

Established by the Pensions Act 2004, the Pension Protection Fund pays compensation to members of eligible occupational defined benefit pension schemes when there is a qualifying insolvency event in relation to the sponsoring employer, and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.

Compensation payments will be funded by:

- Assets transferred from schemes that enter the Pension Protection Fund
- An annual levy raised from eligible pension schemes
- Assets recovered from insolvent sponsoring employers
- Returns on Pension Protection Fund investments.

Principles underpinning the Pension Protection Fund's proposals

- **Fairness** – ensuring that schemes pay an appropriate amount towards the levy reflecting the level of risk they pose
- **Simplicity** – applying effective and simple mechanisms and solutions for collecting the data required to set the levy
- **Proportionality** – ensuring that the levy is fair and proportionate between schemes and in its impact on individual schemes.

For 2006/07, the pension protection levy will be made up of two parts:

- **Scheme based levy (20%)** – based on the level of a scheme's Pension Protection Fund liabilities
- **Risk based levy (80%)** – based on scheme underfunding risk, and the insolvency risk of the sponsoring employer(s).

The risk based levy will be capped at 0.5% of a scheme's Pension Protection Fund liabilities. This will protect weaker schemes, and strikes an appropriate balance between the principles of fairness and proportionality.

Risk based levy Underfunding risk

Underfunding risk will be measured by taking account of the difference between the value of a scheme's assets (including any special contributions and contingent assets) and the value of its Pension Protection Fund liabilities.

Any scheme that is more than 125% funded on a Pension Protection Fund basis¹ will not be liable to pay the risk based element of the pension protection levy.

Scheme funding information on a section 179² basis (which broadly approximates the cost of buying out Pension Protection Fund liabilities from an insurance company) should be provided to the Pension Protection Fund by 31 March 2006. The simplification of the section 179 valuation process announced in October 2005 should reduce the cost of producing levy valuations by up to 80%.

For schemes that are unable to produce a section 179 valuation for the 2006/07 levy calculation, the Pension Protection Fund will adapt the results from the scheme's most recent Minimum Funding Requirement (MFR)

valuation. To avoid schemes having to produce out-of-cycle valuations, the option to adapt MFR valuations will be retained for the 2007/08 levy year.

The Pension Protection Fund will request a legislative change that will require all eligible schemes to submit an initial section 179 valuation to the Board by 31 March 2008. This will result in the risk based levy being calculated using data from an actual section 179 valuation for all schemes from 2008/09.

Recognising special 'deficit repair' contributions

The Office of National Statistics estimates that employers have injected £17bn of special cash contributions in the last three years to reduce pension scheme deficits. The Pension Protection Fund will recognise special cash contributions which serve to reduce a pension scheme's section 179 deficit in the underfunding risk calculation. Special cash contributions can include both lump sum contributions and regular contributions in excess of the cost of accrual of benefits. To claim this adjustment, scheme actuaries should complete the form, available on the Pension Protection Fund website, by 7 April 2006.

1. Either the section 179 or adapted MFR basis described in the following paragraphs
2. This is a reference to section 179 of the Pensions Act 2004

Recognising Contingent Assets

The Pension Protection Fund acknowledges that contingent assets have an important role in risk management. The 2006/07 levy calculation will recognise several different forms of contingent assets (listed below). This list may be expanded to include other types of asset in future years. Contingent assets must be established using standard form documentation. Standard form certificates must be provided to the Board, and standard conditions will apply. These conditions will regulate, among other things, who can provide the arrangements and when they will come to an end.

The 2006/7 levy calculation will recognise the following contingent assets:

- **Group company guarantees** – Provided by any group company domiciled in an Organisation for Economic Co-operation and Development (OECD) country
- **Security over cash, real estate or securities** – Pledged by the sponsoring employer(s)
- **Letters of credit and bank guarantees** – Provided by banks, domiciled in an OECD country, rated AA-/Aa3 or better. Such assets would be renewable annually, and if not renewed or replaced would entitle the trustees to call for the full cash value of the asset.

Insolvency Risk

The law requires the Pension Protection Fund only to measure the insolvency risk of sponsoring employers. The inclusion of contingent assets in the levy calculation allows formal support from a non-sponsoring group company to the pension scheme to be recognised.

In measuring insolvency risk, the Board will:

- Use D&B's failure score to measure the insolvency risk for all sponsoring employers of eligible schemes
- Take account of the structure of multi-employer pension schemes, where schemes provide information about their structure by 31 March 2006
- View insolvency risk over a twelve month horizon
- Cap insolvency risk at 15%
- Extend the number of risk bands from 10 to 100 to increase precision.

An explanation of D&B's methodology for calculating failure scores is available on the Pension Protection Fund website, www.pensionprotectionfund.org.uk

Timetable

12 July 2005	The Pension Protection Levy Consultation Document
14 October 2005	The Pension Protection Levy Consultation Document update
16 December 2005	The Pension Protection Levy Consultation Document – December 2005
23 January 2006	Consultation period ends
28 February 2006	The Board's levy determination, and a summary of consultation responses

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