NAPF

Securing the future of pensions

Consultation on the second PPF Levy Triennium – A response by the National Association of Pension Funds

July 2014

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Executive Summary

The NAPF supported the broad principles of the last levy framework when it was introduced in 2012-13, largely because it would inject greater predictability into the levy system and would establish a more direct link between the risk a scheme poses to the Pension Protection Fund and the levy it pays. The proposals in the current consultation largely remain true to those principles.

The NAPF supports the PPF's decision to move to a PPF-specific model for insolvency risk which better reflects the insolvency risk of those entities sponsoring DB pension schemes. We also welcome the increased transparency and improved processes for submitting information that come with the new model. We believe that it is important that this new facility is communicated to schemes, to ensure that they have the opportunity to fill any information gaps. Feedback from members suggests that data gaps are one of the critical issues with the new model and could detrimentally affect those schemes whose employers do not routinely file accounts with Companies House or the Charities Commission.

However, the move to a new PPF-specific model of insolvency risk is not without its challenges. The move to Experian's PPF-specific model will lead to a significant redistribution of the levy across the universe, around £200m in aggregate. The NAPF recognises that this redistribution is the result of moving to a more accurate measure of the insolvency risk of PPF employers and therefore it could be argued that 'losers' have not been paying their fair share of the levy so far, and vice versa for the 'winners'. We also recognise that the proposed transitional arrangement set out in the consultation would increase the scheme-based levy collected from schemes from the current £70m to £135m, just under the 20% maximum allowed. The dramatic nature of the redistribution could have profound consequences for those outlier schemes that see the greatest increases in levy payments and we would urge the PPF to examine these on a case by case basis and explore ways of reducing the immediate impact for these employers and schemes. On balance, the NAPF supports the proposed transitional arrangements in the consultation.

The NAPF supports the creation of a specific not-for-profit (NFP) scorecard as this, on balance, presents a fairer assessment of the overall risk of this group of employers. However we remain concerned that the focus on financial data under the new model means that NFPs stand to lose out under the new framework. We recommend Experian and PPF work with NFPs to improve the relevance, availability and sourcing of financial data for NFPs, and consider whether inclusion of some subjective factors will increase predictability in this sector. We also support the on-going evaluation of the NFP definition and scorecard components to ensure that NFP insolvency risk is reflected in their scores.

The NAPF does not support a credit rating over-ride. Whilst such an over-ride may benefit a certain number of schemes we believe it complicates the model. The disadvantages outweigh the advantages; in particular the costs and complexity as well as ongoing monitoring could be significant.

About the NAPF

The National Association of Pension Funds is the leading voice of workplace pension provision in the UK. We represent 1,300 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. We represent both public and private sector schemes, including over 70% of Local Authority pension funds. Our members provide pensions for 16m people and collectively hold assets of around £900bn, making them major institutional investors. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

The NAPF's response

1. The NAPF supported the broad principles of the last levy framework when it was introduced in 2012-13, largely because it would inject greater predictability into the levy system and would establish a more direct link between the risk a scheme poses to the Pension Protection Fund and the levy it pays. The proposals in the current consultation largely remain true to those principles.

PPF-specific model

2. The NAPF supports the PPF's decision to move to a PPF-specific model for insolvency risk which better reflects the insolvency risk of those entities sponsoring DB pension schemes. The model recognises that they are markedly different from the average UK business (on which standard insolvency models are trained). The PPF has demonstrated, through external independent assessment, and through its own analysis that this model provides a much greater predictability of insolvency across sectors, scorecards and over time.

3. We also welcome the increased transparency and improved processes for monitoring and appeals that come with the new model. One of the most consistent pieces of feedback we received from our members regarding the use of Dun & Bradstreet (D&B,) the previous insolvency risk provider, was the challenge of understanding company insolvency ratings when schemes (and their sponsoring employers) had little or no access to the information used to formulate their scores. There was also limited opportunity for schemes/sponsors to submit additional information outside the scheme return in order to ensure that the measure of risk remained accurate. The new model will allow schemes/sponsors to see exactly what information is held by Experian, submit additional information where this might be useful and see how changes in certain model variables might affect ~~a~~an employers' insolvency score and ultimately the overall scheme levy.

