What topics are we going to cover today?

- Enabling good DC member outcomes
- The End
  - Retirement and the new flexibility
- The Middle
  - Investment Governance Group’s Principles
  - Investments to suit the members
- A New Beginning
  - Auto-enrolment
- Other DC changes
The regulatory challenge

- DC assets are expected to overtake DB assets within the next 5 years
- Of the FTSE 100, 89% offer DC schemes to new joiners
- Increased focus on all areas of DC schemes from tPR, DWP and industry bodies.

“I welcome the additional attention the Regulator is bringing to the regulation of defined contribution pension schemes”
Steve Webb – Minister for Pensions
January 2011

Enabling Good DC Member Outcomes

- The Pensions Regulator published its initial response to its discussion paper about Enabling Good DC Member Outcomes.
  - Detailed conclusions and further analysis to be published in autumn 2011.
The End

Retirement

General principles

<table>
<thead>
<tr>
<th>We believe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poor decisions at retirement could have a significant impact on members (and dependants) future income</td>
</tr>
<tr>
<td>Trustees and employers can add real value - help boost the value of a member's retirement income</td>
</tr>
<tr>
<td>It is ‘best practice’ for schemes to develop (and keep under review) a robust member support framework – help pension scheme members to be able to make an informed decision at retirement</td>
</tr>
<tr>
<td>Providing access to a specialist annuity broking service is an integral part of a ‘best practice’ pre-retirement support framework</td>
</tr>
</tbody>
</table>

“We all think that when you reach a certain date, your pensions all click in and it all happens automatically. It was only when I approached that date that I realised there were lots of options.”

Source: Department of Work and Pensions (2008), Research Report No 515

“It would have been better to receive it earlier, to give me time to decide: ‘when I am 65, this is what I want to do’. I think they should give it to you about two years before”
Retirement Income Options
UK DC Pension Schemes – Post 5 April 2011

As the market grows, complexity will increase

UK Annuity Market - Chart for level payment

The above chart has been generated using the following annuity basis: purchase price £50,000, level in payment, male annuitant aged 65, 5 year guarantee, single life, payable monthly in advance, standard commission terms

Source: Towers Watson, September 2011

No single provider is ever the most competitive across all annuity formats
Potential pensions mis-selling claims

- Claims management firms are now targeting pensioners who may not have purchased the most appropriate annuity due to lack of advice/information.
- Brunel Franklin has been piloting around 100 cases and will then take its findings to the Financial Ombudsman Service (FOS).
- www.missoldannuity.co.uk identifies ways that annuities may have been missold, including:
  - If you have a condition which could shorten your life expectancy but you weren’t asked about it
  - If it wasn’t clearly communicated that in the event of your death your partner wouldn’t receive your pension annuity unless a joint policy was purchased
- Pensioners can receive around 20% increase in their pensions due to shopping around. Enhanced annuities could lead to pensions of around 30-40% more than this.

The Trustees should ensure that their retirement communications are robust and clear, and can stand up to decades of scrutiny.

Which factors influence how much income the member will receive?

- The size of the member’s DC account at retirement
- Their age at retirement and their spouses age (if providing a spouse’s pension)
- Their gender - until late 2012
- The annuity features selected by the member
- Their health and whether they smoke
- Their home postcode
- The annuity set-up basis e.g. is commission being taken?
- All of these (and more) determine the ‘annuity rate’, i.e. the rate at which the insurance company converts the value of the member’s DC account into an income stream

It is estimated that 40%-50% of members at retirement could qualify for an enhanced/impaired life annuity
## Member options

<table>
<thead>
<tr>
<th>Option</th>
<th>Annuity basis</th>
<th>Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Single life, level in payment, 5 year guarantee</td>
<td>£3,060 pa</td>
</tr>
<tr>
<td>2</td>
<td>Single life, RPI escalation, 5 year guarantee</td>
<td>£1,896 pa</td>
</tr>
<tr>
<td>3</td>
<td>Joint life, level in payment, 5 year guarantee</td>
<td>£2,820 pa</td>
</tr>
<tr>
<td>4</td>
<td>Joint life, RPI escalation, 5 year guarantee</td>
<td>£1,584 pa</td>
</tr>
</tbody>
</table>

The above table has been generated using the following annuity features: purchase price £50,000, male annuitant aged 65, spouse aged 62.

