NAPF
Securing the future of pensions

NAPF Response to the Pension Protection Fund's Consultation on the Future Development of the Levy

1. Executive Summary

1.1 The NAPF recognises the important role played by the Pension Protection Fund (PPF) in guaranteeing member security and promoting confidence in pension provision. To ensure its success in these objectives we believe that the PPF levy must be placed on a long-term and durable basis and command the support of those who manage and sponsor defined benefit pensions.

1.2 To be viable over the long-term, the Government must recognise that in a context of declining defined benefit provision, it is neither fair nor credible that the ultimate liability for the obligations of unrelated companies should rest on a declining number of pension schemes and their sponsors. Instead, the Government should explicitly recognise its role as the ultimate guarantor of the PPF. Given the difficult economic environment, we believe the Government should either meet, or assume responsibility for, any rises in the aggregate annual levy above a fixed and specified level. Ideally, this level should be no higher than the current (2008-9) level of £675million (rising annually with earnings) and, failing that, certainly not be set at a level which places too great a burden on well funded schemes with a strong sponsor covenant.

1.3 While we can see merit in taking account of long-term insolvency risk as a means of achieving a fairer levy, it only makes sense to do so if a reliable method of calculating it can be found. We are not confident that the current proposals, which are based on 1 year risk extrapolated via a PPF formula to 5 years, and then calculated by looking at very extreme ("unexpected") adverse economic conditions arising every 200 years are the right ones. The impact of applying this extreme scenario is to increase the levy on schemes that are well funded with strong sponsors which could have the unintended consequence of destabilising these schemes. We are concerned that it may result in the pre-funding of risks which may never materialise. Instead, if the PPF is going to adopt a long-term risk measure it should use a less extreme scenario, for example one related to average economic conditions. For the largest schemes the only way of meaningfully assessing long-term risk may be to carry out an analysis of covenant strength, funding plans and investment strategy.

1.4 Similarly, while in principle we support the inclusion of investment risk in the calculation of the levy, it is essential that the measure is accurate. The PPF's core proposal to base the assessment risk on a simple asset allocation model using Exchange data is in our view too simplistic as it will not fairly assess the risk posed by schemes using hedging strategies or dynamic asset allocation measures. Instead, schemes should be allowed the option of self-certifying risk reduction measures on evidence from stress tests or internal modelling data. However, if it is decided to include investment risk in the levy, it should not be included before 2014/15 at the earliest. Applying it earlier would mean that those schemes which are heavily exposed to equities and their recent falls in

value would not only face the short term cost of making good funding levels but also increased levy costs.

1.5 To command widespread support the levy must be fair and stable:

- To be seen as fair, the levy should incentivise trustees and sponsors to ensure that schemes are well funded and secure. Therefore, while we support measures to make the PPF more risk-based, it is important that well funded and secure schemes are not unduly penalised. The current proposals involve a greater degree of cross-subsidy from well funded schemes to less well funded schemes than is desirable.

- Stability is essential in order to encourage confidence among corporate sponsors that their pension fund is a manageable risk and to facilitate constructive discussions between trustees and sponsors. Although the PPF believes its proposals will reduce levy volatility, for larger schemes the new approach may result in higher levels of volatility.

1.6 Greater transparency will also be an important means of maintaining support for the levy. To provide transparency for schemes and their sponsors, the PPF itself should adopt a Statement of Funding Principles which clearly explains its overall approach to funding its liabilities. This should include the role to be played by investment income, the levy, and a Government guarantee. It should also clearly state how this funding will be allocated to meet expected claims, existing deficits and, if the case applies, any intention to build up reserves to meet future "unexpected" claims.

1.7 Further consideration should be given to assessing the risk posed by schemes with an ultra-secure covenant (eg regulated utilities) or with a quasi-government guarantee (state-owned parent companies), or to "last-man standing" multi-employer schemes. We believe the PPF overstates the risk such schemes pose. For such schemes, the D&B score should be adjusted so as to recognise the minimal risk posed. The use of more sophisticated covenant assessment may provide a useful avenue of inquiry.

2. Introduction

2.1 The National Association of Pension Funds (NAPF) is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

2.2 While the NAPF supports the existence of the PPF levy, it is also a matter of concern to pension schemes and their sponsors. There is a real risk that the design of the levy itself could have an impact on the future prospects for defined benefit pension provision. We have, therefore, not only responded to the specific questions raised in the current consultation but also made some other, more wide ranging, comments.

