Pension Protection Fund

Policy statement

Levy rules 2022/23

16 December 2021

Foreword

I am delighted to introduce this policy statement. Its publication marks the conclusion of our consultation on the rules for the levy in 2022/23.

The impacts of COVID-19 have remained at the forefront of our minds. Our September consultation highlighted the action we planned to take. First, despite the economic uncertainty, our strong financial position enabled us to maintain our existing levy rules and allow the levy estimate to fall by over £100 million as a result. Secondly, we proposed to leave in place key support measures introduced in 2021: the lower risk-based levy cap, ensuring no scheme pays a levy of more than 0.25 per cent of its liabilities; payment easement measures; and the Small Scheme Adjustment, halving the risk-based levy paid by small schemes.

These proposals were welcomed by a majority of respondents to our consultation. However, we also committed to careful monitoring of insolvency risk scores as greater numbers of company accounts covering pandemic period trading became available. And a small number of respondents highlighted downgrades in insolvency risk scores that they attributed to the specific circumstances of the pandemic - particularly the forced closure of businesses.

Over 40 per cent of employers have now filed accounts covering the period of the pandemic. Overall what we see is reassuring – the level of change in scores is very comparable to previous years, and the evidence available to us gives us confidence the insolvency risk model continues to work well. We still expect over 80 per cent of schemes paying a risk-based levy to see a fall compared with 2021/22.

However, there is an increase in very significant score movements. Although this affects a small number of employers we do recognise the exceptional nature of the pandemic and the potential impacts of levy increases in this difficult period.

In response, we are introducing an additional support measure for 2022/23 only. For the minority of schemes whose levy is increasing, we will limit increases to 25 per cent. We will not seek to recover the levy foregone as a result of this adjustment.

Our levy estimate, updated for this policy change and the latest data, is £390 million. This means the levy will have fallen by £230 million since 2020/21. Looking ahead, we are considering carefully the direction of the levy in the longer term as part of our funding strategy review. This will consider the risks to which the PPF, and the members who depend on us, remain exposed alongside the reserves we have built. As always, we are committed to engaging levy payers and other stakeholders in the considerations that will inform our strategy.

In the meantime, we remain grateful to all those who have engaged with us over this period: those who responded to our consultation, our SME Forum and all others whose views have helped inform our approach.

David Taylor
Executive Director and General Counsel

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1. Key conclusions

We have now completed our consultation on the 2022/23 levy rules and are publishing our conclusions together with the levy rules for 2022/23. The headlines are:

Levy parameters
• The Levy Scaling Factor ('LSF') and Scheme-Based Multiplier will remain at 0.48 and 0.000021 respectively, and the risk-based levy cap at 0.25 per cent of scheme liabilities. • Over 80 per cent of schemes that pay a risk-based levy are projected to see a lower levy in 2022/23. • Measures introduced in 2021/22 to support schemes through the pandemic stay in place.
Levy policy and the Board's Levy Estimate
• Recognising the impact that COVID has had, for the minority of schemes seeing a rise in levies we are limiting risk-based levy increases to 25 per cent when compared against 2021/22 levy bills. • The Levy Estimate is £390m. This has been updated to reflect the policy change and at the same time we have incorporated the latest data.
Insolvency risk model
• We will continue to measure insolvency risk on the basis in use since April 2021, using credit ratings and the PPF specific model operated by Dun & Bradstreet (D&B). • The mapping of Credit Ratings to Levy Bands / Rates has been updated in line with our policy statement of January 2021. • We are implementing the proposed score override for entities entering restructuring plans, and the proposed recovery mechanism.
Section 179 valuation basis
• Following the updated s179 assumptions guidance which came into force earlier this year, we're changing the s179 valuation output basis from version A9 to A10. • These changes bring our assumptions in line with the bulk annuity market and are expected, typically, to reduce schemes' s179 liability values used to calculate the levy.
Alternative Covenant Schemes
• We are bringing together the previously separate rules covering commercial consolidators and schemes without a substantive sponsor (or SWOSS) into a single appendix (Alternative Covenant Schemes or ACS). In response to feedback we have developed our guidance setting out the circumstances in which the ACS rules would apply.

More about our analysis and rationale for decisions, along with information about other subjects noted in the consultation document can be found in the following sections of this policy statement.

