Title:
The Pension Protection Fund Compensation Cap amendments
IA No: DWP0038

Lead department or agency:
Department for Work and Pensions

Other departments or agencies:

Impact Assessment (IA)

Date: 25/03/2013

Stage: Final

Source of intervention: Domestic

Type of measure: Primary legislation

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Summary: Intervention and Options

RPC Opinion: GREEN

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
-£0.6m	-£139.3m	£8.7m	Yes	IN

What is the problem under consideration? Why is government intervention necessary?

The Pension Protection Fund (PPF) pays compensation to members of underfunded defined benefit occupational pension schemes compensation where the employer has become insolvent. Anyone below the scheme pensionable age at the point of insolvency gets 90 per cent of their accrued pension, subject to a maximum cap. Long serving scheme members see their retirement income disproportionately affected by the compensation cap.

What are the policy objectives and the intended effects?

To re-structure the compensation cap so that individuals with long service in a scheme which enters the PPF receive a higher compensation cap. Anyone who has been a member of a scheme for 21 years or more will have the compensation cap applied to them increased by 3% for each full year of membership over 20 years. There will be a maximum compensation cap of double the base cap.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

A non-statutory approach is not an option, as entitlement to compensation comes from the 2004 Pensions Act.

Two options were considered in detail: Option 1: Have a compensation cap which goes up according to length of service and Option 2: do nothing. The preferred option - 1 - is the one which specifically targets the identified group, without drawing in anyone else. Option 2 - do nothing - would not deal with the identified difficulty.

In addition a range of other options were considered at a high level but they did not target the identified group as narrowly and accurately as the preferred option.

Will the policy be reviewed? It will not be reviewed. **If applicable, set review date:** Month/Year

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:**	**Non-traded:**	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister: Date: 16/04/2013

Summary: Analysis & Evidence — Policy Option 1

Description: Implement a PPF compensation cap that rises according to length of service

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m) Low:	High:	Best Estimate:
2013	2014	16.5			-0.5

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.5	1		
High	0.7			
Best Estimate	0.6		9.7	**139.3**

Description and scale of key monetised costs by 'main affected groups'

This proposal gives rise to increases in the PPF's liabilities which might then be passed on to levy payers. If costs were passed on in full, levy payers would see an increase of £139.3 million in the present value of levy payments in the period to 2030. The administrative costs of altering systems, processes and communications as a result of the change is estimated to be a one-off £500,000 - £700,000 (with a best estimate of £600,000). This is also assumed to be passed on to levy payers.

Other key non-monetised costs by 'main affected groups'

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low				
High				
Best Estimate			9.6	**138.8**

Description and scale of key monetised benefits by 'main affected groups'

Certain individuals who would have seen their compensation capped under the current arrangements will now see an increase in their pensions equivalent to a present value of £138.8 million at the aggregate level. Assuming the costs are passed on in full, this represents a simple transfer of funds from levy payers to current or future scheme members receiving compensation from the PPF.

Other key non-monetised benefits by 'main affected groups'

Reinforces the "it pays to save" principle, as long serving members of defined benefit occupational pension schemes will know that, should the worst happen, they will get this membership recognised.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

Certain assumptions (detailed in the evidence base) have been made about future claims on the PPF and future decisions about how the levy will be collected. In addition, the estimates are significantly influenced by the current level of Defined Benefit scheme funding. The estimated costs and benefits are very sensitive to these assumptions and if the reality turns out to be different from what is assumed here, the actual costs and benefits could vary considerably.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 8.7	**Benefits:** 0	**Net:** 8.7	Yes	IN

Evidence Base

Background

The Pension Protection Fund (PPF) was established under the Pensions Act 2004 as part of the Government's pensions protection structure.

Where an employer which is sponsoring a defined benefit occupational pension scheme experiences an insolvency event the attached pension scheme generally winds up, discharging its liabilities towards its members by, for instance, buying annuities which will provide the accrued pensions. However, it is possible that the scheme will have insufficient funds to fully cover its liabilities to its members.

Where this is possible, the scheme enters what is called the PPF "assessment period" during which it is tested to see if it can provide benefits at least as good as the PPF level benefits (see below). If it cannot, the scheme's assets and liabilities are transferred to the PPF and it provides compensation to the scheme members according to specified terms and conditions given in Schedule 7 of the 2004 Pensions Act.