3. NAPF concerns about the PPF Levy

3.1 NAPF members recognise that the PPF plays an important role in promoting confidence in pension provision and member security. However, we believe it should be considered as a measure of last resort and that while it provides a valuable safety net, it should not be allowed to undermine good pension provision.

3.2 We are greatly concerned that the imperative on the PPF to raise sufficient funds to meet possible future liabilities could result in the levy falling disproportionately highly on well-funded schemes with strong sponsors which could have the unintended consequence of destabilising these schemes.

3.3 Indeed, this appears to be the effect of the current proposals. We note that the highest increases will fall upon schemes that are over 100% funded and that have a sponsor with a good credit rating between Baa and Aa. In such cases, the average increase in levy would be between 0.01% and 0.03% of scheme liabilities. And these increases, can be large, according to the PPF's own data, as many as 800 schemes (11% of schemes) will face a levy increase of 100% or more. By contrast, schemes with weaker employers stand to gain from the changes. PPF projections show that some of the largest levy reductions (0.22% of liabilities) under the proposals will be enjoyed by a scheme with a funding level below 90% and a sponsor with a credit rating of Ba.

3.4 If, as is proposed, a greater proportion of the levy is to fall on better funded schemes rather than on less well funded ones, we believe it would undermine boardroom support for defined benefit provision and, as a result, leave many working people with lower levels of income in retirement. Indeed, some scheme sponsors are already raising questions as to how, over the longer term, rising PPF liabilities may have to be met by a diminishing number of schemes.

3.5 In light of the economic and commercial pressures on scheme sponsors and the current low value of many investment assets, it is far from clear that now is the right time to alter the basis on which the levy is raised. There is a risk that changes to the levy could distract attention away from the immediate priority of addressing deficits. Nevertheless, we can see some advantages in making the PPF levy more risk-based provided it is possible to measure such risk accurately.

3.6 We are concerned that the current proposals for taking account of long-term insolvency risk in the levy do so by extrapolating in a formulaic way from the 1 year risk to a 5 year "unexpected risk" which is then calculated on the basis of 1 in 200 years economic events. This approach raises four problems from our perspective:

- it involves some double counting of risk as a long-term risk may become a 1 year risk over the course of time;
- the assumption that all sponsors with a certain 1 year risk, "P", will all have the same 5 year risk, "Q", seems too simplistic to provide reliable results;
- we believe the assumption that insolvency risk should be measured in highly adverse economic conditions ("unexpected risk") often called "tail" events is likely to lead to an unnecessary level of pre-funding and result in an unfair burden on well-funded schemes with strong sponsors;
- moreover, some experts estimate that the total level of insolvencies predicted by the model is too high, and far out of step with past experience.

We are not, therefore, persuaded that the proposed method of measuring long-term insolvency risk is the right one.

3.7 Similarly, if investment risk is to be incorporated into the levy calculation, it is essential that the measure of investment risk used is accurate. We believe that the PPF's core proposal, to base the assessment risk on a simple asset allocation model derived from data supplied through Exchange, is too simplistic. In particular, it will not provide an opportunity for schemes using hedging strategies or dynamic asset allocation to benefit in terms of lower levy payments from the reduced risk they pose to the PPF. Moreover, if investment risk were to be introduced in the near term, while equity values are at historically low levels, an unfair burden would be placed on those schemes with a high degree of equity investment as they would have to pay both to make up funding shortfalls and more to the levy. As currently drafted, the NAPF cannot support the PPF's core proposal for the inclusion of investment risk.

3.8 In addition, some members feel that the impact of investment risk will only be meaningful if it is accompanied by an assessment of the strength of the covenant, the ability of the scheme to fund payments without realising assets, the maturity of the scheme, and the size of the scheme.

3.9 A further area of concern has been the high level of volatility and unpredictability of the levy over the few years since it was introduced. NAPF members have repeatedly stressed the difficulties that levy volatility causes for corporate financial planning and for relations between trustees and scheme sponsors. It is important that, in future, the levy is more stable than has hitherto been the case. However, the NAPF recognises and appreciates the efforts made by the PPF to make the levy more stable than in the past.

3.10 The levy should also be as simple as possible. A complex levy would be likely to undermine the legitimacy and acceptability of the PPF itself as it could be open to dispute and prone to abuse via "gaming" of the system. We acknowledge, however, that simple approaches are also likely to leave some schemes and

sponsors treated unfairly, and that the PPF has a difficult balancing act to play between achieving fairness and simplicity. Indeed, most ways of introducing greater accuracy to the levy also involve the adoption of a more complex approach.

