Pension Protection Fund

**PPF Restructuring and Insolvency Team**
**Guidance Note 6**
**How PPF Drift arises and should be addressed**

## Contents



## 1. Background

1.1. This guidance explains the concept of PPF Drift, provides an example of how it can arise and the effect it has on the Pension Protection Fund (PPF).

1.2. It is designed to provide a general background for those not familiar with the concept and specific guidance in section 6 for those making the drift calculations to ensure they meet the requirements of the PPF.

1.3. The PPF will seek to minimise the quantum of PPF Drift in order to reduce the level of claims and ultimate impact on PPF levy payers.

1.4. Employers and their advisors should make sure they have fully considered the effect of PPF Drift and include appropriate mitigation in any proposals they present.

## 2. What is PPF Drift?

2.1 PPF Drift is the increase in the PPF's potential exposure as a result of a delay in a pension scheme entering a PPF assessment period. PPF Drift happens because over time the protected liabilities of a scheme are likely to increase.

2.2 More specifically, PPF Drift arises as a result of:

- an increase in PPF benefits (over and above those already anticipated – such as post-1997 increases in payment or inflationary increases before retirement) being paid where benefits in the occupational scheme are different to those in the PPF;
- annual increases being paid to members which are above those that the PPF might offer; and
- members reaching retirement age.

2.3 Examples of each of these instances of PPF Drift may be found in section 5.

## 3. Why is it important to the PPF?

3.1. An employer might, due to a financial restructuring, attempt to reach an agreement with its creditors in order to continue trading. In situations where the PPF has an interest in such restructurings, it will wish to ensure that its position does not deteriorate as a result of the proposed restructuring.

3.2. Sometimes, the refinancing proposal will include a provision for the associated pension scheme to be rescued. An example would be a company voluntary arrangement (CVA) where the scheme employer's intention is to honour its commitments to the scheme. The submission of a nominee's report to court in relation to a CVA proposal is an insolvency event under the Pensions Act 2004, resulting in the start of a PPF assessment period.

3.3. During the assessment period, the PPF exercises the rights and powers of the scheme trustees in relation to any debt due from the employer. The PPF will need to consider whether it is in its interests to vote in favour of a CVA to rescue the employer and the scheme, resulting in an early end to the assessment period, or whether it might be better off by voting against the proposal.

3.4. Part of considering the proposal will involve understanding the quantum of PPF Drift and how the proposal addresses it. It is important to stress that any potential investment returns will also be ignored when assessing the quantum and impact of PPF drift. If PPF drift is not adequately addressed, simply deferring the start of an assessment period may prove to be detrimental to the PPF and our levy payers in the long term and this is therefore something we shall seek to avoid.

## 4. Considerations in RAA or CVA proposals

4.1. In order to mitigate the risk to the PPF, a CVA proposal must include either a mitigation payment to the scheme or contributions paid into the scheme (if not in an assessment period) that cover the ongoing level of PPF Drift.

4.2. Because PPF Drift doesn't always occur uniformly over the year, it will be a requirement that any agreed mitigation payment or deficit reduction contributions are received ahead of PPF Drift occurring. This ensures that the position of the PPF does not deteriorate with the passing of time.

4.3. If the proposal is for a restructuring delivered through a Regulated Apportionment Arrangement (RAA), we would expect PPF Drift to be covered during the period negotiations are taking place up to the time that the RAA is formally executed.

4.4. As already mentioned above, any potential investment returns on assets will be ignored when considering the impact of PPF Drift.

4.5. If the scheme is in surplus, the PPF will expect that position to be maintained. This is a standard approach taken by stakeholders in a financial restructuring - e.g., lenders will typically insist on security cover not being diluted, and more likely, improved.

4.6. if the deficit reduction contributions in place are already large enough to cover PPF Drift, the PPF may still seek increased contributions to the scheme (for a period) as a way of addressing the potential risk of the employer failing in the short term.

