Pension
Protection
Fund

# Annual Report and Accounts 2006/07

HC 1018

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# Annual Report and Accounts

## 2006/07

**Annual Report presented to Parliament by the Secretary of State for Work and Pensions in pursuance of paragraph 119(5) of the Pensions Act 2004 and Accounts presented to Parliament by the Secretary of State for Work and Pensions on behalf of the Comptroller and Auditor General in pursuance of paragraph 22 (6) (b) of Schedule 5 of the Pensions Act 2004.**

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# Role of the Pension Protection Fund

The Board of the Pension Protection Fund is a Public Corporation which derives its duties and powers from the Pensions Act 2004 and is accountable to Parliament through the Secretary of State for Work and Pensions. The Board of the Pension Protection Fund became operational on 6 April 2005.

It was established to pay compensation to members of defined benefit and hybrid occupational pension schemes where an employer has become insolvent, and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation. Providing certain conditions are met the Pension Protection Fund will take over the assets of a pension scheme and pay compensation to eligible individuals. It is funded from investment returns, the assets of schemes transferred to the Fund and by an annual levy on defined benefit and hybrid pension schemes.

In addition, the Board of the Pension Protection Fund has taken over the role of the former Pension Compensation Board to pay compensation to defined benefit and defined contribution pension schemes where these schemes have suffered a loss that is attributable to dishonesty.

# The Board of the Pension Protection Fund

## Annual Report and Accounts 2006/07

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# 1. Chairman's Foreword

**Lawrence Churchill**
Chairman

This, the third, annual report of the Pension Protection Fund marks the completion of the build phase as we have started to pay pensioners their benefits following the transfer of their schemes to us, and also marks the completion of my first term of office. It has been a privilege to play my part in the delivery of social justice for those who, through no fault of their own, would otherwise have forfeited much of their pension entitlement.

During the course of the year we have learned a lot and continued to build and strengthen the organisation:

- We obtained sufficient data on the risk distribution of the Defined Benefit (DB) pensions universe to make it worthwhile issuing, with the Pensions Regulator, the Pensions Universe Risk Profile (known as the Purple Book). Our philosophy is that information is more useful the more it is shared and we hoped to engage the industry in the better management of pension risk. We were pleased – and a little surprised that over 125,000 copies of the Purple Book have been downloaded.

- We published a more comprehensive Statement of Investment Principles (SIP) before we accepted the first scheme assets. Our SIP was well received by the Investment industry. Our objective is to be well matched and yet to attain some out-performance over our liability benchmark.

- We continued to refine our Long Term Risk Model on the basis of which the Board decides the amount of levy to be raised each year. Again, in support of our belief in transparency, we made the non-proprietary parts of our model available publicly in August 2007. One of the more interesting findings is that Long Term Risk has not changed nearly as much as the very benign short term risk profile of schemes. This explains why the levy scaling factor – essentially the ratio between long term risk and short term risk – has increased. In the early summer of 2007, total deficits in pension schemes, based on the PPF's funding assessments, were at a five year low and well over a third of schemes – representing over 75% of assets – were in surplus.

- Having received our powers in April 2005, we were proud to have completed the assessment period for 13 schemes before 31 March 2007. At the end of the financial year we were providing protection for over 7,000 members inside the PPF – with over 1,400 pensioners receiving monthly payments. In addition at the year end there were over 100,000 members and over 170 schemes in the assessment period; providing security for such people is the PPF's raison d'être.

We continue to regard our relationship with our stakeholders as very important and during the year we implemented a number of improvements suggested following a report from Ipsos MORI. We have just received our second report which is both pleasing to read and provides us with a number of fertile ideas for continuous improvement. Success could not have been achieved without constructive engagement with our stakeholders and I thank them for their time, expertise and insight.

Relationships with the Pensions Regulator (tPR) continue to be strong and it was particularly pleasing to see this publicly acknowledged in the submissions to Paul Thornton's independent Institutional Review. While remaining focused on the functions given to us by Parliament, we are continuing to work closely with tPR on a range of both strategic and operational issues, including those in relation to tPR's statutory objective to protect the PPF. We welcomed, and agreed with, Paul Thornton's findings and the submissions of stakeholders that confidence in pensions can best be underpinned by each of the PPF and tPR remaining independent.

Our staff have worked tirelessly and diligently during the year and I thank them for the care that they show and their passion for the cause which has been entrusted to us. It remains a privilege and an honour to lead such a distinguished Board who provide such purposeful advice to chart the way ahead and who have worked significantly in excess of their contracted commitment.

Looking forward to both the year ahead and my second term of office, I share a sense of excitement about the challenges and opportunities. As we now have more complete data on our DB pension universe, we can begin to consider more sophisticated risk management, improving both scheme member security and value for money for levy payers. Our current intention is to focus even more on Long Term Risk (and its sources) for the distribution of the levy as well as for assessing its quantum. We must make further progress to recognise and reduce the long term risks in the system and we intend to promote a debate and consultation on these complex technical issues, having kick-started the process by publicising our Long Term Risk Model. Our shared ambition is that the PPF should remain a stable and resilient part of the financial institutional landscape – operating at all times in a simple, fair and proportionate manner.

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**Lawrence Churchill**
Chairman

Lawrence Churchill

Date: 17 October 2007

# 2. Chief Executive's Report

**Partha Dasgupta**
Chief Executive

*"We were very lucky that the Pension Protection Fund was set up just before the collapse and we have the good news today that it will be taking over the payments to Rover pensioners. I now receive much more than I would have got if the PPF did not exist."*

MG Rover pensioner
(March 2007)

Our second year of operation was marked by the admission of over 1,400 individuals across the UK who are now receiving compensation payments directly from the PPF. A further 5,600 individuals have a compensation entitlement awaiting their retirement. Over 100,000 individuals have the financial security that their pension scheme is being assessed for entry to the PPF and that their pensions will be paid at PPF compensation levels regardless of the finances of their scheme. Given that our youngest beneficiary is five years of age, our oldest in their eighties and we are paying compensation to former scheme members from the Home Counties to rural Scotland, the benefit of the protection we provide is a reality right across the UK. The Purple Book, published during the year has now shown that some 12.5 million members of UK defined benefit pension schemes are protected by the PPF and each of these individuals can be reassured that they share in the protection evidenced by the MG Rover pensioner last March.

Our Accounts show our continuing development into one of the UK's major public financial institutions. Over the last year the solvency position of the PPF has strengthened and we are able to report that we are now 88% funded; an improvement on the position at the end of 2005/06. This is despite the entry of the largest scheme to date into an assessment period, lower than expected levels of levy collected and our taking the robust and prudent step of adopting changed mortality assumptions. While our claims experience has been consistent with our expectations, most of our claims have been from small and medium sized enterprises; our results are however dominated by the entry of the T&N Retirement Benefits Plan into assessment, the largest scheme yet to do so. The changes to mortality assumptions adopted have also raised our liabilities by around £241 million; without these changes the PPF would have been 92% funded.

As I discussed in last year's Annual Report and Accounts we collected a lower level of pension protection levy for 2006/07 than expected. The combined effects of fixing the scaling factor in December 2005 together with the effect of financial market movements, employers providing more accurate data to D&B, schemes providing more accurate information on multi-employer structures and better information in regard to the eligibility of schemes resulted in us collecting less than half of the £575 million originally anticipated. Of course if markets had moved in the opposite manner we would have levied a higher amount than the levy estimate. We are able to report that we expect to collect £271 million in respect of the 2006/07 pension protection levy, a further change in the estimated figure published in the 2005/06 Annual Report and Accounts largely due to continuing improvements in data.

The setting of the pension protection levy for 2007/08 shows the challenge we have in balancing the interests of levy payers against those of current and future beneficiaries of compensation. The levy estimate was based on our Long Term Risk Model, the mechanics and underpinning assumptions of which we shared publicly in August. This projects forward the assets and liabilities of eligible pension schemes, allowing for changes in financial markets, insolvencies and discount rates. Our levy estimate was also intended to make up for the undercollection in the 2006/07 levy. By setting the levy scaling factor in April 2007 we are on course to collect a figure much closer to the intended figure of £675 million, with only real risk reduction by individual schemes, rather than wider market movements, reducing this.

From the consultation we have undertaken and the views we have sought from stakeholders during the year we recognise that stability in the level of the levy continues to be uppermost among concerns. In August 2007 we commenced consultation on the steps that we propose to take to respond to these concerns. Better data and better modelling has allowed us to better understand the risks that we face. As such we are now more strongly equipped to assess how that risk is likely to change over time and therefore how we should price that risk. We are therefore currently proposing that the level of the levy adopted for 2008/09, assuming stability within current economic trends, will also provide the basis of that for the following two years. I believe that this use of our growing capabilities and the improved quality and coverage of our data (the collation of which has been one of our largest challenges), to give certainty to levy payers also balances our duties to those who benefit from our compensation.

Coupled with our wider work to recognise and encourage risk reduction I am confident that, with a rising funding level, our sustainability is more secure than at any point since our creation. The movement in interest rates during 2006/07 led to disappointing performance in our bond portfolio but this was more than compensated for by the offsets from related reductions in liabilities. It has however demonstrated the importance for the PPF of our revised Statement of Investment Principles, announced in October 2006 and implemented from January onwards, which seeks through a diversified liability driven approach to out-perform our liabilities while limiting downside risk.

Over the last year we have also continued to mature as an organisation. We have strengthened the Executive team. We have also sought to build capability across the organisation which resulted in substantial recruitment during 2006/07 to provide the expertise required to fulfil our objectives. While this commitment to ensuring we could meet the tasks before us led to our exceeding our operating budget we are seeking to remain within budget for the current year. As noted last year recruiting staff in high demand areas has remained challenging.

During the last financial year I emphasised the themes of effective communication, innovation and delivery. In each of these areas I believe we made significant strides and the Annual Report details these. Challenges remain however around both the assessment process and our approach to risk.

- We are considering how best we can improve communication with scheme members and lay trustees. Part of this will be seeking to improve the efficiency and effectiveness of the assessment process.
- Having consulted on whether asset allocation should be a specific risk factor for the risk based levy we will also continue to explore how the levy can better reflect long term risk and encourage reductions in such risk. We will also continue to develop our risk management strategy. How risk is understood and distributed in the pensions universe is crucial to us. Over the coming year we will be seeking to explore the use of financial markets to bear risk on our behalf and how we might use financial innovation to mitigate the liabilities arising from future claims.

By March 2007 the PPF was meeting all of the tasks given to it in the Pensions Act 2004; paying compensation, collecting a risk based levy and investing to meet the PPF's long term commitments, while also improving its financial position. On this basis I am optimistic about our continuing development over the years ahead.

Finally, I would like to thank the Board and staff of the PPF and the industry for their continuing commitment, enthusiasm and support.

**Partha Dasgupta**
Chief Executive

Date: 17 October 2007

# 3. Management Commentary – ‘Report on 2006/07’

## 3.1 Context: understanding and reducing risk

### Background

During 2006/07, the Pension Protection Fund (PPF) continued to develop into the organisation envisaged when it was first established by the Pensions Act 2004:

- The first 13 schemes completed assessment periods; for nine of these schemes, the assets were transferred to the PPF and the PPF took responsibility for paying compensation to members. The remaining four schemes were either rescued or sufficiently funded on a PPF basis to effect a buy-out of their own liabilities.
- The first pension protection levies, including a risk based element and totalling £271 million, were invoiced in respect of 2006/07.
- A new liability-driven investment strategy for the Fund was developed and implemented and was reflected in a revised Statement of Investment Principles approved by the Board.
- Deficits on 170 schemes are recognised as provisions. The 170 schemes have over 103,000 members with a deficit provision of £908 million.[1]

### Understanding risk

Understanding the scope of the pensions universe within which the PPF operates was an important area of development in 2006/07. In December 2006, working jointly with the Pensions Regulator (tPR), the PPF published the Pensions Universe Risk Profile (known as the Purple Book). This pulled together data and analysis on all UK-based defined benefit pension schemes for which the PPF held data and, using valuation data from the schemes, coupled with robust modelling, sought to understand the behaviour of their deficits over time and thereby the aggregate risk to the PPF.

The Purple Book showed that as at 31 March 2006, for the 5,800 schemes in the sample, the aggregate deficit on a PPF basis was approximately £33.8 billion. By 31 March 2007 this had become an aggregate surplus on a PPF basis of approximately £6 billion. The methodology underpinning the Purple Book will be used by the PPF to publish regular analysis of aggregate surpluses and deficits for the sample.

### Reducing risk

Understanding and reducing risk remained an important focus for the PPF during its second year of operation. While the work carried out around the Purple Book provided the background and an overview of total deficits, the PPF took a number of significant steps to reduce the risk to which it is exposed. These included:

- the introduction of the risk based levy for all schemes earlier than originally anticipated by Parliament, and
- a series of measures to encourage net risk reduction, minimise the likelihood of claims and potentially reduce the levy for individual schemes.

While these were introduced for the 2006/07 pension protection levy, during the year consideration was also given to how best to develop these themes in respect of the 2007/08 levy. This led to the following approaches being confirmed during the period under review:

- the progressive risk based levy reduction, starting where schemes are over 104% funded and leading to no risk based levy payment for schemes 125% or more funded on a PPF basis, was retained
- protection for the weakest 5% of schemes was retained, albeit with the overall levy cap of 0.5% of scheme liabilities in 2006/07 being raised to 1.25% in 2007/08, and
- there was more accurate recognition of employer insolvency risk, through substantially reducing the effect of County Court Judgements in the calculation of the PPF specific Dun & Bradstreet (D&B) insolvency rating.

The PPF has also continued to work closely with the Pensions Regulator to seek increasing protection for the PPF through supporting the introduction of scheme specific funding arrangements and deficit recovery plans.

[1] This includes an estimated three schemes with estimated deficits treated as Incurred but Not Reported.

### Longevity risk

The PPF has also sought to better understand the risks to which it is exposed as a result of the increasing longevity of the UK population which, unless provided for in advance, could threaten the future solvency of the Fund. Following a review of the latest actuarial information presented to it, the Board has strengthened its assumptions about future mortality improvements. Where the evidential base and materiality of the scheme warrant it, the PPF has also sought to introduce scheme specific mortality assumptions.

### Financial stability

The continuing development of the PPF as a financial institution has also served to shape the context within which it operates. The levy estimate of £675 million for 2007/08 agreed by the Board in December 2006 was adopted to reflect the undercollection of the 2006/07 levy, to address the deficit in the fund as at 31 March 2006 and to support the continuing financial sustainability of the Fund, given the considerable risks to which the Fund is exposed. Further discussion on the levy can be found in Section 3.3.2.

The Board approved a revised Statement of Investment Principles for the PPF in October 2006. The Principles reflect a new strategy for the investment of the assets inherited from pension schemes that transfer to the Fund and of the pension protection levy. The aim of this investment strategy is to match current estimates of the Board's liabilities and provide some outperformance over the estimated liabilities. The strategy specifically seeks to eliminate the unrewarded risks of fluctuations in interest rates and inflation and aims for a low risk approach to outperformance through a diversified portfolio of asset classes and fund managers.

### Corporate Social Responsibility

The PPF is committed to acting in the widest possible interests of stakeholders and scheme members both as a financial institution and as an employer.

#### Responsible investment

The Board of the PPF, as part of its Statement of Investment Principles published in October 2006, outlined its approach to socially responsible investment.

The PPF believes that companies and governments with positive social, environmental, ethical and political principles can reasonably be expected to offer strong long-term financial performance and stability. A preference for investment in securities issued by such organisations is, therefore, consistent with the best financial interests of the Fund and its beneficiaries.

In February 2007, the PPF became a signatory to the Principles for Responsible Investing, an initiative of the UNEP Financial Initiative and the UN Global Compact. In doing so, the PPF has signalled its intention to work towards best practice and encourage others to do likewise.

In its regular review of fund managers' performance, the PPF seeks to monitor the way that managers take account of social, ethical, environmental and political considerations in their investment decisions. The PPF is currently considering how it can cost effectively strengthen this oversight following the growth and diversification of the Fund's assets.

#### Responsible business

The PPF is also committed to acting in a socially responsible manner in the other aspects of its work. While the PPF's main activities are office-based, with limited environmental impact, the organisation has developed an environmental policy. A recycling programme is operated for cartridges, paper, plastics and cardboard. The PPF has also continued to develop its electronic communications, including further use of online forms and a focus on making information available in paperless formats where appropriate, such as the 2006/07 Business Plan.

The PPF is also committed to being a socially responsible employer. The PPF believes in the promotion of equal opportunities and diversity to ensure that the talent and skills of all employees are maximised. Policies and procedures are applied which are consistent and equitable and which recognise the expertise and ability of each individual. To ensure that this is adhered to, the PPF monitors equal opportunities and makes decisions about recruitment and promotion based on non-discriminatory and job-related criteria.

The PPF also seeks to engage with its local community. To date, over £600 has been raised for the Royal Marsden Hospital by staff under the auspices of the PPF staff social committee. The PPF has actively supported these activities. Staff can also elect to make contributions to charity through payroll giving.

**The Chief Executive of the Pension Protection Fund in the 2005/06 Annual Report and Accounts identified three key themes that would be emphasised during 2006/07. These were innovation, delivery and communication.**

## 3.2 Innovation

### The Purple Book

During 2006/07, working with tPR, the PPF sought to use innovative approaches to better understand the risks it is exposed to and the pensions environment in which it operates. The limited data available in respect of the pensions universe was augmented significantly by the joint publication in December 2006 of the Purple Book.

- Data was sourced from a sample of around 5,800 schemes representing 12.5 million memberships and more than 85% of liabilities.
- A majority of the schemes, 58%, were closed to new members or future accrual, with open schemes making up 31%. (The remaining 11% of schemes have some sections open to new membership but others closed.)
- Of scheme members, 41% were deferred, 33% were pensioners and 26% were actively employed by the sponsor of the pension scheme.
- The total aggregate deficit on the Pension Protection Fund's Section 179 basis for the sample schemes was approximately £33.8 billion as at 31 March 2006.

The PPF has also published regular updates on scheme funding levels based on the Purple Book sample to allow the PPF and, more importantly, employers and scheme trustees, to track changes in risk over time. The PPF is committed to sharing these assessments with the pensions industry given that better data and better information on the risks in the pensions universe will benefit both the PPF and the industry as a whole.

### The Long Term Risk Model

The Pension Protection Fund has developed a bespoke and innovative long term risk model to consider its future claims, as well as asset and liability experience against a wide array of possible future outcomes. The model has used input from a number of specialist consultancies, together with the PPF's own in-house knowledge and expertise.

The Long Term Risk Model enables the PPF to project forward the assets and liabilities of eligible pension schemes, allowing for changes in financial markets, insolvencies and discount rates. It was this modelling of long term risk that informed the setting of the pension protection levy for 2006/07 and, following considerable enhancements to the modelling capability of the PPF during 2006, the 2007/08 levy estimate. The PPF will continue to develop its modelling capabilities and, in order to facilitate discussion around these issues, published the Long Term Risk Model in August 2007.

## 3.3 Delivery

2006/07 saw the development of the Pension Protection Fund from prototype to design to enable full operation. As noted in Section 3.1, the organisation is now raising, securing and investing assets, and the first schemes have now completed their assessment periods and, in a number of cases, transferred to the PPF. The PPF has developed the capability to support these activities and during the financial year prepared those capabilities to support the growing demands on the organisation.

### 3.3.1 Compensation and Transition

The period under review saw the first schemes complete the assessment period. In preparation for the first scheme transfers, the Board appointed Capita Hartshead in June 2006 to provide compensation administration on behalf of the Fund. In December 2006, three schemes transferred to the PPF:

- The Chilton Scotland Pension Scheme with 220 members who were former employees of Chilton Scotland Ltd. Thirty-one were receiving compensation at transfer with the remainder having deferred entitlements. The company specialised in the manufacturing, dyeing and finishing of weft-knit fabric and was based in Girvan, Ayrshire.
- The Padiham Retirement Benefits Plan with 37 members from Perseverance Mills Ltd; nine receiving compensation at transfer. The company produced specialist lightweight fabrics for the parachute, leisure and outdoor sports industries and was based in Padiham, Lancashire.
- The BDH Retirement Benefits Scheme with 12 members who were former employees of Hamilton Machinery Sales Ltd; six receiving compensation at transfer. The company specialised in the production of plastic and was based in Aylesbury.

In March 2007, a further six schemes transferred to the PPF:

- The MG Rover Group Pension Scheme, the scheme of the former Midlands car manufacturer, with 6,228 members, 1,267 receiving compensation at transfer.
- The Solid State Logic Group Pension Scheme with 167 members, five receiving compensation at transfer. The former sponsoring employer was an Oxfordshire-based film, audio and video technology specialist.
- The Fiege Merlin Pension Scheme with 127 members, 27 receiving compensation at transfer. The former sponsoring employer was a supplier of vans and tractors.
- The Bristol Community Sport Ltd Retirement and Death Benefit Scheme with 151 members, five receiving compensation at transfer. The former sponsoring employer was a Bristol-based operator of swimming pools and sports centres.
- The Beaujersey Limited Retirement Benefits Scheme with 88 members, 21 receiving compensation at transfer. The former sponsoring employer was a Leicester-based producer of knitted and crocheted fabrics.
- The Pearce Motors Section of the Motor Industry Pension Plan with 33 members, five receiving compensation at transfer. The former sponsoring employer, Pearce Motors, was a retail motor trader based in North-East England.

All of these schemes completed their assessment period in less than the two year target set by the Board (the target being 75% of schemes and 75% of scheme members to complete the assessment period within that timeframe). The number of schemes completing an assessment period during 2006/07 met the expectations laid down in the 2006/07 Business Plan published in July 2006.

Four further schemes exited the PPF assessment process during 2006/07; three due to being rescued and one due to being sufficiently funded on a PPF basis to secure benefits above PPF compensation levels outside of the Fund. These were:

- the UPSU Trading Limited section of the Student Unions Superannuation Scheme
- the Accordis section of the Akzo Nobel (CPS) Pension Scheme
- the Cambridge United Football Club section of The Football League Ltd Pension and Life Assurance Scheme, and
- the MG Rover Contract Related Pension Scheme.

As at 31 March 2007:

- the PPF had taken responsibility for transferred scheme assets to the value of £432 million

- the PPF had assumed responsibility to pay compensation to 7,078 transferred scheme members, a total liability, at date of transfer, of £532 million, and
- there were 146 schemes with some 95,000 members in assessment periods with scheme members receiving benefits at PPF compensation levels. A further 28 schemes with some 17,500 members subsequently entered assessment periods in respect of insolvency events prior to the year end which were only validated by the PPF subsequent to 31 March 2007.

### 3.3.2 Levies and recoveries

#### The 2006/07 Pension Protection Levy

The Board decided, in response to industry requests, that in 2006/07 it would introduce the risk based levy for all schemes. The levy estimate of £575 million, together with the levy scaling factor, for the period under review was published in December 2005.

The risk based levy (representing 80% of the levy estimate) tailored the levy raised to the risk each individual scheme posed to the PPF – a world first. The levy for each scheme was calculated using the funding level of the scheme on a Pension Protection Fund basis, and a probability of insolvency for the sponsoring employer provided by D&B.

Around 1,250 deficit reduction contribution certificates and 140 contingent assets were notified to the PPF prior to the relevant deadlines, which had the potential to reduce the amount of levy payable by a scheme.

The remaining 20% of the levy estimate, the scheme based levy, was calculated as a fixed percentage of the scheme's liabilities.

Individual schemes were issued with their pension protection levy invoices from the autumn of 2006 onwards.

The global factors for the 2006/07 pension protection levy were set in December 2005 (individual schemes could submit data including details of contingent assets, participating employers and scheme structure, and valuations until 31 March 2006, and could notify the PPF of deficit-reduction contributions until 7 April 2006). A combination of factors led to a final estimated figure for the 2006/07 levy of £271 million. The reasons for this undercollection are discussed further in Section 3.7.3.

#### The 2007/08 Pension Protection Levy

The Board of the PPF published their levy estimate of £675 million for 2007/08 in December 2006. This was subject to consultation which lasted six weeks and received 16 responses.

The majority of responses received supported the approach of the Board. The levy estimate was based on a number of factors, including the long term level of risk to the PPF as modelled by the Long Term Risk Model, the existing deficit in the Fund and the need to begin to recoup the undercollection of levy in 2006/07.

In respect of the 2007/08 pension protection levy, the Board also:

- continued the tapering reduction in the level of levy payable by those schemes over 104% funded on a PPF basis, leading to those schemes 125% or more funded paying no risk based levy
- retained the protection against unduly high levies for the 5% weakest schemes, although the overall levy cap was increased from 0.5% of scheme liabilities to 1.25% of scheme liabilities
- made modifications to the way in which D&B assigns insolvency probabilities to sponsoring employers within the PPF universe, notably in relation to the use of County Court Judgments, and
- issued revised guidance on Section 179 valuations and revised documentation around contingent assets including the introduction of the Type C(ii) contingent asset (fixed-term letter of credit or bank guarantee) in support of a schedule of deficit-reduction contributions.

There was also continued take up of the incentives package in respect of the 2007/08 levy prior to the deadline of 30 March 2007 (5 April 2007 in respect of deficit reduction contributions). The number of deficit repair contributions and new contingent assets certified to the PPF was encouraging, with approximately 1,600 and 130 respectively received.

The PPF will continue to seek out the views of its stakeholders both through the formal consultation process and through continuing to meet informally with a wide variety of stakeholders, to ensure that the levy mechanism remains fit for purpose.

### Consultation on Investment Risk

The PPF published a consultation in December 2006 on the inclusion of investment strategy as a factor in the calculation of the risk based levy. When setting the levy, the Board is required to consider scheme underfunding risk and the likelihood of sponsoring employer insolvency. In its assessment of future outcomes using the Long Term Risk Model, the PPF recognises investment risk at the macro level, but it is an additional explicit factor which the Board has the option of considering for individual schemes.

The consultation set out the Board's initial view that it was unlikely to be appropriate to introduce an investment risk factor into the risk based levy, but that it would be important to continue to monitor key trends that affect the impact of investment risk on the risks individual pension schemes pose to the PPF. This was due to:

- the majority of scheme investment strategies being broadly similar
- only around 3% of the levy would be reallocated between schemes, and
- there would be disproportionate compliance costs to schemes.

The consultation period lasted eight weeks and 27 responses were received. A majority of those responding agreed that the impact of investment risk is currently likely to be limited and supported the Board's initial conclusion not to introduce a specific risk factor. The Board published its formal response in May 2007 and confirmed its intention not to introduce an investment risk factor into the risk based levy for the time being.

### Recoveries

The PPF's primary objective, where a pension scheme is expected to enter an assessment period, is to maximise recoveries from the sponsoring employer's insolvency in an attempt to reduce the pension deficit.

On the insolvency of a sponsoring employer, the creditor rights of the pension scheme trustees pass to the PPF. As a consequence, the PPF will seek to recover what it can from the former employer on behalf of the scheme. When faced with an insolvency the PPF will submit a claim to the insolvency practitioner and vote as it considers appropriate during the process with a view to maximising any return that might be available from the realisations of the former employer's assets.

On occasions, the PPF is approached regarding a company which is clearly going to fail and where a pension deficit is involved. A proposition may be put to the PPF which will involve the rescue or restructure of the company or more often the business, and often a better return for creditors than the alternative of a straightforward insolvency. If insolvency is inevitable the PPF, working alongside tPR, seeks to negotiate a better recovery for the scheme than that which would be obtained should the employer enter into insolvency without such negotiations having taken place. Where advantageous to the scheme, and therefore the levy payers, the PPF will support such rescues by exercising the scheme's creditor rights in the ensuing insolvency. The PPF was involved in a number of such discussions during 2006/07, resulting in significantly enhanced realisations for the pension schemes involved.

In such cases recoveries made by the PPF reduce scheme deficits and may also allow a scheme to pass out from an assessment period sufficiently funded to secure benefits at, or above, PPF compensation levels.

### 3.3.3 Investment

With the transfer of the first scheme assets in December 2006 and March 2007, and the collection of the 2006/07 pension protection levies, the asset base of the PPF has grown in size. The Board published its initial Statement of Investment Principles for the Fund in June 2005 but this was substantially updated in October 2006, ahead of the first scheme transfers, setting out the Board's strategy to manage the Fund's assets through this new phase of its development.

The approach adopted by the Board was a dynamic, bespoke liability driven approach with a diversified asset portfolio. The asset allocation adopted by the Board in October 2006 was as follows:

## 3.3 **Delivery** contd

| Asset Class | Allocation | Benchmark |
|---|---|---|
| Cash | 20% | Libor[2] |
| Global Bonds | 50% | JP Morgan Government Bond Index |
| UK Equities | 12.5% | FTSE All shares |
| Global Equities | 7.5% | FTSE Global |
| Property | 7.5% | IPD[3] |
| Currency overlay | 2.5% | 3 month Libor |

The cash element of the asset allocation provides a resource to support the PPF's use of hedging and derivatives. Investments in global equities and global bonds are hedged back into Sterling while the Board will use derivatives, where considered appropriate, to adjust assets to:

- better match the Fund's liability profile
- reduce the impact of unrewarded risks such as interest rate and inflation risk, and
- provide some protection against falls in equities.

The PPF has subsequently during 2006/07 put the structures in place to implement the Statement of Investment Principles. Three fund managers were appointed for the original Statement of Investment Principles in June 2005:

- Insight Investment Management
- PIMCO, and
- Goldman Sachs Investment Management.

These managers were retained for the bond aspects of the investment portfolio. Insight was appointed to manage the instruments and collateral used to hedge interest rate and inflation risks. To adequately manage the new diverse portfolio, five further fund managers were appointed in March 2007. These were:

- State Street Global Advisors UK Alpha strategy using an active quantitative approach to stock selection (UK Equities)
- Lazard UK Equity Diversified Strategy using a fundamental approach to stock selection, focusing on financial productivity and valuation (UK Equities)
- Newton Investment Management Global Equity Institutional strategy which uses an active global thematic approach to stock selection (Global Equities)
- Morley Fund Management Multi-manager property strategy investing in a range of UK balanced and specialist sector funds (Property), and
- Auriel Currency Strategy managed by Auriel Capital Management, a specialist boutique quantitative currency manager (Currency).

The PPF has also retained State Street as Custodian, and Mercer as investment adviser. The PPF has also continued to strengthen its internal finance and financial risk teams to ensure that it can monitor and develop its investment strategy appropriately, as needed.

As at 31 March 2007 the PPF had:

- £322 million invested with new mandates created in accordance with the Statement of Investment Principles
- a further £395 million of scheme assets transferred during March 2007 in the process of transitioning to be invested in accordance with the SIP, and
- a total return on invested funds (time weighted rate of return, gross of fees) of 1.95% against a benchmark of 0.41% over the 12 months to 31 March 2007.

During the period 1 April 2006 to 31 January 2007 the fund was invested in accordance with the June 2005 Statement of Investment Principles. Performance over this period was 2.19% versus a benchmark performance of -0.24%.

[2] London Interbank Offered Rate.
[3] Investment Property Databank.

## 3.3 **Delivery** contd

On 22nd January 2007 implementation of the October 2006 Statement of Investment Principles began with a transition of bond assets from the previous UK Bond mandate to a global bond mandate for assets held with PIMCO and Goldman Sachs Asset Managers. Assets held with Insight remained invested in UK Bonds to provide collateral for the Liability Driven Investment mandate.

Performance over the period 1 February 2007 to 31 March 2007 was -0.24% against a benchmark performance of 0.65%. During this period the fund was invested in global bonds. The performance includes performance of transferred schemes in March 2007.

All performance figures are stated on a time weighted rate of return basis and are gross of fees.

The Statement of Investment Principles for the Fraud Compensation Fund remained unchanged.

## 3.4 **Communication**

The PPF is committed to effective two way communication with stakeholders and has sought active ways of encouraging this during 2006/07. Clear, open and honest communication is a prerequisite for maintaining the trust of those with whom the PPF works and those who have an interest in the work of the PPF. There is also a need to ensure that the communication methods of the PPF are appropriate to the audience. The PPF has continued to develop during 2006/07 a dedicated communications team to support the communications strategy agreed by the Board.

The PPF has carried out regular stakeholder perception audits of its communications work to inform its work with stakeholders. An audit was carried out in spring 2007 identifying strong understanding and recognition of the work of the PPF. In addition, stakeholders continued to regard the PPF as trustworthy (over 90% of those expressing a view believed information from the PPF to be trustworthy) and as acting in an open and transparent way (around three fifths agreed or strongly agreed).

