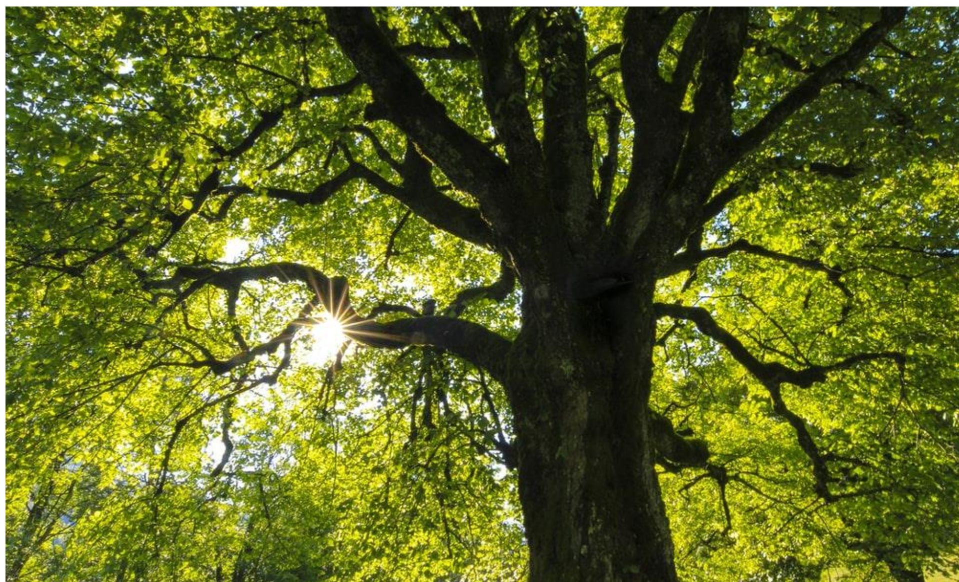
LCP INSIGHT CLARITY ADVICE

Will my company pension end up being paid by an insurance company – and should I care?

November 2020



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01 Introduction

In the UK today there are roughly ten million people with pension rights built up from a private sector job that offered a 'Defined Benefit' (DB) pension[1]. These are pensions which come with a promise to pay a guaranteed amount for as long as you live.

Over four in ten of these DB members are already receiving their pension, around one in ten are in work and still adding to their DB pension rights, and the rest have rights from a previous job or from a closed pension scheme, which they will draw on when they retire.

What few of those ten million people may realise is that there is a whole industry devoted to making sure that their pensions are paid this year, next year and for decades to come, with over £1,500 billion of assets supporting the promises.

This paper focuses on one specific way in which company pension schemes are seeking to guarantee these pensions – a process known as a 'buy-in' or 'buy-out'. In brief, this process involves the scheme doing a deal with an insurance company which in turn takes on responsibility for meeting the pension promises which have been made.

Five years ago, fewer than 1 in 10 members had their pensions backed by an insurance company. New figures from LCP, based on a recent survey of insurers, reveal that around 1 in 6 members have now been insured, and LCP estimates this will increase to 1 in 3 by the middle of the 2020s.

Given the huge expansion of this market and the billions of pounds which are being spent in trying to secure member benefits, we thought it was time to let all members know what is going on 'under the bonnet' in many of the pension schemes of which they are a member.

This paper is about what goes on 'behind the scenes' to try to make sure that pensions are actually paid. In this paper we:

- describe the risks that pension schemes face when trying to build up enough money to meet their pension promises;
- explain what happens to your pension if the sponsoring employer goes out of business before all the pensions have been paid; and
- look at some of the steps that pension schemes take to try to reduce the risks that they face, including pensions insurance arrangements and what this means for you.

[1] Source: The Pension Protection Fund '*Purple Book 2019*'. Note that this is a count of scheme memberships not of individuals, so if someone is a member of two separate DB schemes they will appear twice in the figures.

02 How do Defined Benefit company pensions work?

Under a Defined Benefit (DB) pension arrangement, you receive a pension at a guaranteed level, linked in some way to your earnings and length of service. This pension is payable for as long as you live, generally increases each year to take some account of inflation, and often contains provision for a surviving spouse or civil partner if you die first.

