ICA 2014 CIA
WASHINGTON DC

LEARN
INTERACT
GROW

Defined Ambition – A successful synthesis between defined benefit and defined contribution

A summary of the DWP consultation paper

Reshaping workplace pensions for future generations

by

Andrew Vaughan

Chair, Defined Ambition Industry Working Group
and
Chair, International Association of Consulting Actuaries

Defined Ambition Industry Working Group

- **Set up by the Pensions Minister in the summer of 2012**
- **Industry group of volunteers included representatives from pension providers, investment managers, actuaries and pension consultants, lawyers, trade and professional bodies, the Association of MNTs and TUC**
- **A Consumer Perspective Group was also consulted including representatives from industry, Age (UK), NEST, TUC, Which? and the Financial Services Consumer Panel**
- **Initial report in November 2012 followed by the DWP consultation paper *Reshaping workplace pensions for future generations* published earlier this month**
- **Consultation closed on 19 December 2013**
- **Draft legislation may follow early in 2014**

Theme of the DA consultation paper

Launching the paper, Steve Webb, Pensions Minister, said

"I want people to have the best pensions possible, where risks are shared between employers and workers. Final salary pensions have been in long-term decline and if we do not act it could disappear altogether. We want to help the best employers offer good alternatives including new forms of salary-linked pensions."

Theme of the DA consultation paper

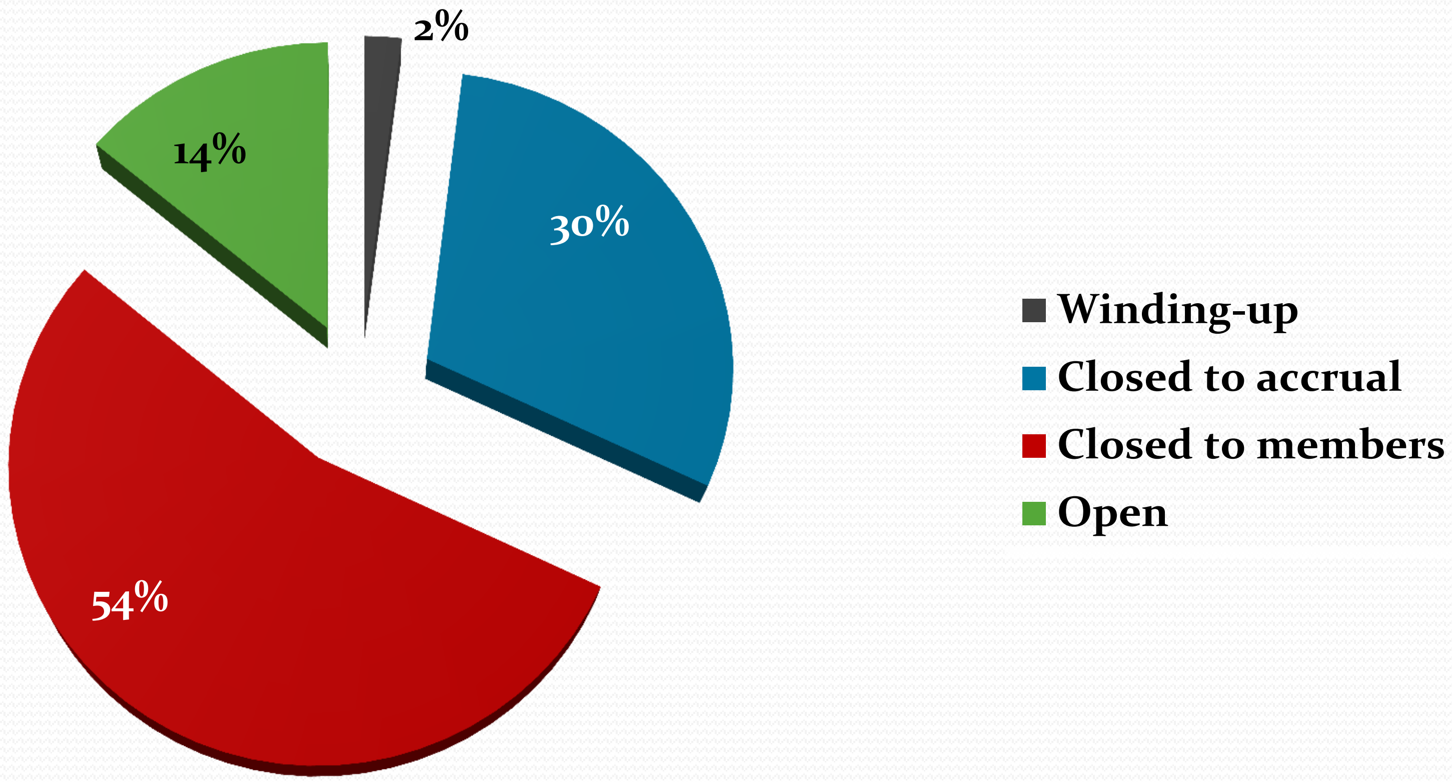
Steve Webb, Pensions Minister, continued

"We have looked at the best pension arrangements around the world and want to give British workers the chance to join such schemes. Our proposals for defined ambition pensions are designed to reinvigorate workplace pensions, providing people with more certainty about what they will get in retirement."

