

Consultation Document

The 2011/12 Pension Protection Levy Consultation: Insolvency Risk

Foreword

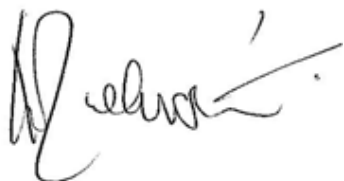
Measuring the insolvency risk for the 20,000 sponsoring employers of the schemes we protect is a complex task. We have just begun invoicing for the fourth pension protection levy and with each year we have learned valuable lessons and improved our understanding of the particular nature of risk for companies with defined benefit pension schemes. Through our regular contact with stakeholders, we are also pleased to see that industry understanding of the failure score has also improved since the first year of the levy.

There are many challenges involved with adapting the product we purchase from Dun & Bradstreet for use in the risk-based levy. We need to operate a system that can accurately reflect the risk of a number of different types of employers commercial and non-commercial, large and small, UK and foreign.

We have shown in the past that we are prepared to make changes to the failure scores to meet these challenges, provided this can be achieved without undermining the basic methodology. We did so in August 2007, when D&B revised their failure score methodology and we continue to work closely with D&B to ensure that failure scores and probabilities of insolvency we associate with those remain appropriate. So when the failure score methodology was updated again in summer 2009, we assessed the probabilities of insolvency D&B suggested to us, and at the same time took the opportunity to consider a number of issues raised by stakeholders.

The context for changes to the way we measure insolvency risk is crucial to this consultation. We all know that the level of risk has changed over the past two years; we are also looking at how we can reflect risk over the longer term in a new, fairer, levy model.

Most of the proposals in this document stem from issues identified by levy-payers and their advisers and representatives. We believe they will ensure that insolvency risk is more accurately reflected - reinforcing the fairness of the levy in 2011/12 and beyond. We look forward to receiving your responses.



Alan Rubenstein
Chief Executive

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1. Introduction and Executive Summary

1.1 The 2011/12 Pension Protection Levy Consultation Document

Purpose

- 1.1.1 This document sets out our proposals for developing the measurement of insolvency risk for the 2011/12 levy year. It reflects the change in D&B's failure score methodology in summer 2009 and stakeholder feedback from previous consultations and general engagement.

Consultation timetable

- 1.1.2 The Board would welcome comments on the proposals by 14 December 2009. A summary of responses and any changes to the proposals will be published early in 2010. This timetable will ensure that schemes will know the basis on which insolvency risk for the 2011/12 levy year will be assessed before the measurement date of 31 March 2010.
- 1.1.3 A further consultation on the levy for 2011/12 will be carried out (in early autumn 2010) once the scaling factor for 2011/12 is available for inclusion in the 2011/12 determination, but there is no expectation of further major policy changes in that consultation.

1.2 Background to the 2011/12 levy proposals

- 1.2.1 We first appointed D&B to be our insolvency risk provider for the 2006/07 levy year. They reviewed their methodology for assessing insolvency risk in the summer of 2007, and the PPF covered those changes in our August 2007 consultation on the 2007/08 and 2008/09 levies.
- 1.2.2 During summer 2009 D&B revised its UK failure score methodology again; this review of the failure score methodology was strongly influenced by the significant economic changes of the previous year, particularly the pace of that change, and its unequal impact on different industrial sectors. To take account of these events, D&B will now make increased use of interim financial statements for quoted companies to reflect the potential for sudden change and give greater weight to changes in payment behaviour, reflecting the financial crisis' impact on short-term cash flow.

- 1.2.3 Alongside updating their failure score methodology, D&B has updated the insolvency risks it routinely attributes to each failure score. These rates differ from those which underlie the existing table of assumed probability of insolvency which has been adopted by the PPF for the levy years from 2008/09 to 2010/11, for two reasons. Firstly, the make up of employers in each failure score will have changed and secondly the risks will reflect recent experience of insolvency rates for businesses with the characteristics of those in each failure score.
- 1.2.4 Changes in the D&B methodology affect the rating of all 5 million businesses it assesses. The PPF announced in 2006/07 that it would, subject to limited specific exceptions, use scores provided in the normal course of business at the relevant measurement date. Accordingly scores based on the new methodology will be used for levy purposes from levy year 2011/12 onwards. Whilst the choice of failure score methodology is a matter for D&B, the PPF has sought to assure itself that the measure remains effective for our purposes.

1.3 Summary of the 2011/12 levy proposals

- 1.3.1 We have assessed the effectiveness of the new D&B approach for our purposes by comparing the actual insolvency rate of schemes entering assessment periods with the theoretical rate implied by the current and proposed insolvency probability tables.
- 1.3.2 Our analysis suggests that, taken together, the new methodology and the associated failure scores will provide results more in line with our actual experience. For this reason, we believe that it is right to continue to use D&B scores as calculated in the normal course of business¹, and to use the associated insolvency risk table in Appendix 2.
- 1.3.3 D&B proposes to update the insolvency risks it associates with each failure score from time to time, at which point they will also review the boundaries for each failure score so that 1 per cent of D&B's overall population is in each failure score. If insolvency risks are reviewed by D&B before we publish our response to this consultation, then the PPF will seek to evaluate any new table based on the approach used here, and to adopt the revised table if it proves superior. Absent such a change, the PPF proposes to use the table in Appendix 2.

