BEN MCDONALD THINKS THE PENSION PROTECTION FUND (PPF) HAS HAD A GOOD FIRST YEAR BUT WONDERS IF THERE IS ROOM FOR IMPROVEMENT.

Testing the vintage

Executive summary

- A number of companies have complained of unfair levy assessment.
- Some of the most reputable and apparently secure companies in the UK have low scores while companies reported to be on the brink of collapse boast high D&B scores.
- D&B's approach is rigid and objective, and companies will need to recognise this and react to it if they are to control their levy.

During the last week of March, Croydon saw an unprecedented number of harassed couriers delivering scheme information forms, whilst the Knollys House phone lines hummed with activity as companies scrambled to reduce their inaugural risk-related Pension Protection levy. With the dust now settling, the UK defined benefit plan sponsors wait anxiously as the Pension Protection Fund (PPF) sieves through its information and calculates the levy due from each scheme. Invoices are expected towards the end of the summer.

THE PENSION PROTECTION FUND – WHAT IS IT? The Pension Protection Fund is the safety net set up by the government to receive pension assets from schemes emerging from insolvent companies, and pay benefits to their former employees. As these schemes are inevitably underfunded, the PPF will make up the shortfall by charging each potential entrant a levy – an insurance premium if you like. For the first time during 2006/2007, the levy will depend not only on the size of a pension scheme, but also on its shortfall of assets to the value placed on benefits and the assessed risk of the company going bust – hence leading to a claim on the PPF. Using the insurance analogy, your premium depends on the size of your car and the likelihood of you having a major crash – it all seems to make sense. However, they have forgotten the no-claims bonus – just ask the larger companies.

LEVY PROBLEMS The methodology employed by the PPF doesn't always seem to add up. A number of companies have complained of unfair levy assessments – caused by issues such as business structure in the UK, incorrect data records or unusual benefit plans that don't fit the model used by the PPF for its levy calculations.

In addition, the cap on the levy means that the very worst risks pay a levy which can be substantially less than their expected cost of claims. Of course, the excess is picked up by the population generally regarded as the better risks.

DUN & BRADSTREET – A BLACK BOX? Back in the summer of 2005, the PPF announced that it would use Dun & Bradstreet (D&B) to provide risk assessments for all UK pension scheme sponsors. The rationale was sound. D&B was the only agency that provided a credit assessment for all UK companies, large or small. Whilst the larger rating agencies may have bemoaned the choice of D&B, they would not have welcomed the significant criticisms directed towards their smaller contemporary since. Are these criticisms justified?

D&B's scores often appear confusing. Some of the most reputable and apparently secure companies in the UK have low scores, mainly driven by payment behaviours, such as failure to settle County Court Judgements (CCJs) or pay suppliers on time. There are examples of CCJs depressing scores to the extent that settling these, perhaps at a cost of thousands, could result in an annual levy saving of millions.

It also appears that many companies have little regard for their D&B score, given its relatively low profile, especially amongst the larger companies that are more concerned about the views of Moodys, Standard and Poor's or Fitch. Perhaps companies are regularly downgraded by D&B (we certainly see more volatility of scores than one might expect), which D&B cites as evidence to support its methods when a failure happens. Maybe as companies pay more attention to their D&B score, there will be less frequent downgrades and failures will appear less correlated to low scores.

In the course of researching PPF levies, KPMG has observed companies reported to be on the brink of collapse that boast D&B scores in the 90s (out of 100). Presumably they are still paying their bills on time. This puts them in the lowest 10% of risks within the UK – not the case if you believe the popular press in some cases.

It also seems that a large number of companies that sponsor schemes have managed to improve their score and KPMG has helped some of these. There seem to be a lot of companies with a score of 100 – it should be 1% of all companies. Are most of the sub-100 scoring companies now those that do not sponsor a defined benefit pension scheme?

The PPF (presumably advised by D&B) attaches an assumed failure probability to each score. The PPF's December 2005 consultation document shows that the failure probability for a score of 99 is around double that at 100 – meaning some small changes to procedures could halve levies in some cases. If those falling out of the 100 score band are not levy payers (i.e. because they do not have a defined benefit scheme), then the total levy collected will therefore reduce.

