IN FOCUS

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PPF levies – past, present and future

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The Pension Protection Fund (PPF) published the response to its latest levy consultation on 29 November 2007. It also published its firm proposals for the 2008/9 and 2009/10 levy years and its draft determination for 2008/9.

The PPF estimates it will need to collect £675m in pension protection levies in 2008/9 – the same as for the current year – and intends to keep the total levy stable at this level in real terms for 3 years.

However, the way the total of £675m is allocated across all eligible schemes is being changed, which will create some significant winners and losers.

It will be vital for many schemes to take action within the next four months. In particular, if they have not already done so, schemes should ensure they submit their first "s179 levy valuation" to the PPF by 31 March 2008. Better-funded schemes who previously thought there would be little or no payback from taking action may now find there is scope to reduce their levy.

This *In Focus* analyses the proposed changes and identifies the likely winners and losers. It also reminds trustees and employers of the steps they can take to reduce their scheme's levy.

Who are the winners and losers?

As a result of the changes the PPF intends to implement for 2008/9 and 2009/10:

- Many well-funded schemes will now pay a risk-based levy for the first time, or pay a much higher one than they may have been expecting – particularly schemes with a "PPF funding level" of between 100% and 120%. Only schemes with a PPF funding level above 140% (up from 125%) at the assessment date (31 October 2007 for 2008/9 and 31 March 2008 for 2009/10) will escape the risk-based levy.

- Schemes with lower funding levels (less than 76%, if the risk-based levy scaling factor is confirmed at 1.60) will pay less, particularly those with weak sponsors.

- Schemes where the sponsor is a not-for-profit organisation or is in the financial sector are likely to pay a lower risk-based levy as result of changes made to D&B's scorecards.

Looking further ahead, when the risk-based levy is better-aligned with longer-term risks in 2010/11 and beyond, the winners and losers are likely to include:

- Schemes with a weaker sponsor will pay less at the expense of schemes with a stronger sponsor.

- The weakest schemes and those with the highest funding levels will pay more, while those in the middle will pay less.

- Schemes with the greatest mismatch between assets and liabilities (i.e. riskier investment strategies) may pay more, with other schemes paying less, if the PPF decides to reverse its recent decision and includes asset allocation as a risk factor.

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Why is this happening?

The key points:

- The PPF is recognising that well-funded schemes with strong sponsors pose a bigger risk to the PPF in the longer term than previously assumed. Likewise, weak schemes/sponsors pose less of a risk.

- In addition, as funding levels generally have improved over the last two or three years, more and more schemes have benefited from paying little or no risk-based levy, leaving everyone else to pick up the tab.

- Further consultation will take place on plans to achieve greater alignment of the levy with the PPF's assessment of longer-term risk using its Long-Term Risk Model, recognising that the PPF can not pick and choose its customers and so must have an eye on, not just the risk of short-term insolvency, but risk of insolvency over longer periods. This is to affect the levy from 2010/11 onwards and may take account of how credit-worthiness tends to evolve over time; a company with a very strong credit rating is more likely to see its rating decline rather than improve if viewed over a longer period, whilst a company with a very poor credit rating that manages to survive is likely to see its rating improve.

What else is changing?

- The deadline for submitting updated details of a scheme's funding position or of the sponsor's covenant, if it is to be taken into account in the risk-based levy, is being brought forward by a year – for the 2009/10 levy year the deadline will be 31 March 2008, the same as for the 2008/9 levy year.

- However, the deadline for submitting contingent asset certificates will continue to be the 31 March immediately before the start of the levy year, and the deadline for certifying deficit-reduction contributions will remain at 7 April, despite the PPF's original proposal that these deadlines should be brought forward a year, in line with the other information deadlines.

An in-depth explanation is set out in the Technical Appendix.

How can you reduce your levy?

There are several ways in which trustees and sponsors can reduce their scheme's future risk-based levies.