¹ Subject to limited adjustments as specified in this document and summarised at paragraph 1.3.6

- 1.3.4 As we are looking at the changes D&B has made to their methodology for assessing UK businesses, we considered that this would be a good time to revisit at a range of issues that have been raised with us by stakeholders. Of course, some criticisms amount to little more than “I don’t like my score”, or are the inevitable result of a measurement system that seeks to assess the risks of millions of UK businesses. Such a system needs to be based on a standard set of data and scoring methodology. There are, however, common themes in stakeholder comments that we consider make a strong case for reviewing the way we use the D&B score for the PPF universe of employers.
- 1.3.5 We have therefore discussed with D&B the key issues raised to assess the possibility of addressing them without undue departures from their standard approach. In particular, we have sought to tackle concerns that certain features of the D&B system can be manipulated without altering true risk.
- 1.3.6 Below is a summary of proposed changes to the measurement of insolvency risk in the 2011/12 levy year (this information is explained in greater detail later in the following chapters of this consultation document):
- That D&B asks for appropriate evidence when employers seek changes to industry sector or geographic region;
 - That D&B collects accounts from the Charity Commission website and potentially a limited number of other sources (if appropriate sources are identified), rather than relying on non-commercial sponsors to provide their accounts themselves²;
 - That D&B introduces a new attribute called “Nationwide” for any business with branches in three or more different UK regions when assessing the impact of an employer’s location on their insolvency risk. This will mean businesses that are essentially nationwide in scope are treated as such, rather than being rated on the location of their main trading address;
 - That D&B exclude PPF-compliant contingent assets when judging whether charges on a company’s assets have a negative effect on its insolvency risk. This reflects the reality that PPF compliant contingent assets are different from other charges, as they are a response primarily to the financial position of the pension scheme not of the employer;
 - That in assessing the failure score of a subsidiary whose ultimate global or ultimate UK parent company is at substantial risk of failure, the score of the subsidiary is limited to (at best) the score of the parent. This is

² D&B will, however, continue to accept accounts sent direct to them and we would not wish to discourage non-commercial sponsors submitting accounts directly.

because, notwithstanding the general principle of separate corporate identity, a weak ultimate parent company can take actions that undermine the strength of an otherwise sound subsidiary in its attempts to preserve its own position.

- 1.3.7 Some of these are changes that D&B will be making to the standard failure score methodology. Others are proposed changes to the way the PPF will use the D&B failure score. This will mean that, for a limited number of schemes, a sponsor may have two failure scores: the score that D&B provides to its customers in the normal course of business and the score after the application of any modifications specified in the 2011/12 determination. If a scheme, or sponsoring employer, wishes to check their PPF specific score they can do so by contacting D&B's dedicated customer service team.

2. Insolvency Risk –Changes to the D&B methodology & the PPF’s assumed probabilities of insolvency

2.1 Chapter Summary

2.1.1 This chapter provides information on the revised D&B failure score methodology introduced in June 2009, as well as our analysis of that new methodology and a revised Insolvency Probability Table for 2011/12, based on information provided by D&B and our own experience of the pattern of insolvency events affecting eligible schemes.

2.2 Revisions to the D&B Failure Score Methodology

2.2.1 During summer 2007 D&B revised its failure score methodology across its entire UK employer universe. The changes at that time included:

- Updating the probabilities of insolvency to reflect the then most recent insolvency experience;
- Ensuring the failure score was no longer overridden where a company had negative net worth;
- Amending the rules concerning County Court Judgements in keeping with the approach taken by the PPF in 2007/08;
- Producing separate scorecards for commercial and non-commercial organisations to address concerns that the prior approach did not recognise the particular characteristics of not for profit sector sponsors.

2.2.2 The impact of these changes will have been felt for the first time in the 2008/09 levy year, which had the measurement date of 31 March 2008. Alongside these changes, the PPF introduced a new table of assumed probabilities of insolvency based on information from D&B on the insolvency risks they associated with failure scores.

2.2.3 In the summer of 2009 D&B again revised its UK failure score methodology. In doing so D&B has cited the unprecedented change in the UK economy during the last year and its impact across all business as the main driver for the revisions.

2.2.4 The changes, which were implemented in June 2009, are as follows:

- A new Economic Index has been developed to ensure specific industry risk is better reflected in D&B's scores. Going forward this will mean that D&B can take account of the possibility that economic changes have a differential impact on different business sectors;
- Regular adjustments will be made to the Economic Index to ensure scores continue to reflect environmental changes going forward;
- Increased use of audited interim financial statements for publicly quoted companies to ensure that D&B's failure scores remain as up-to-date as possible;
- Greater weight has been given to certain trade and financial elements, such as levels of indebtedness and changes in payment behaviour, to better reflect the impact of changing economic conditions on liquidity and cash flow.

2.2.5 It is D&B's view that the changes will allow its failure score to be more responsive to changing economic conditions, trade and financial data. This will generally mean that its customers have a more up-to-date view of the risks they face.

2.2.6 We have assessed the likely impact on the predictive power of the failure score methodology for employers with defined benefit schemes. The results are included below.

2.3 A Revised Insolvency Probability Table

2.3.1 Alongside the changes made to their failure score methodology, D&B has suggested that the PPF update the table that it uses to determine the insolvency risk probabilities for UK failure scores (this table is included in the Determination for each levy year). D&B has suggested a set of probabilities, based on the probabilities that they supply to clients in the normal course of business.

