Pension
Protection
Fund

The Pension Protection Levy Consultation Document December 2005

The Pension Protection Levy Consultation Document December 2005

Contents Page

List of tables and figures 3

Foreword by the Chairman 5

Chapter 1 - Introduction and Executive Summary 7

1.1 Introduction 7
1.2 The Pension Protection Levy Consultation Document December 2005 7
1.3 A summary of proposals 8

Section 1 - Consultation on the Additional Risk Factor 13

Chapter 2 - Contingent Assets 13

2.1 Introduction 13
2.2 Summary of responses to previous consultation documents 14
2.3 Contingent assets in the levy formula 14
2.4 Legal documentation and the role of trustees 19

Section 2 - The Final Levy Proposals 21

Chapter 3 - Levy Principles and Risk 21

3.1 Introduction 21
3.2 Summary of responses to this chapter 21
3.3 Final proposals 22

Chapter 4 - Underfunding Risk 23

4.1 Introduction 23
4.2 The Board's proposals as set out in the July consultation document 23
4.3 Summary of responses to this chapter 24
4.4 Revised approach to calculating underfunding risk 24
4.5 Revised approach for completing a section 179 valuation 26
4.6 Recognising special contributions 26

Chapter 5 - Insolvency Risk 29

5.1 Introduction 29
5.2 Summary of responses to this chapter 29
5.3 The Board's final proposals for measuring insolvency risk 32
5.4 The Board's insolvency risk provider 33

Chapter 6 - Scheme Structures 35

6.1 Introduction 35
6.2 Summary of responses to this chapter 35
6.3 Calculating the insolvency risk of multi employer schemes 36

Chapter 7 - The Levy Structure 39

7.1 Summary of responses to this chapter 39
7.2 The Board's final proposals 40
7.3 Calculating the pension protection levy for new schemes 40
7.4 Levy formulae 41

Chapter 8 - The transitional period ... 43
8.1 Introduction ... 43
8.2 Summary of responses to this chapter ... 43
8.3 Final proposals ... 45
8.4 Asset allocation ... 45
Section 3 – The Board's Levy Estimate ... 47
Chapter 9 – The Levy Estimate ... 47
9.1 The Board's levy estimate ... 47
9.2 Levy scaling factor ... 52
Chapter 10 - Appealing the Pension Protection Levy ... 55
10.1 Introduction ... 55
10.2 Seeking a review of the levy amount ... 55
10.3 Appealing the Dun & Bradstreet Failure Score ... 56
Chapter 11 - The Consultation Process ... 61
11.1 Responding to the consultation ... 61
11.2 Arrangements for written submissions ... 61
11.3 Publishing a summary of responses ... 62
Technical Glossary ... 63
Annex A - Revised Levy Formula ... 67
Annex B - Formulae for Calculating the Insolvency Risk of Multi-employer Schemes ... 71
Annex C - Risk Based Levy Forms ... 75

List of tables and figures

Table

1 Calculation of underfunding risk 23
2 Assumed level of underfunding for levy formula for Pension Protection Fund funding levels between 104% and 125% 25
3 Pension Protection Fund assumed probability of insolvency for each of the 100 risk bands 31

Figure

1 Illustration of modified approach to calculating underfunding risk 25
2 Dun & Bradstreet (D&B) appeals process 57

Foreword by the Chairman, Lawrence Churchill

The Board of the Pension Protection Fund would like to thank everybody who responded to our consultation document issued last July. We received approximately 200 responses from individuals, companies large and small, charitable and not for profit organisations, academic institutions and representative and professional bodies. We were greatly encouraged by the quantity and quality of the response.

The Board's strategy has been inclusive, engaging the experts in every area, consulting widely – formally and informally and listening hard – seeking first to understand. We are pleased that this approach has been appreciated; we are sure it will lead to a better solution.

In considering responses, the Board has taken into account the source of the response and has taken a weighted approach in determining its position, recognising that some issues are of greater interest to certain sectors and that it is difficult to numerically quantify the input of professional bodies and representative groups in terms of their respective constituencies.

A consultative approach does not eliminate the need for difficult decisions and the Board is responsible for the firm proposals it is now making. We acknowledge that we cannot please all of the people all of the time, but our objective of producing a levy which is fair, simple and proportionate has in our view been achieved.

The cost of the levies is not a cost caused by the Pension Protection Fund. The cost is caused by the risk that assets of company pension schemes will not be sufficient to pay the pensions promised; the task for the Board has been to price that risk. The levy is, therefore, the Board's proposal for covering the cost of compensation for schemes that fail. In the longer term we expect companies to reduce the deficits in their schemes by increased funding and use of contingent assets. We have tried to build incentives to support fuller funding into the structure of our levy, and it is now possible for a scheme to pay no risk based levy at all.

Pension scheme deficits have increased in recent years and while we acknowledge the increased contributions made by many employers and some employees, even more needs to be done. We would like to believe there are good prospects of deficits beginning to reduce in the near term and have decided to produce our levy estimate annually until a sustainable trend appears. Our proposals today are, therefore, restricted to the 2006/07 levy year.

For 2007/08 and beyond, we expect to have more comprehensive data on every scheme, including agreements between employers and trustees on deficit reduction. We believe that the 2006/07 proposals are a fair, simple and proportionate basis for getting the risk based levy started.

Our proposals for the distribution of the levy across schemes are now firm, and, taken together with the levy estimate, we believe that schemes and their sponsoring employers have the information required to implement their risk reduction plans with confidence.

Chapter 1 - Introduction and Executive Summary

1.1 Introduction

1.1.1 The Board of the Pension Protection Fund was set up as a statutory corporation established under the provisions of the Pensions Act 2004, and became operational on 6 April 2005.

1.1.2 The Pension Protection Fund has been established to pay compensation to members of occupational defined benefit pension schemes, following an insolvency event of the sponsoring employer where there are insufficient assets to pay a Pension Protection Fund level of compensation. Schemes are eligible for Pension Protection Fund compensation provided the scheme wind-up did not commence prior to 6 April 2005.

1.1.3 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.

1.1.4 For the 2006/07 levy year the Board of the Pension Protection Fund will charge the first pension protection levy, which will be made up of two parts: a scheme based levy, and a levy based on the risk posed by an eligible scheme to the Pension Protection Fund.

1.1.5 The Board of the Pension Protection Fund published a consultation document on the pension protection levy on 12 July 2005, which was followed by a twelve week consultation period. The consultation period ended on 4 October 2005, and over 200 written responses were submitted to the Board. The Board is grateful to all those who provided responses.

1.2 The Pension Protection Levy Consultation Document December 2005

1.2.1 On 14 October 2005, the Board of the Pension Protection Fund published the October consultation update, to help schemes and employers to plan for the levy. That update addressed a number of significant themes which emerged in the early consultation responses, including:

- Extending the timetable for providing additional information to the Board;
- The treatment of special contributions, and modifications to the guidance for completing section 179 valuations;
- Calculations for schemes with multiple participating employers.

1.2.2 The update also indicated that the Board was minded to take account of contingent assets in the risk based levy calculation.

1.2.3 In the original July consultation document, the Board committed to publishing a summary of the consultation responses, its final proposals on the pension

protection levy, and the Board's levy estimate, by 30 November 2005. On 28 November, the Board announced that they would be published on 16 December 2005.

1.2.4 This document sets out what are now, in the light of previous consultation, the Board's firm proposals for the structure of the 2006/07 risk based levy, so that schemes can estimate their levy, and consider whether to take actions that are likely to reduce it. The Board will consider any comments on the document which are received by 23 January. However, the Board does not at this stage expect to make fundamental changes to the proposals. Comments will therefore be particularly welcome where they address more detailed aspects of the proposals, especially in relation to matters which were not addressed in detail in the July 2005 consultation document, such as the inclusion of contingent assets as an additional risk factor, and the Board's levy estimate. The proposals, if adopted for 2006/07, may of course be revised for future levy years. As set out in the July 2005 consultation document, the Board presently intends to consult on its pension protection levy proposals each year.

1.2.5 A draft of the Board's determination under section 175(5) of the Pensions Act 2004 has also been published today, and can be accessed via the risk based levy section of the Pension Protection Fund website. As with the Board's final proposals, comments on the draft determination would be welcome. It summarises the 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. The final version of the Board's determination will be published at the end of February 2006 (subject to the necessary Regulations being in force).

1.3 A summary of proposals

The Board's levy estimate

1.3.1 The responses to the July consultation document supported the Board's proposals to introduce the risk based levy as quickly as possible. The Board confirms that the risk based levy for 2006/07 will be set at 80% of the total pension protection levy and the scheme based levy will comprise the remaining 20%.

1.3.2 The proposed risk based levy estimate is £460million and the proposed scheme based levy estimate is £115million, giving a total proposed levy estimate of £575million for 2006/07.

Contingent assets

1.3.3 The Board supports the development of risk management products of various kinds, and will therefore recognise in the levy calculation for 2006/07 the following forms of contingent assets given directly to pension schemes:

(a) Contingent assets within a group structure – group company guarantees;
(b) Contingent assets provided by the sponsor company – security over cash, real estate or securities;

(c) Contingent assets provided by third parties – letters of credit and bank guarantees.

1.3.4 For each form of contingent asset there will be certain acceptability criteria to protect the Pension Protection Fund and levy payers against enforceability and valuation risks. In particular, to be recognised for levy purposes, there will be standard legal documentation and certificates. For inclusion in the 2006/07 levy calculation, notification of contingent assets should be made to the Board of the Pension Protection Fund by 31 March 2006. The Board's detailed proposals in relation to contingent assets are set out in Chapter 2.

Underfunding risk

Setting an upper limit for risk based levy payments

1.3.5 In line with its desire to create incentives for full funding, and views expressed in a number of consultation responses, the Board has decided to introduce an upper funding level of 125% (on a Pension Protection Fund (section 179) basis) above which the risk based element of the pension protection levy will be nil. The scheme based element will still be due.

1.3.6 If a scheme is less than or equal to 104% funded, then the underfunding will still be calculated as the difference between 105% of the value of Pension Protection Fund liabilities and the value of scheme assets.

1.3.7 For schemes that are funded above 104% on a Pension Protection Fund funding level, a stepped taper from 1% to 0% in steps of 0.25% will be introduced. Further details of this stepped approach are set out in chapter 4, paragraph 4.4.4.

Guidance for completing a section 179 valuation

1.3.8 As set out in our October consultation update, the Board has modified the guidance for completing a section 179 valuation. Actuaries will now be able to roll forward the results of a previous actuarial valuation with an effective date prior to 1 November 2004 to enable the estimation of section 179 liabilities. The Board will require the scheme actuary to certify that the section 179 liabilities have not been underestimated.

1.3.9 It is expected that this modification will enable a greater number of schemes to complete a section 179 valuation for inclusion in the 2006/07 risk based levy calculation, as the costs of conducting a roll forward valuation are significantly lower than the costs of a full valuation.

1.3.10 The Board has also taken the decision to extend the deadline for sending valuation information to the Board to 31 March 2006.

Recognising special contributions

1.3.11 As set out in our October consultation update, the Board proposes to recognise, within the calculation of a scheme's underfunding risk, special

contributions paid into the scheme since the date of the last valuation which have served to reduce the section 179 valuation deficit.

1.3.12 The Board would expect special contributions to be calculated and certified by the scheme actuary, and would require the actuary to complete electronically the Actuarial Certificate of Deficit Reduction Contributions, which is included in Annex C of this consultation document. In order that schemes receive credit for deficit reduction contributions paid into a pension scheme in March 2006, notification of any special contributions should be made to the Board of the Pension Protection Fund by 7 April 2006, for inclusion in the 2006/07 levy calculation.

Insolvency risk

1.3.13 The majority of those responding to the Board's proposals to band insolvency risk agreed that banding was sensible, but a number of responses suggested more than 10 bands, although there was no consensus as to how many more were required.

1.3.14 Given the broad support expressed for banding, the Board has decided to include banding in its final proposals. However, the number of bands will be increased to 100, to correspond with D&B failure scores. To take account of the insolvency risk cap, bands 1, 2 and 3 will be capped at 15%.

Calculating the insolvency risk of multi-employer schemes

1.3.15 The October consultation update stated that the insolvency risk for a scheme that provides information on its scheme structure and participating employers will take account of this information to calculate a weighted average probability of insolvency.

1.3.16 The weighted average will then be multiplied by a factor to ensure the correct hierarchy of risk is maintained between the various types of multi-employer schemes: schemes with an option or requirement to segregate pose a greater risk to the Pension Protection Fund than last man standing associated schemes, which in turn pose a greater risk than last man standing non-associated schemes.

1.3.17 The factor for use in the calculation of insolvency risk for multi-employer schemes will be:

- 1 for those schemes with an option or requirement to segregate;
- 0.9 for a last man standing associated scheme;
- The number of members of the employer with the most members divided by the total number of members for the whole scheme for a last man standing, non-associated scheme.

The levy structure

1.3.18 The formula for the scheme based levy (SBL), which will be 20% of the total pension protection levy, will be:

SBL = L x M

Where:

L = The scheme's Pension Protection Fund liabilities, and
M = The multiplier, which will be 0.014% for 2006/07[1]

1.3.19 The formula for calculating the risk based levy (RBL), which will be 80% of the total pension protection levy, will be:

RBL = U x P x 0.8 x c

Where:

U = Underfunding risk
P = Pension Protection Fund assumed probability of insolvency
0.8 = Percentage risk based for levy year 2006/07
c = Levy scaling factor, which will be 0.53 for 2006/07

1.3.20 The amended technical specification for calculating the risk based levy, to take into account the inclusion of special contributions in the underfunding risk factor, contingent assets, and the proposed approach for calculating the insolvency risk of multi-employer schemes with regard to all the participating employers, is set out in Annexes A and B.

