Collective Defined Contribution Schemes
What’s next?

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### Agenda

<table>
<thead>
<tr>
<th>Topic</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Why are people talking about CDC in the UK now?</td>
<td></td>
</tr>
<tr>
<td>What is CDC?</td>
<td></td>
</tr>
<tr>
<td>The design of the UK’s first CDC scheme</td>
<td></td>
</tr>
<tr>
<td>The DWP’s initial regime for UK CDC</td>
<td></td>
</tr>
<tr>
<td>The future of CDC in the UK</td>
<td></td>
</tr>
<tr>
<td>Q&amp;A</td>
<td></td>
</tr>
</tbody>
</table>
Why are people talking about CDC in the UK now?
Why are people talking about CDC in the UK now?

Following Royal Mail and CWU’s joint lobbying for CDC, the UK Government intends to enable it – background as follows:

| Early 2017 | Royal Mail DB pension accrual becomes materially unaffordable  
|           | Proposes to its employees to introduce individual DC for all employees |
| Mid 2017  | CWU rejects proposal and members vote for strike action |
| End 2017  | Via mediation, Royal Mail and CWU  
|           | investigate risk sharing and identify that a CDC design would best meet their objectives, and  
|           | agree to jointly lobby for CDC to be enabled in the UK |
| 2018 H1   | UK Parliament’s Work and Pensions Committee conducts an inquiry into CDC, and recommends that the Government swiftly enables CDC |
| 2018 Q4 - 2019 Q1 | DWP runs formal consultation on CDC and concludes that it will enable employers to set up CDC schemes for their own employees for new accruals “as soon as Parliamentary time allows” |
| What’s next... | CDC is expected to feature in a 2019 Pensions Bill. |
What is CDC?
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 pays **annual pension income**.

**Pension increases 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.
## Concept

<table>
<thead>
<tr>
<th>Risk to employer</th>
<th>Traditional DB pension</th>
<th>Collective DC</th>
<th>Individual DC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employer contributions</td>
<td>Variable</td>
<td>Fixed</td>
<td>Fixed</td>
</tr>
<tr>
<td>Level of target returns</td>
<td>Typically low</td>
<td>High</td>
<td>Typically <strong>high, then lower</strong> (depending on chosen retirement option)</td>
</tr>
<tr>
<td>Benefits</td>
<td>Fixed, subject to employer guarantee</td>
<td><strong>Variable</strong>, risk shared collectively</td>
<td><strong>Variable</strong>, or from retirement <strong>fixed</strong> via annuity purchase</td>
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The design of the UK’s first CDC scheme
**Initial version of UK CDC**  
Royal Mail example

<table>
<thead>
<tr>
<th>Royal Mail published design of single-employer CDC</th>
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</thead>
<tbody>
<tr>
<td>Contributions</td>
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</table>
| Benefits | • Member’s pension 1/80th of pay (career average)  
• normally payable from age 67  
• spouse’s pension of 50% of member’s |
| Increases | • Increases vary based on best estimate funding position  
• assumptions set by actuary with reference to benchmarking  
• initial expected average increase of CPI + 1% pa  
• pensions can be reduced if asset performance is poor (severe reductions applied over a period of up to 3 years) |

**Investment strategy**  
Specified in Rules; return-seeking assets initially, switch to low-risk assets over in-retirement period

![Diagram showing investment strategy](chart.png)

Note: Royal Mail also plan to open a risk-sharing cash balance scheme to provide a lump sum alongside the CDC pension.
How would pension increases be determined? (1)

Objectives for increase mechanism design

• Increases should reflect what the assets can fund
• Award of increases must be fair
• Ongoing award of increases must be robust to future population changes
• Risk of benefit cuts must be acceptably low

Key principle

• The design must not lead to material bias between generations
• But, as with any investment in growth assets, there will be ‘luck’ – ie there will be variations in increases between generations due to changes in the global economy
How would pension increases be determined? (2)

Annual actuarial valuation:

Asset value  

Pension liability value

ˈheadroomˈ funding for pension increases
• absorbs most asset / liability valuation movements

“Parity” - amount of funding required for existing level of pensions with no further increases – initially typically half of assets.
• If assets fall below parity, pensions must be reduced over a short timeframe to restore parity.

Based on “Sustainable” level of increases funded by the assets – so funding level is rebalanced to 100% at each annual valuation
How would pension increases be determined? (3)

Worked example of adjustment to increases – asset value loss of 20% in one year:

20% reduction in asset value is matched by a 20% reduction in liability value, by reducing the long-term planned level of increases (and applying a lower increase in the current year)

Simplified example:
- Before asset loss, planned increases were 3% pa
- Average term to payment of pensions of 20 years
- Asset loss of 20% would be made good by a 1% pa reduction in increases over the remaining life of the plan
- Plan is now fully funded with planned increases of 2% pa
- The ‘headroom’ for future increases has been reduced due to the asset loss

In this example, the reduction in asset values reduces future pension increases, but does not require a pension cut

- The next year, there is a 10% recovery in asset prices
- Plan is then funded for 2.5% pa increases
How would pension increases be expected to behave under Royal Mail’s design?

