

Technical Briefing

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The 2012/13 Pension Protection Levy Consultation

Introduction

The Board to the Pension Protection Fund (PPF) has now published its consultation document on the 2012/13 PPF levy. The consultation sets out the details of the proposed methodology for calculating the levy for 2012/13 and beyond. It is implementing the changes to the design of the pension protection levy as announced in the PPF's "A New Framework: Policy Statement". We previously covered the new framework in our Technical Briefings 39 and 50.

The PPF has estimated that it needs to raise £550 million in each of the three years starting from 2012/13. This compares with the target of £600 million for 2011/12. The PPF anticipates this amount will support its steady progress towards its long-term funding objective.

Measurement Date

The PPF will calculate the levy for a scheme using information from the scheme return submitted on its "Exchange" system by 5pm on 30 March 2012.

Measure of Underfunding Risk

Volatility in asset and liability values caused by movements in financial markets has played a large part in the sharp changes in levies that some schemes have experienced recently.

The PPF will now smooth assets and liabilities, as reported on Exchange, using their roll forward mechanism. Instead of using index and yield values at a single date (e.g. 31 March), the PPF will use a five-year averaged value so that sharp short-term movements in financial markets will not

be reflected in the measures of scheme's liabilities and underfunding risk.

Investment Risk

The PPF has introduced a new risk factor, investment risk, into the risk-based levy to reflect the differences in risk posed to the PPF by the investment strategies of eligible pension schemes. The current formulae include a 36% loading on the liabilities, which in part reflects the potential funding volatility from investment risk, but fails to discriminate between different levels of investment risk and their impact on the volatility of funding. The PPF will measure investment risk by taking the level of scheme underfunding after applying stresses to the assets and liabilities of schemes.

The vast majority of schemes (those with PPF liabilities under £1.5 billion) will use a prescribed approach to calculate stressed assets. The PPF will use the asset allocation data, currently reported on Exchange as part of the annual scheme return, to calculate stressed assets.

This approach will result in a lower levy for schemes with a defensive investment strategy and a higher levy for schemes with a more aggressive strategy.

The Levy Calculation

The PPF proposes using the new methodology to calculate the 2012/13 levy. The calculation parameters will be fixed for three years (other than in exceptional circumstances). The PPF will transform section 179 valuations to 31 March 2012. The levy continues to consist of two components, namely the Scheme-based Levy (SBL) and the





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Risk-based Levy (RBL) as described below:

1. **SBL** = Smoothed Liabilities (UL) x Scheme-based levy multiplier (**SLM**)

2. **RBL** = Underfunding (U) x Insolvency rate (IR) x Levy scaling factor (**LSF**)

The PPF will determine a scheme's Assets, Liabilities, Unstressed Assets and Unstressed Liabilities) as at 31 March 2012. U is then the greater of:

- (i) the shortfall (if any) between the Assets and the Liabilities and
- (ii) the shortfall (if any) between the Unstressed Assets and the Unstressed Liabilities.

Where neither shortfall exists, U shall be taken as zero.

2012/13 Factors

The consultation paper has stated that the scheme-based levy multiplier, SLM, should be set at 0.000085, and the levy scaling factor, LSF, at 0.89.

The insolvency rate is determined from the following table of levy bands:

Band	Rate	Employer Failure Score
1	0.0018	100-99
2	0.0028	98-96
3	0.0044	95-92
4	0.0069	91-87
5	0.0110	86-73
6	0.0160	72-66
7	0.0201	65-46
8	0.0260	45-38
9	0.0306	37-30
10	0.0400	29-0

The Employer Failure Score will be calculated as the average of the Employer's D&B failure scores at the end of each month (last working day) from April 2011 to March 2012. The insolvency probabilities range from 0.18% to 4.00% such that the weakest sponsoring employer pays more than 20 times that of the strongest sponsoring employer.

The PPF proposes to cap the overall Risk-based levy for 2012/13 at 0.75% of the Smoothed Liabilities.

Summary Comparison of Current and New Formulae

The following table summarises the differences between the new method and the previous method.



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Feature	Current Formulae	New Formulae
Scaling factor (LSF) calculation	The LSF varies, the total amount estimated to be collected is fixed	The LSF is fixed for 3 years and the total amount collected can float
Measurement of funding	Based upon point-in-time values of assets and liabilities	Assets and liabilities smoothed using total return indices over the five years prior to the levy year
Investment risk factor	There is no allowance for scheme specific level of investment risk but liability is increased by the same margin (currently 36%)	Investment risk is measured on an individual scheme basis and allowed for in the levy formula by measuring level of underfunding as the difference between stressed assets and liabilities
Insolvency risk	Measured by 100 Assumed Insolvency Probabilities ranging from 0.03% to 55% but capped at 3%	Measured by levy rates associated with 10 levy bands. The levy rates range from 0.18% to 4%
Scheme-Based-Levy (SBL)	Is currently calculated as a fixed proportion of the liability in order to represent 20% of the total levy	Is calculated as a fixed proportion of the liability and designed to cover the cost of capping. No proportion of the total levy is targeted but it must represent less than 20% and is estimated to represent around 10% of the total levy

Certification for Levy Reduction

There continue to be two main methods available to pension schemes and their sponsors to reduce levies. This can be done by submitting either an actuarial certificate for deficit reduction contributions (DRC) or a contingent asset certificate.

Schemes will receive immediate and full credit for DRCs that have been made up to 31 March 2012 and appropriately certified on the Exchange system by 5pm on 10 April 2012.

Contingent asset certification

Any certificates submitted for the 2012/13 levy year will need to be renewed if these contingent assets

are still appropriate this year. The contingent asset must result from an arrangement which becomes effective no later than 1 April 2012 and any certification or re-certification must be submitted by 5pm on 30 March 2012.

cprm commentary

At **cprm**, we welcome the increase in the number of insolvency rating bands to reduce the “cliff edge” effect as highlighted in Technical Briefing 50. There will inevitably be winners and losers under the new arrangements. The PPF expects poorly funded schemes with strong employers to shoulder the biggest increase.

Whilst the new levy formulae shift the emphasis from insolvency risk to funding and investment



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risks, and also provides levy payers with greater certainty to financial planning, we continue to have some reservations about the mechanics behind the revised framework:

- Although the use of smoothing in the underfunding position and the D&B Failure Scores should lead to greater certainty for levy payers it will also reduce the impact of an improved underfunding position or a stronger sponsor simply due to such averaging;
- The use of stress-testing to take into account a scheme's actual asset allocation could unintentionally influence trustees' investment policy to reduce levies
- There remains concern that there could be a significant "correction" jump every three years if the PPF has either over or under-estimated levy receipts. This could potentially lead to greater volatility affecting mid to longer-term financial planning.

We are pleased the PPF proposed methodology is largely as expected. We welcome that the PPF target for the 2012/13 levy (and the target for the

following two years) has reduced to £550 million from last year's £600 million target. All other things being equal, since the aggregate PPF levy has reduced by 8% then, whilst the distribution of levies may not be uniform between schemes, this would broadly suggest that PPF levies should generally be lower than they were last year. This is very dependent upon individual scheme and sponsoring employer circumstances, however.

The consultation period will close on 2 November 2011. The PPF will publish the final determination by the end of 2011. From past experience, we expect little or no change from the draft determination. When the final determination is released, it will be possible to estimate the levy due for 2012/13.

Please contact your usual **cprm** adviser if you would like any additional information, or to consider submitting a deficit reduction contribution certificate or a contingent asset certificate in advance of the respective deadlines set out above.

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