

Policy statement on the possible inclusion of investment risk as a risk factor in the risk based levy

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Foreword

In December last year the Board of the Pension Protection Fund consulted on whether account should be taken of the risks posed to the Pension Protection Fund by the nature of a scheme's investments when compared with the nature of its liabilities. This Policy Statement summarises the responses that were made to that consultation, sets out the decisions the Board has come to following the consultation, and indicates next steps.

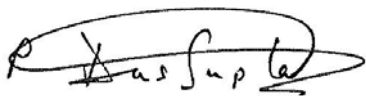
At a global level, the Board of the Pension Protection Fund already takes account of risks associated with investment strategies, in judging the overall levy quantum that may be required to meet future liabilities. This consultation exercise focused on whether the degree of variation in risks that individual schemes pose justified developing the risk based levy to take those investment risks into account at the present time.

The Board recognises that in principle the way that a scheme invests its assets can have an impact on the volatility of the funding position. However, the evidence, as set out in the consultation document, suggested that currently only a small re-allocation of the risk based levy would result from including investment risk as a factor. Accordingly the Board's initial conclusion was that, for now, it would not be proportionate to introduce an investment risk factor into the risk based levy.

A clear majority of those responding to the consultation agree that the impact of investment risk now is likely to be limited and with the Board's initial conclusion not to introduce a general risk factor. The Board has taken note of these responses and now wishes to confirm its intention not to introduce a general investment risk factor into the risk based levy for the time being.

The Board will wish to monitor trends and may review their decision in the light of developments in key indicators. To help inform such consideration, and to help development of the Board's global view of risk, the Board proposes to explore extending the information collected via the Pensions Regulator's Scheme Return and increasing its understanding of pension schemes' approaches to investment risk management through engagement with larger schemes - on a sample basis.

The Board is grateful to all those who contributed to this consultation exercise and thereby assisted the Board in deciding how to develop the risk based levy.



Partha Dasgupta
The Board of the Pension Protection Fund

Chapter 1 – Introduction & Executive summary

1.1 Introduction

- 1.1.1 The Pension Protection Fund has been established to pay compensation to members of eligible defined benefit and hybrid pension schemes, when there is a qualifying insolvency event in relation to the employer on or after 6 April 2005, and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.
- 1.1.2 Compensation will be funded partly by the assets transferred from schemes for which the Pension Protection Fund has assumed responsibility, partly by investment returns and partly by an annual levy raised on eligible pension schemes.
- 1.1.3 The Pensions Act 2004 states that the pension protection levy must be in a form that the Board estimates will result in at least 80% of it being risk-based for each levy year falling after the end of the transitional period. The remaining percentage must be based on the level of scheme liabilities and may include any other scheme factors as set out on the face of the Act or in regulations.
- 1.1.4 The Pensions Act requires the Board to take account of underfunding risk and insolvency risk as factors in setting the risk based levy. Additionally, the Act says that, “if the Board considers it appropriate”, it may assess the risk based levy by reference to: “the risks associated with the nature of a scheme’s investments when compared with the nature of its liabilities” (section 175(3)(a)).
- 1.1.5 The Board of the Pension Protection Fund, following consultation in 2005, introduced a risk based levy, for all eligible schemes, from 2006/07. The Board decided that asset allocation would be not be included as a risk factor in that levy, given the complexity of the subject matter, and the practical implications for schemes. But it committed to consulting in 2006 on the possible inclusion of asset allocation as a risk factor in future years.

1.2 Background to the consultation

- 1.2.1 Having committed to a consultation on this subject, and in view of the complexity of the area, the Board was keen to provide a range of information to help to enable considered responses from consultees.
- 1.2.2 To help frame consideration, the Board gave thought to the appropriate analytical framework for taking a decision on investment risk. The key

questions the Board considered, and on which the consultation document tested opinion were:

- What were the principles that should underlie a decision;
- How should the Board think about investment risk – was it sufficient to consider asset allocation strategies – or was the match with liabilities also important;
- In considering scheme investments, was it sufficient to look at the proportions of equity and debt, or was a more sophisticated approach required.

1.2.3 The second set of questions that the Board considered was:

- Were variations in investment risk already captured through the risk based levy?
- Whether there was a case for introducing a risk factor, in principle, and given present patterns of investment risk;
- What might be done to increase the PPF's understanding of investment risk through improved monitoring?