4. It is important that this new facility is communicated to schemes, to ensure that they have the opportunity to fill any information gaps. Feedback from members suggests that data gaps are going to be one of the critical issues with the new model and could detrimentally affect those schemes whose employers do not routinely file accounts with Companies House or the Charities Commission. Whilst the NAPF supports the move to the new model, we believe it is critical that PPF and Experian work to ensure that all avenues for potential data are explored to minimise the risk of an inaccurate insolvency score being placed against an employer, and therefore a scheme.

5. We also support the new levy rates and the proposal to continue with the ten levy bands to avoid cliff edges between the bands.

Winners and losers

6. However, the move to a new PPF-specific model of insolvency risk is not without its challenges. The model places much less emphasis on non-financial data (CCJs, payment performance data, numbers and characteristics of directors) and more on financial points. This is based on evidence that shows that these data are a much more accurate predictor of insolvency risk for the PPF

universe of employers. However schemes where the employers perform well on non-financials but do not have strong balance sheets will see their levies rise and vice versa.

7. This means that whilst there is an eventual reduction in the scheme-based levy of around £20m, the move to Experian's PPF-specific model will lead to a significant redistribution of the overall levy across the universe, around £200m in aggregate. PPF's impact analysis suggests 34% of schemes (2,100) are 'winners' and 24% (1,500) are 'losers' whilst the levy remains largely the same for the remainder.

8. For those who are 'losers' the average increase is 150% - ie the average 'loser' will see its levy more than double. Around 200 schemes (3%) will see an increase of more than £200,000 each and we understand that a small number of schemes may see substantially greater levy increases.

9. The NAPF recognises that this redistribution is the result of moving to a more accurate measure of the insolvency risk of PPF employers and therefore it could be argued that 'losers' have not been paying their fair share of the levy so far, and vice versa for the 'winners'. We also recognise that the proposed transitional arrangement set out in the consultation would increase the scheme-based levy paid by all schemes from 10% to 20% of the total levy. This is in order to ensure that the appropriate levy is collected each year in a way that is fair to all schemes over time. This could have a substantial impact on some of the largest schemes, many of which are arguably of very low risk to the PPF. For a number of our members the scheme levy is much greater than their risk-based levy and therefore the impact of the transitional arrangement on them would be substantial.

10. The dramatic nature of the redistribution could have profound consequences for those outlier schemes that see the greatest increases in levy payments. For example, 28% of employers of PPF-eligible schemes have fewer than 25 employees. £10,000, the levy amount under which schemes are excluded from the impact analysis in the PPF consultation, might be significant for some of these schemes. We are concerned that in extremis the PPF levy may end up taking precedence over employer scheme deficit payments or may involve the selling of fund assets at less than ideal value, both of which will impact on the scheme's funding level and could, ultimately drive schemes into the PPF.

11. On balance, the NAPF supports the proposed transitional arrangements in the consultation, which will involve comparing the insolvency risk that was calculated for the scheme in 2014/15 with what the assessment would have been had Experian scores been used then. If the increase is more than 200% PPF would abate the 2015/16 bill. Setting the level at 200% focuses the easement on those facing the largest relative increases. However we are still concerned about the impact of lower increases on small schemes, or those with limited ability to pay. We would urge the PPF to consider schemes in such situations on a case-by-case basis.

