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Dear Chris

The Pension Protection Levy: a new framework

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

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 by members 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 defined benefit pension schemes.

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

General Comments

In general terms we welcome the overall proposals, as many of them follow suggestions made in earlier consultations. However, as set out below, we do not agree with all the proposals and we make specific comments on where the proposals could be modified and their objectives clarified. It is important terms such as fairness are used consistently. For example, the application of a levy cap is arguably unfair to the other schemes that have to meet the cost of levies that they would not otherwise have to pay were it not for the capping of levies in some schemes. Also some objectives are contradictory, as simplicity may introduce cross-subsidy and therefore inequity, and we would welcome the PPF's reasoning behind the balance chosen in different areas. We believe that equity should be the main objective unless this would introduce undue complexity.

Some of the changes are designed to capture the possibility of extreme adverse investment scenarios or insolvency of healthy companies. However, the PPF will be aware that in extreme situations the PPF compensation levels can be reduced in the legislation, which differentiates the PPF from an insurance company. This would support the exclusion of extreme events from levy calculations.

We would also urge the PPF to keep schemes, employers and advisers informed of the progress of the consultation (in particular decisions made as a result of these responses). Ideally schemes and employers should be given full clarity on the proposals at an early stage, but we realise that it is most important for decisions to be carefully thought through. However we imagine that some of the proposals in this consultation would be considered separately (eg funding, investment and insolvency measure) so it is likely that decisions may be reached on one part before the full structure is ready for release. We would therefore suggest that the PPF provides interim updates on progress of the consultation before Spring 2011, and are pleased that the PPF has recognised this in its statement of 14 December 2010, particularly so that schemes are aware whether data submitted in the run-up to 31 March 2011 will be used in the 2012/13 levy and can plan how to go about assessing this.

We hope that you find our comments of assistance.

Yours sincerely

Charles Young
Chairman
ACA Pension Schemes Committee

Enc: Appendix

Appendix

The Pension Protection Levy: a new framework

Question 3.1 Do you agree that a review period of three years would provide an appropriate balance of stability for levy payers and ability for the PPF to ensure its Funding Strategy remains on track?

We believe that the proposed three years is reasonable. We note that individual schemes' levies will still be calculated each year, ie individual schemes will still be able to take action which will improve their funding position and minimise their own levy during that period – however we would suggest that this needs to be made clearer. Our most significant concern is that the PPF will be very prudent in their calculation of the initial parameters so that schemes would effectively pay a premium for the additional stability.

Question 3.2 Do you agree with the limited criteria we propose for revising the scaling factor within the review period?

We agree with the suggested events which would trigger a review of the scaling factor (and indeed the other levy parameters). However there could be events external to PPF (or perhaps due to changes within PPF itself) which would otherwise (or when combined with balancing factors) lead for example to a variation in the levy estimate of just less than 25%; Schemes might expect such events to be reflected in the scaling factor (whether by an increase or decrease).

Comment on capping: We would welcome more information on the PPF's thinking behind the proposal for the capping limits. It is important uncapped schemes that pay higher levies can appreciate the equity in doing so.

Question 4.1 Do you support a smoothed approach to funding and do you think that five years is an appropriate smoothing period?

We support a smoothed approach to funding (to reflect the market fluctuations in a scheme's assets and liabilities) although by using the latest s179 valuation data a scheme will receive full credit for derisking activities taken (or additional contributions paid). There may be presentational arguments in favour of the smoothing period being the same as the period over which the parameters are fixed (viz 3 years) but we accept the arguments in favour of five years matching the typical economic cycle.

Question 4.2 Do you agree with our proposed method to smooth scheme assets and liabilities over five years?

We believe there is a risk that the smoothing and investment risk stress test could result in some double counting of the investment risk, and the approach would need to be carefully described to make this more transparent.

We note that the s179 roll-forward does not take account of changes in strategy over time (although it could take account of historic investment strategy data on Exchange rather than just the current asset split). Nor does it take account of long-term strategy (e.g. as per the scheme's SIP) – instead it focuses on the (short-term) position at a particular moment in time.

