The Pension Protection Levy: a New Framework

Response to a PPF consultation paper

The National Association of Pension Funds

20th December 2010

The NAPF

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 around 15 million members and assets of £800 billion. The NAPF's membership also includes 400 businesses that provide essential services to the pensions sector.

Executive summary

- The NAPF welcomes the proposals. They take significant steps towards delivering a closer link between a scheme's risk and the levy it pays to the PPF. They will also make for a more 'bottom up' levy system.

- The proposals represent evolution, rather than revolution. There is still a case for addressing more fundamental questions about the purpose of the PPF levy – particularly whether it is a tax or an insurance premium.

- The NAPF would still like to see more done to reduce the amount of subsidy from well-funded to poorly funded schemes.

- The NAPF supports the three-year period of stability over levy parameters, although substantial fluctuations will still be possible at the end of the three years.

- The NAPF supports the proposed five-year smoothing period for funding.

- The NAPF has consistently supported incorporating an element to reflect investment risk. However, we are concerned that the proposed approach will penalise schemes for holding equities and reward them for holding gilts.

- Ideally, the cost of conducting 'stress tests' on schemes' investment strategies should be covered by the PPF itself.

- Contingent assets are too narrowly defined by the PPF at present. A broader approach would make it easier to establish a closer link between each scheme's levy bill and the risk it poses to the PPF.

- The move to six risk bands, combined with smoothing insolvency risks over a year, should help to reduce volatility in levy bills. However, some well funded schemes with a high sponsor D&B rating will still face significant levy increases as a result of the banding effects. The NAPF would strongly support an extensive system of transitional relief to mitigate these effects.

- The NAPF supported attempts to reflect the quality of scheme governance in the levy, but it has proved impossible to identify how this could be achieved in practice. The search for a means of 'capturing' good governance should now be brought to a close.

The NAPF's approach

2. The NAPF welcomes the proposals set out in the consultation paper *The Pension Protection Levy: a New Framework.* These plans will allow the PPF to take significant steps towards two of the NAPF's key objectives:

(i) *stability* - providing a closer link between the risk that an individual scheme poses to the PPF and the amount of levy that it is required to pay; and

(ii) *transparency* - securing some movement away from the current 'top down' system (where the PPF identifies how much money it wishes to raise and then adjusts the formula accordingly) to one that is 'bottom up' (where each scheme will pay a levy according to its risk to the PPF and the total raised will only become apparent at the end of the process, rather than at the beginning).

3. Although welcome, these proposals represent evolution, rather than revolution. There is still a case for addressing more fundamental questions about the purpose of the PPF levy – particularly whether it is a tax or an insurance premium. This remains a question of real concern to NAPF members; the answers generate very different approaches to the form the levy should take.

4. Although the new system will make the element of cross-subsidy more transparent, the overall level of cross-subsidy will not be reduced. While we recognise the importance of ensuring that the PPF levy does not impose a major additional burden on schemes that are already hard-pressed, we would like to see more done to bear down on the amount of cross-subsidy from well-funded schemes to their poorly-

funded counterparts. The levy system should provide incentives – not disincentives - for achieving strong funding levels.

Answers to specific questions

Q 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?

The three-year review period seems reasonable and should give schemes greater certainty about their levy bills over a medium-term timescale. It will remain possible, however, that schemes could still see substantial increases in levy bills when the three-year point is reached. It would be useful to see some PPF modelling of the potential scenarios at the end of a three-year period.

It appears that a scheme could still face once every three years the same difficulty that it now faces annually, ie, that its levy bill could rise despite a reduction in the risk the scheme poses to the PPF. Until the review process changes to a fully 'bottom-up' basis, this prospect will remain a feature that undermines confidence in the PPF system.

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

Yes, we agree that there should be some provision for revising the scaling factor *in extremis* within the review period, and the conditions set out in the paper seem sensible.

Q4.1: Do you support a smoothed approach to funding and do you think that five years is an appropriate smoothing period?

Yes, we agree with this approach.

Q4.2: Do you agree with our proposed method to smooth scheme assets and liabilities over five years?

Yes.

Q4.3: Do you think that investment risk is appropriately reflected in the proposed funding calculation?

The NAPF has consistently supported the principle of incorporating an element to reflect investment risk in the PPF levy formula. However, we are concerned by the figures set out in Table 4 of the consultation paper, which shows that schemes will be penalised for holding equities and rewarded for holding gilts.

This approach will add to the regulatory incentives for schemes to move away from equities and into fixed-income investments. This might prove contrary to the long-term interests of the scheme and its members. It will certainly make it more difficult for trustees and the sponsor to agree a funding strategy. It also reduces the resources available for investment in business.

Our further concern is that the 'asset value stresses' will encourage schemes to 'game' the system, selecting investments in order to minimise their PPF levy bills rather than to generate long-term investment returns.

We recommend that the PPF reviews its proposed approach to the inclusion of investment risk.

Q4.4: 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?

We agree that particularly large schemes could be expected to provide more information on their investment strategies. However, it is not clear to us from the Redington report published alongside the consultation document what extra information would be required. This should be clarified.

The PPF should also be very wary of assuming that it is better placed to judge what investment strategy a scheme needs than a properly advised and informed trustee board which is familiar with the issues.

Q4.5: Do you agree with Redington's assessment of the costs associated with providing the additional analysis of stress scenarios?

We note from the Redington report (para 7.19) that the cost to schemes of carrying out the stress test on assets could be more than £5,000 per scheme. We would be concerned if this process were to impose such significant extra administrative costs on schemes, and we would urge the PPF to keep these extra costs to an absolute minimum.