### Consultations, Guidance and Workshops

During 2006/07, the PPF continued to seek to demonstrate its commitment to working with stakeholders through a range of activities.

- Guidance was published on a range of topics, including revised guidance to trustees covering all stages of the assessment process and various aspects of the levy. Existing guidance was updated during 2006/07 to ensure it remained current and relevant to stakeholders. Items of guidance published included:
    - May 2006: updated online guidance to trustees on the assessment process
    - June 2006: updated compensation cap factors and an open letter to the actuarial profession on proposed changes to Section 143 and Section 179 assumptions
    - August 2006: A Guide to the Pension Protection Levy 2006/07
    - September 2006: revised and expanded guidance on contingent assets, together with updated standard form documents
    - September 2006: Revised Commutation factors, Compensation Cap factors and Early Retirement factors
    - December 2006: The Purple Book, together with the presentation used at its launch and those from the scheme administrator workshops
    - February 2007: the revised Management Statement and Financial Memorandum between The Board of the Pension Protection Fund and the Department for Work and Pensions and the revised Memorandum of Understanding between the Department for Work and Pensions, the Pensions Regulator and the Pension Protection Fund, and
    - March 2007: the summary of responses to the 2007/08 Levy Estimate Consultation Document and publication of the final 2007/08 Levy Determination.

A full list of publications can be found on the PPF website.

- Consultations were issued on the details of 2007/08 pension protection levy and whether investment risk should be included as a specific risk factor that the Board should include in calculating the risk based element of the pension protection levy. There was also consultation on the actuarial aspects of PPF valuations.
- Two sets of workshops, seven in total, were run focusing on issues around the assessment process. These involved contributions from PPF staff and presentations from associated stakeholders such as NISPI (National Insurance Services to the Pensions Industry, part of Her Majesty's Revenue and Customs) and the Raising Standards of Pensions Administration project.
- The PPF Chairman and Chief Executive between them spoke at or attended over 150 meetings and events with stakeholders.

### Stakeholder Support

The PPF maintains a dedicated team tasked to respond to all external queries about the organisation and its work. They deal with written (letter and email) and telephone correspondence, responding directly to most enquiries and acting as a point of contact for those cases which require technical answers from elsewhere in the PPF.

- In 2006/07 the Stakeholder Support Team (SST) dealt with 10,550 telephone calls and 4,674 written enquiries (emails or letters). The majority of these were from trustees and pension scheme professionals.
- The SST adopted exacting service level standards; 90% of all telephone calls received during the year were answered within three rings and 92% of all letters and emails, including those raising queries of a technical nature, received answers within 10 working days.

### Electronic Communication

The main PPF website (www.pensionprotectionfund.org.uk) and other methods of electronic communication associated with it, such as email alerts, have been an important part of the PPF's communications strategy in 2006/07. In the future, the PPF is looking to enhance the use of technology for more effective communication.

During 2006/07:

- the PPF made available major announcements and documents on its website. This included the draft and final 2007/08 levy determination
- the website had just over 188,000 hits with around 100,000 unique visitors and nearly 1,000,000 page views. The most popular sections were those in respect of the levies and voluntary certificates
- a facility was provided on the website for interested stakeholders to register an email address with the PPF. About 5,000 email addresses were registered with the PPF as at 31 March 2007 and 33 email alerts were sent out during 2006/07, and
- electronic newsletters were sent to stakeholders in July 2006 and January 2007. These detailed all major areas of current PPF activity and highlighted issues of interest to stakeholders. These were sent to about 40,000 recipients in total.

The use of electronic communication by the PPF has been popular with those seeking information from the organisation. Three-fifths of those questioned in the 2007 perception audit identified email as the most effective channel of communication. The PPF is considering ways in which, through redesigning the website and strengthening and tailoring the email alerts, this success can be continued.

### Communication with compensation beneficiaries

The transfer of the first schemes to the PPF with the payment of the first direct compensation payments from the PPF created an important new audience for the organisation.

- Each beneficiary was provided with specific information about the PPF and their compensation entitlement upon transfer.
- Compensation beneficiaries have access to a secure area of the members' website where they can access details of their compensation online and update personal information.
- The PPF is considering how communication methods such as text messaging can be used to inform transferred scheme members when their benefit statements are available or to remind them to ensure that their personal details are up to date.

## 3.5 Report against objectives

The Board published its 'Strategic Plan 2006/07 – 2008/09' in June 2006 and this was followed by the publication of the PPF's Business Plan 2006/07 in July 2006. The 'Strategic Plan 2006/07 – 2008/09' set five year strategic objectives for the PPF revising those originally published in spring 2005. While the Strategic Plan detailed the long term actions to achieve the objectives, the Business Plan outlined detailed actions for 2006/07 and how they would be implemented.

### Strategic Objectives and progress made in 2006/07

#### Objective: maintain the solvency position of the Pension Protection Fund between predetermined limits

The 2006/07 Business Plan detailed three specific strands to achieving this objective.

***1. Ensure timely collection of the 2006/07 levy***

During 2006/07, the PPF:

- introduced the world's first risk based levy three years ahead of initial expectations
- raised approximately £271 million in pension protection levy from around 8,000 eligible schemes. This was lower than the estimate agreed by the Board in December 2005 for the reasons discussed in Section 3.7.3
- adopted an incentive programme as part of the introduction of the risk based levy to encourage a net reduction in risk to the Board posed by eligible schemes. This was implemented through recognition of contingent assets and deficit reduction contributions, and reductions in the level of levy payable for those schemes over 104% funded on a PPF basis, with those over 125% funded paying no risk-based levy
- worked with D&B regarding the insolvency risk of individual sponsoring employers. The Board reviewed and monitored the work of D&B during the year, and
- received 4,427 levy related telephone and written queries from stakeholders.

***2. Develop effective asset management***

During 2006/07, the PPF:

- published a revised Statement of Investment Principles in October 2006. This detailed the strategy for investing levy monies and assets of transferred schemes, including the portfolio benchmarks and investment guidelines
- continued to monitor the performance of Insight Investment, PIMCO and Goldman Sachs Asset Management as fund managers, State Street as Custodian to the Fund and Mercer as investment advisor to the Fund
- reviewed the fund manager structure and appointed, in March 2007, five further managers to implement the revised investment strategy of the Fund: State Street Global Advisors, Lazard UK, Newton Investment Management, Morley Fund Management and Auriel Capital Management
- reviewed the adequacy of the PPF's transition arrangements subsequent to the transfer of the first scheme assets to the Fund, and
- investigated and developed the use of appropriate risk management and hedging instruments to manage the risks to the PPF in the investment strategies of schemes in assessment.

***3. Maximise recoveries in respect of schemes***

During 2006/07, the PPF:

- worked to maximise recoveries for pension schemes which came into the assessment period. Between 5 April 2005 and the end of the period under review, the PPF submitted claims as a creditor totalling approximately £4.5 billion in the insolvencies of various sponsoring employers (this is based on the Section 75 debt falling on the employer) and has received, or anticipates receiving payments in the region of £54 million as a consequence, and

- engaged in negotiations pre-insolvency, securing in the same two year period cash payments of £297 million, 13 agreements of various types (for example loan notes or profit share agreements) and nine equity stakes in various companies. These were secured on behalf of the trustees of the pension scheme involved and will either reduce the deficit for the PPF where a scheme enters the Fund or enable the scheme to exit an assessment period due to being sufficiently funded on a PPF basis.

### Objective: play our part in building confidence in pensions

During 2006/07, the PPF:

- paid compensation to 1,457 former scheme members with a further 5,621 deferred compensation beneficiaries
- provided reassurance and security to over 100,000 members of schemes in assessment
- successfully developed a members' communication strategy around the first scheme transfers. Over 7,000 'welcome packs' were sent to transferring scheme members and a dedicated website for compensation beneficiaries set up
- sought to engage, where appropriate, in the wider debate about pension provision in the UK through, for example, the publication of the Purple Book, in conjunction with tPR. The Purple Book was the first authoritative analysis of aggregate risk in UK defined benefit pension schemes
- continued development of financial research and early warning systems to identify underfunding and insolvency risk so as to place high risks in the pensions system under heightened scrutiny, and
- implemented the risk based levy with a structure that provided incentives for risk reduction. The recognition of contingent assets and scheme funding thresholds above which reduced or no risk based levy is paid sought to encourage strengthened scheme funding levels and therefore enhance confidence.

### Objective: pay the right people the right compensation at the right time

During 2006/07, the PPF:

- successfully transferred the first nine schemes into the PPF by the end of March 2007. A further four schemes completed assessment periods but did not transfer to the PPF. At 31 March 2007, 1,457 former scheme members were in receipt of compensation and there were 5,621 deferred compensation beneficiaries
- implemented the Board's outsourced compensation administration strategy through the appointment of Capita Hartshead in June 2006
- published further guidance to trustees in May 2006 to support the assessment process. As at 31 March 2007 there were 146 schemes with over 95,000 scheme members in assessment, with pensioners receiving benefits at PPF compensation levels[4], and
- continued to introduce initiatives to speed up and improve the assessment process, taking account of the first year's operating experience.

### Objective: ensure two way communications with stakeholders are effective

During 2006/07, the PPF:

- refined the 2006/07 communication programme in the context of the 2005/06 MORI perception audit. A further perception audit was undertaken during the period under review
- established a dedicated Parliamentary and Stakeholder Management team to strengthen communication with those who have an interest in the work of the PPF
- strengthened the PPF's Stakeholder Support Team function to respond better to queries from stakeholders
- sent two electronic newsletters to stakeholders during the year and issued 33 email notifications of events, publications and website changes to around 5,000 registered stakeholders

[4] A further 28 schemes with some 17,500 members have subsequently entered assessment periods in respect of insolvency events prior to the year end which were only validated by the PPF subsequent to 31 March 2007. The start of the assessment period is the date of insolvency and therefore members of these schemes will now be receiving benefits at PPF compensation levels.

- continued to work closely with the Department for Work and Pensions Steward and tPR through regular tripartite meetings and the publication of a revised Memorandum of Understanding in February 2007
- sought to encourage innovation in the capital markets and the development of the buyout market through meeting with new entrants and seeking to understand the wider implications of innovative products
- consulted on the 2007/08 pension protection levy, its risk based element, guidance on PPF specific valuations and asset allocation risk. Specific attention was given to how best to incentivise risk reduction as part of these consultations. Consultations were open for 22 weeks during 2006/07 and a total of 72 consultation responses were received, and
- the Chairman and Chief Executive attended or spoke at over 150 stakeholder meetings or events.

### Objective: ensure investment in human capital to deliver the Board's functions

During 2006/07, the PPF:

- periodically reviewed staffing requirements resulting in accelerated recruitment in key areas due to the increased demands on the organisation. Staff numbers (including both permanent and seconded staff) grew from 56 to 115 over the course of the year as the organisation commenced full operations
- continued to develop a recruitment and retention strategy to ensure that there was sufficient technical expertise available within the PPF to meet its responsibilities. Responding to high demand in the marketplace for the skills sought by the PPF remained a continuing area of concern
- implemented a new Performance and Development appraisal system to better recognise staff achievement and areas where skills can be strengthened
- introduced a new learning and development strategy to better equip PPF staff
- continued to seek secondees from the private and public sector to support the organisation's activities and build external relationships. Secondees worked across the PPF during 2006/07 in the actuarial, levy, transition, insolvency, legal and financial risk teams amongst others, and
- continued monitoring of staff turnover and tracking of any staffing shortfalls to minimise the risk to the PPF achieving its objectives.

### Objective: achieve high levels of stakeholder satisfaction in respect of the organisation's professionalism, policies, processes and helpfulness

During 2006/07, the PPF:

- continued to update the guidance material it provides for trustees, insolvency practitioners, actuaries and advisors taking into account operational experience and emerging best practice
- undertook seven workshops, three for trustees and four for scheme administrators, to explain the assessment process. These were attended by about 200 participants with 99% agreeing or strongly agreeing that the workshop met their needs and only a single attendee not agreeing that they would attend another event, and
- kept in contact with stakeholders through attending and presenting at a range of industry conferences, seminars and other events.

The PPF carries out stakeholder perception audits to measure its effectiveness in delivering on this objective. An audit was therefore carried out by Ipsos MORI in spring 2007, the key findings from which included:

- three-fifths of respondents said that they knew either 'a fair amount' or 'a great deal' about the Pension Protection Fund
- 70% believed that the PPF was achieving an average, good or very good performance
- 10% more stakeholders in 2007 over 2006 believed that the PPF works in partnership with stakeholders
- 67% of those in receipt of compensation say communications with them have been effective or very effective, and
- only 2% of respondents were either 'dissatisfied' or 'very dissatisfied' with the PPF website.

Communication with lay trustees and scheme members were identified as areas for improvement and the revised communication strategy adopted in May 2007 reflected this.

## 3.6 Risks to achieving the PPF's objectives

The Pension Protection Fund, as a normal part of its activities, is exposed to a range of internal and external risks which may have consequences for the achievement of its strategic objectives. The PPF has developed a risk management strategy that enables it to identify and monitor such risks and put in place mitigation strategies to limit any adverse impact. These risks were recognised in the Annual Report and Accounts for 2005/06 and continue to be monitored. The steps taken to mitigate internal risks are discussed in Section 6.2.

Information on the key areas of external risk, and the management of these risks is set out below.

### Investment risk

The liabilities of the fund are financed by the assets of schemes entering the fund, levies raised and income earned from the investment of these funds. The PPF appointed a further five fund managers in March 2007 to work alongside the existing three fund managers to implement the new investment strategy for the Fund. A rigorous selection process was undertaken which was supported by an experienced firm of investment advisers. The spread of fund managers provides a breadth of skills and experience, as well as reducing the concentration of risk.

The allocation of assets invested is set out in the PPF's Statement of Investment Principles. This details the level of holdings permitted in different investment classes and analyses the risks in greater detail. The use of a separate custody firm ensures that assets are held securely and delivered in a timely fashion to enable trades to be completed. In addition, the custody firm provides an independent reconciliation of transactions and valuations which are reviewed by an in-house investment accountant. Where a scheme transfers to the PPF, and the value or complexity of the portfolio justifies the cost, a transition manager is used to ensure that the transferred assets are invested in accordance with the PPF's Statement of Investment Principles in a timely and economic manner.

### Solvency risk

The most significant financial risk facing the PPF is to its solvency position. The steps taken to mitigate investment risk also serve to reduce solvency risk. In addition, the PPF produces actuarial valuations of its liabilities on an ongoing basis and for schemes passing through the assessment process, using recognised techniques. The annual levy quantum is developed using the stochastic Long Term Risk Model which was produced with the support and involvement of recognised external experts. The PPF's in-house insolvency team, through pension debt it recovers as part of its negotiations around corporate insolvency, also strengthens the Fund's financial position.

### Corporate failure risk

The unexpected failure of a specific industrial sector, or a similar concentration of failure, would have significant consequences for the PPF's solvency position and wider reputation. The PPF has started development of warning mechanisms to give early indication of such failures and continues to investigate the use of financial instruments to hedge this risk.

Through working with the Pensions Regulator, one of whose statutory duties it is "to reduce the risk of situations arising that may lead to compensation from the Pension Protection Fund", the PPF aims to minimise this risk. The current focus on improving scheme funding is likely to reduce the scale of deficits that might become the responsibility of the PPF and thereby reduce the impact on the PPF of significant corporate failures.

### Reputational risk

The PPF has worked hard to develop and maintain a good reputation with its key stakeholders. The continued maintenance of the relationships which underpin this is vital to the achievement of the PPF's objectives and to build confidence in pensions. The PPF seeks to take a proactive stance in its approach to stakeholder management and external communications. The approach of the PPF is supported by a communications strategy and associated plans which are subject to regular review and implemented by a dedicated communications team.

### Policy and regulatory risk

The responsibilities of the Board of the Pension Protection Fund are laid down by the Pensions Act 2004 and associated regulations. Changes may therefore be sought by Parliament or Government to the scope of these responsibilities. A significant change in scope could have consequences for the achievement of current objectives unless it is adequately anticipated, planned for and managed.

## 3.6 Risks to achieving the PPF's objectives contd

The PPF seeks to ensure that it keeps abreast of the wider policy and regulatory framework and liaises with key stakeholders to ensure that it is aware of any proposed change at the earliest possible stage. Any subsequent change would be delivered through the PPF's programme management office to ensure managed delivery while reducing the impact on existing organisational capability.

As part of the strategy for risk reduction the PPF became the first public sector body in the world to receive both P2MM (PRINCE2 Maturity Model), at level 3, and P3M3 (Portfolio, Programmes and Projects/Management Maturity Model) accreditation in portfolio, programme and project management. The PPF was accredited by the Association of Project Management Group. P3M3 and P2MM provide benchmarking for best practice in project and programme management, allowing the PPF to manage change effectively.

### External or environmental risk

The Pension Protection Fund's operations and wider financial position are sensitive to changes in its external environment. These can involve a wide range of external changes, beyond the control of the PPF, such as demographics, investment returns and the economy as a whole. The PPF however has sought to understand and mitigate these risks through monitoring them and seeking appropriate responses to them. The PPF has also taken a prudent position in recognising the risk that increasing longevity poses to the Fund, as discussed in Section 3.1.

### Complaints

The PPF is committed to resolving concerns and complaints as swiftly and co-operatively as possible. Complaints in the first instance are received by the Stakeholder Support Team. Where a complaint relates to a particular area of the PPF's work, staff from that team are involved in resolving the complaint. Issues can also be raised more formally through the statutory procedures for review of reviewable matters and complaints of maladministration.

- In 2006/07, 70 requests for a review of a reviewable matter were received and handled in accordance with the Review and Complaints procedure. All of these requests related to the calculation of the pension protection levy; albeit with less than 1% of invoices issued prior to 31 March 2007 being queried in this manner.
- 32 first stage reviews were carried out and decisions issued in 2006/07. In 28 of these cases the Board upheld the invoice under review. In the remaining four cases, a revised invoice was issued as a result of corrected input data.
- Of the 32 first stage decisions issued in 2006/07, seven were referred to the Reconsideration Committee, which upheld the Board's decision in every case (two of these reconsideration decisions having been taken after the year end).
- Four of these reconsideration decisions were referred to the independent Pension Protection Fund Ombudsman (PPFO) (one of such referrals occurring after the year end). The PPFO published his decision in one of these cases on 10 August 2007, upholding the decisions of the Board and Reconsideration Committee. The remaining cases are under consideration by the PPFO as at the date of publication of these accounts.
- Six of the 70 review requests received in 2006/07 were subsequently withdrawn, and the remaining 32 cases were being investigated and considered by the Board at year end.
- The Board received one complaint of maladministration in 2006/07. This was considered and rejected by both the Board and the Reconsideration Committee. The applicant referred his complaint to the PPFO and, as at the date of publication of these accounts, the PPFO's decision is awaited.

The Board of the Pension Protection Fund has also been informed of three outstanding cases currently with the Pensions Ombudsman in respect of schemes for which the Fund has now assumed responsibility.

Guidance on how complaints are handled can be found on the PPF website.

## 3.7 Financial review

### 3.7.1 Accounting Officer Statement

In accordance with the standard practice for public bodies contained in HM Treasury guidance, as Chief Executive of the Board of the Pension Protection Fund, I was appointed Accounting Officer on a permanent basis coincident with my appointment as Chief Executive from 21 June 2006. I served as Accounting Officer for the Board on an interim basis from 12 May 2006. The previous Chief Executive, Myra Kinghorn, served as Accounting Officer until she stood down from her position as Chief Executive on 12 May 2006.

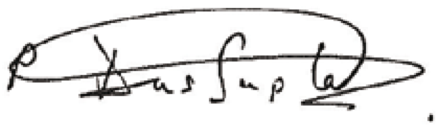
In order to satisfy myself as to the completeness and accuracy of the accounts and accompanying statements I have taken appropriate steps both in respect of my time as Accounting Officer and that part of the period under review prior to my appointment. Having completed these assurance processes, I am satisfied that it is in order for me to sign these accounts.

As far as I am aware, there is no relevant information of which the Board's auditors are unaware, and I have taken all steps that I ought to have taken to make myself aware of any relevant audit information and to establish that the Board's auditors are aware of that information.

### Audit

The Pensions Act 2004 requires the Board of the Pension Protection Fund's accounts to be audited by the Comptroller and Auditor General. His certificate and report are on pages 50-51. The cost of the audit is shown in Note 3.3b and no services other than the audit are provided by the Comptroller and Auditor General.

**Partha Dasgupta**
Accounting Officer



Date: 17 October 2007

### 3.7.2 Introduction to the Funds

The PPF is responsible for two funds created under the Pensions Act 2004, the Pension Protection Fund and the Fraud Compensation Fund. The PPF is also self-accounting in respect of its operating expenses and so effectively runs its own Administration Fund. This review considers each of these three funds separately.

### 3.7.3 Pension Protection Fund

The principal activity of the PPF is to pay compensation to members of defined benefit pension schemes where the scheme's employer has become insolvent and where the scheme's assets are inadequate to meet its protected liabilities (as defined by the Pensions Act 2004). It takes over the assets and liabilities of these schemes and, in order to make up the shortfall between assets and liabilities, raises pension protection levies designed to ensure the long term solvency of the Fund. The Fund invests these assets to provide investment returns.

During 2006/07 the first schemes transferred into the Fund. Nine transfers of scheme assets and liabilities occurred during the year under review and 1,457 scheme members were in receipt of compensation from the Fund, with a further 5,621 having a deferred entitlement as at 31 March 2007.

#### Levies and other income

For 2006/07, the Pension Protection Levies were raised incorporating risk based factors (principally scheme underfunding and employer insolvency risks) and a scheme based factor (the value of scheme liabilities). Long term modelling carried out by the PPF led the Board in December 2005 to agree an estimated levy of £575 million based on projections of asset and liability information from a representative sample of 1,000 pension schemes. The model incorporated projections of insolvencies, interest rate changes and financial market returns, reflecting the major risk factors to which the PPF is exposed. The scaling factor, which when combined with the scheme funding level and sponsoring employer underfunding risk provides the levy figure for each scheme, was also set in December 2005.

The calculation, billing and collection of the Pension Protection Levy were undertaken by the PPF. By the end of the period under review, £201 million had been collected and had been invested in accordance with the Fund's Statement of Investment Principles. As at the date of this report, a further £60 million had been collected, leaving £10 million outstanding. As part of this billing process the PPF had rigorous credit control procedures in place.

The change in the amount of levy collected for 2006/07 in relation to that estimated in December 2005 was due to a combination of:

- market movement
- funding changes – this included the notification of contingent assets and deficit-reduction contributions to the PPF and the submission of updated valuation data for schemes
- more accurate data provided to D&B by employers, and
- more accurate data on multi-employer scheme structures.

Chart 1 details the specific contribution that each of these factors made to the difference between the levy estimate of £575million and the expected final total of £271 million.

For 2007/08, the Board announced in December 2006 its intention to raise £675 million, again based on long term modelling, the need to make up for undercollection in 2006/07 and to reduce the deficit that applied at the end of the 2005/06 financial year. The scaling factor was not, however, set until April 2007 so as to provide certainty as to the total amount of levy that would be raised and give greater confidence to individual schemes as to the likely level of their levy in 2007/08.

During 2006/07, the Pension Protection Fund assumed responsibility for assets totalling £432 million following the transfer of nine schemes into the Fund. These are now incorporated into the Fund.

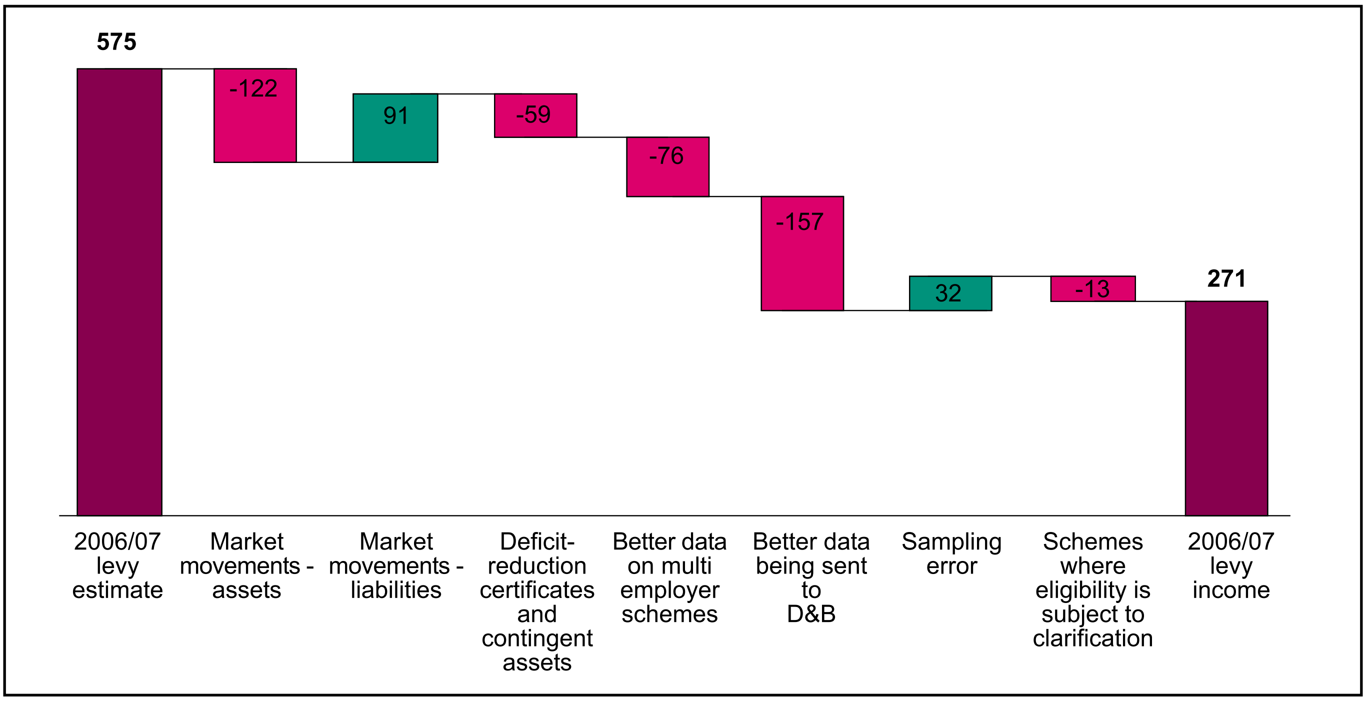
The Pension Protection Fund achieved a time-weighted investment return of 2.6% in the 9 months to December 2006. During this period the Fund was invested wholly in UK Bonds and, whilst bonds have performed poorly during this period and interest rates have risen, the Fund outperformed its benchmark by 0.7%.

During the year the investment strategy of the Fund was revised, with a new Statement of Investment Principles being approved by the Board in October 2006. Transition of the investments began in January 2007 to comply with the new strategy and was phased to take advantage of positive cash flows from levy receipts and the transfer of the assets of the MG Rover Group Pension Scheme. The first stage involved the transition of the existing UK bond portfolio to a worldwide mandate. In February, the PPF completed its first major hedging operation to remove interest rate and inflation risks associated with its liabilities. And finally, in March and April, the transition of MG Rover assets was used to populate the five new mandates established under the new investment strategy. Over the period of transition decreases in bond values detracted from performance and the overall investment return for the financial year was 1.6%.

### Provisions for compensation payments

During 2006/07, Transfer Notices were issued by the PPF accepting the assets and taking on responsibility to pay compensation in relation to nine pension schemes. A further three schemes were rescued and one scheme completed the assessment period with sufficient assets to secure its liabilities outside of the PPF. The schemes which transferred to the PPF involved over 7,000 scheme

## Chart 1



members. At 31 March 2007, compensation was in payment to 1,457 of these with a further 5,621 deferred compensation beneficiaries. The accounts as at 31 March 2007 disclose liabilities associated with these beneficiaries valued at £536 million.

The accounts of the Fund show that the PPF has also recognised provisions in respect of 170 pension schemes (including those already in an assessment period) totalling £908 million where the PPF judges eventual entry into the Fund to be probable. "Probable" in this context is defined as schemes where the employer insolvency event occurred on or before the Fund's accounting date; where no scheme rescue is judged likely; and where protected liabilities exceed scheme assets (including recoveries from insolvent employers) at the assessment date. This is the same basis applied in the 2005/06 Financial Review.

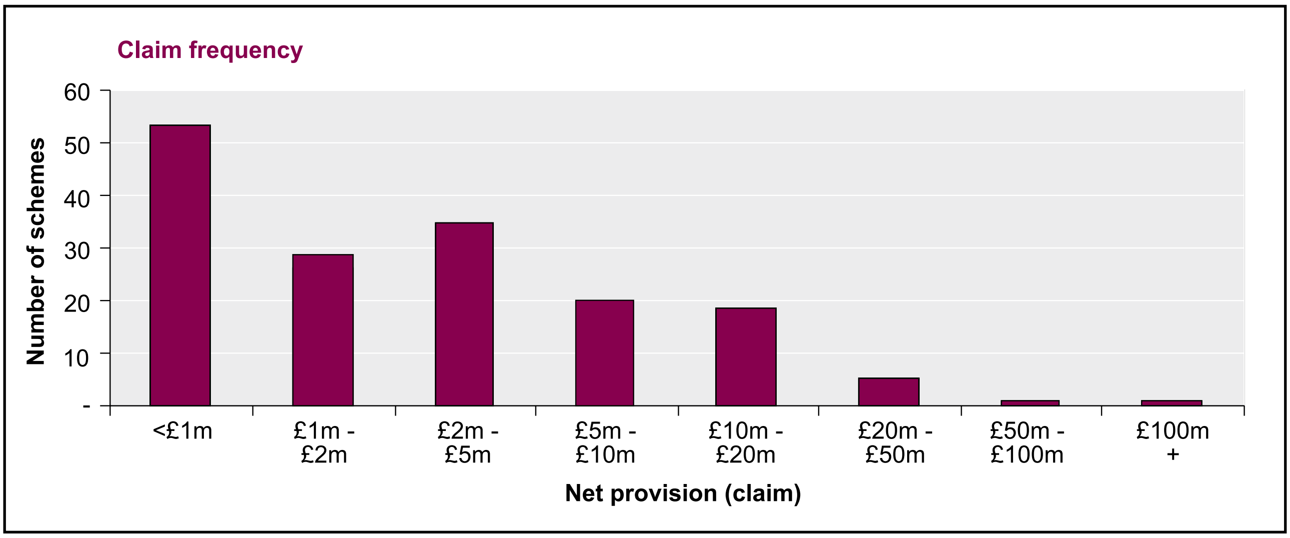
The provisions for claims are arrived at as follows:

| For schemes where eventual entry is considered probable: | £ million |
|---|---|
| Scheme assets valued at: | 3,489 |
| Estimates of recoveries from insolvent employers: | 85 |
| Protected liabilities valued at: | 4,482 |
| Provisions for claims | 908 |

The schemes included in these provisions are, therefore, in aggregate 80% funded against their protected liabilities, after asset recoveries, on the Fund's ongoing actuarial basis.

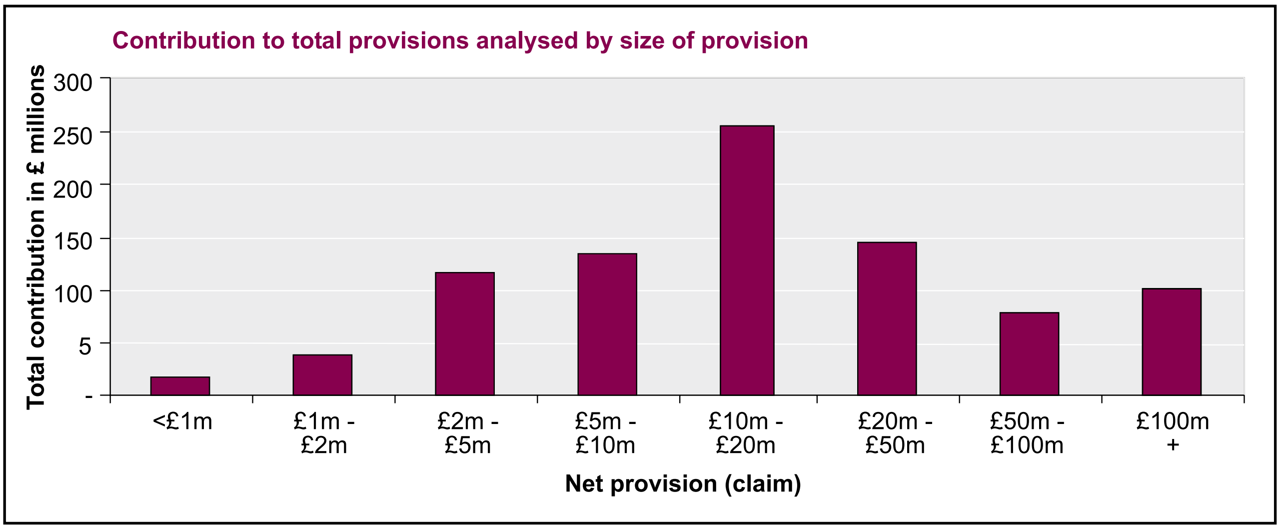
The largest single scheme contributes £101 million to the total provision for claims, while the top 5 schemes contribute £277 million. 50% of the total provision for claims is concentrated in just 9% of schemes. This pattern of contribution is shown in Charts 2 and 3 – note that the provisions for schemes where we hold no specific data are excluded from the charts.

