Pension Protection Fund

Actuarial Profession Pensions Conference

Stephen Rice, PPF Chief Actuary

3 June 2011

The Pension Protection Levy from 2012/13

What we'll cover

Pension
Protection
Fund

- Context – how the PPF has evolved and our view of the future
- Our consultation exercise and stakeholder response
- Our final plans for the levy from 2012/13

Overview – PPF at 5 years & beyond

Pension
Protection
Fund

- Manage portfolio of £5bn, with 50,000 members transferred in and £200m compensation paid out.

- Time to reflect on experience

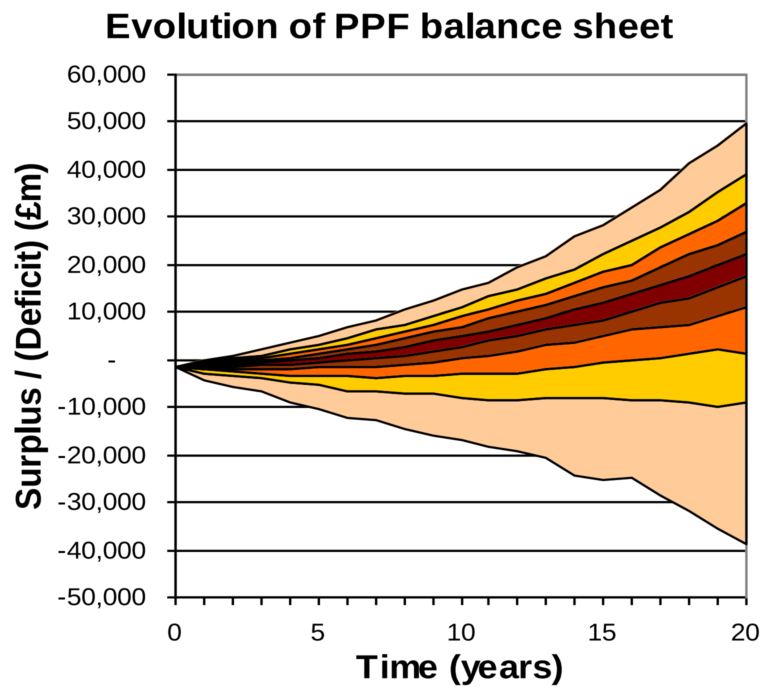
  – Strategic framework (April 2010) set out new vision, mission and strategic objectives.
  – Funding Strategy (August 2010) establishes long-term target of self-sufficiency by 2030.
  – Worked with stakeholders on Assess & Pay model

The PPF Long-Term Funding Strategy
A brief reprise

Pension Protection Fund

PPF Long-Term Funding Strategy uses Long-Term Risk Model (LTRM), to model outcomes over 20 years

- Takes account of average claims and tail risk
- We expect risk to decline significantly over that period – so must reinforce balance sheet as scope for levy recedes
- Our funding objective is '**self-sufficiency**' by 2030, including reserve to hedge future claims and longevity risk
- Projections suggest a probability of success of **85 per cent** as at 30 September 2010



So why change the way we charge the levy?

- Risk measures used in determining levy quantum different from those used to share levy

- Worked with Steering Group of industry experts key messages:
  - Wanted more predictability in individual bills - bills should respond to changes in the scheme's risk, not others' risk
  - Stability of levy bills also a priority – so schemes would be less likely to experience large changes between years.
  - Levy should focus more on things schemes can actually control: funding position, potentially investment strategy
  - More transparency on cross-subsidy
  - Stronger link to commercial charging – market consistency

Key Features of New Framework

Pension
Protection
Fund

Bottom-up approach

- Fixed parameters (incl. scaling factor) for three years, only adjusted in limited circumstances
- Total levy not set – will be sum of individual levies
- More predictable levy bills

New approach to how underfunding and insolvency risks measured:

- Investment risk taken into account
- Changes smoothed by using average values
- Market-consistent rates for insolvency

Stakeholder responses and PPF's conclusions: overview

- Broad welcome for proposals – comments largely focus on altering design at the margin – number of comments re "big step forward"
- Strong support for "bottom up" aspect and idea of parameters set for 3 years
- Comments on detail have been addressed through revisions to the proposal
- Implementation from 2012/13

