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New Levy Framework from 2012/13: delivering stable, predictable levies

ACA Regional Meetings, November 2011

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Agenda

- The PPF: Current Position and Future Evolution
- The New Levy Framework (NLF)
- Path to the 2012/13 Determination
- Actions for schemes and advisers

The PPF today

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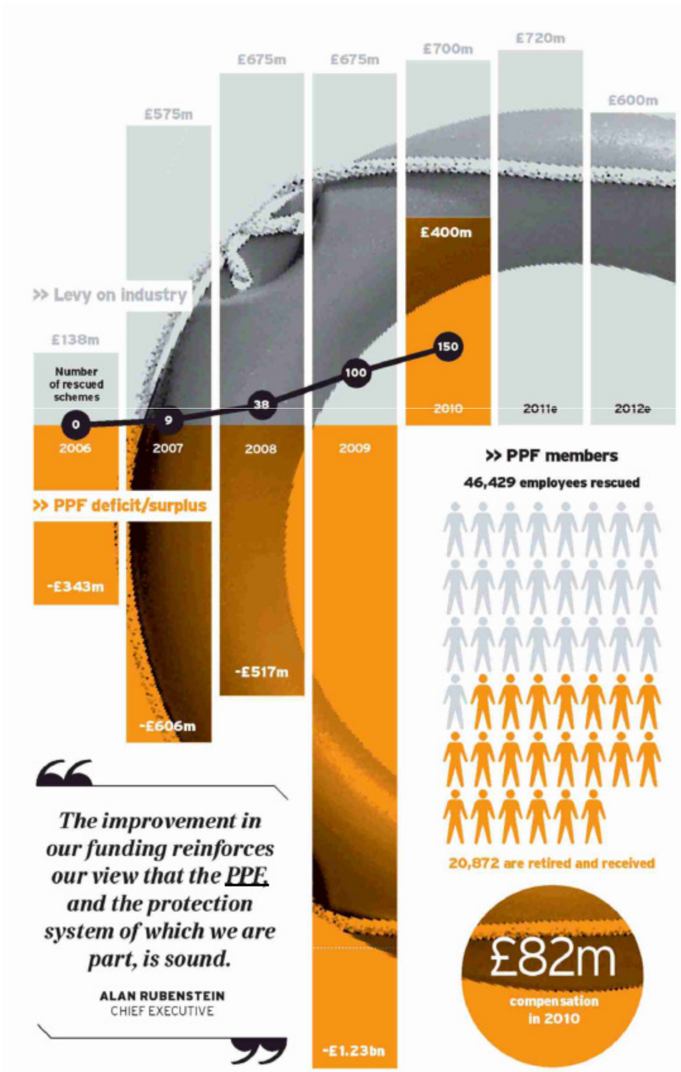

Graphic: Daily Telegraph, 2010

Members

- 90,000 members already protected
- A further 208,000 potential members from 355 cases in assessment

Financials

- £7.4bn investment portfolio
- Valuation reserve

  £394m at 31 March 2010

  £678m at 31 March 2011

Looking to the future: PPF Funding Strategy

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- Published August 2010
- Establishes target of self-sufficiency by 2030
- Update published with 2010/11 Annual Report & Accounts

Looking to the future: PPF Funding Strategy

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- We expect risk to decline significantly over the period to 2030:
  - size of defined benefit universe
  - liability duration
  - scheme de-risking

- PPF aims to reinforce balance sheet as scope for levy recedes
  - no reliance on levy when aims for 2030 realised

Funding Strategy

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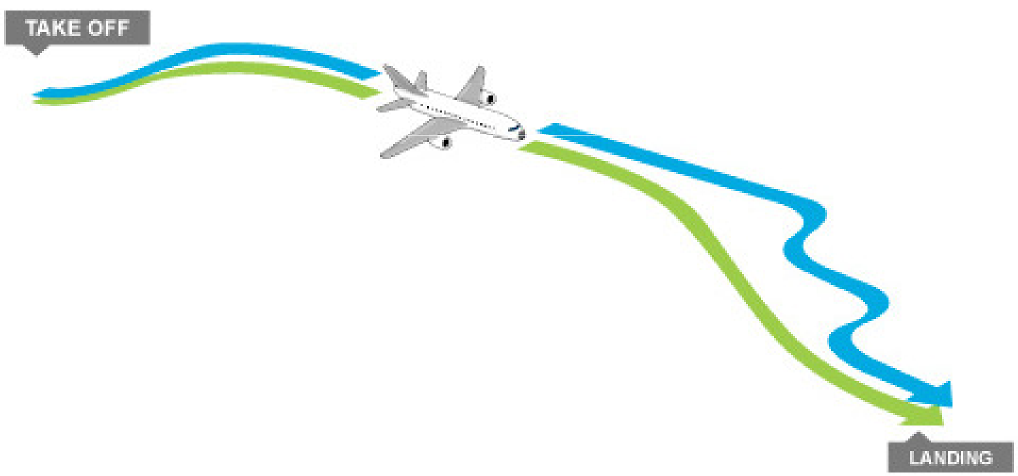
A flight-path to self-sufficiency by 2030:



