A flea-bite at best

PETER ELWIN EXAMINES THE PRICE COMPANIES ARE LIKELY TO PAY FOR PENSION PROTECTION.

The Pension Protection Fund (PPF) was established under the terms of the Pensions Act 2004 to provide pensions to employees of insolvent companies whose pension funds were in deficit. The funds to provide this 'insurance' are raised by imposing a levy on all companies whose pension schemes are eligible for PPF protection.

Unlike the levy raised this year, from April 2006 the Pension Protection Fund Board (PPFB) is proposing that the levy should be risk-based. It will also need to be higher. The fund raised around £300m last year but the PPFB has said it expects the levy raised in 2006/7 to be "somewhat higher". The Confederation of British Industry estimates that the total levy could be £600m, other estimates have been even higher. The PPFB will publish its estimate by 30 November at the same time that it releases final details of the calculation process.

The protection offered by the PPF will be limited. Broadly speaking, scheme members who are already in retirement will receive all of their pension entitlement whereas members not yet in retirement will only be guaranteed to get a maximum of 90% of their entitlements when they retire (subject to an over-riding age-related cap on the amount paid).

THE PPFB LEVY PROPOSALS The proposed system aims to impose the greatest levy on those schemes that pose the greatest risk to the Fund, and to provide an incentive to companies to reduce this risk.

The key elements of the proposed system are as follows:

- 80% of the total levy raised will be risk-based i.e. based on an assessment of the underfunding risk of the schemes covered by the PPF and the insolvency risk of sponsoring companies.

- 20% of the total levy raised will be scheme-based i.e. based on the liabilities in the schemes covered by the PPF.

- The levy applied to individual companies will be capped to ensure that it does not push them over the edge into insolvency. The exact level of cap has yet to be determined (the proposals use 3% of liabilities as an illustration only).

PPF CALCULATIONS WILL USE THE S179 BUY-OUT BASIS The PPF levy will be calculated based on liabilities measured on a buy-out basis under s179 of the Pensions Act 2004. The full buy-out basis is defined as "the amount which an actuary estimates would be sufficient to enable the accrued entitlements of the scheme members to be secured through the purchase of annuities". In other words it is the price that the company would have to pay to shut down the scheme and walk away from its pension obligations.

Executive summary

- The Pension Protection Fund Board (PPFB) is proposing that the levy on eligible companies should be risk-based.
- The proposals ensure that the greatest levy is imposed on the schemes that pose the greatest risk to the Fund.
- The cost is based on the price a company would have to pay to shut down a scheme and walk away from its pension obligations.
- A scheme has to satisfy several conditions but the PPFB has already agreed that several schemes can enter assessment periods.

The low discount rate used in annuity calculations (a reasonable assumption is 50 basis points below gilts) means that the buy-out liability for a scheme is usually significantly higher than the equivalent International Financial Reporting Standard (IFRS) figure. The Watson Wyatt Pension Index estimates that the aggregate pension liabilities for FTSE 350 companies was £575.7bn in August 2005, compared to an equivalent FRS 17 *Retirement Benefits* figure of £448.0bn, a premium of 28%.

However, because the protection offered to non-pensioner scheme members by the PPF will be restricted, the s179 liability for PPF purposes will be lower than might otherwise be the case. The *Financial Times* recently suggested that the PPF buy-out liability for a typical scheme was 95% of the FRS 17 equivalent, but this will depend on the membership profile of the scheme. If most members are already in retirement, the s179 liability will be very close to the

full buy-out liability. Conversely, if most members have yet to retire, the s179 liability could be even less than 95% of the FRS 17 figure.

ELIGIBLE SCHEMES The PPF will only assume responsibility for a scheme if it satisfies the following conditions:

- it is eligible (a private sector defined benefit scheme);
- it must not have commenced wind-up before 6 April 2005;
- the scheme's employer has become legally insolvent;
- there must be no chance that the scheme can be rescued; and
- scheme members must be better off as a result.

