An educated guess

Executive summary

In August 2007 the Pension Protection Fund published two important documents:

- Modelling Uncertainty: An introduction to the PPF Long Term Risk Model; and
- The Consultation on the Future Development of the Pension Protection Levy (the consultation document).

This article is mainly concerned with the impact of the latter on UK pension schemes and their sponsors in the event that the changes it proposes are accepted after the consultation, which is due for completion on 3 October. These changes are far-reaching, with potentially significant consequences. We also briefly describe the long-term risk model, since its output is driving some of the levy changes proposed by the PPF. This article does not attempt to summarise all the subjects dealt with in either the consultation document or the long-term risk model paper – for example, we do not comment on multi-employer schemes, schemes with international employers and schemes funded above 104% of PPF liabilities.

The long-term risk model (LTRM) of the Pension Protection Fund (PPF) is a stochastic model that integrates processes that forecast the future possible behaviour of investment markets, the rate of future employer insolvencies and the exposure of the PPF to underfunding in pension schemes of insolvent employers. It is used to provide the PPF with information about potential risks over a multi-year period and, therefore, the amount of levy it needs to collect over the medium term to fund any deficits for which it could become responsible.

Output from the LTRM allows a 'raw' levy to be calculated that helps the PPF determine the total levy it needs to collect each year. However, this raw levy differs from the levy actually charged by the PPF for a number of reasons, not least that the actual levy is based on short-term insolvency probabilities provided by Dun & Bradstreet and takes account of the principles the PPF has set itself, which include 'affordability'.

Nevertheless, there needs to be alignment between the theoretical levy computed by the LTRM and that actually collected if the PPF is to be appropriately funded in the long term – this assumes, of course, that the LTRM is properly designed and calibrated. The PPF has indicated that it not only wishes to seek such alignment, but also wishes to align the levy paid by individual schemes more closely to their individual contributions to the overall risk – in other words, to allocate levy costs more fairly between stronger and weaker schemes and stronger or weaker employers.

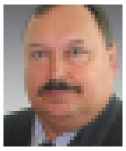
PRINCIPLES UNDERLYING THE NEW PROPOSALS FOR THE LEVY
In its consultation document, the PPF lays down certain principles underlying its proposals, some of which, it says, are in response to feedback from levy payers.

These principles are:

- increased stability and certainty for levy payers (and, by inference, for the PPF);
- collecting an amount each year closer to the total levy estimate (a problem in the first two years);
- improving the fit between the way the total levy estimate is distributed between all eligible schemes and the theoretical levy produced by the LTRM;
- managing cross-subsidy between stronger and weaker schemes and stronger or weaker employers;
- maintaining the effectiveness and adoption of incentives (for example, contingent assets); and
- balancing implementation and transition costs.

It is the first of these principles that, if adopted, will cause most changes to the current system in the short term. The detailed proposals involve setting an overall levy estimate that, allowing for indexation, will be stable for the next three years (subject to there being no significant change in long-term risk exposure). This, in turn, should lead to reduced volatility of individual levies year on year during this period.

While stability is desirable, the cost of such stability in terms of a higher levy and reduced flexibility to manage it downwards should



JOHN HAWKINS EXPLAINS THE SIGNIFICANCE OF THE 2007 CONSULTATION FOR THE PENSION PROTECTION FUND LEVY.

not be underestimated. Sophisticated schemes and sponsors placing a high level of importance on flexibility will almost certainly consider these proposals retrograde. Also, if sponsors do not benefit from risk reduction actions for a long period, they may be put off from making them at all.

THE LEVY SCALING FACTOR The levy scaling factor is the multiplier in the individual levy formula used by the PPF to ensure that the total risk-based levy targeted for collection is in line with its requirements. A single factor was used for all schemes in 2006/07 and 2007/08, although it increased around fourfold year on year.

The PPF has now suggested that it may vary the way the scaling factor is calculated, with separate factors calculated for different categories of schemes to reflect their different contributions to the levy estimate and to the PPF's long-term risk. This proposal has been published with no indication of how it could be achieved, so its possible consequences are difficult to forecast.

The single scaling factor approach was driven by the lack of comprehensive data, a limited understanding of the distribution of risk across the PPF universe of eligible schemes and the embryonic state of the LTRM in 2005. All these factors have changed significantly over the past two years. Also, the economic environment in October 2005 was different, with most schemes being in deficit; redistribution and cross-subsidy issues were not as stark then as they are currently.

In an environment of improving funding, the PPF believes that consideration needs to be given to refining the incentives for long-term risk reduction. Smaller schemes should benefit from this approach as a result of two mechanisms. First, their levies are likely to reflect their normal risk (rather than including a loading for the catastrophe risk of other, larger schemes). Second, if the biggest schemes by exposure take steps to reduce their risks, then this should feed back through a reduction in the levy estimate, resulting in lower levies for all. Of course, this is not necessarily good news for the larger schemes.

In the short term the PPF is proposing the adoption of a 'simple' strategy, whereby the levy is redistributed more towards those schemes posing the greatest catastrophe (or tail) risk, which by and large will be the larger and less well-funded schemes.

According to the consultation document, it is possible that separate scaling factors could be introduced as early as the 2008/09 levy year. In the longer term the PPF has suggested (in its policy statement on the possible inclusion of investment risk as a risk factor in the risk-based levy, published in May 2007) that it would like to take into account and encourage a greater variety of risk reduction activities by employers (for example, liability-driven investment). It is possible that these actions could also be rewarded through the mechanism of a reduced scaling factor.

