How to do (and how not to do) Collective Defined Contribution Pension Schemes

Derek Benstead FIA

Some terminology

- Defined Contribution
  - The contribution going in to the pension scheme is defined
  - The benefit coming out of the pension scheme is not defined

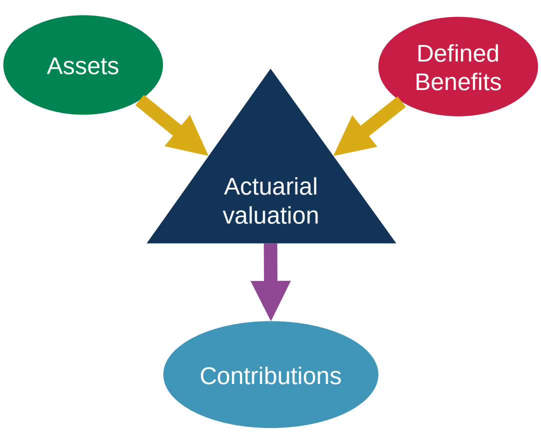
- Money Purchase
  - Every member has their own investment account to receive the defined contribution
  - The investment account is spent on retirement benefits
    - Cash sum
    - Draw down
    - Annuity

Collective Defined Contribution

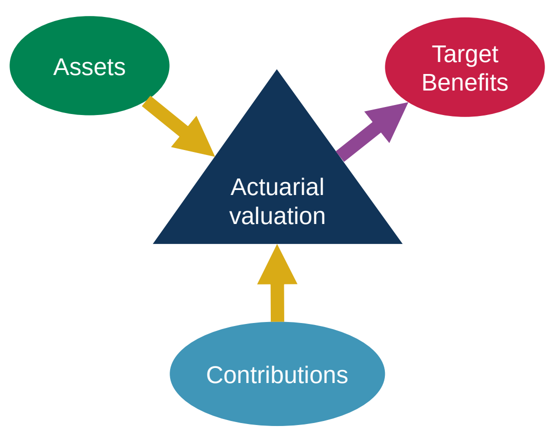
- Defined Contribution
  - The contribution going in to the pension scheme is defined
  - The benefit coming out of the pension scheme is not defined

- But there aren’t any Money Purchase accounts
  - The contributions are pooled together in the scheme

