

Pension
Protection
Fund

The 2007/08 Pension Protection Levy Consultation Document September 2006

Foreword

The Board of the Pension Protection Fund has been encouraged by how positively scheme trustees, employers, charitable and not for profit organisations and representative and professional bodies have all reacted to the introduction of the first pension protection levy in 2006/07.

The incentives package announced last December which encouraged better funding and stronger covenants has been well received, with many schemes and employers certifying additional contributions or putting in place acceptable contingent asset arrangements. We were also encouraged by the positive steps taken by many companies to work with Dun & Bradstreet to ensure that the assessment of employer insolvency was as accurate as possible. We are working with D&B on a number of important issues identified during the introduction of the pension protection levy for the 2006/07 levy year. In particular, we will seek to consider whether aspects of the D&B methodology, such as the weighting applied to County Court Judgements, and the application of the methodology to certain types of employers (e.g. large companies and the not-for-profit sector), may need to be adjusted.

Through extensive formal and informal consultation we have prompted a greater level of engagement and a better appreciation of the scale of the problem of deficits. Pension schemes have been able to plan for the payment of levy invoices with a fuller understanding of the role and purpose of the Pension Protection Fund.

Our work is, however, by no means done and, as we begin the process of sending out levy invoices this month, we must now focus our efforts on the future evolution of levy calculation.

This is the first of two consultations we will undertake on our approach to levy calculation for 2007/08. This first consultation tackles the amendments we propose to make to the way in which the levy is distributed across all eligible schemes. We will publish a second consultation on the changes that will be made to the way we estimate how much levy we plan to collect, later this year. A second period of consultation will follow the publication of this document.

The Pension Protection Fund is keen to promote stability, giving our original approach to levy calculation time to bed-down. This is particularly important as pension schemes and sponsoring employers are in the early stages of implementing risk reduction plans based on our original approach to levy calculation. We do, however, also recognise the importance of reflecting changes in the amount and distribution of risk, both short term and long term, and the continued need for consultation. In preparation for the 2008/09 levy year we expect therefore to carry out a full review of all aspects of the levy calculation. This review will be followed by an extensive consultation exercise in early spring 2007.

We look forward to considering your responses to this document and to continuing to work closely with all our stakeholders.

**Partha Dasgupta, Chief Executive
Board of the Pension Protection Fund**

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Chapter 1 - Introduction and Executive Summary

1.1 Introduction to the pension protection levy

- 1.1.1 The Board of the Pension Protection Fund was set up as a statutory corporation, under the provisions of the Pensions Act 2004, and became operational on 6 April 2005. The Pension Protection Fund has been established to pay compensation to members of occupational defined benefit and hybrid pension schemes, following an insolvency event of the sponsoring employer where there are insufficient assets to pay a Pension Protection Fund level of compensation.
- 1.1.2 Compensation payments will be partly funded by the assets transferred from schemes for which the Pension Protection Fund has assumed responsibility, and partly by an annual levy raised from eligible pension schemes. The initial levy for 2005/06 was based on scheme membership numbers only.
- 1.1.3 The Board of the Pension Protection Fund introduced the first pension protection levy for the 2006/07 levy year. This levy is made up of two parts: a scheme based levy and a levy based on the risk posed by the scheme to the Pension Protection Fund.
- 1.1.4 The Board consulted on its proposals for calculating the 2006/07 pension protection levy on two occasions over a total of 17 weeks between July 2005 and January 2006. The Board published two consultation documents, in July and December 2005, and a consultation update document in October 2005. Through this range of documents, the Board sought to achieve its objective of ensuring that all stakeholders remained fully informed of the ways in which the Board's initial thinking developed in response to the consultation responses received. This open approach to consultation was driven by the Board's principles of fairness, simplicity and proportionality. The Board was encouraged by the positive way in which the consultation documents were received, and by the 280 responses submitted.
- 1.1.5 The Board's final response to the 2006/07 levy consultation exercise was published in February 2006, accompanied by the Board's Determination under section 175(5) of the Pensions Act 2004 which set out the rules for levy calculation.
- 1.1.6 The 2007/08 levy year will be the second year in which a pension protection levy is calculated for all eligible schemes.

1.2 The 2007/08 Pension Protection Levy Consultation Document

- 1.2.1 The Board highlighted a need for consistency in the methodology used to calculate the pension protection levy between the 2006/07 and 2007/08 levy years in the "Response to the Second Pension Protection Levy Consultation - February 2006". This reflected the feedback from stakeholders that they wanted a stable regime and, in particular, that it would be helpful to allow the risk based levy to "bed down" in the second year of operations. However, the

Board also recognised that, in response to the 2006/07 consultation process and operational experience, a number of minor revisions should be made to the way in which the levy is distributed between eligible pension schemes for the 2007/08 levy year. In particular, the Board aims to make improvements to practical processes associated with the pension protection levy, for example in relation to data collection.

1.2.2 It was intended that any amendments to the approach taken to calculation of the levy for the 2007/08 levy year would be informed by:

- The significance of improvements as measured against the principles of fairness, simplicity and proportionality;
- The degree of change in the risk of the universe of eligible schemes;
- The desire of our stakeholders to avoid unnecessary change.

1.2.3 This document sets out a number of minor amendments that the Board proposes to make to the way in which a scheme's pension protection levy is calculated for 2007/08, as compared with the way in which their 2006/07 levy was calculated. The publication of this Consultation Document will be followed by a four week consultation period.

