

The Board of the Pension Protection Fund (the “PPF”)

PPF Levy Practice Guidance in respect of the financial year 1 April 2010 – 31 March 2011

Guidance on the use of discretionary powers

The determination of the PPF issued under section 175(5) of the Pensions Act 2004 contains a number of discretionary powers for the PPF. This guidance note sets out principles and case studies showing how the PPF expects to exercise those discretionary powers.

This document is not part of the determination and it is not a binding restriction on the way in which the PPF will exercise its powers. The PPF will update this document from time to time in the light of its experience, either for the current levy year or for future years. The PPF will have regard to this document but may decide to depart from it when the circumstances of an individual case make it appropriate to do so or when the PPF is persuaded that the approach indicated in this document is no longer appropriate.

This document is not a binding interpretation of the law, which can only be supplied by the courts.

The first part of this document focuses on the limited circumstances in which the PPF may calculate the levies using something other than data submitted on the Pensions Regulator’s Exchange system at the relevant deadline. The second part covers contingent assets, specifically the rules that apply when contingent asset cover is removed, amended or replaced. Finally we include a reminder of how scheme trustees can appeal their invoices, including the exercise of any relevant discretions.

I. DISCRETIONS RELATING TO SCHEME DATA

A. Introduction

As is made clear by the determination, in the vast majority of cases (and except where expressly stated, such as in the case of contingent assets, where hard copy documentation will be equally relevant) the fundamental basis of the calculation of the Levies will be the data submitted on Exchange at the relevant measurement time, together with the data provided to Dun & Bradstreet in respect of that time. Cases for the use of PPF discretion will be

exceptional. Most cases will be determined by a straightforward application of the basic rules in the determination.

B. Exercising the discretionary powers

There are a number of different categories of case in which exercise of discretion may be relevant:

1. Cases where it is not possible to produce an invoice which complies with the determination – usually, this will be because the data supplied to the PPF is insufficient.
2. Data errors including (a) cases where the PPF's own plausibility tests indicate that there is an error; and (b) other data errors, that do not fit into category (a).
3. Mistaken analysis/presentation of the scheme's partial winding up provisions or the persons who were the employers in relation to the scheme.
4. Post-deadline changes to information on Exchange and accepting late data.

1. Inability to produce an invoice

This (rare) situation will most commonly arise where the data supplied by the scheme via Exchange is insufficient to allow the calculation of an invoice which complies with the determination. This will usually be dealt with through the application of prudent assumptions e.g. it will be assumed that the scheme is amongst the least well funded schemes.

2. Data errors

The PPF does not generally allow data corrections. Some of the reasons for this are as follows:

- Requests for corrections cause an administrative and cost burden in making changes to our databases and generating new invoices.
- The need to issue new invoices extends the invoicing period and delays the receipt by the PPF of the levies and thereby delays the investment of levy revenue. We are trying to increase stability in the levy

estimate, reduce the invoicing period and create conditions in which schemes can know and budget for their invoices in advance. The provision of correct information by the deadlines is essential to achieving this. The sooner the PPF has accurate data on all schemes, the sooner we can validate it and begin invoicing, the shorter the invoicing period, and the closer the amount we collect will be to the levy estimate.

- We also think that it is reasonable to expect schemes to supply us with correct data and to incentivise appropriate behaviour. Schemes and their advisers have had a number of years now to get used to the system and, as a matter of law, are under an obligation to provide correct data.

Notwithstanding this, some sensible exceptions need to be made, so we still reserve the discretion to allow schemes to correct incorrect data or indeed to correct it ourselves. However, in order to achieve the policy aims, these exceptions must be extremely limited. Additionally, the discretion only applies where the information originally supplied was, in fact, incorrect (as opposed to where the scheme could have submitted later information or presented the information more advantageously but chose not to).

(a) Plausibility tests

Over its short history, the PPF has developed a data testing regime designed to flag data which we believe, based on our experience, is likely to be incorrect. Clearly, these tests cannot be designed to cover all data (for example, we cannot test whether a scheme has established who its employers are correctly), but we have tried to develop a significant body of tests. In doing so, we aim to ensure that we are protected to a certain extent from gaming of the levy system. Where possible, we also carry out these tests very shortly after the measurement date, so that we can capture any changes in the scaling factor.

