

**Consultation Document**

# **The Pension Protection Levy: A New Framework**

**October 2010**

## Foreword

By the end of 2011/12 the risk-based levy system will have been in place for six years. We are proud of having introduced a risk-based system so rapidly, but recognise that much has changed over the intervening period. We now have much improved data from pension schemes, and increased experience of the risks facing the Pension Protection Fund, so now is an appropriate time to consider a new approach to the Pension Protection Levy.

The proposals in this document represent a significant leap forward from the last round of consultation on the future development of the levy. They are based on fresh ideas, conceived in principle by a Steering Group chosen to represent the full spectrum of levy payers, and developed for practice in conjunction with our stakeholders.

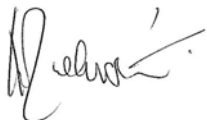
We've considered how to make levies more stable and predictable, which is a priority for schemes and their sponsoring employers. By developing a new levy that is 'bottom-up', schemes would have better control over their levy bills. A new scaling factor, driven by our funding strategy, would give schemes more transparency as to how their bills are linked to our need to compensate members, as well as schemes' risk.

We also propose some important changes to how we incorporate underfunding and insolvency risk in the levy calculation to better reflect the risk that schemes pose to the PPF through an economic cycle, allowing the stability that schemes require.

These proposals are part of a long process of research, modelling, analysis and consultation, supported by five years of PPF experience. Since August 2007, we've had more than 100 responses to two consultations on levy development, 500 delegates have attended road shows and the Steering Group has set out the essential principles of a fairer levy.

This document is the culmination of that process. As always, we recognise that changes cannot benefit everyone financially, as those who gain by paying a lower levy are balanced by those who pay more. A more stable levy that is better aligned with our risks, and which shifts the focus to risks that schemes and their sponsors can control, brings wider benefits to the stakeholders we protect.

I look forward to receiving your responses.



Alan Rubenstein  
**Chief Executive**

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# 1 Executive Summary

## 1.1 Introduction: Why are we proposing to change the levy?

- 1.1.1 The pension protection levy is a key source of funding for the Pension Protection Fund (PPF) and ensures that the PPF can fulfil its responsibilities to provide compensation to members of eligible pension schemes should their employer become insolvent.
- 1.1.2 The Board intends to set the overall level of levy (the levy estimate) by reference to the objectives and framework set out in its recently published Funding Strategy, published in August 2010. It will continue to do so within the framework of the Pensions Act 2004, which limits both the overall size of the levy estimate and year-on-year movements.
- 1.1.3 The proposals outlined in this paper are about putting in place the necessary changes to make sure that the levy we charge individual schemes will more appropriately reflect the risk they pose to the PPF, both now and in the future, while still providing a limited degree of cross-subsidy to ensure affordability for those schemes that pay the most, relative to their size.
- 1.1.4 This consultation paper represents the culmination of nearly three years' work examining options to improve the stability and fairness of the levy formula. In 2009 we asked a Steering Group of pensions experts to share their thoughts on the objectives we should build into the new pension protection levy. This group highlighted the priorities of simplicity, predictability, equity and the promotion of good behaviour.
- 1.1.5 We have considered these priorities and other principles, such as stability and transparency, carefully. The principles put forward by the Steering Group, combined with previous stakeholder feedback, have provided the foundation for the development of the new levy formula that is proposed in this consultation document.

## 1.2 How we propose to change the levy formula

- 1.2.1 The key features of the new framework would be:
- A formula that is fixed for a period of three years, so that a scheme's levy bill would change during this period only if its risk characteristics change. This approach would support greater predictability and stability in individual scheme levies.
  - A new measure of funding would be calculated in such a way that market movements would be averaged over five years to reduce volatility in assessed funding levels, and thereby scheme levies, between years.

However we would continue, as now, to recognise, in the year after they are made, contributions to improve funding.

- Allowance for investment risk would be built into this new underfunding measure in the form of a funding stress to ensure that the levy reflects a scheme's risk to the PPF. The stress applied would be built into the PPF's roll forward methodology based on standard scheme return data supplied through the Exchange system.
- Schemes with liabilities over £1.5 billion would be required to perform their own analysis of the impact of stresses on their assets, and report the results. Individual certification of investment risk would also be an optional alternative to the standard approach for all schemes. Schemes most likely to benefit from carrying out their own analysis would be those making use of derivative instruments to manage risk.
- New insolvency probabilities that are aligned with the market's view of risk and benchmarked against external practice – with, as a result, a narrower range of insolvency probabilities. This would improve fairness by better reflecting the underlying risks to the PPF in a way that is consistent with market measures and our own historical claims experience.
- There would be fewer insolvency bands, with measurement averaged over one year. The levy would be less sensitive to short-term changes in the D&B Failure Score of the sponsoring employer(s). Taken together with the new insolvency probabilities, this will rebalance the levy so that funding becomes as significant as insolvency risk in determining levies.
- To keep the levy affordable and to maintain incentives to improve funding, insolvency probability would continue to be capped and the risk-based levy (RBL) capped relative to liabilities.

### **1.3 A new framework**

1.3.1 Our proposal maintains the basic structure of the levy, as required by statute, which is:

$$\text{Total Levy} = \text{Risk-based levy} + \text{Scheme-based levy}$$

1.3.2 The PPF is required by law to calculate the levy so that it is estimated that at least 80 per cent of the total PPF levy will be risk-based. To date, the risk-based levy has been set to equal an estimated 80 per cent of the total levy and the scheme-based levy 20 per cent.

1.3.3 We propose that the scheme-based levy should have a more defined role. This would be limited to recovering the cost of cross-subsidy (i.e. the cap) and potentially contributing to improving funding where adverse claims shifted the PPF materially away from achieving its funding target. This approach would make the extent of cross-subsidy much more transparent.

- 1.3.4 The likely result of these changes is that the scheme-based levy would be significantly less than 20 per cent of the total levy – about 10 per cent in the first few years of this new approach.

Implementing a bottom-up approach

- 1.3.5 A bottom-up approach should mean that a scheme's individual levy would fall if its risk decreases and would rise if its risk increases. The parameters of the levy formula would be fixed for a three year period and the total levy collected each year during that period would be the sum of all individual scheme levies. This is in contrast to the current approach where the total is fixed and individual scheme levies are scaled up or down as a result of changes in data of all schemes.
- 1.3.6 The importance of a bottom-up approach was emphasised by the Steering Group on the basis that it would provide the clearest link between the risk a scheme poses to the PPF and the levy it pays.
- 1.3.7 In the absence of any further conditions, a pure bottom-up approach could expose the PPF to excessive uncertainty in its levy collection, which may make it difficult to apply its Funding Strategy and could lead to highly variable individual levies. We have introduced various features described below to mitigate this risk.

How fixing the scaling factor for three years would work

- 1.3.8 We propose to carry out a funding and levy review every three years. Following this review, the Board proposes to set the levy parameters - the scaling factor, levy caps and scheme-based levy proportion - in line with its funding requirements. These parameters would remain fixed for the following three levy years at which point the next review would take place.
- 1.3.9 Within each fixed period, the PPF would revise the levy parameters only if the total levy would otherwise be expected:
- To exceed the levy ceiling set by legislation;
  - To vary from the previous year's levy estimate by more than 25 per cent; or,
  - To result in an estimate of the scheme-based levy that exceeds 20 per cent of the total expected levy.
- 1.3.10 The work that we have done to assess the likely levels of volatility of total levy suggests there is a good probability that we would not need to revise the scaling factor in the three year period. However we think it would be a reasonable precaution to allow flexibility in these limited circumstances. This protects levy payers from the possibility that overall levies rise sharply, and the PPF from the possibility of a substantial fall (which might subsequently need to be redressed through higher levies).
- 1.3.11 The PPF believes this arrangement would produce an acceptable balance between the risks taken on by the Fund, and those that would continue to be faced by levy payers.

## 1.4 Calculating the risk-based levy

- 1.4.1 To maintain simplicity, the high-level risk-based levy formula is similar to the current one. However there would be significant changes to how underfunding and insolvency risks would be calculated.

$$\text{RBL} = \text{Underfunding Risk} \times \text{Insolvency Risk} \times \text{Fixed Scaling Factor}$$

### A new measure of underfunding risk

- 1.4.2 In order to further stabilise a scheme's levy, the PPF would look at a scheme's 'smoothed' funding position averaged over a period rather than the current approach of using the value of assets and liabilities at a specific point in time.
- 1.4.3 To minimise the reporting burden on schemes, the PPF would use the latest information already provided in the section 179 valuation data supplied through Exchange and, as part of our roll forward methodology, apply five-year averages of various market indices to calculate smoothed values. This would mean we still use the most up-to-date s179 valuation data available, but that market movements in assets and the yields used to value liabilities would effectively be smoothed out.
- 1.4.4 The funding measure would incorporate an allowance for investment risk. For the purpose of levy calculation, we propose to further adjust the smoothed funding level to reflect the way adverse movements in asset and liability values can reduce funding levels. The size of this adjustment (or "stress") we propose would depend on how responsive a scheme's funding level would be to a range of investment risks, such as falls in the stock market or interest rate changes. Thus the funding measure in the levy formula would be dependent on an individual scheme's level of investment risk.
- 1.4.5 We propose to apply this stress based on data received in the annual return through the Exchange system. However, schemes could voluntarily certify the results of their own calculation in line with the PPF stress scenario based on their own more detailed information of the sensitivity of their portfolio under stressed conditions.
- 1.4.6 We propose that schemes with liabilities of £1.5 billion or more would be required to report the results of their risk analysis in the scheme return so that their levy could accurately reflect the possibility of a significant deterioration in funding levels due to investment positions we would otherwise be unaware of.

1.4.7 These changes would provide an improved and comprehensive measure of through-the-cycle underfunding risk, including consideration of the range of investment strategies selected by schemes.

A new approach to insolvency probability

1.4.8 A new approach to insolvency probability has been developed. Our proposed approach is more in line with financial market practice. It would also reduce the sensitivity of PPF levies to changes in D&B Failure Scores. We believe this helps address stakeholder concerns about levy instability.

1.4.9 It is proposed that the current table of insolvency probabilities, based on D&B Failure Scores of 1 to 100, would be replaced with six bands.

1.4.10 We also propose to smooth the measurement of insolvency probability, by taking account of the circumstances of scheme sponsors over the year leading up to the start of the levy year, rather than using a 31 March figure in isolation.

1.4.11 The indicative rates that we would charge for insolvency risk are as follows:

**Table 1: Indicative Levy Rates**

PPF Band	1	2	3	4	5	6*
D&B Failure Score	100-97	96-90	89-69	68-42	41-6	5-1
Levy Rate	0.20%	0.50%	1.10%	1.60%	4.00%	4.00%

\* Capped rate

1.4.12 The new rates are more in line with what financial market participants would charge to cover insolvency risk. They would also be closer to the PPF’s actual claims experience over the past five years. The range of rates (from highest to lowest) is narrower than the current table of insolvency probabilities. Combined with the smoothing over twelve months referred to in 1.4.10 above, we can expect to see significantly reduced volatility in levy rates from one levy year to another.

1.4.13 The PPF would continue to engage an external provider to advise the PPF on which band should be applied in determining a scheme’s levy bill. Currently, the PPF has engaged D&B to provide this service.

1.4.14 The PPF recognises that there may be some schemes where minor changes in their underlying risk may push them down to the next band and that some levy payers may be concerned at this possibility. The narrowing in the range of insolvency probabilities that comes from the new levy rates would mean this has less impact than for the current insolvency probabilities. Averaging the insolvency risk measurement over 12 months would also reduce the probability of this happening.

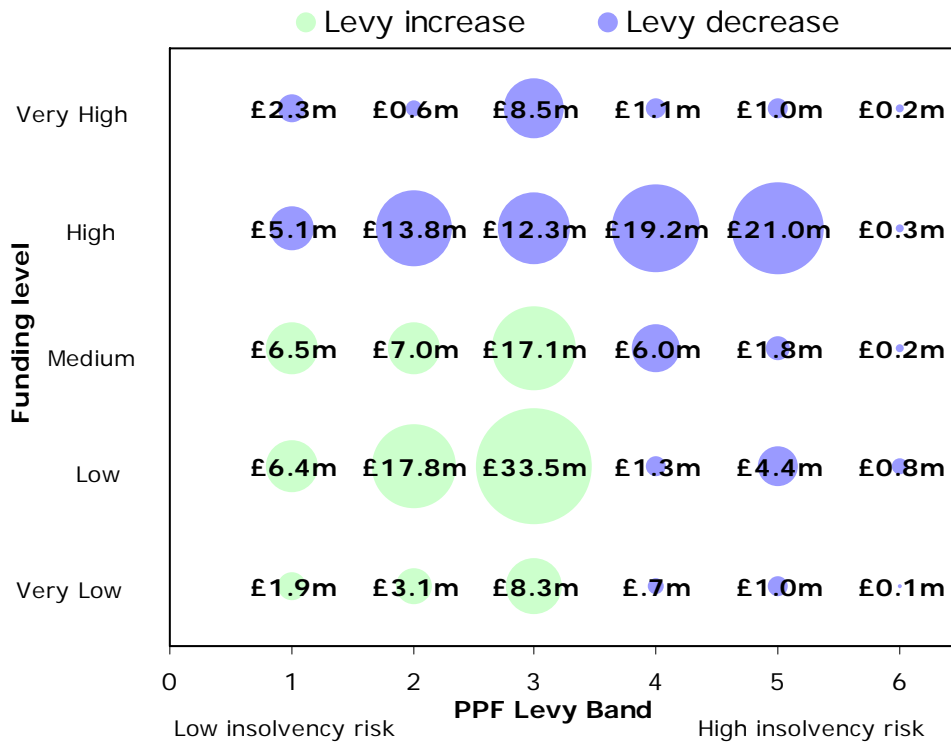
1.4.15 We are consulting on a possible system of transitional relief should stakeholders favour such an approach. This would see schemes that fell into a worse levy band than they occupied in the earlier year being charged an intermediate level of levy. The cost would be recovered either through a higher scaling factor or a higher scheme-based levy.