1.2.4 The Board considers these proposals to be firm and is publishing this document at an early stage to enable schemes to consider whether to take further action to reduce their levy. Any comments on this document which are received by 9 October 2006 will, however, still be considered. A summary of those responses and any changes to the Board's proposals will be published in mid November 2006.

1.2.5 The Board will set out the levy estimate and the more substantial changes that it proposes in respect of the levy scaling factor in a separate consultation document which will be published before the end of 2006.

1.3 The Levy Estimate and the Board's Determination under section 175(5) of the Pensions Act 2004

1.3.1 The Board has committed to consulting annually on the amount of levy it estimates will be collected in each levy year. The 2007/08 Levy Estimate Consultation Document will be published before the end of 2006. This document will also include the levy scaling factor for the 2007/08 risk based levy, and the levy scaling factor ("the multiplier") for the 2007/08 scheme based levy. This second consultation period will last for 6 weeks as we expect to make more substantial changes to the way the levy scaling factor is determined.

1.3.2 The Levy Estimate Consultation Document will also be accompanied by a draft of the Board's Determination under section 175(5) of the Pensions Act. This Determination will set out the 2007/08 levy formulae, the risk factors for the risk based levy, the time at which the risk factors will be assessed and the time when the levy becomes payable.

- 1.3.3 A summary of responses to the Levy Estimate Consultation and the final version of the Board's Determination will be published at the end of January 2007.

1.4 Summary of policy development for 2007/08

Summary

- 1.4.1 As set out in paragraph 1.2.1 above, the Board proposes to make minor revisions to the way in which the levy is calculated, in response to the 2006/07 consultation process and operational experience of the implementation of the first pension protection levy. In summary, these changes are:
- Revised standard documentation for contingent assets, including new standard documentation for a Type C contingent asset (letter of credit or bank guarantee) in support of a schedule of deficit-reduction contributions;
 - Working closely with Dun & Bradstreet (D&B) to ensure that their assessment of the insolvency risk of the sponsoring employers of eligible pension schemes suits the universe under consideration.
 - Revised section 179 guidance, including changes to two assumptions.
 - A revised approach to the inclusion of insured liabilities within a section 179 valuation.

Contingent assets

- 1.4.2 The Board has created standard documentation for a fixed term Type C arrangement (letter of credit/bank guarantee) to support a schedule of deficit-reduction contributions. This new documentation clarifies and simplifies an approach that was already possible within the scope of the Board's 2006/07 standard documentation for a Type C arrangement.
- 1.4.3 The acceptable caps for Type A and B contingent asset arrangements (group company guarantees and security over assets) have been extended to include a maximum liability in cases where the contingent asset covers the full section 75 debt or a percentage of the deficit on a section 179 basis.
- 1.4.4 The Board has revised the way in which Type A contingent assets (group company guarantees) are considered in the risk based levy calculation where a scheme is funded over 104% of section 179 liabilities (taking into account any deficit-reduction contributions paid into the scheme since the most recent valuation and Type B and C contingent assets). Schemes funded above 104% on a section 179 basis will gain credit for contingent asset arrangements which guarantee a funding level between the actual funding level of the scheme and 125% of section 179 liabilities. This revised formula is set out in annex A of this Consultation Document.
- 1.4.5 We will require that all arrangements put in place for the 2007/08 levy year

use the revised 2007/08 standard documentation. The Board will continue to recognise arrangements put in place using the 2006/07 versions of the standard documentation which were certified to the Board prior to 31 March 2006. The Board will only require that those arrangements are re-certified using standard certificates that will be issued by the Board to all relevant schemes (see paragraph 2.1.3 of chapter 2).

- 1.4.6 Each of these revisions is discussed in greater detail within chapter 2 of this Consultation Document.

Insolvency risk

- 1.4.7 The Board will continue to calculate the insolvency risk element of the risk based levy calculation using the Dun & Bradstreet (D&B) Failure Score and associated probability of insolvency of the scheme's sponsoring employer(s).
- 1.4.8 The Board will work with D&B to ensure that the D&B methodology used to assess the insolvency risk of the sponsoring employers of eligible pension schemes best suits the specific universe under consideration by the Board.
- 1.4.9 The Board's intended approach is discussed in greater detail in chapter 3 of this Consultation Document.

Multi-employer schemes

- 1.4.10 The information required by the Board to calculate a weighted average probability of insolvency for multi-employer schemes will now be incorporated into the annual Scheme Return issued by the Pensions Regulator. This information will no longer be collected on a voluntary basis by the Board using the two part Declaration of Scheme Structure and Participating Employer Forms, as was the case for the 2006/07 levy year.
- 1.4.11 The Board will therefore be able to calculate a weighted average probability of insolvency for every multi-employer scheme and so make a more detailed assessment of insolvency risk than would be the case if the Board only considered the insolvency risk of the largest sponsoring employer.
- 1.4.12 Schemes will also be required to include membership information for all sponsoring employers in the annual Scheme Return, enabling the insolvency risk calculation to be weighted by number of members in all cases. Since weighting by number of members leads to a more relevant calculation, the option to weight by number of employees will no longer be available.
- 1.4.13 The Board acknowledges that it may be challenging for some schemes to allocate all members between participating employers but would ask that schemes make a reasonable estimate where necessary. The Board's suggested approach is set out in paragraph 3.3.6 of this Consultation Document.

