



PENSIONS

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# Reimagining pensions

WTW white paper

October 2024





# Foreword

In this white paper, we contend that DC, as it is today, is broken. And because it is broken, we ask two questions: ***how can we do DC better,*** and ***can we do better than DC?***

Our language around DC being broken is deliberately stark and provocative. This is because even though the pensions industry has known for a while that there is a retirement inadequacy issue looming, not nearly enough priority and urgency has been given to taking action to avert the issue.

To act as a catalyst for deeper and better conversations about doing better than DC, we set out four alternative pension designs — distinctly different to each other — all of which deliver better expected outcomes than DC.

By launching this white paper, we are urging employers, the Government and the pensions industry to reimagine pensions. It is our passionate belief that we all have a social responsibility to society to do so, so that we can deliver better retirement outcomes for tomorrow's savers.

**The time to act is now.**



**Rash Bhabra**  
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# Executive Summary

UK pensions are unsustainable in their present state. They need to be reimagined.

The vast majority of today's pension savers do so through defined contribution (DC) vehicles. However, DC, in its current form, does not provide an adequate income in retirement for many savers. This is not simply because contribution rates are too low. The problem runs deeper than that.

## **Fundamentally, DC is broken.**

DC is broken because it leads to poor retirement outcomes. It's broken because individuals do not have the tools and resources to navigate very complex decisions. And it's broken because it just doesn't work beyond the point of retirement.

At retirement, individuals have three main options, each of which has significant weaknesses. Some buy annuities, but such annuities often represent poor value. Some fully cash out, often with detrimental tax consequences and without expert support to manage the net proceeds through retirement. Others end up in drawdown, where they are again left to manage on their own, needing to sort through complicated, multi-faceted decisions, often without specialist help.

What most individuals really need is three things:

1. That deep expertise and specialist knowledge are applied to the thorniest and most intricate financial decisions, such as those on how to invest, on their behalf.
2. An income in retirement that is sustained and reasonably reliable through life.
3. That they receive the best possible value from their hard-earned savings.

## So, if DC is broken, how can it be fixed?

We contend that there are two essential questions that must be addressed.

### 1

#### First: can we do DC better?

The answer to this is very clear: “Yes”. Some of the initiatives progressed by the current and previous governments will have a positive impact. Consolidation leads to scale, which can provide better value for money (VFM) for the member. Revamping the VFM framework so that value assessments look beyond “low cost” and at the value provided will also help. There can be further innovation in DC investments, accessing a broader range of asset classes which will enhance returns and diversify risks. And better support, guidance and advice will reduce value leakage for members to limit the consequences of poor decision making by individuals.

Making these changes will improve DC, but we don’t think this is sufficient. Ultimately, DC places too much responsibility on individuals and they are ill-equipped to bear that burden. If Nobel-prize winning economist William Sharpe called the decumulation of retirement savings “the nastiest, hardest problem in finance”, it does not feel right to leave individual members to tackle this on their own. It’s a bit like giving people the parts to assemble their car, rather than building a car for them and providing a service plan.

### 2

#### Second: can we do better than DC?

And the answer, again, is “Yes”.

We think this question is not receiving enough attention within the pensions industry, in Government, amongst employers and from employee representatives. So, to act as a catalyst for a deeper, better debate on reimagining pensions, in this white paper we set out four ready made blueprints for alternative pension designs.

Each is different, with its own unique risk-sharing and investment profiles. Each seeks to share risks in a way that enables higher returns. Each seeks to improve member outcomes.

A summary of the four pension designs is set out in the next section. They all provide members with an income for life, dealing with the difficult investment decisions for individuals and providing them with the security of knowing they will not run out of money.

## The time to act is now

We call on UK employers to acknowledge that DC, as it is today, is broken. We urge them to engage on the two questions we raise in this white paper: can we do DC better, and can we do better than DC? And we encourage them to be open-minded about the art of the possible. These questions fall squarely under the social responsibility that employers have, within the “S” of ESG.

We call on Government to introduce legislative change that improves outcomes in DC and paves the way for the other types of pension design we set out in this white paper. As we run through each design, we call out the key changes to law required for each design to be implementable and we have summarised those changes overleaf. Legislation should be in a form that encourages industry to innovate, in order to avert the looming societal crisis of inadequate retirement provision.

And we call upon the whole of the pensions industry to come together to proactively take this debate forward with employers, employee and member representatives, and Government.

