Why should we consider mutual insurance for pension schemes.

People currently seem to think that a DB pension will ‘guarantee’ you a good pension. This is simply not true. A DB scheme is only as good as the employer who provides it and it can be wound up or closed at a stroke! Government has not done anything to protect the pensions of those members of the scheme who are still at work (even those who are just a few months from retiring). If the assets are insufficient, a DB pension could provide no pension at all.

I will try to encapsulate the main arguments involved in this debate about insurance for you, but would be happy to chat through any other issues or points which are not clear on the phone tomorrow. I'm really sorry if this email is far too long for you, but I was not sure how much detail you want!

SHORT RESPONSE:

Yes, I think mutual insurance would be a great idea for UK pension schemes. At the moment, members of a final salary scheme which winds up may not even get their contributions back, if assets in the fund are insufficient**.** This is because pensions in payment must be paid out in full - including index linked increases - before other liabilities can be met.

I have recommended this insurance solution for the last couple of years. I think it could be run like an 'ABTA' scheme for travel agents, where all pension funds should be encouraged (or compelled) to belong and pay premiums to provide cover in case the fund is wound up. At least this way, everyone will get some level of pension, which seems fairer.

The premiums could be varied to be lower for better funded schemes (to encourage them to keep funding levels adequate).

The US has had its Pension Benefit Guaranty Corporation scheme running since 1974 and we can learn from some of their mistakes and get a sensible scheme in the UK.

I don't believe there is any other realistic way of actually ensuring that everyone who is in a pension scheme will get some kind of pension from it, if it is wound up. Given that so many schemes are winding up at the moment, I am sure many people will wish that insurance had been in place already. The MFR has not provided the protection people thought it would. To contain the cost of the insurance we will need to cover only up to a certain maximum amount of pension. People who have been promised pensions of £100,000 per year or even more than this, will not be paid in full. But then no other group really has such protection anyway. Bank customers are only protected up to about £30,000 per account and investors are only protected up to £48,000. If we can accept that we have been trying to protect pensions 'too much', then the possibility of providing some affordable guarantees for all pension scheme members becomes a reality and some creative insurance solutions can be found.

I honestly believe it would be excellent if insurance were introduced as a requirement for pension schemes.

THE LONG ANSWER - WITH FULLER DETAILS

The problem:

At the moment, there is no proper safeguard for members of a final salary pension scheme, in the event that their employer decides to wind it up, or becomes insolvent and it is forced to wind up. The current legislation provides for different levels of protection for different classes of scheme member, depending on whether they are :

1. already receiving a pension from the scheme, 2. have left the scheme and are entitled to a pension in the future when they come to retirement age, or 3. are still working and contributing to the scheme.

The members of a pension scheme are treated differently on wind up, as follows:

1. pensions already in payment must be met in full from the assets of the fund (including LPI increases, which means that even someone with a promised pension of £100,000 per annum must be paid their full £100,000 indexed by inflation up to 5% a year, for the rest of their life). The rationale for this is that, once they have retired, people have no opportunity to earn more and save more to support themselves. Therefore, their pensions should be sacrosanct. Unfortunately, however, the cost of providing the very high levels of pension that some directors and others are receiving is enormous and could mean that ordinary people, perhaps still working and contributing, will lose out, in order to fund these huge pensions. Many will consider this to be unfair.

2. deferred pensioners (that is, those who have left the employer, but did not transfer their pension rights and are therefore still members of the scheme, who have been promised a particular pension, based on the final salary when they left the company) and active members should have a 'reasonable expectation' of getting their full rights - which will mean purchasing deferred annuities, including index linking and this is very expensive.

In practice, it is actually possible that 'active' members i.e. those still working and contributing to the scheme, could end up with nothing at all - not even a return of any contributions they have made!! I think this is grossly unfair. People who have contributed to the scheme, or who have had contributions made on their behalf can end up with nothing to show for it (and may even be losing their job at the same time!)

What do we need?

I think we need a system which guarantees at least some minimum level of pension to everyone who is a member of a final salary scheme that winds up or is closed.

It's obviously vital, then that pension schemes are adequately funded. The government is working on trying to ensure that pension funds have adequate assets to meet their pension liabilities. This was the original aim of the MFR. The MFR was introduced in order to try and ensure some 'minimum' level of funding for UK occupational final salary schemes - after the Maxwell scandal. It was designed to check the solvency position of all pension schemes and, if they were underfunded, they would be required to make up any shortfall with extra employer contributions. Unfortunately, the way the MFR was calculated, it did not actually do what it was designed to do. There were hugely complicated actuarial assumptions and calculations made, but, in practice the fact is that, even if a scheme is 100% funded on the MFR basis, it usually only guarantees about 70% or less of the pension liabilities. This is largely because deferred annuities are very expensive and the assumptions used for the calculations are often incorrect Also, the legislation focuses first on protecting existing pensioners - even those who are receiving huge pensions - and fully indexing them up to 5% per annum. Only after this will other members be able to get anything.

The Government has announced that it is going to scrap the MFR, but it has not replaced it with any better or adequate funding level instead.