Underfunding risk

Changes to the section 179 valuation guidance and assumptions

- 1.4.14 The publication of this Consultation Document is accompanied by the publication of a revised version of the “Guidance for undertaking the risk based levy valuation in accordance with section 179 of the Pensions Act 2004”. This revised guidance can be found on the Pension Protection Fund website at www.pensionprotectionfund.org.uk.
- 1.4.15 The Board has revised two of the assumptions used to determine pension scheme liabilities on a section 179 basis and estimates that on average the effect of the changes could be a reduction of approximately 5% in section 179 liabilities. These technical amendments have previously been consulted on, in the form of an open letter to the Actuarial Profession.
- 1.4.16 The series of Frequently Asked Questions that accompanied the section 179 guidance on the Pension Protection Fund website have also now been incorporated into the guidance itself.

Revised approach to the inclusion of insured liabilities within a section 179 valuation

- 1.4.17 In response to a number of representations made during 2006 the Board, in collaboration with the Department for Work and Pensions, has also reconsidered the way in which insured liabilities (annuities bought out in the name of trustees) are included in a section 179 valuation.
- 1.4.18 The Board’s revised approach is set out in detail in section 4.5 of this Consultation Document. In summary, the Board recognises the difficulties faced by scheme actuaries when completing a section 179 valuation where schemes do not hold records of historic annuity purchases.
- 1.4.19 The Board therefore approached the Department for Work and Pensions to consider legislative change, and they will be publishing amended section 179 regulations to permit scheme actuaries to exclude annuities bought out in the name of the trustees in restricted circumstances (where the annuities were purchased before 6 April 1997 and, in the scheme actuary’s opinion, no record of the insurance contract is available). The Board’s section 179 guidance will be amended in light of the change to regulations.

1.5 Data collection and voluntary certificates for the 2007/08 levy year

- 1.5.1 The Board used information contained in the most recent annual Scheme Return issued by the Pensions Regulator to calculate the 2006/07 pension protection levy. This was supplemented by information submitted by a scheme in one of the following voluntary forms:
- Section 179 Valuation Certificate

- The Actuarial Certificate of Deficit-Reduction Contributions
 - Contingent Assets Certificates
 - The two part Declaration of Scheme Structure and Participating Employers Forms
 - Sectionalised scheme forms
- 1.5.2 From November 2006 the Pensions Regulator will be issuing the annual Scheme Return to all eligible schemes. The scheme returns that will be used for the 2007/08 levy year are web-based and pre-populated with certain information already provided by schemes (e.g. information on scheme structure and participating employers). The data that will be used for levy calculations will be clearly identified. They will contain validation rules, to help ensure the data collected is accurate.
- 1.5.3 The following voluntary certificates can be completed up until 30 March 2007 (5 April 2007 in the case of the Actuarial Certificate of Deficit-Reduction Contributions):¹
- Section 179 Valuation Certificate
 - The Actuarial Certificate of Deficit-Reduction Contributions
 - Contingent Assets Certificates
- 1.5.4 A summary of the forms available and links to electronic images of these forms are included in annex B of this Consultation Document.
- 1.5.5 Apart from in the case of re-certification of existing contingent asset arrangements, the process for submitting voluntary certificates will remain consistent with the approach taken for the 2006/07 levy year. Schemes and their advisers will still be able to download the relevant voluntary certificate from the Pension Protection Fund website and to submit that certificate electronically to the Board by the 30 March 2007 deadline (5 April 2007 in the case of the Actuarial Certificate of Deficit-Reduction Contributions). More detailed guidance on completing each individual voluntary certificate will however be available on our website as well as detailed advice on the use of the Adobe reader package. The process for re-certifying existing contingent assets arrangements is set out in section 2.3 of this Consultation Document.
- 1.5.6 We will also reduce the amount of additional contact made with individual schemes, by focusing on the unique Scheme or Section Identification number (SSID) as the key reference for all communications between the Pension Protection Fund and eligible schemes. The SSID will be quoted on all 2006/07 pension protection levy invoices, and is made up of the Pension Schemes Registry number, a hyphen and a section identifier set to 000 for

¹ Since 31 March and 7 April are not working days, the deadlines for this year will be advanced by one and two days (as 6 April is also not a working day) respectively.

non-sectionalised schemes (e.g. 12345678-000). Increased use of the SSID will ensure that we will always be able to match voluntary form information provided, with existing Scheme Return data.

- 1.5.7 The new voluntary certificates can be submitted electronically from mid-November 2006. Images of the certificates are already available within the Pension Protection Levy section of our website at www.pensionprotectionfund.org.uk. These images can be printed out for reference and to help schemes and their advisers prepare the information required.
- 1.5.8 The previous version of the section 179 valuation certificate will continue to be available online for completion and submission to the Board until mid-November, in the Voluntary Certificates 2007/08 section of the Pension Protection Fund website.

1.6 The timetable for consultation on the Board's proposals for calculating the 2008/09 pension protection levy

- 1.6.1 As noted in the foreword to this Consultation Document, the Board intends to undertake a comprehensive review of all aspects of the levy calculation in preparation for the 2008/09 levy year. We currently intend to publish the 2008/09 Pension Protection Levy Consultation Document in early February 2007 and will follow the publication of this document with a 12 week consultation period. This is to ensure that there is sufficient time to make any necessary changes to legislation and data collection to support the proposals.
- 1.6.2 **The Board would appreciate an indication as to whether stakeholders support this proposed approach.**

Chapter 2 - Contingent Assets

2.1 Introduction

2.1.1 The Board took account of the following contingent asset arrangements when calculating the amount of risk based levy payable by a particular scheme for the 2006/07 levy year, provided they were put in place using the Board's standard documentation and certified by 31 March 2006:

- Guarantees given by parent/group companies and undertakings (Type A)
- Security over cash, real estate and securities (Type B)
- Letters of Credit and Bank Guarantees (Type C)

2.1.2 For the 2007/08 levy, the Board will take account of the same types of contingent asset arrangements. A number of minor amendments have however been made to the standard documentation. The Board has also consolidated and expanded its guidance for putting in place acceptable contingent asset arrangements.

