EXPLANATORY MEMORANDUM TO

THE PENSION PROTECTION FUND AND OCCUPATIONAL PENSION SCHEMES (LEVY CEILING AND COMPENSATION CAP) ORDER 2012

2012 No. 528

1. This explanatory memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.

2. **Purpose of the instrument**

This Order increases two amounts used for the Pension Protection Fund (PPF). The increases ensure that rises in average earnings are taken into account in the value of these two amounts, so that they retain their value. The two amounts are:

- the compensation cap, which helps control PPF expenditure by limiting the amount of compensation payable by the PPF, and

- the levy ceiling, which controls the maximum amount of levy the PPF can charge pension schemes.

3. **Matters of special interest to the Joint Committee on Statutory Instruments**

None.

4. **Legislative Context**

4.1 The Board of the PPF is required to charge a levy to defined benefit occupational pension schemes (and the defined benefit element of hybrid schemes) to fund the compensation it will pay to schemes' members if their employer becomes insolvent and the scheme is underfunded below a certain level.

4.2 The Secretary of State is required to set a levy ceiling preventing the PPF from raising the levy above a set maximum. The current ceiling of £892,092,092 came into effect on 1st April 2011 (S.I. 2011/841). http://www.legislation.gov.uk/uksi/2011/841/pdfs/uksi_20110841_en.pdf

4.3 The Secretary of State is required to uprate the levy ceiling annually in line with the general level of earnings in Great Britain (unless there is no increase in the general level of earnings). The Secretary of State has reviewed the general level of earnings and concluded that earnings in Great Britain have risen by 3 per cent during the year from 1st August 2010 to 31st July 2011.

4.4 The 3 per cent figure was obtained from the Office of National Statistics, is not seasonally adjusted and does include bonuses and arrears. The same method of calculating the general level of earnings is used to uprate the Pension Protection Fund compensation cap (see below).

4.5 The ceiling is uprated in line with average earnings as this is the closest approximation to the increase in a scheme's liabilities. A person's earnings are a significant factor in determining the level of their pension, which in turn determines the level of pension compensation they are entitled to from the PPF.

4.6 This Order specifies that the increase in the general level of earnings for the year ending on 31st July 2011 is 3%. It also specifies that the amount of the levy ceiling for the financial year beginning on 1st April 2012 is £918,854,855. It uses the 3% increase in the general level of earnings to calculate the new levy ceiling.

4.7 This Order also sets out the level of the compensation cap for the PPF from 1st April 2012 as a result of a review by the Secretary of State of the general level of earnings in the 2010/2011 tax year.

4.8 The Secretary of State is required to make an Order to increase the amount of the compensation cap. This requirement arises where he concludes that the general level of earnings in Great Britain has gone up over the period of a tax year (see section 148(2) of the Social Security Administration Act 1992). http://www.dwp.gov.uk/docs/a1-1801.pdf

4.9 The Secretary of State has reviewed the general level of earnings in Great Britain for the purposes of determining the amount of the compensation cap. He concluded that the general level of earnings for the period from April 2010 to April 2011 (i.e. the 2010/11 tax year) exceeded the general level of earnings at the end of the period taken into account for the last such review by 2.5 per cent. The period for the last such review, for the purposes of the current Compensation Cap Order (S.I. 2011/840), was the 2009/2010 tax year.

4.10 The level of compensation payable by the Board of the PPF to members who are below their scheme's normal pension age is normally limited to a maximum of 90 per cent of the compensation cap.

4.11 Average earnings increased by 2.5 per cent in the 2010/2011 tax year. That percentage is applied to the current compensation cap, which provides an uprated cap of £34,049.84. When applying the 90 per cent provision to that uprated cap it will provide, at age 65, a maximum level of compensation of £30,644.86.

4.12 The Secretary of State has made two measurements of the general level of earnings for the purposes of this Order. In previous years, he has used for these measurements the Average Earnings Index (AEI) statistic produced by the Office of National Statistics (ONS). However, the ONS has replaced the AEI with the Average Weekly Earnings (AWE) statistic. The AWE is now the lead measure of earnings in the UK, and AEI is no longer calculated or published.

4.13 AWE is a more accurate measure of earnings than AEI. This is largely because AWE more accurately reflects the level of wages across industries and sectors. Also, its calculation incorporates various methodological improvements.

