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Charting a Course for the Future: Our expected direction of travel for the Levy

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Overview – PPF at 5 years

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- 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.
  - Consultation for New Levy Framework October to December 2010.
  - 2009/10 Annual Report and Accounts

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The PPF Long-Term Funding Strategy
A brief reprise

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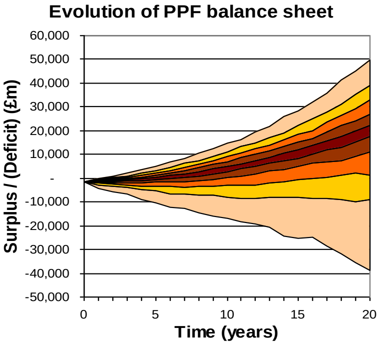
PPF Long-Term Funding Strategy uses Long-Term Risk Model (LTRM), to model outcomes over 20 years

- 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 at 31 March suggest a probability of **83 per cent**



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So why change the way we charge the levy?

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- 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

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Key Features of New Framework

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 insolvency and underfunding risks measured

- Changes smoothed by using average values
- Market-consistent rates for insolvency

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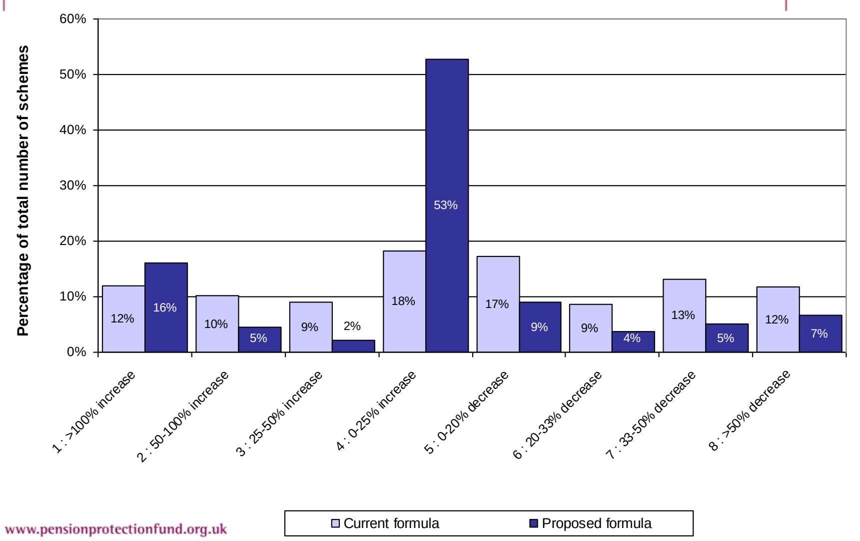
Analysis of Stability – Individual Levies



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Responses: overview

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- Broad welcome for proposals – comments largely focus on altering design at the margin – number of comments re "big step forward"
- Sufficient support for Board to announce go ahead
- Strong support for "bottom up" aspect and idea of parameters set for 3 years
- Some commentators suggest should allow more flexibility to reflect changing conditions

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Key Features of New Framework: Funding

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- Funding measurement smoothed over 5 years, by averaging market movements in roll forward calculation
- Funding calculation would incorporate investment risk by applying stresses to assets and liabilities
- For great majority of schemes, this would be based on existing asset allocation data reported through Exchange.
- Largest 100 schemes required to provide more detailed analysis; optional for others.

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Responses – Funding

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- Strong support for proposition on smoothing
- 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

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Further work on funding issues?

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- Unlikely to be significant change to smoothing proposals
- Will look at whether the "standard" investment risk measure can be rendered more sophisticated without increased burdens to schemes
- Will explore informally and consult on draft guidance for carrying out "bespoke" assessment of investment risk.