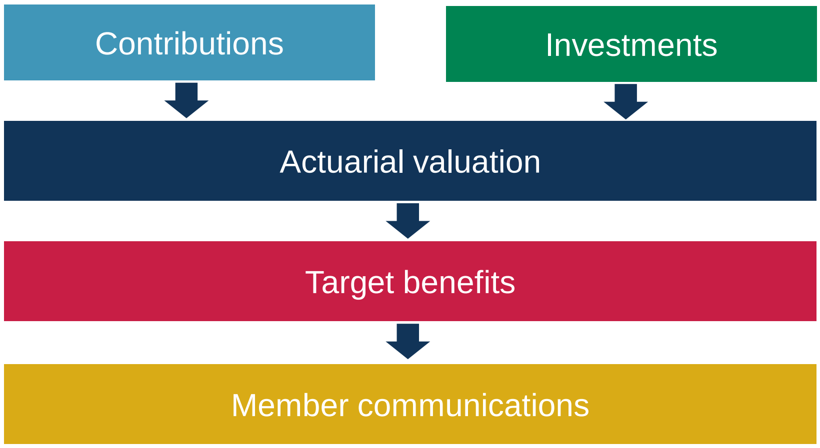
DB valuation



CDC valuation



Management process



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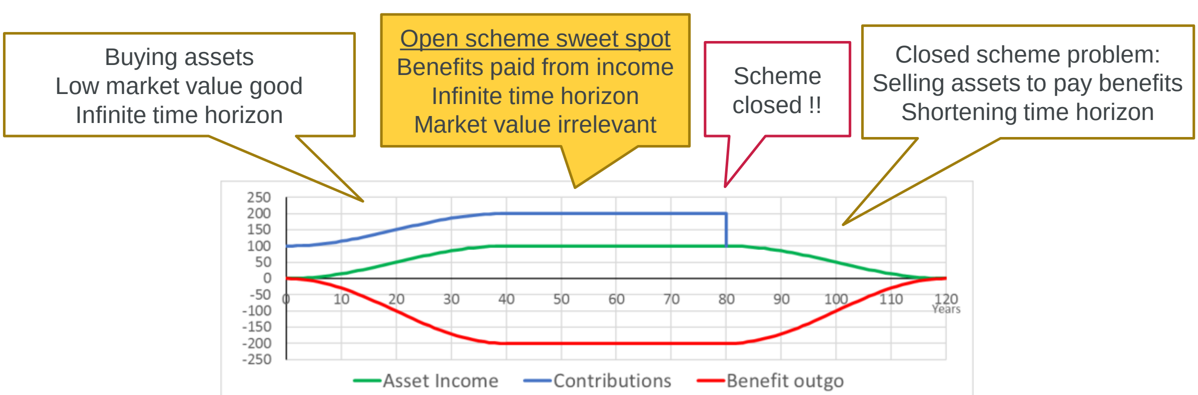
The life cycle of a collective* scheme



* *Whether DB or CDC*

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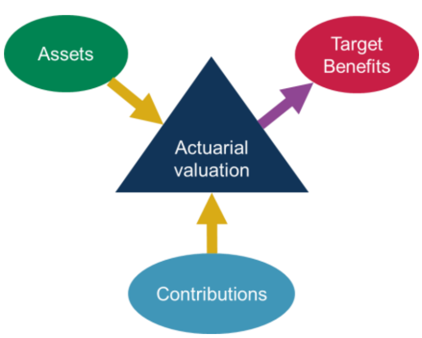
Investments

- Unconstrained – invest for a good return wherever it may be found

- Not compelled to invest in growth
- Not necessarily anticipating average growth returns

Actuarial valuation



- Best estimate basis for inter-generational fairness
- Discount rate for valuing target benefits
  = **Internal rate of return** on investments
- Matches the outgo on target benefits to income from assets and contributions

Member communications

- Best estimate target benefits

- Common concern that members should not be disappointed
- Could also communicate:
  - Smaller benefit with 75% probability of delivery
  - Even smaller benefit with 90% probability of delivery

Definitions of fairness

The same benefit for everyone

The same contribution for everyone

With or without employer sponsorship?

- "Open access" to general public
- Member's contribution buys target benefit of equal value

- Single employer sponsorship
- Exact value for members' contributions not necessary
  - Same target benefit for all members regardless of age or gender

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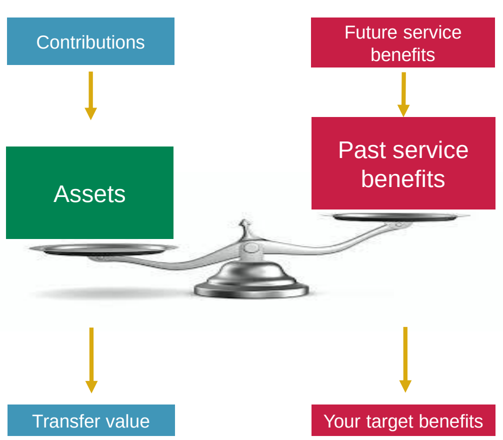
Open access CDC



- Open access to general public, not necessarily any employer contribution
- Each valuation decides an annual rate of increase which balances assets with the value of benefits
- Contribution converted to target benefit
  - according to age of member and daily market conditions
  - on fair terms relative to existing target benefits
- Sum of transfer values = assets

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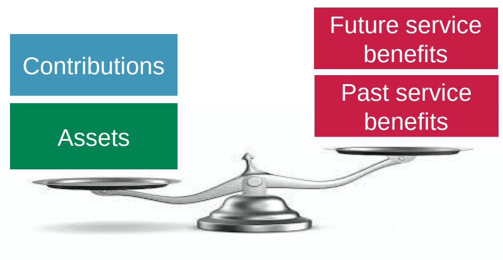
Employer sponsored CDC



