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Pension Protection Levy: Developments this autumn

Chris Collins, Head of Levy Policy
Pension Protection Fund

Immediate developments: Invoicing and electronic data capture

Invoicing 2008/09

- Invoicing began on 26 September 2008
- Range of materials to help make bills easier to understand

Electronic data capture for 2009/10

- All levy data capture (scheme returns & voluntary certificates) on Exchange from November/December
- Not too late for contingent assets/DRCs for 2009/10 – deadlines are 5pm on 31 March/7 April

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Conclusions of 2009/10 consultation:

- **Conclusions published on 20th November**
- **Announcement package included:**
  - ➢The Levy Determination
  - ➢The Levy Estimate of £700m
  - ➢Levy Scaling Factor of 2.22
- **Block Transfer Certificates – reflected feedback :**
  - ➢relaxing timescales for reporting, and
  - ➢raising materiality thresholds

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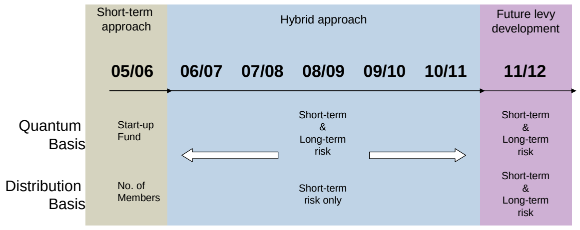
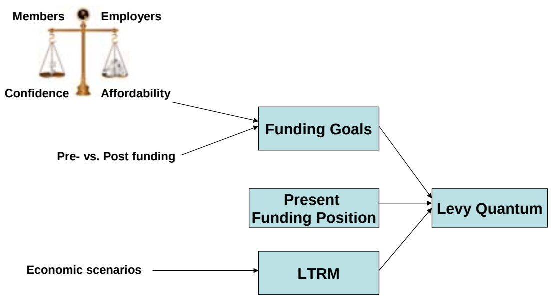
The Levy Journey



Quantum = total levy we aim to collect in a year
Distribution = how do we share the quantum between schemes?

How do we decide levy quantum?



Recent experience makes case for allowing for adverse claims

- PPF 7,800 Index shows scheme deficits are highly volatile
  - £ 84.1 billion net surplus at end October 2007
  - £97.3 billion net deficit at end October 2008
- Corporate insolvencies lag changes in growth
  - Insolvency Service report rise in insolvencies, likely to see rise in other measures later
- Big companies fail
  - Lehman Brothers scheme entered assessment in October 2008

2011/12 consultation: Why we should use long-term risk in the levy

- **We take account of long-term risk when setting levy total**
- **Fair to reflect long-term risk when sharing the levy**
- **Last year, 56 per cent of you supported our initial ideas :**
  - "This should lead to increased stability in the levy and fairer distribution of the cost."
  - "We agree with this proposal. It is a measure which should help reduce the volatility of levy charges to individual schemes, an aim which we fully support."

Responses to the August 2007 PPF Consultation

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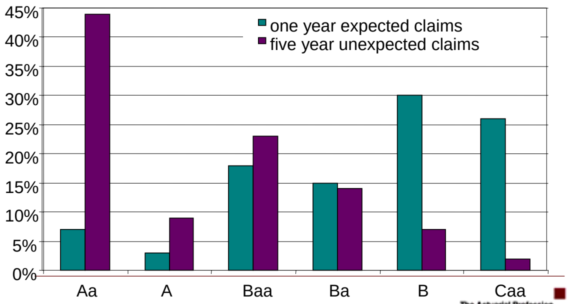
The difference in short-term and long-term risk



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New suggested approach: second risk-based component

Risk-based levy | **Scheme-based levy**

Short-term risk component + **Long-term risk component** + **Percentage of scheme liabilities**

Short-term risk component:
Reflects contribution to one year ahead expected claims
Uses underfunding risk & insolvency risk

Long-term risk component:
Reflects contribution to unexpected risk over 5 years
Uses conditional underfunding risk and insolvency risk

Percentage of scheme liabilities:
Component to include redistributing capped risk-based levies; amortise deficit if required

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The proposed new formula is:

risk-based levy = c x U x P + w x Q x V

Where:

- U the scheme's short-term underfunding
- P is the scheme's short-term insolvency probability
- c is the rate for short-term risk

- Q is the scheme's long-term insolvency probability
- V is the scheme's long-term underfunding
- w is the rate for long-term risk.

