Pension Protection Fund

Combined Third Triennium Policy Statement and 2018/19 Consultation Document

September 2017

Foreword

In my foreword to our March consultation - which set out our initial proposals for the next three years - I noted the particularly challenging environment in which the PPF is operating. Six months on and a high degree of political and economic uncertainty persists and scheme deficits remain high.

However, whilst the risks we face are significant, our financial position remains sound. Our funding level has increased and we remain on track to meet our long term funding target. As a result, we are able to announce that we will seek to collect £550 million for 2018/19 – a reduction of more than 10 per cent compared to our levy estimate of £615 million for 2017/18. We aim to keep the parameters that give effect to that reduction (and on which we are consulting here) unchanged over the next three years.

Of course, an individual scheme's levy will depend not just on the aggregate amount we aim to collect but also on movements in the risk it poses to us. We have always sought to make our levy calculation methodology reflect that risk as well as we can. Our March consultation set out our plans to continue that evolution into the third triennium. The proposals looked to build on the success of the PPF-Experian model, now in its third year. We suggested using alternative methodologies - particularly credit ratings - for assessing the insolvency risk of some entities. We believe the proposals represent important improvements in our approach and were pleased the majority of respondents agreed with us.

In this document we are, therefore, able to confirm we will implement the proposals we consulted on in March, with only limited change. We are also seeking views on a small number of additional proposals - including to improve our assessment of scheme underfunding - as well as consulting on the draft rules for 2018/19.

If these rules were in place now two-thirds of schemes would have seen a decrease in their 2017/18 levy, with around a fifth of schemes seeing an increase. In particular SMEs would collectively have seen a reduction of around a third in their levy. This redistribution reflects the improved risk reflectiveness of the levy as a result of the changes we will be making for the third triennium. We believe they leave us well placed for the next three years with a robust, evidence based methodology.

I thank everyone who responded to our first consultation, our industry steering group and all those who help us to improve the levy. I look forward to hearing your views on our remaining proposals and draft Levy Rules.

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1. Introduction and Executive Summary

1.1 Introduction

1.1.1 In March we issued our first consultation on the third levy "triennium" (the three year period running from 2018/19 to 2020/21). This consultation focused on our proposals to develop the assessment of insolvency risk for the PPF levy. It also covered proposed changes in other areas such as Contingent Assets and the certification of Deficit-Reduction Contributions (DRCs).

1.1.2 Part I of this document summarises the responses we received on those proposals; explains the further analysis and consideration we have undertaken, and confirms our policy for the next triennium. We are not generally seeking further comment on these matters.

1.1.3 Part II forms the consultation document for the draft Levy Rules (the "Determination") for 2018/19. These rules reflect the proposals covered in Part I - including where we have made changes since the March consultation following consideration of responses. As part of our Levy Rules we are publishing the Levy Scaling Factor (LSF) and Scheme-Based Levy Multiplier for 2018/19, and the Levy Estimate. Part II also sets out proposals on levy bands and rates, and on measures designed to improve our assessment of scheme underfunding.

1.1.4 The consultation on the Levy Rules for 2018/19 will run to 1 November, and we aim to publish our conclusions and the final Levy Rules before Christmas.

1.1.5 Changes related to the measurement of insolvency risk, including the collection of credit rating and credit scoring data, may lead to changes in scores for some employers. The portal will reflect these changes when it is re-launched in early October. In addition, scores may change as schemes and employers provide new data. As indicated in the March consultation, we intend only to use scores collected between 31 October 2017 and 31 March 2018 for the 2018/19 levy year.

Part I: Policy Statement on the Triennium

1.2 Responses to the Triennium Consultation

1.2.1 Our first consultation on the third levy triennium closed in May with 74 responses. This included 47 from schemes and employers, large and small, and responses from collective stakeholders including the Confederation of British Industry (CBI), Pensions and Lifetime Savings Association (PLSA), the Institute and Faculty of Actuaries (IFoA) and the Association of Consulting Actuaries (ACA).

1.2.2 Comments primarily focused on the measurement of insolvency risk, and in particular our proposals to develop the PPF-specific insolvency risk model, though there were a considerable number of comments on proposals in relation to contingent assets.

1.2.3 In addition to the formal consultation, we have also carried out an extensive programme of engagement with stakeholders. This included holding levy roadshows around the UK, running a series of webinars - including one focussed on Small and Medium sized Enterprises (SMEs) - and a range of meetings. What we have learnt from this activity has fed in to our policy development.

1.3 Measurement of insolvency risk

Development of the PPF-Specific Model

1.3.1 We introduced the PPF-specific model - “the model” - as the basis for assessing insolvency risk for the second levy triennium, which began in 2015/16. In our March consultation we set out evidence to support our view the model is generally working well, but that there is a case for developing it further for the third triennium. We proposed rebuilding five of the eight existing scorecards – leaving unaltered the three scorecards for subsidiary companies filing full accounts. In rebuilding our aim was partly to improve predictiveness where that was relatively less strong, but also to tackle the potential for arbitrage (employers artificially altering group structures to “choose” the scorecard that scores them best) and to ensure, as far as possible, scorecards were trained on homogenous groups of employers, rather than scoring employers of very disparate size.

1.3.2 The level and nature of comments we received supports our view that the model has been broadly successful. A number of comments explicitly reinforced that conclusion. We were also pleased the general reaction to our proposals to develop the model was positive. Respondents did, however, raise a number of points for consideration and we have subsequently undertaken significant analysis including assessing a range of potential changes. As with previous levy development, we started from the principle that change should be objectively justified and not weaken the predictiveness of the model, nor reduce its robustness. We have concluded that relatively limited changes to our initial propositions are appropriate.

1.3.3 Key points raised in the consultation included:

The scope of change - on balance the proposed scope for change was supported – though some stakeholders felt we should have updated the group company scorecards or at least should have addressed perceived weaknesses (such as reliance on mortgage data) that have been eliminated in the new scorecards. In response, we considered amending or rebuilding the three group scorecards to remove the mortgage age variable, but concluded removing the variable in isolation would weaken the predictiveness of the scorecards. Also, there was little need to do so as, typically, information on mortgages is available for these populations (the concern about the mortgage variable on scorecards that have been rebuilt was largely due to the high proportion of entities for which there was no data and so a “default” value had to be used). More broadly, we concluded there was no case for rebuilding the scorecards simply because other scorecards have been; the level of predictiveness these scorecards provide remains high and we recognise the importance of retaining stability for levy payers unless there is a clear case for change. We have, however, recalibrated the group scorecards so that each is expected to produce a level of predicted insolvencies consistent with our past experience.

Impact on larger companies - Some respondents commented that the impact of changes was to worsen the scores of some larger companies and we should retain the existing scorecards. However, the worsening of scores for some larger companies reflects that the new scorecard for entities with turnover above £30m per annum will predict a level of insolvencies consistent with our actual experience. The existing scorecards had come to underestimate risks and, if they were retained, would have had to be recalibrated so that they produced scores in line with actual insolvency rates (leading to a very similar impact in aggregate for larger companies). Without doing so, schemes with other, smaller, employers would effectively be providing a cross subsidy to schemes with the largest employers in our universe.

Specific concerns with individual variables - some responses questioned whether there were individual variables that dominated scoring for some scorecards. We investigated this but concluded there were no scorecards where a single variable dominated across the whole range of scores. We also found where a variable did have a very strong influence on scores for part of the distribution, this was supported by evidence on insolvency rates.

1.3.4 A number of responses focussed on the use of logarithmically transformed variables – which, it was suggested, can mean scores are less likely to change with a moderate change in the variable value – unless the value was close to zero. It is a design feature of log variables that even a sizeable change in the variable value only has a moderate impact on the score. That they have proved the most predictive reflects, for example, a business making a profit ten times larger than another business may be lower in risk, but not ten times lower. We recognise that this may make it harder for a company to alter its score, but do not think this is necessarily undesirable. However, we do recognise that for values close to zero, log variables are far more sensitive to changes in variable value.

1.3.5 Whilst only a very small proportion of companies report values in these ranges, we have concluded that a potential solution is to smooth low values both positive and negative (where this is relevant). This creates a step change in scoring but we think it is at a reasonable point – since it distinguishes between businesses which, for example, are respectively - profit or loss making, or have positive or negative net assets. Less than 2 per cent of entities would see a change in levy band as a result.

1.3.6 Chapter 2 sets out in more detail the work we have done on assessing the model.

Alternative assessment of insolvency risk

1.3.7 A key element of the proposals set out in our March consultation was the use of alternative methodologies to assess the insolvency risk of certain employers. This is primarily through the use of credit ratings for rated entities and the Standard and Poor's (S&P) Credit Model for regulated financial institutions. In the consultation we set out evidence showing that these methodologies provided more accurate scores for our biggest levy payers.

1.3.8 Responses on the option to use credit ratings to override model scores were divided but with significantly more in favour than against, a striking change from when we consulted three years ago. In particular, the work done to map from a default risk to an insolvency risk has provided an objective basis to incorporate credit ratings. We have concluded that the use of ratings - and the analogous credit model for financial services entities - is justified by the improved predictiveness they offer.

1.3.9 A limited number of comments were received on the proposed conversion factors for turning ratings (and letter grade scores on the credit model) into insolvency probabilities and levy bands. In particular comments reflected an anecdotal view that companies with lower investment grade ratings were somewhat stronger than the implied band. However all the evidence available supports the proposed conversion factors. We also received a number of proposals seeking an extension of the use of ratings or the credit model. As set out in chapter 3, we believe it appropriate to make use of credit ratings and the credit model with the proposed scope for now, though we could consider whether there is a case for extending the use of the credit model to other regulated entities in future.

1.3.10 There was a positive response to the proposal to recognise a limited group of entities, related to government, whose insolvency risk could not be assessed by reference to financial data. A number of responses sought clarification on scope and there were some proposals for a substantial extension in scope, particularly in relation to businesses that contract with government. We have clarified the proposed draft rule to make clear that it could cover entities that are related to a foreign government, but do not consider it appropriate to broaden the definition more substantially.

1.4 Contingent Assets

1.4.1 We indicated in March, in response to specific concerns, we expected to update our standard form contingent asset agreements and to ask trustees and guarantors to re-execute agreements on the new basis, in order for them to be taken into account from 2018/19 onward.

1.4.2 In response to comments from stakeholders, and in reviewing the wider policy underlying the contingent asset agreements, we have revised our proposals. We will consult further with stakeholders before we publish a set of amended forms alongside the final Levy Rules for 2018/19. This will mean new contingent asset agreements entered into for the 2018/19 levy year will be required to be on these new forms. For existing Type A and Type B agreements, we are likely to require action to be taken for 2019/20, but will not do so for 2018/19. This change of timescale is to take the opportunity to ensure that before requiring a significant step such as re-execution to be undertaken by schemes and guarantors:

- the agreements continue to appropriately reflect the types of obligations entered into in the marketplace for pension risk reduction, and
- the levy credit that we offer for such risk reduction measures is appropriate.

1.4.3 Our consultation also proposed, for the largest Type A (group company) guarantees, certification of the amount available from the guarantee (in the event of employer insolvency) must be backed by a report to trustees on the ability of the guarantor to meet the sum certified. Consultation responses were mostly positive about this change, with a number noting that many trustees already obtain reports along similar lines.

1.4.4 A number of responses covered our proposed use of the realisable recovery to set the threshold above which the new requirement would apply. As an alternative respondents suggested using the levy saving from the guarantee, arguing this should be the key focus for the PPF, and that generally the levy benefit is well understood by those schemes large enough for it to be relevant. We agree and have modified our proposal to have a limit based on levy saving – set at £100,000 – which will apply to around 1 in 5 guarantees.

1.5 Deficit-Reduction Contributions

1.5.1 We set out in our consultation two options to simplify the certification of payments to reduce deficits. These were either: a simplified version of the current approach - which removes the requirement to account for scheme investment management expenses when calculating the size of the deficit reduction - or to base certifications on information submitted through recovery plan payments.

1.5.2 We have decided that it will be possible to operate both approaches: with all schemes being able to certify on the simplified current basis; and for schemes with below £10 million in liabilities, where the circumstances are straightforward – eg, where the scheme is not open to accrual - to be able to base certification on information provided to the Pensions Regulator (TPR) on recovery plan payments. As this is information that has been calculated previously this should (in almost all cases) be able to be certified without the need for further actuarial input. Taken together, we expect these changes to materially increase the level of reduction payments that can be certified.

1.6 Good Governance

1.6.1 Our consultation called for evidence in relation to the scope for incorporating good governance as a factor in the levy. There was wide recognition of the importance of good scheme governance, and the strides being made through the work of TPR, PLSA and others to support it. A number of responses noted that its positive effects were likely already captured – for example, through the positive impact that governance can have on investment decision making. However, there was limited evidence to suggest that it might be possible to measure governance objectively in a way that could feed through into a levy factor.

1.6.2 We have concluded that it is right to keep the area under review, but there is not a clear, and implementable, basis for recognition in the levy.

1.7 Small and Medium sized Enterprises (SMEs) and small schemes

1.7.1 As our consultation indicated, the updating of the model has been an important step in ensuring that we have a system of insolvency risk measurement that can be demonstrated to be fair across different sizes of sponsor. As a result of the redesign of the scorecards dealing with parent companies and stand-alone businesses, the proportion of the levy paid by those on scorecards linked to SMEs has fallen by around a third.

1.7.2 We expect the changes we are making to the certification of DRCs will particularly benefit SMEs leading to greater recognition in the levy of such payments. These proposals were widely welcomed. Otherwise, we had a limited response to our consultation questions on measures that are focussed on small schemes. Accordingly, we plan to particularly focus on what can be done to improve information flows to smaller schemes, rather than seeking to design substantially different rules, in the coming months. This is discussed in more detail in section 14 on customer services.

Part II: The Levy Consultation for 2018/19

1.8 Consultation on Levy Rules for 2018/19

1.8.1 Part II of this document includes the consultation on the Levy Rules for 2018/19. The consultation runs from 27 September until 1 November.

1.8.2 We will publish the final Levy Rules and associated documents in December.

1.8.3 The consultation provides an opportunity to offer comments on any aspect of the draft Levy Rules. However, we are particularly seeking comments on specific policy changes. These are:

- To narrow the range of levy rates used for the “best” levy bands (bands 1-4)
- To update the way that we allow for investment risk in the levy through asset and liability stresses.

1.8.4 More generally we would welcome comments on the way in which the draft Levy Rules implement our decided policy.

1.8.5 The draft Levy Rules are set out in full on our website at http://www.pensionprotectionfund.org.uk/levy/Pages/1819LevyDetermination.aspx

1.8.6 To help guide stakeholders through the draft, we have included a chapter on the main changes to the Levy Rules (Chapter 16).

1.8.7 We are looking to make improvements to our customer service, particularly for smaller schemes and would welcome views and suggestions. We are also proposing simplification of certain types of block transfers.

1.9 Levy Estimate for 2018/19

1.9.1 The Levy Estimate for 2018/19 is £550 million. This represents just over a 10 per cent reduction on the Estimate set for 2017/18 (£615 million) and is the lowest Estimate we have set. Based on expectations of how the funding position of schemes will improve over the third triennium, our expectation is that levy collections will fall marginally over the succeeding two years. The exact path of the levy for future years is uncertain, however, as it will move with changes in measured risk.

1.9.2 We expect to set a Levy Scaling Factor (LSF) of 0.48, and Scheme-based Levy Multiplier of 0.000021 – ie, unchanged from its current level – to target our levy estimate.

1.9.3 It is worth noting that how much we will actually collect for 2018/19 is significantly more uncertain than in a year when significant policy changes were not being made. As we know from the initial implementation of the PPF-specific model (and, indeed, the PPF's early years of using D&B), once scores are used in levies, schemes and employers act to correct data and fill in gaps – and there will be a degree of behavioural change to reduce levies. Similarly, it is hard to predict with precision the degree to which higher levels of DRCs will be certified following the simplifications set out in chapter 6. Whilst we allow for these and other changes in calculating the LSF, the impact is impossible to predict with certainty. More information about the assumptions we have made in order to calculate the scaling factor are set out in chapter 10.

1.9.4 In deciding to target £550 million for 2018/19, the Board has balanced the PPF's strong financial position with the significant uncertainty that we and our stakeholders face with challenging economic conditions and a collective deficit of around £220 billion among the schemes we protect.

1.9.5 A key reason for this approach is that we want to maximise the chance that the path of the levy over time is stable, and limit the risk of having to reverse course. We believe this will meet the desire for stability and predictability that schemes and sponsors, often now planning across several years, have expressed to us on a regular basis.

1.9.6 We propose to set the Risk-Based Levy Cap at 0.5 per cent of smoothed liabilities for 2018/19, a reduction from the current level of 0.75 per cent. This will help to maintain similar numbers of schemes benefitting from the protection of the cap over the course of the third triennium as at present.

1.10 Levy bands and levy rates

1.10.1 We have considered whether to adjust the starting and finishing insolvency probabilities for each levy band, which would alter the distribution of employers across the bands. However, we concluded this would not be merited.

1.10.2 The very low level of insolvencies amongst employers in bands 1 to 4 means the difference in insolvency rates between bands are small in absolute terms – and we have limited evidence to support the distinctions in risk that the model makes. The existing levy rates imply a significant increase in levy for a single band movement – and an increase of 135 per cent between band 1 and band 4. We believe there is merit in adjusting the levy rates applied, so that the differential is smaller – reflecting the limited increase in risk and the degree of certainty we can have about relative ratings.

1.10.3 We propose to do this by setting levy rates to start at 0.28 for band 1 (instead of 0.17 currently) and to rise to 0.40 for band 4 (as now). These rates provide the equivalent of a single band movement elsewhere in the population for the move from band 1 to 4 – ie, around a 50 per cent rise in levy - and a slight increase in steps up between each successive band (ie, 0.03, 0.04, 0.05 increase). This reflects that we can be confident that employers in band 4 will show worse insolvency experience than those in band 1 – as, for example, we can be confident band 6 entities will have a higher insolvency rate than band 5 – but that, whilst the expectation is the same, for intermediate bands less certainty is possible.

1.10.4 The adjustment to levy rates for bands 1-3 will be offset by a reduction in scaling factor, so that overall collection remains unchanged. In combination, these two changes will result in a reduction in the scale of increases in levy if a scheme sees its score worsen. Schemes with employers remaining in the same band will, other things equal, remain net gainers from the move to new scores. Those seeing an increase in levy will find that their levy has gone up by around two-thirds, on average, instead of around 85 per cent.

1.11 Underfunding and investment risk

1.11.1 In 2012, we introduced a new approach to underfunding, which included smoothing of yields and indices used to calculate scheme underfunding, and incorporation of investment risk into the calculation of levies, through stress factors applying to both assets and liabilities.

1.11.2 On the whole we believe this framework is working well and we are not proposing any changes for the third triennium.

1.11.3 However, we have taken the opportunity to review both the level at which the asset and liability stress factors are set (incorporating the latest scheme and market data) and the methodology used to calculate them.

1.11.4 Overall, since recent market volatility has been subdued, the factors are typically lower in nominal terms than the current factors. However, because an across the cycle view of volatility has been taken they do not simply reflect recent abnormally low volatility.

1.11.5 The most significant methodological change is to move to calculating real and nominal stress factors and using these to derive the interest rate and inflation stress factors. Presentationally, interest rate and inflation rate stress factors will continue to be used to stress the liabilities. Only the derivation of these factors will change.

1.11.6 The proposed new stress factors are set out in Appendix 4.

1.12 Impact Analysis

1.12.1 Our impact analysis shows that overall the impact of our proposals are very similar to those shown in our March consultation:

- around three-fifths of schemes would see a lower bill than had the existing Levy Rules been used
- around one in five schemes seeing a higher bill
- schemes with employers remaining in the same band or seeing a single band worsening will, other things equal, see a lower levy from the move to new scores and levy rates
- SMEs in aggregate see a reduction in levy of over 30 per cent, and
- by contrast some schemes supported by larger employers see an increase in levy.

1.12.2 This analysis is designed to show the existing and proposed methodologies on a level playing field, and so does not take account of the reduction in the overall levy that the Board is seeking to collect in 2018/19, reducing our target levy – the levy estimate – from £615 million to £550 million. Other things equal, this will increase the proportion of schemes seeing a reduction in levy.

2. Experian model

2.1 Introduction: Summary of proposals in consultation

2.1.1 In our consultation document we explained the basis on which we assessed the case for re-building or re-calibrating the scorecards used in the second triennium. We proposed re-building five scorecards taking account of several factors.

2.1.2 Generally the model had performed well but we had identified a significant deterioration in the performance of the two small accounts scorecards, and the Not for Profit (NFP) scorecard.

2.1.3 Our proposals also reflected feedback from stakeholders on a number of issues:

- the scoring of SMEs on the Large and Complex scorecard
- the scope for manipulation through switching scorecards, particularly between stand-alone business and corporate parents through creating/absorbing subsidiaries, and
- reflection of risk for some non-standard corporate structures - eg, mutual ownership. Concerns centred on a variable focused on secured charges (“mortgage age”).