2.1.3 The Board will continue to recognise arrangements put in place by 31 March 2006 using the 2006/07 versions of the standard documentation, provided that the trustees/manager re-certify the arrangements to the Board confirming that the arrangement remains in place for 2007/08. The Board's intention is that once a scheme has put a contingent asset in place in accordance with the Board's policies in any given year, that scheme will continue to receive credit for that arrangement in the levy calculation in perpetuity, assuming the arrangement continues to meet the Board's requirements and is re-certified each year.

2.1.4 This chapter summarises the changes that have been made for the 2007/08 levy year. The Board had previously communicated its intention to consider the inclusion of credit default swaps (CDS) within the definition of acceptable arrangements for 2007/08. The Board has taken the decision that, given the relative complexity of CDS arrangements and the degree of further investigation required to determine whether and how credit could be given for CDS arrangements within the risk based levy calculation, CDS arrangements will not be recognised within the 2007/08 risk based levy calculation .

2.2 Amendments for the 2007/08 levy year

Creation of a fixed term Type C (letter of credit and bank guarantee.) arrangement to support a schedule of deficit-reduction contributions

2.2.1 For the purpose of the 2007/08 risk based levy calculation the Board has developed standard form documentation for employers wishing to put in place a fixed-term letter of credit or bank guarantee arrangement that supports an agreed schedule of deficit-reduction contributions into the

pension scheme. The outstanding value of the letter of credit could then be called upon in the event of failure to pay any of the agreed contributions.

2.2.2 In creating separate standard documentation, the Board is clarifying and simplifying an approach that was possible under the 2006/07 standard documentation but which required amendments to be made. This new documentation is now available within the Pension Protection levy section of the Pension Protection Fund website at www.pensionprotectionfund.org.uk.

2.2.3 The Board's prescribed form for such an arrangement includes:

- a documented obligation to make deficit-reduction contributions to a specific schedule;
- a duration of at least the time span of that schedule plus an enforcement period of one month after the last planned contribution;
- failure to pay any contribution as a call event under the arrangement for the amount unpaid;
- a schedule whereby the face value of the arrangement steps down as each contribution is made (upon notice from the trustees to the bank issuer).

Broadening definition of acceptable caps

2.2.4 For the 2006/07 levy year, acceptable Type A and B contingent asset arrangements included a limitation on the overall liability of the guarantor/chargor in one of three forms. The liability cap could be a fixed monetary amount, an amount guaranteeing a specified percentage funding level on a section 179 basis, or the full section 75 debt of the pension scheme.

2.2.5 The Board has now taken the decision to broaden the definition of an acceptable cap to include a cap as a specified percentage funding level on a section 179 basis or the full section 75 debt but **subject to an absolute maximum liability**. Employers may choose to put in place a contingent asset arrangement with one of the following caps to ensure that the absolute maximum liability under the arrangement is known in advance:

- Lower of (a) percentage funding level on s.179 basis (e.g. 105%) and (b) fixed amount £X;
- Lower of (a) full s.75 debt and (b) fixed amount £Y.

Proposed revision to way in which Type A contingent assets (group company guarantees) are considered in the risk based levy calculation

2.2.6 Currently if a Type A guarantee has been put in place in respect of a particular scheme, credit is only given in the risk based levy calculation for that guarantee if the scheme is funded below 104% or if the contingent asset guarantees the full section 75 debt or 125% of liabilities on a section 179

basis as at 31 March 2006.

- 2.2.7 For the 2007/08 levy year, the Board has revised the levy formula so that an insolvency risk switch occurs for the percentage of deficit guaranteed, even where the scheme is funded above 104% and the guarantee does not cover the full section 75 debt or 125% of liabilities on a section 179 basis. This revised formula is set out in annex A of this Consultation Document.

Amendment and replacement - M&A transactions

- 2.2.8 The amendment and replacement provisions within the standard form documentation have been modified. In particular, under the new documentation, changes can be proposed and implemented at any point in the year. This ensures that a change to the contingent asset could be part of, and simultaneous with, a larger corporate transaction, or could immediately recognise an improvement in funding or the making of a deficit-reduction contribution. Asset and liability values for these purposes can now also be based on a statement from the Scheme Actuary - the parties are not restricted to using formal section 179 valuations.
- 2.2.9 Further information has also been included in the guidance as to how the amendment and replacement provisions should operate in the context of M&A transactions, restructurings etc. In particular, the guidance clarifies that, where a specific transaction is in contemplation, the parties are free to agree bespoke amendment and replacement provisions in the contingent assets, so long as they are consistent with the underlying policy.

