Pension Protection Fund, 1993-2003

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The *Pensions Bill* due to be introduced during the 2003-04 session of Parliament will include provision for a Pension Protection Fund. Employers providing defined benefit (final salary) pension schemes will pay a levy to the Fund, which will compensate scheme members if their employer goes bust, leaving a pension scheme with insufficient assets to meet its liabilities. 100% of pensions in payment and 90% of the accrued rights of members yet to retire will be guaranteed up to a cap. Controversially, the scheme is unlikely to be retrospective, so that members of schemes, such as ASW, which have already started to wind up, will not benefit.

This note describes the background to the proposal, mentioning several earlier reports on pension security which rejected the idea of such a fund; outlines the main features of the scheme, so far as they are yet known; looks briefly at some of the main issues involved; describes a similar scheme in the United States, the Pension Benefit Guaranty Corporation; and mentions a legal challenge by ASW workers under the European Insolvency Directive.

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A. Background

1. Goode Report, 1993

The question of how to secure the "pension promise" made by defined benefit occupational pension schemes has exercised policy makers for many years. In 1993, the Goode Report, set up in the wake of the Maxwell scandal, acknowledged that the pension promise was not an absolute one:

> ***What does the pensions promise mean?***
>
> 4.2.4 In theory, the promise in an earnings-related scheme is to provide the benefits set out in the scheme documents and prescribed by law, whilst in a money purchase scheme it is to pay contributions into a fund and to use the member's share of the fund at retirement to purchase pension benefits. In an earnings-related scheme, therefore, the benefit is measured by the scheme rules, not by the size of the pension fund, the benefits are known but the cost is unknown, and the risk is borne by the employer; in a money purchase scheme the benefit is measured by the size of the fund and the member's interest in it, the costs are known but the benefit is unknown, and the risk I borne by the scheme member.
>
> 4.2.5 The apparent simplicity of the earnings-related/money purchase dichotomy is, however, misleading. A common provision in scheme rules is that if the scheme is wound up in deficit the rights of members are reduced accordingly. The effect is to limit the promised defined benefits to the size of the fund. It is true that a provision of this kind in an earnings-related scheme must be ignored when calculating the value of a scheme's liabilities on insolvency of the employer for the purpose of the employer's statutory liability to make good the deficit. But it is not clear that this rule adequately protects the earnings-related pensions promise.[1]

The Goode Report made various recommendations – notably for a Minimum Solvency Requirement (later adopted as the Minimum Funding Requirement in the *Pensions Act 1995*) – which were designed to increase the security of pension funds, but it nevertheless recognised that there would still be occasions when an insolvent employer was unable to make good deficiencies in a fund which had to be wound up. Goode, therefore, considered the possibility of a "safety net" scheme to provide compensation for scheme members whose pension promise was not met in full.[2] He concluded that there should be such a scheme but that it should only cover loss caused by misappropriation of assets. The Pensions Compensation Scheme, established under the *Pensions Act 1995*, provides precisely this limited amount of cover.

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1 Pension Law Review Committee, *Pension Law Reform*, (the Goode Report), Cm 2342-1, September 1993
2 See chapter 4.11, *Protection against insolvency of the employer*, for a full discussion of theissues

Goode's reasons for rejecting a compensation scheme which covered all risks, including investment under-performance, were that it would be very difficult to manage in practice and that his proposals for minimum solvency requirements should prevent prolonged shortfalls of assets:

> 4.11.34 The idea of covering all risks is attractive in the light of the pension promise, which, as we have observed, is quite independent of the assets which underpin it. This approach is favoured by one of us, but the majority of the Committee does not believe that it is practicable to shelter a scheme which invests from all risks of investment. This does mean that the promise is less firm than may appear, but as a consequence members have a direct interest in the investment policy and performance of their fund, not so much in relation to benefit improvements as in relation to the security of benefit entitlements already accrued.
>
> 4.11.35 Compensation against under-funding would be very difficult to manage in practice. In normal circumstances losses on investments should not, in isolation, lead to difficulties for schemes which are prudently and diversely invested. If losses do cause problems it is likely to be because of a widespread fall in asset values which would affect a great many schemes ….
>
> 4.11.36 it is important to recognise that if our proposals are introduced, funds will be much less vulnerable to investment fluctuations short of complete market collapse. Minimum solvency requirements should mean that schemes will always be or be close to being fully funded ….The gap between an all-risks compensation scheme and one which protects against a narrower range of risks may be smaller than is often suggested.

2. Proposals 1998-2001

The Minimum Funding Requirement (MFR) did not prove quite the salvation that its authors had hoped, and the Labour Government's first Pensions Green Paper, published in December 1998, announced a review of the MFR.[3] It also said that, as part of this review, the Government would be "considering the viability of a Central Discontinuance Fund to which pension rights might be transferred when a scheme has to wind up because the employer is insolvent." A Consultation Document issued in September 2000 conceded that the MFR might not be the most appropriate approach to ensuring the security of occupational pensions.[4] It put forward a number of other approaches, including insurance schemes and a Central Discontinuance Fund. However, these alternatives proved unpopular, and the Government decided to proceed by revising the MFR.