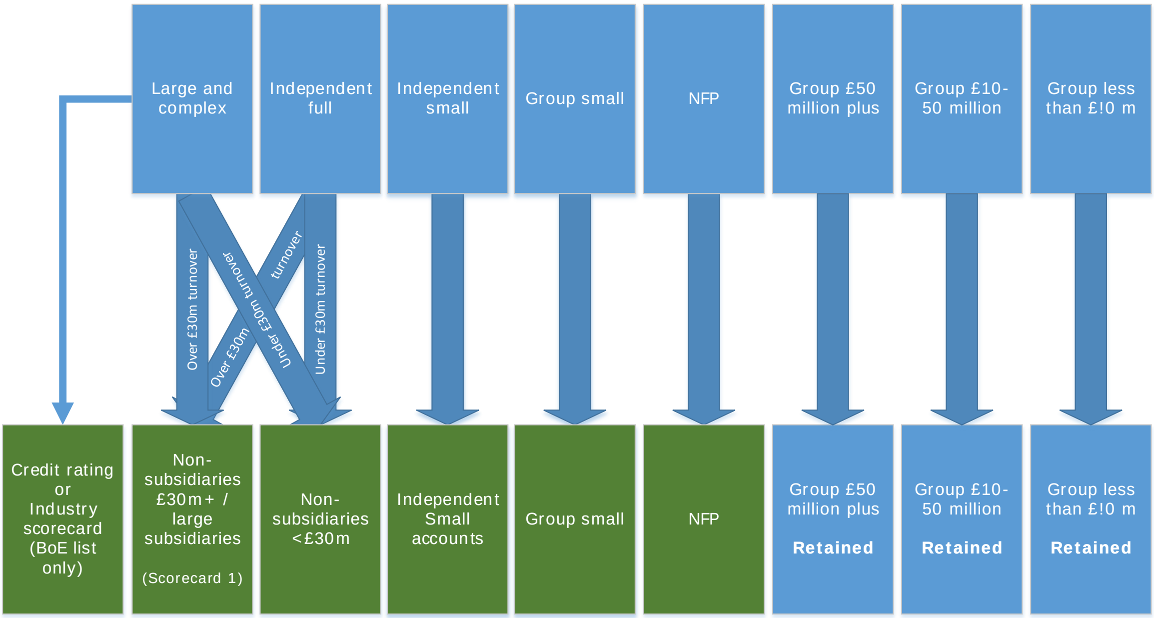
2.1.4 This led to our proposals to create new scorecards 1 and 2 (in place of the Large and Complex/Independent Full scorecards). These new scorecards no longer distinguished between entities that are independent and those that are the ultimate parent of a group, instead dividing the population on size - using a £30 million turnover threshold. We also rebuilt the NFP scorecard and the small accounts scorecards where the predictive quality was weaker.

2.1.5 We did not propose to re-build the scorecards for subsidiary companies, the “group company scorecards” (other than the group small scorecard) as we were satisfied with the performance of these scorecards and relatively few issues had been raised by stakeholders.

2.1.6 We noted that whilst the actual insolvency rate fell in the last three years, the predicted insolvency rate on some scorecards - particularly the Large and Complex scorecard - had dropped significantly further. This suggested a need to recalibrate the scorecards that are not otherwise rebuilt, so they can be expected to produce predicted insolvencies in line with experience. It also implied, for the populations on the scorecards that were underestimating risk, it was likely, whatever solution was proposed for the third triennium, that the share of the levy charged to those schemes would rise.

2.1.7 The changes to scorecards for the third triennium are summarised in the chart below.

Diagram 1: Comparison of existing and proposed model



2.1.8 We asked for responses on the scope of review of the model and our decision to rebuild five scorecards and recalibrate the other three. We also asked for confirmation that the rebuilt scorecards presented sufficient benefits to justify replacing the existing ones.

2.2 Responses

2.2.1 The level and nature of comments supports our broad view of the success of the model over the last triennium – and a number of comments explicitly reinforced that conclusion.

2.2.2 A majority of responses supported the scope of the review of the Experian model responses. Most responses that discussed the re-built scorecards focused on concerns about particular features, and the impact this would have for individual scheme levies.

2.2.3 The areas in which significant comment was received were:

- The decision to rebuild five rather than all eight scorecards – a minority of stakeholders felt we should have updated the group company scorecards or at least to have addressed perceived weaknesses – ie, reliance on mortgage data - eliminated in the new scorecards.
- The impact rebuilding has on levies for companies on the scorecard for non-subsidiaries greater than £30 million turnover and large subsidiaries[1] (scorecard 1), previously on the “Large and Complex scorecard”. These impacts were highlighted in the March consultation – and we explained this was a reflection of better scoring of their risk.

[1] This scorecard covers parent companies and stand-alone companies with turnover above £30million and subsidiary companies that have total assets of over £500m and turnover above £50 million

- That individual variables can appear either to dominate the scorecard in which they appear or were felt to have substantial drawbacks.
- (Related to the previous two), the characteristics of logarithmically transformed variables ("log variables") which are prominent in scorecards following the move to modelling on a continuous basis. Their use means that scores are less likely to change with a moderate change in the variable value – unless the value was very small.

2.3 Scope of review and mortgage age variable

2.3.1 Among responses asking us to look again at group scorecards the main reason given was this would allow the mortgage age variable to be removed from these scorecards. Although we have concluded that we should not remodel the group scorecards, we did investigate whether removing the mortgage age variable completely or replacing it with a variable assessing a similar aspect of an employer's financial standing could be justified.

2.3.2 The main factors favouring retaining the existing group scorecards from the second triennium are that:

- They have maintained their predictiveness (in fact, more than this, the Gini on these scorecards improved during the course of the second triennium).
- Concerns regarding "missing data" requiring the use of default variables are less significant than for other scorecards. Mortgage Age information, for example, is available for 99 per cent of employers on these scorecards.
- There was less movement in the population scored on these scorecards since they were first developed (between 87 and 90 per cent remaining the same), and so less reason to suppose the best markers for insolvency risk would have altered - and also less concern about the possibility of artificially adjusting group structure in order to trigger a move in scorecard.

2.3.3 Experian first investigated the impact of simply removing mortgage age as a variable and using the remaining variables. This led to a worsening of the Gini of between 3 and 6 per cent and would leave two of the three group scorecards with only four variables, increasing the extent to which scores could be affected by a single variable.

2.3.4 Experian also investigated replacing mortgage age with an alternative variable focused on borrowing – ie, equity gearing. However, although apparently a related variable, it was found that this variable had an unsatisfactory level of statistical significance[2]. Finally the fill rate (the proportion of entities for which data is available) for the mortgage age variable on these scorecards is high and the use of default scores is less

2 The greater the statistical significance, the lower the likelihood that an apparent correlation is random. If, individually, a variable has no significance it is not appropriate to include it in a scorecard.

common, in part due to the absence of non-UK employers on these scorecards3.

2.3.5 We are, therefore, confirming we do not intend to rebuild the group scorecards and have decided that mortgage age should remain as a variable on the group scorecards.

2.3.6 We have, however, recalibrated the scorecards so that they predict a level of insolvencies in accordance with actual experience and schemes may be affected by other changes – in particular to the calculation of the group strength component of their score (since group strength is assessed by using scorecards that are changing as explained in this section).

2.4 Impact on companies on scorecard 1

2.4.1 Some stakeholders questioned whether, in the light of the new scorecard 1, having a similar level of predictiveness to one of its predecessor scorecards (the Large and Complex scorecard), it was worth implementing it – given that it had significant impacts on scores (and levies) for some employers assessed.

2.4.2 Our main reasons for rebuilding the predecessor scorecards were:

- To reflect feedback – both from stakeholders and the consultants advising us on model design – that it was important to ensure scorecards were appropriate to the size of entity. (In this case, the predecessor scorecard scored small businesses alongside global companies).
- There had been a very significant change in the population actually scored on the predecessor scorecards, since they were built.
- There was significant potential for future changes in population, given the opportunity for employers to move scorecard by changing their corporate structure.

2.4.3 In addition, the rebuilding of the predecessor scorecards has generated a number of additional benefits, beyond the ones we were seeking:

- The variables used have a high fill rate. This limits the need to apply “default” scores, a particular issue for entities that do not file information at Companies House - such as the many foreign companies assessed on the “Large and Complex” scorecard, and also UK mutuals.

3 The use of default rates where information on mortgages is unavailable has been the most common concern raised by stakeholders in respect of this variable. Where an entity does not file with Companies House there is no basis to assess whether or not that entity has a mortgage and so a default value is assigned, which is less positive than the score if there is no mortgage. This issue, however, is less material to this scorecard – as shown by the high fill rate – as almost all entities are “corporates” filing with Companies House. For other scorecards the issue has been addressed through the rebuilding process.

- The elimination of trend variables means scores are less likely to be affected by changes in accounting practice, or indeed restructuring, a concern for some stakeholders.
- Administrative burdens should be reduced, as there is less need to provide information to Experian - for example, in relation to mortgages and charges. This material has proved particularly burdensome in relation to parent companies – which forms the bulk of scorecard 1 and it predecessors.

2.4.4 Taken together, we consider these advantages make a strong case for adopting the rebuilt scorecard, even if the improvement in predictiveness it provides is limited[4].

2.4.5 We do recognise that many sponsors will see a change in levy band following the introduction of scorecard 1. However, our analysis suggests this is largely a result of calibrating the scorecard to predict a level of insolvencies in line with our actual experience – rather than the move to a scorecard measuring different variables. Had we been retaining the existing scorecards we would have recalibrated those, with a similar effect in terms of changes in scores. The reason for requiring recalibration is that the predecessor scorecards – especially the Large and Complex scorecard - whilst initially calibrated to predict insolvencies in line with our experience, had come to predict lower rates of insolvency than have actually been occurring. To a significant extent this has been due to poorly rated entities transferring off the scorecard[5]. The following table illustrates how the insolvency rate has evolved:

Historical insolvency rate (2007-2015)	0.44%
Historical insolvency rate (2013-2015):	0.18%
Predicted Insolvency rate current scorecards	0.10%
Predicted insolvency rate new scorecards	0.26%

2.4.6 The new scorecard 1 is calibrated to produce a rate of insolvencies which over the last ten years would have been equal to actual experience. This leads to a predicted rate for the next that is similar to, but slightly above, the recent rate of insolvencies of those on the scorecard. In our view this is appropriate in view of the intention that scorecards should be calibrated against experience across the cycle, and that insolvencies in the general population have been at a historic low in the recent past. By comparison, the existing scorecard was

[4] Scorecards 1 and 2 replace two predecessor scorecards, and considered together are slightly more predictive than their predecessors were.

[5] Only 11 per cent of those with the best scores transferred compared to 70 per cent of those in bands 9 and 10. See appendix 1 for more detail.

predicting a rate in the future significantly below even our recent experience (as well as understating the number of past insolvencies).

2.4.7 Had we simply recalibrated the existing scorecard this would also be expected to worsen all scores to increase the predicted level of insolvencies by a factor of two and a half. As we showed in our impact analysis as part of the March consultation[6] this would have led a broadly similar pattern of changes in scores. Since then we have carried out another analysis looking at the population of companies in each of the ten levy bands and testing whether the groups rank in the same order following the move to the new scorecards[7], which without exception they do (see Appendix 1). This shows that, whilst there will be individual companies that experience an atypical movement in score, in aggregate those that were rated strongest by the predecessor scorecard are also rated strongest on the new scorecard.

2.4.8 Our expectation is, following initial movement in scores on transition, the new scorecards will prove to be stable. This is supported by testing the effect of past changes in accounting information, which show the new scorecards are as stable as their predecessors.

2.5 Stakeholder comments on variables selected

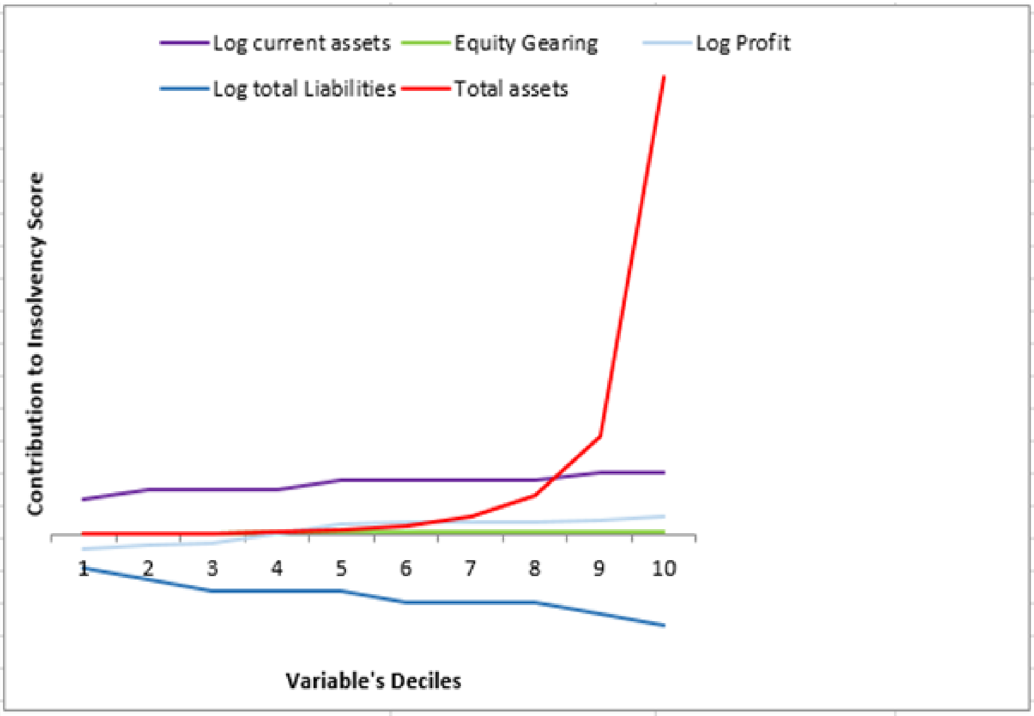
2.5.1 A number of responses focussed on particular variables or groups of variables. These responses questioned whether different variables should be used and in some cases questioned the way in which the variable calculation is done.

2.5.2 A small number of responses raised questions about the extent to which a single variable appeared to dominate the scoring for an entity for the scorecard as a whole. It is important to remember the scoring of variables is based upon observations of historical data and the correlation between differing values of variables and the risk of insolvency.

2.5.3 The “main” example of a variable held to operate in this way, was the total assets value for the NFP scorecard. It was noted that high values for total assets were associated with always being in levy band 1 (the best band) and lower values with always having a poor score. To understand the extent to which total assets influenced scored we asked Experian to calculate the contribution each of the NFP scorecard variables makes to the overall score for successive deciles by value of the variable.

[6] Section 7.2.3 onwards

[7] This is a different way to look at how the model preforms from the Gini coefficient – which shows how well the scorecard differentiates between insolvent and non-insolvent companies.



2.5.4 The chart above shows the extent to which total assets and all other variables contribute (either positively or negatively) to the overall score at successive deciles. It is only for the very highest values of total assets that total assets dominates the overall score. To understand why the variable acts as it does, Experian investigated the insolvency rate associated with the different deciles of the total assets values. They found dramatically lower insolvency rates at the ninth and tenth deciles (see the following chart) supporting a positive contribution to the overall score for the highest deciles of total asset values.

2.5.5 Experian also found that no single variable could achieve a Gini anywhere near the Gini produced by the scorecards overall. This leads to the conclusion that it is the interaction of the variables that is important. We appreciate that it is possible to experiment with the model (e.g. using the “What If” tool) to test out a variety of combination of asset values. However this can lead to a combination of variable values that are unlikely or sometimes impossible to apply in reality.

2.5.6 We have reviewed all the scorecards to assess whether there might be other variables that dominate the new scorecards across part or all of their range. We have found that the scoring of these variables is supported either by their individual contribution to the score or through their interaction with other variables on the scorecard.

2.5.7 We also had comments regarding the definitions of certain variables. In building the new scorecards Experian considered a wide range of potential variables – over 1,000 for each scorecard and selected those that proved most predictive individually and in combination, and for which data was available for a high proportion of the population (referred to as a high ‘fill rate’).

2.5.8 An example of a variable on which we received comments was net worth. This variable excludes intangible assets – and some responses suggested we should instead use a variable, such as shareholders funds which includes intangible assets. Experian tested just such a variable - shareholders funds - alongside net worth and found that the net worth variable contributed more strongly to predictiveness. We appreciate that individual entities or groups of companies may feel that this approach is less appropriate to their particular circumstances but in selecting variables we need to use those which, across the population, are most predictive.

2.5.9 Another variable questioned was cash – with some stakeholders pointing to the various reasons why an apparently weak or strong cash position might be unrepresentative of overall strength (e.g. due to cash pooling / sweeps or conversely charges over cash). Whilst we accept that this may be the case, given the number of entities we need to assess for the purposes of the levy calculation it is not possible to adjust accounts figures for different entities on a particular scorecard as it would require subjective assessments, increase administrative costs for all parties and would not be based upon the evidence of the most predictive variables. And across the population, cash is shown to be a predictive measure.

2.5.10 We have concluded that none of the variable definitions should be amended.

2.6 Log variables

2.6.1 Another issue several responses raised was the use of log variables. These have the design characteristic that they show limited variation as variable values alter across the majority of their range - though they are sensitive to small changes in value when that variable value is very close to zero.

2.6.2 The limited sensitivity of log variables to changes in variable value has proved to suit them to measuring risk for our population of employers because we have to assess companies of very different sizes (and other widely divergent characteristics) and, for example, a business with ten times the profit of another is likely to be lower risk, but not ten times lower.

2.6.3 However, the sensitivity to change for small values does mean that, for example, a business on Scorecard 1 (with minimum turnover £30 million) might see a substantively different score depending on whether its profit was £10 to £1,000.

2.6.4 As an initial analysis, therefore, Experian identified the extent to which scores in these low ranges were reported in practice – using £10,000 as a measure of low.

2.6.5 Whilst, in practice, we have found that very few entities were reporting values within the most sensitive range, the existence of such counterintuitive results is clearly unattractive, since it means a very small change in a variable value leads to a large change in score.

2.6.6 We, therefore, propose creating a plateau between positive and negative values of £10,000 by using a value of £10,000 for all values between 0 and £10,000 (and -£10,000 where the value was negative up to -£10,000). In addition where trade creditors days was between zero and 1, 1 would be used. The analysis Experian performed showed that using this approach for the scoring of all log variables would leave 98.5 per cent of scores in the same levy bands while 0.50 per cent improved and 1 per cent worsened.

2.6.7 Adjusting scores in this manner will create a step change for those log variables that can take both positive and negative values. However for variables such as net worth or profitability we believe that a distinction can be drawn between an entity that has positive or negative net worth and/or makes a profit rather than a loss. This is a common practice in credit modelling – and is supported by evidence on relative insolvency rates: entities in our universe of employers that are making losses are four times that of those making the smallest profits. We are proposing that this adjustment is made on this basis to the scoring of all log variables.

2.6.8 The following chart shows the proposed adjustment to the calculation of log variables for small values.

Raw Value	Log Transformation	Revised transformation
100,000,000,000	11.0	11.0
10,000,000,000	10.0	10.0
1,000,000,000	9.0	9.0
100,000,000	8.0	8.0
10,000,000	7.0	7.0
1,000,000	6.0	6.0
100,000	5.0	5.0
10,000	4.0	4.0
1,000	3.0	4.0
100	2.0	4.0
10	1.0	4.0
1	0.3	4.0
-1	-0.3	-4.0
-10	-1.0	-4.0
-100	-2.0	-4.0
-1,000	-3.0	-4.0
-10,000	-4.0	-4.0
-100,000	-5.0	-5.0
-1,000,000	-6.0	-6.0
-10,000,000	-7.0	-7.0
-100,000,000	-8.0	-8.0
-1,000,000,000	-9.0	-9.0
-10,000,000,000	-10.0	-10.0
-100,000,000,000	-11.0	-11.0

2.6.9 For the log variables using current assets, total assets, current liabilities, total liabilities and cash the negative £10,000 plateau does not apply, as we would not expect these to have negative values. If negative values are reported for these the replacement value is used. The adjustment for creditor days sales based applies where the calculation of the ratio produces a number higher than zero but less than 1, in which case 1 is used.

2.7 Replacement scores

2.7.1 The scoring of variables where either data is missing or is shown in the accounts as zero is done using a replacement value. This partly reflects difficulties in identifying cases where the actual score is a 'true' zero from those where it is just missing or part of a wider item in the accounts. It also appears that entities that do not report certain items may not be typical of the wider scorecard population.

2.7.2 These replacement values have been reflected in scores viewed on the portal to date. They were developed by examination of the observed insolvency for each continuous variable grouped into 10 deciles and the corresponding insolvency rate and the observed insolvency rate for the subset of the population with a null value for that variable. This informed the basis of the replacement value.

2.7.3 In cases where the null insolvency rate was statistically similar to that at the median (for the scorecard) that median value (in the form of a log value) was used.

