Executive Summary

- The long term funding deficits in most SME legacy defined benefit schemes have cut deep into the competitiveness and viability of the UK’s ‘mittelstand’
- The scale of the deficits and the contributions required by these schemes has led to a huge, long term transfer of funds:
  - from long established manufacturing, engineering and technology businesses to the financial services industry
  - from the UK regions to the City,
  - from the Midlands and the North to London
  - from the young to the old
  - from investment in industrial production to saving in non-productive financial instruments
- It leads to long established, local, paternalistic and caring employers collapsing or failing to prosper, replaced by owners with shorter horizons, and lower quality or no employment
- It cuts deep into the productivity of medium sized British industry and its competitiveness, just when the country needs to increase competitiveness
- The concept of ‘investment’ in these pension schemes is a misnomer: it transfers money from productive investment in industry into the buying of a limited pool of non-productive savings products at inflated prices
- As employers, we are trapped in funding the DB schemes, unable to invest sufficiently in R&D and recruitment which would otherwise sustain and develop quality businesses
- Over protection and over zealous definition of employer promises inflate these liabilities has an adverse impact on UK business as a whole
- Much of the funding deficit problem is arguably of various governments’ creation and of the pensions industry over the last 34 years, not the employers. But the entire cost falls upon the current generation of business staff and owners.
- Without bold moves now, the long-term damage to the UK’s ‘mittelstand’ will be beyond recovery and the PPF may not be sustainable in the long term.

1. About the writer
1.1 I am chairman of the boards of directors of two medium sized regional companies with legacy DB pension schemes and have been dealing with these problems for a number of years.
1.2 Company ‘A’ is a 200 year old business. Located in the North West, it has a turnover of £70m, 320 employees and has subsidiary operations in 5 EU countries. It is involved in technology, engineering and data management. Over half its turnover is from exports. It has a long established legacy DB pension scheme with a current deficit of £3m and a full buy out deficit of some £14m. Annual contributions and running costs of the scheme are over £550,000.
1.3 Company ‘B’ is an 80 year old business, based in the North East, with turnover of £42m and 300 employees. It also has a long established legacy DB scheme in deficit.
1.4 Both are highly responsible employers, proving secure and high quality employment in the regions; investment in training and R&D; recruitment of apprentices.

1.5 I have also spent the last 16 years working in business rescue and restructuring and have had to deal with major business problems caused by these schemes. This includes being the Chief Restructuring Officer on ‘Project Maple’ in 2014. This was a major and innovative rescue of a North West business with a large DB scheme, in conjunction with The Pensions Regulator.

1.6 My comments are therefore from the particular perspective of medium size businesses in the UK regions and the damage the DB pensions crisis is causing in that sector.

2. Responses to the committee’s issues

2.1 The existence of these scheme deficits and the fact that the liabilities still continue to grow, despite continued payment of employer contributions, is damaging sponsoring employers:

- Long term business planning by owners become paralysed because of these open ended liabilities – “we seem to keep pouring water into a leaking bucket”
- Scheme trustees and covenant advisors still err on the side of caution, preferring contributions to the scheme in preference to adequate investment in the employer.
- But to meet these ever growing liabilities, the employers need to grow faster than the wider economy, and that requires substantial long term investment in the businesses.
- Banks and equity investors are very reluctant to be involved in businesses with DB schemes, increasing the under-investment problem.

2.2 The investment strategies which company schemes are require to follow are, I believe, unproductive and damaging:

- Contributions to schemes are not really ‘investment’, but are simply purchases of existing financial savings products from other investors – e.g. public company shares, gilts, UK real estate
- The effect is thus mainly to drive up the prices of this pool of assets, not to create value or growth
- The amount of investment from these huge capital flows in new productive capacity in the UK economy is negligible, and so the underlying problem of how to pay these pensions is not really being addressed.
- These pension schemes are being encouraged to buy shares in UK public companies, which have themselves got DB pension schemes and which are invested in turn in other public companies with their own DB pension scheme deficits and so on. This could be described as little more than a giant Ponzi scheme.