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[3] Department of Social Security, *A new contract for welfare: partnership in pensions*, Cm 4179, December 1998, para 8.22

[4] Department of Social Security, *Security for Occupational Pensions: a consultation document*, September 2000, http://www.dwp.gov.uk/consultations/consult/2000/mfr/mfrrev.pdf

In a document entitled *Security for occupational pensions: the Government's proposals,* published in March 2001, the Government reported that:

> 5. Very few were attracted to the idea of **a central discontinuance fund** which would be unworkable in the absence of an ultimate financial guarantor. The Government cannot act as guarantor of a discontinuance fund, and there was little support for such an arrangement with costs being levied on employers with occupational pension schemes.
>
> 6. Those who commented, including the Association of British Insurers (ABI), were dubious that **a commercial insurance** market could be developed. The system of safeguards on funding which would be acceptable to insurers might in effect replicate many of the problems of the MFR in adding to the cost and volatility of funding defined benefit pension schemes.
>
> 7. There was also little support for the alternative – some form of **compulsory mutual insurance**. Some of the same problems would apply as above, and many employers sponsoring well-funded schemes would object to subsidising firms which neglected their obligations.
>
> 8. Again, there was little support for **prudential supervision** of pension schemes by a regulator. The prospect of significant burdens on schemes through increased bureaucracy and red tape was felt to rule out this option.
>
> 9. Two basic models for a replacement for the MFR received significant backing. The first was for a **common funding standard** which would apply across the board to all pension schemes – a 'one-size fits all'. Those who favoured this approach felt it should be designed with the aim of ensuring an adequate level of long-term scheme funding without distorting schemes' investment management plans. However, a wide range of different views were expressed as to the exact basis and design of such a common funding standard.
>
> 10. The Government has considered this proposal but has rejected it. The Government is not satisfied that a practical regime can be devised which avoids the drawbacks affecting the current MFR. A common funding standard does not take into account the scheme's specific circumstances and can therefore worsen protection. Assumptions that are right for one scheme are not necessarily right for another scheme. Further, the process of valuing liabilities on the basis of a common funding requirement inevitably leads to actuarial conventions driving and distorting investment leading to increased costs. This option would be fundamentally no different to the current situation and is likely to damage the long-term future of defined benefit pensions or risk reducing the benefits that they provide. It does not provide the best protection for pensions and brings with it the risk of damaging consequences for investment like the current MFR.[5]

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[5] Department of Social Security, HM Treasury, *Security for occupational pension schemes: the Government's proposals*, March 2001, http://www.dwp.gov.uk/publications/dss/2001/opp/opp.pdf

The Government went on to back the **scheme-specific funding standard** for the MFR:

> 11. The Government has decided to proceed on the basis of the other general approach which received substantial support in the consultation exercise, including from the National Association of Pension Funds (NAPF) as well as from other major representative organisations. This is for a long-term, scheme-specific funding standard with a regime of transparency and disclosure. This proposal also builds on the framework put forward by Paul Myners in his report, but incorporates various additional measures to strengthen protection further for all defined benefit scheme members.
>
> 12. The Government proposes a long-term scheme-specific funding standard, in the context of a strong regime of transparency and disclosure, with the following additional measures to strengthen protection further:
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> • a statutory duty of care on the scheme actuary;
> • stricter conditions about voluntary wind-up than at present; and
> • an extension to the fraud compensation scheme.[6]

3. ASW

The problem became more pressing during 2002 as an increasing number of insolvent employers wound up pension schemes and were unable to meet their pension promises in full. One particularly distressing example was the collapse of ASW (Allied Steel and Wire) in Sheerness and Cardiff, with an underfunded pension scheme.[7] Scheme members who had not yet retired found that they would only receive a fraction of the pensions they had expected. This case has been raised in the House of Commons on several occasions.[8] In a recent debate, Kevin Brennan, MP for Cardiff West said ASW workers in his Cardiff were now being told that their pension may only be 14% of its expected value:

> That is an 86 per cent. cut in their pension. That is the scale of the catastrophe that has been visited on constituents in my part of Wales and in other parts of the United Kingdom, including those of my hon. Friend the Member for Sittingbourne and Sheppey (Mr. Wyatt), whose Allied Steel and Wire workers at Sheerness have suffered a similar fate.