Question 4.3 Do you think that investment risk is appropriately reflected in the proposed funding calculation?

The proposed default approach might not be unreasonable – any schemes which are not happy with the approach can always choose to provide their own stress testing, although for smaller schemes the cost of doing so might be prohibitive in comparison with any advantage.

However the approach of smoothing the assets and liabilities, applying the stress test and then smoothing the assets and liabilities with a margin for investment risk seems overly complex. Credits could also apply where assets are very closely matched to liabilities.

We have particular concerns:

- Lack of any allowance for the positive effects of diversification between asset classes
- 'Other' assets being treated as equities. In many cases these are risk reduction assets, in other cases return seeking assets. We suggest that this class needs to be subdivided into at least two to reflect the risk characteristics.

On the proposed treatment of corporate bonds held by schemes in the PPF's proposed asset value stress, the suggestion appears to be that all corporate bonds are treated the same in the stress test calculations, irrespective of their rating. Given the wide range of quality of corporate bonds, and the readily available categorisation of these (from their rating), we do not consider this to be appropriate. While we agree that the value of lower quality corporate bonds might fall in the 'stressed scenario' the PPF is trying to model, the value of high quality corporate bonds (e.g. those that are AA or AAA rated) is likely to move closely in line with gilts, and therefore could be assumed to increase in value under the PPF's proposed stress test calculations.

We understand the need for the PPF's 'standard' stress test calculations (i.e. where a scheme does not submit its own detailed stress test results) to be kept relatively simple, but we consider that it would be straightforward for information on the credit ratings of a scheme's corporate bond holdings (i.e. the percentage of these holdings with each rating at a particular date) to be provided via the Scheme Return and then used by the PPF in stress test calculations which differentiate between corporate bonds of different quality.

We would like to have more detail on how self-certification of the asset stressing will work – for example will it mean that schemes can provide information on asset classes that do not fit into the PPF's simplified breakdown, and if so, what information will need to be provided, and what would the effect be (eg how would hedge funds or Diversified Growth Funds be stressed). Also, who can provide the certification?

If the PPF does not consider this to be appropriate, then where schemes undertake their own detailed stress tests the PPF should specify parameters which differentiate between corporate bonds of different quality, such that schemes with significant holdings of high quality corporate bonds are given credit for their investment strategy in the PPF levy calculation rather than being penalised.

In addition, there may be a need to clarify the definition of insured contracts so that they are properly picked up in the asset breakdown.

We do feel that there could be difficulties in how the PPF use the existing data from Exchange to calculate levies. For example, should Exchange be amended to require additional information (e.g. on LDI strategies)?

[We believe that there should be more categories of other assets classes. For example overseas equities are all grouped together whereas it could be argued that US should be different to emerging markets. However this would require a change to the roll forward formula to correspond with differential treatment.]

Question 4.4 Do you agree with the Board's proposal that schemes with liabilities above £1.5 billion should be required to provide additional information on the effect of the stress scenarios?

Yes, the £1.5billion threshold does not seem unreasonable. However the consultation document is not clear on exactly what such larger schemes are expected to do to provide such additional information. In addition there should be clarification on what is meant by liabilities in this context (is it the value at a given date or smoothed liabilities?), and exemption for schemes with straightforward investment strategies.

Question 4.5 Do you agree with Redington's assessment of the costs associated with providing the additional analysis of stress scenarios?

The Redington paper suggests that the £2,000-£5,000 cost is itself subject to significant variations depending on the complexity of the scheme involved. Before commenting on Redington's assessment of the cost we feel that far more information needs to be given regarding what schemes must actually do in order to report stresses themselves. It is not clear whether the quoted cost includes the cost of obtaining information from custodians etc.

Question 4.6 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?

The proposed method is acceptable for simple schemes, although we suggest that schemes which have taken action to reduce risk on their asset profile should be allowed to certify assets separately in order to capture that action.

Question 4.7 Do you agree that the information schemes could use to calculate their investment risk should be readily accessible from asset managers, for example, sensitivity to interest rate changes for specific interest rate exposures?