Background to the DWP paper

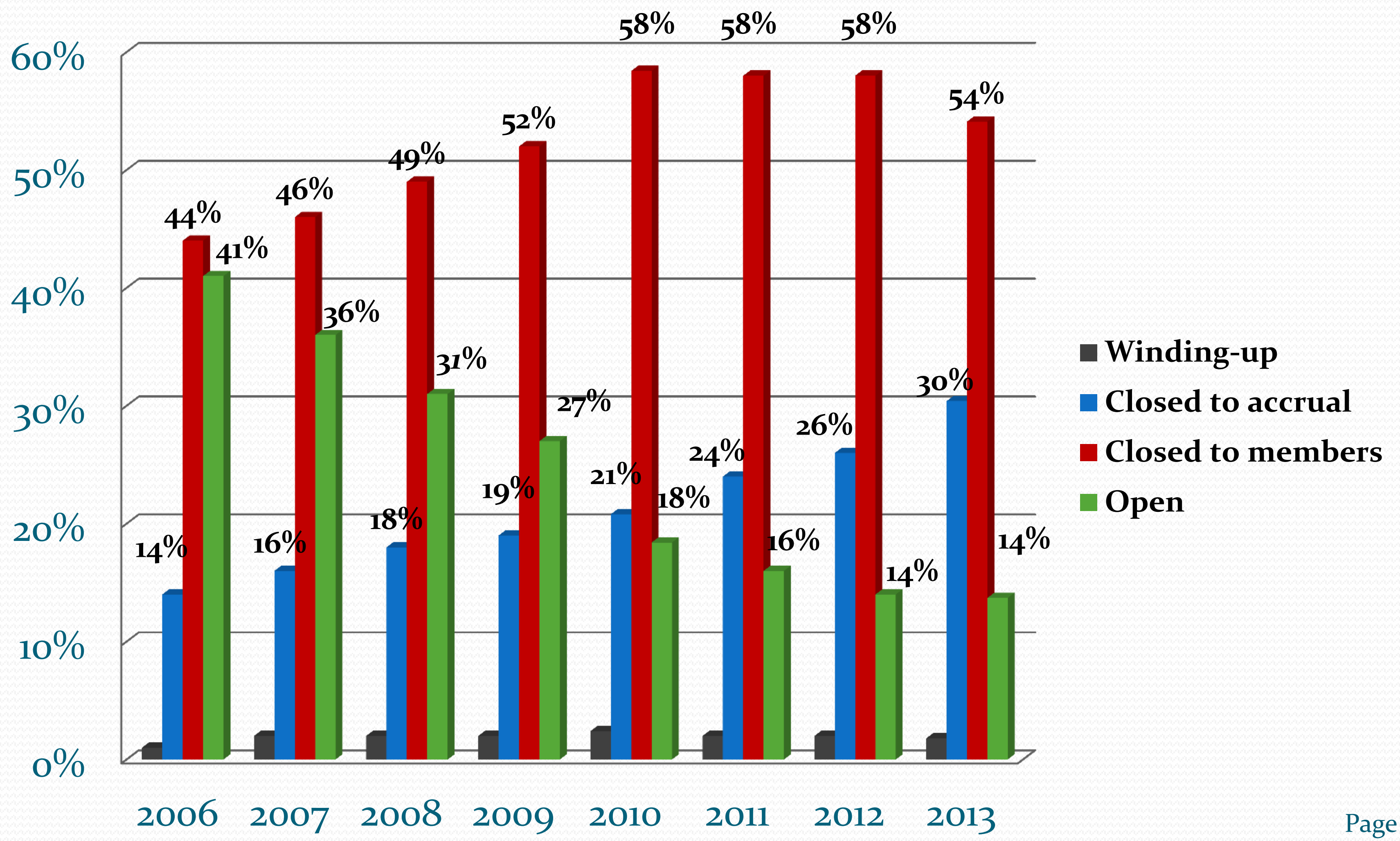
Defined Benefit Schemes – just 841 schemes now open to new members (14% of total)

Source: TPR Purple Book as at 31/3/2013

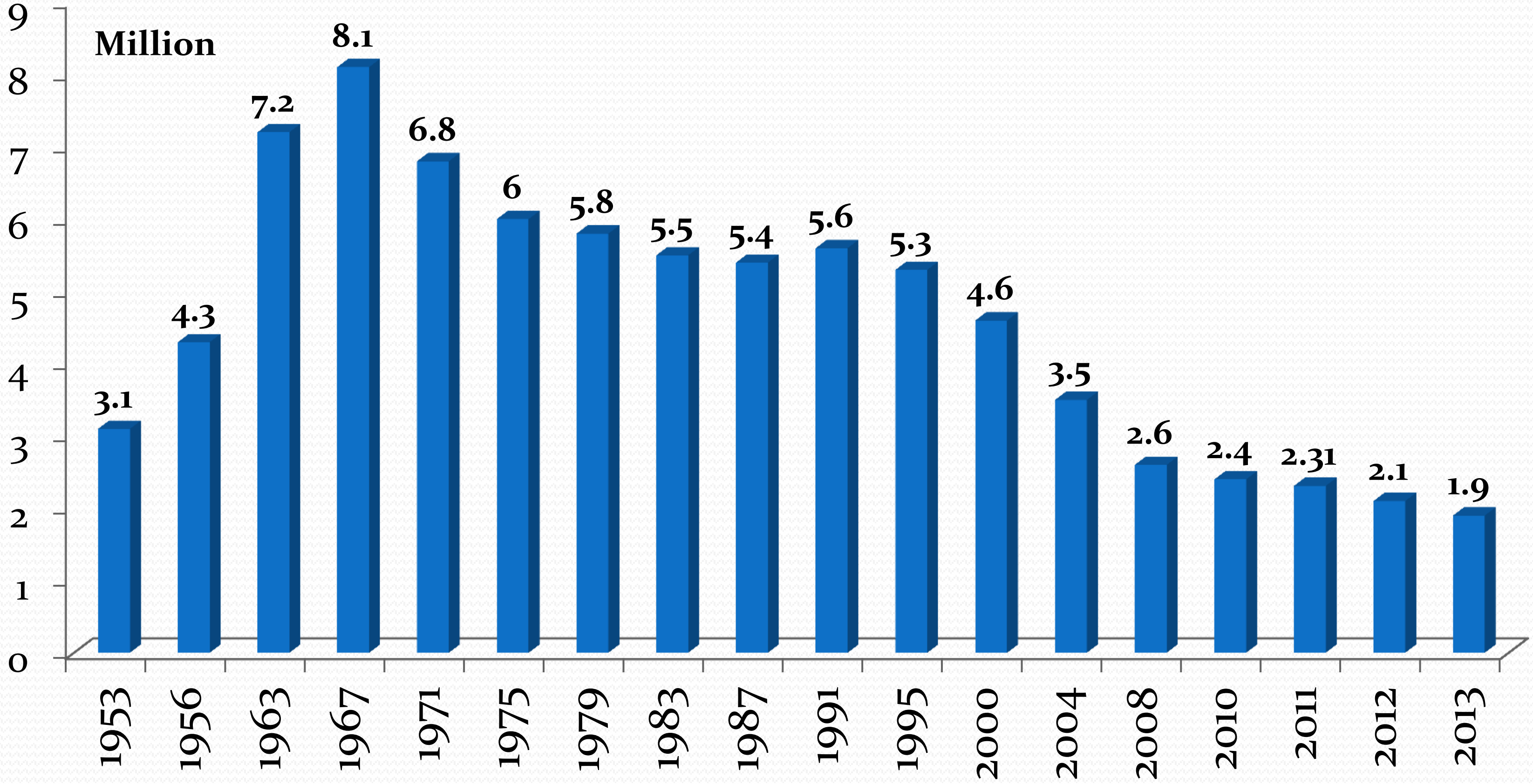


Defined Benefit Schemes – trend line of closures

Source: TPR Purple Book as at 31/3/2013



Active DB membership (private sector)