The fact that a test has been triggered does not necessarily mean that the data is incorrect. The tests are designed to flag data which we think is inconsistent or unusual, in some cases, as compared with other data. Nor will tests detect all erroneous data – so schemes should not rely upon them to pick up their errors.

Where a test is triggered, we conduct data cleansing activities on the particular piece of data that is flagged as inconsistent or unusual. In these circumstances, we will contact the trustees or their advisers to confirm

whether the data is correct and seek an explanation if it is and the correct data if it is not.

In most cases, where the information referred to in our correspondence is confirmed to be incorrect, we will correct it.

However, equally, in most cases, we will not permit other data (in respect of which no tests have been triggered) to be amended at the same time. If we allowed other corrections once a plausibility test had been triggered, this would render the data deadlines meaningless for any scheme where any plausibility test was triggered. This would not be fair for those for whom no plausibility test was triggered.

(b) Other data errors

In considering whether or not to exercise its discretionary powers, the PPF will consider the following circumstances:

- a. The effect of the error on the calculation of the Levies.
- b. The reason that erroneous data was validated¹.
- c. Responsibility for the erroneous data, including whether any professional indemnity insurance may compensate the scheme.
- d. The speed with which the error was identified.
- e. The reason for the error.

Where an error has resulted in under-calculation of the levies, the PPF is more likely to exercise its discretionary power to make a data correction, as the underpayment is to the detriment of all other levy payers who have submitted correct data². Where the scheme pays higher levies, as a result of a mistake

¹ In particular, where the scheme can establish that it has had difficulty with Exchange (e.g. the system does not allow correct data to be input or is misleading) and has made an error as a result, the PPF might be more minded to allow the correction.

² If it is clear that the scheme has deliberately entered incorrect data in an attempt to reduce their invoice, it might be appropriate to correct the relevant data without anything further needing to be shown.

by someone with responsibility for the scheme, it is not usually unfair to collect and retain the higher levies as the scheme has breached its statutory duty to provide correct information. In a case where the extra cost is caused by the carelessness of professional advisers, the trustees may be able to take action against those advisers for any loss suffered as a result.

4. Winding up provisions and employer relationship

The PPF accepts that some of the matters reported through Exchange – such as the nature of winding up provisions and the identity of the employers – are subject to uncertainty and complex analysis. In considering whether or not to exercise its discretionary powers, the PPF will take account of the circumstances set out in 3 above, including taking account of questions as to whether there is a good explanation as to why the incorrect analysis was used.

5. Late data

Exchange allows for an update of information right up to the relevant deadline. Therefore, requests for exercise of discretion based on changes in information which are not updated will not normally be accepted. Notwithstanding this, the Board does retain the right to obtain data from schemes after the relevant deadlines and may exercise this discretion where it considers it expedient to do so.

Additionally, where a communication failure has occurred Rule B4 of the determination may apply. This generally requires evidence that the information was despatched at an appropriate time, but was delayed by the post or by breakdown in electronic communications. For example, where contingent assets hard copy documentation has been sent to us by courier, we would generally expect you to be able to provide us with:

- a copy of the collection receipt from the courier indicating the time of collection by the courier; and
- evidence of the service level requested from the courier.

From these, we could then establish whether the documents were indeed despatched at an appropriate time and were delayed.

C. Examples of corrections

Example 1 – correction request accepted

The ABC Pension Scheme was established in 1998, but had received a transfer from the XYZ Pension Scheme, which was established in 1985. Andrew, the chairman of trustees of the ABC Pension Scheme, was completing the scheme return online, but found that Exchange would not allow him to enter a figure in the "pre 1997" liabilities box. He emailed the PPF's stakeholder support team to let them know that there was a problem and the figure that should be in the box.

When Andrew receives his invoice, it seems quite high and he writes to the PPF's stakeholder support team, the next day, to check what figure had been used for the pre-1997 liabilities, explaining the problem with Exchange and referring to his previous email.

Andrew's correction is granted and his invoice adjusted. The problem here was with Exchange and Andrew could not have been expected to provide accurate data through Exchange.

Example 2 – correction request denied

The DEF Pension Scheme has asked its actuary, John, to fill in the scheme return for it. John asks his temporary secretary to extract the data for the latest s179 valuation from his firm's system. Unfortunately, he gives the secretary the wrong PSR number and he fails to check her work. As a result, John submits the wrong valuation results. To make matters worse, the PSR he does use is for a bigger scheme which has a greater deficit.