2.4 Assessing the changes to failure scores and the proposed new insolvency probabilities

- 2.4.1 To test the impact of the new failure scores and the proposed insolvency probabilities, we compared the pattern of insolvencies they predict with our actual experience of insolvency events that trigger assessment periods. Our historic experience of claims is beginning to provide a basis for assessing how D&B's model performs for our universe. This is important because employers sponsoring defined benefit schemes may not be typical members of the 5 million strong D&B universe (being on average larger and more long-established and being concentrated in particular industrial sectors). So, statistical relationships that are generally valid for the D&B universe may be less valid for our part of it.
- 2.4.2 It should be noted that the PPF has only been in operation for four years and the rate of insolvencies amongst the employers that sponsor defined benefit pension schemes has been relatively low. The PPF has only limited actual experience against which to measure the predictive power of failure scores. However, by comparing sponsoring employers' insolvency rate with a cumulative insolvency probability over four years, we have been able to assess how accurate failure scores are likely to be as a predictor of insolvency for employers sponsoring defined benefit schemes.
- 2.4.3 Our analysis considered the effects of the failure score and the revised insolvency probabilities separately. Whilst the Board took the decision that the fundamental basis of the insolvency risk assessment would be the D&B methodology, when selecting them as the insolvency risk provider for the 2010/11 and 2011/12 levy years, it would be open to the Board to decide to calibrate the scores differently. This could be through retaining the Associated Probability of Insolvency table used in 2010/11 or substituting a different set of probabilities.
- 2.4.4 Our analysis indicates the proposed changes would be a significant improvement. In comparison with the methodology and insolvency table used for 2010/11, the new approach brings the predicted pattern of insolvencies 15 percent closer to our experience to date. Two thirds of the improvement comes from the move to the new failure score methodology, the other third from the move to the new insolvency risk table. Appendix 1 sets out the results and the methodology used to produce them in more detail.
- 2.4.5 It is possible that the introduction of the new D&B failure score methodology may lead to some increase in the volatility of scores for 2011/12 when compared to the previous year, since any change in methodology is bound to

lead to shifts in scores. It may also increase volatility in the longer-term as D&B say the scores will be more responsive to changing circumstances. However D&B's monitoring to date suggests that this will not be a material factor for many employers.

- 2.4.6 The new insolvency risk table should be a fairer reflection of our risks. Indeed, when combined with the move to capping insolvency risks at a maximum of 3 per cent (which affects failure scores 1 – 19 in the revised table), as proposed in the 2010/11 consultation, it will amount to a slight narrowing in the range of insolvency risk scores. On an ongoing basis, this should marginally reduce volatility as well as bring the assessment of insolvency risk closer to the PPF's experience of insolvencies.

2.5 Conclusions

- 2.5.1. Our analysis suggests that the proposed table has greater predictive power than the current table. Therefore we believe that it should be adopted for 2011/12 rather than retaining the existing table
- 2.5.2. As part of the enhancements to its Failure Score methodology, D&B will be updating their insolvency probabilities more frequently. Whilst D&B will consider changes on a regular basis, it will only introduce changes if there would be a substantial difference from the existing result. It is possible, but not certain, that D&B will wish to update the probabilities they routinely use prior to the measurement date for the 2011/12 levy year.
- 2.5.3. If revised insolvency probabilities are provided to the Board prior to the publication of the conclusions on this consultation exercise and, following evaluation, they show a better fit with actual PPF experience, the Board expects to adopt those probabilities in its table for 2011/12. Otherwise it will adopt the set of insolvency probabilities in Appendix 2. Once the conclusions document has been published in early 2010, the Board would not anticipate making further changes for the 2011/12 levy year.

Question

- 1. Do you agree that we should adopt the proposed insolvency probability table?**

2.6 Changes in 2010/11 that will affect the levy

- 2.6.1 Readers of this consultation should note that there are changes to the levy scheduled for introduction from the 2010/11 levy year that will alter the way the levy is calculated from current practice. These were published in The 2010/11 Pension Protection Levy Consultation (September 2009).
- 2.6.2 A change to note is the new approach to the measurement of insolvency risks of foreign employers and guarantors. This sees foreign failure scores translated into a UK equivalent failure score and the insolvency probability associated with that UK failure score used to determine the entity's insolvency risk. This required a set of conversion tables to be produced for each country where D&B produces failure scores. An updated set of tables will be published for 2011/12 reflecting the changes in the UK failure score methodology.
- 2.6.3 The consultation period on the 2010/11 proposals began on 30 September and the deadline for responses is 11 November 2009.

3. Responding to Stakeholders and changes to certain D&B scorecard elements

3.1 Chapter summary

- 3.1.1 This chapter considers stakeholder concerns about the D&B scoring methodology expressed in response to previous consultation exercises. The chapter outlines proposals to deal with these concerns.

3.2 Stakeholder Concerns

- 3.2.1 Responses to the 2009/10 Pension Protection Levy Consultation (published in November 2008) highlighted particular concerns about the application of D&B failure scores which were described by one respondent as "...arbitrary and in many cases an inaccurate reflection of a company's genuine risk of insolvency." Another respondent identified "...negative experiences on insolvency scoring" and went on to note that "...irrelevant proxies are often used to judge corporate strength, such as the number of registered directors or a company's geographical region."

- 3.2.2 Responses to the November 2008 consultation also highlighted an issue in relation to PPF legal charges that seek to reduce scheme risk:

"Contingent assets are promoted as a beneficial action to reduce the PPF levy and support the recovery plan where a pension fund is in deficit. However, by putting a type B contingent asset arrangement in place a legal charge is filed against the sponsoring employer. D&B consider this as a weakening of the security of the sponsor and reduce the failure score. This results in a higher risk based levy, negating the benefit sought."

- 3.2.3 In addition to consultation responses, schemes have also made representations to the PPF on aspects of D&B's scoring methodology. The charitable sector has, for example, highlighted that D&B does not routinely access the financial information included in the annual accounts of unincorporated charities. These charities have been described by the sector as being at a disadvantage because D&B do not use the account information when assessing an unincorporated charity's failure score.

3.3 Consideration of the issues raised

- 3.3.1 We have held discussions with D&B on each of the points that have been raised by stakeholders as particular points of concern. As a result the PPF has identified a number of areas for change. We would note that the issues identified here, though relevant, have a limited impact on a scheme's D&B score. By far the most important step companies can take to ensure that their insolvency risk is correctly assessed is to engage with D&B to ensure they have the most up-to-date and accurate information.
- 3.3.2 The starting point for considering comments has been to consider the extent to which a change in approach might lead to a fairer measure of insolvency risk, whilst at the same time addressing concerns that certain elements in the D&B Failure Score can be subject to artificial changes. Discussions with D&B have sought to establish whether certain susceptible elements of the D&B scoring mechanism could be made more resistant to artificial adjustments. Our discussions with D&B and stakeholders have focussed on four elements:
- **Industry Sector**
 - **Geographic Region**
 - **Directors and Principals & Associations**
 - **Charges**
- 3.3.3 A more detailed consideration of these four elements and the proposals for change follows.