Our proposals on assessing funding

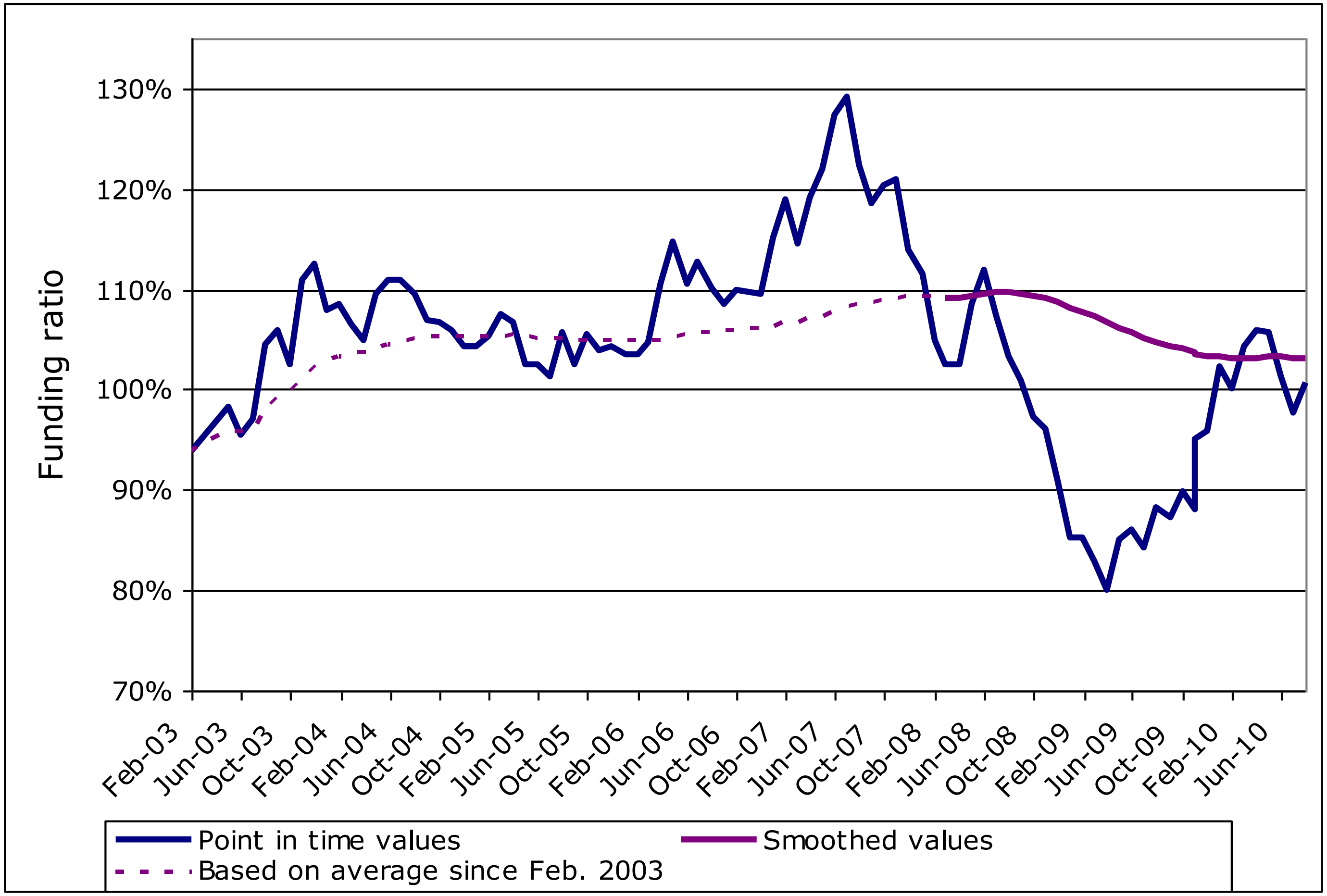
Pension
Protection
Fund

- Funding measurement smoothed over 5 years, by averaging market movements in roll-forward calculation
- Funding calculation incorporates investment risk by applying stresses to assets and liabilities
- For great majority of schemes, based on existing asset allocation data reported through Exchange.
- Largest 100 or so schemes required to provide more detailed analysis; optional for others. Guidance on "how" being consulted on now