2.7.4 However, where there was a risk of manipulation - for example, if it was possible to choose whether or not to report a variable value from filed accounts, or to include it in a wider data item - a null value could provide an incentive to omit more detailed data from the accounts. In these cases a minimum value was used, in some cases zero (for example, for log retained earnings on the independent small scorecard) where a higher value produced a more positive value and a maximum value where a higher value has a negative impact (for example, log current liabilities). The replacement value for an unknown pre-tax profit value (including where it may have been reported as zero) is an example of the use of a minimum value. This approach is taken because pre-tax profit is not a required reporting field and there would be a risk of manipulation by non-reporting if we used a median score that might produce a better result than an entity's actual pre-tax profit value.

2.7.5 We considered whether we should replace an absent trade creditors value with either 'other current liabilities' or 'total current liabilities' which might include trade creditors. However, we found that using other current liabilities left a large number of scores unchanged and a significant majority of those changing worsening; using total creditors saw more significant negative moves in banding (with very few improvements).

2.7.6 We have, therefore, decided not to make any change to the way in which the score has been calculated by the model. The drafting of the rule covering log transformations (Rule 3.2 of the Insolvency Risk Appendix) has been re-drafted in part to reflect the introduction of the plateaus described in 2.6 above and we are also making clear that replacement values are used if zero values are reported in accounts for either trade creditors or pre-tax profit.

2.8 Decided view

2.8.1 In conclusion, we have decided that the five new scorecards should be adopted, and that the group scorecards should be maintained as developed for the second triennium apart from being recalibrated.

2.8.2 We have not changed the definitions of any of the variables though we have adjusted the way in which log variables are calculated for values from +£10,000 to -£10,000 and for Credit Days Sales Based by calculating it as 1 if it is below this (the treatment of nulls and zeros will be unaffected by this change). We have also corrected the drafting of the Insolvency Risk Appendix in relation to the calculation of the Creditor Days Sales Based to reflect the intended process.

3. Alternative approaches to insolvency risk

3.1 Introduction

3.1.1 Our triennium consultation sets out proposals to develop a range of approaches to measuring the insolvency risk of employers, in limited circumstances where we consider there is the potential to significantly improve assessment.

3.1.2 Firstly, where an employer (or ultimate parent of an employer) has a public credit rating we proposed this would be used as the basis for the assessment of insolvency risk. To do so in a way that provides equivalence with scores based on the PPF-specific model we set out a conversion table mapping ratings to an insolvency probability and appropriate levy band.

3.1.3 Secondly, for regulated financial services entities that are not rated, we proposed the use of a credit scoring model developed by S&P. This model provides scores that can be converted to insolvency probabilities and levy bands using the same mapping as for credit ratings.

3.1.4 Finally, for a group of entities close to government, for which the PPF scoring model does not always provide appropriate scores, and which are judged to be of very low risk, we proposed a rule to provide for allocation to levy band 1.

3.1.5 We asked questions in relation to each proposal – and on the conversion table we proposed for ratings and credit model scores.

3.2 Responses on use of credit ratings and consideration of points made

3.2.1 The balance of responses received were significantly in favour of accepting the proposal to use public credit ratings, with those in favour including a number of key collective stakeholders representing employers and schemes. Indeed there were suggestions that we should look to use ratings more widely than had been proposed in the consultation - these suggestions are dealt with below.

3.2.2 The minority of responses that questioned the use of ratings raised a range of points– some of which had been considered in our consultation document - eg, that it was not appropriate to have different measures for different groups in the population. Additional points raised were that:

- there was an element of subjectivity in ratings
- ratings were argued to be slow to respond to evidence of improvement in company performance, and
- it wasn't possible for relatively smaller companies to gain an investment grade rating from a credit rating agency (CRA).

Subjectivity in ratings

3.2.3 Clearly, credit ratings do make use of subjective judgements – typically following in depth discussion with senior management of a business, and reviewing a broad range of evidence. However, the evidence is that the resulting assessments are highly predictive – the three ratings agencies we proposed to use (S&P, Fitch, and Moody's) have an average annual Gini superior to that of the PPF specific credit model.

3.2.4 Furthermore, financial rating agencies need to be registered in major markets such as the US and Europe. For example, in Europe, the European Securities and Markets Authority (ESMA) requires a CRA to use "rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back testing".

3.2.5 Accordingly, we are not persuaded that the subjective component in ratings need be a barrier to their use in the levy calculation.

Speed of recognition of improvement in performance

3.2.6 Whilst the PPF-specific model incorporates new accounting information when it is published, this does not necessarily mean that improvements in performance will, therefore, be recognised more swiftly than they would in a credit rating. Public credit ratings are forward looking and, as such, might already have captured the performance coming through in newly filed accounts. Events which can trigger a change in circumstances justifying a rating change are not limited to the filing of accounts, allowing rating agencies to act before accounts having been filed.

3.2.7 We investigated whether it is the case that ratings agencies are quicker to downgrade scores than to improve them, by comparing the speed with which an initial indication of a possible future change (a "Credit Watch") is translated into an actual movement in rating. The data suggests that whilst downgrades happen slightly faster, the difference is not material, at around 10 per cent for the median case.

3.2.8 We did consider whether there was a case to improve "responsiveness" with respect to the use of public credit ratings by taking into account a change in "Credit Watch" status when assigning a levy band, accepting that the anticipated change in levy band might not materialize (as happens in approximately 20 per cent of cases), might be more than one levy band, or might be in the opposite direction (around 10 per cent and 5 per cent of cases respectively). Including "Credit Watch" status as part of the levy assessment would add another layer of complexity to what are already material changes and might be perceived to be unfair in the minority of cases where a downgrade doesn't follow a negative watch. We, therefore, concluded any improvement in responsiveness was not sufficient to justify such a development.

The impracticability of attaining an investment grade rating for smaller companies

3.2.9 We explored this issue with one of the ratings agencies. They indicated that none of their industry methodologies prescribe a ceiling on ratings based solely on firm size. Additionally, the median factor weight on size is limited, implying a maximum 1-2 notch impact for size. This would imply that relatively smaller enterprises could still achieve high ratings (though clearly our smallest employers are very unlikely to seek a rating at all) and that it is reasonable that where a rating is available for a smaller enterprise it should be used.

Could we use a wider range of ratings or extend the use of ratings to "related companies"

3.2.10 Consultation responses included suggestions that we consider issue ratings, including secured ratings, in addition to issuer ratings, other public credit rating agencies, as well as private ratings. Others suggested we might broaden eligibility criteria to include public credit ratings from companies closely linked to a sponsor or from companies where a sponsor has a material impact on the public credit rating.

3.2.11 Obligations on employers to fund pension schemes are generally unsecured and non-preferential. This means they rank alongside an employer's other unsecured creditors. We, therefore, consider it appropriate to use public credit ratings which are indicative of a senior unsecured credit rating.

3.2.12 The use of private credit ratings was also considered in relation to mortgage exclusions at the time of the 2016/2017 consultation. Responses were mixed at the time and the proposal to use private credit ratings was rejected. Consideration was given to the number of companies benefitting from a private credit rating being limited in number, and the PPF being unable to monitor if an employer has multiple private credit ratings. This would lead to a potential selection bias – where we are only advised of ratings that improve scores.

3.2.13 In relation to the use of ratings for companies elsewhere in a corporate group, the legislation that governs the levy requires us to base our assessment on the insolvency risk of the sponsoring employer. We think it would be difficult to determine objectively, when it might be appropriate to recognise that a linked rated entity was sufficiently closely related that we could legitimately conclude that its risk of insolvency was best assessed by using a rating for another entity[8]. We do, of course, recognise the strength of the wider group – through building an element in to group company scores for group strength – but this approach is based on statistical evidence of the impact of wider group strength / weakness on the employer's risk. By comparison, were we to directly apply ratings from other entities, we would need to make subjective judgements we could not evidence.

Conclusion

3.2.14 In the light of the significant improvement in predictiveness offered by ratings we remain of the view that it is appropriate to make use of ratings where they are available. Whilst this will mean there will be different bases for assessing different sponsors we think this is justified by the improvement in outcomes. We do not consider there is a case to broaden the range of ratings used. The PPF/ Experian portal will display

[8] This is very different from the position recognised through a Type A contingent asset where there is a legally binding commitment to meet the employer's obligations.

whether a rating is being used as the basis for a score, and what the rating is.

3.3 Basis for converting ratings to levy bands

3.3.1 Relatively few of the responses that commented on credit ratings offered an opinion on the conversion basis – suggesting for many this was uncontroversial. Of those explicitly commenting, there was a balance between those supporting the conversion table and those expressing doubts about particular conversions, especially that those rated BBB/Baa should be mapped to a more favourable levy band. Typically these responses cited knowledge of one or more undisclosed companies in levy band 4 which are perceived not to be of equivalent strength. In our view, the extensive body of evidence collected for us, including statistical evidence on the proportion of defaults that lead to insolvencies by rating modifier (BBB+, BBB- etc), outweighs the above anecdotal evidence.

3.3.2 A second argument was that only the most recent years should be taken into consideration for the mapping, which shows for those rated category BBB/Baa a more favourable default experience compared to the long term annual average. As both public credit ratings and PPF Credit Model scores are scored through the cycle, we judge it to be more consistent to use the longer term annual default rate average. We, therefore, concluded we should use the conversion on the basis proposed.

3.3.3 Some respondents also highlighted the subjectivity in the "Second Best" approach applied in case of multiple credit ratings. We satisfied ourselves that this is consistent with good practice – eg, the proposal put forward by the Basel Committee on Banking Supervision in December 2015 when it published a consultation document on the revision of the standardized approach for credit risk.

3.4 Use of credit model

3.4.1 As with credit ratings, the balance of responses received was significantly in favour of accepting the proposal. The support from stakeholders further strengthens the evidence collected by the PPF in favour of using industry scorecards. We, therefore, intend to implement the credit model on the basis proposed.

3.4.2 The main concern expressed in relation to the model was about the transparency of scoring on an ongoing basis. This reflected that we were only able to provide limited information on scores for consultation – due to contractual constraints and the need to limit portal development (to provide the capability to show credit model derived scores) until consultation could be completed. Now that a decision to proceed has been made, we have worked with Experian and the provider, S&P, to provide scores through the PPF/Experian portal and to support queries as quickly as possible. We anticipate being able to include scores on the portal in the course of October.

3.4.3 We received a couple of requests that we should allow additional information to be voluntarily provided but, having looked at the particular data items suggested, we are satisfied that either it will be possible to obtain the data or, in rare cases where that is not possible, the alternative approach used to assess the data item will not disadvantage any schemes.

3.4.4 As with credit ratings, there were a number of responses that suggested extending the range of entities covered – in the case of the credit model by extending it beyond the financial services sector to other regulated entities. In particular, we received a number of suggestions that it might be possible to develop a similar approach in relation to the regulated energy sector.

3.4.5 It may be worth examining the case for this further, though we would need to weigh the complexity of the utility sector (which has a large range of different licences to operate) and limited numbers of entities on each, and we are concerned not to extend the scale of change proposed for 2018/19 further. However, the limited number of entities involved means that we could consider the case for extension outside of the triennial review.

3.5 Special Category employers (entities that cannot be assessed by reference to financial information)

Analysis of the responses to the consultation

3.5.1 In our March consultation we proposed a new rule for a small group of entities for which in our view the PPF scoring model does not provide appropriate scores, and which are judged to be of very low risk (all employers with these characteristics have close links to government). The proposed rule would allocate these entities to levy band 1.

3.5.2 Just under half of consultation responses included comments on this issue. Comments were overwhelmingly in favour of the proposal, with the exception of one concern - placing governmental entities in levy band 1 could mean other entities are subsidising these schemes. A number of responders had suggestions for extending the proposed criteria and there were suggestions on the certification process itself.

Scope of rule – suggested broadenings

3.5.3 Most of the responses focused on the wording of the first two limbs of the test. Some responses were from organisations that came outside the scope of the rule as consulted upon. In response, we have made minor amendments to the rule without fundamentally broadening its scope, for example, clarifying that “Employers established by legislation” includes employers established under international treaty and that reference to “central government” entities includes foreign governments and entities close to foreign governments.

3.5.4 For a range of reasons, we do not believe that it would be appropriate to extend the definition more significantly - for example, to cover entities that are appointed by or in contract with government. Objections of principle include that we did not see convincing evidence that the Experian methodology does not reflect the risk of insolvency of such entities, and of practicality, the difficulty of establishing a boundary for which entities would fall in scope, and the reality that they typically operate in competitive markets – and so would be excluded by virtue of state aid requirements.

"Cross-subsidy"?

3.5.5 We considered the concern that placing entities owned by the Crown or central government in levy band 1 could mean that other entities are effectively subsidising these schemes. We do not consider there will be a cross-subsidy, since the proposed rule requires that the Board consider that band 1 is the most appropriate band, and that using the standard methodology provides a less appropriate score, before deciding to score the entity in band 1.

3.6 The wording of the rule

3.6.1 We have made a range of limited changed to the text of the rule. These are explained in Appendix 2.

3.7 Implementation

3.7.1 We have updated the proposed certification to make it clear that the Officer is confirming the first two limbs of the test and that the other two limbs of the test are consistent with the Officer's view (rather than the Board's) based on the information set out in the certificate.

3.7.2 We will also update the Insolvency Risk Guidance to provide clarity over the operation of the new rules.

3.7.3 Particularly for 2018/19, our intention is to consider the applications as soon as possible after the Final Determination is confirmed, expected to be in December – and to operate in as flexible a way as we are able. Whilst we do have a deadline for evidence of 31 March 2018, the sooner that such applications are made after the publication of the Final Determination the better, as this could provide us the opportunity to consider the application and potentially respond with any questions in advance of the Measurement Time.

3.8 Group strength scoring

3.8.1 Where an ultimate parent is scored using a public credit rating, the industry scorecard for regulated financial entities or is classified as a special category employer, this score will be the basis of the assessment of the parental strength contribution used for any of its subsidiaries that are employers[9].

3.8.2 The parental strength score for the ultimate parent, where it is scored using a credit rating or a letter score from the industry scorecard is calculated using the insolvency probability indicated in the credit rating conversion table and then applying the corresponding 1-100 score for parental strength. The parental strength score for the ultimate parent where it is a Special Category Employer shall be into score 100 in the

[9] If no such score exists, Experian will seek to use the ultimate parent's accounts. As now, if Experian cannot source these accounts they will use consolidated accounts of the entity that is at the top of the UK group in their stead.

1-100 Score Table in the Insolvency Risk Appendix (or where the employer in question is assigned to Scorecard 6 (Group Small), a rate of zero is applied as the Variable Value).

3.8.3 This means that we may now be able to generate a score for an entities' ultimate parent where previously we were unable to do so (because Experian could not access the relevant accounts). This may lead to a change in scorecard for some entities e.g. an employer that has been scored in the second triennium as being on the Large and Complex scorecard but is an intermediate ultimate parent will move onto a group scorecard if the global ultimate parent can now be scored via a credit rating.

3.8.4 Guarantors classed as Special Category Employers, or who are CRA Rated, will be excluded from the Type A contingent asset guarantor gearing adjustment via new paragraph 17(4)(d) in the Contingent Asset Appendix.

3.8.5 In order to be classified as 'Special Category Employers' employers will need to show they are amongst our lowest risk and that their accounts do not allow an appropriate assessment of their insolvency risk. It does not, therefore, make sense to impose an accounts based adjustment to the decided score. For guarantors who are CRA Rated, we consider that the credit ratings measures already take into account the presence of guarantee arrangements without requiring further adjustment.

4. Averaging of Scores

4.1 Introduction

4.1.1 Our consultation paper set out three options for averaging insolvency risk scores for the new triennium.

- No change (continue to calculate Mean Scores on the basis of 12 monthly scores)
- Only use the last six months scores to calculate the Mean Score, and
- Move to a single point calculation at 31 March.

4.1.2 We indicated that if we were sticking with a 12 month approach we would, for 2018/19 only, use scores from the second half of the year – ie, starting 31 October 2017.

4.2 Stakeholder responses

4.2.1 Just under half of 28 of the consultation responses covered the issue of averaging of insolvency scores. Two-thirds of those expressing a preference argued for retaining monthly scores, with averaging.

4.2.2 Amongst those favouring retention of monthly scores, the majority of responses drew attention to the potential for gaming if moving to a single point as the main reason for staying with the current approach. This is a theme that has been reinforced by subsequent discussion with consultants – some of whom have noted that there is a higher potential for gaming than had been identified in consultation materials.

4.2.3 Other common themes centred on keeping the levy calculations stable; the predictability of scores, and that the smoothing implied by monthly values avoids cliff edges. Some advisors also mentioned that averaging increases engagement with schemes through the year - and helps with identifying errors/issues early. Since the PPF-specific score is driven largely by published accounts, late engagement would reduce the chance to ensure that, for example, appropriate data items are reported in accounts.

4.2.4 Amongst those favouring a single measurement time, the majority of responses cited simplicity. Others commented that the expected stability of new scores meant there is less of a reason for averaging. There was also a point raised that moving to a single point would give a better reflection of the employers current strength and gives levy payers early certainty of levy rate immediately after 31 March – ie, removes the need to wait for mean scores to be published.

4.2.5 The proposal to use fewer scores in 2018/19 (due to the later availability of access to the portal) was supported by those who commented on the proposed approach.

4.3 Decided view

4.3.1 In view of the general preference for continued use of averaged scores, and the concerns raised that a single point could encourage gaming, we have decided to retain monthly averages, sticking with a 12 month average in general, except for 2018/19 when we will use a six month average (the first date used in the average for 2018/19 will be 31 October 2017).

5. Small and Medium sized Enterprises, and Small Schemes

5.1.1 A key theme of our March consultation was the desire to engage with SMEs and small schemes – and to ensure their interests are protected. We set out some specific options for small schemes, and more broadly sought input on what could be done to ease engagement with levy. Our plans for certifying payments reducing deficits – set out in the following chapter, are also focused on assisting small schemes.

5.1.2 Our review of the Experian model had as an aim to ensure we were assessing smaller employers fairly – by providing a separate scorecard for smaller parent and stand-alone companies (scorecard 2) which we could ensure reflected their insolvency risk. Our plans for certifying payments reducing deficits – set out in the following chapter - also have a particular relevance to small schemes.

5.1.3 In the third triennium consultation document we recognised that engagement with the PPF levy can be challenging for smaller schemes and explained that our aim was to identify ways in which we might be able to make simplifications which would particularly assist smaller schemes though they might also improve processes for all schemes. We invited comment on two ideas - to change the balance of scheme and risk based levies (putting greater emphasis on the scheme based levy for small schemes), and the use of a single insolvency risk assessment for all small schemes. In addition we invited other suggestions.

5.2 Consultation proposals

5.2.1 Most responses sympathised with the idea of simplification where possible, but it was argued by some stakeholders that there should be a single set of rules that applied to all schemes regardless of size. Linked to this it was argued that, even where the intention was to simplify the rules, the addition of alternative rules could actually add complexity, creating a need for schemes to take advice on whether to 'opt' in or out. It was suggested there could also be a trade-off between fairness and simplicity, and that any change would create winners and losers.

5.2.2 There were mixed responses to the specific ideas identified in the consultation document. Those supporting welcomed the potential reduction in complexity. However, as set out above a group of respondents argued that there should be a single set of rules, and one respondent argued that the risk-based levy incentivised 'good behaviour' as it encouraged the payment of additional contributions and the implementation of risk reduction measures.

5.2.3 Four responses opposed the use of a single insolvency risk assessment, citing a loss of accuracy and a lack of a link to the insolvency risk of individual employers. Amongst those responding to the question of whether there should be an opportunity to opt in or out of the single insolvency risk assessment, it was argued this would add to complexity (needing to take advice on whether to exercise such an option). In conclusion, we have decided we will not take forward the proposals set out in the consultation.

5.2.4 We have considered other alternatives put forward in the consultation.

5.2.5 The suggestion of simply not collecting or waiving the risk-based levy was made though this is an issue we had previously considered and it is unlikely to be compatible with the existing legislation. The legislation allows us to exclude a class of schemes from the risk-based levy by determining that the risk-based levy rate should be nil. However, in order to do so, we would need to be able to show that treating a class of schemes in this way was reasonable. We have carried out some limited analysis of small schemes (with liabilities of less than £5 million) and found that they have higher Experian scores on average than other schemes – ie, they have higher insolvency risk. The average levy band for this group is between levy bands 5 and 6, as opposed to between levy bands 2 and 3 for the largest schemes (schemes with liabilities in excess of £100m).The work we have done with Experian in the past (see the 2015/16 Policy Statement) demonstrated statistically, smaller companies scored under the Large and Complex scorecard were riskier compared to the rest of the population for that scorecard. We do not, therefore, have evidence to support such an approach.

5.2.6 Another suggestion was that in order to simplify a scheme's understanding of their underfunding for the risk-based levy we should allow small schemes to use an averaged s179 calculation based upon the two most recent s179 valuations. This would avoid the scheme needing to calculate the impact of the roll forward to the measurement time and the smoothing of market indices in order to predict their levy bill.

5.2.7 We see a number of possible pitfalls with this approach, for example, the s179 valuations could be as much as six years out of date, hence this would give a less accurate reflection of the underfunding risk that the scheme poses. We, therefore, do not consider this to meet our requirement that changes should only be made if there is a 'risk based' justification for doing so.

