

Future Development of the Pension Protection Levy

Feedback from the Steering Group

March 2010

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The Steering Group also gratefully acknowledges the input received from Tesco plc.

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Foreword

Ever since the PPF first introduced the risk-based levy in 2006/07, it has sought to listen to and build on the experience of its stakeholders. That approach continues here, as we seek to develop the levy in line with our analysis of the empirical knowledge gained from nearly five years of the Pension Protection Fund's operation.

This report reflects an exercise that has been the most important of the PPF stakeholder working relationship so far. With the help of the Steering Group, the PPF is trying to redesign the levy so it remains fair to all over the economic cycle, but better recognises differences in the nature of risk between different types of scheme and the techniques schemes put in place to mitigate risk.

This Steering Group brought together a range of individuals of significant experience – from across the range of our stakeholders and from the PPF. But everyone involved was acting in a personal capacity, rather than aiming to represent any one group's point of view. The result is a consensus on some key ideas, though of course there were a range of differing views, and the discussion paper recognises that. I'd like to thank all members of the Steering Group for the generous contribution they have made, in terms of their time and thoughtful ideas.

This paper does not represent an official view from the PPF or any of the organisations members of the Steering Group are drawn from. Nor does it constitute a final conclusion on what the PPF's future policy on the levy should be. The PPF's proposals will be set out in a formal consultation document from the Board of the Pension Protection Fund, once the Steering Group's ideas have been discussed by the PPF's Board, and following some further work. However, my fellow Steering Group members and I consider the approach discussed in the report lays the foundations for developing a future levy formula.

From previous consultations it is clear that these ideas are unlikely to prove popular with everyone. If implemented, they would change the way the levy is distributed between schemes, inevitably creating winners and losers. The combined experience of our Steering Group members has therefore been invaluable in developing this analysis of the risks the PPF faces and aligning practical implications with the objective of creating a fairer levy.

Once again, my thanks to all those taking part.

Alan Rubenstein
Chairman of the Steering Group

1. Introduction

- 1.1.1 The Pension Protection Fund formed the Steering Group as a result of the industry response to *The Consultation on the Future Development of the Pension Protection Levy*, published in November 2008. That consultation contained the PPF's early proposals for a levy formula that would, in its view, distribute the overall levy amount more fairly among schemes.
- 1.1.2 Responses to the consultation supported a levy design that reflected the different types of risk that schemes pose to the PPF, but wanted to ensure that the proposals were of sufficient transparency and that all of the options for a fair measure of risk had been fully explored.
- 1.1.3 In July 2009 the PPF published an update to the consultation, in which the Board confirmed its desire to increase the fairness of the levy calculation, but to resolve the issues above. The Steering Group was formed to take a fresh look at these issues, with the objective of providing as broad as possible a consensus on the way forward. It was supported by a Technical Group, which has considered the practical options for implementing a levy based on the principles established by Steering Group members.
- 1.1.4 The Steering Group consists of individuals who bring experience from key roles with a range of stakeholders. Each was asked to make a personal contribution, rather than being simply a delegate of their organisation. As one would expect, the result of discussions has been a compromise, reflecting contributions from all, but should not be taken as the position of individual members.
- 1.1.5 The role of the Steering Group has been to offer comment on the principles that should guide the development of the levy, rather than to focus on technical issues, or matters of detail. In due course, having obtained any necessary technical assistance from consultants, the PPF can set out a detailed proposition for consultation.
- 1.1.6 Since September 2009, the Group has been considering the PPF's evidence and analysis, and the practical work undertaken with support from the Technical Group. This document summarises the issues and draws together some ideas that could form the basis of the next round of consultation.

1.1.7 The Steering Group is grateful for the support from PPF and the Technical Group,¹ the members of which acted in a personal capacity and are listed below:

Name	Firm	Qualification
Robert Gardner	Redington	Investment Consultant
Ian Maybury	Redington	Investment Consultant
Richard Thornton	Oliver Wyman	Finance and Risk Consultant
Dr David McCarthy	Imperial College Business School	Pensions Academic
Dr Jane Beverley	Punter Southall	Pensions Actuary
Sathish Ramdayal	PSolve	Investment Consultant
Martin Lowes	Hewitt	Pensions Actuary
Ted Belmont	Xafinity	Pensions Actuary
Jean Pierre Charmaille	PPF	Chief Risk Officer
Chris Collins	PPF	Head of Policy
Martin Clarke (chair)	PPF	Executive Director of Financial Risk
Kerry Craig (secretary)	PPF	Research Analyst

¹ The Technical Group was assembled by the PPF on the basis of technical expertise and familiarity with pension issues rather than to reflect particular stakeholder experience. Its role was to assist in developing and testing analysis shared with the Steering Group.

