Written evidence from an SME PPF Levy Consultation Group (PPF0019)

1 Group Background

1.1 Our group includes seven SME companies in the manufacturing and engineering sectors. This submission is made on our behalf by the individuals named below.

1.2 All companies in this group are sponsoring employers of defined benefit (DB) pension schemes. It was formed because of an interest in sharing our experiences of DB schemes but has subsequently become more active and expanded, in particular because of the impact felt by our companies from the PPF levy in recent years. The group now includes a specialist pensions advisor, who is also a signatory to this submission.

1.3 Following a direct conversation with the Minister of State for Pensions, representatives of this group were invited to a meeting with the PPF in February 2016, at which we raised various DB scheme issues affecting SMEs. It was apparent that no other SME groups had submitted matters for consideration by the PPF.

We were well received and believe that our conversations were mutually beneficial. The PPF has invited us to continue to be involved in consultation for the levy in the Third Triennium.

2 Executive Summary

2.1 The impact of the levy cost on SMEs that have a weak risk assessment and a substantial deficit can be sufficient to cause insolvency.

2.2 In addition to funding scheme contributions and levy payments, SMEs have been faced with significant costs arising from external fees and legislative changes.

2.3 We believe that the consequences of the levy costs have become more severe for SMEs as a result of recent changes to the risk model adopted for the Second Triennium.

2.4 The level of the cap on the risk-based level appears too high.

2.5 An instalment plan for levy payments should automatically be permitted for companies / schemes or, if this is not acceptable for all schemes, at least those below a certain size limit.

2.6 There should be greater communication between the PPF, trustees and sponsors, particularly SMEs, to explain the levy models and basis of calculation.
2.7 We believe that there should be recognition of the contributions made by way of rebates of levies paid should the PPF become fully funded.

2.8 We have set out a suggestion for easier wind-up of schemes using the resources of the PPF.

3 Impact of the PPF Levy

3.1 This inquiry has given the opportunity for owners and managers of SMEs to consider again whether the PPF levy system is appropriate and fair. Our conclusion is that neither applies.

3.2 There are significant disproportionate costs in smaller running DB schemes in addition to funding scheme contributions and levy payments. These include internal governance plus external administration, actuarial, legal, investment, audit and consultancy fees. For businesses with a weak risk assessment and a substantial deficit, the associated PPF levy can exacerbate its problems.

3.3 Although the payment of the levy is due from the scheme, in most cases it is the company that meets the cost. This restricts its ability to use cash for investment but, importantly, also the capacity for making additional contributions into its own scheme.

Recovery plans have developed flexibility to improve affordability – there is no such flexibility with the risk-based levy.

We recognise that the stated aim of the PPF is to become self-sufficient, thus removing the need for a levy at present levels. However, until that situation is achieved, companies should be able to use a proportion of the risk-based levy assessed as an additional contribution to its own scheme. This would make the scheme better funded if it does ultimately enter the PPF “lifeboat”.

3.4 The BHS experience illustrates how the model of regulation and levy is inadequate in regulating large corporates. Not so long ago, BHS was determined as having a very strong covenant paying little risk-based levy. The BHS pension scheme is effectively now waiting to receive compensation for its members from the PPF, with surviving levy payers, including SMEs, potentially paying the bill. The present system opens itself up to this type of distortion.

At another level, given the reasonably fair PPF formula benefits, DB businesses trading at the edge might decide that keeping the funding into their schemes to a minimum is the only strategy open to them, in the expectation that the next generation of owners will accept technical insolvency.

The duration of a DB pension scheme is generally longer than the average SME lifecycle. Such a business will need to grow at a faster rate than the DB liabilities to
This can prove difficult in the current economic environment, with the potential impact on employment an obvious danger.

3.5 It is worth recalling how many long-established SME owners find themselves in a position where they may be trading at a margin of profitability and, when allowing for the pension buy-out deficit, have a business of little or negative value.

These are businesses that have voluntarily introduced a small DB scheme with an insurance company in the 1960s / 70s on the basis of a determined benefits structure with the then current regulatory and tax regime. Along the way, benefits were compulsorily increased by legislation, with administration becoming significantly more complex (eg contracting out), tax breaks were reduced, actuarial practices changed, investment returns fell, liabilities increased (greater longevity and interest rate falls) and exit became prohibitively expensive.

The levy imposes an additional and, in many cases, increasing burden, which many SMEs find difficult to accommodate.

3.6 It should be emphasised that SME owners often have a close relationship with their employees, invariably recognise their responsibilities and wish to meet their contractual pension liabilities. They are also clear that governance needed to be tightened to rectify abuse. However, the constant and sometimes disjointed legislative changes (which may not affect businesses without DB) give rise to uncertainty and more costs.