### Chart 2



## 3.7 Financial review contd

### Chart 3




### Contingent liabilities for compensation payments

The accounts as at 31 March 2007 disclose contingent liabilities associated with 94 schemes valued at £201 million. This is where the PPF judges eventual entry into the Fund to be less than probable but higher than remote. The value represents the PPF's estimate of the contingent liabilities for claims of all these 94 schemes, and of these, 84 schemes with an aggregate provision of £161 million fall into the Type 4 category (as defined in the Actuary's Supplementary Report). Type 4 schemes are schemes where the risk of employer insolvency is considered significant, that is on average 21% in any one year; however the PPF has decided to include 100% of the aggregate allowance for claims value in contingent liabilities.

This level of probable and possible claims is broadly in line with the PPF's expectations, in the context of a period which is relatively benign for the UK economy. The rate of corporate insolvencies in England and Wales during the year was 0.6% (compared with 0.7% in 2005/06 and a ten year average of 0.9%) in a year in which real interest rates remained low, corporate profits remained strong and the economy as a whole continued to grow.

The PPF received 1,563 insolvency notices, in respect of Section 120 of the Pensions Act 2004, during the year, of which 1,476 were rejected, primarily for being in respect of defined contribution schemes and, therefore, not relevant to the Fund. By the year end 152 notices were validated, and 65 were in the process of validation. During 2005/06 the PPF noted in some cases a time lag between the date of insolvency event and the submission of the notice. This remains an area of concern and the PPF is working with those organisations which regulate insolvency practitioners to improve the quality of reporting. However, validating insolvency notices has remained a demanding task, given the range of assessments that are required to be made.

The PPF seeks to maximise the recovery of pension scheme debt for schemes which enter the assessment period. It may also be involved in negotiations prior to the insolvency event. As a consequence, since April 2005, £397 million has been received or is due from insolvent employers to the PPF or scheme trustees where the PPF has acted as a creditor. The basis on which the PPF values recoveries is detailed in the Financial Statements.

### Expenses

Investment expenses consist of fund management fees and custody fees charged to the Protection Fund, as per the Pension Protection Fund (Payments to meet Investment Costs) Regulations 2005.

## Solvency

The PPF measures its solvency position in the following way:

The Board aggregates the value of the assets directly controlled by the Board with the assets (including anticipated recoveries) of the pension schemes which are judged probable for future entry into the PPF. We then aggregate the value of the PPF's own actuarial liabilities with those of the same pension schemes judged probable for future entry into the PPF. The solvency ratio is then the total assets divided by the total liabilities.

This presentation differs from that shown in the financial statements, where the assets and liabilities of the schemes judged probable for future entry into the PPF are disclosed as a net value of the deficits of those schemes. This presentation in the financial statements is required to comply with the relevant account standard, FRS 12 "Provisions, Contingent Liabilities and Contingent Assets".

This can be summarised as follows:

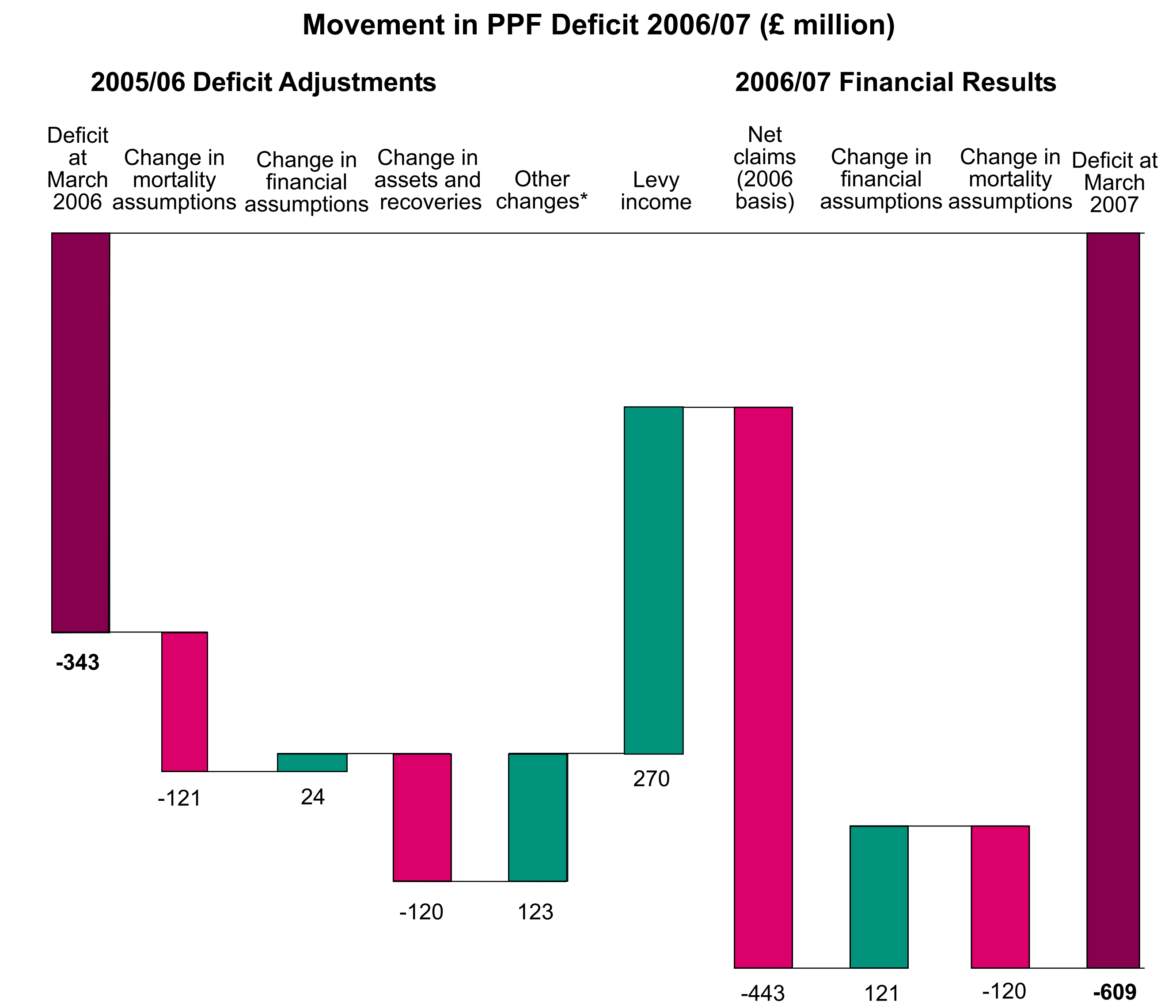
| | £ million |
|---|---|
| Pension Protection Fund net assets: | 835 |
| Scheme assets valued at: | 3,489 |
| Estimated outstanding recoveries from insolvent employers: | 85 |
| Total assets: | 4,409 |
| Pension Protection Fund liabilities valued at: | 536 |
| Protected scheme liabilities valued at: | 4,482 |
| Total liabilities: | 5,018 |
| Deficit | 609 |
| Solvency = Total assets/total liabilities | 88% |

## 3.7 Financial review contd

The PPF has adopted a revised longevity basis in the preparation of its 2006/07 assessment of its actuarial liabilities. The PPF has chosen to adopt a more prudent mortality basis and, where appropriate, on an evidential basis, adopted a scheme specific mortality basis for larger schemes in assessment. If the PPF had retained the 2005/06 basis, the PPF would have been in aggregate 92% funded against its protected liabilities, after asset recoveries, on the previous actuarial basis.

The diagram below provides a reconciliation of the major factors influencing the movement in deficit in the financial year.

### Chart 4




* ‘Other changes’ includes a number of factors including better scheme data and benefit options taken by scheme members.

### 3.7.4 Fraud Compensation Fund

Under the Pensions Act 2004, the Board of the PPF is responsible for providing compensation to occupational pension schemes that suffer a loss that can be attributable to dishonesty. This responsibility was inherited from the Pensions Compensation Board on 1 September 2005. The assets are held in a ring-fenced fund called the Fraud Compensation Fund.

#### Levies

The PPF did not consider it necessary to raise a Fraud Compensation Levy in 2006/07 and does not currently anticipate raising a levy in 2007/08. This is based on the PPF's view of the level of funds it already controls compared with the level of claims in process and its current view that the likely incidence of future claims will continue to be very low.

The PPF will keep under review the level of assets compared with the level of liabilities.

#### Claims

There were five outstanding claims as at 1 April 2006 and no new claims were received by the PPF during 2006/07. During the course of the year four of these claims were determined as unlikely to result in payment. The PPF discloses in its accounts contingent liabilities of £2,835,000 reflecting the one claim which may possibly result in payment.

#### Investment

In September 2005, the PPF published a Statement of Investment Principles for the Fraud Compensation Fund, benchmarking its investment performance against Bank of England repo rate and allowing investments in cash, deposits and money market funds. Insight Investment Management and Fidelity Investments, appointed in March 2006, remain responsible for managing money market funds for the Fund.

#### Expenses

All operating expenses incurred in administering the Fraud Compensation Fund are accounted for through the Administration Fund of the PPF.

### 3.7.5 Administration Fund

The PPF is an autonomous Public Corporation and is responsible for accounting for its own income and operating and capital expenditures. It operates under the stewardship of the Department for Work and Pensions (DWP).

The PPF is funded by drawing down grant-in-aid from DWP as empowered by Section 116 of the Pensions Act 2004. These grant-in-aid payments are in turn funded by the DWP raising an annual PPF administration levy on eligible pension schemes as set out in Section 117 of the same Act. The Board and DWP's powers, together with processes described below by which these powers are utilised, led the PPF to consider it appropriate for accounts of its Administration Fund to be prepared on a going concern basis.

The key risks facing the PPF and DWP in this funding process relate to the accuracy and completeness of its budgeting processes, which inform the DWP's setting of the rate of administration levy, and the accuracy and completeness of its forecasting processes, which generate the amounts of grant-in-aid drawn down to cover forecast expenditure in the next period.

These risks are mitigated by robust financial disciplines such as:

- the PPF submits each year a Strategic Plan for the three years ahead to the DWP
- the first year of the Strategic Plan is developed into a detailed Business Plan, with objectives for the year and associated budgeted expenditure required to fulfil those objectives
- the regular review of actual in-year expenditures against budgets and the preparation of regular forecasts of expenditures for the remainder of the year, and
- approval by the Accounting Officer of specific periodic (normally quarterly) drawdown requests.

The PPF had sufficient funding on hand throughout 2006/07 to meet operating and capital expenditure requirements. At no time were payments to staff or suppliers delayed due to inadequate funding.

The PPF exceeded its operating budget during 2006/07, but operated within its capital expenditure budget. Total operating expenditure amounted to £13.1 million compared with the budget of £11.1 million. The net result for the year was a DWP-agreed overspend of £2 million at the total cash level. This was funded from the net operating surplus of £2.1 million in 2005/06 which was carried forward into 2006/07, and reflected in calculations of grant-in-aid drawn down from DWP during the period under review.

The increased operating expenditure was due to the underspend in 2005/06 being caught up, some items budgeted as capital expenditure subsequently being classified as operating expenses and accelerated recruitment, originally budgeted for 2007/08, being undertaken to ensure the PPF had sufficient capability and capacity to fulfil its responsibilities in 2006/07. The rapid maturing of the PPF as a financial institution created particular staffing needs in the areas of financial risk management, asset management and economic research and modelling. Overall the administrative cost of the PPF per scheme member in assessment or compensation, averaged over the year, has fallen from £322 in 2005/06 to £171 in 2006/07.

The PPF budget for 2007/08 was agreed with the DWP in September 2006 to inform the setting of the PPF administration levy for 2007/08. This budget covered all aspects of operating expenditure including staff costs, outsourced services and consultancy and advisory services. As a result of this budgeting process and the expected outturn for 2006/07, following the required consultation, the DWP decided to increase the rates of the administration levy for 2007/08. The total administration levy will rise from £12 million in 2006/07 to £20 million in 2007/08.

Processes developed during 2005/06 covering the financial operations of the PPF continued to be developed during 2006/07. These included financial controls, procurement processes and procedures for appointing suppliers and service providers and assignment of levels of authority for staff.

### 3.7.6 Going concern

#### The Pension Protection Fund

The Board of the PPF remains entirely confident that the Fund remains solvent and that its accounts can be prepared on a going concern basis. This is because:

- cash flows out of the Fund for compensation payments will be at a very low level during the early years of the Fund's operation, and the current level of funding is considered adequate to ensure cash will be available to meet compensation payments as they fall due
- relevant accounting standards require the Fund to immediately recognise the full present value of probable scheme deficits but the Fund cannot recognise the future streams of protection levy income which will effectively bridge the gap between the assets and liabilities of schemes it transfers in
- the PPF is fully confident that its levy raising powers (and its powers to increase levies up to a ceiling set by the Secretary of State for Work and Pensions), and the processes for calculating, billing and collecting levies which it is developing, justify viewing the fund as a going concern. The PPF's levy-raising powers are set out in Sections 174 to 181 of the Pensions Act 2004, and
- the PPF also has the reserve powers (in extreme circumstances after due consultation and with approval of the Secretary of State) to reduce benefit payments both for scheme members already within the Fund and for new scheme members entering the Fund. These powers are set out in the Pensions Act 2004, Schedule 7, paragraph 29 and 30 covering powers to alter rates of revaluation and indexation, and to vary the percentage paid as compensation.

#### The Fraud Compensation Fund

The Board of the Pension Protection Fund is fully confident that the Fraud Compensation Fund is solvent, and that its accounts can be prepared on a going concern basis.

- The Fund would be 111% funded even if all the claims currently under consideration were to result in compensation payments.
- The PPF has powers to raise further fraud compensation levies to reflect further claims made on the Fund. The PPF's powers are set out in Section 189 of the Pensions Act 2004 and in the Occupational Pension Schemes (Fraud Compensation Levy) Regulations 2006.

- The time required to investigate and decide whether payment (including any interim settlements) should be made has in the past proved adequate to raise any required further levy income.

### The Administration Fund

The view is formed in the case of the Administration Fund because:

- of the robust financial procedures, as set out under Section 3.7.5, governing the setting of operating budgets, in-year reviews and forecasts and the drawing down of grant-in-aid.

### Freedom of Information

As a public corporation the PPF is subject to the Freedom of Information Act 2000. Wherever possible, PPF staff provide information requested without invoking the formal FOI procedure and so statistics on such informal FOI compliance are not available. However, where the content of an enquiry indicated (whether explicitly or not) that it should be treated formally as a request for information under the Act it was logged separately from other enquiries.

- the PPF received 14 requests for information which were considered under the Act during 2006/07
- in six cases the PPF was able to fully disclose the information requested
- in three cases the PPF was able to partially disclose the information requested with other information requested not being disclosed
- in five instances the organisation would not disclose any of the information requested
- where the PPF was unable to disclose information requested, in four cases this related to restricted information, the release of which is prohibited by the Pensions Act 2004, in one case to commercial sensitivity, in one case a formal publication of the information being in preparation and in two cases the information requested not being held.

A publication scheme and Freedom of Information procedures can be found on the PPF website.

# 4. Directors' Report

## 4.1 Introduction to the Directors' Report

The structure and functions of the Board of the Pension Protection Fund are defined by the Pensions Act 2004. The Members of the Board comprise the Chairman, the Chief Executive and at least 5 ordinary Members, at least 2 of whom must be appointed from the staff of the Board of the Pension Protection Fund. The Chief Executive and the Members who are appointed from the staff of the Pension Protection Fund are "Executive Members". The other members are "Non-executive Members". A majority of the Board of the Pension Protection Fund must comprise Non-executive Members.

To fulfil the functions laid down in the Pensions Act 2004 and to comply with its statutory remit, the Board has produced a Statement of Operating Principles and Scheme of Delegations. This details the functions which are reserved to the Board and where functions have been delegated to the Chief Executive. This document is available at http://www.pensionprotectionfund.org.uk/statement_of_operating_principles.pdf

### Biographies[5]

**Lawrence Churchill**

Before joining the PPF, Lawrence was Chief Executive of Zurich Financial Services, UK Irish and International (2002 to 2004). Lawrence holds a number of non-executive positions, including as a member of the Board of Actuarial Standards.

**Ian Abrams**

Ian has been Non-executive Director of Mizuho International plc since 2003 prior to which he was its managing director. Ian holds a number of non-executive positions.

**Ann Berresford**

Ann was Finance Director for the Bank of Ireland's UK Financial Services Division and Bristol & West plc until 2006. She was also a Board member of Bristol & West Pension Trustees Ltd from 2001 to 2006. Prior to this, Ann held a range of senior roles in Clyde Petroleum plc. Ann is now an independent trustee to the local government Avon Pension Fund.

Ann joined the Board on 6 September 2007.

**Mark Baker CBE**

Mark was formerly Chairman of Magnox plc and of Electricity Pensions Ltd. Mark was Deputy Independent Chairman of the Police Negotiating Board from 2000 to 2005 and is a member of the Senior Salaries Review Body.

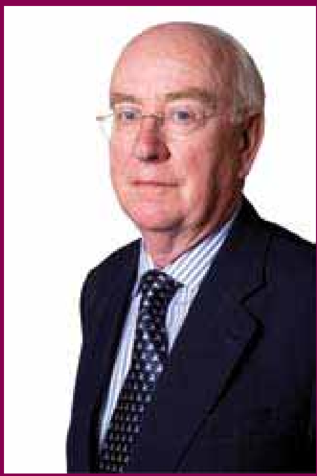
[5] This includes all members of the Board at date of publication.

## Michael Deakin

Michael set up a consultancy business in October 2003 providing strategic investment advice to pension funds. Prior to this, Michael was Chief Investment Officer and an Executive Director of Insight Investment.

## Jeannie Drake CBE

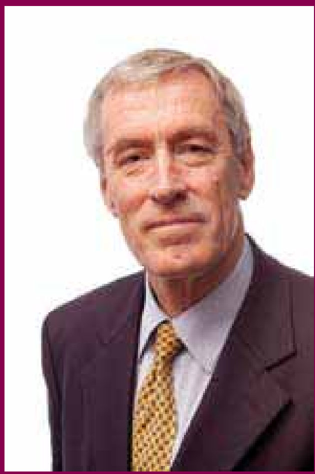
Jeannie has been Deputy General Secretary of the Communications Workers Union since 1995. Jeannie holds a number of non-executive positions and served as one of the three Pensions Commissioners. Jeannie is also a past President of the TUC.



## Sir Anthony Holland

Sir Anthony was a Solicitor who has had extensive experience in private practice and has held a range of senior appointments in the legal and financial services sectors. He is a former President of The Law Society and has written a number of legal textbooks. Sir Anthony is the Independent Complaints Commissioner at the Financial Services Authority, Chairman of the Standards Board for England and was Chairman of the Northern Ireland Parades Commission.

Sir Anthony joined the Board on 6 September 2007.



## Christopher Hughes

Christopher is Head of International at the solicitors' practice Wragge & Co LLP, of which he was formerly managing partner. Christopher has also been a Board Member of Severn Trent Water Authority and the Chairman of Newman Tonks Group plc. Christopher is the Senior Independent Director of the Board of the Pension Protection Fund.

## Partha Dasgupta

Partha is Chief Executive and Accounting Officer.

Prior to joining the PPF, Partha was Managing Director of Barclays Global Investors, Fixed Income Europe.

## Martin Clarke

Martin is Executive Director of Financial Risk and was appointed on an interim basis in July 2006. His appointment was made permanent and he joined the Board in May 2007.

Prior to joining the PPF, Martin's career was spent in retail financial services with Co-operative Insurance Society (CIS), the insurance services arm of the Co-operative Group, which he joined in 1977.

## Peter Walker

Peter is Chief Operating Officer and was appointed on an interim basis in July 2006. His appointment was made permanent and he joined the Board in February 2007.

Prior to joining the PPF, Peter spent three years working as an interim executive for a number of international companies. Before that, he was Chief Financial Officer for Kleinwort Benson Private Bank.

## Myra Kinghorn

Myra was Chief Executive before standing down in May 2006. Prior to becoming Chief Executive of the PPF, Myra was a non-executive director of the Serious Fraud Office and a member of the Board of the Occupational Pensions Regulatory Authority.

## Alan Duncan

Alan was Director of Compensation until 1 May 2007. Prior to joining the PPF, Alan was Director of Operations at INVESCO Pensions Limited. He was previously Vice-President for Business Development and Strategic Planning at Fidelity Investments.

## 4.2 Corporate governance

The Board is committed to adhering to high standards of corporate governance and its compliance with HM Treasury's 'Corporate governance in central government departments: Code of good practice' was monitored by the Audit Committee.

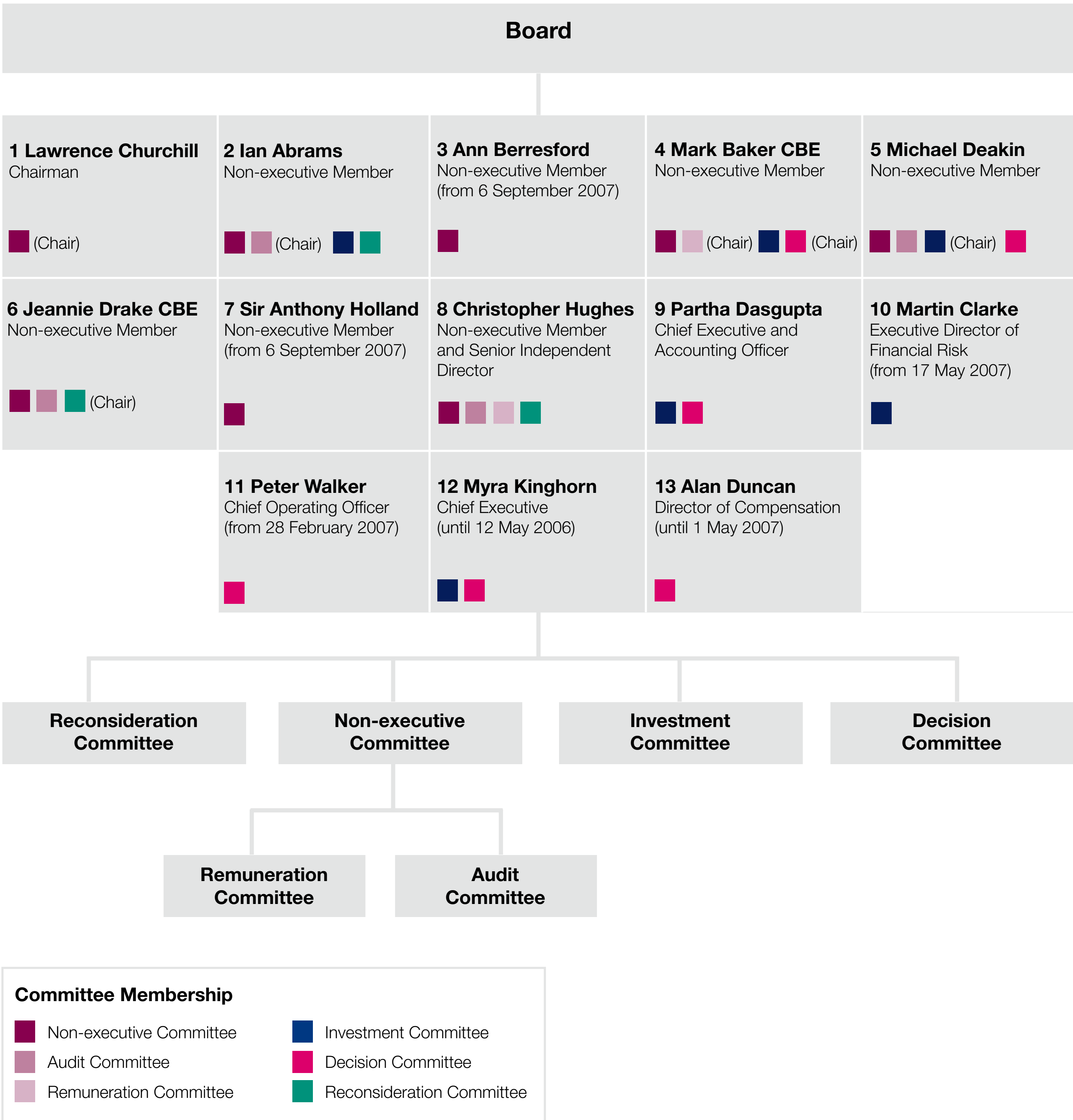
In accordance with the Pensions Act 2004, the Board has a majority of Non-executive Members, including a Non-executive Chairman. All Non-executive Members are independent, having no current or previous material relationship with the organisation as an employee, officer or contractor. All Board Committees are chaired by Non-executive Members. The Board Secretary acted as Secretary to the Board and its Committees during the reporting period.

### Attendance at meetings from 1 April 2006 to 31 March 2007

| | Board | Non - executive | Audit | Remuneration | Investment | Decision | Reconsideration | Nomination ***** |
|---|---|---|---|---|---|---|---|---|
| **No: of Meetings** | 13 | 5 | 5 | 5 | 8 | 5 | 6 | 1 |
| **Lawrence Churchill** | 13 | 5 | 1* | 2* | 1* | 4* | n/a | 1 |
| **Ian Abrams** | 13 | 5 | 5 | n/a | 8 | n/a | 6 | n/a |
| **Mark Baker** | 11 | 4 | 1* | 5 | 6 | 5 | n/a | n/a |
| **Michael Deakin** | 13 | 4 | 5 | n/a | 8 | 5 | 1**** | n/a |
| **Jeannie Drake** | 11 | 4 | n/a | 4 | n/a | n/a | 6 | n/a |
| **Christopher Hughes** | 12 | 5 | 5 | 4 | n/a | n/a | 5 | 1 |
| **Partha Dasgupta** | 13 | n/a | n/a | n/a | 7 | 4 | n/a | 1 |
| **Peter Walker** | 2** | n/a | n/a | n/a | n/a | 1** | n/a | n/a |
| **Myra Kinghorn** | 1*** | n/a | n/a | n/a | n/a | n/a | n/a | n/a |
| **Alan Duncan** | 13 | n/a | n/a | n/a | n/a | n/a | n/a | n/a |

| | |
|---|---|
| * | Exercising rights of attendance – Non-executive Board Members may elect to attend meetings of the Audit and Remuneration Committees and all Board Members may elect to attend meetings of the Investment Committee. |
| ** | Peter Walker was appointed as a Member of the Board on 28 February 2007. |
| *** | Myra Kinghorn stood down as Chief Executive on 12 May 2006. |
| **** | Michael Deakin attended the Reconsideration Committee meeting held on 11 January 2007. He had no involvement in the first stage decision. |
| ***** | The Nomination Committee is formed from a panel of available Non-executive Board Members for Non-executive appointments and the Chief Executive and Non-executive Board Members for Executive appointments. |

## 4.3 Board and committee structure and membership[6]




The Chairman of the Board is appointed by the Secretary of State for Work and Pensions.

[6] This includes all members of the Board at the date of publication.

## 4.4 Board Report

### Strategy and objectives

The Board has continued to set the strategic direction of the organisation. It has also sought to assess the performance of the organisation against the objectives that stem from the strategy. A full written review of the PPF's performance in meeting its objectives for 2005/06 was considered by the Board at its May 2006 meeting.

The Board published its 'Strategic Plan 2006/07 – 2008/09' in June 2006 which was then followed by the publication of the organisation's 2006/07 Business Plan in July 2006. At each of its meetings the Board received regular reports on the progress of the organisation toward meeting the objectives laid down in these Plans. The Board had discussions on the broad strategic direction of the organisation at a strategy day in November 2006, with a further day held in April 2007.

### Levy

The Board agreed a levy estimate of £675 million for 2007/08 in December 2006. The Board agreed the policy of deferring the setting of the levy scaling factor until the start of 2007/08 to reduce the risk of undercollection. Again the Board sought to balance the interests of compensation beneficiaries and levy payers and consulted on the levy estimate figure. The figure agreed by the Board was based on the level of risk posed to the Fund, modelled using the Long Term Risk Model, but did not represent the full insurance cost of covering the risk.

The Board had previously agreed a levy estimate of £575 million for 2006/07. Throughout the year, the Board monitored the levy collection process and the issues arising from it. Regular reports were made to the Board on the projected level of collection and the reasons for variation.

### Contracts

The Board approved the appointment of Capita Hartshead as compensation administrator to the Fund. The Board, in January 2007, also approved the extension of the appointment of D&B to assess insolvency risk until 2009.

### Communication strategy and stakeholder engagement

The Board agreed a Communications Strategy in 2006/07, building on what was agreed in 2005/06. The Board remain committed to developing and maintaining good relationships with stakeholders. The Communications Strategy adopted, therefore aimed to further this through implementing the recommendations arising from the Stakeholder Perception Audit and continuing the range of activities undertaken to provide guidance to, and to listen to, stakeholders.

The relationships of the Board with the Department for Work and Pensions and the Pensions Regulator were both strengthened during the year. A revised tripartite Memorandum of Understanding was published in February 2007. The Board also considered ways to develop these relationships and received a presentation from Mr Paul Thornton as part of his Institutional Boundaries Review.

### Board performance

A review of performance of the Board and governance was led by the Chairman of the Board through individual interviews with, and feedback from, Board Members. This repeated the previous review carried out during 2005/06. The outcome of the review was reported back to the full Board in March 2007. As with the previous review a number of proposals came out of the review and are being implemented. These included publishing the reporting lines of the Board Committees and greater Board level discussion of strategic risk management. The principles set out in the Good Governance Standards for Public Services underpinned the review.

### Standards

Board Members adhered to a code of conduct which complied with the Cabinet Office's model code. The Code encompasses the Seven Principles of Public Life as defined by the Committee on Standards in Public Life. It includes sections on openness and responsiveness; accountability; personal responsibility; conflicts of interest and confidentiality.

Board Members register interests with the Board Secretary throughout the year. The register of interests can be viewed at: http://www.pensionprotectionfund.org.uk/board_register_of_interests.pdf

Where Board Members were aware of a conflict of interest in respect of a matter under discussion, the Chairman and Board Secretary were advised of this and the Board Member did not participate in the discussion of that item or, where appropriate, left the meeting for that item.

### 4.4.1 The Non-executive Committee of the Board

The Non-executive Committee met on five occasions between 1 April 2006 and 31 March 2007. The Committee is constituted of all Non-executive members of the Board.

The matters reserved to the Committee are set out in Section 112 of the Pensions Act 2004, and are:

a) the duty to keep under review the question of whether the Board's internal financial controls secure the proper conduct of its financial affairs

b) the duty to determine under sub-paragraph (5) (a) of paragraph 12 of Schedule 5, subject to the approval of the Secretary of State, the terms and conditions as to remuneration of any Chief Executive appointed under sub-paragraph (4) of that paragraph

c) the duty to determine under paragraph 13(3)(a) of that Schedule, subject to the approval of the Secretary of State, the terms and conditions as to remuneration of any member of staff who is also to be an Executive Member of the Board, and

d) the duty to determine under paragraph 13(3)(b) of that Schedule, the terms and conditions of remuneration of any member of staff of a description prescribed for purposes of that provision.

The Committee has established Audit and Remuneration Committees.

In 2006/07, the Non-executive Committee:

- agreed the procedures to be adopted to appoint a new Chief Executive. Non-executive board members subsequently served on the interviewing panels for short-listed candidates
- adopted interim governance arrangements for the period in which the position of Chief Executive was vacant
- appointed Christopher Hughes as Senior Independent Director which, inter alia, provided a mechanism through which Non-executive Board Members could review the performance of the Chairman of the Board formally
- considered the appointment of further Non-executive Members to the Board to ensure that the Board continues to be resourced adequately and contains an appropriate balance of skills and experience, as its committee work increases
- received reports from the Audit and Remuneration Committees at each of its meetings, and
- continued to consider means of reviewing the effectiveness of the Board.

