

# THE PENSION PROTECTION LEVY CONSULTATION DOCUMENT

July 2005

## Response by AIRTO

### Chapter 1 – Introduction and background

We fully support the concept that where promises of future pension rights have been made, that these are fulfilled with respect to the employee. It is necessary that companies be encouraged to have funds in place to meet their obligations as defined by the trust deeds. We believe that this has been the basis of UK pensions commitment in the past and will continue into the future. AIRTO member companies are committed to meeting pension obligations to their employees, however their ability to do so is affected by trading conditions and trading style. These two important factors must be recognised by the Board in its plans.

We accept that changes within the UK economy have occurred since the introduction of UK occupational pensions in 1921. Clearly instances have occurred where companies have blatantly failed to meet their obligations or misused the powers they had over the trust funds of their employees. To counter this, controls - checks and balances have been necessary within the UK pensions industry.

We understand the process being adopted by the Government that it is necessary to introduce a “safety net” to support employees where the employer has or is likely not to fulfil its obligations as stated in the trust deed to its employee. The decision to adopt a two tier approach is seen by AIRTO as a mechanism that will address the issues and prove a vehicle for the Board to provide funds to deal with the issue of funding pensions to those employees of scheme that have failed.

The concern of AIRTO is that the proposal takes no account of the difference between those company’s that “will not pay” versus those that “cannot pay” either as a result of the financial structures they operate against as defined by the governing Memorandum of Association and Articles or the economics of current trading.

We agree that to be able to fund pensions for those people who have paid in to funds that cannot meet their obligation a fund pool has to be established on a continuous basis. It is recognised that some pension funds will, during the course of time, fail because companies are unable to meet their payment schedules as identified by the actuaries.

To have a process where funds are generated on a two-stream basis seems sensible. Our concern is that the basis of levy as identified in the consultation document cannot be applied universally across industry, in particular across the spectrum of our members, many of whom fall into the “charity” or “not for profit” category. Our main concern is the application of the risk based levy, particularly the application of the “failure based element”. Many of our members have been established solely for investment into research, and therefore under rating schemes such as Dunn & Bradstreet will never gain a high rating.

We believe that the Board has failed to adequately consider or include other changes that are being made within the financial reporting structures not only of our members but industry in general. A major change, effective from the 1<sup>st</sup> April 2006 will be the inclusion of the pension deficit as calculated within the FRS rules being consolidated into the statutory accounts. This change will have a devastating effect on the net assets of companies and in many instances remove completely the net assets of the business. This can only increase the “failure factor” still further, which will in turn increase the payment of the risk-based levy. This cannot be sensible or the objective of the Board.

Excess levies will only weaken the organisations to the point they will be insolvent and therefore forced into liquidation, the associated pension fund therefore will have to seek protection under the Pension Protection Fund. Surely it cannot be the purpose of the Pension Protection Levy to close both companies and schemes.

## **Chapter 2 – Levy principles and risk**

**Question 1** - *Do you agree that the Board should construct the risk based levy in a way that combines the principles of fairness, simplicity and proportionality.*

**Response** - We firmly believe that the Board should develop a process that is fair to all schemes, and the companies that support them. However as presently constructed, the process fails to recognise that the risk of failure will be significantly increased precisely because of the application of the levy itself. As an insurance scheme, which in effect it is, it does not propose to spread the risks over a sufficiently wide base.

It is clear that the sponsoring company has to remain strong to meet its obligations to the scheme. It is important to use best evidence that relates to the company concerned. Our opinion is that the failure rating measure is too crude to factually identify the sponsoring employers ability and willingness to meet its obligations as per the trust deed and the actuarial review. We firmly believe that the Board’s process must not jeopardise the company’s ability to survive and meet its obligations. Under the process being proposed the Board runs the real possibility of forcing companies into liquidation, hence further damaging the rights of the scheme members.

We support the Board’s objective in introducing a funding mechanism that is fair and simple to administer. Our concern is that the proposal in respect to the risk based element of the levy does not reflect the ability of the sponsoring employer to pay appropriate contributions into their schemes. This flaw will place an undue strain on our member companies to the point that the levy will not be supportable by the employers performance as determined by current and future business trend.

We also believe that not-for-profit organisations should be subject to an alternative basis to assess the risk based levy. Using the Dun & Bradstreet failure rating based on the annual balance sheet and trading account is inappropriate.

### **Chapter 3 – Pension scheme data analysis**

We agree with the data stated in the report by the Board that there has been a significant decline in the number of operational final salary scheme (FSS). This is borne out by many of our member companies. Due to the increasing financial burden of supporting FSS schemes, poor financial investment returns and the lower mortality rates, many of our members companies have been forced to contain and /or cap further liabilities into the future. Many companies see this as a retrograde step as the provision of pension benefits is to be an important employee benefit for the retaining valued staff.

