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# Role of the PPF in financial risk management of UK DB pension sector: A multi-period economic capital study

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IAA Colloquium, June 2015

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# Agenda

- 1 Introduction
- 2 Economic capital
- 3 Stochastic model
- 4 Model assumptions
- 5 Results
- 6 Conclusions

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  - Background
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# Background

## Regulatory developments

- Basel 2/3.
- Solvency 2.
- Pensions Regulations.

## Pensions: Developments in the UK

- Pensions Act (2004): PPF and the Pensions Regulator.
- Private pension membership: 46% (1997) to 32% (2012).
- DB scheme membership: 34% (1997) to 8% (2012).

## Questions:

- 1 Impact of capital requirements on individual DB pension schemes.
- 2 Role of the PPF for the risk management of the entire sector.

# Agenda

1 Introduction

2 **Economic capital**

- Formulation
- Eligible schemes
- PPF

3 Stochastic model

4 Model assumptions

5 Results

6 Conclusions

# Economic Capital Formulation

**Economic capital** is the excess of assets over liabilities in respect of accrued benefits required to ensure that assets exceed liabilities on all future valuation dates over a specified time horizon with a prescribed high probability.

## Notations:

$X_t$ : Net cash flow of the scheme;

$L_t$ : Value of s179 liability of the scheme;

$I_{s,t}$ : Accumulation factor;

$D_{s,t}$ : Discount factor.

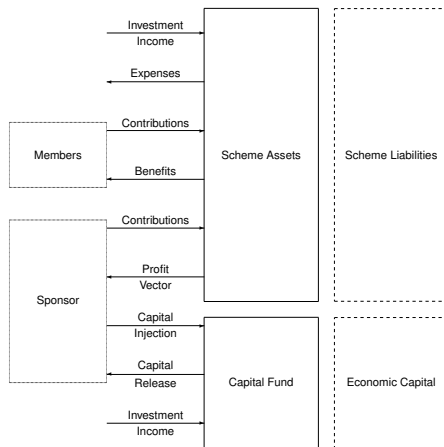
## Building blocks

$P_t = L_{t-1}I_{(t-1,t)} - X_t - L_t$ : Profit vector, with  $P_0 = -X_0 - L_0$ .

$R_t = \sum_{s=0}^t P_s I_{s,t}$ : Accumulated retained profits until time  $t$ ,

$V_t = \sum_{s=t+1}^T P_s D_{t,s}$ : Present value of future profits at time  $t$ .

# Eligible Scheme Cashflow and Capital Requirement

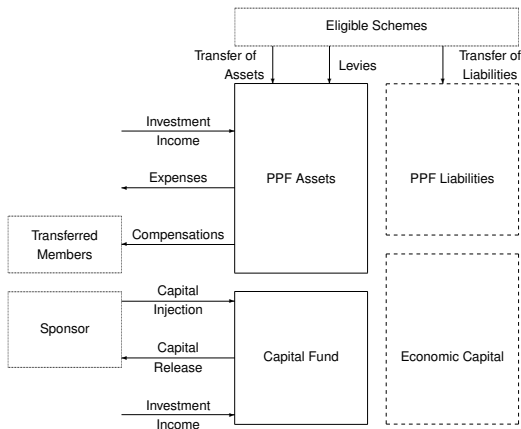


$$\text{Capital requirement: } C_t = \max \left[ - \min_{s=t}^T V_s D_{t,s}, 0 \right].$$

$$\text{Economic capital requirement: } \rho(C_t) = \text{VaR}(C_t, p = 0.995).$$



# PPF Cashflow and Capital Requirement



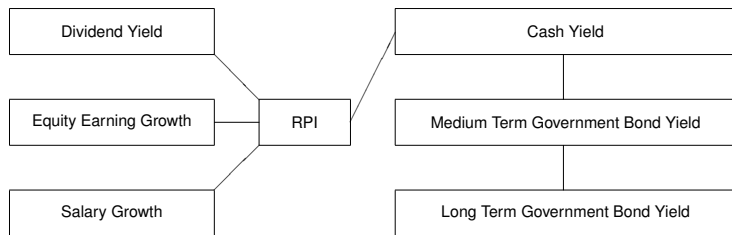
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  - Economic variables
  - Longevity
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# Stochastic model: Economic Variables



The individual economic random variables,  $Z_{it}$ s, are modelled as:

$$Z_{it} = \mu_j + Y_{it}, \text{ where } Y_{it} = \beta_j Y_{i(t-1)} + \varepsilon_{it} \text{ and } \varepsilon_{it} \sim N(0, \sigma_j^2).$$

The error terms

- are assumed to be independently distributed across time  $t$ ;
- which are directly connected to each other are dependent;
- which are indirectly connected are still dependent, but more weakly so.

