In search of stability

PETER WILLIAMS GAUGES REACTION TO THE MOVE BY THE PENSION PROTECTION FUND TO INCREASE THE PENSION LEVY SCALING FACTOR.

Executive summary

- The Pension Protection Fund set up shop in 2005 to protect the pensions of defined benefit pension scheme members whose employers become insolvent and leave a scheme with inadequate assets to meet its liabilities. The PPF is financed by levies paid by employers that continue to sponsor defined benefit schemes. Every year since then, the PPF has published a consultation document, followed by a final 'determination' that sets how it will calculate the levy for the forthcoming year.

Some companies face a sharply increased Pension Protection Fund (PPF) levy, according to pension experts. The unexpected increase follows the recent announcement by the PPF of an increase in the levy scaling factor.

In November 2007 the PPF issued a consultation from which it was possible to estimate the likely PPF levy for individual companies that have defined benefit pension schemes. But these figures have turned out to be a serious underestimation of the numbers that the PPF is determined to collect.

The latest announcement indicates that the PPF believes scheme funding levels are better than originally estimated, but does not believe that this justifies a smaller levy. Pensions consultancy Mercer said that the PPF is concerned that while funding levels has increased, over the longer term the risk that it is exposed to has not declined.

Compared with the original estimates, some well-funded pension schemes could see their levy increase by as much as 50% to ensure the PPF meets the revenue targets it thinks it needs. And that's just the well-funded ones; less well-funded schemes are going to be landed with even bigger increases.

Deborah Cooper, Principal in Mercer's retirement policy group, said: "Some trustees and employers may have to adjust their budget for the PPF levy by as much as 100%. The PPF said it wished to bring stability to the levy formula; judging by this year's experience it has still not achieved this."

These unexpected increases have occurred because the PPF announced that the scaling factor it would apply to the risk-based levy for 2008/09 would be 3.77, rather than the 1.6 it had originally indicated in its autumn 2007 consultation document. While bad news for pension funds and their sponsors, the increase means that the PPF will be able to collect £675m – the total levy it was aiming for (see *Box 1*).

The PPF said the scaling factor was a crucial element of levy calculations as it enabled it to distribute the levy proportionately between eligible schemes.

But the scaling factor on its own does not determine the size of individual levy bills. Any change in a scheme's risk between 2007/08 and 2008/09 will also have an impact on the size of its bill.

PPF Chief Executive Partha Dasgupta said: "When working out this year's scaling factor, we had to take account of the significant volatility we have seen in scheme risk during the last 12 months, and make sure that we still collect the £675m we said we need to collect.

"In the short term, we have seen scheme funding and insolvency probabilities improve. But it is long-term risk that we have to protect ourselves against, particularly as we are now in the middle of a credit crunch, which can only mean a lot more uncertainty for the future."

In setting the scaling factor, the PPF first calculates each scheme's individual levy, save for the scaling factor. It then compares the total of all individual schemes' levies with what it needs to collect – £675m for 2008/09 – and scales the total figure accordingly.

The PPF is due to issue a consultation paper containing proposals on altering the levy so that it more fairly reflects the risk posed by different schemes. Experts suggested that large schemes that would pose a serious threat to the PPF if their sponsors went bust could pay more, as might schemes that run riskier investment strategies.

The PPF move has also been seen as penalising those firms that have pumped in more money to their schemes or adopted a more conservative investment strategy.

The move will be all the more irritating if the PPF collects more than it plans.

Box 1: Estimated levy for schemes with £100m liabilities (no contingent assets)

D&B rating 98			
Funding level	80%	100%	120%
Consultation levy	£41,440	£28,640	£15,840
Actual levy	£78,328	£48,168	£18,008
D&B rating 50			
Consultation levy	£529,504	£278,624	£27,744
Actual levy	£1,016,500	£637,193	£46,057

Box 2: Other factors in the levy calculation determined in February 2008

- Assets and liabilities (to work out the underfunding risk) are adjusted to 31 October 2007, but deficit-reduction contributions and contingent assets put in place by 7 April 2008 and 31 March 2008 respectively count towards the calculation.
- Insolvency probabilities are taken as at 31 March 2008.
- The funding limit at which schemes pay a reduced levy is 120%.
- The funding limit where no risk-based levy is paid is 140%.
- The levy cap will be 1.0% of liabilities.

"Many have commented about the final risk-based levy scaling factors announced by the PPF at the end of May," said Nick Curry, Partner at actuary Lane Clark & Peacock. "An additional point we need to recognise is that due to the buffer of 0.87 the PPF has included in the scaling factor, it could end up with the embarrassment of collecting closer to £837m than its target of £675m."