2.3 Revised certification, standard documentation and contingent asset guidance note

Arrangements that were put in place by 31 March 2006

- 2.3.1 Provided that no changes have been made to an acceptable contingent asset arrangement that was certified to the Board prior to the 31 March 2006, all that will be required is a re-certification prior to 30 March 2007. We will provide schemes in this position with a pre-populated re-certification form in November 2006. Depending upon the notes supporting each specific type of arrangement, a new valuation may also be required. Schemes will not however, be required to submit new legal opinions, but may do so if they so wish.
- 2.3.2 Schemes with contingent assets in place in the 2006/07 form will also be able to transfer to the 2007/08 form by invoking the amendment/replacement provisions, should they wish to do so.

New arrangements

- 2.3.3 All new arrangements must be put in place using the 2007/08 standard documentation and certified using the 2007/08 certificates, if they are to be included as part of the 2007/08 levy calculation.

- 2.3.4 The standard documentation and contingent asset guidance are now available on the Pension Protection Fund website at www.pensionprotectionfund.org.uk.
- 2.3.5 The revised guidance provides relevant information for any employer seeking to put a contingent asset arrangement in place in respect of a particular pension scheme.
- 2.3.6 Schemes that wish to certify new arrangements will be able to download the relevant certificate from the Pension Protection Fund from mid-November 2006. Images of these certificates are currently available on the Pension Protection Levy section of the PPF website (www.pensionprotectionfund.org.uk).

Chapter 3 - Insolvency Risk

3.1 Introduction

- 3.1.1 The Board of the Pension Protection Fund appointed Dun & Bradstreet (D&B) as its insolvency risk provider in August 2005.
- 3.1.2 The Board will use the D&B Failure Score and the associated probability of insolvency of each sponsoring employer to calculate the risk based levy payable by a particular scheme for the 2007/08 levy year.
- 3.1.3 The Board will in recognition of continued feedback from levy payers, work with D&B to ensure that the D&B methodology used to assess the insolvency risk of the sponsoring employers of eligible pension schemes reflects the specific nature of the universe under consideration by the Board.

3.2 The D&B Failure Score

- 3.2.1 In consultation with D&B, the Board made a number of changes to the way in which the D&B Failure Score methodology was applied for the purpose of the risk based levy calculation. For example, the Board took the decision to ignore the Negative Net Worth and Severe Parental Risk overrides which D&B would apply in the normal course of business.
- 3.2.2 The Board has now undertaken to build on this progress to date by working with D&B on a number of important issues identified during the introduction of the pension protection levy for the 2006/07 levy year. In particular, we will seek to consider whether aspects of the D&B methodology, such as the weighting applied to County Court Judgments and the application of the methodology to certain types of employers (e.g. large employers and the not-for-profit sector), may need to be adjusted.
- 3.2.3 The Board will calculate the insolvency risk element of a scheme's 2007/08 risk based levy calculation based on the Failure Scores and associated probabilities of insolvency, assigned to the scheme's sponsoring employers by D&B, as at 30 March 2007.
- 3.2.4 The 30 March Failure Score will take account of any changes made to the Failure Score methodology prior to that date.
- 3.2.5 The specific probabilities of insolvency associated with each of the 1 to 100 Failure Scores will also be updated to take account of an additional 12 months of employer insolvency experience. A revised probability of insolvency table will be published with the final version of the Board's Determination under section 175(5) of the Pensions Act 2004 in January 2007.

3.3 Calculating the insolvency risk of multi-employer schemes

- 3.3.1 The risk profile of a pension scheme sponsored by multiple employers is

markedly different to that of a scheme sponsored by a single employer. The structure and rules of different types of schemes have an impact on how risk is shared among participating employers and therefore on the calculation of levy risk factors.

- 3.3.2 For the 2006/07 levy year the Board was only able to take account of the structure of a multi-employer scheme and the risk of insolvency of all the sponsoring employers if the scheme in question had submitted the two-part Declaration of Scheme Structure and Participating Employers Form to the Board by 31 March 2006.
- 3.3.3 If the two-part form was not submitted in respect of a particular scheme, the insolvency risk element of the risk based levy calculation was based on the D&B Failure Score and probability of insolvency of the largest employer (defined in terms of number of active, deferred and pensioner members).
- 3.3.4 For the 2007/08 levy years these voluntary forms will no longer be available. This data will be collected for all schemes via the Pensions Regulator's annual Scheme Return which will be issued to eligible schemes from November 2006.
- 3.3.5 Schemes will also be required to include membership information for all sponsoring employers in the annual Scheme Return. For the 2007/08 levy year the insolvency risk calculation will be weighted by number of members in all cases. The option to weight by number of employees, where membership information has not been provided, will not be available. This is because weighting by number of members is a much more accurate calculation as it includes all members associated with an employer, not just a proxy for active members. The Board appreciates that it may be challenging for some schemes to apportion members to employers but would expect that where necessary, schemes make a reasonable estimate.
- 3.3.6 In relation to orphan members² and members who cannot be apportioned accurately, trustees should attempt to allocate scheme members between participating employers. Having correctly allocated as many members as possible, they should then allocate the remaining members to the participating employers in proportion to the number of members already allocated to each participating employer.
- 3.3.7 For example, if we assume a scheme has 120 members in total and only 60 of these can be correctly allocated between three participating employers as follows:

Employer A - 10 members

Employer B - 20 members

Employer C - 30 members

² "Orphan members" are deferred or pensioner members who do not belong to any of the participating employers of the scheme i.e. because their employer has previously left the scheme, for whatever reason.