Funding

The PPF is funded from those transferred assets, investment return, recoveries and a levy on ongoing schemes. The levy is made up of two components:

- The scheme-based levy based on a scheme's liabilities to members; and
- The risk-based levy which takes account of the risk a scheme's sponsoring employer might become insolvent and the amount of compensation that might then be payable by the PPF. (underfunding risk).

Some very well-funded schemes will not have to pay any risk-based levy. All schemes will pay the scheme-based levy.

The amount to be collected through the levy and how that is distributed amongst levy payers is a matter for the Board of the PPF. The pension protection levy is charged annually; the levy year runs from 1 April to 31 March. Before the levy year begins, the Board of the Pension Protection Fund is required by law to consult if any of the levy factors or levy rates differs from the previous year's levy.

When setting the levy, the Board of the PPF takes account of its funding strategy. This published strategy is to be 110% funded by 2030 in order for it to be self-sufficient at that time. (The 10 per cent margin is to cover the risk of longevity improvements greater than the PPF's best estimate and also the residual risk of future claims.)The Board is responsible for calculating its probability of success; the level of probability is determined by taking the current funding position of the PPF as its starting point and then projecting the Fund's balance sheet forward to 2030 using a number of stochastically generated economic scenarios in its Long Term Risk Model. 1,000 projections of different economic scenarios are generated each time the model is run. In addition, 500 projections are generated on different credit or insolvency scenarios. The number of outcomes out of the total which give rise to a funding level of more than 110% (the funding target) determines the probability of success of reaching that funding target.

Compensation

The PPF compensation system provides a standard amount to all qualifying members. Anyone over their scheme pension age when the scheme enters the assessment period is paid 100 per cent, with future indexation based on the minimum statutory requirement on all ongoing schemes. Anyone under the scheme pension age when the scheme enters the assessment period is paid 90 per cent, subject to an overall compensation cap. This compensation cap was introduced for two reasons:

(i) to control costs; and

(ii) moral hazard. It was not felt to be fair that a person could take risks which resulted in the insolvency of that company, in the knowledge that their (normally substantial) pension rights would be covered by the PPF, if the worst happened.

The level of the compensation cap also has an effect on schemes which are funded above the PPF levels and wind up normally. Under Section 73 of the Pensions Act 1995, underfunded schemes which wind up are required to distribute assets to its members following a specified priority order. The relevant parts of the priority order require assets to be allocated against liabilities for:

(a) pensions, insofar as they do not exceed PPF level benefits; and, if there is any funds left,

(b) voluntary contributions made by members; and then;

(c) any other pension or benefits not yet covered.

The compensation cap is set as at age 65. It is then actuarially adjusted if a person takes their compensation at an age other than 65. This ensures equality of treatment: two people of the same age and the same accrued pension will get the same amount of compensation overall, even when one takes their compensation at age 55 and the other waits until they are aged 65.

When the PPF was established there was a significant level of analysis and consultation on what would be the appropriate level of compensation cap, before it was set at £27,777 (which, because the compensation cap is then reduced to 90% produced a compensation payment at age 65 of £25,000). This compensation cap has been increased annually by earnings. As part of the consideration the Department’s analysts provided information on pensioner income, average earnings and the type of members the compensation cap would affect most. It was judged that this level of the compensation cap was fair when compared with the amount of average pension income. In 2003 figures from the Office for National Statistics showed that the average yearly income from occupational pensions was between £4,500 and £6,500. The Department’s analysts also advised that the compensation cap would be likely to only apply to a very small number of scheme members, such as higher paid directors and managers (approx 2% of members).

Problem under consideration

There are currently 228 people in the PPF whose compensation is capped; 160 of these have service of 20 years or more (70%).

The compensation cap means members with pension entitlements above a specified amount get the same level of compensation, regardless of other differences between the members. A person who had worked for a significant proportion of their working life for one company and has, therefore, been relying on the pension from that company for a larger proportion of their income in retirement, could (all other issues being equal) get the same (capped) compensation as a person who was a member of the scheme for a short period of time and has other pension income to fall back upon.

Recently a number of schemes have entered the PPF assessment period which have a higher than anticipated proportion of potentially capped members, who have worked for the sponsoring employer for a significant proportion of their working life. It does not appear fair that such people would get the same amount of compensation as another who, because of their short service with this scheme, has had the opportunity to build up other pension income.

