Rt Hon Frank Field MP
Chairman of the Work and Pensions Select Committee
House of Commons
Westminster
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11 May 2016

Dear Mr Field,

Use of guarantees for Pension Protection Levy purposes

Thank you for the opportunity to give evidence to the joint session of the two Committees on Monday. I hope that my evidence was helpful in providing detail on our role, our approach and our financial strength. Most importantly, I hope the message that members of the BHS pension schemes are protected and receiving benefits at PPF compensation levels, regardless of the current wider situation, was a reassuring one.

During my evidence session I committed to writing to you about the number of guarantees that were not recertified for PPF levy purposes for the 2012/13 levy year. I have also seen copy of the letter sent by Adam Goldman, Company Secretary of the Arcadia Group, dated 11 May, to both Select Committee Chairs which refers to the Davenbush guarantee.

I can confirm that a total of 895 guarantees[1] were certified for PPF levy purposes for the 2011/12 levy year. For 2012/13, 849 guarantees[2] were certified. 157 guarantees were not recertified, though in some cases a new guarantee may have been put in place and certified in relation to the same scheme.

Background

The Pension Protection levy is charged on the basis of an annually published set of rules. In line with the legislation, the levy is based on a number of factors, primarily the level of underfunding in the scheme, and the insolvency probability of the sponsoring employer(s).

Some schemes have arrangements in place whereby a company within the group which is not a sponsoring employer of the scheme (so would not otherwise have any direct responsibility for the scheme) provides an unsecured guarantee of the pension deficit. The PPF has always been willing to recognise these guarantees, by offering a levy reduction, provided the guarantee genuinely reduces the risk in the scheme.

Since the risk based levy was introduced for the 2006/07 levy year, we have recognised such guarantees (known as ‘Type A’ contingent assets). This was an outcome of the

[1] 764 of these were ‘Type A’ contingent assets as discussed further below. ‘Type B’ contingent assets relate to pledges of cash, land or securities in the event of sponsoring employer insolvency. ‘Type C’ contingent assets relate to Letters of Credit or similar instruments.
[2] 716 of these were ‘Type A’ contingent assets as discussed further below.

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consultation we undertook on the first iteration of the levy rules and our broad approach was announced on 14 October 2005.

Under the PPF's rules, the Type A guarantee must be implemented using our standard form of agreement[3] (to ensure comparability of terms offered) and the trustees must certify the existence of the guarantee to the PPF each year – by 31 March for recognition in the following year's levy calculation. If the face value of the guarantee exceeds the deficit, we base the levy on the financial strength of the guarantor instead of that of the employer(s). This therefore reduces the levy payable, as the risk to the PPF has been reduced as a stronger company is willing to stand behind the scheme.

It is worth noting that the existence of the levy reduction incentivised a large number of companies to put in place new Type A guarantees. Anecdotally we know that in many cases companies were willing to put in place binding, "trustee-friendly" guarantees because of the levy reduction, which the trustees would not otherwise have been able to persuade those companies to provide. However in the early years the PPF did not formally assess the ability of the guarantor company to pay out on the guarantee – relying instead on those involved (particularly the directors of the guarantor company) only to enter into arrangements that were *bona fide*.

From the 2012/13 levy year, alongside wider changes[4], our levy rules were tightened so a guarantee would only be recognised (for the levy) if the risk reduction was suitably substantial. Trustees certifying new and existing contingent assets also had to make a certification that the guarantor could meet the amount potentially due under the guarantee in full - with the PPF calling in a sample of certifications for review.

As I indicated in my oral evidence, there was previously no reference to proportionality, and we had become concerned that guarantees were being put in place that resulted in a levy reduction (often substantial) but with little real reduction in risk. Companies with good D&B scores[5] but no ability to shoulder the deficit in a scheme were being used to offer guarantees. This would reduce the levy payable but with little reduction in risk. As I also indicated, anecdotally we had become aware that a number of consultancy firms were actively marketing this as an approach to reduce levy bills. We therefore considered we should act promptly to close down opportunities for abuse.

We widely publicised our proposed change of approach for the 2012/13 levy year, in our May 2011 policy update, our September 2011 consultation and with the announcement of the final levy rules in December 2011. A number of guarantees were not recertified by scheme trustees to the PPF for the 2012/13 levy year – though some may not have been recertified for unrelated reasons due to other changes in our levy rules. This meant that, unless the trustees gave up the guarantees, they would have remained in place, but not attracted any reduction in levy. We did not collect information on why guarantees were not recertified; this may have been for a range of reasons, or they may have simply been replaced by new guarantees.

[3] Other guarantees can be put in place for scheme funding purposes but not meet this test of being in a standard form, permanent in nature and certified to us.

[4] From 2012/13, the New Levy Framework introduced rules held broadly stable for three years, with a stronger focus on funding, including investment risk, and the division of employers in to ten insolvency risk bands.

[5] Prior to the 2015/16 levy year the financial strength of sponsoring employer(s) and guarantors was assessed using D&B 'Failure Scores' on a 1-100 scale. Prior to 2012/13 these were used directly in the levy. From 2012/13 onward these were converted in to one of ten risk bands

Guarantees from associated companies remain an important tool for allowing companies other than the sponsoring employer(s) to stand behind the deficit in a pension scheme. Where this represents a genuine reduction in risk it will reduce the risk based levy payable. We have continued to strengthen the test of whether guarantors are 'good for the money' in terms of the guarantees they provide, with further changes in 2015/16.

The BHS Guarantee

From December 2006 BHS Limited has been the sole sponsoring employer of the BHS pension scheme. A guarantee from Davenbush Ltd was certified for levy purposes for the BHS pension scheme for the 2011/12 levy year. It purported to guarantee a deficit of c£260 million, while Davenbush had insufficient turnover and net assets in comparison to the deficit.

The guarantee from Davenbush Ltd was not recertified for levy purposes for the 2012/13 levy year onwards and no other guarantee has since been certified to the PPF. We understand that the guarantee to the scheme, although not recognised for levy purposes, remained in place and Davenbush was one of the companies sold to Retail Acquisitions. We would expect that the guarantee will be called upon now that the pension schemes are in assessment.

As I indicated in my oral evidence (and mentioned in Adam Goldman's letter today), I met Sir Philip Green and Paul Budge, the Group Finance Director, in advance of the 2012/13 levy year given that we had flagged the rule changes widely and they anticipated a much higher levy than in the preceding year. This was partly due to our wider changes to the levy for 2012/13 with greater weight being placed on the funding position of the scheme; the BHS scheme was relatively poorly funded with a high equity exposure. It was also anticipated by BHS that the guarantee would not be recertified by the Trustees.

We briefed both the Pensions Regulator and the Department for Work & Pensions on the conversations we had at this stage, and understand that Sir Philip Green subsequently raised his concerns about the levy with the relevant Minister.

I trust that the above is helpful additional information and clarification. I would of course be happy to respond to any further questions you or colleagues might have.

Yours sincerely,

Alan Rubenstein
Chief Executive

CC: Iain Wright MP, Chairman of the Business, Innovation and Skills Select Committee