The Actuarial Profession
making financial sense of the future

Consultation response
Pension Protection Fund
The Pension Protection Levy: A New Framework

December 2010

About the Actuarial Profession

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.

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20 December 2010

Email to: consultation@ppf.gsi.gov.uk

Dear Mr Collins,

The Pension Protection Levy: A New Framework

Thank you for providing the Actuarial Profession with the opportunity to comment on your proposals for the future pension protection levy.

We were pleased to see that the proposals set out in the October 2010 Consultation Document have been developed considerably and are set out more clearly than in the previous paper issued in November 2008.

We set out below our comments on a number of the questions included in the Consultation Document.

Q4.3 Do you think that investment risk is appropriately reflected in the proposed funding calculation?

We note that categorising investments into a small number of asset classes means that the risk relating to many types of investment will not be reflected appropriately. However, this is an inevitable consequence of the simplification of the calculations. The PPF will need to balance how well asset risk is reflected against the danger of complicating the provision of asset data etc.

It will be important for there to be absolute clarity as to the definition of the asset classes, and how different investments should be sorted into these. For example, many small schemes are "insured schemes" which hold all their assets in a policy of insurance with an insurance company. But the value of that policy may be linked to returns on specified pooled funds, such as UK or overseas equity funds. Other schemes may hold bulk deferred and immediate annuity contracts. These different types of insured assets have very different characteristics.

We note that there will be opportunities to game the system in order to generate a lower levy. For example:

- schemes could change their asset mix immediately before each year end to reduce the perceived risk (the PPF should note that some schemes investing in pooled funds or in insurance policies linked to pooled funds may be able to switch between funds before and after the accounts date at mid-price and without cost, so that there would be little to discourage them from this course)
- schemes could put in place very short term options covering only a day or two around the year end to hedge their investments against market falls
- schemes could achieve exposure to equity market movements through derivatives which have an economic exposure many times greater than their fair value at the balance sheet date instead of investing in equities directly
- schemes could invest in options which provide a measure of protection for market movements up to the level specified by the PPF, but (in order to minimise the cost) with no protection whatsoever if market movements exceed this
- schemes could invest in a smaller value of a geared vehicle rather than investing in the relevant asset class directly with no gearing in order to reduce the apparent value exposed to risk

We note that the Consultation Paper provides no details of the calculations that specified relevant schemes will be required to carry out or may opt to carry out. Clearly, bespoke calculations will be required in relation to derivatives of all sorts. However, it is not clear what will be required in relation to standard asset types that are covered by the standard stress test. For example, will corporate bond portfolios be stressed by reducing their value by 4.6% as in the standard stress test, or will schemes be required to apply the 120 basis point credit adjustment and 66 basis point interest adjustment to each individual bond held? In the absence of this further detail, it is difficult to comment on the appropriateness of the funding calculation. We suggest that a further consultation is carried out on the detail of the proposed bespoke stress test before the proposals are finalised.

We also recommend that the PPF should demonstrate that for typical holdings of standard asset classes the two approaches will give very similar answers, in order to demonstrate that schemes will only be affected by applying the bespoke calculation rather than the standard test to the extent that they have investments that do not match the standard categories.

Figure 11 in 6.2.9 shows that the new levy formula produces amounts that are typically closer to the "theoretical levy". However, as the PPF has not specified how it has calculated the "theoretical levy", it is difficult to comment on whether the new proposals reflect scheme risks appropriately. We recommend that in the interests of transparency the PPF should communicate what it regards as the theoretically fair levy.

Q4.5 Do you agree with Redington's assessment of the costs associated with providing the additional analysis of stress scenarios?

As noted under Q4.3 above, the Consultation Paper provides no details of the calculations that the relevant schemes will be required to carry out or may opt to carry out. In the absence of this information, it is difficult to comment on the assessment of likely costs.

Q4.6 Do you agree with the method by which we propose that schemes should report their asset values, both stressed and unstressed? What are the implications for schemes of the annual accounts date (which may be later than the s179 valuation date) for this calculation?