### **Chapter 4 – Under funding Risk**

**Question 1** – *Do you agree that 104% should be the cut-off point above which schemes' underfunding risk would be based on a fixed percentage of Pension Protection Fund Liabilities*

**Response** - We have considered the 104% factor as recommended by the Board. Our view is that if levies are to be introduced to fund ailing schemes, then stronger schemes need to contribute to the fund at a higher rate than is proposed.

We feel that a greater proportion of the funding of the “deficit fund” needs to be directed towards schemes that have higher funding levels (100% +) rather than those with deficits (100% -). We therefore disagree with the Boards' proposal.

**Question 2**– *If you are a trustee of a scheme, do you expect to submit a S179 valuation by 31 December 2005? If not, when do you expect to submit a s179 valuation?*

**Response** - All of our member companies are independent trading companies, with their own Memorandums of Association and Articles. We believe that the majority of companies will not submit S179 valuations by 31<sup>st</sup> December 2005. We are sure that the Board is aware that the completion of S179 valuation places yet another financial burden upon the schemes, hence the companies.

### **Chapter 5 – Insolvency risk**

**Question 1** – *Do you agree with the proposed approach to measuring insolvency, including measuring the insolvency risk of all eligible schemes?*

**Response** - We fundamentally disagree with the approach being taken in this area of the proposal by the Board. As commented previously the majority of our members fall into the category of “not for profit” business. The method being proposed to measure insolvency does not fit the actual business model. Our members are mainly companies limited by guarantee, and therefore do not have the ability of raising additional capital either through the issuing of additional shares or debentures. The proposed method of calculation will ensure that companies currently able to support their final salary schemes will not be able to do so in the future.

**Question 2** – *Do you agree that insolvency should be viewed over a 12 month horizon, since the levy is intended to meet the cost of new claims arising during the annual levy cycle.*

**Response** – We feel that a twelve months horizon does not represent a true trading cycle for any company and does not reflect the changes that occur within the economy of the UK. We believe that a three-year average would be more appropriate and be more reflective of a trading cycle.

**Question 3** – *Do you agree that insolvency should be banded*

**Response** – We accept the Board’s proposal that insolvency should be banded. We believe that the banding must not be so coarse that companies are over charged against the risk based levy being proposed.

**Question 4** – *Do you agree that there should be ten bands*

**Response** – We accept that ten (10) bands will meet the need of the Board. We do have a major concern as an organisation that the failure score is used to identify the risk band. The computation of the risk band is subjective, against facts which are not related to the “Actual Failure Rate” Our members are in a position whereby the tangible net worth of their operation, (applicable to many limited companies) does not reflect the true net worth of the operation on a year by year basis.

**Question 5** – *Do you agree that insolvency risk should be capped at 15%*

**Response** – We believe that at 15% it is highly probable that application of the levy in conjunction with additional payments that will almost certainly be required by scheme actuaries will push companies into early insolvency. We cannot see how a scheme that is designed to recover risk costs within each risk band can ever operate successfully. The risk needs to be spread over a wider base either by an increase in scheme funded elements to say 40% or through the application of a “flattening factor”. If this is not done then individual scheme failure at the vulnerable end of the spectrum will be a self-fulfilling prophecy.

**Question 6** – *Do you agree that there should be a generic band*

**Response** – We cannot see how a generic band calculated by reference to averaging insolvency risk across an industry sector can operate with any degree of fairness. A valid means of assessing individual company insolvency risk is required. The banding approach to setting the risk based levy would bring together companies with very different financial backgrounds and structures and therefore would be wrong. We would prefer to see companies assessed individually based upon the real strength of the business as well as the balance sheet, which in turn relates to their ability to pay on a continuous basis into the future. We do however believe, as we have stated elsewhere in this document, that there are special factors in respect to charities and not for profit organisations which should be reflected in the way in which their levies are calculated.

**Question 7** – *Do you agree with the focus on market-based approach*

**Response** – We understand why the Board have decided upon a market-based approach to measure insolvency. However the “scoring” to achieve the rating must be transparent and reflective of the position of the company being assessed. This is not the case with the proposal, as the ratings used are primarily computed to understand credit ratings for business decisions and not as a guide for assessing the potential failure of our members business. Not-for-profit companies will be very severely disadvantaged using this methodology without modification.

We have a grave concern with respect to the proposal to use the risk based levy against the company with the most employees to obtain the failure rating. The corporate structure used by many of our members, as recommended by the Dti will reflect trading company results that will normally have a zero trading position as profits are subject to gift aid to the company Limited by Guarantee, reducing net worth and the majority of the employees. The rating of the trading company will therefore in most instances give a high risk of failure score. This cannot be the intention of the PPF and therefore to this end we do not support the failure rating process being proposed.