The Audit and Remuneration Committees are sub-committees of the Non-executive Committee and report to it.

#### Audit Committee

The Audit Committee met on five occasions between 1 April 2006 and 31 March 2007.

Both the internal and external auditors had full access to meeting papers and minutes and attended meetings of the Committee. Internal audit was provided by BDO Stoy Hayward while the National Audit Office provided the external audit service.

In 2006/07, the Committee:

- reviewed, considered and recommended the Annual Report and Accounts for 2005/06 for the Board's approval
- reviewed reports received from the internal auditors and the Executive's action plan to implement recommendations
- reviewed an audit, carried out by KPMG, of the integrity, robustness and capabilities of the Long Term Risk Model
- monitored the organisation's top down risk register, receiving quarterly reports on how these risks were managed
- reviewed the organisation's accounting policies, and
- reviewed and revised the organisation's whistleblowing policy.

The Audit Committee monitored and commented on the organisation's risk management processes and reported on these to the Non-executive Committee after each meeting.

### Remuneration Committee

The Remuneration Committee met on five occasions between 1 April 2006 and 31 March 2007.

In 2006/07, the Committee:

- determined the remuneration for the Chief Executive, the Chief Operating Officer and the Director of Financial Risk for approval by the Secretary of State for Work and Pensions
- reviewed the performance of the Chief Executive and that of the Executive Directors; this included the establishing of bonus arrangements and agreement of annual bonus payments
- ensured that appropriate objectives were in place for the Executive Directors against which performance would be measured in 2006/07 and 2007/08. Those for 2006/07 were finalised subsequent to the start of the year while those for 2007/08 were agreed, subject to minor amendments, in the period under review, and
- was consulted on the proposals for staff remuneration arrangements including the reward and remuneration strategy for 2006/07 and the revised reward strategy and 2007 pay remit. As part of this the Committee was consulted on a revised approach to staff appraisals, objectives and linkage to the Business Plan.

## 4.4.2 Board Committees

### Decision Committee

The Decision Committee met on five occasions between 1 April 2006 and 31 March 2007.

The Decision Committee takes decisions on matters which are normally delegated to the Chief Executive that he elects to refer back to the Committee as well as any specific decisions assigned to it by the Board. This may be where it is judged necessary in the light of the possibility of future review or complaint, in which instance those Members of the Board who are also Members of the Reconsideration Committee will not be party to the decision.

### Reconsideration Committee

The Reconsideration Committee is a Committee of the Board required to be established by the Pensions Act[7] for the purpose of carrying out the second stage of the formal appeals process for reviews and complaints.

The Reconsideration Committee met on six occasions between 1 April 2006 and 31 March 2007.

In 2006/07, the Committee:

- considered a complaint of maladministration made by an individual against the PPF. The complaint was not upheld
- considered separately five cases where the levy payer challenged the level of levy invoiced. In each of these cases the levy figure was found to have been correctly calculated in accordance with the Determination of the Board and on the basis of the information notified to the PPF by the appropriate deadlines. The complaints were therefore not upheld, and
- was attended, on a single occasion, by a representative of the Council on Tribunals to observe its proceedings.

Where the Reconsideration Committee has not upheld a complaint the applicants may take their case to the PPF Ombudsman (this must normally be within 28 days of issue of the Reconsideration Committee's written decision).

### Nomination Committee

The Nomination Committee met on one occasion between 1 April 2006 and 31 March 2007. The Committee and its remit were agreed by the Board in February 2007.

[7] Its precise remit is set out in Sections 207 and 208 of the following Regulations: The Pension Protection Fund (Review and Reconsideration of Reviewable Matters) Regulations 2005 (2005 No. 669) as amended and The Pension Protection Fund (Maladministration) Regulations 2005 (2005 No.650).

In 2006/07, the Committee:

- agreed the appointment of the Director of Financial Risk.

### Investment Committee

The Investment Committee met on eight occasions between 1 April 2006 and 31 March 2007.

In 2006/07, the Committee:

- prepared and published a revised Statement of Investment Principles in October 2006, approved by the Board. A bespoke liability driven approach was adopted to govern the investment of the Fund given the collection of the pension protection levy, and assets inherited from pension schemes that transfer to the Fund. The Statement also outlined the portfolio benchmarks and investment guidelines. The Statement of Investment Principles will be reviewed annually and can be found at http://www.pensionprotectionfund.org.uk/sip2006.pdf
- selected and appointed five new fund managers to implement the new investment strategy. These were State Street Global, Lazard UK, Newton Investment Management, Morley Fund Management and Auriel Capital Management. This included the setting of mandates and performance criteria
- monitored the performance and compliance of Insight Investment, PIMCO and Goldman Sachs with their agreed mandates. As the new investment strategy was implemented monitoring of the performance and compliance of the five additional fund managers with their agreed mandates began
- received advice on the practical implications of the first transfers of assets and liabilities into the Fund. This included discussion of how such assets would be transitioned
- reviewed reports from State Street, Custodian to the Fund, and monitored its compliance with agreed standards. State Street's role as transition manager to the Fund was also monitored
- received reports from Mercer Investment Consulting, investment adviser to the Fund, and monitored its compliance with agreed standards
- considered the strategy of the Fund in respect of Socially Responsible Investment and options for future approaches to the issue, and
- agreed that the Statement of Investment Principles for the Fraud Compensation Fund would remain substantively unchanged.

# 5. Remuneration Report

| Salary and Pension Entitlements (subject to audit – see auditor's report pages 50-51) | | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Salary (in bands of £5,000)** | | **Pensions** | | | | |
| | Period end 31 March 2007 | Period end 31 March 2006 | Real increase in pension and related lump sum | Total accrued pension at age 60 at 31/3/2007 | CETV at 31/3/2007 | CETV at 31/3/2006 | Real increase in CETV |
| | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 | £'000 |
| **Lawrence Churchill**<br>Chairman | 80-85 | 80-85 | 0-2.5 | 0-5 | 81 | 50 | 29 |
| **Myra Kinghorn**<br>Former Chief Executive (Board member until 12 May 2006) | 60-65 | 140-145 | 0-2.5 | 0-5 | 68 | 53 | 13 |
| **Partha Dasgupta**<br>Chief Executive from 21 June 2006 (formerly Director of Investment and Finance) | 165-170 | 120-125 | 0-2.5 | 0-5 | 41 | 23 | 14 |
| **Alan Duncan**<br>Director of Operations | 110-115 | 115-120 | 0-2.5 | 0-5 | 58 | 30 | 24 |
| **Peter Walker**<br>Chief Operating Officer (Board member from 28 February 2007) | 10-15 | N/A | 0-2.5 | 0-5 | 7 | N/A | 5 |
| **Ian Abrams**<br>Non-Executive member | 15-20 | 10-15 | N/A | N/A | N/A | N/A | N/A |
| **Mark Baker CBE**<br>Non-Executive member | 15-20 | 10-15 | N/A | N/A | N/A | N/A | N/A |
| **Michael Deakin**<br>Non-Executive member | 15-20 | 10-15 | N/A | N/A | N/A | N/A | N/A |
| **Jeannie Drake CBE**<br>Non-Executive member | 15-20 | 10-15 | N/A | N/A | N/A | N/A | N/A |
| **Christopher Hughes**<br>Non-Executive member | 15-20 | 10-15 | N/A | N/A | N/A | N/A | N/A |

This report is based on payments made by (or accrued by) the Board and so recorded in the accompanying financial statements (rather than, for example, on annual rates of salary).

## Contracts

The Chief Executive was appointed to his post on 21 June 2006 on a three-year fixed term contract and had formerly held the position of Director of Investment and Finance having been appointed to this position in 2004 on a three-year fixed term contract. The former Chief Executive was appointed in September 2004 on a three-year fixed term contract but stood down from office on 12 May 2006.

The Chief Operating Officer was appointed on 10 July 2006 on an interim basis. In this capacity he was not a member of the Board but attended Board meetings. He was appointed on a permanent basis, on a three-year fixed term contract, on 2 January 2007. He formally became an Executive member of the Board from 28 February 2007.

The Director of Operations was appointed in February 2005 on an 18 month contract, subsequently extended. He subsequently did not extend his contract further and left the PPF with effect from 1 May 2007.

The Chairman of the Pension Protection Fund was appointed by the Secretary of State in July 2004 for a three-year term of office and subsequently reappointed in July 2007 to a further three-year term of office. All other Non-executive Members of the Board were appointed by the Secretary of State in December 2004 for a three-year term of office.

## Remuneration

The Executive Directors received a fixed salary which is reviewable annually by the Remuneration Committee. The Remuneration Committee during this period comprised Mark Baker CBE (Chairman), Jeannie Drake CBE and Christopher Hughes, who are all Non-executive Members of the Board.

The Chairman of the Board was paid a fixed salary together with a pension contribution and was contracted to work for the PPF for two days a week. All other Non-executive Members received a fixed fee of £15,300 per annum based on an estimated time commitment of 20 days per annum. Non-executive Board Members' salary was not performance-related and there was no provision for compensation in the event of termination.

## Bonuses

Executive Directors were eligible for an annual bonus of up to 20% of their base salary. The bonus level was set by the Remuneration Committee and was determined by reference to Executive Directors within comparable organisations. Base pay covered normal competent performance and any bonus paid represented a significant contribution or achievement in addition to this. Bonuses were determined by the Remuneration Committee which assesses the performance of each Executive Director against the objectives and the targets for meeting these objectives for the year. There was no contractual undertaking to make termination payments for any of the Executive Directors.

## Notice periods

The Chief Executive, the Chief Operating Officer and the Director of Financial Risk have notice periods of six months. The Director of Operations left the PPF with effect from 1 May 2007.

Non-executive Members' appointments can be terminated on a month's notice by either the Board or the Non-executive Member. The Chairman's appointment is subject to a notice period of six months which can be terminated by the Secretary of State or by the postholder in writing. The right to notice can be waived by the Secretary of State or the postholder and the postholder can accept payment in lieu of notice.

## Pensions

The pension entitlement of the Chief Executive and Executive Directors was based on the HM Revenue and Customs earnings cap of £108,600. Employees do not accrue defined benefits in the Civil Service pension scheme until they have been members for two years, before which their entitlement on leaving service is to apply for a transfer value to a personal or stakeholder pension.

Since 1 October 2002, civil servants and other employees eligible to join a civil service pension scheme may be in one of three statutory based "final salary" defined benefit schemes (classic, premium and classic plus). The schemes are unfunded with the cost of benefits met by monies voted by Parliament each year. Pensions payable under classic, premium and classic plus are increased annually in line with changes to the Retail Prices Index. New entrants after 1 October 2002 may choose between membership of the premium scheme or joining a good quality "money purchase" stakeholder arrangement with a significant employer contribution (partnership pension account).

Employee contributions are set at the rate of 1.5 per cent of pensionable earnings for the classic scheme and 3.5 per cent for the premium and classic plus schemes. Benefits in the classic scheme accrue at a rate of 1/80th of pensionable pay for each year of service. In addition, a lump sum equivalent to three years' pension is payable on retirement. For the premium scheme, benefits accrue at a rate of 1/60th of final pensionable earnings for each year of service. In the premium scheme there is no automatic lump sum payable on retirement but members may give up (commute) some of their pension to provide a lump sum. The classic plus scheme is a variation of the premium scheme but with the benefits in respect of service prior to 1 October 2002 calculated broadly in the same way as in the classic scheme.

The partnership pension account is a stakeholder pension arrangement. The employer makes a basic contribution of between 3 per cent and 12.5 per cent (depending on the age of the member) of pensionable salary into a stakeholder pension product chosen by the employee from a selection of approved products. The employee does not have to contribute but where they do make contributions, the employer will match these up to a limit of 3 per cent of pensionable salary (in addition to the employer's basic contribution). Employers also contribute a further 0.8 per cent of pensionable salary to cover the cost of centrally-provided risk benefit cover (death in service and ill health retirement). Further details about the Civil Service pension arrangements can be found at: www.civilservice-pensions.gov.uk

### Cash Equivalent Transfer Values (CETV)

A Cash Equivalent Transfer Value (CETV) is the actuarially assessed capitalised value of the pension scheme benefits accrued by a member at a particular point in time. The benefits valued are the member's accrued benefits and any contingent spouse's pension payable from the scheme. A CETV is a payment made by a pension scheme or arrangement to secure pension benefits in another pension scheme or arrangement when the member leaves a scheme and chooses to transfer the benefits accrued in their former scheme. The pension figures shown relate to the benefits that the individual has accrued as a consequence of their total membership of the pension scheme, not just their service in a senior capacity to which disclosure applies. The CETV figures, and from 2003/04 the other pension details, include the value of any pension benefit in another scheme or arrangement which the individual has transferred to the Civil Service pension arrangements and for which the CS Vote has received a transfer payment commensurate with the additional pension liabilities being assumed. They also include any additional pension benefits accrued to the member as a result of their purchasing additional years of pension service in the scheme at their own cost. CETVs are calculated within the guidelines and framework prescribed by the Board for Actuarial Standards.

### Real increase in CETV

This reflects the increase in CETV effectively funded by the employer. It takes account of the increase in accrued pension due to inflation, contributions paid by the employee (including the value of any benefits transferred from another pension scheme or arrangement) and uses common market valuation factors for the start and end of the period.

**Partha Dasgupta**
Accounting Officer

17 October 2007

# 6. Financial Statements for the period 1 April 2006 to 31 March 2007

## 6.1 Statement of the Board of the Pension Protection Fund's and the Accounting Officer's responsibilities for these accounts

Under paragraph 22 of Part 4 of Schedule 5 to the Pensions Act 2004 the Board is required to prepare a statement of accounts which complies with any accounting directions given by the Secretary of State with the approval of the Treasury.

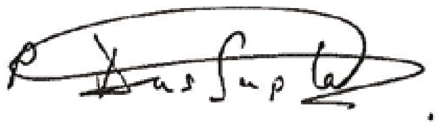
The accounts direction issued on 20 September 2006 in respect of these accounts requires the Board to prepare accounts which give a true and fair view of the Board's income and expenditure, total recognised gains and losses and cash flows for the financial year and the state of affairs at the year end; and which provide disclosure of any material expenditure or income which has not been applied to the purposes intended by Parliament or material transactions that have not conformed to the authorities which govern them.

In preparing the accounts, the Accounting Officer is required to comply with:

- the accounting principles and disclosure requirements of the edition of the Government Financial Reporting Manual in force for the financial year
- other guidance which HM Treasury may issue from time to time in respect of accounts which are required to give a true and fair view
- the Management Statement and Financial Memorandum between the Board of the Pension Protection Fund and the Department for Work and Pensions
- any other specific disclosure or other requirements required by the Secretary of State for Work and Pensions.

For the period 1 April to 12 May 2006, the then Chief Executive, Myra Kinghorn, was the Accounting Officer for the Board. This appointment expired with effect from 12 May 2006 when Mrs Kinghorn stood down as Chief Executive. I was appointed Accounting Officer for the Board with effect from 12 May 2006, initially on an interim basis and then, with effect from 21 June 2006, on a permanent basis, co-incident with my appointment as Chief Executive. The relevant responsibilities of Accounting Officers, including the responsibility for the propriety and regularity of the public finances and for the keeping of proper records and financial procedures are set out in the model "Non-Departmental Public Bodies Accounting Officers' Memorandum" issued by the Treasury and published in Government Accounting. Although the Board of the Pension Protection Fund is classified as a Public Corporation rather than a Non-Departmental Public Body, I still consider this guidance to be the most appropriate for me to follow as Accounting Officer for the Board.

**Partha Dasgupta**
Accounting Officer



17 October 2007

## 6.2 Statement of internal control

### Scope of responsibility

As Accounting Officer[8] I have responsibility for maintaining a sound system of internal control that supports the achievement of the Pension Protection Fund's policies, aims and objectives, whilst safeguarding the public funds and departmental assets for which I am personally responsible, in accordance with the responsibilities assigned to me in Government Accounting.

I am also responsible for ensuring that proper records are maintained as set out in the Non-Departmental Public Bodies Accounting Officer Memorandum, issued by the Treasury and published in Government Accounting, Annex 8.2.

My responsibility to ensure compliance with the requirements of the Board of the Pension Protection Fund's Management Statement and Financial Memorandum with the Department for Work and Pensions has been supplemented by regular meetings with our departmental Stewardship team, the Board and the executive team of the Pensions Regulator. These meetings covered updates on the implementation of our strategic objectives, helped formulate our future business direction and highlighted the inherent risks and opportunities in implementing our policies.

These meetings have been supplemented by a regular dialogue between the Executive team and officials at the Department for Work and Pensions and the Pensions Regulator.

### The purpose of the system of internal control

The system of internal control is designed to manage risk to a reasonable level rather than to eliminate all risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to identify and prioritise the risks to the achievement of the Board of the Pension Protection Fund's policies, aims and objectives; to evaluate the likelihood of those risks being realised and the impact should they be realised and to manage them efficiently, effectively and economically.

The system of internal control has been in place in the Board of the Pension Protection Fund for the year ended 31 March 2007 and up to the date of signing of these accounts and accords with Treasury guidance.

Key systems and procedures were subject to internal audit review during the period ended 31 March 2007. All significant internal audit recommendations which were due during the period were implemented by 31 March 2007.

### Capacity to handle risk

The Board of the Pension Protection Fund covers the risks of insolvency of sponsors of eligible defined benefit pension schemes at a time when the pension schemes have insufficient assets to meet the liabilities at the PPF compensation level. It takes on and manages the financial and operational risks inherent in the transferred assets and liabilities of these schemes. The Board of the Pension Protection Fund raises an annual Levy from eligible schemes.

The Board of the Pension Protection Fund monitors the significant risks to achieving our strategic goals and has delegated to the Audit Committee the responsibility for ensuring that an appropriate risk management strategy is in place and embedded throughout the organisation.

The Management Committee, which comprises the Executive Members and senior managers across the organisation, established the Risk Management Committee with executive authority to take action to manage the operational risks faced by the Board of the Pension Protection Fund. The Committee, which is chaired by the Chief Operating Officer, is responsible for leading and overseeing the Risk Management Strategy and processes of the Pension Protection Fund. The membership includes a wide spread of skills and knowledge including a specialist risk manager. We have consciously enlisted heads of teams into the membership of the Risk Management Committee to embed risk responsibility and ownership deeper into the organisation.

The Committee obtained an independent review of the systems of corporate governance from BDO Stoy Hayward. The overall summary confirmed that the

8 For the period 1 April 2006 up until 12 May 2006 when she stood down as Chief Executive, Myra Kinghorn had responsibility as Accounting Officer.

## 6.2 Statement of internal control contd

processes employed by the Board of the Pension Protection Fund are substantially compliant with the HM Treasury Orange Book – Management of Risk – Principles and Concepts (October 2004) and Code of Good Practice for Corporate Governance in Central Departments. BDO Stoy Hayward made four recommendations which have now been completed.

The Management Committee also established the Asset and Liability Committee to oversee the financial risk management activities of the Board of the Pension Protection Fund including investment (risk and performance) management, insolvency, underfunding and other balance sheet risk management.

In my opinion, the Board of the Pension Protection Fund has made steady progress in developing its risk management processes in its second year of operation, including:

- The renewal and regular monitoring of the top down risk profile
- The use of risk management in programmes and projects and developing a risk register
- The introduction of self assessment of the control framework
- The introduction of a series of workshops led by the risk officer, to identify risks in core and enabling business processes
- Ongoing programme of internal audit reviews.

These developments have built on the risk management foundations laid down last year and have continued in the post year end period.

### The risk and control environment

The risk management process underpins the risk management strategy and provides a continual cycle that both informs and is informed by the strategic objectives of the Board of the Pension Protection Fund.

The Board of the Pension Protection Fund has identified risks at three levels:

- Top down risk profile: This is the process whereby we capture the key risks to the achievement of our strategic objectives
- Process or team assessment: This process drives at the heart of our operational capability and considers those risks which may adversely impact on the objectives of a process or team. Additionally the risks identified will inform the top down risk profile
- Project assessment: The final aspect of our risk identification approach looks at the risks that accrue from our change portfolio. The programme office capability which we introduced last year has improved the effectiveness of this aspect of our approach, including through training and accreditation on MSP[9] and PRINCE2[10] techniques.

Risk management information is recorded in risk registers and the assessment of the level of risk informs both the priority and ownership of risks. Risks are identified and controlled by:

- Identifying the objective and the risks which may prevent the achievement of that objective
- Assessing the inherent risk with reference to predetermined criteria covering impact and likelihood
- Considering risk against the appetite set by the Board
- Determining appropriate control strategy [tolerate, treat, transfer, terminate]
- Identifying controls in place to manage the risk
- Assessing the residual risk after the application of controls
- Preparing an action plan for activities to achieve the control strategy
- Assigning responsibility for ownership of risk and action plans.

9 **M**anaging **S**uccessful **P**rogrammes
10 **PR**ojects **IN** **C**ontrolled **E**nvironments

The Risk Management Committee meets monthly and considers operational risk and internal control matters across the organisation. There is an independent Audit Committee chaired by a non-executive Board member with appropriate financial expertise which meets quarterly. This committee oversees the control environment and risk management framework and receives reports from our internal and external auditors on our system of internal control.

The Asset and Liability Committee meets monthly and considers investments and financial risk matters across the organisation and reports to the Investment Committee (on investments) and the Board (on other financial risks).

Internal audit services are supplied by BDO Stoy Hayward LLP. Internal audits are undertaken on those processes which are considered to be higher risk or as specifically agreed with management.

The work undertaken by internal audit is agreed with management and the Audit Committee and is amended as defined by the Board of the Pension Protection Fund's continuous review of its needs and as the priorities for management change. All work undertaken by BDO Stoy Hayward is operated to criteria in the Government Internal Audit Standards. They submit reports that include their independent opinion on the appropriateness and effectiveness of the Board of the Pension Protection Fund's internal controls, together with their recommendations for improvement.

In my opinion, the Board of the Pension Protection Fund has built upon the standard of risk management reported in the last annual accounts. We continually strive to achieve high standards of risk management and have the opportunity to enhance the framework further with the following developments planned for implementation by 31 December 2007:

- Improving the reporting processes to Management Committee and Audit Committee
- Developing interactions between the Asset and Liability Committee and Risk Management Committee.

### Review of effectiveness

As Accounting Officer, I also have responsibility for reviewing the effectiveness of the system of internal control. My review of the effectiveness of the system of internal control has been informed by:

- The assurances I sought and received from the former Chief Executive and Accounting Officer who held office for the period 1 April 2006 up until 12 May 2006, as detailed in the Interim Statement on Internal Control she prepared on leaving office
- The assurances I sought and received from other Board members and senior staff of the Board of the Pension Protection Fund detailing the work undertaken to ensure risk management and control is addressed in their areas of responsibility
- The work of the internal auditors and the Board members and senior managers who have responsibility for the development and maintenance of the internal control framework and
- Comments made by the external auditors in their management letter and other reports.

I have been advised on the implications of the result of my review of the effectiveness of the system of internal control by the Audit Committee and a plan to address any reported weaknesses and to ensure continuous improvement of the system is in place.

### Significant internal control issues

During its second year of operation, the Board of the Pension Protection Fund has continued to develop as an organisation, particularly as it has started to take on the full range of functions required of it by the Pensions Act 2004. For example, during the year under review, the Board of the Pension Protection Fund has:

- Calculated, invoiced and collected its first Protection Levy using both risk-based and scheme-based factors
- Issued its first transfer notices to bring schemes into the Pension Protection Fund and taken over those schemes' assets and liabilities
- Made the first compensation payments directly to former members of transferred schemes
- Implemented the first full Statement of Investment Principles setting out the strategy for the long-term investment of transferred assets and levy receipts.

Significant effort has been expended in the planning and preparation for taking on these functions effectively, with ensuring the success of these crucial operational objectives placed at the heart of the planning work. The

Board and its staff have designed systems and processes to carry out these functions, and have responded proactively, for example to reactions from levy payers, scheme trustees and scheme members, to improve the relevant systems and processes. The business environment in which these functions have developed over the year has been far from stable and mature.

A number of control issues did arise for which mitigating actions have been taken, and which I attribute mainly to unfamiliarity with the functions being taken on and the requirement to react speedily to stakeholder feedback. The one internal control issue which I consider significant and which attracted significant public interest concerned the calculation and publication of the Levy Scaling Factor.

Under the Pensions Act 2004, the Board of the Pension Protection Fund is required each year to estimate the pension protection levies it will raise (section 177(1)) and then, before the start of the levy year, to publish the rules for calculation of those levies in respect of each eligible scheme (section 175(5)). In December 2005, the Board decided upon the overall quantum of pension protection levies it intended to raise in 2006/07 and published that figure (£575 million) as its estimate under section 177(1). The Board indicated that it intended to impose on each eligible scheme a risk based levy equal to the product of four factors: the level of under funding; the insolvency probability of its employer(s); the percentage of the levy intended to be risk based (0.8); and the "Levy Scaling Factor". Based on the quantum it had set, and the scheme information then available to it, the Board indicated that it would set the Levy Scaling Factor for 2006/7 as 0.53. When the Board's final "Determination" under section 175(5) was made in March 2006, it incorporated the Levy Scaling Factor of 0.53, which became final and unchangeable at that point. At the point the Determination was published, the Board of the Pension Protection Fund had no reason to believe that the use of the Levy Scaling Factor of 0.53 would result in its collecting significantly less than the estimate originally published.

However, a number of factors contributed to a significant reduction in the amount which the Board now estimates that it will actually collect for 2006/07. Those factors include investment market movements; improvements in the quality of data at both a scheme and employer level used in levy calculations; and the use by employers of deficit reduction contributions and contingent assets. The full effect of these factors on the overall levy quantum was not appreciated until later in 2006, when the information on which the 2006/07 levy would actually be based had been supplied to the Board. At that point it was not open to the Board to change the Levy Scaling Factor since it formed part of the Determination under section 175(5). The obligation under section 175(5) to set the rules for the levies before the start of the relevant levy year prevented the Board from reacting to these developments and adjusting the Levy Scaling Factor so that the required levy quantum could still be raised. The impact of this issue was that protection levy income amounted to £271 million in the year, and not the £575 million originally estimated. Corrective action has been designed to prevent a re-occurrence of this control issue, in that the Levy Scaling Factor for 2007/08 was published as a formula, rather than an absolute percentage, to absorb the impact of such events in the distribution of the levy quantum over eligible schemes.

I am satisfied that no other significant internal control issues materialised in the operations of the Board of the Pension Protection Fund in the year to 31 March 2007 and up to the date of this report.

**Partha Dasgupta**
Accounting Officer

17 October 2007

## 6.3 The Certificate and Report of the Comptroller and Auditor General to the Houses of Parliament

I certify that I have audited the financial statements of the Board of the Pension Protection Fund for the year ended 31 March 2007 under the Pensions Act 2004. These comprise the Operating Statement, the Statement of Total Recognised Gains and Losses, the Balance Sheet, the Cash Flow Statement and the related notes. These financial statements have been prepared under the accounting policies set out within them. I have also audited the information in the Remuneration Report that is described in that report as having been audited.

### Respective responsibilities of the Board of the Pension Protection Fund, the Accounting Officer and Auditor

The Board of the Pension Protection Fund and Accounting Officer are responsible for preparing the Annual Report, the Remuneration Report and the financial statements in accordance with the Pensions Act 2004 and directions made thereunder by the Secretary of State for Work and Pensions and for ensuring the regularity of financial transactions. These responsibilities are set out in the Statement of the Board of the Pension Protection Fund and Accounting Officer's Responsibilities.

My responsibility is to audit the financial statements and the part of the Remuneration Report to be audited in accordance with relevant legal and regulatory requirements, and with International Standards on Auditing (UK and Ireland).

I report to you my opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Remuneration Report to be audited have been properly prepared in accordance with the Pensions Act 2004 and directions made thereunder by the Secretary of State for Work and Pensions. I report to you whether, in my opinion, certain information given in the Annual Report, which comprises the Chairman's Foreword, Chief Executive's Report, Management Commentary and Directors' Report is consistent with the financial statements. I also report whether in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

In addition, I report to you if the Board of the Pension Protection Fund has not kept proper accounting records, if I have not received all the information and explanations I require for my audit, or if information specified by HM Treasury regarding remuneration and other transactions is not disclosed.

I review whether the Statement on Internal Control reflects the Board of the Pension Protection Fund's compliance with HM Treasury's guidance, and I report if it does not. I am not required to consider whether this statement covers all risks and controls, or form an opinion on the effectiveness of the Board of the Pension Protection Fund's corporate governance procedures or its risk and control procedures.

I read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. I consider the implications for my report if I become aware of any apparent misstatements or material inconsistencies with the financial statements. My responsibilities do not extend to any other information.

### Basis of audit opinion

I conducted my audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. My audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of financial transactions included in the financial statements and the part of the Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgments made by the Board of the Pension Protection Fund and Accounting Officer in the preparation of the financial statements, and of whether the accounting policies are most appropriate to the Board of the Pension Protection Fund's circumstances, consistently applied and adequately disclosed.

## 6.3 The Certificate and Report of the Comptroller and Auditor General to the Houses of Parliament (contd)

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance that the financial statements and the part of the Remuneration Report to be audited are free from material misstatement, whether caused by fraud or error, and that in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Remuneration Report to be audited.

### Opinions

#### Audit Opinion

In my opinion:

the financial statements give a true and fair view, in accordance with the Pensions Act 2004 and directions made thereunder by the Secretary of State for Work and Pensions, of the state of the Board of the Pension Protection Fund's affairs as at 31 March 2007 and of its deficit (net result) for the year then ended;

the financial statements and the part of the Remuneration Report to be audited have been properly prepared in accordance with the Pensions Act 2004 and directions made thereunder by the Secretary of State for Work and Pensions; and

information given within the Annual Report, which comprises the Chairman's Foreword, Chief Executive's Report, Management Commentary and Directors' Report is consistent with the financial statements.

#### Audit Opinion on Regularity

In my opinion, in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

#### Report

I have no observations to make on these financial statements.

**John Bourn**
Comptroller and Auditor General

National Audit Office
157-197 Buckingham Palace Road
Victoria
London SW1W 9SP

John Bourn

Date: 22 October 2007

"The maintenance and integrity of the PPF's website is the responsibility of the Accounting Officer; the work carried out by the auditors does not involve consideration of these matters and accordingly the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website."

## 6.4 Financial statements

### The Board of the Pension Protection Fund

### Operating Statement for the period 1 April 2006 to 31 March 2007

| **All amounts in £000s** | **Pension Protection Fund** | | **Fraud Compensation Fund** | | **Administration Fund** | | **Total Funds** | **Total Funds** |
|---|---|---|---|---|---|---|---|---|
| | Notes | Appendix 1 | Notes | Appendix 2 | Notes | Appendix 3 | Year ended 31 March 2007 | Period from 6 April 2005 to 31 March 2006 |
| **STATUTORY OPERATING ACTIVITIES** | | | | | | | | |
| **Operating Income** | | | | - | | - | | |
| Income from levies | 1.2 | 270,255 | 2.2 | - | | - | 270,255 | 138,043 |
| **Total operating income** | | **270,255** | | - | | - | **270,255** | **138,043** |
| **Operating expenses** | | | 2.3 | | | | | |
| Staff costs | | - | | - | 3.3a | (6,534) | (6,534) | (3,619) |
| Other costs | | (11) | | - | 3.3b | (6,138) | (6,149) | (3,324) |
| Depreciation and impairment charges | | - | | - | 3.5 | (484) | (484) | (109) |
| **Total operating expenses** | | **(11)** | | **-** | | **(13,156)** | **(13,167)** | **(7,052)** |
| **Net Operating Surplus/(Deficit)** | | **270,244** | | **-** | | **(13,156)** | **257,088** | **130,991** |
| **INVESTMENT ACTIVITIES** | | | | | | | | |
| Interest on operating bank accounts | 1.3 | 607 | 2.4 | 1 | 3.4 | 64 | 672 | 600 |
| Investment income | 1.4 | 6,681 | 2.5 | 146 | | - | 6,827 | 1,616 |
| Change in fair value of investments | 1.5 | (13,311) | | - | | - | (13,311) | 1,562 |
| Investment expenses | 1.6 | (543) | | - | | - | (543) | (114) |
| **Net Investment Return** | | **(6,566)** | | **147** | | **64** | **(6,355)** | **3,664** |
| **CLAIMS ACTIVITIES** | | | | | | | | |
| Losses on actuarial liabilities | 1.7 | (5,434) | | - | | - | (5,434) | - |
| Current year claims for compensation | 1.8 | (442,120) | | - | | - | (442,120) | (484,511) |
| Revaluation of prior year claims for compensation | 1.9 | (82,188) | | - | | - | (82,188) | - |
| **Net Cost of claims** | | **(529,742)** | | **-** | | **-** | **(529,742)** | **(484,511)** |
| **Transfers to reserves** | | **-** | | **-** | | **13,092** | **13,092** | **6,838** |
| **NET RESULT FOR YEAR** | | **(266,064)** | | **147** | | **-** | **(265,917)** | **(343,018)** |
| **Net result brought forward** | | **(343,081)** | | **63** | | **-** | **(343,018)** | **-** |
| **Net result carried forward** | | **(609,145)** | | **210** | | **-** | **(608,935)** | **(343,018)** |

### Statement of Total Recognised Gains and Losses

There are no recognised gains or losses other than the net result disclosed above.