Industry Sector

- 3.3.4 D&B tell us that some industry sectors have historically had a lower risk of insolvency than others. So, in principle, it might be desirable for employers to have D&B classify them as operating in a "low-risk" sector rather than a higher-risk one. By informing D&B that they belong to a different industry sector than is listed on the annual return to Companies House, employers might be able to improve their failure score, without having the lower level of risk associated with the new industry sector.
- 3.3.5 D&B proposes not to accept changes to an employer's primary industry sector, as listed on its Companies House return, without evidence, such as a breakdown of turnover, confirming that most revenue comes from a new sector.

Geographic Region

- 3.3.6 The region in which a business's main trading address is found forms a (relatively small) part of D&B's failure score, owing to the correlation between certain areas of the UK and higher historical insolvency rates.
- 3.3.7 In its application to the levy, this causes two issues for fairness. Firstly, a multi-location company with a main trading address in a low-risk area can attain a better score than a similar company headquartered in a high-risk area, despite the two having a similar exposure to nationwide risk. Secondly, a company could manipulate its score by designating a branch in a low-risk area as the main trading address. In either case, this would mean that the true risk of the business is not reflected.
- 3.3.8 D&B have analysed the relative risk of companies with multiple locations and concluded that companies based in three or more regions have a lower risk profile than those based in one or two³:

Number of Different Regions	Still Trading	Insolvent	Total	Bad Rate
1	11,300	221	11,521	1.9%
2	8,980	153	9,133	1.7%
3+	8,014	79	8,093	1.0%
Overall Total	28,294	453	28,747	

- 3.3.9 To recognise this D&B proposes that they introduce a new attribute called "nationwide" for any business with branches in three or more different UK regions.
- 3.3.10 A business that has branches in three or more different UK regions would be considered less of a risk than a business located in, for example, London or Leeds.
- 3.3.11 The addition of the nationwide attribute will ensure that the failure score will recognise the exposure of companies with locations in multiple regions to different local economies. This solution will also help to alleviate the problem of employers' perception that changing the location of their main trading address will artificially improve the failure score and hence reduce the risk-based levy. The PPF considers that it would better reflect the PPF universe of employers to require D&B to apply a nationwide attribute when supplying failure scores to the PPF.

³ D&B inflated the number of businesses present in the multiple region categories, to achieve a statistically robust sample. This was done by adding businesses that are comparable to those in the PPF universe, but which do not actually have a DB pension scheme.

3.3.12 Dealing specifically with the problem of manipulation, D&B propose to ensure that businesses can only change their main trading address, where they can provide evidence that the main office has changed (e.g. employee numbers by branch location, production output by factory, or location of main operational directors and HQ functions).

Directors and Principals & Associations

3.3.13 Statistical analysis of historical UK insolvencies and bankruptcies demonstrates a clear correlation between the size and make-up of the Board of Directors (or principals for non-corporate entities) and subsequent business failure rates.

3.3.14 The precise relationship will vary depending on a range of factors (including size and nature of employer). But D&B has found that typically (and all other factors being equal) a company with a large Board of directors with an excellent track record of leading well-run, established businesses is 2-3 times less likely to fail than one with two directors with no other experience and 4-5 times less likely to fail than a company with two directors who have a history of failures.

3.3.15 As a result, D&B's Failure Score models assess the risk of businesses on characteristics relating to the number of directors and principals, the other current UK associations (a principal's other UK directorships) and the historic track record of these associations (for example, the proportion of associations which have failed or experienced a negative legal lead-up event).

3.3.16 For the vast majority of businesses, the Principal's section of the scorecard represents a relatively small proportion of the potential Failure Score, though the precise proportion varies for different market segments. The points assigned to each attribute are statistically determined by the relative levels of insolvency risk represented.

3.3.17 There is a perception among some stakeholders that D&B's models consider companies to have a lower risk if they have more directors, and that some businesses have therefore been adding directors, in order to improve their risk.

3.3.18 However, as noted above, the experience of a company's directors and their other associations is also taken into account in the assessment. These factors can, in fact, be more important than the number of directors. It therefore follows that a director with a proven track record of working across a number of directorships will be given more credit on this risk scoring element than a new director.

3.3.19 While the Board recognises that there are concerns around the manipulation of Board membership, the evidence D&B presents does make a case for including the control of businesses as a factor in assessing insolvency risk. To the extent that adding directors (and indeed ensuring D&B are aware of their experience) is more accurately reflecting the actual oversight of a business, this can be seen as giving a better picture of the insolvency risk it poses. Though it would, in principle, be possible to make wholly artificial changes, the legal implications of being a director (statutory and common law duties, possible liability for wrongful or fraudulent trading etc.) ought to discourage such appointments.

3.3.20 The Board therefore does not intend to seek changes to this aspect of the scoring methodology in respect of the measurement of pension scheme sponsors. This is, however, an area that the PPF will keep under review in the future.

Charges

3.3.21 Since the Board introduced the contingent assets regime for the 2006/07 levy, 136 type B contingent assets (securities over cash, property or securities) have been correctly certified, reducing the underfunding risk of the schemes to which they are pledged.

3.3.22 However, the failure score can be reduced as a result of certifying a type B contingent asset: if the guarantor or chargor of the asset is registered at Companies House, then the contingent asset will also be registered there, as a charge against the company. This may have a detrimental effect on the Failure Score, the magnitude of which would be determined by a number of factors:

- the number of existing charges registered at Companies House
- the time since the most recent existing charge still outstanding
- the Failure Score model used, and
- the current underlying Failure Score.