The remaining 60 members should be allocated in the same proportions i.e. 10 members to Employer A, 20 members to Employer B and 30 members to Employer C, resulting in the following totals which should be entered in the relevant fields on the Scheme Return:

Employer A - 20 members

Employer B - 40 members

Employer C - 60 members

Chapter 4- Underfunding Risk

4.1 Introduction

- 4.1.1 The Board calculates the level of scheme underfunding based on an assessment of the scheme's assets and protected liabilities (as per section 179 of the Pensions Act 2004) at a consistent date.
- 4.1.2 The publication of this Consultation Document is accompanied by the issue of a revised version of the "Guidance for undertaking the risk based levy valuation in accordance with section 179 of the Pensions Act 2004". This revised guidance can be found on the Pension Protection Fund website at www.pensionprotectionfund.org.uk.
- 4.1.3 For the 2007/08 levy year, as was the case for 2006/07, schemes may choose whether or not to submit a section 179 valuation prior to 30 March 2007. If a section 179 valuation is not submitted (either on a voluntary certificate or in the annual Scheme Return issued by the Pensions Regulator) the Board will take account of the most recent MFR valuation included on the Scheme Return.
- 4.1.4 In every case the Board will take the most recent valuation information provided and roll it forward to a section 179 basis at a consistent date.
- 4.1.5 The methodology for adapting MFR valuations to estimate liabilities on a section 179 basis, and the formulae for rolling forward section 179 valuation results to a consistent date, are available on the Pension Protection Levy publications page of the Pension Protection Fund website, at www.pensionprotectionfund.org.uk. Updated versions including minor amendments for the 2007/08 levy year will be available on the website from November 2006.
- 4.1.6 Subject to legislative change, all schemes will be required to submit an initial section 179 valuation by 31 March 2008.

4.2 Revisions made to the assumptions for undertaking a section 179 valuation

- 4.2.1 During June and July 2006, the Board sought the views of the Actuarial Profession on the proposed changes to the following three financial assumptions:
- The discount rate in deferment
 - The discount rate for pre-1997 pensions in payment
 - The discount rate for post-1997 pensions in payment.

4.2.2 The Board has revised the section 179 assumptions as follows (all other assumptions remain unchanged³):

- The discount rate in deferment should now be 0.7% less than the index-linked gilts yield
- The discount rate used to value post-1997 compensation in payment for the period after retirement should now be the higher of (i) the index-linked gilts index yield minus 0.5%; and (ii) the yield on the FTSE Actuaries Government Securities 10-year Fixed Interest index minus 2.5%.

4.3 Effect of proposed changes

4.3.1 The Board estimates that on average the effect of the changes could be a reduction of around 5% in section 179 liabilities. In practice the reduction may vary considerably from one scheme to another.

4.4 Further changes to the section 179 guidance

4.4.1 The series of Frequently Asked Questions that accompanied the section 179 guidance on the Pension Protection Fund website have now been incorporated into the guidance itself.

4.4.2 The Board has also sought to separate out the section 179 guidance from the section 179 assumptions and has published these separately. Both of these documents are now available on the Pension Protection Fund website. The Scheme Actuary will now be required to certify the version of guidance and the version of the assumptions used on submitting a section 179 valuation certificate.

4.5 Insured liabilities

4.5.1 Legislation and the Board's supporting section 179 guidance currently requires all annuities bought in the name of trustees (but not members) to be included in section 179 valuations. This is because these annuities remain assets of the scheme and therefore should be included in scheme valuations.

4.5.2 However, the Board recognises the difficulties faced by scheme actuaries when completing a valuation in accordance with section 179 of the Pensions Act 2004 where schemes do not hold records of historic annuity purchases.

4.5.3 The Board approached the Department for Work and Pensions to request legislative change. As a result, the department will be publishing amended section 179 regulations which will enable scheme actuaries to exclude annuities bought in the name of the trustees in restricted circumstances. These regulations will permit scheme actuaries to exclude annuities purchased in the name of the trustees before 6 April 1997 where, in their

³ In response to consultation, it was decided that the discount rate for pre-1997 pensions in payment should not be changed.

opinion, no record of the insurance contract is available. The Board's section 179 guidance will be amended in light of this change to regulations.

- 4.5.4 The Board continues to believe that annuities remain assets of the scheme and therefore should be included in scheme valuations. This regulatory change is simply designed to deal with poor historic record-keeping, where it would be either disproportionate or impossible to identify historic annuity purchases.

4.6 Deficit-reduction contributions

- 4.6.1 The Board will once again take account of deficit-reduction contributions paid into the scheme since the most recent valuation. These contributions need to be correctly certified to the Board by 5 April 2007.
- 4.6.2 The Board will only take account of the most recent Actuarial Certificate of Deficit-Reduction Contributions submitted, and requires that the certificate relates to the latest section 179 valuation provided to the Board (or the MFR valuation included within the most recent annual Scheme Return, where no section 179 valuation has been supplied). Any new certificate should, therefore, include all contributions paid into the scheme since the most recent valuation, including any certified prior to 7 April 2006. The Board will not however require a new certificate where contributions were certified prior to 7 April 2006 and the scheme has not since provided a new valuation to the Board or received any further deficit-reduction contributions.
- 4.6.3 A revised version of the Actuarial Certificate for Deficit-Reduction Contributions will be available on the Pension Protection Fund website for completion from November 2006. An image of the certificate is already available in the Pension Protection Levy section of our website at www.pensionprotectionfund.org.uk. This certificate can be printed out for reference and should help schemes and their advisers prepare the information required. A link to the image of this certificate on the Pension Protection Fund website is included in Annex B of this Consultation Document.
- 4.6.4 A new guidance note is now available on the Pension Protection Levy section of our website to support the completion of this certificate. This guidance replaces the notes and series of Frequently Asked Questions that accompanied the 2006/07 version.