MEASUREMENT DATES OF RISK FACTORS To enable schemes to have greater certainty and advance notice of their individual levies, the PPF proposes to bring forward the date of calculation of the risk factors (that is, the failure score and scheme deficit) and the deadline by which all data will be collected to a date 12 months before the start of the relevant levy year. Consequently, schemes would be able to calculate their levies from the previous November, following the publication of the levy estimate and scaling factor. This change would take place from the 2009/10 levy year. The PPF has published the table shown on this page, which demonstrates how this approach would be introduced.

If the proposals in the consultation document are accepted, the importance of the date 31/03/2008 will be immediately apparent. In terms of insolvency measurement, it is the date that will drive the risk-based levy for schemes for both the 2008/09 and 2009/10 levy years. It is therefore vital that schemes plan to engage with D&B well in advance of March 2008 to ascertain their failure score and to ensure that it is based on the fullest, most up to date and accurate information.

Since risk factors will be calculated 12 months prior to the start of the levy year, from the 2009/10 levy year risk reduction steps (such

Levy year	Data deadline	Underfunding measured	Insolvency measured
2006/07	31/03/2006	31/03/2006	31/03/2006
2007/08	31/03/2007	31/10/2006	31/03/2007
2008/09	**31/03/2008**	31/10/2007	**31/03/2008**
2009/10	**31/03/2008**	**31/03/2008**	**31/03/2008**
2010/11	31/03/2009	31/03/2009	31/03/2009
2011/12	31/03/2010	31/03/2010	31/03/2010

Source: The Consultation on the Future Development of the Pension Protection Levy, Pension Protection Fund, August 2007.

as additional funding and the provision of contingent assets) will also have to be taken 12 months in advance of the year in which they will first affect a scheme's levy. In other words, there will be at least a 12-month delay between certifying a risk reduction action to the PPF and first receiving credit for it.

INSOLVENCY RISK The PPF has also confirmed that it will continue to use D&B as its provider of insolvency information for the 2008/09 and 2009/10 levy years. For 2010/11 and beyond it will be undertaking a tender exercise, commencing almost immediately, to appoint one or more providers of such information. The result of the tender will be announced in the spring of 2008. One possible objective will be to align risk measurement for levy computation purposes more closely with the approach taken in the LTRM.

D&B is in the process of rolling out a revised methodology for calculating failure scores of UK employers. Despite some delays, this process was due to be completed by September 2007. This methodology incorporates some ad hoc changes introduced over the last 18 months, revised parameterisation of the underlying models and some philosophical changes – for example, the introduction of separate scorecards for commercial and non-commercial (not-for-profit) organisations.

The key changes compared to the original methodology are as follows:

- The failure score is no longer over-ridden where a company has negative net worth;
- The PPF has instructed D&B to disregard the 'severe parent risk' over-ride;
- The rulings concerning county court judgements (CCJs) have been amended, broadly in line with the approach taken by the PPF in 2007/08;
- The D&B over-ride for accounts filed in foreign currencies is no longer part of the basic methodology and so no longer needs to be disregarded;
- The probabilities of insolvency have been recalibrated to reflect the most recent insolvency experience; and
- Finer grading is applied to those employers that represent the lowest insolvency risk, with new lower probabilities of insolvency of 0.01%, 0.03% and 0.05% for failure scores 100 to 98.

Information is provided in the consultation document that maps each of the new D&B failure scores to a probability of insolvency which will be used for the 2008/09 and 2009/10 levy years. For comparison it also shows how the old failure score would have mapped to the same probability of insolvency.

In theory, this information can be used to calculate the impact of the new mapping, assuming there is no change in the employers' failure score. However, the PPF believes that failure scores will generally be lower for individual employers than they were previously, except for those in the not-for-profit and financial sectors. This means that individual probabilities of insolvency may change little overall. In practice, estimating risk-based levies until the consultation is complete and the new scaling factors are known is fraught with difficulty.

A STEP FORWARD? The proposals in the consultation document are not final, and in some cases lack detail. The preference of sponsors for predictability over flexibility will always be a personal choice, but taking away the ability of sponsors to manage in such a way that their actions will be promptly rewarded is hard to categorise as a step forward.

John Hawkins is a Principal at Mercer in the Financial Strategy Group.
John.Hawkins@mercer.com
www.mercer.com

The ACT is submitting a response to the PPF on this issue. To see the ACT's response, go to www.treasurers.org/technical/index.cfm.

Evolution of the pension protection levy

SCALING In addition to evolving the levy distribution formula to take into account longer-term measures of underfunding and insolvency and to allocate catastrophe risk, the PPF is suggesting a further refinement could be made to the way the scaling factor is calculated, with separate scaling factors calculated for different categories of scheme reflecting their different contributions to the levy estimate and long-term risk, particularly catastrophe risk.

The current approach to reflecting long-term risk in the levy distribution formula is by applying a single scaling factor. This approach was driven by the lack of comprehensive data, a limited understanding of the distribution of risk across the PPF universe of eligible schemes, and the embryonic state of the LTRM in 2005. All these factors have changed significantly over the past two years. The economic context in October 2005 was different, with most schemes being in deficit, so the distribution and cross-subsidy issues were not as stark as they are currently.

Instead of applying a single scaling factor, it is proposed that a separate scaling factor could be calculated for different categories of scheme, reflecting their different contributions to the levy estimate and long-term risk, particularly catastrophe risk. The net result is a redistribution of levy to those schemes that pose the greatest catastrophe or tail risk. In an environment of improving funding, consideration needs to be given to refining the incentives programme to credit long-term risk reduction. Smaller schemes are likely to benefit from this approach through two mechanisms. First, their levies are likely to reflect their normal risk (rather than including a loading for other's catastrophe risk). Second, if the biggest schemes by exposure take steps to reduce their risks, then this should feed back through a reduction in the levy estimate, resulting in lower levies for all. **Peter Williams**

Source: PPF consultation document. See www.pensionprotectionfund.org.uk