5.2.8 However, we appreciate that the suggestion of an averaged s179 calculation was prompted by the idea of helping small schemes to understand their likely levy charge before invoices are issued. To that end we are exploring the possibility of being able to provide levy invoice estimates ahead of invoicing. Such an approach might need to heavily caveated if there were aspects of data that were not finalised. We would be interested to understand the extent to which such a development would be seen as a benefit for small schemes and would welcome views in order to determine whether this is worth pursuing further.

5.2.9 We would also highlight to schemes that where they anticipate difficulties in paying their levy invoice within 28 days they can discuss payment by instalment arrangements (which are likely to include interest payments) with our credit control team.

5.2.10 Elsewhere in this document we explain our conclusions on the proposals to simplify the calculation and certification of DRCs, including the alternative approach available to small schemes which meet certain conditions. We believe the new approach will make the certification of DRCs significantly less costly and burdensome for small schemes.

5.3 Decided view

5.3.1 In summary, we believe that the best way to advance the interests of SME employers and small schemes is to implement the changes proposed in relation to the measurement of insolvency risk – which should reduce the aggregate bill for the SME sector by around a third combined with the changes to reporting of payments to reduce deficits - which should help small schemes to report their sponsors efforts to tackle funding issues. Coupled with this, we will continue to focus on improving communication, especially for smaller schemes, rather than to put in place separate rules.

6. Deficit-Reduction Contributions (DRCs)

6.1 Summary of consultation proposals

6.1.1 Since the risk-based levy was first introduced, we have sought to give accelerated recognition of additional payments into schemes to reduce deficits. Our consultation document explored how we might simplify our current DRC methodology, in order to better capture the contributions sponsors are making. In particular we noted that, especially for smaller schemes, there was evidence to suggest that deficit reducing payments being made were not always certified. Accordingly, we set out two alternative approaches for the third levy triennium:

a) Simplifying the existing regime by removing the requirement for investment management expenses (both implicit and explicit), to be deducted when calculating the certified amount.

b) Allowing schemes to certify the contributions paid under their recovery plan, plus any 'special' contributions which have served to amend the recovery plan or remove the need for one.

6.1.2 We proposed that option (b) would be accompanied by a relaxation of the certification requirements, namely to permit certification by a scheme trustee or a suitable representative of the sponsoring employer (rather than by the Scheme Actuary) in cases where the certified DRC amount does not exceed £1 million and relates only to contributions documented in the recovery plan.

6.1.3 We noted that options (a) and (b) did not need to be mutually exclusive at the global level and that it would be possible to construct a regime where the applicable option was determined by reference to scheme-specific features, for example by size or whether the scheme was open or closed to future accrual.

6.1.4 The consultation document invited views on whether respondents supported our proposals to amend the DRC methodology, and if so, which factors should be used to allocate schemes between the two options (which could include applying a single option to all schemes).

6.2 Consultation responses

6.2.1 Just under half of 28 responses covered this subject, with a significant consensus in favour of the policy intention to simplify the DRC process through either option (a), option (b) or some combination thereof.

The main themes of responses were:

- Schemes should be closed to future accrual in order to use option (b) since there is a risk that the certified DRC could be overstated under option (b) where the scheme is open to future accrual and the contributions paid in respect of future service are insufficient on a PPF basis.
- Option (b) could potentially disadvantage schemes without a recovery plan if it were the only option available to them.

- Option (b) should be available for smaller schemes, but option (a) should be available where this would permit a higher DRC amount to be certified; and recognition should be given where actual contributions exceed those in the recovery plan. In particular, some employers are committed to material contingent contributions that are not part of the recovery plan due to uncertainty over their timing and/or amount.

- Any qualified actuary with appropriate experience (rather than just the Scheme Actuary) should be allowed to carry out the DRC certification, as this would increase competition and lower costs for schemes.

6.3 Decided policy

6.3.1 The responses indicate broad support for option (a), but with option (b) available on a voluntary basis for smaller schemes. Accordingly we will be proceeding on this basis, with ‘smaller’ schemes defined as those with submitted s179 liabilities of less than £10 million. The approach we propose will allow smaller schemes the option to report on the new standard basis if, for example, they are overfunded on a scheme-specific funding basis and do not have a recovery plan.

6.3.2 However, we acknowledge that there are certain situations where option (b) would not be workable or could produce a DRC amount that is artificially overstated or understated. Smaller schemes will, therefore, only be able to use option (b) as an alternative to option (a) if they were closed to accrual throughout the certification period and had a recovery plan in force for all or part of that period.

6.3.3 Option (a) is available to all schemes and represents a simplification of the current approach, by removing the requirement for the certified DRC amount to incorporate a deduction in respect of investment management expenses met out of scheme assets. Some stakeholders suggested another aspect of current framework that led to complexity was the requirements regarding accrual. We note this view. However, we were not persuaded it would be appropriate to make simplifications, as excluding accrual is at the heart of demonstrating payments are addressing the deficit.

6.3.4 We can confirm that any qualified actuary with appropriate experience (including, but not restricted to, the Scheme Actuary) can complete the certificate on Exchange under option (a).

6.3.5 Schemes which satisfy the conditions set out in paragraphs 6.3.1 and 6.3.2 above can certify on a recovery plan basis under option (b), as an alternative to the more detailed methodology under option (a).

6.3.6 We are proceeding with the relaxation of the certification requirements under option (b) as set out in the consultation document, namely to permit certification by a scheme trustee or a suitable representative of the sponsoring employer (rather than by the Scheme Actuary) in cases where the certified DRC amount does not exceed £1 million and relates only to contributions documented in the recovery plan.

6.3.7 In the limited cases where actuarial certification is required under option (b), this should be carried out by the Scheme Actuary, since the contributions to be certified will flow directly from the Scheme Actuary's statutory work in relation to scheme-specific funding valuations and the associated recovery plans.

6.3.8 The DRCs Certificate has been updated to reflect our settled approach and a draft is attached as Appendix 4. Finally, it should be noted that the draft DRC Appendix, Guidance and Certificate adopt the nomenclature 'Option Alpha' and 'Option Beta' rather than 'option (a)' and 'option (b)', to avoid confusion with the naming convention of the calculation components under Option Alpha.

6.3.9 The Board may seek to confirm that schemes electing to certify under Option Beta satisfy the conditions for its use as set out above. If the Board's investigations establish that a scheme does not satisfy the conditions, the DRCs Certificate will be deemed invalid and disregarded in the calculation of the scheme's levy.

7. Good Governance

7.1 Consultation call for evidence

7.1.1 The Work and Pensions Select Committee included a recommendation that we re-examine whether the levy framework could incentivise schemes to improve governance in their report on defined benefit pension schemes, though any such discount "would need to be based on objective and transparent criteria that are demonstrably associated with positive outcomes for members and that complement the levy model's calculation of insolvency risk".

7.1.2 Accordingly, as part of our policy development for the third triennium we reviewed the initiatives taking place to strengthen scheme governance and called for evidence from stakeholders on the extent to which governance could be shown to affect factors we are permitted to assess in calculating the levy. We also invited suggestions on how the impact of good governance could be measured and demonstrated.

7.1.3 There was unanimous recognition, amongst those responding, of the importance of good scheme governance, and many references to the strides being made through the work of TPR, PLSA and others to support it. However, two-thirds of responses expressed doubts about either the principle of reflecting good governance in the levy or the practical difficulty of assessment.

7.1.4 A number of responses noted that good governance was likely to have positive effects on the risk that schemes pose – for example, through the positive impact that governance can have on investment decision making. However, it was argued that it was not practical to disentangle the influence of governance from other factors that influence the funding risk of schemes or insolvency risk of their sponsors. As a result, stakeholders argued, it wasn't possible to demonstrate the individual contribution of governance.

7.1.5 A second concern was that, in principle, the positive effects of governance might already be being captured. Again, the example of the positive impact that governance can have on investment decision making was cited and that, over time, this could be expected to be reflected in improved scheme funding or decreased risk; each of which could be expected to reduce the levy directly. In these stakeholders' views, there would be a sense of "double counting" in reflecting good governance.

7.1.6 A third challenge was to suggest, to the extent that a robust justification in risk terms was not available; allowance in the levy reflected an encouragement to good behaviour, and that regulatory activity – of the kind seen in recent years - was more appropriate than a pricing mechanism, such as the levy, which was likely to be a blunt instrument.

7.1.7 Another theme emerging was that steps to encourage good governance might be most successfully reinforced through work following from the Government's February Green Paper, "*Defined benefit pension schemes: security and sustainability"*.

7.1.8 Finally, there was a concern that a good governance discount would predominantly benefit larger schemes as it might positively view those schemes with more sophisticated investment strategies, within more regulated sectors or with the required resources to evidence adherence to good/practice. In doing so it would run counter the desire to ensure that SMEs were not disadvantaged by the Levy Rules.

7.1.9 The remaining third of responses were either neutral in tone, or offered thoughts on how one could assess governance if it were decided to do so. Suggestions on what might be practical to use as indicators of good governance were:

- Adherence to the UK Corporate Governance Code (the response was, however, framed in terms of evidencing good governance of the employer rather than the scheme); though another response specifically opposed the use of existing codes for listed companies.
- The existence of independent trustees.
- Evidence of trustee understanding and monitoring of scheme risks, agreed information flows between employer and scheme, effective mechanism for managing conflicts of interest, using many of the processes / techniques used for formal accreditation – eg, evidence of a risk register.

7.1.10 However, those making the suggestions were not able to provide evidence to demonstrate specific outcomes or support a particular level of recognition though the levy.

7.1.11 One respondent argued that a change of legislation should be sought if there was a decision to recognise good governance.

7.1.12 We have concluded we do not have evidence of a clear independent measure of improvements in one or more of the factors set out in legislation resulting from improved scheme governance. ; and a majority of respondents expressed concerns about its inclusion or measurement. We will not, therefore, take forward proposals for a levy discount to reward good governance at this time.

7.2 Encouraging good governance

7.2.1 We recognise and support the work being done by other organisations to promote good scheme governance. In particular, we will look to support where we can initiatives by TPR - such as their recently launched 21st Century Trusteeship campaign (www.tpr.gov.uk/21st-century-trusteeship.aspx). This sets out clear standards that TPR expects trustees to meet and provides practical tools and resources to help trustees improve governance in their schemes, and industry bodies - such as, the PLSA, who recently published a discussion document on good governance.

7.3 Conclusion

7.3.1 We have, therefore, concluded whilst there is not a clear, and implementable, path to direct recognition at this stage, it is right to keep the area under review. At the current time it is not appropriate to seek to reflect good governance explicitly in the levy but the situation may be different by the time of the fourth triennium.

8. Contingent Assets

8.1 Introduction

8.1.1 From the first year of operation of the risk based levy we have recognised parental guarantees and charges through the levy (as respectively type A and type B contingent assets). Where they are robust, guarantees can provide a real benefit to schemes and, indeed, to the PPF in the event a guarantee must be called. Our policy has, therefore, been to encourage guarantees to be put in place, but to seek to ensure that they are robust before recognising them through a reduction in levy. This protects other schemes which might otherwise pay an undue proportion of the levy, were ineffective guarantees accepted.

8.1.2 Our objectives in reviewing our contingent asset regime for the third triennium have, therefore, been to ensure that contingent assets deliver legal certainty for schemes through our standard form agreements; provide genuine financial support to schemes, and that the extent of recognition provided through the levy calculation appropriately reflects that level of support.

8.1.3 In our March consultation we highlighted that, given our contingent asset regime has been in place for 10 years, we felt the time was right to undertake a comprehensive review of the drafting of our standard form agreements. Our aim is to ensure that our standard forms deliver legal certainty and provide genuine financial support to schemes. We highlighted a particular concern that - in the case of type A and type B contingent assets - it might be argued that the wording of the cap on guarantor obligations could be interpreted in such a way as to limit the value of the guarantee in a manner inconsistent with the original intention.

8.1.4 Through the consultation we sought input to our review; stakeholders with experience of using the existing agreements were asked to highlight any points in relation to the drafting of the standard forms that we ought to consider.

8.1.5 We explained that we expected the review to result in a set of updated standard forms and we were likely to require existing contingent assets to be amended or re-executed so that they would be on the new terms (in order to receive levy credit). Again, we sought stakeholder views on this, in particular, to understand any practical difficulties with re-execution; the necessary lead times, and whether there were preferences on the manner of re-execution – eg, whether an option to amend and restate agreements would be easier for stakeholders to implement.

8.1.6 Separately to the review of standard form agreements, we also consulted on proposals to:

- Require trustees – with the largest value Type A contingent assets – to obtain a pre-certification report analysing the guarantor’s strength; to confirm the realisable recovery can be met, and so justify the levy benefit resulting from recognition.

- More accurately provide for type A guarantor-employers in our levy calculation formulae.
- Allow increased flexibility for multiple guarantors to certify separate realisable recoveries under a single agreement.

8.2 Standard form agreements

8.2.1 We set out in our March consultation our intention to review our standard form contingent asset agreements to clarify the drafting of the guarantor/chargor's obligations in the Type A and B agreements, and otherwise to ensure the drafting across the agreements is as robust as possible. We also signaled existing contingent asset holders would be required to update their existing agreements to the latest basis from the 2018/19 levy year, and invited comments from stakeholders on the practicalities of doing so.

8.2.2 This was a departure from our standard approach of allowing existing agreements to continue to be recognised when improvements are made to the standard forms. As would be expected, the proposed requirement to change existing agreements was not welcomed. Stakeholders asked that we consider:

- if we really needed to require re-execution, and if so
- to provide as much time as possible, and
- to make the process as straightforward as possible.

8.2.3 We considered this issue carefully. We are conscious the timing and practical implications of requiring re-execution for 2018/19 would, for some stakeholders, have been significant. We would need to be comfortable that requiring schemes to undertake re-execution onto a new standard form was the right thing to do, not only in terms of there being no realistic alternative at that point in time, but also that we were as confident as we could be that schemes will not have to re-execute again in a future year unless it was necessary.

8.2.4 The issue we had identified, in respect of which we had intended to require schemes to take re-execution steps, concerns the wording of the cap in the Type A and Type B agreements. The specific issue is it might be argued that the wording in the agreements means any payments made (whether by the guarantor/chargor, the employer, another guarantor, or otherwise) in respect of the guaranteed obligations of the employer that were not as a result of demands made under the agreement would erode the cap.

8.2.5 As we stated in our consultation document, we do not agree with this interpretation, and we also do not think it is the interpretation that guarantors/chargor's and employers would be expecting. Nonetheless, given the importance of these agreements to schemes and the PPF, we remain of the view we should amend the standard forms to put the matter beyond doubt. However, consideration of the issue has also raised further questions around the operation of the caps – for example, whether payments under the guarantee but outside of insolvency should erode the cap and, if so, how we ensure appropriate levy credit is given.

8.2.6 These are important questions and we appreciate the need to proceed carefully. Whilst maximising the value of the guarantee on insolvency is in line with the PPF's core interest we are conscious that our standard form agreements cover obligations that arise pre-insolvency and this may well be providing a level of risk reduction to schemes. For example, we are aware that our current standard form wording provides trustees with comfort that pre-insolvency payments, such as recovery plan payments are guaranteed up to the relevant cap. We are also aware that in many situations, support is being provided by guarantors / chargor's without a formal demand being made in respect of the particular contingent asset.

8.2.7 We, therefore, believe we should consult further and will be issuing a separate consultation during October to cover these issues. The consultation will set out our proposals as to how caps should operate and provide draft Type A and Type B contingent asset standard form agreements for comment. Our intention is, following consideration of responses, we will publish new forms alongside the final Levy Rules for 2018/19 this December.

8.2.8 We would require any new contingent assets being certified for the 2018/19 levy year to be on those new forms. We will not require the re execution of existing agreements for 2018/19 though, we are likely to require steps to be taken for 2019/20. It is our intention that any contingent assets that are executed on the forms to be issued in December will not then have to be re-executed for 2019/20. Further details on our proposed approach will be in the forthcoming consultation document.

8.3 Guarantor strength reports

8.3.1 Our consultation document proposed that, in view of the continuing significant rate of Type A contingent asset rejections on the basis of guarantor strength, we would introduce a requirement for a report, prepared by a professional adviser, to be obtained by trustees prior to certification. We proposed that the reporting requirement would apply where the realisable recovery was certified at £100 million or higher.

8.3.2 Amongst responses addressing the issue, there was significant support amongst respondents for a reporting requirement. In particular, respondents considered that the requirement would ensure trustees certifying at a higher level exercised an appropriate degree of due diligence, and would also be consistent with the Board's approach to asset-backed contributions. A number of responses noted that a reporting requirement would not entail substantial change for many trustees, as it would reflect what many schemes were already doing in practice. By comparison, a limited number of responses opposed the idea of a requirement to obtain a report, especially where the scheme currently makes assessments "in-house".

8.3.3 In relation to the reporting threshold a number of responses suggested a threshold based instead on the extent of levy benefit, on the basis this would better capture those contingent assets that matter most in terms of value to the scheme and potential cross-subsidy if the guarantee is deficient. Respondents taking this view also stated that, from the scheme's perspective, assessing the extent of levy benefit to be gained should not generally be difficult, on the basis they would already have assessed the extent of the potential benefit before certification. It was also suggested that a levy benefit threshold could apply where the benefit was likely to be £100,000 or more. We found that this threshold would apply to a very similar number of schemes to our proposed threshold, but that only 60 per cent of guarantees were covered by both threshold – which strongly supported the points made by these stakeholders.

8.3.4 Having considered responses received, we have decided to proceed with introducing a guarantor reporting requirement from the 2018/19 levy year, with reports to be provided to the trustees prior to certification. A significant proportion of these will be reviewed by us in the way we review ABC reports, with other Type A contingent assets below the threshold being assessed as per our current testing regime. The critical distinction in our approach is, where certification is based on a report, the existence of a compliant report containing the appropriate duty of care is tested rather than directly testing whether the guarantor is able to meet the guaranteed sum.

8.3.5 As highlighted in our consultation document, schemes for whom the levy benefit is below the threshold will also be free to voluntarily base certification on a report if they wish, in order to achieve certainty regarding the information we will use in assessing their guarantor's financial position.

8.3.6 We were also persuaded by respondents' views that setting a reporting threshold based on a levy benefit of £100,000 or more would be the most appropriate means of ensuring our contingent asset regime is risk-reflective. We estimate this will cover around one fifth of Type A contingent asset. We have, therefore, concluded that this threshold should be adopted.

8.3.7 Our consultation document set out a number of (non-exhaustive) issues we consider should be covered in a guarantor strength report. We are publishing draft updated guidance covering reporting content as part of this consultation.

8.3.8 This guidance also covers the approach schemes should take when recertifying their contingent asset. As set out in our consultation document, we will expect a report to be prepared with each recertification. However, we consider it reasonable that schemes take an approach consistent with that applying to recertification of ABCs, and commission either a fresh report or an updated version of the existing one. It will be the adviser's responsibility to consider the guarantor's position since the previous certification and decide whether the circumstances call for a new or an updated report and, where the latter is chosen, to also set out the basis for this view in the report.

8.3.9 We recognise there may be some cases in which trustees, quite reasonably, form a view their levy benefit of a contingent asset will be significantly below £100,000 but, due to unforeseen circumstances, the saving is larger than expected and breaches the threshold. Our draft rules provide for a discretion for us to recognise the contingent asset following a report being commissioned after certification, where that is reasonable in all the circumstances.

8.4 Guarantor who is also scheme employer

8.4.1 We consulted on two alternative proposals to change the way in which we recognise Type A contingent assets where the guarantor is also an employer. Both proposals seek to recognise that a guarantor-employer is already covering its share of the underfunding in its capacity as an employer, without the need for this element to be certified as part of the realisable recovery.

8.4.2 Our preferred approach would calculate the guarantor-employer's share of the underfunding as an employer, using this as a new component in the calculation. The guarantor would, therefore, have two associated insolvency risks – one as an employer, and one as a guarantor. We would then:

- order the guarantors in decreasing order of strength (as in the current formulae)
- for each guarantor, apply the new component relating to its capacity as an employer first, followed by the existing guarantor component, and
- apply each guarantor against the underfunding until it is used up.

8.4.3 Our second proposal was to simply divide the underfunding between all employers in proportion to member numbers before calculating the levy. However, we made clear in the consultation document the first proposal was our preferred one, on the basis its impact would be limited to those schemes who had certified a Type A contingent asset, whereas our second proposal would involve changing the levy calculation for all schemes.

8.4.4 While there was some support expressed for our second proposal, the majority of respondents favoured our first proposal. While recognising this approach would be conceptually more complex, they were supportive of our view that minimising the impact on unaffected schemes was a preferable outcome.

8.4.5 We have, therefore, decided to proceed with implementing our first proposal, and to allow for the Type A guarantor's share of the underfunding to be credited in the levy calculation in addition to the realisable recovery actually certified. In practice, this means that a lower level of realisable recovery can be certified while still retaining the same levy credit as under the current regime.

8.4.6 As with any review, we would expect trustees to contact us on a timely basis and set out the steps they had taken to assess the levy impact prior to certifying, including the circumstances that has rendered this assessment inaccurate.

