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airto
driving growth and innovation

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15 May 2017

Dear Sirs,

AIRTO Response to Consultation Request on Third Triennium Proposal: Revised scorecard for Not for Profit Organisations

As the trade body for Innovation, Research and Technology (IRT) sector organisations in the UK, AIRTO (the Association of Innovation, Research & Technology Organisations) wishes to make representation on behalf of some of its member organisations on the proposals in the Third Triennium Consultation document in respect of the proposed changes to the Experian Scorecard used to measure Insolvency Risk in Not for Profit Organisations.

After reviewing the effect of adopting the proposed revised scorecard using the "What If" spreadsheet facilities of the www.ppfscore.co.uk score portal in respect of a representative sample of our not for profit members, we conclude that:

1. **The proposed scorecard for Not for Profit companies is not capable of distinguishing low risk Not for Profit organisations from those with moderate or higher risk**.
    a. A review by our Members has indicated that the risk levy band allocated under the proposed Not for Profit scorecard is predominantly determined by a single balance sheet metric, Total Assets, to the exclusion of all other potential measures of the financial health of the Company.
    b. Further the scoring for Total Assets is allocated on an absolute basis. It therefore appears that no not for profit organisations with less than £18M Total Assets can expect to achieve a risk score lower than levy band 4, while a not for profit organisation reporting over £25M Total Assets can expect to have a score in levy band 1 irrespective of any of the other financial metrics relating to the Company.
    c. In some cases a relatively financial strong Not for Profit organisation will be given a higher risk probability score on the Not for Profit scorecard than it would if scored on the scorecard applicable to a profit distributing company.
    d. The proposed scorecard therefore discriminates against:
        i. Smaller not for profit organisation;
        ii. Those who do not have significant property assets;
        iii. Not for profit Organisations who by objective measures have a strong financial performance.

    We do not believe organisations have inherently increased failure risk merely because they are smaller, or do not have significant property assets (there is some evidence that owning mortgaged property increases failure risk), or don't have shareholders and pay dividends.

2. **We believe there may have been a "cohort" effect which has affected the past experience of the Pension Protection Fund (PPF) with not for profit organisations ("NFPs") and which has led it to conclude that their previous models had underestimated the failure risk of NFPs and which may not be representative of the current population of NFPs with Defined Benefit (DB) pension schemes.** A large number of Not for Profit organisations with Defined Benefit pension schemes were set up in the 1990s to undertake activities previously undertaken in the public sector. One of our Members reported that the Government Actuary at the time (1995) encouraged such organisations to offer DB rather than DC pensions and

furthermore encouraged them to accept transfers in for their then current employees from the previous public sector pension schemes.

b. When from the early 2000's it became clear that the cost of providing those historic pensions had risen substantially, that cohort of companies fell into two camps:
    i. those that could not continue in the then current political and funding environment to fund these past service deficits and generated a PPF triggering event; and
    ii. those members of that cohort that been able to continuing sponsoring a (closed) DB pension scheme by making deficit and PPF levy payments out of income or reserves.
c. This second group, who the scorecard now seeks to assess, are those who have managed to support deficit payments over the past 10 – 15 years and with a stable business could arguably be reasonably expected to continue to do so indefinitely into the future.
d. The cohort of Not for Profit organisations set up since the late 1990's while subject to the same political and funding risks are extremely unlikely to have offered DB pensions.

3. **A failure in the scorecard which leads to a disproportionately high levy payment becomes a self-fulfilling prophesy.**
    a. Traditionally, Not for Profit Research and Technology Organisations have allocated a substantial proportion of their free cash flow to deficit payments into the pension scheme. The remainder of the cash flow being used to maintain employer's growth prospects, in turn securing future pension scheme deficit and administration payments.
    b. NFPs do not have access to fresh capital nor can they forego dividends etc. nor can they reasonably additionally fund the pension scheme out of current income to permit a buy-in or buy-out until the pension scheme itself is super mature and the insurer's risk premium is relatively low.
    c. Therefore for Not for Profit organisations a strategy which secures long term, but comparatively low, pension scheme deficit payments is much lower risk than attempting a buy out or buy in.
    d. By the very nature of the organisation, the only exit route for a NFP with a pension scheme which it cannot afford to support, including payment of the PPF Levy, is insolvency and hence a PPF triggering event.
    e. Any increase in the PPF levy payable will therefore reduce either the employer's growth prospects or increase the time before the pension scheme becomes self-financing. Both of these will ultimately increase the risk of a PPF triggering event.

To help you understand why we have reached these conclusions and submitting them to you on behalf of not-for-profit Research and Technology Organisations ("RTOs"), we attach some information on AIRTO and its members and also our activities in the pensions area (Appendix).

In particular, AIRTO held a seminar on "Pension Scheme Risk Management in an RTO" held (by coincidence) on the 23rd March 2017. In that seminar we considered a review of the background to the experience of all of the former RTOs or their subsidiaries who experienced a PPF triggering event and considered which risk factors were most significant.