DC Pensions: problem areas

- **Pension contributions:** average DC contribution rates are 9.4% of earnings as against 19.1% into DB schemes (ONS 2013).
- **Pension income:** pension income from annuities has declined by over 60% since 1990 (not a peak year). £100,000 pension pot now typically delivers an income of c£6,000pa at age 65 (no indexation and no spouse's benefit). Average DC pension pot delivers c£2,000pa pension.
- **Volatility:** can be big differences between what a DC pot delivers as a pension from year to year because of volatility in market prices and/or interest rates.
- **Charges/Scale:** DC charges tend to be considerably higher than for DB 'collective' schemes and presently are often opaque. Many DC schemes are small and lack economies of scale.
- **Advice**: DC members increasingly need advice on investment choices, but few have access or can afford tailored guidance.

DA Paper: summary of proposals

DA Reform Agenda

Principles for development of DA pensions

Reinvigoration objective

Enable industry innovation and development of new products including those which will give people more certainty about their pensions and encourage more risk sharing.

A DA scheme should be:

- **Consumer focused** – address consumer needs (members and employers).
- **Sustainable** – affordable to the stakeholders (employers/pension providers/members) over the long term.
- **Intergenerationally fair** – not biased to pensioners, but also take on board needs of future pensioners.
- **Risk sharing** – incorporate genuine risk sharing between stakeholders.
- **Proportionately regulated** – the regulatory structure needs to be permissive to enable innovation in risk sharing, while protecting member interests.
- **Transparent** – there should be high governance standards with clarity for members about any promise made and any associated risks.

Source: Department for Work & Pensions - Public consultation - Reshaping workplace pensions for future generations – November 2013

Three possible models for flexible DB

- **Design 1: Ability to pay fluctuating benefits**
  Employers would be able to fluctuate any extra benefits they offer, such as indexation, for future accrual above a core level of DB provision.

- **Design 2: Automatic conversion to DC when member leaves employment**
  Under the "automatic conversion" proposal, an employee's DB pension would be crystallised and transferred to a nominated DC fund when they leave the firm. This would reduce the longevity risk borne by the employer running the scheme.

- **Design 3: Ability to change scheme pension age**
  The DWP is considering allowing employers to adjust the age at which members receive their pension if life expectancy rises.

Design 1: Ability to pay fluctuating benefits Consultation questions

- Views on the feasibility of this scheme design?
- Are employers likely to be interested in providing benefits in addition to a simplified flat-rate DB pension on a discretionary basis or otherwise?
- The role of scheme trustees in relation to discretionary payments? For example:
  - Should they be involved in deciding whether a discretionary payment is made at all?
  - Should they be involved in setting out how these payments are apportioned to members or should this be down to the employer?
- Should the starting point be to keep regulatory requirements around discretionary benefits to a minimum?
- How can the funding for the non-discretionary DB element be sufficiently protected while allowing for extra discretionary benefits?

Design 2: Automatic conversion to DC on leaving
Consultation questions

- Views on the feasibility of this scheme design?
- Could this scheme design be extended to permit employers to automatically transfer members out of the scheme at retirement?
- What is the most suitable way for benefits to accrue under this model? And how might this best be communicated to ensure members understand the value of their pension benefits?
- Assuming a CETV would not represent 'fair value' for the accrued rights when the member leaves or retires, how should fair value be calculated? Should the basis for calculation be different when the transfer is initiated by the employer (for example on redundancy)?
- For schemes providing a lump sum benefit, how should the cash value be calculated for members who leave before retirement?
- What forms of regulatory requirements would be needed to:
  - prevent avoidance activity?
  - ensure the scheme has access to sufficient funds to enable a transfer when a member leaves?

Design 3: Ability to change scheme pension age
Consultation questions

- Views on the feasibility of this scheme design?
- The design could lead to more schemes having proportions of accrued pension payable at different pension ages. Would this further complexity outweigh the benefits?
- What role should the scheme trustees play? Should they be involved in setting a new NPA, or should this be down to the employer and the employer's actuary?
- How should future pension ages be set?
  - For GAD to publish a standard index based on longevity assumptions?
  - Or schemes link their NPA with the State Pension age, so that when the latter changes, the scheme's pension age automatically changes in line with this?
- How would the NPA change work in multi-employer schemes?

Including past accruals
Consultation questions

- As an alternative to opening a new scheme, should an employer be able to modify the rules of an existing scheme so that it can be re-designed as a Flexible DB scheme in relation to new accruals?
- Do you agree that employers should not have the power to transfer or modify accruals built up under previous arrangements into a new arrangement, beyond what is allowed under current legislation?
- Should there be a requirement to provide independent financial advice in all cases where an employer offers to transfer a member's accrued rights from a traditional DB scheme to a new arrangement?

Four possible models to provide greater certainty for DC scheme members

Model 1 – the "money-back" guarantee

This would involve encouraging pension providers to develop products which guarantee the value of a person's pot does not fall below the nominal value of contributions made to the scheme.

However, the DWP says: "Our discussions suggest a money-back guarantee is the least favoured model because of the low number of scenarios in which the risk could occur, and because of the emphasis on the savings pot rather than the actual income that will be received. We have considered whether the Government should intervene and concluded that, in light of the significant hurdles that would need to be negotiated, we can not justify direct Government intervention in providing money-back guarantees."

Four possible models to provide greater certainty for DC scheme members

Model 2 – the capital and investment return guarantee

This would involve the creation of a guarantee which would protect the value of a person's fund once it reaches a certain size. Providers offering the guarantee would have to agree to standardised terms and conditions.

Four possible models to provide greater certainty for DC scheme members

Model 3 – retirement income insurance

Under this option, a fiduciary would use a portion of the member's fund from a certain age each year to buy an income insurance product on the member's behalf.

Four possible models to provide greater certainty for DC scheme members

Model 4 - the pension income builder

Here, a proportion of a member's contributions would be used to purchase a deferred nominal annuity, payable from their pension age.

The remainder of the person's contributions would be invested collectively in risk-seeking assets along with other members' contributions.