## 1.5 What would the impact on schemes be?

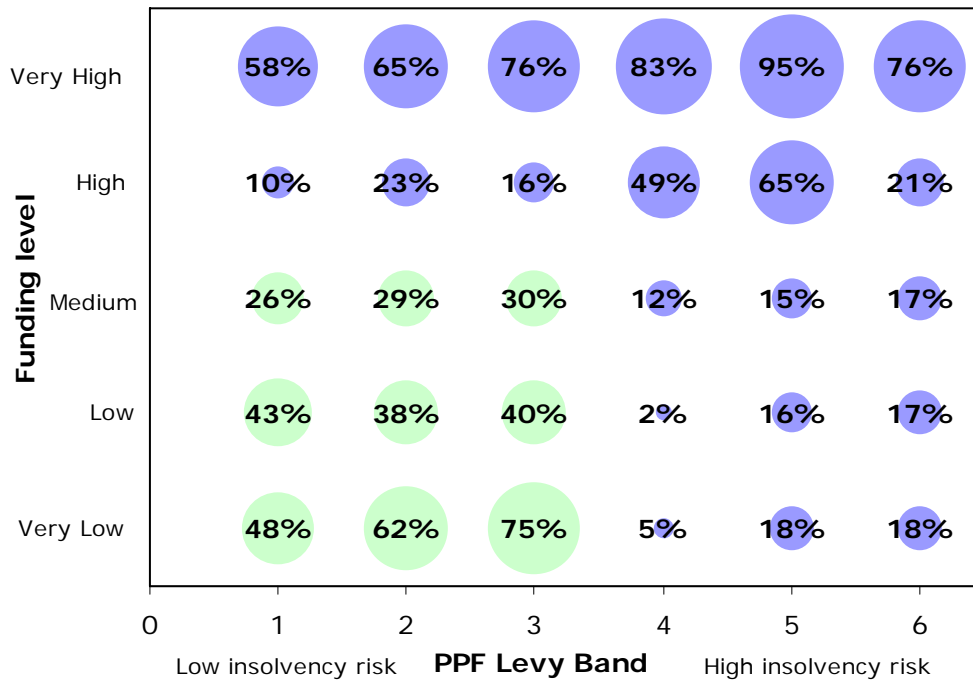
1.5.1 A primary objective of the proposed changes to the levy formula is to better align scheme risks to the levy they pay. In getting the balance right, the overall effect of the new approach is to give greater emphasis to funding and reduce the emphasis on covenant (which in this document we use as a shorthand for the insolvency probability of the scheme’s sponsor or sponsors) in calculating schemes’ levy bills.

1.5.2 We have compared the distribution of the total levy under the new formula and the current formula for levy years 2010/11 and 2011/12. While broadly similar impacts can be observed in both years, the scale of these varies - this highlights the undesirable differences in distribution of the levy that arise with the current formula.

**Figure 1: Impact of New Formula, Compared to 2010/11 (£m change)**



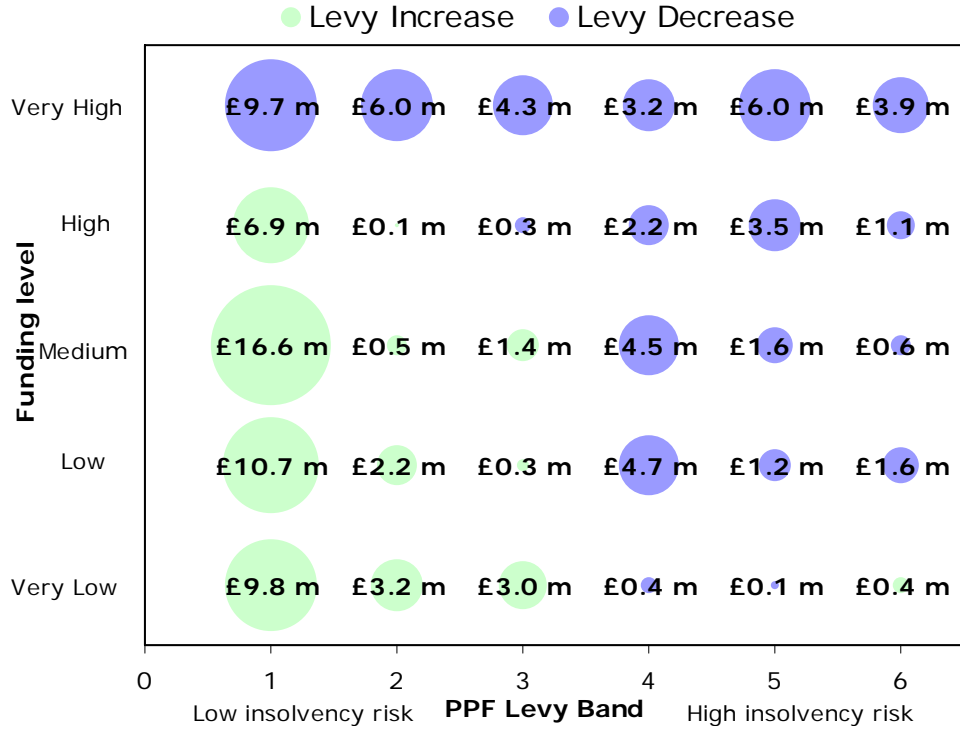
**Figure 2: Impact of New Formula, Compared to 2010/11 (% change)**



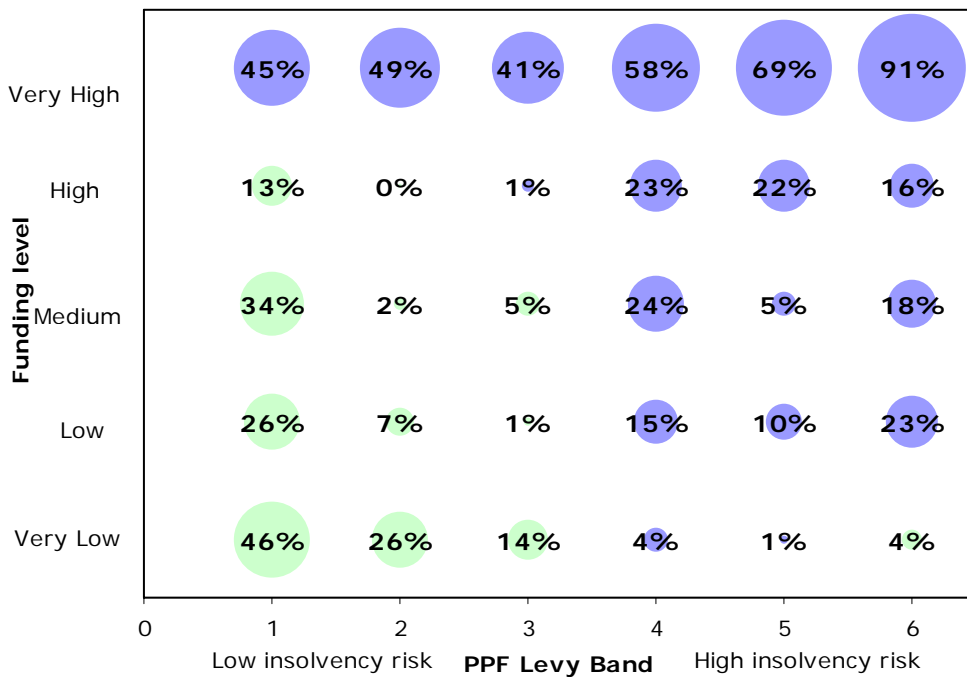
1.5.3 Figures 1 and 2 show the expected impact (in £million and percentage terms) of the new formula on schemes by their funding and insolvency risk profiles, compared to the 2010/11 levy.

- There would be decreases for very highly- and highly-funded schemes, across all levels of insolvency risk.
- Schemes with moderate to weak sponsors would also see a decrease in their levies across all funding levels. For less well-funded schemes, this would be a slighter decrease.
- Schemes that are not well-funded and have stronger employers would see increases in the amount of levy they contribute. The largest increases would be for those schemes that have low to moderate levels of funding and moderately- to highly- rated (Bands 1-3) employers.

**Figure 3: Impact of New Formula, Compared to 2011/12 (£m change)**



**Figure 4: Impact of New Formula, Compared to 2011/12 (% change)**



- 1.5.4 Figures 3 and 4 above show the expected impact of the new formula on schemes by their funding and insolvency risk profiles, compared to the 2011/12 levy.
- Schemes with strong funding positions generally gain. Schemes that have very high levels of funding would see decreases in their levy across all insolvency bands.
  - Schemes with well-rated employers (Bands 1 and 2), but which are not very well-funded, would tend to pay more, reflecting more appropriately the risk margin associated with these schemes.
  - Schemes with weaker employers (Bands 4-6) would pay less, with the exception of those that are very poorly funded which would tend to pay slightly more.<sup>1</sup>
- 1.5.5 We have looked at how stable the levy would have been, at individual scheme level and in terms of the overall total levy charged, had we implemented the proposed approach before the last recession.
- 1.5.6 This analysis, which was undertaken using unsmoothed insolvency probabilities, shows that the new formula offers key advantages over the current one. Between 2009/10 and 2010/11, nearly half of schemes would have seen only moderate year-on-year changes in their levy bills (i.e. between -20 per cent and +25 per cent) with the new formula. This compares to just over a quarter of schemes with the current formula (see Annex B). A similar number of schemes (around 1 in 7) would have seen their bills experience a large change – i.e. either doubled or halved - as for the current formula.
- 1.5.7 As noted above, this analysis does not take account of the impact of averaging D&B Failure Scores throughout the year. We would expect this to further reduce volatility in bills since fewer schemes would shift band. In particular, averaging would be expected to reduce the proportion of schemes with large changes in levy (which are primarily caused by shifts in insolvency risk band).
- 1.5.8 The new formula would also have delivered an acceptable level of stability in the aggregate levy. As Table 2 shows, a fixed scaling factor for the years 2008/9-2010/11 would have resulted in an 11 per cent decrease in levy in 2009/2010, and an 11 per cent increase the following year.

**Table 2: Aggregate Levy with New Formula, 2008-2011**

Levy Year	Risk-based Levy (£M)	Total Levy (£M)	Change
2008/2009	639	675	
2009/2010	562	598	-11%
2010/2011	625	662	+11%

<sup>1</sup> The exception would be those that are very poorly funded on a stressed value basis. These schemes would tend to pay slightly more. This arises as a result of more aggressive investment strategies pursued by a significant proportion of schemes with weak covenants.

## **1.6 When would the changes take effect?**

- 1.6.1 Subject to the outcome of this consultation, the Board expects that the proposed new levy formula would take effect from 2012/13.
- 1.6.2 To improve the timeliness of the levy, the measurement date for schemes' individual levy calculations would be aligned to the start of the levy year, i.e. 31 March 2012 for 2012/13.
- 1.6.3 Other key data submission dates are likely to be consistent with current practice. We would expect deadlines of, for example, 30 March 2012 for certification/re-certification of contingent assets and 10 April 2012<sup>2</sup> for certification of deficit-reduction contributions.

## **1.7 Consultation arrangements**

- 1.7.1 Responses to the questions set out in this consultation document, as well as any comments on the overall proposition, are requested by 20 December 2010. A policy statement, setting out the Board's considered view in the light of comments received and any other pertinent factors, will be published in Spring 2011.

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<sup>2</sup> These deadlines reflect the fact that 31 March and 7 April 2012 fall on Saturdays, and Friday 6 April is a bank holiday.

## 2 Introduction

### 2.1 Who are we?

2.1.1 The Pension Protection Fund was established by the Pensions Act 2004 (the Act) and became operational on 6 April 2005. The PPF was established to pay compensation to members of eligible occupational defined benefit and hybrid pension schemes, where the sponsoring employer has become insolvent and there are insufficient assets to pay the PPF level of compensation.

2.1.2 The PPF is funded by a combination of:

- The assets transferred from the schemes for which it has assumed responsibility;
- Recoveries of money, and other assets, from those schemes' insolvent employers;
- An annual levy raised from eligible pension schemes; and
- Investment returns on assets held by the PPF.

### 2.2 What is the pension protection levy?

2.2.1 In order to fulfil its statutory objectives, the PPF must have sufficient funds to pay compensation to members of eligible schemes. The Board of the PPF determines how much levy it needs to collect from eligible schemes in order to meet its short- and long-term obligations to members.

2.2.2 The Board has, so far, aimed for the amount collected to be relatively stable. In 2008/09, the Board set the levy quantum at £675 million, indexed to wage increases, for three years to 2010/11. This policy commitment was fulfilled throughout the effects of the global financial crisis.

2.2.3 In August 2010, the PPF published its Long-Term Funding Strategy.<sup>3</sup> This set out our target of funding self-sufficiency by 2030, and describes how we will balance our different sources of funding in light of the range of risks that the PPF faces in the long term. Our funding needs, therefore, are based on an assessment of factors such as the level of claims, investment performance of PPF assets and how much is raised through the levy. The Board intends to set the overall level of levy by reference to the Funding Strategy.

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<sup>3</sup> The PPF Funding Strategy is available on the PPF website at:  
[http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/PPF\\_Funding\\_Strategy\\_Document.pdf](http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/PPF_Funding_Strategy_Document.pdf)

- 2.2.4 Legislation requires that the estimated amount to be collected from eligible schemes is at least 80 per cent based on risk factors (including underfunding and insolvency risk); in the levy formula, this is called the risk-based levy (RBL). The remaining 20 per cent (maximum) is collected via the scheme-based levy (SBL), which is calculated as a percentage of schemes' liabilities.
- 2.2.5 The risk-based levy is currently based on the expected likelihood of a scheme making a claim on the PPF and the size of that claim. The insolvency and underfunding measures are measures at a single point in time and also take very little account of the potential for actual experience to be materially different from that expected. As an illustrative example of the volatility of spot measures, the pension scheme funding position as estimated by the PPF 7800 Index moved from an aggregate deficit of £192.2 billion at 31 March 2009 to a surplus of £52.7 billion at 31 March 2010.
- 2.2.6 In order to collect a stable sum overall, we scale everyone's bill up or down by a standard factor, called the levy scaling factor. The current risk-based levy (RBL) is:

$$\text{RBL} = \text{Underfunding Risk (U)} \times \text{Insolvency Risk (P)} \times \text{Levy Scaling Factor (LSF)} \times 80\%$$

- 2.2.7 The scheme-based levy and risk-based levy parameters, e.g. the cap and the underfunding risk taper, also play a part in how the levy is distributed among the eligible schemes and these are reviewed each year by the Board alongside the levy estimate and the scaling factor.<sup>4</sup>

## 2.3 Why change?

### To address stakeholder concerns:

- 2.3.1 Stakeholders have consistently told us that the key limitation of the current levy formula is that it is unpredictable, too sensitive to changes in the overall level of risk rather than changes in schemes' individual risk positions, and volatile at scheme level.
- 2.3.2 For example, an individual scheme's underfunding and insolvency risk may have improved since the last levy year, but the scheme may still see an increase in its levy bill. This could happen because of a general improvement in pension schemes' funding positions, which would trigger an increase in the levy scaling factor to ensure enough levy is collected overall to meet the levy estimate. If the increase in the levy scaling factor is greater than the

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<sup>4</sup> A description of the current levy formula and how it has changed is available on the PPF website, at:  
<http://www.pensionprotectionfund.org.uk/levy/howthelevyworks/Pages/howthelevyworks.aspx>

improvement in an individual scheme's funding, all else constant, their levy bill would rise.

