

Pension
Protection
Fund

The Response to the Second Pension Protection Levy Consultation February 2006

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Contents Page

Chapter 1 - Introduction and Summary of Responses	2
1.1 Introduction.....	2
1.2 Summary of Consultation Responses	2
1.3 Implementing the pension protection levy.....	3
Chapter 2 – Final Proposals for Contingent Assets as a Risk Factor	4
2.1 Introduction.....	4
2.2 Summary of consultation responses.....	4
Chapter 3 - The Final Levy Proposals.....	7
3.1 Introduction.....	7
3.2 Revised proposals.....	7
3.3 Levy determination	8

Chapter 1 - Introduction and Summary of Responses

1.1 Introduction

- 1.1.1 The Board of the Pension Protection Fund was set up as a statutory corporation established under the provisions of the Pensions Act 2004, and became operational on 6 April 2005. The Pension Protection Fund has been established to pay compensation to members of occupational defined benefit and hybrid pension schemes, following an insolvency event of the sponsoring employer where there are insufficient assets to pay a Pension Protection Fund level of compensation.
- 1.1.2 Compensation payments will be partly funded by the assets transferred from schemes for which the Pension Protection Fund has assumed responsibility, and partly by an annual levy raised from eligible pension schemes. The initial levy for 2005/06 was based on scheme membership numbers only. For the 2006/07 levy year the Board of the Pension Protection Fund will charge the first pension protection levy, which will be made up of two parts: a scheme based levy, and a levy based on the risk posed by an eligible scheme to the Pension Protection Fund.
- 1.1.3 The Board of the Pension Protection Fund published a consultation document on the pension protection levy on 12 July 2005, which was followed by a twelve week consultation period. The consultation period ended on 4 October 2005 and over 200 responses were received. The Board's final proposals for calculating the pension protection levy, including how contingent assets would be recognised within the levy calculation, were published on 16 December 2005. Alongside this December consultation document, the draft Determination by the Board under section 175(5) of the Pensions Act 2004 was also published.
- 1.1.4 A second five week consultation period followed, which ended on 23 January 2006. Over 70 responses were submitted during the second levy consultation period, and the Board is grateful to all those who provided responses.

1.2 Summary of Consultation Responses

- 1.2.1 The Board welcomes the positive and encouraging manner in which the December consultation document and the final proposals for calculating the pension protection levy have been received.
- 1.2.2 The Board has considered all the consultation responses. As set out in the December consultation document, the December proposals were intended to be firm, so that schemes and employers could plan with confidence. We are, however, pleased that we have been able to incorporate a number of improvements to the more detailed aspects of the final proposals in the light of the consultation responses received.

- 1.2.3 The Board is particularly grateful for the comments provided on its contingent asset proposals, and has revised the contingent asset documentation accordingly, as discussed in chapter 2 of this document.
- 1.2.4 In response to a number of consultation responses, the Board has decided to amend the requirement that valuations be submitted to the Board within one year of the effective date. For the 2006/07 levy year, if trustees miss the one year deadline in regulations but still submit the section 179 valuation results by 31 March 2006, and comply fully with the relevant regulations and guidance in all other respects, the Pension Protection Fund will use such results in the risk based levy calculation. The Board hopes that this amendment may increase the number of section 179 valuations submitted by the deadline of 31 March 2006.
- 1.2.5 The Board has also amended its proposals for calculating the insolvency risk of UK branches of foreign registered companies.
- 1.2.6 In addition, further consideration has been given to the parental severe risk override within the Dun & Bradstreet (D&B) failure score. As discussed in chapter 3 of this document, this override will be ignored for the 2006/07 risk based levy calculation.

1.3 Implementing the pension protection levy

- 1.3.1 The pension protection levy will now be implemented as per the finalised Determination by the Board under section 175(5) of the Pensions Act 2004. The Determination is published alongside this document.
- 1.3.2 The Board's final proposals are determined for the 2006/07 levy year only. The Board will seek to work with key stakeholders to implement longer term changes suggested during the first and second consultation periods and to revise the 2006/07 levy proposals for future levy years where appropriate. The Board's approach will be informed by:
- The significance of improvements as measured against the principles of fairness, simplicity and proportionality;
 - The degree of change in the risk of the universe of eligible schemes;
 - The desire of business to avoid unnecessary change and to have a relatively stable regime.
- 1.3.3 The Board will consult on its levy proposals annually. As set out in the December consultation document, during 2006 the Board has also committed to consulting on how asset allocation could be included in the risk based levy calculation for future levy years.

