ASSOCIATION OF MEMBER NOMINATED TRUSTEES 2018 ANNUAL CONFERENCE

An introduction to Collective Defined Contribution Pension Schemes

Thursday 13th September, 2018 at 2:15pm

Speakers: Con Keating and Philip Bennett

What we will be covering

I What is a CDC Scheme?

II What needs to be done to allow CDC schemes to be introduced in the UK?

III Closing defined benefit pension scheme to future accrual: CDC as a better alternative than individual DC

IV Decumulation options in DC schemes: CDC as a better alternative than individual drawdown

V What a CDC scheme is not?

VI Drawing the strands together

I. What is a CDC Scheme?

In essence:

- Each scheme year's employer (and if applicable, employee) contributions for an active member "purchase" a target retirement income for that scheme year for that member from the trustee of the occupational pension scheme
- The target benefit is a **non-guaranteed** income from normal retirement age (eg age 67) for the life of the member
- **It can go up or down.**

What is a CDC Scheme? (cont'd)

- The target benefit "purchased" by the employer (and if applicable, the employee) contribution for an active member for a scheme year is determined by using a "**best estimate**" actuarial assumptions of which the key ones are:
  - ➢ the rate of investment return expected to be earned on the employer contribution
  - ➢ how long the member will live
  - ➢ if the benefit design includes increases before retirement date to the accrued target benefit and increases to the target benefit when in payment, the assumed rate of increase (eg in line with the increase in the RPI or the increase in the CPI)
- Why "**best estimate**"? Answer: because a "prudent" basis would

What is a CDC Scheme? (cont'd)

- Pre-set non-discretionary rules for increasing or decreasing the target benefit to bring its value, at any point in time, back into balance with the value of the scheme assets at that point in time
- Members' economic interest in the scheme assets, at any point in time, is:

L/TL x A

➢ **L** = present capital value of member's target retirement income using "best estimate" actuarial assumptions

➢ **TL** = the total of the present capital values of all members' target retirement income

➢ **A** = value of scheme asset

What is a CDC Scheme? (cont'd)

Why would I want to be in a CDC Scheme if the target benefit is not guaranteed?

- Compared to a DC scheme:
  - ➢ for the same contribution, as a minimum, a higher level of target retirement income for life (if all other variables (see next slide) are the same as between DC and CDC)
  - ➢ how? Just by pooling longevity - a man aged 65 in 2018 in normal health has an average life expectancy of 86 (88 for a woman)

Notes:

1. A man aged 65 in 2018 in normal health has a 25% chance of surviving until at least age 93 and a woman aged 65 in normal

What is a CDC Scheme?

1. Source: Office for National Statistics Life Expectancy Calculator

https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsanddmarriages/lifeexpectancies/bulletins/pastandprojecteddatafromtheperiodandcohortlifetables/2016baseduk1981to2066

What variables are assumed to remain constant?

- ➢ Expenses charged to the CDC scheme/the individual DC scheme
- ➢ The investment strategy and investment return

What is a CDC Scheme? (cont'd)

- But CDC scheme does require a reasonable number of members to be cost effective and to benefit from pooling of longevity risk in a way which provides reasonably predictable outturns.
  - ➢ How many members do you need to have a "**reasonable number**".
  - ➢ What is a "reasonable number" – in excess of 700 members (the position turns on how alike or diverse the members are from a longevity perspective).

What is a CDC Scheme? (cont'd)

Comparison of risk allocation and accounting treatment between DB, individual DC and the CDC Schemes

Table 1

Type of Scheme	Risks borne by employer	Risks borne by member	Accounting treatment for employer
DB	All except employer insolvency risk	Employer insolvency risk (but back stopped by the Pension Protection Fund)	Deficit (measured as the present capital value of the future pension payment obligations using a AA corporate bond discount rate less the value of the scheme assets) is on the employer's balance sheet (under FRS102/IAS19 as applicable to the employer)
2. Individual DC	None (except loss of assets of scheme through fraud /dishonesty in an occupational pension scheme)	All (except loss of assets of scheme through fraud/dishonesty in an occupational pension scheme)	No employer balance sheet impact. Charge to the profit and loss account equals employer contributions paid in the accounting period

What is a CDC Scheme? (cont'd)

Type of Scheme	Risks borne by employer	Risks borne by member	Accounting treatment for employer
3. CDC	None (except loss of assets of scheme through fraud/ dishonesty in an occupational pension scheme)	Shared amongst members' interests in the assets of the CDC scheme in accordance with pre-set non discretionary fair risk sharing rules	No employer balance sheet impact. Charge to the profit and loss account equals employer contributions paid in the accounting period.