Where a qualifying insolvency event occurs in relation to the employer of an eligible scheme, then a 12-month assessment period will automatically begin.

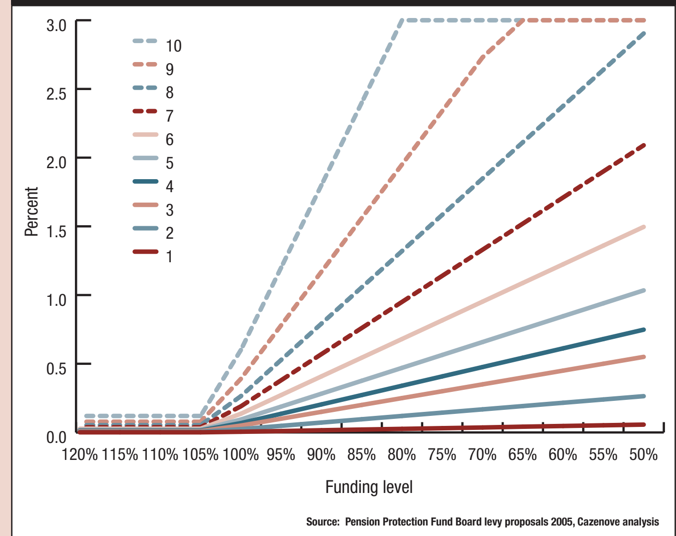
SCHEMES BEING ASSESSED FOR PROTECTION The PPF has already agreed that several schemes can enter assessment periods, for instance the Heath Lambert schemes on 1 July 2005 and the MG Rover schemes on 31 August. Recent press reports have suggested that the Turner & Newall pension schemes may also be eligible for protection. Estimates for the deficits that may become the PPF's responsibility as a result vary, but could amount to a total of around £1.36bn, adding further pressure to increase the overall levy.

ESTIMATING THE PPF LEVY FOR A PARTICULAR SCHEME The levy will be determined by two elements:

- A scheme-based component, which will be determined by applying a multiple to the scheme liabilities calculated on an s179 buy-out basis. The PPFB's levy proposals use a multiple of 0.006% but this may well change once companies have submitted their scheme valuations to the PPFB.

- A risk-based component, which will be determined by a combination of the 'insolvency risk' of the sponsoring employer (i.e.

Figure 1. Risk exposure as a percentage of scheme liabilities for each insolvency band



Source: Pension Protection Fund Board levy proposals 2005, Cazenove analysis

Figure 2. Receivables' credit quality

Equivalent credit rating	PPFB Band	Probability of insolvency within the next 12 months (%)
AAA to A-	1	0.13
BBB+ to BBB-	2	0.60
BB+ to BB	3	1.25
BB-	4	1.70
	5	2.35
B+	6	3.40
	7	4.75
B	8	6.60
B-	9	9.75
CCC	10	15.00

Source: Pension Protection Fund Board levy proposals 2005

Figure 3. The impact of insolvency bands on the PPF levy given a particular level of funding in a scheme

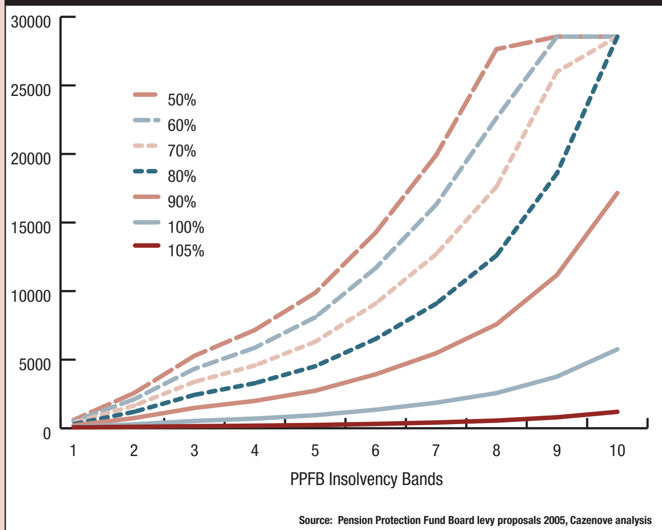


Figure 4. Comparison of PPF levies under two scenarios

Company insolvency rating	2	9
Scheme PPF funding ratio (%)	80	60
FRS 17 pension liability	£3.5bn	£7.0bn
PPF levy	£4.2m	£100.0m
PPF levy if insolvency rating worsens by one grade		
New insolvency rating	3	10
New PPF levy	£8.5m	Unchanged due to cap
Percentage increase in PPF levy (%)	102	0