1.2.4 The Board looked at a range of evidence, both existing and newly commissioned, to provide it with a basis for judging whether investment risk should be a factor in the distribution of the risk based levy. This material, and the Board's initial conclusions are set out in full, in the consultation document, which was published in December 2006 on the Pension Protection Fund's website¹.

1.2.5 Based on this evidence, the Board's initial view was that it was unlikely to be appropriate to introduce an investment risk factor to the risk based levy at the current time. However the Board considered that consultation might provide additional evidence to [consider] and also might helpfully test the analysis carried out to date. Consulting would also meet the commitment that the Board had made to consult and demonstrate transparency in decision making.

1.3 Consultation responses

1.3.1 The Board received 28 formal consultation responses. By comparison with some previous consultations this is a relatively limited response rate. This may be explained in part by the fact that the Board had made a clear proposition that there be no change, and that this has significant stakeholder support.

¹ See www.pensionprotectionfund.org.uk/index/pension_protection_levy-2/levy_policy_-_investment_risk

- 1.3.2 There was widespread support for the Board's focus on investment risk – in terms of the relationship between characteristics of assets and liabilities – rather than simply asset allocation. And there was general agreement with the proposition that measuring investment risk would need to be done in a relatively sophisticated way.
- 1.3.3 Two thirds of respondents were supportive of the Board's initial view that investment risk should not be incorporated as an additional risk factor at present, but that key trends ought to be monitored.

1.4 The Board's decision

- 1.4.1 Evidence drawn from scheme return data, and now also published in the Purple Book, suggested that investment strategies are broadly similar for most schemes – with more than half of schemes holding 65% or more of assets as equities, but few holding 90% or more as equities. In addition, given this and the scale of underfunding at present, the analysis carried out for the Board suggests that including investment risk would make relatively little difference to the pattern of levy charges as a whole.
- 1.4.2 There are, of course, funds that are exceptions to the typical balance of investment, and a number of high-profile recent cases of funds that are altering their investment strategy, seeking to match the risks of their assets and liabilities now rather than over time. However, judging by the data that the Board has available to it, such schemes remain rare enough that adjusting the risk based levy to reduce their levy and to increase the levy of schemes which pose more risk to the Pension Protection Fund would not be proportionate. The costs of introduction could mean that a majority of the schemes that gained from a re-allocation of the levy still faced higher overall costs, and this would particularly apply to smaller schemes.
- 1.4.3 Consulting has reinforced the Board's belief that there would be little consensus amongst stakeholders on the merits of introducing an investment risk factor (with two thirds of consultees against introduction now) or on the best way to balance the tension between a fair factor and a simple factor in this area. It has also sharpened the Board's appreciation of some of the sensitivities of introducing a factor.
- 1.4.4 Weighing these considerations, and recognising that any decision must disappoint some levy payers, the Board has decided that introducing a factor now would be disproportionate in the light of the limited impact when set against the cost.

1.5 Proposed steps on monitoring

- 1.5.1 However, the Board (along with most respondents) believes it will continue to be important to monitor key trends that affect the impact of investment risk on the risks individual funds pose to the Pension

Protection Fund. In particular, the Board recognises that if the level of underfunding in schemes reduces over time, as it hopes and expects that it will, and if the investment strategies of funds diverge, that the case for taking account of investment risk in the risk based levy could strengthen.

1.5.2 It is proposed to keep trends under review and to seek to improve the information available to the Board through:

- Aligning the Scheme Return more closely with the statutory requirements for pension scheme accounts;
- Working with larger schemes to develop information on the sensitivity of their funding to changes in interest rates, asset prices and inflation.

Chapter 2 – Background to the Board’s decision

Chapter summary

This chapter sets out key background information, including the principles that underlie the Board’s decisions about further developments to the levy. It also sets out what investment risk is, and summarises views expressed to the Board by stakeholders on these points.

2.1 Development of the Pension Protection Levy

2.1.1 In the initial development of the pension protection levy the Board had regard to three core principles:

- Fairness – ensuring that schemes pay an appropriate amount towards the levy reflecting the level of risk they pose;
- Simplicity – applying effective and simple mechanisms and solutions for collecting the data required to set the levy; and
- Proportionality – ensuring that the levy is fair and proportionate between schemes and in its impact on individual schemes.

2.1.2 In considering the issue of whether to include investment risk as a factor in the risk based levy the Board decided it should continue to have regard to these key principles. Specifically in the context of this consultation, it decided that that the best interpretation of these principles was as set out in the boxes below.