II. What needs to be done to allow CDC schemes to be introduced in the UK?

- Assume not currently achievable under existing UK legislation
- Royal Mail/CWU announcement in February 2018 to introduce CDC scheme if permitted by legislation
- Government includes statement in DWP White Paper "Protecting Defined Benefit Pension Schemes" published in March 2018 that it is exploring how it may be possible through modest changes to legislation to enable CDC schemes to be introduced in the UK
- House of Commons Work and Pensions Select Committee report on inquiry into Collective Defined Contribution Pensions published on 11 July, 2018
- Pensions Minister, Guy Opperman, announced on 4 September, 2018 consultation on CDC schemes to take place in Autumn 2018 (with

What needs to be done to allow CDC schemes to be introduced in the UK? (cont'd)

- CDC schemes already up and running in the Netherlands.
- CDC schemes (referred to as target benefit plan) up and running in a number of provinces of Canada
- Objective is to come up with a UK model CDC scheme which draws on the real life experience in the Netherlands and Canada and adapts appropriately to the UK environment

III. Closing defined benefit pension scheme to future accrual: CDC as a better alternative than individual DC

DB scheme closing to future accrual:

- use a CDC benefit design for active members for future service?
- if the sponsoring employer is closing DB scheme to future accrual, what replacement retirement benefit is being provided?
- Answer: currently DC
- But (see Royal Mail) CDC could, depending on size of active member population, be a viable alternative providing a higher level of target retirement income

CURRENT LEGISLATIVE PROVISIONS: A FALSE DAWN

1. UK Pension Schemes Act 2015 enacted to allow:
   - Defined ambition schemes (risk sharing between employer and plan members), and
   - Collective benefit schemes (risk sharing amongst members).
2. But not yet brought into force (over complex/over ambitious)

A NEW DAWN

1. CDC Schemes to be introduced, prompted by:
   - the Royal Mail/CWU agreement in February 2018.
   - number of employees c.140,000
   - creative solution to union position (continuation of DB) and Royal Mail position (DB not sustainable, move to DC):
     - ➢ **Lump sum DB scheme:** lump sum of 3/80ths x pensionable pay for each year of future pensionable service in that scheme (with Target Revaluation in line with RPI) payable at age 67 **(no longevity risk for employer)**

A NEW DAWN? (CONT'D)

- **CDC/Target Benefit scheme:** where risk/reward shared by and amongst generations of members providing a target pension of 1/80th x pensionable pay for each year of pensionable service
- **Insured risk benefits:** lump sum death in service 4x pensionable pay and ill-health benefit (50% of pensionable pay less state benefits payable for up to 3 years plus a lump sum payment at the end of the 3 years)

A NEW DAWN? (CONT'D)

"The CDC Scheme will be the first of its kind in the UK and Royal Mail and the CWU will lobby the Government to find the quickest route to getting the scheme established and then enacting the necessary regulations".1

Note: No conversion of past service DB benefits into CDC benefits.

1 Page 10 of the February 2018 Royal Mail/CWU Agreement.

THE PROPOSED ROYAL MAIL CDC SCHEME IN MORE DETAIL1

	ISSUE	DETAIL	COMMENT
1.	Employer contributions	1.1 A fixed percentage of pensionable pay (c. 10% of pensionable pay) 1.2 No employer liability for deficit (because CDC Scheme cannot have a deficit)	The employer has agreed an overall contribution rate to cover all 3 types of benefits of 13.6% of pensionable pay. **Key point:** This rate is fixed.
2.	Employee contributions	3% of pensionable pay?	The overall contribution rate for members is 6% of pensionable pay to cover both the CDC benefit, the DB lump sum benefit and the risk benefits.
3.	Normal retirement age	67	