2. Executive summary

- 2.2.1 This paper sets out the principles that the Steering Group considers might be applied to designing a new levy, resulting from discussion in the Steering and Technical Groups and further analysis undertaken by the PPF. Critical to the Steering Group's thinking is the proposition that changes in a scheme's bill ought to derive primarily from changes in its risk, not from others' risk, and that it should be possible, therefore, to estimate a scheme's levy for a number of years.
- 2.2.2 The Steering Group has also made a number of points that flow beyond the formula itself to inputs to the levy and the setting of the levy quantum. A formula along the lines envisaged in this paper may meet the principles that are set out below and would allow for an approach to the levy that remains stable for a number of years at a time.²
- 2.2.3 The Steering Group's view is that to feel fairer to stakeholders the levy needs to be more predictable i.e. be more proportional to changes in scheme risk – so that risk reduction by a scheme is reflected in a lower levy. Currently a scheme can see its risk fall and its levy rise.
- 2.2.4 For the system to be fairer, schemes should pay a levy that reflects their own risk characteristics. This should be externally benchmarked and, subject to consultation, could include:
- employer covenant – measured to a degree of accuracy supportable by evidence;
 - scheme funding;
 - investment strategy – provided this is able to take account of the range of strategies used by schemes; and
 - the benefits of risk reduction, such as contingent assets, and deficit reduction contributions.
- 2.2.5 The Steering Group also suggests the PPF considers the practicability of extending the risk characteristics to include:
- governance; and
 - funding strategy.
- 2.2.6 The focus of the Steering Group's work has been to start from thinking about the position of an individual scheme, and ensuring that its levy behaves in way that is fair, in other words taking a "bottom-up" approach. This is the opposite of the current "top-down" approach,

² An example of such a formula is the one used in the PPF's impact analysis in the supporting paper.

where the Board sets a target amount each year (£720 million in 2010/11), and the risk measure at scheme level is then scaled up or down to meet it. Such a bottom-up approach would feel fairer (as schemes would pay based on their risk alone) and more predictable. However, it would mean that the PPF was no longer targeting the collection of a fixed amount in each levy year and as a result the levy could be pro-cyclical, making it more volatile at scheme and overall level.

- 2.2.7 The Steering Group considers appropriate stability at both scheme and overall level could be attained, without departing from a bottom-up approach, by assessing risks on a through-the-cycle basis rather than at a point in time. For example, underfunding measurement could be smoothed over a number of years and insolvency risk could be an average over the economic cycle and build in an allowance for years of high claims and low claims. Insolvency risk could also be measured using far fewer categories than at present (e.g. 7, as compared to the current 100).
- 2.2.8 In addition, the Steering Group would like to see an end to the annual PPF consultation exercise on the levy, with its changes to various scaling factors and parameters used in the formula. Instead, schemes ought to be able to look to a levy that, subject to changes in the scheme's own risk, would remain stable over a number of years.
- 2.2.9 Additionally, in its design, the levy should reinforce improvements in governance by having a stronger focus on risks that schemes can genuinely control: funding, and potentially investment strategy and their management.

3. Background to the development of the levy

3.1 Development of the pension protection levy

3.1.1 A history of the development of the pension protection levy since 2006/07 can be found in Chapter 2 of *The Consultation on the Future Development of the Pension Protection Levy*.

3.1.2 Without seeking to explain in detail how the current levy is calculated, it is worth noting that the apparent simplicity of the headline formula used to calculate the levy belies a system that is significantly less simple. The current risk-based levy formula is sometimes described as: "Underfunding risk (U) x Insolvency risk (P) x LSF x 80%".

3.1.3 A number of factors make the calculation of the levy far more complex than it appears:

- the setting each year of the levy scaling factor (LSF), which scales up the levy when short-term risk (the sum of U*P) is low meaning, paradoxically, that an individual scheme's levy can increase even if the scheme's funding improves and risk of insolvency falls;
- the scaling up of liabilities by 21 per cent when measuring underfunding risk;
- the tapered cut-off to the levy above 120 per cent funding;
- the need to redistribute the capped levies across uncapped schemes by inflating the levy scaling factor.

3.1.4 These factors, combined with the rolling forward (or backward) of valuations to a common date and a system of insolvency risk measurement in which small changes in risk can be amplified into large differences to bills leave the levy less transparent than it ideally should be.

3.1.5 At the same time, the PPF argues that it is also less than optimally fair.

3.2 Formation of the Steering Group

3.2.1 Reflecting on concerns about the November 2008 proposals, the Board concluded that it wished to see further engagement with individuals with expertise beyond the PPF to develop the proposals. The consultation response suggested the following potential areas of work for the Steering Group:

- the principles of a new levy formula that charges fairly for risk;

- how to take account of the effects of long-term and unexpected risk as well as short-term risk;
- options for the measurement of insolvency risk; and
- options for the measurement of investment risk, particularly for the more sophisticated investment strategies.

