

# ABOUT US

The British Chambers of Commerce (BCC) is the national voice of local business; a national network of quality-accredited Chambers of Commerce, uniquely positioned at the heart of every business community in the UK. The BCC represents approximately 100,000 businesses of all sizes across all sectors of the economy that together employ over 5 million people.

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The funding of pensions in the UK is an issue of importance, not only to business, but to the entire population. It is crucial that individuals save for retirement and that is why the British Chambers of Commerce supports the principles behind the Pensions Act 2008, which will give every employee access to a private pension scheme.

The firms who provide, or provided, Defined Benefit schemes to their employees are those who care most about the welfare of their employees. They are often family businesses, founded many decades ago, and tend to be skewed towards the manufacturing sector. Many of these employers are part of the Chamber Network and have spoken to me of their desire to keep providing this important employee benefit, whilst at the same time being frustrated at the spiralling costs involved.

The most unfair and illogical of these costs is the Pensions Protection Fund levy. Ironically, the firms hit hardest in this recession find themselves with an increased levy to pay. This in turn affects the amount they can pay into their pension scheme, and also affects broader business decisions and access to finance. Of course, businesses should do their utmost to honour their pension obligations to their employees. At the same time, however, the Government needs to take action on the levy to prevent more pension scheme closures and, ultimately, business closures.

A handwritten signature in black ink, reading "David J. Frost". The signature is written in a cursive style with a small flourish at the end.

David Frost  
Director-General

The cost of private sector pension provision in the UK has long been an issue for the business community. The recession has once again put the spotlight on Defined Benefit (DB) schemes in the UK and their associated costs.

The British Chambers of Commerce (BCC) does not question the need for there to be some protection for employees, should the sponsoring employer of their pension scheme become insolvent. We strongly believe that employees should not be left with a significantly reduced pension pot because their employer becomes insolvent.

This report looks at the effect of the Pension Protection Fund levy on the future of private sector DB schemes in the UK and makes recommendations on the future role of The Pensions Regulator (TPR) and the Pensions Protection Fund (PPF), both of which fall under the aegis of the Department for Work and Pensions (DWP).

This report argues that the private sector alone should not bear the cost of pension protection. There are significant negative externalities associated with the PPF levy that undermine the very presence of DB schemes in the private sector.

All Defined Benefit schemes in the UK have to pay into the levy, including those based in the devolved regions. This report is therefore applicable to businesses in Scotland, Northern Ireland and Wales.

# RECOMMENDATIONS

## **The levy for 2010/11 should be suspended and future payments kept under review**

The PPF has sufficient funds to pay out for the next 25 years without levy payments. A short term suspension would help to underpin economic recovery by allowing businesses greater flexibility to invest resources elsewhere.

## **The burden must be redistributed and the levy be made more flexible immediately**

The levy is based on insurance principles but they do not, and should not, apply here. The burden needs to be redistributed so that businesses in the worst financial position are not further crippled by the levy.

## **The amount that businesses pay towards the levy must be more predictable**

The amount the PPF collects should be brought back down to the original level, £300m, and any shortfall should be made up by the Government.

## **The way that the levy is calculated should be more accountable and transparent**

If the PPF is going to sub-contract out some of the calculation to a private firm, such as Dun & Bradstreet, a mechanism should be put in place to ensure that the process is more open and that sponsoring employers have more rights to analyse their score. A fairer appeals process should be put in place.

## **As designed, the PPF and the PPF levy are unsustainable in the long term**

The principle of the PPF levy is flawed. We do not believe it is in the long term interests of employees, schemes or sponsoring employers that this levy is collected from the very narrow group of businesses with DB schemes. This issue should be taken up with urgency in the next Parliament, with a view to replacing the levy with alternative pension protection arrangements.

## PENSIONS IN THE UK

### The Changing UK Population

Changes in living standards and medical advances mean that life expectancy is increasing. In 1981, a man in the UK could expect to live to the age of 70 and women to the age of 77. By 2007, this had increased to 77 for men and 81.5 for women.