8.4.7 We are, however, mindful this new relaxation could create opportunities for employers to certify relatively low realisable recoveries in order to obtain the credit relating to their proportionate share of the underfunding. We may, therefore, disapply the new rule if we consider that the level of recognition would not be commensurate with the reduction in risk actually secured by the contingent asset.

8.5 Realisable recovery for multiple guarantors

8.5.1 We proposed changing our requirements where more than one guarantor was a party to a single Type A contingent asset agreement, to allow for two or more guarantors to certify separate realisable recoveries rather than requiring each to certify individually for the full amount.

8.5.2 Responses received to our March consultation uniformly supported our proposal. We have, therefore, decided to allow, from the 2018/19 levy year, for certification of the realisable recovery to be made on an individual rather than aggregate basis where more than one guarantor under a single agreement is being certified. The levy benefit in respect of each guarantor will be based on the individual realisable recovery certified, subject to an overarching credit of the liability cap specified within the contingent asset agreement. As now, the liability of the guarantors remains joint and several.

8.6 Guarantor gearing adjustments

8.6.1 No guarantor gearing adjustment will be applied where a guarantee is from a credit rated or 'Special Category Employer'. The existing adjustment formula remains appropriate for guarantors scored using the credit model.

8.6.2 When calculating the gearing adjustments, we will no longer reduce the guarantee for guarantor-employers by their proportionate share of the underfunding (on the basis that they will already be receiving credit for this component under the relaxations set out in section 8.4 above).

8.7 Asset-backed contributions

ABC loan notes

8.7.1 In our March consultation, we invited views on options for reducing the certified ABC Value by an adjustment factor based on comparing the levy reduction which would result from treatment as an ABC against the reduction which would result if the ABC was treated in the same way as a Type A contingent asset. This was on the basis we considered ABC loan notes, being a financial promise to the scheme, to be closer in nature to Type A contingent assets than other ABC arrangements.

8.7.2 While responses indicated a level of support for a change in treatment in principle, the majority of respondents considered that no change to the current treatment of ABC loan notes was required. In particular respondents felt that treating these arrangements as analogous to evergreen Type As may result in overly generous treatment due to their finite nature, and the greater level of restrictions which they considered were in place around ABC loan notes in comparison to Type A arrangements.

8.7.3 A number of respondents also felt that the risk attaching to ABC loan notes was already factored into the valuation and that, given the diverse range of structures in use, creating a universal form of treatment may be difficult in practice.

8.7.4 Having considered responses received, we are persuaded that, at this point, there is not a strong case for changing our current treatment of ABC loan notes. However, in large part this reflects the relatively limited size of the population of loan note based ABC's, and we will keep these arrangements under review for future levy years.

ABCs based on real estate

8.7.5 A number of stakeholders have suggested that our current requirement to obtain a certificate of title in respect of an ABC based on real estate can be difficult where multiple properties are involved. Currently, our requirement is that the trustees obtain a certificate of title in respect of an ABC asset consisting of real estate.

8.7.6 Having considered stakeholders' views, we recognise that there may be practical difficulties in obtaining individual certificates of title for each property under an ABC arrangement where multiple properties are involved. From the 2018/19 levy year, we have, therefore, decided to offer trustees wishing to certify such an arrangement two alternative options. They will be able to partially certify the ABC in respect of those properties for which a certificate of title has been obtained. Alternatively, they may obtain some alternative evidence of title and provide this to the valuer who will then decide how this evidence should be taken into account when producing the valuation the valuer is able to have confidence that the properties are owned sufficient to offer a duty of care on the valuation, then we are prepared to accept it.

8.7.7 We have updated paragraph 6(4) of the ABC Appendix and added guidance to Part 2 of the ABC Guidance to reflect the above decision.

9. Other Issues

9.1 Schemes without a substantive sponsor

9.1.1 In February we consulted on a levy rule for 2017/18 for "schemes without a substantive sponsor" (SWOSS) that were newly arising as a result of a regulatory apportionment arrangement (RAA) or insolvency. This consultation was necessarily brief, and gave rise to a limited number of comments, and questions. So, alongside publishing the final levy rule in March, we provided further information on how the rule might be expected to operate – and encouraged stakeholders to comment further with a view to informing our approach for 2018/19.

9.1.2 So far, we have received no additional comments on the SWOSS levy rule from stakeholders, though it has become clear that a SWOSS scheme is likely to come into existence. We have considered whether there is a need to change the levy rule but concluded there is no need to adjust the rule as it stands for 2018/19.

9.1.3 Recognising there might be existing schemes that had the characteristics of a SWOSS, we indicated in the 2017/18 consultation that we did not rule out extending the rule to cover a wider group of schemes in a later year. Although there is a good theoretical case for extension to schemes (in order to more accurately "price" their risk), we believe the issue is most appropriately considered with Government and TPR – rather than amending our approach to the levy in isolation. In view of the policy intention to treat SWOSS schemes separately from other schemes and, in particular our aim to avoid cross-subsidy, we see no difficulty in amending it outside our normal three-yearly cycle as effects on other schemes would be minimal.

9.2 Schemes following a restructuring

9.2.1 Our Levy Rules currently provide for a scheme that enters assessment and cannot be rescued to be charged no levy. In the light of recent experience we have identified there may be circumstances in which, due to a restructuring, a scheme enters an assessment period in the expectation that a successor scheme will be established.

9.2.2 We think it is appropriate that we have the ability to charge a levy in such a scenario, as the expectation is there will be an ongoing risk to the PPF from the new scheme. We have, therefore, put in place a rule that allows us to charge a levy to the scheme in assessment, and to the successor scheme that is established, and provides flexibility in the way that it is assessed, since it is impracticable to specify the most appropriate basis in advance. As with a SWOSS scheme, we anticipate that the rule will only apply in very limited circumstances.

Part II: Consultation on the Levy Rules for 2018/19

10. The Levy Scaling Factor and Levy Estimate

10.1 Introduction

10.1.1 Our levy framework was introduced for the levy year 2012/13 with the aim of placing levy payers' priorities of stability and predictability at its heart, whilst also maintaining progress towards the PPF's long-term funding objective.

10.1.2 The intention was for the levy parameters - including the LSF and Scheme-Based Levy Multiplier – to be fixed within a three year period or triennium under normal circumstances. To allow for exceptional circumstances, we said we would plan to revise the levy parameters within a triennium if the levy estimate would otherwise:

- exceed the statutory levy ceiling for any given year; or
- result in the scheme-based levy estimate exceeding the statutory maximum of 20 per cent of the total levy estimate; or
- vary from the previous year's estimate by more than 25 per cent (increase or decrease).

10.1.3 Our 2018/19 Levy Rules will set the levy parameters for 2018/19 - the first year of the third triennium - when they are published in December and we expect them to remain unchanged for the following two years.

10.1.4 A key feature of our levy framework is that, to meet levy payers preference that their bills are calculated on the most up-to-date data, we set our levy estimate in advance of collecting the information on which bills are based. This means that we have to accept a degree of uncertainty about the level of actual levy collection – which could differ from the published levy estimate. We set out the process we have followed to generate the estimate and key assumptions below.

10.2 Context for the Levy Estimate

10.2.1 In considering the level at which to set the levy estimate we have had regard to three key factors - our Funding Strategy, which focuses over the next 13 years; likely shorter term trends, and the desirability of maintaining stability in overall policy on the quantum across successive triennia.

10.2.2 The Funding Strategy was reviewed and updated alongside our Annual Accounts published in July. These showed that the PPF funding level was 121.6 per cent as at 31 March, an increase from 116.3 per cent as at 31 March 2016. The probability of success[10] has remained steady at 93 per cent.

[10] The probability of success, the chance of being self-sufficient, or 110 per cent funded, in 2030, is one of two key measures of progress in our funding strategy – alongside our downside risk.

10.2.3 Our funding strategy, therefore, remains on track, though there remain substantial risks to our funding objective with the aggregate deficit on eligible schemes many times our reserve.

10.2.4 Over the past year, we have seen growth in equity markets but a low interest rate environment has meant that scheme funding remains weak. Our published measure of scheme funding, the PPF 7800 funding ratio, was 87.0 per cent at March 2017, significantly lower than the equivalent figure three years ago (96.7 per cent at March 2014). As a result of the significant fall in gilt yields over the period since the last triennium review, the five year moving average of the funding ratio, relevant for the PPF levy, has decreased from around 91 per cent to around 86 per cent.

10.2.5 Insolvency risk has been broadly steady over the past year. The one-year ahead insolvency probability for the company sponsors of our 500 biggest risks has increased only marginally, from around 0.6 per cent in March 2016 to 0.7 per cent at March. The aggregate deficit for schemes in deficit has decreased from £337.9 billion to £295.4 billion over the same period.

10.2.6 UK economic growth recovered relatively quickly from the result of the EU referendum in June 2016, but has slowed markedly in the first half of 2017, and remains lower than this time last year.

10.2.7 Overall, the economic forecast is highly uncertain, mainly as a result of Brexit, with the UK outlook depending very much on how the negotiations as a result develop over time.

10.2.8 Once the LSF is published it is expected to remain fixed over the triennium, if risk falls over the period, the amount of levy collected will also fall (and vice versa). Our projections show that total levy collected is likely to fall marginally over the triennium. This reflects our expectations that scheme underfunding will improve as interest rates (and gilt yields) rise.

10.2.9 The introduction of new Experian scorecards will have a significant impact on some individual bills (and we would see both increases and decreases). However, any bills which are projected to increase may drive behavioural changes that are very hard to predict. The need to make assumptions in this respect increases the extent to which actual collection may differ from the published estimate.

10.3 The Levy Estimate

10.3.1 In setting the levy estimate for 2018/19, the Board has been mindful that there remains significant risk within the PPF eligible universe, for example:

- interest rates remain very low, but expectations are that they may rise, potentially causing a rise in insolvencies
- the impact of Brexit on both the PPF and the wider universe is highly uncertain, and
- a large claim in the near future remains a very real prospect.

10.3.2 However, our funding position is strong, as noted above, and we are aware of the pressures that remain on scheme funding - for example, due to the challenging market conditions which persist.

10.3.3 On balance, the Board considers that a reduction to the 2017/18 levy estimate of £615 million is appropriate for 2018/19 and as such, has set an LSF which is expected to collect a quantum of £550 million, given the policy changes which are set out and the assumptions we have made.

10.4 Levy Parameters

10.4.1 Following the policy changes which have been set out in the Policy Statement and proposed in this consultation document, we expect to need to set an LSF of 0.48 to collect the 2018/19 Levy Estimate of £550 million.

10.4.2 When the Risk Based Levy Cap was set, the policy intention was for around 5 per cent of schemes to benefit from this introduced limit. Our projections show that, if the level of the cap were to remain unchanged at 0.75 per cent of smoothed liabilities, fewer schemes would benefit from the cap at the start of the third triennium with numbers falling as the triennium progresses.

10.4.3 For this reason, combined with the fact that as gilt yields have fallen, the monetary amount of the cap for a given scheme has risen, the Board intends to reduce the risk based levy cap from 0.75 per cent of smoothed liabilities to 0.5 per cent of smoothed liabilities.

10.4.4 Although our policy intention is to use the scheme-based levy to cover the “cost” of the cross-subsidy introduced by the cap on the risk-based levy, the Board proposes to set the scheme-based multiplier for 2018/19 at 0.000021 – ie, unchanged from its current level - as we expect the financial impact of the reduction to the cap to be offset by other factors.

10.4.5 Retaining the scheme-based multiplier at its current level results in a scheme-based levy constituting around 5 per cent of the total levy.

10.5 Assumptions

10.5.1 Assumptions are needed to generate the scaling factor which we expect will collect £550 million, since we produce this estimate well in advance of receiving any of the data that will be used in the levy invoice calculations. For example, scheme return data, contingent asset certifications and average monthly Experian failure scores will not be known until 31 March 2018, with block transfer and Deficit-Reduction Contribution information received later than this.

10.5.2 Our approach to setting the assumptions is broadly unchanged from that used to set the levy estimate last year. The main exceptions to this are:

- improvements to Experian scores
- contingent asset certifications, and
- DRCs.

10.5.3 In other areas, broadly speaking, we have used past experience as our best guide to the future.

10.5.4 To provide further information in support of our approach, we sent a questionnaire to a number of firms of actuaries requesting their views on scheme behaviour in relation to deficit-reduction contributions, contingent assets and bespoke stress submissions, amongst other things. We received a response from 11 firms, and are grateful for their valuable input.

10.5.5 Setting assumptions is always difficult, but we consider these assumptions provide a balanced view of the factors which may affect the total levy.

10.5.6 The sections below give commentary on the assumptions where our methodology has changed most significantly since last year.

10.6 Improvements to Experian scores

10.6.1 The 2017/18 levy estimate was based on historical Experian scores under the current scorecards. No allowance was made for any aggregate improvement in these scores, as the prevailing trend at the time was for scores to remain stable.

10.6.2 The new and recalibrated scorecards to be used for levy year 2018/19 do not come into force until October. However, Experian have provided us with retrospectively calculated scores for the purpose of our analysis.

10.6.3 As noted above, it is difficult to predict the extent to which employer action will serve to improve the scores from this new 'basepoint'. Nonetheless, we consider that some allowance for score improvement is appropriate; consistent with the patterns observed in the earlier years under Dun & Bradstreet, and again with the introduction of the current Experian model for the second levy triennium.

10.6.4 Any allowance for score improvements is necessarily subjective. We anticipate that the introduction of the new and recalibrated scorecards may provide incentives for employers to seek to improve their scores. However, the potential scope is likely to be smaller than it was under the more fundamental shift from a commercial to a bespoke insolvency risk model for the second triennium. Consequently, we have assumed the aggregate reduction in levy collections will be £30 million, representing approximately half the corresponding impact observed at the start of the second triennium.

10.7 Contingent Asset certifications

10.7.1 Our assumptions in respect of contingent asset recertifications, new certifications and rejections have been derived using similar methodology to last year, based on a continuation of the existing regime. However, as set out in more detail in chapter 8, we are proposing a number of changes for the third triennium.

10.7.2 On one hand, our new requirement to obtain a guarantor strength report before certifying a contingent asset which gives rise to a levy reduction of £100,000 or more could potentially lead to a reduction in the number or value of contingent asset certifications. On the other hand, our proposals to credit guarantor-employers with their proportionate share of the underfunding in addition to the realisable recovery certified, and recognising separate realisable recoveries under multi-guarantor agreements could potentially lead to an increase in the number or value of contingent asset certifications.

10.7.3 On balance we consider the two relaxations of our requirements are likely to dominate the impact of the new certification requirement, leading to increased contingent asset certifications and hence lower levy collections. In particular, our questionnaire respondents commented that schemes certifying contingent assets with a substantial levy credit were likely to already obtain guarantor strength reports as part of good governance.

10.7.4 It is difficult to predict the extent to which these changes will drive scheme behaviour. However, to inform our analysis, we have examined the impact of the tighter certification requirements which were introduced for levy year 2012/13 and which led to additional collections for that year due to a significant number of non-recertifications. Contingent assets now have a relatively small overall impact on levy collections compared to 2012/13, so that the potential impact of policy changes in this area is similarly reduced. We have, therefore, assumed the changes to the contingent asset regime for 2018/19 will have half the impact of the 2012/13 policy change, calculated as a proportion of the overall contribution of Type A contingent assets to levy collections and expressed as a reduction rather than an increase. This produces a modest anticipated reduction in levy collections of around £5 million.

10.8 Deficit-Reduction Contributions (DRCs)

10.8.1 In our March consultation document, we suggested two possible options for simplifying the regime for certifying DRCs. As noted above, responses to proposals to simplify the regime were overwhelmingly positive, and our settled approach is to remove the requirement to deduct investment management expenses and, for some smaller schemes, to instead allow certification based on Recovery Plan contributions.

10.8.2 Based on this, we expect to see an increase in the level of DRCs certified from 2018/19 onwards. We expect larger amounts to be certified from schemes which have previously certified DRCs, and additionally for DRCs to be certified from some schemes that have not previously certified, since it may now become cost effective to do so.

10.8.3 In order to estimate how much bigger the certified contributions will be under this new methodology for schemes which already certify DRCs, we have used data on annual management charges from the PLSA 2015 Fee Arrangement Survey to estimate, for each scheme with an existing DRC submission, the impact on certification of excluding investment management charges.

10.8.4 In addition, we expect the new DRC methodology to encourage new certifications of DRCs from schemes not currently certifying. For simplicity, we have assumed that all such schemes with a recovery plan and which are underfunded for levy purposes will certify the recovery plan contributions due to be received over the 2018/19 certification period.

10.8.5 The combined impact of these two assumptions is to reduce levy collections by around £20 million.

10.9 Consultation questions

10.9.1 ***Do you have comments on the approach to calculating the LSF?***

10.9.2 ***Do you agree with our proposal to reduce the Risk-Based Levy cap?***

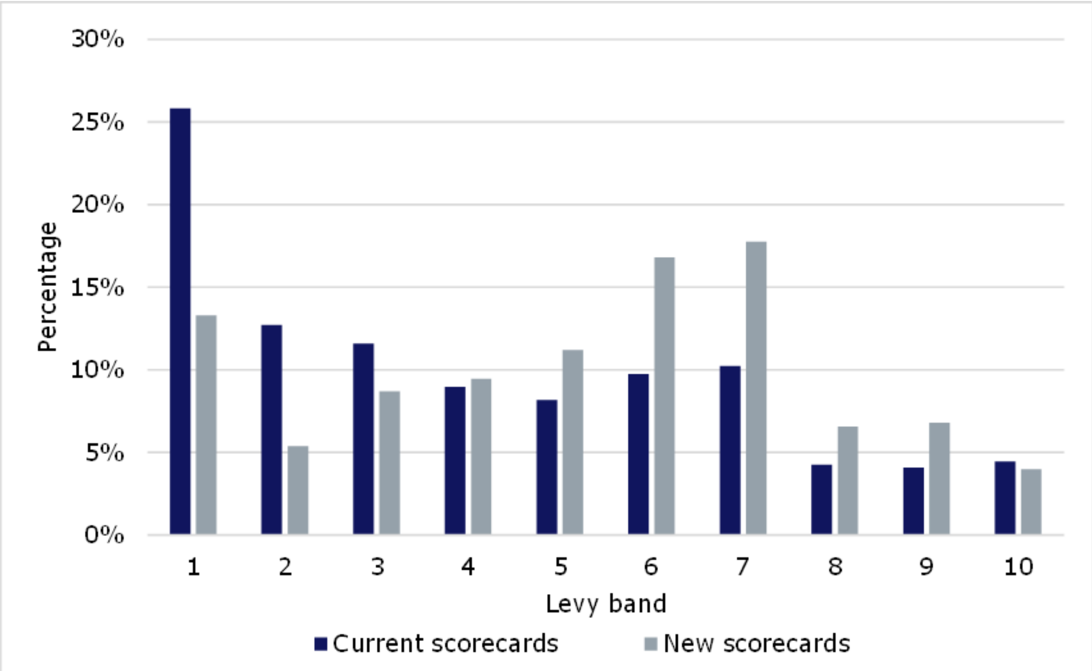
11. Levy Bands and Rates

11.1 Levy Bands

11.1.1 For previous triennia we have carried out work to assess how to set the levy bands in order to produce a desired distribution of scores across the population of employers. As part of our work on the third triennium we have considered whether to adjust the starting and finishing insolvency probabilities for each levy band, which would alter the distribution of employers across the bands.

11.1.2 The initial design for the levy bands for the second triennium was for 10 bands, with 20 per cent of employers and guarantors in the top band, 5 per cent in each of the bottom two bands, and 10 per cent in other bands. In practice, scores were more heavily skewed toward the best bands than intended, with around 40 per cent in the top two bands. For the third triennium a lower proportion are currently scored in the top bands than have been for the second triennium (though there is the potential for scores to drift upward as stakeholders become familiar with the new scorecards) and the figures are relatively close to our initial intent. The chart below shows the comparison.

Chart 11.1: Employers by Levy Band: existing v new scorecards



11.1.3 Generally accepted practice in segmenting risks suggests the following guidelines:

1. A minimum of 8 to 10 bands for "performing" insolvency risks – ie, insolvency risk <5 per cent or <10 per cent.
2. 1 to 3 bands for "high risk cases" – ie, insolvency risk >5 per cent or >10 per cent.
3. Proportion in any performing band not to exceed 5x proportion in any other band.

11.1.4 Based on the second triennium design, an insolvency risk greater than 5 per cent is associated with levy band 10 (since it covers risks above 2.986 per cent) satisfying the second condition. The remaining nine levy bands are for “performing” insolvency risks, satisfying the first condition. The third and final condition is also satisfied as shown in the table below: as for those nine bands – the ratio of the largest band to the smallest (band 7 to band 2) is just over 3. By comparison, whilst our design intention for the existing scorecards was a maximum ratio of 4, this has in fact been exceeded.

11.1.5 We, therefore, conclude that continuing to use ten bands in the third triennium model is consistent with the suggested approach.

11.1.6 In addition we looked at the confidence intervals around the average insolvency rates by levy band. We calculated a 95 per cent confidence interval and found that for the PPF universe, as a whole, actual observed insolvencies are within the 95 per cent confidence interval for each of the levy bands.