Chapter 2 – Final Proposals for Contingent Assets as a Risk Factor

Chapter Summary

This chapter considers the comments received in relation to contingent assets, following publication of the Pension Protection Levy Consultation Document December 2005. Revised contingent asset documentation was placed on the Pension Protection Fund website on 24 January 2006. A number of amendments were made to the documents in the light of the consultation responses received.

2.1 Introduction

- 2.1.1 A contingent asset is an asset that will produce cash for a pension scheme contingent on an event (insolvency) occurring to the sponsoring employer. It may take the form of an insurance type contract with a third party (for example a letter of credit with a bank), a right to a specific asset (such as a property) or a guarantee that another company in a group (typically the parent) will step in and provide financial support upon the failure of the sponsoring employer. Contingent assets have generally been used by employers to provide security in place of immediate funding.
- 2.1.2 In the October consultation update, the Board expressed its intention to work towards including contingent assets in the levy calculation and set out an updated levy formula to include contingent assets, where applicable.
- 2.1.3 The December consultation document set out the proposed approach for when and how contingent assets would be reflected in the 2006/07 levy calculation.
- 2.1.4 For the 2006/07 levy year the Board proposed to recognise the following contingent assets:
- Type A assets: Direct group company guarantees;
 - Type B assets: Contingent assets provided by the sponsoring employer, specifically: security over cash, securities or real estate;
 - Type C assets: Contingent assets provided by third parties, specifically letters of credit and bank guarantees.

2.2 Summary of consultation responses

- 2.2.1 The majority of responses received during the second levy consultation exercise discussed the Board's proposals for recognising contingent assets within the levy calculation.

Revised Documentation

- 2.2.2 In particular, the Board received a series of detailed comments on the standard documentation which was made available on the Pension Protection Fund website in draft form as part of the December consultation.
- 2.2.3 The contingent asset documentation was subsequently amended in the light of those comments and revised documentation was placed on the Pension Protection Fund website on 24 January 2006.
- 2.2.4 The main refinements made have been to:
- Include, in all of the Pension Protection Fund's standard form documents, provisions permitting the value of the asset to be reduced, and/or different contingent assets to be substituted, within specified rules;
 - Expand the guidance in relation to the use of the standard forms and the provision of legal opinions and related documentation;
 - Add standard form documentation in relation to security over land in Scotland and Northern Ireland, based on the existing document for land in England and Wales.
- 2.2.5 Before considering putting a contingent asset in place, schemes and employers should read the guidance, standard documentation and certificates available on the Pension Protection Fund website. If any scheme or employer has done detailed work on the versions published on 16 December, the revised versions with changes from the drafts marked are available on the risk based levy publications section of the Pension Protection Fund website (www.pensionprotectionfund.org.uk).

Acceptability Criteria

- 2.2.6 A number of responses also questioned aspects of the Board's acceptability criteria for contingent assets. Several responses considered that the requirement that contingent assets remain in place for the long term did not fit with the principle of an annual levy assessment.
- 2.2.7 However, pension liabilities are also long term in nature and, as the Board set out in its December consultation document, it is seeking to value contingent assets in line with the real reduction in risk they effect. To ensure that all schemes and employers are aware of the conditions under which a contingent asset could be reduced or removed, we have now included, in all of the Pension Protection Fund's standard form documents, provisions permitting the value of the asset to be reduced, and/or different contingent assets to be substituted, within specified rules.

- 2.2.8 Several responses also requested that non-standard contingent asset arrangements be recognised by the Board if a legal opinion was provided confirming that the Pension Protection Fund's minimum terms had been met.
- 2.2.9 However, the Board considers it essential that the standard documentation is used, to mitigate enforceability risk and minimise the administrative burden on the Pension Protection Fund.

Credit Default Swaps

- 2.2.10 Several consultation responses specifically noted the Board's intention not to recognise Credit Default Swaps (CDS) within the 2006/07 risk based levy calculation. As set out in the December consultation document, the Board has decided not to recognise CDS in the levy calculation until such time as standardised documentation and procedures can be developed to reflect the specific and more complex mechanics of their operation.
- 2.2.11 The Board has particularly welcomed the helpful responses which have discussed in detail the ways in which standardised documentation could be adapted to enable recognition of CDS without disproportionately increasing the administrative burden on the Pension Protection Fund, and the cost to levy payers. The Board will be working closely with key market stakeholders to develop their proposals in this area during 2006 with a view to including CDS in the risk based levy calculation for future levy years.

