

Technical Briefing

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Risk Based Levy Update

On 16 December, the Board of the Pensions Protection Fund ('PPF') issued an update to its consultation on the Risk-Based Levy ('RBL'). It also set out its proposals on the way in which the Scheme Based Levy ('SBL') would be calculated.

The PPF has changed the formula for calculating both the RBL and the SBL and this update describes both of these in full. The PPF has also confirmed a scaling factor of 53% is to apply for 2006/07.

The PPF has invited comments on these new measures but has stated that it expects the final version to be more or less unchanged.

Final proposals for the period 2006/07

$$RBL = \frac{\text{Insolvency Risk (IR)}}{\text{Risk (IR)}} \times \frac{\text{Underfunding Risk (U)}}{\text{Risk (U)}} \times \frac{\text{RBL \%age}}{\text{RBL \%age}} \times \frac{\text{Scaling factor}}{\text{Scaling factor}}$$

$$\text{or } ?\% \times \frac{\text{Value of PPF Liabilities}}{\text{Liabilities}} \text{ if less}$$

where

IR is the probability of employer insolvency (see table overleaf)
U is 105% of PPF liability value minus asset value (but see below)
RBL %age is 80% for 2006/07
Scaling factor is 53% for 2006/07

$$SBL = \text{Multiplier} \times \frac{\text{Value of PPF Liabilities}}{\text{Liabilities}}$$

where

the multiplier for 2006/07 is 0.014%

Overview

The PPF intends to raise a total of £575 million in levies for 2006/07. Of this amount, £460 million (i.e. 80%) would be raised by the RBL and £115 million (i.e. 20%) by the SBL. The PPF has adjusted the formula for calculating the RBL by basing the underfunding risk on the size of a scheme's PPF deficit instead of its total PPF liability value.

For 2006/07 the RBL is subject to an overall cap of _% of the scheme's total PPF liability value, which will limit the impact on weak companies and those companies with poorly funded schemes. In addition, special contributions made after the valuation date and contingent assets can be allowed for if accompanied by the appropriate certification.

The PPF has also introduced a modified approach for multi-employer schemes, both in sectionalised and non-sectionalised form. This is designed to tackle the potential risk of the ensuing RBL failing to reflect the combined insolvency risk and combined underfunding risk.

The PPF has also confirmed its intention to include asset allocation as a further risk factor with the calculation of the RBL, perhaps from April 2007. In this event, schemes that pursue a more bond-based investment strategy might expect to pay a lower RBL than those investing predominantly in equities.

The PPF has decided to base the SBL solely on the size of the PPF liabilities for 2006/07 and not use additional factors such as a scheme's membership numbers, pensionable salary roll or any other factors it deemed appropriate.

Insolvency risk

The PPF has kept its original proposal of using an independent assessment of each company's risk of insolvency within the RBL calculation. However, it



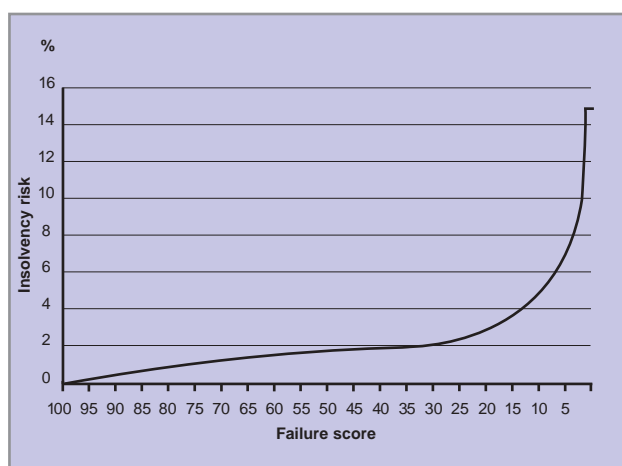
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has followed industry requests to increase the number of risk bands thus reflecting the wider range of risks posed by each company and smoothing out some of the steps in the RBL calculation.

The PPF has appointed Dun & Bradstreet ('D&B') to undertake the risk assessment of each company for 2006/07. The assessments will be made as at 31 March 2006 and based on the information provided to the Pensions Regulator on the Scheme Return forms issued recently.

The risk assessment made by D&B will produce a Failure Score of between 1 and 100, with higher scores representing lower probabilities of insolvency over the following year. Each Failure Score equates to a particular Insolvency Risk, which is used within the calculation of the RBL.

The graph below shows the relationship between Insolvency Risk and Failure Score and a table of these figures is shown at the end of this Technical Briefing.



The PPF will be informing schemes and their sponsoring companies of their Failure Score at the time they confirm the RBL and SBL to be paid from April 2006. However, companies can gain an indication of the size of their levies beforehand by applying directly to D&B to obtain a Failure Score rating report for a cost of around £25 plus VAT.

Upon receipt of the levy notice, companies have 28 days in which to appeal against D&B's Failure Score. The appeals procedure is set out in the PPF's update document and is geared mainly towards ensuring accurate data has been used.

Underfunding Risk

The PPF initially proposed to measure underfunding risk by reference to a scheme's total PPF liabilities, an approach that many commentators criticised given that the risk is proportional to the size of the scheme's deficit on the PPF basis and not the total liabilities. The PPF has responded by basing the RBL on the size of the PPF deficit but has included a 5% loading on the value of the PPF liabilities as a margin of prudence.

An assumed funding level is used for those schemes whose PPF funding level is 104% or above. The table opposite shows the assumed level of underfunding for PPF levels of 104% and above.