1 All derived/inferred from the February 2018 Royal Mail/CWU Agreement

THE PROPOSED ROYAL MAIL CDC SCHEME IN MORE DETAIL (CONT'D)

	ISSUE	DETAIL	COMMENT
4.	Target Benefit Accrual Formula	1/80th of pensionable pay per year of pensionable service e.g. 1/80th x pensionable pay of £24,000 = £300 p.a. from age 67 (but subject to Target Revaluation)	4.1 Pensionable pay is base pay plus pensionable allowances. 4.2 This is an average salary scheme with each "brick" of pension derived from a particular year of pensionable service being subject to separate revaluation in line with RPI.
5.	Revaluation target	In line with the Retail Prices Index (RPI) increases	
6.	Target increases to the Target revalued pension	In line with the RPI	

IV. Use of a CDC scheme to improve decumulation outturns for existing DC schemes

- Assumed facts:

➢ Member's retirement account at retirement age 65 in DC scheme is £100,000

➢ Member's average life expectancy, if aged 65 in 2018 , if a man is 86, if a woman is 88.

Note 1: Member assumed to be in "standard" health – ie not an impaired life

Note 2: For what follows, we will assume the female life expectancy, to err slightly on the safe side.

Use of a CDC scheme to improve decumulation outturns for existing DC schemes (cont'd)

- An investment return assumption of 6% p.a. (not guaranteed) (before expenses) and after expenses of 5% p.a

  Note: Only relevant for income drawdown and CDC target retirement income purposes

- Member's options to provide a retirement income are as follows:
  - purchase an annuity
  - elect for income drawdown, for "apple with apple" comparison purposes, assumed to be in equal monthly instalments - by definition this cannot be guaranteed since it is based on drawing down the member's "pot" in equal instalments with those equal instalments derived from:
    - o assumption as to longevity, and
    - o assumption as to investment return net of expenses
  - elect to "purchase" a CDC target retirement income (not guaranteed)

Use of a CDC scheme to improve decumulation outturns for existing DC schemes

Let's turn these choices into numbers on the assumptions made

Table 3

Annuity purchased with £100,000	Annual amount of payments (monthly in arrears)	Comment
1.1 Single life annuity with no guarantee and no inflation protection	1.1 £5,175 a year	The annuity rate is gender neutral (as required by law). It is an illustrative rate.
1.2 Single life annuity with a ten year guarantee period	1.2 Less than £5,175 a year	This is an illustrative figure as published in the Financial Times of Saturday 11th August, 2018.
1.3 Joint life annuity (spouse assumed to be same age as member and survivor annuity equals one half of member's annuity)	1.3 Less than £5,175 a year	Amount guaranteed by insurance company which has taken on longevity risk and investment risk.

Use of a CDC scheme to improve decumulation outturns for existing DC schemes (cont'd) Table 3 (Cont'd)

Income drawdown (member assumed to die at age 88) Having equal instalments with no inflation proofing	Annual amount of payments (monthly in arrears) £7,320 a year (£7414 if paid annually in arrears)	Comment 2.1 Calculation assumes 23 years worth of payments. Note that the net 5% p.a. investment return is not guaranteed. 2.2 If member lives beyond age 88, member will have run out of money at age 88 2.3 If member dies before age 88, balance of member's "pot" can be paid out of a lump sum death benefit.

Use of a CDC scheme to improve decumulation outturns for existing DC schemes (cont'd)

Purchase of target retirement income from CDC scheme:	Annual amount of payments (in arrears)	Comment
3.1 with no guarantee period (equal instalments and no inflation proofing)	**3.1 approximately £9,050 a year (greater than the amount at 2 above and the amount at 1 above (but not guaranteed)).**	**(a) Assumes a sufficient number of members of the CDC Scheme to provide a reasonable degree of predictability on longevity outturns normally distributed (so scope for providing a retirement income for life) which is higher, using the same expense and investment return assumptions as for individual drawdown than individual drawdown.**
3.2 with a 23 year "target guarantee" period (equal instalments and no inflation proofing)	**3.2 approximately £6,780 a year (annually in arrears) being less than the amount at 3.1 above and the amount at 2 above.** (a) **The 23 year "target guarantee" means that if a member dies before his or her expected date of death at age 88, the balance of the instalments to age 88 will be paid out** (b) **But if the member lives beyond age 88, unlike individual drawdown, the member would receive a target retirement income for life**	**(b) This amount not guaranteed**