# Stochastic model: Longevity

The mortality model used is developed in three steps:

- Step 1:** Set S1PM and S1PF as the baseline mortality tables for males and females respectively.
- Step 2:** Project these base mortality tables from year 2006 to year 2012 using the mortality projection table published by the Institute and Faculty of Actuaries.
- Step 3:** Finally, model the future stochastic mortality improvements starting from 2012 by modelling stochastic uncertainty around the central mortality projection (Sweeting (2008)).

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  - Membership profile
  - Model points
  - Investment

5 Results

6 Conclusions

# Membership Profile

**Table :** Average membership profile of eligible schemes.

Membership group (Members)	Number of schemes	Average membership			Total
		Active	Deferred	Pensioner	
A: (5-99)	2,260	6 (13%)	23 (52%)	15 (35%)	44
B: (100-999)	2,828	56 (16%)	182 (52%)	113 (32%)	351
C: (1,000-4,999)	824	384 (17%)	1,103 (49%)	754 (34%)	2,241
D: (5,000-9,999)	192	1,231 (17%)	3,297 (46%)	2,601 (37%)	7,129
E: (Over 10,000)	212	6,651 (19%)	14,763 (42%)	13,608 (39%)	35,022

# Model Points

Table : Eligible schemes model points.

Membership types	Age	Gender	Accrued service/benefit
Active	30	Male/Female	7 years past service
	40	Male/Female	16 years past service
	50	Male/Female	25 years past service
	60	Male/Female	34 years past service
Deferred	50	Male	Accrued pension of £3,000 per year
	50	Female	Accrued pension of £1,500 per year
Pensioner	70	Male	Pension of £6,000 per year
	70	Female	Pension of £3,000 per year

# Assets, Liabilities and Investment Strategies

Table : Comparison of assets and liabilities.

	Estimated	Actual
Assets	£1,018b	£1,027b
Liabilities	£1,218b	£1,231b

Table : Distribution of eligible scheme by investment strategies.

Investment strategy	Asset allocation		Proportion of eligible schemes
	Equities	Bonds	
<i>L</i>	25%	75%	25%
<i>M</i>	50%	50%	60%
<i>H</i>	75%	25%	15%

PPF broadly follows investment strategy *L*.

