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Mr Chris Collins
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Our Ref: EMB/MB

Dear Mr Collins

Consultation on the future development of the Pension Protection Levy

I am writing on behalf of the Association of Consulting Actuaries, in response to the above consultation.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is effectively the 'trade association' for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

Our general comments are set out below, while comments on the specific questions asked by the consultation are annexed to this letter. We have also made some additional points in the Annex which we believe are relevant, albeit not in response to any specific question.

We hope that you will find our comments of assistance.

General Comments

We support the principle that the PPF levy:

- should be based on a model that takes long-term risk into account.
- should include an allowance for investment risk.

However, it is not clear to us that the best way of allowing for long-term risk is to consider only the extreme tail of the distribution (the 'unexpected risk' of 1-in-200-year events).

We also have some concerns about the LTRM itself:

- It is not yet sufficiently transparent. Indeed, to anyone other than the PPF it is in effect a 'black box'.

- Using the outputs of the model itself to judge the fairness of the resulting levy is a circular argument which is virtually guaranteed to produce a positive conclusion.

- It is not self-evident that it remains a valid model in view of the unprecedented changes in global investment markets and economies since it was built.

We are also unconvinced by the assertion that changes to the levy formula will not produce changes in schemes' behaviour.

We are not sure why five years is considered to be the appropriate period to use when assessing long-term risk. It would be helpful if the PPF could publish its justification for using five years rather than any other period.

If the type of levy formula currently proposed is retained, we believe that more work will need to be done on the balance between short-term and long-term risk in the levy formula, i.e. the relative sizes of the scaling factors c and w.

Finally, the ACA would be happy to work alongside the PPF in deciding on the best way to measure scheme-specific investment risk.

Yours sincerely

Charles Young
Chairman, Pension Schemes Committee

ANNEX – DETAILED RESPONSES

Chapter 3 – Overview of the long-term risk model

It is stated in paragraph 3.3.4 that the PPF's total risk is lower than the sum of its parts "because risks are not fully correlated".

While this is undoubtedly true, it must nevertheless be the case that as a "monoline credit insurer" (Annex D, section 2.5) the PPF is insuring risks that do have a high degree of correlation. In an adverse economic scenario, many companies will fail at the same time.

A traditional multiline insurer, by contrast, will cover many diverse risks which are much less correlated (or even, in some cases, negatively correlated). This enables it to offer more favourable terms to its customers since the reserves it needs to hold are lower.

We wonder whether similar principles could be applied to the PPF. We are not suggesting that it should seek to be permitted to take on new kinds of risk – but an element of commercial reinsurance with those who do so might be beneficial. If it was established that this would indeed enable the PPF to reduce the overall levy quantum then the necessary legislative changes (if any) could no doubt be arranged.

Chapter 4 – Proposals for developing the levy formula

Question 1: Do you agree that the PPF should keep the two caps on the risk-based levy under review to seek to maintain the affordability of the levy?

Yes. Affordability is a crucial issue for many schemes, and if anything will become more so as the recession bites.

Question 2: Do you consider that the scheme-based levy should be reduced when the PPF is no longer in deficit, or alternatively at some other point?

We do not have a strong view either way, though any reduction would of course be welcomed by schemes.

Question 3: Should the PPF now move to include unexpected risk in the risk-based levy on the basis proposed?

We agree that long-term risk should be included in the levy formula. Whether the best way of doing this is to focus solely on the tail of the distribution, however, is at best a moot point.

We are also concerned that the proposal to charge a levy that is significantly based on extreme scenarios appears to overlook the powers in legislation, specifically granted by Parliament, to reduce compensation if a catastrophe occurs.

If ‘unexpected risk’ is to be included in the formula, we would prefer to use a more descriptive term such as ‘tail claims’ (as used in the charts on page 59) or ‘extreme scenarios risk’.

Our intuitive feeling is that the weighting currently placed on the long-term risk is too high. Can it really be correct that 82% of the combined risk measure (£603m out of £738m in the example in Annex D) is the long-term risk?