The transitional period - adapting MFR valuations and requiring schemes to submit section 179 valuations to the Board

1.3.21 In considering all of the consultation responses received on this chapter, the Board has decided to revise its original proposal to require all schemes to complete a section 179 valuation by 31 December 2006, and to use adapted MFR valuations for those schemes which have not submitted a section 179 valuation for the 2006/07 levy year only.

1.3.22 The Board will approach the Department for Work and Pensions to legislate to require all schemes to submit a section 179 valuation by 31 March 2008 (the Board has decided to focus on the end of the financial, rather than the calendar year), which will ensure that no schemes will have to conduct an out-of-cycle valuation.

1.3.23 The Board has therefore decided that, particularly in the light of the confidence expressed in the consultation responses for the Board's proposed approach for rolling forward MFR information, the option of using adapted MFR valuations will remain for the 2007/08 levy year, for those who do not submit a section 179 valuation by 31 March 2007.

1.3.24 The proposed methodology for adapting MFR valuations to estimate liabilities on a section 179 basis was published in the October consultation update. This

[1] Assuming the levy estimate remains as proposed in this document

methodology has since been slightly revised. There are changes in the calculation of the equity easement and the section 179 wind-up expenses, and there are a few other changes for clarification. The updated methodology can be accessed from the risk based levy section of the Pension Protection Fund website.

Asset allocation

1.3.25 The Board intends to conduct a consultation exercise during 2006 on the potential inclusion of asset allocation as a risk factor in future levy years.

Providing additional information to the Board

1.3.26 The Board has also revised the deadline for voluntary submission of additional information, so that the default position will be that the risk based levy will be based on information as at the end of the financial year, rather than the calendar year. The following items of additional information should, if appropriate, be submitted to the Board by 31 March 2006:

- Section 179 Valuation Certificate;
- Declaration of Scheme Structure and Participating Employers forms;
- Contingent Asset Certificates.

1.3.27 In order that schemes receive credit for deficit reduction contributions paid into a pension scheme in March 2006, the Actuarial Certificate of Deficit Reduction Contributions should be submitted by 7 April 2006.

1.3.28 Each of these certificates is included in Annex C of this document.

1.3.29 The 2006/07 risk based levy will be payable within 28 days of an invoice being issued. Given the extension of the deadline for submitting information to the Board, as detailed above, it is likely that invoices will not start to be issued until late summer 2006.

Section 1 - Consultation on the Additional Risk Factor

Chapter 2 - Contingent Assets

Chapter Summary

This chapter considers the comments received in relation to contingent assets, following publication of the original Pension Protection Levy Consultation Document. It outlines how, subject to regulations, the Board proposes to make allowance for the existence of an additional risk factor, contingent assets, in the levy formula.

2.1 Introduction

2.1.1 A contingent asset is an asset that will produce cash for a pension scheme contingent on an event (insolvency) occurring to the sponsoring employer. It may take the form of an insurance type contract with a third party (for example a letter of credit with a bank), a right to a specific asset (such as a property) or a guarantee that another company in a group (typically the parent) will step in and provide financial support upon the failure of the sponsoring employer. Contingent assets have generally been used by employers to provide security in place of immediate funding.

2.1.2 In the October consultation update, the Board expressed its support for the development of risk management products of various kinds, along with its intention to work towards including contingent assets in the levy calculation as soon as is practically possible. Annex B of that document set out an updated levy formula which took account of the inclusion of special contributions and a proposed adjustment to reflect the existence of contingent assets, where applicable.

2.1.3 The October update proposed that the formula for the calculation of assets for levy calculation purposes would be adjusted to reflect contingent assets as follows:

$$A = S + C + (N \times z)$$

A = asset calculation
S = value of scheme assets
C = special contributions (post effective valuation date)
N = face value of contingent assets
z = discount factor applied to contingent assets

2.1.4 This second consultation document sets out the proposed approach for when and how contingent assets will be reflected in the levy calculation.

2.1.5 In developing its policy towards the inclusion of contingent assets within the levy formula, the Board has recognised that it should:

- Encourage positive risk management by employers in relation to their pension schemes;

- Seek to view positively actions taken by the scheme or employer to improve scheme funding or the strength of the employer covenant;
- Set a levy formula that is consistent, equitable and flexible, but relatively simple and standardised;
- Use methodology that is consistent with the methodology used by the Pensions Regulator where practically possible;
- Incorporate contingent assets in a way that reflects the Board's principles of fairness, simplicity and proportionality;
- Value contingent assets in accordance with the real reductions that they effect on the risks faced by the Pension Protection Fund.

2.2 Summary of responses to previous consultation documents

2.2.1 The July consultation document did not specifically seek views with regard to contingent assets. However, many responses expressed opinions in this area, in particular urgently encouraging the Board to make an allowance for these in the formula where they provide genuine security to the pension scheme. This would accord with the Board's principle of fairness.

2.2.2 Research suggests that contingent assets provided by the sponsor or a third party in the event of insolvency (e.g. a charge over assets or a letter of credit) are relatively sparsely used at present. It is likely that their use will increase if they are recognised as contingent assets within the risk based levy formula.

2.2.3 A number of organisations suggested that failure probabilities in the levy formula should relate to parent companies, rather than the sponsoring employer (which is the entity the Board is legally required to consider). Some responses referred to established documented and legally binding group company guarantees that provide additional protection to a pension scheme in the event of the insolvency of its sponsoring employer. Such arrangements have often been set up as a consequence of funding discussions, or other negotiations between companies and trustees.

2.2.4 A further group of organisations noted that they do not have such formal structures in place, but described a form of informal support between group entities driven by corporate culture or the specific structure of a corporate group and the positioning of the pension scheme relative to this. In particular, overseas businesses with UK companies sponsoring final salary schemes often felt that the insolvency risk attributed to the UK sponsor did not reflect the financial strength of the wider group.

2.2.5 It was also suggested that allowance should be made for letters of credit from OECD banks, although the possible credit risk associated with the third party provider should also be recognised.

2.3 Contingent assets in the levy formula

Type A: Contingent asset arrangements within a group structure

2.3.1 The Board proposes to recognise in the levy formula the existence of direct

group company guarantees to the pension scheme (not to the sponsoring employer(s)), subject to certain acceptability criteria. For these purposes, a group company could be a parent, sister, subsidiary or any other associated company within the group.

2.3.2 The Board intends to recognise company guarantees from any group company domiciled in an OECD country. The restriction to OECD countries is to mitigate enforceability risk for the Pension Protection Fund, and thereby levy payers. To be recognised, the guarantee must remain in force until such time as all actual or contingent liabilities of the relevant employers to the scheme have been satisfied in full.

2.3.3 For levy calculation purposes, the insolvency risk of the sponsoring employer(s) will be adjusted to include credit for the insolvency risk of the guarantor, reflecting the fact that it is the guarantor's insolvency that would potentially lead to a call on the Pension Protection Fund. As the levy formula is required by legislation to reflect the expected failure of the sponsoring employer, this will be achieved in practice in the majority of cases by applying a discount multiplier to the value of the contingent asset N of

$$z = 1 - \frac{\text{probability of insolvency of guarantor}}{\text{probability of insolvency of sponsor(s)}}$$

If a group company guarantee is for more than 105% of the value of the section 179 liabilities, the formula as set out in Annex A paragraph A.3.1(b) will apply.

2.3.4 Consistent with the approach for direct scheme sponsors, insolvency risk information for guarantors will be supplied by D&B.

2.3.5 If a company wishes to determine the probability of insolvency that would be used in respect of an overseas guarantor they can:

- Contact D&B's UK customer service team on 0870 243 2344 who will obtain a failure score for the overseas company. For existing D&B customers this failure score will also be available directly from the D&B website; then
- Contact the Pension Protection Fund helpline on 0845 600 2541 providing details of the country of domicile of the overseas guarantor and the corresponding failure score provided by D&B. The Pension Protection Fund will provide the company with a Pension Protection Fund assumed probability of insolvency for that failure score.

2.3.6 The guarantee may be limited to a fixed monetary amount or cover a specified percentage of the Section 179 scheme (or section) liabilities, or may cover the full section 75 buy-out debt of the scheme or section. In order to be recognised for levy purposes, the protection offered by the group company guarantee must remain constant over time.

2.3.7 If the scheme is less than 104% funded on a section 179 basis (including any

special contributions and type B or C contingent assets), a group company guarantee will only affect the levy calculation to the extent that it covers up to 105% of the section 179 liabilities. In other words, no credit will be available for providing a higher level of guarantee, and a risk based levy will always be payable. This is because, as set out above, the Board is effectively seeking to replace the insolvency risk of the sponsoring employer(s) with the insolvency risk of the guarantor, to the extent that the guarantor provides additional support to the scheme. To the extent that the Board gave credit for cover over and above 105% of the section 179 liabilities, it would be giving more credit than would be achieved by directly replacing the insolvency risk of the sponsoring employer(s) with the insolvency risk of the guarantor.

2.3.8 In many cases a group company guarantee may be used for a scheme sponsored by several employers. The guarantee must cover the liabilities of all sponsoring employers which are associates of the guarantor (within the Insolvency Act definition[2]). If one employer becomes insolvent, the scheme will be able to call for the amount due in respect of that employer and the guarantee will remain in place to cover any remaining employers.

2.3.9 The Board recognises that some sponsoring employers wishing to use this type of arrangement will not necessarily have a group company that satisfies the eligibility criteria as specified above (e.g. other group companies may be based in countries outside the OECD). Such sponsors could potentially use the credit strength of a non-eligible group company to facilitate the provision of an alternative contingent asset, for example a letter of credit.

Type B: Contingent assets provided by the sponsoring employer

2.3.10 The Board proposes to recognise in the levy formula the existence of certain contingent assets provided by sponsoring employers, subject to a series of acceptability criteria.

2.3.11 For the 2006/7 levy year, the Board proposes that security over cash, securities or real estate may be incorporated as contingent assets, subject to certain limitations.

2.3.12 These secured assets must be irrevocably available to the trustees upon insolvency of the sponsoring employer(s) (see paragraph 2.3.18 for comments on multi-employer schemes). The security will remain in force until such time as all actual or contingent liabilities of the relevant sponsoring employers to the scheme have been satisfied in full. It is proposed that the assets used as security would be re-valued annually.

2.3.13 The pension scheme should hold first priority security interest in relation to any such asset to ensure that the full value of the secured asset is available to the scheme upon enforcement. Securities must be held by an appropriate custodian, and must be those in which the trustees themselves could invest, recognising any restrictions on investment contained within the scheme's Trust Deed and Rules.

---

[2] As set out in Section 435 of the Insolvency Act 1986.

2.3.14 Independent real estate assets will be valued at their market value. However, real estate assets occupied by a sponsoring employer or related entities will be valued on a 'Vacant Possession'[3] basis to reflect diminution of value arising from the insolvency of the sponsoring employer.

2.3.15 Securities will be valued at market value. Securities issued by the sponsor or related group entities will not be included within the value available for inclusion as contingent assets.

2.3.16 Employers willing to provide support in this way may wish to limit the extent to which the trustees can recover the underlying assets and may cap the trustees' recovery at (i) a fixed monetary amount, (ii) covering a specified percentage of the Section 179 liabilities, or (iii) the full section 75 buy-out debt of the scheme or section. This is consistent with the equivalent caps available for group company guarantees. As with group company guarantees, to be recognised for levy purposes, the protection offered by the contingent assets must remain constant over time.

2.3.17 These assets will be recognised in the levy calculation at full face value (z=1.0), except as noted in 2.3.14 above, reflecting the equivalent value such assets would have in the scheme's portfolio of actual investments. Full credit will be offered to the extent that (when added to scheme assets and special cash contributions) they cover a scheme's Section 179 liabilities by up to 125%, above which no risk based levy will be payable (see Chapter 4). The approach here is different to that set out in paragraph 2.3.7 above. This is because these contingent assets provided by the sponsoring employer(s) are being treated in the same way as assets of the scheme. By contrast, group company guarantees are being treated as a way to substitute the insolvency risk of the sponsoring employer(s) with the insolvency risk of the guarantor, although this is being achieved in the underfunding risk part of the levy calculation.

2.3.18 Where a contingent asset of this type is used for a scheme in which several employers participate, the asset must cover the liabilities of all sponsoring employers which are associates of the owner of the underlying assets (within the Insolvency Act definition[4]). If one employer becomes insolvent, the security can either remain in place until the actual liability of the insolvent company is determined, or all or part can be immediately enforced and the proceeds held in a suspense account pending calculation of that liability.

2.3.19 The Board has also considered the inclusion of security over receivables as contingent assets, but has decided there are too many complexities regarding their operation (e.g. valuation, release and renewal, and analysis of security rights) to allow for their inclusion in the 2006/7 levy year. Inclusion in future years may also be challenging. The Board has concluded that security over

[3] Real estate assets owned by a group company will be included on the basis of 'Vacant Possession' values as set out in the Royal Institute of Chartered Surveyors valuation guidelines (the 'Red Book'). This valuation basis will offset anticipated diminution of open market value arising from the insolvency of the relevant group company. Valuations provided for this purpose will be required to be consistent with the various requirements of the Red Book.