This question only impacts on those schemes which provide their own information on the effect of stress scenarios to PPF (either because they have to as large schemes, or because they choose to do so). We do agree that managers should be in the position to provide such information at reasonable timescale and at proportionate cost for larger schemes.

Question 4.8 Do you think the types of contingent assets that the Board recognises for levy purposes is still appropriate, or are there other arrangements that you think should be recognised?

Asset backed funding structures are probably the newest form of contingent assets. However, these are often set up such that a pension fund's interest in such a structure counts as an asset of the fund and therefore can be utilised immediately for PPF levy reduction purposes. The Regulator has recently issued a policy statement on these structures; it may be helpful for the PPF to comment upon these structures too.

Question 4.9 Do you think the requirements in terms of the current types of contingent assets are appropriate, or are there areas in which you think the current requirements are disproportionate or unnecessary?

In our experience a large number of PPF compliant parent or group company guarantees have been put in place over the last five years (i.e. the terms of these guarantees have not been a deterrent to their implementation). Relatively few Type B contingent assets have been put in place. We believe that this is for reasons other than the attaching PPF requirements: for example, because of economic conditions, sponsors have been keen to maintain cash within their businesses rather than use it for pension purposes (either directly or via escrow type solutions).

Question 4.10 To what extent do you think that changing the way the levy is calculated means that the PPF could or should change the types of contingent asset recognised, or the requirements for recognition?

As noted above, asset backed funding structures are often recognised immediately as fund assets. It may therefore be appropriate for the PPF to consider how to "stress test" these assets. Most of these structures are put in place for periods of significantly more than 5 years. In addition, many schemes have contingent assets in place which do not satisfy the relatively tight PPF qualification criteria, although they do provide additional security.

Question 5.1 Do you agree that a significantly smaller number of insolvency risk bands (six instead of the current hundred) provide a more appropriate reflection of the risk posed to the PPF?

We do not agree with this approach. In general the concept of such a small number of bands is ill-conceived. It is difficult to see how a smaller number of risk bands will provide a more appropriate reflection of the risk posed to the PPF. We would imagine that the risk to the PPF is mitigated most by ascribing probabilities to a larger number of discrete risk bands, rather than simplifying the calculation and reducing the number of risk bands to just six.

In particular the proposed spread of the bands produces a skewed distribution of insolvency probabilities (for example 41% of the population are in band 5 or 6, and only 4% in band 1).

In addition the proposed approach penalises those schemes which have habitually been at D&B rating 100 – the assessed insolvency probability has risen vastly, meaning that a scheme which up to now had not needed to focus too much on the levy aspects is now forced to do so. PPF seems to believe that schemes sponsored by high D&B rated companies pose an unacceptable extra risk on the PPF, which has not been costed hitherto. If this is indeed the case, then such adjustment should be made via some loading to the IP at each D&B score (or alternatively using some other approach to rating than D&B). Grouping the bands together and making a broad-brush adjustment is a very opaque way of achieving the desired adjustment. In particular, in relation to pension schemes sponsored by charitable and not-for-profit organisations, we believe that the grouping should be more discrete so as to recognise the reduced risks that are presented to the PPF by such schemes – and the proposed smaller number of risk bands fails to do this. In particular, even if the proposed banding system is adopted, we suggest that those charities with a D&B score of 100 should not be considered together with all private sector employers scoring 97 and above as representing a homogenous group in terms of the risk they present to the PPF.

Question 5.2 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))?

There is no requirement for the PPF to behave as an insurance company by charging stronger employers more in order to cover tail-risk extreme scenarios, given its powers to respond differently in stressed situations to reduce compensation levels or increases. Also, how would schemes benefit if surpluses emerge in the PPF when such events do not happen?

We acknowledge the logic in pricing insolvency risk in a way which closer reflects how markets would 'price' insolvency risk and appreciate that this will result generally in 'tail risk' becoming a more significant issue the better the quality of the business, (but as stated above do not agree that the levy should take account of extreme outcomes). This is shown in option (i) where the risk weighting (when combined with the cost of claims) produces a risk margin which is very high compared to the average D&B probabilities in the lower bands.

