Grant Thornton Pensions Advisory podcasts

4. Issues around the PPF Levy: transcript

Welcome to the series of Grant Thornton's Advisory Pensions Podcasts.

In this second edition, we will be looking specifically at some of the PPF levy issues facing Trustees and Sponsors.

To make sense of those issues, I'm joined by my colleagues from the Pensions Advisory team, **Kevin Hollister** and **Jamie Mackenzie**, both of whom are very experienced pensions specialists - Kevin is a qualified actuary and Jamie a Chartered Accountant - but both have worked over many years advising a large number of Trustees and Sponsors on their Schemes

Russell Jamie, my first question to you: in simple terms what is the Pension Protection Fund?

Jamie The Pension Protection Fund is a lifeboat fund that was established by the Government via the Pensions Act 2004 and it does is it pays compensation to members of all eligible Defined Benefit pension schemes in the case where their employer or employers have become insolvent. And to fund the PPF there is a PPF Levy which is a compulsory levy which is annually charged to all eligible DB pension schemes in the UK.

It's akin to an insurance premium where the amount you are required to pay is dependent on the sum you insure and the probability of you making a claim so the probability of your scheme entering the PPF.

Russell There is presumably a complex calculation - how is the PPF levy calculated on an annual basis?

Kevin There are two parts to the levy: there's a part that is the Risk-based levy and a part that is the Scheme-based Levy which is based around the membership of the Scheme and is pretty much fixed. So then you have the Risk Based Levy which is usually the larger component and that is determined by the amount of Underfunding Risk within the Scheme and the Insolvency Risk within the Scheme

The Underfunding Risk is essentially the deficit which exists on a prescribed basis, and that is smoothed over a 5-year period so it's an average over a 5-year period using those market conditions

The Underfunding Risk also takes into account exactly how the assets may move if there as a shock to market conditions so market conditions are stressed and you can see if the deficit was to become larger.

The Insolvency Risk is more round an assessment of how likely it is that the Employer may fail over the period. And this is calculated using scores from Experian for each employer with a DB scheme. So the higher the underfunding and the insolvency risk, the higher the PPF Levy will be.

Essentially, as Jamie touched on, it's like an insurance premium. There's a sum insured and the probability of making that claim.

Russell But there have been some changes in the last few years which have affected the PPF levy and what schemes have to pay?

Kevin There have been a number of changes over the years, the largest change came in in around October 2014 where the PPF changed the methodology for calculating the Insolvency score.

They moved from using the old D&B, Dun & Bradstreet methodology, to a new PPF-specific Experian methodology so they changed the Credit Rating adviser. So under that methodology, each Employer is allocated to a scorecard and that will depend on whether you're a Not-for-Profit, the relative size of the business, and within each scorecard, there a number of financial variables, say 5 to 7, and those can range from mortgage age, change in turnover, parental strength, level of fixed assets, those kinds of financial metrics. Basically each one of those metrics will be given a different weighting for different scorecards and that will drive the insolvency rating that you will get

Russell Is it possible then to consider each of these individual variables in detail and therefore understand the insolvency score better?

Jamie Yes that is really the first level of any calculation . It's important to understand how much of the maximum possible score you can get in each variable. It's possible to consider what would happen if you were able to improve that individual variable and what impact that would have on the Insolvency score and thereafter the individual PPF Levy that you'd be due to make.

We have seen cases where improvements to the individual variable has reduced the insolvency score by a large degree and by that I'm talking about millions of pounds but in other cases we've seen where it's moved by tens or hundreds of thousands. In all those cases though it has been material to both the scheme & employer to make those changes.

Russell What about PPF guarantees, how does that work?

Kevin PPF Guarantees is where another Employer in the Group with a better Insolvency score will provide a Guarantee certifiable to the PPF. Then that employer's score can be used in the calculation of most or all of the Levy.

In order to do that, the Trustees need to certify that in the event of insolvency, the entity that is providing the guarantee is able to actually meet that guarantee in an insolvency. Or if it is not able to meet that guarantee, then it can certify the level it could meet on insolvency.