3.2.2 The purpose of the Steering Group has been to look at the broad principles behind a fair levy that takes account of the different types of risk posed to the PPF by schemes. The Group has considered and advised on approaches to the measurement of investment risk and long-term insolvency risk in the context of the broad principles. With the help of the experts in the Technical Group, the Steering Group has also discussed how the PPF might assess risks over the economic cycle and how best to meet issues raised by consultation respondents and Group members in relation to the use of the outputs of the PPF's own model to develop parameters for the new formula.

3.2.3 This document summarises the criteria established for the development of a fairer levy, reviews the evidence seen by the Group and presents the Steering Group's conclusions.

4. The initial criteria for a new levy

4.1 Criteria for success

4.1.1 The Steering Group considered the criteria for a fair levy that accurately reflects risk. These requirements were developed as the Group's work progressed and the PPF's analysis and evidence was considered. The final principles for development of the levy formula are detailed in section 6.1.

4.1.2 The issues to balance if the PPF is to deliver proposals for change that would meet stakeholder concerns included:

- simplicity;
- transparency;
- affordability;
- timeliness;
- an increased perception of fairness;
- more predictability and stability;
- a sense of a more direct interrelationship between a scheme's risk and the size of its levy (implying a more bottom-up approach);
- rewarding good governance;
- articulating proposals in a way that chimed with pension fund experience – even possibly linking the levy to schemes' triennial funding valuations;
- avoidance of unintended consequences (e.g. scheme closure, employer insolvency);
- a solution with some longevity, to avoid further significant changes in the levy formula; and
- resolution of both short-term irritants with the current formula as well as long-term issues.

4.1.3 The Steering Group agree that the highest priority should be for fairness, transparency, predictability and positive behavioural impacts. They also agreed that maintaining affordability for scheme sponsors was very important. There was recognition that timeliness too was relevant.

4.1.4 The Steering Group considered the trade-offs between stability, predictability and timeliness. The key issue was that changes in bills should be related to changes in the risks of the scheme, and that there

should be clarity early enough to allow for budgeting. But it was recognised that there might be a case for some smoothing of very large changes in levy if these gave rise to genuine affordability issues, and that a more flexible approach to the total collected might be a challenge for the PPF.

4.2 What does fairness mean?

- 4.2.1 Given the frequency with which fairness is mentioned in connection with the levy, the Steering Group has considered what, in principle, this should mean.
- 4.2.2 Fairness can be thought of as implying that rewards (or burdens) are conferred according to merit. In the context of the levy, this concept suggests that costs must match the cover received. This results in two competing notions of a fair levy.
- 4.2.3 An accounting or actuarial definition of a fair value for a good or service is the price at which two willing parties would exchange this good or service. Applying this definition to the levy, and assessing fairness at scheme level, then fairness is achieved if the bill of each scheme matches the cover it receives.
- 4.2.4 If one considers fairness at a member level, all members deserve equal protection, but an actuarially fair levy would impose large costs on weaker (riskier) schemes, increasing the risk that their members would end up with PPF levels of benefit if the size of levy charged pushed the scheme and therefore the sponsor into insolvency. Members of weaker schemes are therefore afforded less protection, in a sense, than members of stronger schemes. On this analysis, a fair levy would attempt to compensate for variation in funding so as to ensure all members are equally protected.
- 4.2.5 The Steering Group considers that the levy ought to aim primarily at technical fairness at scheme level — that is fairly reflecting the risks that schemes pose to the PPF. Cross-subsidy is a difficult thing to balance; in discussion there were differing views on the extent of cross-subsidy that ought to be a feature of the levy system.
- 4.2.6 The Steering Group considers that excessive cross-subsidy would potentially influence behaviour (e.g. in encouraging the closure of remaining open schemes), and reduce support for the levy. On the other hand, affordability needs to be addressed if riskier/more poorly funded schemes are to be protected.

4.3 Other criteria

Predictability

- 4.3.1 In terms of individual levy bills, predictability has to date been limited to providing notice ahead of the start of the levy year of the rate for the levy (the levy scaling factor) to allow schemes to calculate their bill in the December before the levy year starts. To achieve this, the levy has been based on data that is a year old, which makes the levy less accurate.
- 4.3.2 Genuine predictability would mean schemes being able to draw a direct relationship between movements in their risk and their levy (ideally “if my risk halves so does my bill” but at least “if my risk halves I know what that does to my bill”).
- 4.3.3 The Steering Group considers this principle to be central to a levy that stakeholders will perceive as fair. That implies a move away from the annual setting of a scaling factor that can see a scheme’s bill rise as its risk falls.