We also include the results of a survey of the effect of the proposed changes contained in the Third Triennium Consultation document on our not for profit members with defined benefit pension schemes. This shows, after adjustment for FRS102 reporting changes, that all those surveyed were being placed in a higher risk levy band than under the previous scorecard and in some cases being downgraded 5 levy bands purely because of the revision to the scorecard. Our Members were strongly of the opinion that such a downgrading of their risk rating was not justified by their true failure risk and this entirely reflected failures in the proposed scorecard.

I do hope you will give careful consideration of these points as part of the consultation process and can develop revised proposals which will more fairly reflect the risk of not for profit research and technology organisations and at the same time avoid claims on the PPF which could have been avoided.

If you wish to contact us concerning this submission, please contact either Nancy Moore, Executive Administrator (Tel: +44(0)20 8943 6600, e-mail: nancy.moore@airto.co.uk) or the facilitator to our Finance Directors' Interest Group: Peter Cameron Brown, Director ACFV Ltd (Tel: +44(0) 161 904 7117, e-mail: pcb@acfv.com)

Yours sincerely,

J. Gate

Dr Jane Gate
Executive Director, AIRTO

Appendix

Introduction to AIRTO

AIRTO is the Association for Innovation, Research and Technology Organisations ("RTOs"), the foremost membership body for organisations operating in the UK's Innovation, Research and Technology sector.

AIRTO currently has about 60 member organisations who typically supply business-to-business and government services such as R&D, consultancy, validation and testing, multi-client project inception and management, incubation and financing.

A significant proportion of AIRTO's members are not for profit organisations with a small number of charities and a larger group operating as scientific research associations (a corporation tax exempt body which requires adherence to similar rules to a charity preventing distribution of profits or assets).

Many of AIRTO's activities with members are centred round special interest groups who meet periodically. These include interest groups for Human Resources Officers and one for Finance Directors and Company Secretaries. There is also an ad hoc interest group on Pensions which meets occasionally, largely formed by members of the Human Resources and Finance Directors and Company Secretaries' Interest Groups.
More details on AIRTO can be found at www.airto.co.uk.

AIRTO's Pensions Group

AIRTO, as part of its Pensions Group activities, held a pensions seminar on the 23rd March 2017. This was attended by 21 representatives of RTOs with DB pension schemes, either trustees or company officials with responsibility for pension matters. The theme for the session was "Pension Scheme risk management in RTOs" and was primarily designed to help trustee boards and sponsoring companies develop an integrated risk management approach appropriate to the organisation when assessing and monitoring covenant risk.
As part of that session, the facilitator of the FDs' interest Group, Peter Cameron Brown BA(Econ) LLB FCA himself a former finance director of an RTO and also currently an independent chair of trustees for a not for profit organisation, gave a presentation on the experience of RTOs with the PPF. In that presentation, Peter reviewed all the RTOs or their subsidiary companies that had PPF triggering events and attempted to highlight the reason for the failure of the employer.
There have been 8 former RTOs or their trading subsidiaries generating a PPF triggering event of whom one is still in assessment (Table 1).

- Of the 8, half were not for profit organisations with the others being profit distributing companies or subsidiaries.
- 5 of the 7 RTOs who completed the PPF assessment transferred to the PFF. One of those who did not transfer (a profit distributing subsidiary) transferred the pension scheme within the parent Group, while the pension scheme of the other (a NFP) had sufficient funds to complete a buy out at slightly above PPF benefit levels.
- In addition, Peter identified 4 other not for profit organisations with DB pension schemes who have ceased trading in their own right but who did not trigger a PPF assessment for varying reasons including transfer of business and pension scheme to another RTO, a return to the public sector, or a restructuring (2) that included a substantial injection of funds into the pension scheme.

Peter Cameron Brown identified the fundamental reasons for the failure of the employer in order of importance as:

1. Long term changes in Government structural or funding arrangements - often occurred decades before the PPF triggering event.
2. Management led corporate restructuring, which intentionally or unintentionally left the Pension Scheme with an insolvent employer.
3. Failure to renegotiate bank loans or mortgages at critical points (e.g., during the financial crisis whilst long term contracts or funding arrangements were subject to renegotiation).

In his presentation Peter Cameron Brown also noted that:

4. Where the cause is structural or market led business decline, the PPF triggering event tends to follow only after a long time.
5. Balance sheet strength is not a good predictor of failure. The majority of those RTOs who failed had property assets valued significantly in excess of outstanding loans.
6. Cash generation over a long term (>5 year) period appeared to be the key measurable that indicated the financial strength of the employer. In a not for profit organisation it is the stability of cash flows, rather than absolute size, that appears to be key.

Members experience with the Third Triennium Proposals

Being alerted by one of our members that the proposed changes to the Not for Profit Scorecard detailed in the Third Triennium Review document had significantly adversely affected his organisation's risk levy rating, we consulted all our members who are subject to the PFF with risk based levies calculated on the Not for Profit Scorecard to advise us of their levy bands on both the present basis and on the revised basis. We received seven replies (Table 2), in all cases except one[1] the organisation was placed in a higher risk levy band on the new scorecard by at least two bands and in two cases five bands higher (worse) than on the current basis. On the revised basis none of the companies would be placed in the Pensions Regulator's Covenant Group 1, whereas at present four out of the seven respondents would fall into that category.

