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The Hundred Group
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Chairman
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Chris Collins
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Dear Mr Collins

Consultation on the Future Development of the Pension Protection Levy

I am writing on behalf of the Hundred Group of Finance Directors with regard to the PPF's latest consultation on the pension protection levy.

Who we are

The Hundred Group represents the views of the finance directors of the UK's largest companies drawn largely, but not entirely, from the constituents of the FTSE100 Index. Our members are the finance directors of companies whose market capitalisation collectively represents over 80% of that of companies listed on the London Stock Exchange. While this letter expresses the views of The Hundred Group of Finance Directors as a whole, they are not necessarily those of all our individual members or their respective employers

Our response

The Hundred Group much appreciates the willingness of senior members of the Board of the PPF to attend meetings of our Pensions Committee to discuss its policy proposals, and has also valued the opportunity to play a part in the Technical Reference Group established to assist with the development of levy policy.

However, we do still have a number of concerns with the PPF's current proposals, which we set out in this letter and which we hope will assist the PPF in the development of its policy.

In particular, we note that the current financial climate is very different from that under which these proposals were originally drawn up. The proposals could have very damaging consequences for some companies in current circumstances.

We would therefore urge the PPF to engage in an active dialogue with Government about financing arrangements that achieve the best balance between members, sponsoring companies and taxpayers. It is important that the PPF should view all options as being still on the table, and should not for example discount the possibility of either a reduction in the level of PPF compensation or of asking the Government for additional funding to pay the difference between an affordable levy and the cost of funding PPF compensation adequately.

We have not answered all the questions set out in your consultation paper, but have focused our response on certain key points.

1. The Long Term Risk Model and D&B Scores

The rationale for the proposals is that "a significant proportion of our total levy estimate reflects long-term risks – a large part of which relates to schemes that are initially well funded and/or whose sponsors enjoy strong solvency". We do not dispute that there is merit in this premise nor that there may be good arguments for allowing for a longer term assessment of risk in calculating the levy.

However, we note that we are largely expected to take on trust the underlying model on which the proposed levy calculation will be based. On the basis of the evidence in the public domain, we are not able to assess whether the increase in the amount of levy being paid by larger, better funded schemes with strong employer covenants meets the criterion of fairness or not.

We recognise that the PPF's Long Term Risk Model (LTRM) is a valuable model that has been developed with the assistance of external providers and we welcome the PPF's publication of an introduction to the LTRM in August 2007. These measures give us some reassurance as to the quality and nature of the model.

However, it is important to be aware that the model will have limitations. Paul Seymour comments in his introduction to the Board for Actuarial Standards' consultation on a generic modelling standard: "I cannot stress enough how important it is that users of actuarial information, especially those who make important decisions based on it, should not only understand how useful the underlying models are, but also understand their limitations".

In particular, we are concerned about the use of the model to transform one-year D&B failure scores into five-year D&B failure scores. In our various correspondence and discussions with the PPF, we have raised our continuing concern about the D&B failure scores, which we continue to find arbitrary and in many cases an inaccurate reflection of a company's genuine risk of insolvency. We note, for example, that Lehman Brothers had a score of 100 at 31 March 2008.

An industry has grown out of manipulating D&B failure scores by adding new company directors or changing trading addresses – actions that improve the failure score without reducing the probability of insolvency at all. The D&B system is designed to cover over 3 million UK businesses, providing insights to credit departments about which customers to extend credit to. It is not a system designed to determine the risks for a premium for some 7,000 schemes covering perhaps 15,000 companies. It is therefore inevitable that gaming of the D&B system can occur.

Incidentally, we note that the PPF's decision to base the 2009/10 levy on insolvency scores as at 31 March 2008, whilst taken in the interests of stability at that time, may now seem unfortunate in considerably underestimating the relative insolvency risk of certain industries, especially the banking sector. It may mean that many companies are paying a higher share of the levy than now seems appropriate while other companies are not paying enough.

We therefore do not believe that D&B scores accurately reflect the probability of insolvency over a one year period, but even less do we believe that they can be used to create a credible probability of insolvency over a five year period.