4.14 In previous years, the annual uprating for the compensation cap and part of the annual uprating for the levy ceiling have been subject to the affirmative Parliamentary procedure. They are now subject to the negative Parliamentary procedure as a result of changes made by the Pensions Act 2011. This means that all the changes for uprating the compensation cap and the levy ceiling can be included in this Order. In previous years, they were included in three separate Orders.

5. Territorial Extent and Application

This instrument applies to Great Britain.

6. European Convention on Human Rights

As this Order is subject to the negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- ***What is being done and why***

7.1 The Pensions Act 2004 established the PPF, which is a fund run by the Board of the PPF, from 6th April 2005. The PPF was set up to provide compensation to members of eligible defined benefit occupational pension schemes. It provides compensation where the employer has a qualifying insolvency event, there is no possibility of a scheme rescue and there are insufficient assets in the scheme to pay pension benefits at PPF compensation levels. An insolvency event is typically when an employer does not have sufficient funds to pay its debts, buy goods, etc.

7.2 The PPF provides two levels of compensation:

- The first is for individuals who have reached their scheme's normal pension age or, irrespective of age, are either already in receipt of a survivor's pension or a pension on the grounds of ill health. The PPF will pay for them a 100 per cent level of compensation (i.e. compensation at the same level as their pension would have been), subject to PPF rules;

- The second is for the majority of people below their scheme's normal pension age. The PPF will pay for them a 90 per cent level of compensation subject to the compensation cap and PPF rules.

7.3 The compensation cap is a limit on the compensation that can be paid by the PPF to a single member who is under the normal pension age of the scheme at the assessment date and who is not in receipt of a survivor's or admissible ill-health pension. The compensation cap is one of a number of measures which helps to control PPF expenditure to enable sustainability of the PPF. It encourages high earners, who may have an influence over their scheme, to try to ensure that the scheme does not enter the PPF. This is achieved by limiting compensation to a level of 90 per cent and applying the compensation cap, for the majority of members under normal pension age. (The assessment date is the start of the procedure by which the PPF assesses whether the scheme can enter the PPF.)

7.4 The PPF is funded by a number of sources including:
- the pension protection levy that is charged to eligible defined-benefit schemes occupational schemes;
- the remaining assets of schemes that enter the PPF;
- funds recovered from insolvent employers; and
- investment returns on the PPF's assets.

7.5 The pension protection levy is comprised of a risk based levy (required by law to be at least 80 per cent of the total) and a scheme based levy making up the remainder. The scheme based levy is calculated using the level of a scheme's liabilities and the risk based levy is calculated using the level of a scheme's underfunding and the likelihood of insolvency for that scheme.

7.6 The levy ceiling prevents the Board of the PPF from raising the total pension protection levy above a certain amount. The ceiling is set at a level that is sufficient to allow the Board of the PPF to raise a levy that ensures the safe funding of the compensation it provides, whilst providing reassurance to business that the levy will not be above a certain amount in any one year.

- ***Consolidation***

7.7 The compensation cap and the levy ceiling are uprated annually in line with the general level of earnings in Great Britain. This Order does not amend any previous instruments. Consolidation is therefore not appropriate in these instances. However, DWP includes a copy of this Order in the Blue Books, which are available for free on the internet at: http://www.dwp.gov.uk/publications/specialist%2Dguides/law%2Dvolumes/the%2Dlaw%2Drelating%2Dto%2Dsocial%2Dsecurity/.

8. Consultation outcome

Consultation on the draft Order was considered but would be inappropriate as there is no scope to change the Order as a result of consultation. In addition, the Order represents no policy shift; it simply enables routine annual uprating.

9. Guidance

No guidance is being issued on this instrument since it is largely based on existing legislation. The Department for Work and Pensions (DWP) will have copies of the instrument and be in a position to explain it to members of the public.

10. Impact

10.1 This Order amends the existing regulatory regime by a pre-determined formula and has no new direct impact on the private sector or civil society organisations.

10.2 This Order has only a negligible impact on the public sector.

10.3 A full impact assessment has not been prepared for this instrument.

11. Regulating small businesses

This instrument has no new direct impact on small businesses.

12. Monitoring & review

This Order is monitored by the DWP and the PPF and reviewed every 12 months.

13. Contact

Any queries regarding these instruments are to be directed to Maria Meyer at the Department for Work and Pensions Tel: 020 7449 7683 or e-mail: maria.meyer@dwp.gsi.gov.uk