Intergenerationally fair

Future pension increase expectations do not vary by generation, even if the active population shrinks or the plan closes to accrual.

1932 / 1933

Backtesting shows that these are the only years in which this CDC design would have applied a reduction to the nominal pension amount in the last 90 years.
The DWP’s initial regime for UK CDC
The Government intends to press ahead with legislation "as soon as Parliamentary time allows"

It intends to start by allowing single or associated employers to establish CDC designs of a similar kind to that proposed by Royal Mail and the Communication Workers Union

It intends to legislate "in a way that can quickly accommodate other models of CDC" including master trusts or other multi-employer solutions and potentially decumulation-only vehicles offering alternatives to drawdown or annuities.
Fitting CDC Schemes into the UK Pensions Landscape

**Authorised by TPR**
Authorisation by TPR required before a CDC scheme can be opened

**Money Purchase**
CDC pensions will be categorised in law as “money purchase” benefits

**Tax status**
Equivalent tax treatment to DB and DC benefits – still to be finalised.

**Automatic enrolment**
Minimum standards and alternative quality tests to be determined

**Future service only**
No changes would be allowed to existing benefits

**Freedom and choice**
Members would be able to transfer out before retirement

**No reliance on employer covenant**
So not eligible for PPF
Determination of benefit increases via scheme valuations

“We do not want to preclude or legislate against buffers in CDC schemes.”

“Any increase or decrease in benefits... should be applied across the entire membership.”

“We remain committed to the best estimate framework as the most suitable way of assessing a scheme’s funding.”

“Annual valuations will... need to be submitted to the Pensions Regulator.”
What are the consequential cross subsidies between members?

Collective pension schemes are for employers who want variations in pension levels to be evened out over time. Also, employers can choose whether to have a design in which the same initial pension level is provided to all members, regardless of age.

The resulting cross subsidies are then as follows:

1. **By age, within each year’s active population**
   - (unless accumulation rates or contribution rates are age-related)
   - The contributions for younger members have longer to generate asset returns, and so the expected cost of providing the pension to younger members is less.
   - The same is true for DB schemes with flat accrual and contribution rates and which hold return-seeking assets before retirement.

2. **Over time, across generations of members**
   - The effects of asset experience are spread over time via the increase mechanism, so that pension levels are relatively stable. This introduces cross subsidy, compared to the alternative where members hold individual DC / drawdown accounts.

3. **Longevity pooling**
   - Longer lived members will receive higher total pension payments.
   - The same is true for DB schemes and insured annuities.
## Summary of pros and cons of CDC design

<table>
<thead>
<tr>
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<th>Pros</th>
<th>Cons</th>
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<tr>
<td><strong>Financial perspective</strong></td>
<td>Design has fixed costs</td>
<td>Employees could pressure employer to top up scheme to avoid pension reductions</td>
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<td>No accounting deficit / risk under IAS19 / UK GAAP</td>
<td>Or: reputational risk if increases much lower than expected</td>
</tr>
<tr>
<td><strong>Employee benefits perspective</strong></td>
<td>Expect much higher initial pension than insured annuity from a DC pot</td>
<td>Pension in payment is not guaranteed</td>
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<td>Expected smoother initial pension amount outcomes than insured annuity</td>
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<td>Automatic pooling of longevity risk (without having to buy an annuity)</td>
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<td>Investment / pension management done on behalf of employees</td>
<td>Some employees prefer to have their own account and manage their own investments</td>
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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:

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

**Employer’s ‘own trust’ CDC**

To be enabled "as soon as Parliamentary time allows" - potentially 2020

Some other early movers could be companies in a similar position to Royal Mail:
- can no longer support defined benefit accrual
- individual DC is seen as an unsuitable or unsatisfactory benefit design for the workforce
- CDC is seen as an acceptable compromise
- employer has the resources to set up a new CDC trust / section

**Other forms of CDC – master trusts / other multi-employer / decumulation-only**

Government positive about moving “promptly” on these. Existing DC master trusts could potentially add a CDC section.

This would make CDC much more accessible for employers:
- No governance requirements for employer
- Spreading of running expenses across a number of employers
- Employer is not as closely associated with level of increases scheme is providing

**WTW polling data (around 70 organisations polled, in March 2019)**
- 1 in 8 organisations are likely to have CDC in place by 2025
- 58% thought master trusts would be more suitable for their organisation
Any questions

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