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Key Features of New Framework: Insolvency Risk

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- Failure Scores placed into six PPF levy bands – less granularity.
- Average levy band over past 12 months used so levies would be less affected by short-lived dips in employer(s) Failure Score.
- Insolvency probabilities in line with how financial markets would price PPF-equivalent risk.

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Key Features of New Framework: Insolvency Risk

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PPF Levy Band	**1**	**2**	**3**	**4**	**5**	**6**
D&B Failure Score	100-97	96-90	89-69	68-42	41-6	5-1
Average D&B probabilities	0.04%	0.10%	0.30%	0.80%	2.80%	13.00%
Risk Margin	0.16%	0.40%	0.80%	0.80%	1.20%	1.20%
Indicative Levy Rate	**0.20%**	**0.50%**	**1.10%**	**1.60%**	**4.00%**	**14.20% (capped at 4%)**

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Responses – Insolvency risk

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- 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

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Why base levy on broad insolvency probability bands?

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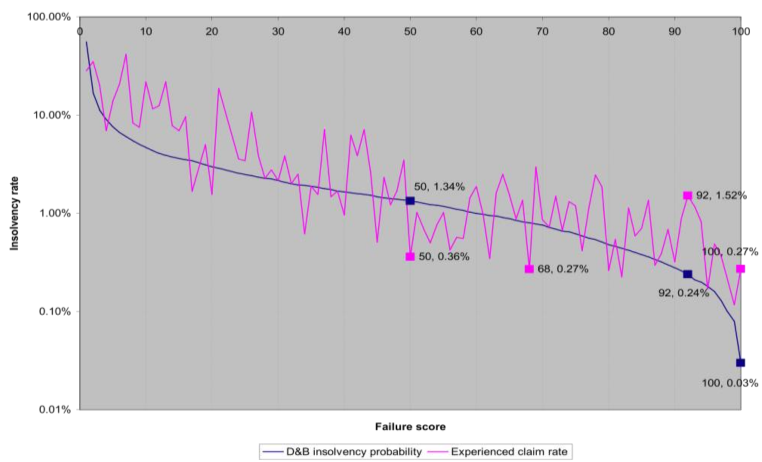

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Are limitations on discrimination "just a D&B problem": the evidence from credit ratings

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- 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

So what further development of proposal is possible?

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- Further consideration of banding design. Any alternative needs to be assessed on:
  - Accuracy
  - Volatility
- Simplified approach to averaging
- Considering scheme structures further – could be scope to use more sophisticated approach to assessing concentration risk for non-associated schemes

Impact of Proposal - Funding Trumps Covenant

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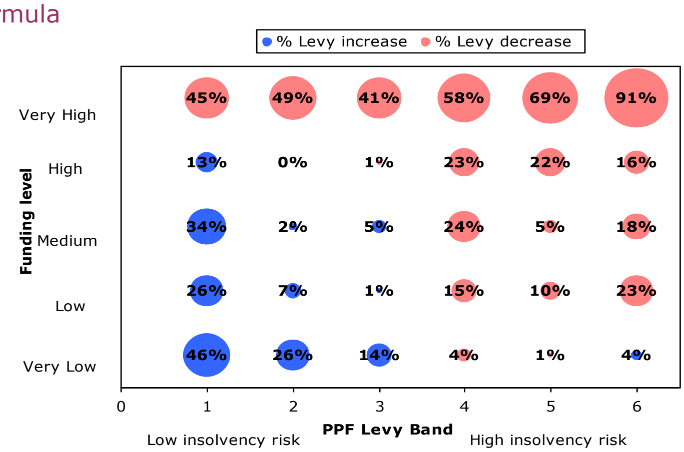
Change in levy for 2011/12: Current formula compared to new formula



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Consultation on New Framework: Key Dates

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Consultation ended 20 December

Initial Announcement on 31 January

Further analysis, informal engagement with stakeholders February to April

Full Policy Statement in spring 2011

Final parameters published late 2011

Implementation for levy year 2012/13

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Questions?

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