Smoothing significantly reduces volatility of funding

Pension Protection Fund

Funding ratio of PPF 7800 over time



Responses – Funding

Pension Protection Fund

- Strong support for proposition on smoothing: so implementing as proposed

- Many comments on measuring investment risk – not a surprise as wholly new aspect of levy

- General support for principle. Comments focus on detail:
  - Extent to which standard test can recognise low risk
  - How bespoke test will work

So what did we change?

Pension
Protection
Fund

- For the “standard” investment risk measure now use full range of information captured on exchange
- Considered, but rejected, suggestions of making exchange requirements for all more detailed
- Now issued draft guidance for carrying out “bespoke” assessment of investment risk, for consultation.

Investment risk: Indicative stresses for standard approach

Pension Protection Fund

- PPF proposes to adjust assets reported through exchange for following stresses

Corporate bonds	Nominal gilts	Index-linked bonds	UK Equity	Overseas Equity	Property
+1%	+9%	+16%	-22%	-19%	-7%
Cash	**Hedge Funds**	**Commodities**	**Insurance Funds**	**Annuities**	**Other**
0%	-9%	-19%	-22%	+11%	-22%

- Scheme likely to need advice
- Outcome similar to standard model, except for those with derivatives
- Two stage process
  - Expanded set of asset categories
  - Assessment of sensitivity to risk factors for derivatives
- PPF looking for feedback on draft guidance

Our proposals on insolvency risk

Original proposals:

- Average score over past 12 months used so levies would be less affected by short-lived dips in employer failure score.

- Employers placed into six PPF levy bands – instead of using failure scores.

- Insolvency probabilities in line with how financial markets would price PPF-equivalent risk.

Responses – Insolvency risk

Pension Protection Fund

- Large number of comments on banding – a few on principles – most on rate increases between bands (cliff edges)
- Some comments on complexity: banding and then re-banding
- Also some points regarding reflection of last-man standing scheme structure

Why base levy on broad insolvency probability bands?

Pension Protection Fund

Are limitations on discrimination "just a D&B problem": the evidence from credit ratings

Pension Protection Fund

- Default rates for broad ratings robust trend…

Rating	Default rate
Aa	0.06%
A	0.09%
Baa	0.27%
Ba	1.06%
B	3.39%
Caa-C	13.10%

Moody's default rates 1920-2008

- Less "well-behaved" at granular level

Rating	Default rate
Aa2	0.00%
Aa3	0.11%
A1	0.04%
A2	0.02%
Ba1	0.63%
Ba2	0.60%
Ba3	1.94%
B3	10.30%
Caa1	7.90%
Caa2	21.65%
Caa3	14.37%

