



The Pension Protection Fund levy Further update

The proposals from the Pension Protection Fund (PPF) for the 2006/07 levy are now virtually complete. At £575 million, the total levy it intends to raise is almost twice the £300 million quoted initially. Nevertheless, for many hard-pressed employers and the trustees of schemes that they sponsor, the final proposals are likely to be welcomed compared to the basis first put forward in July of last year and summarised in Buck Issues 98.

Welcome changes

- the levy scaling factor will be 0.53, whereas many like us were expecting something in excess of 1.0
- the maximum risk-based levy will be 0.5% of a scheme's PPF liabilities, compared to the 3% originally suggested
- it will be possible to have contingent assets or guarantees taken into account to reduce (or possibly even eliminate) the risk-based levy
- in addition (admittedly favouring some and worsening the position for others), there will now be 100 bands for employer insolvency compared to 10 previously, giving a result more focused on each employer's circumstances.

Even now, the basis is not absolutely cast in stone but the PPF suggests that it should enable schemes and sponsoring employers to plan with a reasonable degree of certainty. The final PPF response to consultation is expected on 28 February 2006.

Here, we are focusing on the levy that is intended to fund the provision of benefits, which will incorporate both a scheme-based and a risk-based element. In addition, there will again be an administration levy to cover the infrastructure costs. For the current year, this is based on a per member charge, using a sliding scale dependent upon scheme size (e.g. £1.80 per member for schemes with between 100 and 1000 members).

"The cost of the levies is not a cost caused by the Pension Protection Fund. The cost is caused by the risk that assets of company pension schemes will not be sufficient to pay the pensions promised; the task for the Board has been to price that risk."

Lawrence Churchill, Chairman of the PPF

Scheme-based element

Of the total levy, 20% will be raised from a scheme-based element, determined purely on the value of a scheme's PPF liabilities. Based on the data and estimates now available to the PPF, this element will be calculated as £140 per million pounds of PPF liability, namely:

$$0.014\% \times \text{PPF liabilities}$$

Risk-based element

The remaining 80% of the required levy will be raised based on a formula that takes account of the level of a scheme's PPF liabilities, the degree of underfunding and the perceived risk of employer insolvency during the next 12 months. The basic formula, as before, will be:

$$\text{Underfunding risk} \times \text{PPF assumed probability of employer insolvency} \times 0.8 \times \text{levy scaling factor}$$

Compared to the original proposals, there are a number of changes in the way these factors will be taken into account.

The scheme underfunding – this will still be assessed against a target of 105% of PPF buy-out liabilities, using the valuation assumptions contained in Section 179 of the Pensions Act 2004. This means that a scheme that is, for example, funded to 80% of its PPF liabilities, would be regarded as having an underfunding risk of (105% - 80%) – i.e. 25% of its PPF liabilities. Whereas the previous minimum underfunding risk was 1% of PPF liabilities (because it was assumed that even the most richly-funded scheme had a small risk of calling on the PPF), under the new proposals, schemes above 125% PPF funded will now be assumed to have nil risk, and no risk-based levy will be payable. For schemes between 104% and 125% PPF funded, the risk will be scaled back as follows:

Greater than 104% but not more than 111%	0.75%
Greater than 111% but not more than 118%	0.50%
Greater than 118% but not more than 125%	0.25%
Greater than 125%	NIL

Scheme underfunding risk – assessment of funding level

Unless there is more up-to-date data, the scheme underfunding risk will be assessed by adapting the last minimum funding requirement (MFR) valuation data as submitted to the Pension Regulator on the scheme return form for 2005. The PPF itself will carry out the restatement of liabilities, using a methodology that is explained in some detail in the latest documents. This restatement will inevitably be approximate, as the specific scheme data available to the PPF will be very limited. Broad allowance will be made for the significantly different assumptions prescribed for an MFR valuation compared to a PPF levy valuation (a Section 179 valuation), and asset and liability figures will be notionally updated to 31 March 2006. Standard adjustments will be used to translate full scheme liabilities to a figure that might more closely resemble the lesser PPF benefits. These standard adjustments could often significantly fail to provide an accurate conversion to a scheme's true PPF position (either positively or negatively). In addition, they do not try to take account of any deficit-reduction contributions paid to the scheme since the MFR valuation.

Schemes therefore, have the following options to provide additional data prior to 31 March 2006.

1. Submit an Actuarial Certificate of Deficit-Reduction Contributions

If contributions over and above the cost of ongoing accrual have been paid to the scheme since the effective date of the last valuation (whether on the MFR or PPF valuation basis), the Scheme Actuary may be able to complete such a certificate, showing the amount of additional contributions paid. This amount would then be taken into account as an asset of the scheme when determining the scheme's underfunding risk. It should be noted, however, that no investment gain (or loss) on such contributions would be taken into account.