Stability

- 4.3.4 Stakeholders have frequently argued that individual bills should be more stable. Despite the restrictions on the overall estimate, at a scheme level the current levy formula has proved to be significantly geared so that small changes in funding or D&B score can lead to large changes in levy between years. Whilst there is clearly a case for reflecting changes in risk, such large year-on-year changes are undesirable.
- 4.3.5 A limit to bill variability could conflict with fairness and predictability if it meant a real change in risk could not be fully reflected. Taking an approach to calculating the levy that looks at risk over a longer time-horizon might make the levy more stable and reflect the general proposition that pensions are long-term commitments. At the same time, it might make a scheme’s levy less immediately responsive to steps that lead to risk reduction (i.e. benefits might only be felt over a period).

Affordability

- 4.3.6 A technically fair levy would charge the most³ to schemes likely to require PPF protection, and could be unaffordable. There is a risk of weak sponsors being pushed into insolvency by their levy bill, where insolvency might otherwise have been avoided. This could mean that the system costs more overall than it needs to.
- 4.3.7 The Steering Group recognises that some degree of cross-subsidy between levy payers is inevitable. However, it is of the view that it should be transparent and limited. In our initial discussion, a range of views about the current direction of cross-subsidy were put forward — some members saw the levy as currently containing a cross-subsidy from

³ As a proportion of liabilities.

strong schemes to weak, others that the cross-subsidy worked in the opposite direction. Critical to this were views on catastrophe risk, insolvency risk measurement and the PPF's approach to funding.

- 4.3.8 When a final proposal for a new formula is made by the PPF it will be important for there to be clarity about the direction and degree of cross-subsidy. The Steering Group would expect to see an analysis setting out the extent to which levies to different groups of levy payers (defined by covenant strength and funding position) differ from what a theoretically fair levy would produce. This would enable an informed discussion of the scale of cross-subsidy within the levy, which the Steering Group believes needs to be limited (though views differed on how limited).

Short term issues

- 4.3.9 Having looked at what, in principle, a new levy should include, the Steering Group also discussed whether there were specific aspects of the way the levy functions currently that needed addressing to help create an environment for more significant change. A significant concern for Steering Group members was confidence in the measurement of insolvency risk by Dun & Bradstreet.
- 4.3.10 The PPF has since consulted on a number of changes in relation to insolvency risk measurement to be implemented for 2011/12. These reflect changes to the D&B standard methodology, but also responses the PPF had received to its consultation exercises (particularly in November 2008) and other engagement with stakeholders, and are aimed at better reflecting actual risk.
- 4.3.11 In its Policy Statement summarising consultation responses and its conclusions, the PPF committed to further work to investigate:
- whether it would be possible to recognise as nationwide companies that are internet based or that trade nationally from a single site with national distribution;
 - the implications of extending the disregard to all charges over company assets that benefit the pension scheme (rather than just charges relating to PPF-compliant assets);
 - whether manipulation of the 'directors' attribute can be gauged, and if it is substantial, consider whether anything else can be done to prevent it in the future; and
 - further extending the proactive collection of accounts.
- 4.3.12 The Steering Group is hopeful this will meet concerns of a number of members about the impact of directors and principals on failure scores, particularly as the universe of DB sponsors is significantly different in nature to the universe of all firms operating in the UK. It notes the PPF view that as D&B based their assessment not just on how large a board was but also on the track record of those directors, and that the scoring of these was based on statistical evidence about links between the

factors and risks of insolvency — albeit in the wider employer community — the measure remained valid.

- 4.3.13 Members also expressed doubts about the weight given to payment behaviour, given that the samples on which these were drawn could be small, and it was not clear how D&B chose their sample. There was a risk this could lead to volatility in failure scores, and therefore in levy bills.
- 4.3.14 The Steering Group notes that D&B's view is that trade patterns are a significant factor when assessing insolvency risk: 90 per cent of businesses that fail exhibit lengthening payment habits prior to insolvency. In terms of impact, D&B report that monitoring so far suggests changes to scores remain at reasonable levels, given an environment where new information about the impact of the recession on individual businesses is emerging on a regular basis. In a recent analysis of a three month period, just over half of scores were the same at the end as at the beginning, with only one in 10 employers seeing more than two changes in score. Changes in failure score can, however, make a very large difference to levy bills, given the wide range of insolvency probabilities then applied.
- 4.3.15 This emphasises the case for considering a less granular approach to insolvency risk, which would see fewer changes that impact levy bills. D&B's developments to make their system more responsive to changes in short-term behaviour also raise a question about the alignment of their standard measure with the PPF's need for a view of covenant risk over time. The Steering Group considers this would merit further investigation in developing a through-the-cycle insolvency measure.