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**Unless we collectively act now, we will fail tomorrow’s retirees. So let us be bold and reimagine pensions.**

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## Summary of pension design blueprints put forward in this paper

### 1. Whole-of-life Collective Defined Contribution (CDC)

	Build up annual pension	Expected retirement income	✓ Fixed cost for the employer
	Increases variable: target CPI, can cut pension	<b>55%</b> higher than individual DC with annuity purchase	✓ Can smooth experience over long lifetime of the scheme

### 2. DB with variable increases

	Build up annual pension	Expected retirement income	✓ Similarities with traditional DB
	Increases variable: target CPI, cannot cut pension	<b>35%</b> higher than individual DC with annuity purchase	✓ Could use DB surplus ✓ DRCs unlikely to be needed

### 3. DC in accumulation followed by CDC in decumulation

	DC for accumulation, buy CDC pension at retirement	Expected retirement income	✓ Fixed cost for the employer
	Increases variable: target CPI, can cut pension	<b>40%</b> higher than individual DC with annuity purchase	✓ Works with existing DC

### 4. Variable cash balance followed by CDC in decumulation

	Build up lump sum, used to buy CDC pension at retirement	Expected retirement income	✓ Guarantee provides comfort, but extremely unlikely to bite
	Pre-retirement returns variable: target CPI+3.75%, cannot cut lump sum	<b>40%</b> higher than individual DC with annuity purchase	✓ Smoothed outcomes just before retirement

Further details on the modeling assumptions and methodology underlying the figures above are set out in the Appendix.



## Legislative changes the government needs to introduce to allow pensions to be reimagined

Recognising that some of our proposals will require legislative changes, we have summarised those below for ease of reference, and expand on these within the paper.

### Doing DC better:

- 1. Finalise the updated VFM framework** — see through planned changes so that value assessments look beyond “low cost” and at the value provided.
- 2. Expand the pensions advice allowance** — this should be increased from £500 and its scope expanded to be able to fund guidance as well as advice.

## Doing better than DC

- 1. Extend Collective Defined Contribution (CDC) legislation** — to allow CDC in decumulation schemes to be set up, along with forthcoming multi-employer and master trust legislation.
- 2. Introduce auto-enrollment easements** — changes to auto enrollment quality tests are needed to ease compliance for DB schemes with variable increases (without having to resort to workarounds) by removing the requirement for them to always be funding for fully inflationary revaluation.
- 3. Amend statutory minimum increases for “DB with variable increases” schemes** — under current legislation, DB pension increases in payment cannot be below CPI inflation subject to a cap of 2.5% pa. For future accrual in a DB scheme with variable increases, this should remain the minimum target increase, but they should be allowed to reduce actual increases to zero if needed, in a similar way to the rules that apply for CDC schemes.

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# The challenges with DC

There is consensus within the pensions industry that DC, in its current form, will not provide individuals with an adequate income in retirement. Our view on this is very clear — **DC is broken** — and there is a looming crisis that will unfold over the coming years if action is not taken now.

There has been a lot of debate about increasing auto-enrollment minimum contributions to 12% of salary and we support this, but we don't believe that increasing contributions alone is enough. There are underlying structural problems with DC.

## The challenges with annuities

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**At present, we estimate that a member who wants to receive an inflation-linked income in retirement may be able to achieve an income only a little over 40% of their salary if they buy an annuity at retirement — even if they were to receive a 12% contribution into their DC pension every year for 40 years.<sup>1</sup>**

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With the State Pension added to this, an individual would still need an average salary over their working life of almost £50,000 pa to enjoy what the Pensions and Lifetime Savings Association deems to be a “moderate” amount of income in retirement (£31,300 pa for a single person living outside of London), let alone a “comfortable” level of income. That also assumes they own their own home outright by retirement.

Given the perceived poor value of annuity rates, it's perhaps unsurprising that few people choose to buy an annuity at retirement. The latest data from the FCA, covering 2023/24, suggests that still only around 10% of new DC retirees purchase an annuity, despite recent rises in interest rates making these more attractive than they have been for a long time. Many more DC retirees are therefore turning to drawdown or cashing out their DC pot in full, where the risk of making poor decisions is huge.

<sup>1</sup> See appendix for details of all of our calculations and modeling assumptions.

<sup>2</sup> <https://core.ac.uk/download/pdf/191869539.pdf>

<sup>3</sup> [https://www.monash.edu/\\_data/assets/pdf\\_file/0012/2052102/WP2016-04.pdf](https://www.monash.edu/_data/assets/pdf_file/0012/2052102/WP2016-04.pdf)

## The challenges with drawdown

While many individuals may choose to draw down their DC savings during retirement, this requires them to make regular decisions about their investment strategy and the pace of drawdown, at a life stage where many members will, ultimately if not initially, be facing cognitive decline.

It will also be an individual's responsibility to respond to investment market shocks. Research has shown that individuals under perform average fund returns by around 1.5% pa due to poor timing of their investment decisions; often selling after a market shock and buying after markets have rallied. The gap in under performance is wider for the more volatile asset classes<sup>2</sup>.

Retirees will also have to choose how much income to take each year from their drawdown pot, whilst obviously not knowing how long they will live. As well as the risk of running out of money, individuals may also underspend, which goes against the purpose of retirement saving. From the Australian experience, we have seen this borne out in practice<sup>3</sup>: many people are very cautious and withdraw the minimum possible amount (a feature of Australian pension legislation), effectively suppressing their own standard of living to an unnecessary extent.

So, while some people may do better through drawdown and it has a place as part of an overall retirement solution, drawdown isn't best suited to being the default norm for providing individuals with a regular and appropriate level of income in retirement. Actual outcomes for individuals are all too often down to a matter of luck, which isn't the best way to implement a retirement strategy.