2. Introduction

2.1. Consultation

2.1.1. On 28 September 2021, we launched the consultation on the Levy Rules for 2022/23. It closed on 9 November 2021 and we received a total of 26 responses. These were considered in determining the final Levy Rules.

2.1.2. This document summarises the responses we received, our analysis of the issues raised and the conclusions we reached.

2.2. The levy rules

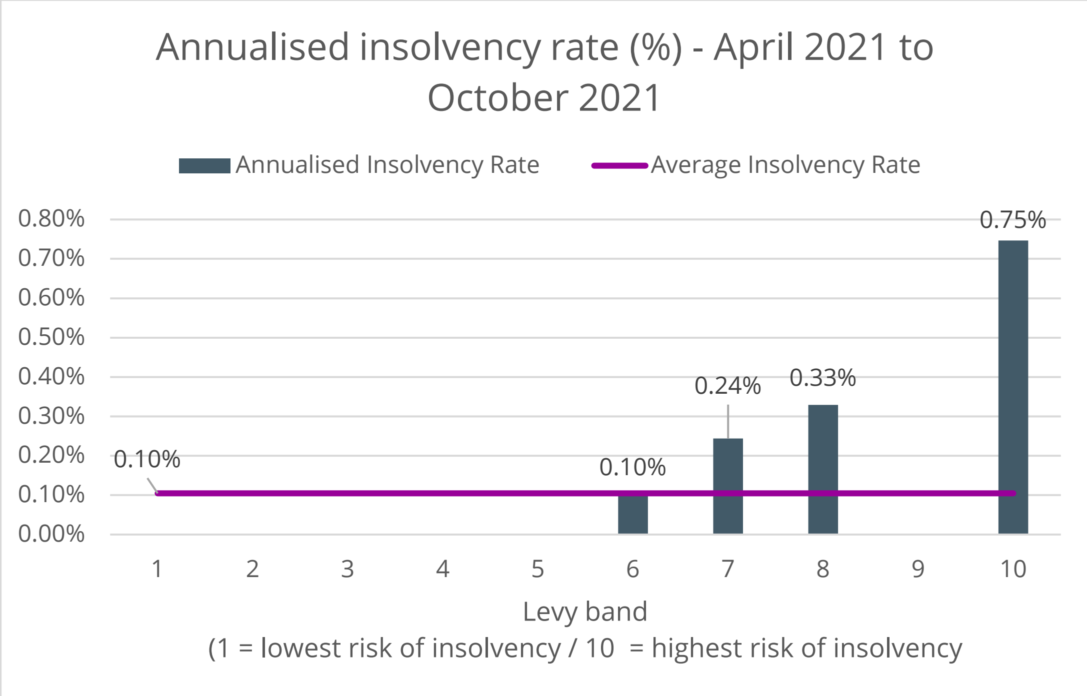
2.2.1. The Levy Rules that will govern the calculation of the levies for 2022/23, as specified in the Board's Determination under section 175(5) of the Pensions Act 2004, are published alongside this Policy Statement. Together with the Levy Rules, we have published guidance for schemes on how to meet the requirements of the Levy Rules, and to explain how we expect to make use of the areas where the Levy Rules provide us with flexibility.

3. Monitoring in light of COVID-19

3.1. Insolvency risk scores and levy impact

3.1.1. In our consultation we proposed to leave the PPF-specific model unchanged but undertook to continue monitoring how insolvency risk scores changed as accounts covering pandemic period trading were filed. We noted that performance monitoring - and an annual review carried out by D&B over the period April 2020 to March 2021 - had given us the confidence that the model had continued to be predictive and was fit for purpose, illustrating that insolvencies were concentrated in the weakest levy bands – even though there are more companies in the stronger bands. This suggests that, although trading conditions have been unprecedented, the strength of a business prior to the start of the pandemic has remained a good indicator of its risk of insolvency.

3.1.2. Insolvency rates since April have been very low. However, continued monitoring between April 2021 and October 2021 shows that the picture remains the same with 6 further insolvencies observed in the weakest levy bands. The below graph illustrates this.