When the DEF Pension Scheme gets its invoice, Peter, the chairman of trustees, calls John and expresses his concern at the size of the invoice. John reviews the invoice, realises his mistake, and gives Peter the correct figures. Peter writes to the PPF the next day, requesting that his invoice is adjusted by using the correct figures for the DEF Pension Scheme's s179 valuation results.

Peter's request is denied. He has given no explanation as to why the mistake could not reasonably have been avoided. There may be a claim against the professional indemnity insurance carried by John's firm.

Example 3 – correction request granted

Martin, a trustee of the UVW Pension Scheme, is filling in the scheme return. He is completing the scheme structure question and gets out the trust deed to check what the scheme provides in terms of partial winding up. He reads clause 32 of the deed, which states as follows:

“Upon a Participating Company ceasing to participate in the Scheme the Principal Employer may, subject to Rule 33, segregate a part of the assets of the Scheme in relation to-

- (i) those Active Members who are then in the Service of the Participating Company; and (if the Principal Employer so decides)*
- (ii) Members in the Service of the Participating Company who are not Active Members, and other Members who were formerly in its Service and persons whose benefits arise in respect of such Members,*

the choice of (i) or (ii)(or neither) being determined by the Principal Employer at its absolute discretion.”

Martin fills in the Scheme return ticking the box which says that the scheme has a discretion to segregate. He is later discussing the issues around partial winding up rules with his legal adviser, David. David tells him that, whilst on its face, it might appear that Martin had ticked the right box, in fact, the correct analysis is that the scheme does not have a provision for partial winding up. He explains that this is because of the precise wording of the legislation, which only treats the scheme as having an option to segregate if that option is given to the trustees, not the Principal Employer as the deed provides.

Martin contacts the PPF and asks if he can amend this. He explains that he filled in the scheme return on the basis of what he thought was appropriate and had seen no reason to seek legal advice on this issue.

The invoice for the UVW Scheme is adjusted on the basis that the scheme is a scheme without a provision for partial winding up. Martin has made a mistake on a highly technical legal matter, but one which (as a lay trustee) he reasonably thought was straightforward.

Example 4

The GHI Pension Scheme transferred all its assets and liabilities to the RST Pension Scheme on 1 January 2010. As part of the transfer agreement, the Trustees of the GHI Pension Scheme undertook to “take all such actions as are required to ensure that appropriate notification is made in relation to the transfer to ensure that no fines or other loss is suffered by the RST Pension Scheme”. However, Paul, the scheme administrator of the GHI pension scheme who is charged with doing this task takes a 6 month sabbatical

starting in February and forgets to pass on this task to his colleagues. Because it was Paul's task, nobody at the RST Pension Scheme takes a note and consequently nobody chases Paul.

When the chairman of trustees of the GHI Pension Scheme, receives a levy invoice for the 2010/11 levy year, she informs the PPF's eligibility team that the GHI scheme has fewer than two members. The eligibility team ask her to explain in a bit more detail and she tells them about the transfer.

As a result, the RST Pension Scheme (who has not yet been invoiced) receives an invoice based on an underfunding figure which Ayesha, a trustee of the RST Pension Scheme, finds surprisingly high. Ayesha queries this and is referred to the requirements in respect of block transfers. She asks if she can resolve the situation by making sure all the required information is submitted in the next week. Her request is rejected. She has provided no reason as to why the transfer was not properly notified and she may be able to recover the loss through the transfer agreement provisions. Even if she were not so able, she had the opportunity to insist on something more specific in the transfer agreement which would have allowed her to make a claim.

Example 5

The JKL Pension Scheme transferred all its assets and liabilities to the OPQ Pension Scheme on 1 January 2010. As part of the transfer agreement, the Trustees of the JKL Pension Scheme undertook to "take all such actions as are required to ensure that appropriate notification is made in relation to the transfer to ensure that no fines or other loss is suffered by the OPQ Pension Scheme".

Jin, the scheme administrator of the JKL Pension Scheme who is charged with doing this task immediately starts the notification process and Jane, the administrator of the OPQ Scheme confirms the basic details in February 2009. Jane then asks Tim, the Scheme Actuary to supply her with a valuation of the OPQ Scheme after the transfer, which she posts on Exchange on 15th May.

