The Pension Protection Levy 2007/08

Pension Protection Fund

Background

The Pension Protection Fund (PPF) was set up under the Pensions Act 2004 and opened its doors for business on 6 April 2005.

Its primary role is to pay compensation to people who belong to occupational defined benefit and hybrid pension schemes.

Compensation is paid when the employer sponsoring the scheme becomes insolvent – and there are not enough assets in the pension scheme, including recoveries from the insolvency, to pay its members more than the compensation levels available under the Pension Protection Fund.

Funding compensation payments

The Pension Protection Fund raises money to fund its compensation payments by:

- Transferring the assets of pension schemes which enter the Pension Protection Fund;
- Collecting an annual levy from all eligible pension schemes;
- Recovering further assets from the insolvent employer as a major creditor; and
- Maximising returns on its own investments.

The levy

The levy that schemes have to pay is split into two parts: The first part of the levy (the scheme based levy) is based on the scheme's Pension Protection Fund liabilities.

The remaining levy (the risk based levy) is set by assessing:

- By how much the scheme is underfunded, allowing for any recent deficit repair contributions;
- How much risk there is of the employer becoming insolvent; and
- The impact of contingent assets that have been put in place by the scheme.

Pension Protection Fund levy 2007/08

The levy estimate for 2007/08 will be set at £675 million as opposed to last year's £575 million. This is made up of £135 million scheme based levy and £540 million risk based levy.

This increase is necessary to:

- Help reduce the Pension Protection Fund's current deficit including making up for undercollection of the levy during 2006/07;

  - this was due to market movements, improvements in data quality and incentives on schemes to reduce their risks

- More accurately reflect the Pension Protection Fund's exposure to long-term risk; and

- Ensure public confidence in the Pension Protection Fund's financial security.

Levy cap

As was the case for 2006/07, the Pension Protection Fund has set a cap on the maximum amount of levy payable to protect weaker schemes and their sponsoring employers. As was the case for 2006/07, the Pension Protection Fund considers that a cap which affects 5 per cent of schemes strikes the correct balance between affordability and security and the cap is accordingly set at 1.25 per cent of liabilities for 2007/08.

Underfunding risk

The underfunding risk is assessed by considering the value of a scheme's assets (including any deficit reduction contributions and contingent assets) and the value of its Pension Protection Fund liabilities.

Any scheme more than 125 per cent funded is exempt from paying the risk based element of the levy.

For most schemes, the Pension Protection Fund holds Minimum Funding Requirement (MFR) valuation data. An increasing number of schemes are providing valuations of their Pension Protection Fund liabilities (under section 179 of the Pensions Act). The Government Actuary's Department (GAD) converts the MFR valuations to a section 179 basis to enable the Pension Protection Fund to calculate the levy on a consistent basis.

To ensure a greater degree of stability and certainty for levy payers, the Pension Protection Fund will fix the date at which scheme underfunding is calculated at 31 October 2006.

The Pension Protection Fund will continue to accept section 179 valuations submitted up to 30 March 2007, but where appropriate will roll back the valuation using market assumptions as at 31 October 2006. Subject to regulations coming into force by March 2007, all schemes will need to submit their first section 179 valuation by 31 March 2008.

The risk based scaling factor

For 2006/07 the Board fixed the scaling factor (the mechanism for distributing the levy between schemes) prior to 31 March 2006 when all scheme information became available. This led to an under-collection of the 2006/07 levy, because of a reduction in risk exposure between when the scaling factor was fixed and 31 March 2006.

In order to prevent the risk of over of under-collection of the levy estimate in 2007/08, the Board delayed calculation of the final figure until the data that actual levy calculations would be based on was available. In the interim, the formula for calculating the scaling factor, and an indicative scaling factor were published based on information as at 31 October 2006.

The final levy scaling factor has now been set at 2.47.

The scheme based levy multiplier has also been determined as 0.00016.

Special 'deficit reduction' contributions

Last year, schemes certified approximately £12.5 billion of deficit reduction contributions to reduce their 2006/07 risk based levy, as well as their underlying deficits.

The Pension Protection Fund will recognise such contributions paid into the scheme since its most recent valuation when calculating the underfunding risk, provided those contributions were certified to the Board in the correct format by 5pm on 5 April 2007.

Cash contributions can include both lump sums and regular payments which are more than the cost of benefit accrual.

Contingent assets

The Pension Protection Fund acknowledges that contingent assets have an important role to play in risk management.

For the purpose of calculating the 2007/08 levy, the Board recognises the additional security provided by three different forms of contingent assets. These are:

- Group company guarantees – provided by any group company based in an Organisation for Economic Co-operation and Development (OECD) country
- Cash, property or securities – pledged by the sponsoring employer(s)
- Letters of credit and bank guarantees – provided by banks based in OECD countries and with a set credit rating.

The Board will take account of any acceptable contingent arrangements in the risk based levy calculation, provided those assets were certified to the Board, using the appropriate standard form certificates, by 30 March 2007.

Insolvency risk

The insolvency risk element of the 2007/08 levy calculation will again be calculated using the failure scores and related probabilities of insolvency provided by Dun & Bradstreet (D&B), as at 30 March 2007, incorporating the minor changes made by the Pension Protection Fund for the 2007/08 levy year.

The Pension Protection Levy 2007/08

Pension Protection Fund

Following consultation with D&B the Board has taken the decision to implement an additional rule for 2007/08 which will adjust the weighting applied to County Court Judgments (CCJs) in the failure score methodology. This change will ensure that the way in which the Pension Protection Fund measures insolvency risk best suits the universe of sponsoring employers under consideration.

Insolvency risk will once again be capped at 15 per cent.

An explanation of how D&B calculate failure scores is available on the Pension Protection Fund website and any queries on the D&B failure score should be directed to D&B Customer Services on 0870 243 2344 or email customerhelp@dnb.com.

Statement of principles

The processes and proposals outlined in this document are underpinned by three guiding principles:

Fairness – the Pension Protection Fund aims to ensure that schemes pay an appropriate amount towards the levy, reflecting the level of risk they pose;

Simplicity – it applies effective and simple mechanisms and solutions for collecting the data needed to set the levy; and

Proportionality – it aims to ensure that the levy is fair and proportionate between schemes and in its impact on individual schemes.

Timetable

The Pension Protection Fund has already consulted on the way in which an individual scheme's levy will be calculated for the 2007/08 levy year and on the total amount that the Board estimated it needed to collect.

We aim to issue 2007/08 levy invoices from Summer 2007.

For further information contact:

Pension Protection Fund helpline

Tel: 0845 600 2541
Email: information@ppf.gsi.gov.uk

D&B customer service helpline

Tel: 0870 243 2344
Email: customerhelp@dnb.com