Chapter 3 - The Final Levy Proposals

Chapter Summary

This chapter sets out the minor changes that have been made to the Board's December proposals.

3.1 Introduction

- 3.1.1 The Board presented the December proposals as firm, so that a scheme could estimate its individual levy, take any action to reduce it and submit any appropriate voluntary forms to the Board by the deadline of 31 March 2006. However, the Board was keen to welcome any consultation responses that addressed detailed aspects of the proposals.
- 3.1.2 As well as the revisions to the contingent asset documentation set out in chapter 2 of this summary, and the relaxation of the requirement that section 179 valuations be submitted to the Board within one year of the effective date of the valuation as discussed in chapter 1, the Board has revisited two aspects of its proposals for calculating insolvency risk.

3.2 Revised proposals

Calculating the insolvency risk of UK branches of foreign registered companies

- 3.2.1 In the December consultation document the Board said that they would calculate the insolvency risk of UK branches of foreign registered companies (identified with an FC prefix on their Companies House Registration number) by using the average failure score of the UK sponsoring employers of defined benefit pension schemes within the relevant industry.
- 3.2.2 The Board has now given further consideration to which entity should actually be considered the employer of the pension scheme, and has determined that the employer should be the foreign company concerned. We have revised our proposals accordingly.
- 3.2.3 If an employer is a branch of a foreign registered company, the Board will use the Dun & Bradstreet (D&B) score of the foreign company of which the employer is a branch. Only if the Board were unable to obtain a failure score or risk indicator for that company would the average industry score (restricted to those companies sponsoring a defined benefit scheme) be used.
- 3.2.4 If a company wishes to determine the probability of insolvency that would be used in respect of an overseas employer they can:
- Contact D&B's UK customer service team on 0870 243 2344 who

will obtain a failure score for the overseas company. For existing D&B customers this failure score will also be available directly from the D&B website; then

- Contact the Pension Protection Fund helpline on 0845 600 2541 providing details of the country of domicile of the overseas employer and the corresponding failure score provided by D&B. The Pension Protection Fund will provide the company with a Pension Protection Fund assumed probability of insolvency for that failure score.

Overrides within the D&B failure score

- 3.2.5 The Board has previously communicated to stakeholders that the current D&B policy to cap the failure score of a business with negative net worth will be ignored within the 2006/07 risk based levy calculation.
- 3.2.6 In response to consultation responses received, the Board has also given further consideration to the D&B policy to apply a parental severe risk override to the failure scores of subsidiary businesses of a weakening company.
- 3.2.7 The Board, in consultation with D&B, considers that although it is important to consider the strength of the group within which a particular company operates, this rule in its current form is not appropriate for calculating insolvency risk as part of the levy calculation, particularly given the Board's current approach to contingent assets. The Board has therefore decided to ignore this rule for the purposes of the 2006/07 risk based levy.

3.3 Levy determination

- 3.3.1 As noted in chapter 1, the full rules for determining the pension protection levy for 2006/7 are set out in the Board's Levy Determination, published alongside this document. Further information on the levy proposals, and all related factsheets, FAQs, voluntary forms and documents can be found in the risk based levy section of the Pension Protection Fund website (www.pensionprotectionfund.org.uk).
- 3.3.2 The Board encourages schemes and employers to take the opportunity to ensure that the data used to calculate the pension protection levy incorporates the maximum amount of relevant, accurate information, by submitting the following voluntary forms by email to schemeinfo@ppf.gsi.gov.uk, by 31 March 2006:
- Section 179 valuation certificate (which can now be submitted more than one year after the effective date of the valuation);
 - Declaration of Scheme Structure and Participating Employers forms;
 - Contingent asset certificates.

The actuarial certificate of deficit reduction contributions should also be completed, where appropriate, and submitted to the Board by 7 April 2006.

- 3.3.3 Where any levy-related information submitted on the Pensions Regulator's annual scheme return is now out of date, the Board also encourages schemes to submit updated information by email to srupdate@ppf.gsi.gov.uk, by 31 March 2006.

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