Moody's default rates 1983-2008

How we will assess insolvency risk

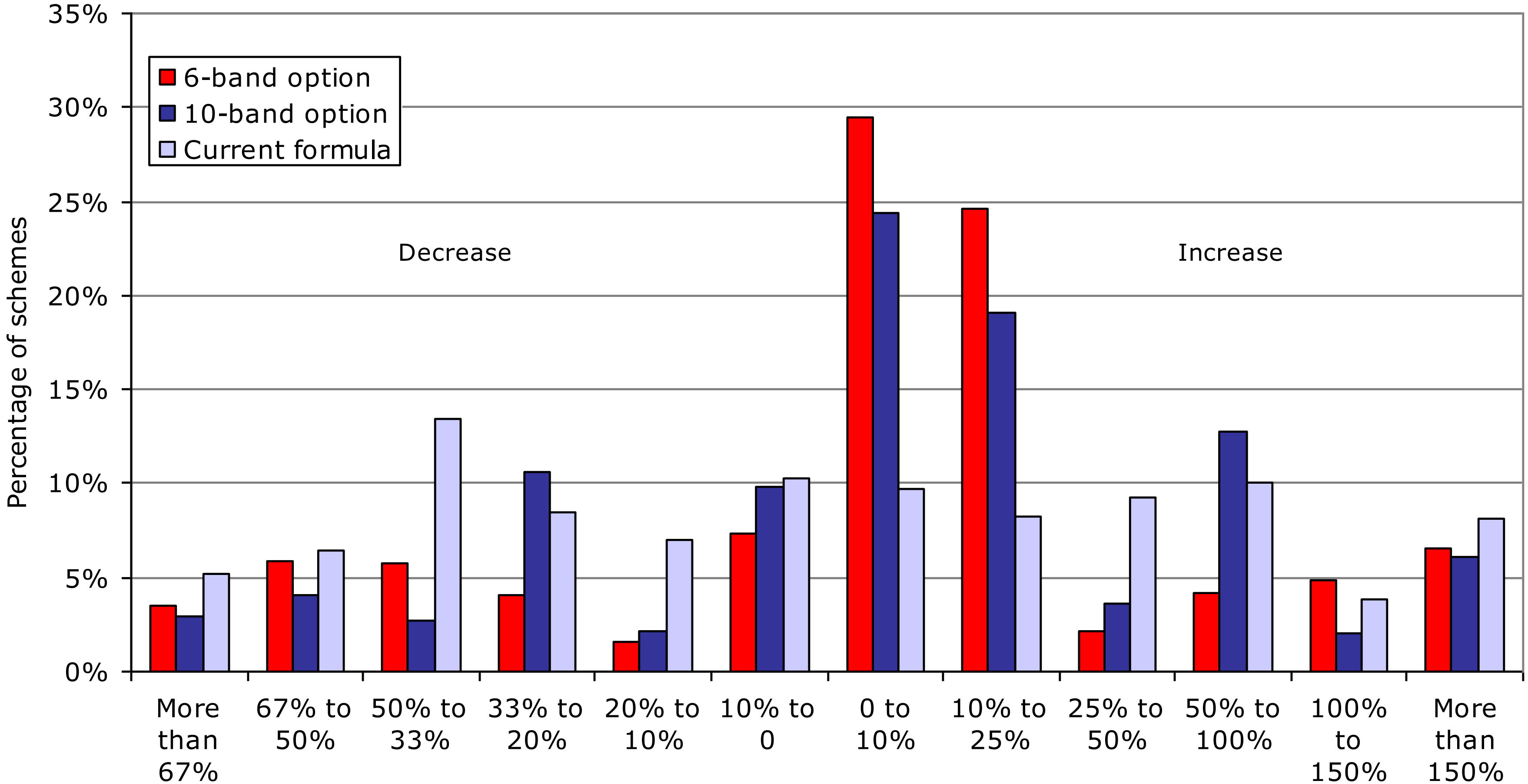
- Have changed banding design. Will use a 10-band system. Benefits:
  - Reduced impact of cliff-edges
  - Volatility of levies year on year lower than either current approach or initial 6-band proposal
- Employers' failure scores monitored monthly, annual average of scores calculated then employer banded
- Greater recognition of reduced risk for non-associated last man standing schemes.

