First Actuarial Briefing for Trade Unions

Q2 2018

Introduction

Apologies that we weren't able to produce a briefing last quarter. Our preparatory work on GDPR requirements meant we weren't able to spend time on it. To make amends we are taking the opportunity to relaunch the briefing to widen our readership. Please do encourage your colleagues to sign up to the briefing by e-mailing alexandra.cherouvim@firstactuarial.co.uk.

In this issue, we'll look at the following topics

- Can't the State COPE with pension forecasts?
- BT loses court battle to change to CPI indexation
- Transfer Values and lessons from Port Talbot
- Mortality improvements fall again
- Don't be late, Royal Mail won't wait!
- What a FABulous idea!
- DC schemes part 2 - Key Issues

Can't the State COPE with pension forecasts?

The Government provide forecasts of your State Pension on their website (here) but if your State Pension Age falls after 2016, the forecasts come with an unfortunate "this is what you could have won" twist as you may find that these forecasts show you are entitled to more pension than you will actually receive from the State.

Before 2016, schemes could "contract-out" from part of the State Pension, meaning that both members and the employer paid lower National Insurance contributions. The part of State Pension that employees gave up by contracting-out is called the Contracted-Out Pension Equivalent (COPE).

In Defined Benefit pension schemes, the decision to contract out was made by the scheme and the vast majority of schemes did so. In return, the scheme had to provide a minimum level of pension called the Guaranteed Minimum Pension (GMP), which is at least equal to the COPE but could be higher.

If your State Pension forecast includes a COPE, remember this amount will not be paid to you by HMRC. Instead, the pension you receive from your workplace pension scheme will include an amount broadly equivalent to the COPE.

So when you reach retirement you'll receive your state pension from Government and your GMP from your scheme.

To check your State Pension forecast and see if you have a COPE element offsetting your State Pension, visit https://www.gov.uk/check-state-pension.

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BT loses court battle to change to CPI indexation

Over the years, governments have introduced minimum statutory increases to pensions.

Many schemes do not specifically refer to these increases in their rules as they are a Government requirement and must be applied. Other schemes' rules have wording like "increases are in line with the regulations in force". But other rules refer specifically to RPI.

In 2010, Government announced that statutory increases to both public and private sector pensions would be in line with the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI).

Scheme rules that referred to increases being in line with regulations could automatically switch to CPI for all future pension increases. But if the rules specifically referred to RPI, then RPI continues to apply.

Over the last 10 years CPI has been lower than RPI by around 0.7% pa so applying this change would reduce the scheme benefits.

The British Telecom (BT) scheme has different sections for members joining before and after 1986. For employees who joined BT before 1986 (Sections A and B of the scheme), the rules refer to regulations so increases switched to CPI. For employees who joined after 1986 (Section C – introduced after privatisation), the scheme rules were not clear on whether the switch would apply

BT sought legal advice and the case was taken to the High Court in December. In January, the Court ruled that BT could not switch Section C members to CPI increases.

Transfer Values and lessons from Port Talbot

The amount of money transferred out of defined benefit schemes tripled in 2017 to £34.2bn.

Last year, the highest profile transfer value activity was in the British Steel Pension Scheme – and the fallout from the estimated £3bn of transfers continues with ten financial advice firms no longer working on pension transfers.

We will be running a webinar at 2pm on 26 June 2018, discussing the lessons that can be learned from what happened in Port Talbot.

To book your place on our webinar please visit: http://bookings.firstactuarial.co.uk.

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Mortality improvements fall again

The latest version of the model used to project mortality improvements has shown that year-on-year improvements continue to be lower than previously assumed.

Data from the Continuous Mortality Investigation's (CMI) latest model, CMI_2017, shows that annual improvements since 2011 have been close to zero for both males and females. This compares to approximately 2.7% a year for males and 2.2% a year for females from 2000 to 2011.

What was regarded as a short-term blip a few years ago is now looking more like a long-term trend. There is still uncertainty about the causes of this slowdown.

One clear point is that there is now little further room for reducing circulatory diseases (responsible for 70% of the improvements from 1968 to 2010). Excess deaths from flu were a contributory factor in some years. There is speculation that austerity generally and insufficient NHS spending in particular are to blame. But a clear causal link has not been established.