The number of people aged 50 and over in 2005 was 19.8 million, but this is expected to rise to 24.5 million by 2020. Although the old age dependency ratio (number of people at state pension age as a percentage of the working population) has remained steady at around 30% over the past three decades, it is now expected to dramatically increase. Without the recently announced changes to the state pension age, the dependency ratio would have been 49% by 2051; however, as a result of Government reforms, it is expected to be 34%.

## Contribution schemes: a definition

**Defined Contribution (DC):** Schemes where the contribution is defined but not the benefit. The benefit is dependant on investment decisions and the available annuity rate when the member retires. These schemes do not contribute to the PPF.

**Defined Benefit (DB):** Also called Final Salary Schemes. The retirement benefit is based on salary or a pre-determined formula. These schemes do have to contribute to the PPF, and are the schemes discussed in the remainder of this report.

## Defined Benefit and Defined

## **Defined Benefit Schemes Today**

Membership of DB schemes continues to decline. In 2008, 50% of schemes were closed to new members, compared to 45% in 2007. Larger schemes, those with over 10,000 members, are slightly more likely to be closed to new entrants than mid-sized schemes. In 2008, schemes had 2.74 million active members, 22% of the PPF's sample. Nearly a third of schemes are sponsored by manufacturing employers.

The average employer contribution in a DB scheme is 15.6%, compared to 6.5% in a Defined Contribution (DC) scheme. This makes it a much more attractive employee benefit as the contribution is almost three times as much as in a DC scheme. However, this can also be compared with public sector pension contributions, which are 24% on average, although this will reduce to 21% after government reforms.

## **2012 Pensions Reform**

In October 2012, all qualifying employees will have to be auto-enrolled into a pension scheme. Employers will have to pay a minimum 3% contribution into this scheme. This is a significant change in the provision of pensions in the UK. Currently, all businesses with more than 5 employees have to set up a stakeholder

scheme, but they do not have to make contributions into that scheme. These reforms catch all businesses of all sizes and mean a minimum contribution must be made. To facilitate this change, the Government has set up the Personal Accounts Delivery Authority (PADA), a public body charged with delivering a low cost pension scheme that will have a public duty to accept all employers.

## THE ORIGINS OF THE LEVY AND THE RISK BASED PRINCIPLE

The scandal in the 1990s which saw Robert Maxwell take £400m out of his businesses' pension fund contributed to the establishment both of the Occupational Pensions Regulatory Authority (OPRA, which has now been replaced by The Pensions Regulator) and the PPF. Maxwell's actions left 32,000 people fearing for their financial future and retirement plans.

In 1995, The Goode Committee proposed, but then discarded, the idea of a central fund which sponsoring employers would pay into to compensate employees, should other sponsoring employers become insolvent. They concluded that without the Government being prepared to act as the guarantor of last resort, the inevitable shortfall would never be made up so the fund was destined to fail.

However, in 2004, the Government decided to introduce the PPF, even though this proposal had been discarded almost a decade earlier. It never dealt with the central problem that, *"at some level it is impossible to escape the fact that well funded and well run pension schemes will end up paying*

*for the shortfall caused by badly funded and badly run schemes."*<sup>1</sup>

The original cost assessment of the levy was £300m per year as estimated in the Regulatory Impact Assessment that accompanied the Pensions Act 2004. The impact assessment noted that:

*"The costs will be particularly sensitive to any insolvencies of large companies with relatively large levels of pension scheme underfunding."*

In an article in 2005 for Global Pensions, Dr Ros Altmann also concluded that,

*"The PPF is designed to handle a few very large companies failing every few years."*<sup>2</sup>

These original predictions illustrate how very different the economic outlook was when the PPF levy was designed. In 2009/10, the levy will collect £700m, over double the original estimate in the impact assessment.