The accounting policies and notes on pages 55 to 114 form part of these financial statements.

## The Board of the Pension Protection Fund

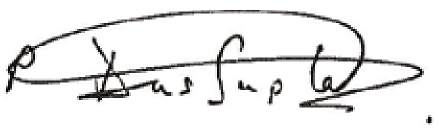
## Balance Sheet as at 31 March 2007

| **All amounts in £000s** | **Pension Protection Fund** | | **Fraud Compensation Fund** | | **Administration Fund** | | **Total Funds** | **Total Funds** |
|---|---|---|---|---|---|---|---|---|
| | Notes | Appendix 1 | Notes | Appendix 2 | Notes | Appendix 3 | As at 31 March 2007 | As at 31 March 2006 |
| **Fixed assets** | | - | | - | 3.5 | 2,532 | **2,532** | **1,805** |
| **Total investment assets** | 1.10 | **716,903** | 2.7 | **3,144** | | - | **720,047** | **88,189** |
| Cash | 1.11a | 26,861 | 2.8a | 3 | 3.6a | 374 | 27,238 | 20,262 |
| Levy debtors | 1.11b | 71,849 | | - | | - | 71,849 | 39,223 |
| Transfer-in debtors | 1.11c | 23,095 | | - | | - | 23,095 | - |
| Other current assets | 1.11d | 2,534 | 2.8b | - | 3.6b | 38 | 2,572 | 26 |
| Current liabilities | 1.11e | (5,728) | 2.8c | - | 3.6c | (3,140) | (8,868) | (1,346) |
| **Net current assets/(liabilities)** | | **118,611** | | **3** | | **(2,728)** | **115,886** | **58,165** |
| **Total assets less current liabilities** | | 835,514 | | 3,147 | | (196) | 838,465 | 148,159 |
| **Non-current liabilities** | 1.12 | | | | | | | |
| Actuarial liabilities | | (536,166) | | - | | - | (536,166) | - |
| Claims provisions | | (908,493) | | - | | - | (908,493) | (484,511) |
| **Total Non-current liabilities** | | **(1,444,659)** | | **-** | | **-** | **(1,444,659)** | **(484,511)** |
| **TOTAL NET ASSETS/(LIABILITIES)** | | **(609,145)** | | **3,147** | | **(196)** | **(606,194)** | **(336,352)** |
| **Represented by:** | | | | | | | | |
| Net result carried forward | | (609,145) | | 210 | | - | (608,935) | (343,018) |
| Revaluation and other reserves | | - | 2.9 | 2,937 | 3.7 | (196) | 2,741 | 6,666 |
| **TOTAL LEVY PAYERS' FUNDS** | | **(609,145)** | | **3,147** | | **(196)** | **(606,194)** | **(336,352)** |

The accounting policies and notes on pages 55 to 114 form part of these financial statements.

The Board of the Pension Protection Fund approved these accounts on 17 October 2007 and authorised the Accounting Officer to sign this Balance Sheet on the same date.

**Partha Dasgupta**
Accounting Officer



17 October 2007

## 6.4 Financial statements contd

### The Board of the Pension Protection Fund

### Cash flow statement for the period 1 April 2006 to 31 March 2007

| All amounts in £000s | Pension Protection Fund | Fraud Compensation Fund | Administration Fund | Total Funds<br>Year ended 31 March 2007 | Total Funds<br>Period from 6 April 2005 to 31 March 2006 |
|---|---|---|---|---|---|
| **CASH FLOW STATEMENT** | | | | | |
| **Cash balance at start of period** | **17,079** | **11** | **3,172** | **20,262** | **2,943** |
| Cash flow from operating activities | 252,610 | (22) | (743) | 251,845 | 102,668 |
| Cash transfers from/(to) Fund Managers | (242,828) | 14 | - | (242,814) | (85,011) |
| Capital expenditure | - | - | (2,055) | (2,055) | (338) |
| **Net cash flow** | **9,782** | **(8)** | **(2,798)** | **6,976** | **17,319** |
| **Cash balance at end of period** | **26,861** | **3** | **374** | **27,238** | **20,262** |
| **Reconciliation of the operating surplus/(deficit) to the cash flow from operating activities** | | | | | |
| Operating surplus/(deficit) | 270,244 | - | (13,156) | 257,088 | 130,991 |
| Compensation payments | (1,402) | - | - | (1,402) | - |
| Assets from schemes transferring into the PPF receivable as cash | 36,251 | - | - | 36,251 | - |
| Financing from DWP | - | - | 10,011 | 10,011 | 8,991 |
| Items reported in “Investment return” but settled through operating bank accounts | 93 | 1 | 64 | 158 | 486 |
| Depreciation and impairment | - | - | 484 | 484 | 109 |
| Movement in current liabilities | 5,668 | (23) | 1,877 | 7,522 | 1,304 |
| Movement in other debtors | (58,244) | - | (23) | (58,267) | (39,213) |
| Cash flow from operating activities | 252,610 | (22) | (743) | 251,845 | 102,668 |

## 6.4 Financial statements contd

### General accounting policies

#### a) Basis of preparation

These accounts are prepared in accordance with the Accounts Direction dated 20 September 2006 given to the Board of the Pension Protection Fund by the Secretary of State, with the approval of the Treasury, in accordance with the Pensions Act 2004 (Schedule 5, Part 4, Paragraph 22 (2) (b)). It requires the Board's accounts to give a true and fair view of the income and expenditure, total recognised gains and losses and cash flows for the financial year, and the state of affairs at the year end. It requires the Board to prepare accounts in accordance with the Government Financial Reporting Manual. This Manual in turn requires accounts to be produced on an accruals basis following, as far as appropriate, private sector practice based on generally accepted accounting practice in the United Kingdom (UK GAAP), i.e. the requirements of the Companies Act and on the accounting standards issued or adopted by the Accounting Standards Board, including, where appropriate, Statements of Recommended Practice (SORPs).

These financial statements have been prepared on an historical cost basis, modified to account for the revaluation of fixed assets and investments.

The specific accounting policies adopted by the Board in order to comply with these requirements include the following:

#### b) Segmental reporting

The Board of the Pension Protection Fund was created by the Pensions Act 2004 and this Act specifies that the Board must hold, manage and apply two ring-fenced funds:

- The Pension Protection Fund; and
- The Fraud Compensation Fund.

Additionally, as a separate statutory corporate body, the Board is responsible for the management and control of its own administration functions, funded by grant in aid from DWP.

The Board have therefore adopted an accounting policy in compliance with SSAP25 which presents the financial transactions and balances of these three separate streams of activity in a coordinated set of primary statements in a columnar format. An aggregate total is also presented in order to indicate the total value of the transactions and balances for which the Board is responsible.

However, to assist users of the accounts to navigate to their areas of particular interest, an appendix to the accounts is then devoted to each of the three segments described above, which consists of the accounting policies and detailed notes relating only to that segment.

#### c) Accruals basis

All items of income and expenditure are accounted for on an accruals basis. The application of this general policy to specific items of income and expenditure is detailed in the notes for that specific item within the appendix devoted to the relevant segment.

#### d) Going concern

These accounts have been prepared on a going concern basis.

## 6.4 Financial statements contd

### e) Related parties

The Board considers the following to be related parties for the purposes of these accounts:

a) Individual Board members and staff;

b) The Department for Work and Pensions, to whom the Board is accountable as a Public Corporation for the achievement of a number of pensions policy objectives;

c) The Pensions Regulator, a Non-Departmental Public Body, also accountable to the Department for Work and Pensions, with whom the Board shares certain pensions policy objectives.

Transactions with these parties are discussed below.

a) Transactions relating to the remuneration of individual Board members and staff are disclosed in Note 3.3a and in the Remuneration Report section of the Annual Report. There were no transactions other than the payment of salaries and expenses during the accounting period.

   Michael Deakin, a Non-executive member of the Board and Chair of the Investment Committee, was formerly Chief Investment Officer and an Executive Director of Insight Investment Management. In order to avoid any potential conflict of interest, Mr Deakin took no part in the decisions to appoint Insight Investment Management as fund managers to the Pension Protection Fund and the Fraud Compensation Fund, and takes no part in reviews of their performance and in negotiating contractual arrangements with Insight.

b) Transactions relating to the provision of funding to the Board to cover its operating expenses by the Department for Work and Pensions through the grant-in-aid process, and the related Administration Levy, are disclosed in Note 3.2.

   Expenditure incurred by DWP in establishing the Board and its functions prior to the Pension Protection Fund opening for business on 6 April 2005 is also discussed in Note 3.2. In particular, the information and communication technology (ICT) assets acquired by DWP as part of this establishment project, and brought into use by the Board on 6 April 2005, are disclosed in Note 3.5.

   The Board has also been able to procure goods and services at discounted rates by having access to central purchasing arrangements managed by DWP's Commercial Policy and Procurement Division and by the Office for Government Commerce. It is not practical to quantify the value-for-money benefit to the Board from these arrangements.

   Of the accommodation costs disclosed in Note 3.3b, £564,000 (period to 31 March 2006: £388,000) was payable to the Estates Division of DWP who manage the facility occupied by the Board and its staff and through whom all related facilities costs, including rent, rates and property service charges, are routed. DWP Estates also provided project management services for the fitting out of additional office accommodation for the Board's staff in the first quarter of 2007. DWP Estates charge no explicit fee for these property and project management services.

c) As set out in Note 1.2, protection levies for the levy year 2005/06 were calculated, billed and collected on the Board's behalf by the Pensions Regulator. As disclosed in Note 3.3b the Board has contributed £60,000 (period to 31 March 2006: £190,000) to the Pensions Regulator's ongoing costs of carrying out these data collection, data processing, billing and collection activities.

## 6.4 **Financial statements** contd

### f) Whole of Government Accounts

HM Treasury is responsible under the Government Resources and Accounts Act 2000 for preparing Whole of Government Accounts for a group of bodies each of which appears to the Treasury to exercise functions of a public nature or to be entirely or substantially funded from public money. The Board of the Pension Protection Fund is not one of these publicly funded bodies and so lies outside of the “Whole of Government Accounts boundary”. The transactions and balances of the Board will not therefore be consolidated into the Whole of Government Accounts. However, in line with best practice set out in the Government Financial Reporting Manual, the Board will disclose separately any of its assets and liabilities (in particular its debtors and creditors) related to entities that, to the best of the Board’s knowledge, lie inside the Whole of Government Accounts boundary.

### g) Post balance sheet events

The Board has carried out a detailed review of events since the balance sheet date, and has incorporated into these financial statements any material adjustments it considered necessary arising from that review, including events with an impact on the valuation of provisions and contingent liabilities in both the Pension Protection Fund and the Fraud Compensation Fund. As far as the Board is aware, at the date of issue of these financial statements, there have been no further material post balance sheet events necessitating adjustment to these financial statements.

The Board’s financial statements are laid before the Houses of Parliament by the Secretary of State of the Department for Work and Pensions.

FRS21 requires the Board of the Pension Protection Fund to disclose the date on which the accounts are authorised for issue. This is the date on which the certified accounts are dispatched by the Board to the Secretary of State of the Department for Work and Pensions.

The authorised date for issue is 22 October 2007.

Appendix 1

# Accounting policies and notes relating to the operation of the Pension Protection Fund for the period 1 April 2006 to 31 March 2007

## Note 1.1 Accounting policies

### a) Recognition of Protection Levy income

Protection Levy income is recognised on an accruals basis, that is, on the basis of the value of levies due in respect of each levy year. This may involve the use of estimation techniques in order to recognise levy income which, for a variety of operational reasons, remains unbilled at the date of preparing the financial statements.

The Board only recognises Protection Levy income where it judges that the scheme's eligibility for pension protection (or, where relevant, the eligibility of the section of the scheme or part of pension scheme membership) is virtually certain. Absolute certainty of eligibility may, in the most complex cases, only be achieved through a legal process, but for practical purposes, the Board considers acceptance by scheme trustees of the eligible status of their scheme (including settling the scheme's Protection Levy invoice) to be sufficient. Where the Board judges that a scheme's eligibility is probably (but not virtually) certain, no income or debtor will be recognised, but the Board will disclose a contingent asset for the value of the levy that is probably receivable.

Where the Board judges that the scheme's eligibility is less than virtually certain (that is, possible or remote) no income or debtor will be recognised, neither will any contingent asset be disclosed.

In certain circumstances, schemes may have paid their Protection Levy invoice whilst they continue to dispute the eligibility status of the scheme (either as a whole or in part). If the Board judges that the scheme's eligibility for pension protection is less than virtually certain, even though the scheme has settled the levy invoice, the Board will establish a creditor for any monies already received.

### b) Investment assets and investment return

Investment assets are included in these accounts at fair value, which is defined as follows:

- Quoted securities and other exchange-traded assets, including derivative contracts, are valued at closing prices, which may be defined as mid-market price or last traded price depending on the convention of the stock exchange or other market on which they are quoted.
- Derivative contracts which are not exchange-traded (often referred to as over-the counter contracts) are valued at prices calculated by the fund managers, using valuation methodologies based on market sources.
- All other assets for which a recognised investment exchange does not exist are valued at a fair value estimated by the appointed custodian, fund manager or other appropriately qualified professional adviser, and approved by the Board.
- Pooled investment vehicles are valued at the average of the closing bid and offer prices (if both prices are published) or, if single-priced, at the closing single price.
- Investments denominated in foreign currency are valued in sterling using the closing spot rates of exchange from a recognised information source.

Investment return is defined as the net total of:

- Investment income earned on invested assets, including interest, dividends and (where appropriate) rental income on properties; plus
- The "change in the fair value of investments" defined above, including gains and losses realised on the disposal of investments; unrealised gains and losses on investments held at the accounting date, that is, the difference between acquisition cost and current market value; and gains and losses arising on the translation of investments (including cash, payables and receivables) denominated in foreign currencies into sterling; less

- Fund management fees and custody charges charged to the Protection Fund, as permitted by the Pension Protection Fund (Payments to meet Investment Costs) Regulations 2005 (SI 2005/1610)
- “Acquisition cost” includes the costs associated with purchase transactions such as brokers’ fees and commissions, and sales proceeds are stated net of the same costs associated with disposal transactions.

Investment income is accounted for on an accruals basis, that is:

- Interest income arising from cash deposits, fixed interest securities and similar investments is accounted for on a daily basis as interest is earned;
- Dividends are accounted for when the dividend is declared, for example, when the quoted security is quoted in its investment exchange as “ex-dividend”;
- Rents are accounted for in accordance with the terms of the relevant leases or other governing documentation.

## c) Actuarial liabilities and changes in value of actuarial liabilities

### i) Actuarial liabilities

The Board recognises the full value of the liabilities of the Fund disclosed in the annual actuarial valuation of the Fund, prepared and signed by the appointed actuary in accordance with the Pensions Act 2004 (Schedule 5, Part 4, Paragraph 22 (2)(a)). This represents the present value, as at the balance sheet date, of the liability to pay compensation to the members, both deferred and retired, of all pension schemes in respect of which Transfer Notices have been issued, valued on the assumptions set out in the actuary’s report.

### ii) Changes in value

The movement in the value of actuarial liabilities arises:

- In the year of Transfer, from the Transfer Notice date to the balance sheet date;
- Subsequently, between the opening and closing balance sheet dates.

The movement in value will be analysed to distinguish between:

- The effects of discounting due to the passage of time;
- The effects of changes in discount rates;
- The effects of changes in actuarial assumptions;
- Other actuarial gains and losses;
- The payment of benefits during the period.

### iii) Recognition of payments of compensation

In order to disclose the effect of the payment of benefits on the actuarial liabilities of the Fund, the Board recognises compensation payments on an accruals basis, with the objective of ensuring that all compensation payments that fall due for payment in the accounting period are taken into account.

For recurring periodic compensation payments, this policy is interpreted as follows:

- The Fund’s usual payment policy is to make recurring compensation payments monthly, on the first day of each calendar month, in advance for that month. If the first calendar day is not a banking day, the payment will usually be brought forward to the last banking day of the previous calendar month, and will be treated in the financial statements as a prepayment.

- If the payment of periodic compensation to any individual member due in respect of periods within the accounting period is delayed until after the end of the accounting period, the compensation due up to the accounting date will be accrued as a current liability.
- Any overpayments of periodic compensation, including overpayments made by trustees that they have not been able to recover, will be accounted for as a current debtor.

For lump sum compensation payments, this policy is interpreted as follows:

- Where the member has a choice about the form in which to take compensation, the liability to pay compensation does not arise before the choice is made; for example, if the member on retirement is entitled to either full compensation or a lump sum plus reduced compensation (including total commutation of a trivial compensation amount), and has reached retirement date before the end of the accounting period but as at the accounting date has not made his choice, then there is no liability at the accounting date to pay any lump sum. Any compensation (at the unreduced rate) due in respect of periods within the accounting period remaining unpaid at the accounting date will be accrued as a current liability.
- For a member with less than 3 months' service at their scheme's assessment date with no relevant accrued rights but with a right under the scheme rules to a contribution refund or transfer payment, the member is entitled to compensation by way of a lump sum payable to the member at a rate of 90% of his contribution payments or a transfer payment at a rate of 90%. The refund should be accounted for as at the effective date of the Transfer Notice, and the transfer value only when the member has completed all the necessary consents and approvals and has irrevocably instructed the Fund to make the payment.

### d) Money purchase assets and benefits

Where the Fund inherits the liability to discharge money purchase benefits which the trustees of a pension scheme have been unable to settle prior to the effective date of the Transfer Notice, the Board will account for the money purchase assets transferred to the Fund, and will also account for the liability to discharge the money purchase benefits.

### e) Provisions and contingent liabilities for claims

The Board recognises provisions for claims in respect of schemes where eventual entry into the Protection Fund is judged probable, and discloses contingent liabilities for claims in respect of schemes where eventual entry into the Protection Fund is judged possible. No liability is recognised or disclosed for claims in respect of schemes where eventual entry into the Protection Fund is judged unlikely. In all cases, the liability is valued at the net deficit impacting the Protection Fund, that is, scheme liabilities valued at protected benefit levels, net of assets under the scheme trustees' control, including asset recoveries from insolvent employers. Each element of this process is discussed in greater detail below.

#### i) Population of schemes

When considering provisions and contingent liabilities for claims on the Protection Fund, the Board reviews schemes in the following categories:

1. Schemes remaining in an Assessment Period at the Fund's accounting date;
2. Schemes accepted into an Assessment Period in the post year end period, where the date of employer insolvency (and hence the effective date of the commencement of an assessment period, the "Assessment Date") was prior to the Fund's accounting date;
3. Schemes accepted into an Assessment Period in the post year end period, up to the date of approval of the actuarial report, where the Assessment Date was after the Fund's accounting date;
4. Schemes in respect of which a notice of employer insolvency has been received by the Board but which the Board has not been able to validate up to the date of approval of the actuarial report, regardless of the date of employer insolvency;

5. Schemes where no notice of employer insolvency has yet been received but where, based on the Board's specific knowledge of circumstances prevailing at the accounting date, entry into Assessment is considered likely in the foreseeable future;
6. Schemes associated with employers with the lowest failure scores (and hence the highest risk of insolvency in the foreseeable future) as measured by the Board's independent insolvency risk measurer, Dun & Bradstreet.

The Board also reviews the requirement for a reserve for claims incurred but not reported ("IBNR reserve") which, by definition, cannot be associated with individual schemes.

**ii) Likelihood**

Having established the population of schemes which it needs to consider for the purposes of setting up provisions and disclosing contingent liabilities, the Board then considers claims information on those schemes in order to reach judgements on the likelihood of schemes' eventual entry into the Protection Fund. The following guidelines apply to these considerations:

Schemes judged **"probable"** for eventual entry include:

1. Schemes in Assessment for which a Scheme Failure Notice has been validated;
2. i Schemes in Assessment at the accounting date for which no Scheme Failure Notice has yet been received;

   ii schemes accepted into Assessment after the accounting date but where the effective Assessment Date is within the accounting period;

   iii and schemes, in respect of whose employer a Notice of Insolvency had been received but not validated up to the date of approval of the actuarial report, but where the potential effective Assessment Date would be within the accounting period;

in all cases:

- where there is no reliable evidence that a scheme rescue will occur; and
- in respect of which current estimates of the protected liabilities as at the Assessment Date are in excess of current estimates of scheme assets (including any recoveries from insolvent employers) at the Assessment Date; and
- where those estimates of assets and liabilities are believed to be reliable. Where no reliable estimates are available, the values involved would be considered as contingent liabilities.

Schemes judged **"possible"** for eventual entry include:

1. Schemes accepted into Assessment after the accounting date and schemes, in respect of whose employer a Notice of Insolvency had been received but not validated up to the date of approval of the actuarial report, where the employer insolvency event occurred after the accounting date and where there is no evidence either that a scheme rescue may occur or that scheme assets (including any recoveries from insolvent employers) as at the assessment date are adequate to meet protected liabilities valued at the assessment date;
2. Schemes, in respect of whose employer no Notice of Insolvency has been received up to the date of approval of the actuarial report, but where there is reason to believe that entry into Assessment is likely in the foreseeable future, and in respect of which current estimates of the protected liabilities as at the accounting date are in excess of current estimates of scheme assets (including any recoveries from insolvent employers) at the accounting date.

Schemes judged **"unlikely"** eventually to enter the Protection Fund include:

1. Schemes in respect of which there is reliable evidence that a scheme rescue will occur;
2. Schemes in respect of which current estimates of scheme assets at the Assessment Date (including any recoveries from insolvent employers) are in excess of current estimates of the protected liabilities at the Assessment Date.

**iii) Materiality**

Recognising the desirability of minimising the administrative burden on schemes in (or being considered for entry into) Assessment, the Board has decided to classify schemes into material and non-material schemes, according to the following criteria for material schemes:

- the scheme's MFR liabilities according to the latest MFR valuation exceeded £15 million, or
- the scheme's protected liabilities according to the latest valuation prepared under either section 179 or section 143 of the Pensions Act 2004 exceeded £30 million,
- and with an overriding requirement that at least 65% in aggregate of the Fund's liabilities generating provisions must relate to material schemes.

For material schemes, additional specific information on scheme assets and liabilities was sought, as described in paragraphs iv) 1 and vi) 1 below. For non-material schemes, robust estimation techniques were developed to enable existing information on scheme assets and liabilities to be used without the need to place additional burdens on scheme trustees to provide further detailed information. These techniques are described in paragraphs iv) 2 and vi) 2 below.

**iv) Scheme assets**

Pension scheme assets will be valued in the deficit calculations described above in ways consistent with the valuation policies for the Fund's own investments, which are also consistent with the valuation policies used in the accounts of pension schemes themselves, as set out in the Statement of Recommended Practice "Financial Reports of Pension Schemes". Scheme asset information has been captured in the following ways:

1. For schemes which are considered material to the Fund's liabilities, actual asset information at the Fund's accounting date has been obtained from scheme trustees and used in the calculations;
2. For schemes which are not considered material to the Fund's liabilities, scheme asset information has been extracted from other information readily available to the Board, such as the latest actuarial valuation or audited scheme accounts. These asset values have then been indexed forward to the Fund's accounting date using generally accepted investment return indices appropriate to the asset classes in which the schemes' investments are held. Further adjustments are then made to allow for benefit payments between the valuation date and the Fund's accounting date using assumptions consistent with those used to estimate scheme liabilities. The Board consulted in June 2006 with the actuarial profession on the methodology for making these adjustments.

**v) Asset recoveries from insolvent employers**

The experiencing by an employer of an insolvency event may trigger the right for trustees to claim the debt due to a scheme under section 75 of the Pensions Act 1995 (deficiencies in scheme assets). These may be unsecured or secured by charges over other employer assets such as real estate or machinery and equipment. These claims may also entitle trustees to be party to negotiations relating to the reconstruction, re-financing or acquisition by a third party of the employer's business, out of which trustees may acquire assets such as a shareholding in the reconstructed company. Under section 137 of the Pensions Act 2004, these rights to pursue debts and to acquire assets are exercisable by the Board. The Board's policy for recognising these recoverable assets is to take them into account when assessing the net deficit of schemes in the categories described in paragraph e(i) above.

The Board's policy for valuing these recoverable assets is guided by the principle of prudence. Specifically:

1. Unsecured claims recoverable as cash out of the liquidation of the employer company will be valued at the amount assessed by the Board to be recoverable as dividends from the liquidation (adjusted as necessary to account for the time value of money over the projected future period of dividend distributions). The Board's assessment of recoverable amounts will be based on available evidence. For example, where the liquidator has not yet made any dividend distributions nor produced any estimate of likely dividends, the Board assesses the recoverable value as nil. Where a liquidator has produced an estimate of likely dividends, the Board will test this estimate against any history of actual dividend distributions to assess its probable accuracy. Where a liquidator has produced a range of estimates of likely dividends, the Board assesses the recoverable value using the lowest value in the range.
2. Secured claims will be valued by the Board at the full face value of the claim, provided the Board is satisfied that the value of the security at least covers the claim value. If the Board assesses the value of the security as less than the face value of the claim, it will provide against the shortfall.
3. Other assets acquired by the Board on behalf of trustees will be valued at fair value, in compliance with accounting standards or valuation guidelines appropriate to the type of asset, for example:
    - Quoted securities are valued at closing prices, which may be defined as mid-market price or last traded price depending on the convention of the stock exchange or other market on which they are quoted.
    - Unquoted securities including private equity will be valued in accordance with the "International Private Equity and Venture Capital Valuation Guidelines" issued by the British, French and European venture capital associations. These guidelines emphasise the evidence base required to produce reliable valuations, for example, the enterprise's value implied by a history of dividend payments; the net asset value from the latest audited accounts; the value of recent share dealings, adjusted to take account of the non-open market nature of those dealings; or (for recent acquisitions) the acquisition cost. Where the Board uses acquisition cost to value these assets, the value will normally be assessed at nil, since no explicit purchase price has been paid to acquire the asset.

**vi) Scheme liabilities**

Scheme liabilities are taken into account in assessing the net deficits of schemes in the categories described in paragraph e(i) above at the net present value, at the Fund's accounting date, assessed by the Fund's appointed actuary as being the realistic cost of settling the liabilities for compensation on a continuing basis from the Fund as a going concern. This realistic cost of settlement includes where relevant the impact of the use of scheme-specific factors (for example, mortality rates) where the Board has reliable evidence from the scheme trustees or their advisers that this has generated a more accurate and robust valuation than the use of generic factors. This cost will therefore not be the same value as the liabilities disclosed in actuarial valuations obtained under s143 of the Pensions Act 2004 ("valuation of assets and protected liabilities") nor as disclosed in valuations obtained under s179 of the Act ("valuations to determine scheme underfunding").

It should also be noted that the criterion for accepting a scheme into the Fund involves comparing scheme assets with protected liabilities at the Assessment Date. Provisions may therefore be recognised (or contingent liabilities disclosed) in respect of schemes where protected liabilities valued on a statutory basis are estimated to exceed assets at the Assessment Date, but where differential movements in asset and liability values mean that assets are estimated to exceed protected liabilities valued on a realistic basis at the accounting date. The aggregate deficit for schemes in (or likely to enter) Assessment recognised as provisions (or disclosed as contingent liabilities) may therefore include values for individual schemes "in surplus" at the accounting date.

Consistent with its desire to minimise the administrative burden on schemes in (or being considered for entry into) Assessment, the Board has decided to use liability information already in existence or generated by trustees and their actuaries for other purposes, such as Minimum Funding Requirement valuations, or valuations under s143 or s179 of the Act. Methodologies have been developed in consultation with the actuarial profession (and quality-assured by the Government Actuary's Department) for transforming liability information produced for MFR, s143 or s179 purposes at past dates into liability values on the Fund's own realistic basis at the Fund's accounting date. This transformation is then supplemented as follows:

1. For schemes which are considered material to the Fund's liabilities, further liability information has been obtained from scheme trustees, such as details of changes to benefit designs, material changes to the membership, and significant benefit payments or bulk transfers between the scheme's valuation date and the Fund's accounting date, and used in the calculations;
2. For schemes which are not considered material to the Fund's liabilities, further adjustments may then be made to allow for benefit payments between the valuation date and the Fund's accounting date using assumptions consistent with those used to estimate scheme assets. The Board consulted in June 2006 with the actuarial profession on the methodology for making these adjustments.

### f) Current assets

Current assets arise as a consequence of the accruals basis of accounting for income and expenditure, to ensure all income (for example, protection levies due in respect of periods ending on or before the accounting date) which had not been received by the accounting date, are disclosed within the Board's accounts. Similarly, items of expenditure paid in advance of the due date (for example, compensation payments) will be accounted for as prepayments.

Only debtors which are virtually certain of recovery will be accounted for as assets. The application of this policy to protection levy debtors is described in Note 1.1a.

The application of this policy to debts representing assets recoverable for the previous sponsoring employers of pension schemes which have transferred into the Pension Protection Fund is as follows:

- Only debts (or those portions of debts) which are virtually certain of recovery (including if appropriate by legal enforcement) will be recognised;
- Debts that are recognised will be valued consistently with the valuation policies set out in Note 1.1e(v) which governs the valuation of these assets prior to transfer to the Pension Protection Fund.

### g) Current liabilities

Current liabilities arise as a consequence of the accruals basis of accounting for income and expenditure, to ensure all liabilities (for example, for compensation payments or for investment management expenses) falling due on or before the accounting date which had not been settled by the accounting date are disclosed within the Board's accounts.

### h) Impact of the issue of Transfer Notices

Schemes may exit the PPF Assessment process through the Board issuing a Transfer Notice under section 160 of the Pensions Act 2004. This Notice has the effect of the Board assuming responsibility for the scheme, so that all the property, rights and liabilities of the scheme are transferred to the Board. The following accounting policies apply to this transfer of assets and liabilities:

- Investment assets are transferred to the legal ownership of the Board at fair value as at the effective date of the Transfer Notice. "Fair value" carries the same meaning as in Note 1.1b governing the valuation of the Board's investment assets.
- Asset recoveries from insolvent employers are recognised where the Board judges that the assets are virtually certain of recovery, and are valued using the same policies set out in Note 1.1e(v), governing the valuation of the same assets prior to transfer to the PPF. In appropriate circumstances, the Board will also disclose contingent assets in respect of recoveries which are less than virtually certain of recovery.
- Current assets and current liabilities are transferred to the Board at fair value using the accruals basis of accounting. Debtors which are virtually certain of recovery are recognised; creditors are recognised on an accruals basis including, for example, all outstanding fees to trustees, actuaries, auditors, administrators and other advisers for work commissioned prior to transfer and necessary to complete the transfer of the scheme to the PPF and its subsequent winding-up.

- Actuarial liabilities are transferred to the Board as at the effective date of the Transfer Notice and are valued using the same policies set out in Note 1.1e(vi), that is, as assessed by the Board's appointed actuary as being the realistic cost of settling the liabilities for compensation on a continuing basis from the Fund as a going concern.
- Where the net deficit of a transferring-in scheme has been provided for at the previous balance sheet date, changes in the value of the deficit due to changes in the value of the scheme's assets and liabilities up to the effective date of the Transfer Notice are accounted for as "revaluation of prior year claims".

## Note 1.2 Income from levies

Income from protection levies derives from:

| | Notes | Year ended 31 March 2007 | Period 6 April 2005 to 31 March 2006 |
|---|---|---|---|
| | | £000s | £000s |
| Initial levy in respect of 2005/06 | i | (852) | 138,043 |
| Risk-based levies in respect of 2006/07 | ii | 162,553 | - |
| Scheme-based levies in respect of 2006/07 | ii | 108,554 | - |
| **Total income from protection levies** | | **270,255** | **138,043** |

### i) Initial levy

In respect of the levy year 2005/06 an Initial Levy is chargeable to eligible pension schemes, calculated on standard per capita rates for different categories of members (active, deferred, retired etc.).