However, Jin takes a 3 month sabbatical starting at the beginning of May and forgets to pass on the task of supplying the post-transfer valuation for the JKL Pension Scheme to his colleagues. He does not put an out of office note on his emails. Jane, the administrator of the OPQ Pension Scheme, emails Jin with increasing urgency as the 30 June deadline approaches and also emails the trustees direct, to remind them of their obligations. She points out that their valuation should be extremely simple (as they will have no assets or liabilities) and highlights the effect that their failure could have on the OPQ

Scheme. Lastly, on 27th June, she emails the PPF stakeholder support team to explain her difficulty.

When Jessica, the chairman of trustees of the JKL Pension Scheme, receives a levy invoice for the 2009/10 levy year, she informs the PPF's eligibility team that the JKL scheme has fewer than two members. The eligibility team ask her to explain in a bit more detail and she tells them about the transfer.

As a result, the OPQ Pension Scheme (who has not yet been invoiced) receives an invoice based on an underfunding figure which Tim finds surprisingly high. Fiona, the chairman of the trustees, queries this and is referred to the requirements in respect of block transfers. She explains that Jane had done everything she could to comply with the provisions and had tried to ensure that the JKL Pension Scheme did too. She refers the stakeholder support team to the data she submitted on Exchange and sends in copies of Jane's increasingly urgent emails to the JKL Pension Scheme.

Her request to adjust the invoice for the OPQ Pension Scheme (to use the post-transfer valuation she has supplied) is accepted. Jane has indeed done everything she could to properly notify the transfer and, although she may be able to recover the loss through the transfer agreement provisions, given her exemplary efforts, it is unduly harsh to require the scheme to pursue that route.

Example 6 – correction imposed

MNO Pension Scheme entered its Section 179 Valuation data on Exchange on 27 March 2009. In the liabilities section, the sum of the liabilities excluding expenses for active members, deferred members, pensioner members, estimated costs of winding up, estimated expenses of benefit installation/payment and external liabilities came to £100,000 less than the figure entered in the total protected liabilities box. The mismatch in the figures triggered a PPF plausibility test and on 6 April 2009 the PPF data cleansing team contacted MNO Pension Scheme to seek an explanation. Rachel, the scheme actuary, realised that she had mistakenly entered the liabilities in respect of the deferred members to be £100,000 less than the actual liabilities in respect of deferred members. The PPF imposes the data correction.

II. AMENDMENT AND REPLACEMENT OF CONTINGENT ASSETS

A. Background

1. Since the PPF contingent asset regime was introduced as part of the first risk based levy in 2006/07, it has always been a key policy of the PPF only to recognise contingent assets that are “long term” in nature. Generally this means that only agreements of indefinite duration are recognised; however there are the following main exceptions:

(a) all the PPF standard form agreements contain provisions whereby “excess” contingent asset cover may be reduced once certain funding levels are achieved;

(b) Type C(i) letters of credit/bank guarantees need only be for a minimum one year duration; however they must include an “evergreen” provision whereby the trustees may call on the asset if it is not renewed before expiry; and

(c) Type C(ii) letters of credit/bank guarantees need only last for as long as the schedule of deficit reduction contributions which they guarantee.

In each case, it will be seen that the overall long term funding enhancement associated with the arrangement will be (very broadly) constant, whether because the contingent asset remains in place itself or it has been replaced by another contingent asset or cash in the scheme.

2. Policy justifications behind this approach include:

(a) although the levy for individual schemes is currently calculated based on measures of short term underfunding and insolvency risk, that measure is scaled so that each scheme makes a contribution in respect of future years’ risk as well. The PPF therefore considers it is fair within the current system only to include, in the calculation of assets at the measurement date, contingent assets that are expected to be in place for the long term (as, of course, are the assets in the scheme already). To take a simple example, consider a scheme which has a weak employer, but benefits from a fixed term guarantee from a strong parent. If, shortly after the expiry of the guarantee, the employer becomes insolvent, is abandoned by the parent and the PPF takes over the scheme, then the scheme will have substantially underpaid for the risk it posed to the PPF over the preceding years.

(b) the PPF seeks more generally to encourage behaviours which remove long-term risk from the system, to the benefit of the wider community of eligible schemes.

