. To date the PPF has had a very successful investment strategy with a relatively low risk approach. Adding further risk to this strategy could also bring around further losses which would worsen the position further. Whilst additional return-seeking may be possible, the PPF would not likely want to be seen to be almost "gambling" its way to full funding.

- **Changing assumptions –** The value of the PPF liabilities is dependent on the assumptions used to value them. It could be that the current situation warrants a change in the assumptions being used. That includes for example potentially lower or higher future expected returns or lower or higher future mortality. However, there is likely to be little scope to change the key assumptions for the discount rates in a credible and objective manner because of the way the assets are invested.

- **Changing benefits** – This is the PPF's trump in the pack, the potential nuclear option that means it should not go bust. But it is actually the Government rather than the PPF that holds the cards. Should PPF compensation become unaffordable, the Government can choose to reduce PPF benefits. This allows the PPF the freedom to invest in a long-term way anticipating that there might be a "get out of jail free" card if it all goes wrong. This is the primary reason that the PPF cannot truly fail in the way normal DB pension schemes can. For example, reducing pensioner benefits to 90% of the current benefits would create a saving of nearly £2bn on existing PPF liabilities and provisions, as well as dramatically reducing the number of schemes that would fall into the PPF and the deficits associated with them. Reducing deferred pensioner benefits by an additional 10% would be expected to save a little less than that, at more like £1.5bn, and again reduce future claims on the PPF.

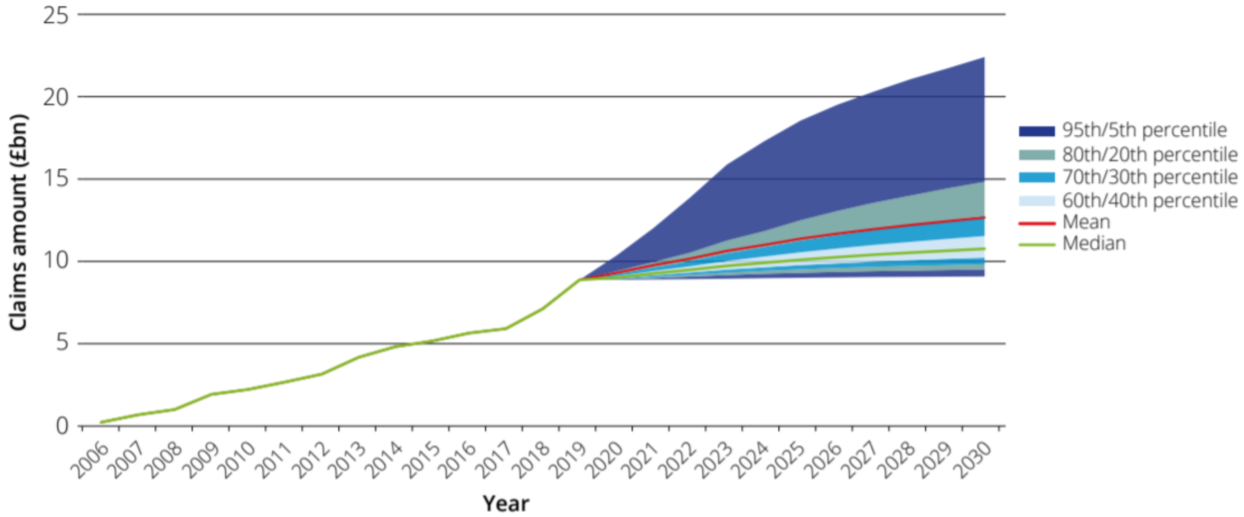
05 How could the PPF deal with a post-Covid-19 influx of schemes?

We outlined earlier two possible scenarios that the PPF might have to deal with:

- **Insolvencies Double scenario –** which would see schemes with a combined deficit of £10bn entering the PPF over the next 6 years; and
- **Deeper Downturn scenario–** which would see schemes with a combined deficit of £20bn entering the PPF over the next 6 years

Both of these scenarios are at the extreme end of the claims the PPF modelling had been predicting before the Covid-19 pandemic. In its 2019 Purple Book the PPF showed how its model was predicting less than a 5% chance of £20bn or more of cumulative claims by 2026. Our Insolvencies Double scenario would take cumulative claims to the region of £20bn by the end of 2026, whilst the Deeper Downturn scenario would take cumulative claims to almost £30bn[15].

