PPF Proposals

Comments from a Consultant’s Perspective

Martin Lowes
18 November 2010

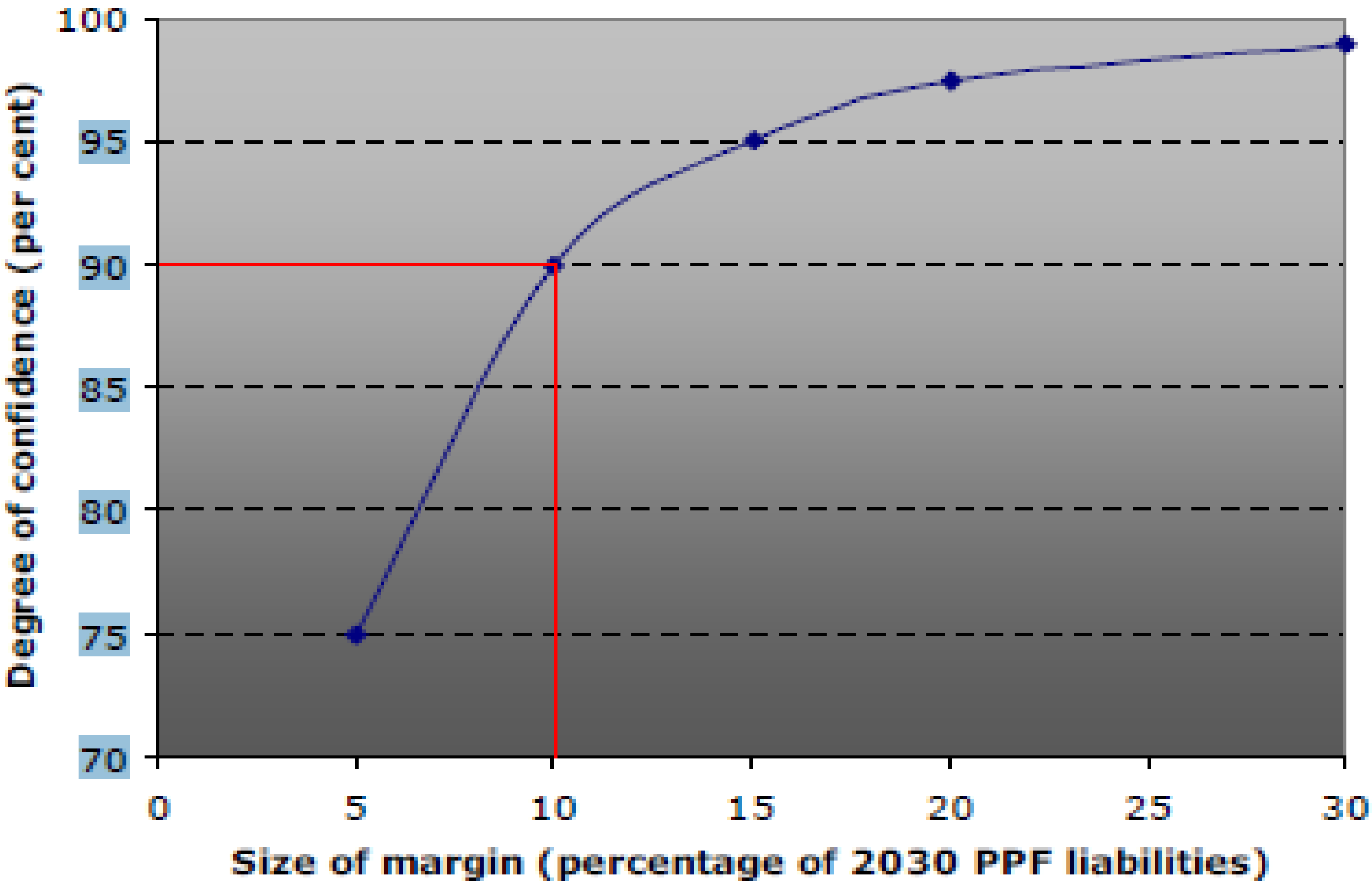
- Long term funding strategy
- New Levy framework