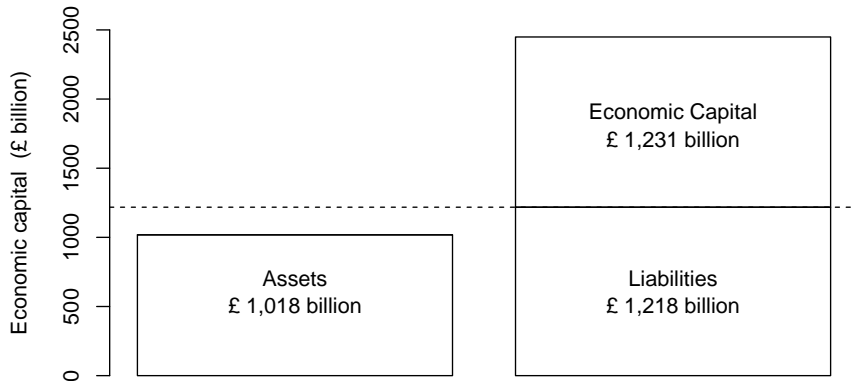


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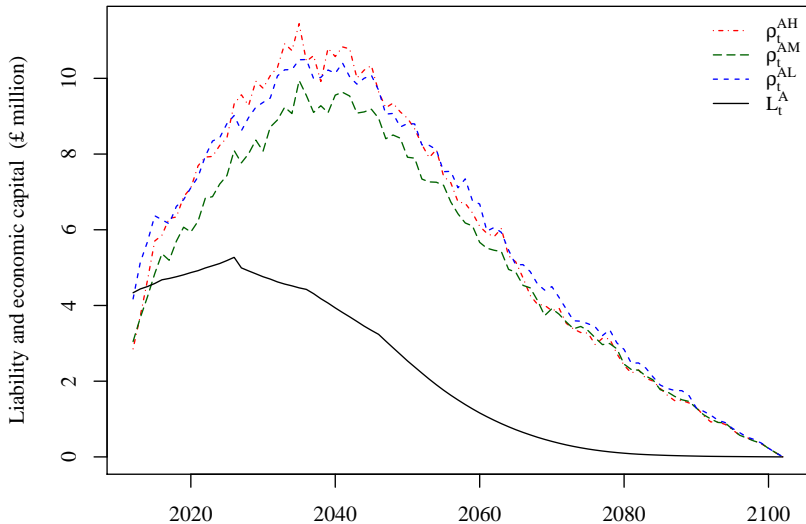
# Aggregate Economic Capital for Eligible Schemes

As at 31 March 2012



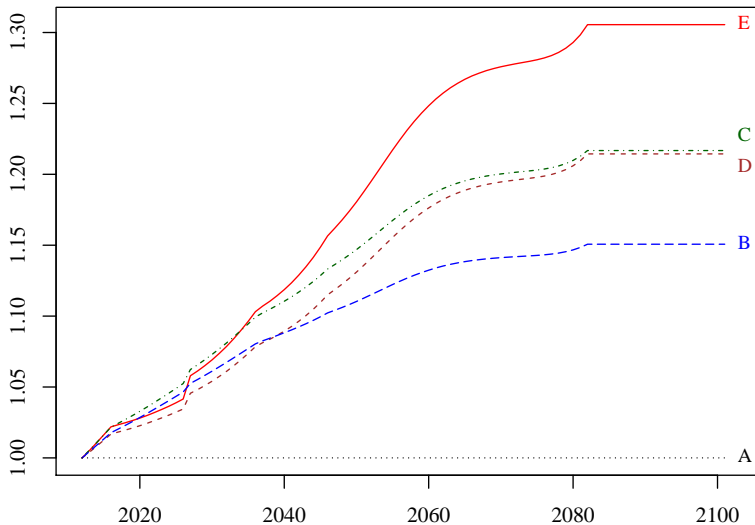
# Economic Capital: Eligible Scheme in A

Membership group A



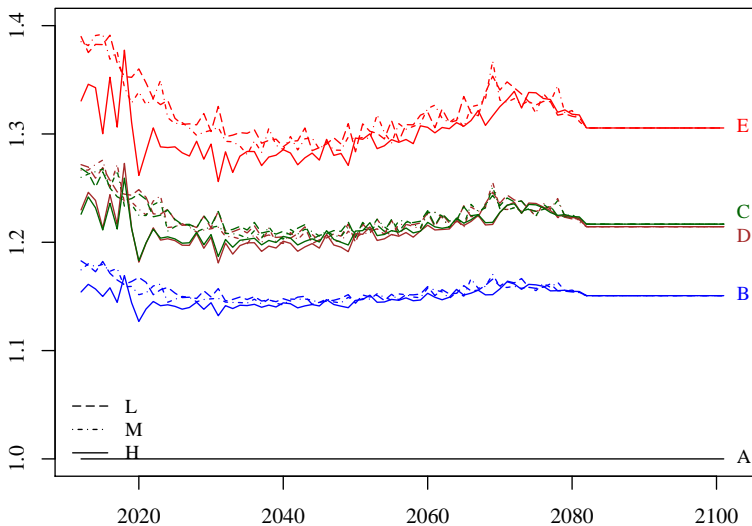
# Eligible Schemes: Liability Comparison

$L_t^X/L_0^X$  as multiples of  $L_t^A/L_0^A$  where  $X=A,B,C,D,E$



# Eligible Schemes: Economic Capital Comparison

$\rho_t^{XY}/L_0^X$  as multiples of  $\rho_t^{AY}/L_0^A$  where  $X=A,B,C,D,E$  and  $Y=L,M,H$