3.1.3. Respondents were very supportive of our proposal, with 13 out of 17 agreeing with our approach. One response had no opinion on the matter, and three disagreed. A small number of responses raised concerns surrounding impacts on accounts information (such as turnover) as a result of forced closure during periods of lockdown.

3.1.4. We committed to monitor new company account filings and the impact they had on the scores. Further analysis has been undertaken based on scores provided by D&B as at the end of October (incorporating accounts filed with Companies House up to October). Around 40 per cent of these scores now incorporate COVID period trading[1] and can be used for comparison purposes.

3.1.5. In the summer of 2020, we modelled what impact the pandemic could have on insolvency scores and levy band movement, assuming a decrease in turnover, increase in liabilities, a loss position in the P&L, and an increase in cash.

3.1.6. Looking across the 40 per cent of companies for which we now have data, levy band movement appears much less dramatic than our modelling suggested 18 months ago. In line with our initial views in the consultation document, there remains little evidence that using such company accounts for credit scoring results in an overall pattern of scores that is out of step with previous years. The overall proportion of companies changing levy band is similar to the average for the years used for building the PPF-specific model (2007-2019). Around half of employers move up or down in levy band – with similar numbers moving in each direction[2]. Coupled with the improvement in scheme funding we have seen, this means that we continue to expect that over 80 per cent of schemes that pay a risk-based levy will see it fall.

[1] The most common end-date for accounts is end December, followed by end September, March and June. We have chosen to monitor accounts from September 2020 onward as these will have captured a significant period of COVID affected trading – and should give a good idea of impacts on scores.

[2] 25 per cent of employers saw a one or more band improvement, 27 per cent a one or more band worsening. Historically, the average is a small year-on-year net improvement

3.1.7. However, a picture that has emerged recently is – in a limited number of cases - of larger levy band deteriorations than observed in previous years. For example, around 2 per cent of companies have seen their levy band deteriorate by 5 or more bands. This is around 50 per cent higher than the average observed in our modelling data, and around 25 per cent higher than the highest yearly observation (following the 2008 financial crisis).

3.1.8. We have investigated some of the largest downgrades observed and a significant proportion do relate to businesses in sectors that will have been heavily affected by COVID and periods in which trading would have been muted due to lockdown (others are for more individual reasons).

3.1.9. It should be noted however, that only a proportion of those large levy band movements will actually translate into large levy increases – as some schemes pay no risk-based levy (around a third) and in some cases less affected or improved scores for other employers in the same scheme may dampen impacts. Improvements in funding levels may also offset - to an extent – levy increases and the risk-based levy cap will also serve to cap the highest levies (currently 0.25 per cent of scheme liabilities).

3.1.10. In total our analysis suggests that – taking all these factors into account - just under 3 per cent of schemes are currently projected to see (at least) a doubling in levy.

3.1.11. We acknowledge that challenges potentially still lie ahead for employers. The government's removal of some support measures introduced at the peak of the pandemic presents a possibility that we will see a greater number of corporate insolvencies in the coming months. Both the impact and timing might differ by size and type of business[3]. That said, observed insolvency events currently remain low against what we would expect to see to date and we are continuing to see low levels of early stage engagement from struggling businesses.

3.1.12. In assessing the performance of our model, this low rate of insolvencies presents challenges. If this trend continues we will have very few insolvencies we can look to for our assessment of whether the model continued to discriminate successfully between solvent and insolvent employers. We will of course continue to use the same objective metrics we have always used to assess if the model remains fit for purpose, but it will be harder to draw firm conclusions.

4. Responding to consultation comments and new data

4.1. Insolvency risk scores

4.1.1. We are encouraged that the picture continues to be more favourable than initially expected when we first started monitoring COVID impacts on accounts data in 2020. However, we have considered carefully the position of businesses seeing large

[3] Government support measures currently still in place are now more tailored. For example, protection from the use of winding-up petitions to pursue commercial rent arrears or debts smaller than £10,000 will remain in place till at least 31st March 2022.

deteriorations in trading activity which is impacting accounts, and could drive significant levy increases.

4.1.2. Some responses to our consultation focused on this issue. They argued that it was inappropriate to score companies based on accounts that reflected periods of closure enforced by government during the pandemic, without any adjustment.