Source: FSA comparative tables, September 2011

---

## Level or increasing?

- Annual pension available with a purchase price of £50,000
- Male aged 65 at retirement
- Single life pension
- 5 year guarantee
- Annuity rates: FSA Comparative Tables – September 2011
- RPI assumed to be 5%
New annuity flexibility rules for DC arrangements

• Unlimited funds can be withdrawn if member has sufficient ‘income’ to meet Minimum Income Requirement (MIR) - £20,000 pa
  – Scheme pensions and lifetime annuities
  – pensions from certain overseas pension schemes
  – State pensions (basic and additional) in payment
  – No adjustment for age, couples or indexation
• Treasury will review MIR level at least every 5 years

A radical reshaping of retirement options

Annuity reform – what might it look like for DC members?

• Ms Smith:
  – Aged 65 in May 2011
  – No DB pension entitlements
  – DC assets from previous employer
• After maximum tax-free cash, and State pension, she can buy a DC annuity of £21,000 a year i.e. £1,000 more than the MIR. So she chooses to:
  – Buy an annuity to meet MIR (@25:1)
  – Take remaining c£25,000 as lump sum
• But if Ms Smith is a smoker, she can get better annuity terms (say £23,000pa):
  – Buy a smokers annuity to meet MIR (@22:1)
  – Take remaining c£66,000 DC as lump sum

Shopping around for enhanced annuities has material cash benefits
Likely to impact on retirement processes and annuity rates

* As a smoker, she could have bought more than £1,000 a year over the MIR if she had requested an enhanced annuity.
Annuity reform – what else might it do to DC?

- 2010 approach to lifestyle
  - Typically aiming to match liabilities:
    - 75% fixed interest bonds, 25% cash
    - To match 75% level annuity, 25% cash

- 2011+ approach to lifestyle?
  - ‘Excess’ fund is different for each member
  - ‘MIR’/‘excess’ ‘boundary’ different for each member
  - Bonds still make sense for annuities – up to MIR?
  - 25% of whole fund in Cash for tax-free lump sum

Perhaps a different investment approach for every member?

Do members treat the MIR as a target?

The Middle

Investment Governance Group’s Principles
Investment Governance Group (IGG)

- Joint Government-industry group sponsored by HMRC and DWP
  - Encourage industry ownership of DC
  - Build on and promote Myners’ Principles for DC
- Aimed at all stakeholders
  - Trustees
  - Employers
  - Advisers
  - Pensions providers
  - Members
- Not a legal requirement
  - Viewed as Best Practice
  - But adherence should result in better outcomes for members and more engaged employees

IGG - Six principles

1. Clear roles and responsibilities for investment decision-making and governance
2. Effective decision-making
3. Appropriate investment options
4. Appropriate default strategy
5. Effective performance assessment
6. Clear and relevant communication with members
So what does this mean in practice?

Fiduciaries need to …

1. Consider the risk tolerance distribution of the membership
2. Understand the ‘outcome’ needs and objectives of the membership
3. Develop an appropriate investment choice/default framework
4. Derive a set of strategic objectives for the default

The Middle

Investments to suit members
Assessment of membership risk tolerance and investment decision-making

- A member’s tolerance to risk is made up of two factors:
  - Attitude to risk
  - Ability to take risk
- We believe it can be determined by a combination of four criteria:
  - Net wealth (e.g. assets, liabilities, State benefits, etc)
  - Human capital (e.g. education, prospects, job security, etc)
  - Life influences (e.g. health, gender, age, dependents, lifestyle, etc)
  - Governance (e.g. time, interest, expertise, etc)
- By using basic member demographic data, we believe it is possible to begin to understand a scheme membership risk tolerance distribution.
- This can be refined through an understanding and discussion around the membership’s employment environment (e.g. industry sector, corporate culture, etc).

