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4<sup>th</sup> October 2005

Sara Protheroe  
Levy Manager  
Pension Protection Fund  
Knollys House  
17 Addiscombe Road  
Croydon  
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Dear Ms Protheroe

### **The Pension Protection Levy Consultation Document – July 2005**

Thank you for giving us the opportunity to set out our comments on the package of measures that will implement the pension protection levy provisions of the Pensions Act 2004.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial.

Our comments are set out in 7 schedules that coincide with the chapters (excluding chapters 1 and 3) of the consultation document in which you asked questions.

We support in principle what you are trying to achieve although as you will see from our response we have some concerns regarding the detail of the proposals. In particular we would like to work with you to mitigate the problems that arise from earlier implementation of the risk-based levy.

We would particularly like to highlight the following issues:

- We are broadly supportive of the measure of pension scheme under funding that has been developed by the PPF. In our response we have suggested some reasonably minor alterations so that the system can take account of the most up-to-date possible information. We have also asked for the deadline for submission of the first PPF valuation to be moved back to 31 March 2006, to give schemes time to undertake

valuations. This is particularly necessary because of the significant number of outstanding queries about the detail of the PPF valuation method.

- Based on our initial work with clients, we have some concerns about the suitability of Dun & Bradstreet failure ratings. We suspect that there will be a significant number of companies which will wish to challenge their rating. It is unhelpful that the rating system is not transparent. The system would be more likely to be accepted if Dun & Bradstreet could produce statistical evidence that the failure score is a good predictor of the likelihood of insolvency.
- We are very concerned about the risk ratings for multi-employer schemes, and in particular for the large number of non-sectioned schemes where there is discretion or a requirement to segregate the scheme on insolvency. To calculate the risk-based levy, each employer is treated as an individual entity when assessing the probability of failure. In practice, the Pensions Regulator will, in most cases, be able to issue a Financial Support Direction if a weak employer fails while an associated employer remains solvent, and so it would be more consistent to rate these schemes taking account of the failure risk of the group of companies as a whole. This is exacerbated by the Dun & Bradstreet ratings, where we are aware of cases where closely linked companies have very different failure scores. In the absence of any changes in this area, the PPF will inadvertently initiate an industry in “rating improvement services”: companies will attempt to restructure themselves and their employment contracts to reduce the levy, with no material reduction in actual risk of entering the PPF.
- Finally, we should like to express concern that the cost of providing PPF benefits will be very much higher than originally estimated when the Fund was initiated. A number of companies and schemes will find the levy unaffordable. We do not believe that this feature can be satisfactorily addressed by amending the degree of cross subsidy, decreasing levies for riskier schemes by substantially increasing levies for less risky schemes. We suspect that more fundamental changes are necessary, perhaps by reducing the level of benefits that is provided by the PPF, or perhaps providing support for less solvent employers and schemes from other government sources.

We would be happy to expand on any of our concerns, by whatever means is convenient for you.

Yours sincerely

**Charles Young**  
**Chairman**  
**Pension Schemes Committee of the Association of Consulting Actuaries**

## Levy principles and risk

### General remarks

It is difficult to argue against the three principles (fairness, simplicity and proportionality) when expressed in the abstract.

### Specific questions

**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?**

Yes in the widest sense of the words. But earlier implementation than had hitherto been planned may result in unfairness issues for specific schemes that has to be balanced against a much wider unfairness issue had the original timetable been followed.

We accept that adjusted MFR valuations driven from this year's scheme returns are probably the best default approach that can be used in the circumstances. But for those who wish to carry out section 179 valuations there is a real problem as the valuation guidance is not sufficiently detailed and there are many questions left outstanding.

There is no indication of how the PPF intends to set the part of the pension protection levy that relates to any strains arising from claims already taken on, or from any deficits or surpluses that will emerge in future years. The strain could be significant in 2006/07 given the low first year levy of £150m and the number of schemes that have apparently been 'limping on' to 6th April 2005.

There would be logic in distinguishing this from that part of the pension protection levy in relation to the claims that may be taken on in the levy year. It would not seem appropriate to use the levy scaling factor to meet any strains arising from claims already taken on: the amount of any past shortfall is not related to a scheme's current degree of risk. One possible approach is for the scheme-based levy to be used as the mechanism for apportioning prior year deficiencies, although this would not cater at all for the different risks that have applied. There is no straightforward answer and further views on this specific matter should be sought over the next year or so.

