Institute
and Faculty
of Actuaries

Second PPF Levy Triennium: 2015/16 to 2017/18

Consultation response

9 July 2014

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

Chris Collins
Chief Policy Adviser
Pension Protection Fund
Renaissance
12 Dingwall Road
Croydon
SURREY CR0 2NA

9 July 2014

Dear Chris

Consultation on the second PPF Levy Triennium 2015/16 to 2017/18

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to this consultation. Our response has been prepared by the Pensions Consultations Subcommittee and is limited to those questions that would benefit from actuarial expertise.

Chapter 2

1. Do you agree that we should seek to maintain stability in the overall methodology for the levy, only making changes where there is evidence to support them?

Stability within the levy methodology should be considered at two levels. Firstly, there is a requirement for stability in the operation of the levy as the mechanism for funding the PPF. Neither defined benefit (DB) pension schemes, nor the PPF, would benefit from a lack of stability arising from the levy mechanism. Secondly, at a micro level, each scheme would benefit from stability in the methodology to ensure that there are no hidden surprises in the levy calculation from year to year, assuming the scheme's broader environment remained unchanged.

Accordingly, we agree that the PPF should only make changes where there is evidence to support them and we do not believe that a desire for stability should be used to block changes justified by evidence that those changes would increase fairness.

Initially, the change in the levy methodology is likely to create a large number of winners and losers. The IFoA welcomes the publication of the PPF's analysis of the levy change in the consultation document (Chapter 6), recognising that the change in methodology will be a cause of immediate instability for many schemes. It is important that the change in methodology should not lead to any further instability in subsequent years.

Chapter 3

2. Do you consider that the definition of the variables in the scorecards is sufficiently precise to provide for consistent treatment?

The definition of the variables in the scorecards is reasonable. Our only comment is around the treatment of Joint Ventures, particularly where the ownership is split equally between the parties. As such, there is no independence; but there is also no direct group ownership. Consequently, we would welcome clarity on how the PPF would consider such operations.

3. Do you agree that it is appropriate to re-evaluate the model to ensure that it remains predictive?

The benefit of the predictive aspect of the model would be best seen over a complete economic cycle, rather than a shorter period of time. The last three years have seen specific economic conditions that may not be experienced in the near future. The development of a model that "works well" in those conditions may be different to what works well in the future. Training the model over data from a complete economic cycle may be preferable.

Using an economic cycle as an indicator of the model's predictive capability would also ensure that any re-evaluation would not affect stability.

4. Do you have comments on the design of the "core model" developed by Experian?

While the IFoA does not have specific comments, we would welcome confirmation from the PPF that the model would be consistent in application across all industry sectors; and that no industries would be subject to any in-built bias arising from the nature of operations. [For example, is it appropriate for financial services companies that the impact of entering "nil" for the value of stocks is significant?]

5. Do you agree with the success criteria set out by the Industry Steering Group and that the PPF-specific model developed by Experian is a better match with them than Commercial Delphi?

The IFoA supports the use of the success criteria set out in the consultation document. The work undertaken by the PPF to compare the different models is valuable in understanding their strengths and weaknesses.

6. Do you agree that it is appropriate to use the separate scorecard developed by Experian for not-for-profit entities, even though this requires an extension of the data set used to generate the scorecard?

We would refer to our response to question 1. Fairness is important in setting the levy. We support an approach where the use of a modified scorecard for not-for-profit entities has made the methodology fairer.

Chapter 4

10. Do you favour a credit rating over-ride?

The IFoA is comfortable with the use of a credit-rating override. Where amendments to the methodology (as for not-for-profit entities) improve accuracy (4.1.5 of the consultation), the amendments are welcomed.

Chapter 5

11. Do you agree with our proposed aims for setting levy rates?

The IFoA is in agreement with the intent for setting the levy rates.

12. Do you agree it is appropriate to divide the entities with the best insolvency probabilities in to a number of bands, to ensure that the cliff-edges between subsequent bands are limited, or do you favour a broad top band?

AND

13. Do you agree with the proposed 10 levy bands and rates?

The IFoA recognises the suggested approach as being appropriate to avoid the cliff-edge movements between bands. However, we would encourage the PPF to offer greater explanation of the rationale for limiting the cliff-edges, by adjusting the levy rate away from the 'fair' rate, as opposed to considering an alteration of the boundaries to the bands. A change in boundaries could similarly limit the cliff-edges, while retaining the appropriate levy rate for each band.

We note that, as for the previous triennium, the PPF proposes to set the levy rate in excess of the expected probability of insolvency. The IFoA would welcome justification of this approach (which we assume is intended to reflect a market price for the risk, rather than just the expected loss, although this is not made clear). In particular, we would welcome justification for increasing the gap between the insolvency probabilities and levy rates for the best risks, and for moving to a negative gap for the poorest risks (which seems particularly hard to justify).