Reduce "underfunding risk":

- A new s179 levy valuation can be carried out earlier than required under the triennial cycle if the scheme's funding position has improved by more than will be recognised in the PPF's roll-forward calculations (e.g. because of investment out-performance) – from the 2009/10 levy year onwards, there will be a time lag of at least 12 months before a new s179 levy valuation is recognised, so serious consideration should be given to submitting one by 31 March 2008 as this will be the deadline for influencing the levy for both 2008/9 and 2009/10.

- In particular, schemes that have yet to submit their first s179 levy valuation should do so by 31 March 2008 to avoid their levy for 2008/9 being based on a penal estimate of the value of the scheme's assets (and to avoid any sanctions the Pensions Regulator may impose for non-compliance with a legislative requirement).

- The sponsor can make a special contribution – it will continue to be possible to submit a deficit-reduction certificate right up to the start of the levy year and so gain an immediate benefit in terms of a lower levy.

- The measure of the scheme's underfunding can be reduced if the sponsor pledges assets, such as land, to the scheme (a Type B contingent asset) or a letter of credit is purchased from a bank or insurance company (a Type C contingent asset) – again it will continue to be possible for such contingent assets to be put in place and certified right up to the start of the levy year.

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Reduce "insolvency risk":

- The strength of the sponsor's covenant can be improved if another group company provides a funding guarantee to the scheme's trustees (a Type A contingent asset) – it will continue to be possible for such contingent assets to be put in place and certified right up to the start of the levy year.
- The sponsor can take internal action to manage its D&B Failure Score by, for example, avoiding or paying off CCJs or bad debts. (Rather more extreme, consideration could also be given to replacing young company directors or those associated with previous business failures, unless there are compelling reasons for retaining them.)

Other steps can be taken to ensure that the levy invoice is based on accurate information, thereby avoiding over-paying inadvertently:

- Check the data set out in the annual Scheme Return before submission to the Pensions Regulator, particularly any fields used to calculate levies.
- Make sure that the PPF has up-to-date information regarding the scheme's participating employers.
- Check that D&B is supplied with up-to-date information about the sponsor so that the right Failure Score can be calculated – from the 2009/10 levy year onwards, there will be a time lag of at least 12 months before any new information supplied to D&B is recognised, so it is doubly important to ensure that D&B has up-to-date information by 31 March 2008 as this will be the deadline for influencing the levy for both 2008/9 and 2009/10.
- Where your scheme has already submitted its first s179 levy valuation, but is planning to submit another by 31 March 2008, ask your actuary to confirm whether submission of the new valuation is expected to reduce the levy for both 2008/9 and 2009/10. In some cases it may be better to hold fire.

Comments

The PPF has been accused of "moving the goalposts" by changing how the total risk-based levy is distributed between better-funded and weaker-funded schemes. It intends to move the goalposts again and place more of the burden on schemes with the strongest employers in a couple of years' time.

The PPF claims to be making the changes in the pursuit of longer-term fairness, creating some transitional winners and losers in the process. Some may argue there is an element of political expedience.

For many schemes – particularly those whose PPF funding level is between 100% and 120% – there will now be a much greater incentive than before for taking action to reduce their levy. Such schemes should give urgent and serious consideration to the merits of the various options outlined above.

The use of contingent assets may be particularly attractive where schemes have been closed to future benefit accrual as they help to avoid the "asymmetrical risk" of the sponsor paying too much into the scheme and it becoming "trapped surplus".

This *In Focus* is based on "The Response to the August 2007 Pension Protection Levy Consultation", including the "Draft Determination under Section 175(5) of the Pensions Act 2004 in respect of the financial year 1 April 2008 – 31 March 2009", published in November 2007, "Guidance in relation to contingent assets" published in November 2007, "Consultation on the Future Development of the Pension Protection Levy" published in August 2007, "Modelling Uncertainty - An Introduction to the PPF Long Term Risk Model" published in August 2007, "Slides from the September 2007 Levy Seminars" and "The 2007-08 Pension Protection Levy Consultation Document" published in September 2006, all of which are available on the PPF's website.

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