[4] As set out in Section 435 of the Insolvency Act 1986.

stock/work in progress and intangible assets are unsuitable for inclusion as contingent assets, because they are highly complex items to value.

Type C: Contingent assets provided by third parties

2.3.20 The Board proposes to recognise in the risk based levy formula the existence of certain contingent assets provided by third parties, subject to a series of acceptability criteria.

2.3.21 Letters of credit and bank guarantees are relatively straightforward and widely available products that can be incorporated as contingent assets.

2.3.22 These assets must provide for a cash payment to be made following the insolvency of the relevant sponsoring employer(s) (see below for comments on multi-employer schemes) during the annual levy year. For levy purposes, the protection offered by contingent assets provided by third parties must remain constant over time.

2.3.23 Letters of credit and bank guarantees must be structured to have a minimum 12 month maturity. It is proposed that 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 irrespective of the solvency or otherwise of the sponsor. Such a cash call could be avoided if, instead, the sponsoring employer replaces the asset with cash.

2.3.24 Acceptable counterparties would need to satisfy certain financial strength conditions[5], be regulated and approved for business by the Financial Services Authority either directly or through the EU “passporting” system, and be domiciled in an OECD country.

2.3.25 These products will be recognised in the levy calculation at full face value (z=1.0). Full credit will be offered to the extent that they (when added to scheme assets and special cash contributions) cover a scheme’s Section 179 liabilities by up to 125%, above which no risk based levy will be payable (see Chapter 4). As with contingent assets provided by the sponsoring employer, the approach is different to that for group company guarantees, because contingent assets provided by third parties are being treated in the same way as assets of the scheme.

2.3.26 Where a contingent asset of this type is used for a scheme in which several employers participate, the asset must cover the liabilities of all sponsoring employers which are associates of the company purchasing the contingent asset (within the Insolvency Act definition[6]). If one employer becomes insolvent, the trustees will be able to call the asset to cover the underfunding associated with that employer, whilst leaving the balance of the asset in place.

2.3.27 The Board has also considered the inclusion of credit default swaps, but has

[5] Acceptable counterparties must be rated at least Aa3 by Moodys and/or AA- by Standard and Poors and/or AA- by Fitch.
[6] As set out in Section 435 of the Insolvency Act 1986.

decided not to recognise these for the 2006/7 levy year. These may be included in future levy years, if standardised documentation and procedures can be developed to reflect the specific and more complex mechanics of their operation, and if there is evidence that such products may be practically used by pension schemes. The Board will also consider the inclusion of credit insurance policies for future levy years, should evidence demonstrate that such products would become widely used.

2.4 Legal documentation and the role of trustees

2.4.1 Scheme trustees have duties and responsibilities that align their position substantially with that of the Board. The Board therefore proposes that trustees should exercise discretion in the management and evaluation of contingent assets.

2.4.2 The Board proposes that contingent assets should be established using standardised forms of documentation. This will reduce the administrative burden for the Pension Protection Fund (and hence the administration levy). This approach fits well with the Board's principles of simplicity and proportionality. Trustees will be asked to certify that the contingent assets for which they are seeking credit are in the standard form and are legally valid, binding and enforceable. This should encourage them to ensure that the correct procedures and formalities are observed. The trustees will also be required to obtain a legal opinion to satisfy themselves that this is the case, and to supply a copy to the Board.

2.4.3 Draft forms of certification which trustees will be required to provide to the Board in relation to contingent assets when they are in place can be found in Annex C. The certificates will be made available on the risk based levy section of the Pension Protection Fund website to complete electronically by 23 January 2006.

2.4.4 As with the other voluntary forms to be provided to the Board, contingent asset certificates must be provided by 31 March 2006 in order for the relevant contingent assets to be taken into account for the 2006/7 levy calculation. Drafts of the standard form legal instruments and accompanying guidance for trustees can be accessed via the risk based levy section of the Pension Protection Fund website. Of course, the Board's provision of standard documentation does not preclude employers and trustees from making non-standard arrangements to provide additional funding support, but non-standard arrangements will not be recognised in the risk based levy calculation.

Section 2 - The Final Levy Proposals

Chapter 3 - Levy Principles and Risk

Chapter Summary

This chapter includes a summary of responses to chapter 2 of the July consultation document, as well as the Board's final proposals for the principles which will underpin the introduction of the risk based levy.

3.1 Introduction

3.1.1 In Chapter 2 of the July 2005 Pension Protection Levy Consultation document, the Board of the Pension Protection Fund set out its commitment to implementing a risk based levy based on the principles of fairness, simplicity and proportionality.

3.1.2 The principle of fairness led to the proposal to introduce a risk based approach for all schemes as soon as was practicably possible. It was also intended that a fair risk based levy would reward well funded schemes that effectively managed their risks, and would create incentives for full funding.

3.1.3 The principle of simplicity was designed to minimise data requests from schemes, and to ensure the Board developed transparent proposals that could be easily understood.

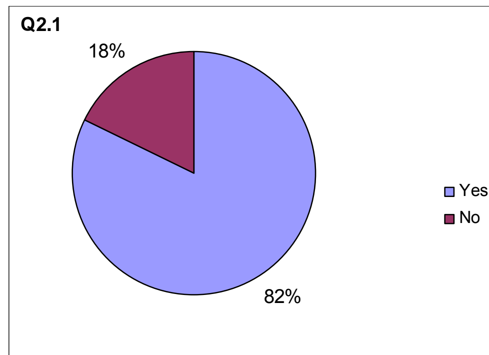
3.1.4 The principle of proportionality was designed to ensure that the levy would be fair and proportionate between schemes, and in its impact on individual schemes.

3.2 Summary of responses to this chapter

3.2.1 Chapter 2 of the July Pension Protection Levy Consultation document posed only one question for direct consideration in the consultation responses:

"Do you agree that the Board should construct the risk based levy in a way that combines the principles of fairness, simplicity and proportionality?"

3.2.2 The majority of responses did not address this issue. However, of those who did, over 80% expressed broad support for the principles of fairness, simplicity and proportionality.



3.2.3 A number of the responses recognised that the Board's proposals would have to balance the three principles. Others suggested that the Board should consider two further principles: affordability and transparency.

3.3 Final proposals

3.3.1 The Board of the Pension Protection Fund has given consideration to extending its principles to include transparency and affordability. The Board has, however, concluded that affordability is linked to proportionality, and transparency to simplicity. The Board therefore continues to uphold and support its three original principles of fairness, simplicity and proportionality.

Chapter 4 - Underfunding Risk

Chapter Summary

This chapter gives a summary of responses to chapter 4 of the July consultation document, and the Board's final proposals for determining the underfunding risk of all eligible pension schemes.

4.1 Introduction

4.1.1 The Board of the Pension Protection Fund is required by the legislation set out in the Pensions Act 2004 to assess pension scheme underfunding when calculating the risk based levy.

4.1.2 To obtain a consistent basis for determining underfunding, schemes will be required to complete a Pension Protection Fund valuation of assets and protected liabilities as per section 179 of the Pensions Act 2004. The protected liabilities for a section 179 valuation are defined in regulation 6 of the Pension Protection Fund (Valuation) Regulations 2005. They are based on the scheme benefits taking into account key features of the levels of compensation paid by the Board of the Pension Protection Fund as set out in Schedule 7 of the Pensions Act.

4.2 The Board's proposals as set out in the July consultation document

4.2.1 In the July consultation document the Board proposed to scale up the value of the section 179 Pension Protection Fund liabilities by 5% for the first levy year as a margin for prudence reflecting that deficits will change during a one year period. A scheme's underfunding level would then be determined by reference to this 105% scale. If the Pension Protection Fund funding level was less than 104%, then the underfunding risk would be the difference between 105% of the value of Pension Protection Fund liabilities and the value of scheme assets. If the scheme was funded to 104% or more, the underfunding risk would be 1% of the value of the Pension Protection Fund liabilities, as set out in table 1 below.

Table 1- calculation of underfunding risk

Pension Protection Fund funding level[7]	Underfunding risk
<104%	1.05 x Value of Pension Protection Fund liabilities – Value of assets
≥ 104%	0.01 x Value of Pension Protection Fund liabilities

[7] Section 179 or adjusted MFR basis

4.3 Summary of responses to this chapter

4.3.1 Chapter 4 of the July consultation document posed 2 questions for particular consideration in the consultation responses:

1. *Do you agree that 104% should be the cut-off point above which a scheme's underfunding risk would be based on a fixed percentage of Pension Protection Fund liabilities?*
2. *Do you expect to submit a s179 levy valuation by 31 December 2005? If not, when do you expect to submit a s179 levy valuation?*

4.3.2 The majority of respondents to question 1 agreed with the need to make allowance for the risk to the Pension Protection Fund of volatility, and as such agreed that "fully funded" would mean a funding level greater than 100%, in the context of the risk based levy.

4.3.3 Many respondents, including the Confederation of British Industries (CBI), the Association of British Insurers (ABI) and the Association of Consulting Actuaries (ACA), were keen to extend the incentive to increase funding higher than the 104% level.

4.3.4 A significant number of responses suggested tapering the percentage of liabilities used to calculate the levy, from 1% where a scheme was 105% funded down possibly as far as to zero where a scheme was, for example, 125% funded on a Pension Protection Fund basis. Variants of this approach were suggested by, among others, the CBI and the Actuarial Profession.

4.3.5 Several responses highlighted the importance of having a point at which a scheme would be so well funded that it would no longer be liable to pay any Pension Protection Fund risk based levy. It was suggested that without such an upper limit, schemes that were extremely well funded, but sponsored by a weak employer, would be disadvantaged by the risk based levy.

4.3.6 Of the respondents to question 2 in chapter 4, on the expected timescale for completion of a section 179 valuation, a significant number expected schemes to be in a position to submit a section 179 valuation by 31 December 2006. However, fewer expected schemes to be in such a position by 31 December 2005.

4.4 Revised approach to calculating underfunding risk

4.4.1 The October consultation update acknowledged the large number of responses stating that an extension to the Board's original timetable for provision of section 179 information would be welcome. The update paper extended the deadline to the end of March 2006.

4.4.2 The Board has also modified its approach to calculating underfunding risk to strengthen the incentive effect.

4.4.3 If a scheme is less than 104% funded on a Pension Protection Fund funding level, then the underfunding risk will remain the difference between 105% of

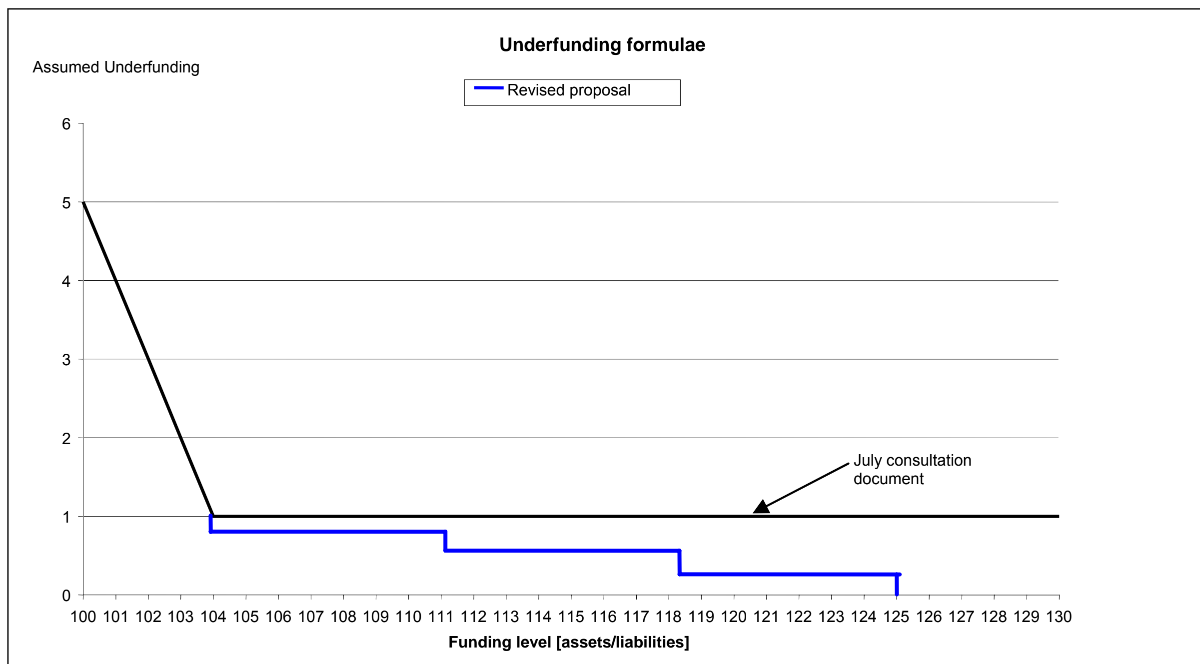
the value of Pension Protection Fund liabilities and the value of scheme assets. For schemes that are funded above 104% on a Pension Protection Fund funding basis, the Board will use a stepped taper from 1% of Pension Protection Fund liabilities at the 104% funded level down to 0% in steps of 0.25%. This approach is detailed in table 2 and figure 1 below.

4.4.4 The risk based levy will be nil for schemes that are more than 125% funded on the Pension Protection Fund basis. The reason for choosing 125% is that for many schemes this will broadly equate to the cost of buying out full scheme benefits from an insurance company.