## 5. Examples of PPF Drift

5.1. The effects of annual increases for those drawing benefits on protected liabilities.

- The PPF provides benefits as set out in the Pensions Act 2004. Indexation and revaluation may therefore differ from what an ongoing scheme provides. Inflationary increases are only provided on member benefits accrued after April 1997. These increases are in line with the Consumer Price Index (CPI), capped at 2.5 per cent. Where there is less than a year between a scheme entering assessment and the date they'd normally provide increases, members would receive proportionate increases.
- Most pension schemes will increase benefits on a basis set in their scheme rules, often on a fixed date. These increases may differ for different periods of service. For example, a scheme may increase pensioner benefits on 1 January each year with three per cent fixed increases on benefits accrued pre-April 1997 and CPI increases capped at 2.5 per cent on those accrued post-April 1997.
- A scheme entering a PPF assessment period on 1 January, having implemented annual increases, may have materially higher protected liabilities than if it had entered a PPF assessment period the day before (particularly if the membership is a mature one with a high proportion of pensioners with pre-April 1997 benefits). Using the above example, a pensioner with a third of their benefits accrued pre-April 1997 and CPI of two per cent would see their benefits increase by 2.3 per cent.
- This means the liability that PPF is taking on is higher (2.3 per cent higher). This is entirely due to PPF Drift and happens at a very specific point in time (the pension increase date).

5.2. The effects of annual increases for deferred scheme members on protected liabilities.

- A similar effect happens due to increases in deferment for non-pensioner members. The PPF provides inflationary increases on PPF compensation over the period before it comes into payment, revaluing compensation in line with the CPI between entry into the assessment period and the date compensation comes into payment. These annual increases are capped at five per cent for compensation linked to benefits accrued prior to April 2009, and capped at 2.5 per cent for benefits accrued after that date. An ongoing pension scheme might give a higher level of increases. Sometimes scheme benefits include Guaranteed Minimum Pensions (GMPs) which might increase at a higher rate.
- A scheme coming into assessment at a later date may therefore lead to a higher level of protected liabilities due to the revaluation of benefits – the liability being taken on by the PPF would be higher. This is entirely due to PPF Drift but occurs more uniformly over the year as individual member benefits are revalued at different dates.

5.3. The effects of deferred scheme members reaching retirement age and becoming entitled to full scheme benefits.

## 6. Actuarial principles for calculating drift for PPF purposes

**Background**

6.1. For the purposes of this section of the guidance, PPF Drift is defined as:

"The expected change in the value of a defined benefit scheme's liabilities calculated in accordance with section 179 of the Pensions Act ("the s179 liability value") over a specified period, assuming that no changes in actuarial assumptions occur from date of calculation to the end of the period being considered."

6.2. From time to time, the PPF may request that trustees provide them with an estimate of PPF Drift. This part of the guidance is intended for actuaries undertaking estimates of PPF Drift with the aim of setting a consistent approach for the calculation.

6.3. The PPF recognises that this guidance will not cover all eventualities and that it is not binding on the actuary performing the calculation. However, where an actuary's approach differs from the guidance, it is likely that the PPF will seek clarification from the actuary on the reasons and impact of any departures from the guidance.

6.4. There may be other parties who request actuaries to undertake PPF Drift calculations for different purposes (e.g., trustees considering alongside ongoing valuation negotiations). The actuary should consider the specific requirements in these scenarios as a departure from this guidance may be appropriate.

**A consistent approach for the calculation of PPF Drift**

6.5. This guidance is concerned only with the change in the s179 liability value over the period under consideration ("Drift Period"), **not** with any changes that may or may not occur in a scheme's asset value over the same time period(s) apart from due to outgo from the scheme.

6.6. To allow comparisons with contributions paid into a scheme, it is recommended that the period over which PPF Drift is calculated should not exceed 12 months. If longer-term PPF Drift calculations are required, it is recommended that these are separated into segments not exceeding 12 months.

6.7. For periods beyond 12 months, it may be sufficient for the actuary to comment on the direction of PPF Drift over time and any material PPF Drift events rather than conducting detailed calculations.

6.8. The PPF expects that PPF Drift will be calculated/estimated on a "roll-forward" basis. The PPF does not expect the actuary to conduct formal valuation calculations on full membership data for the purposes of calculating PPF Drift, unless this information is readily available and/or the actuary believes that a full valuation is required.

6.9. In order to estimate PPF Drift for the period under consideration (Drift Period), the actuary will require:

**Original s179 Liabilities**: e.g., taken from the most recent s179 valuation. These will reflect assumptions as at the original s179 date and PPF benefits determined with reference to the original s179 date. If the calculations are being done during an assessment period and the s143 valuation has already been done, it may be more convenient to use the s143 valuation, in which case “Original s179 Liabilities” below should be read as “Original s143 Liabilities”.