11.1.7 We have not tested if each levy band has a statistically significantly different estimated mean annual insolvency rates. However, it appears that despite the small population size, there is strong evidence of there being a significant difference between the estimated mean annual insolvency rates for levy bands 6 to 10 – ie, lower bounds and upper bounds do not overlap, so that there can be 95 per cent confidence the insolvency rate for the “better” band will be lower than for the “worse” band.

Table 11.3: Predicted insolvency rates and confidence intervals

Levy Band	Lower Bound	Upper Bound	Observed Insolvencies
1	0	3	3
2	0	4	1
3	1	9	6
4	4	17	13
5	13	31	17
6	59	93	59
7	118	165	125
8	92	133	114
9	182	238	219
10	272	339	325
Total	825	940	882

Levy Band	Lower Bound	Upper Bound	Predicted Insolvency Rates
1	0.00%	0.05%	0.01%
2	0.00%	0.11%	0.04%
3	0.01%	0.13%	0.07%
4	0.05%	0.20%	0.11%
5	0.11%	0.27%	0.19%
6	0.28%	0.44%	0.36%
7	0.60%	0.84%	0.72%
8	1.05%	1.52%	1.29%
9	1.90%	2.48%	2.18%
10	4.53%	5.65%	5.08%
Total	0.81%	0.92%	0.86%

11.1.8 Finally, consideration was given to the mapping of public credit ratings to levy bands. The current levy band design results in those with letter rating BBB/Baa (eg, BBB+/BBB/BBB-) not being assigned levy band 1, unlike those with a public credit rating of letter rating A or better. To sense check this result we reviewed a report by Moody's in the "Journal of Banking & Finance" which investigated if historical mean default rates for different letter ratings effectively distinguished relative credit risk. The conclusion was for the "low-default portfolio" portion of the rating scale – letter ratings Aaa, Aa, and single A - the default rates are not statistically different over a horizon of one year, but they are for all the other letter ratings categories. This is consistent with the current levy band design. On the other hand, optimizing the lift links those rated BBB (flat) /Baa2 or better to levy band 1.

11.1.9 In the light of: the similarity of the distribution to our initial intent for the second triennium, consistency with best practice, observed insolvencies / predicted insolvency rates being within their 95 per cent confidence interval, and consistency with Moody's in terms of grouping the "low-default-portfolio" it is, therefore, proposed not to alter the design of the levy bands.

11.2 Levy Rates

11.2.1 We have also reviewed the levy rates that linked to each levy band. The levy rates associated with each levy band have, in the past, been set using a combination of a theoretical approach, based on the incorporation of a risk margin, together with expected insolvency rates, and a desire to produce a pattern of charges that offer a relatively smooth progression from band to band. We have also, to an extent, recognised the evidence for considering successive levy bands reflect genuinely different levels of risk is less strong for those in the lowest risk categories.

11.2.2 We have relatively little experience of insolvency for entities within bands 1-4 on which to justify differential rates – and, as set out above, the confidence intervals for these levy bands make a limited case for saying that successive bands will produce more insolvencies. Given that an employer can be in levy band 1 with a 1 in 3,400 chance of becoming insolvent, or in levy band 4 with a 1 in 1,200 chance, movements within these 4 bands in particular can be influenced by very minor factors. However, the existing levy rates imply a significant increase in levy for a single band movement and an increase of 135 per cent between band 1 and band 4. e propose adjusting the levy rates applied, so that the differential is smaller – reflecting the limited increase in risk and the degree of certainty about relative ratings.

11.2.3 We are proposing revised levy rates for levy bands 1 to 3 starting at 0.28 for band 1 and rising to 0.40 for levy band 4. These rates are proposed as providing the equivalent of a single band movement elsewhere in the population for the move from band 1 to 4. (ie, around a 50 per cent rise in levy rather than 135 per cent rise)and a slight increase in steps up between each successive band (ie, 0.03, 0.04, 0.05 increase).

11.2.4 Other things equal, the adjustment made to the levy rates would increase levy collection, and so a lower LSF will be required than without the change.

Do you have comments on the proposals for levy bands and levy rates?

12. Underfunding

12.1 Appropriateness of current approach to underfunding

12.1.1 We made significant changes to our approach to measuring underfunding and investment risk for the 2012/13 levy year as part of the implementation of our new levy framework. The main changes made were the introduction of:

- Smoothing of the rolled forward assets and liabilities using a five year smoothed average of relevant indices and yields.
- An assessment of scheme investment risk through the application of standard stresses to scheme assets and liabilities.
- Replacement of the standard asset stresses with a bespoke stress test for schemes with protected liabilities at their last section 179 valuation of £1.5 billion or more, with optional completion for other schemes.

12.1.2 Overall we believe that the methodology introduced for 2012/13, and reviewed for 2015/16, continues to work well and we are, therefore, not proposing any changes to the framework for the third triennium. We have, however, reviewed the actual stress factors that are applied to assets and liabilities.

12.2 Asset classes and indices

12.2.1 Information on the assets and liabilities of schemes is captured through TPR's Exchange system, and the format of the information collected has remained broadly unchanged since 2005.

12.2.2 It is now five years since stressing of assets and liabilities was introduced and we would like to ensure that the way in which asset information is split for the standard and bespoke stress tests remains fit for purpose. Over the past five years investment products have evolved and more sophisticated investment strategies have become accessible to a wider range of schemes. We are, therefore, planning to work with TPR to review the suitability of asset classes to support better risk management for both organisations and to enable a more risk reflective levy to be set which in turn should translate into a fairer levy.

12.2.3 This work may result in updates being made to asset classes, however any such changes would be introduced for the 2019/20 levy year at the earliest. In the event that changes were to be introduced then we would be mindful of the desirability of having regard to impacts in a non-triennial year.

12.2.4 We are also keen to understand whether the differences in asset classes between the standard and bespoke stress tests remain appropriate. When we introduced the bespoke stress test in 2012/13 we expected that it would only be advantageous for schemes to complete if they had risk-reducing derivative strategies. Increasingly however, we are seeing schemes which do not appear to have such derivative strategies but nonetheless elect to carry out bespoke stress tests. Anecdotal evidence suggests that this is in order to benefit from the increased granularity of the asset classes which the bespoke stress test offers, such as for bonds.

Consequently there may be a case for routinely collecting this more granular information to increase the accuracy of assessment of funding and allow schemes of all sizes to benefit from that better assessment.

12.2.5 In line with our policy intention we would only make changes where we believe that requiring additional information would lead to a substantially improved view of scheme investment risk.

12.2.6 Over recent years we have received comments from some stakeholders that they do not favour the use of the IPD UK Monthly Property Total Return Index for use in the roll forward of the property asset class due to the cost of obtaining the index values making it more challenging for advisors to predict or accurately replicate actual levy bills.

12.2.7 We have worked with investment consultants to review the appropriateness of the index. Although the IPD property index comes at a cost to obtain, we are of the view that the index is extremely widely used and that its constituent make-up means it is the most appropriate index to use at this time.

12.2.8 We will continue to review the situation and consider alternative indices for their suitability.

12.2.9 We confirm that no changes to either asset classes or indices will be made for 2018/19.

12.3 Review of asset and liability stress factors

12.3.1 As part of our review we appointed Mercer Limited ('Mercer') to work with us on updating the asset and liability stress factors for the third triennium and in considering whether the underlying methodology remains fit for purpose.

12.3.2 Mercer have updated the stress factors to incorporate the latest scheme asset allocation data and market conditions. The current factors in force are based on scheme data at 31 March 2009 and market data between 31 December 2005 and 31 March 2011. The new factors are based on scheme data as at 31 March 2017 and market data between 31 December 2005 and 30 June 2017.

12.3.3 We believe the reference period of data used to produce the stress factors should be extended to be the longest period we have available. This captures a through the cycle view of volatility – reflecting periods (in the aftermath of the credit crunch) of high volatility - and recent experience of lower volatility. It is also consistent with the approach we use for insolvency data - where all available experience was included when the model was rebuilt.

12.3.4 We consider that focusing only on recent data or a move to market consistent rates might have some advantages in offering a more plausible view of volatilities in the very near future but that the choice of period or market forecasts used could be difficult to frame objectively. Moving to such a basis could also render levy methodology less stable over time (eg, if expected volatility increases again our stresses would need to increase).

12.3.5 Given the task that we are seeking to carry out – making a broad assessment of the investment risk posed by schemes as part of a risk-reflective but stable levy - for the purposes of allocating levy between schemes we do not think such an approach would be proportional or desirable.

12.4 Stress factor methodology changes proposed

12.4.1 Mercer concluded that the methodology currently in place remains broadly fit for purpose; however, we propose to make a number of adjustments to the methodology on their recommendation to better assess investment risk and ensure consistency between schemes.

Change of approach to liability risk factor stresses

12.4.2 Mercer have recommended, and we propose to adopt, a different approach to derive the risk factor stresses that are applied to the section 179 liabilities.

12.4.3 Currently the interest rate and inflation rate stress factors are set separately. However, as nominal yields can be quite volatile compared to real yields setting the interest rate and inflation stresses separately can overstate the impact of stressing.

12.4.4 Section 179 liabilities mirror PPF compensation and are, therefore, significantly fixed in nature (due to the caps on indexation). This in turn means that underfunding is particularly sensitive to the interest rate stress rather than the inflation stress.

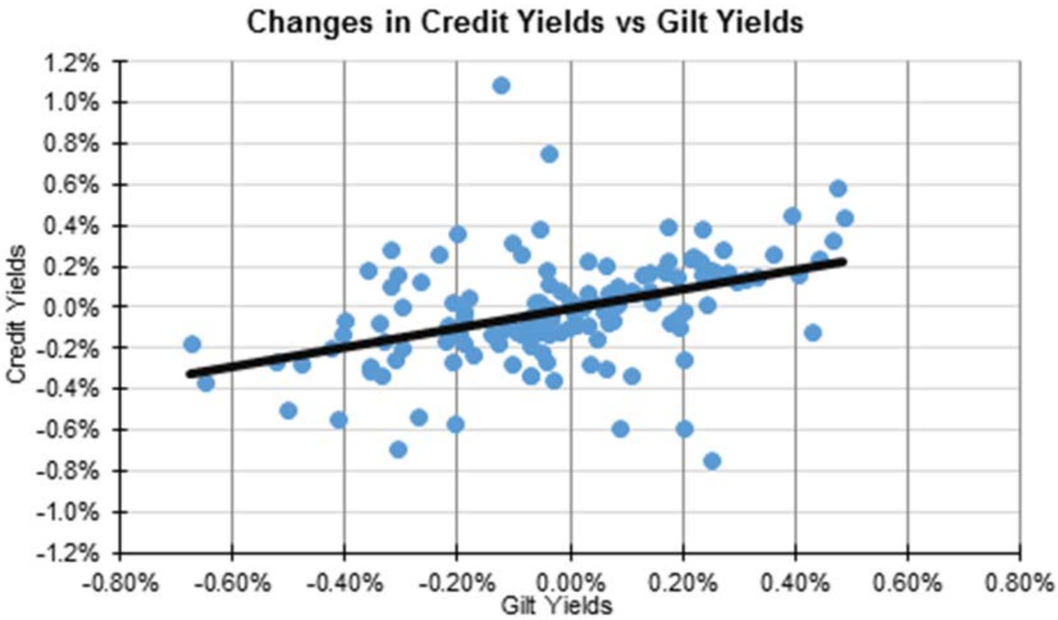
12.4.5 Therefore, for 2018/19, we have instead calculated stress factors for real and nominal rates and then used these to set the interest rate stress factor (equal to the nominal rate stress factor) and the inflation stress factor (equal to the difference between the real rate stress factor and the nominal rate stress factor).

12.4.6 We are continuing to specify risk factor stresses using the existing interest rate and inflation factors as this will prevent the move to estimating volatility using real and nominal rates from requiring the rebuilding of existing models for rolling forward and stressing assets and liabilities. This change of approach will not have any operational knock-on effects since presentationally the factors will not look any different to how they look currently. We have updated the draft Investment Risk Appendix, Transformation Appendix and SWOSS Appendix to reflect this change (and the other changes described below).

12.4.7 The change impacts the liability stress factors and also flows through into the government bond stress factors.

Change of approach to credit spread risk factor stress

12.4.8 The approach to deriving the credit spread stress has also been adjusted. Since corporate bond yields and gilt yields are highly correlated Mercer looked at a comparison of gilt yields and corporate bond yields.



12.4.9 The graph shows that the correlation between corporate bond yields and gilt yields is roughly one half, and, therefore, it is expected that any movement in gilt yields is accompanied by a similar move in corporate bond yields in the same direction, but to half the extent. Therefore, since the corporate bond yield is the combination of the gilt yield and the credit spread, the credit spread yield would increase by half the extent of the gilt yield movement. The credit spread stress factor has, therefore, been set to be half of the interest rate stress factor.

Allowance for diversification

12.4.10 The present methodology gives credit for diversification of asset allocation by reducing the stress factor for each of the growth asset classes by a uniform percentage.

12.4.11 However, this approach does not take any account of the varying correlation of volatility between different asset classes.

12.4.12 Mercer have therefore worked with us to produce asset specific diversification factors and apply them to the growth asset stress factors. In some cases we have applied a ‘cap’ to the diversification benefit to limit the reduction to the stress factor. This is to avoid reducing any particular stress factor so much that schemes are encouraged to heavily invest in one class thereby negating the diversification benefits.

Frequency of sampling of property index

12.4.13 Properties are typically valued for the index on a quarterly basis. The current approach of calculating volatility using a monthly index sampling period, therefore, artificially reduces volatility since, in each month, many properties will have the same valuation as the previous month.

12.4.14 The monthly sampling approach could potentially be countered by applying a ‘de-smoothing’ adjustment to artificially uplift the property stress factor, but any such adjustment would necessarily involve a degree of judgement.

12.4.15 Instead Mercer have used a quarterly sampling approach thus removing the need for a 'de-smoothing' adjustment.

12.4.16 All other asset stress factors have been calculated using the current approach of daily index sampling.

12.5 Revised asset and risk stress factors

12.5.1 The asset and risk stress factors we propose to use for levy year 2018/19 onwards, for both the standard and bespoke stress test, are set out in Appendix 5, along with the current factors for comparative purposes.

12.5.2 Generally stress factors for growth asset classes have reduced in absolute terms whilst those for fixed interest bonds have increased reflecting a more stringent interest rates stress on the liabilities.

12.5.3 The inflation stress factor now serves to reduce liabilities and this leads to a reduction in the value of inflation-linked bonds.

12.6 Bespoke stress test

12.6.1 As awareness of the bespoke stress test has increased and more sophisticated investment strategies have become available to a wider range of schemes more and more schemes have been voluntarily submitting the results of a bespoke stress test.

12.6.2 As set out in the bespoke stress test guidance, we typically only expect that schemes with risk reducing derivative strategies will benefit from voluntarily submitting a bespoke stress test.

12.6.3 The guidance also sets out our expectation that once trustees of a scheme have chosen to submit a bespoke stress test result we generally expect them to continue to submit results in respect of that scheme each year, rather than opting in or out.

12.6.4 Since we consider that there is scope for gaming potential in respect of voluntary bespoke stress test submissions, we have carried out some analysis of these submissions, particularly looking at those schemes that submit results on a voluntary basis.

12.6.5 Our analysis shows that of the schemes which have voluntarily submitted a bespoke stress test result since the regime was introduced, as we expect, the majority of schemes either consistently submit a stress test result or consistently do not submit a result.

12.6.6 However, we have found that a significant minority of schemes appear to be opting in and out of the regime, year on year.[11] Whilst there are a number of reasons why we might expect this behaviour, for example due

[11] We excluded the first year of operating the bespoke test from our analysis as there was an expectation that there might be schemes that carried out the test once but found the impact less significant than expected.

to changes in investment strategy, the volume of schemes behaving in this way is higher than could be reasonably attributed to such changes. This leads us to suspect that some schemes are calculating their stressed assets under both the standard and bespoke stress tests each year and submitting under the more favourable approach.

12.6.7 We would draw trustees' attention to the guidance when considering whether to voluntarily submit a bespoke stress test or not.

12.6.8 We will continue to monitor submissions, and may consider, for example, a reduction to the £1.5 billion threshold in a future year to minimise any suspected gaming should the trends that we are starting to see continue to materialise.

13. Impact Assessment

13.1 Introduction

13.1.1 We have updated the impact analysis of levies for 2017/18 carried out for our March consultation to reflect the full range of policy proposals included in this consultation document, and also data received since March (including insolvency risk data for April 2016 to March 2017). In both cases we targeted a total levy Estimate of £615 million to enable a fair comparison to be made.

13.1.2 In other words, the impact analysis shows what the impact would be on 2017/18 levy invoices were these policies in place now. It does not, therefore, reflect the impact of the lower levy Estimate for 2018/19 – which will reduce levies payable by schemes by around 10 per cent – relative to a £615 million levy Estimate for 2017/18.

13.1.3 Overall, the analysis shows a very similar pattern of results to the March impact analysis – reflecting the main factor affecting levies is the move to the new scorecards and the consequential reduction in levy scaling factor. Limited changes arise because of the new data available and the new policy changes.

13.1.4 In summary, our latest analysis shows:

- almost two-thirds of schemes would have seen a lower levy if the new rules had applied in 2017/18
- fewer than one fifth of schemes would have seen increases in levy
- employers on scorecards used for SMEs will see a significant reduction in levy – in aggregate paying one-third less in levy[12]
- not for profit entities and those with credit ratings also pay less, and
- schemes with employers on scorecard 1 (the non-subsidiaries £30+ and large subsidiaries scorecard) are the most likely to see an increase in levy, with around one in three seeing an increase in levy – and average increases across the scorecard of 45 per cent.

13.1.5 This chapter focuses on the key themes to emerge from the impact analysis. A more detailed analysis is shown within Appendix 6.

13.2 Schemes seeing changes in levy

13.1.6 As in the March consultation, the proportion of schemes seeing a reduction in levy overall is almost two-thirds, with just under a fifth of schemes seeing no change in levy, and just under a further fifth paying a higher levy. Table 13.1 below summarises this.

[12] See Table 13.4

Table 13.1: Number of schemes that would see increases / decreases / no change in levy

	Increase in levy	Decrease in levy	Unchanged	Total
Number of schemes	1,050	3,593	995	5,638
Percentage	18.6%	63.7%	17.6%	100.0%

13.3 Shift in the distribution of levy

13.1.7 The most notable effects of the proposed policy changes, as shown when looking at each scorecard separately (as shown in charts 13.2 and 13.3), are:

- Most schemes sponsored by rated companies see a reduction in levy (however, a small number pay substantially more). In aggregate, this group experiences a slight reduction in levy.
- There are a number of large schemes whose employers are on scorecard 1 that see an increase in levy (though a larger number of entities on this scorecard see a fall). The increases largely reflect that this scorecard now predicts a historic level of insolvencies consistent with experience (whereas predecessor scorecards were underestimating the level of insolvencies). There are also significant changes in scores under the revised model for a smaller number of schemes.
- The vast majority of entities scored on other scorecards see a reduction in levy, and the total levy collected from these schemes falls. This includes those scorecards most associated with SME employers, and not for profit entities.