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6 Ibid

7 The ASW plant in Cardiff formerly employed over 900 people and the ASW plant in Sheerness employed over 300 people prior to being placed in Receivership on 10 July 2002. On 18 July 2003 The Independent Trustee, Pinsents', appointed by the Receiver – KPMG – announced that it was winding up the Sheerness and Cardiff pensions schemes. There were 1,100 Members (750 deferred) of the Sheerness fund, and approximately 4,500 Members (2,400 deferred), http://www.pensionstheft.org/3895.html.

8 eg, by Derek Wyatt in an adjournment debate on 16 October 2002, HC Deb cc 434-442, by Oliver Heald in an Opposition Day debate on pensions on 20 January 2003, cc 50-95, and by Kevin Brenan in an adjournment debate on 23 October 2003, cc 876-882. Pensioners involved have set up a Pension Action Group with a website at: http://www.pensionstheft.org/1112.html

> The state has not exercised a proper duty of care on behalf of those people. The state did not insist on a proper health warning on occupational pensions—on the contrary, it encouraged workers to enter those schemes. The result has been a real injustice for a few who understandably feel bitterness, bewilderment and betrayal, and uncertainty for the many who, on hearing of the plight of the few, lose confidence in the whole occupational pensions system, when even the most rock solid "guaranteed" form of pension fund turns out not to be worth the paper on which it is written, for thousands of people.
>
> That is an injustice, not just a misfortune. Those people feel that they have been duped, and they have been.[9]

Pensioners involved have set up a Pension Action Group with a website at: http://www.pensionstheft.org/1112.html

4. Pensions Green Paper, December 2002

The Labour Government's second Pensions Green Paper, published in December 2002, revisited the proposals for an insurance scheme or central discontinuance fund:

> **Insolvent employers**
>
> 77. Another approach to dealing with defined benefit schemes that are under-funded when the employer becomes insolvent would be to introduce some form of **insurance or a centralised 'clearing house' arrangement**. Following a number of scheme wind-ups, the Government wants to look again at whether this might be a practical way of reinforcing the pension promise. Some form of insurance might be attractive to scheme members as it would give them greater confidence in the benefits promised.
>
> 78. There are a number of different approaches that could be taken here, for example:
>
> - a centralised arrangement or 'clearing house' into which people whose employer became insolvent could pay the funds they receive on wind-up. The clearing house could then seek to buy on their behalf the best available annuity from an insurance company; and
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> - a form of insurance (possibly a Central Discontinuance Fund) that enables members to be more confident that, if their employer becomes insolvent with an under-funded pension scheme, they will receive the benefits promised.[10]

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[9] HC Deb 23 October 2003, cc 877-878

[10] Department for Work and Pensions, HM Treasury, Inland Revenue, *Simplicity, security and choice: working and saving for retirement*, December 2002, Cm 5677, http://www.dwp.gov.uk/consultations/consult/2002/pensions/gp.pdf

Views were invited. The Work and Pensions Committee, in its report on *the Future of UK Pensions*, published in April 2003, felt that more should be done to protect the pension promise and threatened to return to the issue:

> **We feel strongly that employees deserve more protection than they currently receive when underfunded schemes are wound up.** We recognise that a balance needs to be struck between increasing protection without threatening the existence of schemes by increasing the costs for employers who voluntarily provide schemes for their employees. **We call on the Government to say whether or not it would be prepared to act as ultimate guarantor of an insurance scheme. We urge the Government to announce its intentions on increasing security of pension funds soon. This is an issue to which we may wish to return**.[11]

The Pensions Advisory Service (OPAS) drew attention to the crisis of confidence in pensions, caused by losses such as those experienced at ASW, in its annual review of 2002-03:

> • The year has been one of the most turbulent in the history of pensions in this country.
> • The pensions crisis is really a savings crisis but there is also a developing crisis of confidence.
> • People are not saving enough for their old age. To halt the decline, they will have to be persuaded or coerced. Success on either front is currently uncertain.
> • Pension scheme wind-ups continue to hit the headlines. The whole issue of underfunding – insufficient money to fulfil a scheme's commitments – is sapping public confidence in final salary schemes.
> • Bad news worries the public. Increasing numbers are seeking our help and reassurance. Important issues need to be addressed by the Government as soon as possible.[12]

5. Pensions White Paper, June 2003

On 11 June 2003, the Government did act, with the publication of the Pensions White Paper, *Simplicity, security and choice: working and saving for retirement: action on occupational pensions*.[13] This announced that the Government would be establishing a Pension Protection Fund (PPF) to provide compensation for members of schemes which wound up on the employers' insolvency with insufficient assets to meet their liabilities.