Overall assessment of DC models

Consultation questions

- Would more certainty than traditional DC be welcomed by members, and help generate consumer confidence and persistency in saving?
- If these products mean there is no funding liability, only the requirement to contribute as for a traditional DC scheme, would employers be interested in offering these products to employees?
- In relation to medium- and long-term guarantees outlined in models 2 and 3, would removal of the legislative barriers be sufficient to stimulate the development of market-based solutions?
- As insufficient scale has been identified as a barrier to providing affordable guarantees, is there a role for the Government in facilitating different types of pension vehicles that would create greater scale for this purpose?
- Do existing protection arrangements for DC products provide sufficient protection for members in the event of provider insolvency?
- Would any protection mechanism need to apply in order to provide extra security for members and reassurance for the employer that it would not be liable in the event of any deficits arising?
- On model 4 – pensions income builder – how do you regard this model in which members are in effect deploying their own capital to guarantee their own entitlements?

Collective Defined Contribution (CDC)

Under this proposal a member's contributions would be pooled and their pension paid from the collective fund, rather than buying a retirement income product from an insurer.

The employer would pay a fixed rate of contributions and would not need to take on any liability for the scheme.

The DWP says it will explore changes to the legal framework in order to allow UK employers to offer CDC schemes. Scale would be needed.

Collective Defined Contribution Consultation questions

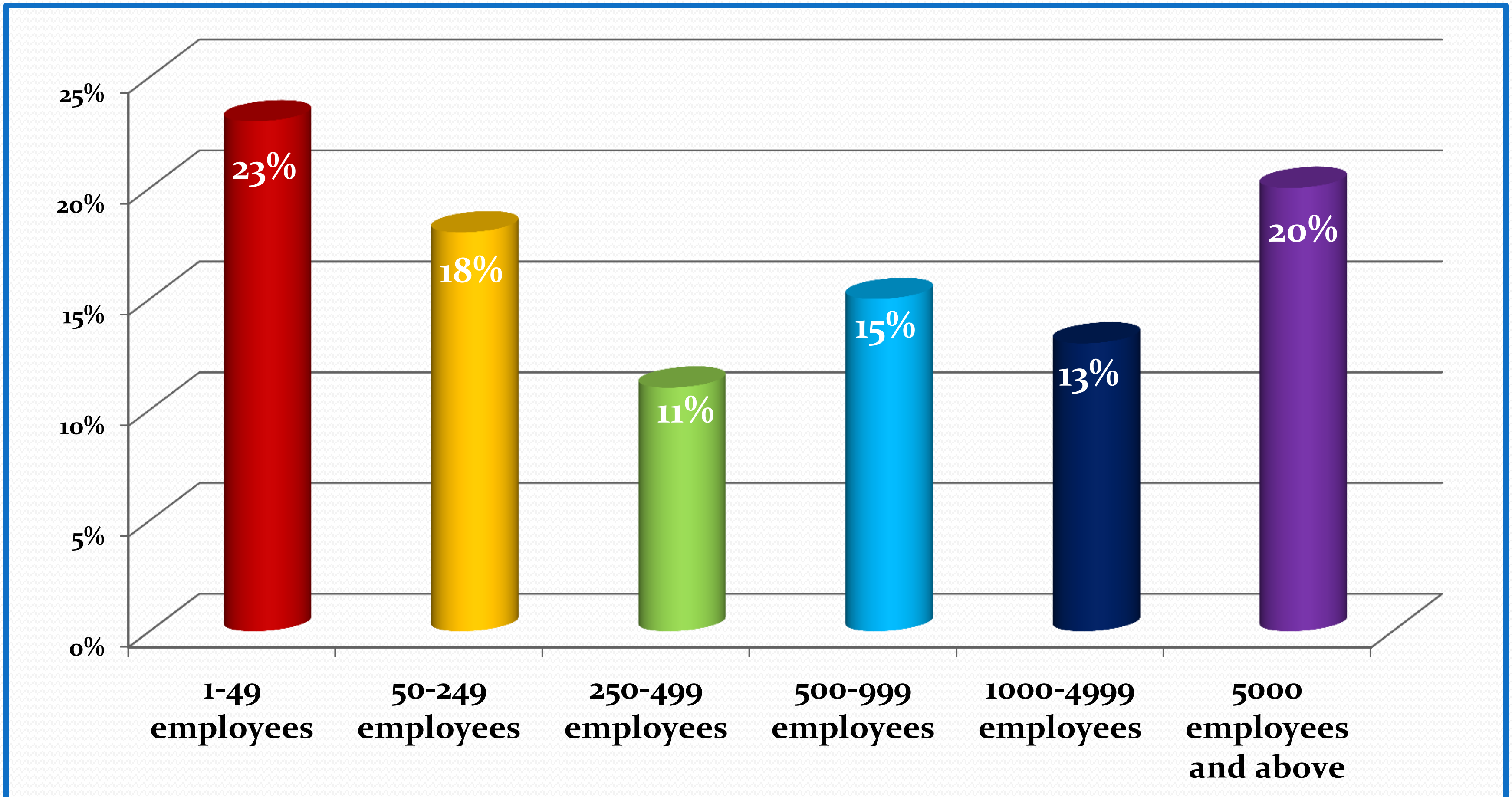
- Do you agree that CDC schemes have the potential to provide more stable outcomes on average than traditional DC schemes?
- Given there is no tradition of risk sharing between pension scheme members in the UK, are individuals going to be willing to share the benefits of protection from downturns in the market and increased certainty of outcome, with the potential disadvantages of intergenerational risk transfer?
- Is a CDC scheme designed to manage funding deficits by cutting benefits in payment going to be acceptable in the UK where traditionally maintaining the value of benefits in payment has been an overriding priority?
- What levels of funding are appropriate to ensure that a CDC scheme has sufficient capital to meet the liabilities and minimise the risk of benefits in payment being cut?
- Given the need for scale and an ongoing in-flow of new members to ensure the sustainability of a CDC scheme, will it be possible to set up a scheme without some form of Government intervention?
- As a mutual model, it has been suggested that CDC schemes might prove attractive to the trades unions and other social partners – might this be an option worth exploring?

Too late for employers?