Measured as *probability of success*

87% as at 31 March 2011

- Fully funded on a 'risk-free' measure of liabilities
- Fully hedged against key market risks:
  - interest rates
  - inflation
- Reserve (10% of liabilities) against future claims and longevity risk

Why the levy needed updating

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- Quantum vs distribution
  - quantum based on funding strategy – takes account of tail risk to cover against worse than expected experience
  - distribution only takes account of expected risk
- Consumer feedback:
  - experience of volatility in individual bills
  - difficulties in planning and budgeting
- Established Steering Group

Messages from the Steering Group

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- More predictability in individual bills
  - i.e. levy reflects a scheme's own risk, not aggregate risk
- Stability of levy bills also a priority
- Speak our language & focus on what schemes can control:
  - schemes typically have three year cycle
  - funding position
  - potentially investment strategy
- More transparency on cross-subsidy
- Stronger link to commercial charging – market consistency

Key Features of New Framework

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Bottom-up approach

- Fixed scaling factor for three years, only adjusted in limited circumstances
- Levy quantum will vary over the three years to reflect overall changes in risk
- More predictable levy bills

New approach to risk measurement

- Changes smoothed by using average values, so levy bills exhibit greater stability
- Market-consistent rates for insolvency
- Takes account of investment risk for the first time

How we will assess underfunding risk

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- Continue to roll-forward assets and liabilities using s179 valuation results submitted on Exchange
- Data deadline for s179s moved to start of levy year (rather than one year in advance)
- Funding measurement smoothed over five years by averaging market movements
- Funding calculation then incorporates investment risk by applying stresses to the smoothed assets and liabilities

How investment risk (stressing) will be measured

- For all schemes, PPF will adjust liabilities reported through Exchange by applying risk factor stresses after roll-forward and smoothing

Inflation	Interest rate
+34bps	-61bps

- Schemes with s179 liabilities at least £1.5bn (approximately 100 schemes) are required to submit information on stressed assets in scheme return (bespoke stress analysis)

- PPF will apply standard asset stresses for all other schemes, unless a bespoke stress analysis has been submitted

Investment risk: Standard approach

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PPF will adjust assets reported through Exchange by applying the following stresses after roll-forward and smoothing

Corporate bonds	Nominal gilts	Index-linked bonds	UK Equity	Overseas Equity	Property
0%	+10%	+16%	-22%	-16%	-6%
Cash	**Hedge Funds**	**Commodities**	**Insurance Funds**	**Annuities**	**Other**
0%	-7%	-16%	-22%	+16%	-22%

Investment risk: Bespoke approach

- Schemes submit stressed and unstressed asset values as at date of last audited financial statements
- Ratio of these values used to derive an overall stress factor applied to assets after roll-forward and smoothing
- Schemes likely to need advice from investment managers in calculating stressed asset value
- Outcome similar to standard model, except for schemes with derivatives
- Two stage process
  - expanded set of asset sub-categories and stresses for equities and bonds
  - assessment of sensitivity to risk factors for derivatives
  - approach covered in Investment Risk Guidance and Investment Risk Appendix

How we will assess insolvency risk

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- Employers placed into one of ten PPF levy bands – instead of allocation to one of 100 failure scores
- Levy rate = insolvency probability + risk margin
- Employer's levy band based on average of 12 monthly failure scores to end of March 2012
- Banding at employer level not scheme level, so weighted average for multi-employer schemes is not rounded to a band
- Changes to scheme structure factor for non-associated last man standing schemes