Use of a CDC scheme to improve decumulation outturns for existing DC schemes (cont'd)

It provides an extra option to move to CDC from individual DC during the "accumulation" phase for future service for active members of an existing large DC scheme to improve retirement outcomes by offering:

- a greater certainty than individual drawdown that you will not outlive your DC "pot"
- by pooling longevity, a higher level of target retirement income (using the same cost and investment return assumptions as for individual drawdown)
- scope to improve the level of target retirement income over individual drawdown through:
  - ➢ higher investment return (by not having to de-risk as quickly as for an individual DC "pot")
  - ➢ potential scope for lower costs (if the CDC scheme is sufficiently large)

V. What a CDC scheme is not?

- A CDC scheme is not a "Ponzi scheme":

➢ a "Ponzi scheme" (or pyramid selling scheme) is based on those who are in first taking out from money put in by those who come later but it is dependent on a continuing supply of new money from an ever widening base of individuals. It goes bust when the flow of sufficient new members dries up.

Note: A CDC scheme which has pre-set non-discretionary rules for adjusting the value of the target benefits and is not dependent on a flow of new individuals or a flow of new money in order to work is, by definition, not a "Ponzi scheme".

- A CDC scheme is not a with profits insurance arrangement

Note: A CDC scheme with pre-set non-discretionary rules for adjusting the value of the target benefits to be equal in value to the assets of the CDC

What a CDC scheme is not? (cont'd)

- A CDC scheme does not restrict any of the April 2015 pension freedoms. It adds to them by giving employers an additional benefit design option and members an additional option. **Entirely compatible with April 2015 pension freedoms:**

➢ **freedom to opt out:** a member who wishes to opt out of a CDC scheme as an active member could do that just as he can opt out of an existing DB scheme as an active member or an existing DC scheme as an active member. Of course, no employer contributions would go to an alternative arrangement in that situation.

➢ **freedom to take a transfer value before retirement (just like an existing DB scheme):** on becoming a deferred member, or shortly before retirement as an active member, a member of a CDC scheme could, just like an existing DB scheme, elect to take a transfer value to a DC scheme (usually a personal pension scheme) which offers all of the existing pension freedoms (including UFPLS and income drawdown).

Note: Suggest that, as for DB scheme transfers out of more than £30,000 only permissible if member has obtained independent financial advice

What a CDC scheme is not? (cont'd)

- **Potential for transfer once target retirement income is in payment:** unlike a DB pension once in payment or an annuity purchase with a member's DC pot once in payment (where the in payment benefit cannot be turned into a transfer value), it would be open to a CDC scheme benefit design to allow transfer of the capital value of the in payment target benefit **but only if that was not disadvantageous to the continuing members (which would, in general, require medical underwriting in the calculation of the transfer value to establish whether an impaired life transfer value factor would be used)**

Note: Suggest that, as for DB scheme transfers out of more than £30,000 only permissible if member has obtained independent financial advice

IV Drawing the strands together

What's different with CDC

- As benefits may be altered, there are no guarantees - avoiding these costs.
- Unlike DC they offer a target income in retirement – completing the pension offer.
- The accounting does not introduce DB-type liability volatility.
- The value of a member's interest may be reported at any and all times as a capital sum and as a retirement income
- Risk-sharing among members smooths the vagaries of market prices, fund values and pension incomes
- It also maintains equity, fairness, among members
- A member may transfer out or in at the net asset value of their interest at any time
- There should be little variation in a member's retirement income expectation

Scheme rules

- Scheme rules may be hard coded
- They may correct automatically for errors in trustee judgement on award
- They operate a risk-sharing arrangement – no intra-member subsidies and no buffers are needed
- They set a target investment return for the fund
- This investment fund target is an average over a multi-year period determined by the risk-sharing rules of the scheme – encourages long-term investment.
- The investment fund should produce higher returns than DC – it has a longer investment horizon.
- Risk management for these schemes is vastly simpler than for DB
- There is great flexibility in the detail of scheme design – customisation is possible

Any questions?