Table 2 - assumed level of underfunding for the levy formula for PPF funding levels between 104% and 125%

Pension Protection Fund funding level %	Assumed level of underfunding for levy formula %
104	1.00
Over 104 to 111	0.75
Over 111 to 118	0.50
Over 118 to 125	0.25
Over 125	0.00

Figure 1 – illustration of modified approach to calculating underfunding risk



4.4.5 The Board of the Pension Protection Fund is keen to provide employers with a clear incentive to better fund their pension schemes and expects that a step change in the levy charged above the 104% funding level will support this aim.

4.5 Revised approach for completing a section 179 valuation

4.5.1 The October consultation update also announced the Board's decision to modify the guidance for completing a section 179 valuation to allow for a degree of prudent approximation when calculating liabilities on a section 179 basis. The modified guidance enables a scheme actuary to use liability data from a previous valuation, including one carried out prior to 1 November 2004, and to roll forward those liabilities on a prudent basis to the relevant time. Legislation requires that the assets valued for an approximate section 179 valuation be based on relevant accounts.

4.5.2 It is expected that this modification to the actuarial guidance will enable more schemes to complete an early section 179 valuation without the need for a further full valuation exercise.

4.5.3 The Section 179 Valuation Certificate can be completed electronically on the Pension Protection Fund website by accessing the risk based levy section on the Home Page and by following the link to risk based levy forms. A copy of the layout of the form is also available at Annex C. It should be completed and returned to the Pension Protection Fund electronically by 31 March 2006 to enable the valuation figures to be used in the risk based levy calculation for the 2006/07 levy year.

4.5.4 Detailed guidance for undertaking a section 179 valuation was published on October 14 and can be found within the risk based levy section of the Pension Protection Fund website.

4.6 Recognising special contributions

4.6.1 A number of consultation responses supported the recognition of deficit reduction contributions paid to the pension scheme between valuations. They considered that the Pension Protection Fund would discourage sponsoring employers from better funding pension schemes by not recognising such contributions.

4.6.2 The October consultation update has already detailed the Board's approach to taking deficit contributions into account in the 2006/07 levy calculation. Any special contributions will be certified by the scheme actuary, who will then complete an actuarial certificate of deficit reduction contributions.

4.6.3 As with the Section 179 Valuation Certificate, the Actuarial Certificate of Deficit Reduction Contributions can be completed electronically on the Pension Protection Fund website by accessing the risk based levy section on the Home Page and by following the link to risk based levy forms. A copy of the layout of the form is also available at Annex C. It should be completed and returned to the Pension Protection Fund electronically by 7 April 2006 to enable the deficit reduction contributions to be reflected in the risk based levy calculation for the 2006/07 levy year.

4.6.4 Annex A details the revised formula for the 2006/07 risk based levy

calculation, taking into account special contributions made to the pension scheme.

Chapter 5 - Insolvency Risk

Chapter Summary

The chapter sets out the Board's final proposals for calculating insolvency risk for a single employer scheme. Chapter 6 sets out how the Board proposes to calculate insolvency risk for multi-employer schemes.

This chapter also considers the responses received to chapter 5 of the Pension Protection Levy Consultation Document July 2005, which set out the Board's initial proposals for measuring insolvency risk (the financial strength of the sponsoring employer(s)) for the purpose of the risk based levy calculation.

5.1 Introduction

5.1.1 The Pension Protection Levy Consultation Document July 2005 set out the Board's proposed approach to calculating the insolvency risk of the sponsoring employers of all eligible schemes. This document also established the Board's intention to appoint a third party provider to measure insolvency risk. On 10 August 2005 the Board of the Pension Protection Fund announced that D&B had been appointed as the third party provider for 2006/7.

5.2 Summary of responses to this chapter

5.2.1 Chapter 5 of the original July consultation document contained seven questions for consideration in the consultation responses.

1. *Do you agree with the proposed approach to measuring insolvency, including measuring the insolvency risk of all eligible schemes?*
2. *Do you agree that insolvency should be viewed over a 12 month horizon, since the levy is intended to meet the cost of new claims arising during the annual levy cycle?*
3. *Do you agree that insolvency should be banded?*
4. *Do you agree that there should be ten bands?*
5. *Do you agree that insolvency risk should be capped at 15%?*
6. *Do you agree that there should be a generic band?*
7. *Do you agree with the focus on a market based approach?*

5.2.2 The responses to question 1 expressed a very large degree of support for the Board's decision to appoint a third party to calculate insolvency risk.

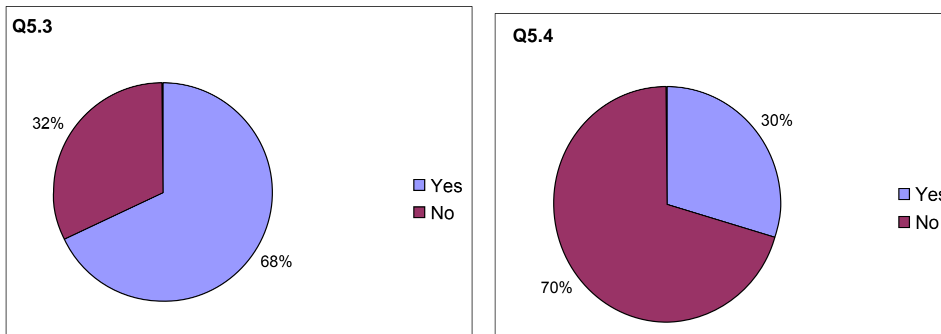
5.2.3 The major issue raised in relation to question 1 was the view that if the Board were to accurately reflect the insolvency risk posed by the sponsors of a pension scheme, it needed to look at the strength of the whole group structure, and particularly the strength of a parent company, rather than just the covenant of the sponsoring employer(s).

5.2.4 The Board is required to measure the insolvency risk of sponsoring employers only. However, the thrust of the point made in responses can be met by the

Board's proposals to acknowledge contingent assets within the levy calculation. These proposals give non-sponsoring employers within a company group a mechanism for securing recognition of formal support for a pension scheme.

5.2.5 Two-thirds of respondents to question 2 agreed that insolvency should be viewed over a 12 month horizon, so the Board will proceed on that basis.

5.2.6 In responding to questions 3 and 4 on the proposals to band insolvency risk, the majority of respondents agreed that banding was sensible, but fewer respondents agreed with the 10 band system proposed. There was a large degree of support for a greater number of bands, ranging from 20 to 100.



5.2.7 The representatives of last man standing non-associated schemes suggested that such schemes should be automatically placed in the lowest band possible, or should be assigned a special band to reflect absolute minimal risk. They were joined by charity representatives, who also considered that their particular schemes posed an extremely small risk to the Pension Protection Fund.

5.2.8 Given the broad support expressed for banding in the responses received, the Board has decided to continue to use banding, but will expand the number of bands to correspond with the D&B 1 to 100 scale of failure scores. To take account of the insolvency risk cap, bands 1, 2 and 3 will be capped at 15%.

5.2.9 The Board considers that 100 bands will address the many different requirements for subdivision set out in consultation responses. For multi-employer schemes that complete the two part Declaration of Scheme Structure and Participating Employers form, the precise probability of insolvency for the scheme will be used in the risk based levy calculation, rather than the assumed probability of insolvency for any of the risk bands (as long as this gives a lower probability of insolvency than the assumed probability of insolvency of the employer with the most members – see chapter 6).

5.2.10 Table 3 shows the assumed probability of insolvency for the risk based levy calculation for each of the 100 risk bands. With the exception of estimating the risk based levy of individual eligible pension schemes, these probabilities of insolvency should not be used for statistical analysis without the prior written consent of the Pension Protection Fund.

Table 3 – Pension Protection Fund assumed probability of insolvency for each of the 100 risk bands

D&B Failure Score	Insolvency Risk Band	Assumed Probability of Insolvency for the Risk Based Levy Calculation (%)	D&B Failure Score	Insolvency Risk Band	Assumed Probability of Insolvency for the Risk Based Levy Calculation (%)
100	100	0.0740	50	50	1.5800
99	99	0.1360	49	49	1.5945
98	98	0.1804	48	48	1.6474
97	97	0.2216	47	47	1.6742
96	96	0.2621	46	46	1.6800
95	95	0.3033	45	45	1.6900
94	94	0.3456	44	44	1.7077
93	93	0.3858	43	43	1.7756
92	92	0.4286	42	42	1.8367
91	91	0.4714	41	41	1.9054
90	90	0.5133	40	40	1.9200
89	89	0.5548	39	39	1.9400
88	88	0.5943	38	38	1.9590
87	87	0.6370	37	37	2.0344
86	86	0.6827	36	36	2.0570
85	85	0.7241	35	35	2.0898
84	84	0.7619	34	34	2.0990
83	83	0.8008	33	33	2.1010
82	82	0.8351	32	32	2.1120
81	81	0.8744	31	31	2.1190
80	80	0.9047	30	30	2.1240
79	79	0.9313	29	29	2.1350
78	78	0.9609	28	28	2.1460
77	77	1.0050	27	27	2.1560
76	76	1.0384	26	26	2.2344
75	75	1.0645	25	25	2.2850
74	74	1.1119	24	24	2.3853
73	73	1.1300	23	23	2.4950
72	72	1.1566	22	22	2.5844
71	71	1.1911	21	21	2.6845
70	70	1.2112	20	20	2.8018
69	69	1.2317	19	19	2.9446
68	68	1.2400	18	18	3.0801
67	67	1.2580	17	17	3.1876
66	66	1.2800	16	16	3.3358
65	65	1.3044	15	15	3.5210
64	64	1.3534	14	14	3.7079
63	63	1.3891	13	13	3.9115
62	62	1.4123	12	12	4.1610
61	61	1.4370	11	11	4.3711
60	60	1.4620	10	10	4.7612
59	59	1.4945	9	9	5.0279
58	58	1.4950	8	8	5.4906
57	57	1.4960	7	7	6.1536
56	56	1.4970	6	6	7.0235
55	55	1.4980	5	5	8.4751
54	54	1.5384	4	4	11.0298
53	53	1.5500	3	3	15.0287[8]
52	52	1.5650	2	2	20.7261
51	51	1.5700	1	1	37.7973

[8] The assumed probability of insolvency for bands 1, 2 and 3 will be capped at 15%.

5.2.11 The majority of responses to question 5 agreed that insolvency risk should be capped at 15%, so the Board will retain this initial proposal.

5.2.12 Of the small number of responses to question 6, most acknowledged that a generic band would be required in the levy calculation. The majority considered that this should apply to the smallest number of schemes possible, and that more than one band may be required.

5.2.13 D&B are able to calculate a failure score for the sponsoring employers of almost every eligible scheme. While the Board intends to take a generic approach, where necessary, this can now be more refined.

5.2.14 The Board has so far only identified the UK branches of foreign registered companies (identified with an FC prefix on their Companies House Registration number) as a type of employer which D&B will be unable to score. In these cases, the Board will use the average failure score of the UK sponsoring employers of defined benefit pension schemes within the relevant industry. For example, if the foreign company is a bank, the failure score for the UK branch will be the average failure score for all UK banks that sponsor defined benefit schemes. In order to define industry groups, the Board will use the two digit 1972 Standard Industry Classification (SIC) codes.

5.2.15 The average failure scores will be calculated once the Board has collected the employer-related information for eligible schemes on 31 March 2006.

5.2.16 The Board intends to use this approach where a failure score cannot be obtained. However, as stated above, such cases are likely to be extremely rare.

5.2.17 A large majority of responses to question 7 agreed with the Board's focus on a market-based approach. Some responses did, however, question whether a broad brush market approach would be appropriate for certain organisations e.g. charities and not-for-profit organisations. While the Board will keep such issues under review, we are currently satisfied that the D&B methodology is appropriate for the full range of sponsoring employers of eligible schemes.

5.2.18 As with other employers, the Board would encourage charities and not-for-profit organisations to liaise directly with D&B to understand the scoring methodology, and take action where necessary that could improve their scores. In addition, Charities' Statement of Recommended Practice (which provides guidance to charities on the preparation of their accounts) allows charities to exclude certain heritage assets from their balance sheets. The Board suggests that charities consider using such real estate as a contingent asset to improve their levy position.

5.3 The Board's final proposals for measuring insolvency risk

5.3.1 The Board has given careful consideration to the responses received to chapter 5 of the July consultation document. The Board acknowledges the

strength of views expressed regarding aspects of its proposals, and has responded to this in a number of ways (e.g. taking contingent assets into account, and publishing comprehensive question and answer material on D&B's Failure Score methodology on 28 October 2005).

5.3.2 The Board's final proposals for 2006/07 are to:

- View insolvency risk over a twelve month horizon for the purpose of allocating the risk based levy between schemes;
- Use a refined, generic approach where necessary (see 5.2.14 above);
- Have 100 insolvency risk bands;
- Cap the insolvency risk at 15%;
- Use a market solution to calculate insolvency risk;
- Use D&B as the Board's insolvency risk provider.

5.4 The Board's insolvency risk provider

5.4.1 D&B was appointed following a competitive tendering exercise where all tenders were measured against specific criteria included within the July consultation document.

5.4.2 On 28 October 2005 the Board, in conjunction with D&B, published comprehensive question and answer information on the D&B methodology on the Pension Protection Fund website. This information is accessible via the risk based levy section of the website.