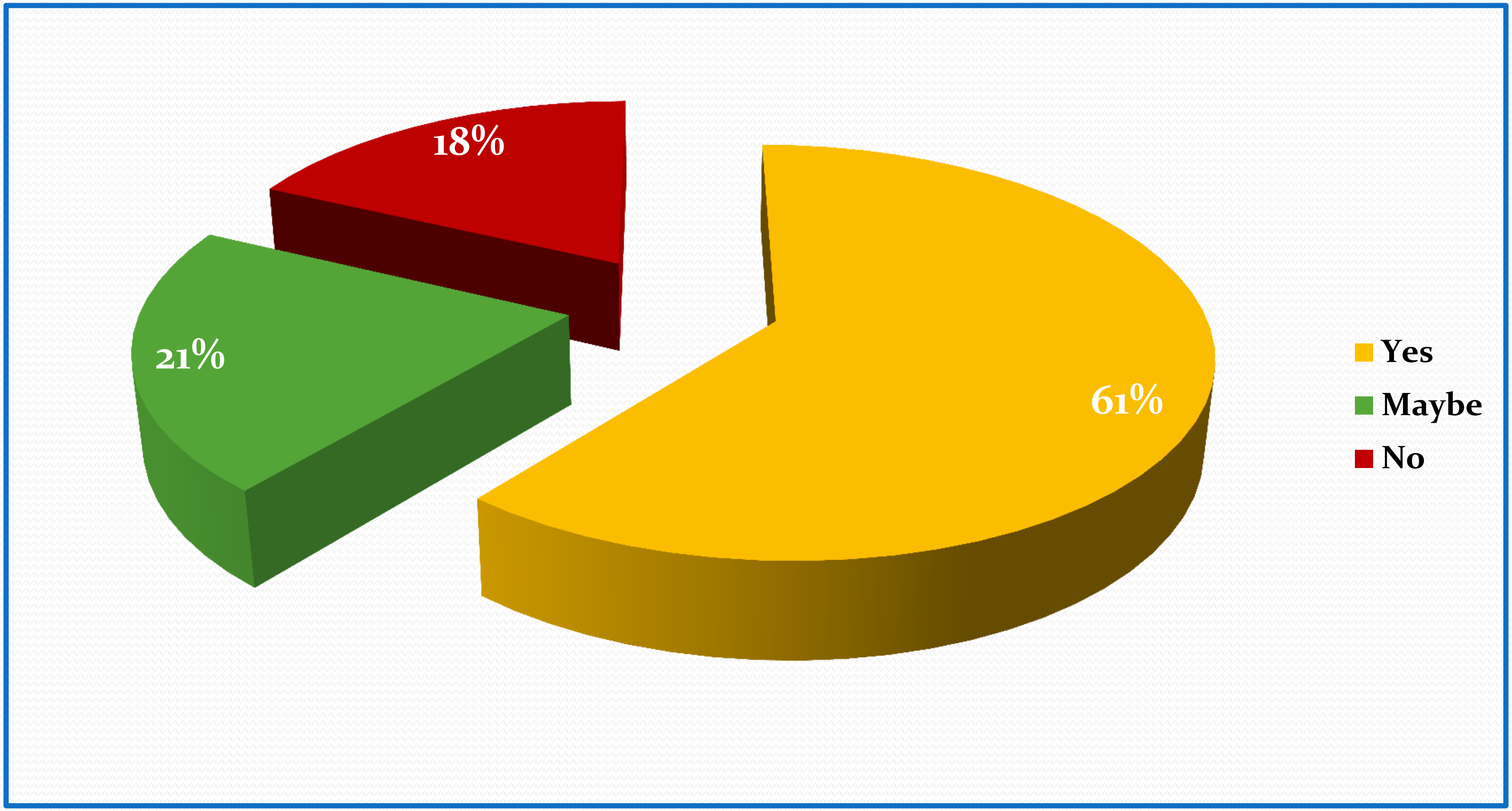
DA Reform Agenda

Organisations responding to the ACA survey

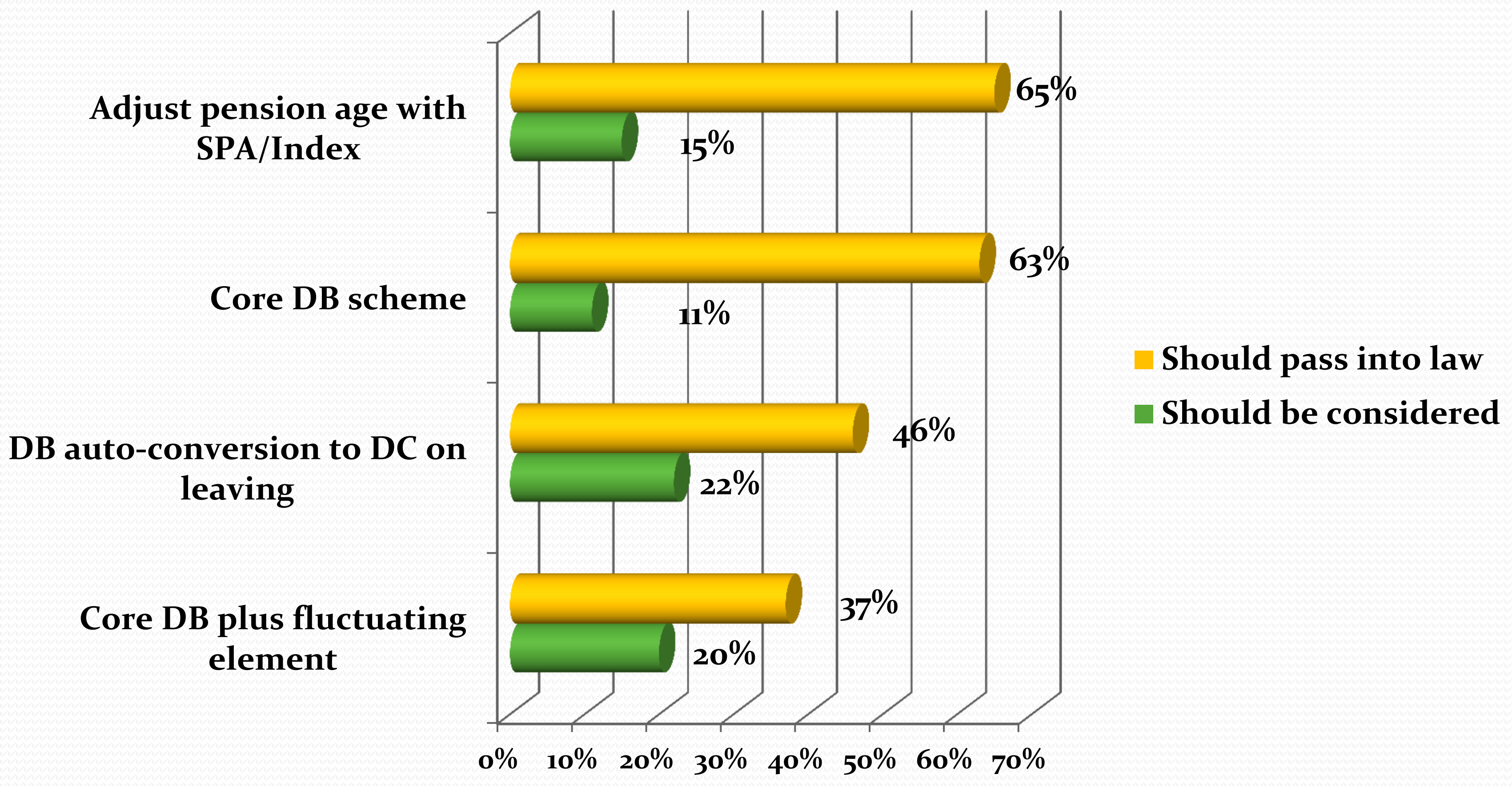
308 employers with over 430 schemes answered questionnaire