Chart 13.2: Proportion of employers that would see increases / decreases / no change in levy by scorecard[13]

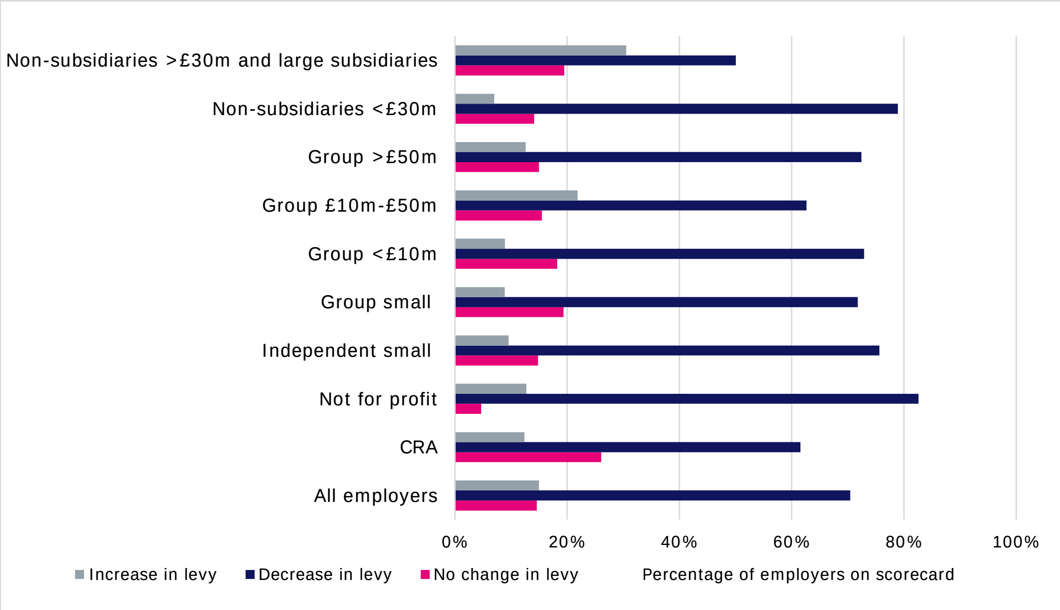
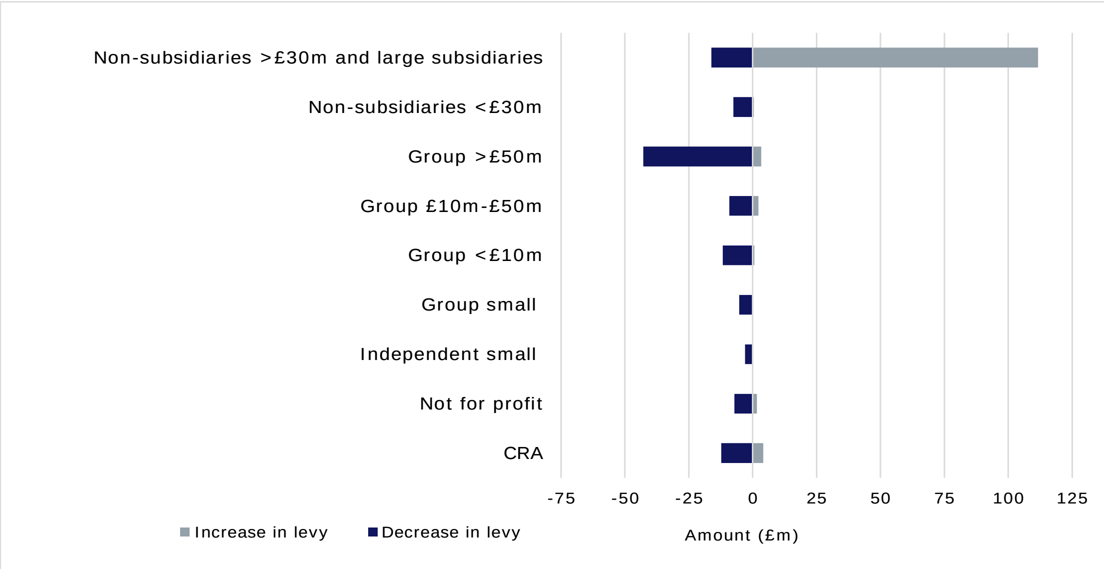


Chart 13.3: Increases / decreases in levy amount by scorecard



13.1.8 As in the March consultation, it is worth noting that scorecard 1 includes a disproportionately high number of employers which sponsor large schemes. Therefore, the increase we are seeing in levies for scorecard 1 are in the context of a large base.

[13] Multi-employer schemes where the employers are on different scorecards have had their levy attributed to the different scorecards according to the number of members in each participating employer to the scheme.

13.1.9 Table 13.4 below shows the percentage change in levy. It is notable from this there are large percentage reductions in levy for the group companies, particularly for companies on the group small scorecard where the levy is expected to halve on average, which is much more pronounced than in the first consultation. So for some corporate groups, an increase in levy for a parent company may be offset by a reduction for its subsidiaries.

Table 13.4: Percentage change in levy by scorecard

Scorecard	% increase / decrease in levy collections
Non-subsidiaries £30m+ and large subsidiaries	45.5%
Non-subsidiaries <£30m	-39.0%
Group £50m+	-25.1%
Group £10m-£50m	-16.9%
Group <£10m	-38.1%
Group small	-53.5%
Independent small	-45.0%
Not for profit	-18.9%
CRA	-7.7%

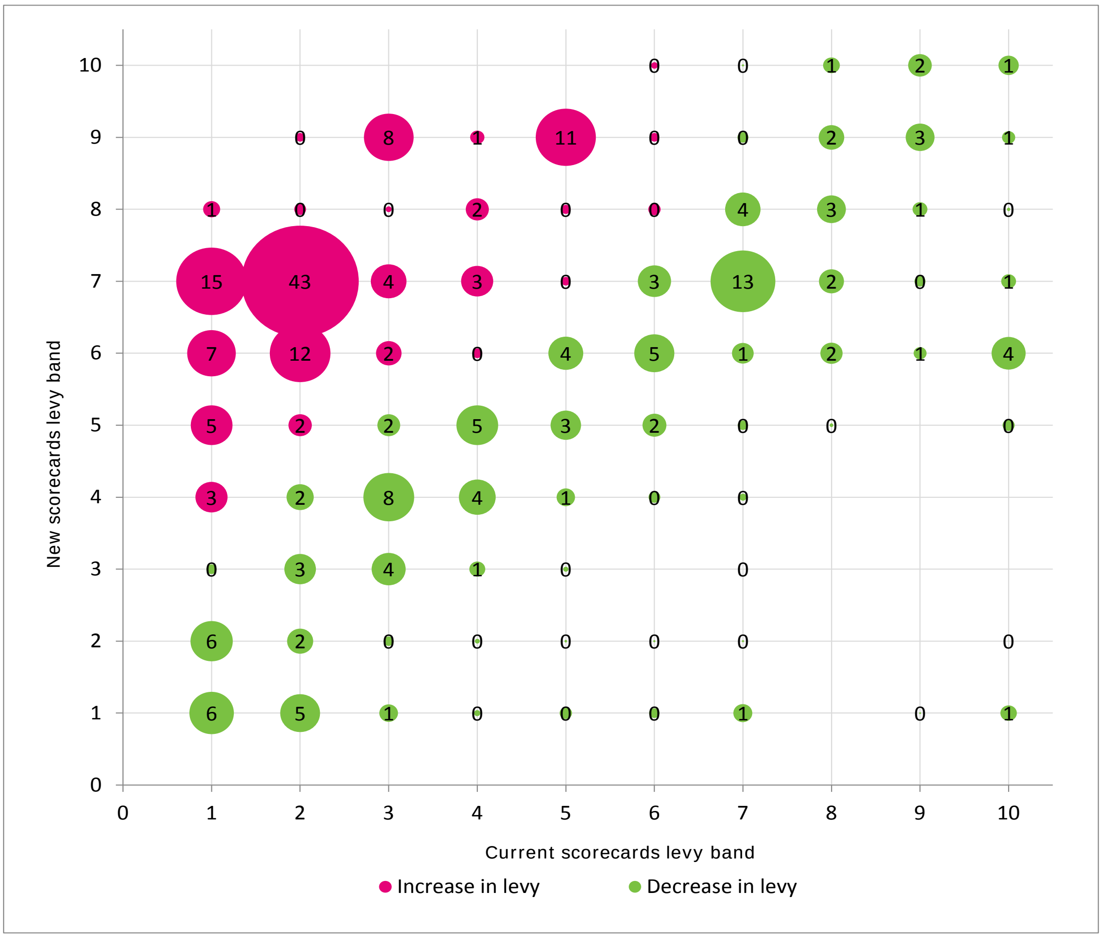
13.1.10 The scorecards we use are all directly or indirectly size based – though not all align with a SMEs definition. We have assessed as scorecards relevant to SMEs - the two scorecards for companies filing small companies' accounts (for which a criterion is less than £10 million turnover); the scorecard for parent companies of groups with less than £30 million turnover, and the scorecards for group companies with turnover below £10 million and below £50 million. In aggregate entities on these scorecards see a decline in levies of around one-third.

13.4 Impact on Pension Protection Scores

13.1.11 Overall, the dominant factor in movements in levy is how employer scores shift with the move to the new scorecards. The bubble chart presented - Chart 13.5 - shows the aggregate levy paid by schemes with employers in each levy band before and after the move to the new scorecards has altered – taking account of all policy changes.

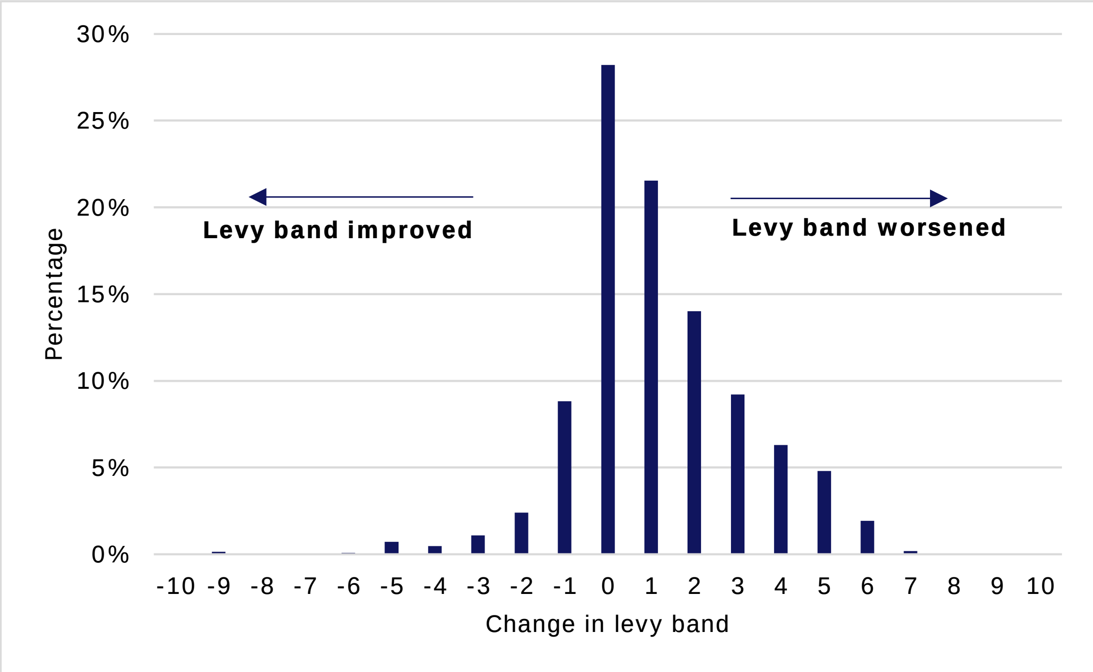
13.1.12 It will be seen that schemes with employers that remain in the same levy band or see a single band deterioration generally see a reduction in levy – indeed where employers begin in bands 1-3, even a worsening of two bands sees an aggregate reduction in levy. By comparison those that see a more significant decline in bands pay more. The reduction for schemes remaining in the same band reflects the impact of increased levies for those with worsening scores in reducing the scaling factor (so that expected levy collections overall are unchanged between the current and new scorecards).

Chart 13.5: Aggregate change in levy by levy bands (£m) – all policy changes



13.1.13 Chart 13.6 shows the effect on employer levy bands of moving to the new scorecards with all other policy changes, notably the recalibration of group scorecards. In each case the chart shows the difference between the new and old score – so a negative number is an improvement in score.

Chart 13.6: Change in levy bands - all employers

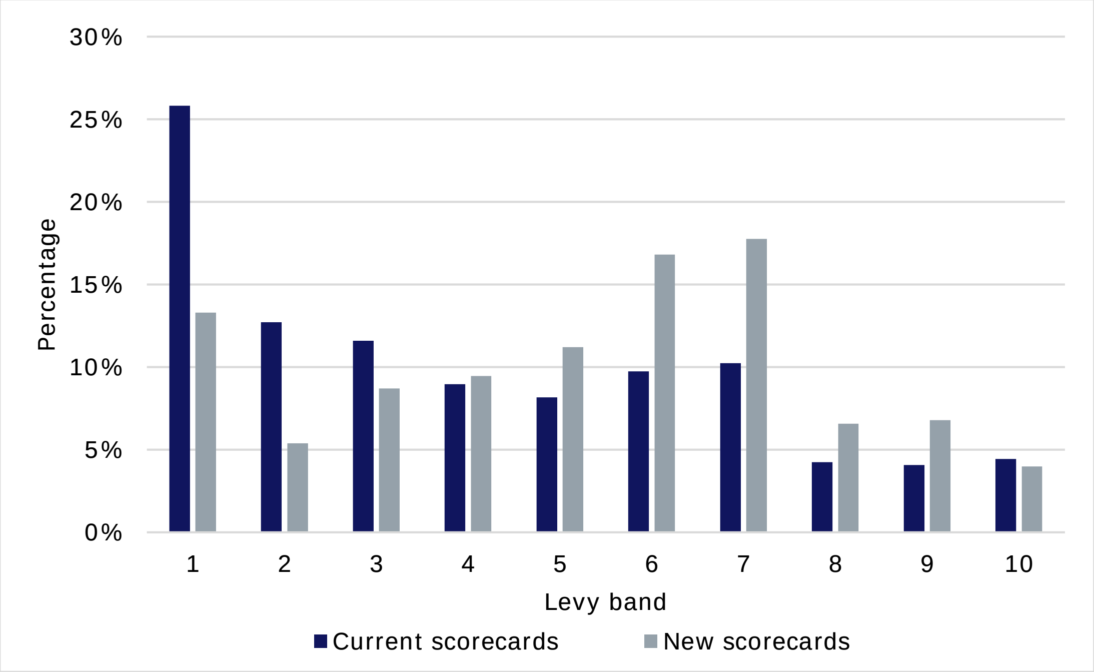


13.1.14 Chart 13.6 above shows a worsening in levy bands overall, particularly by one and two levy bands (and for such schemes the reduction in scaling factor compensates). This effect is more pronounced than the corresponding chart in the first consultation and this is largely the result of improvements in Experian scores between 2016/17 and 2017/18 on the current scorecards not captured in the March impact analysis and which are not seen on the new scorecards.

13.5 Distribution of levy bands

13.1.15 Chart 13.7 shows the proportion of employers placed in each levy band. There is a reduction in the proportion of the population scored in levy bands 1 and 2 and a somewhat higher proportion scored in levy bands 6 to 10.

Chart 13.7: Proportion of employers by levy band - all employers



13.1.16 This reflects changes on individual scorecards (which can be seen in the charts in section 6.3 of Appendix 6):

- Scorecard 1 (for non-subsidiaries £30m+ and large subsidiaries) sees a particularly substantial fall in the proportion in levy band 1 – with increased numbers of employers in levy bands 3 to 10.
- Scorecard 2 (for non-subsidiaries <£30m) sees an increase in the proportion in levy band 1, a fall in levy bands 2 to 4 and an increase in levy bands 5 to 7.
- Scorecards 6 and 7 (for Group Small and Independent Small) see an increase in entities scored in levy band 1. Indeed, it is a feature of the new scorecards that they allow a wider range of scores than was possible under their predecessors (which effectively prevented an independent company filing small accounts from scoring better than levy band 2).
- Scorecard 8 for not for profit (NFP) entities sees a large reduction in the proportions in levy bands 1 to 3 and a significant increase in employers in levy bands 6 to 8. This reflects the scorecard distinguishing more sharply between strong and weak sponsors. Whilst numbers are not large, there are now some NFPs scored in bands 9 and 10, whereas the previous scorecards scored all NFPs in levy band 8 or better.

14. Customer Services

14.1.1 We aim to provide excellent customer service to our levy payers and their advisers.

14.1.2 Over the past 12 months, both the PPF and Experian customer support teams have met stretching targets focused on the quality and timeliness of responses. The PPF team, for example, aims to resolve at least 85 per cent of queries within five days, with 90 per cent of queries answered on a 'once and done' basis.

14.1.3 We also track customer satisfaction through surveys issued following resolution of a query - by phone, e-mail or post. The results of the surveys show we are achieving high levels of satisfaction with stakeholders noting in particular

- the promptness and quality of responses received
- the professionalism and patience of customer advisors, and
- advisers' ability to resolve technical issues quickly.

14.1.4 However, we are always looking for ways to improve the service we provide. From last year, for example, we have introduced new processes to accelerate the speed with which we conclude formal review applications. We now aim to complete 75 per cent of all reviews within 28 days. Feedback is vital to help us continue to identify where we are doing well and where we could improve. We would, therefore, encourage stakeholders to take a few minutes to complete our survey.

14.1 PPF/Experian portal

14.1.1 The PPF/Experian portal has now been operational for over three years. The feedback we receive shows it is considered a valuable resource for schemes and employers helping them understand how their insolvency scores have been calculated in advance of levy invoicing.

Improvements to the portal

14.1.2 We seek comments from users on the structure and design of the portal and use that to identify improvements. This year we supplemented that ongoing feedback by establishing a portal user group. The group met in January to discuss potential improvements and identified the changes considered to be most beneficial. Working with Experian and the portal developers we subsequently implemented a number of key changes:

- It is now possible for users to tailor the alerts they receive when employer data changes. Users can also see a timeline showing alert history.
- The portal now shows employer member numbers enabling users to understand the levy calculation better for multi-employer schemes.
- Portal access has been improved for delegated users who can now set up an account via an online registration process.
- Portal speed has been improved – in particular for schemes with a large number of sponsoring employers.

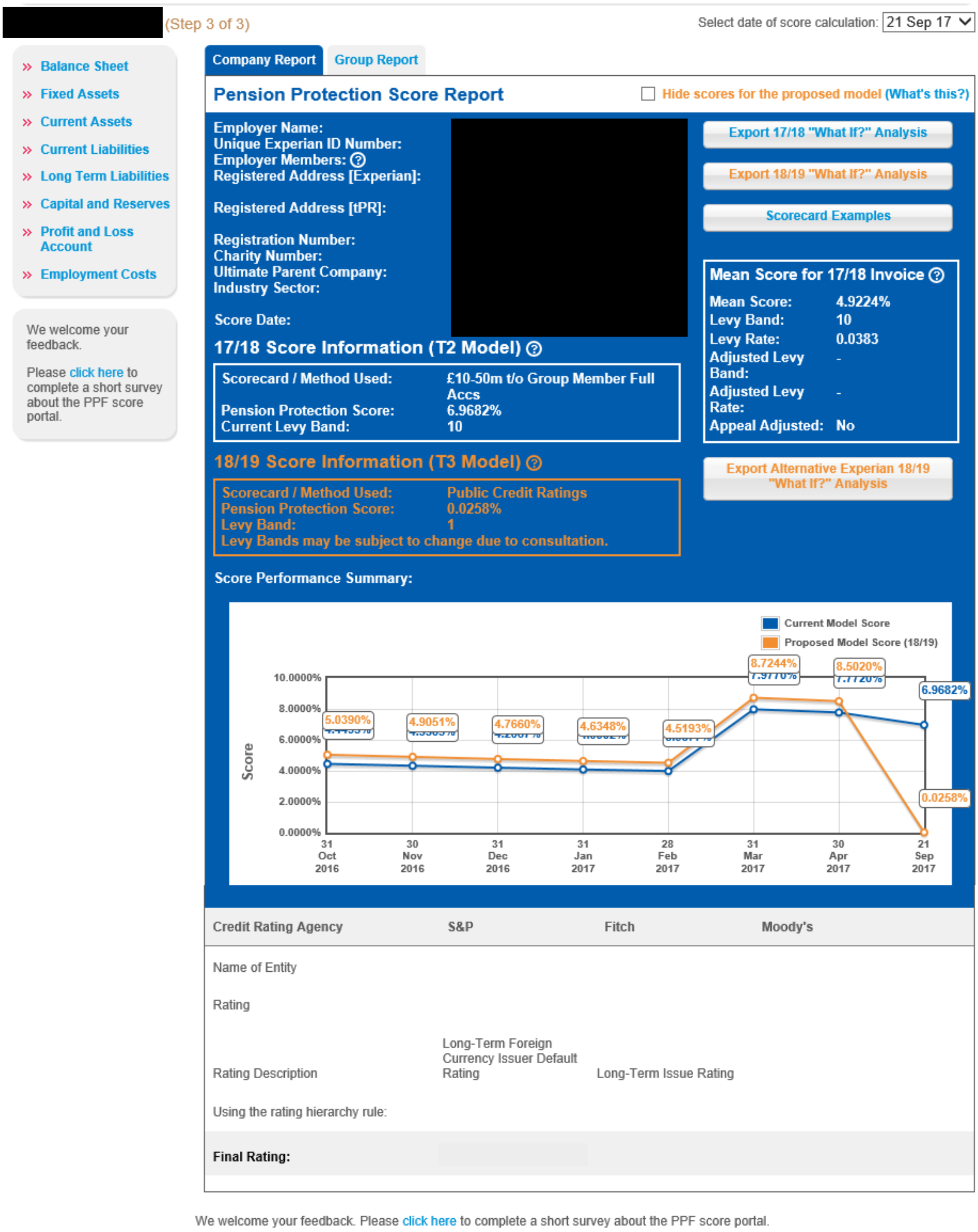
14.1.3 We are planning to host another user group session early in the New Year and would encourage users to contact us if they are interested in participating. We are particularly interested in suggestions from representatives from SMEs who use the portal.