However, contingent asset agreements are private agreements between the providers and the trustees of the scheme. The PPF is not a party to the agreements, and the contingent asset providers and trustees are able (as a matter of contract) to cancel or amend the agreements at any time. The trustees' scope to do this will of course be significantly circumscribed by their duties as trustees; however, ultimately, that decision is a matter for the trustees, not the Board and the PPF cannot directly guarantee that a PPF-compliant contingent asset entered into in year 1 will in fact still be in place in year 2. What the PPF can and should do, however, is reflect the subsequent history of the contingent asset in calculating the levy.

3. The PPF recognises that removal, reduction or replacement of contingent assets may in some cases be entirely appropriate and not lead to any, or any significant, increase in risk. A broad outline of such "acceptable changes" is set out at B below. However, other changes by voluntary actions of the parties are regarded as "unacceptable changes".

Arguably, where a contingent asset that was expected to be in place for the long term is subject to an unacceptable change, the PPF should "claw back" at least part of the levy reductions related to that contingent asset for every year since the asset was put in place. However this would be a rather extreme approach, as well as being administratively difficult to achieve. Instead, the approach of the PPF in the determinations up to and including that for 2009/10 has been (very broadly) as follows:

(a) where an unacceptable change occurs in the middle of a levy year, the levy for that year will be recalculated as if the contingent asset in question had never been in place during that year

(b) where an unacceptable change occurs between levy years, no credit at all will be given for any contingent assets in the latter year (even if there remain some contingent assets with value which would otherwise satisfy the recognition requirements)

(c) where an unacceptable change takes place, the scheme may not be given credit for any contingent assets in future years until the

position has at least been restored to that which prevailed before the unacceptable change occurred.

In practice, it is very difficult to specify in advance all of the possible circumstances in which parties might legitimately want to make changes to their contingent asset arrangements, and the impact which such changes ought to have on the levy. The PPF has become aware of isolated examples in which the prescriptive rules in past years' determinations have hindered or prevented entirely appropriate actions. The draft determination for 2010/11 therefore contains, at Rule D3, a slightly broader discretion whereby the PPF can decide not to adjust the levy where contingent assets are subject to acceptable changes, whilst the basic non-recognition rule will continue to apply for unacceptable changes.

4. The broad principles on which the PPF intends to exercise this discretion are as follows:

(a) Any change that is made strictly in accordance with rules set out in the standard form agreements is very likely to be an acceptable change. So, in circumstances where the guarantor in respect of a Type A contingent asset puts forward a "Proposal" as defined in the standard form guarantee, and under the terms of the agreement the Trustees may not unreasonably withhold their consent to the Proposal, then the Proposal is very likely to be an acceptable change. The fact that the trustees may have been content to do this on shorter notice than the standard form anticipates would not generally affect this analysis.

(b) Changes in value resulting from actions entirely outside the control of the parties to the contingent asset agreement are very likely to be acceptable changes. Rule D3 explicitly confirms that for example, a fall in the market value of a piece of land charged in a Type B(ii) asset, taken alone, will not attract specific action under Rule D3 (though of course it may result in a direct reduction in the levy credit each time the contingent asset value is used in the levy).

(c) However, the PPF regards the following as being within the control of the parties and therefore potentially unacceptable changes:

(i) a decision by a contingent asset provider not to continue to provide the asset on grounds of cost – e.g. where a Type C(i) asset is not renewed on expiry, or a charge is released in order to improve the balance sheet of the chargor; or