3.3.23 Affected levy-payers perceive the potential reduction in Failure Score as unfair: the business is taking steps to reduce the risk it poses the PPF, but is then being penalised for doing so.

3.3.24 We asked D&B to review this point and see whether companies with a recent PPF compliant contingent asset actually pose the same insolvency risk as those with other kinds of charges and, hence, whether the Failure Score should reflect this.

3.3.25 How an outstanding charge affects the score generally depends on the time since it was registered at Companies House. This is the *Time Since Most Recent Charge* characteristic of the scorecard, the most important of the factors identified above.

3.3.26 D&B categorises the time as follows:

Time Since Most Recent Charge	Relative Raw Points
No Charges	Maximum
Over Four Years	Positive
2 – 3 Years	Average
Less Than 2 Years	Zero

3.3.27 Applying these categories to the PPF sample shows the following distribution:

Time Since Most Recent Charge	% of Total
No Charges	23.5%
Over Four Years	3.7%
2 – 3 Years	12.3%
Less Than 2 Years	55.6%
Total	100%

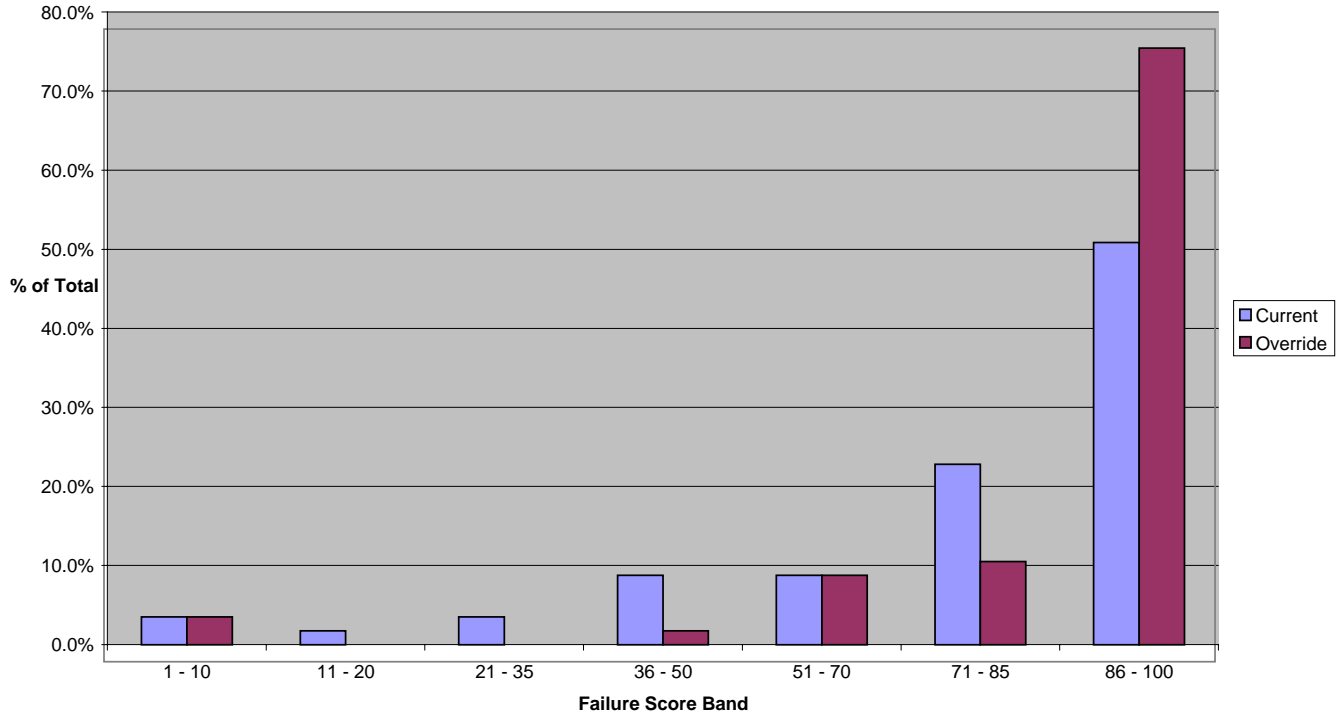
3.3.28 The companies with no registered charges are unaffected by the additional liability of the contingent asset. Either these companies are not registered at Companies House (hence no charges will ever be registered against them), or they are scored on a D&B Failure Score model which does not consider charges.

3.3.29 We believe that this is problematic: there are equality issues if charges related to contingent assets only affect the failure score for employers required to file accounts at Companies House, or if charges are incorporated into one scoring system but not another. The Board has demonstrated its desire to overcome such inequality with the proposal on accounts for non-commercial employers in this consultation and the proposal on foreign probabilities of insolvency in the consultation on the 2010/11 levy.

3.3.30 Failure scores for the remaining entities, for which charges are counted, are reduced according to the period of time passed and whether there are any other non-PPF charges registered. In the great majority of the cases investigated, the contingent asset was the only charge. For the others, it was the newest. The contingent asset therefore tends to reduce the score independently of other factors.

3.3.31 If the failure scores of these employers were adjusted to disregard the impact of the PPF-compliant contingent asset, effectively overriding an aspect of the failure score — as was done for County Court Judgements in 2007/08 — the distribution of scores would change as shown in chart 1.

Chart 1: Distribution of Failure Score for Cases Affected Detrimentally by Charges



3.3.32 The override produces a striking redistribution of employer strength towards the higher failure score bands. Most employers appear otherwise strong, with three quarters belonging among the safest 15 per cent in the UK, if one ignores their certification of a contingent asset. This is not what would be expected if the decision to put in place the contingent asset was based on an expectation of financial difficulty ahead. The most reasonable conclusion must be that a contingent asset is more a reflection of a desire to protect the scheme in the longer term and/or manage their levy than of employer weakness.