Not-for-profit

12. The NAPF supports the creation of a specific not-for-profit (NFP) scorecard as this, on balance, presents a fairer assessment of the overall risk of this group of employers. However we remain concerned that the focus on financial data under the new model means that NFPs stand to lose

out under the new framework. Not least because of the points we made above about the availability of accounts data for this sector. We recommend Experian and PPF work with NFPs to improve the relevance, availability and sourcing of financial data for NFPs, and consider whether inclusion of some subjective factors will increase predictability in this sector. We also support the on-going evaluation of the NFP definition and scorecard components to ensure that NFP insolvency risk is reflected in their scores.

Credit rating over-ride

13. The NAPF does not support a credit rating over-ride. Whilst such an over-ride may benefit a certain number of schemes we believe it complicates the model. The disadvantages outweigh the advantages; in particular the costs and complexity as well as ongoing monitoring could be significant.

Treatment of asset backed contributions.

14. We recognise that the PPF needs to understand the true value of an asset backed contribution ABC in the event of insolvency to ensure fair treatment across schemes. However we are concerned that the provisions in this section are overly prescriptive and risk excluding items that would have genuine value in the case of insolvency.

15. We also support the continued application of the 10% discounted to non-associated last man standing schemes in recognition of the minimal risk they pose to the PPF.

16. Detailed answers to the consultation questions can be found below.

For further information please contact:
Helen Forrest, Policy Lead: DB
helen.forrest@napf.co.uk
020 7601 1700
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Responses to consultation questions

Q1. Do you agree that we should seek to maintain stability in the overall methodology for the levy, only making changes where there is evidence to support them?

Yes. The NAPF supported the broad principles of the last levy framework when it was introduced in 2012-13, largely because it would inject greater predictability into the levy system and would establish a more direct link between the insolvency risk a scheme poses to the Pension Protection Fund and the levy it pays. We continue to want to see a degree of stability for schemes.

Q2. Do you consider that the definition of the variables in the scorecards is sufficiently precise to provide for consistent treatment?

We have not received any feedback from members on this point. But as we point out under Q3 it would make sense to keep this under review.

Q3. Do you agree that it is appropriate to re-evaluate the model to ensure that it remains predictive?

Yes. The move to any new model is likely to throw up unexpected outcomes once that model is being applied to actual employers. Therefore we would welcome ongoing evaluation of the model to ensure it continues to provide an accurate prediction of insolvency risk. The challenge will be what to do should one of the components on a scorecard be found to not be optimising the predictability as any change to that component is likely to result in a change to the insolvency risk for that employer and, ultimately, their scheme's levy. As stated above we want to see a degree of stability of schemes so it will be a balancing act for Experian and the PPF to make these changes on when they seem most appropriate and in full awareness of the impact on scheme levies.

Q4. Do you have comments on the design of the "core model" developed by Experian?

We support the development of the PPF-specific model and welcome the proposal to keep parts of the model under review to ensure they continue to optimise the prediction of risk. We are particularly keen that this evaluation focuses on the not-for-profit scorecard, where we are concerned that the focus on financial data may be disadvantaging a group of sponsors who are traditionally low risk.

However, schemes in sectors where the government has a role to play (such as the education sector or transport sectors) point out that the levy system still takes no or little account of the fact that the Government would very likely step in if one of their major employers were facing insolvency. The NAPF recognises that this is difficult to quantify, but we would urge the PPF to keep this important issue under review.

Q5. Do you agree with the success criteria set out by the Industry Steering Group and that the PPF-specific model developed by Experian is a better match with them than Commercial Delphi?

As a member of the Industry Steering Group the NAPF fed into the success criteria. We believe this new model better reflects the insolvency risk of those entities sponsoring DB pensions schemes, which are markedly different from the average UK business (on which standard insolvency models are

trained). The PPF has demonstrated, through external independent assessment, and through its own analysis that this model provides a much greater predictability of insolvency across sectors, scorecards and over time.