Ideally, the PPF itself should cover the costs of these stress test exercises.

Q4.6: 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?

We agree that, wherever possible, information should be extracted from returns submitted via the existing Exchange system.

The PPF should bear in mind that annual accounts data will inevitably be out of date by the time the Exchange return is submitted, and that derisking switching mechanisms, for example, can mean that today's asset balance is very different from that of 18 months earlier.

Q4.7: Do you agree that the information schemes could use to calculate their investment risk would be readily accessible from asset managers, for example, sensitivity to interest rate changes for specific interest rate exposures?

Schemes should be able to obtain much of this information from asset managers, but by no means all. For example, the composition of a hedge fund could be equity-biased at the start of the year but neutral a few months later. It might be difficult for schemes to reflect this kind of investment shift in their returns to the PPF or Pensions Regulator..

The process of requesting, assimilating and submitting the information will itself represent an extra administrative process with its own attendant costs. As indicated above, the PPF should meet the costs of extra administrative burdens.

Q4.8: Do you think the types of contingent assets that the Board will recognise for levy purposes is still appropriate, or are there other arrangements that you think should be recognised?

NAPF members raise concerns that some kinds of contingent asset are not recognised by the PPF. This would include, for example, asset pledges, insolvency insurance and credit default swaps. Ship mortgages are a further kind of contingent asset overlooked by the PPF – a major issue for the maritime sector.

These problems stem from the PPF's approach to contingent assets, which could usefully be reformed. At present, the PPF recognises specific types of tightly defined contingent assets. The NAPF proposes that the PPF should take a broader view. For example, the PPF could recognise further kinds of contingent asset where the scheme provides certain information about the asset itself and the arrangements in place to ensure that the arrangement can be enforced.

This new approach would help the PPF to achieve one of its objectives in the current reform process – a closer link between each scheme's levy bill and the risk it poses to the PPF.

Q4.9. 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?

Q4.10 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?

Q5.1 Do you agree that a significantly smaller number of insolvency risk bands (six instead of the current hundred) provide a better reflection of the risk posed to the PPF?

The key to ensuring the PPF levy accurately reflects the risk posed by each scheme is to ensure that the insolvency ratings that underpin the system are as accurate as possible. Our members frequently raise concerns about the ratings assigned to individual scheme sponsors by Dun and Bradstreet. The PPF should continue to do all it can to strengthen this system.

A particular concern is that the current system does not always give credit for guarantees provided to pension schemes by parent companies where one of their subsidiaries is the formal sponsor.

A further issue relates specifically to multi-employer schemes, where insolvency ratings are averaged out across all employers involved in the scheme. Some NAPF members are concerned that this approach is inappropriate for 'last man standing' schemes.

Members are also very concerned that the PPF does not work with the grain of the modern PLC. In most group companies it is the group that pays the PPF invoice and the group that supports any subsidiary. Yet it is perfectly possible for the group's levy bill to be inflated by, for example, an outstanding invoice against a non-trading dormant subsidiary. This can lead to groups recapitalising a non-trading subsidiary solely to reduce the PPF bill. The PPF should avoid incentivizing companies to move money around in this way.

Having noted these concerns, we recognise that the move to six risk bands (instead of the current hundred), combined with smoothing insolvency risks over a year, should help to reduce volatility in levy bills. However, we are aware that some schemes with a high sponsor D&B rating and which are well funded will still face significant levy increases as a result of the banding effects. The NAPF would strongly support an extensive system of transitional relief to mitigate these effects.

Q5.2: 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))?

Whichever method is chosen, the PPF should consider which organisation really funds the pension scheme (in a group this is usually the parent company) and assess risk on that basis.

Q5.3 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 agree with the proposal to use an averaged measure of insolvency risk. Using monthly data points would appear appropriate – as long as there is no extra work or expense for schemes.

Q5.4 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?

As indicated above in the answer to question 5.1, the NAPF is concerned that some schemes could experience 'cliff edge' situations that generate sharp increases in their levy bills. We would support a system of transitional relief.

Q7.1: Do you think that there is a relationship between a scheme's governance practices and its risk to the PPF?

Q7.2: If so, do you think that good governance should be measured and lead to a reduction in the risk-based levy?

Q7.3 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 some sort of sliding scale to reflect differing standards?

Q7.4 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)?

The NAPF supported the PPF's attempts to reflect the quality of scheme governance in the levy, but we recognise that it has proved impossible to identify how this approach could be put into practice.

It now seems sensible to bring the search for a means of 'capturing' good governance to a close. The PPF should instead make progress on implementing the rest of its reform package.

Q7.5: Do you agree that the application of the levy cap should be conditional on the capped scheme taking some sort of risk reduction measure(s)?

We agree that there should be a *quid pro quo* for schemes that benefit from the cap; some form of derisking seems appropriate.

However, closing to future accrual is by no means the only way of reducing risk, so we would not agree that schemes should be forced to take this specific step.

Q7.6: What type of measures would you suggest offer appropriate assurance that a scheme is committed to reducing their risk?

Alternatives to closing to future accrual could include:

- increasing liability-matching assets;
- raising pension age;
- reducing benefits;
- changing the nature of the scheme – eg, from final salary to career average;
- increasing employer or employee contributions; and
- taking a charge on contingent assets.

Conclusion

5. The NAPF remains supportive of the broad thrust of the PPF's proposals, and we look forward to their implementation. We have concerns about some specific points, as set out in this response, and we would be happy to discuss these issues in more detail.

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