Fairness

Fairness will be promoted when setting the levy structure by seeking to ensure that schemes pay an appropriate amount towards the levy reflecting the level of risk they pose.

- **Best evidence will be used to develop the levy.** The Board therefore commissioned analysis to measure the potential impact of including investment risk, rather than simply considering already published evidence.
- **Any investment risk factor introduced into the levy would be designed solely to reflect the risks faced by the Pension Protection Fund.** The Board’s role is to assess the aggregate risk to the Fund and at the level of the individual scheme to seek to match the levy to the individual contribution to that risk.

Simplicity

In developing the levy structure the aim should be for a charging system that remains simple to understand and implement.

- **Any development of the levy should have regard to the benefits of having a system that is relatively simple to understand.** At the same time it will need to increase fairness, which some simpler approaches might struggle to do.

Proportionality

Any development of the levy needs to balance costs of implementation against an increase in the accuracy with which the risks to the Fund are reflected.

- **An investment risk factor would only be introduced if it could be shown to be likely to result in a fairer distribution of the levy, taking account of costs of implementation.**
- **The Board will seek to measure the impact of investment risk in the future efficiently.** Recognising that additional requirements for information can be costly, the Board will seek to minimise the costs to pension funds of monitoring investment risk.

2.1.3 The first question in the Consultation document tested whether these principles were felt to be an appropriate basis for deciding on whether to introduce an investment risk factor into the risk based levy:

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?

2.1.4 90% of respondents agreed that the Board's core principles of fairness, simplicity and proportionality provide a good basis for considering extending levy risk factors to take account of investment risk. Those that did not essentially argued that the Board had applied the principles incorrectly – and come up with an unfair result – rather than genuinely disagreeing with the proposition. One respondent suggested an additional principle – transparency – was also important in developing the levy.

2.1.5 The Board has concluded that the principles as expressed in the consultation represent a sound basis for reaching decisions on the further development of the levy. It notes the point about transparency

and sees this as of the greatest importance. In the context of the levy, the Board intends to demonstrate its commitment to transparency through continuing to consult on both the levy quantum and on the levy distribution formula whenever these are subject to significant change.

2.2 What is investment risk?

2.2.1 The Pensions Act 2004 sets out the risk factors the Board must take account of in developing a risk based levy, and also provides flexibility for the Board to consider additional factors including specifically:

”factors which the Board considers indicate...the risks associated with the nature of a scheme’s investments when compared with the nature of its liabilities”.

2.2.2 The Board suggested in the consultation document that the approach envisaged in the Pensions Act 2004 was a helpful basis for considering investment risk, as it could affect the Pension Protection Fund. Critically, it focuses not only on the nature of the investments of a scheme – what is often referred to as asset allocation – but also on the extent to which they match the liabilities of the particular scheme. This is a helpful formulation, in that it draws attention to the way in which the risk that an investment strategy presents to the Pension Protection Fund may vary depending on the nature of the liabilities of the particular scheme – which are affected by factors such as the maturity of the scheme.

2.2.3 One aspect of investment risk, not particularly highlighted by the legislation, but which the Board believe may need to be considered, is the extent to which schemes use instruments designed to alter the effective characteristics of their investments – such as interest rate derivatives. This is an area of current interest in the industry, where schemes are beginning to use instruments to undertake liability hedging or liability driven investment strategies.

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?

2.2.4 All respondents commenting on this question agreed with the importance of considering the match with liabilities, and a number of interesting additional points were made. One consultee argued that there was a potential tension between asset liability matching for PPF liabilities and full scheme benefits.

2.2.5 A number of respondents flagged that assessing risk in terms of asset liability matching ought to take account of factors such as the strength of employer covenant and duration risks for liabilities due to uncertainty

about mortality trends. Respondents were divided on the implications of this duration risk and what if anything was the appropriate response to the issue in terms of design of the levy. Some argued annuity matching was of major importance and that there should be recognition through the levy of the benefits of matching use of annuities. Others argued that equity investment – with its expectation of higher returns – would help counterbalance underfunding and longevity risks and that it was therefore important not to do anything which might diminish the attractiveness of equity investment (such as introducing an investment risk factor).

2.2.6 Another point some respondents made was that investment risk can be measured in two different ways:

- by the extent to which assets are matched with liabilities
- the extent to which assets are diversified

And that managing investment risk using the former measure may lead to an increase in bond type investment, but that a concentration in one asset class could increase investment risk measured by the latter measure.