Employers will be placed in one of 10 bands

Pension Protection Fund

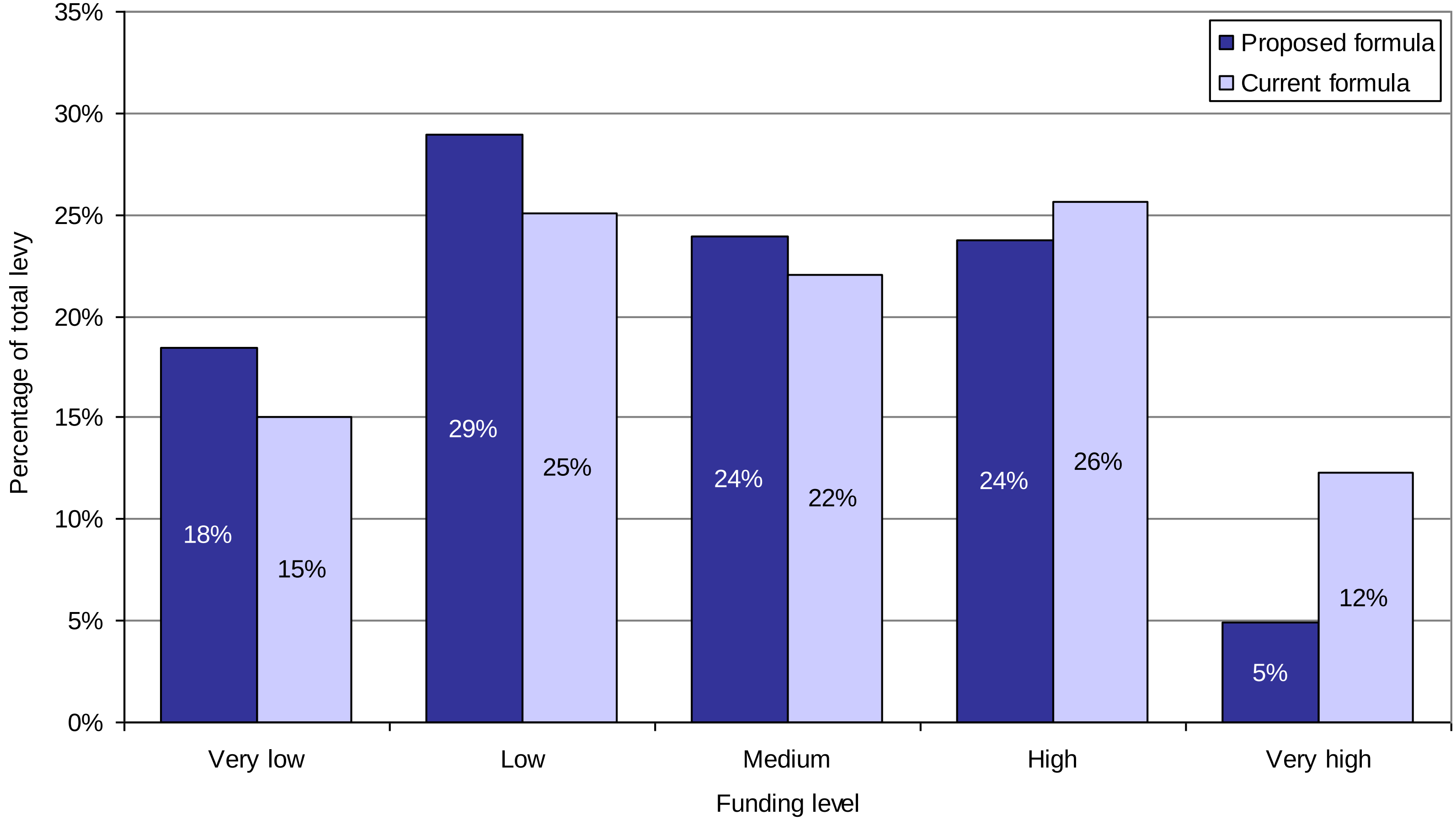
Levy Band	1	2	3	4	5	6	7	8	9	10
Levy Rate	**0.18%**	**0.28%**	**0.44%**	**0.69%**	**1.10%**	**1.60%**	**2.01%**	**2.60%**	**3.06%**	**4.00%***
D&B FS	**100-99**	**98-96**	**95-92**	**91-87**	**86-73**	**72-66**	**65-46**	**45-38**	**37-30**	**29-1**
Risk Margin	0.16%	0.21%	0.33%	0.52 %	0.80%	1.14%	1.20%	1.20%	1.20%	1.20%
Avg D&B IP	0.02%	0.07%	0.11%	0.17%	0.30%	0.46%	0.81%	1.40%	1.86%	5.05%