5. Ideas for a new levy

5.1 Ideas for a new levy

5.1.1 The key objective in developing a new approach based on the considerations above is to produce a levy that:

- is more proportional to individual scheme risk;
- better reflects the interactions between sponsor covenant, scheme funding and, if appropriate, investment strategy;
- is benchmarked, where possible, to commercial comparators, to test that charging is fair; and
- works with the grain of messages on good governance (though for many schemes the levy may be a lever of limited influence).

The new approach will not target the collection of a fixed amount (£720 million in 2010/11) each levy year. So, provided suitable ways to manage the stability of levies at scheme level can be found, this may mean that scaling up or down bills to meet a levy quantum is unnecessary, or at least that the scaling factor can be fixed for a period of years.

How might the PPF develop a new formula?

5.1.2 PPF staff, with input from the Technical Group, designed a possible approach to meeting the objectives set by the Steering Group. This results in a formula that incorporates the following characteristics:

- sponsors categorised by insolvency rating;
- fewer categories than now, in line with standard credit rating systems;
- levy rate (the assumed insolvency probability for each category) set by the PPF but benchmarked against external practice/market;⁴
- consistent with market practice, a levy rate (insolvency probability) which would include a margin for risk through the economic cycle;
- levy rate (insolvency probability) multiplied by underfunding level, like in the current formula;
- allowance for investment risk will be built into underfunding level, and measured by a stress test;

⁴ I.e. a commercial comparator. The PPF could take advice on appropriate comparators to use, and set out views when it consults on firm proposals.

- levy stabilised to allow a bottom up approach, e.g. by adjusting underfunding to a common baseline;
- discounts also available to reflect good governance;
- to keep the levy affordable, a levy rate (insolvency probability) that is capped and an overall cap on the risk-based levy; and
- the scheme-based levy used to spread the cost of capping.

Insolvency risk

- 5.1.3 The PPF argues that the evidence does not support a highly granular⁵ system for measuring insolvency risk, as the predictive power of the current D&B measure clearly diminishes if used in a highly granular way to allocate levy. Particularly for relatively low risk businesses, distinctions finer than credit rating systems achieve produce dramatically different levies (in the current year a failure score of 99 attracts 3 times the levy of a failure score of 100). The Steering Group agrees it is hard to defend this as fair.
- 5.1.4 The current 1-100 scale of probabilities of insolvency creates an incentive for employers to focus on seeking minor improvements in failure score which make a large difference to the levy but which do not necessarily result in a much-reduced likelihood of insolvency. Larger categories of insolvency risk might help switch the focus of effort to funding and hence strengthen incentives to reduce risk in that area, which is more within trustees' control.
- 5.1.5 The Steering Group would recommend a through-the-cycle measure on insolvency risk,⁶ to reflect the long-term nature of PPF cover and avoid the negative impacts of highly variable insolvency scores (which contribute to the need to scale up and down the levy and to the volatility of individual bills).
- 5.1.6 A potential downside to a reduction in the number of insolvency risk bands foreseen by the Steering Group is that it could, in principle, lead to a problem of cliff-edges (where levy rose sharply when a scheme moved from one band down to another). However, the differences between bands would be reduced by taking account of risks across the cycle, and using a less granular system would reduce the number of sponsors that could expect to improve a category between years. The effect of cliff edges could also be mitigated by requiring the new score to fall below a trigger level that was lower by a margin than the start of the new band. Although a similar arrangement could apply to insolvency score improvements, it is likely that one would want to recognise risk

⁵ A system which distinguishes many different levels of risk, potentially making very fine distinctions between those measured.

⁶ A through-the cycle measure is one that takes account of periods of high and low insolvency risk, and the likelihood that the impact of periods of heightened insolvencies is increased due to those also being periods when funding declines.

improvements more immediately. The Steering Group recommends further consideration is given to managing cliff-edges.

- 5.1.7 Once the system bedded down, we expect that few sponsors would remain in the upper parts of each band, so that there would be less movement between bands. The Technical Group has noted that there is empirical evidence of this sort of trend occurring in US credit ratings.

Benchmarking the rate for the levy (insolvency probabilities)

- 5.1.8 It is a key principle of the proposed approach that the PPF seeks to benchmark the levy against market comparators, where practical. This is not to ensure that the levy is set at a full commercial rate because there may be grounds for charging below market rates at a given time. Rather, the intention is to ensure that the relative premia paid for risks are consistent — so if the market would charge double the premium for a Aa rated business it would for a Aaa rated business, the levy should do likewise. In other words, if the levy is less expensive than commercial comparators that advantage is shared across all schemes.