For those cashing out, outcomes can be even worse. While this may be a reasonable strategy for those with smaller DC pots, we see evidence of many individuals with pots in excess of £100,000 taking these as a single lump sum and paying high rates of tax as a result. In most cases this is unlikely to be efficient, nor is it likely to help the individual generate a steady income in retirement.

## Doing DC better

So, how can you do DC better to overcome these challenges?

Firstly, we believe it's important individuals have an appropriate exposure to growth assets. In accumulation, we hope that planned changes to the VFM framework, so that value assessments look beyond "low cost" and at the value provided, will help lead to more DC assets being invested in a diverse range of growth assets including illiquids. It's also important to retain some exposure to these assets as individuals approach and enter retirement. We do not believe it makes sense to de-risk fully at the start of what may typically be a 20-30 year retirement — and in many cases starting that de-risking journey 10-15 years before retirement. This investment aspect is a large part of the reason why a DC annuitisation strategy will often struggle to provide a "moderate" level of retirement income.

Secondly and equally important is providing more help to individuals with decision making — either through better support to improve their decisions or through those decisions being taken by a fiduciary on their behalf.

The two biggest financial decisions most people have to make are buying a house and planning for retirement. Using a mortgage broker for the former is commonplace, but use of guidance or advice at retirement is very low. This needs to change to enable people to maximise the potential of their DC savings. As an example, we have seen evidence from a case where guidance has been put in place that, for individuals with DC pots above £100,000, those who have not taken guidance are four times more likely to fully cash out their DC pots than those who have taken guidance.



Part of the challenge with the low take-up of retirement guidance or advice is the reluctance of individuals to pay an explicit fee for this service — in comparison there is often no explicit fee for a mortgage broker, with brokers being compensated through commission from the mortgage lender. If we are to see greater take-up of retirement guidance and advice it is likely that we need to reduce or eliminate the up-front cost to the individual. This could be achieved through:

- it being funded by either the employer or the pension scheme, or
- an expansion of the pensions advice allowance, to allow advice costing greater than £500 to be funded from an individual's pension pot and to allow guidance as well as advice to be funded using this allowance.

Alternatively, we can improve outcomes by using fiduciaries to take decisions on behalf of individuals — most retirees probably don't want to be making their own investment decisions in retirement and would prefer someone with the appropriate knowledge and skills to suggest a sensible pace of drawdown of their funds. The proposed Pension Schemes Bill starts to move further in this direction; there is the intention of requiring pension schemes to provide retirement products “including default investment options”. We see scope for further progress and innovation, for example through products which offer a form of “guided drawdown”.

## Whose responsibility is it to fix DC?

Inevitably, this responsibility doesn't rest with just one party.

Clearly there is a role for Government to help resolve the societal problem we see looming — and as set out in this paper, we believe there are key steps that need to be taken to facilitate new forms of pension scheme design.

Equally, individuals cannot completely absolve themselves of any responsibility to make plans for their own retirement. Even if they need further support, it is paramount that they engage with pensions more and at an earlier stage in their lives than is currently the case.

However, we also believe there is a critical role for employers to play in facilitating the provision of better pensions for their employees. Most employees assume their employer's pension provision will give them an adequate income in retirement, and start to check it themselves only when nearing their planned retirement age. Failing to provide better pensions risks storing up workforce planning problems in the coming years as an increasing number of employees reach retirement age with mostly, or entirely, DC pension provision. Further, with company boards increasingly focused on ESG issues, we believe under the social “S” of ESG there is an onus on companies to help address this known societal issue stemming from the inadequacy of current retirement provision.



# Introducing four viable new pension designs

In the previous section we outlined the challenges with DC and how we can do DC better. In the rest of this paper, we focus on alternative solutions that allow us to do better than DC.

In particular, we outline four tangible new pension scheme designs, each of which provides an income for life and each of which offers significant advantages over current DC. At a headline level, those four designs are as follows (noting some combine designs with a transition at retirement):

	Before retirement	After retirement
1	Whole-of-life CDC	
2	DB with variable increases	
3	Individual DC	Decumulation CDC
4	Variable cash balance	Decumulation CDC

Each of these designs is expected to provide higher retirement incomes for the same level of contributions than current DC for two reasons:

1. Compared with insured annuity purchase or other low-risk DC options, they invest more in return-seeking risk-taking assets; and higher returns mean higher pension income.
2. They mitigate or reduce the need for individuals to make complex decisions in retirement which can often lead to suboptimal outcomes under drawdown.

All these designs fundamentally involve some level of risk sharing, resulting in variability in retirement outcomes, although each one shares risks somewhat differently. Some share all risks collectively among members, while others feature a low level of employer underwriting. The level of risk taken then drives the level of additional returns that can be generated.

All require a certain scale of membership to be cost-effective, and so either lend themselves to larger employers, multi-employer schemes or master trusts catering for a number of employers. In all designs, it is essential to communicate effectively with members to ensure they understand which elements of their benefit are variable and not guaranteed.