2.2.7 The Board recognises that there is a potential tension between matching PPF liabilities and full scheme liabilities. It also recognises the points made on the need to give thought to factors such as the strength of employer covenant and duration risks for liabilities due to uncertainty about mortality trends. And it recognises that there are different ways to measure investment risk. But taking these points together, it concludes that whilst consultees agreed with the proposition that it was important to consider both assets and liabilities in judging investment risk there was less consensus on how in practice to achieve such a comparison.

2.3 In considering scheme investments, is it sufficient to look at the proportions of equity and debt?

2.3.1 The Consultation document set out a range of approaches that could be taken to measure investment risk. A key issue was whether a simple approach which simply measured the equity/bond ratio might suffice. Or alternatively, to assess the impact of investment risk adequately it might be necessary to use a more sophisticated approach which sought more exactly to measure the relative risks of different assets, most plausibly using an analysis such as value-at-risk (VaR) or some similar method.

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

- 2.3.2 There was wide agreement with the proposition that a simple equity / bond split of assets, or even moving to somewhat more detailed asset class information would not provide a robust basis for charging for investment risk. Two consultees noted that an asset split could ignore LDI overlays and would have potentially unfortunate behavioural implications, and other respondents were concerned that grouping assets into classes ignored distinctions within classes. Taking the responses together there was strikingly little enthusiasm for a “simple” approach, with one respondent capturing the general view in concluding that there was “no alternative to using a VaR analysis”. At the same time, another consultee suggested that such approaches might be outside the experience of many trustees.
- 2.3.3 A number of respondents emphasised the importance of having regard to the strength of the employer covenant in determining how appropriate a more “risky” strategy was.
- 2.3.4 The Board had indicated in the consultation document that an adjustment for employer strength might be a feature of any investment risk measure (paragraph 5.3.2). More generally, the Board is sympathetic to the concerns of the majority of consultees that a simple approach based around broad asset classes would be at risk of creating perverse incentives, and potentially fail to offer an improvement in fairness.

Chapter 3 – The Board’s decision on the introduction of an investment risk factor

Chapter summary

This chapter sets out the Board’s initial views on the merits of introducing an investment risk factor to the risk based levy (as set out in the consultation document), summarises responses received, and sets out the Board’s final decision.

3.1 The evidence that the Board has considered

- 3.1.1 The consultation document drew together a range of information, which in combination led the Board to the conclusion that whilst investment risk was distinct from the other risks facing the Pension Protection Fund, introducing an investment risk factor into the risk based levy was unlikely to be appropriate to now.
- 3.1.2 The consultation document showed that different asset classes exhibit different patterns of risk and return, and that the Pension Protection Fund is asymmetrically exposed to the down side risk of investments held by schemes, where schemes are fully funded or close to fully funded. Additionally, it showed that investment risk was not substantially related to either underfunding risk or to insolvency risk, and that it therefore is not being accounted for fully in existing risk factors.
- 3.1.3 It then introduced evidence available from eligible schemes that, as one might expect, there was a strong link between increasing scheme maturity and high bond and gilt asset shares (together with a reduction in equity holdings). There were weaker tendencies for the proportion of gilts and bonds to increase with increasing scheme size and better funding. It also showed trends over time showing a strong movement from UK equities to a more international portfolio and a shift in proportion from equities overall to bonds (but a significant proportion of this appears to be a valuation effect). It was striking that most schemes had broadly similar asset allocations – through there was evidence that some schemes are looking at strategies such as liability driven investment or diversification.
- 3.1.4 The consultation document then introduced evidence that the impact of introducing an investment risk factor into the risk based levy now would be small overall – with a likely redistribution equivalent to only around 3 per cent of the risk based levy. This was felt by the Board to be an impact very considerably too small to justify introducing a risk factor, particularly in view of the allied difficulties around reconciling the principles of simplicity and fairness.

3.2 The Board's consultation questions on its initial conclusions

3.2.1 Although the Board felt able to form a clear view on its likely conclusions based on evidence available to it before the consultation, it was keen to test that evidence through the consultation and gauge the opinions of stakeholders. Accordingly the Board asked questions to test agreement to the propositions that:

- Investment risk was a separable risk factor from those already included in the risk based levy
- the evidence suggested the current differentials in investment risk were low
- And that it would be disproportionate to include a factor reflecting investment risk at this time (and where there was disagreement with the Board's view, how investment risk might be tackled).

