The Actuarial Profession
making financial sense of the future

Consultation Response
Pension Protection Fund

The 2012/13 Pension Protection Levy Consultation Document

2 November 2011

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.

The Actuarial Profession
making financial sense of the future

Catherine Mo
Pension Protection Fund
Knollys House
17 Addiscombe Road
Croydon
CR0 6SR

consultation@ppf.gsi.gov.uk

2 November 2011

Dear Catherine

Pension Protection Fund: 2012/13 Pension Protection Levy consultation

Thank you for the opportunity to respond on the 2012/13 Pension Protection Levy consultation.

Firstly, we were pleased that the Guidance in respect of the bespoke investment risk calculation has been improved in a number of areas from the draft enclosed with the Consultation in May 2011. However, we note that there is no change proposed to the approach set out in the initial consultation document to valuing equity options (ie the intrinsic value approach) which we do not think fairly assesses their risk-reducing qualities in certain circumstances. For example, if a scheme buys an equity put option with a low strike price, it may not have any intrinsic value even after a 22% market stress, but it will have had a change in value (which was one of the reasons it was purchased). This approach also seems at odds with using the PV01 approach for swaps. Our response to the previous consultation on this theme referred to collar strategies and is set out below for ease of reference:

- Equity options being intrinsic value only ignores genuine attempts to reduce equity risk in portfolios via collar strategies. If a scheme enters a 10 year collar strategy where there is a floor purchased (put option) and a ceiling put on returns (sold call), within certain equity ranges the intrinsic value test on equities plus the collar will have a 1 for 1 impact on the value of the portfolio (i.e. a 20% stress test will reduce this by 20%). However, in the early years of the collar, the two option values would move to offset the movement in equity value (both up and down) even if the movement did not breach the strike prices– i.e. there would be a lot less than a 1 for 1 move in the overall value of equities plus collar. This is one of the reasons for introducing such approaches. It seems to us that since this will require a bespoke calculation anyway, the options could be properly valued under stress with specification of a few variables e.g. fix implied volatility at a specific level.

Secondly, we would welcome clarification of what is expected by the PPF when a certification is being given to the effect that a Guarantor could be expected to meet its full commitment under a Type A contingent asset. For example:

- Although we do not regard this certification as one which would typically be provided by the scheme actuary, given that this point is more subjective than the other points being certified we feel that the guidance could be more explicit about who is providing (or who is expected to provide) this opinion. Under the current wording of the guidance, it is unclear whether the opinion is the responsibility of the Certifier or the trustees.
- Is the assumption that the pension scheme deficit is the only call on the Guarantor's resources, or should allowance be made for other calls on its resources that may be triggered by the insolvency of the guaranteed company;
- Should allowance be made or not for constraints such as banking covenants (can pay but won't easily pay because of consequences of paying);
- Should the guarantee be payable immediately from liquid resources or could assets be realised over time; and
- Paragraph 31 of the Contingent Assets Appendix suggests that certification of the ability to meet a guarantee must be carried out as at the submission date (rather than, for example, as at the last accounting date). We are concerned that this could be impractical, indeed potentially impossible to do in practice.

Thirdly, the new formula for insolvency risk for multi-employer schemes with a Type A guarantor is confusing about whether the 0.9 multiplier should be applied to the insolvency risk for individual employers (but not where replaced by guarantor risk if lower) or to the weighted average insolvency risk (but not where there is a Type A guarantee).

We hope the above will be helpful, but if you have any questions or would like to discuss any of these matters further please do not hesitate to contact us. Please contact Kirstin Lambert (0207 632 2168 or via Kirstin.Lambert@actuaries.org.uk) in the first instance.

Yours sincerely,

Martin Lowes

Martin Lowes
On behalf of the Consultations Group, Pensions Practice Executive Committee
The Institute and Faculty of Actuaries