Andrew Smith, Secretary of State for Work and Pensions, said in his statement to the House on the Pensions White Paper, that ever since he had started looking at the "terrible injustice"

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[11] Work and Pensions Select Committee, *The Future of UK Pensions*, Third Report of Session 2002-03, HC 92-I, April 2003, http://pubs1.tso.parliament.uk/pa/cm200203/cmselect/cmworpen/92/9202.htm

[12] Pensions Advisory Service (OPAS), Review of 2002/2003, *People and Pensions*, http://www.opas.org.uk/AnnualReview/CaseReview_2002-03/Review2003.pdf

[13] Cm 5835

of firms going bust without the money to pay pensions that workers had saved all their lives for, he had:

> asked why, if people expect their holiday provider or motor insurer to be covered if the firm goes bust, there is no cover for something as important as an occupational pension. We will therefore legislate to set up a pension protection fund. That fund will take over the schemes of insolvent companies to ensure not only that pensions in payment are protected, but that those still working can be sure of getting 90 per cent. of what they were promised. It will be paid for by a fixed-rate levy and an additional risk-related premium, which, together with a salary cap, will minimise perverse incentives and moral hazard. The fund will be a non-Government body. It will meet its obligations through the power to set and vary the level of charge without recourse to public funds. Taken with the other measures, that is a big extension of pension security, for the first time guaranteeing protection if a company scheme goes bust.[14]

The White Paper gave the following information on the proposed fund:

> ***The Pensions Protection Fund – a new compensation arrangement for pension schemes in the case of insolvency***
>
> 5. **We will establish a compensation scheme known as the Pensions Protection Fund, run by a statutory body, to protect private sector defined benefit scheme members whose firms become insolvent with unfunded liabilities in their pension scheme. This proposal was welcomed by many respondents.**
>
> ● The National Consumer Council said: *"The [Department for Work and Pensions]should introduce a compulsory insurance scheme for occupational schemes to protect accrued rights to retirement income."*
>
> ● Age Concern said: *"In the case of insolvency we believe that serious consideration should be given to the introduction of an insurance system ... We believe that the increased cost to members may be an acceptable price for security."*
>
> ● Watson Wyatt, the actuarial consultants, remarked: *"We believe that there should be a public debate on whether some form of mutual insurance or central discontinuance fund could improve the security of pension scheme members. We accept that there are arguments for and against the various options. Nevertheless, the research that we have undertaken suggests that this sort of approach could be viable if it was limited to employers who became insolvent."*
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> 6. Some respondents were concerned that introducing such a scheme could introduce an element of moral hazard. We paid particular attention to this important concern in developing our proposals, learning lessons from the compensation scheme that has been running in the United States since the 1970s.

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[14] HC Deb 11 June 2003, cc 683-684

> 7. There are two key risks. The first is that the company could choose to fund to a low level, or the trustees hold a higher risk portfolio than appropriate, because of the existence of the compensation scheme. In order to minimise this risk, we will ensure that pension schemes which are underfunded will pay a higher premium to the compensation fund compared with well-funded schemes. This risk-based premium will be on top of a flat-rate levy payable by all employers with defined benefit schemes other than those public service schemes where benefits are guaranteed by government. The risk-based premium will encourage good levels of funding.
>
> 8. The second key risk is that there could be incentives for example for directors of a company or providers of finance to seek to wind up the company, in order to avoid the debt on the pension scheme. We can minimise this risk by capping the salary which will be used to calculate any entitlement payable by the compensation scheme. Insolvency would still mean significant reputational risk for the controllers of the company and would also mean significant loss of pension for the high-earning decision makers. This will ensure that there is a built-in disincentive, particularly for Board members and other senior executives, to let the company go into insolvency.
>
> 9. It is important that we get the cap right. We want people to have much greater confidence in the pensions they have been promised. But we must not put unnecessary costs on good employers who choose to offer good pensions. And we need to tackle moral hazard, and guard against the Pensions Protection Fund producing unintended incentives. For the scheme to work properly, it must remain in the interests of scheme members and those who control the company for the fund to be managed prudently and for the company to stay in business and meet its pension obligations; and for there to be a reputational risk in insolvency. The fund will pay a maximum of 100 per cent of pensions in payment, and 90 per cent of the benefits of those still working. Over and above this, we believe there should be a cap on the maximum amount guaranteed by the Pensions Protection Fund equivalent to the pension expected by those on a final eligible salary of between £40,000 and £60,000. As we bring forward legislation to set up the Pensions Protection Fund we will take views from the Employer Task Force and others on the right level of the cap to achieve these aims.[15]

The PPF is unlikely to come into operation before April 2005. According to the White Paper Spring 2005 is the “earliest possible date” for most of its reforms to come into force.[16]

6. Queens Speech, November 2003

Legislation to introduce the PPF will be contained in the *Pensions Bill 2003-04*. The Queens Speech on 26 November 2003 announced that:

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[15] Department for Work and Pensions, *Simplicity, security and choice: working and saving for retirement: action on occupational pensions,* June 2003, Cm 5835, paras 2.5-2.9 http://www.dwp.gov.uk/consultations/consult/2002/pensions/actionplanfull.pdf

[16] Ibid, chapter 5

> Legislation will … be introduced to encourage both employers to provide good quality pensions and individuals to save more effectively for their retirement. A Pensions Protection Fund will be set up to protect employees and pensioners if companies become insolvent.