3.3.33 D&B's recommended approach is to distinguish those cases affected by PPF-compliant charges and adjust their failure scores as above, disregarding the negative effect of the charge on the *Time Since Most Recent Charge* scorecard characteristic. This would be done **for the contingent asset only**. Any other

charges will continue to be scored as normal. Where a scheme applies for recognition of a contingent asset for levy purposes but their asset does not meet the requirements of the determination, the PPF will retain the discretion as to whether nonetheless to apply this override to the D&B methodology. As the number of certified contingent assets grows over future levy years, we will continue to monitor the situation.

Example of the impact of the proposed change

<p>Impact</p> <p>This change could affect failure scores for the 2011/12 levy as follows:</p> <p>Example 1:</p> <p>Company A has just one outstanding charge, relating to a PPF compliant Contingent Asset registered in July 2008 related to a defined benefit pension scheme. Its current Failure Score of 72 would increase to 90 under the new approach.</p> <p>Example 2:</p> <p>Company B has three outstanding charges registered against it from April 2000, December 2008 and one from March 2009 which is a Contingent Asset related to a group defined benefit pension scheme. Its current Failure Score of 85 would not change under the new approach as there is another relatively recent outstanding charge.</p>
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Refinement of the substantial parent risk override

- 3.3.34 Currently, we instruct D&B to disregard their standard override which sets a failure score of 1 for a subsidiary company with any parent at substantial risk of insolvency (in the UK equivalent to a D&B score of 1-10). This override was disabled following stakeholder comments that it was too severe and to ensure we measure the insolvency risk of the subsidiary not the parent.
- 3.3.35 However, experience has shown that weak parent companies can drag down seemingly stronger subsidiaries. We therefore propose to adopt a revised override, where the failure score of a subsidiary is capped at the lower of the levels of the global ultimate parent and/or domestic ultimate parent company when D&B's override is applied. This differs from the standard D&B approach, in using the parent company's score and not being triggered in respect of intermediate holding companies, while recognising parental risks.

3.4 The proposals for change

3.4.1 Having considered the issues raised and D&B's recommendations, our proposals for change are as follows:

- **Changes in industry sector or geographic region**
The PPF agrees that D&B should request the appropriate evidence when employers seek changes to industry sector or geographic region;
- **A new nationwide category for business location**
That D&B introduces a new attribute called "Nationwide" for any business with branches in three or more different UK regions when assessing the impact of an employer's location on their insolvency risk;
- **Charges**
The PPF agrees that D&B should distinguish those cases affected by PPF-compliant charges and adjust their failure scores accordingly.
- **Substantial risk over-ride**
To cap the failure score of a subsidiary company at the lower of the levels of its global ultimate or domestic parent, when one or both is at substantial risk of insolvency (D&B score 1-10) or Risk Indicator 4. If no Failure Score is available locally but the parent company is rated as a Risk Indicator 4, then the subsidiary company's score will be capped at a score of 1.

Questions

1. **What are your views on the proposals?**
2. **Do you feel that more areas than the ones identified should be reviewed? If so, can you suggest the areas that you would like to see reviewed?**
3. **Do you feel that the proposals make the D&B scoring methodology more resistant to artificial change?**

4. Data sources used by D&B for measuring Insolvency Risk: Non-commercial accounts

4.1 Chapter Summary

4.1.1 This chapter considers the provision of accounts information from the “not for profit” sector and the proposals for D&B’s collection of account information from that sector.

4.2 Issues and proposals

4.2.1 In July 2007, D&B introduced a specific non-commercial Failure Score model which helped to reflect the differences between the commercial and non-commercial sectors. This included reflecting the particular significance of senior management arrangements and the lesser significance of some financial ratios. It also recognised the fact that not all non-commercial employers are obliged to file accounts by giving a basic neutral points allocation where D&B had seen no accounts (by comparison, where accounts would be expected, failure to file is seen as a negative indicator). In addition, D&B encouraged non-limited businesses, which were not legally required to file statutory accounts at Companies House, to voluntarily provide audited accounts to D&B on an annual basis. The aim was that these accounts would feed directly into their failure score, thus allowing accounts that showed the stability of the employer to be recognised.

4.2.2 The PPF notes that in the majority of cases, non-commercial employers sponsoring DB pension schemes have chosen to provide audited accounts directly. For example 75 percent of charities already provide audited accounts to D&B and this contributes to their risk assessment.

4.2.3 Despite the steps already taken, a number of stakeholders have commented that there is an inequality of treatment in that non-commercial employers have to actively provide accounts (and by failing to do so can suffer) whereas for companies accounts are collected automatically. There is also a risk that a non-commercial employer could opt to submit only if it is likely to be in their interests since weak accounts can worsen a neutral score.

Table 1: Table of employers providing audited accounts

Employer Type	SIC⁴ Codes	Number of Employers	% of Total Providing Audited Accounts
Educational, Religious and Charitable Trusts	6732	1082	74.7%
Residential Care Homes	8361	449	89.3%
Religious, Civic & Social Associations	8631	872	64.0%
Schools and Colleges	8211	673	77.6%
Social and Family Services	8322	268	75.4%
Other Industry Sectors		14721	89.8%
Undetermined Industry Sector		717	50.1%
Total		18,782	85.6%

4.2.4 The proposed approach is for D&B to identify those charities that have not provided audited accounts in the weeks leading up to 31 March 2010 and then extract the financial data where available from the most likely source. In the case of the Charity Commission this would be the Charity Commission website, www.charity-commission.gov.uk, which holds details of the majority of charities). Following the extraction of the details, D&B would key the required data into its systems. This approach would also tackle the risk that a charity with weak accounts, which would diminish its score, would opt not to have them counted.