The most common type of Defined Benefit pension is a 'final salary' pension where the amount you get is a percentage of your salary when you left service (or perhaps an average of your salary over the final three years), where the percentage depends on your years of membership of the scheme. But there are many other variations including pensions linked to the average of your earnings throughout your career.

To pay for DB pensions as they fall due, contributions are made into a fund, usually by both employer and employee, and those funds are invested for when the member retires.

For most members, most of the time, these pension promises are met in full. But this is not always the case, especially if the sponsoring employer goes out of business. This point is particularly pertinent in the current environment, as one consequence of the Covid-19 crisis has been an increasing number of companies filing for administration.

03 What are the risks to my pension being paid?

Pensions are a long-term business. A worker who contributes to a pension in their early twenties may not start to draw their pension for over forty years and can easily receive that pension for another thirty years. Taking account of potential payments to a surviving spouse, one year of work at the start of your career can easily give rise to pension rights which continue to fall due seventy or eighty years later. Such long time horizons cause pension schemes and employers considerable uncertainty and therefore, risk.

For example, the money the scheme has to pay out (the scheme's liabilities) can be known with considerable certainty this year and very high certainty next year, but predicting liabilities in twenty or thirty years can be much more uncertain.

Answering questions such as "what money do we need to set aside now (the scheme's assets) to pay the pensions in future" is arguably even more difficult. Money in a pension fund is generally invested in a wide range of assets and assumptions have to be made about the return on those assets for decades to come, and also about how that asset mix will change. Even in relatively 'normal' times there is some uncertainty about the future performance of assets, but when something like the current Covid-19 crisis strikes, all past assumptions about investment performance can be thrown into the air.

In this section we summarise what goes on 'behind the scenes' at an occupational pension fund to try to manage and reduce these risks. Although there is a very long list of risks faced by schemes, we concentrate here on four of the most significant ones:

a) Investment risk – what happens if the scheme's investments perform worse than expected

Company pension schemes collect money from employers and employees during their working lives and then invest that money so that funds are available to pay the worker's pension in retirement. If investment returns on those funds are not as expected, this can create a shortfall in the pension scheme which may in turn mean that the sponsoring employer has to put in extra money to make up the shortfall.

Because company pension schemes are generally investing for the very long term, they are generally comfortable taking a degree of investment risk because, on average, the more risk they take, the more return they will get. As the scheme gets closer to the date when more and more of its pensions have to be paid out, it will generally start to take less risk and invest more cautiously as it will have less time to address any problems if riskier investments under-perform.

Whilst schemes have a range of strategies to reduce their investment risk (including, for example, diversifying the range of assets in which they invest), for as long as the pension scheme continues to operate and to seek a return on its investments, there will always be a risk that things do not turn out as expected.

It is worth saying that risk is not itself a bad thing. If a company pension scheme took no investment risk at all then it would get very little return on its assets and the employees and the company would have to put a lot more money in. The challenge is to take the optimum amount of risk (to get the scheme's assets the return they need) and to have strategies in place to manage that risk.

b) Longevity risk – what happens if we live longer than expected

One of the great advantages of a Defined Benefit ("DB") pension is that it's a promise to pay you a pension as long as you live. If your pension comes in the form of a pot of money (or 'Defined Contribution (DC)' arrangement), you are responsible for managing that money for your lifetime which is an uncertain period of time. But with DB pensions, the risk of you living a long time – and costing the pension scheme more money – lies entirely with the pension scheme (and the employer who stands behind it). The member simply gets their pension for as long as they are around to receive it.

Improvements in longevity have been one reason why pension schemes have found themselves short of the money they need to pay future pension promises. Contribution rates for workers and firms are set on the basis of assumptions about how long pensions will have to be paid for. If it turns out that we are all living longer then the pension fund will be short of the amount needed to pay all future pensions.

c) Inflation risk – what if prices rise faster than expected?