Turning to the details of the proposed basis, our main concern is that the proposals are heavily based on the PPF’s Long-Term Risk Model (LTRM). The LTRM was built in 2005 and its parameters and correlations were based on periods prior to that date. Yet the financial world has changed enormously since then and it is not obvious that pre-2005 parameters remain valid. To quote the Board for Actuarial Standards:

“Modelling error is often particularly significant in unusual circumstances. A model that works well during a period of financial stability may break down during a period of turmoil, as it ceases to correspond to reality……… Data is likely to be especially scarce or unreliable in the tails of distributions, making parameter error both more likely and more significant in those areas.” (Modelling: Consultation Paper, November 2008, paragraphs 7.11 and 7.18.)

While we appreciate that the LTRM is updated from time to time we do not have any information about the factors that are now being taken into account. If the LTRM now reflects the post-Credit Crisis environment it would be comforting to have confirmation of that fact.

One of the less persuasive elements in the proposed formula is the relationship between the scaling factors c and w. This is a crucial issue as it determines the balance between short-term and long-term risk. It is clear from Section 2.5 of Annex D that there is a wide range of values that could have been chosen for each element of the ‘cost of capital’ calculation, and that 9% is by no means the only plausible figure.

Finally, there is the perennial question of sensitivity to small changes in D & B scores. As recognised in paragraphs 1.5.7 and 1.5.8, this is particularly marked at scores close to 100 – and even with the proposed new formula a scheme’s levy will more than double if its score falls from 100 to 99! We would like to see a reduction in this discontinuity, which could easily be achieved by introducing some intermediate scores between 99 and 100.

Question 4: If so, on what timescale should it be introduced – in 2011/12 as suggested, or in an alternative levy year?

We have no strong views on this, so long as plenty of time is allowed for schemes to digest the new arrangements. If final details are published in Winter 2010, as suggested in paragraph 7.1.3, that should be adequate for introduction in 2011/12. Clearly the new arrangements cannot be introduced any earlier than that in view of the workload the change will create for schemes, advisers and the PPF itself.

Chapter 5 – Measuring scheme-specific investment risk

Question 5:	***Do you agree that taking account of investment risk in the levy is unlikely in itself to alter the behavior of schemes or impact markets?***

Yes and no. While the overall impact on markets may well be small, the behaviour of some schemes may change materially.

We note with interest the analysis in Appendix E. However, we also note the assumption that all trustees will behave rationally. This fails to take into account the psychological impact on trustees of any pronouncement by a body such as the PPF. Trustees of smaller schemes in particular may be expected to over-react, for example by adopting the proposed Investment Risk Factor as a substitute for taking proper investment advice.

There is also the fact that many schemes are already in the process of moving gradually towards a less risky investment strategy, i.e. reducing their equity content in favour of a higher bond content. When they understand that their levy will not reduce just because they have agreed a phased programme of changes, but will take those changes into account as and when they occur, the trustees of such a scheme may well accelerate their phased programme.

Question 6:	***Do you agree with Option 3, the proposal to use asset and liability information currently obtained through the Exchange scheme return to calculate a scheme-specific volatility measure that would be incorporated in the new risk-based levy formula?***

Capturing information via the Exchange scheme return is fine in principle but does not always work smoothly in practice. There are two main reasons for this:-

- Despite several years of evolution, some of the questions remain ambiguous and are therefore hard to answer accurately.

- Pension schemes often treat this as a bureaucratic form-filling exercise which can be delegated to junior staff. As a result, the person dealing with it may fail to recognise the fact that (or the extent to which) any approximations or inaccuracies in the answers given will affect the scheme's PPF levy.

For these reasons it is essential that fuller guidance is made available before any additional questions are included.

On the substantive question, we are not convinced that Option 3 should be preferred to Option 4. The latter has a clear appeal in that it would allow schemes to certify a reduction in risk but without imposing additional data-submission burdens on other schemes.