- (ii) a decision by trustees not to enforce rights available to them – e.g. where a Type C(i) asset is not renewed and the trustees elect not to claim under the “evergreen” provisions.
- (d) Where there are multiple contingent assets, the PPF will look at all the assets together, comparing the overall position after the change with that before.
- (e) If a guarantor in respect of a Type A guarantee is replaced, this will usually be an acceptable change if the new guarantor is at least as strong as the old one. Strength will usually be assessed based on failure scores or risk indicators provided by D&B, as at a date within five days on either side of the date of replacement. Otherwise such a change is likely to be unacceptable.
- (f) If a liability cap is amended upwards within the same cap type (e.g. a guarantee of a 100% funding level on a s179 basis is changed to a guarantee of 105%) this will usually be acceptable.
- (g) If a liability cap type is changed (e.g. a £10m cap is converted to a cap guaranteeing 100% funding on a s179 basis), the actual monetary value of the cap as at the point of the change will be calculated and if the monetary value remains the same or increases the change will usually be acceptable.
- (h) Replacement of a Type A guarantee with a Type B or C contingent asset of equal monetary value will usually be an acceptable change; changes in the opposite direction will usually not be.
- (i) Where the actual funding level of the scheme is so high that the contingent assets may reasonably be considered to be superfluous (in that the likelihood of their being called on at some point in the future to plug a deficit in the scheme is very low), it will usually be acceptable to release the superfluous element.
- (j) Where the aggregate funding level is not so high as to satisfy the test in (i) above, it will usually only be acceptable to reduce Type B and C cover if and to the extent there has been an at least equal improvement in the actual funding level of the scheme since the contingent asset was put in place.
- (k) The value associated with any liability cap as at a particular date will be estimated by the PPF based on whatever funding data appears

to it most appropriate – typically the type of asset and liability data used for the levy..

(l) Extending the list of companies whose pensions obligations are secured by the contingent asset to include new employers will usually be acceptable (and will be necessary to enable the trustees to give the required certification each year). Removal of a company from coverage is likely only to be acceptable if it has ceased to be an employer within the statutory definition set out in section 318 of the Pensions Act 2004.

B. Examples of changes to contingent assets which are likely to be acceptable

(i) A guarantee of the full s75 debt given by Supermarket Ltd is released and replaced by a guarantee in the same terms given by Supermarché S.A. On the date of the change, Supermarket Ltd has a UK failure score for which the associated PPF probability of insolvency is 0.5%, whilst Supermarché S.A. has a French failure score for which the associated PPF probability of insolvency is 0.3%.

(ii) A Type C(i) letter of credit for £10m issued by Bank A expires and is replaced by a Type C(i) bank guarantee for £20m issued by Bank B (Banks A and B must of course both satisfy the recognition requirements as to credit rating, domicile, regulation etc).

(iii) Based on the most recent s179 valuation (dated 31 January 2009 and as at 31 July 2008) and applying the PPF roll-forward methodology, the scheme is 150% funded (without taking into account any contingent assets) as at 31 March 2009. All existing Type B and C contingent assets are released with effect from 31 March 2009.

(iv) As at 31 March 2009, the scheme has liabilities of £100m and assets of £80m on a s179 basis. A Type C(i) contingent asset valued at £10m is put in place. As at 31 March 2010 the scheme's assets have increased to £95m and the liabilities to £105m, meaning the scheme is now over 90% funded. The Type C(i) contingent asset is released.

C. Examples of changes unlikely to be acceptable

(v) As example B(i) above, but Supermarché S.A.'s associated PPF probability of insolvency is 0.6%.

(vi) As B(ii), but the sponsor can only afford a bank guarantee for £5m from Bank B (unless the funding level has improved sufficiently in the meantime).

(vii) As B(iii), but the scheme is only 100% funded as at 31 March 2009 and the Type B and C contingent assets are released and replaced with parent company guarantees.

(viii) Supermarché S.A. guarantees the obligations of three UK subsidiaries, all of which participate in the scheme. One of the subsidiaries is in financial difficulties and Supermarché S.A. persuades the trustees to release the guarantee in relation to that subsidiary while continuing to cover the other two.

III. APPEALING A LEVY INVOICE

The calculation of a levy invoice is a 'reviewable matter' under section 207 of the Pensions Act 2004. The formal review process considers whether the PPF has followed the rules of the determination when calculating the levy. Accordingly, if the trustees of a scheme are unhappy about the way in which the PPF has exercised any of the limited discretions reserved in the determination, and described above, they should apply for a review in the normal way.

It is important to note that the PPF cannot change or depart from the levy determination itself, including the levy formula, or any of the policies or rules contained in it, when calculating individual invoices. So, for example, in a case where D&B have properly provided a failure score for the employer in relation to the scheme, an application which argues that the PPF should depart from the determination and use something other than that D&B score will not be successful, as there is no discretion in this regard.

We consult annually on the levy rules and anyone with an interest in the PPF can respond.

Details of how to apply for a review of a levy invoice, and of levy consultations and how to respond, can be found on the PPF website:

www.pensionprotectionfund.org.uk