- 2.3.3 Table 3 demonstrates a key limitation of the current 'top-down' or levy estimate driven approach is that in order to maintain a relatively stable distribution of levy between schemes, the Board has needed to adjust the levy scaling factor, the cap and the taper from year to year.

**Table 3: The Risk-based Levy, 2006-2012**

Year	Levy Estimate	LSF	Cap %	Taper
2006/07	£575m	0.53	0.5	104% - 125%
2007/08	£675m	2.47	1.25	
2008/09	£675m	3.77	1.0	120% - 140%
2009/10	£700m	2.22	1.0	
2010/11	£720m	1.64	0.5	
2011/12 <sup>5</sup>	£600m	2.07	0.75	135%-155%

- 2.3.4 The proposed new levy formula has been developed in response to, and in consultation with, key stakeholders to address key concerns regarding:
- The fairness of how the levy is distributed among eligible schemes; and,
  - Excessive year-on-year volatility in levy bills.

To improve fairness:

- 2.3.5 Our analysis and recent experiences show us that for many schemes, there seems to be an imbalance between their contribution to the levy and the risk they pose to the PPF. The case on this was set out in supporting material for the Steering Group, published in March 2010.

- 2.3.6 The existing formula does not charge levies that are very close to the PPF's view of the risk that schemes pose, because the insolvency probabilities used do not align with market rates (schemes with poor covenant pay a higher premium relative to those with good covenant than market comparators would suggest) and we do not take account of the differing investment risk characteristics of schemes.

To make levy bills less volatile and more predictable:

- 2.3.7 One feature that has become clear with regard to the current formula is that whilst the levy estimate has been held stable, schemes can experience significant changes in their levy bills each year.

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<sup>5</sup> As proposed in the 2011/12 Pension Protection Levy Consultation Document (September 2010).

- 2.3.8 This is because the current levy formula has proved to be significantly geared so that small changes in funding or D&B Failure Score can lead to large changes in levy between years. Whilst there is clearly a case for reflecting changes in risk, such large year-on-year changes are undesirable and unnecessary given the PPF's longer-term funding horizon.
- 2.3.9 This volatility is further exacerbated by the use of point-in-time estimates of funding and insolvency risks in the current formula. This requires the levy scaling factor, cap and taper to be adjusted each year to reflect changes in economic conditions, claims against the PPF, and funding and insolvency positions of schemes, as demonstrated in Table 3.
- 2.3.10 A key feature of our proposed new levy formula is to set our levy parameters for three years, as well as to replace the current 1-100 D&B Failure Score approach to measuring insolvency risk with 6 insolvency bands and a narrower range of insolvency probabilities, thereby keeping levy bills more stable.
- 2.3.11 It would also make the levy more predictable, since schemes would generally be able to estimate future levies for a number of years – helping make it easier to judge the benefit of a contingent asset for example.

## **2.4 Working together to develop a new levy formula**

- 2.4.1 The PPF has consistently taken a consultative approach to deciding how the levy should be allocated between schemes. This consultation paper represents the culmination of nearly three years' work examining options to improve the stability and fairness of the levy formula.
- 2.4.2 In November 2008, we consulted on a proposed new levy formula designed to address some of the limitations set out above. There was a mixed response, with some support for the principles, but concerns about complexity and a perceived lack of transparency of some elements of the proposal.
- 2.4.3 In July 2009 the Board confirmed its intention to do further work on the formula. The Board also agreed with stakeholder responses that a simpler and more transparent approach was needed. To achieve this, the Board announced that it would establish and work with a Steering Group, supported by a Technical Reference Group, to take a fresh view on redesigning the levy.
- 2.4.4 The Steering and Technical Reference Groups brought together a range of individuals of significant experience from across the range of our stakeholders and from the PPF. These provided an invaluable forum to meaningfully debate the practical issues and limitations of the current formula and to take a fresh and novel approach to developing a sustainable and fairer levy formula.

## **2.5 Our proposal for the future pension protection levy**

- 2.5.1 In March 2010 the Steering Group published a feedback paper which set out the principles it believed should be applied in designing the new levy. Both the Steering Group and the PPF agreed that the highest priority should be for fairness, transparency, predictability and positive behavioural impacts. It was also agreed by the Steering Group that maintaining affordability for scheme sponsors was very important. There was recognition that timeliness too was relevant.
  
- 2.5.2 The principles put forward by the Steering Group have provided the foundation for the development of the new levy formula outlined in this document.

## 3 A New Framework

### 3.1 Introduction

- 3.1.1 This chapter describes the key features of the proposed new framework. The basic structure of the current formula, as required by legislation, is maintained. That is, the total levy would comprise the risk-based levy plus the scheme-based levy.

### 3.2 A bottom-up approach

- 3.2.1 A bottom-up approach means that the Board would collect the sum of all individual levies, rather than adjust the levy scaling factor in each year to reach the desired levy estimate.<sup>6</sup> Individual levies would be independent from changes in other schemes' risk profiles; a scheme's individual levy would fall if its risk decreases and would rise if its risk increases.
- 3.2.2 This approach would be a significant departure from the current method in which the total levy is set each year by the Board and distributed amongst levy payers. In the future, the total levy collected would be a function of the individual bills calculated according to a formula that is fixed over each three year review period. This approach was supported by the Steering Group as it is viewed as providing the clearest link between the risk a scheme poses to the PPF and the levy it pays.
- 3.2.3 In the absence of any further conditions, a pure bottom-up approach would expose the PPF to excessive uncertainty in its levy collection, which may impair the application of its Funding Strategy. We have introduced various features described below to prevent this.

### 3.3 How a fixed scaling factor would work

- 3.3.1 We propose to carry out a funding and levy review every three years. Following this review, the Board proposes to set the levy parameters - the scaling factor, levy caps and scheme-based levy proportion- in line with its funding requirements. These parameters would remain fixed for the following three levy years at which point the next review would take place.
- 3.3.2 For a three year period, this would be a bottom-up levy, as long as the levy estimate was not expected to move outside the limits set out below.

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<sup>6</sup> The Board would still publish a levy estimate for each year, as required by the Pensions Act 2004, but its level would be a consequence of changes in estimated scheme risk, rather than being chosen by the Board.

- 3.3.3 The Board would examine its funding needs before the start of each three year period and would set the overall level of levy by reference to the Funding Strategy.
- 3.3.4 Within each fixed period, the PPF would revise the levy parameters only if the levy would otherwise be expected:
- To exceed the levy ceiling set by legislation;
  - To vary from the previous year's levy estimate by more than 25 per cent in either direction; or,
  - To result in an estimate of the scheme-based levy that exceeds the maximum permitted 20 per cent of the total expected levy.
- 3.3.5 It is a legal requirement that, when calculating the amount of levy to be collected, it is not estimated to increase by more than 25 per cent compared to the previous year's levy estimate. We believe that having a similar threshold on the downside<sup>7</sup> would provide appropriate protection for the PPF's funding position, which is critical to our ability to fulfil our statutory responsibilities.
- 3.3.6 The PPF believes this arrangement produces an acceptable balance of risks taken on by us, and those that would continue to be faced by levy payers.
- 3.3.7 The initial scaling factor set for 2012/13 would be set in the context of a review of PPF funding and levy requirements according to our Funding Strategy. The process would be repeated subsequently every three years to update the levy parameters for the following three year period.
- 3.3.8 Within each review period, the Board will need to make an annual assessment of whether retaining the existing parameters would breach one of the requirements at 3.3.4, before it can publish the levy estimate annually, as required by legislation. It is anticipated that this would be done on a similar timescale to the setting of the levy parameters – i.e. in advance of the start of the levy year.
- 3.3.9 Under the new proposals, the PPF scaling factor is expected to be lower than 1.0: in fact the analysis we have done to date has used 0.6.
- 3.3.10 The work that we have done to assess the likely levels of volatility of total levy suggests there is a good probability that we would not need to revise the scaling factor in the review period. However we think it would be a reasonable precaution to allow flexibility in these limited circumstances and to ensure compliance with the legislation. This protects levy payers from the possibility that overall levies rise sharply, and the PPF from the possibility of a substantial fall (which might subsequently need to be redressed through higher levies).

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<sup>7</sup> The PPF appreciates that this does not produce symmetric thresholds – a decrease of 20 per cent would be a more exact mirroring of the 25 per cent increase.

### **3.4 Cross-subsidy in the levy and the role of the scheme-based levy**

- 3.4.1 A key point for the Steering Group was that, whilst the levy might need to involve cross-subsidy, that cross-subsidy should be transparent. To date, it has been difficult to assess how much cross-subsidy is involved in the levy.
- 3.4.2 Risk-based levies are capped to maintain affordability. At present, the cost of capping is incorporated in risk-based levies through the setting of a higher levy scaling factor than would otherwise be the case. Although the risk-based levy is only 80 per cent of the total levy, a consequence of this feature is that those who tend to pay most for the cost of capping are those with bills closest to the cap level.
- 3.4.3 In addition, the scheme-based levy (currently 20 per cent of the total levy) is regarded by some as a cross-subsidy, since it is not charged by reference to risk. On this basis, cross-subsidy could be seen as making up close to a third of the levy.
- 3.4.4 The new levy formula would maintain a cap on the levy charged to schemes relative to their liabilities. It is likely that the current approach of setting the risk-based levy cap to protect a proportion of schemes (e.g. 10 per cent in 2011/12) would be continued.
- 3.4.5 In the new framework, the scheme-based levy would play a more defined and limited role, as recommended by the Steering Group. To date, the contribution of the scheme-based levy as a proportion of the total levy has been set at 20 per cent. In the new formula, the scheme-based levy would ordinarily be set so that it would recover broadly the estimated cost of capping during the fixed period.
- 3.4.6 There are two roles that the scheme-based levy could fill:
- a) To manage the cross-subsidy introduced by capping levies, the cost of which is currently allocated across scheme and risk-based levies;
  - b) In the event that adverse claims experience shifts the PPF materially away from achieving its funding trajectory.
- 3.4.7 The explicit and exclusive use of the scheme-based levy for the purposes of (a) and (b) would provide schemes with greater transparency as to the size and extent of cross-subsidy.
- 3.4.8 The Board would propose a level for the cap at the same time as other aspects of the levy for 2012/13 are developed in autumn 2011. However, indicative results to date suggest that a cap set at 0.5 per cent of liabilities (the level of the cap in 2010/11) would require a cross-subsidy of less than 10 per cent, which would therefore be the level of the scheme-based levy.

3.4.9 Cross-subsidy would be somewhat higher than that, by around 7 per cent, if the option for transitional relief, set out in paragraphs 5.7.4 – 5.7.11 were adopted.

### 3.5 Questions for consultation

**Q3.1:** Do you agree that a review period of three years would provide an appropriate balance of stability for levy payers and ability for the PPF to ensure its Funding Strategy remains on track?

**Q3.2:** Do you agree with the limited criteria we propose for revising the scaling factor within the review period?

## **4 Underfunding and Investment Risk**

### **4.1 A new approach to measuring funding risk**

- 4.1.1 This chapter sets out key changes to how funding would be measured in the new levy formula. As discussed earlier, funding would take on greater importance relative to insolvency in the new levy calculation; this would be consistent with the Steering Group's desire for a levy that focuses on risks that schemes are able to control.
- 4.1.2 In the new formula, the basic measure of underfunding (the scheme deficit) would be adjusted by 1) smoothing assets and liabilities over five years and 2) considering the scheme's investment strategy.

### **4.2 Why smooth funding?**

- 4.2.1 Recent experience has highlighted the impact that volatility in the financial markets can have on scheme funding. In periods of low or negative growth, funding decreases sharply due to both declines in asset values, and increases in liabilities as a result of low interest rates.
- 4.2.2 We have found that individual scheme levies can vary disproportionately with short term funding fluctuations compared to schemes' actual risk to the PPF.
- 4.2.3 Valuing assets and liabilities based on average values of market movements over a period of years would reduce the volatility of the levy, at both aggregate and scheme levels. This is particularly important given the bottom-up approach we are proposing and the increased weight attached to funding in the new framework.
- 4.2.4 At the same time, the proposed approach ensures that schemes would benefit in full from actions taken to improve their funding, i.e. a deficit-reducing action could still be recognised in full from the year it was made.

### **4.3 How we propose to smooth funding**

- 4.3.1 We currently use schemes' latest s179 valuation results submitted on or before 31 March each year, but the effective date of each such valuation could fall at any point during a triennial cycle. We therefore ensure that all schemes are treated on a consistent basis by transforming the assets and liabilities to a common measurement date.

4.3.2 This process entails:

- adjustments to the value of the liabilities at the valuation date, using ratios of annuity factors and deferred annuity factors, in order to convert the liabilities from the s179 assumptions underlying the original valuation to those in force at the measurement date;
- a roll forward of the adjusted liability value from the original valuation date to the measurement date, using a rate consistent with the s179 assumptions;
- a roll forward of the value of the assets from the original valuation date to the measurement date, based on the scheme's latest submitted allocation and assuming returns for each asset category in line with specified stock market indices.

4.3.3 The method we propose to smooth the values of schemes' assets and liabilities would follow the current roll forward process but would do so by reference to five-year moving averages of the same indices. This would have the advantages of approximating the direct smoothing of levy bills, giving full credit to deficit-reduction contributions and dealing with block transfers as in the current formula.