4.1.3. In particular, it was argued that an adjustment should be made to turnover figures to offset the impact of closures (e.g. if a business could only operate for 9 months of the year, the turnover figure from their financial accounts would be treated as if the accounts were only for a 9-month period, and scaled up). Turnover was seen as a particularly important variable to adjust because of its use as a "change variable" in scorecard 3 (which compares turnover in the latest accounts with that from 3 years earlier). The suggested amendment was seen as necessary to ensure the comparison between years was done on a consistent basis – avoiding comparing turnover from a year when there were enforced business closures, with a 'normal' trading year.

4.1.4. We considered this proposal carefully but concluded that specific change was not one we should make. This was for three reasons:

- We only make changes to the insolvency risk model where there is clear evidence to support them. In this instance, we do not have the evidence to support the proposal that grossing up turnover will lead to a more appropriate score. It is, in fact, plausible that a significant deterioration in turnover – regardless of the cause – *will* lead to some increase in an employer's insolvency risk and that the adjustment would then be inappropriate. And we know that entering the pandemic the insolvency risk model was highly predictive. The evidence for this – or indeed any other - change to the model will only become available over the next 12 months when the latest scores can be compared to actual insolvency experience (though as noted above the low level of insolvencies makes it uncertain whether robust evidence will emerge even over that timeframe).

- We consider that many of the variables that are measured in our model are likely to have been impacted where a business has been closed – for example profits, the cash held by the business etc. We also note that turnover, in addition to being used as a variable in its own right also governs how companies are allocated to scorecards. In the light of the many factors that we have seen influencing scores, the limited adjustment suggested in consultation responses would help relatively few of those with large movements in levy (not least as it would affect companies on only one of our eight scorecards).

- There are some significant practical issues. In particular, we think it is unlikely that during pandemic closures all affected businesses in our universe ceased trading completely. Many businesses found ways to continue trading in some form. The level of turnover adjustment would therefore need to be tailored to the circumstances of each business in order to avoid creating an unduly high value.

4.1.5. However, we recognise the underlying concern about significant increases in levy bills for a minority of schemes. And we are very aware that the period since March 2020 has been truly exceptional, with some companies forced to cease trading as the world sought to combat the pandemic. This has clearly negatively impacted short, and longer term, financial strategies for many. The longer-term impacts on employers, including the extent to which insolvencies may increase, remain very unclear.

4.1.6. In this context, whilst there is not the evidence to support changing the insolvency risk model, we felt it appropriate to consider whether there is other action we can take to support schemes and employers (in addition to those measures we introduced in 2021/22 including the reduction in the risk-based levy cap and alongside continued reductions in the levy estimate).

4.1.7. We also took into consideration the PPF's strong financial position going into and through the pandemic. Our recent Annual Report showed our reserves had risen to £9bn, largely as a consequence of our strong investment performance. Accordingly, we have the flexibility to support the most affected schemes without unduly undermining the security of our existing members or our ability to withstand future claims.

4.1.8. We are therefore introducing a rule that, for 2022/23 only, will limit increases in bills to 25 per cent compared to the 2021/22 value. This measure allows for an increase in individual scheme bills reflecting that the risk posed to the PPF by some schemes will have increased to some extent over the pandemic. However, it will limit the impact of more significant deteriorations in levy band. It is these significant movements that are outside of historic norms and triggering the most concern from respondents. We will not seek to recover the levy foregone by implementing this limit on increases.

4.1.9. In setting this rule[4], we stress that this policy is designed to support schemes where levies increase as a result of employers, that remain viable, seeing downgrades in insolvency risk scores due to COVID impacts. The new rule is, however, constructed in a simple way (we are not, for example, excluding from the rule schemes which paid a zero risk-based levy in 2021/22 and that might otherwise have paid a risk-based levy in 2022/23). In the context, and looking at the schemes where we currently expect the rule to apply, we think this approach is reasonable.

4.1.10. We are though reserving the right to disapply the 25 per cent limit – or alter the base value against which it is calculated - where there is a material change in the scheme's circumstances (such as a material increase in liabilities of the scheme) or where the employer has had an insolvency event so that applying the cap unadjusted would lead to a clearly inappropriate outcome. We expect such cases to be very limited in number. For example, where a block transfer has occurred effectively combining two schemes in one, we would expect to alter the base value by summing the 2021/22 levies of the transferring and receiving schemes. The rule won't apply to alternative covenant schemes.