Putting it into practice - Levy estimate for 2012/13

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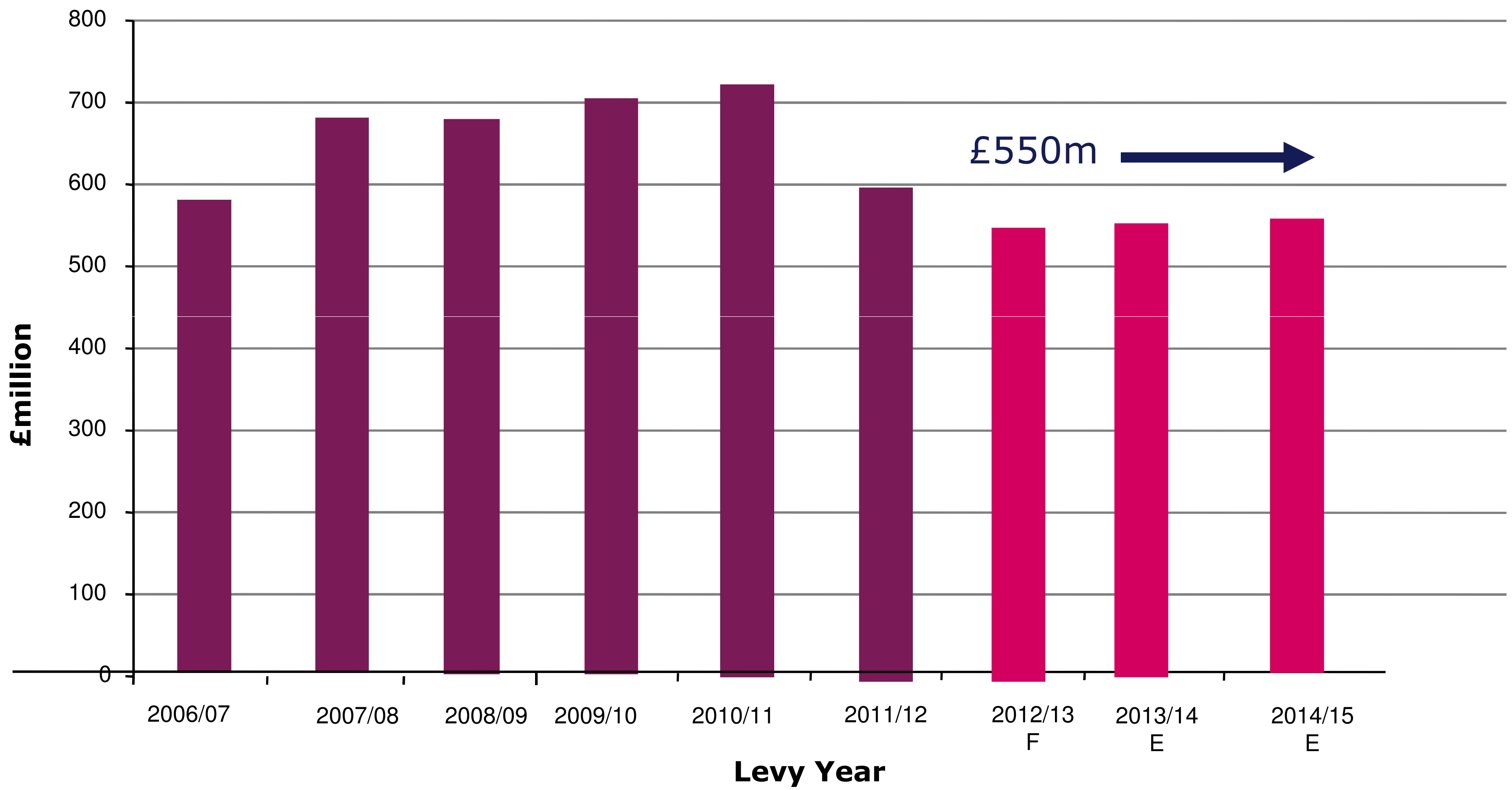

Putting it into practice – Proposed levy parameters for 2012/13 to 2014/15

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LSF = 0.89

RBL Cap = 0.75%

- applied to smoothed but unstressed liabilities
- aim remains to protect the weakest 10% or so of schemes

Scheme-based levy multiplier = 0.000085

- i.e. 0.0085%
- applied to smoothed but unstressed liabilities
- scheme-based levy estimated to comprise around 11% of total levy, compared to 20% in previous years

Contingent Assets

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- Broader definition of ‘associate’
- Type A – application of guarantor’s insolvency risk in multi-employer schemes
- Type A - greater requirements around strength of contingent asset guarantors
- Draft contingent asset guidance to be published in November 2011, with final version in December 2011

What should schemes do next?

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- Ensure D&B has accurate information for monthly failure scores
- Complete and submit scheme return (with special attention to asset allocation information)
- Consider whether bespoke asset stress test is appropriate for schemes with s179 liabilities under £1.5bn
- Consider risk reduction measures and associated deadlines:
  - 5pm on 30 March 2012 for contingent assets
  - 5pm on 10 April 2012 for deficit-reduction contributions

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Any questions?