Comments on behalf of
The Association of Corporate Treasurers on:

The Pension Protection Levy Consultation

A Consultation by the Pension Protection Fund, July 2005

Introduction

The Association of Corporate Treasurers (ACT)

Established in the UK in 1979, The Association of Corporate Treasurers is a centre of excellence for professionals in treasury, including risk and corporate finance, operating in the international marketplace. It has over 3,500 members from both the corporate and financial sectors, mainly in the UK, its membership working in companies of all sizes.

The ACT has 1,500 students in more than 40 countries. Its examinations are recognised by both practitioners and bankers as the global standard setters for treasury education and it is the leading provider of professional treasury education. The ACT promotes study and best practice in finance and treasury management. It represents the interests of non-financial sector corporations in financial markets to governments, regulators, standards setters and trade bodies.

Contact details are provided on the last page of these comments.

This consultation

The ACT is pleased to be able to comment on this important topic. We have had an exceptional number of sometimes quite lengthy comments from members (often showing considerable strength of feeling) during our preparation of this response.

These comments are on the record and may be freely quoted.

Principal comments

1. Mandatory scheme

   The PPF levy is a mandatory scheme for risk insurance whereas companies normally have discretion about how to manage or finance risk. It could be portrayed broadly as an impost on well funded schemes and high credit rating sponsors in favour of badly funded schemes and weak sponsors – a subsidy to their labour costs, artificially benefiting their competitive positions. It is thus very important that it is made as fair as practicable.

2. Subsidies

   The scheme has explicit elements of cross-subsidy – designed to reduce the impact on weaker sponsors of less well funded schemes and to avoid pushing them towards insolvency:

   - The cut-off on gradation of under funding at 104%
   - The cap on insolvency probability (proposed at 15%)
   - The individual risk-based levy cap (discussed at 3% of liabilities).

   This is in addition to the 20% scheme-based element which, making no distinction between well funded schemes from strong sponsors and schemes not so strongly placed, contains a significant cross-subsidy element.

   Such a transfer of resources from well run to less well run or less fortunate businesses should be made explicit in a transparent way monitorable by parliament and funded through general taxation. The value of the subsidies should be charged not to other scheme sponsors but to HM Treasury which could recover it from benefiting scheme sponsors on deferred terms. This would reduce moral hazard, further incentivise sponsors and reduce the advantaging of companies which have for one reason or another under funded their schemes.

3. Risk-based levies

   Fairness and the avoidance of moral hazard require that risk-based levies be introduced as soon as possible.

   Some rough edges are acceptable as speed is important, but a system of appeals to consider such matter as a sponsor wishes to be considered and make a more rounded judgement is necessary if significant unfairness is to be avoided. The appeals process will in any case be permanently required in a basically mechanistic system (correctly so - for cheapness) if unfairness is to be avoided.

4. Responsiveness

   In order to encourage such developments, risk-based levies should be immediately adjusted when a sponsor makes lump-sum or enhanced contributions to a scheme, puts in place credit enhancements or submits a new s 179 levy valuation (or, after asset allocation risk levies come in, a scheme makes significant adjustments to asset allocation).

5. Insolvency risk methodology

   Given the low-cost “quick and dirty” methodology adopted (designed as an input to making of judgements on credit rather than as an answer in itself), an appeals and exception procedure to make a more rounded judgement (considering any matter a sponsor wishes to put forward and particularly paying more attention to capital structure and long-term term ability to fund the pension scheme) is vital.

6. Credit enhancement and group relationships

Sponsors other than those of the highest standing should be encouraged to arrange support to their obligations to schemes by intra-group or external arrangements. Credit enhancements should be recognised by the PPF from the commencement of risk-based levies in the interest of both fairness and reducing risks to the PPF and as a counterpart to the Pensions Regulator's powers to issue financial support directives. In order that credit enhancements be achieved at low cost, encouraging adoption, the full imagination of the market place should be brought to bear on the topic and no attempt should be made to standardise or prescribe acceptable methods.