[4] C2.4 of the Determination

4.2. Our levy estimate and parameters

4.2.1. In the consultation document we proposed maintaining a Levy Scaling Factor ('LSF') of 0.48 and Scheme-based Levy Multiplier of 0.000021. We also announced that the Levy Estimate – the amount we estimated these parameters would raise – was £415 million for 2022/23.

4.2.2. In the light of the policy change to limit increases in bills, we have reviewed our levy estimate. We have also taken account of new data available to us (such as market movements and changes in insolvency scores to end October) which together also have a small impact on the estimate. As a result, we have adjusted the estimate downward to £390 million. We also confirm that for 2022/23 we will use the LSF of 0.48 and the Scheme-based Levy Multiplier of 0.000021.

4.2.3. A small number of respondents to our consultation asked about the overall direction of the levy in view of our financial reserves, and a couple of responses suggested that further reductions in the amount of levy collected were appropriate.

4.2.4. The level of levy collections is set to support our long-term funding strategy. Our reserves need to be considered in the context of the significant risks to the PPF from underfunded schemes as well as the need to ensure the security of our existing members if, for example, longevity improvements are greater than expected. Our existing funding strategy anticipated that levies would fall in the long term as and when risk in the system was reduced. We are undertaking a full review of our long-term funding strategy and this will provide the appropriate framework to set the overall direction of the levy. We expect to engage levy payers and our other stakeholders on this including as we consult on our proposals for the 2023/24 levy. In the meantime, the 2022/23 levy estimate of £390m means we will have reduced the levy by £230 million since 2020.

5. Other policy development

5.1. Alternative Covenant Schemes

5.1.1. The consultation document explained the basis on which our policy and rules had developed with respect to SWOSS and Commercial Consolidators and sought to gain stakeholder feedback on two key areas of change:

- To bring the two existing sets of rules (SWOSS and Commercial Consolidator appendices) together into one new Alternative Covenant Schemes (ACS) appendix.
- To revise the definition of schemes who would be charged under the ACS methodology (as opposed to the standard rules). This aimed to address potential gaps in the existing definitions and ensure that all schemes that ought to be within scope could be included.

5.1.2. Responses were broadly supportive of our approach. However, some raised concerns about the breadth of the definition in the new appendix, with a few citing a risk that some schemes could be in scope due to normal business activity resulting from corporate mergers or restructuring.

5.1.3. Our aim is to apply the ACS methodology to those schemes where, following action to alter the support for a scheme, the risk of a scheme coming to the PPF is best captured by assessing the risk of investment or funding failure. This contrasts with the conventional levy which measures the risk of a scheme claiming on the PPF by assessing the insolvency risk of the sponsoring business. (In cases where investment risk is key, an option pricing methodology – the basis of the ACS approach - is therefore far more appropriate than our conventional levy calculation).

5.1.4. This naturally gives rise to a two-part test for identifying an ACS. One part which identifies the actions that alter the support for the scheme; the other which considers if an option pricing levy is appropriate. Support for a scheme might be altered for example by attaching an additional employer to a scheme, through nominal accrual. This might give rise to an ACS where covenant is then supported by a buffer fund, but would not where the new employer brings a conventional covenant from a trading business (as is often the case in restructurings).

5.1.5. We do not believe it is practical to draft a rule which provides an objective test to distinguish between transactions and structures where the ACS methodology is appropriate and where it is not. We therefore think it is necessary for rules to allow the Board a discretion to determine the most appropriate approach following a transaction. This is because of the range of potential structures and circumstances that may arise and also reflects the immaturity of the ACS market (with the exception of 'superfund' consolidators the range of alternative covenant vehicles is still very much taking shape). That said, our expectation is that very few schemes would need to consider in detail whether the ACS category might apply to their circumstances.

5.1.6. We are therefore proceeding with the new definition and approach that we proposed in consultation. However, to provide greater certainty to stakeholders, we are making some minor amendments to the rule to emphasise that in order for a scheme to be classed as an ACS the Board has to take an active decision that the ACS methodology is the most appropriate. We have also extended our guidance to articulate the limited and specific circumstances in which the Board would consider the ACS methodology to be the most appropriate approach. We recognise that this is a new and developing area, which we will need to keep under review and we will be updating our guidance from time to time, including the identification process. We are prepared to update this guidance further if it proves necessary to help give clarity.