5.4.3 The Board believes that this information should substantially increase understanding of the D&B methodology.

5.4.4 The Board would like to encourage all sponsoring employers to obtain their D&B failure score as soon as possible, so that queries can be raised with D&B before 31 March 2006, the date at which failure scores will be measured for the purposes of the 2006/07 levy calculation. Although sponsoring employers will only be able to obtain the precise failure score that will be used in their levy calculation from 31 March 2006, the employer's current failure score can be obtained at any point before then.

5.4.5 A sponsoring employer can obtain its D&B failure score by contacting the D&B Customer Service team on 0870 243 2344, or by emailing customerhelp@dnb.com.

Chapter 6 - Scheme Structures

Chapter Summary

This chapter considers the responses received to chapter 6 of the Pension Protection Levy Consultation Document July 2005, which set out the Board's proposed high-level approach to calculating the risk based levy for multi-employer schemes.

This chapter particularly concentrates on the Board's more detailed proposals for calculating the insolvency risk of multi-employer schemes as set out in the October consultation update, published on 14 October 2005.

6.1 Introduction

6.1.1 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 sponsoring employers and therefore on the calculation of levy risk factors.

6.2 Summary of responses to this chapter

6.2.1 Only one question was included in chapter 6:

1. *Do you agree with the Board's transitional approach to multi employer schemes, using full data on multi-employer schemes where it is provided, and a simpler approach where it is not?*

6.2.2 Of the responses received to this question, slightly less than half agreed with the Board's transitional approach to calculating the insolvency risk of multi-employer schemes. However, as explained in the July consultation document, the Board's options are limited by the paucity of data currently available. Those responses that disagreed with the Board's approach did not want the risk based levy to be delayed until consistent information could be gathered from all schemes.

6.2.3 Of those that disagreed, most thought that the Board had not explained their approach in enough detail, and that there would be insufficient time between the publication of the final proposals and the deadline for submitting information to the Board.

6.2.4 The Board responded to these issues in the October consultation update. This update included a comprehensive explanation of the Board's proposals for calculating the insolvency risk of multi-employer schemes. This publication also announced the Board's decision to extend the deadline for schemes to submit information about their scheme structure and sponsoring employers to 31 March 2006.

6.2.5 The Board does not propose to make any changes to the detailed explanation in that document. The explanation is summarised in 6.3 below.

6.3 Calculating the insolvency risk of multi employer schemes

6.3.1 The Board of the Pension Protection Fund proposes to take into account the structure of multi-employer pension schemes when calculating the levy factors. This is consistent with its principle of fairness.

6.3.2 The July consultation document, identified two main scheme structures for multi-employer schemes

- Sectionalised, and
- Non sectionalised.

6.3.3 In both of these cases the scheme rules may include a requirement, or discretion, to segregate the scheme on insolvency.

6.3.4 To reflect this broad assessment, the two-part Declaration of Scheme Structure and Participating Employers form identifies six categories for multi-employer schemes. These six categories reflect those set out in paragraphs 74 and 75 of the Pension Protection Fund (Multi-employer Schemes) (Modification) Regulations 2005 or Regulations 74 and 75 of the Pension Protection Fund (Multi-employer Schemes) (Modification) Regulations (Northern Ireland) 2005. These categories are:

1) non-segregated schemes with a requirement to segregate on cessation of participation of an employer;
2) non-segregated schemes with discretion to segregate on cessation of participation of an employer;
3) non-segregated schemes with neither a requirement nor discretion to segregate on cessation of participation of an employer (referred to below as last man standing schemes);
4) segregated schemes with a requirement to segregate on cessation of participation of an employer;
5) segregated schemes with discretion to segregate on cessation of participation of an employer;
6) segregated schemes with neither a requirement nor discretion to segregate on cessation of participation of an employer (referred to below as last man standing schemes).

6.3.5 The Board proposes the approach outlined below to recognise and measure the insolvency risk of the different types of multi-employer schemes as identified in the two part Declaration of Scheme Structure and Participating Employers form. This approach is set out in greater detail in the October consultation update.

6.3.6 In summary:

- The Board will treat single employer sections in the same way as single employer schemes;
- For all multi-employer sections/schemes with an option or requirement to segregate on cessation of participation, which have also submitted the two

part Declaration of Scheme Structure and Participating Employers form, the Board will calculate the weighted average probability of insolvency for all sponsoring employers. The weightings will be equal to the number of employees for each employer divided by the total number of employees for all sponsoring employers in the scheme[9]. If a scheme provides the PPF with information on the number of members for every participating employer the weighted average will be calculated using the number of members;

- For all last man standing, associated sections/schemes, the Board will also perform this weighted average calculation, and multiply the resulting assumed probability of insolvency by a scaling factor of 0.9, to recognise that some degree of cross-subsidy exists within the scheme;
- For all last man standing, non-associated sections/schemes, the Board will also perform the weighted average calculation, and multiply the resulting assumed probability of insolvency by a scaling factor that reflects the number of members of the largest employer divided by the total number of members for the entire scheme;
- For all multi-employer schemes for one year only, the Board will calculate the insolvency risk of the largest sponsoring employer, defined by number of active, deferred and pensioner members[10]. This insolvency risk will then be used in the levy calculation where the section/scheme has not completed the two-part Declaration of Scheme Structure and Participating Employers form, or where a section/scheme that has completed the form would be in a lower insolvency risk band as a result (to ensure no section/scheme is disadvantaged by completion of the voluntary form).

6.3.7 The two part Declaration of Scheme Structure and Participating Employers form can be completed electronically on the Pension Protection Fund website by accessing the risk based levy section of the website and following the link to risk based levy forms. A copy of the layout of the form is also available at Annex C. The two part form should be completed and returned to the Pension Protection Fund electronically by 31 March 2006 to enable the information to be used in the risk based levy calculation for the 2006/07 levy year.

---

[9] In any case where D&B do not have data on the number of employees for a particular employer, the Board will take the median number of employees for all the participating employers in a particular scheme/section for which employee numbers are available.

[10] Including a proportional share of all orphan members.

Chapter 7 - The Levy Structure

Chapter Summary

This chapter discusses the consultation responses received on chapter 7 of the Pension Protection Levy Consultation Document July 2005, and in the light of those consultation responses details the Board's final proposals for the structure of the risk based and scheme based elements of the pension protection levy.

7.1 Summary of responses to this chapter

7.1.1 Chapter 7 of the July consultation document posed three questions for consideration in the consultation responses:

1. *Do you agree that there is a strong imperative to move towards a risk-based system as quickly as possible?*
2. *Do you agree that the risk exposure should be based on a product of insolvency and underfunding risk?*
3. *Do you agree that a cap on individual schemes should be applied and that the cap should apply to those schemes with employers included in insolvency risk bands 9 and 10 and which have weak Pension Protection Fund funding levels?*

7.1.2 The majority of respondents to question 1, including all the representative groups, agreed that the risk based levy should be introduced as soon as possible.

7.1.3 Of those responses that sought a delay (generally small and medium size schemes), the majority said the levy should be delayed for an unspecified period. The reasons given for delay were that more time was needed to:

- Fully understand the implications of the levy;
- Complete a section 179 valuation;
- Complete the two part Declaration of Scheme Structure and Participating Employers form.

7.1.4 A large majority of responses to question 2 agreed that risk exposure should be calculated based on a product of insolvency and underfunding risk.

7.1.5 With regard to question 3, the majority of respondents, including all those received from the actuarial profession and the major representative groups, agreed that there should be an overall levy cap. Of those that disagreed, many recognised that a cap was necessary, but favoured alternative proposals.

7.1.6 One suggestion was that a cap be phased in, starting at 0.5% in the first year and rising to 3% by year 5. Other responses suggested the cap should be 1% or 2% of liabilities.

7.1.7 Detailed consideration was also given in several responses to the ability of an

employer to pay the levy as well as attempting to reduce a funding deficit in partnership with the Pensions Regulator. It was proposed that the Pension Protection Fund should look at the employer's covenant when setting the cap, possibly taking account of net assets as well as liabilities, or reflecting a percentage of a deficit reduction recovery plan agreed with the Pensions Regulator, once scheme specific funding is in place for all schemes. The Pensions Regulator's consultation document "How the Pensions Regulator will regulate the funding of defined benefits" can be found on their website at http://www.thepensionsregulator.gov.uk/pdf/schemeFundingConsultation.pdf

7.2 The Board's final proposals

7.2.1 The majority of responses were in favour of the introduction of the risk based levy in 2006/7. The Board also believes that the reasons articulated for delay have been addressed by the publication of the October consultation update, including simplifications to the section 179 guidance, and the extension of the deadline for submitting information to the Pension Protection Fund to 31 March 2006. The Board will therefore introduce the risk based levy for all schemes in 2006/07.

7.2.2 Given the wealth of support for the proposed structure for the risk based levy calculation, the Board will to retain its proposal to calculate risk exposure as a product of insolvency and underfunding risk.

7.2.3 Equally, given the strong support for an overall risk based levy cap, the Board will retain such a cap.

7.2.4 In the light of consultation responses, the Board has decided to set the risk based levy cap, after the application of the levy scaling factor, at 0.5% of section 179 liabilities. A cap set at this level will affect approximately 5% of schemes (by number). The Board believes a cap set at this level strikes an appropriate balance between its principles of fairness and proportionality.

7.3 Calculating the pension protection levy for new schemes

7.3.1 Special provision will be needed for calculating the pension protection levy for new schemes, and the Board's proposals are set out below.

New Schemes

7.3.2 The Pension Protection Fund will become aware of the existence of entirely new schemes because of the requirement set out in the Pension Protection Fund (Valuation) Regulations that a new scheme must register with the Pensions Regulator within three months of its creation.

7.3.3 New schemes will not, however, be required to submit a section 179 valuation to the Board until up to two years after the date of registration of the scheme. The Board will seek to gather any missing valuation information from these schemes, by directly contacting the scheme and requesting the information is submitted.

7.3.4 Until the Board is in possession of sufficient information to calculate a risk based levy, a charge will not be issued in respect of an entirely new scheme.

Scheme transfers

7.3.5 Alternatively, all or part of a scheme may be transferred into another existing scheme or to a newly created scheme between valuations.

7.3.6 If a further section 179 valuation is not submitted to the Board following a scheme transfer, then the scheme return data that would be used to calculate the risk based levy would not reflect the changes made to either the transferred or the receiving schemes.

7.3.7 Material transfers of more than 5% of liabilities are notifiable events which the scheme would be required to bring to the attention of the Pensions Regulator, who would pass on the information to the Board.

7.3.8 The Board then intends to issue a section 191 notice to the transferring/ receiving scheme, requiring that information regarding the transferred liabilities be submitted to the Pension Protection Fund.

7.3.9 The Board will then calculate a levy based on the valuation of total (including transferring) liabilities, multiplied by the insolvency risk of the receiving scheme, and issue an invoice to the receiving scheme. If a levy invoice for that year has already been issued to the receiving scheme, then this invoice will be reviewed to include the transferred liabilities. The transferring scheme's invoice could also be reviewed if necessary.

Calculating the insolvency risk of new employers

7.3.10 It may also be possible for changes to a pension scheme to be made between valuations which may also involve a new employer being created. This could happen when:

- A new scheme is created by a totally new employer;
- A material transfer takes place and the new scheme is sponsored by a totally new employer.

7.3.11 In each of these cases it is likely that D&B would be able to provide a failure score for the new employer by 31st March the following year. However if D&B were unable to gather sufficient information by 31st March to calculate a failure score, the Board would assign the new employer a generic failure score. The approach to calculating a generic failure is discussed in detail in 5.2.14.

7.4 Levy formulae

7.4.1 As set out in the July consultation document, the scheme based levy SBL will be 20% of the total pension protection levy, and will be assessed in relation to the amount a scheme's Pension Protection Fund liabilities. The formula will be:

SBL= L x M

Where:

L = The scheme's Pension Protection Fund liabilities, and
M = The multiplier, which will be 0.014% for levy year 2006/07[11]

7.4.2 The formula for calculating the risk based levy RBL, which will be 80% of the total pension protection levy, will be:

RBL= U x P x 0.8 x c

Where:

U = Underfunding risk
P = Pension Protection Fund assumed probability of insolvency
0.8 = Percentage risk based for levy year 2006/07
c = Levy scaling factor, which will be 0.53 for levy year 2006/07

7.4.3 Schemes that possess a partial crown guarantee will be charged a risk based levy for the part of the scheme that does not have a crown guarantee. This will be determined by estimating the accrued benefit liabilities for those scheme members that are covered by a crown guarantee.

7.4.4 The amended technical specification for calculating the risk based levy, to take into account the inclusion of special contributions in the underfunding risk factor, contingent assets, and the proposed approach for calculating the insolvency risk of multi-employer schemes with regard to all the sponsoring employers, is set out in Annexes A and B.

[11] Assuming the initial levy estimate remains as proposed in this document

Chapter 8 - The transitional period

Chapter summary

This chapter considers the responses to the questions posed in chapter 8 of the Pension Protection Levy Consultation Document July 2005, which set out the Board's proposals for calculating the risk based levy during the transitional period.

In light of the consultation responses received, this chapter sets out the Board's revised proposals to:

- Use adapted MFR valuations as an estimate of a section 179 levy valuation for the levy year 2006/07 and also as an option for the levy year 2007/08;
- Ask the DWP to legislate to require all schemes to submit a section 179 valuation by 31 March 2008.

8.1 Introduction

8.1.1 Chapter 8 of the July consultation document set out the Board's proposals for introducing the risk based levy during a transitional period, where the Board would not have section 179 valuations for all eligible pension schemes.