Example:

A person with a final salary of £80,000 in a scheme with a normal retirement age of 60 providing the normal 1/60th accrual rate. If their scheme entered the PPF when they were a month under the scheme retirement age, and they choose to take their compensation at the age 60. The cap at age 60 would be £29,867.38 (ie. the current cap of £34, 049.84 actuarially reduced for five years).

Table 1: Percentage of accrued pension covered by PPF compensation for example member

	Accrued Pension	Reduced to 90%	Compensation Paid	% of Accrued Pension
Pension with 25 years service	£33,333.33	£30,000	£26,880.64	81
Pension with 30 years service	£40,000	£36,000	£26,880.64	67
Pension with 35 years service	£46,666.67	£42,000	£26,880.64	57
Pension with 40 years service	£53,333.33	£48,000	£26,880.64	50

Rationale for intervention

The compensation cap should reflect the fact that, people who have worked for a long time for one employer should receive a higher compensation cap because the lost scheme pension is likely to have represented a larger proportion of their retirement savings.

Policy objective

Increase the proportion of the accrued pension covered by pension compensation, where a person has long service in a single scheme.

Description of options considered

A number of different options were considered:

1. Having a compensation cap, which rises according to length of service. Once this had been identified as the preferred option, we also considered:

    (a) should the person have been a member for 10; 15 or 20 years before getting the revised compensation cap; and

    (b) whether the increase for each year of service should be 3%; 2% or 1%.

2. Do nothing.

3. Deem early retirees to be pensioners and, therefore, entitled to 100 per cent uncapped compensation.

4. Stop actuarially reducing the compensation cap for early retirees.

5. Raise the compensation cap amount.

6. Insert an underpin, so all members get at least a specified proportion of their scheme pension.

Option 2 was rejected, as it would not address the difficulty and a non-statutory approach was not an option, as compensation entitlement is governed by legislation.

Options 3 and 4 were rejected early on, as they only dealt with a sub-group of those affected: the early retirees. However, problem identified is also experienced by those who do not retire early.

Options 5 and 6 were also rejected early on, as they applied to too wide a group. They would increase payments to those who were members of the relevant pension scheme for a short period and who, as a consequence of having the opportunity to accrue other pension income, would not be so adversely affected by the current compensation cap.

Therefore **option 1** became the preferred approach.

In many schemes 40 years service provides a full pension. Therefore, it appeared reasonable to define long service as anything over 20 years.

Calculations demonstrated that:

- 3% increase gives a compensation cap increase of £1,021 for each year over 20 years.
- 2% increase gives a compensation cap increase of £681 for each year over 20 years.
- 1% increase gives a compensation cap increase of £340 for each year over 20 years.

3 per cent was chosen as the escalation amount, as it is sufficient to lift a substantial number of the targeted group out of the compensation cap entirely, while still being affordable. Lower percentages did not achieve this outcome.

Monetised and non-monetised costs and benefits of each option (including administrative burden)

The proposal to change the compensation cap gives rise to an immediate expected increase in the PPF balance sheet liability of £70 million, approximately 0.39% of current PPF balance sheet liabilities. This is made up of a liability of:

- £37.7 million for those already in the PPF and who are either already in receipt of capped compensation, or who it is estimated will be entitled to capped compensation once they access their compensation; and
- £32.3 million estimated liability towards members of schemes currently in the assessment period, which it is estimated will eventually transfer to the PPF and will have members who will eventually qualify for capped compensation.

In addition, it is expected there will be future claims on the PPF from schemes with potentially capped members not currently in the PPF or undergoing assessment to enter it. It is assumed that these will also give rise to the same 0.39% increase in liabilities in future years, as that resulting from current capped members.

The combined impact of claims by existing capped members, potentially capped members of schemes currently undergoing assessment to enter the PPF and expected future capped members give rise to an expected increase in the PPF levy of 3.9% for the period to 2030, all other factors remaining unchanged. This has a present value of approximately £138.8 million.

The PPF has estimated there will be a one-off administrative impact of the change - such as costs to alter systems, communications materials, scheme processes - of £500,000- £700,000. This Impact Assessment assumes a point-estimate of £600,000, and that this cost is passed on in full to levy payers in the first year of the policy.

Thus, the present value of all costs (ultimately borne by levy payers) is the sum of these two elements: £139.3 million. For the purposes of this Impact Assessment we have assumed that all costs are passed directly onto the levy payers. However, there is considerable uncertainty over this - see the risks and assumptions section for more detail.