<sup>1</sup> Pensions Week, 26 September 2005

<sup>2</sup> <http://www.rosaltmann.com/global/pensions.htm>

As Baroness Hollis pointed out in the House of Lords on 14 July 2008, *“if the levy continues on this course, it could rise to over £2bn per year.”*<sup>3</sup>

That the original estimate of the burden on business was so inaccurate should be sufficient to force a fundamental review of how this system operates. This also illustrates just how unpredictable the levy is and how reliant the calculations are on volatile factors.

It is not only the predictions that were wrong; the risk-based approach taken is flawed. Insurance works because more people pay into it than need to claim. There also needs to be a fortuitous, future event that the insurance payers are attempting to indemnify themselves against. Neither of these principles apply here.

The ‘event’, schemes running large deficits, is not fortuitous; we know that scheme deficits are increasing and they are likely to get much worse. DB schemes are an unaffordable pensions model for the vast majority of firms in the private sector.

The number of schemes paying into the levy will fall with time as schemes are withdrawn and as sponsoring employers become insolvent. The flip side to this is that the fund will also have to compensate more employees and that, if people continue to live longer, these payments will have to continue for a longer period of time. This makes the PPF levy unsustainable in its current form as the funding that the PPF will need can only increase. The Government should commit to a thorough review of the levy, in both the short and long term.

<sup>3</sup> [http://www.publications.parliament.uk/cgi-bin/newhtml\\_hl?DB=semukparl&STEMMER=en&WORDS=ppf%20levi&ALL=PPF%20levy&ANY=&PHRASE=&CATEGORIES=&SIMPLE=&SPEAKER=&COLOUR=red&STYLE=s&ANCHOR=80714-0009.htm\\_spnew8&URL=/pa/ld200708/ldhansrd/text/80714-0009.htm#80714-0009.htm\\_spnew8](http://www.publications.parliament.uk/cgi-bin/newhtml_hl?DB=semukparl&STEMMER=en&WORDS=ppf%20levi&ALL=PPF%20levy&ANY=&PHRASE=&CATEGORIES=&SIMPLE=&SPEAKER=&COLOUR=red&STYLE=s&ANCHOR=80714-0009.htm_spnew8&URL=/pa/ld200708/ldhansrd/text/80714-0009.htm#80714-0009.htm_spnew8)

## Dun & Bradstreet (D&B) Assessment

The calculation of the PPF levy incorporates an insolvency risk factor which is determined by Dun & Bradstreet (D&B), the business information provider. This is a crucial factor in the calculation of the levy as 80% of the payment is based on the scheme underfunding risk and the risk of the employer becoming insolvent.

The main area of concern for business is the secrecy that shrouds the D&B calculation process (Figure 1). This makes it very difficult for a company to check that D&B are using the right information in order to calculate their score. It also means that a company who wishes to positively influence their score does not have the information it requires to do so. As a private company, albeit one that is being used

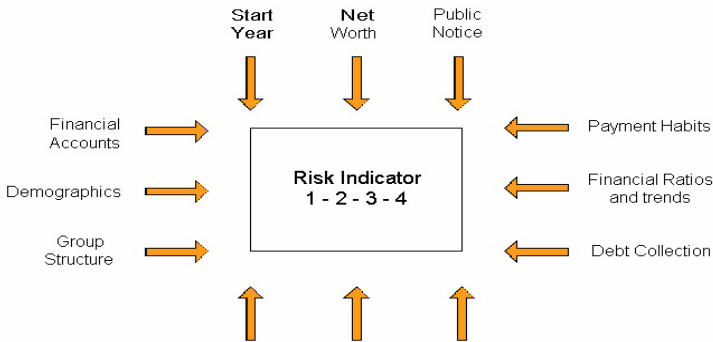
to fulfil a public function, it is difficult to force them to be transparent in the information they provide.

