The Actuarial Profession
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consultation response

Pension Protection Fund

Consultation on the Future Development of the Pension Protection Levy November 2008

February 2009

The Actuarial Profession
making financial sense of the future

consultation@ppf.gsi.gov.uk

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13 February 2009

Dear Chris,

THE RESPONSE OF THE ACTUARIAL PROFESSION TO THE PPF *CONSULTATION ON THE FUTURE DEVELOPMENT OF THE PENSION PROTECTION LEVY NOVEMBER 2008*

We welcome the opportunity to respond to the consultation. The response comes in two parts: a response to the PPF's notion of fairness and a response to several technical issues raised by the consultation.

1. The definition of fairness and its consequences

1.1 The consultation paper justifies the PPF's proposed changes to the levy formula in terms of making the distribution of the levy fairer. However, the paper does not make it clear that this notion of fairness is based on the PPF's own definition of what would be a fair distribution, based on adding an amount in respect of short term risk to an amount derived from 5 year "unexpected" risk as calculated by the PPF's own model. We consider that the PPF should consult on what should be taken as a fair distribution of the levy before turning to the secondary issue of how to amend the levy formula to bring the levy charged closer to the fair distribution. We do not believe it will be possible for stakeholders to engage sensibly with the latter issue until after the PPF has conducted a transparent consultation on how a fair distribution of the levy should be defined.

1.2 We note that the PPF's paper claims that the levy amount itself reflects long term risk as well as short term risk. Most stakeholders looking at the current aggregate levy amount would think that it reflects short term risk plus an amount towards the PPF deficit, which reflects past under-charging for short term risk. The paper does not address the derivation of the overall quantum of the levy at all. We would, however, suggest that a fair allocation of the levy is inherently related to how the overall amount is determined. We therefore recommend that the PPF:

- first consult on its strategy for setting the levy amount
- then consult on what would represent a fair distribution of the levy
- and only then return to the issue of amending the levy formula to make the actual distribution of the levy closer to what has been decided to be theoretically fair.

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1.3 The paper takes as a given that a fair distribution of the levy should include an element based on the distribution of tail claims over the longer term (5 years) rather than being wholly based on the short term distribution of expected claims. This allocates more of the levy to well funded schemes with strong sponsors. The paper does not give any justification for this fundamental assumption. An argument can be made for this approach; that schemes should contribute towards their share of the PPF's cost of capital. The cost of capital element would indeed reflect long term tail risk. However, the paper fails to explain this argument, which is fundamental to the PPF's definition of fairness. The consultation needs to be explicit on this argument.

1.4 This lack of transparency is important because the incorporation of a charge for cost of capital raises important issues on which the PPF should be consulting, but which it has avoided in this paper. Many of these issues arise because the PPF, unlike an insurance company:

- has the ability to reduce the benefits protected should claims be too large
- does not need to hold solvency capital, nor to pay for any capital it does hold

These issues are considered further below.

1.5 It is not clear that it is reasonable for the PPF to charge for "cost of capital" when it is not required to and indeed does not hold solvency margin capital. We understand that the PPF regards the ability to charge levies to schemes to recover deficits following bad years as representing notional capital. We wonder whether it is reasonable to levy actual charges in respect of the cost of what is only notional capital, for which the PPF itself does not incur any cost.

1.6 Any intention to build up actual capital (ie surplus) would be a significant step on which the PPF should consult formally. There is just one passing reference in 4.2.6 to the fact that the PPF intends building up surplus. We understand that the legislation does not envisage the PPF deliberately building up any surplus, and neither did Parliament consider this during discussion on the Bill. Even if the PPF builds up actual capital, it is still far from obvious that it is reasonable for the PPF to levy charges in respect of this capital, because the PPF will still not incur any cost in respect of this capital.

1.7 It is instructive to note that, if you consider from whom the PPF derives its notional and any actual capital, this would appear to be the same schemes whom the PPF is proposing to charge for its cost of capital. In other words, if it is fair for the PPF to charge for its cost of capital, it could be considered equally fair for the PPF to reimburse essentially the same schemes in broadly the same amounts for providing that capital to the PPF, implying nil net payments.