We would again make the observation that charities and livery companies possess unique characteristics and we do not believe that charities with D&B scores of 100 present the same substantial 'tail risk' as equivalently scored private sector businesses.

We would encourage the PPF to consider how they might recognise the unique characteristics of charitable organisations with a D&B score of 100 in the determination of levy rates and differentiate them from private sector employers so that the levies more appropriately reflect the risk posed to the PPF

Question 5.3 Do you agree that it would be beneficial to use an averaged measure of insolvency risk rather than a point estimate at 31 March? If so would you favour using monthly data points or using quarterly dates?

We accept that using an average of D&B/insolvency risk will help to prevent abuse by those schemes that take temporary or last minute action to improve their scores. It should also have the benefit of encouraging behaviours designed to improve the sponsor's strength in the long term. However there will be extra cost involved in gathering such data, and from the company's perspective monitoring such data. Given this, it may be better to use quarterly dates with the insolvency risk being measured at 31 March, 30 June, 30 September and 31 December.

In addition the proposed approach of averaging and then applying a band to match the resulting average seems complex and could result in anomalies. This approach is particularly complex for multi-employer schemes, where for each employer the insolvency probability for each of the 12 months (from bands 1-6) is averaged, and then rounded to the nearest band probability – the result is then averaged across all employers and then rounded to the nearest band probability again.

One issue with the averaging of the D&B score over 12 months rather than just picking it at a spot date, is that the result will depend on the vagaries of how quickly D&B update the failure scores based on information supplied either generally, such as new accounts or specifically by the companies concerned. Based on experience companies that push more can get D&B to respond more quickly and also backdate or "correct" past scores. On the other hand sometimes D&B can be slow if something goes into their "too difficult" box.

The D&B score for many overseas companies is often listed as "not available" where it is set by a D&B sister company overseas rather than by D&B UK. If you try to request the failure score from D&B UK, in generally takes at least two weeks and often considerably longer to establish it, and in such cases it can be very difficult to establish the reasons why a score is as it is. At least with the current spot date approach, you can focus your energies on establishing and challenging the D&B score a bit ahead of that date. The point here is that the proposal seems to put them at an even greater potential disadvantage than currently against UK companies – ie it is not a level playing field.

Question 5.4 Do you think that the benefits of transitional relief to smooth Cliff edges are worth the additional complexity and cross-subsidy, given work to smooth insolvency risks through averaging?

If PPF were to accept our view in relation to question 5.1, there would be no need for transitional relief to smooth such cliff-edges resulting from a small number of bands. However if PPF do introduce a six-band approach (or similar) transitional relief will be necessary even if it poses a high cost.

Question 7.1 Do you think that there is a relationship between a scheme's governance practices and its risk to the PPF?

In general while we agree that a scheme's governance practices could have some impact on the risk it poses to the PPF, this is unlikely to be significant enough to warrant further adjustment to the levy. The material risks to the PPF are already picked up through the funding, investment and employer insolvency measures.

Question 7.2 If so, do you think that good governance should be measured and lead to a reduction in the risk-based levy?

No, see our answer to 7.1.

Question 7.3 If you support a discount for good governance, what sort of level do you think it should be set at? Should it be a fixed discount, or a sliding scale to reflect differing standards?

Given our answer to 7.1, we do not see this question as applicable (but if governance were to be built in, we believe that in fairness it would need to be on some sliding scale).

Question 7.4 If a discount were available for good governance, do you think it should be based on a tick box approach (option A), or a more substantive voluntary certificate approach (option B)?

Given our answer to 7.1, we do not see this question as applicable. However self-certification would probably be too onerous for schemes.

Question 7.5 Do you agree that the application of the levy cap should be conditional on the capped scheme taking risk reduction measure(s)?

Weaker schemes should be required to take risk reduction measures if they are to benefit from other schemes effectively paying some of the levies for them.

Question 7.6 What type of measures would you suggest offer appropriate assurance that a scheme is committed to reducing their risk?

As the Pensions Regulator is taking an interest in the governance of schemes, we feel that monitoring of such actions should be left to the Regulator.

The normal range of liability management, including cease future accrual, de-link to final salary, no discretionary benefits unless paid for at the time, and so on

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