Underfunding

- 5.1.9 If funding, relative to PPF liabilities⁷, is measured on a market basis relative to a fixed point (such as full funding of PPF liabilities or a margin above full funding) then it is likely to be highly volatile over time. This has been the prime cause of the variations in scaling factor under the current formula, and a major cause of variation in individual scheme bills. As funding levels move up and down relative to a fixed point, the distribution of the levy between schemes changes in a way that has little to do with the actual risk schemes may pose should their sponsor struggle a few years into the future, when funding positions will have moved again.
- 5.1.10 A smoothed measure of underfunding could be offered based on average values for assets and liabilities over a period, rather than at one point in time.⁸ Consideration would be needed as to the appropriate time period for smoothing, and the method to employ, and the PPF should cover this in the consultation document.

⁷ Measured by a valuation required by section 179 of the Pensions Act 2004, and so sometimes referred to as an s179 valuation.

⁸ At present, schemes supply asset and liability information at a valuation date which could be as much as 3 years different to that supplied by other schemes. So to charge an equivalent levy, every scheme's assets and liabilities must be rolled forward to a common date, the "measurement date", and the levy charged on that. This is done by taking the assets and liabilities at the valuation date and changing them to reflect the relative movement between then and the measurement date for an appropriate published index. So, for example, if share prices for the FTSE all share index have risen 20% between the valuation and measurement dates, then the equity portion of a scheme's assets is increased by 20%. An approach which sought to smooth changes in funding would value a scheme's assets and liabilities using an average figure derived from the same index. So the equity portion of a portfolio would be revalued relative to the FTSE average for the five (or three or other choice) years to the measurement date.

5.1.11 To date the levy has only taken account of contributions already made — either recognised in a valuation or reported through deficit reduction contribution certificates. As responses to the original consultation argued, taking a longer view in the levy increases the case for recognising committed future deficit reducing payments. This could be done in one of two ways:

- by taking account of contributions in recovery plans alongside existing assets, perhaps at a reduction in their full value reflecting how long it will be before the plan is complete, which could then reflect the risks that either the employer fails before a commitment is due to be paid, or indeed that the weakening position of the employer means that contracted payments are not made; or
- by reflecting them if made in the context of a strong control environment, in which case the assessment would be more of a pass/fail nature.

5.1.12 The Steering Group is of the view that the PPF should consider including the expected impact of recovery plans on the funding position of schemes.

Reflecting investment risk and scheme governance

5.1.13 The Steering Group considered three options for an investment risk factor: not including a factor at all, including one that applied to all schemes, and including one that applied to those schemes that volunteered to certify relevant investment risk data. Members' views were mixed, although the majority of members supported inclusion of investment risk in the levy formula. It was suggested that the PPF should consult further on how investment risk could be incorporated into the levy design and how the related benefit of good governance could be factored in. Both could result in schemes posing a lower risk to the PPF which should result in a lower levy being charged.

5.1.14 An investment risk component to the levy will need careful design if it is to provide appropriate rewards to schemes, given the range of strategies in use today.

5.1.15 The costs of certification should also be considered. As the responses to the PPF's initial consultation showed, significant additional costs to schemes are not popular. Guidance, supported by examples, that enabled schemes to judge whether exploring certification would be likely to be worthwhile for them would be helpful in this regard. Smaller schemes with fewer advisory resources should not be disadvantaged.

5.1.16 The Steering Group suggests there should be further consideration of the merits of the two measurement options identified above, as it is hard to assess now whether a stress test applied to all schemes or a voluntary approach would be preferable. It might be possible to combine elements of both, with a simple test applied to all and the option to offer information derived from a more complex approach.

5.1.17 There is a degree of interaction between sponsor and investment risk which affects scheme funding. This could include qualitative factors as well as numerical data, though difficulties in assessing governance may require a more objective, quantifiable approach. Steering Group members considered this was a potentially worthwhile area to explore further, but that it was complex. There were, for example, interactions with risk reduction measures already recognised in the levy.

5.1.18 A modest recognition of good governance arrangements might be appropriate and could involve looking at a combination of a range of factors. The following is a list of the factors that Steering Group members suggested could be considered further to assess their suitability.

- | | |
|---------------------|---|
| Covenant assessment | <ul style="list-style-type: none"> • Annual presentation from sponsor based on credit rating agency information • Quantitative assessment of reliance on sponsor based on current investment strategy • Quarterly review of covenant capacity in cash terms vs contribution requirement • Ongoing requirement to share information which would have an impact on the covenant |
| Deficit recovery | <ul style="list-style-type: none"> • Annual funding checks and contribution adjustments • Contractual arrangement covering the 3+ year period of the Statement of Funding Principles • Short recovery period / strong technical provisions |
| Additional security | <ul style="list-style-type: none"> • Group companies underwrite the total costs through funding and deficit recovery regime • Explicit guarantees, e.g. contingent assets |
| Funding strategy | <ul style="list-style-type: none"> • Surplus cushion required before contributions suspended • Margins in funding basis eg for mortality improvement • Strength of basis • Annual review of assumptions |
| Quality of Records | <ul style="list-style-type: none"> • Regular data reconciliations (member information) |

6. The basis for a future PPF consultation

6.1 The principles that should be embodied by the new levy

6.1.1 Following discussions the Steering Group's view is that there are a number of key principles that a new approach to the levy should be measured against.