The table below shows life expectancies using the 2014 model (which might have been used for a triennial valuation 3 years ago), the 2016 model (probably used for last year's update) and the 2017 model.

Life Expectancies (years)	Male aged 65	Male aged 45	Female aged 65	Female aged 45
CMI_2014_[1.50%]	**87.9**	**90.1**	**90.0**	**92.3**
CMI_2016_[1.50%]	**87.3**	**89.0**	**89.2**	**91.0**
CMI_2017_[1.50%]	**87.1**	**88.8**	**89.0**	**90.8**
Difference (2017 vs 2014)	**(0.8)**	**(1.3)**	**(1.0)**	**(1.5)**

The impact on scheme liabilities will vary from scheme to scheme, but we estimate that updating from 2014 to 2017 could reduce liabilities anywhere from 2% to 5%.

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Don’t be late, Royal Mail won’t wait!

Royal Mail and the Communication Workers Union (CWU) are pushing Government to introduce regulations enabling Collective Defined Contribution (CDC) schemes.

In recent years there has been a shift away from Defined Benefit (DB) schemes, that offer members a guaranteed level of benefit, to Defined Contribution (DC) schemes, that offer members a great deal of uncertainty.

CDC schemes could offer a valuable new way of providing an income in retirement.

Like DC schemes, members and employers in a CDC scheme would pay a fixed contribution, but instead of contributions being held and invested in individual funds, they would be invested collectively.

CDC has several advantages over DC:

- There is **less risk** that a market crash will impact those members who are close to retirement.
- Contributions can be invested for the long-term in assets that aim to deliver **higher returns** over time.
- Because contributions can be used to pay benefits, there is **less need to invest in low return assets** as members retire.
- A large amount of money is invested across a **large range of funds** rather than lots of little amounts of money across a much smaller range of funds.
- Administration and investment manager **costs can be lower**.

It is important to remember that CDC offers “target pensions”, not guarantees, and those targets might not always be met. For example, if investment returns were lower than expected, annual pension increases may need to be lower than the original target or not awarded at all. If investments performed badly over a sustained period, it might even be necessary to temporarily reduce pensions.

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What a FABulous idea!

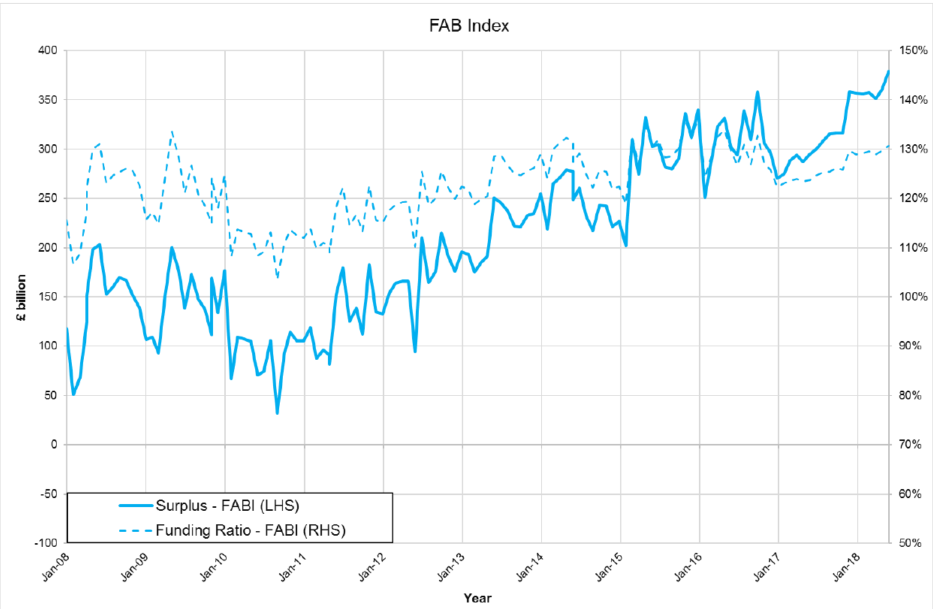
The First Actuarial Best Estimate (FAB) Index is a monthly index showing the aggregate financial position of the UK's 6,000 DB pension schemes. It is calculated assuming they continue to pay out benefits as they fall due and allows for our central estimate of future investment returns they will earn on their assets.