1. Consider risk tolerance distribution of membership

![Risk tolerance distribution chart]

- High risk tolerance
- Low risk tolerance

<table>
<thead>
<tr>
<th>Risk Tolerance</th>
<th>Age Class</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;25</td>
<td>0.7</td>
</tr>
<tr>
<td>25-29</td>
<td>8.9</td>
</tr>
<tr>
<td>30-34</td>
<td>1.1</td>
</tr>
<tr>
<td>35-39</td>
<td>0.2</td>
</tr>
<tr>
<td>40-44</td>
<td>11.8</td>
</tr>
<tr>
<td>45-49</td>
<td>7.0</td>
</tr>
<tr>
<td>50-54</td>
<td>2.0</td>
</tr>
<tr>
<td>55+</td>
<td>7.8</td>
</tr>
<tr>
<td></td>
<td>8.9</td>
</tr>
<tr>
<td></td>
<td>2.4</td>
</tr>
<tr>
<td></td>
<td>2.7</td>
</tr>
<tr>
<td></td>
<td>2.0</td>
</tr>
<tr>
<td></td>
<td>1.3</td>
</tr>
<tr>
<td></td>
<td>0.7</td>
</tr>
<tr>
<td></td>
<td>0.1</td>
</tr>
<tr>
<td></td>
<td>2.5</td>
</tr>
<tr>
<td></td>
<td>1.9</td>
</tr>
<tr>
<td></td>
<td>1.1</td>
</tr>
</tbody>
</table>

21/11/2011
2. Understand the ‘outcome’ needs objectives of membership

- The table below provides an example comparison of each member profile’s projected replacement ratio (RR) with their desired replacement ratio.

<table>
<thead>
<tr>
<th>Example member</th>
<th>Desired RR¹</th>
<th>Projected State pension</th>
<th>RR required from Plan²</th>
<th>Projected RR from Plan</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Low earner, low progress</td>
<td>67%</td>
<td>56%</td>
<td>11%</td>
<td>26%</td>
<td>+15%</td>
</tr>
<tr>
<td>2 Low earner, modest progress</td>
<td>67%</td>
<td>46%</td>
<td>21%</td>
<td>24%</td>
<td>+3%</td>
</tr>
<tr>
<td>3 Mid earner, modest progress</td>
<td>61%</td>
<td>18%</td>
<td>43%</td>
<td>18%</td>
<td>-25%</td>
</tr>
<tr>
<td>4 High earner, high progress</td>
<td>59%</td>
<td>7%</td>
<td>52%</td>
<td>10%</td>
<td>-42%</td>
</tr>
</tbody>
</table>

¹ Desired replacement ratios are taken from our general population research – “The future of UK retirement savings” (2009)
² Obtained by deducting projected State Pension replacement ratio from the desired replacement ratio

**Member 1 and 2 - modest return, low risk**
**Member 3 and 4 - higher return, modest risk**

3. Develop appropriate choice/default framework

- Self-selectors
  - Make informed decisions

- Guided-selectors
  - Make simple, guided decisions

- True-defaulters
  - Don't make decisions
3. Develop appropriate choice/default framework

A New Beginning

Auto-Enrolment
What is Automatic enrolment (AE)?

The basic position

- Employers must auto-enrol the majority of employees into pension scheme which provides minimum levels of contributions
- Other employees have the right to opt-in

• Can be
  - Existing or new arrangement
  - Occupational or contract-based scheme
  - National Employment Savings Trust (NEST)

• Different schemes (or sections of the same scheme) can be used for different groups

• A company’s staging date is based on the size of their PAYE scheme, including any pensioners paid via the company’s payroll.
  - Staging dates range from 1 October 2012 to 1 September 2016
  - Based on tPR’s information as at 1 April 2012

Auto-enrolment and 2012 – where are we?