There are also many possible variations within each design, which an employer or provider could tailor to optimise for their own circumstances. For example some employers may be willing to accept a small amount of contribution volatility within a set range in order to reduce the variability of member outcomes. In the following sections, we set out a simple version of each design that could be funded with a joint employer and employee contribution rate of 12% of salary, and describe its key facets including:

- How our proposed design works.
- Median retirement incomes, based on the calculation methodology and assumptions set out in the Appendix.
- Advantages for both the employer and the employee.
- To illustrate how they cope with variation, we describe what would happen if there were a severe short-term shock to the scheme's funding health as described in the Appendix (where equities fall by 25% and other assets to a lesser extent).
- The main practicalities and any legislative changes needed for setting up the scheme.

# 1

## Design one

### Whole-of-life CDC

The UK's first Collective Defined Contribution (CDC) scheme has just opened in October 2024 to provide CDC pensions to Royal Mail employees. We hope this will be a catalyst for many other employers or providers to set up CDC schemes in the UK.

#### How does our proposed design work?

1. Employee and employer pay contributions (between them) fixed at 12% of salary — no matter what.
2. Pension “accrues” each year at around 1/60th of current salary, on average.
3. The scheme **aims** (*but does not guarantee*) to increase the pension each year, before and after retirement, in line with CPI inflation.
4. The actual increases awarded are variable and depend on how assets perform and demographic experience. So, if the scheme is better funded than anticipated, increases will be higher than CPI, and vice versa.
5. In extremis, in the event of a very substantial shock or accumulated poor experience, pensions are cut and are then not expected to increase again. However, if markets recover, pension increases will resume.

#### What could a member expect in retirement?

##### Expected retirement income after 40 years' service

**65%**  
of earnings

**▲ 55%**  
higher than individual DC  
with annuity purchase

#### What are the advantages for employers and their employees?

- Provides employees with an income for life with good visibility of how this is building up and what to expect.
- Builds on familiarity with the way in which DB pensions build up.
- Crucially though, costs are fixed and sustainable for employers (and employees).
- Enables greater investment flexibility than individual DC, supporting investment in a wide range of illiquid return-seeking assets. Several factors contribute to this — growth assets being held collectively for the long-term, investment risks being shared across individuals, benefits being variable, and centralised decision making by the fiduciaries.
- There is a smooth transition into retirement, without the need for a transaction, or difficult decisions, in order to access an income for life.
- The IFRS accounting treatment is as per DC schemes, avoiding any DB accounting impacts on the company balance sheet.

#### What happens if things don't go to plan?

- Pension increases are variable and act as the balancing item to ensure that payments are sustainable.
- As the cost is fixed, pension levels are cut if necessary following a severe asset shock or change in economic regime.
- When the scheme is new, around 50% of the contributions being paid would typically be earmarked to fund future pension increases; for a mature scheme this drops to around 25%. At that point, the severe **downside shock** in the Appendix would reduce increases from CPI to only minimal increases, absent a recovery. Importantly, even in this scenario, retirement income would not fall.

#### Practical considerations and additional legislation needed

- The Royal Mail design provides a ready-made blueprint for other single employer schemes. Legislation is in place to allow such schemes to launch.
- We eagerly await multi-employer and master trust versions of the legislation, which are due to be enabled next year through further regulations, subject to Government consultation.
- There are significant fixed costs involved in setting up and running your own CDC scheme, which makes this approach feasible only for larger employers or groups of employers — the active membership would usually need to be at least 5,000 individuals per generation for CDC to be demonstrably cost effective. We therefore expect appetite from employers for multi-employer schemes and master trusts in providing CDC, which would give employers of all sizes easier access to CDC, and in time this is likely to be the more popular option to access CDC for most employers.

# 2

## Design two

DB with variable increases



Defined benefit schemes can be brought into the 21<sup>st</sup> century if they have another lever, beyond contributions, with which to respond to changes in funding level. We believe that variable pension increases are best suited to be that lever. Such schemes are widely used in Canada, with the flexibility that comes from variable pension increases allowing schemes to ride the waves of market fluctuations much more sustainably, while investing in long-term growth assets.

### How does our proposed design work?

1. Employee and employer contributions are set at a combined 12% but can vary in some circumstances.
2. Pension “accrues” each year at around 1/70th of current salary, on average.
3. The scheme aims (but does not guarantee) to increase the pension each year, before and after retirement, in line with CPI inflation.
4. The actual increases awarded are variable and depend on how assets perform and on demographic experience. So, if the scheme is better funded than anticipated, increases will be higher than CPI, and vice versa.
5. Pensions cannot be cut and so in some circumstances additional contributions may be needed from the employer to ensure the funding of the scheme remains in balance.