A Background Note on the Bill, published that day by the Department for Work and Pensions (DWP), said that the PPF:

> would revolutionise protection offered to members of pension schemes ensuring a pension promised is a pension paid. The PPF would build on action already taken to protect members of occupational schemes.

B. Issues

1. Retrospection

So far, the Government has resisted calls for the PPF compensation provisions to apply retrospectively to schemes which have started winding up before it comes into operation. When asked about this following his statement on the White Paper on 11 June 2003, Andrew Smith, Secretary of State for Work and Pensions, said:

> He raised the agonisingly awful issue of people who have already lost their pension entitlements. Nothing would be more cruel than for me to come to the Dispatch Box and raise false hopes about what might happen. If we are legislating for the future, in terms of establishing a pension protection fund, that would apply in the future and not retrospectively.[17]

Baroness Hollis, a Junior Minister at the DWP, has highlighted the cost implications of retrospection:

> However, it is the general principle of good legislation that it does not apply until it comes into force. Promising compensation for members whose companies go bust before the introduction of the protection measures would mean taking on unknown—and potentially very large—liabilities. With the prospect of guaranteed compensation, some employers might seek to abandon their pension liabilities, potentially further increasing the cost. This would be a potentially very large burden to place on the general taxpayer or any alternative source of funding.
>
> Member protection is a government priority, and so these new protection measures will be introduced as soon as possible after the relevant legislation is in place.[18]

The Pension Action Group, which is predominantly made up of former employees of Allied Steel and Wire (ASW), has been campaigning for retrospective compensation and it is

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[17] HC Deb 11 June 2003, c 690

[18] HL Deb 11 November 2003, c WA 183

reported that Andrew Smith has agreed to consider proposals, drawn up by their adviser, Ros Altmann, for a Central Fund into which the assets of insolvent pension funds would be paid.[19] Benefits due would be paid from this fund for as long as possible, with ultimate responsibility being taken over by the Government. Ros Altmann estimates that the cost of her proposals would average less than £100 million a year.[20]

Full details of the proposals and the Pension Action Group campaign are available on their website:

http://www.pensionstheft.org/1112.html

2. Government guarantee

The Government has also resisted calls for it to act as a guarantor of last resort. Lord McIntosh of Haringey said in the Debate on the Address in the Lords:

> I was asked whether the Government would act as a guarantor. As an analogy, I simply ask one question. If we want to get rid of asbestos in industrial buildings, housing or anywhere else, is the way to achieve it for the Government to guarantee that if people do not do it themselves, the Government will pay for it? Surely that is not the case. Surely, it would be right for those who have benefited from the ups of pension finance, but are now sometimes risking paying the downs, collectively to pay for it. We shall seek to ensure that our fund will be conducted with the utmost sensitivity to the needs of industry. But for the Government to be the ultimate guarantor would be to move exactly in the wrong direction.[21]

Earlier, Andrew Smith had dealt with a similar question in the Commons:

> As far as whether the public should stand as a guarantor of the fund, that would be wholly inappropriate. First, there would be the moral hazard. Secondly, I hope that a moment's reflection would underline the importance of not nationalising that risk, which is what the hon. Gentleman is advocating amounts to. The state cannot stand behind the hundreds of billions of pounds of what are private sector obligations. Moreover, the scheme that operates in the United States has no such underwriting from the US Government.[22]

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[19] "Smith looks at payouts for past pension loses", *Daily Telegraph*, 11 September 2003
[20] Press release by Dr Ros Altmann, 3 November 2003, *A bold move by ISTC and Amicus*
[21] HL Deb 27 November 2003, c 91
[22] HC Deb 20 October 2003, cc 370-371

3. Cost

The White Paper estimated the cost of the scheme for private sector employers offering defined benefit schemes at between £340 million and £375 million.[23] This would be an annual cost:

> The cost of £340 million to £375 million is an estimated annual cost that represents the estimated overall annual levy needed to meet the benefit funding shortfall of schemes eligible for compensation from the PPF … The flat-rate levy will be in respect of all members of defined benefit schemes (active, deferred members and pensioners), approximately 15 million members in total. The cost per individual member will be the flat-rate levy, with an additional cost depending on the level of underfunding in the scheme. All costs are gross of corporation tax. [24]

PricewaterhouseCoopers has estimated that this might mean an average levy of £50 per member.[25]

4. Impact on occupational pension provision

Employers are concerned that the cost of the levy will be yet another factor encouraging them to move away from providing final salary pension schemes. Half of respondents to the National Association of Pension Fund's 29th annual survey (covering 2002/03) said the government's proposed Pension Protection Fund would make it less attractive for employers to provide defined benefit schemes. [26]

C. Pension Benefit Guaranty Corporation (PBGC)[27]

When drawing up plans for the PPF, British civil servants visited the USA to learn from the experience of the Pension Benefit Guaranty Corporation (PGBC) established in 1974 to protect the basic pension benefits of participants in private sector defined benefit pension plans. The PBGC was established under the *Employee Retirement Income Security Act 1974* (ERISA). It is a Government Corporation but is entirely self-financing and there is no Government guarantee. Its funding comes from insurance premiums paid by companies with insured schemes, assets from pension plans the Corporation has taken over, investment income and amounts recovered in bankruptcy from companies formerly responsible for failed plans.