8.1.2 For the purposes of calculating underfunding risk for the 2006/07 risk based levy, the Board proposed to enable any scheme that was able to do so, to submit a section 179 valuation to the Board of the Pension Protection Fund by 31 December 2005. For any scheme that was unable to submit a section 179 valuation by that date, the Board proposed to take the latest MFR valuation available on the scheme return issued by the Pensions Regulator, and transform that MFR information to a section 179 basis.

8.1.3 The Board originally proposed to use this MFR adaptation for the 2006/07 levy only, and to require all schemes to submit a section 179 valuation by 31 December 2006.

8.2 Summary of responses to this chapter

8.2.1 Chapter 8 of the July consultation document posed six questions for consideration.

1. *Do you agree it is reasonable to use adapted MFR valuations as an estimate of s179 levy valuations?*
2. *Do you consider that an adapted MFR valuation could be used beyond the financial year 2006/07, if all schemes were not required to complete a s179 levy valuation by 31 December 2006?*
3. *Do you agree that it is desirable to receive a s179 levy valuations for all schemes from 31 December 2006?*
4. *If you answered no to Q3 which of the following dates is preferable to 31 December 2006 in your view?*
   a) 31 December 2007

b) 31 December 2008
c) 5 April 2009
d) Any other date, please specify.

5. *Do you agree that the disadvantages of bringing forward the deadline for completing an initial s179 valuation are a price worth paying to move towards a fairer and consistent risk based levy using s179 levy valuations by 31 December 2006?*
6. *Do you think that the estimated costs of bringing forward the deadline for completing an initial s179 valuation are realistic?*

8.2.2 Of the respondents to question 1, most agreed that it was reasonable to use adapted MFR valuations as an estimate of the section 179 levy valuation. These positive responses included the ABI and the CBI, as well as most of the actuarial firms, and two-thirds of the smaller and medium sized schemes who responded.

8.2.3 Of those that disagreed with this proposal, the majority considered that insufficient information was available on how the Pension Protection Fund would adapt MFR valuations to a section 179 basis. As such, it was considered that not enough time would be available between the publication of the finalised proposals in late November and the deadline for submitting section 179 valuation information on 31 December 2005. Moreover, it was considered that the current proposals would be unfair if they did not take into account special contributions made to the pension scheme since the last MFR valuation.

8.2.4 The proposed methodology for adapting MFR valuations to estimate liabilities on a section 179 basis was published in the October consultation update. This methodology has since been slightly revised. There are changes in the calculation of the equity easement and the section 179 wind-up expenses, and there are a few other changes for clarification. The updated methodology can be accessed from the risk based levy section of the Pension Protection Fund website.

8.2.5 As noted earlier, the October consultation update also announced the inclusion of special contributions made since the last valuation, and an extension to the deadline for submitting information to the Board.

8.2.6 The October consultation update has been broadly welcomed, and so the Board will use adapted MFR valuations for the 2006/07 levy calculation.

8.2.7 Consultation responses on using adapted MFR valuations beyond the 2006/07 levy year were broadly 50% in favour, 50% against.

8.2.8 Opinion was divided on whether schemes should be required to submit initial section 179 valuations by 31 December 2006, although the NAPF, the ABI and the ACA were all in favour of a later deadline. Almost all responses agreed that it would be “desirable” to receive section 179 valuations for all schemes by 31 December 2006, but a significant proportion thought that it would not be practical to require this, particularly given the added burdens for small schemes, and the actuarial profession.

8.2.9 Of the relatively small number of responses that stated a preference for an alternative date to 31 December 2006 (question 4), a majority supported 31 December 2007.

8.2.10 Opinion was again divided on whether mandating all schemes to provide an initial section 179 valuation was “a price worth paying”, to ensure a consistent basis of valuations by 31 December 2006.

8.2.11 A significant majority of responses received to question 6 also considered that the Pension Protection Fund had understated the additional costs of completing a section 179 valuation. This added weight to their arguments that the Pension Protection Fund should not require section 179 valuations by 31 December 2006.

8.3 Final proposals

8.3.1 It is expected that a large number of schemes will be able to complete early section 179 valuations following the modifications to the section 179 valuation guidance published on 14 October. The Board therefore expects a high level of voluntary completion of section 179 valuations. This would support the Board’s initial intention to bring forward the mandatory completion of section 179 valuations to 31 December 2006.

8.3.2 However, practical difficulties still remain for some schemes (particularly small ones) in completing additional valuations. The Board has therefore decided to approach the DWP to legislate to require all schemes to submit a section 179 valuation by 31 March 2008 (to tie in with the extension to the 31 December 2005 deadline to 31 March 2006). The option of using adapted MFR valuations will remain for the 2007/8 levy year, so that underfunding risk can be calculated for those schemes that do not submit section 179 valuations until after March 2007.

8.3.3 These proposals will mean that the risk based levy can be calculated consistently for all schemes from 2008/09.

8.4 Asset allocation

8.4.1 The July consultation document included a chapter (chapter 9) which set out the Board’s initial thoughts on the inclusion of asset allocation as a risk factor in the risk based levy calculation.

8.4.2 Although the Board did not propose to introduce asset allocation as a risk factor in the 2006/07 levy, chapter 9 of the July consultation document asked respondents to consider whether asset allocation should be taken into account in the levy calculation as early as was practicably possible.

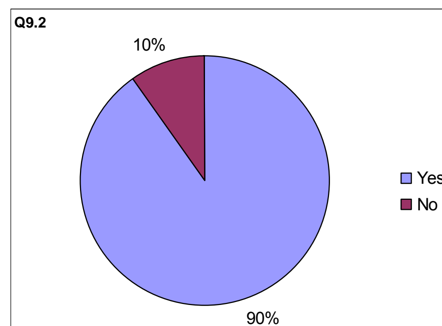
8.4.3 The three questions for consideration were as follows:

1. *Do you agree that the Board should include asset allocation as a factor for setting the risk based levy as early as practicable?*
2. *Do you agree that this is something that is important and which will merit*

early consideration in a separate consultation exercise?
3. *Do you agree that the main issues to consider in a further consultation are those listed here?*

8.4.4 The majority of respondents considered that asset allocation should be included as a risk factor for the levy as early as practicable. A significant number, however, considered that the current proposals for calculating the risk based levy should be allowed to take root first, and that a lot more work would need to be undertaken to determine how asset allocation should be assessed.

8.4.5 This sentiment was supported by the vast majority of responses to question 2, which considered a separate consultation exercise to be essential.



8.4.6 The Board therefore proposes to consult in 2006 on the inclusion of asset allocation as a risk factor.

Section 3 – The Board's Levy Estimate

Chapter 9 – The Levy Estimate

9.1 The Board's levy estimate

Pension protection levy estimate

9.1.1 The Pensions Act 2004 requires the Board to publish an annual estimate of the pension protection levy before the start of the financial year to which the estimate relates. The Board proposes that its levy estimate for the financial year 2006/07 should be £575million. The Board stated in its July consultation document that its levy estimate for 2006/07 was likely to be higher than the £300million set out in the regulatory impact assessment accompanying the passage of the Pensions Bill 2004 through Parliament.

9.1.2 Both the economic context and demographic variables have changed. The advantage to business of lower interest rates resulting in reduced borrowing costs is countered by the impact on the valuation of pension scheme liabilities. Much of the recent increase in pension liabilities has been due to improving longevity. The table below illustrates the improvements in life expectancy at age 65 for both men and women. The increase in life expectancy masks the actual impact on actuarial liabilities and consequently on pension deficits. The positive effect on pension deficits from increases in asset values as a result of companies making special deficit reducing contributions and/or stronger investment market performance has been eroded by the financial impact of improving longevity and lower bond yields on the value of liabilities.

Life expectancy aged 65 in year

	1970	2004	2021*
Male	77.5	82	85
Female	81.5	85	88

*Projected – source Office of National Statistics (ONS) & Government Actuary's Department (GAD)

9.1.3 Small changes to the value of assets and liabilities can lead to large fluctuations in the value of pension deficits. A pension scheme with a deficit of £10million, assets valued at £90million, and liabilities of £100million, would see a 100% increase in the deficit to £20million as a result of a 10% increase in the value of the liabilities, assuming the asset values remained unchanged.

9.1.4 The levy estimate calculated by the Board assumes paying Pension Protection Fund compensation to beneficiaries at the level agreed by Parliament and prescribed in the Pensions Act 2004. The ACA reported that 78% of those questioned in a recent survey felt that the level of compensation was either too low or about right. The Board will fund compensation payments from the assets retained from schemes that transfer to the Pension Protection Fund,

recoveries of pension debt from insolvent employers, the pension protection levy, and the investment return generated from investing all of these. The Board outlined its investment strategy for the financial year 2005/06 in its Statement of Investment Principles, published in June 2005, and stated that it intended to follow a liability driven investment approach in future years, as the pattern of liabilities becomes apparent.

9.1.5 The Board's levy estimate reflects estimates of the level of deficits and insolvency risk represented by eligible schemes as at the end of October 2005. However, the Board will invoice eligible schemes using a calculation of levy risk factors measured at the close of business on 31 March 2006. The Board anticipates that eligible pension schemes and their sponsoring employers are likely to respond to the proposals outlined in this document by injecting further special deficit reducing contributions into their pension scheme and/or using contingent assets to reduce risk on insolvency to the pension scheme either through parental guarantees, letters of credit or pledging securities.

9.1.6 Any such actions taken before 31 March 2006, and notified to the Board using the methods set out elsewhere in this document, are likely to change the risk profile both for individual pension schemes and also in aggregate across all eligible pension schemes. This is likely to result in the Board collecting an amount that is below its levy estimate. The Board encourages sponsoring companies to continue to take action to cut deficits and consequently reduce the aggregate risk to the Board which should result in a lower levy cost and lessen the likelihood of calls on the Pension Protection Fund.

Risk based and scheme based levy estimate

9.1.7 The responses to the July consultation document supported the Board's proposals to move towards a risk based system as quickly as possible. The Board confirms that the risk based levy for 2006/7 will be set at 80% of the total pension protection levy and the scheme based levy will comprise the remaining 20%. The proposed risk based levy estimate is £460million and the proposed scheme based levy estimate is £115million, giving a total proposed levy estimate of £575million for 2006/07.

Principles

9.1.8 The Board has applied the principles of fairness, simplicity and proportionality to determine the pension protection levy estimate, consistent with its approach to the distribution of the levy. The Board believes that it is fair and proportionate to apply financial economic techniques to estimate the level of risk posed by eligible schemes in order to derive a pension protection levy estimate.

9.1.9 The Pensions Act 2004 imposes on the Board the obligation to balance the interests of both the levy payers and the scheme members.

9.1.10 The scheme members' interests are in:

- Having confidence in their pensions promise (through well funded schemes) and confidence in the safety net if their scheme fails;
- Maintenance of the benefit levels approved by Parliament. We should note that the Pension Protection Fund Board has the discretion to initiate a reduction in benefits (of revaluation and indexation) if it is so minded. Independent surveys of stakeholders have confirmed that a majority believe that the benefits are about right or too low;
- The solvency of the Pension Protection Fund. In the short term, solvency in terms of cash flow for compensation is not an issue, but longer term solvency difficulties might lead to benefit reductions, and headline deficits would undermine confidence generally.

9.1.11 The levy payers' interests are in:

- A levy estimate and distribution which is fair, simple and proportionate.

9.1.12 This means that the amount of levy charged to each scheme should be proportionate to the potential risk it poses to the Pension Protection Fund and should be affordable.

9.1.13 There is a trade off between security and affordability.

Approach

Data

9.1.14 The Board's levy estimate, levy scaling factor and scheme based levy multiplier are based on information from a sample of 1,035 defined benefit pension schemes. The sample represents approximately 12% of schemes and 50% of assets and liabilities. The data has been extracted from the annual scheme returns collected by the Pensions Regulator. The Board has adapted MFR asset and liability information to estimate the size of pension scheme deficits on a section 179 basis.

Economic and demographic variables

9.1.15 There is currently insufficient historical claims data available on which to base any levy estimate. The Board has determined its levy estimate by taking into account both quantitative and qualitative factors. The levy estimate depends on economic, demographic and scheme specific assumptions. The Board has used quantitative models to forecast the level of future claims in different economic scenarios. These models take into account the effect of asset market returns and their volatility, insolvency events, and recoveries of employer debt.

Stochastic modelling

9.1.16 The Board has given more weight to the results generated by stochastic

models over alternative deterministic approaches. Stochastic models allow the Board to estimate the distribution of claims by modelling the interaction between asset market returns, yields and insolvency rates.

No reserves for extreme risks

9.1.17 The Board faces a risk profile that is skewed by a range of possible claim values with a large financial impact, but which have a low likelihood of occurrence. For the first year of the risk based levy, the Board has considered both the affordability of the levy, and setting a levy that protects against the most extreme outcomes. The Board wishes to sustain and accelerate the efforts that companies have been taking to reduce deficits and risk in the system. Hence, for the first levy year the Board has set a levy that supports affordability, secures compensation for beneficiaries, but does not build in reserves for extreme events (macroeconomic shock or an extreme claim).

Estimate based on five year review

9.1.18 The obligations of the Board extend many decades into the future. The Board is required to pay compensation to members of eligible schemes from their retirement over their remaining life and subsequently to a surviving spouse. The primary time horizon used to determine this year's levy estimate is five years. The Board has also referenced shorter and longer time periods as a control, as well as empirical evidence to date. Asset market changes tend to dominate variability in the short run (e.g. over a one year period), the impact of the economic cycle can have more influence over the medium term, and behavioural and regulatory changes also start to become important. The impact of regulatory change, behavioural effects and political factors can dominate quantitative factors over much longer time horizons.

