Technical Briefing
No. 50

PPF proposals for new levy formulae from 2012/13

Introduction

As advised in **cprm**'s Technical Briefing 39, the Pension Protection Fund (PPF) intends to introduce new long-term formulae for calculating future levies with the aim of being:

- Simpler to calculate, leading to more predictable and stable levy bills; and
- Increasing the focus on those factors which the levy payer can control such as funding levels and investment risk with less emphasis on insolvency risk.

This Technical Briefing will summarise the PPF's proposals, made in conjunction with a steering group of industry figures, which are intended to be used in the calculation of levies from 2012/13 onwards to achieve the PPF's goal of being financially self-sufficient by 2030.

Change in Measurement Date

The measurement date for the levy calculations will no longer lag the levy period by a year, as at present. This technical change will give schemes more flexibility and control of the factors that can influence the levy and should also mean that levies are based on more up to date information and therefore remove some of the existing cross-subsidies.

Fixing Parameters for Three Years

In a change in approach, the PPF now intends to fix the levy rules and parameters for three years rather than determining a scaling factor each year. By fixing the parameters for three years the PPF hopes to provide levy payers with greater predictability of short-term levies and also greater transparency so that changes in levy amounts during the triennial-cycle would only reflect a change in the perceived risk posed by a scheme to the PPF.

This change in methodology could potentially expose the PPF to greater uncertainty in its levy collection if, for example, more than anticipated risk-mitigation action was taken by the PPF universe of schemes and sponsors. The PPF do, however, reserve the right to review the levy parameters under exceptional circumstances to ensure that it raises the necessary amounts.

The Scheme-based Levy

The current Scheme-based levy (SBL) contributes 20% to the total PPF levy. The new proposals allow for the SBL levy component to gradually reduce to 10% after the first few years. This will increase the Risk-Based levy (RBL) component and reduce the level of cross-subsidy between well-funded schemes with strong employers and poorly funded schemes with weaker employers.

The Risk-based Levy

The proposed Risk-based levy will still be based on the perceived risk posed to the PPF but with a greater emphasis on funding levels and investment risk and less emphasis on employer insolvency risk, all of which are discussed in the following three sections. The new formulae, based on a smoothed underfunding risk, would still retain a RBL cap to protect the most vulnerable 10% of schemes in the PPF universe.

No. 50

1. Measure of Underfunding Risk

The PPF intend to look at an estimate of a scheme's "smoothed" funding position averaged over five years, rather than at a specific point in time (typically 31 March) each year, by introducing the use of averaging of market indices in their roll-forward methodology. The PPF expect to smooth-out market movements in asset values and the yields used to estimate liabilities which should lead to a more predictable level of Underfunding risk (U).

2. Investment Risk

As mentioned in Technical Briefing 39, the PPF also proposes to incorporate an allowance for the investment risk that a potentially volatile strategy might pose. The PPF intend to "stress" measure how a scheme's funding level would vary under certain market scenarios including, for example, a fall in stock markets or changes to interest rates. This in turn will allow for a scheme's levy formulae to be dependent on its level of perceived investment risk.

This will result in a lower levy for schemes with a defensive investment strategy and a higher levy for schemes with a more aggressive strategy. This does raise the question of whether scheme's will factor this into setting their strategy given the long track record that some schemes have of successfully investing in equity markets.

3. Measure of Assumed Probability of Insolvency

The PPF also proposes to reduce the existing 100 failure scores to just 6 bands to be more in line with the granularity of standard credit rating systems and thereby reducing the sensitivity of the RBL to the sponsoring employer's perceived risk of default, as measured by Dun & Bradstreet (D&B). An indication of the new Levy Rates are shown in the following table:

PPF Band	D&B Failure Score Range	Levy Rate (%)	D&B Failure Score*
1	100-97	0.20	94
2	96-90	0.50	79
3	89-69	1.10	57
4	68-42	1.60	42
5	41-6	4.00	12
6	5-1	4.00	12

*This is the D&B Failure Score on the current basis that equates to the same Levy Rate.