- Defined contributions from employee and employer
- Career average target benefit
- Each valuation decides an annual rate of increase which balances assets and contributions with the value of benefits
  - Aggregate method
- Sometimes the accrual rate might need to change
- Rarely pensions might need to be cut

Multi-employer CDC

1. Employers can pay contributions to an “open access” CDC scheme
2. Multiple employers in a master trust can have ring fenced sections
   - each run as a single employer CDC scheme
3. Multiple employers can share in a common target benefit pool with a common contribution rate

Employer sponsored CDC

- Who might be interested? An employer with:
  - a closed to new entrants DB scheme, containing long serving employees it doesn't want to upset
  - An open DC scheme, receiving lower contributions than the DB scheme
- Unify the work force in an open CDC scheme:
  - The target benefit might be similar to the DB scheme
  - The employer has defined contributions for everyone
  - DC employees can expect a better benefit in CDC
- Royal Mail, for example

Why?

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The life cycle of money purchase

- While contributing:
  - Investment time horizon limited by retirement date
  - Want assets to be cheap
- Big risk at retirement:
  - From sale and reinvestment of assets into an annuity
  - Want non-bonds to be expensive and bonds to be cheap
- Big risks of draw down in retirement
- Money purchase is always either accumulating or decumulating, there is no open collective scheme sweet spot

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How not to do CDC

Smoothing ?

- Smoothing: under-spending on benefits in “good times”
  over-spending on benefits in “bad times”

- I don’t advocate smoothing
- I do advocate balanced best estimate budget

Corridors ?

- For a small change in funding of target benefits, don't bother changing target benefits
- But still have to react to bigger changes
- Anchoring in a historic target is a bad idea
- Better behaviourally to keep making small changes

Protect the pensioners ?

- Some suggest protecting the pensioners from the worst of the volatility of outcomes
- All in it together
- The older naturally have better protection by virtue of their age: less time for a change in the annual increase rate to have cumulative effect
- No need to further protect pensioners

Investing to raise the probability of delivery of target benefit ?

- The actuarial valuation has already matched the target benefits to the expected income
- No need to go back to the investment strategy to match the investment strategy to the target benefits
- The target benefit is not a defined benefit

Prudent target benefit plan?

- E.g. Calibrate the actuarial assumptions to have:
  - 75% probability of delivery of target benefits with annual increases
  - 90% probability of delivery of target benefits without annual increases

- Do: Under-report the target in the communications
- Don't: Under-pay the members

CDC myths

CDC doesn't fit with "freedom and choice"

- It's another choice !
- Option to transfer out
- Do offer the traditional choices for pension or cash

CDC needs scale

- If 1,000 different investments form a diversified asset portfolio

  then 1,000 members form a diversified target benefit portfolio

- A 1,000 active scheme could grow to £150m - £200m assets and be administered for 0.1% pa of the assets

CDC is inter-generationally unfair

- Not introducing CDC leaves very large unfairnesses in place:
  - The public sector DB / private sector money purchase pension divide
  - Previous generations of private sector employees in closed collective DB / Current and future generations in open money purchase DC
  - Different generations of money purchase retirements can have hugely different retirement income outcomes
- Widespread adoption of CDC can reduce all these unfairnesses

It’s essential to have entrants

- It’s preferable to have new entrants

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Will CDC happen?

- Work and Pensions Committee CDC inquiry
- Royal Mail, Communication Workers Union, First Actuarial, WTW are in talks with DWP
- Royal Mail willing to sponsor the development of regulations

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CDC Summary

- Employer sponsored CDC could look like DB (but explain it's not !)
  - The benefits are targets, not guarantees
  - Strong investment advantages to an open, collective scheme
  - Unify work force in one scheme, DC for the employer
  - Bigger benefits on average for the members, less volatile than money purchase
- Or in DB world, offer a lower defined benefit plus material discretionary benefit, for not-quite-CDC
- Open access CDC looks a bit more like money purchase
  - Each contribution buys a target benefit as we go along, rather than at retirement