Technical Briefing

No. 28

Consultation on the Future Development of the Pensions Protection Fund Levy

Introduction

The Board of The Pensions Protection Fund (PPF) has recently published a consultation paper outlining its views on the development of the levy.

The main objective of the proposals is to progress from the current short term assessment of risk and balance the levy between recognising short term and long term factors. The proposals also outline various changes to the details of the calculations and in particular a reference to how scheme assets are invested.

The aggregate levy that the PPF proposes to gather will remain unchanged as will some of the steps to minimise levies like deficit reduction contributions and contingent assets.

Comments on the proposals are invited by the 13th of February 2008 and it is expected that, after consideration of comments, the revised levy approach will be effective for the 2011/12 year onwards.

Issues with the Current Formula

The aggregate levy the PPF aims to raise from all schemes has been set at £675M at April 2008 and is expected to increase in line with wage inflation (and hence will be £700M for the 2009/10 year). This, of course, may be subject to review if current economic conditions significantly alter the solvency of the PPF itself.

The format of the current levy is set out in detail in Technical Briefing 23. The levy is presently gathered via a combination of a scheme based and risk based levy. The scheme based levy is a level percentage of the PPF liabilities (via a section 179 valuation). The risk based levy (RBL) is determined from the following formula:

RBL = Insolvency Risk (P) * Underfunding Risk (U) * Scaling Factor * RBL Percentage

The PPF currently aims to recoup 80% of the aggregate levy through the risk based element of the levy and the balancing 20% from the scheme based levy.

The main concern that the PPF has raised regarding the current risk based formula is that it is too focused on short term risk. Indeed the main allowance for the risk of corporate failure in the existing formula is from an assessed probability of insolvency in the next 12 months only. Whilst long term risk is allowed for in the aggregate level of the levy it is not allowed for in the formula that determines the levy for individual schemes.

One simplistic illustration of this is the case of a very solvent and strong company. Whilst a correct view might very well be that such a company presents a limited risk of insolvency in the short term, over the longer term much can change. Of the various future outcomes for that business some outcomes will result in a deterioration of its fortunes, perhaps severely, into the long term. Hence the flaw in only referring to a short term view, and indeed the probability of insolvency in just a 12 month period, is that no allowance is made for potentially reducing security over time. The reverse is true of a weaker employer who, if they survive the next few years, might be expected to grow stronger over time.

No. 28

The Proposed Formula

The main proposal is to consider two elements to the risk based levy formula:

RBL = Rate of Short Term Risk (c) * Short Term Insolvency Probability (U) * Short Term Underfunding (P)

+ Rate of Long Term Risk (w) * Long Term Insolvency Probability (Q) * Long Term Underfunding (V)

The short term element of the formula will be akin to the existing risk based formula and will consider a 12 month probability of insolvency derived from the same Dun & Bradstreet failure scores as presently used. The long term element of the formula will be determined from a 5 year insolvency probability. The full details of this are not yet available but is expected that such probabilities may be determined from the 1 year short term probabilities.

Assessment of investment risk

To make a broad allowance for the risk from the volatility of assets in the current formula, the underfunding is assessed as liabilities, increased by a loading (of typically 121%), less the assets. The new proposal is that underfunding is still fundamentally the difference between liabilities and assets but instead of loading up the liabilities, the assets are written down by an amount which reflects more closely the actual investment risk implied by the types of assets held.

The details of the allowance for investment risk are complex but will essentially compare the actual assets of a scheme with a notional matching portfolio. Typically the greater a scheme departs from a bonds, or fixed interest, based strategy the greater will be the assessed investment risk. In turn, the greater the assessed risk, the greater the asset write down and hence underfunding in the levy calculation.

Whilst schemes investing in equity type assets will expect a higher levy than those following a bond based strategy, the PPF does not believe that their proposals will change investment strategies. In short, the PPF maintains that the differences in levies will be outweighed by the reduction in expected returns from moving away from an equity based investment strategy.

Other changes

The consultation principally addresses the risk based formula, but a scheme based element will remain. There are however proposals to increase the element of aggregate levy attributed to the risk element from 80% to 90%.

Specific points that are not proposed to change are the various mechanisms such as deficit reduction contributions, contingent assets and guarantees that can be used to mitigate levies.

Who will this affect?

The PPF hopes that the proposed formula will lead to a fairer distribution of the levy between the various eligible schemes and companies. Principally by reflecting long term risk more directly and also allowing for investment risk. In reality some of the largest schemes, backed by some of the biggest (and perhaps most solvent) UK business, will pay a greater levy as their longer term risk will be more directly considered. What will be a relatively small increase in their levies, compared to the schemes themselves, will make a not insignificant (£130M) difference to the aggregate levy gathered.

No. 28

Conversely smaller schemes backed by weaker companies may see a reduction in their levy. The PPF states that such reductions may be significant in the context of the size of those schemes.

It is also expected that the proposals will reduce volatility in the levy from year to year, although this will depend on market conditions. One point that will be addressed is the tendency for the levy to be very sensitive to the Dun & Bradstreet scoring for companies where this is close to 100.

Commentary

Inevitably with any changes to the formula, where the aggregate levy remains fixed, there will be winners and losers. The theoretical flaw of the current formula and its limited recognition of long term risks is a welcome change.

This will benefit some of the smallest schemes that have struggled with the existing levy format. Such schemes, and the corresponding employers, might wonder why more could not be done to ease their circumstances where the existing levy is impacting heavily on funding and contributions. Larger schemes, and the corresponding companies, might well argue in the other direction pointing out that there is no reason why they should cross subsidise on the basis of scale (as a proxy for employer strength).

Whilst there has always been a cap on the levy contribution there is no suggestion in the consultation of a minimum collar on the level of contributions. This might have been a simplistic mechanism to ensure all schemes make a levy contribution in excess of the scheme based element. Another aspect of the redistribution debate is increasing the risk based and scheme based split to 90/10 from 80/20. Is this correct or going too far, or conversely would a lower risk based element such as 70/30 be fairer?

Having rejected an allowance for investment risk in the levy formula only in 2007 it is perhaps surprising that this is now proposed by the PPF for the new levy. The risks posed by investment decisions are of course undeniable. The final details of asset write downs, to determine underfunding, by following an equity backed strategy will be crucial. Ultimately the last thing the PPF wishes is for schemes to abandon traditionally successful investment strategies resulting in a long term erosion of funding positions.

Participation in the Consultation

You can participate in the consultation directly to the PPF at their normal address *www.pensionprotectionfund.org.uk* by the 13th of February. Alternatively if you submit any comments to CPRM by the 6th of February we will include those with our own submission.

January 2009