Who Absorbs Adverse Experience

~~Government~~

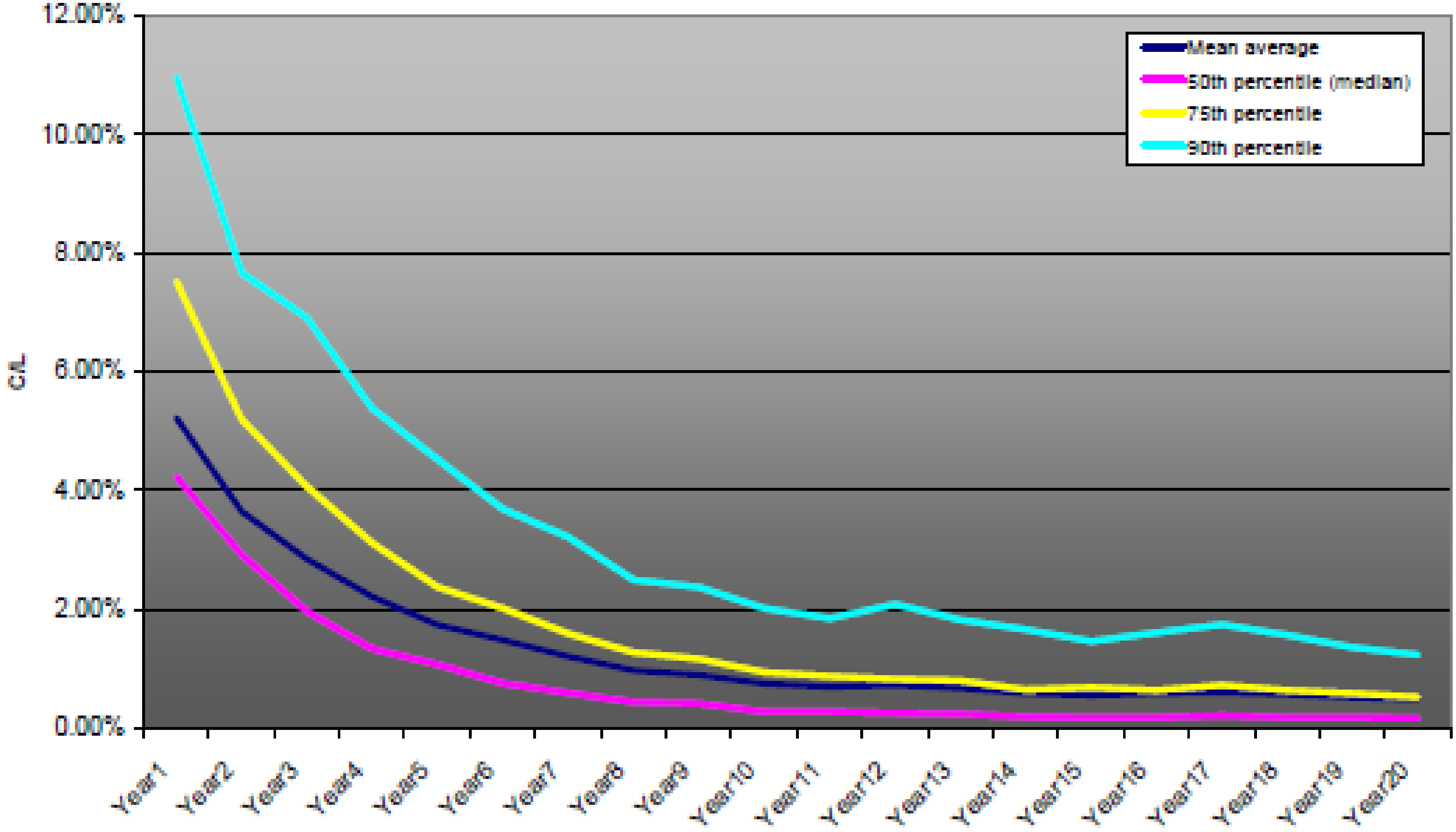
- Government
- PPF members
- Continuing pension schemes
- Funding cushion

Funding Margins for Combined Longevity and Claims Risk



AON Hewitt

Claims as a Proportion of PPF Liabilities Over a 20-year Horizon



Size of Risks

- By 2030, 90th percentile claims reduce to <1½%
  – Relevance
- Claims relative to remaining levy base
- Risks on accrued liabilities relative to remaining levy base

OR

- Risks relative to ability to reduce member benefits (e.g. pension increases)

Getting to Target

- Baseline 82.8% probability of achieving target
- Assumes constant (nominal) £700M p.a. levy
- But defined benefit scheme population reducing
- And PPF expect funding levels to improve, and investment risk to reduce
- How does constant £700M p.a. compare to plausible levy?