Under UK law, pensions in respect of service in a DB pension scheme since 1997 have to be increased each year to take account of inflation. In addition, many pension schemes will have their own rules which offer protection against inflation which can go beyond the minimum required by law, though the nature of this protection can vary hugely between schemes (most notably in terms of things like the measure of inflation that is used, whether inflation protection is open-ended or capped etc). In general, the higher inflation is, the faster pensions increase over time and therefore, the more money it costs to pay for them.

As with the other risks identified above, getting inflation assumptions wrong can leave a scheme short of cash. For example, if a scheme has set aside enough money to pay pensions in retirement which will increase at 1% per year but it turns out that prices are rising at 2% per year, then the scheme will be at risk of running out of money.

As with the other risks identified above, schemes have ways of reducing these risks, including investing in assets whose value is itself linked to inflation. In this scenario, although inflation may be higher than expected and so liabilities are higher, the assets of the scheme which are linked to inflation will also have risen more than expected – the overall impact on the scheme would be reduced.

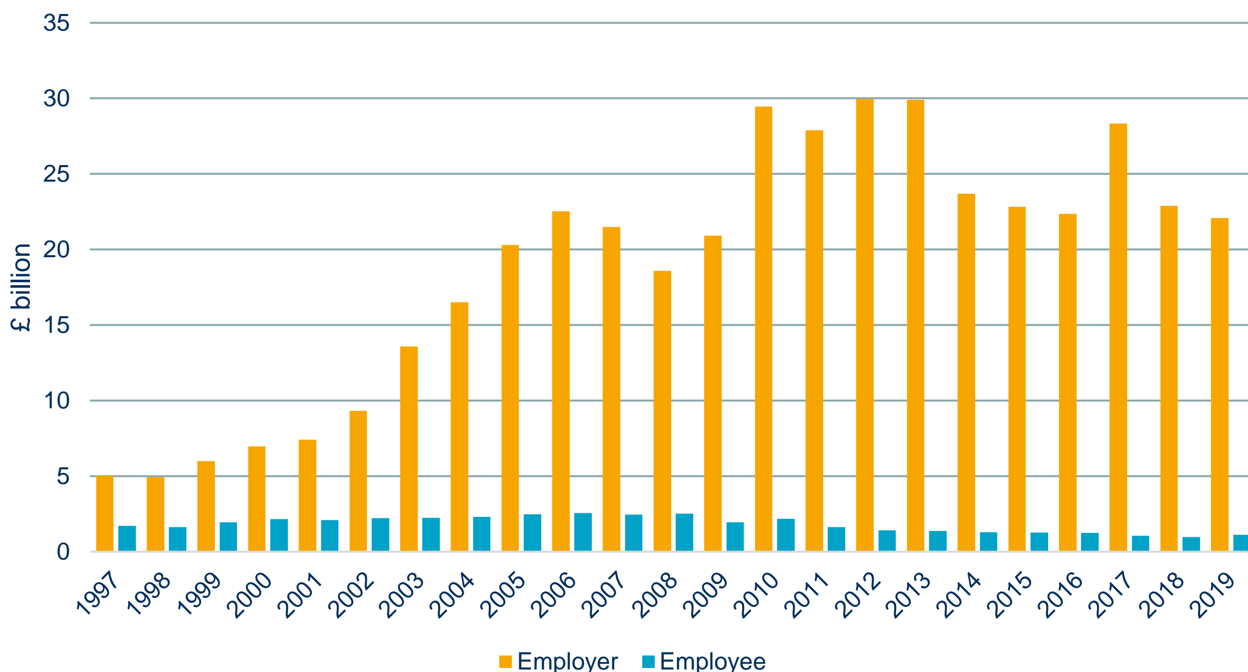
Although there are ways for schemes to manage inflation risk, it is rare for this risk to be zero. Once again, making sure that the scheme has exactly the right amount of money it will need to pay all future pensions can be a challenge and is subject to considerable uncertainty.

d) Employer solvency risk – what happens if the company isn't around in the future to support the pension scheme

All of the risks listed above – longevity risk, investment risk and inflation risk – can result in a DB pension scheme being short of the money it will need to pay the pensions it has promised to pay. However, as long as the company which supports the pension scheme is still trading, the company can be asked to put more money in to make up the shortfall.