So, how can we better protect people's pensions? One of the problems is that we have tried to protect pensions too fully. Why should pensioners be offered full protection, when no-one else in society has anything like it? The cost of providing this full replication of pension promises is very high and actually could mean that ordinary workers whose schemes wind up lose out substantially. Is this fair?

If your bank goes bust, you are covered by the Deposit Protection Scheme, but this will only pay out 90% of the first £20,000 in each account. That means that, even if you have half a million pounds in the bank, you will only get back £18,000 if it fails! And, if your broker fails, the investor compensation scheme will only pay out up to £48,000. In comparison to this, the requirement to meet huge pension commitments in full, plus indexation too, seems quite out of proportion.

A solution:

An obvious solution to the problem of people not getting their pensions, if the pension scheme is wound up, would seem to be to buy insurance protection to cover this eventuality. This insurance would be designed to make sure that people's pensions are protected, in the event that their company's pension fund has insufficient assets to meet its liabilities. None of the existing funding measures (not the MFR, not the 'transparency statement') will do this. A sudden change in investment strategy, an unexpected downturn in investment markets or a poor series of investment decisions, could all mean that the value of a fund on wind up falls well short of what is required to pay the pensions promised. The ONLY realistic way for actually guaranteeing payments would be to introduce some kind of insurance scheme. This could be run by the government, or the private sector, but it should surely be considered as a useful way of providing protection which the current pensions legislation has failed to do.

How could the insurance option work?

a. specified maximum standard cover - e.g. everyone covered up to £10,000 per year

I believe that trying to insure the full value of pension promises is much too costly. Some people have enormous pensions and, if these people had to be fully insured, the cost of such a scheme would be prohibitive.

I would suggest that the insurance scheme should offer some specified maximum level of pension for all members of the scheme - existing pensioners, deferred pensioners and active members. Perhaps up to £10,000 per year? (Perhaps individuals could choose to fund cover for more than this themselves, if they want to). The exact amount could be costed in due course.

If the insurance company knew that it would only have to provide pensions up to this level, it could easily calculate the cost of the premiums. If they had to cover pension promises in full, they would be unable to predict accurately how much the liabilities would be and pricing the insurance would be much more difficult - and much more costly.

This suggestion would mean that everyone whose pension scheme winds up would know that they will get some payment from their scheme.

b. Premiums could vary according to the circumstances of the pension scheme (e.g. funding level, strength of sponsoring company, size of scheme - encourage pooling of smaller schemes).

All final salary pension schemes could be required to pay a small insurance premium, to provide a certain minimum level of cover, in case their scheme wound up with insufficient assets. The premiums are likely to vary according to certain factors:

a well-funded scheme should have lower premiums than an underfunded scheme

a scheme with a strong employer covenant should have lower premiums

perhaps smaller schemes could have a special lower rate, or

smaller pension schemes could be encouraged to pool their assets, to take advantage of economies of scale in terms of lower insurance premiums and more efficient investment costs.

c. Cover to be compulsory and for 5 or 10 years at a time.

If this insurance is compulsory, there will not be a problem of adverse selection and there will be economies of scale in providing the cover.

The insurance should be bought for a long period - say 5 or 10 years at a time - to avoid the problem of having to renegotiate premiums frequently - since this could interfere with the investment strategy of the fund too much. Schemes which could not get cover would either need to join with a larger scheme, or wind up.

What are the drawbacks of this insurance proposal?

1. The cost.

Obviously, a premium will need to be paid by each scheme and, if employers are unhappy about extra cost burdens being placed on their pension fund, this could deter them from providing pensions. My response to this is that the cost of providing insurance is actually likely to be significantly less than the costs of preparing the MFR material or of preparing the 'transparency statement', so this can be portrayed as a 'reduction' in costs to the scheme overall.

2. Moral hazard.

People will be concerned that, by having an insurance safety net in place, the trustees will be less careful about their investment strategy, the employers may be willing to take more risks and the funds may therefore be more likely to fail and be wound up. My response to this is that, by making premium levels higher for poorly funded schemes and by only covering up to a certain amount of the pension promised, the trustees and employers will still have a strong incentive to run the scheme as well as they can.

Experience from the US:

The US has operated the Pension Benefit Guaranty Corporation - PBGC- since 1974. This is funded by insurance premiums paid by the plan sponsors. There is a flat rate premium of around

$20 per member per year for single-employer schemes and around $3 per member per year for multi-employer schemes. A higher premium is charged for underfunded plans (around an extra $10 per $1000 of unfunded benefits). The PBGC only guarantees to pay benefits up to a certain maximum level and this level is adjusted annually by law. There is no expectation of pensions being FULLY protected, as seems embedded in UK current practice.

This PBGC scheme did experience many problems in its early days, but the US has learned much from these events and we can usefully learn from those past mistakes to design a good system in the UK. Under the US system, if a scheme is wound up, the running of it is taken over by a central body and it keeps going, so that the assets can still grow and so that deferred annuities (which are so expensive) do not need to be bought.