Pension
Protection
Fund

Rt Hon Frank Field MP
Chairman of the Work and Pensions Select Committee
House of Commons
Westminster
SW1A 0AA

11 April 2017

Dear ~~Mr Field~~ Frank,

New BHS pension scheme

Thank you for your letter of 28 March containing a number of questions regarding the expected new BHS pension scheme.

The settlement for the BHS pension schemes, agreed between Sir Philip Green, the Pensions Regulator (TPR) and the trustees, with the involvement of the PPF, relieves the PPF's levy payers of the cost of meeting the funding shortfall. As you have noted, under the terms of the settlement it is planned to establish a new BHS scheme which will not have a substantive sponsoring employer. Once established, the new scheme will be monitored by TPR and its members protected by the PPF.

Before answering your specific questions in turn, it might assist the Committee to provide some background on our general views with regards these arrangements.

First, it is clear that this is new and evolving terrain – these types of schemes were not envisaged at the time of the Pensions Act 2004 which set up the PPF. As we have previously set out, we recognise that these arrangements change the nature of the risks we face. Simply put: in the absence of a genuine sponsor, PPF levy-payers would be directly exposed to the risk of failure of a scheme's investment strategy. Our risk becomes very different because there is no longer a "corporate" trigger for PPF entry, only a scheme-based trigger, the risk we are running is that of a scheme simply running on until it becomes unaffordable, and then tipping into the PPF at the discretion of the trustees.

It is also important to stress that new instances of such schemes would generally come into existence as a result of a restructuring or a settlement of the sort agreed in the BHS case, and hence would require appropriate engagement with, and involvement of, TPR and the PPF. As such, we do not anticipate that these arrangements will become commonplace, at least in the near term. DWP in its recent Green Paper identified the legislative and regulatory issues arising from this, and we expect the Government's response will set the longer term direction in this area. The BHS settlement is a response to a specific set of circumstances which highlights broader issues given these arrangements are not explicitly currently part of the wider legislative framework.

For our part, as specific propositions have been put forward, we have necessarily developed our thinking with regard to the challenges they pose to us. In particular, we have developed a new charging methodology and rules as to how we would charge a levy to any such a scheme without a substantive sponsor that meets our criteria. We indicated back in June 2016 that we may need to consider a new approach and in September 2016 consulted on our initial thinking. We then consulted on our proposed approach and the detailed levy rules

earlier this year, and at the end of last month (30 March) confirmed the inclusion of the new rules in our final Levy Determination for 2017/18.

1. Explain the circumstances in which the PPF might have to become involved in the new scheme, including circumstances in which you would expect the scheme to be wound up.

In agreeing to the BHS settlement, we were comfortable that the starting funding position for the proposed new scheme, together with the ongoing governance arrangements, would be sufficiently robust to ensure it poses a limited risk of falling back into the PPF. We do not expect a material claim on the PPF from the expected new scheme, which we expect will be supervised and monitored closely by TPR. Our continued involvement with the scheme is therefore most likely to be focused around setting it a proportionate, risk-reflective levy.

More broadly, the potential circumstances in which a scheme without a substantive sponsor might make a claim on the PPF would likely arise from the failure of the scheme's investment strategy.

It is important to note that there are no directly applicable legislative provisions to set out when such a scheme should be allowed to run, or any requirements to support effective monitoring of such schemes and to control investment risk, or to ensure that the scheme will wind up should its funding position deteriorate. We recognise that this is new and complex territory, and note the Government's recent Green Paper on Defined Benefit pension schemes identified these issues and seeks views on what changes to the existing legislative and regulatory regime might be necessary.

In the absence of clear existing legislative parameters, or a specific regulatory regime, our aim has been to ensure that the risk to PPF members and levy payers is constrained to acceptable levels and that the levy charged should be consistent with the risk posed. In broad terms, we would expect governance arrangements for investment approach and funding triggers to be agreed.