Billing and collection activities in respect of the Initial Levy are administered on the Board's behalf by the Pensions Regulator under the provisions of s181 of the Pensions Act 2004 and have continued throughout 2006/07. The Board's accounts therefore continue to place significant reliance on the levy accounting records of the Pensions Regulator and the control environment in which its levy calculation, billing and collection activities are undertaken. The Board has received appropriate assurances from the Pensions Regulator as to the effectiveness of controls over these processes. The Board has supplemented these assurances with its own controls over the transfer of levy receipts from the Pensions Regulator to the Board and the reconciliation of transfers to the records of levy collections.

Initial Levy income was accounted for in the prior year financial statements on an accruals basis, that is, by recognising the then best estimate of the levy to be collected in respect of 2005/06, net of provisions for bad debts and levies deemed to be uncollectible. The Initial Levy income disclosed in the current year financial statements reflect adjustments to this estimate following resolution of a wide variety of issues, such as eligibility for pension protection, and accuracy of membership statistics. The resolution of these issues has resulted in the issue of credit notes to cancel previously issued invoices; the issue of revised invoices, frequently at lower values than the original invoices, reflecting the lower membership numbers now reported; and the payment of refunds to schemes to correct overpayments; and the issue of new invoices to schemes whose eligibility has been confirmed.

The Board is aware however that a number of Initial Levy issues remain to be resolved, particularly concerning the specific provisions of the PPF Entry Rules and related regulations, and their impact on certain schemes. There is significant disagreement between the trustees (and sponsoring employers) of those schemes and the Board on eligibility for pension protection and hence on their liability to pay protection levies. The Board believes that these issues may only be resolved through binding legal processes and may take considerable time to conclude. If these processes eventually conclude that the schemes involved are liable to pay protection levies, the Board estimates a further £4,398,000 of Initial Levy will be receivable. The Initial Levy income disclosed above includes the impact of setting up a provision for £1,031,000 which may be refundable to schemes should these processes conclude the schemes are ineligible. Where appropriate, the Board has negotiated specific arrangements with the relevant scheme to allow necessary legal processes to continue and to secure that the Board will receive interest on any amounts ultimately found to be payable.

### ii) Risk-based and scheme-based levies

In respect of the levy year 2006/07, protection levies are chargeable to eligible pension schemes incorporating risk-based factors (principally scheme underfunding and employer insolvency risks) and scheme-based factors (principally the value of scheme liabilities). These two separate sets of factors generate separate levies, known as the Risk-based levy ("RBL") and the scheme-based levy ("SBL"). The calculation, billing and collection activities for the 2006/07 levy have been carried out in-house by the Board's staff and are therefore subject to the regime of internal control (including internal audit) described in the Statement on Internal Control in Section 6.2 of these financial statements.

Protection levy income is accounted for in these financial statements on an accruals basis, that is, including amounts billed in respect of the year but after 31 March 2007, and including amounts unbilled at the date of preparing these financial statements. Estimates of amounts unbilled have however only been prepared for schemes where the Board is virtually certain of the schemes' eligibility for pension protection and consequent liability to pay protection levies; accruals of levies chargeable have been set up on a best estimate basis for schemes where only issues such as clarification of scheme and employer data necessary to calculate levies are outstanding.

Similar considerations apply to the 2006/07 levy in respect of specific schemes and the Entry Rules as have been described in respect of the Initial Levy, and may similarly only be resolved through binding legal processes. If these processes eventually conclude that the schemes involved are liable to pay protection levies, the Board estimates a further £5,842,000 of 2006/07 Levy will be receivable; the Board is not aware of any material amounts that would be refundable should these processes conclude the schemes are ineligible. Again, specific arrangements have been made where necessary to allow legal processes to continue and to secure that the Board will receive interest on any amounts ultimately found to be payable.

## Note 1.3 Interest on operating bank account

The bank account operated by the Board for the Pension Protection Fund was interest bearing. The account was used to collect Protection Levy monies, to fund compensation payments to members and to transfer cash to the custodian for investment by the fund managers. Interest was therefore earned on these monies as funds were building up to the required levels for efficient investment by fund managers.

## Note 1.4 Investment income

Investment income earned during the year consists of:

| | **Year ended 31 March 2007** | **Period 6 April 2005 to 31 March 2006** |
|---|---:|---:|
| | £000s | £000s |
| Income arising from: | | |
| UK Government Fixed Interest stocks | 4,443 | 904 |
| UK Government Index linked stocks | 1,083 | 69 |
| Non-UK Government stocks | 6 | 136 |
| Corporate bonds | 362 | 79 |
| Deposit interest | 485 | 386 |
| Other | 302 | 42 |
| **Total investment income** | **6,681** | **1,616** |

## Note 1.5 Change in fair value of investments

The total change in fair value of investments during the year consists of:

| | Year ended 31 March 2007 | Period 6 April 2005 to 31 March 2006 |
|---|---|---|
| | £000s | £000s |
| Arising on: | | |
| Asset classes further analysed in Note 1.10 | (10,074) | 2,025 |
| Other investment assets | (3,237) | (463) |
| **Total change in fair value of investments** | **(13,311)** | **1,562** |

## Note 1.6 Investment expenses

Investment expenses consist of fund management fees and custody charges charged to the Protection Fund, as permitted by the Pension Protection Fund (Payments to meet Investment Costs) Regulations 2005 (SI 2005/1610).

## Note 1.7 Gains/losses on actuarial liabilities

As this is the first year in which the Fund has accepted transfers of scheme liabilities, the gains/losses on actuarial liabilities represents the change in value of those liabilities from the schemes' Transfer Notice dates to the balance sheet date. It can be analysed as follows:

| | Year ended 31 March 2007 |
|---|---|
| | £000s |
| Gain/(loss) arising from: | |
| Effect of discounting due to the passage of time | (803) |
| Changes in discount rates | (54,203) |
| Changes in mortality assumptions | (30,780) |
| Other actuarial gains and losses | 80,352 |
| **Total net loss on actuarial liabilities** | **(5,434)** |

## Note 1.8 Current year claims for compensation

The claims value recognised consists of the aggregate value, as at 31 March 2007, of provisions for schemes where eventual entry into the Fund is considered probable, and where reliable estimates can be made of the impact on the Fund, in accordance with the policies and processes set out in Note 1.1e, where the Board has reached the judgment in the current year that the schemes are likely to enter the Fund in the future.

New claims in respect of 90 schemes (prior period: 98 schemes) have been valued as follows:

| | Year ended 31 March 2007 | Period 6 April 2005 to 31 March 2006 |
|---|---|---|
| | £000s | £000s |
| Scheme assets | 2,133,380 | 1,878,757 |
| Asset recoveries | 60,301 | 65,843 |
| Protected liabilities | (2,635,801) | (2,429,111) |
| **Net deficit** | **(442,120)** | **(484,511)** |

Readers should refer to the Actuary's Supplementary Report as at 31 March 2007, in particular Annexes S6 and S7, for further detailed information on the calculation of these provisions.

## Note 1.9 Revaluation of prior year claims

The total revaluation of prior claims charged to the operating statement can be analysed as follows:

| | Notes | Year ended 31 March 2007 |
|---|---|---|
| | | £000s |
| Release of provisions no longer considered necessary | | 749 |
| Revaluation of provisions brought forward from the previous year end | a | (133,987) |
| Changes in provisions for schemes transferring into the Fund during the year | b | 51,050 |
| **Total revaluation of prior year claims** | | **(82,188)** |

### a) Revaluation of provisions brought forward from the previous year end

Of the 98 schemes for which provisions were created as at 31 March 2006, 9 schemes were transferred into the Protection Fund during the year, while provisions in respect of a further 9 schemes have been released as they are no longer considered necessary. The Board considers that the remaining 80 schemes are still likely to enter the Fund in the future and has therefore retained the associated provisions, and revalued them to 31 March 2007. The revaluation impact can be analysed as follows:

| | **Year ended 31 March 2007** |
|---|---:|
| | £000s |
| Changes in value of scheme assets | (77,960) |
| Changes in value of asset recoveries | (14,045) |
| Changes in value of scheme liabilities | (41,982) |
| **Total changes in provisions for schemes remaining in assessment** | **(133,987)** |

### b) Changes in provisions for schemes transferring into the Fund

During the year 9 schemes transferred into the Protection Fund, in respect of each of which provisions were created as at 31 March 2006. The assets and liabilities of those schemes as at the Transfer Notice dates have been incorporated into the assets and liabilities of the Fund, and the change in provision between 31 March 2006 and the dates of their Transfer Notices is made up as follows:

| | **Year ended 31 March 2007** |
|---|---:|
| | £000s |
| Changes in value of scheme assets | (12,726) |
| Changes in value of asset recoveries | (8,758) |
| Changes in value of scheme liabilities | 72,534 |
| **Total changes in provisions for schemes transferring into the Fund** | **51,050** |

## Note 1.10 Investments

The table below details the purchases, sales, and realised and unrealised gains or losses achieved by the Fund's appointed investment managers, categorised by asset class. It also includes the value of invested assets transferred in in-specie from schemes transferring into the Pension Protection Fund as a result of the issue of Transfer Notices on the completion by the schemes involved of an Assessment Period.

| All amounts in £000s | Market Value as at 1/4/2006 | Asset transfers | Purchases | Sales | Gain/ (Loss) | Market Value as at 31/3/2007 |
|---|---|---|---|---|---|---|
| **Investments** | | | | | | |
| UK Government Bonds | 57,488 | 90,316 | 378,050 | (372,633) | (6,473) | 146,748 |
| UK Government Index Linked Bonds | 28,937 | | 84,763 | (100,542) | (546) | 12,612 |
| Non-UK Government Bonds | 2,578 | | 228,174 | (29,336) | 3,693 | 205,109 |
| Non-UK Government Index Linked Bonds | 241 | | 5,039 | (2,805) | (167) | 2,308 |
| Mortgage Backed Securities | 5,542 | | 231,960 | (200,307) | (149) | 37,046 |
| UK Corporate | 1,014 | | 2,123 | (2,013) | (104) | 1,020 |
| Non-UK Corporate | 2,440 | | 8,171 | (7,129) | (408) | 3,074 |
| Money market funds | 0 | 136,645 | 587,590 | (543,347) | (7) | 180,881 |
| Interest rate swaps | 563 | (3,479) | 1,001,410 | (1,001,244) | (3,311) | (6,061) |
| Unit trusts and managed funds | 113 | 166,745 | | (102) | 307 | 167,063 |
| Inflation rate swaps | 0 | 3,525 | | | (2,861) | 664 |
| Other | (7) | | 19,132 | (19,191) | (48) | (114) |
| **Total Investments** | **98,909** | **393,752** | **2,546,412** | **(2,278,649)** | **(10,074)** | **750,350** |
| **Other investment assets** | | | | | | |
| Cash deposits (sterling and foreign) | 7,038 | 120 | | | | 7,277 |
| Foreign Exchange contracts | (51) | | | | | 229 |
| Insurance policies | 0 | 795 | | | | 791 |
| Income Receivable | 596 | 890 | | | | 3,923 |
| Amounts payable, net of amounts receivable, for outstanding settlements | (21,315) | | | | | (45,667) |
| **Total other investment assets** | **(13,732)** | **1,805** | | | | **(33,447)** |
| **Total Market Value** | **85,177** | **395,557** | | | | **716,903** |

The portfolios managed by the fund managers were valued as follows:

| £000s | Value at 1 April 2006 | Capital invested | Investment return | Closing value |
|---|---|---|---|---|
| Managed by: | | | | |
| Insight Investment Management | 43,134 | 43,650 | (5,507) | 81,277 |
| PIMCO | 42,043 | 78,650 | 1,172 | 121,865 |
| Goldman Sachs Asset Management | - | 120,528 | (2,111) | 118,417 |
| Transition Account | - | 395,557 | (213) | 395,344 |
| **Total** | **85,177** | **638,385** | **(6,659)** | **716,903** |

Investment return in this table excludes investment expenses and interest on the Fund's operating bank accounts.

## Note 1.11 Net current assets

### a) Cash at Bank

As described in the accounting policy on "Segmental Reporting", the Board of the Pension Protection Fund is responsible for three ring-fenced funds. To improve controls over the three funds and ensure that only allowable items of income and expenditure are transacted within each fund, the Board has opened separate bank accounts for the three funds. The Pension Protection Fund account is used to collect the Protection Levy and to transfer cash to the custodian for investment by the fund managers. It is also used for processing compensation payments.

All bank accounts are interest bearing, at rates that the Board consider competitive given the operating requirements of the accounts.

### b) Levy debtors

Levy debtors consist of:

| | Notes | As at 31 March 2007 | As at 31 March 2006 |
|---|---|---|---|
| | | £000s | £000s |
| Invoiced debtors for 2006/07 levies | i | 70,580 | - |
| Accrued 2006/07 levies | ii | 447 | - |
| Invoiced debtors for 2005/06 levy (Initial) | iii | 822 | 33,264 |
| Initial levy cash in transit | iv | - | 5,959 |
| **Total other current assets** | | **71,849** | **39,223** |

i Invoiced debtors for 2006/07 levies consist of scheme-based and risk-based levies billed to qualifying pension schemes remaining unpaid at the accounting date. They are stated after allowing for provisions of £2,148,000 for bad debts and levies deemed to be uncollectible.

ii Accrued 2006/07 levies represent the value of scheme-based and risk-based levies due from eligible pension schemes not yet billed as at the accounting date.

iii Initial Levy debtors represent levies billed to qualifying pension schemes remaining unpaid at the accounting date.

iv Cash in transit represents Initial levy money collected by the Pensions Regulator awaiting transfer to the Pension Protection Fund.

The value of debtors that falls inside the Whole of Government Accounts boundary is: nil.

## c) Transfer-in debtors

These debtors consist of:

| | Notes | As at 31 March 2007 |
|---|---|---|
| | | £000s |
| Assets receivable from schemes in respect of which Transfer Notices were issued during the year | i | 8,006 |
| Asset recoveries | ii | 15,089 |
| **Total** | | **23,095** |

i All the assets receivable from schemes in respect of which Transfer Notices were issued during the year were received in the immediate post year-end period.

ii Asset recoveries represent the best estimate of the value of debts and other assets recoverable from the previous sponsoring employers of schemes which have now transferred into the Pension Protection Fund. These assets arise under the operation of Section 75 of the Pensions Act 1995 and associated regulations, and the rights of recovery of these debts and other assets transferred to the Board when the schemes transferred in to the Pension Protection Fund. However, only assets which are virtually certain of recovery are accounted for here as debtors. The Board is aware of further debts arising in the same way where the Board judges that recoverability is less than virtually certain. The Board believes that these situations may only be resolved through binding legal or similar processes and may take considerable time to conclude. If these processes eventually conclude that the assets involved are recoverable, the Board estimates a further £5,408,000 will be recovered.

## d) Other current assets

Other current assets consisted of:

| | Notes | As at 31 March 2007 | As at 31 March 2006 |
|---|---|---|---|
| | | £000s | £000s |
| Money purchase assets awaiting discharge | | 2,066 | - |
| Prepayments of compensation | i | 468 | - |
| Interest receivable | | - | 11 |
| **Total other current assets** | | **2,534** | **11** |

i Prepayment of compensation represents the compensation payroll paid on 30 March 2007, in advance of the due date of 1 April 2007 which was not a banking day.

### e) Current liabilities

Current liabilities consist of:

| | Notes | As at 31 March 2007 | As at 31 March 2006 |
|---|---|---|---|
| | | £000s | £000s |
| Money purchase benefits payable | | 2,066 | - |
| Levy refunds due | | 2.394 | - |
| Compensation payments due | | 795 | - |
| Accruals and other creditors | | 473 | 60 |
| **Total current liabilities** | | **5,728** | **60** |

Accruals and other creditors represent fund management expenses incurred in respect of the year and outstanding at the accounting date.

The value of creditors that falls inside the Whole of Government Accounts boundary is: £nil.

## Note 1.12 Non-current liabilities

| | Notes | As at 31 March 2007 | As at 31 March 2006 |
|---|---|---|---|
| | | £000s | £000s |
| Actuarial liabilities | a | 536,166 | - |
| Provision for claims | b | 908,493 | 484,511 |
| | | **1,444,659** | **484,511** |

### a) Actuarial liabilities

During the year to 31 March 2007, the Pension Protection Fund accepted 9 schemes into the Protection Fund, and the value of actuarial liabilities disclosed here is the aggregate value of the actuarial liabilities for the members of those schemes, now beneficiaries of the Protection Fund, at 31 March 2007. It is made up as follows:

| | Year ended 31 March 2007 |
|---|---|
| | £000s |
| Actuarial liabilities at dates of Transfer | 532,134 |
| Actuarial losses (see note 1.7) | 5,434 |
| Benefits paid since transfer | (1,402) |
| **Total actuarial liabilities** | **536,166** |

### b) Provisions for claims on the Pension Protection Fund

As at 31 March 2007, the Pension Protection Fund recognises provisions in respect of 170 pension schemes (31 March 2006: 98) where the Board considers that eventual entry into the Fund is probable (as defined in Note 1.1e(ii)), and where reliable estimates of the difference between those schemes' protected liabilities and assets (including any recoveries from insolvent employers) can be made (as defined in Note 1.1e(iv) to (vi)). The total value of provisions also includes an amount of £6,041,000 to provide for claims incurred but not reported (IBNR reserve) following a review of statistical information on the reporting of insolvency events to the Board by insolvency practitioners. Notes 1.8 and 1.9 give further detail of how these values were arrived at.

The aggregate value of provisions can be analysed as follows:

| | Year ended 31 March 2007 |
|---|---:|
| | £000s |
| Claims provisions at 31 March 2006 | 484,511 |
| Release of provisions for schemes transferring into the Protection Fund | (151,376) |
| Release of provisions for schemes no longer considered probable for entry | (749) |
| Revaluation of remaining provisions (see note 1.9a) | 133,987 |
| New claims arising | 442,120 |
| **Total Claims Provisions** | **908,493** |

## Note 1.13 Contingent assets and contingent liabilities

As described in Note 1.2, the Pension Protection Fund discloses contingent assets of £10,240,000 relating to initial and protection levies which may be due from pension schemes depending on the outcome of the consideration of their eligibility for pension protection and hence their liability to pay protection levies.

As further described in Note 1.11c(ii), the Pension Protection Fund also discloses contingent assets of £5,408,000 relating to assets which may be recoverable from the previous sponsoring employers of schemes which have transferred into the Pension Protection Fund.

As at 31 March 2007, the Pension Protection Fund discloses contingent liabilities in respect of 94 schemes, valued at £201,081,000 (31 March 2006: 113 schemes valued at £482,969,000) where the Board considers that eventual entry into the Fund is possible (that is, the likelihood of entry is less than probable, but higher than remote). The Actuary's Supplementary Report as at 31 March 2007 included in the Annual Report and Accounts classifies these contingent liabilities into 4 types and readers should refer to the Supplementary Report, in particular Appendix S2, for definitions and further detail of these contingent liabilities types.

| **Values in £000s Type of contingent liability** | **Assets** | **Liabilities** | **Net deficit** |
|---|---:|---:|---:|
| 1 | - | - | - |
| 2 | 754 | 2,597 | 1,843 |
| 3 | 279,331 | 318,051 | 38,720 |
| 4 | 704,006 | 864,524 | 160,518 |
| **Total** | **984,091** | **1,185,172** | **201,081** |

## Actuarial valuation of the Pension Protection Fund

**To: The Board of the Pension Protection Fund**

**From: Stephen Rice, Appointed Actuary**

**The actuarial valuation of the Pension Protection Fund as at 31 March 2007**

### 1. Introduction

The Board of the Pension Protection Fund ('the Board') is required by paragraph 22 of schedule 5 to the Pensions Act 2004 to prepare a statement of accounts in respect of each financial year. Each statement of accounts must contain an actuarial valuation of the assets and liabilities of the Pension Protection Fund prepared and signed by the Appointed Actuary.

This is the second actuarial valuation of the Pension Protection Fund. The effective date of this valuation is 31 March 2007 which coincides with the end of the Fund's second financial period. The previous report on the actuarial valuation as at 31 March 2006 was dated 23 October 2006.

At its meeting on 26 April 2006 the Board appointed me to prepare the annual actuarial valuations of the assets and liabilities of the Pension Protection Fund. Accordingly I am addressing this report on the valuation as at 31 March 2007 to the Board. As required by paragraph 22(5) of schedule 5 to the Pensions Act 2004, the Board will be sending a copy of this report, as part of the statement of accounts, to the Secretary of State and also to the Comptroller and Auditor General. No party, apart from the Board, the Secretary of State and the Comptroller and Auditor General, should rely on any part of this report.

This report does not contain advice on the funding of compensation payable from the Pension Protection Fund.

In my view, whilst the Professional Conduct Standards of the Actuarial Profession apply to the preparation of this report, there are no professional practice standards which directly apply.

### 2. Data

In respect of former members of schemes for which the Board assumed responsibility on or before 31 March 2007, individual member data was obtained from Capita (the administrators). I have carried out some overall checks on this data to ensure that it is consistent with the data summaries produced as part of the section 143 (entry) valuation reports. A summary of the data is as follows:

**Deferred pensioners**

| Sex | Number | Average age | Total Accrued Pension revalued to 31 March 2007 (uncapped) (£000s) |
|---|---:|---:|---:|
| Male | 5,007 | 46 | 31,014 |
| Female | 614 | 42 | 2,250 |
| **Total** | **5,621** | **46** | **33,264** |

**Pensioners**

| Status | Sex | Number | Average age | Total Compensation at 31 March 2007 (capped where applicable) (£000s) |
|---|---|---|---|---|
| Members | Male | 1,284 | 58 | 6,007 |
| | Female | 86 | 58 | 271 |
| Dependants (excluding children) | Male | 4 | 47 | 4 |
| | Female | 53 | 54 | 218 |
| Children | Male | 13 | 12 | 32 |
| | Female | 17 | 15 | 40 |
| **Total** | | **1,457** | **57** | **6,572** |

A person who is in receipt of compensation in respect of one tranche of compensation and entitled to compensation beginning after 31 March 2007 in respect of another tranche of pension is included in both tables.

## 3. Compensation

The compensation in respect of former members of schemes for which the Board assumed responsibility on or before 31 March 2007 has been determined in accordance with the provisions of Schedule 7 of the Pensions Act 2004. A summary of the compensation provisions is shown in annex M1.

## 4. Method

In respect of each former member of schemes for which the Board assumed responsibility on or before 31 March 2007, the expected compensation cash flows for each future year are estimated. In estimating each yearly compensation cash flow for each former member, account is taken of the initial amount of compensation or accrued pension, mortality, the Normal Pension Age (NPA) for deferred members, compensation increases and the probability of survivors' compensation being paid.

The resulting yearly compensation cash flows are discounted back to a present value at the valuation date, 31 March 2007, and summed to obtain the actuarial present value of each former member's liability.

No allowance is made for commutation of compensation or retirement before NPA because, even though estimated cash flows would be affected by making allowances, nonetheless these member options are roughly cost-neutral.

The financial and demographic assumptions employed are described briefly in the next section of this report and set out more fully in annex M2.

The sum of all former members' liabilities is the estimated sum required, on the financial and demographic assumptions employed, to meet liabilities that have been transferred to the Board's responsibility.

## 5. Assumptions

In order to estimate future compensation cash flows, it is necessary to make assumptions about the demographics (including future mortality) of the former members of schemes for which the Board assumed responsibility on or before 31 March 2007.

In order to determine the present value of the liabilities in respect of the estimated future compensation cash flows five financial assumptions are made:

- discount rate in deferment (net of revaluation increases in deferment – see annex M1 for a description of these increases),
- discount rate in payment for non-increasing compensation for current pensioners,
- discount rate in payment for non-increasing compensation for future pensioners,
- discount rate in payment for increasing compensation for current pensioners (net of increases in payment – see annex M1 for a description of these increases),
- discount rate in payment for increasing compensation for future pensioners (net of increases in payment – see annex M1 for a description of these increases).

These financial assumptions are derived from zero-coupon swap yield curves. Zero-coupon swaps:

- can be used to match estimated compensation cash-flows with precision, and
- are issued by investment banks where, in the context of full collateralisation, the risk and impact of default is small.

Given this minimal default risk, no reduction to these yields is considered necessary. Also this approach takes no credit in advance for any possible outperformance that may be achieved by the actual assets held in the Pension Protection Fund.

A full description of the assumptions made can be found in annex M2.

I have also carried out a sensitivity analysis in which the effect on the liabilities is shown by changes in certain key assumptions. The results of this analysis may be seen in the supplementary report which I have prepared concerning the provisions of the Pension Protection Fund as at 31 March 2007.

## 6. Value of assets

The value of the Pension Protection Fund assets is determined in accordance with regulations 2, 4 and 5 of the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 (SI 2006/597).

I have adopted the value of the assets of the Fund as stated in the relevant accounts prepared by the Board for the financial period ending on 31 March 2007. I have not adopted either of the adjustments made available by regulations 4 and 5.

Accordingly I have taken the value of the assets of the Pension Protection Fund as at 31 March 2007 as £841,242,000.

This compares with £141,490,000 as at 31 March 2006.

## 7. Value of liabilities

The value of the Pension Protection Fund liabilities is determined in accordance with regulation 3 of the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 (SI 2006/597). This requires that:

(a) the liabilities of the Pension Protection Fund shall be any sums or properties falling to be paid or transferred out of the Fund required to meet liabilities listed in section 173(3) of the Pensions Act 2004; and

(b) the value of a liability shall be the present value of that liability at the valuation date.

The actuarial liabilities in respect of former members of schemes for which the Board assumed responsibility on or before 31 March 2007, on the assumptions described in section 5 and annex M2, are summarised in the table below:

| **Type of member** | **£000s** |
|---|---:|
| Deferred pensioners | 421,860 |
| Pensioners | 114,306 |
| **Total** | **536,166** |

Additionally, according to the relevant accounts prepared by the Board for the financial period ending on 31 March 2007 a sum of £5,728,000 was required, as at 31 March 2007, to meet other liabilities listed in section 173(3) of the Pensions Act 2004 (e.g. in respect of AVC assets that match AVC liabilities yet to be discharged).

Accordingly I have taken the value of the liabilities of the Pension Protection Fund as at 31 March 2007 as £541,894,000.

This compares with £60,000 as at 31 March 2006. All of this £60,000 represented current liabilities; there were no liabilities in respect of former members of schemes for which the Board assumed responsibility on or before 31 March 2006.

A reconciliation between the actuarial liabilities (i.e. the liabilities in respect of former members of schemes for which the Board has assumed responsibility – this excludes the current liabilities) as at 31 March 2007 and those disclosed as at 31 March 2006 (£0) is as follows:

| | **£000s** |
|---|---:|
| Actuarial liabilities at the start of the year (31 March 2006) | 0 |
| Liabilities for schemes entering the PPF (measured at their transfer dates) | 532,134 |
| Compensation amendments | 0 |
| Effect of passage of time on discounting | 803 |
| Actuarial loss due to change in the mortality assumption | 30,780 |
| Actuarial loss due to changes in discount rates | 54,203 |
| Actuarial gain due to compensation increase assumptions changes, data changes and experience being different from what was assumed | (80,352) |
| Benefits paid | (1,402) |
| Actuarial liabilities at the end of the year (31 March 2007) | 536,166 |

## 8. Conclusion

The balance sheet in respect of the assets and liabilities of the Pension Protection Fund determined in accordance with regulation SI 2006/597 is as follows:

| | **£000s** |
|---|---|
| **Assets** | |
| The value of the Pension Protection Fund assets determined in accordance with the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 | 841,242 |
| **Total assets** | **841,242** |
| **Liabilities** | |
| The actuarial liabilities in respect of former members of schemes for which the Board assumed responsibility on or before 31 March 2007 | 536,166 |
| The remaining liabilities under Regulation 3 of the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 | 5,728 |
| **Total liabilities** | **541,894** |
| Surplus – before provisions | 299,348 |
| Assets/Liabilities – before provisions | 155% |

In respect of the Pension Protection Fund as at 31 March 2007, the value of the assets was £841,242,000 and the value of the liabilities (including those in respect of former members of schemes for which the Board assumed responsibility on or before 31 March 2007) was £541,894,000.

The surplus of £299,348,000 in the Pension Protection Fund as at 31 March 2007 needs to be understood in the context of additional pension schemes that had entered into an assessment period, as defined in section 132 of the Pensions Act 2004, with effect from a date on or before 31 March 2007. Therefore, in addition to this formal report on the assets and liabilities, I have estimated provisions in respect of the assets, potential recoveries and liabilities of those schemes which, in the Board's judgement, are likely to be transferred into the Pension Protection Fund. These provisions will be shown in the statement of accounts being prepared by the Board for the financial period ending on 31 March 2007.

I have also estimated contingent liabilities as at 31 March 2007 in respect of other pension schemes which, in the Board's judgement, are likely to be transferred into the Pension Protection Fund in the near future. These contingent liabilities will be disclosed in footnotes to the statement of accounts prepared by the Board for the financial period ending on 31 March 2007.

---

**Stephen Rice**
Appointed Actuary

Stephen Rice

Date: 17 October 2007

**Job Title**
Chief Actuary

**Qualification**
Fellow of the Institute of Actuaries

**Employer**
The Board of the Pension Protection Fund

## Annex M1

### Summary of compensation provided by the Pension Protection Fund

Broadly speaking, the Pension Protection Fund provides two levels of compensation:

1. For individuals who have reached their scheme's normal pension age or, irrespective of age, are in receipt of either a survivor's pension or a pension on the grounds of ill health, the Board pays from the Pension Protection Fund – **100% level of compensation**.

   In broad terms and in normal circumstances, this means a starting level of compensation that equates to 100% of the pension in payment immediately before the start of the assessment period, as defined in section 132 of the Pensions Act 2004. This is subject to a review of the rules of the scheme by the Board.

   The part of this compensation that is derived from pensionable service on or after 6 April 1997 will be increased each year in line with the increase in the Retail Prices Index capped at 2.5%.

2. For the majority of people aged below their scheme's normal pension age the Board pays from the Pension Protection Fund – **90% level of compensation**.

   In broad terms and in normal circumstances, this means 90% of the pension an individual had accrued immediately before the assessment date (subject to a review of the rules of the scheme by the Board) plus revaluation in line with the increase in the Retail Prices Index between the assessment date and the commencement of compensation payments (subject to a maximum increase for the whole period calculated by assuming RPI rose by 5% each year). This compensation is subject to an overall cap, which as at 31 March 2007 equates to £26,935.70 at age 65 (the cap is adjusted according to the age at which compensation comes into payment).

   Once compensation is in payment, the part that derives from pensionable service on or after 6 April 1997 will be increased each year in line with the increase in the Retail Prices Index capped at 2.5%.

In addition there is also compensation for certain survivors.

The Board has the power to alter the amount of the levy that it collects to meet its liabilities. Additionally the Board:

- has the power to alter the rates of revaluation and indexation; and
- can recommend to the Secretary of State for Work & Pensions that the percentage of benefits paid as compensation is varied.

## Annex M2

### Assumptions

#### a) Discount rates

I consider that assets that consist of cash plus zero-coupon swaps provide the best match to the Pension Protection Fund liability cash flows. In my opinion, the Pension Protection Fund's Statement of Investment Principles is consistent with this principle, albeit that some extra investment risk is taken in the expectation of outperformance.

I have therefore decided that zero-coupon swap yields should be used to derive the five discount rates required to value the liabilities. The objective was to derive five level discount rates that result in the valuation of members' compensation (with attaching survivors' compensation) broadly equal to the value obtained by using the zero coupon swap curve, the RPI swap curve and the LPI [0, 2.5%] swap curve as at 31 March 2007 to determine and discount future compensation payments.

In carrying out the comparison of the value of liabilities to determine the level discount rates, account was taken of:

- the average age of pensioners and deferred pensioners entitled to non-increasing compensation;
- the average age of pensioners and deferred pensioners entitled to increasing compensation;
- for deferred pensioners, the number of years between their average age and normal pension age.

The net discount rates (described in section 5) determined by our comparison calculations are set out in the following table:

| Net Discount Rate | % p.a. |
|---|---|
| In deferment | 1.3% |
| In payment for non-increasing compensation for current pensioners | 5.0% |
| In payment for non-increasing compensation for deferred pensioners | 4.5% |
| In payment for increasing compensation for current pensioners | 2.6% |
| In payment for increasing compensation for deferred pensioners | 2.1% |

For the pensioner calculation in respect of non-increasing compensation, the value of an immediate annuity (including allowance for survivor's compensation) was calculated by discounting each payment by the swap rate for the term at which the payment was due. The level discount rate was then determined as that which would give the immediate annuity rate equal to the swap rate annuity value.