## **Chapter 6 – Scheme structure**

**Question 1** – *Do you agree with the Board’s transitional approach to multi-employer scheme, using full data on multi-employer schemes where it is provided, and a simpler approach where it is not.*

**Response** – We understand why the need exists to deal with multi-employer schemes, however few of our members fall into this category. We believe that the insolvency risk factor should be matched in the first instance to the company where the members are employed. In groups of companies financial data is often skewed for instance to reflect inter-company charges and inter-company pricing. It therefore follows that the only “true” reflection is to set the levy at the highest possible point within a group structure. The board must be careful to include the effect of provisions and reserves. FRS12 deals with the subject of provisions within company accounts and group accounts. A process needs to be established whereby provisions are correctly identified in any assessment of the risk based levy.

We therefore agree with the board’s transitional approach to multi-employer schemes as outlined in the Consultancy Document.

## **Chapter 7 – The Levy Structure**

**Question 1** – *Do you agree that there is a strong imperative to move to a risk-based system as quickly as possible.*

**Response** - We have a significant issue with the concept of the risk based levy concept as we have already stated. Whilst we agree that a proportion of the levy should reflect individual risks, it is important that the levy is based on a real ability to pay and is based on

financial data that truly reflects the company's position. We do not believe that this current proposal fulfils this objective.

**Question 2** – *Do you agree that the risk exposure should be based on a product of insolvency and under funding risk.*

**Response** – Clearly the risk exposure is the product as shown. However if the scheme is to operate without driving exposed companies to early insolvency then the income required to offset that risk needs to be derived from a mechanism that widens the base. Thus a further "flattening factor" is required to calculate levy.

**Question 3** – *Do you agree that a cap on individual scheme levies should be applied, and that the cap should apply to those schemes with employers included in insolvency risk bands 9 and 10 and which have weak Pension Protection Fund funding levels less than 65% and 80% respectively*

**Response** - We agree that a cap should apply. We are concerned that the assessment of risk band 9 and 10 is factual statement of the company's financial position.

Our main concern with the levy structure is two fold. In the first instance we believe that the failure factor may well not represent the true financial position of the employer. The basis of Dun & Bradstreet and the statutory accounts only give a snapshot and do not reflect the true trend of the health of the company. This is of particular importance when related to AIRTO member companies which have been established as "not for profit".

We also see that the rates applied to insolvency bands 9 and 10 are seen as penal, and will place a weak employer in an untenable position, where reference to the Pension Protection Fund by the trustees is the only way forward.

## **Chapter 8 – Transitional period**

**Question 1** – *Do you agree it is reasonable to use adapted MFR valuations as an estimate of s179 valuation.*

**Response** – Within the scope of the consultancy document, and the levy system being proposed, we accept that in the absence of a s179 valuation the use of the latest MFR valuation should be used as part of the computation. We are concerned however that there is no real guidance as to the likely outcomes of this modification, although the consultation document does outline broad principles. This makes financial planning for the year 2006/7 virtually impossible.

**Question 2** - *Do you consider that an adapted MFR valuation could be used beyond the financial year 2006/07, if all schemes were not required to complete a s179 levy valuation by 31 December 2006*

**Response** – We believe that our members would find it acceptable if the MFR calculation were used beyond the financial year 2006/07.

As an organisation we are concerned that our members will be faced with valuations that exceed the true liabilities. We agree that s179 valuations will become part of the Pension Protection Fund levy process and therefore they need to be computed at the earliest date. We believe that many of our members will not have a valuation completed by the 31<sup>st</sup> December 2005, partially due to the additional cost, therefore it may be necessary to extend the use of MFR into 2006/07

## **Chapter 9 – Asset Allocation Risk**

**Question 1** – *Do you agree that the Board should include asset allocation risk as a factor for setting the risk based levy as early as practicable,*

**Response** - We agree that asset allocation should be included as a factor in respect to setting the risk based levy. The management of scheme funds to underpin the scheme liabilities is key to ensuring the continuing health of the scheme. Companies that have robust and well thought out investment strategies should be encouraged. The encouragement should clearly be reflected in the quantum of the risk based levy.

**Question 2** - *Do you agree that this is something that is important and which will merit early consideration in a separate consultation exercise*

**Response** – We believe that this is an important factor and as such should be included in a separate consultation exercise as soon as is possible.

**Question 3** – *Do you agree that the main issue to consider in a further consultation are those listed here*

**Response** – We agree that the main issues in respect to asset risk allocation have been listed by the Board. We are concerned that frailties of the investment markets are taken into account and that companies with well thought out strategies are not penalised due to market movements beyond their control.

The important issue of ensuring investment profiles match the schemes liabilities needs to be encouraged, by the Board. This can be achieved through the risk based levy.