9.1.19 The likelihood that an eligible pension scheme makes a claim on the Pension Protection Fund is dependent on the financial strength of the scheme's participating employers, the structure of the scheme and the extent of any financial support from a third party or group company. The amount of future compensation payments in respect of an eligible scheme is dependent on the funding level of the scheme at the time that any or all the participating employers become insolvent. A pension scheme's funding level is influenced by its investment strategy, market returns and by bond market yields, inflation rates, and longevity. For Pension Protection Fund purposes, the relevant funding level is in relation to the Pension Protection Fund benefit levels (a combination of the scheme rules and statutory requirements) valued on a section 179 basis.

Estimate based on modified MFR data

9.1.20 The Board has estimated the value of section 179 liabilities for eligible pension schemes by transforming information from the most recently reported MFR liabilities contained in the Pensions Regulator's scheme return. The methodology used to adapt MFR valuations can be accessed from the risk based levy section of the Pension Protection Fund website. The discount rate used to estimate the value of section 179 liabilities is calculated using the

valuation basis outlined in guidance issued by the Board.

Modified valuation basis to eliminate non-relevant costs

9.1.21 The section 179 valuation basis approximates the cost of buying out the liabilities of a pension scheme on a Pension Protection Fund valuation basis from an insurance company. The buy out cost includes an allowance for costs that an insurance company must bear but which the Pension Protection Fund, as a compensation scheme, does not. These extra costs include the cost of regulatory capital, profit margins and some marketing and sales costs. The Pension Protection Fund has therefore used a realistic basis to set the levy estimate which modifies the section 179 valuation by removing the additional margins for these factors. The removal of these margins lowers the levy estimate.

9.1.22 This means that while the levy estimate is set on a realistic basis, the way in which the levy is allocated to pension schemes is based on a schemes' section 179 funding position. The realistic basis is appropriate for the levy estimate because of the reasons set out above. The section 179 basis is suitable for levy distribution because it is a scheme's underfunding on a buy-out basis that would determine whether or not it would enter the Pension Protection Fund, if an insolvency event occurred in respect of the sponsoring employer

Scheme funding

9.1.23 The Pensions Regulator has a statutory objective to protect the Pension Protection Fund. The Pensions Regulator issued a consultation document in October 2005 that outlines its proposals on scheme specific funding (see Chapter 7). These proposals aim to ensure that schemes have objectives to reach appropriate funding levels. The Pensions Regulator has proposed to set trigger points as the filters that will determine which schemes it will wish to have a closer look at. These trigger points will relate to the funding objectives of the scheme and the length of the planned recovery period.

9.1.24 On average, the Pensions Regulator has proposed that the lower trigger should correspond to a fully funded position when measured on a Pension Protection Fund valuation basis. The Pensions Regulator has also proposed to set a trigger level for the recovery period of ten years, and acknowledges that whilst it will want some companies to pay down at a faster rate, there will be some where the specific circumstances will mean that the recovery plan will last longer than ten years.

9.1.25 The introduction of the scheme specific funding regime should lead to a reduction in pension scheme deficits over time. In many instances companies are already making significant efforts to fund legacy deficits through special contributions. The pace of deficit reduction will be reflected in the risk based levy through the measurement of underfunding risk. The reduction of deficits will reduce the net risk in the system and should therefore lead to a reduction in the size of the levy amount collected. The Board has implicitly taken these factors into consideration when setting its levy estimate.

Corporate de-risking and incentives

9.1.26 The Board acknowledges the efforts made by businesses to tackle the issue of pension scheme deficits, particularly the amount of special deficit reducing contributions made by sponsoring companies into defined benefit pension schemes in recent years. These contributions have been generated through the operating and financing activities of companies using either cash flows/profits, asset sales or debt issuance. The ONS estimates that companies have contributed £17billion of special contributions into defined benefit pension schemes between 2002 and 2004.

9.1.27 The Board expects that many companies are likely to use the details of the proposals set out in this document to inform the timing and amount of any special deficit reducing contributions. The option provided by the Board to include in the levy calculation special contributions made by companies by 31 March 2006 could imply that the Board's published levy estimate may not equal the actual levy amount collected.

9.1.28 Chapter 2 outlines how the Board proposes to include contingent assets in the assessment of the risk based levy. The use of contingent assets such as letters of credit and letters of guarantee or security over securities, cash and real estate pledged by a sponsoring employer enhances the support provided by sponsoring companies and third parties to the pension scheme in the event of insolvency of sponsoring employer(s). The Board expects that many companies may elect to use one or more of these contingent assets to reduce the level of risk exposure. The use of these contingent assets will change the residual risk exposure of the Board.

Deficit spreading

9.1.29 Deficits accrued in the Pension Protection Fund at the end of each year need to be eliminated in future years, alongside collecting levy to reflect the risk in the remaining population of eligible schemes. Similarly, surplus reserves could be paid back as a credit over a number of years. The Board has decided to spread any deficits over a ten year period, to align with the recommendations made by the Pensions Regulator.

9.2 Levy scaling factor

Risk based levy scaling factor

9.2.1 The levy scaling factor is set at a level that equates the Board's risk based levy estimate to the sum of the estimated net risk exposure aggregated across all eligible schemes taking into account the impact of the risk based levy cap.

9.2.2 The risk based levy scaling factor for the financial year 2006/07 will be set at 0.53[12]. This has been calculated assuming a risk based levy cap of 0.5% applies to individual pension schemes when expressing the risk based levy as

[12] Assuming the levy estimate remains as proposed in this document

a percentage of section 179 liabilities.

Scheme based levy multiplier

9.2.3 The scheme based levy multiplier is set as the ratio of the scheme based levy estimate to the estimated value of section 179 liabilities across all schemes.

9.2.4 The scheme based levy multiplier for the financial year 2006/07 will be set at 0.014%[13].

9.2.5 The full technical specification of the levy structure is set out in Annex A.

[13] Assuming the levy estimate remains as proposed in this document

Chapter 10 - Appealing the Pension Protection Levy

Chapter Summary

This chapter sets out the process by which a scheme can seek a review of a levy invoice. It also discusses the means by which an appeal can be made against a company's D&B failure score.

10.1 Introduction

10.1.1 The Board of the Pension Protection Fund believes it to be essential that a robust, consistent, transparent process is in place for schemes to appeal the information used in the levy calculation.

10.1.2 If a scheme receives an invoice for the 2006/07 risk based levy and believes that the calculation is incorrect (in terms of incorrect data used to determine a scheme's underfunding risk or erroneous calculations on the part of the Pension Protection Fund), it may seek a review of the amount of its levy as a "reviewable matter" under section 206 and schedule 9 of the Pensions Act 2004. Information on reviews is contained in section 10.2 below.

10.1.3 If an employer wishes to appeal against its failure score, the employer should approach D&B, whose appeals process is set out in section 10.3. An employer's failure score is not a "reviewable matter".

10.2 Seeking a review of the levy amount

10.2.1 As set out above, the amount of the levy is a reviewable matter, defined in Schedule 9 of the Pensions Act 2004. Information on how to ask for a review of a levy invoice can be found in "A guide to the Pension Protection Fund Levies", a copy of which will be included in all levy invoices, and in "How we deal with your concerns", which can be found in the risk based levy section of the Pension Protection Fund website.

10.2.2 A request for a review can be made by a trustee or manager of an eligible pension scheme, a sponsoring employer, an insolvency practitioner acting in respect of a sponsoring employer or any member of an eligible pension scheme. The party requesting a review must do so within 28 days of the date at which the Board issues the invoice.

10.2.3 Once a request for a review has been received, the Pension Protection Fund will revisit the information used to calculate the levy. If a factual error is identified, a revised levy invoice will be issued. In every instance the Pension Protection Fund will aim to make a decision within 28 days.

10.2.4 If the response received from the Pension Protection Fund does not satisfy the concern, the issue can be raised with the Pension Protection Fund Reconsideration Committee.

10.2.5 If the response of the Pension Protection Fund Reconsideration Committee is

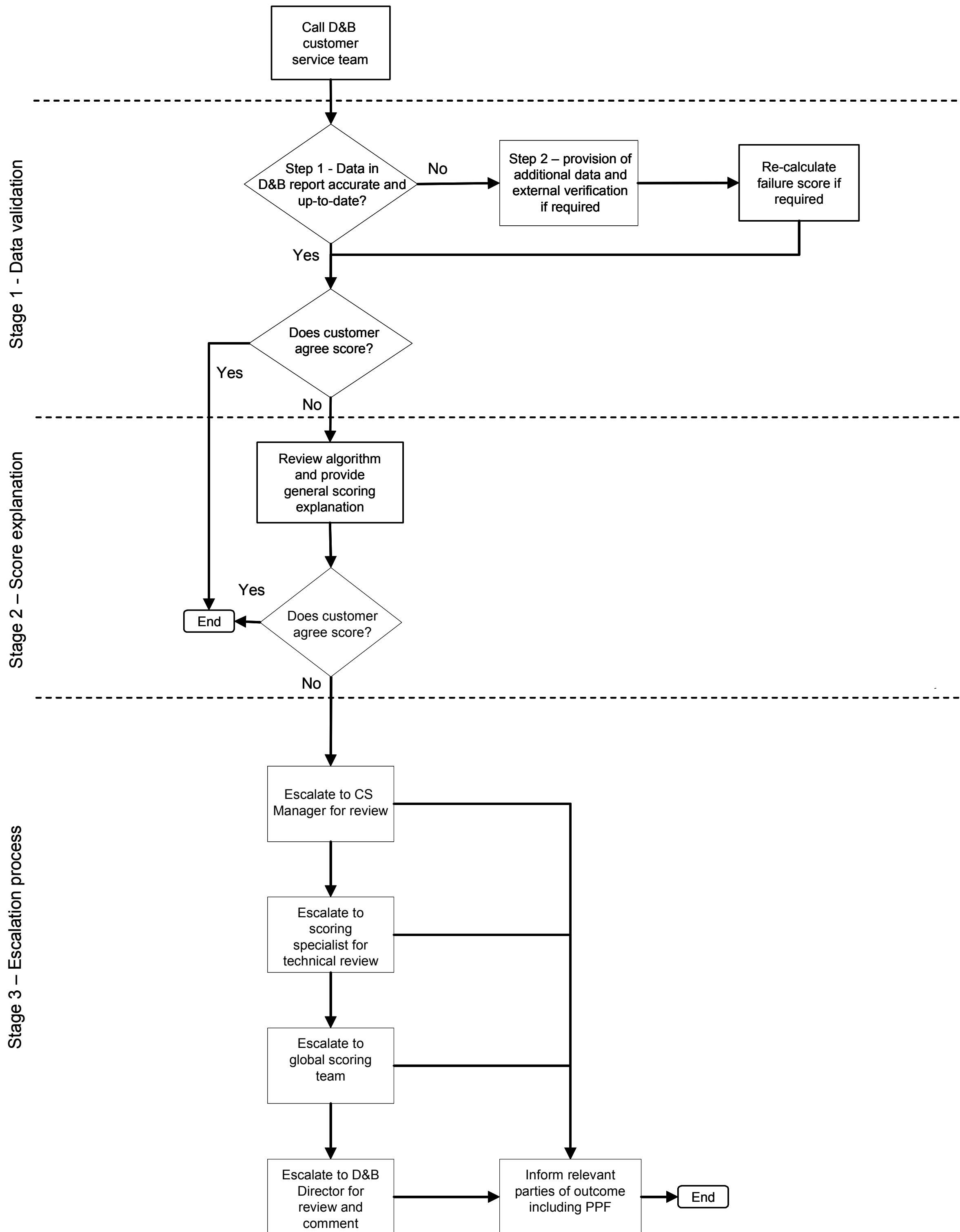
deemed unsatisfactory, the issue may be considered by the Pension Protection Fund Ombudsman.

10.3 Appealing the Dun & Bradstreet Failure Score

10.3.1 As set out in chapter 5, the Board would encourage employers to obtain their D&B failure scores in advance of 31 March 2006. However, whenever an employer obtains its failure score, it may query it, up to 28 days after issue of a levy invoice, by contacting the D&B Customer Service team on 0870 243 2344, or by emailing customerhelp@dnb.com, to request a review of the failure score.

10.3.2 D&B will then undertake the following appeals process in every case. The process is summarised below (figure 2), and the validation of data should take no longer then 28 days in the case of UK failure score queries. Where an overseas failure score is queried, D&B UK Customer Services would aim to complete the validation of data within 28 days. In all cases, a regular update will be provided to parties concerned.

Figure 2 – D&B appeals process



Stage 1: Data validation

The customer service team will check that the data in the D&B report (on which the failure score is based) is accurate and up-to-date.

If the data is found to be incorrect, additional information will be requested from the most appropriate source. If the data is correct, but the company still disagrees with the score, the query moves to stage 2.

Stage 2 - Score explanation

The customer service team will then provide a generic explanation of how the score is calculated based on the data included in the D&B report and the key components of the scoring algorithm.

Stage 3 – Escalation process

Customer service manager review

If a company still wishes to appeal against its failure score following a discussion of how that score is calculated, its appeal will be escalated to the customer service manager. The customer services manager will then review the failure score and speak to the customer service team involved to ascertain that the correct process has been followed, and to ensure all the relevant information has been provided. Once this review is complete, the customer service manager will call the customer back to talk through the score again and discuss any specific concerns still remaining.