7. Asset-allocation risk

It is important to consider this topic and an appropriate levy scheme should be introduced as soon a practical in the interests of fairness and to reduce the risk of moral hazard. We believe that a widely accepted basis of charging may be extremely difficult to establish.

8. Cyclicality

The proposals are potentially pro-cyclical in two respects:

- The 1-year assessment of insolvency probability
- The main basing of the total level on one-year demands.

This is probably disadvantageous to the wider economy and to the PPF itself.

We believe that a smoothed levy based on multi-year evaluations would avoid this and fit better with the PPF's need to build up reserves to cope with major shocks and be more palatable to sponsors.

Responses to consultation questions

Chapter 2 Levy Principles and Risk

Chapter 2: Question 1

Do you agree that the Board should construct the risk based levy in a way that combines the principles of fairness, simplicity and proportionality?

Chapter 2: Question 1 Response

We must agree. However, the relative weight to be given to the three principles is a complex matter.

Proportionality is the most important principle. This should be seen in terms of both the impact on the community as a whole and in terms of impact on any individual sponsor or potential impact on any scheme member.

Simplicity is important in improving people's understanding. It may also be important in reducing the cost and non-cost (management time, trustee and beneficiary worry) impact of a scheme. It is a major contributor to remaining within the proportionality principle.

Fairness and unfairness are relative concepts and proportionality is the key factor. Small unfairnesses which would be costly or complex to resolve are probably unimportant. A higher level of unfairness which would be relatively simply resolved or brought to an acceptable level at relatively low cost should not be accepted. Significant unfairnesses which would be very complex or very costly to resolve are unacceptable but the simplicity and proportionality principles may determine that low(er) cost solutions built around an appeal and exceptions procedure would be a satisfactory solution.

In general, people may legitimately differ in their view of the precise balances to be struck.

Chapter 4 Understanding Risk

No question is asked about contributions to reduce underfunding.

However, we consider it important that sponsors should be able to evidence special contributions (lump-sum or enhanced level regular contributions) to schemes to reduce underfunding and to have an immediate adjustment of their levy accordingly. This would encourage deficit reduction payments.

Chapter 4: Question 1

Do you agree that 104% should be the cut-off point above which schemes' underfunding risk would be based on a fixed percentage of PPF liabilities?

Chapter 4: Question 1 Response

The concept of using a crude inflation factor to represent the risks of non-matched assets and longevity etc. changes seems reasonable providing the inflation percentage is itself small, so that fairness between schemes and sponsors is not significantly affected. The implication that *no* amount of funding would in practical terms eliminate risk seems difficult for sponsors to accept. In part, this seems to be another subsidy from strong to weak sponsors.

The actual amount of such inflation must be commented on by those with appropriate statistical databases. A specific asset-based part of the levy is desirable as soon as possible to improve fairness between sponsors and to reduce moral hazard.

Chapter 4: Question 2

If you are the trustee of a scheme, do you expect to submit a s 179 levy valuation by 31 December 2005? If not, when do you expect to submit a s 179 levy valuation?

Chapter 4: Question 2 Response

Not applicable.

Chapter 5 Insolvency Risk

Chapter 5: Question 1

Do you agree with the proposed approach to measuring insolvency including measuring the insolvency risk of all eligible schemes?

Chapter 5: Question 1 Response

Sponsor insolvency risk is a most important factor. Assigning a specific insolvency risk to each sponsor is very important in achieving fairness between sponsors.

Chapter 5: Question 2

Do you agree that insolvency should be viewed over a 12 month horizon since the levy is intended to meet the cost of new claims arising during the annual levy cycle?

Chapter 5: Question 2 Response

A one year probability risks making the PPF levy act in a pro-cyclical manner, to the disadvantage of the general economy. That is, during an upswing in the general economy, default probabilities will fall as company profitability and cash flow improves - reducing levy costs and adding to companies' prosperity. In a downswing, default probabilities will rise, increasing companies' costs and adding to their difficulties. An assignment to a band of insolvency probability expected over a full economic cycle would avoid this and we propose such an approach[1].