Many commentators have suggested that D&B's methodology is a "black box". What KPMG has learnt is that D&B's approach is rigid and objective, and companies will need to recognise this and react to it if they are to control their levy. The objectives of the PPF may not have been to ensure that all CCJs are immediately settled, head offices move to Northern Ireland or that all Group Treasurers be instantly awarded Executive Board status (sorry, that isn't really a factor), but companies will need to act differently and abide by D&B's rules if they want to keep their levy down.

IS D&B UNDER THREAT? There are a number of large companies who have suggested that the PPF should back-track and appoint one of the more decorated rating agencies, possibly as an override where a company has invested in a rating. This solution has appeal, although to date the PPF seems to have pinned its colours firmly to the D&B mast. A review of D&B's role might be expected over the summer, but in KPMG's view companies shouldn't expect much change.

USE OF CONTINGENT SUPPORT The other way that companies have rushed to reduce their levy has been through the establishment of "contingent asset" support. There are three types of contingent asset available that the PPF recognises – group company guarantees, charges over company assets or guarantees from third parties such as banks. The latter has proved to be generally too expensive in most circumstances. Companies have often found that the cost of credit with the PPF is lower than the price charged by a bank; this calls into question whether the PPF levy is, in fact, "too cheap" overall.

A number of group company guarantees have been established. These effectively replace the failure score of a supposedly sickly scheme sponsor with the insolvency rating of a stronger group company. There are a number of pitfalls with this methodology and the guarantor needs to have a good D&B score. This can be achieved through a good trading history often easily achieved where a company doesn't trade, for example. The levy formula does not actually recognise how able a guarantor is to financially support the scheme; it is effectively assumed that there would be no recovery in the event of insolvency. Hence a guarantee from a company with comfortably enough net assets to cover the pension shortfall, or one with insufficient to cover the deficit, would be worth the same in levy terms, if these two guarantors had the same D&B score (which is quite possible).

The concern companies have with charges over assets (such as buildings) relates to the open-ended commitment, with significant restrictions on a company's ability to get a release from such a charge. In short, the charge can only be removed if it is replaced by either an alternative asset, contingent or otherwise, or a reduction in deficit.

OVERLAP WITH FUNDING Companies that have used contingent assets may get a "kicker" in the form of credit for these in funding negotiations. The Pensions Regulator has indicated that it will encourage the use of contingent assets, where these reduce risk, and may allow companies to reflect these in deficit recovery plans. As the Pensions Regulator's primary objective is to prevent claims on the PPF, this consistency would certainly be welcomed.

WHAT'S NEXT? RECOGNISING INVESTMENT RISK The PPF will consult this summer on how to reflect investment risk in the levy formula. This is primarily based on the pensions industry view that equities are more risky than bonds. This could be immensely complex as the PPF's exposure doesn't just vary with the size of the deficit and the equity bond mix. The absolute level of assets and liabilities is relevant, and there are many complexities in the asset mix such as the allocation within equities, the targeted alpha, and other asset classes such as property, commodities etc. And what about those schemes that have hedged some of their exposure using derivatives – how will their real exposure be measured? On the other hand, it would be perverse to measure investment risk accurately when the crude measure of D&B scores is used to assess a company's creditworthiness. The fear is that the PPF will be forced into a pragmatic approach that simply treats bonds as "low risk" and everything else as "high risk" – which could lead to a further rush to bonds, ever lower yields and increasing deficits.

WILL THERE BE ENOUGH LEVY? With so many companies taking steps to reduce their levy, this raises the question of how much levy will be collected in 2006/2007. The PPF suggested it was collecting £575 million, but the actions taken by companies may have significantly reduced this amount in practice (although presumably the projections made some allowance for this). Of course, if the actions taken by companies to reduce their levy equate to reductions in the risk posed to the PPF, there is no problem. However, the PPF's website shows that over 60 schemes are already going through the entry procedures. There is a strong suspicion that the PPF will itself quickly become what many suspected from the start – the UK's most underfunded pension scheme.

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