Chapter 5 - The Consultation Process

5.1 Responding to the consultation

- 5.1.1 The Board of the Pension Protection Fund welcomes your views on the firm proposals contained in this Consultation Document.

5.2 Arrangements for written submissions

- 5.2.1 The consultation period begins on 11 September 2006 and will end on 9 October 2006. Please ensure that your response reaches us by that date. If you would like further copies of this Consultation Document it can be found on our website at www.pensionprotectionfund.org.uk. Please send all consultation responses to:

Sara Protheroe
Levy Manager
Pension Protection Fund
Knollys House
17 Addiscombe Road
Croydon
CR0 6SR

Tel: 020 8633 4900
Email: consultation@ppf.gsi.gov.uk

- 5.2.2 When responding, please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of an organisation please make it clear who the organisation represents and, where applicable, how the views of members were assembled. If responding on behalf of a pension scheme, please include details of your scheme including the number of members and the most recently calculated value of the scheme's liabilities
- 5.2.3 The requirements of the Freedom of Information Act (2000) state all information contained in the response, including personal information, may be subject to publication or disclosure. By providing personal information for the purposes of the public consultation exercise, it is understood that a respondent consents to its disclosure and publication. 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 Freedom of Information Act obligations and general law on this issue. Queries should be sent to Paul Reynolds. Further information about the Freedom of Information Act can be found on the website of the Department for Constitutional Affairs - <http://www.dca.gov.uk/foi/guidance/exguide/index.htm>.

5.3 Publishing a summary of responses

- 5.3.1 The Board will aim to publish a summary of responses at www.pensionprotectionfund.org.uk before the end of 2006, alongside the 2007/08 voluntary forms.
- 5.3.2 This consultation is being conducted in line with the Code of Practice on Consultation. The code can be accessed at:
<http://www.cabinetoffice.gov.uk/regulation/Consultation/Code.htm>
- 5.3.3 The Board would value any feedback on the effectiveness of this consultation process. If you have any comments then please contact:

Paul Reynolds
Director of Communications
Pension Protection Fund
Knollys House
17 Addiscombe Road
Croydon
CR0 6SR

Tel: 020 8633 4968
E-mail: paul.reynolds@ppf.gsi.gov.uk

Annex A - Revised Levy Formula

A.1 Technical specification of the risk based levy

A.1.1 The formula for determining the underfunding risk factor has been updated. The update takes into account the revised way in which Type A contingent assets (group company guarantees) are considered in the risk based levy calculation for schemes funded over 104% of section 179 liabilities.

A.1.2 The insolvency risk factor for multi-employer schemes has been updated to reflect our revised approach whereby a weighted average probability of insolvency will be calculated in all cases. This average will no longer be compared to the probability of insolvency of the largest employer.

A.2 Insolvency risk (P)

The insolvency risk factor will be calculated as follows:

A.2.1 Single employer

- Calculate failure score of the single sponsoring employer
- Determine the corresponding insolvency risk band (1-100 scale)
- Look up the assumed probability of insolvency for the risk band

F = Failure score of employer
P = PPF assumed probability of insolvency corresponding to failure score F

A.2.2 Multi-employer

- Calculate the failure score of each sponsoring employer in the scheme/section;
- Determine the corresponding Pension Protection Fund assumed probability of insolvency;
- Calculate the weighted average probability for all participating employers in scheme/section.
- Multiply by the appropriate scaling factor

K = number of sponsoring employers in the scheme/section
 E_i = number of members of the i th sponsoring employer in the scheme/section*
E = total number of members for all sponsoring employers in the scheme/section

$$E = \sum_{i=1}^K E_i$$

$$w_i = \frac{E_i}{E}$$

F_i = Failure score of i th sponsoring employer in the scheme/section
 q_i = Pension Protection Fund assumed probability of insolvency corresponding to failure score F_i

$$P = M \times \sum_{i=1}^K w_i \times q_i$$

M = factor dependant on type of multi-employer scheme (see table)

Multi-employer type	Factor (M)
Option or requirement to segregate upon cessation of participation of an employer	1
Associated	0.9
Non-associated	No of members of largest employer / No of members of the entire scheme/section

A.2.3 For a segregated scheme the insolvency calculation will be performed separately for each section of the scheme.

A.3 Underfunding risk including contingent assets (U)

A.3.1 The formula for underfunding risk is as follows. The formula to be used depends on the amount of any Type B and Type C contingent assets.

S = value of scheme assets

C = special contributions (post effective valuation date)

N_a = face value of group company guarantee

N_b = face value of type B contingent assets

N_c = face value of type C contingent assets

z = discount factor applied to type A contingent assets = 1 – probability of insolvency of guarantor / probability of insolvency

If the value of Type B and Type C contingent assets together with the scheme assets (including special contributions) is no more than 104% of the value of the s179 liabilities (either actual or estimated from MFR valuations), then the formula is as follows:

$$U = 1.05 \times L - A$$

L = value of s179 liabilities (actual or estimated from MFR)

$$A = S + C + N_a \times z + N_b + N_c$$

The maximum value that A N can take is $(1.05 \times L) - S - C - N_b - N_c$ or zero if greater.