Indeed the PPF should have an interest in not having a pro-cyclical approach as that would encourage more schemes to need its support during a down-swing in the economy. Of course the promise of and actual payment of minimum pension levels by the PPF may be seen as counter-cyclical, but the PPF should avoid precipitating payments. (See also comment on annual levy estimates under Chapter 7, below.)

Further, as PPF cover is mandatory, it is illusory to consider matters on a year-to-year basis as though the "customer" could choose to go without cover or go to another supplier at the end of each yearly contract. The PPF expects to be supplying a service to a scheme/scheme sponsor over many years and in respect of very long-term liabilities.

[1] This approach, generating a "rating" which is potentially stable over a number of years would be similar that followed by the principal credit rating agencies.

Chapter 5: Question 3
Do you agree that insolvency should be banded?

Chapter 5: Question 3 Response

Banding seems to be a sensible approach to the problem.

Chapter 5: Question 4
Do you agree there should be ten bands?

Chapter 5: Question 4 Response

The number of bands needs to be wide enough to assign an appropriately graduated scale without over elaborating matters. We would urge more rather than less bands throughout. In particular, the size of probability increase between bands 8 to 10 seems far too fast for what are after all the weakest companies. The following, based on graphical interpolation, could address this

Band	Failure score	Probability
7	8 to 12	4.75
8	7	6.2
9	6	7.2
10	5	8.7
11	4	10.4
12	1 to 3	15%

We recognise that the individual levy cap provides some protection for those in the weakest positions.

As experience develops with the banding methodology, consideration should be given to expanding the number of bands generally as small changes in the levy percentage at the end of the calculation can mean large sums for large schemes.

Chapter 5: Question 5
Do you agree that insolvency risk should be capped at 15%?

Chapter 5: Question 5 Response

We recognise that evaluations become difficult at the higher end of insolvency risk and that there may be a desire to "temper the wind" to the weakest sponsors. In this context, the concept of capping the assumed probability of insolvency makes sense. The appropriateness of the 15% cut-off should be commented on by those with access to relevant databases. Please see the comment on implied cross-subsidies in general in the response to Chapter 7 Question 3, below.

Chapter 5: Question 6
Do you agree that there should be a generic band?

Chapter 5: Question 6 Response

A generic band may be a practical solution but we believe that its use should be minimised and it is important to avoid cross-subsidy. We presume that inability to assign a probability is due to lack of information available to your contractor. The consultation document says that the number of affected sponsors is expected to be very small.

We propose that the presumption should be that the generic band probability be assigned at 15% (or whatever the highest cut-off is set at) in order to maximise the incentive of sponsors to provide information. It should be open to affected sponsors to appeal the classification based on whatever further information they wish to adduce (see comment on appeals generally under question 7 below).

When the Board sees the companies for which the contracted supplier cannot provide a probability of insolvency, common sense should be used to see if there would be any advantage in dividing the generic category into a number of sub-classes.

Chapter 5: Question 7

Do you agree with the focus on a market based approach?

Chapter 5: Question 7 Response

Use of an existing provider of credit information operating in the market seems to be a convenient and probably competitive cost route.

However, we do have concerns about the methodology we understand will be adopted. In particular, we are concerned that the methodology will produce major unfairness in that for a proportion of sponsors it will unfairly put them in a category with higher risk than is justified.

The methodology selected has evolved as an input to making of judgements on credit rather than as an answer in itself. Accordingly we consider it essential that a mechanism be established for reviewing the bands for sponsors which appeal their allocation.

We have concerns about some of the details – for example the companies can withhold or delay payments from suppliers for any number of reasons and companies can have county court orders against them for reasons nothing to do with company but arising from employee welfare issues. The odd County Court order may be significant for small firms but for companies making hundreds of thousands of payments annually they are probably not at all significant. Additionally companies lead and lag payments in a group or between joint venturers for a huge variety of reasons, so average payment periods are not always particularly meaningful.

