PensionsWorld

The significance of PPF drift

At Rothesay Life, a large proportion of the schemes we see have reached the end of their natural life cycle. Some are fortunate enough to secure full benefits and buyout, while others are trying to escape the clutches of the Pension Protection Fund (PPF).

Whichever end of the spectrum schemes find themselves at, they will all have been deeply impacted by the covenant afforded to them by their sponsoring employer. Nearly every month we see an article which states the size of the combined deficit of UK defined benefit pension schemes. This deficit often ignores, or only partially takes into account, the sponsor covenant, whether through committed funding or an estimate of the recovery that schemes would make on the insolvency of the sponsoring employer. But why does this matter?

It matters because of the concept of PPF drift. A scheme's PPF liabilities grow each year as more members reach normal retirement age (NRA), when those members are no longer subject to the PPF compensation cap, and because each time a pension increase date is reached, the members bank this increase. While on the face of it, this is good news for the members of the pension scheme, it is only true for all the members when the scheme is underfunded in comparison to the PPF funding requirement.

Where the scheme has assets in excess of the cost of purchasing benefits equal to or greater than those provided by the PPF, PPF drift actually only sees the reallocation of existing assets from one cohort of members to another (those under normal retirement age (NRA) to those over NRA). And while a scheme may on the face of it be underfunded compared with the PPF basis, this may not be true when taking into account any recovery made from the sponsor in the event of insolvency. It is for this reason that understanding the covenant also allows trustees to understand who is most effected by the insolvency of the scheme.

Over the years, we have insured tens of thousands of scheme members who have been impacted by the insolvency of their employer and the loss suffered by the members ranges from a few per cent to losing over half the value of their pension.

Understanding a scheme's unique position allows trustees to negotiate funding in a way that protects all members of the scheme and may in some instances mean that compromising benefits is in the best interest of the greatest number of scheme members and may allow a company to continue to employ its staff and generate value for the wider economy.

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