If the value of Type B and Type C contingent assets together with the scheme assets is more than 104% but not more than 111% of the value of the s179 liabilities (either actual or estimated from MFR valuations), then the formula is as follows:

$$U = 0.0075 \times L - (N_a \times z)$$

The maximum value that N_a can take is $0.0075 \times L$

If the value of Type B and Type C contingent assets together with the scheme assets is more than 111% but not more than 118% of the value of the s179 liabilities (either actual or estimated from MFR valuations), then the formula is as follows:

$$U = 0.005 \times L - (N_a \times z)$$

The maximum value that N_a can take is $0.005 \times L$

If the value of Type B and Type C contingent assets together with the scheme assets is more than 118% but not more than 125% of the value of the s179 liabilities (either actual or estimated from MFR valuations), then the formula is as follows:

$$U = 0.0025 \times L - (N_a \times z)$$

The maximum value that N_a can take is $0.0025 \times L$

(a) If there are no Type A contingent assets:

$$U = 0.0100 \times L \text{ if } f = 104\%$$

$$U = 0.0075 \times L \text{ if } f > 104\% \text{ but } \leq 111\%$$

$$U = 0.0050 \times L \text{ if } f > 111\% \text{ but } \leq 118\%$$

$$U = 0.0025 \times L \text{ if } f > 118\% \text{ but } \leq 125\%$$

$$U = 0 \text{ if } f > 125\%$$

Note: a Type A asset guaranteeing a section 75 debt shall be treated for the purposes of the calculation as if it guaranteed 125% of section 179 deficit. A Type B asset capped at the section 75 debt shall be valued at the lesser of 125% of the section 179 deficit and the value of the assets charged.

If the value of Type B and Type C contingent assets together with the scheme assets is more than 125% of the value of the s179 liabilities

(either actual or estimated from MFR valuations), then the formula is as follows:

$$U = 0.00 \times L - (Na \times z)$$

(I.e. the scheme will pay no risk based levy and the existence of the guarantee will play no part in the calculation.)

A.4 Risk based levy structure

A.4.1 The formula for calculating a scheme's risk based levy remains unchanged

$$RBL = U \times P \times 0.8 \times c$$

RBL = Risk based levy

U = Underfunding risk

P = Pension Protection Fund assumed probability of insolvency

0.8 = Percentage risk based for levy year 2007/08

c = Levy scaling factor

Annex B - Voluntary Forms for the 2007/08 levy year

Introduction

The following voluntary forms will be for electronic submission from mid-November 2006. Images of these forms are currently available on the Pension Protection Fund website (www.pensionprotectionfund.org.uk) and can be accessed via the links below.

- **Section 179 valuation certificate**
http://www.pensionprotectionfund.org.uk/0708s179_certificate.pdf
- **The Actuarial Certificate of Deficit-Reduction Contributions**
http://www.pensionprotectionfund.org.uk/0708actuarial_certificate.pdf
- **Contingent Assets**

Type A

Certificate in relation to group company guarantee for 2007/08 levy year
http://www.pensionprotectionfund.org.uk/0708type_a_asset_certificate.pdf

Type B

Certificate in relation to security over bank account for 2007/08 levy year
[http://www.pensionprotectionfund.org.uk/0708type_b\(i\)_asset_certificate.pdf](http://www.pensionprotectionfund.org.uk/0708type_b(i)_asset_certificate.pdf)

Certificate in relation to security over land in England and Wales for 2007/08 levy year
[http://www.pensionprotectionfund.org.uk/0708type_b\(ii\)ew_asset_certificate.pdf](http://www.pensionprotectionfund.org.uk/0708type_b(ii)ew_asset_certificate.pdf)

Certificate in relation to standard security over land in Scotland for 2007/08 levy year
[http://www.pensionprotectionfund.org.uk/0708type_b\(ii\)s_asset_certificate.pdf](http://www.pensionprotectionfund.org.uk/0708type_b(ii)s_asset_certificate.pdf)

Certificate in relation to security over land in Northern Ireland for 2007/08 levy year
[http://www.pensionprotectionfund.org.uk/0708type_b\(ii\)ni_asset_certificate.pdf](http://www.pensionprotectionfund.org.uk/0708type_b(ii)ni_asset_certificate.pdf)

Certificate in relation to security over a portfolio of securities for 2007/08 levy year
[http://www.pensionprotectionfund.org.uk/0708type_b\(iii\)_asset_certificate.pdf](http://www.pensionprotectionfund.org.uk/0708type_b(iii)_asset_certificate.pdf)

Type C

Certificate in relation to letter of credit or bank guarantee for 2007/08 levy year (evergreen)
[http://www.pensionprotectionfund.org.uk/0708type_c\(i\)_asset_certificate.pdf](http://www.pensionprotectionfund.org.uk/0708type_c(i)_asset_certificate.pdf)

Certificate in relation to letter of credit or bank guarantee (reducing balance)
[http://www.pensionprotectionfund.org.uk/0708type_c\(ii\)_asset_certificate.pdf](http://www.pensionprotectionfund.org.uk/0708type_c(ii)_asset_certificate.pdf)

The deadline for submission of these certificates, for credit to be given for the arrangements in the 2007/08 risk based levy calculation, is 30 March 2007, except the Actuarial Certificate for Deficit-Reduction Contributions. The deadline for submission of that certificate is 5 April 2007.

Pension Protection Fund

If you would like more copies of this document,
you can order these by phone or email.

Please quote reference PPF0603.

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