Source: Cazenove

the probability of insolvency within the next 12 months), and the 'underfunding risk' of the scheme (i.e. a comparison of the scheme assets and scheme liabilities calculated on an s179 buy-out basis).

A cap will be imposed on the risk component to ensure that paying the PPF levy does not push high-risk companies into insolvency. The exact level of the cap has not been determined yet – the proposals use 3% of liabilities as an illustration – but the cap will only apply to the most extreme cases.

At the other end of the spectrum, schemes where the fund assets equal or exceed 105% of the fund liabilities will still have an underfunding risk component in their levy, based on 1% of their liabilities.

Figure 1 illustrates the way that the risk-based component of the PPF levy varies with funding levels and insolvency risk, compared to the liabilities of the pension scheme.

ALLOWING FOR INSOLVENCY RISK A key determinant of the levy will be the company's insolvency rating. This will be determined by D&B using a credit scoring system to allocate companies to one of 10 bands (see *Figure 2*).

Figure 3 shows how the PPF levy will vary according to the insolvency band allocated to a company, given a particular level of funding in the pension scheme.

PPF LEVY CALCULATION – ILLUSTRATION *Figure 4* illustrates the PPF levy that would result under two different scenarios (based on the assumption that the s179 liability is 95% of the FRS 17 liability).

In the first scenario the PPF levy for a company with a strong credit rating and an 80% funding ratio for its pension scheme is £4.2m. By contrast, if the company had a much weaker credit rating, the same FRS 17 pension liabilities, but a PPF funding ratio of only 60%, then the PPF levy would be nearly 24 times higher, at £100m.

Figure 4 also highlights the potentially significant impact of an insolvency band 'downgrade'.

POTENTIAL PROBLEMS WITH THE PPF LEVY Several issues have come to light during the consultation period which may or may not be resolved when the PPFB issues its final decision.

1. It would appear that the insolvency band will be determined by the status of the scheme sponsor as opposed to the credit rating of the ultimate holding company. This obviously means that groups with strong credit ratings in the market may find their insolvency band is higher than expected.

2. It is unclear to what extent the PPF levy can be reduced by intra-group guarantees or other forms of credit enhancement.

3. HSBC Actuaries and Consultants has said that contingent funding arrangements (such as letters of credit) will not be taken into account when assessing the funding level of the scheme.

4. The proposals imply that the PPF levy is more sensitive to the company's insolvency band than it is to the level of funding in the scheme (see *Figures 3* and *4*), implying that companies should concentrate on improving the former rather than the latter.

5. If companies choose not to provide an up-to-date s179 valuation the PPFB will make assumptions based upon the last Minimum Funding Requirement valuation submitted. It is not clear exactly how this will be done, nor the extent to which recent cash contributions to the fund will be taken into account.

6. The structure of the scheme has been criticised on the basis that it imposes undue burdens on stronger companies with better-funded schemes and will add further impetus to the trend to close final salary schemes.

A FLEA-BITE FOR SOME, A PROBLEM FOR OTHERS For many UK companies with a strong credit rating with pension funds that are underfunded but not disastrously so, the PPF levy will be an unwelcome extra cost but probably not that significant a burden.

For sub-investment grade companies with severely underfunded pension schemes, the PPF levy could be a more significant issue.

It will also create an additional risk for companies that are on the borderline of an insolvency band, since the impact of falling to a lower band can be significant.

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See Technical Update, page 54, for ACT warning on PPF levy.