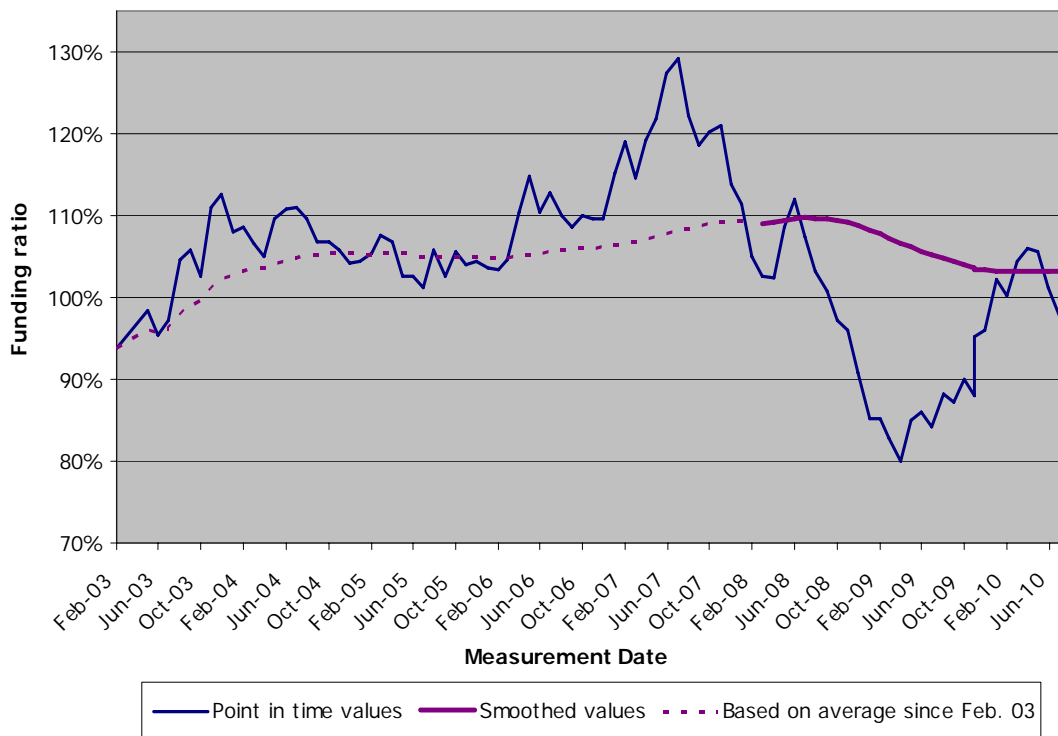
4.3.4 We propose to smooth market movements over five years. This represents an approximate way of adjusting for the impact of the economic cycle on financial markets. Five years approximates the average cycle length for the UK economy since 1958.<sup>8</sup>

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<sup>8</sup> As derived from OECD Business Cycle analysis, the average cycle length for the 11 UK cycles in the period is 4.6 years, although there is variation in the length of individual cycles.

4.3.5 Figure 5 displays the effect of smoothing on aggregate funding levels and shows the lower level of volatility this measure introduces.<sup>9</sup>

**Figure 5: Effect of Smoothing on Funding Levels**



#### 4.4 Why include investment risk in the risk-based levy?

4.4.1 The investment choices made by trustees affect the stability of a scheme's funding level, and therefore risk to the PPF. A potentially volatile strategy might be attractive to trustees for its long-term potential to improve funding through the use of return-seeking assets. But it might carry large downside risks that, in the event of a sponsor insolvency, the scheme might fall to the PPF.

4.4.2 Many schemes are now adopting de-risking strategies including buy-ins so that for a given level of funding two otherwise similar schemes might pose different risks to the PPF – the current formula does not reflect these differences at all.

4.4.3 Legislation empowers the Board to take into account investment risk as a factor in the risk-based levy. We believe that the inclusion of investment risk would be consistent with the introduction of a risk margin (discussed in Chapter 5) in the new levy framework as these both capture the impact of extreme scenarios. The circumstances in which schemes with higher-risk

<sup>9</sup> Smoothed data from February 2008 is based on 5-year moving average; Feb. 2003 – Feb. 2008 is the average using data since the start of series (i.e. less than five years).

portfolios can experience the greatest falls in value coincide with those in which the likelihood of sponsor insolvency is heightened.

- 4.4.4 A measure for investment risk would improve the fairness of the levy.<sup>10</sup> This means that a scheme that is, for example, 120 per cent funded today on a section 179 basis and is well-matched in terms of the risk of its assets and its liabilities would pay a lower risk-based levy (even no risk-based levy at all) than a similarly well-funded scheme that had assets fully exposed to declines in market values. An underfunding measure taking into account schemes' investment strategies offers a closer approximation of the actual risk they pose to the PPF than one without. For example, a mature and well-funded scheme that has implemented a liability matching strategy which poses little risk to us would see that reflected in a reduced or even nil risk-based levy.

## **4.5 How we would measure investment risk**

- 4.5.1 The 2008 consultation explored possible methods for taking account of investment risk in the levy, ranging from a simple binary approach based on certification by low risk schemes to the possible use of internal models. At the time, the PPF's preferred option was to use existing information gathered through Exchange, with a potential move to an internal models approach in the longer term.
- 4.5.2 On the one hand, stakeholders emphasised the importance of being able to take account of the full range of investment strategies and being able to do so straight away, rather than the staged approach we were considering. On the other hand, a number of stakeholders commented that an approach based on internal models was too complex even in the long term. We decided to focus on the use of appropriate stress scenarios as this method would allow for the most consistent yet flexible basis on which to assess scheme investment risk.
- 4.5.3 We are proposing to incorporate investment risk in the risk-based levy by applying a stress to the asset and liability values that schemes already report in Exchange. The stress would be applied to the smoothed values of assets and liabilities before the calculation of the levy, and would provide an appropriate method to calculate the impact of a number of economic and market scenarios on individual funding levels. We used this approach in the impact analysis.
- 4.5.4 We asked a consulting firm, Redington, to consider options for stresses that would appropriately take account of investment risk, while minimising additional reporting requirements. The report by Redington is published alongside this consultation document. This describes how the recommended approach has been developed.

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<sup>10</sup> This was one of the conclusions of McCarthy and Neuberger, Evaluating the fairness of the Risk-based Levy (July 2010).

4.5.5 For the vast majority of schemes, the stress would be applied by the PPF using information on asset allocation already collected via Exchange, unless schemes opted to provide additional information on the results of applying the stress using more detailed scheme data than available on Exchange. Indicative stresses that the PPF would apply to the assets of most schemes are shown in table 4. Assets identified as “other” would be assumed to be held as UK equity. The final values of the stresses may be updated when the PPF publishes its final proposals for 2012/13, including the scaling factor for the levy years 2012/13 to 2014/15. They would not then be expected to change until the end of the levy review period.

**Table 4: Asset Value Stresses**

Corporate bonds	Nominal Gilts	Index-linked gilts	UK Equity	Overseas Equity	Property	Cash	Other
-4.6%	+9.8%	+19.1%	-21.7%	-18.5%	-7.1%	0%	-21.7%

4.5.6 Schemes that use strategies or products to alter the sensitivity of their assets to particular risks and which are not identifiable through the data captured on the Exchange system would be able to elect to reflect the impacts of this activity by applying the stress scenario themselves.

4.5.7 Schemes would report their results before and after stressing their asset positions as at their most recent annual accounts date to us through Exchange. We would expect to capture this information in the scheme return. For example, a scheme that pursues a liability driven strategy that reduces the sensitivity of its portfolio to interest rate and inflation changes would be able to provide additional data on the value of its stressed assets before and after applying the stresses.

4.5.8 For a limited number of schemes, that individually could have a substantial impact on the PPF funding position if they were to give rise to a claim, there would be a requirement to report in the scheme return. This would protect the PPF, and other levy payers, from adverse selection risk.

4.5.9 We would be interested in stakeholders’ views on the appropriate level at which to require reporting of investment strategy. The Board’s proposal is that schemes with liabilities above £1.5 billion should be required to provide additional information, which would equate to the largest 100 schemes.

4.5.10 Redington’s report sets out the information that would need to be covered. In keeping with our approach to other areas of risk reduction e.g. contingent assets, we would expect schemes that choose to report to do so consistently and not opt in and out of reporting depending on whether they benefit in a given year. We would keep patterns of reporting under review, and may take appropriate action in later years if it appears that schemes are seeking to arbitrage.

4.5.11 Table 5 shows the indicative stress scenarios which reporting schemes would be expected to apply to their portfolio to produce stressed asset values. These risk factor stresses were used to derive the asset stresses in Table 4.

**Table 5: Risk Factor Stresses**

Credit <sup>11</sup>	Interest rates	Inflation	UK Equity	Overseas Equity	Property	Cash
+120 basis points	-66 basis points	+60 basis points	-21.7%	-18.5%	-7.1%	0%

4.5.12 The scenarios have been set at one standard deviation. For this distribution this means that there would be an 84 per cent level of confidence, i.e. there is an 84 per cent likelihood that the stresses that could actually occur would be adequately captured.

4.5.13 The Redington report suggests that all schemes with derivative exposures could potentially be required to provide additional information. We do not propose to introduce such a requirement at this time, although we would continue to review the use of complex strategies by all schemes and how these could affect the risks faced by the PPF.

4.5.14 Redington's report explored the idea that schemes might report alternative asset allocations through the existing return, instead of reporting the full results of their analysis, where they have directly exchanged their exposure to one asset class for another. For example, if a scheme has entered into an equity total return swap to receive the return on a particular equity index, the notional value of their position should be identifiable as equity. Whilst we can see some attractions to this measure, we think it would run counter to the general expectation that schemes report their actual position, and could lead to confusion. We do not propose to take this alternative forward.

4.5.15 The proposed approach has been chosen as balancing increased accuracy and the costs of reporting. However, it does have a number of limitations:

- By assessing liability stresses at what is potentially a different date (the s179 valuation date) from assets (annual accounts date), it would give an imperfect picture of investment risk.
- It continues to make use of the standard roll forward of assets and liabilities. We would expect that most of the schemes from which we would collect this information have complex asset structures, which brings into question the use of the standard roll-forward methodology to

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<sup>11</sup> This stress would be applied as the impact of +120 bps credit spread for all corporate credit products.

adjust the assets. However, the smoothing of market movements would reduce the impact of this.

- To roll forward scheme positions using information about investment risk would require more information from schemes. Table 5 shows the information that would be required.

### Illustrative Example

This example uses a simplified situation to illustrate the key differences between the current and proposed approaches to how assets would be measured, first by smoothing and then applying the stresses.

A detailed roll forward example for assets and liabilities is included as Annex F.

### Scheme data

At 31 March 2012, a scheme with no matching insurance contracts has submitted the following data on Exchange:

Effective date of latest s179 valuation: 31 December 2009

Total assets: £5m

Breakdown of assets: 100% UK quoted equities

### Market data

	FTSE All-Share Total Return Index
31 December 2009	5,000
31 March 2012	6,000
Five year daily arithmetic average (1 April 2007 -31 March 2012)	5,250
Effective stressed value <sup>12</sup>	4,111

### Step 1: Smooth value of the assets to 31 March 2012<sup>13</sup>

No smoothing: £5m x (6,000/5,000) = £6m

Proposed approach- smoothed: £5m x (5,250/5,000) = £5.25m

### Step 2: Apply stress test to smoothed assets

Stressed level of UK equity index : 4111

Smoothed assets at 31 March 2012 after stress test: £5.25m x (4111/5250) = £4.11m

<sup>12</sup> Based on a UK equity stress of -21.7 per cent.

<sup>13</sup> In this simplified example, the roll forward uses one index – in current practice, for equity, the FTSE All-World ex UK Total Return Index would also be used.

## 4.6 Impact analysis

- 4.6.1 Annex D is a theoretical analysis of the scale of potential behavioural or market impacts that incorporating investment risk could have. We have modelled the incremental effect of the investment risk margin on schemes' levies and the relative attractiveness of a range of asset classes. This analysis indicates that there would be minimal market impacts as a result of asset re-allocation in response to the new levy framework.
- 4.6.2 The impact of taking account of investment risk within the levy formula on a scheme's investment strategy depends on the strength of the sponsor. For those schemes with strong sponsors, our model shows very limited effects; any change in the levy would be relatively small compared to the higher expected return of riskier assets. For other schemes the effects vary but are unlikely to be substantial. Including investment risk would tend to reduce the relative attractiveness of higher-risk assets for schemes with weak covenant.
- 4.6.3 Overall, as with our proposal in 2008, we believe the incorporation of investment risk in the levy should not cause significant changes to scheme behaviour or impact financial markets.

## 4.7 Other issues

### Role of recovery plans

- 4.7.1 As suggested by some stakeholders in response to the 2008 consultation document, we have considered whether future contributions committed to schemes in deficit through recovery plans approved by the Pensions Regulator (TPR) should be factored into the funding measure. The argument for this is perhaps less strong than it was when the PPF was proposing (as in 2008) to take a five-year view of funding risk. Nonetheless we have given the possibility some consideration.
- 4.7.2 A key concern is equitable treatment of scheme contributions for schemes that do not have recovery plans – and therefore do not report future commitments. It could be perceived as inconsistent with our interest to promote good behaviour if only schemes that were required to submit a recovery plan could benefit from advance recognition of future contributions when other, better funded, schemes could not gain recognition for their contributions.
- 4.7.3 It is also difficult to assess what value to put on a future commitment compared to contributions already made, and whether different values should be applied depending on the strength of the employer. Recognising future commitments could also result in double counting as contributions would be

counted in advance and then possibly again when made as scheduled. To counter this, it would be necessary to deduct the value of contributions that have already been recognised, adding complexity to levy calculations.

- 4.7.4 Were the PPF to take account of committed future contributions there would be a need to develop the Exchange system to capture the relevant information, as whilst data is captured by TPR the reporting system is not designed to form a basis for charging a levy.
- 4.7.5 The PPF is not minded to recognise recovery plans at this stage but if there is significant stakeholder support for doing so, we would need to consider the practicality and equity of any proposal.

#### Contingent assets

4.7.6 We have considered the implications of the new approach to funding measurement for the current contingent asset regime and propose the following:

- The certified value of types B and C contingent assets would be added to the funding measure after smoothing and would not be smoothed separately.
- It would be desirable in principle to apply a margin for investment risk to type B contingent assets so they are treated in the same way as assets of the scheme. However the number of such assets is limited and we would need to consider the operational issues arising further as part of our implementation planning alongside this consultation. If we chose not to discount assets for operational reasons, we would keep this assessment under review.

4.7.7 As part of this consultation on developing the levy, we also invite comments on whether the current contingent asset regime still provides adequate and appropriate recognition of the arrangements available to schemes and their sponsors.

