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PPF NEWS – RISK-BASED LEVY

1 INTRODUCTION

On 12 July 2005, the Board of the Pension Protection Fund (PPF) published its proposals for the introduction of the risk-based levy for all schemes potentially eligible for the PPF.[1] The risk-based levy will apply from the financial year 2006/7. As the Pensions Act 2004 (PA 2004) makes provision for at least 80% of the PPF levy to be risk-based, this information is crucial for trustees and employers of eligible schemes.

The consultation period closes on 4 October 2005.

A copy of the consultation paper can be found at:
http://www.pensionprotectionfund.org.uk/rbl_consultation.pdf

2 FUNDING THE PPF

The PPF was established in April 2005 in order to provide compensation for members of eligible schemes where benefits cannot be paid in full because: (a) there has been an insolvency event in relation to the employer; and (b) the scheme is underfunded on winding-up. Compensation is funded partly by the assets transferred from the schemes for which the PPF assumes responsibility and partly by an annual levy raised from potentially eligible schemes.

In 2005/6 the main source of PPF funding is drawn from the initial flat-rate levy,[2] but as a flat-rate levy is perceived as unfair on schemes which pose little risk to the PPF, it was always part of the game plan to introduce a risk-based levy which recognises differences between schemes.

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[1] Broadly, defined benefit occupational pension schemes

[2] For details of the current levy, please see Sackers Extra Alert "First PPF Levies Announced" dated 3 February 2005

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3 SETTING THE LEVY

In setting the risk-based levy, the differences or factors which the PPF Board (the Board) are required to take into account are[3]:

- the level of scheme underfunding (see section 4); and
- the risk of insolvency of the employer (see section 5).

But the Board may also take into account other factors. The Board suggests in the consultation document that further down the track it will include asset allocation as a factor, the feeling being that inclusion of this in the 2006/7 calculation would "place too much of an additional burden on schemes".

In assessing the above factors the Board indicates that it will be informed by the following "core principles":

- Fairness – "reflecting the level of risk" the scheme poses to the PPF
- Simplicity – "effective and simple mechanisms and solutions"
- Proportionality – "ensuring that the levy is fair and proportionate between schemes".

4 ASSESSING SCHEME FUNDING

A scheme's funding level will be measured by taking account of the difference between the value of its assets and its PPF liabilities. To enable an accurate comparison to be made, PA 2004 requires all eligible schemes to conduct a valuation in a specific way (this is known as a "section 179 valuation"). But schemes should be aware that the Board plans to make two key changes:

[3] PA 2004, section 175

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- Firstly, the Board proposes to scale up liabilities by 5% to reflect the fact that the Board is exposed to the volatility of scheme investments during the period between an insolvency event and the date on which the scheme's assets and PPF liabilities are transferred to the PPF.
- Secondly, because "all schemes present some risk" to the PPF, even those schemes which are funded at 104% or over on the above basis will be assumed to have a 1% underfunding level.

Current proposals give schemes until April 2008 to conduct their section 179 valuations (and then another year to give the information to the Board) but "to promote fairness and the use of best evidence in future years" the Board proposes a legislative change to require all eligible schemes to provide a section 179 valuation by 31 December 2006. In the transitional period before a section 179 valuation is available, the Board will adapt the results of another available valuation (for example, MFR or FRS 17) to estimate the funding level.

5 CALCULATING INSOLVENCY RISK

The Board proposes to measure the insolvency risk of sponsoring employers of eligible schemes by using a market solution provided by a credit rating agency, credit scoring institution or credit insurer. In tackling the problem this way, the Board hopes to enable all parties to "benefit from economies of scale".

The PPF will use this information to estimate the probability of the sponsoring employer's insolvency over a 12 month period. A banding approach will be established for this probability which aims to both mitigate the impact of any short-term volatility in insolvency risk and to reduce the effect of discrepancies between assessments made by different credit risk specialists.

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6 TWEAKING THE FIGURES

The results of applying the risk factors set out above will determine the levy charge to each scheme. However, eligible schemes should note that the figures will be tweaked in specific circumstances.

- The Board will take into account the structure of multi-employer schemes and hybrid schemes.
- If the sponsoring employer is an overseas company but with a UK subsidiary, the Board plans to assess the insolvency risk of the subsidiary.
- The levy will be subject to an overall cap – designed so that an individual scheme will never pay more than a fixed percentage of its PPF liabilities as a levy.
- But a worrying omission from the consultation is an indication of whether the Board will take into account other forms of security for scheme deficits: such as the trustees having status as preferential creditors or having an escrow account in place.

7 HOW MUCH?

All of the above methodology is meaningless unless the sums required to fund the PPF are known.

When PA 2004 was first published in February 2004, the Government estimated that the PPF levy would need to raise £300 million in the year 2005/6. The current levy is designed to raise only half that sum. The Board will be doing modelling work to determine its levy estimate for 2006/7, and will publish the estimate by 30 November 2005. Further consultation will follow in its wake.

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