## Underfunding risk

### General remarks

#### Alternatives to cash funding

The approach does not take account of alternatives to cash funding, such as security over company assets or parent company or bank guarantees that the employer might have taken to inject security into the pension promise. These arrangements clearly reduce the risk that a scheme will fall into the PPF, and schemes and employers should be given incentives to set them up. We understand that the PPF is reviewing the possibility of taking these arrangements into account, and look forward to seeing proposals.

#### Updating valuation results

It is not clear whether the Board will be adjusting the section 179 valuation results from their effective date to a consistent date, say 31st December, and if so how this is to be done. An adjustment could either be performed centrally by the PPF, or by the Scheme Actuary.

One possible approach would run as follows:

- The scheme would be permitted to submit a section 179 valuation based on a rollforward from a full valuation to a more recent date, which could take into account contributions, benefit accrual, market movements and any other issues of which the scheme actuary was aware. The actuary would be required to certify that he/she had no reason to believe that the liability valuation was materially understated.
- The PPF would automatically adjust submitted section 179 valuations (including those devised from MFR estimates) to a common date, ignoring any special contributions.

#### Specific questions

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 Pension Protection Fund Liabilities?**

The 104% cut-off seems reasonable as an interim measure for 2006/07.

We believe that there should be some recognition of the fact that those few schemes that are substantially over funded in relation to PPF liabilities are less likely to call upon the PPF than those that are just above 104%. The risk-based levy as proposed contains no incentives to fund above 104%. Whilst this may be acceptable for 2006/07, this area needs to be addressed as part of the factoring in of asset allocation risk for 2007/08.

**2. Do you expect to submit a s179 levy valuation by 31st December 2005? If not, when do you expect to submit a s179 levy valuation?**

We would expect many trustees to have difficulties in submitting a section 179 valuation by 31st December 2005:

- the importance of this deadline only became apparent with the publication of the consultation paper;
- although an outline of the valuation approach was published in April there are many uncertainties that remain on the approach to valuation permitted – see for example our separate letter to the PPF on this subject;
- given that final terms, and some of the concessions that we have suggested, will only be known around the end of November 2005, it will be impractical for many schemes to complete calculations by the end of the year.

Given this, we make the following recommendations:

- extend the deadline for submission of section 179 valuations to 31st March 2006 and, if necessary, defer the collection of the levy by three months;
- allow section 179 valuations to be submitted by reference to a valuation date earlier than 1st November 2004 – in future years the PPF Board has indicated that it is acceptable for valuations to be three years out of date, so why not allow this for the initial section 179 valuation? This could make very significant savings in professional fees by permitting use of valuation data that had already been prepared.

## Insolvency risk

### General remarks

This is the key aspect of the proposals. It is most important that the approach finally determined is robust and that scheme sponsors understand their insolvency risk rating and what they need to do and by when in order to improve it. Early implementation militates against this – at least for 2006/07.

### Specific questions

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

The proposed approach is outlined in general terms. We would expect that following the appointment of Dun and Bradstreet there is now greater focus on the detail of the approach.

While we cannot hold ourselves out as experts in rating the risk of company insolvency, we do have some concerns about the Dun & Bradstreet ratings, and whether they are fit for the purpose of determining the likelihood that a pension scheme will fall into the PPF.

It is noticeable that the one element of the risk-based levy calculation which is not transparent is the methodology underlying Dun & Bradstreet's ratings. We would strongly encourage the PPF to obtain and publish an explanation of this, together with evidence that demonstrates that the Dun & Bradstreet failure score is well-correlated with the risk of business insolvency.

At this rather early stage, we have some concerns that the Dun & Bradstreet methodology takes excessive account of items such as the number of County Court Judgements, which may be relevant when a potential supplier is deciding what credit terms to give to a company, but which seem less directly related to insolvency. For example, there will be some entities, such as service company subsidiaries which are not directly involved in trading, which may receive an artificially high score because they are not directly exposed to the trading activity of the company group. Such companies may obtain favourable Dun & Bradstreet ratings, in spite of the fact that they have typically very limited assets, and certainly not enough to support the potential shortfall in a pension scheme.

This would not be as significant an issue if the employer rating for most pension schemes was based on a rating for companies in a group, rather than a rating for an individual legal entity. We discuss this further in our comments on chapter 6.

There also needs to be sufficient time for employers to appeal against the ratings that they are given – this is not recognised in the paper.

**2 Do you agree that the 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.**

We agree that the insolvency rating should relate to the likelihood that the employer will become insolvent over a twelve month period, and not over a long-term period.