- Long term funding strategy
- **New Levy framework**

What Does PPF Need to Charge?

- Cost of expected claims
- Amortise deficit / build up funding cushion

What Should Schemes Expect to Pay?

- Not less than expected claims?
- Not more than market would charge?
  - Adds charge for capital held to cover unexpected risk

[Care-market participant cost of capital not PPF cost]

Formula

Scale 1 x Expected failure % x unstressed deficit

Plus

Scale 2 x Cost of capital % x stressed deficit

Versus

Scale x Combined % x stressed deficit

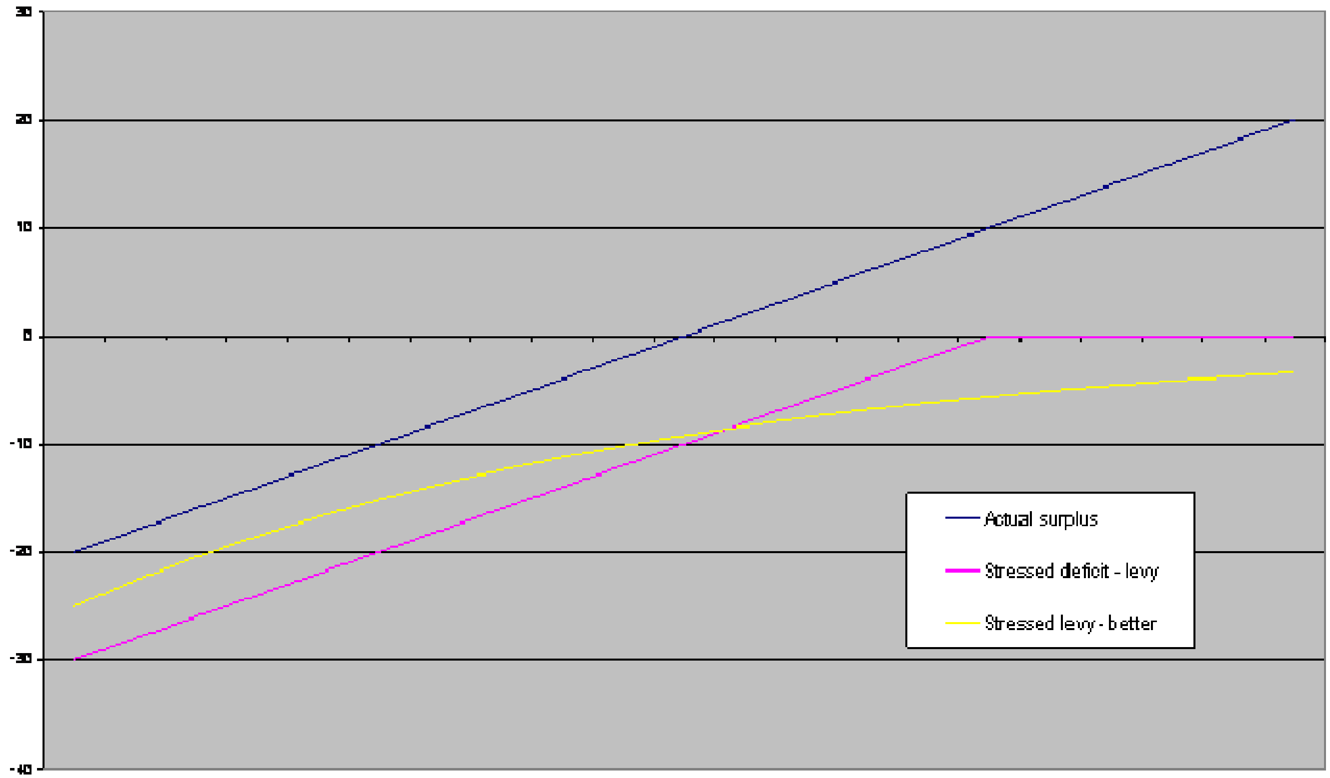
Smoothing

