

BBS briefing note

The 2012/13 Pension Protection Levy

The Board of the Pension Protection Fund has recently issued the draft Determination for the Pension Protection Levy for the 2012/13 levy year. The Determination sets out the proposed parameters for the levy and sets out the detail as to how the new levy structure will apply going forwards.

This *BBS Briefing Note* provides a summary of the revised levy structure and the key deadlines for submitting information.

THE LEVY FRAMEWORK

The Pension Protection Levy will continue to be composed of two parts, the “scheme-based levy” and the “risk-based levy”. However, there are a number of fundamental changes to the underlying calculation framework as set out below. One key change is that the levy estimate, the levy parameters, and the levy cap will be fixed for three years instead of one, and will only be changed in rare circumstances. The PPF believe that this will provide greater stability in the levy and will enable schemes to plan with much greater certainty.

THE LEVY ESTIMATE

The Board has announced that it is seeking to raise £550 million for the 2012/13 and the following two levy years. This is the lowest levy estimate since the introduction of the risk-based levy and reflects the sound financial position of the PPF at present and the positive impact of adopting CPI in place of RPI for the revaluation and indexation of PPF compensation. However, the above factors were tempered by the uncertain economic outlook to arrive at the final estimate.

THE LEVY CALCULATION

The scheme-based and risk-based levy formulae are little changed from previous years:

Scheme-based levy = UL x SLM

Where

UL = the smoothed liabilities, and

SLM = the scheme levy multiplier

The PPF has announced that the proposed scheme levy multiplier will be 0.0085% for the next three years.

The scheme-based levy is now designed to cover the “cost” of the cross-subsidy introduced by the levy cap, which is set at 0.75% of the liabilities and is intended to protect the weakest 9% of schemes. The scheme-based levy is estimated to constitute 11% of the total levy, which is approximately half of the proportion to date.

Risk-based levy = U x IR x LSF

Where

U = Underfunding (i.e. the higher of the smoothed and stressed deficit),

IR = Insolvency rate, and

LSF = Levy scaling factor

The PPF has proposed that the levy scaling factor for the next three years will be 0.89.

UNDERFUNDING RISK - SMOOTHING AND STRESSING

From 2012/13, underfunding risk will be determined by using averaged values, rather than using values at a single date as at present.

In future, the assets and liabilities will be “smoothed” by adjusting the rolled-forward values at the effective date (31 March 2012) by the daily average of the relevant indices and yields over the preceding five-year period.

The smoothed assets and liabilities obtained from the roll-forward process will then be “stressed” to reflect investment risk.

To arrive at the stressed funding position, liabilities related to index-linked benefits will be adjusted by the inflation and interest rate stresses, whilst those related to non index-linked benefits will be adjusted by the interest rate stress only.



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The PPF has updated the table of stresses to be applied to the mainstream asset classes to derive the stressed value of the assets as follows:

Asset Class	Indicative adjustment to asset value
Corporate bonds	0%
Nominal gilts	+10%
Index linked bonds	+16%
UK equities	-22%
Overseas equities	-16%
Hedge funds	-7%
Property	-6%
Annuities	+16%

The stressed values of the assets and liabilities will be used to derive the stressed deficit, with the greater of the stressed deficit and the smoothed deficit taken as the underfunding risk.

Schemes with liabilities in excess of £1.5 billion will be required to submit bespoke results setting out the stressed value of their assets, rather than relying on the PPF's standard approach. Schemes with liabilities of less than £1.5 billion also have the option to submit bespoke results. It is anticipated that the bespoke approach may be beneficial to schemes that have adopted risk-reducing derivative positions, such as LDI strategies.

Naturally, trustees will need to consider whether the costs associated with submitting a bespoke analysis will be justified by a lower levy. In addition, the PPF note that any scheme submitting a bespoke analysis for 2012/13 will be expected to continue to do so in future years.

INSOLVENCY RISK

In a further change, an employer's D&B Failure Score as at 31 March 2012 will be derived as the average of the scores at the end of each of the preceding twelve months. The resulting score will then place the employer into one of ten Levy Bands, each with an associated Levy Rate. The Insolvency Rate to be used will be derived from the Levy Rates of the Employers participating in the scheme as at present.

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.

CONTINGENT ASSETS

The current process and deadlines for certifying contingent assets remain in place. However, there will be some changes to reflect the new methodology, e.g. certified values of charges over property will be stressed (i.e. reduced by 6%) and charges over securities will be smoothed and stressed in line with the process outlined above. In addition, an additional certification will be required confirming that guarantors could have been expected to meet their full commitment under a contingent asset agreement if called upon to do so at the date of the certificate.

KEY DATES

The key deadlines for submitting information for the purposes of the 2012/13 levy are as follows:

- Scheme Returns - 5 pm on 30 March 2012
- Certification of Contingent Assets – 5pm on 30 March 2012
- Certification of Deficit Reduction Contributions – 5pm on 10 April 2012
- Certification of Block Transfers – 5pm on 29 June 2012

FINAL DETERMINATION

The final Determination will be published by the end of the year.

BBS VIEW

From 2012/13 there will be a fundamental shift in the calculation of PPF levies. Whilst providing greater stability and predictability, the new basis introduces added complexity and an increased focus on the impact of investment strategy on the levy.

The new methodology will result in levies which are higher or lower than has applied in the past, and this will inevitably cause concern for some employers. BBS will continue to guide clients in understanding their levy calculation and the options available to mitigate its impact.