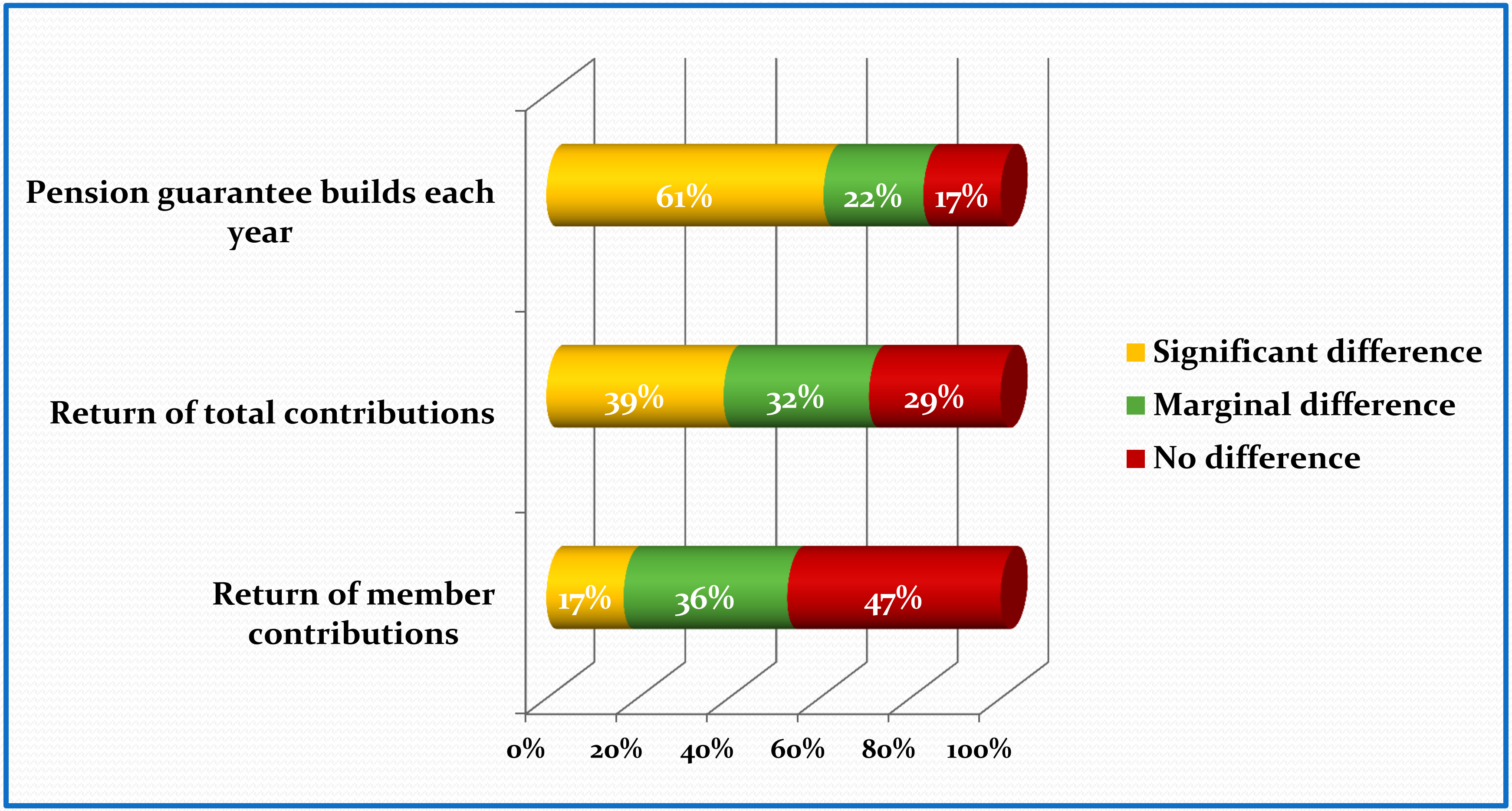
Question: As an employer, if you could offer a pension scheme to your members that enabled you to cap your pension costs, whilst also offering greater certainty of pension income for your employees than most current defined contribution schemes offer, would you consider such an option?