Members of the BCC Chamber Network have expressed serious concerns about the risk assessment model. For example:

*“This process is disturbingly opaque and, despite extended correspondence, it has not been possible to reach a conclusion that either the process or the underlying data is adequate.”*  
Renold PLC

*“D & B have recently announced changes to the scoring system but we don’t understand the implications as information is sparse.”*  
Cornwall Chamber Member

Figure 1



D&B state that they base their assessment on publicly available data. A review of their current report on Renold PLC revealed that more than half of the sections analysed contain incorrect information. Furthermore, it is this reliance on publicly available data which makes companies fearful of publicly stating that the levy has had a detrimental effect on their business. A business that says the levy is pushing them towards insolvency risks this being taken into account in their next D&B assessment, thus pushing their next levy payment even higher.

The actual assessment is confidential to D&B, but one of the factors is understood to include the location of the registered office of the business. Whilst this may be appropriate in cases where the geography of business activity is local to the head office (for example a small owner-managed business), it is meaningless for the many businesses with national or international operations, where business activity may be geographically remote from the head office location.

Another figure used in the assessment is the 'days beyond terms' (number of late payments made) score. One Chamber member was told that they had paid seven invoices a total of 22

days late. Seven invoices is a very small number upon which to base any conclusion on the viability of a company. Furthermore, the business disputes that any invoices were paid late (unless it was a commercial dispute, which should be excluded from D&B data) but D&B won't divulge which invoices they used, meaning it is impossible for businesses to check the veracity of the claim. Another Chamber member, Yamazaki Mazak UK Ltd also disputed the veracity of D&B's information.

*"They marked us down due to non-payment of a debt in their sample but we pay to terms except where there is a query with the invoice." Yamazaki Mazak UK Ltd*

D&B advise that insolvency risk assessment is a relative measure and companies should not necessarily regard their credit rating as having deteriorated, rather that others may have improved. This also undermines the usefulness of the scores for the purposes of calculating the levy payment.

## LEVY PAYMENTS

When the Pensions Act 2004 was being debated, it was anticipated that the levy would raise £300m per year. In 2009/10, the sum that PPF will set out to raise from the levy is £700m.

The increases in the overall amount to be raised come alongside the decline in the number of DB pension schemes. Recent high profile scheme closures include Barclays and Morrisons. The smaller the number of DB schemes overall, the fewer schemes that are making levy contributions. This pushes up the amount that the remaining schemes have to pay.

### Fluctuations in the Levy

It is not just the cost of the levy which troubles businesses, but the huge variations in the costs year on year. One Chamber member, with 6,500 employees, whose DB scheme is still open to new members, paid a levy of:

2006	£32,500
2007	£158,750
2008	£80,000

Fluctuations such as these make it impossible for businesses to plan, even a year in advance. The business above saw its levy rise fivefold in just one year, and then halve a year later. Variations of this magnitude are unacceptable and must be dealt with by the Government, even if this means that the state has to make some payment into the fund.

It is not just larger businesses that are damaged by these wild fluctuations. Howard S Cooke and Co Ltd, a business with only 64 employees, saw its levy payments increase 26 times in one year, and then double the year after:

2006	£ 768.00
2007	£ 20,677.00
2008	£ 44,032.00

The problems that this uncertainty causes should not be underestimated; Yamazaki Mazak UK Ltd, a firm with 444 employees states that,

*“The uncertainty over whether the levy will continue to increase at the current rate is one of the factors which may lead us to close the scheme.”*

The FRS17 accounting standard is another reason why levy payments are so volatile. It was introduced as the previous standard, SSAP 24, was thought to not adequately reflect the potential liability arising from a company’s DB obligations.

FRS17 puts the DB scheme’s liabilities on the company balance sheet. In a time of economic upheaval, this means that companies’ reported results could be heavily affected.

The standard also requires all the assets of the Pension Fund to be given a market value on March 31st each year. Such valuations fluctuate on a day-to-day basis but this is ignored by FRS17 which only takes a snapshot look and then uses this to analyse the position of the Pension Fund. This in turn affects the levy and adds to the unpredictable nature of the levy payments.