#### Longevity risk

4.7.8 Given the nature of schemes' liabilities, the management of longevity risk could play a key role in underfunding risk. In its analysis of risk factors, Redington tested the impact of longevity risk in the proposed stresses and concluded that including this would not be appropriate. This is due to the difficulty in distinguishing meaningfully between schemes in their exposure to longevity risk, given the large proportion of return-seeking assets currently observed in schemes' asset allocations.

4.7.9 In line with Redington's recommendation, we do not propose to include this risk factor at this time. We would monitor whether this conclusion continues to be valid over time.

## **4.8 Implementation**

- 4.8.1 For the vast majority of schemes, no additional information would be required to implement the changes outlined above. Redington has suggested that the asset allocation data currently submitted into Exchange would be sufficient for the purposes of the stress scenarios applied by the PPF.
- 4.8.2 For schemes that are required or choose to report, we would expect the stressed and unstressed values of their assets (as established in their most recent annual accounts) to be submitted as part of their scheme return, in addition to existing s179 information. Schemes' calculations would need to be carried out using stresses for each asset class that would be published together with the levy parameters.
- 4.8.3 This means we would specify the appropriate stress to use for each asset class, as at a date somewhat before 31 March 2012 (e.g. 31 December 2011) to allow schemes time to have the calculation performed and report it as part of their scheme return in the months to 31 March 2012.
- 4.8.4 Redington estimates that the cost to schemes who choose or are required to produce and certify additional information would be in the region of £2000-£5000 each year. Costs would depend on factors such as the complexity of the investment strategy and whether schemes may already compile this information in monitoring their portfolio. Based on preliminary feedback, many asset managers should be able to provide the necessary information on the specific risk profile of their investment strategies for schemes to calculate stressed values.

## 4.9 Questions for consultation

- Q4.1:** Do you support a smoothed approach to funding and do you think that five years is an appropriate smoothing period?
- Q4.2:** Do you agree with our proposed method to smooth scheme assets and liabilities over five years?
- Q4.3:** Do you think that investment risk is appropriately reflected in the proposed funding calculation?
- Q4.4:** Do you agree with the Board's proposal that schemes with liabilities above £1.5 billion should be required to provide additional information on the effect of the stress scenarios?
- Q4.5:** Do you agree with Redington's assessment of the costs associated with providing the additional analysis of stress scenarios?
- Q4.6:** Do you agree with the method by which we propose that schemes should report their asset values, both stressed and unstressed? What are the implications for schemes of the annual accounts date (which may be later than the s179 valuation date) for this calculation?
- Q4.7:** Do you agree that the information schemes could use to calculate their investment risk should be readily accessible from asset managers, for example, sensitivity to interest rate changes for specific interest rate exposures?
- Q4.8:** Do you think the types of contingent assets that the Board recognises for levy purposes is still appropriate, or are there other arrangements that you think should be recognised?
- Q4.9:** Do you think the requirements in terms of the current types of contingent assets are appropriate, or are there areas in which you think the current requirements are disproportionate or unnecessary?
- Q4.10:** To what extent do you think that changing the way the levy is calculated means that the PPF could or should change the types of contingent asset recognised, or the requirements for recognition?

## 5 Insolvency Risk

### 5.1 A new approach to measuring insolvency risk

- 5.1.1 This Chapter describes more fully how we propose to change the allowance for insolvency risk in the new levy formula. As discussed earlier, we propose to use an averaged value for insolvency risk, so that temporary fluctuations in D&B Failure Scores would not cause disproportionate changes in schemes' levies.
- 5.1.2 We also propose to significantly reduce the number of insolvency risk bands and align the associated levy rates (insolvency probabilities) closer to market prices, which produces a much narrower range of levy rates.

### 5.2 Why change approach?

#### Volatility of D&B Failure Scores

- 5.2.1 Stakeholders have raised concerns about the volatility of D&B Failure Scores across years, particularly during periods of economic volatility and following the introduction of a new methodology by D&B in 2009. For most D&B customers this degree of reactivity may be advantageous, as it gives them earlier warning of deteriorating risks, but from the PPF perspective, with our focus on longer-term risks (amongst an overwhelmingly long-lived population and with our long-term funding strategy) it is not necessarily ideal.
- 5.2.2 Accordingly we consider that it would be appropriate to introduce an element of smoothing into the measurement of insolvency risk – as we are with the treatment of funding risk. Preliminary analysis by D&B of a sample of UK sponsoring employers indicates that averaging would reduce the number falling by one or more levy bands to 8 per cent, compared to 12 per cent if a point in time measure is used. This result is based on analysis of the proposed levy bands between April 2010 to September 2010.

#### A fairer approach

- 5.2.3 The Steering Group agreed that fairness of the levy could be based on:  
  
“...fair value for a good or service is the price at which two willing parties would accept to exchange this good or service. Applying this definition to the levy, fairness is achieved if the bill of each scheme matches the cover it receives.”

5.2.4 This means that the levy could be considered as fair if:

- It did not exceed the cost of obtaining protection equivalent to that provided by the PPF through other means (e.g. insurance contract or credit derivative).
- The hierarchy and relative size of individual levies are consistent. If, for scheme A, it would cost twice as much as for scheme B to get PPF-equivalent protection from financial markets or an insurance company, then scheme A's levy should be twice that of scheme B.

5.2.5 These two conditions imply that we need to estimate the premium that a commercial organisation would charge to provide PPF-equivalent protection.

#### Risk margin for extreme scenarios

5.2.6 Under our current practice the insolvency risk measure is based on a simple probability of failure in the following 12 months. These rates are out of line with rates used by financial markets because the latter incorporate a risk margin to cover against worse than expected experience. These risk margins are not uniform across insolvency probabilities adopted by the PPF to date and therefore market rates for the risk of insolvency tend to differ both in absolute and relative amounts to the scale used by the PPF.<sup>14</sup> We believe this feature, allied to the scaling up of the raw calculation under the current system, unfairly disadvantages weakly-rated schemes, to the relative benefit of schemes with more strongly-rated sponsors.

5.2.7 The PPF levy must provide for all sponsor insolvencies whether arising in expected or unexpected economic scenarios. Although the PPF is not a commercial operation, we have always made reference to rates used by financial markets when calculating the overall level of levy to be charged. In our view there is a strong case that the levy should be distributed on this basis. As will be seen below, computing new probabilities in this way (but still based on D&B probabilities for the expected risk component) brings a shallower scale than the current system.

5.2.8 This happens to be closer to past experience and therefore the cost of claims would have more closely matched the levy had this approach applied in the past.

5.2.9 Figure 6 shows our experience of insolvency rates by D&B Failure Score. Our experience<sup>15</sup> indicates a general correlation between D&B Failure Score and

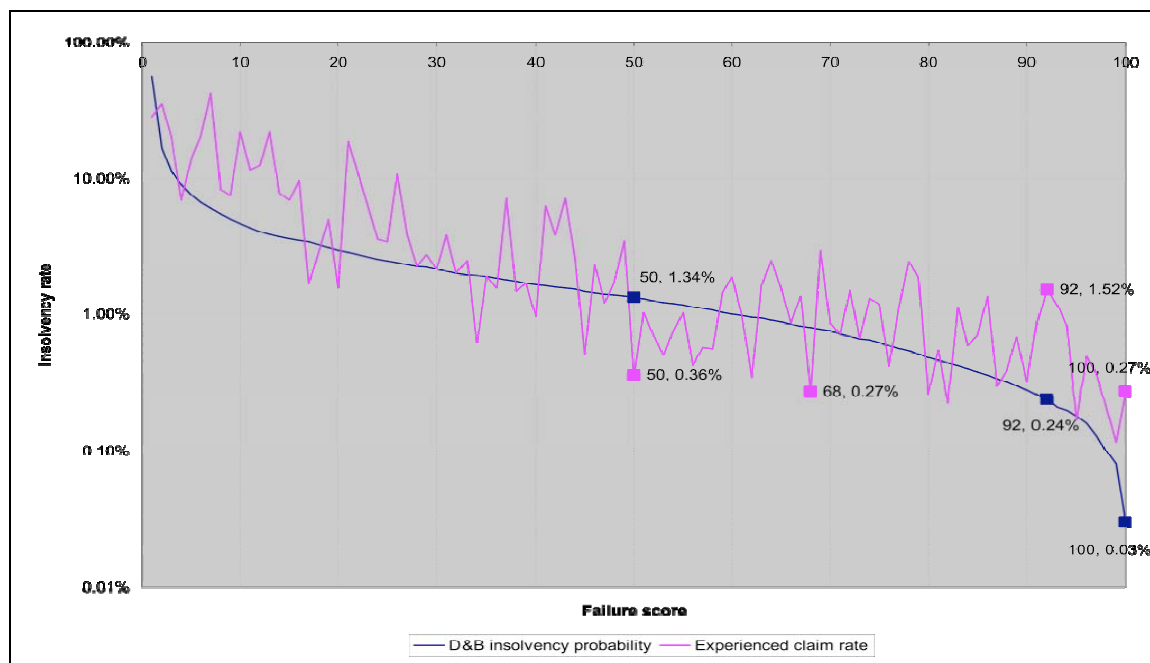
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<sup>14</sup> The risk margin for an AA rated business will make up a larger proportion of the overall commercial rate for insolvency than for a lower rated business. This reflects that commercial expectations are that "tail risk" is a more significant issue the better the general quality of the business.

<sup>15</sup> We have limited claims experience to date, and this includes the period of global financial crisis, so caution should be applied in interpreting the data.

actual failures, but the best D&B Failure Scores appear to produce more claims than expected to date, and there is no evidence to date to support a high level of granularity in the relationship between D&B Failure Scores and claims experience.

**Figure 6: PPF Claims Experience against D&B Failure Scores**



Fewer categories of insolvency risk

5.2.10 The current table of Assumed Probabilities of Insolvency for D&B Failure Scores indicates a smooth improvement in insolvency probabilities. As shown in Figure 6, the PPF's experience to date suggests that this granular approach to insolvency probabilities does not apply to the PPF universe of sponsoring employers. While there is a general increase in the likelihood of a claim on the PPF as D&B Failure Scores fall, there is a limited degree of predictability.

**5.3 Averaging levy bands**

5.3.1 We propose asking D&B to construct an average probability for each employer, by taking the month-end band for each month in the year preceding the start of the levy year. For 2012/13, for example, we would propose to use results from 30 April 2011 to 31 March 2012.

5.3.2 Smoothing insolvency risks over a period of years looks unattractive, but doing so over a one-year period is more reasonable. Averaging would allow employers' insolvency risk throughout the year to be reflected in the levy, so that movements which may be temporary would not cause a disproportionate effect on levy bills. Schemes would be able to access their D&B Failure

Scores for the purposes of the levy calculation at the end of the year with no extra charge from D&B.

- 5.3.3 We have chosen a monthly frequency for our proposal as this would mean that an individual weak D&B Failure Score that causes the employer to change levy bands would be unlikely to have a substantial impact unless repeated, although we recognise that for those schemes that choose to monitor their sponsoring employer's D&B Failure Score it may increase the burden of doing so. Other possibilities are to use quarterly or yearly intervals. However, we do not consider that these would provide a sufficient number of data points to produce an average that would smooth probabilities and convey a complete picture of insolvency risk in a meaningful way.
- 5.3.4 We considered weighting the calculation toward the latter part of the year, but believe that this would add unnecessary complexity, and potentially might reduce the effectiveness of the smoothing – since the more heavily weighted months would drive the results.
- 5.3.5 We would be interested in stakeholders' views both on whether averaging is a good idea in principle, and whether the proposed measurement frequency strikes the right balance or whether a quarterly frequency would be more desirable.
- 5.3.6 The D&B review process would remain as now so that schemes would be able to appeal the D&B Failure Scores used to generate their average levy band probabilities. Those that monitor their D&B Failure Score could query these throughout the year as they do now. However, as now, schemes' right to raise a formal appeal would be triggered by the issue of an invoice (and must be within 28 days of the date of the invoice); this could then relate to any or all of the measurement points used in calculating the average.<sup>16</sup>
- 5.3.7 In relation to new employers, it is proposed that where a pre-existing entity becomes an employer to a scheme during the measurement year that the average produced would still be for the whole year. Where an entity is newly formed, an average would be calculated for the part of the year post-formation.

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<sup>16</sup> We would note that we are currently working with D&B to simplify the current 5-stage reviews process.

## 5.4 How we propose to incorporate an insolvency risk margin

5.4.1 The new approach incorporates the following characteristics:

- Fewer categories than now, with a level of granularity similar to that of standard credit rating systems;
- Consistent with financial market practice, a levy rate which would include a margin for risk; and,
- Sponsoring employers' insolvency risk would be assessed over the preceding year, instead of using a snapshot figure at the end of March. So the final band they are placed in would be based on the average of their bands for each month.

5.4.2 The PPF would continue to engage external experts, currently D&B, to advise on the relative strength of sponsor covenants. As now, the PPF would be responsible for setting the insolvency probabilities that are applied to different sponsor covenants. In place of the current table of Assumed Probabilities of Insolvency (API), which is aligned to the 1 to 100 D&B Failure Scores, it is proposed to use the following table of PPF levy bands and indicative levy rates:

**Table 6: Proposed PPF Levy Bands and Rates**

PPF Levy Band	1	2	3	4	5	6*
Recommended Levy Rate	0.20%	0.50%	1.10%	1.60%	4.00%	4.00%
Corresponding D&B Failure Scores	100-97	96-90	89-69	68-42	41-6	5-1

*\*Capped probability*

5.4.3 The recommended levy rates in this discussion and the impact analysis are partially based on the current table of assumed probabilities used by the PPF for the period 2008-2011. We would update these probabilities to produce final levy rates for implementation.

## 5.5 How we derived the levy rates for the PPF bands

5.5.1 As set out above, our view is that an appropriate way to measure the total insolvency risk we face is to consider different ways in which the financial markets price that risk. To develop the insolvency probabilities associated with each PPF levy band we therefore considered two approaches:

- (i) Setting the levy rates as the sum of the D&B-recommended insolvency probabilities and a risk margin based on an approach specified by the Basel Committee on Banking Supervision; or,
- (ii) Deriving the levy rates from the cost of insuring against insolvency on financial markets.