### What could a member expect in retirement?

#### Expected retirement income after 40 years’ service

**55%**  
of earnings

**▲ 35%**  
higher than individual DC  
with annuity purchase

### What are the advantages for employers and their employees?

- Provides employees with an income for life with good visibility of how this is building up and what to expect.
- Provides a DB pension which is valued by employees, aiding staff attraction and retention.
- Builds on familiarity of the way in which DB pensions build up.
- Costs are usually fixed and so are much more sustainable for employers (and employees) than under a traditional DB scheme.
- Enables greater investment flexibility than individual DC, supporting investment in a wide range of illiquid return-seeking assets. Several factors contribute to this — growth assets being held collectively for the fairly long-term, investment risks being shared across individuals and with the employer, benefits being variable, and centralised decision making by fiduciaries.
- There is a smooth transition into retirement, without the need for a transaction, or difficult decisions, in order to access an income for life.

### What happens if things don’t go to plan?

- Pension increases are variable and in most cases act as the balancing item to ensure that payments are sustainable.
- If pension increases have been reduced to the minimum, the employer and/or members will need to make up the deficit, through additional contributions.
- When the scheme is new, around 50% of the contributions being paid would typically be earmarked to fund future pension increases; for a mature scheme this drops to around 25%. At that point, the **severe downside shock** in the Appendix would reduce increases from CPI to lower target increases of around **CPI – 1.3% pa**. Importantly, even in this scenario, no deficit reduction contributions would be required.





### Practical considerations and additional legislation needed

- Can a DB scheme with variable increases be set up today? The short answer is “Yes”. There is currently enough flexibility within DB legislation to set-up a scheme where increases are variable to an extent. Nevertheless, legislative easements could make these variable increases an even more powerful tool:
  - Currently, increases in payment for DB schemes are subject to a statutory minimum of increasing in line with CPI inflation up to 2.5% pa. This statutory minimum limits the extent to which future increases can be cut back to manage volatility, particularly for a more mature DB population. It also results in questionable inter-generational fairness, with pensioners being prioritised over pre-retirees.
  - There is no such statutory minimum before retirement (if the same increase is awarded to both active and deferred members), although auto-enrolment requires CPI increases to be funded for at all times.
  - Legislative easements should be introduced that remove both of these requirements for new accruals in DB schemes with variable increases to allow them to operate in their simplest and fullest form.
- New DB benefits with variable increases could be introduced for future accruals within an existing DB scheme. This could make good use of existing DB surpluses — either to fund future accruals or to act as a buffer against future adverse experience alongside the variable pension increases.
- The accounting treatment will be an important consideration for some companies. These schemes fall under DB accounting rules and are likely to show a deficit on a company’s balance sheet and higher P&L cost than the contribution rate (because investment strategies are likely to be more return-seeking than corporate bonds, and so funding discount rates are likely to be higher than IAS 19 discount rates). Further, the expected level of pension increases is likely to be interpreted as a constructive obligation, rather than the guaranteed minimum, and as a result would need to be reflected in the IAS 19 liability. However, investor communications could help to mitigate some of these concerns.

# 3

## Design three

DC in accumulation, followed by CDC in decumulation

Almost all UK private sector employers currently provide DC pensions to the majority of their workforce, and so not having to move away from that provision could appeal to many. As explained earlier in this paper, the main problem with DC is at retirement where members cannot get a cost-effective income for life. Keeping DC in accumulation and introducing CDC in decumulation could be the best of both worlds.

### How does our proposed design work?

1. Employees and the employer pay contributions into the employee's DC pot at a fixed rate of 12% of salary between them — no matter what. These contributions would be invested in largely return-seeking investments, with some limited transition into bonds over the 10 years before retirement to mirror the CDC scheme's investment strategy at retirement.
2. The DC pot is converted into a CDC pension at retirement (similar to the purchase of an annuity).
3. In retirement, this has the same features as whole-of-life CDC, i.e. the scheme **aims** (but does not *guarantee*) to increase the pension each year in line with CPI inflation; but **actual** increases awarded are variable and depend on how assets perform and on demographic experience.

### What could a member expect in retirement?

#### Expected retirement income after 40 years' service

**60%**  
of earnings

**▲ 40%**  
higher than individual DC with annuity purchase

### What are the advantages for employers and their employees?

- DC is the status quo for most UK employers and is well understood.
- DC provides simplicity and flexibility for employers and employees in accumulation; there need not be any change to the DC contribution structures already in place.
- DC is portable, so easier for employees with multiple employments in their career to consolidate.
- Adding on CDC in decumulation provides a cost-effective income for life post-retirement, resolving the main challenge with DC, as described in earlier sections.
- An employer could introduce CDC as a new option at retirement, without needing to go through a pension change exercise. This could be added to a single-employer DC trust or master trust.
- As DC is retained for accumulation, there would be no new company accounting impacts.

### What happens if things don't go to plan?

- Before retirement, members would be affected by market changes just as for other DC savers with a similar investment strategy.
- Once the member is in the CDC vehicle, pension increases are variable and pension levels are cut if necessary following a severe asset shock or change in economic regime.
- The severe downside shock in the Appendix would lead to a cut in pensions of around 1% with no further expected increases (absent a recovery).