Scoring specialist review

If concerns are still apparent, the appeal will be escalated to a scoring specialist who will review the technical aspects of the score, and will be able to discuss those aspects in greater detail.

Global scoring team review

Following discussion with a scoring specialist, an appeal can be escalated further for the consideration of the global scoring team. D&B scores are formulated on a country by country basis, to a globally recognised standard. The UK team works closely with the global team at all times. This ensures that all parties are fully aware of the issues being raised, and have a shared understanding of the reasoning and implications of all scoring decisions.

D&B director review

The final stage in the process is for the appeal to be passed to a D&B director for review. The director will gather all the relevant information, speak to the parties involved, and confirm that the processes have been followed correctly. The director will then respond in writing.

The final outcome of the appeal will be communicated to all the relevant parties, including the Pension Protection Fund.

At all stages of review, D&B will keep all parties informed and, if a call back or response in writing is required, will provide an indication of when a response should be expected.

Chapter 11 - The Consultation Process

11.1 Responding to the consultation

11.1.1 The Board of the Pension Protection Fund welcomes your views on the final proposals contained in this consultation document, and on the Board's draft determination, which can be accessed via the risk based levy section of the Pension Protection Fund website.

11.2 Arrangements for written submissions

11.2.1 The consultation period begins on 16 December 2005 and will end on 23 January 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. You may also call our publications number on 020 8867 3297 or email pensionprotectionfund@ecgroup.uk.com to obtain a paper copy.

11.2.2 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

11.2.3 When responding please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger 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

11.2.4 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. The contact point to discuss this issue is 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

11.3 Publishing a summary of responses

11.3.1 The Board will aim to publish a summary of responses at www.pensionprotectionfund.org.uk by the end of February 2006, alongside the Board's determination under section 175(5) of the Pensions Act 2004.

11.3.2 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

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

Paul Reynolds
Head 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

Technical Glossary

Bank guarantee	An instrument issued by a bank comprising an undertaking to pay a certain amount if demanded by the recipient. In practice similar to a letter of credit.
Contingent assets	An asset that will produce cash for a pension scheme contingent on certain events, such as an insolvency event in relation to a participating employer.
Credit default swaps	A type of derivative designed to transfer the credit exposure of fixed income products between parties.
Credit insurance policies	Insurance policies designed to protect against bad debt caused by an insolvency event in respect of a debtor.
D&B failure score	A prediction of the likelihood that a company will cease operations without paying all creditors over the next 12 months. The D&B failure score measures insolvency risk on a 1-100 scoring scale (with 100 representing the lowest chance of insolvency and 1 representing the highest).
Employer covenant	The financial strength of an employer.
First priority security interest	A security interest in an asset which ranks ahead of the interest of any other party in the same asset.
Full section 75 buy-out debt	The liability to the scheme of an employer or employers triggered under section 75 of the Pensions Act 1995, which is equivalent to the cost of buying out the entire scheme liabilities in full with an insurance company, less the value of the scheme assets.
Group company guarantee	A direct guarantee to the pension scheme (not the sponsoring employer) from another employer within the company group.
Intangible assets	[Non-physical] assets, including, in particular, goodwill.
Largest sponsoring employer	Defined by number of active, deferred and pensioner scheme members, including a proportional share of all orphan members.
Last man standing associated scheme	A pension scheme which has more than one sponsoring employer with no requirement or option to segregate upon cessation of participation of an employer, and where the sponsoring employers are linked

	to the same parent company or have a financial dependency on each other.
Last man standing non-associated scheme	A pension scheme which has more than one sponsoring employer with no requirement or option to segregate upon cessation of participation of an employer, and where the sponsoring employers are not linked to the same parent company and do not have a financial dependency on each other.
Last man standing scheme	A pension scheme which has more than one sponsoring employer with no requirement or option to segregate upon cessation of participation of an employer.
Letter of credit	An instrument issued by a bank or other financial institution comprising an undertaking to pay a certain amount if demanded by the recipient. In practice similar to a bank guarantee.
Minimum 12 month maturity	In relation to an instrument, means that the instrument will, on its terms, remain in force for a minimum of 12 months.
Minimum funding requirement (MFR) valuation	An actuarial valuation undertaken to determine the level of scheme underfunding in accordance with the minimum funding requirement established under section 56 of the Pensions Act 1995.
Multi-employer scheme	An occupational pension scheme which has more than one sponsoring employer.
New scheme	A newly created pension scheme, not including a scheme created by the transfer of all or part of an existing scheme.
Notifiable event	Events occurring in respect of a pension scheme which the scheme would be required to bring to the attention of the Pensions Regulator.
OECD country	A country within the Organisation for Economic Cooperation and Development, comprising 30 member countries sharing a commitment to democratic government and the market economy.
Orphan members	Deferred or pensioner members which 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).
Pension Protection Fund assumed probability of	The assumed probabilities mapping to each of the 100 risk bands that will be used for the risk based

insolvency	levy calculation.
Pension protection levy (section 179) valuation	An actuarial valuation undertaken to determine the level of scheme underfunding in accordance with section 179 of the Pensions Act 2004. The valuation results will be used to set and calculate the risk based pension protection levy.
Relevant accounts	Defined in Regulation 1 of the Pension Protection Fund (Valuation) Regulations 2005 as: (a) audited accounts for the scheme which are prepared in respect of a period ending with the relevant time; (b) if none are so prepared, the latest such accounts which are available at the relevant time; or (c) if the appropriate person's opinion is that it is practicable to use them, the latest such accounts which are available on the date the appropriate person signs the section 143 or section 179 valuation.
Reviewable matter	Defined in Schedule 9 of the Pensions Act 2004.
Risk of default - employer	A measurement of the financial strength of an employer based on the probability of that employer failing to make an interest or capital payment on an outstanding debt.
Risk of insolvency	A measurement of the financial strength of the sponsoring employer(s) based on the probability of an insolvency event occurring in relation to the sponsoring employer(s).
Scheme transfer	Where all or part of a scheme is transferred into another existing scheme or to a newly created scheme.
Section 191 notice	A notice from the Board requiring a person such as the trustees or managers to supply information.
Security over cash	For the purposes of the risk-based levy, a first fixed charge over an appropriate sterling cash deposit in the Pension Protection Fund’s standard form.
Security over real estate	For the purposes of the risk-based levy, a first legal mortgage over one or more properties situated in England and Wales, in the Pension Protection Fund’s standard form.
Security over receivables	Security over debts owed to a company e.g. amounts due from customers.
Security over	For the purposes of the risk-based levy, a first

securities	fixed charge over securities held by an appropriate custodian in the Pension Protection Fund's standard form.
Security over stock/work in progress	Security over trading stock or partially completed products/work carried out but unbilled.
Special contributions /deficit reduction contributions	Total contributions payable and paid by the employers and employees into the scheme since the previous valuation (either MFR or section 179) less: 1) the cost of accrual of scheme benefits, subject to the adjustments described in section 4.1 of the section 179 guidance (measured using section 179 valuation assumptions); 2) scheme expenses incurred between valuations; 3) the cost of augmentations granted since the previous valuation.
Sponsoring employer	An employer who has agreed to provide benefits to employees under a pension scheme.
Transferred liabilities	Those liabilities transferred from an existing to a receiving scheme.
Two digit 1972 standard industry classification (SIC) codes	A method of classifying business establishments and other statistical units by the type of economic activity in which they are engaged.
UK branches of foreign registered companies	Companies identified by having a FC prefix to their Companies House Registration number.

Abbreviations

ABI	Association of British Insurers
ACA	Association of Consulting Actuaries
CBI	Confederation of British Industries
D&B	Dun & Bradstreet
GAD	Government Actuary's Department
NAPF	National Association of Pension Funds
ONS	Office of National Statistics

Annex A - Revised Levy Formula

A.1 Technical specification of the risk based levy

A.1.1 The formulae for the calculation of risk factors outlined in the July consultation document have been updated to take into account the following additional elements:

- Special contributions;
- Multi-employer insolvency risk;
- Contingent assets.

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

The formula for calculating the insolvency risk factor is set out in Annex B below.

A.3 Underfunding risk including contingent assets (U)

A.3.1 The formula proposed in July 2005 for underfunding risk is superseded by the formula below which incorporates contingent assets. 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
$z_A =$ discount factor applied to type A contingent assets

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)

$A = S + C + (N_A \times z \ + N_B + N_C)$

$$z = 1 - \frac{\text{probability of insolvency of guarantor}}{\text{probability of insolvency of sponsor(s)}}$$

The maximum value that N_A 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% of the value of the s179 liabilities (either actual or estimated from MFR valuations), then the formula is as follows:

$$f = \frac{S + C + N_B + N_C}{L} \times 100\%$$

(a) If there are no Type A contingent assets or the guarantee represented by the Type A contingent asset is less than $(1.25 \times L) - S - C - N_B - N_C$:

U = 0.0100 x L if f = 104%
U = 0.0075 x L if f > 104% but ≤ 111%
U = 0.0050 x L if f > 111% but ≤ 118%
U = 0.0025 x L if f > 118% but ≤ 125%
U = 0 if f > 125%

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

(b) If there is a Type A contingent asset, which must at least guarantee $(1.25 \times L) - S - C - N_B - N_C$:

U = 0.0100 x L x r if f = 104%
U = 0.0075 x L x r if f > 104% but ≤ 111%
U = 0.0050 x L x r if f > 111% but ≤ 118%
U = 0.0025 x L x r if f > 118% but ≤ 125%
U = 0 if f > 125%

$$r = \frac{\text{probability of insolvency of guarantor}}{\text{probability of insolvency of sponsor(s)}}$$

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.

A.4 Risk based levy structure

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

RBL = U x P x 0.8 x c

RBL = Risk based levy
U = Underfunding risk
P = Pension Protection Fund assumed probability of insolvency
0.8 = Percentage risk based for levy year 2006/07
c = Levy scaling factor, which will be 0.53 for 2006/07

Annex B - Formulae for Calculating the Insolvency Risk of Multi-employer Schemes

Introduction

As set out in Chapter 6 of this consultation document, unless a multi-employer scheme voluntarily provides the Board with information on their scheme structure and participating employers, the Board will calculate its risk based levy for the 2006/07 levy year based on the insolvency risk of the biggest sponsoring employer (measured by the number of active, deferred and pensioner members[14]).

B.1 Calculating the insolvency risk of multi-employer schemes

B.1.1 For a multi-employer scheme that does not submit the two-part Declaration of Scheme Structure and Participating Employers form to the Board of the Pension Protection Fund the insolvency risk factor will be determined using **calculation A** below.

B.1.2 Calculation A

- Calculate failure score of the sponsoring employer with the most members*;
- Determine the corresponding insolvency risk band;
- Look up the Pension Protection Fund assumed probability of insolvency for the risk band.

F= Failure score of employer with most members

p = PPF assumed probability of insolvency corresponding to failure score F

*Largest sponsoring employer by number of members (total of active, deferred and pensioner members)

B.1.3 For a multi-employer scheme that submits the two part Declaration of Scheme Structure and Participating Employers form to the Board of the Pension Protection Fund the insolvency risk will be determined by taking the minimum of **calculation A** and **calculation B**.

B.1.4 Calculation B

- 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.

[14] Including a proportional share of orphan members

K = number of sponsoring employers in the scheme/section

E_i = number of employees of the *i*th sponsoring employer in the scheme/section*

E = total number of employees for all sponsoring employers in the scheme/section = $\sum_{i=1}^{K} E_i$

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

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

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

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

Multi-employer type	Factor (M)
Option or requirement to segregate on cessation of participation of an employer	1
Associated	0.9
Non associated	$\frac{\text{No. of members for the largest employer}}{\text{No. of members for the entire scheme/section}}$

B.1.5 For a segregated scheme the insolvency calculation will be performed separately for each section of the scheme.

In any case where D&B do not have data on the number of employees for a particular employer, the Board will take the median number of employees for all the sponsoring employers in a particular scheme/section for which employee numbers are available.

If a scheme provides details on the number of members corresponding to each sponsoring employer[15] then the Board will use this information in the weighting formula, rather than the number of employees.

[15] Including a proportional share of all orphan members.

B.1.6 The precise probability of insolvency derived from calculation B will then be used in the risk based levy calculation (assuming it gives a lower probability of insolvency than calculation A).

Annex C - Risk Based Levy Forms

Introduction

To ensure that the most up-to-date information is used for the risk-based levy calculation, schemes can provide additional information to the Board, in electronic format, on a voluntary basis.

All completed forms should be returned to the Pension Protection Fund by 31 March 2006.

The following forms can be completed electronically on the Pension Protection Fund website by accessing the risk based levy section on the Home Page and by following the link to risk based levy forms:

- The Section 179 Valuation Certificate;
- The two-part Declaration of Scheme Structure and Participating Employers form;
- Actuarial Certificate of Deficit Reduction Contributions.

The contingent asset certificates are currently in draft form. They will be made available on the risk based levy section of the Pension Protection Fund website to complete electronically by 23 January 2006.

Pension
Protection
Fund

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

Please quote reference PPF0507.

Telephone: 020 8867 3297
Email: pensionprotectionfund@ecgroup.uk.com

www.pensionprotectionfund.org.uk

©The Board of the Pension Protection Fund 2005

Ref: PPF0507

CDS/500027