- The contributions paid into these schemes has led to a huge, long term transfer of funds:
from manufacturing, engineering and technology businesses to the financial services industry
from the UK regions to the City,
from the Midlands and the North to London
from the young to the old – it is damaging to inter-generational fair outcomes
from investment in industrial production to saving in non-productive financial instruments

I would ask the committee to consider a radical change to the investment strategies required including:

- allowing low cost investment in long term UK infrastructure schemes which benefit the economy (why not the new Hinkley Point power station for example?)
- encouraging trustees and TPR to regard investment in the employer’s business at least as favourably as investment in third party financial products
- allowing recovery plans to be spread over much longer periods, closer to the remaining life of the scheme obligations

2.3 The one sided definition of the employer ‘promises’ in scheme liabilities is damaging and does not reflect the promises the employers originally thought they were giving:

- Quote from the chairman of a collapsed 130 year old company, once a key employer in its local (North East) area: “If I’d had any idea that it would become like this I would never have started a pension scheme for the company in the 1970s when the financial advisers recommended it”
- Most employers originally offered just a basic pension based on a proportion of an employee’s final salary, without any ‘bells and whistles’.
- In the 1980s many schemes were in a temporary surplus; government proceeded to tax those surpluses, although those funds were clearly essential for the very long term
- Governments then proceeded to legislate to increase the benefits employers had to provide from these schemes, such as:
  - Inflation indexing
  - Spouse’s pensions
  Thus increasing the long term liabilities of these schemes.
- Then in 1997 government took away the Advance Corporation Tax Credit recovery from pension schemes, cutting into the dividend income into pension schemes and the money available to pay pensions and to reinvest.
- Finally UK government economic policy of low interest rates since 2008, tied to the investment policies schemes have to follow, has caused a massive growth in scheme liabilities

It is arguable that a large part of these scheme deficits are due to the actions of government rather than employers, and government has to play a major role in the solution of this problem.
The present environment of low interest rates does require an urgent, radical and exceptional approach: I would ask the committee to consider the government to address these huge funding problems by issuing a special class of gilts linked to CPI or RPI exclusively for pension schemes as a way of providing stability for these schemes, addressing the economic problems caused by government.

2.4 RPI vs. CPI inflation – This technical point could help a lot of schemes: the difference in liability between RPI and CPI as the inflation index in many schemes is material. Despite Government’s intention in 2011 to allow schemes to switch to CPI, not all schemes have been able to do so, due to very minor differences in wording of scheme rules.

- The NSO considers RPI to be an ‘unsatisfactory’ measure of inflation
- Most employers and employees did not consider specific RPI as distinct from CPI as a specific technical part of the pension promises made. At the time for many employers and employees ‘RPI’ was often used as a simple shorthand for ‘inflation’ (as can be seen by the varied wording in many old scheme rules), as opposed to meaning a specific index
- But some schemes remain locked into RPI increases because of an overzealous legal interpretation of the promises made.
- RPI should not be locked in as part of the employer promise.

I would ask the committee either:

- To ask the NSO to end publication of RPI, which would by default enable all schemes to use CPI
- Seek legislation to end the drafting lottery which still locks some schemes into RPI liabilities into the future

2.5 Investments – investment costs in legacy schemes can be high (1.5% plus an annual charge and many other hidden charges in one Aviva scheme I am aware of) but the exit charges are prohibitive. I would urge that exit fees charged by pension investment providers are abolished. This would encourage much greater efficiency in the industry that has for so long been able to treat these employer schemes as captive ‘money pumps’.

2.6 PPF Levy – high levels of PPF levies are hugely counterproductive. They are based on crude commercial credit ratings from Experion, and actually discriminate against employers who are investing in the long term success of the business, which ought to be the best hope for the long term viability of the pension schemes. As a specific example, Company ‘A’ above has invested over £2m in vital technology R&D over the last two years, but will face an increase in PPF levy as a consequence of the impact on its Experion credit rating. An alternative method of funding the PPF should be found.

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