- 5.5.2 Both these approaches would provide a one-year measure of risk – including a risk margin to reflect the possibility of adverse claim beyond what would normally be expected. This is a change from our 2008 proposal where we considered incorporating a five-year risk measure for our risk margin. We made this change to reflect concerns raised by stakeholders that a five-year measure would effectively double count their risk, i.e. they would be charged for the possibility of a future event in their current levy and then if the event transpired they would be charged again for the same risk in future levies.
- 5.5.3 For a detailed discussion of the options we considered, and how the levy rates were calculated, refer to Annex E: Derivation of Levy Rates for Insolvency Risk.
- 5.5.4 Option (i) would use the sum of an expected risk measure and a risk margin. We would take an average of recommended D&B insolvency probabilities for each band of D&B Failure Scores as the expected risk component. The risk margin would be measured by using the capital charge, as determined by the Basel Committee, weighted by the cost of capital that would apply if a commercial entity were to offer PPF-equivalent protection.<sup>17</sup>
- 5.5.5 The values of these two components are provided in Table 7.

**Table 7: Components of Levy Rates, Option (i)**

PPF Levy Band	1	2	3	4	5	6
Average D&B probabilities	0.04%	0.10%	0.30%	0.80%	2.80%	13.00%
Risk Margin	0.16%	0.40%	0.80%	0.80%	1.20%	1.20%
Levy Rate under Option (i)	0.20%	0.50%	1.10%	1.60%	4.00%	4.0%*

\* Capped probability

- 5.5.6 Option (ii) would take values for the risk margin that are derived directly from the financial markets. Credit default swaps (CDS) are used to provide insurance against credit-related events, such as default and bankruptcy. Based on historical data over 10 years, we can observe pricing of CDS across the spectrum of corporate credit ratings. It is possible to derive the implied rates of insolvency probability from these average prices.
- 5.5.7 The new levy rates (prior to the application of a scaling factor) obtained by applying this method are shown in the table below, including a cap on the levy rate at the level of the rate applied to the PPF levy band 5.

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<sup>17</sup> We have used 10 per cent as an estimate of the cost of capital for the PPF, based on an external assessment of our risk profile. We would note that the levy rates are not particularly sensitive to the precise cost of capital used. See PPF Future Development of the Pension Protection Levy (November 2008), Annex D, p.45. This earlier analysis estimated that the cost of capital would be 9 per cent. We used 10 per cent here as it is a reasonable assumption that the cost of capital has increased from 2008.

**Table 8: Levy Rates, Option (ii)**

<b>PPF Levy Band</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6*</b>
CDS Implied Levy Rate	0.70%	1.20%	1.70%	4.30%	7.00%	7.00%

*\*Capped probabilities*

- 5.5.8 It is noteworthy that both options are much closer to our actual claims experience to date (as displayed in Figure 6 above) than our existing table of insolvency probabilities, though the PPF does only have a limited number of years' experience.
- 5.5.9 The levy rates for option (ii) are higher than for option (i) and as a result, other things equal, would imply a lower scaling factor would be used. In other words, higher levy rates would not result in higher levy bills.<sup>18</sup>
- 5.5.10 Both options would use external assessments of expected risk and the risk margin. Option (i) combines the assessments of credit experts to incorporate expected and margin components, while option (ii) is based on aggregate risk implied by observations drawn directly from financial markets participants.
- 5.5.11 Option (i) measures the risks of different covenant strengths by using the relative rates for corporate risk that have been developed by the Basel Committee. This standard has been developed over a number of years following analysis and scrutiny by a number of international credit experts. This option also provides a smoother progression of probabilities than option (ii).
- 5.5.12 By comparison, option (ii) effectively reflects the cost of risk as assessed by financial markets participants. This means that the price may reflect factors other than credit risk, such as liquidity and counterparty risk. Furthermore, while the rates would reflect observed pricing, the availability and quality of data would play a large role in producing these.
- 5.5.13 On balance, we consider that (i) would offer a more practical measure as this would not include the risk premiums embedded in CDS prices to cover other risks. For example, there is a sharp jump in CDS spreads between sub-investment grade and investment grade debt, which likely reflects broader market dynamics rather than a dramatic increase in the probability of insolvency.

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<sup>18</sup> Detailed analysis of the options is available in Annex E: Derivation of Levy Rates for Insolvency Risk.

## 5.6 Implications of the new approach to insolvency risk

### Market consistency

- 5.6.1 The proposed banding approach distinguishes between a similar number of categories of risk as do current credit rating systems.
- 5.6.2 By incorporating a risk margin, the PPF levy rates are more in line with rates derived directly from market pricing of credit risk.

### Narrower range of insolvency probabilities

- 5.6.3 The recommended approach to calculating levy rates results in the compression of insolvency probabilities compared to the current scale of D&B probabilities. This compression reflects the banding of insolvency probabilities and the addition of a risk margin.
- 5.6.4 In our indicative table of levy rates there is a twenty fold increase between the lowest and highest rates. This compares to the factor of 300 between the lowest probability and the capped highest probability in the table of probabilities currently in use.
- 5.6.5 The narrower range of insolvency probabilities helps make the levy more stable, and shifts the focus of schemes' levy to funding and investment strategy, over which schemes and /or sponsors have more control.

## 5.7 Implementation

### Application of PPF Levy Bands

- 5.7.1 The PPF levy bands would be applied at the employer level for all schemes:
- Where there is a D&B Failure Score, the PPF levy band and its associated levy rate would apply.
  - Where there is no D&B Failure Score, a scheme or industry average probability would be assigned, as currently, at the end of the year; this would then be assigned the appropriate levy band.
  - Foreign employers would continue to use the conversion table to map their D&B Failure Score or local equivalent to a UK-equivalent score, which would then be placed in the associated levy band.
- 5.7.2 For a multi-employer scheme, the PPF levy band would be calculated by taking the weighted average of sponsoring employers' levy rates and rounding this to the closest PPF levy band. In other words, each employer is banded and then the scheme probability of insolvency is also banded.

5.7.3 We propose to maintain a cap on the levy rate so that levy band 5 would have the maximum levy rate applicable to schemes. This would be applied in the same way as the current cap of 3 per cent.

Cliff-edges

5.7.4 Some stakeholders have raised concerns about the risk that a scheme that was previously in a higher band might dip into a lower one temporarily and suffer a disproportionately higher levy.

5.7.5 The move to a narrower range of insolvency probabilities with the new formula means that a reduced number of bands creates less significant cliff-edges than would have been the case for the current formula. Moreover, our move to averaged insolvency risk measurement should help meet this concern, as it would reduce the risk of an unexpected decline in insolvency probability.

5.7.6 However, we recognise that schemes could be disadvantaged, if the effect of a small move in their average insolvency risk is to move them to a lower band and to cause a disproportional increase in the levy.

5.7.7 We have therefore been considering a system of transitional relief to ensure that any movement between bands remains fair and proportional to the underlying insolvency risk. This would allow schemes that experience a drop in risk band to be given an insolvency probability set half way between the band they would be in and the immediately higher one.

5.7.8 For example, a scheme that moves from band 1 to 2 between levy years would receive a probability half way between bands 1 and 2, whereas if it fell two bands from band 1 straight to band 3, it would receive a probability half way between bands 2 and 3. In subsequent years, if there were no improvement, the scheme would pay the full cost for that band.

**Table 9: Example 1 - Transitional Relief**

Year	Average Levy Band	Levy Rate	Explanatory notes
2012/13	1	0.20%	The scheme is initially in the top band, with a levy rate of 0.2%.
2013/14	2	0.35%	The scheme's average levy band is downgraded, so it is now in band 2. However, it would benefit from a transitional rate of 0.35% for the first year it is in this lower band (rather the full 0.5%).
2014/15	2	0.50%	The insolvency risk of the scheme's employer(s) is not improved and it stays in band 2. It would not be able to benefit from relief and would pay the full rate of 0.5%.

5.7.9 While a scheme could not benefit from the same transitional levy rate in consecutive years, it could benefit from different transitional levy rates in consecutive years.

**Table 10: Example 2 - Transitional Relief**

Year	Average Levy Band	Levy Rate	Explanatory notes
2012/13	1	0.20%	The scheme is initially in the top band, with a levy rate of 0.2%.
2013/14	3	0.80%	The scheme's average levy band is downgraded significantly, so it is now in band 3. However, it would benefit from a transitional rate of 0.8%, which is mid-way between bands 2 and 3, for the first year it is in this lower band (rather the full 1.1%).
2014/15	4	1.35%	The insolvency risk of the scheme's employer(s) declines further and the scheme falls again, to band 4. It would benefit from a transitional relief rate of 1.35%, which is mid-way between bands 3 and 4, when it falls into this lower band.

5.7.10 As this protection would operate in only one direction (we would not propose to delay the recognition of improvements in insolvency probability), stakeholders should be aware that there is an element of cross-subsidy involved. Those that do not shift bands would have to pay slightly more to subsidise the levies of those who fall a band and are protected, which runs somewhat counter to the intention to reduce cross-subsidies more generally. Our initial modelling suggests a cross-subsidy in the order of 7 per cent.

5.7.11 We would only implement this aspect of our proposals if it were supported by a significant proportion of respondents, as it would add complexity and does not fit particularly well with the general intention to reduce cross-subsidy. We would be interested also in views on whether, if implemented, it would be preferable to recover the cost through the risk-based levy (setting a higher scaling factor than would otherwise apply) or through the scheme-based levy.

## 5.8 Type A contingent assets

5.8.1 Reducing the granularity in insolvency risk measurement would impact existing type A contingent asset arrangements. Where the guarantor is in the same band as the sponsoring employer of the scheme which benefits from the guarantee, we propose that the two would have the same assumed probability of insolvency under the new levy formula and there would be no

reduction in the levy invoice as a result of having the contingent asset in place.

## 5.9 Questions for consultation

- Q5.1:** Do you agree that a significantly smaller number of insolvency risk bands (six instead of the current hundred) provide a more appropriate reflection of the risk posed to the PPF?
- Q5.2:** What are your views on the method by which we propose to derive levy rates for these bands (option (i) above)? Do you agree that it is preferable or would you prefer us to derive levy rates from the implied cost of insuring against insolvency on financial markets (option (ii))?
- Q5.3:** Do you agree that it would be beneficial to use an averaged measure of insolvency risk rather than a point estimate at 31 March? If so would you favour using monthly data points or using quarterly dates?
- Q5.4:** Do you think that the benefits of transitional relief to smooth cliff-edges are worth the additional complexity and cross-subsidy, given work to smooth insolvency risks through averaging?

## 6 Impact Analysis

### 6.1 Introduction

6.1.1 This chapter summarises key findings of the impact of the proposed new levy formula. Detailed discussion of the impact analysis can be found in Annex B.

### 6.2 Key findings

6.2.1 We have included a comparison of the current and new formulae based on both 2010/11 and 2011/12 levy data to highlight the varying distributional effects of the current formula, which make comparison of the current and proposed new formulae challenging. For the purpose of impact analysis, scheme funding is assessed on a stressed value basis.

6.2.2 The analysis shows that the expected impact of the new formula on schemes by their funding and insolvency risk profiles is as follows:

- Schemes with strong funding positions generally gain as a result of the proposed new levy formula. Schemes that have very high levels of funding would tend to see decreases in their levy across all insolvency bands;
- Schemes with strong employers (Bands 1 and 2) but which are not very well-funded would tend to pay more, reflecting the risk through the cycle that these schemes pose to the PPF; and
- Schemes with weaker employers (Bands 4-6) would tend to pay less of the total levy, with the exception of those that are very poorly funded if 2011/12 is used as the comparator.<sup>19</sup>

6.2.3 The findings of the impact analysis are summarised in Figures 7-10, which show that well-funded schemes of all covenants would pay less under the new formula; with strong and medium strength covenant, moderately- and poorly-funded schemes would pay more, whereas well-funded schemes would pay less. The 2010/11 impact analysis illustrates the new formula's effect of increasing the importance of funding relative to the strength of a scheme's covenant.

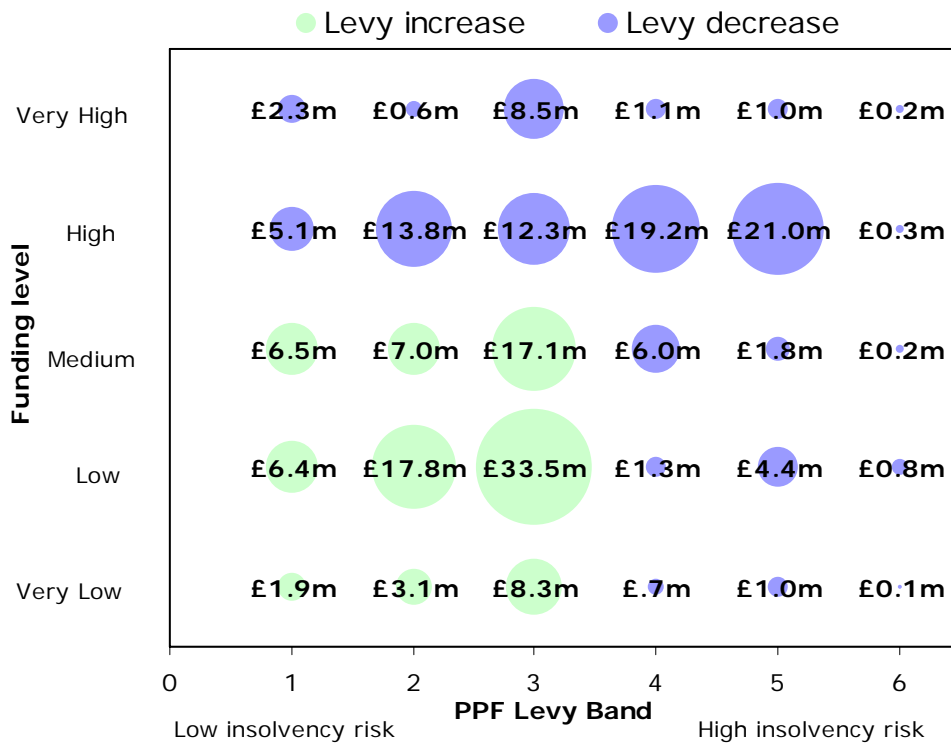
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<sup>19</sup> When compared to the levy they would pay in 2011/12 with the current formula, schemes that are very poorly funded on a stressed value basis would tend to pay slightly more under the proposed formula. This arises as a result of the more aggressive investment strategies pursued by a significant proportion of schemes with weak covenants.