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?

3.2.2 There was a consensus amongst consultees that that in principle investment risk could be separated from the existing risks in the risk based levy, though a number of responses included a call for pragmatism or noted the potential tensions between a simple and a fair factor.

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

3.2.3 Two thirds of respondents agreed that impact was currently limited. Those disagreeing with the proposition offered no additional evidence on the overall impact, but suggested that even if the impact was small on average it might be large for individual schemes. One consultee pointed to the Board's own chart (Figure 21 at paragraph 5.2.4) which showed a little under one in 10 of schemes might experience a change in their risk based levy of 10% or more. However, even for those schemes that might experience a larger percentage change in their risk based levy, as the paper noted, this might still not be a large impact in cash terms - since the biggest percentage swings tended to be for schemes that were well funded and secure and whose risk based levy is small as a proportion of their total levy. Indeed, additional analysis for the Board not included in the consultation paper, has suggested that the (10) largest schemes with strongly bond based investment

strategies all have risk based levies that are significantly smaller than their scheme based levy. This point was reinforced by a consultation response from one of those schemes - which challenged the level of cross-subsidy implied by the scheme based levy – but almost silent on whether in assessing risk there should be an investment risk factor.

- 3.2.4 Amongst those agreeing impact was limited currently, some suggested that the position might be subject to substantial change either in the short term, through the spread of Liability Driven investment strategies and hedging, or longer term as the maturity of some schemes increased. Other responses though were strongly supportive of the analysis, for example a scheme that had done their own modelling of investment risks and concluded that “a switch from 80% to 60% equities would not have a particularly significant impact on risk”.

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

- 3.2.5 Two thirds of respondents said that they supported the Board’s initial view that investment risk should not be incorporated as an additional risk factor at present, but that key trends ought to be monitored. A number of different arguments were cited in support:

- Most commonly, that it would be difficult and disproportionately costly to implement (e.g. "The costs of measuring this risk, if a consistent basis could be agreed - itself a non-trivial assumption, would fall hardest on small schemes. It is our view that the existing deficit and sponsor risk components of the risk based levy are more important and should take precedence over investment risk.");
- That any factor would be at risk from financial engineering;
- That the tension between simplicity and fairness was essentially irreconcilable;
- That it might encourage the adoption of a PPF benchmark strategy, rather than trustees adopting strategies appropriate to their scheme;
- That it was inappropriate to encourage a move away from equities and other “risky” assets since these were likely to offer the potential to protect against risks it was difficult to match such as longevity and provided an appropriate way for immature open schemes with a strong employer covenant to be funded at lower cost thereby remaining sustainable; and, related

- That in encouraging a switch from equities to bonds it could further depress gilt yields (which could, in turn, worsen funding).
- 3.2.6 Just under a third of respondents argued that the Board should take account of investment risk, citing a range of reasons. Most commonly it was argued that it would provide a clear incentive to encourage the adoption of lower risk investment strategies in the future. As one consultee argued: “the Board has a role to educate pension schemes on appropriate risk management.”
- 3.2.7 Alongside this, some respondents drew attention to the moral hazard argument that the existence of the PPF “guarantee” meant that a scheme facing a likely insolvency in an underfunded position might take undue risks to try and improve funding to above PPF levels knowing that the downside is covered.
- 3.2.8 In addition, a number of those disagreeing with the Board’s initial conclusion produced arguments that it was unfair not to reward schemes for their low risk, or suggested that the limited dispersion of investment strategies was likely to change in the near future.
- 3.2.9 The Consultation document also asked for suggestions for taking account of investment risk in the levy. This was intended as a challenge to those that disagreed with the Board’s proposition to put forward specific alternatives, though in practice some respondents who do not necessarily disagree used it as an opportunity to suggest how the Board could implement a factor if it wished to at some future point:
- A few respondents suggested requiring all schemes to carry out an (at least) annual Value-at-Risk measurement on their portfolio – generally based on the proposition that the PPF should incentivise de-risking or “appropriate risk management”;
 - An alternative approach was of allowing schemes to volunteer evidence. Thus, where a scheme believed they were low risk, they would produce evidence (most likely in the form of VaR analysis on some approved methodology) in return for a discount on the levy;
 - A number of respondents with an interest in annuity provision have suggested that liabilities that are matched by annuities should be discounted from consideration in the levy.