Figure 12.2 | Projections of cumulative claims on the PPF
Source: PPF



Source: 2019 Purple Book

So could the PPF cope with these extreme events? Let's first take a simple look at how those scenarios could change the PPF's financial position over the next few years:

[15] Probability figures and graph below from 2019 Purple Book.

	Insolvencies Double (£bn)	Deeper Downturn (£bn)
Initial surplus (based on assets of c£39bn and liabilities of £33bn)	6	6
Estimated effect of recent market movements on non-LDI assets and the impact of the forthcoming change to RPI	(3)	(3)
Future levies expected to the time horizon continuing at current levels	6	6
Claims over the next 6 years	(10)	(20)
PPF's currently required 10% buffer[16]	(6)	(7)
Total shortfall to make up[17]	**(7)**	**(18)**

In the previous section we looked at the levers the PPF have in place to deal with such situations and make up the shortfalls. They were:

Action	Effect
Increase PPF levies	Up to c£4bn
Continue current investment in return-seeking assets	c£8-£10bn to 2030[18]
Lengthening the time horizon	c£2bn pa
Allowing probability of success to reduce	Would vary
Reducing the required 10% buffer	£6-7bn under scenarios, but would also reduce security
Reducing PPF compensation	c£6bn to £7bn for a 10% liability reduction[19]

We can see that in theory the full shortfall under the "Insolvencies Double" scenario could be expected to be covered purely by future investment returns if the PPF maintains its current investment strategy. That would involve accepting a lower probability of success, but if investments went according to plan it would not require any increase in levies or using any of the other available levers. There is of course the danger that investments do not go according to plan, with the associated risk that other actions may be required to fill any investment holes that poor performance might bring.

Should the "Deeper Downturn" scenario unfold, the PPF would have to look to do more. Raising levies as well as maintaining the current investment strategy wouldn't solve the issue. But lengthening the time horizon to the PPF meeting self-sufficiency for around 4-5 years could help to give the required breathing space to make up the c£18bn shortfall in full, again without raising levies. Bear in mind that lengthening the time horizon also carries risks, and if experience were to

[16] This assumes liabilities have grown to around £60bn under the Insolvencies Double scenario and around £70bn under the Deeper Downturn scenario.
[17] This position has assumed the funding position does not change over 2019/20 and ignored the value of future claims from 2027 onwards, the effect of "PPF drift", potential outperformance from the PPF's assets and any drop in the number of PPF-eligible schemes in future.
[18] Based on previous PPF investment outperformance of around 2% pa over the past few years, but would depend on the level of assets invested and any change in strategy in response to events.
[19] Again based on liabilities of around £60bn under the Insolvencies Double scenario and around £70bn under the Deeper Downturn scenario.

go against the PPF it may need to fill a bigger deficit as a result. Should the PPF choose to raise levies as well, that timescale would reduce.

In both the “Insolvencies Double” and “Deeper Downturn” scenarios highlighted above we have therefore identified possible solutions that do not necessarily require compensation to be reduced, or indeed levies to be raised. The PPF would be running additional risk though, and be more susceptible to future bad experience.

It is really important that the PPF (or rather the Government) has the ultimate back up plan of being able to reduce benefits in extremis, because it gives it the freedom to take the investment risk or push back the time to self-sufficiency which enables it to navigate these troubled waters. Should a scenario much worse than those outlined above arise, which could occur if one or more giant schemes in deficit go into the PPF, it may be necessary for additional actions to be seriously considered.

06 Concluding comments

The coronavirus pandemic is causing many businesses to face financial hardship, and just as many trustee boards are wrestling with the uncertainty surrounding their sponsor covenant so it could pose the PPF its biggest problem to date.

But the PPF has proven itself to be a well-run and resilient entity, with options at its disposal to prevent the lifeboat from sinking – at least under the two scenarios we have considered.

The PPF will be keeping a very close eye on the number and especially size of the schemes that do fall into it over the coming years. The way this pandemic is hitting some of the older, more established industries like high street retail, transportation and leisure business is completely different to the global financial crisis of more than a decade ago, making the failure of some of the biggest pension schemes more likely.

Should the impact of the downturn be more extreme than the scenarios we have considered and lead to more than £20bn of additional deficits entering the PPF, perhaps through the sheer quantum of insolvencies or a number of those schemes with the largest deficits entering (or a combination thereof), then difficult decisions may need to be faced around how the additional liabilities are funded including the possibility that the Government attempts to reduce past and future PPF compensation.

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