In recent years, companies have contributed huge sums to repair the shortfalls in their DB pension schemes. Figure 1 shows the total contributions made by employers into their DB pension schemes each year since 1997. Here we can see that the level of employee contributions has declined steadily over the period, as more DB members retire (and most DB schemes don't allow new members to join). However, the level of employer contributions has increased significantly since the late 1990s. These employer contributions have predominantly been needed to make good shortfalls in pension promises that have already been made, rather than to meet the additional cost of new pension rights from current employees.

Figure 1. Employer and employee contributions to private sector DB pensions 1997-2019



Source: Figures provided by the Office for National Statistics on request.

This increase in pension costs has placed a significant burden on many companies, highlighting the potential risk that the sponsoring employer may go out of business. There are recent examples of household names which have historically been in a strong position but which no longer exist (as a walk down any High Street with boarded up shop windows will confirm). If the company becomes insolvent at a time when there is not enough money in the fund to ensure that all the pensions will be paid, then a 'safety net' level of protection is provided by the Pension Protection Fund (PPF). We explain more about this in the Appendix.

04 Buy-ins and buy-outs – what are they and what do they mean for my pension?

As noted earlier, most of the time, most pensions are paid in full. The biggest risk of a pension not being paid in full arises if a sponsoring employer goes out of business. So, is there a way of reducing or eliminating the need to depend on a sponsoring employer?

There is such an option and it involves transferring responsibility for paying future pensions from the pension scheme and its sponsoring employer to an insurance company[2]. This transfer does not come cheap, as the insurance company is taking on all of the uncertainties listed earlier. But if it can be achieved it offers members a very high level of certainty that their pension will be paid.

There are generally two ways in which this can be done:

- A full 'buy-out' whereby the pension scheme pays an insurer a premium, and in return the entire liability for paying pensions is handed over to an insurer; the pension scheme is wound up and thereafter, each individual scheme member has a contractual relationship with the insurance company to pay the pension;

- A partial 'buy-in' which is usually an intermediate step to a full 'buy-out'; this is also a deal between a pension scheme and an insurance company; in this case the insurer contracts with the pension scheme to cover some of its liabilities – for example, the future pensions due to all those members who have retired; the insurer pays the pensions to the pension scheme which retains the responsibility for paying members' pensions.

These pension insurance transactions have the potential to benefit all parties:

- Members have their pensions under-written by a robust insurance company; although insurance companies can also go bust, they are required to meet stringent solvency standards to operate in this market;

- The insurance company expects to make a return for its shareholders from taking on the risk of providing the pensions;

- The sponsoring employer secures all (in the case of a full buy-out) or some (in the case of a partial buy-in) of its pension liabilities; this typically comes at an extra cost but reduces or eliminates the extent to which pension costs feature on the company's balance sheet and the extent to which it will be liable in future for additional contributions to make up for an unforeseen shortfall;

Fifteen years ago, the volume of pension insurance transactions was relatively low, but it has accelerated since then, with over 150 companies transferring some, or all, of their pension schemes to an insurer in 2019, covering over 300,000 members.

[2] In recent industry developments, there have also been new, emerging options which offer alternative ways of seeking to secure member benefits – these are referred to as "consolidator" or "superfund" type solutions. We may see these becoming attractive alternative options in the next few years, as they are typically a lower-cost option for employers, however they don't necessarily come with same security as insurance company provides.

Examples last year include:

- *Rolls Royce*, who insured 33,000 of their members for £4.6bn with Legal & General
- *Asda*, who insured all 12,300 of their members for £3.8bn with Rothesay Life
- *Tate & Lyle*, who insured the remainder of their 6,700 member scheme for £0.9bn.

With big household names carrying out such large transactions there has been a significant increase in the number of DB pension scheme members who are now insured.

What impact does this have on members?

Historically, the majority of the members insured saw no day-to-day difference in how their pension was managed. This is because they were insured through partial buy-ins, where the pension scheme remains responsible for paying their pensions (even if the risks have passed to the insurer). Increasingly more and more members are being paid directly by insurers with this now accounting for nearly 1 million DB pension scheme members. This is where pension schemes have now taken the final step to move to full buy-out and the sponsoring company no longer has responsibility for providing the pensions. With buy-outs becoming increasingly common this number is set to rise significantly over the coming years.