For increasing compensation, the level of increases to apply in each future year was determined using the LPI [0, 2.5%] swap curve and the amount of each future payment calculated. These payments were then discounted at the swap rate for the term at which the payment was due. As for the non-increasing compensation, the net discount rate was then determined such that it would give an annuity value equal to that calculated using the swap yields.

For the deferred pensioners, the rate of revaluation prior to retirement was determined from the RPI swap curve for the term to normal pension age. For the non-increasing compensation, the payments were then discounted at the swap rate for the term at which the payment was due to calculate the swap rate deferred annuity. The level discount rate in payment and the level pre-retirement gross discount rate are equal as they both relate to payments made at the same term. The discount rate is that which results in a deferred annuity value (allowing for the assumed rate of RPI for revaluation in deferment) equal to the swap rate deferred annuity.

For the increasing compensation, the LPI [0, 2.5%] swap curve is used to determine the level of increase that will apply in payment. The payments were then discounted at the swap rate for the term at which the payment was due, to calculate the swap rate deferred annuity. The level gross discount rate was taken to be equal to that determined for non-increasing compensation and the level net discount rate in payment calculated to give a deferred annuity rate equal to the swap rate deferred annuity.

**b) Mortality**

The assumption for mortality is dependent on the amount of a member's compensation and includes an allowance for future expected improvements in longevity.

- **Current mortality**

  The standard table PCMA00/PCFA00 appropriate to each individual member's year of birth was used and adjusted as follows based on the amount of the member's compensation (or the dependant's compensation, where that was in payment as at 31 March 2007).

| Amount of compensation at age 65 | Males PCMA00 with age rating | Females PCFA00 with age rating |
|---|---|---|
| Less than 25% of the compensation cap | + 3 years | + 1 year |
| Between 25% and 50% of the compensation cap | + 1 year | - 1 year |
| More than 50% of the compensation cap | - 3 years | - 5 years |

  This standard table has been issued by the Continuous Mortality Investigation (CMI) of the UK Actuarial Profession.

  At this early stage in the establishment of the Pension Protection Fund the fund has yet to accumulate its own mortality experience to assist in the setting of the mortality assumptions. The assumptions above have therefore been set prudently having regard to the recent Self-Administered Pension Schemes mortality survey conducted by the Continuous Mortality Investigation of the UK Actuarial Profession.

- **Allowance for improvements**

  The 2006 valuation basis used the medium cohort projection of improvements to mortality rates in addition to the levels of future improvement already contained in the PMA92/PFA92 tables published by the CMI. The medium-cohort projection assumes that additional amounts of improvement experienced in the 1980s by those born around 1926 will continue for a period, tailing off to zero additional improvement by 2020.

  In my opinion, the assumption that the cohort improvements will tail off and cease in 2020 is becoming harder to maintain in the light of recent trends. The alternative long-cohort projection assumes that additional amounts of improvement experienced in the cohort generation will continue beyond 2020, tailing off to zero additional improvement by 2040. This long-cohort projection has been adopted on top of the levels of future improvement contained in the PMA92/PFA92 table.

  Population statistics for actual improvements in mortality rates over time are demonstrated in the table below:

| Actual overall annual rates of mortality improvements | | |
|---|---|---|
| | **Males** | **Females** |
| Last 22 years | 2.0% | 1.3% |
| Last 42 years | 1.5% | 1.3% |
| Last 72 years | 1.2% | 1.2% |
| Analysis relates to England & Wales. Based on comparison of 2002-04 Interim Life Tables with English Life Tables for 1930-32, 1960-62 and 1980-82. | | |

Source: ONS/GAD (April 2007)

  In the light of the evidence in this table regarding the rate of mortality improvements as well as the indications from statistical projections of future mortality, I have additionally considered it appropriate to underpin the rate of each future year's mortality improvements. The improvement trend for males appears to be stronger than that for females. I have decided to underpin the male improvement rate by 1.5% per annum and the female improvement rate by 1.0% per annum.

I recognise that there is an element of subjectivity about mortality assumptions and that different actuaries will come to different conclusions. The appropriate mortality assumption for future valuations will be kept under review.

**c) Proportion married**

For pensioners:

Where there is provision for survivor pensions for relevant partners an assumption consistent with 90% (males) or 80% (females) at normal pension age.

Where there is no provision for survivor pensions for relevant partners other than legal spouses an assumption consistent with 80% (males) or 70% (females) at normal pension age.

For deferred pensioners:

Where there is provision for survivor pensions for relevant partners an assumption, at the assumed date of retirement or earlier death, of 90% (males) or 80% (females).

Where there is no provision for survivor pensions for relevant partners other than legal spouses an assumption, at the assumed date of retirement or earlier death, of 80% (males) or 70% (females).

**d) Age difference between member and dependant**

Females assumed to be 3 years younger than males.

**e) Children's pensions**

No specific additional allowance is included for prospective children's pensions. Children's pensions already in payment are assumed to cease at age 18 or age 23 in accordance with the compensation entitlement.

**f) Administration expenses**

There is no allowance for administration expenses because the Pension Protection Fund's administration expenses are met from the Administration Levy rather than the Fund.

## Actuary's supplementary report as at 31 March 2007

### To: The Board of the Pension Protection Fund

### From: Stephen Rice, Chief Actuary to the Board of the Pension Protection Fund

### Actuarial liabilities, provisions and contingent liabilities of the Pension Protection Fund as at 31 March 2007

### 1. Introduction

The Board of the Pension Protection Fund ("the Board") is required by paragraph 22 of schedule 5 to the Pensions Act 2004 to prepare a statement of accounts in respect of each financial year. Each statement of accounts must contain an actuarial valuation of the assets and liabilities of the Pension Protection Fund. This actuarial valuation is set out in my report to the Board dated 17 October 2007.

The statement of accounts also contains provisions and discloses contingent liabilities that require actuarial estimation. This report contains these estimates. It also contains actuarial balance sheets for the Pension Protection Fund showing actuarial liabilities and provisions in comparison with the corresponding assets. The Board is responsible for the accounting policies, and this report has been prepared within the framework which it has determined.

This report does not contain advice on the funding of compensation payable from the Pension Protection Fund.

In my view, whilst the Professional Conduct Standards of the Actuarial Profession apply to the preparation of this report, there are no professional practice standards which directly apply.

### 2. Provisions

Under Financial Reporting Standard 12 (FRS 12) of the UK Accounting Standards Board, a provision should be recognised when:

- an entity has a present obligation (legal or constructive) as a result of a past event;
- it is probable that a transfer of economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

The application of this requirement in the accounting standard to the Board's statement of accounts as at 31 March 2007 is set out in annex S1.

### 3. Contingent liabilities

Under FRS 12, a contingent liability is not recognised as a liability because it is either:

- a possible obligation (it has not yet been confirmed whether there is an obligation that could lead to a transfer of economic benefits); or
- a present obligation that does not meet the recognition criteria in FRS 12 (i.e. it is not probable that a transfer of economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

A contingent liability should, however, be disclosed if the possibility of an outflow of economic benefit to settle an obligation is more than remote. The application of this requirement in the accounting standard to the Board's statement of accounts for the financial period ending on 31 March 2007 is set out in annex S2.

### 4. Data

The data used for this valuation is summarised in annex S3.

## 5. Compensation provided by the Pension Protection Fund

The compensation provided by the Pension Protection Fund is summarised in annex M1 of my report to the Board dated 17 October 2007.

## 6. Assumptions

Calculations of actuarial liabilities, provisions and contingent liabilities are performed using a single set of assumptions. The assumptions used to calculate the actuarial liabilities are set out in full in my report to the Board dated 17 October 2007.

Some different assumptions are made from these in order to calculate the provisions and contingent liabilities as at 31 March 2007. The differences are shown in annex S4.

We have performed sensitivity analysis by amending the valuation basis in key areas. The assumptions adopted for the sensitivity analysis are shown in annex S5.

To determine whether a provision is required for a scheme it is necessary to determine whether as at the insolvency date the value of the assets was less than the amount of protected liabilities (see annex S1). The assumptions to determine this are derived from market conditions at the date of calculation following the published guidance on undertaking a valuation in accordance with section 179 of the Pensions Act 2004. This guidance is available on the Pension Protection Fund website:

http://www.pensionprotectionfund.org.uk/s179_assumptions_guidance_sep06.pdf

## 7. Method to calculate the actuarial liabilities, provisions and contingent liabilities

a) Actuarial liabilities

The method of calculating the actuarial liabilities is set out in my report to the Board dated 17 October 2007

b) Provisions

The method of calculating the provisions varied according to the data that the Board was holding about the scheme as at 12 September 2007.

- If the Board was in possession of a section 143 or a section 179 valuation, then the established methodology for rolling forward a section 179 valuation from a date earlier than 31 March 2007 to 31 March 2007 was used. This methodology is available in the Pension Protection Levy section of the Pension Protection Fund website:

http://www.pensionprotectionfund.org.uk/s179rollforward_mar07.pdf

- If the Board was not in possession of a section 143 or a section 179 valuation, but did have a Minimum Funding Requirement (MFR) valuation, then the established methodology for rolling forward an MFR valuation from a date earlier than 31 March 2007 to 31 March 2007 was used. This methodology is available in the Pension Protection Levy section of the Pension Protection Fund website:

http://www.pensionprotectionfund.org.uk/mfr_methodology_mar07.pdf

- If the Board was not in possession of any scheme valuation report then that scheme's provision was estimated as the median provision for schemes where data was available.

Updated asset value information (as at 31 March 2007) and cash flow information for the period from the latest section 143, section 179 or MFR valuation (as appropriate) up until 31 March 2007 was sought from certain schemes classified as 'material schemes'. Material schemes are schemes where:

(i) the scheme satisfied the definition of a provision as set out in annex S1; and

(ii) one of the following applied:

1. Where an MFR valuation was used as the basis of the roll-forward and the MFR liabilities at the MFR valuation date were at least £15 million; or
2. Where a section 179 (or section 143) valuation was used as the basis of the roll-forward and the section 179 (or section 143) liabilities at the section 179 (or section 143) valuation date were at least £30 million

In aggregate at least 65% of the total liabilities for the schemes which generate the provisions at 31 March 2007 are treated as material (under test 1 or 2 above).

Where cash flow information was forthcoming from these schemes, this information was used to provide a more precise estimate of the scheme assets and liabilities as at 31 March 2007 than was available solely using the roll-forward methodology. In addition, where a material scheme provided an updated asset value at 31 March 2007 this was used in lieu of a roll-forward asset value.

Where neither of these items was available, the roll-forward methodology was used without adjustment.

c) Contingent liabilities

The method adopted for contingent liabilities was identical to that for provisions except that neither cash flow information nor an updated asset value as at 31 March 2007 were sought.

## 8. Results of the calculations

The results of the calculations of the actuarial liabilities, provisions and contingent liabilities are set out in annex S6. We also show the results as at 31 March 2006 on 'Basis 1' as set out in the Report and Accounts as at 31 March 2006.

It is my opinion that the data collection processes and calculation methods described in section 7 have resulted in calculations that represent a reasonable estimate of provisions and contingent liabilities in aggregate for the Pension Protection Fund. I recognise that the use of summary data and roll-forward methodologies inevitably introduce approximations into the calculations, but I consider they remain appropriate for calculating aggregate provisions and contingent liabilities for the purposes of this Supplementary Report.

## 9. Actuarial Balance Sheets

Annex S7 sets out the actuarial balance sheets for the Pension Protection Fund as at 31 March 2007, including the liabilities of the schemes forming the provisions. For this purpose the liabilities are taken to be:

(a) the present value of the liabilities of the Pension Protection Fund to pay sums or transfer property, as required under section 173(3) of the Pensions Act 2004. This includes the liabilities in respect of compensation to members of schemes for which the Board has assumed responsibility. The total value is taken as £541,894,000, the same figure as was used in my actuarial valuation report of 17 October 2007; and

(b) my estimate of the present value of the liabilities of the schemes forming the provisions, as set out in annex S6 of this report, which amount to £4,482,924,000.

Accordingly I have taken the liabilities of the Pension Protection Fund as at 31 March 2007 as £5,024,818,000.

In the actuarial balance sheets for the Pension Protection Fund as at 31 March 2007, the assets are:

(a) the value of the Pension Protection Fund assets determined in accordance with regulations 2, 4 and 5 of the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 17 October 2007; and

(b) the sum of the estimated values of the assets in the schemes that generated the provisions described in section 2 of this report, plus any anticipated recoveries (£84,815,000); this figure amounts to £3,574,431,000.

Accordingly I have taken the value of the assets of the Pension Protection Fund as at 31 March 2007 as £4,415,673,000

## 10. Reconciliation of the change in the deficit

Annex S8 shows a reconciliation of the opening and closing net deficit of the schemes that generate the provisions.

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**Stephen Rice**
Appointed Actuary

Stephen Rice

Date: 17 October 2007

**Job Title**
Chief Actuary

**Qualification**
Fellow of the Institute of Actuaries

**Employer**
The Board of the Pension Protection Fund

## Annex S1

### Provisions in the Statement of Accounts for the financial period ending on 31 March 2007

The statement of accounts as at 31 March 2007 contains provisions in respect of eligible schemes as defined in section 126 of the Pensions Act 2004 in relation to which:

- an insolvency event notice under section 120 of the Pensions Act 2004 had been received by the Board from an insolvency practitioner on or before12 September 2007,
- the Board had not stated on or before 12 September 2007 that the insolvency event was not a qualifying insolvency event,
- the insolvency date was on or before 31 March 2007,
- a withdrawal notice under section 122(2)(b) of the Pensions Act 2004 had not been received on or before 12 September 2007 (and, in the Board's judgement, is unlikely to be received) from the insolvency practitioner, and
- as at the insolvency date, the value of the assets was, in the Board's judgement (if the scheme had not yet transferred to the PPF), likely to have been less than the amount of the protected liabilities as defined in section 131 of the Pensions Act 2004 (determined on the section 179 basis as at the insolvency date).

Additionally, an allowance for insolvency events that occurred on or before 31 March 2007 that have yet to be reported has also been made. This takes the form of an 'IBNR reserve' (Incurred But Not Reported reserve) which is determined by estimating the number of schemes where a claim has been incurred but not reported. This is calculated as a percentage addition to the number of schemes which have been reported and included as provisions. This percentage has been determined from an analysis of the average time lag between solvency event occurrence and notification of such an event to the Board (via a section 120 notice) as shown in the following table.

| Number of months between insolvency event and Board receipt of S120 notice | Cumulative proportion of notifications received by each point in time |
|---|---|
| 0 | 78% |
| 1 | 87% |
| 2 | 93% |
| 6 | 96% |
| 12 | 99% |
| 15 | 100% |

For this estimated number of schemes where a claim is yet to be reported, the provision is based on the median provision of schemes where a claim has been received.

## Annex S2

### Contingent liabilities in the Statement of Accounts for the financial period ending on 31 March 2007

Four types of contingent liabilities are disclosed in footnotes to the statement of accounts.

1. Type 1 contingent liabilities are in respect of eligible schemes as defined in section 126 of the Pensions Act 2004 in relation to which:
    - an insolvency event notice under section 120 of the Pensions Act 2004 had been received by the Board from an insolvency practitioner on or before 15 June 2007,
    - the Board had stated on or before 15 June 2007 that the insolvency event was a qualifying insolvency event,
    - the insolvency date was on or after 1 April 2007,
    - a withdrawal notice under section 122(2)(b) of the Pensions Act 2004 had not been received on or before 15 June 2007 (and, in the Board's judgement, is unlikely to be received) from the insolvency practitioner, and
    - as at the insolvency date, the value of the assets was, in the Board's judgement, likely to have been less than the amount of the protected liabilities as defined in section 131 of the Pensions Act 2004.
2. Type 2 contingent liabilities are in respect of eligible schemes in relation to which:
    - an insolvency event notice under section 120 of the Pensions Act 2004 was received by the Board from an insolvency practitioner on or before 15 June 2007,
    - the Board had stated on or before 15 June 2007 that the insolvency event was NOT a qualifying insolvency event,
    - in the Board's judgement, a subsequent insolvency event, which will be a qualifying insolvency event, is likely, and
    - as at 31 March 2007, the value of the assets was, in the Board's judgement, likely to have been less than the amount of the protected liabilities, as defined in section 131 of the Pensions Act 2004.
3. Type 3 contingent liabilities are in respect of eligible schemes in relation to which:
    - in the Board's judgement, as at 15 June 2007, no insolvency event has taken place, but the Board is nonetheless expecting to receive an insolvency event notice under section 120 of the Pensions Act 2004 from an insolvency practitioner in the future, and
    - the Board has sufficient data about the scheme to be able to make an estimate of a contingent liability.
4. Type 4 contingent liabilities are in respect of schemes where:
    - the Dun & Bradstreet failure score is available to the Board and, based on the data available as at 15 June 2007, this score was less than 10, and
    - the Board in its view had sufficient information as at 15 June 2007 about the scheme to enable the funding level as at 31 March 2007 to be estimated, and
    - as at 31 March 2007, the value of the assets was, in the Board's judgement, likely to have been less than the amount of the protected liabilities as defined in section 131 of the Pensions Act 2004.

Out of a population of 7,494 schemes considered, 136 had a failure score of less than 10 associated with them. Of these 136 schemes, 84 were in deficit.

Type 4 contingent liabilities exclude any scheme already within the provisions or other categories of contingent liabilities.

## Annex S3

## Data

### a) Data in respect of former members of schemes that were transferred to the Board on or before 31 March

This data was shown in my report to the Board dated 17 October 2007.

### b) Data in respect of provisions and contingent liabilities

There are 167 schemes which contribute to the provisions figure in the statement of accounts for the financial period ending on 31 March 2007; liabilities in respect of another 20 schemes have not been recognised (i.e. not included in the provisions) because the value of their assets was, in the Board's judgement, likely to have exceeded the amount of the protected liabilities at their insolvency date. For Type 1 contingent liabilities this recognition test was also undertaken at the insolvency date. For Type 2, Type 3 and Type 4 contingent liabilities the recognition test assessment was undertaken at the valuation date since a qualifying insolvency event had not occurred.

The numbers of schemes contributing to the various types of provisions and contingent liabilities are given in the table below:

| Liability | | Number of schemes recognised | Number of pensioners * | Number of deferred pensioners * |
|---|---|---|---|---|
| Provision | 2007 | 167 (187 in total) | 39,250 | 64,261 |
| | 2006 | 98 (100 in total) | 10,338 | 33,024 |
| Provision - IBNR | 2007 | 3 | n/a | n/a |
| | 2006 | 0 | n/a | n/a |
| Type 1 contingent liability | 2007 | 0 | 0 | 0 |
| | 2006 | 12 (13 in total) | 1,975 | 5,332 |
| Type 2 contingent liability | 2007 | 1 (1 in total) | 10 | 24 |
| | 2006 | 3 (4 in total) | 549 | 1,940 |
| Type 3 contingent liability | 2007 | 9 (10 in total) | 1,446 | 4,127 |
| | 2006 | 1 (1 in total) | 111 | 264 |
| Type 4 contingent liability | 2007 | 84 (136 in total) | n/a | n/a |
| | 2006 | 97 (119 in total) | n/a | n/a |

* Data in respect of recognised schemes only.

The valuation of the liabilities of the schemes forming the provisions and contingent liabilities has not been undertaken using member-by-member data. Instead the historic valuation results available for the schemes have been used and rolled forward on a global basis. As such the valuation will not be as accurate as one undertaken using membership data for each scheme. This approach, whilst perhaps inappropriate for valuation purposes for some schemes on an individual basis, in aggregate is, in my opinion, acceptable for estimating provisions and contingent liabilities. Generally there is no reason to doubt the quality of the information provided within a particular scheme's valuation report. It is important, however, to note that any errors contained within the original scheme valuation will carry through to this valuation.

Because of the lack of uniformity of data summaries in individual schemes' valuation reports, it has not been possible to provide any other summary data about schemes in the various liability categories.

## Annex S4

## Assumptions

### a) Actuarial liabilities

The assumptions adopted were described in my report to the Board dated 17 October 2007.

### b) Basis adopted for Provisions and Contingent liabilities

1. Discount rates

The same discount rates have been adopted as for the actuarial liabilities calculations.

2. Mortality

The mortality in respect of a member is PCMA00, with PCFA00 being used in respect of the member's dependant, in each case with an age rating of 1 year and the long cohort mortality improvement rates with an underpin of 1.5% per annum. The PCMA00 and PCFA00 tables have been issued by the CMI.

The possibility of scheme-specific mortality was considered for large schemes satisfying the following definition:

- Where an MFR valuation was used as the basis of the roll-forward and the MFR liabilities at the MFR valuation date were at least £100 million; or
- Where a section 179 (or section 143) valuation was used as the basis of the roll-forward and the section 179 (or section 143) liabilities at the section 179 (or section 143) valuation date were at least £200 million

Scheme-specific mortality was adopted where the Board had evidence that future mortality for large schemes as defined above was likely to be significantly different from the assumptions set out in the first paragraph. In consequence, in respect of one large scheme where in my opinion there is evidence that mortality is likely to prove significantly heavier than that described above, an age rating of + 2.5 years instead of + 1 year has been adopted for pensioners and dependants in the calculation of the provision.

3. Proportion Married

80% of members are assumed to be married or to have a relevant partner.

4. Age difference between member and dependant

Females assumed to be 3 years younger than males.

5. Children's pensions

No specific allowance.

6. Expenses

Allowance has been made for expenses incurred by the trustees prior to transfer into the Pension Protection Fund.

## Annex S5

### Sensitivity analysis

Results have been calculated on the basis described in annex S4. Also an analysis has been undertaken of the sensitivity of the actuarial liabilities and provisions to variations in the discount rates and mortality assumptions. Results are also shown, as scenario 5, using Basis 1 from the 2006 Report & Accounts. A summary of the assumptions is shown below:

| | **Main assumptions** | **Scenario 1** | **Scenario 2** |
|---|---|---|---|
| Discount rate in deferment | 1.3% | 1.8% | 0.8% |
| Discount rate in payment for non-increasing compensation for current pensioners | 5.0% | 5.5% | 5.0% |
| Discount rate in payment for non-increasing compensation for future pensioners | 4.5% | 5.0% | 4.5% |
| Discount rate in payment for increasing compensation for current pensioners | 2.6% | 3.1% | 2.1% |
| Discount rate in payment for increasing compensation for future pensioners | 2.1% | 2.6% | 1.6% |
| Mortality | As described in annex S4 | As described in annex S4 | As described in annex S4 |

| | **Scenario 3** | **Scenario 4** | **Scenario 5 2006 basis 1** |
|---|---|---|---|
| Discount rate in deferment | 1.3% | 1.3% | 1.0% |
| Discount rate in payment for non-increasing compensation for current pensioners | 5.0% | 5.0% | 4.5% |
| Discount rate in payment for non-increasing compensation for future pensioners | 4.5% | 4.5% | 4.5% |
| Discount rate in payment for increasing compensation for current pensioners | 2.6% | 2.6% | 2.1% |
| Discount rate in payment for increasing compensation for future pensioners | 2.1% | 2.1% | 2.1% |
| Mortality | As described in annex S4 but with no underpin | PMA92 with medium cohort improvement rates | PMA92 with medium cohort improvement rates |

# Annex S6

## Calculation results

### a) Calculation of actuarial liabilities for members who have transferred into the Pension Protection Fund

The actuarial liabilities in respect of former members of schemes for which the Board assumed responsibility on or before 31 March 2007 plus a sum required to meet the remaining liabilities under Regulation 3 of the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 amount to £541,894,000.

### b) Calculation of provisions

170 schemes (including an estimated 3 in respect of the IBNR reserve) were considered in relation to the provisions in the statement of accounts for the financial period ending on 31 March 2007, yielding the following estimated provisions (a comparison is shown with the equivalent figures from the 2006 Report & Accounts under basis 1 as described in that report):

The table below shows the estimated assets held at 31 March 2007 in the 170 schemes forming the provisions. It also shows the anticipated recoveries, the resulting total assets and estimated deficit in respect of those schemes.

| | **31 March 2007 (£000s)** | **31 March 2006 Basis 1 (£000s)** |
|---|---|---|
| Assets excluding anticipated recoveries | 3,489,616 | 1,878,757 |
| Anticipated recoveries | 84,815 | 65,843 |
| Total assets | 3,574,431 | 1,944,600 |
| Provisions | 4,482,924 | 2,429,111 |
| Deficit | 908,493 | 484,511 |

The liabilities recognised as provisions are the present value of the liabilities calculated at each valuation date on the relevant basis.

### c) Calculation of contingent liabilities

The estimated amounts for the various types of contingent liabilities were as follows (a comparison is shown with the equivalent figures from the 2006 Report & Accounts under basis 1 as described in that report):

| **Type of contingent liability** | **Estimated scheme deficit as at 31 March 2007 (£000s)** | **Estimated scheme deficit as at 31 March 2006 Basis 1 (£000s)** |
|---|---|---|
| 1 | 0 | 63,840 |
| 2 | 1,843 | 20,755 |
| 3 | 38,720 | 2,525 |
| 4 | 160,518 | 395,849 |
| **Total** | **201,081** | **482,969** |

The liabilities recognised as contingent liabilities are the present value of the deficit calculated at each valuation date on the relevant basis.

Shown below are the total assets and total liabilities that correspond to the above deficits (contingent liabilities). A comparison is shown with the equivalent figures from the 2006 Report & Accounts under basis 1.

| Type of contingent liability | 31 March 2007 Assets (£000s) | 31 March 2007 Liabilities (£000s) | 31 March 2006 Assets (£000s) | 31 March 2006 Liabilities (£000s) |
|---|---|---|---|---|
| 1 | 0 | 0 | 238,095* | 301,935 |
| 2 | 754 | 2,597 | 62,345 | 83,100 |
| 3 | 279,331 | 318,051 | 3,828 | 6,353 |
| 4 | 704,006 | 864,524 | 2,440,139 | 2,835,988 |
| **Total** | **984,091** | **1,185,172** | **2,744,407** | **3,227,376** |

* includes an estimate of anticipated recoveries of £7,763,000.

## Annex S7

### Actuarial balance sheet

On the main 31 March 2007 basis the Pension Protection Fund actuarial balance sheet is as follows:

| Assets | £000s | Liabilities | £000s |
|---|---|---|---|
| The value of the Pension Protection Fund assets determined in accordance with the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 | 841,242 | The present value of the liabilities of the Pension Protection Fund to pay sums or transfer property as required under section 173(3) of the Pensions Act 2004 | 541,894 |
| The sum of the estimated values of the assets in the schemes that generated the provisions, plus any anticipated recoveries* | 3,574,431** | The present value of the liabilities of the schemes forming the provisions | 4,482,924 |
| Total assets | 4,415,673 | Total liabilities | 5,024,818 |
| Total assets less total liabilities | | | (609,145) |
| Assets/liabilities | | | 88% |

* Inclusive of an allowance for IBNR (scheme assets of £19,256,000 and provisions of £25,296,000).
** Inclusive of anticipated recoveries of £84,815,000.

I have also calculated the actuarial liabilities and the liabilities of the schemes forming the provisions using the bases set out in annex S5. Note that, while the value of assets relating to annuity contracts held with insurance companies should theoretically change under the various scenarios, this has not been done as the changes would not be material.

On scenario 1 (see the description of this scenario in the section on sensitivity analysis in annex S5) the balance sheet is as follows:

| Assets | £000s | Liabilities | £000s |
|---|---|---|---|
| The value of the Pension Protection Fund assets determined in accordance with the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 | 841,242 | The present value of the liabilities of the Pension Protection Fund to pay sums or transfer property as required under section 173(3) of the Pensions Act 2004 | 471,537 |
| The sum of the estimated values of the assets in the schemes that generated the provisions, plus any anticipated recoveries | 3,574,431* | The present value of the liabilities of the schemes forming the provisions | 4,033,194 |
| Total assets | 4,415,673 | Total liabilities | 4,504,731 |
| Total assets less total liabilities | | | (89,058) |
| Assets/liabilities | | | 98% |

* Inclusive of anticipated recoveries of £84,815,000.

On scenario 2 (see the description of this scenario in the section on sensitivity analysis in annex S5) the balance sheet is as follows:

| Assets | £000s | Liabilities | £000s |
|---|---|---|---|
| The value of the Pension Protection Fund assets determined in accordance with the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 | 841,242 | The present value of the liabilities of the Pension Protection Fund to pay sums or transfer property as required under section 173(3) of the Pensions Act 2004 | 607,975 |
| The sum of the estimated values of the assets in the schemes that generated the provisions, plus any anticipated recoveries | 3,574,431* | The present value of the liabilities of the schemes forming the provisions | 4,759,265 |
| Total assets | 4,415,673 | Total liabilities | 5,367,240 |
| Total assets less total liabilities | | | (951,567) |
| Assets/liabilities | | | 82% |

* Inclusive of anticipated recoveries of £84,815,000.

On scenario 3 (see the description of this scenario in the section on sensitivity analysis in annex S5) the balance sheet is as follows:

| Assets | £000s | Liabilities | £000s |
|---|---|---|---|
| The value of the Pension Protection Fund assets determined in accordance with the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 | 841,242 | The present value of the liabilities of the Pension Protection Fund to pay sums or transfer property as required under section 173(3) of the Pensions Act 2004 | 521,300 |
| The sum of the estimated values of the assets in the schemes that generated the provisions, plus any anticipated recoveries | 3,574,431* | The present value of the liabilities of the schemes forming the provisions | 4,365,395 |
| Total assets | 4,415,673 | Total liabilities | 4,886,695 |
| Total assets less total liabilities | | | (471,022) |
| Assets/liabilities | | | 90% |

* Inclusive of anticipated recoveries of £84,815,000.

On scenario 4 (see the description of this scenario in the section on sensitivity analysis in annex S5) the balance sheet is as follows:

| Assets | £000s | Liabilities | £000s |
|---|---|---|---|
| The value of the Pension Protection Fund assets determined in accordance with the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 | 841,242 | The present value of the liabilities of the Pension Protection Fund to pay sums or transfer property as required under section 173(3) of the Pensions Act 2004 | 512,407 |
| The sum of the estimated values of the assets in the schemes that generated the provisions, plus any anticipated recoveries | 3,574,431* | The present value of the liabilities of the schemes forming the provisions | 4,272,374 |
| Total assets | 4,415,673 | Total liabilities | 4,784,781 |
| Total assets less total liabilities | | | (369,108) |
| Assets/liabilities | | | 92% |

* Inclusive of anticipated recoveries of £84,815,000.

On scenario 5 (see the description of this scenario in the section on sensitivity analysis in annex S5 - this is basis 1 from the 2006 report & accounts) the balance sheet is as follows:

| Assets | £000s | Liabilities | £000s |
|---|---|---|---|
| The value of the Pension Protection Fund assets determined in accordance with the Pension Protection Fund (Valuation of the Assets and Liabilities of the Pension Protection Fund) Regulations 2006 | 841,242 | The present value of the liabilities of the Pension Protection Fund to pay sums or transfer property as required under section 173(3) of the Pensions Act 2004 | 543,908 |
| The sum of the estimated values of the assets in the schemes that generated the provisions, plus any anticipated recoveries | 3,574,431* | The present value of the liabilities of the schemes forming the provisions | 4,472,379 |
| Total assets | 4,415,673 | Total liabilities | 5,016,287 |
| Total assets less total liabilities | | | (600,614) |
| Assets/liabilities | | | 88% |

* Inclusive of anticipated recoveries of £84,815,000.

None of these scenarios should be interpreted as upper or lower bounds of the range of reasonable estimates which might be made.