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[23] Department for Work and Pensions, *Simplicity, security and choice: working and saving for retirement: action on occupational pensions*, June 2003, Cm 5835, Annex, para 2 http://www.dwp.gov.uk/consultations/consult/2002/pensions/actionplanfull.pdf

[24] HL Deb 24 June 2003, cc WA 13-WA 14

[25] "Risk must come at a premium", *Pensions Week*, 25 August 2003

[26] NAPF press release, 20 November 2003, *One in four companies close final salary pension schemes in 2003*, http://www.napf.co.uk/news/PR2003/releasesa018.cfm

[27] This section is based on an article by Steven Kandarian, Executive Director of the PBGC, in *PMI News*, November 2003

There are two distinct pension insurance programmes: one for plans maintained by a single employer and one for collectively bargained plans maintained by two or more employers.:

Single-employer program

The single-employer program currently covers about 34 million workers and retirees in roughly 32,000 active plans. It offers "termination insurance". The PBGC assumes responsibility for pension plans that do not have sufficient assets to pay all promised benefits. When the plan is terminated, all additional benefit accruals and vesting credits cease. Once the PBGC assumes control of a plan, it pays guaranteed benefits to the plan's participants subject to insurance limits set by law. <u>This program had a financial deficit in excess of $3 billion as of the end of fiscal year 2002.</u>

Multi-employer program

This is a smaller program, which covers about 9.5 million workers and retirees in about 1,650 plans. It offers "insolvency insurance". Under this program, PBGC provides financial assistance in the form of loans to plans that are unable to pay basic PBGC-guaranteed benefits when due. While such plans must reorganise to improve their financial condition and suspend payments in excess of those guaranteed by PBGC, they generally do not terminate and PBGC does not become directly responsible for the plan or its benefit payments. The multi-employer program is administered and funded separately from the single-employer program and <u>as of the close of fiscal year 2002 had a small reported surplus</u>.

Single Employer Program

The *Single Employer Program* is the program which most resembles the PPF proposals. Steven Kandarian, Executive Director of the PBGC, has given the following explanation of how it works:

> **Three ways of termination**
>
> A single-employer defined benefit pension plan may be terminated in one of three ways. A corporate plan sponsor may initiate a **"standard" termination** of its plan at any time if the plan is fully funded and able to pay all promised benefits. The termination is completed through the purchase of annuities in the private group annuity market or through the lump-sum payment of benefits to all entitled participants. In such a case, PBGC reviews the termination to ensure that it meets legal requirements but otherwise the Corporation has very little role and no liability in the plan's termination. Given that more than 160,000 fully funded plans have terminated since PBGC's creation in 1974, full funding is clearly an achievable goal for pension plans.
>
> If a plan is not fully funded, it may be terminated in two additional ways. In a **"distress" termination**, a company may initiate termination of an underfunded pension as long as the company sponsoring the plan and each of its corporate affiliates meets one of several financial distress tests. Essentially what must be proved

is that termination is necessary for the survival of the company. Most often, this requires that a bankruptcy court judge and the PBGC agree that the distress tests have been met and that plan termination is essential. Once the termination is approved, PBGC trustees the plan and assumes responsibility for paying benefits when due.

The other way an underfunded plan may be terminated is if the PBGC initiates an **"involuntary" termination**. PBGC is required by law to seek the termination of an underfunded plan if the plan does not have enough money to pay current monthly benefits. Otherwise, PBGC has discretion to seek the plan's termination if the Corporation determines that certain specified conditions exist. One such condition is that "the possible long-run loss of the Corporation with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated."

This authority may be invoked, for example, when a plan promises shutdown benefits, a form of severance pay provided by plans in certain industries when an employer closes some or all of its facilities. Shutdown benefits are not advance funded. PBGC guarantees these benefits if a shutdown arises before an underfunded plan terminates, even though the Corporation does not receive insurance premiums for the potential liability. PBGC has encountered plans in which shutdown benefits may increase plan underfunding by 50 percent or more and has acted to terminate plans before a shutdown occurs to maintain the financial integrity of the insurance program.