For many members it may come as a surprise to learn that there is all this activity going on ‘under the bonnet’ of a DB pension scheme in order to ensure that their pension is paid. It may come as more of a surprise to learn that a common way for schemes to reduce risk and increase benefit security is to transfer responsibility to an insurance company. In the final section, we answer some common questions about how this process works and what it means for members.

What’s the role of the pension scheme trustees in all of this?

Whilst a pension scheme is ongoing, the trustees are responsible for the running of the scheme. A trustee acts separately from the sponsoring employer, for the benefit of members.

Before entering into a pensions insurance arrangement, typically trustees will take detailed professional advice, conduct a review of the insurance market and run a competitive selection process before deciding to purchase the insurance policy considering a range of factors as well as price.

The ongoing involvement of pension scheme trustees after a transaction depends on the nature of the insurance policy:

- Under a partial "buy-in" the insurance policy is held as an investment of the pension scheme by the trustees, and so the trustees retain responsibility for the running of the scheme and for paying members' pensions. Income received from the insurance policy can be used to benefit all pension scheme members.

- Under a full "buy-out", the pension scheme is wound up, the trustee board is dissolved, and each individual scheme member has a contractual relationship with the insurance company to pay their pension.

05 Buy-ins and buy-outs – your questions answered

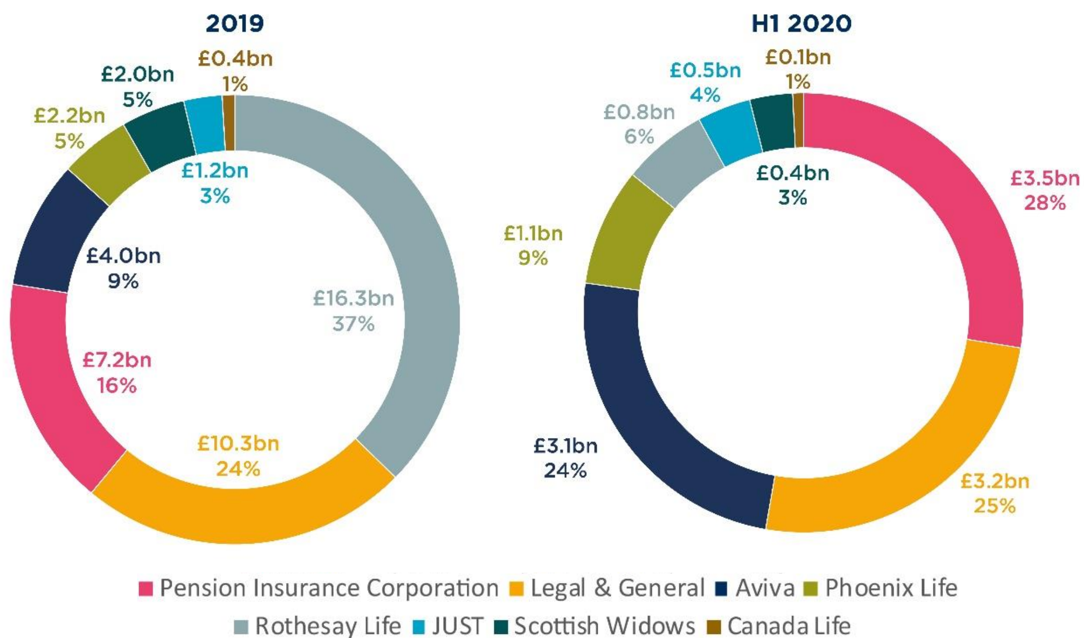
As described in the previous section, when a pension scheme's liabilities are 'bought out' in full, responsibility for paying a member's pension is transferred to an insurance company. Where some liabilities are subject to a 'buy-in', this is a transaction between the scheme and the insurer which does not have any immediate impact on the member. In particular, the scheme remains responsible for paying members' pensions.