The PPF is asking Hundred Group companies to accept a large increase in levy based on a model that is not fully in the public domain, and a figure for long-term insolvency risk that may have no validity whatsoever. We would suggest that the PPF consider the following actions:

(a) Obtaining and publishing an external independent audit of the LTRM that takes account of the Board for Actuarial Standards' suggestions on modelling, and that considers in particular the validity of using D&B scores to obtain a five-year insolvency probability;

(b) Inviting the Hundred Group and other stakeholders to a seminar on the LTRM to facilitate a more detailed understanding of the model (as suggested by your Chairman at a recent meeting with the Hundred Group's Pensions Committee);

(c) Publishing an analysis of the schemes that have entered the PPF assessment period and the D&B scores of their sponsoring companies at the levy valuation date prior to the start of the PPF assessment period. If the PPF could demonstrate that such companies had demonstrably lower D&B scores than those of other companies that have not entered a PPF assessment period,that might give us more confidence in the D&B scores than we have at present. With 68 schemes now in the PPF and many more going through the assessment period, it should now be possible for the PPF to provide a meaningful analysis.

(d) Providing further information on the relative proportions of the levy reflecting long-term and short-term risk and how these are derived. At present, this is a very opaque part of the calculation.

2. Options for Dealing with Investment Strategy

In principle, we are in agreement with the PPF that investment strategy does present a significant risk to pension schemes, and therefore that it may be appropriate to include investment strategy as one of the risk factors in the PPF levy. However, we have significant concerns about the proposals as currently framed.

We believe that it would be wholly inadequate to implement the Option 3 proposals on their own, even as a short-term measure. As the consultation paper itself notes, the methodology put forward does not capture the more sophisticated risk-reduction techniques employed by schemes, such as derivative hedging of equities and interest rates and dynamic asset allocation strategies. Many Hundred Group pension schemes employ such sophisticated strategies in order to minimise the risks of assets being insufficient to meet liabilities. It seems intuitively wrong that pension schemes should be penalised through a risk-based levy for taking actions to introduce the most appropriate investment strategy to minimise the risks in the scheme.

We therefore believe that the PPF must take a much more nuanced approach to investment strategy than basing its risk assessment purely on the information on asset classes conveyed in the scheme return.

One of the options put forward by the PPF is an "Internal Models Approach". We believe that, even for the very largest schemes, such an approach would be prohibitively expensive and we do not believe this represents a realistic option for many schemes, except those sponsored by financial services companies that already have such models in place.

If the PPF remains determined to incorporate investment risk as part of the risk-based levy calculation, then we believe that it must allow some sort of voluntary certification along the lines described under Option 4. The PPF has allowed for voluntary certification elsewhere in the levy calculation and it would be appropriate to do so here as well.

We believe however that further work would be needed on the nature of the voluntary certification, as the proposals contained in the consultation paper are only sketched in outline and, at present, do not go far enough to recognise strategies involving interest rate derivatives or dynamic asset allocation.

Our suggestions are therefore that the PPF should consider:

(e) delaying the introduction of investment risk as a factor in the risk-based levy calculation until it has produced a credible model for voluntary certification of investment risk which takes full account of modern risk-reduction strategies. The Hundred Group would be very happy to circulate a questionnaire to its members on the current investment strategies of Hundred Group companies to assist the PPF in drawing up proposals for assessing investment risk.

(f) providing information on how the investment risk factor σ will be recalibrated to take account of market changes. At present, the methodology for deriving σ remains opaque.

Without such developments, the PPF would be introducing a levy which would appear to fail the tests both of transparency and of fairness. For many trustees, the investment risk factor σ used in their levy calculation will appear to be an arbitrary 'magic number' generated by the PPF from a model that the trustees do not understand and will be far from transparent. For those trustees with sophisticated investment strategies, the levy will also seem patently unfair.

In addition, as investment strategy is only a risk where a scheme is insufficiently funded, we believe that the PPF should consider:

(g) introducing a funding level above which investment risk plays no part in the funding calculation (for example, 120%).

3. Wider Concerns with Investment Strategy

As indicated above, we are not fundamentally opposed to the introduction of investment strategy as a factor in the calculation of the risk-based levy, so long as a solution can be found that genuinely reflects the actual risk posed by a scheme's investment strategy.