## **The effect of levy payments on businesses**

Firms are cutting costs in all areas of their business in order to continue trading through the recession. Renold PLC, a large manufacturing firm in the North West said,

*“Costs have been reduced across the business to match the anticipated fall in revenues. Amongst other measures, this has resulted in redundancies of almost one-quarter of the workforce, pay cuts to all Directors, senior managers and most employees, and short-time working.”*

This firm had to make a levy payment of £1.7m a year. To put this in its financial context, the firm made £6m profits after tax, of which £3m went on reducing the pension scheme deficit. This also affects the credit that the banks will make available to them. Due to the imposition of the levy, Renold have lost the opportunity of £7m worth of credit being made available. This, understandably, has a direct knock-on effect on the business, and on capital expenditure in particular.

Pye Motors is another firm affected by high levy payments. They believe that the effect on business is so significant that there is a real risk the company will become insolvent, with the loss of 155 jobs in the North West.

## **The effect of the levy payments on employees**

Many businesses commented that payment of the levy adversely affected the amount that they had to pay into the scheme to reduce the overall deficit. Especially in a recession, businesses only have a certain amount to pay into the fund; if a lot of this is taken up by the levy payment, then the position of the fund will not improve. Even those companies doing relatively well budget for an amount to be paid into the fund each year. If they have no certainty as to how much the levy payment will be, this makes planning to reduce their pension scheme deficit even more difficult.

Another Chamber Member, Howard S Cooke and Co. Ltd., stated that the payment of the levy has a direct knock on effect on the benefits, including bonuses, that are given to employees. Again, this effect is exacerbated by the uncertainty surrounding the levy each year.

## RECOMMENDATIONS

*The levy for 2010/11 should be suspended and kept under review depending on economic recovery*

The PPF has sufficient funds to pay out for the next 25 years without levy payments. In recognition of the extraordinary economic situation that businesses in the UK are now facing, levy payments should be suspended for the coming financial year.

In March 2009, Lord McKenzie said in the House of Lords,

*“There is sufficient liquidity in the PPF, even testing it against some quite severe economic scenarios, to continue to pay benefits for many years to come—I think it is about 20 years.”*

### **The burden must be redistributed and the levy be made more flexible immediately**

The levy is based on insurance principles but they do not, and should not, apply here. The burden needs to be redistributed more evenly so that the businesses that are in the worst financial position are not further crippled by the levy.

### **The amount that businesses pay towards the levy must be more predictable**

Our report highlights the fluctuations in levy payments that businesses face year on year as a result of interplay between the risk analysis and the amount of money the PPF has decided it needs to collect in a given year. Some of the reason for this is that balance sheets are assessed using FRS17, which is only a snapshot look at a company's balance sheet. The amount the PPF collects should be brought back down to the original level, £300m, and any shortfall should be made up by the Government. This, combined with the risk element being taken out of the levy calculation, should enable businesses to better plan the payment of their levy contribution.

## **The way that the levy is calculated should be more accountable and transparent**

If the PPF is going to sub-contract out some of the calculation of the levy to a private firm, such as D&B, a mechanism should be put in place to ensure that the process is more open and that sponsoring employers have more rights to analyse their score. A fairer appeals process should also be put in place. Businesses should be better able to present evidence that the D&B scoring was incorrect, especially in cases where the business disputes the 'days beyond terms' data that D&B holds.

The PPF and the PPF levy are unsustainable in the long term. The principle of the levy is flawed. The more businesses that withdraw DB schemes or go into insolvency, the fewer businesses there are to pay into the fund, whilst at the same time the number of individuals claiming from the fund will increase. The British Chambers of Commerce does not dispute the need for these individuals to have protection, should their scheme's sponsoring employer become insolvent. However, we do not believe it is in the interests of these employees, the schemes or the sponsoring employers that this levy is paid in its current form.

The PPF recently announced a review into the levy's future, which is a positive step. We believe a Government review is needed, however, as many of the necessary fundamental responses are outside the PPF's remit.

This issue should be taken up with urgency in the next Parliament with a view to replacing the levy with alternative pension protection arrangements.

# NOTES



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