The increased compensation benefits some members who would, otherwise, have seen the existing compensation cap bite. Thus the increased costs of compensation – £138.3 million – represent a benefit to members in the PPF and, assuming this cost is passed on in full to levy payers, is therefore a straight transfer of funds from levy payers to scheme members.

This leaves a net present value of -£600,000 – the cost of the administrative changes that is passed onto levy payers; this cost is a deadweight loss.

Rationale and evidence that justify the level of analysis used in the IA (proportionality approach)

(i) Estimation of the impact on members already in the PPF or in the PPF assessment period

The PPF has liabilities in respect of schemes which have transferred their assets and liabilities into the Fund and it also has liabilities in respect of schemes where the employer is insolvent and the scheme is being assessed for entry into the PPF and is expected to enter at some point in the future. Reliable data at the individual member level is only held by the PPF after the scheme is transferred into the PPF. Schemes being assessed for entry are still administered by the scheme trustees and data on these schemes is held by the PPF only at scheme level.

The PPF obtained data in respect of those members who are currently in receipt of compensation and capped. It also obtained data in respect of non-pensioner members and, by projecting the compensation and the current level of the compensation cap to retirement age for each of those members, estimated which members will be capped in future. For this purpose the compensation cap was increased by 1.5% per annum above the rate at which compensation is increased to keep pace with inflation. This is because, before entitlement, the level of the compensation cap is increased in line with earnings inflation and compensation in payment is increased in line with price inflation (CPI) – price inflation being limited to no more than 5% per annum (2.5% for compensation in respect of service which accrued after April 2009).

With this set of pensioner and non-pensioner members the PPF was able to determine the effect on each member's compensation of applying the proposed compensation cap change. The increase in compensation was then determined by multiplying the compensation increase by an annuity factor – i.e. the cost of £1 per annum of income. As compensation in payment which accrued after April 1997 increases in line with price inflation (subject to a maximum of 2.5% pa) and compensation which accrued before that time does not increase, different annuity factors have been used for each member to increase their pre and post April 1997 compensation. To calculate the annuity factors, assumptions are required, the most important being in respect of mortality and future mortality improvements, interest rates and inflation (see attached Annex). The assumptions used by the PPF to determine these annuity factors are consistent with the assumptions used to determine liabilities for the PPF's Annual Report and Accounts 2011/12 (Annex S4, page 109. http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/ARA_1112.pdf) but based on financial conditions at the time of carrying out the estimate. Annuity factors are also significantly affected by the age of the member – but this data is given and is not an assumption.

The result of this calculation was an increase in liabilities in respect of schemes which had already transferred to the PPF of £37.7m.

For reasons described above, there is no reliable individual membership data in respect of the schemes currently being assessed for entry into the PPF. To produce an estimate of the increase in liability in respect of these members who may be capped, the PPF assumed that the liabilities for that group would increase by the same proportion as the liabilities for those schemes which have already transferred to the PPF. At the time of carrying out the calculations, the total liabilities of the PPF were £17.9bn, of which £9.7bn was in respect of schemes which had completed their transfer into the PPF. As a proportion of the £9.7bn liabilities in respect of this latter group, the £37.7m increase as a result of the new cap represents an increase of 0.39% in liabilities. Applying this same proportionate increase to total liabilities of £17.9bn yields a total increase to current and future liabilities – and therefore the immediate impact on the PPF balance sheet – estimated to be £70m, split between £37.7m in respect of members already in the PPF and the residual £32.3m in respect of members in schemes currently undergoing assessment.

(ii) Estimating the impact on members who may enter the PPF in the future

It is obviously not known today what the future claims will be on the PPF. However, the level of future claims and the proportion of members who are affected by the cap will have a significant impact on the cost of the policy and, without an estimate of this cost, the impact would be significantly understated.

It has been noted above that the impact of the increased cap on members already in the PPF, or in schemes undergoing assessment to enter it, was an increase in liabilities of 0.39 per cent. In order to estimate the impact of future unknown claims, it was further assumed that schemes that arise in future to be assessed for entry into the PPF would give rise to liabilities 0.39% higher than previously assumed in the PPF's modelling.

(iii) Total costs

These increased costs must be covered in some way. As discussed above, the PPF is funded through (i) the assets of the schemes that enter it; (ii) a levy on schemes potentially eligible to enter the PPF if the need should arise; (iii) assets recovered from the employer after the insolvency or from deals where an employer/brand takeover has occurred; and (iv) investment returns on its portfolio of assets. In reality, any one, or a combination, of these three sources of funds could cover the increased cost, but it is not possible to say today which it is.