3.3 The Board's decision

- 3.3.1 The Board has given thought to the points made by consultees. The proposition that the Board should aim to incentivise the adoption of lower risk investment strategies in the future was explicitly considered and rejected in the consultation document - which said the Board did not believe it should form a view on what an appropriate investment strategy is, but merely reflect the risks that those strategies gave rise to - if proportionate to do so (see for example paragraph 7 of the Executive Summary, or paragraph 1.2.5). And KPMG provided persuasive evidence of the limited impact that including a factor would have in current conditions.
- 3.3.2 The Board recognises that a minority of schemes would experience larger changes in their risk based levy – as one consultee noted the consultation document shows a little under one in 10 of schemes might experience a change in their risk based levy of 10% or more. But as noted in paragraph 3.2.3 even those schemes that might experience a larger percentage change in their risk based levy, might still not experience a large impact in cash terms - since the biggest percentage swings tended to be for schemes that were well funded and secure and whose risk based levy is small as a proportion of their total levy.
- 3.3.3 The moral hazard argument was also considered in the consultation document, and it was noted that there was no evidence of this behaviour pattern at present. In any case an investment risk factor would probably offer only a limited protection from such behaviour – since there may be a substantial time lag between the high-risk strategy being adopted and any increased levy for it.
- 3.3.4 The “voluntary incentive” approach would be more proportionate than introducing an across the board requirement to carry out VaR analysis. In terms of simplicity, it has the advantage over a compulsory approach of only increasing complexity for those that choose to pursue certification. While it would offer an opportunity for those with low risk strategies to gain credit for this, it would take no account of schemes posing higher than average risks. It would also increase costs to those who did not provide evidence (as they would pay a larger share of the overall quantum). This could particularly affect smaller schemes for which the cost of such an analysis would be prohibitive. Taken together this means it would not necessarily make the levy fairer overall.
- 3.3.5 Introducing even a voluntary investment risk adjustment would raise complex questions about how to handle a “low risk” portfolio where a scheme was less than fully funded – since as demonstrated by the KPMG analysis such a portfolio may not be truly low risk at all. It would also increase operational complexity, potentially for a relatively limited overall redistribution of the levy. On the other hand, it could help the PPF to gather evidence about what risk management strategies are in

use, potentially paving the way for a full investment risk factor longer term.

- 3.3.6 If a voluntary incentive were to be robust it would probably still require the PPF to specify the methodology followed for the assessment – which could mean that analysis already carried out for some schemes was not acceptable – so whatever approach was suggested would be unlikely to please everyone active in the area. A number of respondents specifically noted that achieving consensus on a measurement methodology was likely to be extremely difficult.
- 3.3.7 Taking these points in combination, it is clear that significant obstacles would have to be overcome before such an approach could be introduced.
- 3.3.8 A number of respondents with an interest in annuity provision have suggested that liabilities that are matched by annuities should be discounted from consideration in the levy. This proposal has some attractions, since if liabilities are bought out they are unlikely to impact the PPF (unless an annuity provider fails). Again there would be complex issues to resolve – including a likely need for changes to regulations. And the treatment of annuities is as at least as much an issue for the scheme based levy as for the risk based levy and so it is suggested that the merits of (and practical issues raised by) discounting liabilities matched by annuities be considered in a subsequent, more general review of the levy.

Chapter 4 – Looking to the future: monitoring the impact of investment risk

Chapter summary

This chapter considers the factors that might operate, over time, to strengthen the case for including investment risk as a factor in the risk based levy, and how key trends might be monitored.

4.1 Introduction & consultation responses

- 4.1.1 The Board has concluded that it should not include investment risk as a factor in the risk based levy in the near future. However, a number of the factors that underlay that decision may be subject to change over time, so the Board proposes to monitor trends that may have a bearing on the importance of investment risk in the longer term.
- 4.1.2 The Board's initial thinking on what it might be useful to monitor, and possible approaches to monitoring was set out in the consultation paper. The Board was interested to receive consultees' comments on how the issue of investment risk should be monitored and asked questions which covered what were the key trends to monitor and how improved monitoring might be accomplished in a way which did not impose disproportionate costs on schemes. Consultees made a number of interesting points:
- 4.1.3 Respondents were overwhelmingly in agreement about the main trends the PPF should be looking to monitor, as being those suggested in the consultation document. A number of consultees suggested the Board should have an increased focus on monitoring the impact of longevity and the need to collect more information.
- 4.1.4 Responses to the consultation document did not offer such a consistent message on how future monitoring of investment patterns and risks might best be carried out. Though a number of respondents suggested developing the Scheme Return, there was also recognition of the Boards concern that this not hinder ease of completion. As one consultee noted there could be a trade off between complexity and speed of response to the scheme return – were it to need increased specialist input. Another noted that information on some aspects of investment risk might be outside of the experience of trustees of smaller schemes. In the Board's view this points to the case for an approach that is, to an extent, differentiated between schemes, though it will inevitably depend in part on developing the Scheme Return. It also needs to be recognised that changes to the Scheme Return may take some time to implement.