In the event an underfunded plan must be terminated, PBGC guarantees the payment of "basic" pension benefits earned before the plan terminated. Such benefits include those payable at normal retirement age, most early retirement benefits, disability benefits for disabilities that occurred before the plan was terminated, and certain benefits for survivors of plan participants. PBGC does not guarantee health and welfare benefits such as vacation pay or severance pay.

There is no pre-conceived benefit structure for PBGC's payments to participants in trusteed plans. Rather, the benefit PBGC pays to each person is determined by the provisions of the plan. The law does, however, set a maximum limit on PBGC payments, which is adjusted annually. For pension plans terminating in 2003, the maximum guaranteed amount is $43,977.24 a year for a person who retires at age 65. This maximum guarantee is reduced for persons receiving benefits before age 65 and for pensions that include benefits for a surviving spouse or other beneficiary. PBGC may pay a person more than the maximum guaranteed amount if the plan has enough assets to pay benefits not guaranteed by law. The Corporation also may pay non-guaranteed benefits if it recovers sufficient amounts of the plan's under-funding from the plan's corporate sponsor. In about 90 percent of all cases, plan participants receive the same benefit from PBGC that they had earned from their plan.

When an underfunded plan is terminated, PBGC becomes responsible not only for paying the plan's benefits but also for collecting as much as possible of the plan's unfunded benefits (both guaranteed and non-guaranteed) from the plan's corporate sponsor. This liability also extends to all corporate affiliates of the plan sponsor. However. PBGC's recoveries tend to be extremely limited, particularly since most companies are already bankrupt when their plan is terminated.

How PBGC's insurance premiums are assessed

> PBGC's premiums are set by the Congress. Originally, the Congress set the premium at $1 per plan participant (for premium purposes, "plan participant" includes active workers, retirees, survivors of deceased participants and separated former employees with accrued vested benefits). The inadequacy of this premium level was soon evident as the Corporation had a financial deficit virtually within days after beginning operation. The Congress has since raised PBGC's premium seven times.
>
> The current premium paid by sponsors of single-employer plans has two components: a flat-rate fee of $19 per plan participant that is paid by all insured plans, and an additional exposure-related variable fee of $9 per $1,000 of unfunded vested benefits paid only by underfunded plans. PBGC's premiums do not take into account the financial health of the plan sponsor or the asset allocation of the pension plan, both of which are important factors in determining whether a plan is at risk of defaulting on its benefit obligations. While PBGC may propose changes to its premium level and structure, it can implement these changes only with the approval of the U.S. Congress.[28]

As in the UK, under-funding of private pension plans has increased significantly in the USA over recent years. The reasons are similar to those in the UK:

- Severe drop in both equity values and interest rates
- Over-investment in equities
- Increased longevity
- Scheme maturity and growing numbers of older and retired workers

It has been estimated that under-funding in US private sector defined benefit plans now exceeds $350 billion. This has obvious consequences for the PBGC, and at 31 July 2003, the single employer program had a deficit of $5.7 billion:[29]

> As of July 31 2003, the PBGC’s single-employer insurance program had a deficit of $5.7 billion. The gap between PBGC's assets and liabilities has been growing primarily due to the failure of a significant number of large companies with highly underfunded plans. During 2002 alone, PBGC sustained a loss of $11.3 billion, $9.3 billion of which was due to terminations of underfunded plans. Pension claims during 2002 were greater than the total claims for all previous years combined.[30]

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[28] “Pension Insurance in the United States”, *PMI News,* November 2003

[29] In evidence to the US Senate Special Committee on Aging, Steven Kandarian said that the deficit was still growing and that “based on our latest unaudited financial report, [it] had grown to $8.8 billion as of August 31, 2003”, http://www.pbgc.gov/news/speeches/testimony_101403.pdf#xml=http://pbgc.gov.master.com/texis/master/search/mysite.txt?q=deficit&order=r&id=7049505858d0348c&cmd=xml.

[30] Ibid

Steven Kandarian's article concludes with the following lessons for the UK:

> There are benefits and costs associated with pension insurance. The principal benefit is increased security for workers and retirees, whose pensions no longer depend exclusively on the financial health of their company. Even if the company fails, workers will get the benefits they have earned. A collateral benefit is that a system of pension insurance can make defined benefit plans more attractive. To the extent that societies embrace employer-sponsored pensions as an important component of retirement security, encouraging defined benefit plans furthers that goal.
>
> The principal risk associated with pension insurance is moral hazard. If pension benefits are insured no matter how underfunded a plan may be, underfunding is encouraged. This is especially true when an employer can offer pension benefits in lieu of cash wages, knowing that the cost of pension benefits will be paid by others if the company fails.
>
> Another risk is adverse selection. Financing pension insurance with flat premiums levied on all plan sponsors causes those who pose the least risk to the system to pay for the unfunded promises of those who pose the most risk. If the burden of this cross-subsidy becomes too high, healthy employers may terminate their defined-benefit plans, leaving only the most troubled behind.
>
> Policymakers who find the benefits of pension insurance attractive but want to minimise the costs should give proper attention to two issues. The first is adequate funding. Pension insurance works best when it goes hand-in-hand with rules requiring companies to fund promised benefits. The closer pension plans are to being fully funded when they terminate, the lower the premiums that need to be charged to other companies in the defined benefit system. One possible approach to adequate funding would be to make the rules risk-based, taking into account the financial health of the plan sponsor, the volatility of the assets held in the pension fund and the nature of the plan's benefits.
>
> The second issue is properly priced premiums. As mentioned, charging all companies the same premium leads to cross-subsidies that may prompt healthy employers to terminate their pension plans. This can be addressed with a premium structure that incorporates the major exposure and risk factors, including the level of underfunding, the size of the benefit promise, the financial health of the plan sponsor, and the mismatch of the plan assets and liabilities.
>
> The United States made a policy choice in 1974 to establish relatively weak pension funding rules and to create a pension insurance system that results in wealth transfers from low-risk to high-risk companies. The problems flowing from that decision have been partially corrected by legislation enacted in 1987 and strengthened in 1994, but the PBGC's current financial deficit demonstrates that it is still relatively easy for plan sponsors to underfund their benefit promises and leave the cost for others to bear. In many ways, policymakers in the United Kingdom face the same question today that the United States faced 30 years ago: Who will pay for the pension promises made by companies to their workers? The only choices are the company that made the promise, other companies through a system of pension insurance, or the taxpayers.

D. EC Insolvency Directive

Article 8 of the *Insolvency Directive* (80/987/EEC) provides that:

> Member States shall ensure that the necessary measures are taken to protect the interests of employees and of persons having already left the employer's undertaking or business at the date of the onset of the employer's insolvency in respect of rights conferring on them immediate or prospective entitlement to old-age benefits, including survivors' benefits, under supplementary company or inter-company pension schemes outside the national statutory social security schemes.

The UK Government believe that provisions in section 124 of the *Pension Schemes Act 1993* providing for unpaid pension scheme contributions to be met from the National Insurance Fund in the event of an insolvency adequately implement this requirement in UK legislation:

> **Pensions: Employer Insolvency**
>
> **Lord Lea of Crondall** asked Her Majesty's Government:
>
> What are the current obligations in United Kingdom law arising from European Union Directive 80/987 in regard to the rights of employees for occupational pension benefits in bankrupt companies.[HL3774]
>
> **The Parliamentary Under-Secretary of State, Department for Work and Pensions (Baroness Hollis of Heigham)**: On 20 October 1980 the Council of European Communities adopted Council Directive 80/987/EEC on the approximation of the laws of the member states relating to the protection of employees in the event of the insolvency of their employer.
>
> Each member state was required to set up a "guarantee institution" (the National Insurance Fund in the UK) to meet certain debts—for example, holiday pay and deductions from employees' salaries—owed to former employees of insolvent employers. The provisions in question are now contained in the Employment Rights Act 1996 and the Pension Schemes Act 1993.
>
> Specifically, the Pension Schemes Act 1993 provides that certain unpaid pension scheme contributions can be claimed from the National Insurance Fund, through the redundancy payments offices, if the employer sponsoring a pension schemes becomes insolvent. If a claim is successful funds are paid to the trustees of the pension scheme being wound up.[31]

And:

> **Employee Pension Rights**

[31] HL Deb 15 July 2003, cc WA110-WA111

> **Mr. Wyatt**: To ask the Secretary of State for Work and Pensions if he will make a statement on procedures to protect employee pension rights in cases of employer insolvency due to fraud, with particular reference to requirements under the 1980 Insolvency Directive. [135092]
>
> **Malcolm Wicks** [holding answer 28 October 2003]: The Pensions Compensation Board helps members of occupational pension schemes where the assets of the scheme have been reduced through dishonesty and the employer is insolvent. This is an important protection for scheme members and will act as a last resort for schemes seeking to restore their funding position.
>
> As stated in the Green Paper ("Simplicity, security and choice: Working and saving for retirement", December 2002), we intend to increase protection to those schemes that suffer from acts of dishonesty where the employer is insolvent. In future these pension schemes will be compensated for the full amount lost.
>
> The new Pension Protection Fund will ensure greater protection for members in all cases of insolvency, not just those that arise due to fraud.
>
> We take our obligations under Article 8 of the Insolvency Directive seriously and the European Commission has confirmed that we have met those obligations. [32]

However, two trade unions, ISTC and Amicus, acting on behalf of ASW pension scheme members, are taking the Government to Court, alleging failure to properly apply the Directive.[33]

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[32] HC Deb 3 November 2003, c 466W

[33] ISTC press release, 2 November 2003, *ASW unions launch pension legal action against Government and back Labour MP's amendments to Pensions Bill*