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Collective Defined Contribution (CDC) pensions

Bringing CDC to the UK

On behalf of the IFoA's CDC working party:

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19 June 2019

Agenda

- Introduction
- The UK Government's new CDC framework and the actuary's role
- CDC design considerations
- Comments / questions

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The UK’s new CDC framework and the actuary’s role

Simon Eagle

19 June 2019

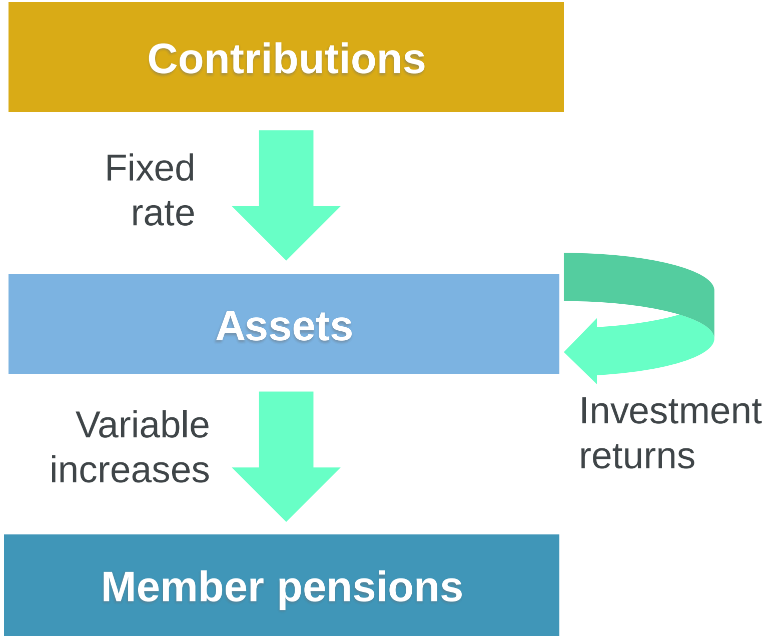
What is Collective Defined Contribution (CDC)?

In Collective Defined Contribution pension schemes savers **pool** their money into a **single fund** to **share the risks** of **investing** and **longevity**.

The fund usually pays benefits in the form of an **annual pension**. **Benefit increases (+ or -) vary** depending on the funding level.

Funding costs are fixed, while the risk sharing supports return seeking holdings so that **higher member pensions** are expected than under traditional DC annuities.

The pooling of longevity means that, unlike individual DC drawdown, **retirement income is evenly spread** over each individual's retired life.



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DWP's initial CDC framework for the UK (1)

Department for Work & Pensions

- **"Money Purchase"** – CDC pensions will be categorised in law as "money purchase" benefits
- **"Own trusts"** – initially, CDC trusts can be established only by single / associated employers
- **Future service only** – employers can provide CDC pensions for future service; past service cannot be converted to CDC, except possibly at the member's choice of a transfer in
- **Authorised by TPR** – employers will require authorisation by The Pensions Regulator before they can open a new CDC scheme
- **Contributions** – these will be paid at a fixed rate; there will be no reliance on employer covenant
- **Investment strategy**
  - set by the Trustees subject to prescription in Rules
  - maturing schemes would increase allocation to bonds / secure income

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DWP's initial CDC framework for the UK (2)

Department for Work & Pensions

- **Annual increase/decrease on benefits**
  - Each year, the same pension increase (or decrease) must be applied across the entire membership (active, deferred and pensioner)
  - To set the increase, CDC schemes will need to undertake annual actuarial valuations to determine the long-term level of increase which the assets fund
  - A 'best estimate' basis is intended for use in the valuations to determine increases, but the Government will not be legislating against the use of prudence buffers
  - The increase mechanism must be inter-generationally fair
- **Communications**
  - Annual member benefit statements must be transparent about expected increases and the risk of cuts
  - Increase levels and backing valuation assumptions will be published for external transparency
- **Transfers:** members can transfer out up until retirement; schemes could permit transfers in
- **Operational expenses** will be subject to a charge cap similar to other money purchase arrangements used for automatic enrolment

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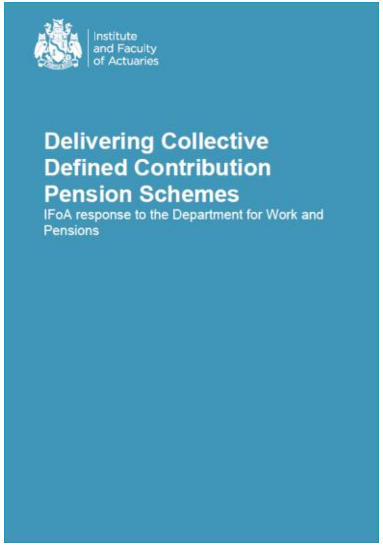
DWP's initial CDC framework for the UK – IFoA response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Delivering Collective Defined Contribution Pension Schemes
IFoA response to the Department for Work and Pensions