In order to arrive at an estimate of the costs of this policy, this Impact Assessment makes the crucial assumption that it is passed on, in full, to levy payers. This is a strong assumption and may not hold in practice, because the setting of the levy on an annual basis takes into account a large number of decisions. However, proceeding in this way does allow for an upper bound to be placed on the estimated costs of this policy.

It has been noted earlier in the Impact Assessment that the PPF Board targets a probability of meeting its target of being self-sufficient (110% funded) by 2030. When asked to look at the effect of increasing the compensation cap, the PPF has used its stochastic model of funding outcomes to determine the impact that the preferred option would have on the levy, if the probability of success were to remain at its current level. The result of the PPF's modelling is that a 1% increase in current and future liabilities would require an increase in levy of around 10%. It should be noted that the levy is expected to tail off over the period to 2030. Therefore, although PPF members will still be capped at 2030 and beyond, no future calls on schemes for levies are assumed to be made.

The PPF has estimated that the increase to current and future liabilities arising as a result of the proposed compensation cap increase would be 0.39% so that a 3.9% increase to the levy would be required.

The PPF estimates that its baseline levy in 2013/14 will be £630 million (see http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/Funding_Strategy_Review_2012.pdf, paragraph 4.12). Because the PPF is targeting being self-sufficient (i.e.110% funded) by 2030, the levy in 2030 is estimated to be zero. Between 2013 and 2030 this impact assessment assumes a linear decline in the value of the levy to reflect a reduction in the risk posed to the PPF by pension schemes in the future as the PPF's funding level increases. Given the uncertainty over the value of the levy in future years, in order to avoid imposing an assumed distribution on the future value of the levy, a simple linear decline is used, as this requires the weakest assumption about how the levy evolves. This results in the following profile of levies to be charged to levy payers in the future.

Table 2: Estimated PPF levy – baseline and under the increased compensation cap scenario, £ million, 2013 prices

	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21	21/22
Baseline	630	581	534	489	445	403	362	323	285
Inc. cap	630	604	555	508	462	418	376	335	296
Increase	0	12	21	19	17	16	14	13	11

	22/23	23/24	24/25	25/26	26/27	27/28	28/29	29/30	30/31
Baseline	248	213	179	146	115	84	55	27	0
Inc. cap	258	221	186	152	119	88	57	28	0
Increase	10	8	7	6	4	3	2	1	0

Source: DWP estimates. The GDP Deflator (with assumptions provided by HM Treasury) is used as the price deflator.

The figures above are given in financial years, because this is the basis for the levy calculations. The policy is assumed to begin in October 2014, which is halfway through the financial year 2014/15 covered by the levy in that year. As a result, the increased levy is only collected for half the financial year – hence, while the estimated levy in 2014/15 is calculated as being 3.9% higher than in 2013/14 (£604m - £581m = £23m), the increase applied is only half the amount (£12m) because the increased levy that year is only collected for half the year.

As discussed above, the impact of the compensation cap proposal is to raise the levy by 3.9 per cent – accordingly, the second line of table 2 shows the estimated value of the levy under the higher cap; the levy is 3.9 per cent higher in every year. The third line simply shows the increase in the levy – the difference between the first two lines.