3.11 Finally, we are concerned that the D&B insolvency scores fail to fairly recognise the reduced risk posed to the PPF by schemes with ultra-strong covenants, such as regulated utilities and multi-employer schemes with a "last man standing" covenant, or quasi-government guarantees as is the case with state owned parent companies.

4. NAPF proposals for reform

4.1. In light of the concerns set out above, the NAPF proposes the following measures for the reform of the PPF levy:

- **A cap on the PPF levy and a Government guarantee**: We propose that the Government should recognise reality and explicitly guarantee that it will meet, or at least assume responsibility for, the cost of aggregate levy demands over a specified level. Ideally, this level would be no higher than the current (2008-9) aggregate levy of £675 million (rising annually with earnings) and, failing that, certainly not be set at a level that would place too great a burden on well funded schemes with a strong sponsor covenant.

- **Long-term insolvency risk**: While we see merit in taking account of long-term insolvency risk, we are concerned that the measure to be used is likely to give a poor indication of risk. If the PPF does adopt a long-term measure, we suggest that the 5 year score should be related to average economic conditions. For the largest schemes, the only way of meaningfully assessing long-term risk may be to carry out an analysis of covenant strength, funding plans and investment strategy.

- **Investment risk**: We support the inclusion of investment risk but only if an accurate measure can be developed. We do not, however, agree with the PPF's core proposal to base investment risk on the asset allocation data supplied through Exchange. We believe that schemes should be allowed the option of providing self-certification so that where they have risk reduction measures in place they can justify a lower levy on the basis of either stress tests or internal modelling. However, due to the current adverse investment climate, and the risk of a double penalty being paid by schemes that are currently highly invested in equities, we believe that investment risk should not be included in the levy until 2014/15 at the earliest.

- **Transparency - PPF Statement of Funding Principles**: To provide certainty and transparency for schemes and their sponsors, the PPF should adopt a Statement of Funding Principles which clearly explains its approach to funding. The statement should include details of the proportion of PPF liabilities that the PPF expects to be funded by the levy, through the assets it manages and from investment income. It should also outline the role to be played by the Government as guarantor. It should also clearly state how this funding will be allocated to meet expected claims, existing deficits and, if

the case applies, any intention to build up reserves to meet future "unexpected" claims.

- **Fair and stable – sending the right signals**: While a more risk-based approach is good in principle, we must be sure that its practical effects are positive. The levy should incentivise trustees and scheme sponsors to provide good levels of funding and security for their schemes. It is also important that the PPF continues in its efforts to achieve stability in the levy.

- **Treatment of ultra-strong or quasi-Government covenants**: The PPF overstates the risk such schemes pose. For such schemes, the D&B score should be adjusted so as to recognise the minimal risk posed. The use of more sophisticated covenant assessment may provide a useful avenue of inquiry.

5. Answers to specific questions

1. **Do you agree that the PPF should keep the two caps on the Risk-Based Levy (RBL) under review to seek to maintain the affordability of the levy?**

   Although it is desirable to make the RBL more risk-based, due to the high level of uncertainties involved in assessing long-term risk, we believe that the maintenance of caps is a necessary safeguard against unfairly high levies.

2. **Do you consider that the Scheme-Based Levy should be reduced when the PPF is no longer in debt, or alternatively at some other point?**

   We welcome the PPF's proposals to reduce the proportion of the PPF levy met by the Scheme-Based Levy from 20% to 10%. This is an issue we have raised previously with the PPF and we are pleased to see the PPF has responded to this concern. More generally, to reduce the burden on schemes, and to avoid unnecessary amounts of pre-funding, we believe it would be sensible to reduce the Scheme-Based Levy further as soon as it is possible.

3. **Should the PPF now move to include unexpected risk in the RBL as proposed?**

   While the inclusion of "unexpected risk" will help achieve the PPF's aim of funding future claims, in practice it may simply lead to large well-funded schemes having to pay unnecessarily high levies for insolvencies that are very unlikely to occur.

   We are concerned that the current proposals for taking account of long-term insolvency risk in the levy do so by extrapolating in a formulaic way from the 1 year risk to a 5 year "unexpected risk" which is then calculated on the basis of 1 in 200 years economic events. This approach raises four problems from our perspective:

   - *it involves some double counting of risk as a long term- risk may become a 1 year risk over the course of time;*
   - *the assumption that all sponsors with a certain 1 year risk, "P", will all have the same 5 year risk, "Q", seems too simplistic to provide reliable results;*

- *we believe the assumption that insolvency risk should be measured in highly adverse economic conditions ("unexpected risk") often called "tail" events is likely to lead to an unnecessary level of pre-funding and result in an unfair burden on well-funded schemes with strong sponsors;*
- *moreover, some experts estimate that the total level of insolvencies predicted by the model is too high, and far out of step with past experience.*

We are not, therefore, persuaded that "unexpected risk", as currently defined by the PPF, should be included in the levy. Instead, the PPF should find a more accurate and reliable measure. If an assessment of future economic conditions are to be included it should be based on average economic conditions not extreme outlier events as currently proposed. For the largest schemes, this may involve undertaking an analysis of the employer covenant, funding plans and investment strategy.