Expected insolvency % - next year

Expected insolvency % - through cycle current rating

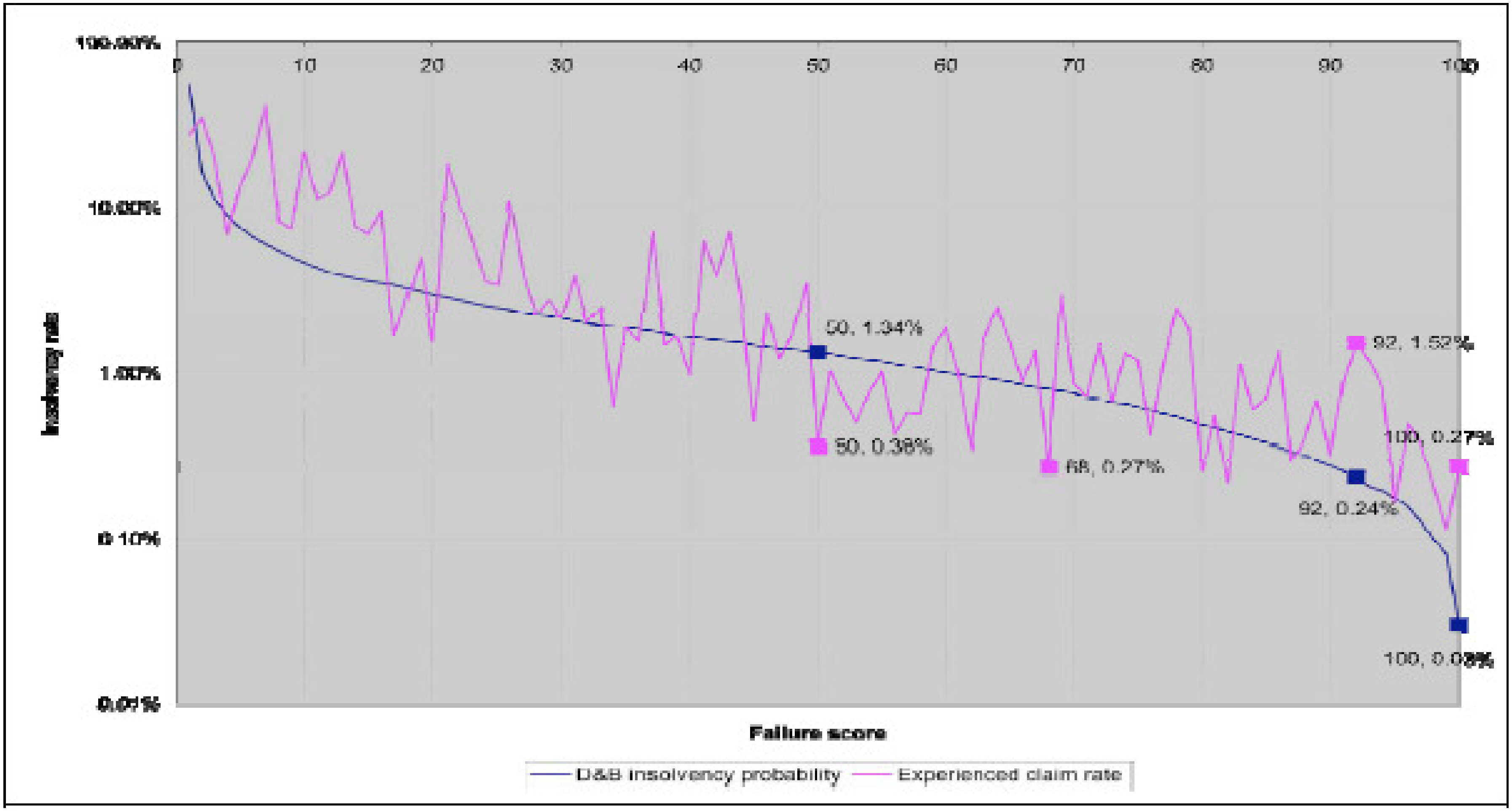
Expected insolvency % - average over say 5 years implicitly reflecting rating drift

Unexpected risk



30
20
10
0
-10
-20
-30
-40
Actual surplus
Stressed deficit - levy
Stressed levy - better

PPF Claims Experience Against D&B Failure Scores



No evidence to support ⟶ evidence to reject gratuity

Proposed PPF Levy Bands and Rates

PPF Levy Band	1	2	3	4	5	6*
Recommended Levy Rate	0.20%	0.50%	1.10%	1.60%	4.00%	4.00%
Corresponding D&B Failure Scores	100-97	96-90	89-69	68-42	41-6	5-1