5.1.7. As a result of feedback on specific areas of the rule, we have also made minor amendments to the description of transactions in C5.2 (d) (iii), and C5.2 (e) (ii). For C5.2 (d) (iii), we improved the clarity of wording in relation to funding available to schemes which is held outside of a scheme (e.g. capital buffer). While for C5.2 (e) (ii) we clarified the wording in relation to a ceding employer who may still have a funding obligation to the scheme.

5.2. Monthly score overrides – restructuring plans

5.2.1. We proposed – in our consultation – to amend section 5.1 of the Insolvency Risk Appendix to apply an override of 100 per cent insolvency risk for entities that enter a restructuring plan under the Corporate Insolvency & Governance Act 2020. We also proposed the introduction of a recovery mechanism to allow for instances where companies entering restructuring plans, CVAs, or Administration and Chapter 11 proceedings under the United States bankruptcy code could - in the event of recovery and upon filing new accounts – have the override removed.

5.2.2. All respondents agreed with our proposals. There was a suggestion that – for consistency – we could consider applying the override to companies entering moratoriums as well. These events do pose additional risk to the PPF, but we consider our reasoning behind not including them in the override remains valid. As such, we are confirming the changes to paragraph 5.1 as proposed under consultation.

6. Customer service

6.1. Support with payments

6.1.1. In June 2020, we introduced additional payment flexibility for the levy to help schemes with sponsors financially impacted by COVID-19. Based on stakeholder feedback, and on what we're permitted to do by legislation, the policy introduced a new payment plan option – available for the invoices issued in 2020/21. This policy was also extended to be available for the most recent levy invoices issued – 2021/22.

6.1.2. Affected schemes or their sponsoring employers were able to submit a notification form via our website – within 28 days of receiving their invoice – explaining how they had been negatively affected by COVID-19 and requesting an extension to payment terms. If approved, interest charges that would have normally accrued due to late payment were waived for up to 90 days (as long as payment was made within those 90 days).

6.1.3. Where schemes/employers needed longer than 90 days (or there were other reasons why they would face particular difficulties paying on time) applications could be made under the existing payment plan processes.

6.1.4. In our consultation, we were interested in views on the merits of extending the flexibility to cover the 2022/23 levy that the consultation covered. Responses were fully supportive of extending the payment flexibility, but noted that the level of financial impact that has been seen so far hasn't warranted the need for easements in many cases. It was also raised that appropriate controls should remain in place to avoid loss of levy income if there is a significant increase in demand.

6.1.5. For 2021/22 invoices, fewer than 10 easement terms were requested, primarily for small to medium sized schemes, and all were agreed. We consider this level of take up to be low and the cumulative levy value subject to the extended term was not considered material. We agree that the conditions surrounding any payment easement – entry criteria for example – should be relevant at the time the flexibility is offered. We will therefore continue to monitor the economic environment through 2022 and we will announce any changes to the existing easement for 2022/23 invoices in advance of invoicing.

7. Key dates and next steps

7.1. Key dates for 2022/23

7.1.1. The following table sets out the key dates in the coming year:

Item	Key dates and times
Scheme returns and electronic contingent asset certificates to TPR	31 March 2022 - Midnight
ABC certificates and special category applications to us	31 March 2022 - Midnight
Send contingent asset documents to us	01 April 2022 – 5.00pm
Start of 2022/23 levy year	01 April 2022
Deficit-reduction contributions certificates to TPR	29 April 2022 - 5.00pm
Send exempt transfer applications to us	29 April 2022 - 5.00pm
Certify full block transfers with TPR	30 June 2022 - 5.00pm
Publication of Mean Scores	July 2022
Invoicing starts	Autumn 2022

7.2. Next steps

7.2.1. We expect to consult on the levy rules for 2023/24 as normal in the autumn of next year. We expect these rules to incorporate the use of new asset classes as per our joint policy statement of October 2021 with TPR. As part of that, we also anticipate reviewing the overall system of asset and liability stress factors and consulting on the outcomes of that review.