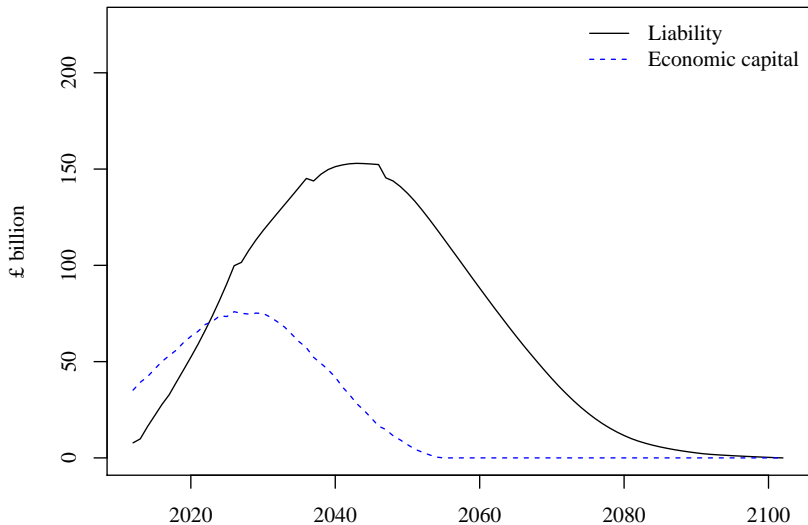
## PPF: Some Additional Assumptions

- PPF levy: 0.072% of the total s179 liabilities.
- Amortisation period: 10 years.
- Funding cap: 120% of s179 liabilities.
- Insolvency rates:

Membership group	Annual insolvency rate
A	1.60%
B	0.95%
C	0.90%
D	0.53%
E	0.72%

# PPF: Base Case Results

PPF schemes liability and economic capital : Base case



# PPF: Sensitivity Results

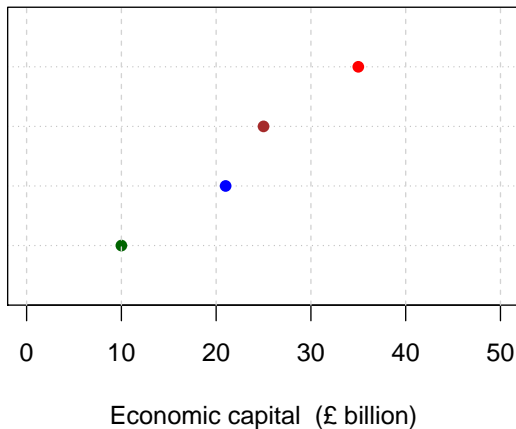
As at 31 March 2012

1: Base Case

2: 4-year Amortisation

3: 50% Buffer

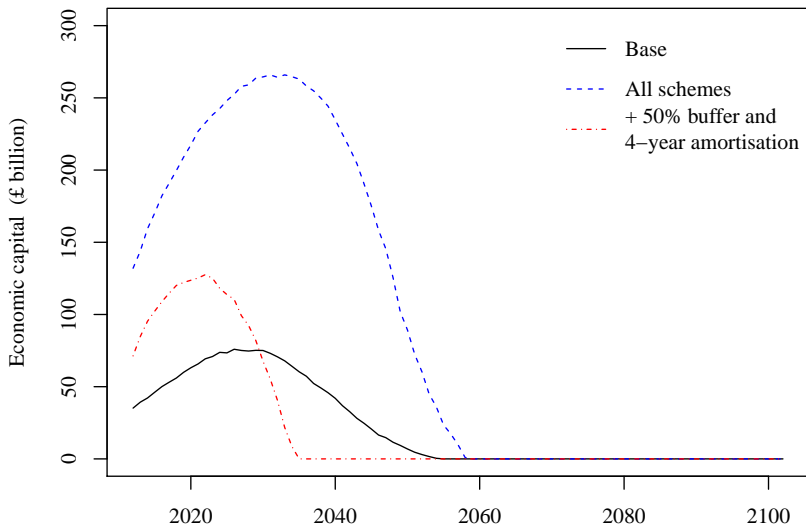
4: (2) + (3)





# PPF Takes Over All Schemes With Insolvent Sponsors

PPF takes over all schemes with insolvent sponsors



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# Conclusions

## Summary

- Aggregate economic capital requirement:
  - ▶ On eligible scheme basis: **£1,200 billion**.
  - ▶ For PPF: **£35 billion**.
- **Reasonable capital buffer + shorter amortisation period** can bring down the economic capital requirement further.

Need a **holistic view**, taking PPF into account, while devising regulations for defined benefit pension sector.

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