The Association of Corporate Treasurers

Comments in response to

Consultation on the possible inclusion of investment risk as a risk factor the risk based levy
Pension Protection Fund
December 2007

1st February, 2007

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the end of these comments and on our website www.treasurers.org.

Contact details are also at the end of these comments.

We canvas the opinion of our members through our monthly e-newsletter to members and others, *The Treasurer* magazine, topic-specific working groups and our Policy and Technical Committee and in the case of Pensions have held numerous conferences and events which have included lively discussions of the issues.

Our comments are made from the perspective of our members active in non financial companies, where treasurers have a strong interest in the activities and performance of their pension schemes.

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General

We were pleased to be able to contribute comments to KPMG during the period of their initial enquiries, and appreciate the opportunity to respond now to your preliminary conclusions regarding the merits of including investment risk as a factor is setting the risk based levy applicable to different schemes.

We recognise that you have undertaken an assessment in depth and overall we agree with all your conclusions.

We agree that in assessing the long term risks to the Pension Protection Fund, amongst other factors, you will need to take account of the differing risks and returns to pension scheme assets under a range of economic scenarios. This quite rightly should come into Board's calculation of the levy scaling factor for each year and the total levy you will seek to recover. Although the PPF will be interested in the investment strategies of the combination of all schemes in order to assess the overall risk to itself, the investment strategy for each individual scheme must be a matter for the Trustees of that particular scheme.

You conclude that it is not appropriate to introduce an investment risk factor to the risk based levy at the current time. This is largely based on the findings that investment strategies are broadly similar for most schemes and, given this and the scale of underfunding at present, that including investment risk would make relatively little difference to the pattern of levy charges as a whole.

However, you will continue to monitor key trends that affect the impact of investment risk on the risks individual funds pose to the Pension Protection Fund. In particular, in recognition that if the level of underfunding in schemes reduces over time, as you hope and expect that it will, and if the investment strategies of funds diverge, then the case for taking account of investment risk in the risk based levy could strengthen. It should only be a concern in the most extreme concentration in a bizarre asset class.

In allocating the levy you quite rightly are seeking to ensure that it is based on the principles of fairness, simplicity and proportionality. However in addition we would contend that you need to take care that nothing you do is such as to influence the behaviours of the sector in such a way as to increase the risk to the PPF itself. Inevitably there is a danger that if the PPF deems one form of investment as particularly favourable it could cause a concentration of risk into that asset class and hence a loss of the benefits of diversification across the sector as whole.

Although you are not proposing to differentiate based on investment risk we note your comment that there is a form of post event correction since to the extent that a particular fund's portfolio does not perform, under-funding may be created or increased, which in turn will affect the existing risk based levy for that scheme.

Specific Questions

Chapter 2
1 Do you agree that the Board should continue to develop the risk based levy in a way that combines the principles of fairness, simplicity and proportionality?

We agree that with these principles for determining the allocation of the levy

2. Do you agree that in considering investment risk the Board should look not just at the nature of scheme assets but also at the match with liabilities?

We agree that it would be perverse to look at the scheme assets in isolation and not in the context of the liabilities, both their intrinsic characteristics (especially maturity) and their absolute quantum relative to the assets.

Chapter 3
1. Do you agree that there is a theoretical case for including investment risk as a factor in the risk based levy - provided it can be demonstrated to be sufficiently material?

A theoretical case can be made for including investment risk in order to achieve the fairness and proportionality criteria. However if the benefits are not sufficiently material we agree that there is little point in trying to be too sophisticated.

Furthermore you should also consider risk from a PPF perspective, rather than just the perspective of individual schemes, so that you are more interested in the potential costs to the fund from the investment strategies of those funds with significant underfunding. Your modelling shows that at significant levels of underfunding, the expected outcomes from schemes invested in bonds may be worse than those with equity portfolios (cf para 3.1.7), so that a simplified approach could have perverse consequences.

We believe that your preliminary conclusions not to introduce an investment based risk levy is preferable to introducing an arrangement that could have significant unintended consequences, namely a tendency to drive schemes to concentrate assets into those scored most favourably. This could cause a concentration of risk rather than a broad diversification which we would contend would be materially better for the PPF overall and so better for its stakeholders.

Chapter 4

In 4.3.3 you note that some funds are seeking diversification through switching a proportion of their equity portfolio into hedge funds and private equity. While hedge funds may have markedly different characteristics to long equity we wonder whether private equity is really a significantly different class from traditional equity? Private equity often adds gearing and may bring new management insights, but we doubt it is a separate asset class.

Chapter 5

1. Do you agree that investment risk should be considered more broadly than simply by measuring the equity/bond ratio?

The equity/bond split is a convenient simplification and proxy for a risk categorisation. However it is far from accurate if one looks down into the specifics of individual assets. Were you to conclude that you did intend to impose a risk based levy then one would need to find a more rigorous method for evaluating risk, but given your conclusions the question becomes unnecessary. However in our view a risk based levy of the type considered is not desirable.

2. Do you agree that the evidence available points to a limited impact of investment risk given the similarity in portfolios of most funds?

One of your findings is that, (using the modelling based on adjusting the levy in proportion to the VAR assessment), nearly a half of schemes would have a change in their levy (up or down) of less than 1% and only one in twenty would have a change of 10% or more. We consider that introducing this minimal degree of differentiation, with all the additional costs and risks of unintended consequences, is not worth while, and, of course, we see dangers in trying to restrict the overall diversification of fund investments.

Chapter 6

1. Do you agree with the Board's initial view that it would be disproportionate to include a factor reflecting investment risk at this time?

Although we had not undertaken the analysis of existing schemes nor any modelling as you have done, the conclusions that the ACT had reached based on intuitive reasoning were identical to yours, namely that it would not really be beneficial to introduce an asset related risk based levy. If some form of asset related dependency were to be deemed necessary our view was that this should simply be based on some measure of overall diversification rather than on the specifics of each asset class.

2. If not, what do you consider to be viable alternatives that would meet the Board's objectives?

All your work shows that there are major difficulties in creating a risk based levy and minimal benefit. We therefore do not suggest any alternative.

Chapter 7

1. Do you agree that the key factors which might reasonably lead the Board to reconsider investment risk are fuller funding of more pension schemes and greater differentiation in investment strategy?

On the face of it we agree your conclusions that the more underfunded a schemes is, the less its investment strategy influences the risks the Pension Protection Fund faces. This result arises because of the asymmetric impact of poor and good investment performance on the Pension Protection Fund where a scheme is fully funded, or close to fully funded.

2. Are there other considerations that the Board should have regard to?

We presume that the PPF will be only too aware of any significant shocks occurring in certain investment classes. If evidence shows that there is economic concentration of overall investments in one asset class, this might need to be addressed.

3. What should the Board do to monitor relevant trends in an effective but economic way?

The board will no doubt be able to keep generally in touch with the market as a whole through liaison with individual schemes and advisors and actuaries to the industry, supplemented with the occasional commissioned piece of work as with the service provided in this instance by KPMG

The Association of Corporate Treasurers

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce, financial institutions and professional service firms.

Our guidelines on policy and technical matters are available at http://www.treasurers.org/technical/resources/manifestosept2006.pdf.

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