2. Obtain a PPF levy valuation as at a date subsequent to the last MFR valuation date

Such a valuation could be on the basis of either:

- determining PPF liabilities from scratch as at the effective date, or
- rolling forward liabilities from the last valuation and adjusting to PPF benefits.

The Scheme Actuary would have to certify that these were not undervalued. In either case, the asset values used should be on the basis of audited accounts. The PPF regards it as best practice that such accounts are as at the new effective date of the valuation, but the regulations do allow, if they are not available, the latest such accounts available at that time. (They also allow, if the scheme actuary is satisfied that it is reasonable to do so, the use of audited accounts at a date subsequent to the valuation date.) Valuations not yet submitted would have to have an effective date not earlier than 31 December 2004.

Employer insolvency risk

For a single employer scheme, the insolvency risk factor will be based on the assumed probability of failure for the employer’s actual D&B failure score. Failure scores range from 1 (most likely to fail) to 100, and it is no longer intended to group scores into 10 bands. Since the assumed probability of failure for each of the previously assumed 10 bands was set roughly at the mid-point of the ranges, the new basis will mean an improvement for some, but an increase in the assumed failure probability for others. The table on page 6 provides full details. It should be noted that, under the new proposals, a low rating (equivalent to the failure score) equates to a high insolvency risk (opposite to the original proposals).

For a multi-employer scheme, the default method for assessing the employer insolvency risk will be to look solely at the risk of the largest employer (in terms of the aggregate number of members), as declared on the 2005 scheme return. However, schemes will have the option of submitting details of scheme structure and all the participating employers by 31 March. This will allow an alternative assessment to be made. In a typical non-segregated multi-employer scheme for associated employers, the alternative would be based on the weighted (by number of members) average insolvency risk of all the participating employers. In a true ‘last man standing’ scheme where there is no requirement or option to segregate on cessation of participation, the weighted average insolvency risk would be reduced by applying a factor of 0.9, to recognise that some degree of cross-subsidy exists within the scheme. For 2006/07, the rating used will not be worse than that used in the default method.

Contingent assets

Strong representations were made to the PPF during the initial consultation, that allowance should be made for contingent assets and for the fact that a group of companies may be much stronger than would be apparent from the technical strength of the particular sponsoring employer. As a result, such factors can now be taken into account, subject to their being documented in a standard legal format published by the PPF and meeting other strict criteria. The trustees will be responsible for obtaining legal opinion and certifying to the PPF that the form of agreement providing the contingent asset is legally binding and is in the format required. There are three specific types of contingent support that may be acceptable.

Type A Contingent asset arrangements within a group structure

A direct group company guarantee to the pension scheme (not the sponsoring employer) may be acceptable provided:

- the guaranteeing company is domiciled in an OECD country
- the guarantee will remain in force until all actual or contingent liabilities of the relevant employers to the scheme have been satisfied in full
- the guarantee will remain constant but may be for a fixed amount or cover a specified percentage of the PPF liabilities, or the full buy-out liabilities
- if there is more than one sponsoring employer in the same group, the guarantee will cover the liabilities of all such employers.

A group company guarantee will be treated by the PPF as a way of substituting, to the extent of the guarantee, the insolvency risk of the sponsoring employer with the insolvency risk of the guarantor. This will be achieved by adjusting the scheme assets and hence the scheme-underfunding risk element of the formula. The full amount of the guarantee will not normally be taken into account, but rather the amount of guarantee will be adjusted by a factor of:

$$1 \text{ less } \frac{\text{probability of insolvency of guarantor}}{\text{probability of insolvency of sponsor(s)}}$$

For an overseas-based guarantor, the PPF can provide the probability of insolvency that would be used, if it is given details of its country of domicile and its D&B failure score.

Because it is essentially a reduction of the employer insolvency risk, the allowance will not be permitted to increase the funding to more than 104%, ensuring that such a guarantee can never totally eliminate a levy. A guarantee from a company with an equal or greater risk of insolvency than the sponsor will not improve the risk-based levy calculation. However, neither will it worsen the levy position, thus avoiding the creation of a disincentive to put in place such a guarantee which could still ultimately prove beneficial to the membership.

Where financially strong group companies are not able to provide a suitable guarantee in this way because, for instance, they are not based in an OECD country, they may possibly be able to use their credit strength to facilitate an alternative contingent asset such as a letter of credit.

Type B Contingent assets provided by the sponsoring employer

Security over cash, securities or real estate owned by the sponsoring employer may be made irrevocably to the scheme in the event of the employer's insolvency. In addition to the agreement being in a standard format, other conditions are that:

- the security must remain in force until all actual or contingent liabilities of the relevant employers to the scheme have been satisfied in full
- the assets used will be revalued annually
- the scheme must hold a first priority security interest over the asset
- the asset must be one which the trustees could hold directly under the investment powers of the scheme
- assets will normally be valued at market value except for any real estate occupied by the sponsor or related entities, which will be valued on a 'vacant possession' basis
- securities issued by the sponsor or related parties will not be acceptable.