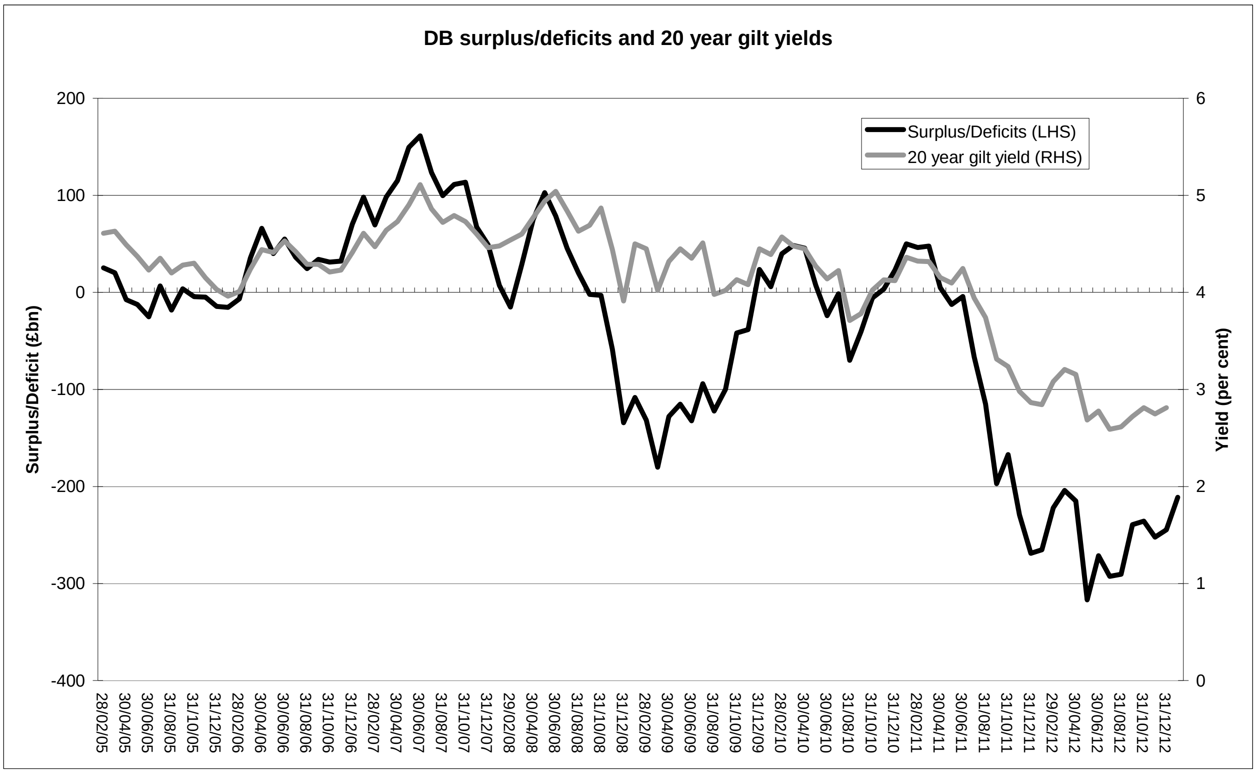
Discounting this increase in the levy back to 2014 (anticipated to be the first year of the policy) using a real discount rate of 3.5 per cent (in line with HM Treasury guidance on option appraisal in government – see http://www.hm-treasury.gov.uk/data_greenbook_index.htm) yields an estimated present value of the cost of the increased levy of £138.8 million.

Adding on the £600,000 administrative cost incurred from administration changes - such as system processes and communications (assumed to be passed on in full to levy payers in 2014) - gives the total increased cost of £139.3 million.

As noted above, the benefit to members of increased compensation is simply the £138.8 million present value figure – assumed to be a direct transfer from levy payers.

Risks and assumptions

The biggest uncertainty underlying the analysis in this Impact Assessment is the future evolution of defined benefit scheme funding levels, relative to today. The estimates are highly dependent both on the current level of scheme funding and the deficits of schemes entering the PPF in the future. The chart below shows how the level of funding on a PPF-benefits basis has evolved since the creation of the PPF in 2005, along with movements in long dated gilt yields, a key driver of defined benefit liabilities.



Source: PPF, Bank of England

As can be seen in the chart, aggregate deficits have hit historic highs over the course of 2011 and 2012, as a result of the current low bond yield environment. Because the figures in this Impact Assessment take today's historically low funding levels as a starting point, they may end up over-estimating the costs in future years if scheme funding levels recover.

Aside from this important caveat, there are two further important assumptions used in this Impact Assessment:

- a key risk to the actual cost is that members for whom the PPF has no data will be capped in the same proportion as the members for whom the PPF does have data. Furthermore the capped members arising from the group for whom the PPF has no data will be similarly affected by the proposal to increase the compensation cap as those for whom the PPF does have data. The number of members in respect of transferred schemes who are capped (or likely to be capped in future) is small compared to the number in the PPF so the estimated cost is sensitive to this assumption. It is possible that future schemes will have different proportions of capped members and so the actual costs could be lower or higher than those estimated; and

- that all the costs will be passed on to the levy payers. As described, the PPF is partly funded by way of a levy on schemes. We have assumed that an increase in the PPF liability will be fully reflected by an increase in the levy. However, caution should be exercised here, as when setting the levy, the Board of the PPF take into account a large range of different factors that exist at the time the levy is set (such as the risk of schemes entering the PPF, the level of funding if that event occurs, anticipated investment return) only one of which will be its liabilities. Thus, the estimated costs and benefits in this Impact Assessment are also highly sensitive to this assumption. Should investment return improve and/or the number of company insolvencies reduce, then some of these costs could be absorbed.