We also note that, with peaks and troughs in the economic cycle, there will be some years where far more insolvencies are expected than others. We suggest that insolvency probabilities should be based on the average level expected over an economic cycle. The alternative, to charge a premium based on the current position within the economic cycle, could have disastrous results. PPF premiums would be set at their highest level just at the point in the cycle where most employers were becoming insolvent and where employers were least able to afford additional costs.

**3. Do you agree that insolvency should be banded?**

No. Now that Dun and Bradstreet have been appointed, it would seem appropriate to use some variation on their 100-point credit scoring system. This would get over one particular concern we have with the banding approach – the jumps between bands (for example moving from band one to band two increases the risk-based levy by 350%).

**4. Do you agree that there should be ten bands?**

No – banding is unnecessary (see above).

**5. Do you agree that the insolvency risk should be capped at 15%?**

This is a question about cross-subsidies between schemes: to what extent is it fair for low risk schemes to subsidise high risk ones?

For the very lowest risk schemes, there is more cross-subsidy inherent in the use of a 20% scheme based levy, than in the caps and the consequent increase in scaling factor.

So far as the risk-based component of the levy is concerned, we accept that there is some need for cross-subsidy. If the effect of capping increases the scaling factor by less than 5%, say, we believe that the degree of cross-subsidy is likely to be acceptable to the less risky schemes.

We do not have definitive comments in relation to the specific design of capping. The current proposal is that the insolvency probability is capped, and then a second cap is applied to the overall risk-based levy which will also take into account under-funding risk. Perhaps an approach with a single cap would be more transparent.

However we do note that a levy as high as 3% of PPF liabilities is likely to be unaffordable for most schemes, and we do see this leading to a risk of company failure in a number of cases.

**6. Do you agree that there should be a generic band?**

Clearly arrangements must be made where there is no Dun & Bradstreet rating. Without knowing which employers this relates to it is difficult for us to make specific comments.

So far as is possible, the rating ought to reflect the risk of the employer being unable to support the pension scheme. This may well require the use of several generic risk bands for different types of employer.

We understand that one of the main areas where Dun & Bradstreet ratings are not available is where the employer is the UK branch of a non-UK company. This can apply to a wide range of companies. Our recommendation would be that some form of rating, perhaps based on the non-UK Dun & Bradstreet products, should be used where this is available and reasonably comparable to the UK rating system. We suspect that this may be feasible, for example, for companies based in many European or North American locations.

An alternative possibility is to use a generic rating for different industry types. We believe that this would only be acceptable if there was little divergence of company strength within each industry sector, and we suspect that this may well not be the case.

**7. Do you agree with the focus on a market-based approach?**

Yes.

## Scheme structures

### General remarks

Dealing in a fair, simple and proportionate manner with multi-employer schemes is clearly a major challenge – and especially as the consultation paper recognises, given that many of the top 500 pension schemes are multi-employer.

We do not believe that the proposed structure satisfies the PPF requirement for fairness in cases where a scheme may or must segregate when a participating employer becomes insolvent. This is because the method treats each employer as a completely isolated entity, and does not allow for the fact that the Pensions Regulator can issue a Financial Support Direction or Contribution Notice against other stronger group companies. A more appropriate measure of insolvency risk for such schemes is that of all the employers becoming insolvent rather than an average of individual company ratings across the group.

For “last man standing” schemes or sections it is not made clear how the “assessment of risk of all employers... becoming insolvent” will be made.

In relation to schemes sponsored by an overseas employer, the consultation paper says that “the Board intends to apply a consistent insolvency assessment for the overseas employer” to that being proposed for UK employers. Does there also not need to be recognition that recoveries from such employers, especially if outside the EU, are less likely than from UK employers?

### Specific questions

- 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?**

We agree that the approach is reasonable, as long as the full data is reasonably straightforward to supply.

We have a practical concern with the full data request. We note that the return to the Pensions Regulator requires the Scheme to identify the employer with the largest number of “members” which includes employees, deferred pensioners and pensioners. We also note that, for where there is a requirement or discretion for segregation or insolvency, an average rating will be calculated. We assume that the intention is to use some form of weighted average for this calculation, perhaps weighted by member headcount.

We would warn the PPF that, in many schemes, it may not be possible to identify the employer of deferred pensioners or pensioners accurately. This information is typically not needed for regular scheme administration, and can be complex to obtain, particularly where a group of employers has restructured in the past.

Some scheme members will (correctly) not be allocated to any currently participating employer.

This will not be an issue if, as we suggest, ratings are always based on the risk of the entire group becoming insolvent. If our suggestion is not followed, some PPF guidance will be needed to ensure that a pragmatic approach is adopted.

