Pension
Protection
Fund

# How PPF Drift arises and should be addressed

PPF RESTRUCTURING & INSOLVENCY TEAM – GUIDANCE NOTE 6

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# Contents

# 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** 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.

**1.3** 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.

"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."

# 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 – 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 which 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.

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# 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 economic 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** While part of this equation will involve the relative investment performance of the scheme's assets against its liabilities, subject to consideration of an acceptable level of risk to be taken in relation to the scheme's invested assets, the quantum of PPF Drift is an issue that needs to be carefully assessed. Simply deferring the start of an assessment period may prove to be detrimental to the PPF and our levy-payers in the long term.

# Considerations in RAA or CVA proposals

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

**4.2** Because PPF Drift doesn't always occur uniformly over the year, it will be a requirement for calculating that mitigation payment or the level of contributions to accelerate deficit reduction contributions to ensure that PPF Drift is always covered. This will also reduce the risk of a regular deficit reduction contribution not being paid on 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** Any potential investment returns on assets will be ignored when considering the impact of PPF Drift.

**4.5** If the scheme is in surplus, consideration should be given to how long it would take for that surplus and deficit reduction contributions to be eroded by PPF Drift. Consideration should be given as to whether this period is appropriate, or whether contributions will need to be increased to cover the level of PPF Drift.

**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.

"If the scheme is in surplus, consideration should be given to how long it would take for that surplus and deficit reduction contributions to be eroded by PPF Drift."

# 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.

Section 5

# Examples of PPF Drift
## continued

**5.3** *The effect of members subject to the compensation cap on protected liabilities*

- Members over the scheme's Normal Pension Age (NPA) at the assessment date are entitled to their total pension and members under NPA are subject to a reduction to 90 per cent and application of the compensation cap. This creates another opportunity for PPF Drift to occur.
- A scheme continuing on with a delay in entering the PPF assessment period may mean members reach NPA where they might have previously been capped. This impact is likely to be spread throughout the year.
- While very few members are capped, the impact on the protected liabilities in respect of those individual members may be significant. Even for those members who reach NPA who would not be capped, the increase in protected liabilities is commonly around 11 per cent because of the impact of the reduction to 90 per cent. This is, again, entirely due to PPF Drift.

"PPF drift can occur if a scheme delays entering the PPF assessment period."

# Conclusions

**6.1** PPF Drift can have a significant impact on the quantum of protected liabilities that the PPF has to adopt. The PPF will always seek to minimise the liabilities taken on.

**6.2** PPF Drift can accrue on a 'lumpy' basis, for example when annual increases are awarded.

**6.3** PPF Drift is likely to be higher the more mature the scheme is with members approaching normal retirement age.

**6.4** Employers and advisors should fully consider the effect of PPF Drift when preparing proposals and include appropriate levels of mitigation.

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