

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

Response from Prudential plc

Introduction

Prudential plc is a leading provider of Bulk Annuity and Risk Management products for Defined Benefit schemes and has long history of involvement with Defined Benefit Scheme administration and investment.

Summary Comments

We agree that the information presented in the report supports the position that it is unlikely to be appropriate to introduce an investment risk factor to the risk based levy at this stage. However we believe that the position should be kept under review.

We also believe that the Board of the Pension Protection Fund should explore the scope for rewarding behaviours by schemes that reduce their level of risk.

It may also be appropriate for the Pension Protection Fund to work with the Pension Regulator to identify any schemes whose investment strategies may represent a disproportionate risk to the Pension Protection Fund.

Answers to specific questions

- 1) Do you agree that the key principles of fairness, simplicity and proportionality should be used by the board to decide on whether to modify the risk based levy?

We agree with these key principles but believe that the Board should also consider the scope for rewarding behaviours that reduce the risk to the Pension Protection Fund. For example, where a scheme annuitises all or part of its pension liabilities it takes a significant step in reducing the risks it faces. We believe this should be recognised and rewarded accordingly.

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

Yes. We believe that asset: liability mismatching represents a significant risk to the ability of schemes to meet their pension obligations.

- 3) 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?

Yes. We believe investment risk represents a significant factor in the ability of schemes to meet their benefit obligations.

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

Yes. Investment risk can also include the quality and duration of the assets held, the asset: liability match, the level of reinvestment risk and the extent to which scheme investments protect against longevity risk.

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

Yes. However it does appear that a number of schemes have an investment strategy that differs significantly from the norm. In addition it is not clear whether the relative quality of the assets held by schemes has been assessed.

There does therefore appear to be the potential for some schemes to represent a disproportionate risk of failure due to their investment strategy. It may be appropriate therefore for the Pension Protection Fund to work with the Pension Regulator to identify these schemes with the aim of reducing the potential risk they represent.

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

Yes, on the basis of the information and analysis outlined in the paper. However we believe the position needs to be kept under review.

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

As indicated in response to question 1, we believe that the Board should examine the scope for rewarding schemes whose investment strategy reduces or removes the risk they pose to the Pension Protection Fund.

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

We believe the Board will also need to take into account the increasing maturity of schemes, and in particular of schemes closed to new members.

We believe the Board also need to take account of whether schemes' investment strategies reflect and/or take account of changes in assumptions regarding mortality and mortality improvements.

There may also be a case for considering whether schemes are holding assets of appropriate quality and duration.

- 9) Are there other considerations that the Board should have regard to ?

These have been outlined elsewhere in this response.

- 10) What should the Board do to monitor relevant trends in an effective but economic way?

We believe the starting point is the monitoring of scheme funding levels and scheme maturity. As funding levels improve and schemes become increasingly mature, the potential downside risk for the Pension Protection Fund from scheme investment strategies increases.

We also believe that the Board needs to monitor the level of longevity risk incurred by schemes and the extent to which this risk is reflected in, or mitigated by, their investment strategies.

In addition we believe the Board needs to monitor smaller schemes where the level of longevity risk posed by one or two individuals with high levels of benefit can be disproportionate. We believe there is a strong case for requiring schemes to annuitise these members' benefits in order to reduce the level of risk for other scheme members.

Prudential plc
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