4.2.5 Charities are only one amongst a number of types of non-commercial employer that do not routinely provide accounts to Companies House. Where there are regulatory bodies that collect and publish accounts for groups of non-commercial employers it may be possible for D&B to develop a similar system to that being developed with the Charity Commission. The PPF would be interested to hear of proposals for other organisations that could be approached, with a view to establishing a limited number of additional potential sources for accounts information.

⁴ Standard Industry Classification

Questions

1. Do you agree with the proposal to proactively collect accounts for charities from the Charity Commission?
2. Do you feel that we should investigate whether there are any other similar organisations which could help to collect the accounts for the other remaining “non limited” entities?
3. If so, can you give the name(s) of the organisation(s) that you feel should be approached?

5. Key dates related to the 2011/12 levy

5.1 Chapter Summary

5.1.1 This chapter provides some key dates related to the 2011/12 levy.

5.2 Consultation documents issued during Autumn/Winter 2009 – Key dates

5.2.1 September 2009 – Publication of the 2010/11 Pension Protection Levy Consultation document. The deadline for the receipt of responses to this document is 11 November 2009. A summary of responses and any changes to the proposals will be published in winter 2009, along with the final 2010/11 determination and final 2010/11 Levy Scaling factor.

5.2.2 November 2009 – Publication of the 2011/12 Pension Protection Levy Consultation on insolvency risk. The deadline for the receipt of responses to this document is 14 December 2009. A summary of responses and any changes to the proposals will be published early in 2010. A further consultation on the levy for 2011/12 will be carried out (in early autumn 2010) once the scaling factor for 2011/12 is available for inclusion in the 2011/12 determination, but there is no expectation of further major policy changes in that consultation.

5.3 Data deadlines and measurement dates for the 2011/12 levy

5.3.1 The measurement date for underfunding (the date to which the PPF transforms section 179 valuations) and for insolvency risk is 31 March 2010. The following deadlines are applicable for submission of relevant information:

2010

- 5pm on 31 March 2010 for updating Exchange with levy-related information (except where set out below)
- 5pm on 30 March 2010 for providing information to D&B to be taken into account in sponsoring employers' failure scores

- 5pm on 30 June 2010 for certification of partial block transfers that have taken place up to and including 31 March 2010⁵

2011

- 5pm on 31 March 2011 for certification/re-certification of contingent assets
- 5pm on 7 April 2011 for certification of deficit reduction contributions. and
- 5pm on 30 June 2011 for certification of full block transfers that have taken place up to and including 31 March 2011 (note: this is a single deadline for full certification, which differs from the approach in 2009/10).

5.3.2 Further details in relation to both the consultation exercises and the data deadlines and measurement dates can be found on the PPF website at the address:

<http://www.pensionprotectionfund.org.uk/levy/Pages/PensionProtectionLevy.aspx>

⁵ For full transfers to be taken into account in 2011/12 there is a single deadline of 30 June 2011 for full certification. The 7 April deadline is no longer applicable.

6. Responding to this consultation

- 6.1.1 We welcome your comments on this consultation document.
- 6.1.2 The deadline for written responses is 5pm on 14 December 2009. Whilst this is a relatively short period for a consultation exercise, this will allow responses to be evaluated by the PPF and a response document issued well before the measurement date for 2011/12, providing certainty for schemes about the basis on which sponsors' and guarantors' insolvency risks will be assessed on 31 March 2010.

6.2 How to respond

- 6.2.1 If you would like further copies of this document, it can be found on our website at www.pensionprotectionfund.org.uk. Please send all consultation responses to:

Chris Collins
Head of Policy
Pension Protection Fund
Knollys House
17 Addiscombe Road
Croydon
CR0 6SR

Email: consultation@ppf.gsi.gov.uk

- 6.2.2 When responding, 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. If you are responding on behalf of a pension scheme, please include your Pension Schemes Registry (PSR) number.

6.3 Confidentiality and Code of Practice

- 6.3.1 The requirements of the Freedom of Information Act (2000) state all information contained in the response, including personal information, may be subject to publication or disclosure. It is the Board's intention that all responses will be

published on the Pension Protection Fund's website alongside the summary of responses.

- 6.3.2 By providing personal information for the purposes of the public consultation exercise, it is understood that a respondent consents to its disclosure and publication. 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 the Freedom of Information Act 2000 and otherwise permitted by law.
- 6.3.3 Queries should be sent to Paul Reynolds at the address below. Further information about the Freedom of Information Act 2000 can be found on the website of the Ministry of Justice at:
<http://www.justice.gov.uk/guidance/guidancefoi.htm>
- 6.3.4 This consultation is being conducted in line with the Code of Practice on Consultation. The code can be accessed via the website of the Department for Business, Innovation and Skills at: <http://www.berr.gov.uk/files/file47158.pdf>
- 6.3.5 If you have any comments on the effectiveness of this consultation, please contact:

Paul Reynolds
Director of Corporate Affairs
Pension Protection Fund
Knollys House
17 Addiscombe Road
Croydon
CR0 6SR