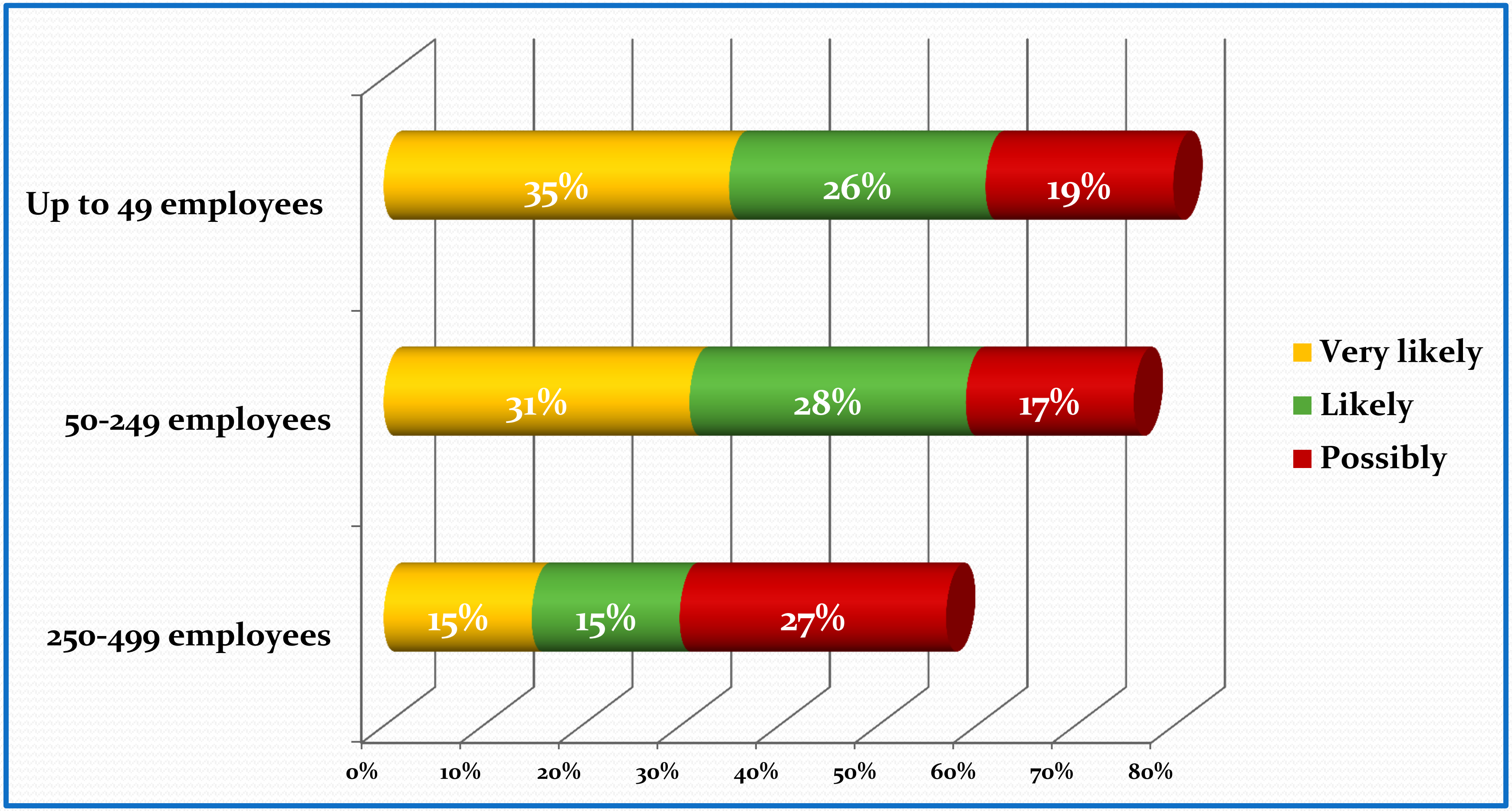
Question: Employers with 500 or more employees - The November 2012 pension 'reinvigoration' paper suggested a number of reforms that might encourage employers to offer workplace pensions where risks are or continue to be shared. What do you think of the various ideas proposed to date?



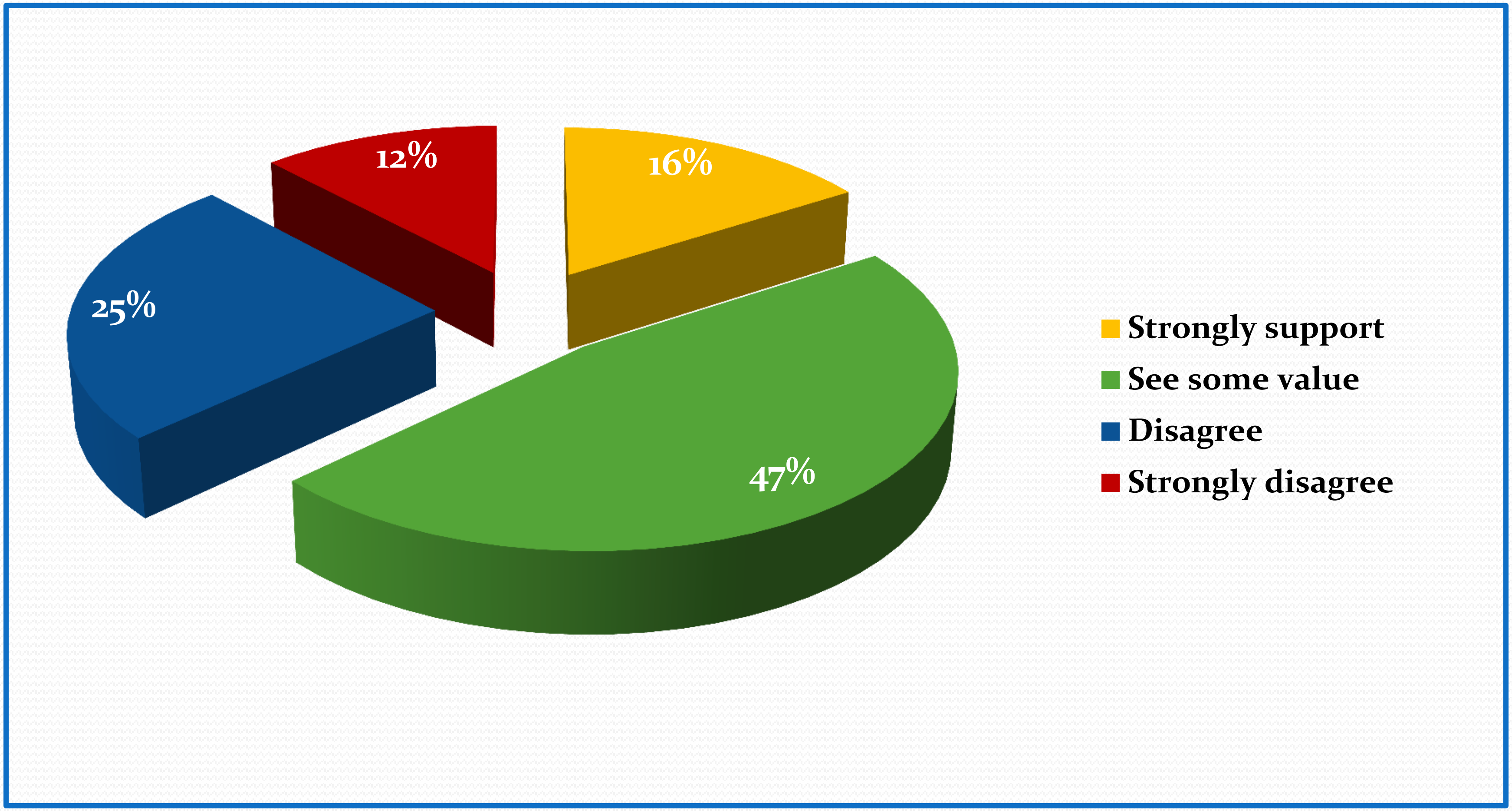
Question: If you run a defined contribution scheme (or are considering offering such a scheme) do you think more employees would consider joining or paying higher contributions if there was one of the following 'guarantees' at either retirement or death in respect of contributions held in a qualifying default fund run by the scheme? (Question noted: the greater the guarantee, the higher the cost and the greater the impact on investment returns)