We also welcome the increased transparency and improved processes for monitoring and appeals that come with the new model. One of the most consistent pieces of feedback we received from our members regarding the use of D&B as the previous insolvency risk provider was the challenge of understanding company insolvency ratings when schemes (and their sponsoring employers) had little or no access to the information D&B was using to formulate their scores. There was also limited opportunity for schemes/sponsors to submit additional information outside the scheme return in order to ensure that the measure of risk remained accurate. The new model will allow schemes/sponsors to see exactly what information is held by Experian, submit additional information where this might be useful and see how changes in certain aspects of the information might impact of a scheme's insolvency score, and ultimately its levy.

However, we acknowledge that the move to this new model is not without its challenges and we focus on this in our answers to other questions.

Q6. Do you agree that it is appropriate to use the separate scorecard developed by Experian for not-for-profit entities, even those this requires an extension of the data used to generate the scorecard?

We support the creation of a separate scorecard for not-for-profit entities. We agree that the standard model was generating a significantly higher insolvency rate than that experienced in the sector. However, whilst we understand that Experian has been able to create a scorecard that has similar levels of predictiveness to that of other scorecards, the not-for-profit (NFP) sector currently stands to be amongst the 'losers' in terms of increased levy payments. We understand that the main reason for this is that, despite the effort to create a separate, more appropriate means of evaluating NFPs, the focus on financial data puts them at a disadvantage. We hope that the ability to submit data to Experian will be structured so that NFPs have opportunity to improve their scores. In any case, we believe that as part of ongoing monitoring and evaluation of the new model, the NFP scorecard should be an area of particular focus to ensure that those sponsors who are likely to have a lower insolvency risk are not disadvantaged by the focus of the new model on financial data.

Q7. Do you have comments on the approach to the rating and proposed identification of not-for-profit entities, developed by Experian?

As the consultation document points out some charities ('exempt charities') are not required to register with the Charities Commission as they are typically regulated by another authority. The most common amongst these are the education charities, which are regulated by the Higher Education Funding Council (HEFCE). We presume that PPF is exploring ways to ensure that such charities are included in the definition, but would welcome clarity on this point.

Q8. Are there other public sources of data that Experian should consider extending coverage to?

One organisation suggested by our members is the Higher Education Funding Council and its Scottish and Northern Irish counterparts, mentioned above which is likely to hold relevant financial data on higher education bodies.

More generally we believe this is an area that Experian and PPF should continue to explore. Whilst we welcome the fact that schemes and sponsors can submit data to Experian to supplement what is collected from public sources this is difficult for large multi-employer schemes whose employers have no incentive to provide such data to the scheme, especially as employers can often be in competition with one another and are therefore reluctant to share such data. It may be worth considering ways to publicise to schemes and their sponsors the fact that sponsors can submit such data direct to Experian for the specific use of the PPF-specific model and that this will have no impact on the data held against them under the generic Commercial Delphi model.

Q9. Do you agree with the proposed data hierarchy?

We have no comments on the hierarchy.

Q10. Do you favour a credit rating over-ride?

No. Whilst such an over-ride may benefit a certain number of schemes we believe it complicates the model. The disadvantages outweigh the advantages; in particular the costs and complexity as well as ongoing monitoring could be significant.

Q11 and Q12. See answer to Q13.

Q13. Do you agree with the proposed 10 levy bands and rates?

Yes. In particular we support the aims of the levy rates and the continued used of ten levy bands. We do not believe there is a compelling reason to reduce the number of bands.

Q14. Do you agree that for 2015/16 levy year insolvency probabilities are averaged from 31 October 2014 to 31 March 2015?

Yes. However we believe it is important that schemes are aware that they have until 31 October to submit any additional information to Experian. This is a marked shift from schemes' experience with D&B and has the potential to dramatically increase the predictiveness of their score. The NAPF would be happy to support the PPF in communicating this to DB schemes.

Q15. Do you support transitional protection for those most affected by the move to the new methodology, recovered through the scheme-based levy?