In this section, we answer some common questions which members may have.

a) What do we know about the insurance company who is now going to pay my pension?

The pensions insurance market is currently made up of eight insurance companies. In some cases these will be household name firms with a consumer brand such as Aviva or Legal & General. In others they will be specialist insurers who may be less familiar to the public. A breakdown of recent transactions, by insurer, is shown in the graphic below. Each insurer is required to hold large amounts of capital to back the pension promises it is taking on, and a pension scheme will typically undertake careful checks before entering into a deal to make sure it can be confident that the insurer is financially sound.

Buy-in and buy-out volumes by insurer



b) Is insurance "safe"?

When pension scheme trustees and sponsoring employers consider insurance, a key concern will be whether that insurance company has suitable financial strength, and whether the insurer will continue to do so for the full term of the payments (which often stretch for many years into the future).

Trustees will often take advice on this point specifically, which will include understanding the regulatory regime in which life insurers operate. Both buy-ins and buy-outs bring a number of valuable protections to provide a secure environment for providing pension benefits over the long term.

Life insurance regulations are restrictive. When a pension scheme purchases a partial buy-in or full buy-out from a life insurer, the insurer:

- has to ensure its liabilities and assets meet strict conditions around liquidity and matching (for regulatory purposes), as a buy-in fully hedges all investment and longevity risk.
- cannot mismatch its assets and liabilities, so there cannot be a "run on an insurer".
- will put forward their own shareholder's money as additional reserves – the more risk the insurer runs the higher the reserves required.
- cannot simply sell the buy-in policy to another insurer (it can only be transferred via a "Part VII" transfer process, which involves approval by the High Court).
- has to treat policyholders as priority creditors - in a default scenario the policyholders would be paid out before any payments to loan creditors.

There is also a very close level of oversight from the Prudential Regulatory Authority (PRA) – the relatively small numbers of insurers, compared with high numbers of pension schemes means that the PRA is able to carry out close and regular monitoring of the insurers.

Evidence of the strength of the insurance regime is demonstrated by how the life insurance industry held up well in both the banking crisis in 2008 and through the Covid-19 crisis in 2020.

c) What happens if the insurance company does go bust?

Despite the protections described above, the insurance regime is not intended to be a zero failure, and so there does remain the possibility that an insurer could go bust. For this reason the Government provides the Financial Services Compensation Scheme ("FSCS"). This protects your pension providing compensation, in the event an insurer cannot meet its obligations, of the value of your pension with no maximum compensation limit. This is higher than the level of cover than provided by the Pension Protection Fund (see Appendix).

Since its creation in 2001, the FSCS has paid over £26bn in compensation (mainly for banking failures). No UK life insurer has been unable to meet its obligations since the FSCS was created.

d) Does an insurance transaction affect how much pension I get?

Not usually. The agreement with the insurer would generally be to pay the pensions due to members unchanged from the rules of the pension scheme.

Does an insurance transaction affect the options available to me?

The same options normally continue to be available. If your scheme allows you to take part of your pension as a lump sum, or retire before or after normal pension scheme age, or transfer out into another type of pension, you will normally retain these rights (or “options”) after a buy-out. However, the way in which a transfer value or other member options are calculated will be different when the pension is paid by an insurer.

Whilst the pension scheme is ongoing, actuarial terms for calculating these member options are typically determined by pension scheme trustees or employers, having taken actuarial advice.

Following transfer to an insurer on a full buy-out, the insurance company would take over responsibility for calculating the member option terms. Insurance companies have standard terms calculated by their actuaries. The terms typically reflect the expected cost of providing the benefits but such an assessment will vary between insurers and pension schemes so there is likely to be some change.

A key point is that there are requirements on insurance companies to treat customers fairly. This provides reassurance that insurers’ standard terms are likely to be reasonable over time. The Financial Conduct Authority (“FCA”) regulates insurers in how they treat their customers.

e) What happens to the pension scheme administration?

After a partial “buy-in”, your pension benefits will normally continue to be administered by the trustees. If this is the case you will see no change to the payment of your benefits. Pension schemes can pass the administration to the insurance company but this is rare prior to full buy-out.

