

The price of protection

With proposals for the Pension Protection Fund's risk based levy now up for discussion, charities offering defined benefit pension schemes are well advised to get in on the consultation if they hope to influence change on the potentially hefty charges they will have to pay. Christopher Andrews examines what the proposals entail

Pensions have, in the past, not generally been considered the most interesting of topics, so who'd of thought they'd become normal dinner party conversation and front page news. This change in perception is largely due to the high profile series of companies going into administration over the past few years, from ASW to Alders to MG Rover, leaving thousands of people high and dry with no retirement provision after working for a company for decades.

The government did not fail to take notice of this social injustice, and responded with the introduction of the Pension Protection Fund (PPF). Finalised in the 2004 Pensions Act, the PPF aims to protect the pensions of workers whose companies have gone bust. It resembles a similar scheme in

American called the Pension Benefit Guaranty Corporation, which it may be worth noting is currently in deficit to the tune of \$23 billion, partly because of the massive liabilities of airlines United and US Airways being foisted on it. Worse to come, the US director of the Congressional Budget Office now predicts a \$71 billion deficit for the PBGC in the next decade.

There is a key difference between the PBGC and the PPF, however, with the former collecting a flat rate levy per defined benefit pension scheme member of \$19 (expected to rise to \$30 in light of its deficits), and the latter being 80 per cent funded by a risk based levy.

And it is that levy which is currently up for discussion. Proposals for how the first year's levy should be calculated were published in mid-July, with the new levy to be introduced "as early as possible" during the financial year 2006/7. It will initially be calculated by looking at a scheme's level of funding – or underfunding – and the insolvency risk of the scheme's sponsor.

The levy will also be capped at a fixed percentage of a scheme's liabilities, expected to be 3 per cent, which the PPF is adamant in saying will protect smaller companies or weaker schemes.

The funding level bit of the equation will be measured by taking account of the difference between the value of assets

and PPF liabilities rather than FRS17 liabilities. This actually works out a bit more favourably as the PPF calculation doesn't take account of future accrual and the discount rate is calculated with gilt yields rather than the typical rate based on corporate bond yields.

The insolvency risk element is a different kettle of fish, and for charities, which obviously have an organisational structure dissimilar to corporate entities, it is difficult to tell exactly how this will be determined.

The idea is that employers are going to be put into risk bands ranging from one to ten, the top of that group, with the highest potential of defaulting and therefore calling on the PPF, paying the highest fees. "And we're going to ask a credit risk organisation to provide this market solution which allows us to estimate the likelihood of an employer becoming insolvent over a one year period," says the PPF's director of investment and finance, Partha Dasgupta.

"We're aware that charities, in the sense of the way that they are organised, clearly may represent a different form of organisation," he says, pointing out that the firms being considered to provide the solution with which the PPF has been in discussion, have already provided insolvency assessment in the not-for-profit sector.

Aidan O'Mahony, managing director, head of pension services in Europe at the credit rating firm Standard & Poor's, however, says that a model will need to be created in order to carry out credit ratings for charities because the precedent isn't there. "Someone like S&P is used to, say, analysing oil companies. We don't have many requests to rate charities. So we'd have to build a one off methodology."

"And it is not so easy to build a model driven approach," he says. "If we had 1,000 charities of which ten defaulted every year, we could start modelling it mathematically with that information. To my knowledge, charities don't tend to default, unlike companies. Their sources of revenue and their expenses are quite different to corporates. So you're finding you have to do an analysis in a sector that doesn't behave like the normal corporate world."

Robert Hayes, head of Merrill Lynch Investment Mangers' Strategic Advice Service, says that while he's not sure how the credit rating for most charities would stack up, nevertheless "the presumption is that the charity sponsor, I suspect, will not be exempt from this" he says. "They might argue about what the nature of their covenant is and what their credit rating is, but they are going to have to pay this levy. The good news is that the levy will be capped at three per cent – the bad news is that if you roll that up every year it's actually quite a lot of money."

The PPF also has plans to add other variables in future to determine the levy, including asset allocation. Dasgupta says the PPF would consider an approach that is consistent with the risk framework used by banks and insurers, including some variety of self-assessment looking at assets relative to liabilities, how those assets will behave, and how the level of volatility can be measured.

"We decided to defer [the asset allocation variable] introduction because the regulator will be introducing the scheme funding objective this year, and we didn't want to place an additional burden on collecting information when other changes were happening," he adds. "We will be looking to introduce it as soon as possible after that."

Speculation

Now while we can talk hither and thither about levy calculation, the problem at this point is that everything is somewhat speculative as the PPF doesn't have an exact figure of how much it actually wants to raise annually. Its initial figures said £300 million, but as Paul Reynolds, spokesperson for the PPF points out, those figures are from 2003 and time has marched on

since then. "Interest rates have changed, mortality rates have changed, so those factors need to be taken into consideration so that we have a realistic figure."

He also says the PPF board does believe the amount will be higher than £300 million, but does not yet know how much higher. There are figures being bandied around, however. The consultancy Hymans Robertson, for example, based on its interpretation of information from the PPF consultation document, has put a figure of £1.5 billion or higher.

Charles Young, a partner at Hymans, said: "The PPF has laid down some markers to a debate that will continue into the Autumn. Although there is broad support for the principles of a risk based levy, we will have to wait to see whether the detailed proposals get watered down. In the meanwhile, pension schemes and their sponsors will have to sweat it out. PPF levies are going to rise – possibly very substantially. The timing and missing details, however, make it extraordinarily difficult for anyone to decide how to act in the meanwhile."

One potential way of acting is to follow suit with Barnardos, reportedly facing an annual levy of £4.5 million, which called for an urgent meeting to work out a resolution with Secretary of State for Work and Pensions, David Blunkett. Barnardos said that an annual bill of the size it was expecting would result in having to scale back projects, potentially reduce staffing and re-consider their staff pension arrangements. (At time of press there was still no word on what Mr Blunkett was going to do, but a DWP spokesperson told Charity Times that "a lot of it is being dealt with by the PPF and it is obviously up to them how they collect the levy and from whom").

The potentially good news for Barnardos, and other charities offering defined benefit pension schemes, is that nothing is yet written in stone. Back to the current speculative nature of things, the PPF is quick to point out that we are in a consultation period and there is still potential for re-thinking how the levy will be determined. What this means is that charities must get involved in the consultation, particularly concerning the insolvency risk variable, or they will only have themselves to blame for the sky-high annual insurance bill.

The consultation period closes on 4 October 2005 with a summary of responses to be published by 30 November. Go to http://www.pensionprotectionfund.org.uk/rbl_consultation.pdf for the full consultation document and details of how to get involved