Essentially coming back to this insurance premium analogy, you are reducing the probability that a claim will be made, reducing the risk of insolvency, and therefore there should be some benefit to the Levy. You should see a reduced amount payable to the Levy.

Jamie The PPF encourage it, because it mitigates the risk of there being a claim on the PPF by an Employer putting forward another company to guarantee if it goes insolvent. It reduces the chance of a claim on the PPF so therefore you should get a benefit in your PPF Levy payment.

Russell Are there any other ways you can reduce the Levy?

Kevin If we talk about the other side of the equation, so if we look at Underfunding risk, which again coming back to that insurance analogy, is really the premium size. There are many ways to reduce the level of underfunding risk like Deficit Reduction contributions where in the calculation of the underfunding risk at any point in time you can allow for contributions that have been paid to reduce the deficit since the last formal funding assessment was made.

You can look at bespoke investment tests where we mentioned earlier that the assets and liabilities can be stressed for changes in market conditions. If the assets are well hedged and they perform well under those stresses, you can get some allowance for that, which can help reduce the Levy.

You can also get credit for contingent assets or asset backed funding arrangement. On the subject of Asset backed Funding arrangements they have to go through a process where they are audited so that they are acceptable to the PPF. We have worked with many Scheme through that audit process so that they are able to be allowable by the PPF in the calculations.

Russell Where do you feel that Employers can improve how they deal with their PPF levies?

Jamie I think the first stage as we mentioned earlier is to understand the granular details that make up the levy because small changes to these individual variables can drive a big difference in the actual Levy payment and the amount that is required to be paid.

We find that many employers consider these variables and their expected PPF levies shortly before March each year. The final insolvency score is actually calculated in March but it is actually calculated monthly over the year. Therefore on many occasions there is little that can be done at the final stage so ideally we think Employers and Trustees should be monitoring their insolvency risk and expected Levy throughout the year. That way you can consider if there is a change in your Levy score or change in your Insolvency score you can act promptly and proactively and try and improve it as soon as possible or what is driving that change.

Russell Have you got any examples of where we have helped reduce or better manage the Levy payment?

Kevin If you look at their scores over the whole year and you have some flexibility for example in when you can submit accounting information, you can look at whether the submission of that accounting information improve or reduce my insolvency score and what effect will it have on the Levy. Now if it's going to reduce the Levy or improve your monthly score, then you are almost better off providing that information as soon as possible, if you have the flexibility to do that. If it looks like it's going to increase your Levy, then you can look to defer submitting that information for as long as possible, again if you've got the flexibility to do that.

Jamie It's really just finding that optimum submission time for each sets of accounts really. Another example is when you think about corporate restructuring, sometimes the levy isn't really in consideration at that point and you're thinking about the benefits of this corporate restructuring, but actually if you have not taken into account the Levy, an adjustment to the corporate structure which reduces the Insolvency score could actually end up being less beneficial in making the whole restructuring less feasible from that perspective.

Another recent example was where we looked at a mortgage a company had taken and the impact of the Levy on this was effectively that it added 5% interest onto the mortgage. They would have been much better to fund that through other mechanisms rather than taking out a new mortgage because of the impact on the variables and the resulting insolvency score.

Russell Do we have an overall message for Employers and Trustees about the Levy?

Jamie Overall I'd say it's really about being proactive and understanding throughout the year the likely levy you think you're going to have and taking actions when it might change.

Kevin Many Employers and Trustees as well, they look to get an estimate of their expected PPF Levy late on in the year and they pay for that estimate, but

really monitoring it throughout the year, there's very little additional cost in doing so and you get all the benefits of acting beforehand, of acting before you submit the accounts and the information, or if there is a change in your Insolvency score for whatever reason, it can be reasonably investigated quickly at that time rather than waiting till the end of the year when to be quite honest there's little that can be done to improve past Insolvency scores that have already occurred throughout the year.

Both, thank you for your time and thanks for joining us. As usual you can find all the information you will need on this complex subject, including a transcript of this podcast, on our web pages at **http://www.grantthornton.co.uk/pensionsadvisory**