Housing Bulletin – June 2018

Pension risks don't have to be one-sided

Risk is not a dirty word. If no one took any risks, life would be pretty dull and not much would get done. Pension risk is, rightly, high up on the agendas of boards and governance committees. But is there a balance to share risk between employers and employees?

The pensions industry is again debating whether there are scheme designs that pool risks and are likely to lead to better outcomes for both the employer and employee. Support is increasing for Collective Defined Contribution ("CDC") plans and this could offer a potential alternative solution for housing associations in the future.

Risks tend to be one-sided

Risks associated with Defined Benefit ("DB") pensions generally fall on employers to handle. Increasing deficits and contributions have proved too costly for many, so DB risks are often mitigated by closing the scheme. This can bring forward costly cessation debts for employers, and inadequate and inefficient replacement schemes for employees. The solution for many employers struggling with providing affordable and sustainable DB pensions is individual Defined Contribution ("DC") retirement savings. Investment risk transfers to the employee, as well as the risk of not managing to save enough for a retirement income.

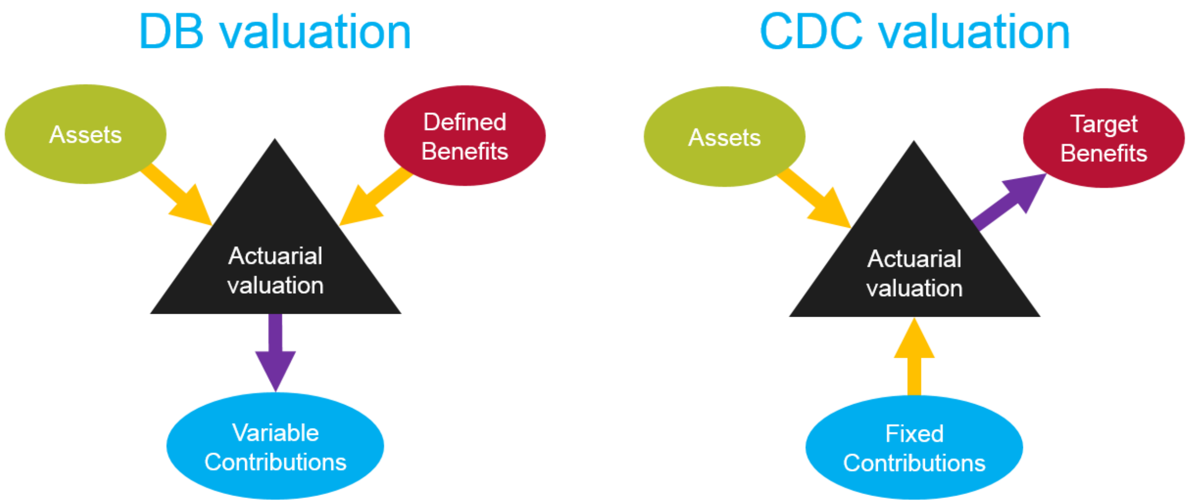
But what if there was something in the middle? A collective scheme that could invest contributions efficiently, and on a large scale, to provide a pension for employees (or a "wage in retirement") without the risk of deficits. Well, perhaps there is…

Royal Mail are looking to deliver CDC

The Royal Mail recently found itself in the classic position of considering replacing DB with DC. However, in discussions with the Communication Workers Union ("CWU") a joint proposal was put forward to introduce a CDC scheme. At this point, we would like to mention that First Actuarial are advisers to the CWU, with Derek Benstead (part of our Housing Team) a key player in working to get CDC off the ground (or through the letterbox). All parties are continuing to work with the Department for Work and Pensions to bring in the necessary legislation, and it's all looking very positive.

So, what is CDC?

Employers and employees pay fixed contribution rates which target a chosen level of benefit (for example, 1/80th of average earnings for each year of service) with some inflation-linking. "Target" is the operative word here. DB pensions offer guaranteed benefits which have become very costly for many reasons we would love to expand on, but not here! A CDC scheme targets benefits by investing for the long-term (with any luck, in perpetuity). This means that a CDC scheme doesn't have to transition from investing in growth assets to fixed income assets (such is often the way with individual DC, and closed DB). If the target benefit is affordable in a given year, great. If the target benefit is not affordable, it can be reduced (probably by little lower inflation-linked pension increases for a period). Lots of stress testing and modelling has been done on the likely outcomes by several actuarial firms, and the results show the benefits of pooling investment and longevity.



OK, sounds great, but could this work for housing associations?

Yes, we believe a CDC plan would work for housing associations – as it is a stable sector wanting to provide good, affordable and efficient pension provision to employees. It is also a sector prepared to innovate for the "greater good".

Do you want to find out more?

We want to hear from you! Derek is our leading figure in this area, but your usual First Actuarial consultant will gladly discuss this with you as well.

Our report "An introduction to CDC" is available free-of-charge to our housing clients or housing contacts that would like to meet to discuss this issue.

We're thinking big and we'd love housing associations to join forces, stand together, and offer a multi-employer CDC scheme which provides real value for money for employers and good retirement outcomes for members.

But we can't have CDC yet, can we share pension risks with employees right now?

Yes and no.

In the LGPS? No, as benefits and member contributions are set by regulations. However, there is the employer cost cap mechanism to ensure costs (and risks) do not increase to an unsustainable level.

In SHPS? Yes, to some degree. The easiest way to risk share in SHPS is to combine both the DB and DC sections.

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Case study: Risk sharing in SHPS

Our client decided that the costs and risks from the 60ths Career Average section in SHPS had become too high. The employer set a budget for future service pension costs at a maximum of 10% of salary. After advice and analysis, the employer decided that the most effective use of this spend was to use both the DB and DC sections in SHPS.

The 60ths Career Average section was closed to future accrual and the employer joined the 120ths Career Average section with the employer contributing 5.6% of salary and employees 3%. In addition, employees were able to join the DC section with an employer matching contribution (up to a maximum of 5% of salary).

This benefit design meant that, for a contribution of 8% of salary, employees could receive each year a guaranteed pension of 1/120ths of salary plus 10% of salary paid to the DC section to provide a pension pot at retirement. The maximum employer contributions are 10.6% of salaries but in reality costs will be less than this as not all employees will contribute the full 5% towards the DC section.

The DB pension provides the guaranteed level of income most people need in retirement ("bedrock income") and the DC section provides a pot of money that they can use flexibly (including possibly taking their combined DB/DC tax-free cash lump sum from their DC pot only leaving their DB pension unreduced).

While most employees would have preferred to have kept the higher DB benefit it was recognised that the new design better shared the risks between the employer and employees than the DC only alternatives as well as providing employees with valuable retirement benefits at an affordable and efficient cost.

Want to discuss CDC or need help on your current pension offer?

Please pick up the phone or email your usual First Actuarial consultant or any of our Housing Team. And feel free to contact Derek, our expert and thought leader on CDC.

OUR CDC EXPERT

Derek Benstead
Email: derek.benstead@firstactuarial.co.uk
Tel: 0161 348 7451

PETERBOROUGH	MANCHESTER
Neal Thompson Email: neal.thompson@firstactuarial.co.uk Tel: 01733 447 657 or 07429 118 877	**Rob Hammond** Email: rob.hammond@firstactuarial.co.uk Tel: 0161 348 7440 or 07479 494 030
BASINGSTOKE	**TONBRIDGE**
Colin Freeman Email: colin.freeman@firstactuarial.co.uk Tel: 01256 297 779 or 07456 811 791	**Tony Barnard** Email: tony.barnard@firstactuarial.co.uk Tel: 01732 207 510 or 07472 302 508