The contingent asset will again be taken into account by adjusting the scheme assets. No factor will be applied to its value in this instance and there will be no upper cap on the degree to which the underfunding risk of the scheme can be reduced. Consequently, it would be possible to contingently improve funding to above 125% and thus eliminate the obligation for any risk-based levy.

Type C Contingent assets provided by third parties

The third type of contingent asset that can be taken into account is a letter of credit or bank guarantee issued by a financial institution to the pension scheme. Essential criteria are that:

- the issuer must be based in an OECD country and regulated by the FSA or another EU regulator
- the issuer must have a specified minimum credit rating (equivalent to AA- by Standard & Poor's)
- the asset must have a minimum of 12 months to maturity, expiring on 31 March
- if the asset is not replaced or renewed on expiry, the trustees are entitled to call for the cash value of the asset, irrespective of insolvency
- similar ability to demand the face value applies if the issuer's credit rating is no longer of acceptable standard and the issuer cannot find a replacement issuer.

As with Type B, the contingent asset will again be taken into account by adjusting the scheme assets, with no factor applied and no upper cap, thus allowing the possibility of eliminating the obligation for any risk-based levy.

Future reduction in the value of a contingent asset

The PPF generally expects the provision of contingent assets to be long term, although accepts that if the funding position of a scheme has improved, there may be good reasons for trustees to agree to a future reduction in the contingent asset. Consequently, it has set down rules specifying acceptable reductions and will refuse to give any credit for a contingent asset in a future year if its value does not fall within what is acceptable.

Conclusion

It has to be said that the employer D&B failure score is still the most significant factor in determining the risk-based levy, although this is possibly the most difficult element to influence. Certainly anyone considering a financial restructuring, with a view to improving the failure score, should discuss with D&B the relevant timescales that need to be met for actions to impact on the failure score as at 31 March 2006. Timescales are short and, if clients wish to consider reducing their risk-based levy by any of the options above, then prompt action will have to be taken. If they haven't already done so, your Buck Consultants contact will be in touch shortly to discuss action.

One final point; if you do wish to consider possible action and haven't yet obtained your D&B failure score, please do so as soon as possible, as this will provide the framework for ascertaining the best route forward.

D&B Failure Score and Insolvency Risk table

D&B Failure score & Insolvency Risk Band	Assumed probability of insolvency (%)	Original proposed banding and assumed failure probability	D&B Failure score & Insolvency Risk Band	Assumed probability of insolvency (%)	Original proposed banding and assumed failure probability
100	0.0740	Band 1 0.13	50	1.5800	Band 4 1.70 continued
99	0.1360		49	1.5945	
98	0.1804	Band 2 0.60	48	1.6474	
97	0.2216		47	1.6742	
96	0.2621		46	1.6800	
95	0.3033		45	1.6900	
94	0.3456		44	1.7077	
93	0.3858		43	1.7756	
92	0.4286		42	1.8367	
91	0.4714		41	1.9054	
90	0.5133		40	1.9200	
89	0.5548		39	1.9400	
88	0.5943		38	1.9590	
87	0.6370		Band 5 2.35	37	2.0344
86	0.6827			36	2.0570
85	0.7241			35	2.0898
84	0.7619			34	2.0990
83	0.8008			33	2.1010
82	0.8351			32	2.1120
81	0.8744			31	2.1190
80	0.9047	30		2.1240	
79	0.9313	29		2.1350	
78	0.9609	28		2.1460	
77	1.0050	Band 3 1.25	27	2.1560	
76	1.0384		26	2.2344	
75	1.0645		25	2.2850	
74	1.1119		24	2.3853	
73	1.1300		23	2.4950	
72	1.1566		22	2.5844	
71	1.1911		21	2.6845	
70	1.2112		20	2.8018	
69	1.2317		19	2.9446	
68	1.2400		18	3.0801	
67	1.2580	17	3.1876	Band 6 3.40	
66	1.2800	16	3.3358		
65	1.3044	15	3.5210		
64	1.3534	14	3.7079		
63	1.3891	13	3.9115	Band 7 4.75	
62	1.4123	12	4.1610		
61	1.4370	11	4.3711		
60	1.4620	10	4.7612		
59	1.4945	9	5.0279	Band 8 6.60	
58	1.4950	8	5.4906		
57	1.4960	7	6.1536	Band 9 9.75	
56	1.4970	6	7.0235		
55	1.4980	5	8.4751	Band 10 15.0	
54	1.5384	4	11.0298		
53	1.5500	3	15.02878*		
52	1.5650	2	20.7261*		
51	1.5700	1	33.7973*		

* The assumed probability of insolvency for bands 1, 2 and 3 will be capped at 15%.

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