

BBS briefing note

Pension Protection Levy Consultation: Insolvency Risk

The Board of the Pension Protection Fund (“PPF”) has issued a consultation document setting out their proposals for developing the measurement of insolvency risk for the 2011/12 levy year. This *BBS briefing note* summarises the proposals.

BACKGROUND

Since the PPF introduced a risk-based element into the calculation of the PPF levy in 2006/07, Dun&Bradstreet (“D&B”) has been appointed to assess the insolvency risk of sponsoring employers.

During summer 2009, D&B revised their failure score methodology to enable it more quickly to reflect changes in market conditions. The changes made include the use of a new Economic Index to better reflect specific industry risk, increased use of interim financial statements for quoted companies, and greater weight given to changes in payment behaviour.

D&B has also updated the probability of insolvency associated with each Failure Score, with sample rates shown in the table below (with prior probabilities shown in brackets):-

Failure Score	Probability of Insolvency
100	0.03% (0.01%)
90	0.28% (0.15%)
80	0.48% (0.30%)
60	1.00% (0.65%)
40	1.65% (1.47%)
20	2.98% (2.69%)

It will be noted that the probability of insolvency is significantly greater for stronger employers. The PPF has also noted the expectation that the new scores may be more volatile for certain employers.

Following review, the PPF has concluded that D&B’s new scores remain appropriate for levy purposes and accordingly they will be used to determine the insolvency risk at 31 March 2010 to be used in the 2011/12 PPF levy.

PROPOSALS FOR 2011/12 LEVY

Following concerns raised that features of the D&B Failure Score can be manipulated without altering the true underlying risk, the PPF are also proposing the following changes:

- D&B will seek evidence when an employer requests a change to their industry sector or geographic region;
- A new “Nationwide” attribute will apply for businesses with branches in three or more UK regions;
- D&B will independently collect financial information from the Charity Commission;
- PPF-compliant contingent assets will be excluded by D&B when assessing insolvency risk; and
- If the ultimate parent has a Failure Score of 1 to 10 then the subsidiary’s Failure Score will capped at that of the parent.

It is noted that some of the above changes will result in there being two Failure Scores for certain employers: the normal Failure Score and an adjusted score for PPF levy purposes.

The proposals are discussed in more detail overleaf.



INDUSTRY SECTOR AND GEOGRAPHIC REGION

Evidence collected by D&B shows that risk experience is dependent on industry sector and also the main trading region, with the differentials being reflected in Failure Scores. This has encouraged some employers to request changes to their industry sector or their main trading address. The proposal is that D&B will, in future, seek appropriate evidence, e.g. revenue by sector, employees by location etc, prior to making any changes.

“NATIONWIDE” CATEGORY

Analysis carried out by D&B shows that companies based in three or more UK regions have a lower risk than those based in fewer regions. It is proposed that this is reflected by introducing a new “Nationwide” attribute.

CHARITIES

75% of charities with final salary pension schemes have voluntarily submitted accounts, which have been taken into account when assessing Failure Scores. To increase this coverage, D&B will actively seek financial data for other charities, most likely from the Charity Commission website.

The PPF would like to introduce similar approaches for other non-commercial employers.

CONTINGENT ASSETS

A certified Type B contingent asset (security over cash, property or securities) reduces a scheme’s underfunding risk. However, if the guarantor is registered at Companies House, the guarantor’s Failure Score may also be

reduced, potentially negating the positive effect of the contingent asset on the levy. This creates an inequality with those guarantors who are not registered. In addition, it is argued that the charges are generally put in place to protect the scheme and/or manage the levy rather than reflect employer weakness.

To address these issues, the PPF has proposed that D&B adjust, for PPF purposes only, an employer’s Failure Score to exclude the impact of Type B contingent assets.

PARENT RISK

To reflect the risk that a “weak ultimate parent” can take actions that will undermine the strength of a subsidiary, it is proposed that the Failure Score of a subsidiary is restricted to that of their ultimate parent. A “weak ultimate parent” is described as one with a Failure Score in the range of 1 to 10.

TIMESCALES

The Consultation period closes on 14 December 2009 with a summary of the responses and any changes to the proposals expected to be published early in 2010.

BBS VIEW

The overall aim of the Board of the PPF is continually to develop the levy mechanism in order to achieve fairness across all employers, and this objective should be supported.

However, it needs to be noted that the proposed changes could be significant for some employers, with little lead-in time before the 31 March 2010 deadline.