One major concern is the question of use of published balance sheets etc. as the fundamental basis of evaluation. For companies with material intellectual property or “brand value” associated with their business or with long-life but fully depreciated assets, the published balance sheet information can be misleading. Commonly such factors are reflected in the cash-flows generated by those valuable assets. D&B seem to set an arbitrary limit on the “rating” of companies with negative net worth which would be wholly unjust in many such cases, even if it may be suitable in industries which normally have close to 1:1 correspondence between book and economic value.

Especially under IFRS commentators generally expect also volatility.

The credit rating companies deal with these matters in greater depth by analysis of the business beyond analysis of the published financial information and by interviews with management to improve their appreciation.

Members have provided us with many examples of anomalous results from the simple D&B methodology.

Another major concern is to do with the relationship between companies in a group. Currently in the UK a group of companies will operate with the capitalisation of individual companies varying according to historical accident and frequently without significant planning by management. A variety of links between companies may strengthen or weaken an apparent credit standing as intra-group support, guarantees, etc. vary and by inclusion or exclusion of companies in "group" debt covenants and pledges or negative pledges etc. vary. This of course may be complicated by interaction with overseas parents or fellow-subsidiaries. Standard and Poor's comments in its published ratings methodology[2] that

> "In general, economic incentive is the most important factor on which to base judgements about the degree of linkage that exists between a parent and subsidiary. This matters more than covenants, support agreements, management assertions, or legal opinions."

And, of course, there can be other supports to the obligations of a sponsor, such as extra-group guarantees or performance letters of credit, giving of charges over parcels of assets and so on. It is, and must remain, legitimate for companies to provide support in the manner which they believe gives low cost or convenience according to their own judgements. We believe that it is important that the PPF encourage market mechanisms to give free reign to their creativity in finding low cost ways of promoting sponsors to more favourable bands. Any attempt to stipulate standardised methods of credit enhancement would deter development of new techniques and should be avoided. And, when a sponsor puts in place credit enhancement arrangements, there should be an immediate adjustment of the levy.

These are complex areas – mostly going to post-insolvency loss-minimisation rather than reducing insolvency risks (although group relationships often do address the latter as the group re-capitalises or reorganises subsidiaries well ahead of the subsidiaries' insolvency). However, we believe that it is very important to take account of the specific arrangements and relationships. We understand that the PPF is giving consideration to how to take credit enhancements into account, and that is important work[3]. We expect group

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[2] www.corporatecriteria.standardandpoors.com

[3] The PPF will have to consider the legal enforceability of credit enhancements. We make two specific comments on this:

- Standard and Poor's comment that the attitude of the Group is more important in assessing intra-group forms of such enhancements rather than legal form is very important
- Sensible attention needs to be given for guarantees etc. from overseas incorporated parents etc. The attitude of some UK government departments, that all overseas sourced commitments should be regarded as unenforceable, is quite unacceptable. Agreements stating that he laws of England (etc.) are to apply and service etc. is accepted in the UK might be considered. A presumption of enforceability should apply as widely as possible and for the UK's major trading partners generally, (North America, the European

relationships similarly to be taken into account. The Pensions Regulator is able, under the Act, to direct group members to support a company sponsor's scheme contributions. So in fairness PPF levies should recognise group arrangements.

As the "quick and dirty" approach contracted with the service provider is no doubt part of its low cost, we believe that factors such as those discussed above should be resolved on a case by case basis by an appeal mechanism in which sponsors are able to set out whatever information they consider relevant for consideration. This is fundamental to the achievement of fairness for affected sponsors without over-complicating the process for all sponsors.

In passing, we note that the banding structure seems to be based on the S&P/Moody's/Fitch scales. Where ratings from those agencies are already available, surely they could provide a short-cut to banding, reducing the time and cost of appeals.

Chapter 6: Scheme structures

Chapter 6: Question 1

Do you agree with the Board's transitional approach to multi-employer schemes, using full data on multi-employer schemes where it is provided, and a simpler approach where it is not?