Summary

- CDC would be a positive development for UK pensions
- Proposals would allow some different designs, and we see this flexibility as a helpful start to the introduction of CDC
- Primary legislation should allow space for further secondary legislation to facilitate other types of CDC schemes, eg master trusts
- The role of actuaries will be critical to ensure CDC is fair and sustainable both in the design of each scheme and then in the increases awarded
- In addition The Pensions Regulator will have an important role in authorising new CDC schemes and providing ongoing supervision
- Good member communications are critical to ensure members understand the nature of the vehicle in which they are investing

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The role of actuaries in CDC

- An employer’s application to the Regulator for a new CDC scheme will be required to include actuarial calculations and modelling of pension increase expectations and variability
- Trustees of CDC schemes will be required to appoint a scheme actuary, to assist with the setting of annual increases (through valuations) and member option terms. Three potential governance models:

Assumption-setting approach	Pros	Cons
1. Trustees set assumptions having taken actuarial advice	• Trustees subject to TKU and legal requirements	• If the Trustees do not take the actuary’s advice, would that be for the right reasons?
2. Scheme actuary sets the assumptions	• Actuary is subject to professional requirements	• Could still be pressure on the actuary to avoid pension cuts
3. An independent body prescribes the assumptions	• Avoids risk of pressure biasing the assumptions	• Prescription would need enough parameters to be relevant to each scheme

- Under 1 and 2 above, a “Statement of Valuation Principles” could also be published, for transparency when one of the principles changes.
- Also, the assumption-setter could have regard to benchmarking against views of others.
- Combinations of the above are also possible, eg independent body sets ‘tramlines’

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CDC design considerations

James Franklin-Adams

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- Fundamental design
- Increase mechanisms
- Other aspects

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Design – benefit type and accumulation approach

Colour coding:

- Single employer only
- Multi-employer / master trust
- Could apply to both

- **Deferred pension**
  - Similar in form to DB pension, but with variable increases
  - Choose between: fixed accumulation rate, or vary to ensure actuarial value matches each individual's contribution
  - Salary link or CARE while in service
  - Commute pension for lump sum, or accrue lump sum
- **Immediate pension – decumulation only**
  - Similar to DC pension purchase of annuity at retirement
  - Choices by the individual, eg pension increases, dependant's pension, guarantees
  - Higher initial pension but variable level (no insurer guarantee)
- **Cash balance**
- **Drawdown with tontine arrangement** (longevity risk sharing)
  - Benefit primarily described as a pot of money rather than a pension amount
  - No sharing of investment risk, so very different to other CDC arrangements

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Design – methods for keeping variability acceptable

- CDC pension schemes should be return seeking
  - As annuities already work well for low risk
  - Higher investment risk → higher starting pension & higher variability of pension
  - Lower investment risk → lower starting pension & lower variability of pension
  - Diversification of investments
- Bonds / secure income assets for more mature liabilities?
  - To the extent needed to manage variability
- Benefit increase mechanism:
  - Longer vs shorter time between adjustments to members' benefits
  - Risk 'buffer' reserves from prudent assumptions or probabilistic assessments

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Design – increase/cuts mechanism (1)

Why must benefit levels vary?

- Today's funding level is a function of:

Past experience	Assumptions for the future – relevant depending on design
Investment returns	Expected investment returns
Mortality	Future longevity expectations
CPI/RPI	Expected CPI/RPI

Must benefit levels vary each year?

- Possible to delay variations for single employer schemes if 100% funding level is not required at all times
- If delayed, need strict rules for when and how adjustments will be applied

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Design – increase/cuts mechanism (2)

How?

- Prescribed in rules and communicated to enable clear expectation for members
  - As mechanistic and transparent as possible
- Give short-term stability by adjusting long-term pension increases
  - Especially where the funding level includes remaining ‘headroom’ for increases
  - Or have occasional bigger adjustments to benefits – especially if nominal pension cuts are required
- Same increase / cut each year for all members?
  - One way to give intergenerational fairness
- Same increase / cut each year for all pension tranches? Either:
  - ‘Reset’ expected increases at price inflation for each year’s worth of accrual, but have to tranche increases, or
  - Have one tranche, accepting that increase expectations can materially vary from price inflation
- How much warning do members need that their benefits will be cut?
  - Delaying cuts can mean bigger cuts are needed due to overpayments in the meantime

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Other aspects

Contributions

- For CDC to be DC, contributions are fixed over the long term – all variation is to benefit levels
- Designs with some variation of contributions are instead “Defined Ambition”

End game

- It is important to have a plan in place for how to close a CDC pension scheme
- Wind up needed if the scheme becomes too small to be efficient
- Transfer to CDC / DC?

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The IFoA working party's views

- Different CDC scheme designs will be suited to different organisations / workforces
- All designs should however:
  - Be demonstrably fair in how benefits are determined (in all circumstances)
  - Aim to outperform insured annuities while having acceptable levels of variability of benefits
  - Be capable of being explained to the membership

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Questions

Comments

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