### Practical considerations and additional legislation needed

- It is not currently possible to implement CDC in decumulation in the UK, pending the introduction of specific regulations to allow this, which we would like to see introduced as soon as possible. The DWP had said in 2023 that they would consult on regulation of CDC in decumulation after 2024's consultation on whole-of-life CDC master trust regulations. This option is therefore likely to be at least a couple of years away from becoming a practical reality.
- The transition at retirement from DC into CDC needs care. Either:
  - the member needs to be sufficiently informed to make the decision to transition — needing excellent communications and potentially further support, or
  - the scheme would need to provide CDC as a default decumulation option, which would need to be considered to be in the members' interests and supported in law.

# 4

## Design four

Variable cash balance in accumulation, followed by CDC in decumulation

Variable cash balance provides an alternative way to build up a lump sum at retirement with which an individual can purchase a CDC pension. Unlike DC it provides individuals with a minimum guarantee as to the lump sum they will receive at retirement and smooths out year-on-year volatility compared with DC, with limited additional risk for the employer.

### How does our proposed design work?

1. Employee and employer contributions are set at a combined 12% but can vary in limited circumstances.
2. Employee builds up a “cash balance pot” of 12% of salary each year.
3. Up until the member retires, each year the cash balance pot receives a ‘bonus’, which aims to be in line with CPI inflation plus 3.75% pa but is not guaranteed.
4. The actual bonuses awarded are variable and depend on investment returns (and demographic experience to a limited extent) to ensure the scheme always remains fully funded. So, if investment returns are above the target return, higher bonuses are declared, and vice versa.
5. While bonuses do not have to be awarded, the cash balance pot cannot be reduced and so in some circumstances additional contributions may be needed from the employer to ensure the funding of the scheme remains in balance.
6. At retirement, the cash balance pot is converted to a CDC pension, which then operates in exactly the same way as in the previous design.

### What could a member expect in retirement?

Expected retirement income after 40 years’ service

**60%**  
of earnings

**▲ 40%**  
higher than individual DC  
with annuity purchase

### What are the advantages for employers and their employees?

- Before retirement, employees have the comfort that their ‘pot’ won’t ever decrease — unlike a DC pot.
- Further, they will see much more stability in their pot from year-to-year given the smoothing of awarded investment returns. This will be particularly valuable in ensuring that individuals’ retirement plans aren’t significantly impacted by market movements just prior to their retirement.
- The guarantee introduces only limited additional risk of contributions to an employer.
- CDC in decumulation provides a cost-effective income for life post-retirement, as explained in previous sections.

### What happens if things don’t go to plan?

- For the cash balance element, annual bonuses are variable and act as the primary balancing item to ensure that a 100% funding level is always maintained. However, as the cash balance pot cannot be reduced, there could be recourse to the employer for additional contributions in extreme scenarios.
- The severe downside shock in the Appendix would reduce CPI + 3.75% pa increases to CPI + 1.2% pa increases. However, no deficit reduction contributions would be required in this scenario; annual bonuses can still be cut all the way down to 0% in extremis.
- The CDC element in retirement would fare the same way as detailed in the previous section.

### Practical considerations and additional legislation needed

- Similar to DB with variable increases, there is already enough flexibility within DB legislation to set-up a variable cash balance scheme where increases are not guaranteed and can be cut back if needed. Once again though, the Government should introduce small legislative easements, to remove the auto-enrolment requirement for schemes to be funding for fully inflationary revaluation at all times, which would make auto-enrolment compliance easier to achieve and give additional flexibility before retirement.
- As the cash balance benefit would be DB in nature, a variable cash balance scheme could be added to an existing DB scheme. This could make good use of existing DB surpluses — either to fund future accruals or to act as a buffer against future adverse experience alongside the variable pension increases.
- However, one downside is that, as for DB with variable increases, the cash balance benefit falls under DB accounting treatment. This is likely to give a higher P&L cost than the contributions paid, and also result in a deficit on a company’s balance sheet.
- For the CDC element in retirement, the practical considerations and additional legislation needed will be as set out in the previous section.

# Are there any other options to consider?


Within this paper, we have focused on four tangible alternatives to DC that we believe are better suited to providing an income for life than current DC. These four alternatives represent a good cross-section of the options which an employer can most readily consider implementing — either because it can already be done or it is in line with the industry's direction of travel.

Within the spectrum of four designs we have laid out, there are many subtle variations possible. For example, within the variable increase designs it would be possible to introduce some allowance for contributions to rise to an agreed limit before pension increases are fully cut back. Or, a risk buffer could be built up to help manage the risk of additional contributions. For some employers, this could provide a better balance of the risks between the employer and employee.

Moreover, we continue to see further innovation in addressing the challenges with DC — which we welcome — and so there are a number of designs which we haven't focused on within this paper which could become more viable in the coming years if providers bring products to market.