• Pensions Bill 2011
  - Has now received Royal Assent

• DWP Consultation on regulations (closed 11 October)
  - Changes recommended by Making Automatic Enrolment Work report
  - DC Certification

• The Pensions Regulator
  - Issued detailed guidance notes
  - Second versions already

• Know most of the basics
  - Implementation / practical considerations can now be looked at
Other DC Changes

There are more changes coming…….

Legislative changes

- Contracting out ceasing from April 2012 for DC schemes
- Review of short service refunds for Trust based schemes
- Gender-specific annuities not allowed from December 2012
- Review of State Pensions, including State Pension Age
- Pensions Bill 2011 amended the definition of ‘money purchase benefits’
- DWP’s guidance for default options in DC schemes

What will be next?
Questions or comments?

Expressions of individual views by members of the Actuarial Profession and its staff are encouraged. The views expressed in this presentation are those of the presenter.

Eligibility Criteria

- Different groups of employees are entitled to different levels of pension provision:

<table>
<thead>
<tr>
<th>Earnings</th>
<th>16-21</th>
<th>22-SPA</th>
<th>SPA-74</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total earnings under lower earnings threshold (£5,035)</td>
<td>Entitled worker</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total earnings between £5,035 and £7,475</td>
<td>Non-eligible jobholder</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total earnings over earnings trigger for auto-enrolment (£7,475)</td>
<td>Non-eligible jobholder</td>
<td>Eligible jobholder</td>
<td>Non-eligible jobholder</td>
</tr>
</tbody>
</table>
What do employers need to pay?

- Minimum pension contributions:

<table>
<thead>
<tr>
<th>Tier</th>
<th>Pay definition</th>
<th>Minimum total employer rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td>&quot;Pensionable earnings&quot;</td>
<td>9% / 4%</td>
</tr>
<tr>
<td>Tier 2</td>
<td>As Tier 1, but &quot;pensionable earnings&quot; must be at least 85% of total gross pay</td>
<td>8% / 3%</td>
</tr>
<tr>
<td>Tier 3</td>
<td>Gross pay</td>
<td>7% / 3%</td>
</tr>
</tbody>
</table>

Individual Minimum Contributions

- "Qualifying Earnings"
- Band of gross earnings 8% / (3% ‘er)

Qualifying DC schemes

- Scheme wide certification

Individual minimum contributions

Conditions for qualifying DB schemes

- Not just for auto-enrolment but also existing employees

Contracted out (for now!)

- ‘Test scheme’ standard
  - 1/120ths of final salary (3 year average) from age 65

Revaluation of at least 2.5% LPI

CARE

Accrual at least 16% of qualifying earnings or at least 8% accrual + 3.5% pa revaluation

Cash balance
How would it work in practice?

Up to three months

Issue postponement info

Assessment date: Employee joins - 1 March

Auto-enrolment date

New Assessment date – 1 June

Pension membership starts & contributions payable

Up to one month

Active membership achieved

Provide information to the pension scheme & to the employee

Inform employee they are an active member and opt-out period has started – 1 July

One month

1 August

Opt-out period ends

National Employment Savings Trust (NEST)

• Contributions
  – Minimum as for Qualifying Scheme
  – Maximum of £4,200pa (2011/2012)

• Member benefits
  – Pension plus cash (as for other schemes)
  – Limited refunds (only for opt-outs in first month)
  – Generally no transfers in or out

• Charges
  – Annual Management Charge: 0.3% of fund value
  – Initial Contribution Charge: 1.8% of all contributions (for 20 years?)

• Investment
  – Default, relatively cautious – especially for those aged under 30
  – Target date funds with active management switches
  – Small range of self-select funds