As all the RTO's affected expressed great surprise and concern about this, we then asked them to use the "What If" facilities provided by the spreadsheets downloaded from the Experian PPF Score website, to identified which characteristic of their financial data would need to change to permit them to recover their former levy band. All those who completed this exercise, came back to say that only an increase to their Total Assets figure would permit this. Further investigation revealed that there appeared to be a direct correlation between the absolute size of the Total Assets figure and the resulting risk levy band (total Assets over £20m appeared to always secure risk levy band 2 or better). To show the correlation between the total assets figure and the risk levy band we have shown the current Total Assets figure for each organisation on Table 2.

Considering this against the analysis of previous RTO failures we concluded that:

1. The proposed scorecard will only generate risk levy scores dependent on the Asset base of the organisation (i.e. only size matters).
2. This dependency applies irrespective of how those assets are financed.
   For example in one case, the spreadsheet was flexed assuming the company purchased additional Land and Buildings of £10M entirely financed by a long term loan – the interest on which would turn the annual profit into a loss. It was found that this transaction alone would improve the company's risk score up two levy bands on the proposed scorecard. This appears counter intuitive.
3. The scorecard does not appear to reflect any of the risk characteristics identified in the analysis of the PPF experiences of RTOs, in particular there is no reflection of stability of income and cash flow streams.
   For example, one of the organisations whose risk levy was downgraded by two levy bands out of Covenant Group 1, generates a steady modest financial surplus each year from the operation of a statutory monopoly, has cash reserves many (5) times the FRS102 pension scheme deficit and no other significant liabilities, but does not have any property assets, instead operating out of rented properties which have been adjusted over the years to meet its operational business needs. That company, currently very close to the turnover figure would be scored in levy band 1 on the Non-subsidiary > £30M scorecard on the same financial data.

We therefore concluded that either there is a mistake in the factors applied in the Experian spreadsheet for the not for profit scorecard, or the Scorecard itself is not capable of distinguishing low risk Not for Profit organisations from those with moderate or higher risk.

During the process of exploring these issues with our members, more than one RTO advised that because they already paid as much of their free cash flow as possible by way of deficit contributions into the pension scheme, the effect of an increase of the amount of annual PPF levy payable would be to reduce the amount applied towards the pension scheme deficit. This would apply irrespective of whether the pension scheme or the employer paid the PPF levy.

[1] We believe the results for Organisation 3 on the current scorecard may have inflated by the effect of FRS102 adjustments.

Table 1 – Former RTOs or their Subsidiaries with PPF Triggering Events

RTO	Event Date	PPF Outcome
RAPRA Technology Ltd (Rubber & Plastics)	2006	Transferred Feb 08
SIRA Group (Scientific Instruments)	2006	Transferred Nov 14
Advanced Manufacturing Technology Research I.	2007	Transferred Jul 11
BHR Group Ltd (Hydromechanics)	2011	Transferred Jul 13
The National Computing Centre	2011	Wound up - non PPF
BMT Marine and Offshore Surveys Ltd	2011	Not Transferred
AEA Technology plc. (Atomic Energy)	2012	Transferred Jul 16
BTTG (Textile Technology & Shirley Institute)	2013	Transferred Feb 14
Leatherhead International (Food)	2015	In assessment

Table 2 – Comparison of PPF Levy Bands on Not for Profit Scorecard

Organisation	Current PPF Levy Band	Proposed PPF Levy Band	Total Assets
1	1	4	£17.5M
2	2	4	£12.4M
3	3	7	£1.2M
4	4	3	£19.3M
5	3	8	£2.9M
6	1	5	£10.3M
7	1	3	£16.9M

These figures are not adjusted for FRS102 changes

About AIRTO: Declaration of Interests

AIRTO (The Association of Innovation, Research and Technology Organisations) represents research and technology and similar organisations operating in the space between the academic research of universities and the commercial needs of industry. AIRTO members undertake research and development, knowledge/technology transfer and many supporting activities. AIRTO currently comprises organisations employing more than 40,000 scientists and engineers, with a combined annual turnover in excess of £5Bn. Their work contributes around £34Bn to UK GDP.

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Please note that this submission does not necessarily represent the views of individual member organisations.

The members of AIRTO currently are:

Advanced Forming Research Centre
AMRC with Boeing
Agrimetrics
APHA
Axillium Research
BCIS
BGS
BHR Group
BMT Group
BRE Group
BSRIA Ltd
C-Tech Innovation Ltd
Campden BRI
CIRIA
City University London
CPI
DG Cities Ltd
Digital Catapult
Fera
FloWave TT Ltd
Fraunhofer UK Research Ltd
Fripp Design and Research
Future Cities Catapult
Health & Safety Laboratory
High Value Manufacturing Catapult
HORIBA MIRA Ltd
HR Wallingford Group Ltd
Institute for Environmental Analytics
LGC
Lucideon Ltd
Materials Processing Institute
Met Office
MTC
NCC
NIAB
National Nuclear Laboratory
National Physical Laboratory
NICA
Northern Automotive Alliance
NNFCC
Nuclear AMRC
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