## These include:

- **Better use of annuities** — acknowledging that annuitising the entirety of an individual's DC pot at retirement may be de-risking too far, this would be a packaged offering which combines drawdown in the early years of retirement with a pre-determined annuity purchase in later years, potentially on a bulk basis, to ultimately provide a guaranteed income for life. At the current point in time, there is a limited market in later life annuities and no truly packaged solution.
- **Individual longevity protection** — acknowledging that a challenge with income drawdown is the difficulty in planning for an unknown period of retirement, individual longevity protection would provide an individual with "mortality credits" to their drawdown pot that would seek to offset the impact of them living longer than expected. This protection could be offered on either an insured or a pooled basis — although UK legislation doesn't currently allow the latter. There is also not currently an insured product on the market. It is likely that any such product may naturally appeal to only the more sophisticated investor given the other challenges with decision making in drawdown discussed earlier in this paper.
- **DB pension at retirement** — acknowledging that individuals understand and prefer a DB benefit, this would see individuals being offered the ability to buy a DB pension at retirement provided by a vehicle structured like a DB superfund, as put forward by the Pension SuperHaven for example. The income would come with protections, and for many members could be around 10-15% higher than from an insured annuity. It is not currently clear how the Pensions Regulator would seek to regulate such an arrangement, and an individual would need to understand that the DB benefit was not underwritten by their employer and does not have the same protections as an annuity.



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Given the overview above, we would suggest employers could maintain a watching brief on further innovations in this space, as will we. However, at the current time, we believe the four alternative designs we have set out in this paper represent the most viable alternatives to employers looking to reimagine pensions and do better than DC.

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# Appendix

## Summary of modeling assumptions and methodology for this paper

In this Appendix we set out the supporting information on the approach we have taken to model the variable benefit designs in this paper.

### Assumptions common to all designs:

- Employees are assumed to retire at age 67
- A typical workforce is assumed to be of average age 45, and individuals will have worked for 40 years when they retire.
- Combined employee and employer contributions of 12% are assumed on all of an employee's salary.
- Salary increases are assumed to be in line with CPI inflation.
- Return expectations are with reference to long-term expectations. In particular, the long-term assumptions are:
  - CPI inflation: 2% pa
  - Gilt yields: 3% pa
  - Corporate bond returns: 4% pa (i.e. gilts + 1% pa)
  - Return-seeking asset returns: 6% pa (i.e. CPI inflation + 4% pa)

	Individual DC with annuity purchase	Whole-of-life CDC	DB with variable increases	Individual DC with decumulation CDC	Variable cash balance with decumulation CDC
<b>Best-estimate investment return assumptions</b>					
<b>Before retirement</b>					
<b>Assumed underlying investment strategy</b>	100% return seeking lifestyling to 50% corporate bonds/50% gilts	100% return seeking	100% return seeking	100% return seeking lifestyling to 50% return seeking/ 50% corporate bonds	100% return seeking to age 57, trending to 50% return seeking/ 50% corporate bonds by age 67
<b>Assumed asset returns</b>	CPI + 4% to age 57, trending to Gilts + 0.5% (CPI + 1.5% pa) by age 67	CPI + 4%	CPI + 4%*	CPI + 4% to age 57, trending to CPI + 3% by age 67	CPI + 4% to age 57, trending to CPI + 3% by age 67*
<b>After retirement</b>					
<b>Assumed underlying investment strategy</b>	Implied returns underlying inflation-linked annuity purchase	100% return seeking at 67, trending to 100% corporate bonds by age 90	100% corporate bonds	50% return seeking/ 50% corporate bonds at 67, trending to 100% corporate bonds by age 90	50% return seeking/ 50% corporate bonds at 67, trending to 100% corporate bonds by age 90
<b>Assumed asset returns</b>	Gilts — 0.5%	CPI + 4% at 67, trending to Gilts + 1% (CPI + 2%) by age 90	Gilts + 1%* (CPI + 2%)	CPI + 3% at 67, trending to Gilts + 1% (CPI + 2%) by age 90	CPI + 3% at 67, trending to Gilts + 1% (CPI + 2%) by age 90
<b>Inflation protection</b>					
<b>Target increase</b>	n/a	CPI	CPI	CPI (post-retirement)	CPI + 3.75% (pre-retirement) CPI (post-retirement)
<b>Median income at retirement based on joint contribution rate of 12% of salary</b>					
<b>% of salary*</b>	40%	65%	55%	60%	60%
<b>Relative to DC with annuity purchase*</b>	—	+55%	+35%	+40%	+40%

\*The DB with variable increases returns and the pre-retirement cash balance returns shown are best estimate. In practice, such a scheme would fund prudently, but over time, if experience is line with assumptions, then outcomes would broadly align with best-estimate returns.

\* These figures have been rounded to the nearest 5%, and hence may not appear to be consistent.