The NAPF recognises that the redistribution of the levy under the new framework is the result of moving to a more accurate measure of the insolvency risk of PPF employers and therefore it could be

argued that 'losers' have not been paying their fair share of the levy so far, and vice versa for the 'winners'. We also recognise that the proposed transitional arrangement set out in the consultation would increase the scheme-based levy paid by all schemes from 10% to 20% of the total levy. This is in order to ensure that the appropriate levy is collected each year in a way that is fair to all schemes over time. This could have a substantial impact on some of the largest schemes, many of which are arguably of very low risk to the PPF. For a number of our members the scheme levy is much greater than their risk-based levy and therefore the impact of the transitional arrangement on them would be substantial.

However the dramatic nature of the redistribution could have profound consequences for those outlier schemes that see the greatest increases in levy payments. For example, 28% of employers of PPF-eligible schemes have fewer than 25 employees. £10,000, the levy amount under which schemes are excluded from the impact analysis in the PPF consultation, might be significant for some of these schemes. We are concerned that in extremis the PPF levy may end up taking precedence over employer scheme deficit payments or may involve the selling of fund assets at less than ideal value, both of which will impact on the scheme's funding level and could, ultimately drive schemes into the PPF.

On balance, the NAPF supports the proposed transitional arrangements in the consultation, which will involve comparing the insolvency risk that was calculated for the scheme in 2014/15 with what the assessment would have been had Experian scores been used then. If the increase is more than 200% PPF would abate the 2015/16 bill. Setting the level at 200% focuses the easement on those facing the largest relative increases. However we are still concerned about the impact of lower increases on small schemes, or those with limited ability to pay. We would urge the PPF to consider schemes in such situations on a case-by-case basis.

Q16. Do you agree that the appropriate route to reflecting ABCs in the levy is to value them based on the lower of the value of the underlying asset (on employer insolvency) after stressing or the NPV of future cash flows?

We recognise that the PPF needs to understand the true value of an ABC in the event of insolvency to ensure fair treatment across schemes. However we are concerned that the provisions in this section are overly prescriptive and risk excluding items that would have genuine value in the case of insolvency. Additional requirements to assess the value of an ABC will add to scheme costs so the PPF should take care to be proportionate in valuing such arrangements.

Q17. Do you agree that credit should only be allowed where the underlying assets of the ABC is UK property?

We accept the principle that the underlying assets should be UK property. However members have expressed concern about whether such a position would prevent schemes using ABCs set up under Scottish Limited Partnership as the legal structure of such arrangements means that, technically, the scheme does not own the underlying asset.

Now we understand from speaking to the PPF that this is not the intention and that such ABCs would be accepted should the scheme have ultimate access to the asset in the event of employer insolvency. However, given that SLPs are the most common structure utilised for ABCs, but each ABC will have been set up in a slightly different way we are, once again, concerned that being overlying prescriptive here risks excluding items that would have genuine value in the case of insolvency.

Q18. Do you agree the proposed form of confirmation when Last Man Standing scheme structure is selected on Exchange?

We have received no comments from members on this particular aspect.

Q.19. Do you agree with the revised scheme structure factor calculation proposed for associated last man standing schemes?

We support the continued application of the 10% discounted to non-associated last man standing schemes in recognition of the minimal risk they pose to the PPF.

We also recognise that there may be some associated last man standing schemes where the dispersion of members is limited and therefore if the employer with the greatest amount of members goes under there is an increased likelihood that the remaining employers will have limited ability to meet that employer's obligations. Therefore it would make sense in such cases not to apply a blanket reduction as the spreading of risk is limited.

However, dispersion of members (or lack of it) is not necessarily a direct proxy for the financial ability of the employers with in the scheme to meet the overall obligations in the event of one or more employer insolvencies. Now we recognise that getting perfect financial records of all employers in such arrangements is not an easy task but in the longer term the PPF may wish to review whether it has the ability to apply the calculation based on insolvency risk/financial strength of all scheme employers rather than purely on the dispersion of members.