We do not believe that yet more regulation is required as the Regulator appears to have the necessary powers and we hope they can be used effectively.

3.7 Unless the PPF does become self-sufficient, the pressure on remaining sponsors through the levy could spiral into a growing financial pressure, with fewer and fewer companies remaining to meet the excess liabilities.

4 Unfairness of the PPF levy

4.1 Risk model: the model created by Experian for use in assessing the risk-based levy has, we believe, shifted the responsibility for meeting the costs of the PPF levy more heavily towards SMEs. In our own companies we have established that the average levy rate has increased from 2014/15 (D&B) to 2015/16 (Experian) by 110%. This rate has a direct bearing on the amount of risk-based levy assessed and therefore a substantial impact on the finances of our companies. We do not feel that this is justified by any perceived increased risk of insolvency.

The PPF does not have data that can provide details of levy paid by size of company and we are therefore pursuing the collection of information from other companies of a similar size to assess this point in more depth.
4.2 Scorecards: in our own companies, we have experience of the significant changes in the risk-based levy that can arise from adoption of different scorecards in the Experian model, sometimes by breaching an arbitrary turnover limit. In one member company of the group, an increase in trading activity, taking it above £10m pa, will change the scorecard applied, with the effect that it is expecting an increase to the levy rate of more than 50%, creating a disincentive for business expansion.

For another member, the application of a scorecard as part of a group, of which the sponsoring company was by far the dominant entity, instead of a stand-alone company, had the effect of more than doubling the risk assessed. We believe that Experian carried out modelling on insolvency risk related to size of group, but we are not aware that a comparison was made against similar individual entities, though this is where the impact is significant.

4.3 Charges and banking: changes in the dating of recent charges against a company’s assets can have a dramatic effect on the perceived likelihood of its insolvency in the risk analysis. In the case of SMEs, charges can be an important aspect of raising finance, though this may not be frequently undertaken. We know of circumstances where a new charge has had the effect of increasing the risk of insolvency by more than three times that which would have been the case without that charge. In circumstances where a company is considering changing to a new bank, creating charges that are accepted as replacement mortgages is very difficult. Therefore, the resulting impact on risk rating and levy payable could be a significant deterrent. This will reduce the effectiveness of Government’s stated aim of competition amongst banks.

Where replacement charges are anticipated, it would be helpful to have a pre-approval arrangement in place. This would avoid sponsoring companies unknowingly falling foul of breaching criteria applied, with a resulting increase of risk being assessed.

4.4 Credit worthiness: the emphasis on generic calculations based on size of company and other specific criteria in assessing the risk-based levy can miss the long-term credit worthiness of established companies. This is particularly the case in the SME sector, where owners are often involved directly in the management of risk.

4.5 Instalment payments: the importance of cash flow to SMEs cannot be overestimated. Whilst we are aware that the PPF is prepared to consider payment by instalments in certain circumstances, we feel that this option should be generally available. This would avoid the impact frequently felt by companies faced with a large bill, whereby they may consider that insolvency becomes inevitable, with other options not worth pursuing.

4.6 Risk-based levy cap: the cap appears too high for companies in the lowest bands, struggling to meet other costs. In these circumstances, the conclusion is that
these levies would have been better directed at keeping the business alive and / or helping the scheme funding.

4.7 Communication: we feel that many directors of sponsoring companies and trustees of schemes in the SME sector find evaluation of liabilities and calculation of levies opaque. In particular, understanding the effects of the new risk model, which came into full force following only a short period of consultation, can be difficult for those affected. We believe that there should be additional resources provided to ensure that communications are more effectively directed at affected entities without the resources to employ in-house expertise or external advisors.

4.8 Recognition: payments of levies to date have been made, generally by sponsoring companies, without any recognition of the contributions made to the establishment of the funds of the PPF. If the PPF becomes self-sufficient, or indeed creates surpluses in the future, we feel that there should be a rebate scheme for those companies continuing to trade. To this end, there would need to be creation of a type of “share” in the fund. We understand that there is no clarity on what happens to any eventual surplus and this would be a fair way to reflect the way that funding has been shaped.

5 Suggestion for easier wind-up using PPF resources

5.1 If a sponsor is profitable enough to consider buy-out, they are often dissuaded from following through because of the additional costs of buying annuities.

We have debated the idea of having available an alternative option of transferring assets of a fully funded scheme to the PPF to administer on an ongoing basis. To be clear, fully funded would be on an agreed pure gilts basis (called self-sufficiency) and the scheme benefits would be met in full (not the existing PPF levels). We acknowledge that the PPF is effectively run and the resources that have been put in place would be fully utilised. For pension scheme trustees and sponsors, there would be a savings in buy-out costs and no need to evaluate any risks associated with investing with an external business entity. We put forward this suggestion for independent further investigation.

Signatories:

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