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Catherine Mo
Pension Protection Fund
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Dear Catherine

The 2012/13 Pension Protection Levy

We are writing with our response to your consultation document on the 2012/13 levy determination.

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 all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes.

The ACA is the representative body for UK consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

Overview

We understand the position taken by the PPF following its earlier consultation on the new framework for PPF levies. Our comments now are for the most part about points of detail.

In the relatively short time available for this consultation, it has not been possible to obtain extensive feedback from our members or to undertake detailed calculations to fully understand the effect of the parameters that the PPF has chosen. Our main request therefore is that the PPF should treat the structure, well researched as it may be, as a work in progress that may need some refinement when the full implications have been understood by UK pension trustees, sponsoring employers and their advisors. While we support the approach of keeping the levy parameters fixed for three years, we think that the PPF should not hesitate to make changes in the intervening years if the levy calculations work in an unexpected way in particular investment circumstances.

Our main comments relate to some of the asset stress factors used, particularly within equity portfolios. Details of this are in the appendix.

Finally we commend the PPF for its continuing transparency in the way that it develops its thinking. We encourage the PPF to continue with this, especially during the planned review of the D&B methodology. To date there have been some surprises in the pensions community about some of the factors that D&B take into account in their current methodology, and the ability that exists to change the D&B score for a company through minor changes in its governance or operation. We hope that the new methodology will be exposed at an early stage, to help trustees, employers and advisors get to grips with the implications of any change. We believe that working in this way can only improve the credibility of the revised methodology.

Our detailed comments are set out in the appendix to this letter.

Please do not hesitate to contact me (charles.young@hymans.co.uk) if you have any questions arising from matters raised in this letter.

Yours sincerely

Charles Young
Chairman, Pension Schemes Committee

Appendix

Main Consultation Document

Revising the levy parameters

We understand and approve of the approach this year to set levy parameters which will last for three years, unless exceptional circumstances arise. Nonetheless, we recommend that, in the intervening 2 years, the PPF publishes details of what the parameters would have been had the PPF continued to revise them annually.

The reason for this is so that levy payers are aware of the direction of change of the levies, and in particular so that they are forewarned if there is likely to be a significant increase in levies in the third year. It would be perfectly acceptable to publish broad indications rather than a precise set of figures.

Asset stresses

Table 1 in section 4.3.2 covers a selection of asset classes. We think that you have omitted one class, namely cash and net current assets, for which the stress should be 0%, as for the bespoke investment risk calculation.

We comment under the bespoke calculation guidance on apparent internal inconsistencies in the equity asset stresses.

Our view is that a different approach should be taken for schemes with annuities. Annuities are provided by FSA-monitored insurance companies, which are required to maintain capital reserves that are sufficient to withstand a "1 in 200" shock in investment markets. As such, the level of protection provided by annuities, removing both economic and mortality risk, is higher than other scheme assets.

The proposed method for dealing with annuities and the liabilities that they cover is to include the value of both in the calculation of the scheme underfunding, applying stress factors which will typically be different for assets and the relevant liabilities. We believe that it would make much more sense to recognize that annuities remove risk, and:

- calculate the value of the full benefits covered by the annuities, using the s179 valuation assumptions (with some extension where the annuities provide benefits that differ from the standard PPF benefit design), and then
- subtract this figure from both the assets and liabilities before applying the remainder of the levy calculations.

Certifying Type A contingent assets

We understand the PPF's intentions in requiring that schemes should certify that Type A guarantors. We would like to understand the implications and practical requirements of this proposal. The proposal is presented as if it is just a matter of ticking a box in the Exchange data system. In practice, we are sure that the PPF will expect some work to have been done to check the situation before the relevant box is ticked.

Schemes will need to understand the degree of care required of those providing the certification, and indeed it is not obvious to us who will be required to provide the certification: pension trustees, directors of the principal employer, directors of the guarantor? It will almost certainly not be the individual who actually enters data onto the Exchange system.