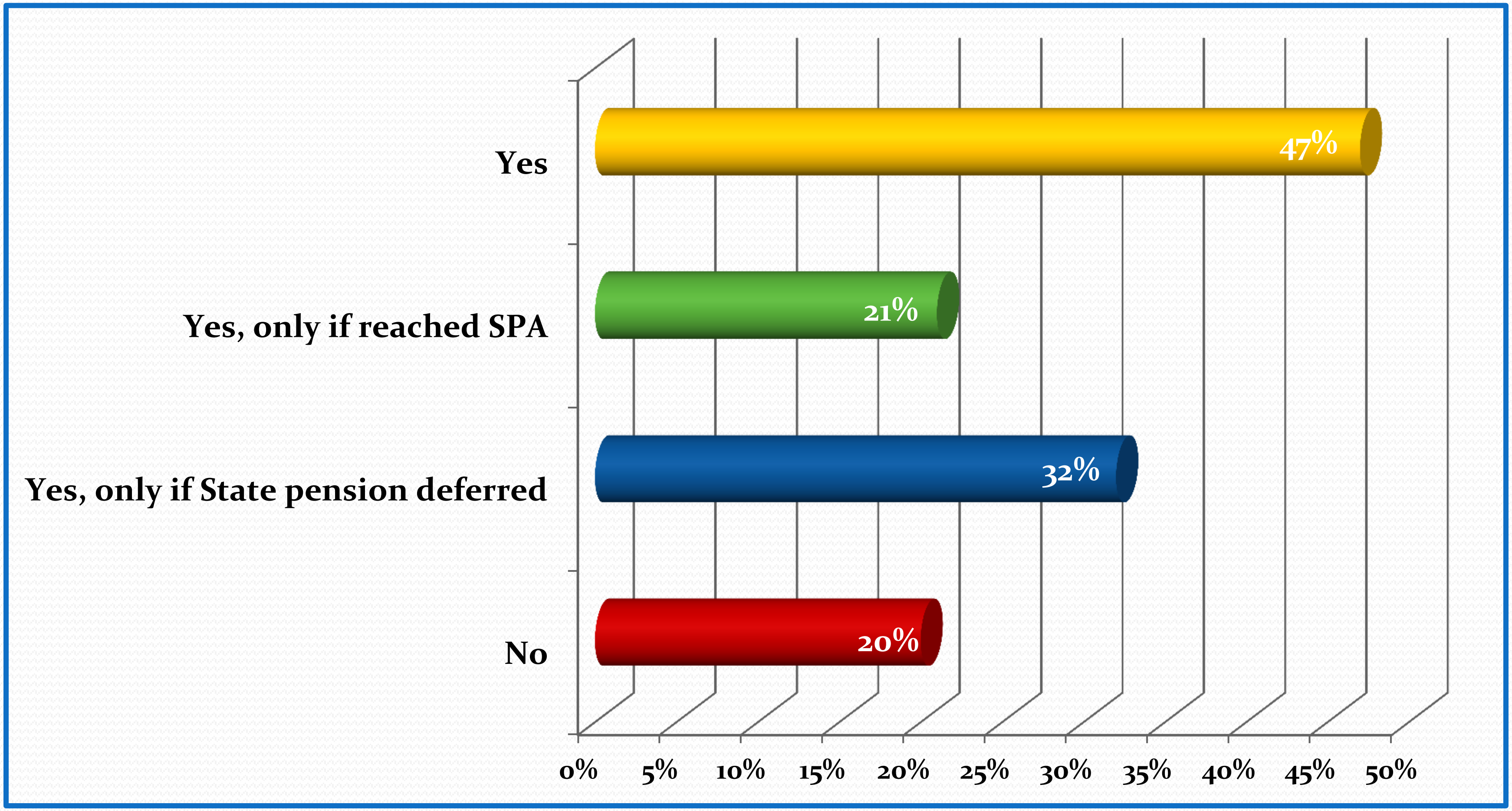
Question: Employers with 499 or fewer employees - How likely would you be to offer your employees a pension which is like a DC pension, but which is part of a much bigger scheme which other employers belong to?



Question: Do you believe Government should encourage businesses with small DC arrangements to merge these schemes into larger multi-employer arrangements?



Question: Particularly in the early years of auto-enrolment, many retirees will have only small pension pots to convert into pension income, yielding very low regular pension payments on top of the State pension. Do you think the Government should permit those retirees with small pots below a certain value to buy a fixed-term pension payable over say 5 years, enabling them to choose to retire before SPA or to defer taking their State pension?



Conclusions

- New DA schemes will offer employers the flexibility they need to offer better than minimum pensions, whilst controlling their costs
- DA schemes will offer employees greater certainty of pension income as against 'vanilla' DC (Current DB in the private sector is unlikely to survive in any significant way, so no legislative alternative to DC available within a few years)
- DA legislative changes are needed ahead of the end of DB contacting-out in 2016, by which time all remaining DB schemes will be reviewed (with many more closures likely)
- Legislative changes will allow new DA schemes to develop over time – won't necessarily be a sudden revolutionary change

Appendix
The DA challenge

The problem definition – the challenges DA is responding to.

- **Structural**: the polarisation of risks represented by traditional DB and DC pension schemes creates the perception of an incomplete system, with the burden of risk falling wholly on the employer or, increasingly, being placed on the individual. DA should provide the space for a greater amount of risk sharing.
- **Regulatory**: the criticism that the DB promise brings too great a regulatory and funding burden to the employer. DA should consider reducing some of the regulatory requirements on DB and any new DA framework should be clear about the limits of employer liabilities, and avoid creating new regulatory burdens.
- **Supply/demand**: demand from employers and employees for something between DB and DC is not being met by the market. There is a need to examine the extent to which Government intervention is needed to stimulate innovation.
- **Member-driven product design**: the extent to which uncertainty about pension savings and retirement incomes from a DC scheme (however good) is a disincentive to save in a pension.

Source: Department for Work & Pensions - Public consultation - Reshaping workplace pensions for future generations – November 2013