E-mail: paul.reynolds@ppf.gsi.gov.uk

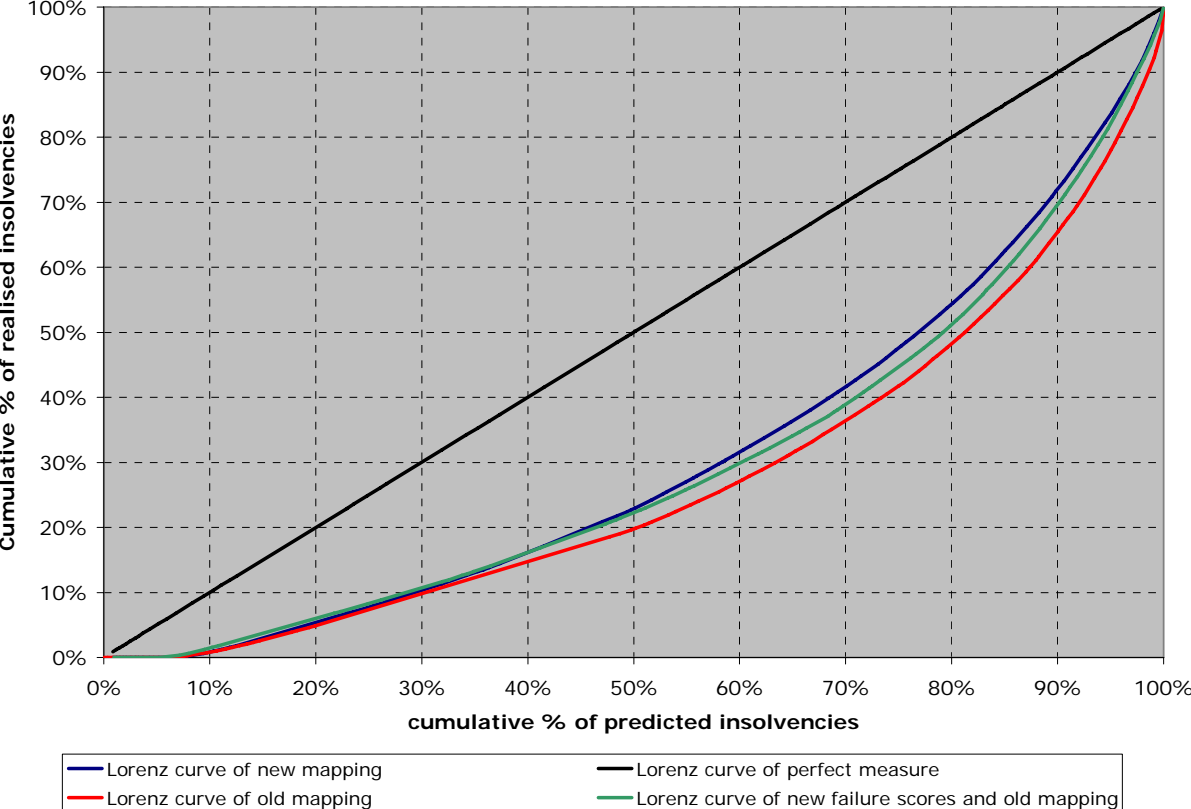
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Appendix 1 - Impact analysis

Changes to the D&B failure score methodology and proposed new insolvency risk table

- 1 D&B provided us with failure scores of a sample of sponsoring employers of 415 scheme sections which are in assessment or have transferred to the PPF. Failure scores were provided at the date of assessment and each month for the 12 months prior to assessment. We used this data to assess the predictive power of D&B insolvency probabilities by comparing the predicted insolvency rate by failure with the realised insolvency rate. We applied the same analysis to the new D&B methodology.
- 2 The predictive power of a scoring system can be measured using a set of Lorenz curves shown in Chart 1. The black curve represents perfect predictive power, while the other three curves represent the predictive power of differing combinations of failure score and insolvency probability table. The red curve is the current failure score methodology and insolvency table, the green curve the new failure score methodology and current insolvency table, and the blue line the new failure score methodology and proposed insolvency table.
- 3 The Gini coefficient quantifies the predictive power of a set of failure scores with mapped insolvency probabilities by measuring how far the Lorenz curve is from a perfect insolvency measure. A Gini close to zero indicates a very good predictive power, while a Gini of less than 0.5 indicates a degree of predictive power. The Gini coefficient of the failure score on the current methodology (and current insolvency risk table) is estimated at 0.46.
- 4 Applying the new methodology without changing the mapping of the failure score to insolvency probabilities reduces the Gini coefficient to 0.42. Finally moving to the new failure scores and the new mapping further improves the Gini coefficient to 0.40.

Chart 1: Lorenz curve of failure scores and insolvency table combinations



3

Appendix 2 – Proposed Insolvency Probability Table

Failure Score	Probability of Insolvency	Failure Score	Probability of Insolvency	Failure Score	Probability of Insolvency	Failure Score	Probability of Insolvency
1	3.00%	26	2.41%	51	1.31%	76	0.59%
2	3.00%	27	2.33%	52	1.26%	77	0.56%
3	3.00%	28	2.27%	53	1.23%	78	0.54%
4	3.00%	29	2.24%	54	1.21%	79	0.51%
5	3.00%	30	2.16%	55	1.18%	80	0.48%
6	3.00%	31	2.07%	56	1.14%	81	0.46%
7	3.00%	32	2.00%	57	1.10%	82	0.44%
8	3.00%	33	1.95%	58	1.07%	83	0.42%
9	3.00%	34	1.92%	59	1.03%	84	0.40%
10	3.00%	35	1.89%	60	1.00%	85	0.38%
11	3.00%	36	1.84%	61	0.98%	86	0.36%
12	3.00%	37	1.79%	62	0.95%	87	0.34%
13	3.00%	38	1.75%	63	0.94%	88	0.32%
14	3.00%	39	1.69%	64	0.91%	89	0.30%
15	3.00%	40	1.65%	65	0.88%	90	0.28%
16	3.00%	41	1.62%	66	0.85%	91	0.26%
17	3.00%	42	1.59%	67	0.82%	92	0.24%
18	3.00%	43	1.56%	68	0.80%	93	0.21%
19	3.00%	44	1.53%	69	0.78%	94	0.20%
20	2.98%	45	1.47%	70	0.76%	95	0.18%
21	2.88%	46	1.44%	71	0.72%	96	0.16%
22	2.79%	47	1.41%	72	0.69%	97	0.13%
23	2.67%	48	1.39%	73	0.66%	98	0.10%
24	2.56%	49	1.37%	74	0.65%	99	0.08%
25	2.48%	50	1.34%	75	0.62%	100	0.03%