Chapter 6: Question 1 Response

We understand that this year and next the PPF and the Pensions Regulator will collect information about multi-member schemes with a view to adopting a "sophisticated method for determining the insolvency risk of multi-employer schemes". Meanwhile the PPF propose to assess the risk of the biggest employer in a scheme or section of the scheme and apply that to the whole scheme or section of scheme.

We believe that the mechanism for the short-term proposed may give rise to unfairness. The "sophisticated method" may be used for 2006/7 where the necessary information is available. In other cases the use of the largest employer as the determinant of the band is not satisfactory. This applies to both schemes in which the sponsors are all members of the same group as where sponsors are otherwise unrelated and to both sectionalised and non-sectionalised schemes.

Dealing with the "same group" issue, the background is as discussed above over the determination of the risk for companies in a group. That is, the allocations of debt, assets etc. in a group are often arbitrary. Members have drawn our attention to cases in which the financial statements for a subsidiary show high leverage because of high brand-values while other subsidiaries appear low geared. The biggest employer may thus significantly over- or under-state the credit standing.

Accordingly, in order to avoid unfair imposition of costs on a sponsor group or cross-subsidy from other sponsors – unfair to the latter – we believe that even in the transition year attention must be paid to this issue. Sponsors who

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Economic Area, etc.). Imposing the cost, credit and administrative burden of paying UK institutions to front guarantees etc. would be unreasonable in normal circumstances.

"should" be highly rated might even find themselves in the lowest rated band. Sponsors should be able to appeal their allocation to a band, furnishing such information as they believe appropriate. The band allocation should in any case be reviewed (with notification to the affected sponsors inviting them to provide such information as they believe is appropriate) at the initiative of the PPF where there is significant deviation between group and subsidiary credit standings where the band appears anomalously favourable. (The additional cost of the contracted provider furnishing information of a group basis to permit this last is likely to be small.)

We recognise that there would be cost associated with a mechanism for the appeals but we consider such a mechanism proportionate and essential to avoid cases of severe unfairness.

Chapter 7: The Levy Structure

While no question is posed on the topic, we question the basis of annual levy estimates.

We believe that this should be reconsidered. A longer term view should be taken – consistent with the noted possible need to accumulate a reserve for future large claims

The use of estimates of expected claims in the year means that the levy is likely to be pro-cyclical – more schemes coming to be affected as a downturn gets underway. This likely to be reinforced as a downturn proceeds as variances of actual from expected claims in preceding years is taken in to account. The reverse applies in an upturn.

Such pro-cyclicality is undesirable from the point of view of the economy as a whole.

It is surely also disadvantageous from the PPF's viewpoint as schemes incur rising costs as a downturn gets underway. We appreciate that the Secretary of State will set a limit to the overall levy and that the individual cap can limit this for the weakest schemes but this does not detract from the point.

We believe that a basis of a multi-year projection looking across a cycle would give a more stable basis for the levy to the advantage of the economy as a whole and also to the advantage of the PPF. Even in this case, the levy should remain subject to the Secretary of State's cap. (See also comments on one-year insolvency probabilities in Chapter 5 Question 2 response, above.)

Chapter 7: Question 1

Do you agree that there is a strong imperative to move to a risk-based system as quickly as possible?

Chapter 7: Question 1 Response

Little in this world is imperative, but we consider it very desirable to move to a risk-based levy as soon as is practical on grounds of fairness to the stakeholders.

Chapter 7: Question 2

Do you agree that risk exposure should be based on a product of insolvency and underfunding risk?

Chapter 7: Question 2 Response

Risk exposure is conveniently proxied by the product of insolvency risk and underfunding risk as defined.

Chapter 7: Question 3

Do you agree that a cap on individual scheme levies should be applied, and that the cap should apply to those schemes with employers included in insolvency risk bands 9 and 10

Chapter 7: Question 3 Response

We agree that a cap should be applied to the weakest schemes, though we would prefer that this is conditional on, not merely consistent with the recovery plans being agreed with the Pensions Regulator.