Analysis of Stability – Individual Levies



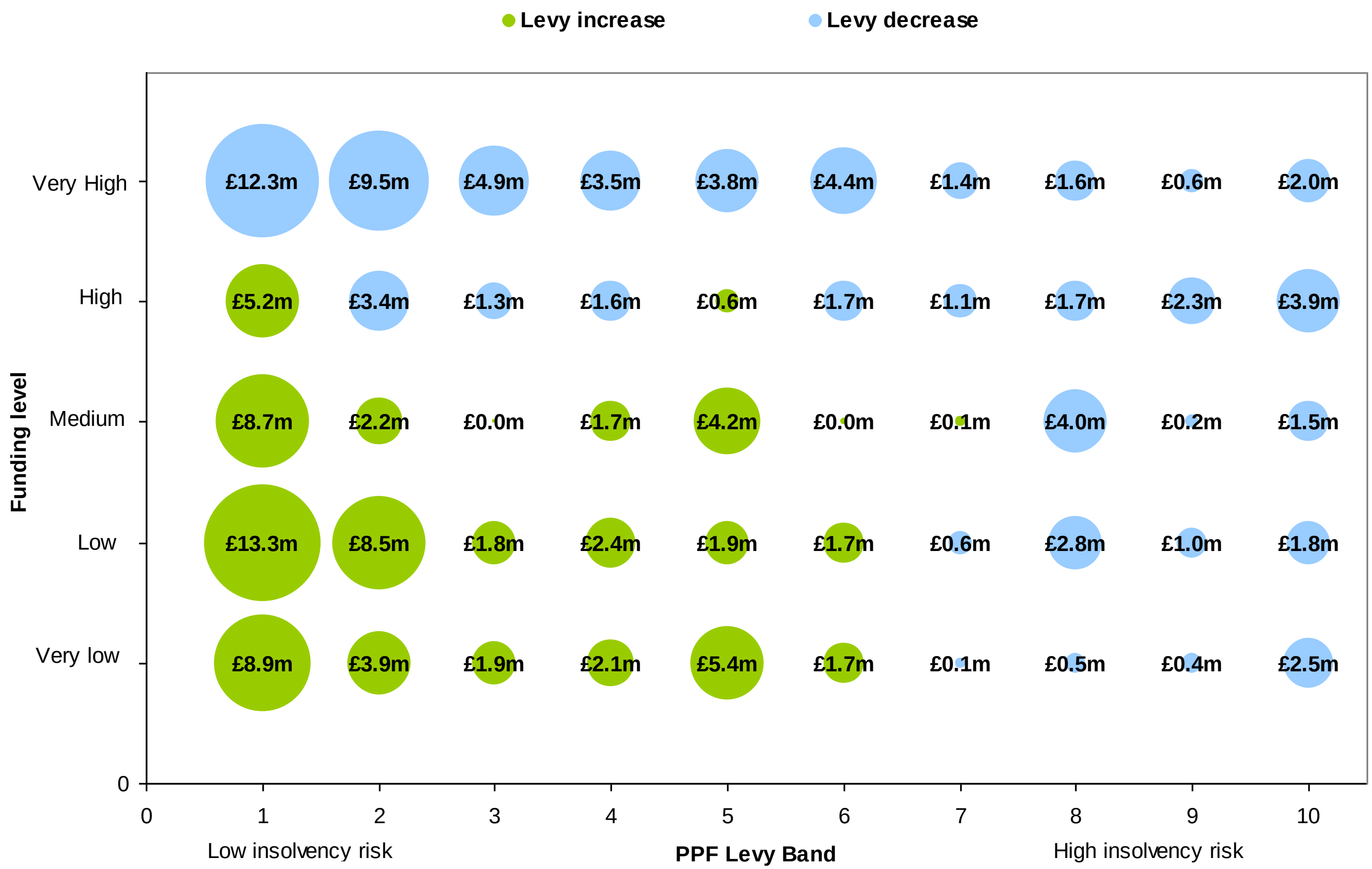
Levy will focus more on funding

Pension Protection Fund



Impact of Proposal - Funding Trumps Covenant

Change in levy for 2011/12: Current formula compared to new formula



New Framework: Key Dates

Pension
Protection
Fund

- Policy Statement in May 2011
- Consultation on approach for carrying out bespoke stressing – 24 June
- Consultation on parameters for 2012/13 to 2014/15 Autumn 2011
- Implementation for levy year 2012/13
- Outcome of levy review – Autumn 2013 & Autumn 2014

Pension
Protection
Fund

Questions?