14. Do you agree that for 2015/16 levy year insolvency probabilities are averaged from 31 October 2014 to 31 March 2015?

Given the time horizon before the introduction of the new methodology, this is a sensible approach prior to implementation.

Chapter 7

15. Do you support transitional protection for those most affected by the move to the new methodology, recovered through the scheme-based levy?

The IFoA recognises the need for fairness in the levy calculation for both the winners and losers. We suggest a longer notice period would have provided the fairness for levy payers; thus reducing the need for transitional protection. However, given the shorter notice, the IFoA views the arguments between stability and fairness as being much more finely balanced.

Chapter 9

16. Do you agree that the appropriate route to reflecting ABC's in the levy is to value them based on the lower of the value of the underlying asset (on employer insolvency) after stressing or the net present value of future cashflows?

The proposals regarding asset backed contributions (ABCs), set out in section 9.2; appear to be based on a misunderstanding of how they are valued in the scheme accounts. Section 9.2.6 states that "there is currently no requirement for the asset underlying the ABC to have a value equal to the NPV nor for consideration of whether that value may reduce on employer insolvency". Rather, the value placed on ABCs in scheme accounts (which is the value reflected in the PPF levy calculations) is required to be taken as the fair value of the asset, in accordance with UK GAAP and, in particular, the SORP on the financial reports of pension schemes.

In order to place a fair value on the scheme interest, it is necessary to consider a number of aspects of the vehicle including:

- The probability of default;
- The payment due on default;
- The impact of default on the value of assets underlying the vehicle; and
- The degree of under- or over-collateralisation which that stressed value represents.

Indeed, a common approach is to calculate the NPV of the contractual payments, but in calculating that NPV, the discount rate used will be increased to reflect the credit risk (and likely loss given default) and the illiquid nature of the vehicle. The value placed on the contractual payments will, therefore, be consistent with the value placed on any other bond-like investment held by the scheme.

In practice, the fair value placed on the payments will generally be lower than on a comparable bond, due to the illiquidity adjustment. Where the payments are contingent on future circumstances (e.g. future funding levels), the fair value will be adjusted to reflect this.

Consequently, the IFoA would question much of the justification given for the change in approach to ABCs.

If the PPF were to proceed with the revised approach, we would encourage the PPF to give more consideration to the detail of its proposals. The proposal is to take the value as the smaller of the value realisable on insolvency and "the NPV of future cashflows". However, there is not a unique NPV. The NPV placed on a series of cashflows depends on the discount rate used and the PPF would need to provide an explanation of the chosen discount rate. If the NPV were to be the 'fair value' used for the scheme accounts (as now), this would appear to double count the impact of the credit risk (and the impact of the degree of collateralisation), as it would be reflected in both legs of the comparison.

PPF could explore whether the NPV should be derived from using another discount rate such as the relevant s179 valuation.

17. Do you agree that a credit should only be allowed where the underlying assets for the ABC is UK property? Do you have any comments on the example voluntary form/required confirmations?

Limiting the nature of underlying assets treated as recognisable for ABCs, will discourage the establishment of arrangements that could reduce the risk of underfunding on sponsor insolvency for some schemes, so has some disadvantages. However, we can understand that the PPF might wish to seek consistency between the types of assets recognised as security, for Type B contingent assets, and under ABCs. The IFoA believes however, that it would be sensible to include tangible assets other than UK property for ABCs and for Type B contingent assets, provided that these assets can be expected to increase the security of members' benefits.

20. Do you agree with our proposals to adjust guarantor scores to reflect the value of the guarantee they are potentially liable for? Do you favour the adjustment being achieved by a factor being applied to the guarantor's Pension Protection Score or by an adjustment of the guarantor's levy band?

The provision of a guarantee increases the financial stress on the guarantor. However, the provision of the guarantee does not have the same impact as promising a payment with certainty. Applying the adjustments in table 9.1(which are derived from the impact of gearing due to actual, rather than contingent liabilities) seems likely to massively overstate the impact on the guarantor of providing a guarantee – which is, after all, only contingent. This seems unlikely to increase the fairness of the levy distribution.

There should also be consideration of who is providing the guarantee. If a parent company provides the guarantee in respect of a subsidiary company, accounting treatment would already cover it. It would appear unreasonable to make a further adjustment to reflect the guarantee; this would effectively double-count.

22. Do you agree with the proposed form of confirmation when Last Man Standing scheme structure is selected on Exchange?

AND

23. Do you agree with the revised scheme structure factor calculation proposed for associated last man standing schemes?

Although it is unclear whether the proposed approach would be sufficiently robust in mathematical terms, it is a pragmatic adjustment and offers a more sensible approach to the ‘last man standing’ schemes than offering a fixed adjustment.

If you have any questions about our consultation, or if you wished to discuss any of our comments in more detail, you should contact Philip Doggart, Policy Manager at the IFoA, in the first instance. (Philip.Doggart@actuaries.org.uk 0131 240 1319)

Yours sincerely

Nick Salter
President, Institute and Faculty of Actuaries