

# BBS briefing note

## The New Pension Protection Levy Framework to Apply From 2012/13

Following detailed consultation, the Board of the Pension Protection Fund ("the PPF") has confirmed the framework that will apply for the calculation of PPF levies from 2012/13.

As initially proposed by the PPF, the new framework will take a "bottom-up" approach, designed to reduce the degree of cross-subsidy between schemes and to result in a more stable and predictable levy.

This *BBS briefing note* provides a summary of the main components of the levy calculation.

### LEVY FRAMEWORK

The basic structure of the levy will remain unchanged as:

$$\text{Total Levy} = \text{Risk-based levy (RBL)} + \text{Scheme-based levy (SBL)}$$

To date, the RBL has been set to equal an estimated 80% of the total levy and the SBL set to 20%. However, the SBL is to be given a more defined role which will primarily be to recover the cost of the cross-subsidy (i.e. the levy cap). The expected result of this change will be that the SBL will be significantly less than 20% of the total levy, perhaps around 10% in the first few years after implementation.

### A "BOTTOM-UP" APPROACH

The current framework adopts a "top-down" approach, whereby the total levy to be collected from all schemes is set by the Board, and then allocated amongst eligible schemes to reflect the risk profiles of each scheme. Such an approach can lead to excessive year-on-year volatility in levy bills and can also lead to the levy for an individual scheme increasing year-on-year even though the scheme's underfunding and insolvency risk may have improved.

Recognizing the disadvantages of this approach, a "bottom-up" approach is to be adopted, whereby individual scheme levies are set, and the total levy collected by the PPF is then the sum of all individual levies charged. Individual levies will therefore be independent from changes in other schemes' risk profiles and a scheme's levy would fall if its risk (to the PPF) decreases and rise if its risk increases.

Such an approach could, however, lead to excessive uncertainty as to the total levy that will be collected by the PPF and therefore the PPF has introduced various features to control the risk.

### RISK-BASED LEVY

The high-level risk-based levy formula will be as follows:

$$RBL = U \times P \times c$$

where:

U = Underfunding risk

P = Insolvency Risk

c = Fixed scaling factor

Whilst this is similar to the current formula, there will be significant changes to how the underfunding and insolvency risks will be calculated.

### SCALING FACTOR

The Board will carry out a funding and levy review every three years. Following each review, the Board will set the levy parameters (the scaling factor, levy caps and scheme-based multiplier) in line with its funding requirements. The factors will remain fixed for the full three years unless the PPF determine that the levy will:

- exceed the levy ceiling set by legislation; or
- vary from the previous year's levy estimate by more than 25% in either direction; or
- result in an estimate of the SBL that exceeds 20% of the total expected levy.

The levy parameters that are proposed to apply for the three years commencing in 2012/13 will be notified in the draft Determination to be issued in autumn 2011.



## BBS briefing note (continued)

### UNDERFUNDING RISK

To further stabilize a scheme's levy, its 'smoothed' funding position will be calculated by the PPF, using the latest section 179 valuation data supplied through Exchange. For this purpose, five-year averages of various market indices and yields will be used to calculate smoothed values for assets and liabilities.

The smoothed funding level will then be adjusted by the PPF to incorporate an allowance for investment risk, based upon the asset information included in the latest submitted section 179 valuation data. The indicative adjustments (final adjustments will be published in autumn 2011) applying to the main asset classes are as follows:

Asset Class	Indicative Adjustment
Corporate bonds	+1%
Nominal gilts	+9%
Index linked bonds	+16%
UK equities	-22%
Overseas equities	-19%
Property	-7%

The deficits under the smoothed and adjusted funding positions are then compared, with the greater deficit used as the underfunding risk.

As an alternative to the PPF carrying out the calculations for investment risk, schemes will be able to voluntarily certify and submit their own bespoke calculations, based on their own more detailed information. Very large schemes (over £1.5 billion liabilities) will, however, be required to carry out and submit bespoke calculations.

A separate *BBS briefing note* will set out further details on the smoothing process and the bespoke option.

### CONTINGENT ASSETS

Contingent assets will continue to be recognized as currently, the only change being that if a charge is given over assets the value of that asset will be adjusted as discussed above.

### INSOLVENCY RISK

The current table of insolvency probabilities, based on D&B Failure Scores of 1 to 100, will be replaced with ten bands, with rates as follows:

PPF Band	D&B Failure Score	Levy Rate (P)
1	100-99	0.18%
2	98-96	0.28%
3	95-92	0.44%
4	91-87	0.69%
5	86-73	1.10%
6	72-66	1.60%
7	65-46	2.01%
8	45-38	2.60%
9	37-30	3.06%
10 (capped)	29-1	4.00%

The Failure Score for the employer will be assessed on the last working day of each month over the year preceding the levy date (1 April), with the average Score determining the PPF Band and hence the Levy Rate.

As at present, for multi-employer schemes the individual employer Levy Rates will be weighted by the number of scheme members to determine the average Levy Rate.

### BBS VIEW

The consultation process has led to a framework that remains largely in line with the original proposals. Although employers will welcome the broad aims of the framework, i.e. to make levies more stable and predictable and ensure they more appropriately reflect the risk their scheme poses to the PPF, there will still be winners and losers.

BBS will be working with clients to assist them in understanding the implications for their levy and identifying mitigating strategies, once the levy parameters are published in the draft Determination this autumn.

This BBS briefing note is based on BBS's understanding of the law and is provided for information only. It should not be relied upon as a definitive statement of the law and detailed legal and financial advice should be obtained on the specific circumstances before proceeding.