According to Curry, this is because much of the increase in the scaling factor was due to companies improving their D&B failure scores between October 2007 and March 2008. There may not therefore be much scope left for companies to appeal against their failure scores when they receive their levy invoices. Only a small amount of the buffer might therefore be used. The final scaling factor appears to include an element of double-counting.

Curry said: "If this happens, will levy payers be offered a refund? While the PPF may quote seemingly comforting statistics about the number of schemes that will be paying a lower levy during 2008/09, the reality is that many schemes will be paying more than twice what they expected to pay based on the indicative scaling factor. This hardly seems fair bearing in mind that many would have taken additional steps to reduce their levy if they had known what the final bill was going to be."

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Box 3: How the Pension Protection Fund levy is calculated

DEBORAH COOPER, PRINCIPAL IN MERCER'S RETIREMENT POLICY GROUP, LOOKS AT THE BACKGROUND TO THE MAKE-UP OF THE PPF LEVY.

The risk-based part of the levy depends on three elements:

- The difference between a multiple of the scheme's liabilities and its assets (the underfunding measure);
- the insolvency probability of the employer; and
- a scaling factor.

While trustees and employers have some chance of estimating the value the PPF will put on the first two of these, the third is in the gift of the PPF.

The scaling factor is just a balancing number that lets the PPF to collect the total levy it believes it needs, and so depends on the underfunding levels and insolvency probabilities the PPF will use. These are measured at different dates (for the 2008/09 levy year): 31 October 2007 for the scheme information and 31 March 2008 for the company information.

In a document published in November, the PPF estimated a scaling factor of 1.6. At that date it should have had a reasonable grasp of the level of underfunding, except that it had agreed to allow for voluntary certification of deficit contributions and contingent assets made before the start of the levy year. It will have estimated the insolvency probabilities that would apply at 31 March 2008.

When the PPF published the scaling factor for the 2008/09 levy year, at the end of May, it had increased to 3.77. The outcome will be due to a mixture of factors being different from expected. Looking at the employer insolvency and the underfunding in isolation, using the data PPF publishes as part of its PPF7800 index, we estimate that:

- if the underfunding has not changed, then D&B ratings will have had to improve from 65 to 86 on average (a change in average insolvency probabilities from 0.054% to 0.021%, or from an average Baa rating to a Ba rating). Given the turmoil in financial markets, this seems unlikely.
- if D&B ratings have not changed, then on average the additional assets made available to schemes via deficit contributions and contingent assets will be about 6% of the total (following section 179 valuations submitted between October and 31 March, the PPF found it had overestimated liabilities by about 6%).

Particularly when the difference is small, small changes in assets or liabilities can have a disproportionate effect, so the second explanation doesn't seem impossible. Since the levy depends on the difference, it can be disproportionately affected if nothing else changes in the formula.

The PPF has justified the increase in the scaling factor by saying that the improvements in funding levels experienced do not represent any material reduction in risk. Unless the PPF can be persuaded differently, particularly as schemes become better funded, the scaling factor will become more volatile.

This will be no consolation to schemes and employers who planned for a levy based on a scaling factor in the order of 1.6. Some will have faced a double-whammy of a falling credit rating between October and March, with the effect that levies could have increased by more than the increase in the scaling factor. The PPF clearly has to protect itself against the risks it is exposed to, but this degree of uncertainty for levy payers who are (to all intents and purposes) unable to opt out of paying the levy is hard to defend. No wonder there is an increasing drive towards alternative vehicles for securing pension scheme liabilities.

The scaling factor has helped the PPF keep the levy formula simple, by being a blunt tool that enables the PPF to cover the risks it faces apart from scheme funding and employer solvency. However, blunt tools don't work well, in this case to the cost of many schemes and employers.

Later this year, the PPF plans to publish a further consultation on adjusting the levy formula explicitly to allow for its risk exposure. The proposed formula is likely to differentiate between short-term risk (which is all the current formula, absent the scaling factor, allows for) and investment risk. If the risk-based formula becomes more closely related to the underlying risk, its effect on different schemes should become more predictable. Trustees and employers who have taken steps to reduce the degree of risk in their scheme should find this reflected in a lower levy, which seems like progress.

However, the revised structure is unlikely to result in lower levies across the board: those schemes that have chosen not to mitigate their risk exposure could find their levy increasing even further, but at least the reason for the increase will be understood, rather than apparently arbitrary. Even so, the PPF is unlikely to completely avoid criticism from levy payers, who have very little short-term control over the amount of a payment that, to many, resembles a compulsory tax. A levy formula more closely aligned to the underlying risks could just replace one incentive to re-engineer pension provision with another.