We are concerned that the focus of many of the funding updates covered in the press are either the position on buy out or the disclosed funding level in the employer's accounts. Both of these assume bond based investment strategies which place a very high value on liabilities and produce very high deficit numbers.

These worryingly high numbers are the backdrop against which proposals are judged – for example, closing schemes, allowing schemes to take benefits away from members and failing to meet member expectations – for example by not paying discretionary pension increases.

We think it is important to have a good understanding of the funding position of schemes assuming they continue to invest long term in a diversified portfolio of assets including a significant commitment to growth assets such as equities.

At 31 May 2018, First Actuarial's Best estimate (FAB) Index showed that the UK's **6,000 defined benefit schemes had an estimated surplus of £379bn**.



The chart above shows the FAB Index from 1 January 2008 to 31 May 2018, with the overall surplus shown on the left-hand side, and the funding ratio (assets divided by liabilities) shown on the right-hand side.

https://firstactuarial.co.uk/InfoCentre/FAB

We'll keep you posted on the FAB Index in future editions of the briefing.

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DC schemes part 2 - Key Issues

In our last briefing we began a series of articles looking at DC schemes. Here we look at the key differences between the three ways of setting up a DC scheme. We've also highlighted areas where trade unions can take an active role.

All DC schemes provide members with a savings pot which is used to provide a retirement income. DC schemes can be set up in one of three ways.

Own-trust

These are established for a single employer or for a number of associated employers.

Master trust

These are set up for non-associated employers and include:

- newly set up master trusts like Smart Pension;
- mass market auto-enrolment vehicles e.g. NEST; and
- insurance company master trusts e.g. Legal & General or Standard Life.

Contract based

In a contract based scheme, each member has an individual contract with the provider, although these are grouped together under an employer's arrangement. The scheme is likely to be a Group Personal Pension plan (GPP) or a Stakeholder plan.

Tax relief

Own trust schemes mainly operate on a net pay basis so contributions are taken out of pay before tax is applied. This means all tax-payers immediately receive tax relief at their marginal rate through payroll. But non-tax payers do not benefit under this approach.

Contract based schemes operate on a relief at source basis. This means that HMRC make a separate payment to the pension pot equal to 20% tax relief on all employee contributions. Non-tax payers also receive this top up. Higher-rate tax payers have to reclaim higher-rate tax relief through self-assessment.

Master trusts can operate on either basis, with the approach dependent on the provider.

Trade unions can make sure members understand how tax relief works. They should also think about what is the best scheme approach for their members.

Governance

All trust-based schemes are regulated by The Pensions Regulator, and have a board of trustees who have full control and responsibility over the scheme. At least one third of the trustees must be nominated by members of the scheme (called Member Nominated Trustees or MNTs). One of the key requirements on trustees is the preparation of an annual Chair's Statement commenting on, amongst other things, value for money for members.

Contract based schemes, are regulated by the Financial Conduct Authority. Individual insurers have an Independent Governance Committee that oversees the entirety of that insurers' book of business.

> Trade unions can ensure that the right MNTs are elected and that they have support. They can also put in place pensions negotiating or governance committees to monitor the performance of the provider.

Performance monitoring

Master trusts and contract based providers should prepare regular management information reports setting out the membership of the scheme, how members are investing their pots and the provider's administration and investment performance.

These reports help governance committees review the provider and decide what issues to communicate to members. This might include the availability of higher employer contributions, investment options and guidance on accessing online retirement planning tools.

> Trade unions should ensure they are well represented on governance committees.

Trustees of trust-based schemes must publish their annual Chair's statement (commenting on value-for-money) on a publicly available website.

> Trade unions will be able to readily access these for all trust-based schemes in which their members participate.

> From April 2019, trade unions will also be able to request details of the pooled funds that are available to members.

Pensions Fun Fact!

Out of 34 developed countries which one of the following do you think has the largest number of workers (age 20-64) for every one pensioner (over 65)? *[Answer in next quarter's bulletin].*

Japan, **Germany**, **US**, **France**, **UK**, **Turkey**, **Italy**, **Spain**, **Greece**, **Australia**, **US**

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Further information

If you'd like more information on any of the issues contained in the bulletin, please contact:

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We welcome feedback on any of the issues covered and suggestions for issues that should be covered in the future. If any of your colleagues would like to receive future briefings but are not on our circulation list, please let us know and they will be added to the list.