Insolvency scores for the third triennium

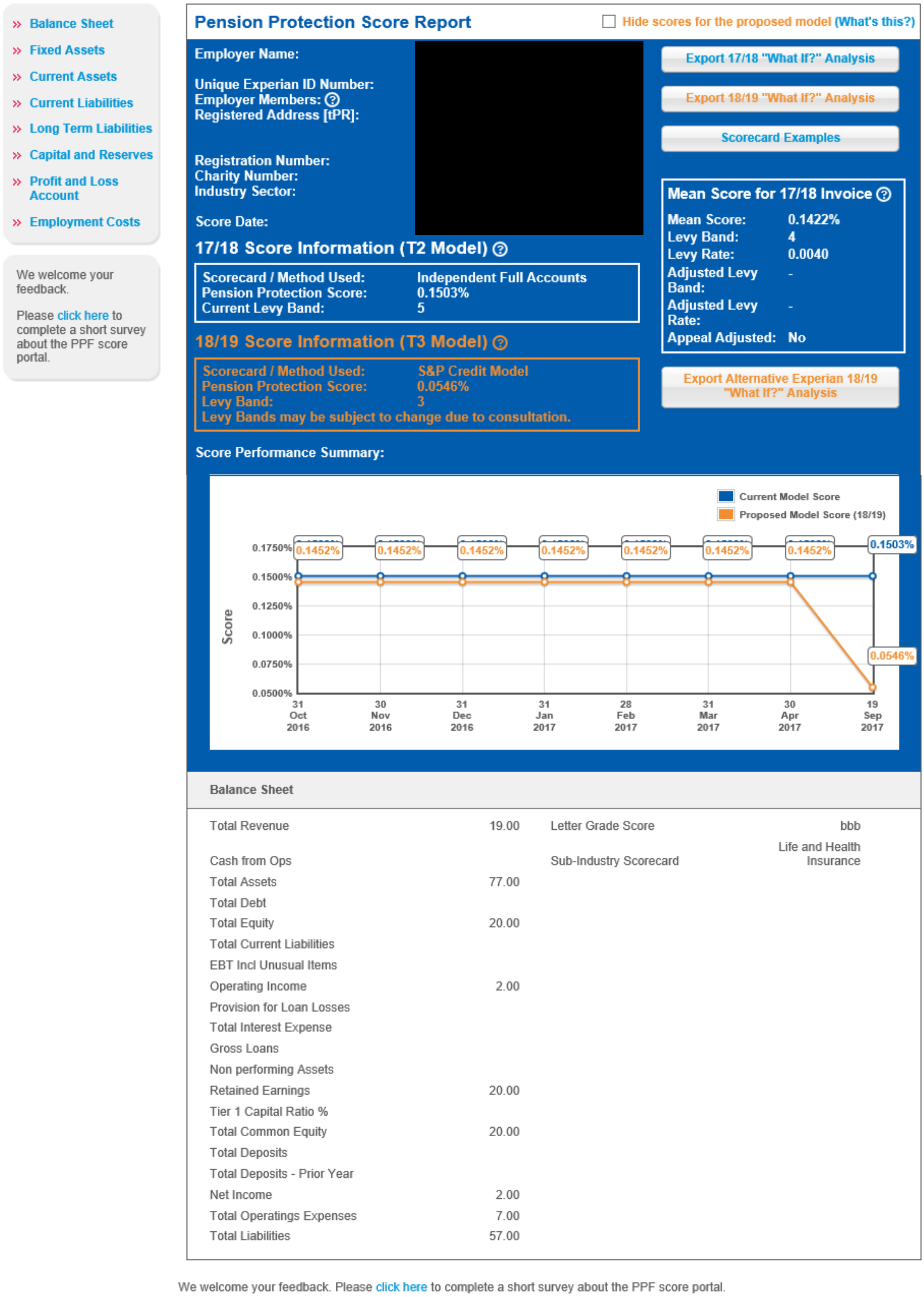
14.1.4 Following the publication of this document the portal will be 'refreshed' to show scores calculated in line with the proposed methodology for 2018/19. That will include scores calculated under the PPF/Experian model but will also include scores derived from credit ratings or the S&P credit model. 2018/19 scores will be shown alongside scores for 2017/18 (on which this year's invoices are based).

Credit rating and credit model scores

14.1.5 For employers or guarantors scored by reference to public credit ratings, the company report screen will show an indicative score and levy band, together with the underlying ratings used to generate them, as illustrated by the screenshot below. Users will also be able to download a static 'what-if' analysis showing how final credit ratings map to levy bands.

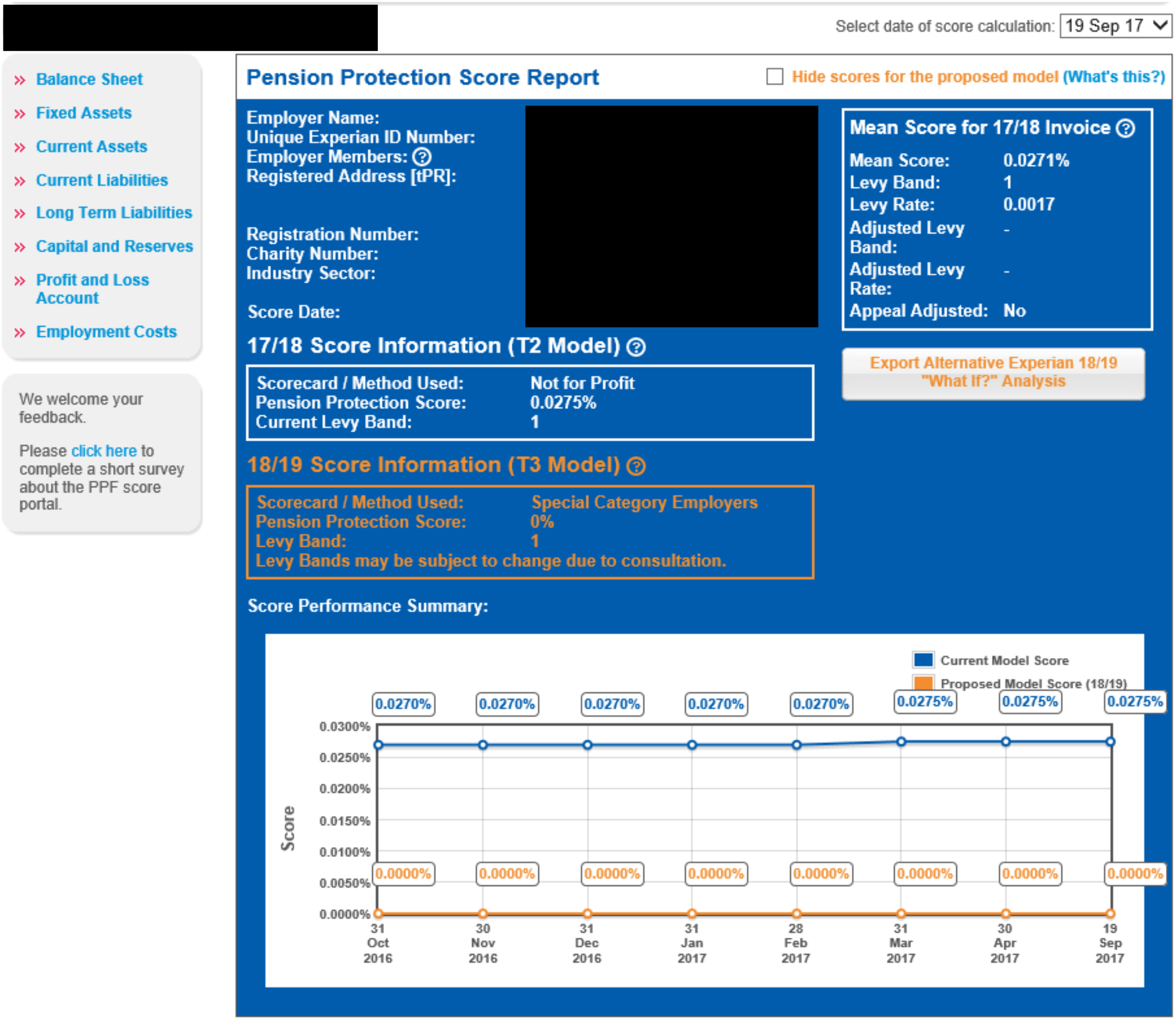


14.1.6 Where insolvency risk is to be assessed using the S&P credit model, users will be able to see a indicative score and levy band on the company report, together with details of the financial information feeding into the score:



Special Category Employers

14.1.7 When entities qualify as Special Category Employers portal users will see this indicated on the company report screen as shown below. However, it should be noted that this change will not take effect until after we have published the Determination when the score override will come into effect.


[redacted]

Select date of score calculation: 19 Sep 17

» Balance Sheet
» Fixed Assets
» Current Assets
» Current Liabilities
» Long Term Liabilities
» Capital and Reserves
» Profit and Loss Account
» Employment Costs

We welcome your feedback.

Please click here to complete a short survey about the PPF score portal.

Pension Protection Score Report

Hide scores for the proposed model (What's this?)

Employer Name:
Unique Experian ID Number:
Employer Members:
Registered Address [tPR]:

Registration Number:
Charity Number:
Industry Sector:

Score Date:

[redacted]

Mean Score for 17/18 Invoice

Mean Score:	0.0271%
Levy Band:	1
Levy Rate:	0.0017
Adjusted Levy Band:	-
Adjusted Levy Rate:	-
Appeal Adjusted:	No

Export Alternative Experian 18/19 "What If?" Analysis

17/18 Score Information (T2 Model)

Scorecard / Method Used:	Not for Profit
Pension Protection Score:	0.0275%
Current Levy Band:	1

18/19 Score Information (T3 Model)

Scorecard / Method Used:	Special Category Employers
Pension Protection Score:	0%
Levy Band:	1

Levy Bands may be subject to change due to consultation.

Score Performance Summary:

We welcome your feedback. Please click here to complete a short survey about the PPF score portal.

15. Block Transfers

15.1 Block Transfers – simplification of requirements

15.1.1 The PPF's key objective in respect of block transfers is to ensure that liabilities transferred between schemes are appropriately included in the levies for one of those schemes.

15.1.2 If a full transfer takes place so that a transferring scheme becomes ineligible as at the start of the levy year, the Board would be unable to levy the transferring scheme. The transferred members may not be reflected in the scheme return information for the receiving scheme, as would have been assessed as at 31 March. However, the transferred members would still represent a risk to the PPF that would not have been levied. Therefore, the PPF imposes requirements on schemes that undertake full transfers.

15.2 Exempt Transfers

15.2.1 We have received occasional consultation responses in the past asking us to simplify the block transfer requirements in particular circumstances. Two specific scenarios raised with us have been:

- 'self-segregation' transfers where a single employer scheme becomes a segregated scheme and the assets and liabilities of the scheme (prior to segregation) are unchanged and form a section of the newly segregated scheme, and
- '1-to-1' transfers, where the whole of the assets and liabilities of a scheme or section are transferred and comprise the whole of the receiving scheme or section.

15.2.2 It has been put to us that the requirement for a submission of a block transfer certificate in such cases is unnecessary, and that the most recent s179 valuation prior to segregation or a 1 to 1 transfer could be used as the basis for calculating the levy for the receiving scheme or section.

15.2.3 We accept that where certain conditions apply such an approach is appropriate. Accordingly, we have drafted rule changes that would result in such transfers being treated as 'Exempt Transfers' with different requirements applying.

<u>Self-segregation transfers</u>

15.2.4 The conditions for a block transfer to qualify as a 'self-segregation' transfer include that a copy of legal advice is provided confirming that the assets and liabilities of the scheme prior to segregation remain unchanged as a result of it becoming a section following segregation. In addition, if the newly created section wishes to maintain the benefit of contingent assets and ABC arrangements, the legal advice must confirm that the provisions and legal enforceability of these arrangements are unaffected by the segregation.

15.2.5 The Scheme Actuary would need to confirm that the most recent s179 valuation fully reflects the position of the newly created section on the basis that (i) the assets and liabilities of the new section are identical to those of the transferring scheme immediately prior to the segregation and (ii) no benefit changes have been made as a result of segregation. If these conditions are met, and provided the pre-segregation s179 valuation was within the triennial cycle at the time of segregation, we anticipate that it will be used in place of a post-transfer valuation in the calculation of the levies for the new section (without application of the Poor Data Methodology) until such time as a new s179 valuation is submitted for the section. The existing s179 triennial valuation cycle will be carried on under the new PSR (scheme reference number).

15.2.6 The full conditions for a self-segregation transfer are set out in the draft Transfers Appendix and revised draft Block Transfer guidance we are publishing alongside this consultation. Where the conditions are met the PPF will liaise with TPR to have the s179 data, DRCs, contingent assets and ABC data entered into the new PSR.

1-to-1 Transfers

15.2.7 The types of transfers we describe in this section could occur when a scheme first segregates, where a section transfers into a new scheme or section or where a scheme transfers into an existing segregated scheme. These transfers have some similarities with self-segregation transfers and so we are proposing a similar simplification (though more limited). Where the PPF is satisfied that the s179 valuation of the transferring scheme or section accurately reflects the position of the receiving scheme the normal block transfer requirements may not be required. The key feature of these types of transfers is that the whole of the assets and liabilities of a scheme or section are transferred and comprise the whole of the receiving scheme or section.

15.2.8 Our proposal could also avoid the need to complete a block transfer certificate, as we would liaise with TPR to transfer the s179 valuation data to the new section/scheme PSR. The new section/scheme would be required to decide upon an effective date for its s179 within 12 months of the transfer and provide it to TPR within 15 months of the effective date. DRCs could be carried over but contingent assets and ABCs would need to be certified as new by the new section/scheme.

15.2.9 The conditions for a 1-to-1 transfer are also set out in the draft Transfers Appendix and guidance. These types of transfer would not require a copy of legal advice to be provided but would require similar confirmation from the Scheme Actuary.

15.2.10 **We would welcome stakeholder comments on our proposed rule changes and our draft guidance.**

15.3 Block Transfer Processes

15.3.1 Outside of the proposed changes set out above we are keen to improve the block transfer processes more generally. Within the third triennium consultation we received one response asking us to consider adding data fields to the block transfer certificate. We are not proposing specific changes at this stage but we are keen to make improvements if we can.

15.3.2 Following on from the discussions we have had with TPR around the revised processes above we are reviewing both forms and processes to see whether improvements can be made. We will look to implement any improved processes we can identify as soon as possible but changes to the block transfer certificate are something we will consider for 2019/20. The types of issues we are considering are the extent to which data from the transferring/receiving scheme can be updated and used prior to and post transfer, whether and when scheme returns are sent to the receiving scheme/section etc.

15.3.3 **We would welcome suggestions on improvements that could be made to the supply of data following block transfers**.

16. Draft Levy Rules

16.1 Overview of Determination, Appendices and Guidance

16.1.1 Arising from our conclusions on the Third Triennium Consultation and our new proposals included in this consultation we have introduced a range of the levy amendments to the Determination, Appendices and Guidance. Below we set out the main substantive changes from the partial draft rules published in March or the 2017/18 rules.

<u>The Determination</u>

16.1.2 Rule E3.1(11) includes our revised criteria for Special Category Employers, as explained in Chapter 3.

16.1.3 Rule F4 in the Determination sets out our proposed changes to our block transfer requirements for Exempt Transfers as explained in Chapter 13.

16.1.4 We have amended the definition of 'Other Permitted Sources' in the Determination removing the Prudential Regulatory Authority, the Scottish Housing Regulator and the London Stock Exchange from the list. This is on the basis that these sources either do not include any employers in our universe or only include information which is already captured from elsewhere. We have also clarified the date(s) on which Experian will collect and use data from the remaining permitted sources within the definition of 'Filed'.

16.1.5 The definition of 'Score Measurement Date' in the Determination confirms that for levy year 2018/19 monthly scores will be calculated as at the final day of each month from October 2017 – March 2018.

<u>Insolvency Risk Appendix</u>

16.1.6 Paragraph 3.2 of the Insolvency Risk Appendix which covers log transformations has been revised to clarify the basis of calculation where there is a low or absent value.

16.1.7 Paragraph 3.4 of the Insolvency Risk Appendix has been amended and now includes the basis on which the Parent Strength variable will be applied in respect of employers who are classed as Special Category Employers.

16.1.8 Paragraph 3.10 of the Insolvency Risk Appendix allows for an accounting standard change certificate to be provided to allow for a change in total assets on new Scorecard 7 Independent Small.

16.1.9 Annex II of the Insolvency Risk Appendix, dealing with credit model scoring, provides the Board with the ability to direct that an entity is scored on a particular scorecard.

16.1.10 Table 4 Part 7 of the Insolvency Risk Appendix sets out our proposed revised levy rates for levy bands 1 – 3 as explained further in Chapter 11.

<u>Contingent Asset Appendix</u>

16.1.11 Paragraph 17(4) of the Contingent Asset Appendix confirms that guarantors classed as Special Category Employers, or who are CRA

Rated will be excluded from the Type A contingent asset guarantor gearing adjustment.

16.1.12 Paragraph 25 of the Contingent Asset Appendix confirms the requirement for trustees certifying a Type A contingent asset to obtain a guarantor strength report prior to certification where the levy saving resulting from recognition would be £100,000 or more.

Other

16.1.13 Our revised rules for the certification of DRCs are reflected in the DRCs Appendix.

16.1.14 Paragraph 4.2 of the Transformation Appendix includes the revised asset and liability stresses we are proposing for 2018/19.

16.1.15 Paragraph 6(4) of the ABC Appendix and the ABC Guidance have been updated to reflect our revised requirements on obtaining a certificate of title where an ABC Asset includes more than one piece of real estate.

16.2 Measurement Time in 2018/19

16.2.1 The standard Measurement Time for the submission of scheme data (including hard copy contingent asset documentation) will be midnight at the end of 29 March 2018. This change, introduced for 2016/17, will not apply to the Measurement Time for certification of DRCs and block transfers. For these, the submission time will remain at 17.00 on 30 April 2018 and 29 June 2018 respectively.

16.2.2 The midnight deadline would also apply to mortgage exclusion certificates submitted by email to Experian by midnight at the end of 29 March 2018. Stakeholders should be aware that telephone support provided by the PPF and Experian will be available until 17.00 on 29 March 2017.

17. Consultation Arrangements

17.1 Consultation on the 2018/19 Levy Rules

17.1.1 The consultation on the 2018/19 Levy Rules runs from Wednesday 27 September 2017 to 17:00 on Wednesday 1 November 2017. Please ensure that your response reaches us by the deadline. Submissions may be made by email or post, using the details below.

Email:	consultation@ppf.gsi.gov.uk
Postal address:	Chris Collins Chief Policy Adviser Pension Protection Fund Renaissance 12 Dingwall Road Croydon, Surrey CR0 2NA

17.1.2 Please state whether you are responding as an individual or representing the views of an organisation. If you are responding on behalf of an organisation please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

17.1.3 Under the Freedom of Information Act 2000 (FoIA), all information contained in the response, including personal information, may be subject to publication or disclosure. By providing personal information for the purpose of the public consultation exercise, it is understood that a respondent consents to its disclosure and publication.

17.1.4 If this is not the case, the respondent should limit any personal information which is provided, or remove it completely. If a respondent requests that the information given in response to the consultation be kept confidential, this will only be possible if it is consistent with FoIA obligations and general law on this issue. Further information can be found on the website of the Ministry of Justice at:

https://www.gov.uk/make-a-freedom-of-information-request/the-freedom-of-information-act

17.1.5 A summary of responses and the Board's final Determination and confirmed policy are planned to be published on the PPF website at:

http://www.pensionprotectionfund.org.uk in due course.

17.2 Key Dates

17.2.1 We will continue to use information from the annual scheme return that is submitted via the Pensions Regulator's Exchange system to calculate levies. The deadline for submission is midnight at the end of Thursday 29 March 2018, except as detailed below.

Item	Key dates
Monthly scores to be used in 2018/19 levy	Between October 2017 and March 2018
Deadline for providing updated information (to Experian) to impact on monthly Experian scores	One calendar month prior to the score measurement date
Submit scheme returns on Exchange	By midnight on Thursday 29 March 2018
Reference period over which funding is smoothed	5-year period to Saturday 31 March 2018
Certification of contingent assets	By midnight on Thursday 29 March 2018
Certification of asset-backed contributions	By midnight on Thursday 29 March 2018
Certification of mortgages and accounting standard changes (emailed to Experian)	By midnight on Thursday 29 March 2018
Certification of deficit-reduction contributions (DRCs)	By 5pm on Monday 30 April 2018
Certification of full block transfers	By 5pm on Friday 29 June 2018
Invoicing starts	Autumn 2018

17.3 Comments on the Consultation Arrangements

17.3.1 Where the principles are appropriate to our status as a public corporation, we aim to conduct our consultations in line with the Cabinet Office's Consultation Principles that can be found on its website at:

http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance

17.3.2 The Board would welcome feedback on the consultation process. If you have any comments, please contact:

Email: richard.williams@ppf.gsi.gov.uk

Postal address: Richard Williams
Head of Corporate Affairs
Pension Protection Fund
Renaissance
12 Dingwall Road
Croydon, Surrey
CR0 2NA

Deadline for consultation responses is 17:00 on Wednesday 1 November 2017.

Summary of Consultation Questions

Issue	Questions
Levy Scaling Factor and Risk-Based Levy cap	*Do you have comments on the approach to calculating the LSF?* *Do you agree with our proposal to reduce the Risk-Based Levy cap?*
Levy Bands and Rates	*Do you have comments on the proposals for levy bands and levy rates?*
Block Transfers	*We would welcome stakeholder comments on our proposed rule changes and our draft guidance.* *We would welcome suggestions on improvements that could be made to the supply of data following block transfers.*