Simplicity

6.1.2 The formula should be simpler and have fewer seemingly arbitrary features than the existing levy and the proposals introduced in November 2008.

Predictability

6.1.3 The levy should be more predictable, i.e. it should be more proportional to changes in scheme risk. This would feel fairer to levy payers.

6.1.4 This would mean the levy will be more bottom-up, and will need to be more stable at scheme level if the aggregate levy the PPF collects is to stay within reasonable bounds — it being a corollary of a bottom-up approach that the PPF will no longer seek to target the collection of a fixed amount (£720 million in 2010/11) each levy year. This stability should be achieved by smoothing the measurement of risks, but without unnecessarily delaying the reflection of risk reduction measures.

Equity

6.1.5 Schemes should pay a levy that reflects their risk characteristics. This should be externally benchmarked and should include:

- employer covenant, which should be measured to a degree of accuracy supportable by evidence;
- scheme funding, including investment strategy; and
- the benefits of risk reduction, such as contingent assets and deficit reduction contributions.

6.1.6 The PPF could also consider the practicability of extending the risk characteristics to include:

- trustee behaviours; and
- funding strategy.

6.1.7 Levies should be benchmarked against market comparators. They will need to include a component for risk through-the-cycle to avoid a scheme failing without having paid for the risk it represented at that

point in the economic cycle. This reflects the reality that the PPF cannot decline to cover schemes, and that schemes are required to pay the levy.

- 6.1.8 The cost of affordability measures, such as the levy cap, should be transparent and some members felt consideration should be given to restricting the circumstances in which schemes can have their levy reduced (e.g. that they are already closed to future accrual). Capped schemes are having part of their risk paid for by others, and ought to be taking steps to reduce their risk. The circumstances under which levies should be capped should also be subject to consultation.

Promotion of good behaviour

- 6.1.9 The levy should have a stronger focus on risks that schemes can genuinely control: funding, investment strategy and their control environment.
- 6.1.10 Risk reduction at a scheme level should be recognised without delay. And, reflecting that risk reductions such as contingent assets are expected to be long-term, it should be possible to estimate their impact over a number of years. This would strengthen the incentives to put in place risk reduction measures — with the result that risk in the system should reduce.

6.2 Commentary on a possible formula to deliver the Steering Group's objectives

- 6.2.1 The Steering Group would expect the following broad patterns in a formula that delivers our objectives:
- The influence of funding level is likely to increase significantly — so that poorly funded schemes pay more than at present. This is an expected result given the removal of the current approach of scaling up liabilities of all schemes (regardless of their actual investment risk) when measuring underfunding and of the taper (which together mean well-funded schemes still pay some risk-based levy).
 - Provided that the points flagged in 5.1.14 to 5.1.16 can be addressed and that investment risk can therefore reasonably be included, the inclusion of investment risk will tend to reinforce the importance of choices over funding and investment strategy.
 - Insolvency risks for a given Failure Score will be higher, and will be over a narrower range. This will tend to shift the balance of the levy towards schemes with stronger sponsors. But top-rated schemes with good covenant and strong funding may still see their levies fall because the insolvency effect is outweighed by the benefit from the new approach to funding. The PPF's preliminary impact analysis suggests that schemes with employers rated Aaa – A would see a £21 million increase in levy, but of those schemes with strong employers, those in the two strongest funding categories would save £22 million.

- A reduction in granularity will result in winners and losers within each insolvency group (those at the bottom of a group gain), but these effects would be limited in relation to other effects since the through-the-cycle adjustment reduces this impact especially for the top-rated schemes.
- Though a bottom-up approach to the levy would be pro-cyclical, stability in bills could be attained by smoothing the underfunding measure over a number of years (at least three), mitigating the effects of volatility in the financial markets.

6.3 Broader implications: what does this mean for inputs to the new formula/setting of the levy?

6.3.1 The Steering Group would like to see an end to the annual (indeed sometimes more than annual) PPF consultation exercise on the levy, with its changes:

- to the scaling factor used in the formula; and potentially,
- to the factor applied to scale up liabilities in calculating deemed underfunding;
- to the point at which the levy is tapered;
- to the operation of the two caps.

6.3.2 In the past the PPF has set a levy fixed in total for a 3 year period. The Steering Group would like the PPF to go further and commit to a period over which the parameters used in the levy would not change. This would enable schemes to plan more effectively over a timescale equivalent to that used in their funding reviews.