After a full buy-out, the insurer will take over responsibility for the payment and administration of your benefits and those of all the other scheme members. Once this has happened you will no longer be a member of the scheme; instead you will have an individual policy with an insurer which will provide all the benefits to which you are entitled. At this point the scheme will be wound up. Usually as part of this process the trustees carry out a review of the benefits and pension scheme data, to make sure all members are receiving the correct level of pension benefit before they are issued with individual policies.

As an insurer takes on direct responsibility for paying your pension, they work closely with the trustees and their advisers to make sure the transfer is smooth. Once this process is complete, the insurer will send you a policy document which will show what benefits you are entitled to, in line with the trustees’ instructions in accordance with the rules of the pension scheme.

The insurers generally put a lot of effort into making sure that they’re able to provide a high-quality member experience. Whilst some insurers carry out their administration directly in-house, others outsource their administration to specialist providers. In both cases the insurers monitor performance of their administration teams carefully, and complaint levels are typically low. This process is overseen by the Financial Conduct Authority (“FCA”), and the Financial Ombudsman service provides an independent body for settling any disputes should they arise.

06 Conclusions – should you care about any of this?

At one level, the workings of company pension schemes need not concern members unduly. Given that in most cases pensions are paid in full, it may not matter to you how this has been achieved.

However, in a world where corporate insolvencies hit the headlines on a regular basis, it is good for members to be aware how the solvency of their (former) employer might affect the likelihood of their pension being paid. It is also worth understanding the extent to which those who have responsibility for DB pension schemes are seeking to reduce risk and improve the security of your benefits.

As we have shown in this paper, in many ways, a member is in a better position if their DB pension scheme secures benefits via a full buy-out - they are often significantly more likely to receive their benefits in full, even if the scheme sponsor becomes insolvent. In this case, rather than be at risk of a cut in benefits if company insolvency is followed by entry into the Pension Protection Fund, the members' benefits are secured by an insurance company and, if the worst comes to the worst, protected by the Financial Services Compensation Scheme.

From historically being a niche experience affecting a minority of scheme members, partial buy-ins and full buy-outs are likely to affect a significant number of members of DB pension schemes over the coming decade. We hope that this simple guide has shone a light on the process and has offered some reassurance to those who may be affected.

Appendix: What happens if things go wrong? – the Pension Protection Fund

In 2004, the Pension Protection Fund (PPF) was created. The role of the PPF is to help to make sure that when companies with DB pension schemes go out of business, members do not completely lose their pensions.

When a company with a DB pension scheme goes out of business, the pension scheme is assessed to see if it has enough money to pay out at least at the level of PPF compensation. The level of PPF compensation is typically lower than the original scheme benefits – for example, benefits could be subject to a reduction/cap (depending on member status), and PPF compensation typically offers less generous future pension increases than the original scheme.

Under a PPF assessment, there are two potential outcomes:

1. **Scheme does not have enough money to pay PPF benefits**: In this scenario, the PPF will take over. All of the assets of the scheme are transferred to the PPF, and liability for paying future compensation payments falls to the PPF.

2. **Scheme has enough money to pay PPF benefits**: If it does, then rather than the PPF taking on responsibility for paying future compensation payments, instead scheme assets are typically used to do enter into a full buy-out with an insurance company to pay out the benefits it can afford. This normally still involves a cut-back but to a level above PPF compensation.

Because under scenario 1 the funds transferred to the PPF are not even enough to pay PPF level compensation, the PPF needs an additional source of revenue. This is something called the PPF levy and is collected annually from all DB pension schemes. The amount of the levy varies from scheme to scheme and depends on scheme size and in part on the risk of the scheme falling into the PPF.

Although the PPF itself faces uncertainties (again on longevity, investment returns and inflation), its funding position is relatively robust and has been designed to withstand a range of economic uncertainties.

Whilst the PPF provides more security to members of DB pension schemes than the situation before the PPF was established, the PPF does not provide full replacement of scheme benefits, even for those over pension age. It is still better for members that their pension scheme continues to operate or that their pensions are guaranteed in some way to avoid the risk of ending up in the PPF.

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