4.2 What should the Board do to monitor trends?

- 4.2.1 The Board will continue to monitor the information that all eligible schemes provide about their levels of funding, the assets that they hold and information on other relevant factors such as scheme maturity, through their annual Scheme Return. This, combined with monitoring trends shown by other published information sources, such as the data provided by ONS, Mellon Analytic solutions and NAPF, and monitoring media coverage of pension investment issues, has provided a suitable basis for forming a view about investment risk at this time. However, the Board is conscious that this has only been the case because the balance of evidence appears clear, that assumptions have needed to be made (e.g. that data which applies to all pension schemes, not just eligible schemes, is representative of the position of eligible schemes) and that the position in relation to differentiation in investment strategies is likely to become more complicated over time.
- 4.2.2 Accordingly, through dialogue with the Pensions Regulator and stakeholders, the Board will seek to develop the information provided by the Scheme Return. The current scheme return data set was not designed to provide a comprehensive picture of scheme investment patterns, for example it does not distinguish between different equity classes or between gilts and corporate bonds, nor does it provide reliable information on strategies that are being used to hedge against risks (since they would simply fall into an “other” category – in respect of which there is little guidance as to the information required).
- 4.2.3 By comparison, in other contexts more detailed information is produced for pension schemes. Pension scheme annual accounts are statutorily required² to provide considerably more information about assets held, distinguishing between quoted and unquoted equities, corporate and Government bonds, and assets denominated in sterling and foreign currency, and statements of investment principle may also include more detail. Scheme return information was designed to be a simplification of these, but in practice some schemes have struggled to complete it in a consistent manner. Aligning Scheme Return questions more closely with the information contained elsewhere may simultaneously provide more detailed data for the Board, and at the same time render it easier to complete.
- 4.2.4 It would also be useful to ask a limited number of questions designed to explore the extent to which risk exposures are managed via hedging or other strategies such as diversification. The most attractive approach

² The requirements for all schemes annual reports are set out in the schedule to The Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 and the requirements for a SIP are set out in The Occupational Pension Schemes (Investment) Regulations 2005

to doing this might be to ask questions to develop information on the sensitivity of their funding to changes in interest rates, asset prices and inflation. This, however, would be likely to require a degree of specialist input, and the Board considers that it would only be proportionate to ask for this information from larger schemes.

- 4.2.5 In addition to obtaining information itself, either through the scheme return or on a sample basis, the Board would be interested in exploring the scope to use surveys already carried out by stakeholders.

Chapter 5 - Conclusion

- 5.1.1 In the consultation document, the Board set out its analysis of the case for introducing an investment risk factor, and its initial view that it would not be proportionate to do so now. It also recognised that trends in pension scheme funding and investment strategy could see the case for including an investment risk factor strengthening over time.
- 5.1.2 The majority of consultation responses have been supportive both of the proposition that in principle investment risk is a relevant factor to look at in judging risk, and the practical case for not introducing an investment risk factor now. There was also support for the Board monitoring key trends, and developing its information base in order to do so.
- 5.1.3 Based on the information set out in the consultation document, and the responses of consultees the Board has decided to confirm the decision not to introduce an investment risk factor at this time, but to develop its monitoring capacity. It will seek to do this in a way that does not pose undue burdens on schemes.
- 5.1.4 If monitoring of key trends led the Board to conclude that there was a material change in the balance of arguments about introducing an investment risk factor, the Board would consult again. However, given the uncertainty about the extent to which the key trends identified may have an impact on investment risk the Board does not intend, at this time, to set a date by which the issue will be considered again. It will not be including consideration of an investment risk factor in the forthcoming consultation on the risk based levy for 2008-09.
- 5.1.5 The Board would like to place on record its thanks to those that participated in the consultation exercise.

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