We envisage that such arrangements would then be assessed on at least an annual basis, so that if they are no longer met then the scheme must be wound up, triggering the start of a PPF assessment period. The existence of such wind up triggers, together with a regular cycle of assessment, will be key to protect the PPF's levy payers. In addition, governance arrangements would need to ensure that potential risks, such as "re-risking" in the event of a deterioration in funding, are managed.

A key element of any wider framework will therefore be the necessary reporting requirements to support the operation of the wind up triggers as well as the calculation of levies. This would include a requirement for valuations and investment risk data to be provided on at least an annual basis. We expect such arrangements to be in place as part of the setting up of a new BHS scheme.

2. Set out your assessment of the particular risks posed to the PPF by schemes without a substantive sponsor and whether the risks to each such scheme are likely to be closely correlated.

Schemes without a substantive sponsor present a different type of risk to our levy payers from that posed by other schemes. Simply put, in the absence of a 'genuine' sponsor, the primary risk to which PPF levy payers would be exposed is the risk of failure in the scheme's investment strategy.

A direct consequence is that our standard approach to calculating levies – a key element of which is an assessment of the likelihood of a sponsoring employer becoming insolvent and so triggering a claim on the PPF - is not suitable for such schemes because it focuses on the likelihood of failure of a corporate business. For a scheme without a substantive sponsor a claim on the PPF requires only a deterioration of the scheme's funding position, in order for the claim to be triggered by generating an insolvency of the non-substantive sponsor.

Of those that do emerge, we expect them to be well funded, and that there will be governance arrangements and monitoring put in place. With regards to this case, the settlement was such that the expected new scheme will start with a suitable funding position to meet future liabilities. The expected new scheme should also be funded to pay the anticipated levies and other scheme expenses, its expected investment strategy will be low risk and appropriately calibrated to meeting future liabilities, and robust governance arrangements will be put in place.

However, even low risk investment strategies reduce, rather than eliminate, risk. One foreseeable potential risk is that schemes in this position invest in similar types of assets, meaning market reverses for one might be experienced by others at the same time. This might become an issue if we saw schemes of this type becoming common (for a limited number of schemes of this type the risk would remain limited) and we will consider this if further schemes emerge. These are issues we also expect to be looked at in the context of the Government's Green Paper consultation.

3. **Outline what stress testing you undertake or commission to assess the sustainability of the PPF, both in general and with particular regard to schemes without a substantive sponsor.**

Our Long Term Funding Strategy, first published in 2010, provides the framework we use to ensure we have the financial resources required to pay existing levels of compensation to current and future members of the PPF. It provides the basis for setting levies and our investment risk. We review the Long Term Funding Strategy annually. The most recent iteration, released in July 2016, reflected that the claims arising from the insolvency of BHS were included on our March 2016 funding position.

A key element of our Long Term Funding Strategy is what we term our Funding Objective – this is our aspiration to be financially self-sufficiency by an appropriate time horizon, at present 2030. By this point, we envisage the number of eligible schemes will have reduced, the risk posed by the remainder will be lower, the liabilities that we have ourselves taken on will have matured, and the fund will have grown substantially in relation to the levy we charge. Beyond it, we anticipate that the levy would only be needed for a remaining tail of potential claims.

As part of this framework, we have developed our Long-Term Risk Model (LTRM) which we use to measure our 'probability of success' of meeting this Funding Objective. The LTRM provides stochastic analysis of one million potential future scenarios based on our current funding position, the position of the schemes we protect (including their current deficits) and different economic conditions. As a stochastic, as opposed to a deterministic or 'single point' model, it generates a distribution of outcomes. This enables us to see not just what our best estimate is, but also the likelihood of other potential outcomes, both on the upside and downside. At 31 March 2016, which incorporated the claims arising from the BHS insolvency, our modelling indicated our 'probability of success' in reaching our 2030 target was 93 per cent, up from 88 per cent the previous year.