Pension Protection Fund funding level %	Assumed level of underfunding for key formula %
104	1.00
Over 104 to 111	0.75
Over 111 to 118	0.50
Over 118 to 125	0.25
Over 125	0.00

PPF Liabilities

Both the RBL and the SBL are based on the value of the scheme's PPF liabilities. This value is found by assessing the benefits under the scheme that would be payable were it to fall into the PPF and using assumptions prescribed by the PPF, which are a proxy to a buyout basis. This type of valuation is called a section 179 valuation.

Schemes that have obtained a section 179 valuation and submitted the formal certificates to the PPF by



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31 December 2005 will receive a levy demand from the PPF based on the results on that valuation. In all other cases, the levy calculation will be based on the scheme's most recent MFR results, adjusted in line with the PPF's stated methodology.

Current regulations require schemes to obtain their first section 179 valuation using an effective date no later than April 2008 and no earlier than November 2005. It is expected most schemes will obtain their first section 179 valuation at the same time as the triennial valuation falling within that period, especially given that it must be based on an audited asset value.

Example Calculation

A company is given a Failure Score of 55. Like most other schemes, the company's scheme has not yet obtained a section 179 valuation but using the PPF's methodology, the most recent MFR valuation was adjusted to show a PPF liability of £5.0 million compared with assets of £3.0 million.

In this situation, the RBL is £14,291, based on an Insolvency Risk of 1.498%, Underfunding of £2.25 million (= $1.05 \times £5.0m - £3.0m$) times 80% times 53%, which is lower than ___% of the PPF liability (£25,000). Further, the SBL is £700, equal to 0.014% times £5.0 million giving a total PPF levy payment of £14,991.

Further Information

The PPF's press summary can be found on its website at:

<http://www.pensionprotectionfund.org.uk/news-details.htm?id=4488>

The PPF's update to its consultation on the RBL and SBL can be downloaded from:

http://www.pensionprotectionfund.org.uk/rbl_dec_05.pdf

The PPF's original consultation document on the RBL can be found at:

http://www.pensionprotectionfund.org.uk/rbl_consultation.pdf

CPRM Commentary

The PPF has addressed the main concerns raised in the consultation process in that (i) the RBL is now sensibility based on the PPF deficit instead of the PPF liabilities, and (ii) the increase in insolvency risk bands prevents small differences in the assessment creating large differences in the RBL amount. However, it remains to be seen whether or not smaller companies can absorb the significant increase in levy costs together with the increase in contributions brought on by the new scheme funding regime.

If you would like further advice on this or other pension issues, please contact either Walker Yule or Philip Wheeler in Edinburgh (0131 220 8247) or Simon Chrystal in Newcastle (0191 233 9408).



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Failure Score & Insolvency Risk Table

D&B Failure Score	Insolvency Risk Band	Insolvency Risk	D&B Failure Score	Insolvency Risk Band	Insolvency Risk	D&B Failure Score	Insolvency Risk Band	Insolvency Risk
100	100	0.0740%	66	66	1.2800%	32	32	2.1120%
99	99	0.1360%	65	65	1.3044%	31	31	2.1190%
98	98	0.1804%	64	64	1.3534%	30	30	2.1240%
97	97	0.2216%	63	63	1.3891%	29	29	2.1350%
96	96	0.2621%	62	62	1.4123%	28	28	2.1460%
95	95	0.3033%	61	61	1.4370%	27	27	2.1560%
94	94	0.3456%	60	60	1.4620%	26	26	2.2344%
93	93	0.3858%	59	59	1.4945%	25	25	2.2850%
92	92	0.4286%	58	58	1.4950%	24	24	2.3853%
91	91	0.4714%	57	57	1.4960%	23	23	2.4950%
90	90	0.5133%	56	56	1.4970%	22	22	2.5844%
89	89	0.5548%	55	55	1.4980%	21	21	2.6845%
88	88	0.5943%	54	54	1.5384%	20	20	2.8018%
87	87	0.6370%	53	53	1.5500%	19	19	2.9446%
86	86	0.6827%	52	52	1.5650%	18	18	3.0801%
85	85	0.7241%	51	51	1.5700%	17	17	3.1876%
84	84	0.7619%	50	50	1.5800%	16	16	3.3358%
83	83	0.8008%	49	49	1.5945%	15	15	3.5210%
82	82	0.8351%	48	48	1.6474%	14	14	3.7079%
81	81	0.8744%	47	47	1.6742%	13	13	3.9115%
80	80	0.9047%	46	46	1.6800%	12	12	4.1610%
79	79	0.9313%	45	45	1.6900%	11	11	4.3711%
78	78	0.9609%	44	44	1.7077%	10	10	4.7612%
77	77	1.0050%	43	43	1.7756%	9	9	5.0279%
76	76	1.0384%	42	42	1.8367%	8	8	5.4906%
75	75	1.0645%	41	41	1.9054%	7	7	6.1536%
74	74	1.1119%	40	40	1.9200%	6	6	7.0235%
73	73	1.1300%	39	39	1.9400%	5	5	8.4751%
72	72	1.1566%	38	38	1.9590%	4	4	11.0298%
71	71	1.1911%	37	37	2.0344%	3	3	15.0000%
70	70	1.2112%	36	36	2.0570%	2	2	15.0000%
69	69	1.2317%	35	35	2.0898%	1	1	15.0000%
68	68	1.2400%	34	34	2.0990%			
67	67	1.2580%	33	33	2.1010%			

Insolvency Risks have been capped at 15%, as indicated by figures in red.