4. If so, when should it be introduced – in 2011/2012 or another levy year?

As noted above, we do not agree that a measure of "unexpected risk" should be included as it is currently proposed. It is not possible to say when a measure should be introduced unless we are clear about the nature and impact of the proposal.

5. Do you agree that taking account of investment risk is unlikely in itself either to alter the behaviour of schemes or to impact markets?

While views within the sector differ on this point, on balance we believe there is a strong risk that schemes and their sponsors will be influenced in their investment strategy by the introduction of investment risk into the PPF levy formula. The experience since the introduction of FRS17 would suggest that such incidental regulatory factors can influence investment strategy. Since FR17 was introduced in 2005, schemes have undertaken a marked move out of equities and into bonds. We believe that this risk will be greatest among those small and medium sized schemes that do not regularly take advice from investment consultants.

6. Do you agree with the proposal to use Exchange scheme return information for the calculation of a scheme-specific volatility measure to be incorporated in the new RBL formula?

In light of the prevalence of hedging and dynamic asset allocation among the larger, more sophisticated schemes, we do not think it would be appropriate to only base the investment risk estimate on the asset allocation data provided to Exchange. Instead, we believe that it should be possible for schemes to provide self-certification of their risk reduction methods via either stress testing data or submission of their internal modelling. However, due to the current investment conditions, we do not think investment risk should be included in the levy calculation until 2014/15 at the earliest.

7. **If that proposal is adopted, do you think that behaviour which seeks to reduce the levy charge, rather than genuinely reducing risk, would have a material impact on levy collections? (eg using alternative investment strategy immediately after a reporting date, or using derivatives to increase risk.)**

   We do not believe that this is a likely eventuality.

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

   We believe that this should be an option for all schemes that wish to use it. For those that do not wish to use it, the option of simply having an investment risk estimate based on their Exchange data should continue.

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

   No. As stated above, it should simply be an option. The option should be available to all schemes.

10. **If so, what threshold should apply?**

    N/A

11. **What questions relating to this approach need resolving before its introduction?**

    Far more analysis and discussion of the best method of assessing long-term insolvency risk is required. In particular, the inclusion of "unexpected risk" as proposed, seems hard to justify given the very many uncertainties that exist in assessing insolvency even over periods as short as one year. With regard to investment risk, we do not think it should be introduced until account can be taken of hedging strategies and dynamic asset allocation or until after current investment conditions have passed.

12. **Should an internal models approach be offered to smaller schemes if they wish to use it?**

    It should be available as an option for any scheme that wishes to use it.

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

    No. The interpretation of fairness used relies too heavily on the soundness of the PPF's calculation of risk. We believe it places too much emphasis on the inclusion of "unexpected risk" with the result that the levy falls too heavily on large well-funded schemes with strong sponsor covenants.

6. Conclusions

6.1 The PPF provides a large measure of protection for pension scheme members who might otherwise lose out if there employer goes insolvent with an underfunded pension scheme. It has an important role to play in encouraging confidence in the UK's pension system.

6.2 However, finding a fair means of apportioning the cost of providing this protection is fraught with difficulty. While the PPF understandably is focussed on gathering money where it may, for the long-term maintenance of defined benefit pensions, it is important that it only does so in a way that encourages the right behaviour by scheme sponsors and trustees. We believe that this should involve incentivising high levels of funding and rewarding strong covenants.

6.3 The PPF also has a difficult task in measuring risk. If it underestimates risk, it may face a shortfall – unless the NAPF's proposal for a Government guarantee is adopted – and if it overestimates risk it may unnecessarily burden schemes and discourage defined benefit pension provision. This is why, while supporting the PPF in its efforts to adopt a more risk-based approach, the NAPF emphasises that long-term insolvency risk should not be introduced until a more accurate way of measuring it can be identified.

For further information, please contact: Nigel Peaple, Director of Policy (nigel.peaple@napf.co.uk or tel. 0207 808 1309)

NAPF
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