The data in respect of members who are capped and in receipt of compensation shows their compensation after they had commuted any of that compensation for a cash lump sum. The PPF does not have data in respect of amounts of compensation given up for this lump sum. In order to determine what level of compensation would have been paid had a lump sum not been taken (so that any increase can be capped at the level of uncapped compensation) the PPF assumed that members commuted on average 25% of their compensation for a lump sum. It is not expected that the actual costs would be significantly different had the PPF been in possession of the actual data, as the PPF looked at costs based on an alternative model data set which gave rise to similar costs.

When a scheme transfers to the PPF the data required to administer PPF compensation is subject to a high degree of scrutiny and cleansing before the records are finalised. Whilst the PPF holds service data, this data is not, as yet, necessary for the administration of compensation and would not have been subject to the same level of scrutiny. The PPF has assumed that the service data provided in respect of the members who have already transferred to the PPF was of adequate quality. However, the actual costs are sensitive to this assumption holding true for all member service data.

The estimation of the effect of this proposal on the costs of compensation as a result of potentially capped members of schemes which may enter the PPF assessment period in the future is highly uncertain and will depend on a large number of factors, amongst which are the number of employers which become insolvent, the level of funding in their schemes at that date and the number of scheme members below normal retirement age with high pension entitlement and long service. In assuming that the future liabilities as a result of this proposal to change the compensation cap rise in the same proportion as the increase in liabilities in respect of members currently in the PPF or in schemes undergoing assessment, much of this complexity is being assumed away. Without this assumption it is not possible to estimate the future impacts and would severely understate the impacts of the policy. Therefore we believe the assumption is defensible, but the dependency of the results on this assumption should be borne in mind.

The estimated costs and benefits in the IA are very sensitive both to the current level of DB scheme funding and the assumptions detailed in the IA. However, the IA does not include a range of estimates to illustrate the scale of this uncertainty because to do so would require additional, highly uncertain assumptions – thus adding in further layers of uncertainty.

Direct costs and benefits to business calculations (following one in, two out methodology)

The proposed change to the compensation cap constitutes a regulatory IN under the one in, two out (OITO) methodology, since it results in an increase in the PPF levy, which although paid by a pension scheme, is ultimately borne by the sponsoring employer of that scheme. Using the Estimated Annual Net Cost to Business (EANCB) formula cited in the OITO methodology, the change to the compensation cap yields an estimated annual cost to business (on a calendar year basis) of £8.7 million. That is, the regulatory IN from this measure is around £8.7 million a year.

Wider impacts

Costs to business

We believe there will be no impact on micro businesses, as these are unlikely to provide a defined benefit pension scheme for its employees. Similarly, it is rare for a small business to run a defined benefit scheme. It is therefore believed the costs of this proposal to small and/or micro businesses would be negligible.

Age

Older workers are most likely to be affected by the current compensation cap, because a person would require a final salary of between £45,000 (on 40 years service) and £90,000 (on 20 years service) for it to bite. The increase in the compensation cap is most likely to benefit older high earners, because of the 20 year qualifying period.

Sex

While the proposal applies to men and women equally, men are most likely to benefit as they are more likely to be members of a defined benefit scheme, to be a member for a significant period and to have higher earnings.

Summary and preferred option with description of implementation plan.

The current compensation cap will remain as the base cap applied to all relevant members of the PPF. Where a person has 21 years or more service in the scheme this base compensation cap will be increased by 3 per cent for each full year above 20 years. Service transferred from a previous scheme will count towards the qualifying periods, because these people have, effectively, been relying on this single pension scheme for their retirement income. Where a person has a scheme pension which does not equate to a period of service (for instance, some individuals who have been given part of a pension during a divorce settlement) will have a deemed period of service for these purposes.

Those in the PPF will be moved onto this method of calculating the compensation cap. Those who are in receipt of a payment will, where appropriate, have their payments increased with effect from the April following the legislation coming into force, based on 3 per cent of their original compensation cap for each full year over 20 years.

The PPF is operated by the Board of the PPF. It employs a commercial company to determine and pay entitlement to compensation (currently Capita).