**Capped probability*

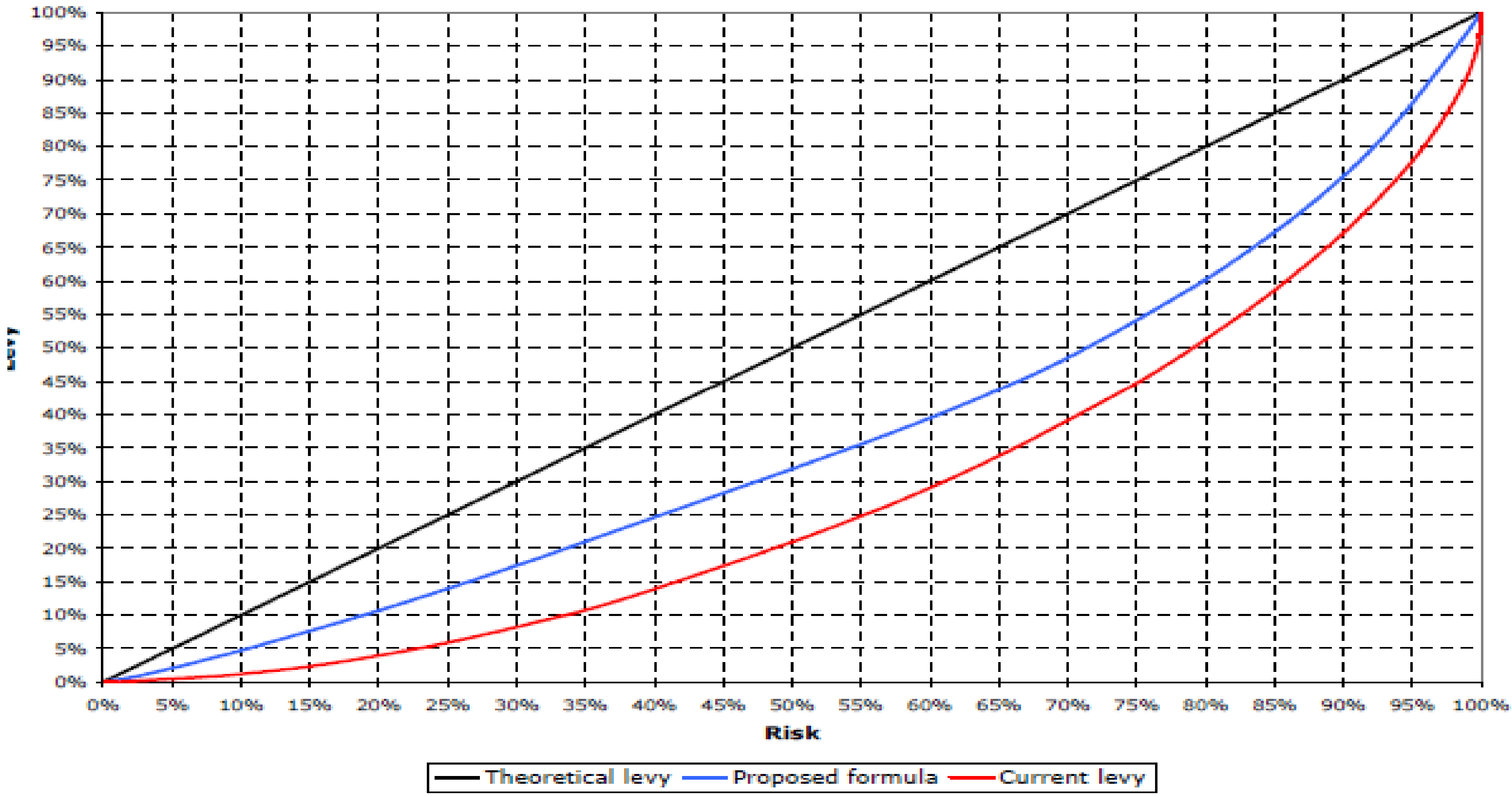
Aim – Expected insolvency % + cost of capital %

But – For band 1 = experience %

Investment Risk

- If scheme calculates own stressed cost value, what will be requirements
  - e.g. apply “standard” stress to total corporate bonds value as for most schemes, or calculate from each bond?
- Gaming system?
  - Direct equity exposure versus derivatives (fair value of derivative versus economic experience)
  - Geared property unit trust versus direct ungeared property
  - Options protecting specified fall – but no more
  - Changing strategy at year end

Lorenz Curves Showing Current, Proposed Formulae



What is “fair” – not defined