6.2.4 Figure 7 below compares the new levy with the 2010/11 levy in £ terms.

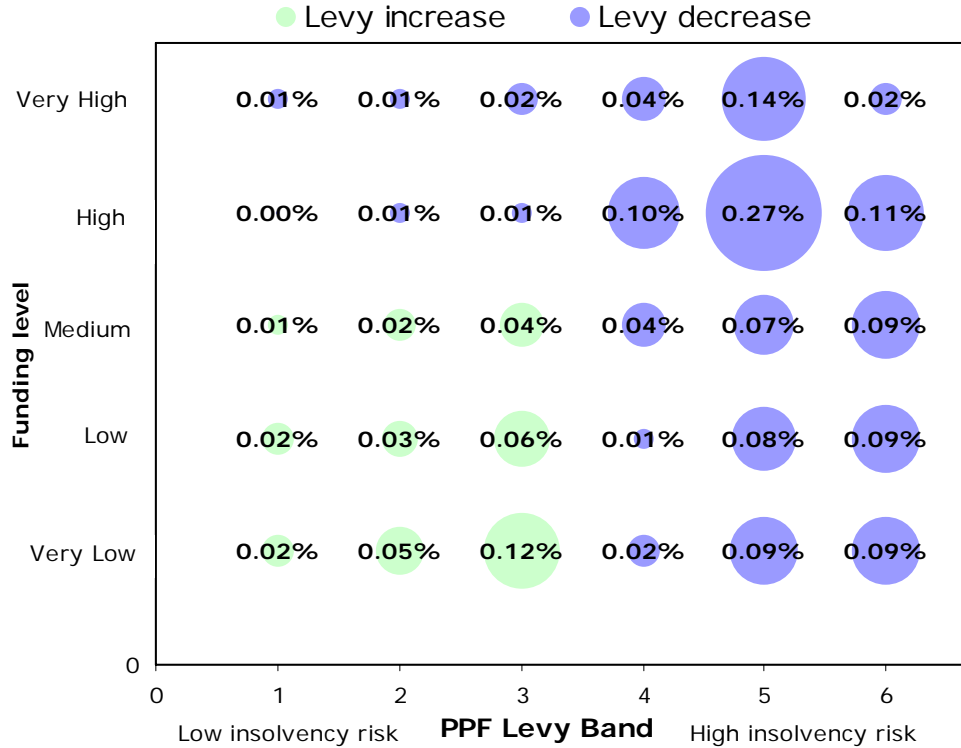
- There would be moderate levy decreases for very highly-funded schemes and larger decreases for highly funded schemes, across all covenant strengths.
- Schemes with moderate to weak sponsors would also see a decrease in their levies across all funding levels. For less well-funded schemes, this would be a smaller decrease.
- Schemes that are not well-funded and have stronger employers would see increases in the amount of levy they contribute. The largest increases would be for those schemes that have low to moderate levels of funding and moderately- to highly- rated (Bands 1-3) employers.

**Figure 7: Impact of New Formula, Compared to 2010/11 Levy (£m)**



6.2.5 Figure 8 below shows the changes in levy calculated as a percentage of scheme liabilities.

**Figure 8: Impact of New Formula, Compared to 2010/11 Levy (as a percentage of liabilities)**

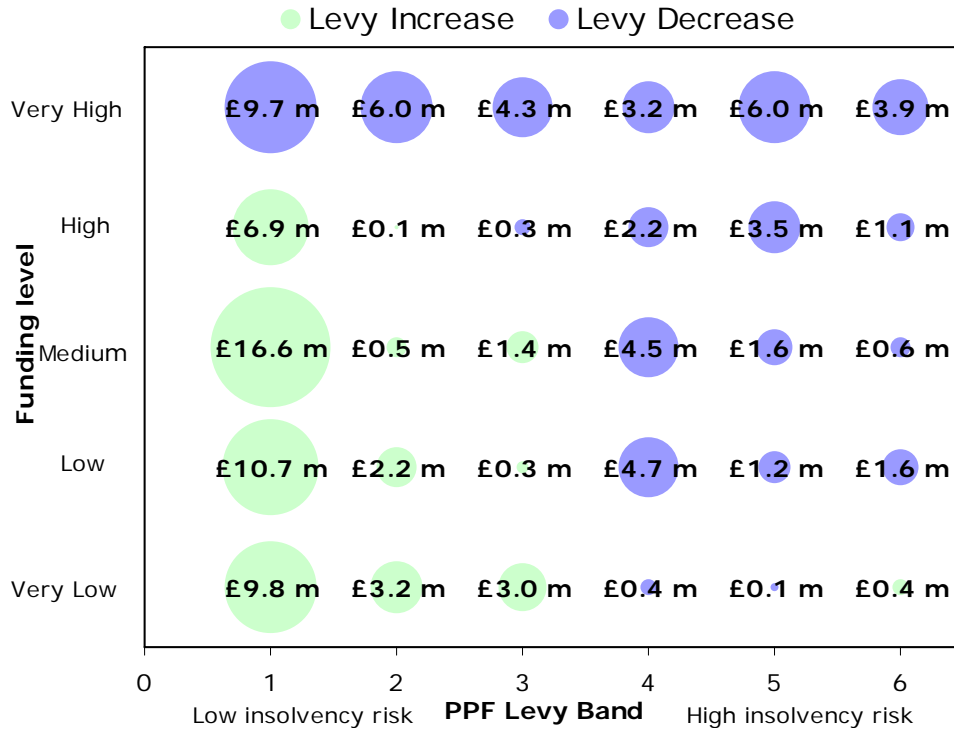


6.2.6 The findings of the impact analysis by reference to 2011/12 scheme data are summarised in Figure 9, reflecting the significant improvement in scheme funding positions compared to the 2010/11 dataset. The schemes that gain most from the new levy formula are those with relatively weak covenants and those with high or very high funding level categories.

- Schemes with well-rated employers (Bands 1 and 2), but which are not very well-funded, would tend to pay more, reflecting more appropriately the risk margin associated with these schemes.
- Schemes with weaker employers (Bands 4-6) would pay less, with the exception of those that are very poorly funded which would tend to pay slightly more.<sup>20</sup>

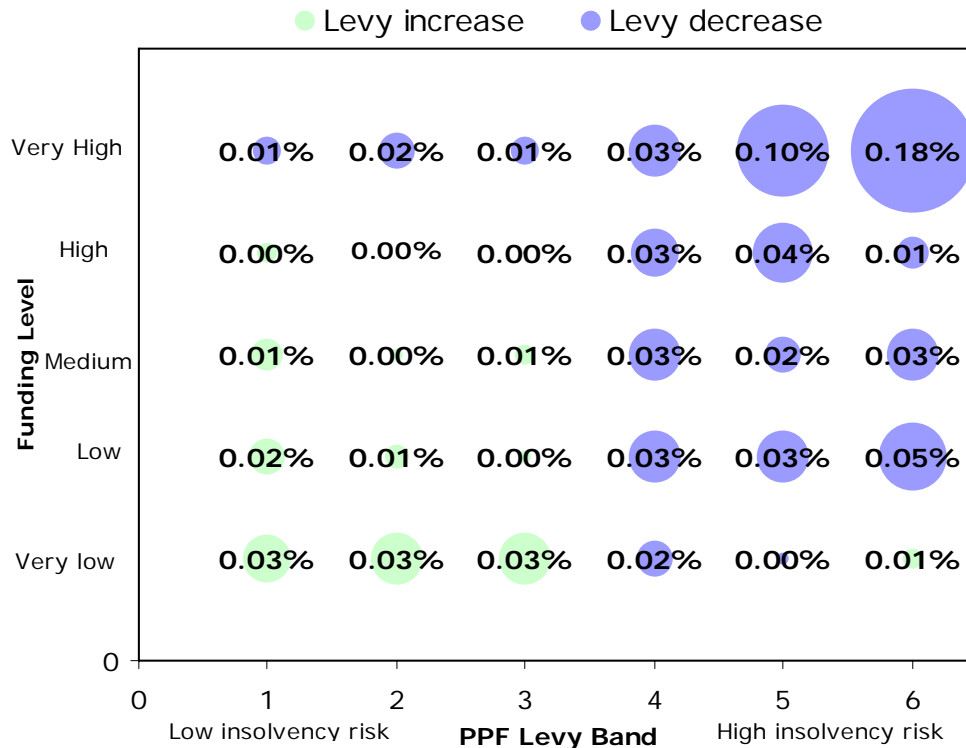
<sup>20</sup> The exception would be those that are very poorly funded on a stressed value basis. These schemes would tend to pay slightly more. This arises as a result of more aggressive investment strategies pursued by a significant proportion of schemes with weak covenants.

**Figure 9: Impact of New Formula, compared to 2011/12 Levy (£m)**



6.2.7 When the change in levies is displayed as a proportion of liabilities, more groups of schemes would see moderate changes in levy, while very well - funded schemes with poor covenant would see the largest proportionate gain. For example, schemes with very high funding and in levy band 6 would see their contribution to the total levy fall by 0.18 per cent of their liabilities as a group. (Figure 10)

**Figure 10: Impact of New Formula, compared to 2011/12 Levy (as a percentage of liabilities)**

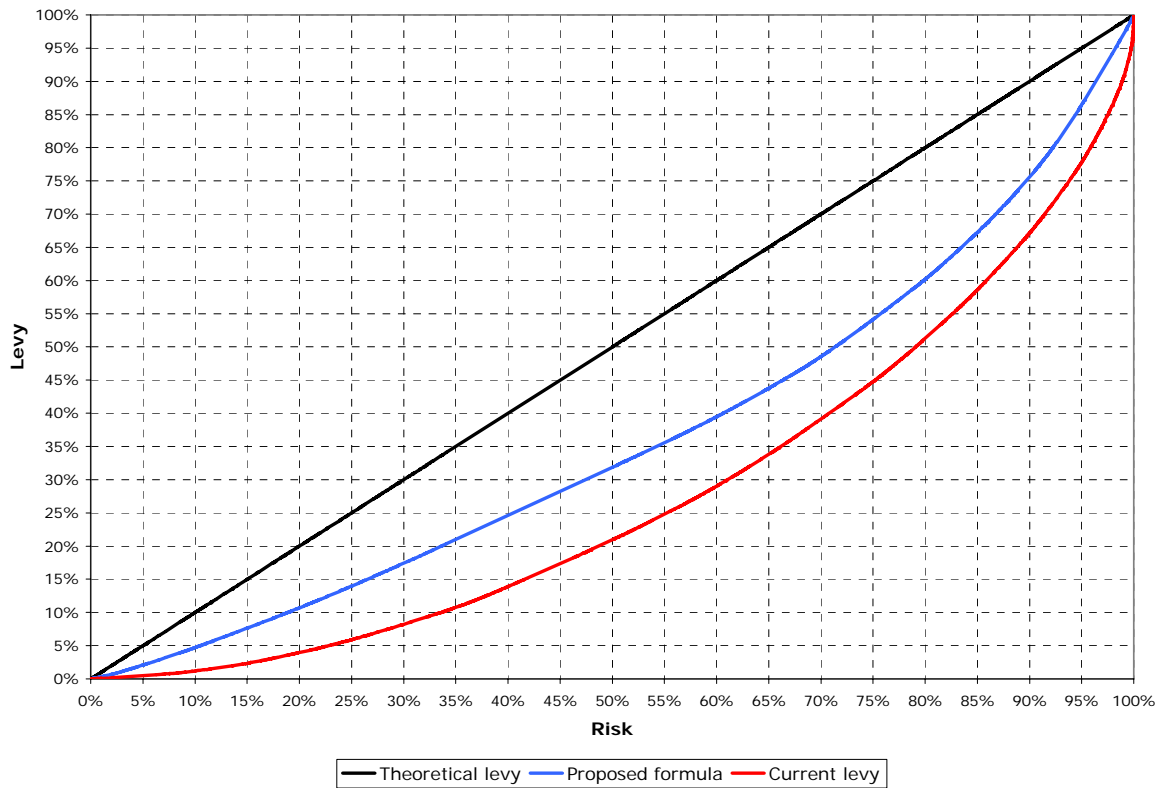


6.2.8 We use Lorenz curves to show how various levy formulae offer different results in terms of the distribution of levy. To model a Lorenz curve, a benchmark must be selected; we have compared our own theoretical calculation of a fair levy and market-derived pricing from independent researchers. Both indicate that the proposed new formula would improve fairness.<sup>21</sup>

6.2.9 A levy based solely on market-derived rates provided by McCarthy and Neuberger is plotted as the straight line. The implementation of the new levy formula would shift the distribution significantly closer to market rates, as shown by the proximity of the blue line to the black one representing fairness.

<sup>21</sup> The report by Anthony Neuberger and David McCarthy, *Evaluating the Fairness of the Risk-based Levy* (July 2010) is published with this consultation. We commissioned this research to consider how the concept of fairness could be modelled theoretically. They suggest that a totally fair levy is not necessarily practical or even desirable and that other considerations should be the PPF’s focus in developing the levy: “A perfectly fair levy is not stable or predictable for individual schemes and it does not provide schemes with strong incentives to encourage good behaviour.” (p.26).

**Figure 11: Lorenz Curves showing Current, Proposed Formulae**



6.2.10 The Gini coefficient, which measures how far from perfect fairness a result is (specifically, the area between a distribution's Lorenz curve and perfect fairness), would be 44 per cent for the current risk-based levy. This would be reduced to 28 per cent in the new framework, marking a significant improvement based on this measure of fairness.

## 7 Good Governance

### 7.1 Introduction

- 7.1.1 This chapter considers whether the calculation of the risk-based levy should include some provision to reward high standards of scheme governance.
- 7.1.2 The Steering Group noted that scheme governance plays a role in the management of a scheme's key risks and suggested that the PPF consider the practicality of a modest discount to reward good governance. A reduction in a scheme's levy based on this would be consistent with the Steering Group's position, which we share, that the levy formula should be more reflective of risks that schemes themselves can actually control.
- 7.1.3 The twin objectives of inclusion of governance in the PPF risk-based levy would be to:
- (i) Promote good governance; and,
  - (ii) Recognise the reduction in scheme risk that accompanies good governance.
- 7.1.4 In February 2010, the PPF commissioned the consulting firm Mercer to explore potential approaches to measuring and recognising governance in the risk-based levy calculation. The final report is available alongside this consultation document on the PPF website.
- 7.1.5 We recognise that there is no firm empirical evidence that good governance reduces the risk to the PPF, and that assessing scheme governance in the levy calculation might involve some ambiguity in identifying good practices.
- 7.1.6 We therefore do not propose to implement a discount for good governance in the new levy formula at this stage. If stakeholders are strongly in favour of such a discount, we would explore the issue in greater detail, though implementation would need to be after 2012/13.