## Market shock scenario

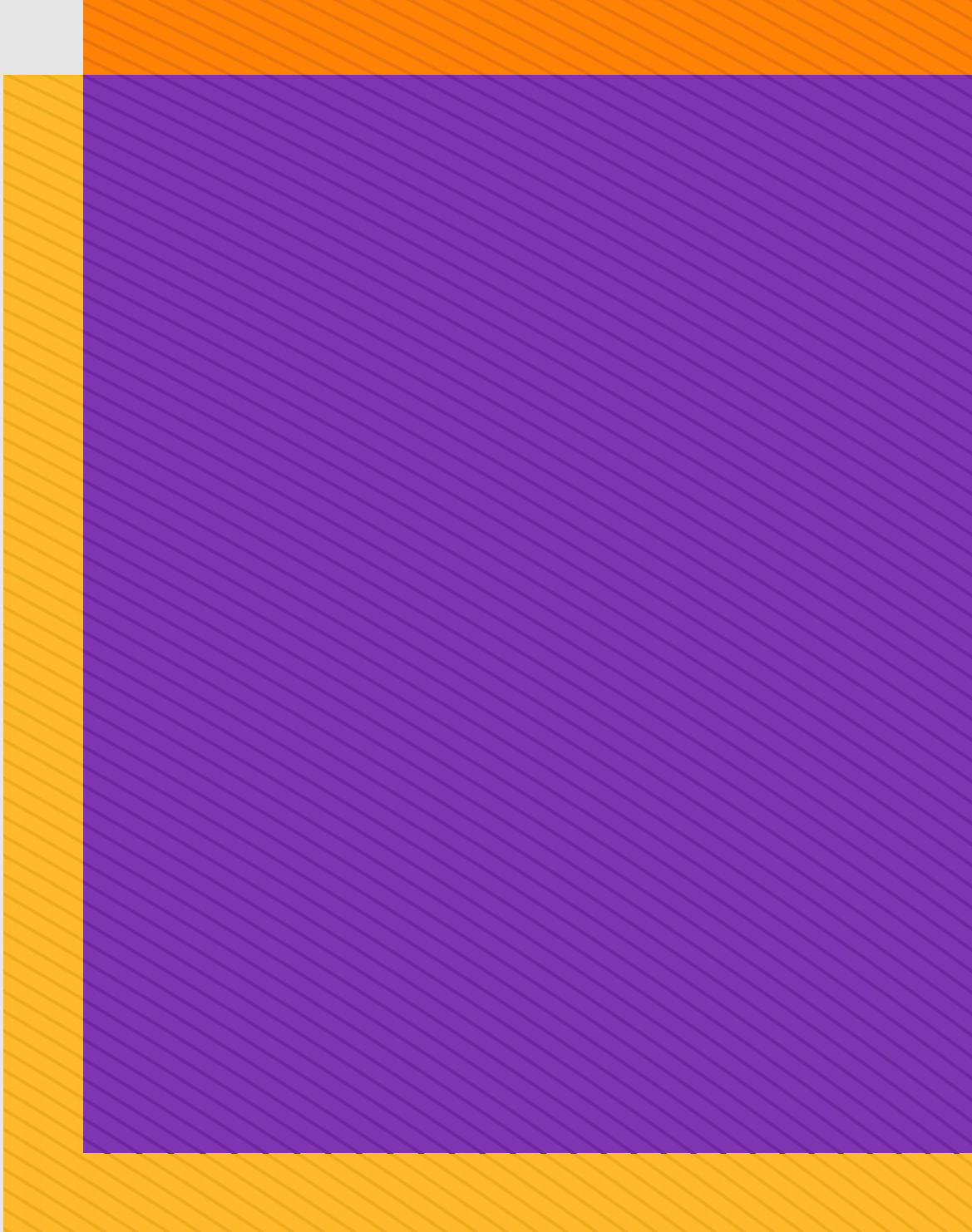
For the severe market shock we have picked a simple scenario to illustrate how each design might react to a change in economic circumstances. We have assumed values of high return / risk assets (e.g. equities) would reduce by 25% and lower return / risk assets (e.g. corporate bonds) by 10% which is broadly consistent with a 1-in-20 one-year downside event for these asset

classes, although this could also happen gradually over a number of years. For the scenario we assume that, despite these events, there is no change to future asset return expectations, so that the funding health of the scheme is reduced. We have applied these shocks assuming the schemes have matured to a point of being in a steady state.

	Individual DC with annuity purchase	Whole-of-life CDC	DB with variable increases	Individual DC with decumulation CDC	Cash balance with decumulation CDC
<b>Severe market shock impacts</b>					
<b>Impact of shock on assets held</b>	-25% (if shock is pre-lifestyling) 0% if shock is post-retirement	-21%	-18%	-25% (if shock is pre-lifestyling) -14% (if shock is post-retirement)	-23% (if shock is pre-retirement) -14% (if shock is post-retirement)
<b>Impact of shock on retirement income</b>	Younger members pre-retirement: -25% No impact post-retirement	No reduction in retirement income, future pension increases reduce by 1.8% p.a. for all members	No reduction in retirement income, future pension increases reduce by 1.3% p.a. for all members	Younger members pre-retirement: -25% Post retirement: One-off cut to retirement income of 1% plus future pension increases reduce by 2% p.a. (i.e. to nil)	Pre-retirement: Future pension increases reduce by 2.6% pa Post-retirement: One-off cut to retirement income of 1% plus future pension increases reduce by 2% p.a. (i.e. to nil).







### About WTW

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