As noted under Q4.3 above, the Consultation Paper provides no details of the calculations that the relevant schemes will be required to carry out or may opt to carry out. In the absence of this information, it is difficult to comment on the method of calculation.

Q4.7 Do you agree that the information schemes could use to calculate their investment risk would be readily accessible from asset managers, for example, sensitivity to interest rate changes for specific interest rate exposures?

As noted under Q4.3 above, the Consultation Paper provides no details of the calculations that the relevant schemes will be required to carry out or may opt to carry out. In the absence of this information, it is difficult to comment on whether the data required will be readily available.

Q4.8 Do you think the types of contingent assets that the Board will recognise for levy purposes is still appropriate, or are there other arrangements that you think should be recognised?

We are aware that there continue to be stakeholders who believe that there should be changes to the recognition of contingent assets. However, we do not believe that the proposed changes to the levy calculation themselves justify any changes to the recognition of contingent assets.

Q5.1 Do you agree that a significantly smaller number of insolvency risk bands (six instead of the current hundred) provide a better reflection of the risk posed to the PPF?

The PPF has given two reasons for moving from 100 to 6 insolvency risk bands:

- experience of solvency rates amongst the PPF universe shows erratic insolvency rates across the current 100 bands
- with fewer bands, each year most companies will stay within the band they were in the year before, smoothing levy amounts

We do not believe that either of these reasons justifies a change from the current approach.

- With fewer than 7000 schemes in the PPF universe, spread across 100 bands, there are only a small number of relevant scheme sponsors in each band, and a still smaller number of insolvencies expected each year amongst the companies in each band. With a small number of insolvencies expected in each band each year, natural statistical variation fully explains the observed experience. The experience does not indicate any reason to believe that the graduation of expected insolvency rates across the existing 100 bands is inappropriate. Any consideration of the justification of using 100 bands would need to look to experience across the much larger number of companies across the wider D&B universe.
- It is far from obvious to us that schemes (and their sponsors) will see fewer but much larger changes, with large cliff edges between bands, as preferable to more frequent but smaller changes. In this context, it is worth noting that the current ratio between the assumed insolvency risk between D&B score 100 and D&B score 99 is a red herring.

While this leads to a several fold increase in the risk based levy, for the schemes this affects the risk based levy is generally a small fraction of the scheme based levy, so the percentage increase in the total (risk based plus scheme based) levy as a result of moving from D&B score 100 to D&B score 99 is generally small.

The PPF may have other reasons for moving from 100 to 6 insolvency risk bands, but the reasons given do not appear to us to justify a change. On the face of it, using just 6 bands would appear to give a much poorer representation of risk than using more bands.

Q5.2 What are your views on the method by which we propose to derive levy rates for these bands (option (i) above)? Do you agree that it is preferable or would you prefer us to derive levy rates from the implied cost of insuring against insolvency on financial markets (option (ii))?

The primary question is whether it is appropriate to base the levy on the rates that would be charged for protection in the private sector, including allowance for the cost of capital that would have to be held by relevant financial institutions, rather than just on the expected cost of claims (bearing in mind that the PPF does not incur any cost of capital). We believe that the PPF should consult explicitly on this primary question before addressing the secondary issue as to how this market cost should be derived.

Also, we understand that the levy may be set below the level that would be payable to a private sector provider. We believe that the PPF should also address and consult on whether in these circumstances the scaling factor should (for simplicity) be applied equally to both elements of the levy (the expected cost of claims and the notional cost of capital) or whether instead only the notional cost of capital element should be scaled down (because there is no actual cost of capital for the PPF).

We suggest that the PPF also consider whether the market rates it looks at which generally apply to known credit exposures are appropriate when applied to pension scheme under-funding, where the exposure is subject to variation. And whether both elements of the levy rate (the expected cost of claims and the notional cost of capital) should be applied to the stressed rather than the actual level of under-funding.

We hope that you will find our comments helpful. If you have any questions, please contact Margaret Watchorn, Pensions Practice Manager on 0207 632 2185 or via margaret.watchorn@actuaries.org.uk. Indeed, we would welcome the opportunity to meet to discuss with you our comments set out above.

Yours sincerely,

Martin Lowes

Martin Lowes
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