## The levy structure

### General remarks

The proposal to publish the overall levy estimate required in 2006/07 by 30th November 2005 is far too late given that at the present time the amount would appear to be anything between “somewhat higher than” £300m (as recognised by the consultation paper) and £1.5bn (estimates flowing from the figures set out in the consultation paper).

The paper fails to set out the logic for a scheme-based levy and why it should be 20% – it would be possible, within the current legal framework to have an entirely risk-based levy.

### Specific questions

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

We support in principle the quicker move to a risk-based system than was previously indicated. But this consultation paper does not explore sufficiently the consequences of earlier implementation.

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

Yes, subject to our earlier remarks about how both should be measured.

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 and which have weak Pension Protection fund funding levels (less than 65% and 80% respectively)?**

We addressed the issue of caps in our response to question 5 of chapter 5.

## The transitional period

### General remarks

We are generally supportive of the reduced transitional period, but it is necessary to address the issues that then arise.

### Specific questions

**1. Do you agree it is reasonable to use adapted MFR valuations as an estimate of s179 levy valuations?**

The adapted MFR valuation approach can be problematic. We would like to assist the Board in finding ways of addressing the issues that it raises.

We understand that the PPF intends to issue detailed information about its proposed MFR adjustment method. We support this level of transparency.

In general, we are satisfied with the use of an MFR adjustment method, provided that schemes have an option to submit a section 179 valuation, and sufficient time to prepare this.

A problem is that there will be insufficient information on the scheme return form to enable an MFR valuation to be appropriately rolled forward. Some issues are set out below:

- for schemes that at their last MFR valuation were more than 120% funded, it may not have been necessary for the scheme actuary to carry out accurate calculations and so the MFR liabilities may be unknown;
- some MFR valuations will have been done on a gilts-matched basis;
- some will have the equity easement;
- some will have scheme-specific mortality for pensioners;
- some MFR valuations may incorporate insured liabilities;
- the MFR valuation will incorporate DC assets and liabilities (AVCs and DC sections) – irrelevant for PPF purposes; and
- the ‘change of basis and benefits’ from MFR to section 179 is fraught with problems – e.g. in determining the extent to which the PPF compensation cap impacts the valuation result.

We ask that a paper setting out in more detail the approach to adapted MFR valuations be made available as soon as possible.

We would like to have the ability to submit a further MFR valuation before 31st December 2005 as the valuation result reported in the scheme return may be too dated.

- 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 section 179 levy valuation by 31st December 2006?**

We do not want to force a section 179 valuation to be carried out by 31st December 2006. So we would like the adapted MFR valuation retained as an option. This should allow submission of the most recent MFR valuation where such is finalised after the scheme return has been submitted.

- 3. Do you agree that it is desirable to receive s179 levy valuations for all schemes from 31st December 2006?**

Desirable but it should not be made a requirement. Also, we do need to know now precisely how to do these calculations. It is all very well for the consultation paper to state that “it encourages trustees to complete an initial s179 levy valuation at the earliest opportunity” but trustees must be given all the tools to do the job.

- 4. If you answered no to Q3 which of the following dates is preferable to 31st December 2006 in your view?**

**(a) 31st December 2007**

**(b) 31st December 2008**

**(c) 5th April 2009**

**(d) any other date, please specify**

Option (b).

- 5. Do you agree that the disadvantages of bringing forward the deadline for completing an initial s179 valuation are a price worth paying to move to a fairer and consistent risk based levy using s179 levy valuations by 31st December 2006?**

Not applicable – we don't want the deadline brought forward to the extent that is being proposed.

**6. Do you think that the estimated additional costs of bringing forward the deadline for completing an initial s179 valuation are realistic?**

It is not possible to answer this question without knowing the level of accuracy required for the section 179 valuations. However we suggest that the £1,500 cost is far too low as whatever level of detail is required. The actuary is being asked to certify numbers, not carry out an approximate roll forward to test the adequacy of an MFR schedule of contributions.

**Asset allocation risk**

General remarks

In the interests of simplicity and earlier implementation, we are content for asset allocation risk not to be taken into account in 2006/07. But it must form one of the rating factors as soon as practicable; otherwise the fairness principle will not be met.

Specific questions

- 1 Do you agree that the Board should include asset allocation risk as a factor for setting the risk based levy as early as practicable?**

Yes – in 2007/08.

- 2. Do you agree that this is something that is important and which will merit early consideration in a separate consultation exercise?**

Yes.

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

Yes.