As regards where the cap comes in, one is down to arbitrary line-drawing (we have proposed increasing the number of insolvency probability bands, of course).

In many industries a net profit of 4 or 5% is normal, so even a capped amount of the size considered is a very serious matter. This "insurance" is not like others a company buys – in which the directors can decide to purchase external cover, to carry the risk internally or use some other method of risk financing: the "insurance" provided by the PPF is mandatory. Some companies will find an extra cost of the order considered to be burdensome.

We would like to raise the question of the funding of the implied subsidies to weaker sponsors (see Chapter 5 Question 5, above – cap of 15%, the cut-off of 104% funding for calculations (Chapter 4, Question 1) and the cap considered in this question).

For the first and third such subsidies, the consultation presumes that the "subsidy" will be charged to those sponsors not benefiting from the caps. This can only be justified if the reason for the caps is to reduce the likelihood of claims on the PPF – and so reducing the overall amount of levy to be raised. However, there would be an element of wanting to avoid the damage to the economy as a whole by avoiding needless insolvencies etc.

We believe that such matters are properly the concern of HM Treasury and the taxpayer generally and any implied required subsidy should be met from general taxation and not from pension scheme sponsors.

Chapter 8 – The transitional period

Responses to all Chapter 8 questions are at the end of the section.

Chapter 8: Question 1

Do you agree with it is reasonable to use adapted MFR valuations as an estimate of s 179 levy valuations?

Chapter 8: Question 2

Do you consider that an adapted MFR valuation could be used beyond the financial year 2006/7, if all schemes were not required to complete a s179 levy valuation by 31 December 2006?

Chapter 8: Question 3

Do you agree that it is desirable to receive s 179 valuations for all schemes from 31.12.2006

Chapter 8: Question 4

If you answered no to Q3 which of the following dates is preferable to 31.12.2006 in your view:

(a) 31.12.2007
(b) 31.12.2008
(c) 5.4.2009
(d) Any other date, please specify.

Chapter 8: Question 5

Do you agree that the disadvantages of bringing forward the deadline for completing an initial s 179 are a price worth paying to move to a fairer and consistent risk based levy using s 179 levy valuations by 31.12.2006?

Chapter 8: Question 6

Do you think that the estimated additional costs of bringing forward the deadline for completing an initial s 179 valuation are realistic?

Chapter 8: Responses

Others are better placed to respond to these questions.

However, we believe that sponsors should be able to submit actual s 179 levy valuations at any time and have their levy adjusted accordingly.

Up-to-date enhanced-level contributions should be taken into account in any calculation of underfunding irrespective of the timings etc. of liability calculations.

In general we believe that the calculation of liabilities should be based on only those liabilities the PPF will cover and that s 179 valuation guidelines should reflect this.

Chapter 9 – Asset allocation risk

Chapter 9: Question 1

Do you agree that the board should include asset allocation risk as a factor for setting the risk based levy as early as practical?

Chapter 9: Question 1 Response

Yes. It adds to the fairness of levy between schemes and helps to avoid moral hazard.

Chapter 9: Question 2

Do you agree that this is something important and which will merit early consideration a separate consultation exercise?

Chapter 9: Question 2 Response

Yes. It could lead to significant differences in charges between schemes and should not be taken lightly or deferred too long.

Chapter 9: Question 3

Do you agree that the main issues to consider in a further consultation are those listed here?

Chapter 9: Question 3 Response

Broadly, yes.

While it is surely not the intention, the consultation's language seems to regard assets as either matched or non-matched. Some assets are more matched than others but few sit right at the extremes of perfect match or perfect non-match.

Match or non-match is also sometimes non-obvious. This is a difficult area. For example a rolling programme of relatively short term debt instruments may be regarded as a good proxy for a long-term index-linked investment (which may be in short supply) despite the apparent duration mismatch with liabilities.

Where a scheme makes a significant switch in asset allocation it should notify the PPF and an immediate adjustment to the levy should apply.

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