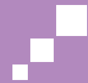
The proposed insolvency probabilities range from 0.20% to 4.00% such that the weakest sponsoring employer pays 20 times that of the strongest employer. This contrasts with the assumed probabilities for 2011/12 which range from 0.03% to 2.41% whereby the weakest employer pays over 80 times that of the strongest employer.

The Insolvency risk (P) would also be a smoothed measure to take into account of changing circumstances every month over a year rather than a snap-shot at 31 March so that a temporary change in the sponsoring employer's insolvency risk score would not disproportionately affect the levy bill and is less likely to lead to a change in the Levy Rate.

Although the size of the bands reflect the non-linear relationship between score and probability of failure, the PPF have recognised the "cliff-edge" effect of moving from one band to another. They propose "transitional rate relief" for the first year such that moving from Band 1 to Band 2, for example, would result in the RBL being based on an average Levy Rate of 0.35% – however this is still an increase of 75% and also increases cross-subsidy between levy payers.

Mitigation

In line with Technical Briefing 49, the use of Deficit Reduction Contribution and Contingent Asset certificates will still be available to schemes and their sponsors to reduce or mitigate the perceived

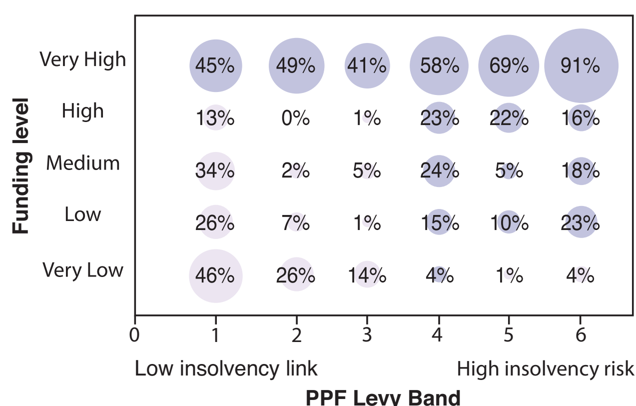


No. 50

risk they pose to the PPF and hence be reflected in a lower levy bill.

How May it Affect Your Levy – Winners and Losers

Like any fundamental change in methodology there will be winners and losers with the changes designed to have less cross-subsidy so that schemes will pay a levy which is more in line with the perceived risk they pose to the PPF. The PPF published the following graph showing how the proposed new formulae would be expected to change levies split by the funding level of the scheme and the insolvency risk of the employer (this does not factor in investment issues). In this graph the darker circles indicate the level of levy decrease and the lighter circles the level of levy increase.



cprm Commentary

At **cprm**, we welcome the proposal for a more predictable and pragmatic approach towards future levy calculations which in turn should provide greater certainty to financial planning as well as shifting the emphasis from insolvency risk to funding and investment risk. However we do have some reservations on the mechanics behind such a revised framework as summarised below:

- The D&B Failure Scores are collated together under just 6 bands meaning that it is more difficult for sponsoring employers to see any gradual improvement in the RBL.
- The reduced number of risk bands will lead to a 'cliff edge' effect.
- Whilst the use of smoothing in the underfunding position and the D&B Failure Scores should lead to greater certainty for levy payers they 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 has been flagged up beforehand and fuller details of how this would be implemented will be awaited. Trustees and sponsors will weigh up the extent of the impact this would have on their levy against any restriction on investment policy.
- There is also a potential concern that there could be a significant "correction" jump every three years if the PPF have either over or under-estimated levy receipts which could potentially lead to greater volatility affecting mid to longer-term financial planning.

It should be noted that these proposals only discuss how the aggregate levy amongst all UK schemes will be distributed – there is no proposed increase or reduction to the total levy bill.

Ultimately, there will be winners and losers if the proposals are brought into force in their current form with the biggest losers being strong employers who choose to fund their pension scheme below the level required by the PPF.

Please contact your usual **cprm** adviser if you have any questions or would like any additional information of the PPF's consultation for the 2012/13 levy onwards.

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