1.8 If it is concluded that it is appropriate in principle to charge for the PPF's (notional) cost of capital (and not to reimburse the providers of the capital), the next step would be to consider the size of that capital. This is important because the contribution of each scheme to the (notional) capital will reflect the limit on the claims that the PPF can meet without having to restrict the benefits protected, which in turn will depend on the size of the capital it can draw on. If the maximum claims it expects to be able to meet in this way are for example at the 90% level, it would not be consistent to apportion the cost of capital based on the tail claims at the 99% level. The PPF paper considers unexpected claims at the 97.5% level, with no justification as to why it chooses that percentage.

1.9 The PPF needs to set out what claims it expects to be able to meet without having to restrict the benefits protected, before moving on to consider how to attribute its cost of capital (if this is determined to be appropriate after a transparent consultation). We recognise that this will require discussion of politically sensitive issues, but consider this both inevitable (since despite the concerns we expressed before the PPF was set up, it has been established with neither a government guarantee nor capital at the level that would be required by an insurance company) and sensible (we believe the PPF should consider and communicate openly about how it will be managed in scenarios that are too adverse to be covered from its levies alone: for example, how likely is a scenario so adverse that benefit increases and/or revaluation will have to be restricted; how likely is a scenario so adverse that the proportion of benefits protected will have to be restricted etc). Only then will a stakeholder be able to engage in an informed consultation on the future financing of the PPF.

1.10 The levy legislation requires at least 80% of the levy to be based on risk. A natural interpretation of risk in this context would be that at least 80% of the levy should reflect the expected cost to the PPF of the scheme making a claim. This would reflect short term rather than long term losses, and expected rather than unexpected (or tail) losses. We would urge the PPF to explicitly consult on this issue. Has the PPF taken legal advice on whether its proposed approach complies with the legislation?

1.11 A lot of emphasis is placed on “stability” of contributions from year to year – and the paper notes that under the proposals the well funded schemes will have greater stability of levy than in the past. However, we expect many such schemes would prefer lower volatile levies to higher stable levies. The assumption that “stability” is paramount calls for a clearer definition of stability. We note that the levy will only be more stable because there will be a weaker link to the scheme funding level and to the sponsor insolvency risk. As noted above, it is not clear to us that this is what the legislation intended in the requirement for 80% of the levy to be risk based.

2. Technical issues with the PPF’s proposals:

2.1 We have serious concerns over the reliability of deriving 5 year insolvency risk probabilities from 1 year D&B failure scores in the way proposed. D&B’s methodology is based on a short term analysis of the risk that a company cannot pay its bills and the failure score is not easily extrapolated to reflect actual longer term risks. We are concerned that the impression the paper gives, that D&B scores correlate well with longer term D&B ratings or longer term risk, may be misleading.

2.2 We support the move to reflect investment policy in the levy formula, subject to the following provisos

2.2.1 The paper's claim that the industry supports recognition of investment risk generally is based on a survey showing support for recognition of low risk strategies in particular – this is not necessarily the same as overall support for recognition of investment strategy generally.

2.2.2 We doubt the validity of the analysis in Appendix E of the impact on schemes' investment strategy. Few schemes set their investment strategy using the indifference curve approach assumed. Many actuaries would regard the approach as theoretically flawed. So the impact may be very different from that estimated in the consultation paper.

2.2.3 The main impact is likely to be that large schemes change the way they achieve their investment risk, rather than that schemes change the risk they are exposed to. If the levy formula penalises equity risk in a simplistic way as proposed, large schemes will invest in geared hedge funds or derivatives rather than in direct equity so as to maintain the same risk exposure with less impact on their levy, ie they will "game" any simplistic approach to reflecting investment risk in the levy formula.

2.2.4 In aiming for simplicity, the approach to projecting the 5 year risk ignores many elements that could make its impact significantly different between schemes, namely:

- any recovery plans in place and therefore expected contributions over the 5 year period
- existing derisking strategies. An implicit assumption is that a scheme's investment strategy remains unchanged over a 5 year period and that new contributions are invested in line with existing assets
- the duration of the bond assets and the age distribution of the different categories of members
- the treatment of contingent assets in the 5 year projections may well be too simplistic, e.g. where guarantees are limited to fixed amounts
- the derivation of Q for multi-employer schemes, particularly those with a "last man standing" structure, may well overstate significantly the actual risk.

We hope the above points are helpful, but please contact Martin Hewitt, Pensions Practice Manager on 0207 632 2185 or via martin.hewitt@actuaries.org.uk if you require any further clarification.

Yours sincerely

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Chief Executive

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