6.3.3 The PPF should set out an overall strategy for funding in the long term that places levies in the context of past and future claims and recognises the contribution of assets received from schemes and investment returns. The funding strategy should be explicit about how it would react to any short-term surplus or deficit, including the timescale of action, and take account of reducing numbers of schemes and of the likely increasing maturity of levy payers, in its approach to risk. And it should indicate the assumptions the PPF will use in relation to, for example, mortality, and the degree of prudence built into these.

6.3.4 The PPF's analysis of insolvency risk measurement raises a number of points for the Steering Group. In particular, it is not clear how much of the mis-match between levy collected and claims that the PPF evidenced is a result of failure score measurement being open to manipulation and how much genuinely reflects secure employers failing. Whilst recognising that this is a difficult area, and that steps have been taken

through a recent consultation on the levy (for 2011/12), the Steering Group suggests further analysis would be appropriate.

6.4 What should the next steps be?

- 6.4.1 This report concludes the work of the Steering Group. But it is only a starting point for the full development of a new levy formula, and the changes in governance that will be needed alongside it. The Board of the PPF will need to consider the Steering Group's conclusions, and the reports of consultancy projects that have been started to build on this report, and set out their view for formal consultation.
- 6.4.2 Stakeholders who wish to comment on aspects of this report, potentially influencing the further development of the levy, should do so by writing to Chris Collins, Head of Policy at the PPF, who has been Secretary to the Steering Group, and is responsible for developing policy on the levy:

Chris Collins
Head of Policy
Pension Protection Fund
Knollys House
17 Addiscombe Road
Croydon
CR0 6SR

Or by e-mail to:

futurelevy "at" ppf.gsi.gov.uk

Appendix 1: Steering Group Terms of Reference

Establishment

The Board of the PPF's *Consultation on the Future Development of the Pension Protection Levy*, published in November 2008, delineated detailed proposals on a new levy formula that could take account of unexpected risk and investment risk in individual bills.

These proposals were developed in part through discussions with a Technical Reference Group, to whom the initial ideas were aired.

Responses to the consultation indicated broad support for the inclusion of an unexpected risk factor in the risk-based levy formula, but there were reservations about whether the principles behind the proposals had been fully explored and whether the details of the proposed calculation accorded with those principles.

To look at the possibilities for alternative proposals and/or the development of those already made, the Board wishes to establish two new groups that could explore the options and their implementation. The Steering Group will be supported by a Technical Group which will take advantage of industry expertise to develop and test its proposals.

Purpose

The purpose of the Steering Group is to look at the broad principles behind a fair levy that takes account of the different types of risk posed to the PPF by schemes. It is intended that the group will be able to consider and advise on approaches to the measurement of investment risk and long-term insolvency risk in the context of the broad principles. We also expect to discuss how the PPF assesses risks over the economic cycle and how best to meet issues raised by stakeholders (in the consultation exercise) in relation to the use of PPF's internal model to develop parameters for the new formula.

There is no expectation that discussion with stakeholders on these issues will result in proposals supported by all schemes, since the development of the formula will affect the distribution of the levy. However, we consider it is important to provide an opportunity to explore existing proposals and consider whether alternative approaches can adequately meet the principles of fairness, simplicity and proportionality. Any solution will need to be both transparent and practical to implement.

Membership

Members of the Steering Group will be able to take a high level view of the development of the levy system, rather than specialise in technical detail. The PPF has issued personal invitations for membership, but has sought to select individuals that can reflect a range of stakeholder interests.

Alan Rubenstein, CEO, will chair the group. This will ensure the group works to the PPF's aims, but also take advantage of Alan's relative newness to the proposals in stimulating fresh, impartial debate.

Secretariat

Supported by the PPF.

Meetings

A likely programme might be 4 meetings, provisionally to cover the following areas:

- The principles of a new levy formula that charges for unexpected risk.
- What the balance should be between short-term (expected) and long-term (unexpected) risk.
- Options for the measurement of long-term insolvency risk.
- The use of the PPF long-term risk model in the development of proposals.
- Options for the measurement of investment risk, particularly in relation to the more sophisticated investment strategies.
- Consideration of final proposals for further consultation.

Confidentiality

Membership of the Steering Group will not be published at this time, to allow steering group members to participate without being lobbied by interested parties. Information about participants should be restricted to broad descriptions of role that do not allow individuals to be identified.

The PPF wants to be able to provide information to the Steering Group that is not in the public domain, to better help it form a judgment on how to proceed. Accordingly, we would ask that information shared with the Steering Group be regarded as confidential.

The Technical Group

Supporting the PPF in preparing propositions and analysis for the Steering Group was the Technical Group. The Technical Group considered a similar set of issues as the Steering Group but in greater detail. The Group addressed the practical application of proposals and potential impacts on the PPF, pension schemes, and sponsoring employers, as well as the theoretical principles regarding the measurement of risk and the PPF levy.