We appreciate that the PPF intends to provide guidance on this. In view of the limited time between now and 31 March 2012, with many pension schemes now having only one trustee meeting planned between now and then, it is vital that the PPF provides guidance on the topic in the very near future. If the requirements are onerous, it may be better to postpone this change until the 2013/14 levy year.

Comments on Guidance for bespoke investment risk calculation

Not bespoke enough

We are disappointed that the “bespoke” calculation still involves some broad brush assumptions. Where a scheme has put in place a risk reduction strategy that has been carefully designed to reduce risk relative to its own specific pension liabilities, it is disappointing that the PPF bespoke calculations may not give full credit for this. We understand the need for a standard approach for most schemes, but it is a shame that schemes are not permitted to use a more accurate approach if they wish to do so.

Inconsistencies between stresses for different classes of equities

The differences between the stress factors for UK and Overseas quoted equities in the basic test, -22% and -16% respectively, seem most peculiar. Intuitively, increased globalisation coupled with the fact that many UK companies have a lot of overseas earnings and the argument that large global companies could equally well be listed in or out of the UK all point to the stresses being the same.

The difference between the stresses is now 6%. In Redington’s 2010 report[1], the difference appeared to by just over 3% (Table 4b, section 5.5). While this difference is somewhat surprising, it is small enough that it might be accepted. The updated figure strains credulity.

We do understand that there are other factors in the Redington model that may introduce some apparent distortions. The published stresses are intended to incorporate some allowance for diversification, and perhaps this explains part of the difference. Without knowing the details of the Redington model, it is impossible for us to tell. However, we think that it is telling that the final figures are based on the period January 2006 to March 2011. Using one of the least representative periods in history to calibrate the models may provide more of an explanation!

On similar lines, in the bespoke calculation, we find it difficult to accept that the stress for UK quoted equities is the same as the stress for unquoted and private equity, and is lower than the stress for emerging market quoted equity.

(In passing, we also find it a little surprising that, based on the last 5 years, the stress for corporate bonds is zero. Has some subjective input been overlaid over the statistics from the Redington model?)

[1] The introduction of investment risk as a risk factor in the formula of the Risk-Based Levy

Overall, we think that the set of stresses within the equity classes will cause significant credibility issues for the PPF. We wonder whether the system has resulted from blind application of the statistical results from a particular set of historical figures. We encourage the PPF to review this part of the model and overlay a degree of sound subjective judgement.

Inconsistency between basic and bespoke asset stresses

Table 1 in section 4.12 of the bespoke guidance contains some figures which are inconsistent with the table in 4.3.2 of the main consultation document.

For example, in the basic test the stress for overseas equity is -16%, whereas in the bespoke test it is -16% for developed market equities and -21% for emerging market equities. Any scheme which invests in emerging markets will automatically obtain a lower figure for its stressed assets under the bespoke test than it would under the basic test.

A similar issue exists for fixed interest government bonds, where the basic test uses +10% for government bonds, while the bespoke test uses lower figures for bonds of under 15 year maturity.

We suggest that some minor changes are made to the tables to remove this feature. For example, with over 15 year fixed interest government bonds typically having an average duration of 12 or 13 years, perhaps the correct figure for these bonds should be +12% instead of +10%.

Illustration on page 32

The illustration on page 32 of the guidance for the bespoke calculation shows the underfunding based on the smoothed and stressed basis, and the risk based levy as being based on this underfunding. We think this needs a very short additional comment (not necessarily with any illustrative figures) to explain that the underfunding will be the larger of the stressed and unstressed figures.

Reliance on fund managers' calculations

Not all PV01 etc. calculations by fund managers will be audited independently as a matter of course. It will be very costly for individual schemes to get those numbers checked on a case by case basis. We believe that it would be appropriate for schemes to use manager-provided PV01 figures in good faith in calculating their bespoke stressed values, and we would ask the PPF to extend its guidance to confirm this.