## Annex S8

### Comparison with the deficit as at 31 March 2006

Under FRS 12 a reconciliation of the opening and closing net deficit of the schemes that generate the provisions is required. I show this as a table below:

| **Reconciling item** | **£000s** |
|---|---|
| Net deficit of schemes that generate the provisions at 31 March 2006 | 484,511 |
| New claims arising | 442,120 |
| Schemes accepted into the PPF (deficits as at the Transfer Date) | (100,326) |
| Claims no longer considered probable (exits) | (801) |
| Claims no longer considered probable (schemes estimated to be in surplus as at their assessment date) | 52 |
| Change in schemes' liabilities on account of change in mortality assumption | 90,501 |
| Change in schemes' liabilities on account of changes in financial assumptions | (78,616) |
| Change in schemes' liabilities on account of other changes | (42,437) |
| Change in schemes' assets (including changes in recoveries from employers) | 113,489 |
| Net deficit of schemes that generate the provisions at 31 March 2007 | 908,493 |

I also show a reconciliation of the new claims arising over the financial year ending 31 March 2007:

| **Reconciling item** | **£000s** |
|---|---|
| Assets arising (including recoveries) | (2,193,681) |
| Liabilities arising on 2006 valuation basis | 2,637,141 |
| Change in schemes' liabilities on account of change in mortality assumption | 120,049 |
| Change in schemes' liabilities on account of changes in financial assumptions | (121,389) |
| Net deficits for new claims arising over the financial year ending 31 March 2007 | 442,120 |

## Appendix 2

# Accounting policies and notes relating to the operation of the Fraud Compensation Fund for the period 1 April 2006 to 31 March 2007

## Note 2.1 Accounting policies

### a) Transfer from the Pension Compensation Board

The financial statements for the prior period 6 April 2005 to 31 March 2006 disclosed that on 1 September 2005, the Board of the Pension Protection Fund assumed responsibility for the functions of the Pension Compensation Board (PCB). The Pensions Act 2004 requires the Board to manage these functions through a distinct ring-fenced fund called the Fraud Compensation Fund. The transfer of the assets and liabilities of the PCB associated with this transfer of responsibility was dealt with under the "Machinery of Government changes" provisions of the Government Financial Reporting Manual, which requires them to be accounted for using merger accounting (as defined in FRS6 "Acquisitions and Mergers"). Merger accounting was interpreted in this situation as requiring the results and cash flows of the PCB to be brought into the financial statements of the Fraud Compensation Fund from the beginning of the financial period in which the merger occurred, i.e. from 6 April 2005. The net assets of the PCB as at the beginning of the financial period were brought onto the balance sheet of the Fraud Compensation Fund at fair value as disclosed in the PCB's accounts for the financial year ended 5 April 2005. The income, expenditure and any other recognised gains and losses of the PCB were brought into the operating statement of the Fraud Compensation Fund at the values stated in the PCB's closing accounts for the period 6 April to 31 August 2005.

### b) Income recognition

The accrual bases for different sources of income are as follows:

- Interest income arising from cash deposits, fixed interest securities and similar investments is accounted for on a daily basis as interest is earned.
- Fraud Compensation Levy income is recognised on an accruals basis.

### c) Investments

The investment assets of the Fraud Compensation Fund are held in the form of units in liquidity funds managed by external fund managers. Interest is accounted on these funds on a daily basis and is settled by the fund managers issuing new units in the liquidity funds which are added to the Board's holdings in those funds. These liquidity funds are therefore valued as cash, at £1 per unit.

### d) Current liabilities

Current liabilities arise as a consequence of the accruals basis of accounting for income and expenditure, to ensure all liabilities falling due on or before the accounting date which had not been settled by the accounting date are disclosed within the Board's accounts.

### e) Claims

Within the Fraud Compensation Fund, the Board recognises provisions for claims where it judges that it is probable that the claim will be validated and a compensation payment to the claimant scheme be made from the Fund. Where the Board judges that validation of the claim is possible (i.e. that the likelihood is greater than remote but lower than probable) a contingent liability will be disclosed. Where the Board judges that the likelihood of validation is remote, the Fund will not recognise any provisions nor disclose any specific contingent liabilities.

## Note 2.2 Income from levies

The Board of the Pension Protection Fund did not raise any Fraud Compensation Levy in the year to 31 March 2007. Similarly, in respect of the prior period, neither PCB (in the period to 31 August 2005) nor the Board of the Pension Protection Fund (in the period from 1 September 2005) raised any new Fraud Compensation Levy in the period to 31 March 2006. PCB did transfer to the Board responsibility for the collection of levy debtors outstanding as at 31 August 2005 (see note 2.8b) but provisions were set up for substantially all of these debtors in PCB's accounts to 31 August 2005 (see note 2.3). No new information has come to light in the period since 1 April 2006 which would lead the Board to release any of these provisions and so disclose any levy income.

No levy income is therefore recognised in these accounts.

## Note 2.3 Operating expenses

The financial statements for the current year to 31 March 2007 disclose no operating expenses charged to the Fraud Compensation Fund because operating expenses incurred by the Board of the Pension Protection Fund in administering the Fraud Compensation Fund in periods from 1 September 2005 onwards have been accounted for through the Administration Fund of the Pension Protection Fund. The financial statements for the prior period to 31 March 2006 disclosed the operating expenses incurred by PCB in the period 6 April 2005 to 31 August 2005, as analysed below, and were accounted for in those financial statements due to the operation of merger accounting as described in Note 2.1a.

| | **Fraud Compensation Fund for the period 6 April 2005 to 31 March 2006 £000s** |
|---|---:|
| Levy collection fee | - |
| Remuneration and Travel expenses of PCB's Chairman and Board members | 2 |
| Management fee paid to the Office of the Pensions Ombudsman | 8 |
| Legal fees | 8 |
| Accountancy services | 10 |
| General office expenses, Accommodation costs and IT software and maintenance costs | 1 |
| Audit fees | 8 |
| Printing costs | 3 |
| Corporation Tax | 9 |
| Provisions for levy collection costs and doubtful debts | 15 |
| **Total Operating Expenses** | **64** |

## Note 2.4 Interest income

The bank account operated by the Board of the Pension Protection Fund for the Fraud Compensation Fund is interest bearing.

## Note 2.5 Investment income

The investment assets of the Fraud Compensation Fund are held in the form of units in liquidity funds managed by external fund managers. Interest is accounted on these funds on a daily basis and is settled by the fund managers issuing new units in the liquidity funds which are added to the Board's holdings in those funds.

## Note 2.6 Compensation payments and provisions for claims

As described in more detail in note 2.10, the Board does not consider it appropriate at this time to recognise provisions for any claims currently under consideration by the Board, as it considers it does not yet have adequate evidence to judge whether it is probable that these claims will be validated and subsequently paid.

## Note 2.7 Investment assets

The investment assets of the Fraud Compensation Fund are held in the form of units in liquidity funds managed by external fund managers. Interest is accounted on these funds on a daily basis and is settled by the fund managers issuing new units in the liquidity funds which are added to the Board's holdings in those funds. These liquidity funds are therefore valued as cash, at £1 per unit. The closing values of the funds were:

| | **As at 31 March 2007 £000s** | **As at 31 March 2006 £000s** |
|---|---|---|
| **Liquidity Fund managed by:** | | |
| Insight Investment Management | 1,564 | 1,506 |
| Fidelity Investments | 1,580 | 1,506 |
| **Total Investment assets** | **3,144** | **3,012** |

## Note 2.8 Net current assets

a) Cash at Bank

As described in the accounting policy on "Segmental Reporting", the Board of the Pension Protection Fund is responsible for three ring-fenced funds. To improve controls over the three funds and ensure that only allowable items of income and expenditure are transacted within each fund, the Board has opened separate bank accounts for the three funds. The Fraud Compensation Fund account is used to collect fraud compensation levies, to transfer cash to the fund managers and to pay out compensation claims.

All bank accounts are interest bearing, at rates that the Board consider competitive given the operating requirements of the accounts.

b) Other current assets consisted of:

| | **As at 31 March 2007 £000s** | **As at 31 March 2006 £000s** |
|---|---|---|
| Levy debtors | 6 | 15 |
| Provisions for levy collection costs and doubtful debts | (6) | (15) |
| **Total other current assets** | **-** | **-** |

The Board of the Pension Protection Fund did not raise any Fraud Compensation Levy during the accounting period, and the levy debtors disclosed in the Fraud Compensation Fund relate to debtors transferred by PCB when it was closed on 31 August 2005. Billing and collection activity was carried out on PCB's behalf by the Pensions Regulator and this activity has continued throughout the year under the supervision of the Board. This has resulted in the crediting of previously billed amounts as it has been established that the scheme has completed wind-up or was otherwise ineligible to pay the levy. The impact of this has been to reduce the gross amount of levy debtors still outstanding, but as all levy debtors were fully provided for as at 31 March 2006, this has had no effect on the Fund's income or net assets at the end of the year.

The value of debtors that falls inside the Whole of Government Accounts boundary is: nil (31 March 2006: nil).

c) Current liabilities consist of:

| | Notes | As at 31 March 2007 £000s | As at 31 March 2006 £000s |
|---|---|---|---|
| Accruals and trade creditors | | - | (14) |
| Provision for corporation tax | i | - | (9) |
| **Total current liabilities** | | **-** | **(23)** |

The value of creditors that falls inside the Whole of Government Accounts boundary is: £nil (31 March 2006, £19,000).

i) Provision for corporation tax

Income earned on the assets of the Pensions Compensation Board was deemed to be subject to corporation tax and this provision related to the tax payable on the net income of the PCB for its final accounting period ended 31 August 2005. The tax was paid in June 2006. The transfer of PCB's assets to the Board of the Pension Protection Fund means that those assets are now subject to the Pension Protection Fund (Tax) Regulations 2006 and so exempt from income tax, corporation tax and capital gains tax.

## Note 2.9 Reserves

| | £000s |
|---|---|
| Opening balance | 2,937 |
| Movement in the period | - |
| **Closing balance** | **2,937** |

The reserves figure of £2,937,000 represents the net assets of the Pensions Compensation Board, valued at fair value as at 5 April 2005, which have been brought onto the balance sheet of the Fraud Compensation Fund under the operation of merger accounting as described in Note 2.1a.

## Note 2.10 Contingent liabilities

Five claims for compensation were under consideration at 31 March 2006 and one new claim was received during the year. Further investigation of these claims has been carried out to verify both the loss of assets by the claimant schemes, and to verify that the loss was caused by dishonesty. Claims may eventually fail on either of these counts.

Final determination of these cases will depend on evidence being produced to the Board's satisfaction on these points, as well as evidence that reasonable efforts have been made to recover losses from other sources, so that losses paid by the Board are minimised. These processes could take a considerable time to complete and may extend over several years. In the meantime the Board does have powers to make discretionary interim awards in case of immediate need. No such awards were made during the accounting period.

The Board has considered the evidence so far made available to it in order to judge the likelihood that claims will be validated and paid. Based on new evidence, or in some cases based on the lack of new evidence, the Board now judges that five of the six claims (including the new claim arising during the current year) are unlikely to result in any payment. Four of these five were disclosed as contingent liabilities in the Fund's accounts to 31 March 2006, the likelihood of a successful claim having been judged at that time as "possible". The payment likelihood of these claims has therefore been reclassified as "remote" and removed from the value disclosed below.

One substantial claim remains under active investigation, and significant amounts of new evidence have been considered by the Board. The Board's current judgement remains that the claim may possibly result in a payment, and its status as a contingent liability is therefore retained in the analysis below.

Should this claim be validated, the rules for compensation which governed the PCB would apply to this claim, as the Board took over the claim from PCB. Under these rules, the successful claimant scheme would be entitled to interest based on 100% of the value of the validated loss, to be calculated at a rate of 2% above base rate, for the period between the effective date of loss and the date of payment of compensation. The contingent liabilities disclosed below include interest calculated on this basis up to 31 March 2007.

| **Values in £000s** | **At 31 March 2007** | **At 31 March 2006** |
|---|---|---|
| Number of claims | 1 | 5 |
| Value of contingent liabilities | £2,835 | £2,806 |

The movement from 1 April 2006 to 31 March 2007 can be summarised as follows:

| | **Values in £000s** | **Number of claims** |
|---|---|---|
| Value disclosed at 31 March 2006 | 2,806 | 5 |
| Reclassification of claims | (137) | (4) |
| Further interest on claims | 166 | - |
| **Value disclosed at 31 March 2007** | **2,835** | **1** |

The rules governing compensation payments in respect of claims made on the Fraud Compensation Fund after 31 August 2005 are different to those which governed payments made by PCB. Under the Pensions Act 2004, Section 185(3), the Board is only authorised to pay the value of the loss suffered by the claimant scheme, net of any recoveries made the scheme trustees from other parties.

## Note 2.11 Financial instruments

FRS13, Derivatives and Other Financial Instruments, requires disclosure of the role which financial instruments have had during the period in creating or changing the risks an entity faces in undertaking its activities. Because of the non-trading nature of the Fraud Compensation Fund's activities and the way it is financed, the Fund is not exposed in this area to the same financial risks faced by business entities.

**Funding risk** – The Fund's Statement of Investment Principles describes the major risk facing the Fund as not having sufficient funds to pay compensation as required under the Pensions Act 2004. The Board has no powers to raise income other than by raising Fraud Compensation levies and no powers to borrow to fund compensation payments. The Fund's assets arise from the receipt of Fraud Compensation Levies, so the Fund's funding strategy is designed to mitigate the risks, both in the short- and the long-term, that the Fund's assets will be inadequate to meet its liabilities. Specifically, the Board will target the Fund towards a balance between securing the compensation payments for schemes whilst setting a fair and proportionate levy. All Fund investments will therefore be held in cash deposits or equivalent vehicles such as liquidity funds.

**Liquidity risk** – The Fund is not exposed to significant liquidity risks as the Board is of the opinion that

- the assets of the Fund, including its investment assets, are highly liquid and readily realisable; and
- the time required to investigate claims and decide whether payment (including any interim settlements) should be made is adequate to raise any levy income required over and above the funds already under the Board's control.

**Interest rate risk** – As described in Note 2.10, current claimants on the Fund would be entitled to interest based on 100% of the value of the validated loss, to be calculated at a rate of 2% above base rate, for the period between the effective date of loss and the date of payment of compensation. The Fund therefore faces the risk that the return on its investments will be inadequate to cover these interest payments. The Fund's Statement of Investment Principles recognises this risk and describes the investment strategy designed to mitigate it.

**Foreign currency risk** – The Fund has no significant exposure to foreign currency in respect of its compensation activities as all of its income, costs, assets and liabilities are denominated in sterling.

## Appendix 3

# Accounting policies and notes relating to the operation of the Board of the Pension Protection Fund's Administration Fund for the period 1 April 2006 to 31 March 2007

### Note 3.1 Accounting policies

#### a) Change of accounting policy

With effect from the 2006-07 reporting period the Government Financial Reporting Manual requires non-departmental public bodies (and other analogous bodies such as the Board of the Pension Protection Fund) to account for grants and grants in aid received for revenue purposes as financing because they are regarded as contributions from a controlling party (in the Board's case, its sponsor, the Department for Work and Pensions) which gives rise to a financial interest in the residual interest of the body. This is a change in accounting policy from earlier periods when such items were recorded as income. The effect of this change on the certified 2005-06 accounts and the impact of the change on the results of the current year is shown below. Note there is no impact on the net liability position of the Board as a result of this change in policy.

| | At 31 March 2006 (as previously stated) | Impact of adopting the new policy | At 31 March 2006 (re-stated) |
|---|---|---|---|
| Net Result for 2005/06 | 2,153 | (8,991) | (6,838) |
| General Reserve | 0 | 2,153 | 2,153 |
| | **At 31 March 2007 (without applying the new policy)** | **Impact of adopting the new policy** | **At 31 March 2007 (applying the new policy)** |
| Net Result for 2006/07 | (3,081) | (10,011) | (13,092) |
| General Reserve | 0 | (928) | (928) |

#### b) Income recognition

Interest income arising from cash deposits is accrued on a daily basis.

#### c) Fixed assets and Capitalisation policies

- Intangible fixed assets:

  The costs of purchasing major software licences are capitalised as intangible fixed assets.

  The costs of major software and software development and enhancement, including related consultancy costs, are capitalised as tangible fixed assets, where it is considered that the resulting software has an extended useful life. Ongoing software maintenance costs are written off in the year they occurred.

- Tangible fixed assets:

  The costs of purchasing hardware are capitalised as tangible fixed assets provided the cost of the hardware, either as a single item or as a group of related items bought for a common purpose, exceeds £1,000.

- Leasehold improvements:

  The costs of leasehold improvements, including the refurbishment and fitting out of new premises ready for occupation by the Board's staff, are capitalised as fixed assets. Property repairs and maintenance, and the costs of purchasing individual items of furniture and equipment not exceeding £1,000, are written off in the year of purchase.

**d) Depreciation policies**

Depreciation is provided on all fixed assets at rates calculated to write down the cost or valuation (less any estimated residual value) of each asset evenly over its expected useful life as follows:

| | |
|---|---|
| • Information technology equipment | 3 years |
| • Major software licences | 3 years or the life of the licence if shorter |
| • Software & software development | 3 years |
| • Leasehold improvements | 5 years |

Fixed assets are valued at current replacement cost which is calculated by applying appropriate Office for National Statistics indices to the historical cost of the asset. Any surplus on revaluation of fixed assets is credited to a revaluation reserve through the Statement of Total Recognised Gains and Losses; any permanent diminution in the value of a fixed asset on revaluation is charged (and captioned as an impairment charge) to the Operating Statement in the period when it occurs.

**e) Current liabilities**

The Board's policy for current liabilities is to account on an accruals basis for all liabilities falling due on or before the accounting date which had not been settled by the accounting date. This includes all goods and services supplied during the accounting period but not paid for as at the accounting date.

Accounting for these liabilities may involve the use of estimates.

## Note 3.2 Grant in aid

Grant-in-aid received by the Board from DWP is used to finance activities and expenditure which support the statutory and other objectives of the Board. These receipts are treated as financing and credited to the General Reserve, because they are regarded as contributions from a controlling party (see "Change of Accounting Policy" note above).

The Board is authorised to draw down grant-in-aid from DWP under s116 of the Pensions Act 2004. Grant-in-aid is normally drawn down on a quarterly basis to fund the forecast operating and capital expenditure of the Board.

The Pensions Act 2004 also empowers the Secretary of State to raise an Administration Levy to recover these (and other) costs from qualifying defined benefit and hybrid occupational pension schemes. These powers are detailed in s117 (1) of the Act. This levy is raised on an annual basis, using the Board's resource expenditure budget for the relevant year as one source of information in setting the overall levy – see the note below.

**Administration Levy**

The Pensions Act 2004 empowers the Secretary of State for Work and Pensions to raise a Pension Protection Fund Administration Levy, from which to fund the operating costs of the Board and other associated costs. These other costs consist of the expenses incurred by the DWP in establishing the Board and its operating infrastructures prior to the Board opening for business on 6 April 2005. These establishment costs include the expenses of appointing and remunerating Board members and staff prior to 6 April 2005; of developing policies and processes for the initial operating functions of the Board, particularly in the legal, HR, accounting and procurement areas; of identifying and fitting out the premises from which the Board would begin its operations; and of specifying and installing the ICT systems to support the Board's initial operating functions. The Board understands that it is DWP's intention to recover these costs over the first three financial years of the Administration Levy.

The establishment costs can be analysed as follows:

| | £000s |
|---|---:|
| Treated as operating expenses | 6,487 |
| Treated as capital expenditure (ICT systems) | 2,498 |
| **Total establishment costs** | **8,985** |

The Board have been advised by DWP that the total Administration Levy raised by the Secretary of State, and its disposition during the year, can be summarised as follows:

| | Year to 31 March 2007 £000s | Year to 31 March 2006 (re-stated) £000s |
|---|---:|---:|
| Surplus brought forward | 2,812 | - |
| Total Administration Levy raised (including adjustments to prior year levies raised) | 11,920 | 12,645 |
| Retained by DWP to recover establishment costs | (2,995) | (2,995) |
| Resource expenditure of the Board | (13,092) | (6,838) |
| **Surplus/(deficit) carried forward to future levy years** | **(1,355)** | **2,812** |

Last year's disclosure has been re-stated to include the resource expenditure of the Board in the year, rather than the grant-in-aid drawn down in the year, as a consequence of the change in accounting policy required by the Government Financial Reporting Manual, as detailed in Note 3.1a.

One consequence of the re-statement impacts the treatment of capital expenditure. Grant-in-aid is used by the Board to finance its capital expenditure; however, the PPF Administration Levy is designed to cover the Board's resource expenditure, which only includes the depreciation on those capital assets. The deficit disclosed above therefore includes in part the DWP's financing of the net book value of the Board's capital assets, and this deficit will be corrected as the DWP raises Administration Levy in future years to cover the depreciation charge.

The value of Administration Levy raised disclosed in the above table is on an accruals basis, that is, it includes Administration Levy debtors at the year end. These debtors were valued at 31 March 2007 at £2,806,000 (31 March 2006: £3,865,000). The grant-in-aid process ensures that DWP finance the Board's resource expenditure independent of Administration Levy collections.

## Note 3.3 Operating expenses

### a) Staff costs

Staff costs charged to the Administration Fund consisted of:

| | Year to 31 March 2007 £000s | Period ended 31 March 2006 £000s |
|---|---|---|
| Salaries and wages | 3,537 | 1,985 |
| Social security costs | 328 | 186 |
| Other pension costs | 708 | 365 |
| Temporary staff | 505 | 30 |
| Seconded staff | 1,456 | 1,053 |
| **Total** | **6,534** | **3,619** |

The average number of staff employed, including secondment and temporary staff, was:

| | Year to 31 March 2007 | Period ended 31 March 2006 |
|---|---|---|
| | **No.** | **No.** |
| Permanent employees | 83 | 52 |
| Secondment and temporary staff | 16 | 12 |
| **Total** | **99** | **64** |

Details of the remuneration of members of the Board of the Pension Protection Fund are given in the Remuneration Report in section 5 of the Annual Report. The staff costs reported include the costs of all Board members.

Employees of the Board of the Pension Protection Fund are eligible for membership of the Principal Civil Service Pension Scheme (PCSPS) and can opt to join the defined benefit section, or to contribute to a stakeholder (defined contribution) arrangement. The PCSPS is an unfunded multi-employer defined benefit salary related scheme but the Board is unable to identify its share of the underlying assets and liabilities. Defined benefit contributions are therefore accounted for by the Board as if they were contributions to a defined contribution scheme. A full actuarial valuation of PCSPS was carried out as at 31 March 2003 and details can be found in the Cabinet Office: Civil Superannuation Resource Accounts (www.civilservice-pensions.gov.uk).

During the year to 31 March 2007, employer's contributions of £701,000 (period to 31 March 2006: £320,000) were payable to the defined benefit section of the PCSPS at one of four rates in the range 17.1% to 25.5% (period to 31 March 2006, 16.2% to 24.6%). The scheme's actuary reviews employer contributions every four years following a full scheme valuation. These contribution rates reflect the benefits as they are accrued, not when the costs are actually incurred, and reflect past experience of the scheme.

Employees of the Board can opt to open a partnership pension account, which is a stakeholder pension with an employer contribution. Employers' contributions of £7,000 (period to 31 March 2006, £45,000) were paid to one or more of a panel of three appointed stakeholder pension providers. Employer contributions were age-related and range from 3% to 12.5% of pensionable pay, and employers also match employee contributions up to 3% of pensionable pay.

In addition, employer contributions were payable to the PCSPS to cover the cost of the future provision of lump sum benefits on death in service and ill health retirement of these employees.

At 31 March 2007, pension contributions in respect of the month of March 2007 totalling £92,000 were outstanding, and were paid over to PCSPS in April 2007 in accordance with legislative requirements.

**b) Other costs**

Other costs charged to the Administration Fund consisted of:

| | Year to 31 March 2007 | Period to 31 March 2006 |
|---|---|---|
| | £000s | £000s |
| Training and recruitment costs | 776 | 140 |
| Staff travel, expenses and hospitality | 88 | 61 |
| Advisory and other professional services | 3,052 | 1,102 |
| Statutory audit costs | 137 | 171 |
| Accommodation | 624 | 515 |
| General office expenses | 194 | 136 |
| IT and telephony | 1,061 | 902 |
| Billing and collection costs (Protection levies) | 60 | 190 |
| Publicity & Communications | 146 | 42 |
| **Total** | **6,138** | **3,259** |

Other costs include where appropriate Value Added Tax which the Board is not able to recover. In compliance with SSAP5, this irrecoverable VAT is included in the cost of the items reported in the financial statements.

## Note 3.4 Interest income

As described in Note 3.2, the Board draws down grant in aid from DWP on a periodic (normally quarterly) basis to cover forecast expenditure, and these funds are held in interest bearing accounts to cover, for example, monthly salary payments and regular supplier payments. The Board therefore earns interest income on these funds, and this income is used to reduce the grant in aid requirement in the subsequent period.

## Note 3.5 Fixed assets

The fixed assets included in the Administration Fund consist of information and communication technology assets held for the purposes of the Board's operations and administration. They include the IT hardware and software assets acquired by DWP as part of the project to establish the Board of the Pension Protection Fund and brought into use by the Board from 6 April 2005. The book cost of these assets has been brought into the Board's Administration Fund accounts as at 6 April 2005 through reserves, analogous to donated assets. "Additions in the period" represents further fixed assets acquired directly by the Board during the period.

Impairment and depreciation charges are made in relation to these assets in accordance with the policy set out in Note 3.1d. However, charges that relate to the assets transferred to the Board by DWP are then offset against the fixed asset reserve, with the intention of writing off the reserve over the useful life of the fixed assets concerned (see note 3.7). The net charge to the Operating Statement is arrived at as follows:

| | | Year to 31 March 2007 | Period to 31 March 2006 |
|---|---|---|---|
| | Note | £000s | £000s |
| Total impairment charges in the year (see below) | i | 207 | 135 |
| Total depreciation charges in the year (see below) | i | 1,121 | 896 |
| Offset against fixed asset reserve (see below) | ii | (844) | (922) |
| **Net charge to Operating Statement** | | **484** | **109** |

i Analysis of fixed assets

The net book value of fixed assets at 31 March 2007 is arrived at as follows:

| **All amounts in £000s** | **Tangible fixed assets** | **Intangible assets** | **Leasehold Improvements** | **Total** |
|---|---|---|---|---|
| **Cost** | | | | |
| At 1 April 2006 | 2,761 | 75 | - | 2,836 |
| Additions in the year | 884 | 498 | 673 | 2,055 |
| Disposals in the year | - | - | - | - |
| At 31 March 2007 | 3,645 | 573 | 673 | 4,891 |
| **Depreciation and impairment** | | | | |
| At 1 April 2006 | (1,011) | (20) | - | (1,031) |
| Impairment charges | (207) | - | - | (207) |
| Depreciation/amortisation charged in the period | (1,037) | (65) | (19) | (1,121) |
| At 31 March 2007 | (2,255) | (85) | (19) | (2,359) |
| Net Book Value at 31 March 2007 | 1,390 | 488 | 654 | 2,532 |
| Net Book Value at 31 March 2006 | 1,750 | 55 | - | 1,805 |

Tangible fixed assets consist of installed computer hardware and operating systems; intangible assets consist of software licences.

ii Transfer to fixed asset reserve

As indicated above, impairment and depreciation charges on the assets acquired by DWP as part of the project to establish the Board are written off directly to the associated fixed asset reserve. The total value written off in this way is as follows:

| | Year to 31 March 2007 | Period to 31 March 2006 |
|---|---|---|
| | £000s | £000s |
| Impairment charges on tangible fixed assets | 170 | 135 |
| Depreciation charges on tangible fixed assets | 658 | 771 |
| Depreciation on intangible assets | 16 | 16 |
| **Total transferred to fixed asset reserve** | **844** | **922** |

## Note 3.6 Net current assets

a) Cash at Bank

As described in the accounting policy on "Segmental Reporting", the Board of the Pension Protection Fund is responsible for three ring-fenced funds. To improve controls over the three funds and ensure that only allowable items of income and expenditure are transacted within each fund, the Board has opened separate bank accounts for the three funds. The Administration Fund account is used to receive grant in aid from DWP and to pay staff and other suppliers of goods and services.

All bank accounts are interest bearing, at rates that the Board consider competitive given the operating requirements of the accounts.

b) Other current assets

Other current assets consist of amounts recoverable from staff in respect of season ticket and other similar loans, and prepayments of certain costs. The value of debtors that falls inside the Whole of Government Accounts boundary is: nil.

c) Current liabilities consist of:

| | As at 31 March 2007 | As at 31 March 2006 |
|---|---|---|
| | £000s | £000s |
| Amounts due to suppliers | 182 | 82 |
| Taxation and social security | 130 | 74 |
| Other creditors | 93 | 43 |
| Accruals | 2,735 | 1,064 |
| **Total current liabilities** | **3,140** | **1,263** |

The value of creditors that falls inside the Whole of Government Accounts boundary is £577,000 (2006: £560,000).

## Note 3.7 Reserves

Administration Fund reserves consist of:

| | As at 31 March 2007 | As at 31 March 2006 |
|---|---|---|
| | £000s | £000s |
| General reserve | (928) | 2,153 |
| Fixed asset reserve | 732 | 1,576 |
| **Closing balance** | **(196)** | **3,729** |

a) The general reserve consists of:

| | As at 31 March 2007 | As at 31 March 2006 |
|---|---|---|
| | £000s | £000s |
| Opening balance | 2,153 | - |
| Grant-in-aid received in the period | 10,011 | 8,991 |
| Net result for the period | (13,092) | (6,838) |
| **Closing balance** | **(928)** | **2,153** |

The general reserve appears in these Financial Statements for the first time as a result of the prior period adjustment required by the change in accounting policy described in Note 3.1a. This change requires grant-in-aid receipts to be treated as financing, credited to the General Reserve, because they are regarded as contributions from a controlling party. Grant-in-aid receipts were previously treated as income in the Board's operating statement.

b) The fixed asset reserve consists of:

| | As at 31 March 2007 | As at 31 March 2006 |
|---|---|---|
| | £000s | £000s |
| Opening balance | 1,576 | - |
| Fixed assets received in period | - | 2,498 |
| Movement in the period (see Note 3.5 ii above) | (844) | (922) |
| **Closing balance** | **732** | **1,576** |

Fixed assets to the value of £2,498,000 were brought into use when the Board of the Pension Protection Fund opened for business on 6 April 2005, having been acquired by DWP as part of the project to establish the Pension Protection Fund. The book cost of these assets has been brought into the Board's Administration Fund accounts as at 6 April 2005 through reserves, analogous to donated assets.

The movement in the period represents impairment and depreciation charges on these assets which has been charged to operating expenses in the first instance (see note 3.5) but then offset against the fixed asset reserve with the intention of writing off the reserve over the useful life of the fixed assets concerned.

## Note 3.8 Financial Instruments

FRS13, Derivatives and Other Financial Instruments, requires disclosure of the role which financial instruments have had during the period in creating or changing the risks an entity faces in undertaking its activities. Because of the non-trading nature of the Board of the Pension Protection Fund's administration activities and the way it is financed, the Board is not exposed in this area to the degree of financial risk faced by business entities. For example, the Board has no powers to borrow to fund administration activities or to raise income other than by the grant-in-aid process described in Note 3.2. Financial assets and liabilities are generated by the Board's routine operational activities, and are not held to change the risks facing the Board in carrying out its administration functions.

**Liquidity risk** – Both the Board's resource and capital requirements are funded by grant-in-aid from its sponsor department, DWP. The Board is therefore not exposed to significant liquidity risks.

**Interest rate risk** – The Board has no power to borrow to fund administration activities and therefore is not exposed to any interest rate risk. Any surplus funds on its Administration account are held in interest-bearing accounts- see Note 3.6a.

**Foreign currency risk** – The Board has no significant exposure to foreign currency in respect of its administration activities.

# Glossary

| | |
|---|---|
| **The "PPF"** | the Board of the Pension Protection Fund was established as a body corporate under the Pensions Act 2004 and is run by a Board which must consist of:<br><br>(a) a Chairman;<br>(b) the Chief Executive of the Board; and<br>(c) at least five other persons ("ordinary members"). |
| **The "Board"** | the Members of the Board of the Pension Protection Fund are referred to in the Directors' Report as the "Board". |
| **The "DWP"** | the Department for Work and Pensions is the PPF's sponsoring department. The PPF is accountable to Parliament through the Secretary of State for Work and Pensions. |
| **The Pensions Regulator** | the Pensions Regulator is the UK regulator of work-based pension schemes. One of its statutory duties is "to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund". |
| **Section 120 notices** | a prescribed notice to the Pension Protection Fund required under the Pensions Act 2004 which must be completed by an insolvency practitioner when he becomes aware that an insolvent employer has sponsored an occupational pension scheme. |
| **Section 143 valuations** | an actuarial valuation carried out on a prescribed basis, required under the Pensions Act 2004 to determine whether, as at the assessment date, the value of the pension scheme's assets was less than the amount of its protected liabilities. |
| **Section 179 valuations** | an actuarial valuation carried out on a prescribed basis, required under the Pensions Act 2004 to determine, for the purposes of calculating the risk based levy, the funding of an eligible pension scheme. |
| **The Purple Book** | the Pensions Universe Risk Profile (Purple Book) pulls together data and analysis on the defined benefit pensions landscape. It was published jointly by the PPF and the Pensions Regulator for the first time in December 2006. |

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