### 7.2 Governance and risk

- 7.2.1 Mercer highlighted that there are risk factors associated with governance, such as trustee competence and record-keeping, distinct from those around funding and investment strategy which are already taken account of in the underfunding risk factor. In addition, there are aspects of good governance such as covenant monitoring and contingency planning that may influence risk factors we measure. This would suggest that governance should perhaps be recognised in some way when assessing a scheme's risk of making a claim on the PPF.

- 7.2.2 The report contains a number of examples to illustrate how strong governance could support value creation or value protection for a scheme.
- An appropriate level of oversight of scheme management supports cost-effective and preventative intervention should administrative or service delivery problems arise.
  - An effective trustee board would be well-placed to manage aspects of key risk factors. This includes establishing a suitable investment strategy, and implementing and monitoring this strategy to reach funding targets.
- 7.2.3 It seems likely that there is a link between good governance and the risk a scheme poses to the PPF, but there has been no research carried out in the UK that provides firm empirical evidence of this.

### **7.3 Approaches to assessing governance**

- 7.3.1 The Mercer report identified three options for the inclusion of governance in the risk-based levy calculation:

#### Option A: Simple checklist of governance activities and tools

- 7.3.2 Option A would present schemes with a simple checklist covering the areas of:
- (i) Governance tools;
  - (ii) Governance processes; and,
  - (iii) Trustee board structure
- 7.3.3 A checklist format would allow scheme responses to be submitted through the Exchange system. Some qualitative aspects could be captured through multiple choice questions. Schemes that achieved a high correlation with a PPF-defined benchmark could then benefit from a discount, with the possibility of greater discounts for higher correlations. Random verification audits could support confidence in this simple approach.
- 7.3.4 A test of this nature would appear better able to distinguish satisfactory practice from practice that did not meet expectations, rather than identify practice that was out of the ordinary. It is not clear whether this approach to measuring good governance would be robust enough to justify a discount in levy for those schemes meeting the standard.

#### Option B: Detailed disclosure and voluntary certification

- 7.3.5 Under this approach, schemes that seek to benefit from the discount would need to submit detailed disclosures regarding trustees' use and application of governance tools and processes.

- 7.3.6 Mercer suggested that detailed qualitative questions on trustees' risk management programmes would be appropriate. Other areas that could be assessed are governance processes and trustee board structure.
- 7.3.7 A system of voluntary certification would be required. This would entail additional time and financial resource; a degree of self-selection would inevitably result as schemes would only invest resources where the expected discount would more than offset the associated costs.
- 7.3.8 While this option would be more likely to capture materially higher standards of governance compared to option A, there would be higher associated costs, and potentially greater subjectivity in assessing the point at which a scheme's disclosure meets the threshold for a discount. It would also be challenging to achieve consistency of measurement across schemes.

Option C: Allow existing regulatory framework to develop further

- 7.3.9 The final option, which we support, subject to stakeholder views, is to allow the regulatory regime to develop and drive governance disclosure standards.
- 7.3.10 Mercer highlighted current initiatives and recent shifts in expectations and standards relating to governance, indicating that improvements could be achieved in the medium term, without the need for the incentive of a reduced levy bill.

## **7.4 Further considerations**

- 7.4.1 The Steering Group also encouraged us to investigate the circumstances in which the cap on levy bills is currently applied. As the cap operates as a cross-subsidy from the non-capped to capped schemes, the Steering Group felt that, to promote good behaviour, schemes benefiting from the cap should be in a position to demonstrate that they have taken risk reduction measures. One suggested criterion, for example, was that capped schemes should be closed to future accrual.
- 7.4.2 We would be interested to receive feedback from our stakeholders regarding whether conditions should be applied to benefiting from the levy cap, and also views on what these conditions might be.

## **7.5 Implementation**

- 7.5.1 As noted above, we do not propose to implement a discount for good governance in the new levy formula at this stage. If stakeholders are strongly in favour of such a discount, we would explore the issue in greater detail and may publish a refined design for further consideration.

- 7.5.2 We are interested to receive feedback on the ideas and options outlined in the Mercer report to inform any further policy development regarding a levy discount for good scheme governance.

## 7.6 Questions for consultation

- Q7.1:** Do you think that there is a relationship between a scheme's governance practices and its risk to the PPF?
- Q7.2:** If so, do you think that good governance should be measured and lead to a reduction in the risk-based levy?
- Q7.3:** If you support a discount for good governance, what sort of level do you think it should be set at? Should it be a fixed discount, or a sliding scale to reflect differing standards?
- Q7.4:** If a discount were available for good governance, do you think it should be based on a tick box approach (option A), or a more substantive voluntary certificate approach (option B)?
- Q7.5:** Do you agree that the application of the levy cap should be conditional on the capped scheme taking risk reduction measure(s)?
- Q7.6:** What type of measures would you suggest offer appropriate assurance that a scheme is committed to reducing their risk?

## 8 Implementation

### 8.1 Implementing the Board's proposed approach in 2012/13

- 8.1.1 The Board proposes to implement the new levy formula for the 2012/13 levy year.
- 8.1.2 In a change from current practice, it is proposed that from 2012/13 levies would be based on data collected immediately before the start of the levy year (i.e. in 2012/13, data up to 30 March 2012).<sup>22</sup> This has a range of practical advantages, including ensuring that the data used is as up-to-date as possible – but has previously been impossible to reconcile with providing schemes notice of likely levy bills through publication of the scaling factor and other parameters in advance of the levy year.
- 8.1.3 For the vast majority of schemes, the new formula can be implemented without requiring further information. However, the significance for schemes of supplying accurate information on asset allocation through Exchange would increase.
- 8.1.4 Schemes may wish to take account of the proposed changes when considering new contingent assets, deficit-reduction contributions or when reviewing their investment strategy.
- 8.1.5 In the light of consultation feedback, the Board will publish its policy decision on the proposed new levy formula in spring 2011. Given that the key data deadline for the new formula would be immediately before the start of the levy year (30 March 2012 in this case), this would mean schemes would have a significant amount of time to put in place the necessary arrangements for 2012/13.<sup>23</sup>
- 8.1.6 Scheme data on Exchange as at 31 March 2011 would be an important input to setting the scaling factor for the first review period of three years. To the extent that data used to calculate individual scheme levies diverges from the data held on Exchange as at 31 March 2011, the Board could over or under-collect as a result. This would increase the chance that the conditions for maintaining a fixed scaling factor for three years would be breached, and we would eventually revert to a system of annual scaling factors, with all the inherent uncertainty that this brings for schemes.
- 8.1.7 It is therefore extremely important that schemes ensure that the data held on Exchange as at 31 March 2011 is accurate. The importance of providing accurate data to the Regulator and the PPF is also highlighted by sections 80 and 195 of the Pensions Act and the potential offences under those sections.

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<sup>22</sup> This reflects that 31 March 2012 is a Saturday.

<sup>23</sup> The deadline for block transfers would be 29 June 2012 – see timeline in 8.3.1.

- 8.1.8 Schemes, and sponsoring employers should also note that insolvency risk information as at 31 March 2011 would also be used as the benchmark for determining whether transitional relief should apply to the levy rate for 2012/13, if we adopt transitional relief, and that information that feeds into their 2012/13 insolvency probability would be being collected by D&B even before the end of March 2011, since the first monthly data would be on 30 April 2011.

*Certification of Investment Risk*

- 8.1.9 For the minority of schemes that are required to certify how their portfolios would be affected by the application of stresses, and for all those who elect to do so, stressed asset values would be reported through Exchange.

## 8.2 An indicative implementation timetable

8.2.1 The Board's indicative timescale for implementation is set out in the following table:

Action	Indicative Timeframe
Consultation period closes.	20 December 2010
PPF policy paper published, setting out the Board's conclusions following consultation.	Spring 2011
Consultation on levy determination, including proposed parameters (i.e. levy scaling factor, levy estimate and cap) for the first review period (2012/13 – 2014/15).	September/October 2011
Publication of the Board's final levy determination and levy parameters for 2012/13 (including impact analysis), and expected parameters for the remaining years of the review period.	December 2011
PPF and the Pensions Regulator (i.e Exchange) systems updated for new calculations (including investment risk on the scheme return).	November 2011
The deadline for underfunding and insolvency risk data.	30 March 2012
Time frames for the submission of other relevant information, described below, are likely to be consistent with current practice:	
<ul style="list-style-type: none"> <li>• Certification/re-certification of contingent assets;</li> </ul>	30 March 2012
<ul style="list-style-type: none"> <li>• Certification of deficit-reduction contributions;</li> </ul>	10 April 2012
<ul style="list-style-type: none"> <li>• Certification of full block transfers that have taken place up to and including 31 March 2012.</li> </ul>	29 June 2012
Invoicing for 2012/13 levy year commences.	Autumn 2012

## 9 The Consultation Process

### 9.1 Responding to the consultation

- 9.1.1 The Board of the Pension Protection Fund welcomes your views on the proposals included in this consultation document as well as the specific questions included in the chapters, which are repeated below for ease of reference.

### 9.2 Summary of consultation questions

#### **Chapter 3: A New Framework**

- Q3.1:** Do you agree that a review period of three years would provide an appropriate balance of stability for levy payers and ability for the PPF to ensure its Funding Strategy remains on track?
- Q3.2:** Do you agree with the limited criteria we propose for revising the scaling factor within the review period?

#### **Chapter 4: Underfunding and Investment Risk**

- Q4.1:** Do you support a smoothed approach to funding and do you think that five years is an appropriate smoothing period?
- Q4.2:** Do you agree with our proposed method to smooth scheme assets and liabilities over five years?
- Q4.3:** Do you think that investment risk is appropriately reflected in the proposed funding calculation?
- Q4.4:** Do you agree with the Board's proposal that schemes with liabilities above £1.5 billion should be required to provide additional information on the effect of the stress scenarios?
- Q4.5:** Do you agree with Redington's assessment of the costs associated with providing the additional analysis of stress scenarios?
- Q4.6:** Do you agree with the method by which we propose that schemes should report their asset values, both stressed and unstressed? What are the implications for schemes of the annual accounts date (which may be later than the s179 valuation date) for this calculation?
- Q4.7:** Do you agree that the information schemes could use to calculate their investment risk would be readily accessible from asset managers, for example, sensitivity to interest rate changes for specific interest rate exposures?
- Q4.8:** Do you think the types of contingent assets that the Board will recognise for levy purposes is still appropriate, or are there other arrangements that you think should be recognised?
- Q4.9:** Do you think the requirements in terms of the current types of contingent assets are appropriate, or are there areas in which you think the current requirements are disproportionate or unnecessary?
- Q4.10:** To what extent do you think that changing the way the levy is calculated means that the PPF could or should change the types of contingent asset recognised, or the requirements for recognition?

## **Chapter 5: Insolvency Risk**

- Q5.1:** Do you agree that a significantly smaller number of insolvency risk bands (six instead of the current hundred) provide a better reflection of the risk posed to the PPF?
- Q5.2:** What are your views on the method by which we propose to derive levy rates for these bands (option (i) above)? Do you agree that it is preferable or would you prefer us to derive levy rates from the implied cost of insuring against insolvency on financial markets (option (ii))?
- Q5.3:** Do you agree that it would be beneficial to use an averaged measure of insolvency risk rather than a point estimate at 31 March? If so would you favour using monthly data points or using quarterly dates?
- Q5.4:** Do you think that the benefits of transitional relief to smooth cliff-edges are worth the additional complexity and cross-subsidy, given work to smooth insolvency risks through averaging?

## **Chapter 7: Good Governance**

- Q7.1:** Do you think that there is a relationship between a scheme's governance practices and its risk to the PPF?
- Q7.2:** If so, do you think that good governance should be measured and lead to a reduction in the risk-based levy?
- Q7.3:** If you support a discount for good governance, what sort of level do you think it should be set at? Should it be a fixed discount, or some sort of sliding scale to reflect differing standards?
- Q7.4:** If a discount were available for good governance, do you think it should be based on a tick box approach (option A), or a more substantive voluntary certificate approach (option B)?
- Q7.5:** Do you agree that the application of the levy cap should be conditional on the capped scheme taking some sort of risk reduction measure(s)?
- Q7.6:** What type of measures would you suggest offer appropriate assurance that a scheme is committed to reducing their risk?

### **9.3 Arrangements for written submissions**

9.3.1 The consultation period begins on 7 October 2010 and will end on 20 December 2010. Please ensure that your response reaches us by that date. If you would like further copies of this document it can be found at the Pension Protection Levy section of the Pension Protection Fund website at [www.pensionprotectionfund.org.uk](http://www.pensionprotectionfund.org.uk).

9.3.2 Please e-mail all electronic responses to [consultation@ppf.gsi.gov.uk](mailto:consultation@ppf.gsi.gov.uk).

9.3.3 Hardcopy responses can be addressed to:

Chris Collins  
Head of Policy  
Pension Protection Fund  
Knollys House  
17 Addiscombe Road  
Croydon  
CR0 6SR

9.3.4 Please state whether you are responding as an individual or representing the views of an organisation. If you are responding on behalf of an organisation please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

9.3.5 The requirements of the Freedom of Information Act (2000) state that all information contained in the response, including personal information, may be subject to publication or disclosure. By providing personal information for the purpose of the public consultation exercise, it is understood that a respondent consents to its disclosure and publication.

9.3.6 If this is not the case, the respondent should limit any personal information which is provided, or remove it completely. If a respondent requests that the information given in response to the consultation be kept confidential, this will only be possible if it is consistent with the Freedom of Information Act (2000) obligations and general law on this issue. Further information about the Freedom of Information Act 2000 can be found on the website of the Ministry of Justice at: [www.justice.gov.uk/guidance/freedom-of-information.htm](http://www.justice.gov.uk/guidance/freedom-of-information.htm).

## 9.4 Publishing a summary of responses

9.4.1 The Board will publish a summary of responses, and a statement of the final policy, on the PPF website at [www.pensionprotectionfund.org.uk](http://www.pensionprotectionfund.org.uk) in spring 2011.

9.4.2 This consultation is being conducted in line with the Code of Practice on Consultation. The code can be accessed via the website of the Department for Business, Innovation and Skills (BIS) at:  
<http://www.bis.gov.uk/policies/better-regulation/consultation-guidance/code-of-practice>.

9.4.3 The Board would value any feedback on the effectiveness of this consultation process. If you have any comments then please contact:

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