If Option 3 was to be selected it would be essential to overcome the drawback set out in the first bullet point of paragraph 5.5.12. The absence of any recognition of 'more sophisticated' risk reduction techniques would make Option 3 very unpopular – and rightly so – with those schemes which have adopted such techniques.

Depending on the nature of the stress tests adopted, the same drawback might also apply to Option 4. Whether the choice falls on Option 3 or Option 4, the ACA would be happy to work alongside the PPF to resolve this important issue. It will also be important to ensure that the stress tests are easy for schemes to use.

Finally, one other factor in favour of adopting Option 4 is that it might not then be necessary to consider moving to Option 5 even in the longer term. We do not envisage much demand for this from schemes if a suitable version of Option 4 is chosen at the outset.

Question 7:	***Do you think that, if Option 3 is implemented, behaviour that seeks to reduce the levy charged, rather than genuinely reducing risk, would have a material impact on levy collections? (For example by altering investment strategy immediately after a reporting date or using derivatives to increase risk).***

We think it is unlikely that trustees would find it acceptable to behave in this way.

Question 8:	***Do you agree that, in the longer term, Option 5, the approach which is based on schemes modelling their own investment risk, should be introduced, at least for larger schemes?***

If Option 3 is introduced as a method of calculating a scheme-specific volatility measure, we believe that many schemes – and not necessarily just larger ones – would welcome the alternative Option 5 in the longer term. However, if Option 4 is introduced instead (see our comment above) there should be much less need to consider Option 5.

Question 9:	***If so, should this be compulsory for the largest schemes?***

No, we see little to be gained by making it compulsory.

Question 10:	***If so, what threshold should apply?***

N/A

Question 11:	***Should an internal models approach be offered to smaller schemes if they wish to use it?***

Yes. We can see no sound rationale for denying the facility to “smaller” schemes if it is available to “larger” ones.

Question 12:	***What questions about the approach do you consider would need to be resolved before Option 5 could be introduced?***

The questions set out in paragraph 5.5.25 will need to be answered. As regards Question 3 we do not see how the shocks could be left for individual schemes to determine; surely all schemes must consider the same shocks?

There is also the question, raised in paragraph 5.5.22, as to who should be responsible for signing certificates. We do not believe that actuaries should be the only people permitted to certify; situations vary, and in some cases other parties such as investment managers or investment consultants will be better placed to provide certification.

Chapter 6 – The impact on fairness, stability and distribution

Question 13:	***Do you agree with the PPF's preferred approach to measuring the fairness of the levy?***

We have no objection to the approach set out in Chapter 6, i.e. the use of the Lorenz curve and the Gini coefficient. However, the result is fundamentally dependent upon the accuracy of the 'combined risk measure' calculated by the LTRM. While 'fairness' is important, getting the risk measure right in the first place is even more important – and especially so if 'fairness' is to be judged by reference to it.

Many different risk measures could be devised and each would produce a different Lorenz curve. The PPF's argument that its particular choice of risk measure is the right one, and that 'fairness' is therefore to be assessed against that measure, is in our view a somewhat circular one. What is really being measured is the degree of approximation in the chosen levy formula, which is not the same thing as fairness.

One other aspect of fairness – not covered in the consultation paper itself – is fairness between the commercial sector and not-for-profit (NFP) organisations. NFP organisations include charities, housing associations and educational institutions. At the recent PPF Roadshow it was stated that 'non-commercial' organisations constitute 17% of all levy-payers.

The point about these NFP organisations is that their apparent insolvency risk, as measured by D & B, may not reflect their true circumstances. For example, if a charity runs into financial difficulties it is very likely to be forced by the Charities Commission into a merger with another charity. Similarly it is difficult to envisage a situation in which the authorities would allow a university to become insolvent. We should like to see a mechanism for recognising these special circumstances in the levies paid by NFP organisations.

In paragraph 6.2.10 there is a cryptic reference to "further measures that could address levy stability". We are not clear what measures the PPF has in mind here and should welcome clarification.