



THE PCS ALERT

The latest in DB Pensions

THE PPF LEVY IS COSTING SHAREHOLDERS MILLIONS AND IS OUT OF CONTROL. WHAT CAN BE DONE ABOUT IT?

Dear Sid

Strong equity markets meant that 2006 was a good year for pension schemes. But despite improvement in pension scheme funding levels, companies are facing huge increases in Pension Protection Fund (PPF) levy premiums. The total levy which the PPF Board plans to collect for 2007-8 is £675 million. This is more than double the amount it collected in levies last year. Some pension schemes are likely to see a quadrupling in their PPF levy.

Companies have only recently paid the 2006/07 PPF levy. Was this a fair premium to pay to provide some protection for employees' pensions or was it just another unnecessary burden on companies? Whatever your thoughts, the very significant increase in next year's PPF levy will inevitably fuel further debate.

To add to the confusion, the European Court of Justice (ECJ) has just delivered its long awaited ruling in the case of Carol Robins and others vs Secretary of State for Work and Pensions, concerning the protection that is given to members of insolvent pension schemes on the failure of the employer (i.e. the ASW case).

The ECJ has ruled that the system established by the UK for implementation of the European Directive, i.e. the introduction of the Financial Assistance Scheme and the Pension Protection Fund, "does not constitute proper implementation of Article 8 thereof". Whilst the ECJ has said that less than 100% protection is acceptable, the UK Government is likely to be forced to make changes to improve the protection provided by the Financial Assistance Scheme (potentially by extending the PPF) and also, possibly, the Pension Protection Fund (by improving benefit levels). This could lead to further significant increases in future PPF levies.

The PPF levy payment is a function of the deficit in the pension scheme and the Dun & Bradstreet (D&B) credit score of the company. Both of these are highly volatile measures making management of the PPF levy difficult. But that is no excuse for companies to sit back and hope for the best. Action is required now. Indeed, as the D&B score is a relative score, a failure to act could see a decline in the score (and a significant increase in PPF levy) simply as a result of the action taken by other companies to improve their score.

Why has the PPF increased its targets?

Part of the reason for the significant increase in PPF levies is down to the £343 million deficit, which the PPF revealed in its first Annual Report and Accounts, as at 31 March 2006. In addition, the initial target for the 2006/07 levy was £575m; but with favourable market conditions at 31 March 2006 and some companies taking steps to reduce their levy, the PPF estimates it will collect no more than £320m.

To add to these problems, a number of companies have found intricate ways of creating an insolvency event to get their pension scheme in to the PPF and many more are likely to do so this year. The liabilities the PPF are already considering taking over are much higher than their initial estimates. Inevitably, companies will have to pay for this through higher levy payments.

How will the PPF collect more money?

The PPF Board is proposing changes in the method of calculating the levy, which will mean that the burden of the levy increases will fall more heavily on the least well-funded pension schemes. We believe that some pension schemes will see a quadrupling of their PPF levy - for a number of schemes it could be worse still. This will give greater incentives to companies to improve pension funding levels. But for some companies this may not be an option and other solutions must be sought.

The key changes in the PPF levy calculation are:

- The scaling factor, which has a significant effect on the PPF levy, is proposed to increase from 0.53 to 2.02. The final figure will be set at the end of April 2007, once the PPF has sufficient information to ensure it collects the full amount of the levy. For companies with a failure score below 95, this will have a significant impact on the cash required for next year's levy.
- The scheme-based levy multiplier is increasing by 40% (i.e. the flat part of the PPF levy, which all schemes pay irrespective of any pension deficit, will increase by 40%)
- Recent improvements in stock markets will not be taken in to account, as pension scheme deficits will be measured at 31 October 2006 (although it will be possible to get credit for additional deficit funding paid after 31 October).