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Including investment risk

- The PPF has monitored the implications of investment risk
  - Consulted in 2006
  - Concluded time was not then right for inclusion
  - Committed to continuing to monitor the situation
- Scheme investment strategy is important for modelling and pricing long-term risk

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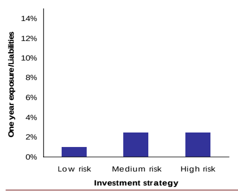
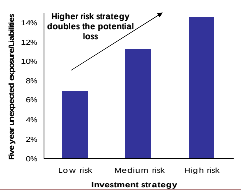
Including long-term risk in levy means greater differentiation between investment strategies

- Investment risk is a significant contributor to the second component of the risk-based levy

One year ahead expected exposure



Five year unexpected exposure



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There is a spectrum of approaches that can be adopted to recognise investment risk

Less complex & less accurate ←→ More complex and more accurate

	1. Do not differentiate by scheme	2. Simple differentiation	3. Use all data currently collected	4. Voluntary certificate	5. Internal models approach
Description	• 'Average' investment risk taken into account in calculating scheme ST and LT risk through same "std deviation"	• Schemes can submit a voluntary certificate stating they have lower investment risk • Discount applied to assets would be reduced	• Scheme-specific asset & liability mix in calculating ST and LT risk	• Collect results of stress-tests on assets • E.g. impact of 10% and 40% falls in equity / property assets	• Allow schemes to measure their own deficit volatility (e.g. pre-defined stress tests) • Default (e.g. option 1) for smaller schemes
Key challenges	• No recognition of de-risking • 'Unfair' on schemes which have already derisked	• Creates cliff edge for those who just miss out on low risk status • Certification requirements need to be determined	• May understate some risks? • Unfair on schemes that have hedged their equity risk and on those with LDI strategies	• Doesn't fully reflect investment risk e.g. interest rate hedges not captured? • How to calibrate tests? (potentially big impact on results…) • selection bias?	• Major undertaking for schemes and for PPF to put the framework in place, spelling out what schemes need to do & validation • Adverse selection risk

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The advantages of the new formula

New formula more closely reflects risks to the PPF of each scheme

- ➢It is fairer than before and will improve stability of levy bills year-on-year
- ➢We won't need ANY new data from schemes
- ➢Potentially, opportunity to recognise impact of more sophisticated risk reduction measures

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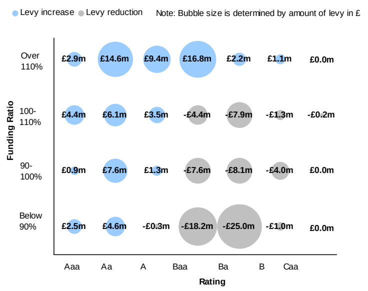
What is the impact on schemes: by funding level and credit rating/1



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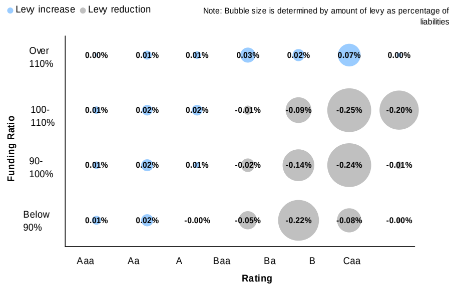
What is the impact on schemes: by funding level and credit rating/2



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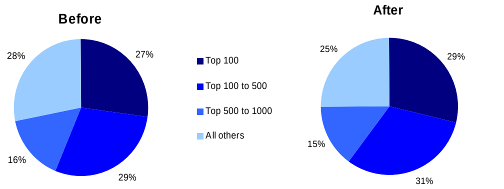
What is the impact on schemes: by size

Percentage of total collections from each liability size group



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Next steps

- 12 week consultation on long-term proposals, began 17th November
- It closes 13th February 2009
- Programme of road shows on long-term proposals in January – two in London

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