**S179 Liabilities at the start of the Drift Period:** estimated by rolling forward the Original s179 Liabilities to the start of the Drift Period allowing for any changes in assumptions from those used in calculating the Original s179 liabilities (but also including allowance for the expected impact on the liabilities of PPF Drift matters as outlined in the following section).

In other words, this is an estimate of the PPF liabilities if the PPF assumed responsibility for the scheme at the start of the Drift Period.

**Updated s179 Liabilities**: estimated by rolling forward the s179 Liabilities at the start of Drift Period to the end of the Drift Period, allowing for:

- any changes in assumptions from those used in calculating the S179 Liabilities at start of Drift Period;
- interest; and
- expected PPF benefit outgo.

No allowance is made for PPF Drift within the Updated s179 Liabilities (in other words this is an estimate of the PPF liabilities at the end of the Drift Period had the PPF assumed responsibility for the Scheme at the start of the Drift Period).

**Updated s179 Liabilities With Drift**: estimated by rolling forward the S179 Liabilities at start of Drift Period to the end of the Drift Period (as for Updated s179 Liabilities above) but also including allowance for the expected impact on the liabilities of PPF Drift matters as outlined in the following section.

In other words, this is an estimate of the PPF liabilities if the PPF assumed responsibility for the scheme at the end of the Drift Period (with the scheme continuing on an ongoing basis until the end of the Drift Period).

6.10. The amount of PPF Drift for the Drift Period under consideration is then taken to be:

**PPF Drift = Updated s179 Liabilities With Drift - Updated s179 Liabilities**

6.11. In calculating the Updated s179 Liabilities and Updated s179 Liabilities With Drift, the actuary should consider the appropriate Market Conditions Date for determining assumptions. This is likely to depend on the purpose of the PPF Drift calculations but could for example be:

- the original s179 date.
- the start of the Drift Period (if this is in the past).
- the end of the Drift Period (if this is in the past).
- the date of latest available Market Conditions (if the end of the Drift Period is a future date).
- another specified date within the Drift Period.

6.12. Unless otherwise agreed with the PPF, financial and demographic assumptions should be those consistent with assumptions set out in section 179 of the Pensions Act 2004 at close of business on the Market Conditions Date. If Drift is being calculated starting from a s143 valuation, the actuary may use corresponding assumptions from section 143 of the Pensions Act 2004.

**Matters that should be allowed for in the calculation of PPF Drift**

6.13. It is the PPF's view that the following matters should be allowed for in the calculation of PPF Drift:

- Ageing of members – specifically the increase to the 100% level of benefits for members reaching Normal Pension Age (NPA) over the Drift Period.
- Differences between scheme-level and PPF-level pension increases over the Drift Period.
- Differences between scheme-level and PPF-level revaluation over the Drift Period.
- Any accrual of benefits/material benefit step-ups/other augmentations over the Drift Period.

6.14. In the above matters, the actuary should allow for known liability experience up to the Market Conditions Date and expected future liability experience up to the end of the Drift Period. The actuary should do this on an estimated basis, rather than using actual member data (except in exceptional circumstances).

**Other factors to allow for if the expected impact on PPF liabilities is material**

6.15. It is the PPF's view that the following matters should be allowed for in the calculation of PPF Drift, if the actuary believes they will be material, either individually or in aggregate, to the calculation:

- Any other scheme specific benefits that differ to PPF compensation which could materially increase or decrease s179 liabilities.
- Any options taken by members over the Scheme Year that would act to materially increase or decrease s179 liabilities.
- Allowance for any material expenses met (or expected to be met) directly by the scheme and not funded by corresponding contributions to the scheme. Such expenses should be treated as a liability of the scheme.

6.16. In the above matters, the actuary should allow for known liability experience up to the Market Conditions Date and expected future liability experience up to the end of the Drift Period. The actuary should do this on an estimated basis, rather than using actual member data (except in exceptional circumstances).

**Hampshire, Hughes and Bauer**

6.17. It is not expected that the potential impact of Hampshire, Hughes and Bauer should be allowed for in the calculation of PPF Drift except in exceptional circumstances.

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