- The PPF plan to double the levy companies pay this year.
- The PPF collected only 55% of the amount it targeted last year.
- Pension deficits are falling, but the PPF is taking over a significant number of liabilities.
- The PPF had a deficit at 31 March 2006 of £343 million.
- Recent ECJ ruling may make matters worse.
- Companies that are prepared can reduce their levy now and in future years.

- The cap on the PPF levy is increasing 150% to 1.25% of the pension scheme's liabilities. This levy cap benefits those with large deficits, or a low D&B rating. Previously this cap was set at 0.5% of the scheme's liabilities.

These changes (particularly the increase in the levy cap) will be a significant burden on those companies who are already in the most difficulties with soaring pension debts. It also represents a shift in the balance of who pays for the PPF protection. Those who are perceived to represent a much higher financial risk on the PPF will be asked to pay a greater share of the cost of the PPF.

The PPF levy formula

For a pension scheme in deficit, the basic formula for the next levy is currently projected to be:

$$\text{PPF levy} = \{ L \times 0.0195\% \} + \{ (1.05L - A) \times 0.8 \times 2.02 \times \text{IR} \}$$

where L = PPF liabilities
A = Pension assets
IR = Insolvency risk, as determined by the D&B failure score.

Examples

We have chosen three typical pension schemes in different positions to illustrate the impact of the levy change. Last year's levy calculations for these schemes are as follows:

Scheme A		Scheme B		Scheme C	
PPF liabilities	= £100m	PPF liabilities	= £70m	PPF liabilities	= £180m
Assets	= £90m	Assets	= £55m	Assets	= £120m
Deficit	= £10m	Deficit	= £15m	Deficit	= £60m
D&B score	= 95	D&B score	= 75	D&B score	= 25
2006 levy	= £33,300	2006 levy	= £93,300	2006 levy	= £693,700

Assuming no changes in D&B ratings, this year's levy calculations for these schemes will look very different:

Scheme A		Scheme B		Scheme C	
PPF liabilities	= £100m	PPF liabilities	= £70m	PPF liabilities	= £180m
Assets	= £95m	Assets	= £60m	Assets	= £130m
Deficit	= £5m	Deficit	= £10m	Deficit	= £50m
D&B score	= 95	D&B score	= 75	D&B score	= 25
2007 levy	= £68,500	2007 levy	= £245,900	2007 levy	= £2,214,000
% of 2006 levy	= 206%	% of 2006 levy	= 264%	% of 2006 levy	= 319%

So despite material reductions in deficits in all the above schemes, PPF levies have soared, with 2007 levies increasing to between 200% and 300% of 2006 levies. For companies with pension difficulties, these numbers are going to make very uncomfortable reading.

What can be done?

PCS is working with a number of companies to help them reduce their levy payment next year and beyond. Time is short though and actions need to be taken over the next 2 months. The PPF showed last year that they will not accept any late filings.

The calculation of the liabilities on which the levy is based is not an accurate assessment. The PPF make many sweeping assumptions. PCS can analyse the specifics of a pension scheme and determine whether providing additional information to the PPF will help reduce the levy. Failure scores are volatile, a change from 100 to 99 can increase the levy by more than 50%. PCS is helping companies understand the factors which affect their score. In very many cases action is still possible to improve D&B failure scores in time for the next levy calculation.

PCS is helping companies analyse the financial impact and pros and cons of changing the pension scheme funding plan, in order to reduce the burden of the levy. PCS are also working with companies on alternatives to pension scheme funding, such as credit insurance and bank guarantees, which can also reduce levy costs.

Companies that are prepared can reduce their levy now and in future years. Companies that just accept the massive increase in levy and do nothing about it, are simply throwing shareholders' money away.

Yours sincerely



Rob Dales

For further information on the services PCS can offer you, please email us at solutions@pensionstrategies.co.uk or visit our website at www.pensionstrategies.co.uk to register your interest. Alternatively call Charles Cowling on 0161 242 5388 or Peter Redhead on 020 7309 8198

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