Even if, however, a satisfactory solution can be found for voluntary certification of more complex risk reduction strategies, concerns will remain that the investment risk factor will send the wrong messages to trustees about their investment strategy.

We note the PPF's belief that the introduction of investment risk as a levy factor is unlikely to have a major effect on scheme's actual investment strategies. The PPF may be correct that actual 'game-playing' to reduce the levy by changing the investment strategy is unlikely to occur at a significant level (though some schemes undoubtedly will do this).

However, we believe that the PPF is underestimating the probable effect of the messages it is sending to trustees, in particular the messages that investment in equities is to be avoided and that adoption of risk-reduction strategies involving dynamic asset allocation or derivatives may be worthless unless Option 4 is pursued. The PPF's views are respected by trustees, and the PPF needs to be wary of giving a signal about what trustees might see as

‘good’ investment strategies. Such behaviour on the part of trustees may well be irrational, but the PPF should not discount it as a possibility. The PPF’s proposals could therefore lead to a trend to investment in gilts, even if this is not necessarily the best option for pension schemes.

4. Awareness of the Wider Economic Climate

When we first engaged with the PPF on its plans for the longer term levy, the credit crunch was nowhere near as advanced as it now is. We do not believe that it is appropriate for the PPF to introduce its plans for the levy calculation along the lines it has proposed, without taking account of developments in the wider economic climate.

As the number of corporate insolvencies rises, the PPF is already facing a substantial increase in the number of schemes it is likely to take on board over the next couple of years. This will inevitably feed into higher levies from the levy years 2010/11 onwards.

The PPF should consider whether this is the right time to be introducing a major redistribution of the levy which would lead to some schemes facing a double increase – from the general increase in the levy, and then from the change in the levy calculation. Now is a time when pension schemes (and their sponsoring employers) would particularly appreciate stability in their levy calculation from year to year.

We appreciate that these are difficult times for the PPF. To some extent, the PPF has been presented with an inappropriate model from Government, under which levies have to increase at precisely the time when they are least affordable to companies. It should therefore not be afraid to admit that it needs Government support at the present time. This does not necessarily represent any failure on the part of the PPF.

We would therefore recommend that the PPF considers:

(h) Raising with Government the possibility of reducing increases to PPF compensation in deferment and payment. As a recent NAPF report showed, the UK is unique in requiring mandatory indexation in both deferment and retirement. The PPF has the powers to reduce increases in compensation set out in the Pensions Act 2004, and should remember that these powers were given by Parliament for a reason. If these powers are not to be used in the present economic conditions, in what circumstances does the PPF think they should be used? It is hard to imagine a more appropriate time.

(i) Discussing with Government whether it is appropriate for Government to provide partial funding for the PPF in the current circumstances. We believe that there is a case to be made for levy-payers funding only a reduced part of the compensation (for example, 70% of the pension promise to all members, subject to a cap) with the excess being made up by the taxpayer in the short term to reflect the current extraordinary financial circumstances which are likely to result in much higher rates of insolvencies.

    A solution along these lines would meet the concerns of levy-payers, who feel that they are being forced to pay for compensation that has been promised at too high a level at a levy cost which is becoming unaffordable, without impacting on the compensation being paid to individuals within the PPF. By way of comparison, Government support up to the extent of even 50% of the full economic levy would be considerably less than the amount already earmarked to support banks in the current financial climate.

(j) Delaying any major redistribution of the levy until economic circumstances have improved.

5. Conclusions

We have set out above our concerns with the PPF's levy proposals, in particular about the use of the LTRM to convert D&B failure scores into a five-year insolvency probability and about the proposals to use a simplistic model to allow for investment risk as part of the levy calculation. We do not think it appropriate for the PPF to implement its plans in their current form.

We believe that the PPF has a crucial role to play in recognising that we find ourselves in unprecedented economic times, and in asking Government to intervene with some short term assistance to the PPF. It is important that the PPF does not pursue its existing proposals without amendment, blind to external developments. We would be very happy to assist the PPF in any discussions with Government on these issues.

Please contact me if you would like to discuss any of the matters raised in this letter.

Yours sincerely

Eddie Weiss

Edward Weiss
Chairman
The Hundred Group – Pensions Committee