Hewitt

Hybrid Pension Plans
UK and International Experience

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Society of Actuaries Pensions Seminar

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Think Results Think Experience Think Big Picture Think Full Spectrum Think Partnership Think Solutions

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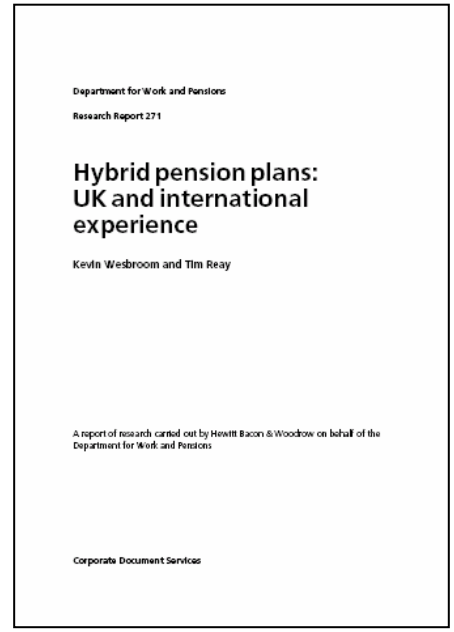
DWP Exercise – and a definition

- Our research report was one of three projects commissioned by the Department for Work & Pensions (DWP) with the objective *“to increase the knowledge of risk sharing and hybrid pension plans compared to traditional final salary and pure defined contribution plans; and to promote discussion and better understanding of these within Government and the wider pensions world”.*



Department for Work and Pensions

Research Report 271

Hybrid pension plans: UK and international experience

Kevin Wesbroom and Tim Reay

A report of research carried out by Hewitt Bacon & Woodrow on behalf of the Department for Work and Pensions

Corporate Document Services

- Report available at **http://www.dwp.gov.uk/asd/asd5/rrs2005.asp#hybrid**
- We define hybrids as *“private pension schemes which are neither pure Defined Benefit (DB) nor Defined Contribution (DC) arrangements, where pure DB arrangements are taken to mean final salary pension schemes”.*
- Our interest in this?

Some (Fairly) Common New UK Hybrid Designs

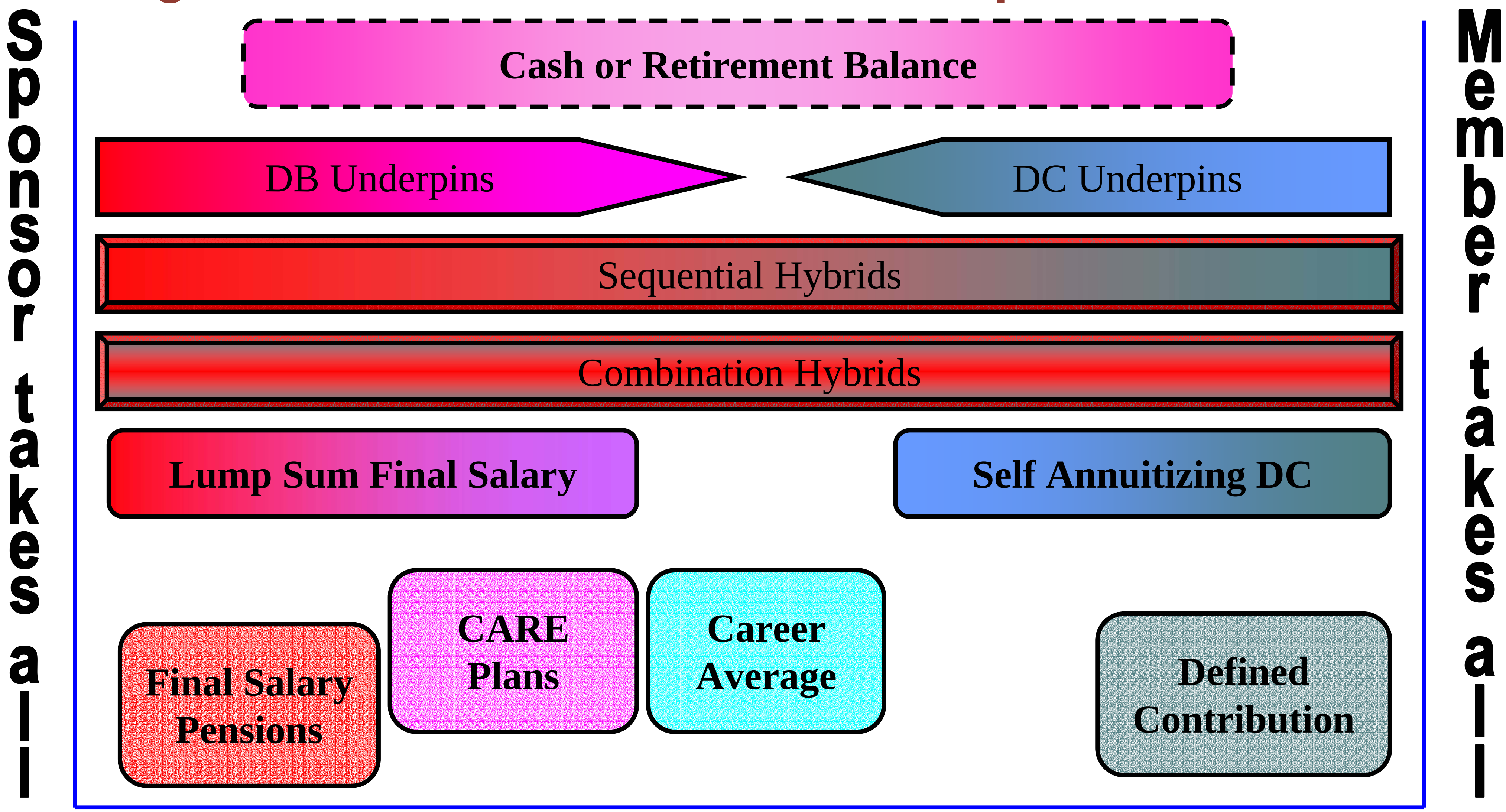
Career Average/CARE

- Pension = $1/60^{th}$ of pay
- Each year's pension revalued in line with RPI
- Variations around the revaluation
  - statutory leaving service (LPI)
  - none
  - bonus revaluations

Cash/retirement balance

- Account = 15% of pay
- Account is guaranteed to be revalued in line with RPI to retirement.
- Applied to purchase pension at retirement.
- Variations around
  - revaluation
  - bonuses
  - conversion terms

Categorisation & the Pension Risk Spectrum



Source: Hewitt

Hybrids in theory ….

Risk Feature	Investment	Annuity Conversion	Salary Inflation
Final Salary Pension	Sponsor	Sponsor	Sponsor
Final Salary Lump Sum	Sponsor	Member	Sponsor
Career Average/CARE	Sponsor	Sponsor	Member
Sequential Hybrid	Both	Both	Both
Combination Hybrid	Both	Both	Both
Final Salary Underpin	Sponsor	Sponsor	Sponsor
DC Underpin	Member	Member	Member
Cash Balance	Sponsor	Member	Member
Self annuitising DC	Member	Sponsor	Member
Defined Contribution	Member	Member	Member

Source: Hewitt

Perspectives on scheme design

Scheme Type	Pension or Lump Sum	Allocation	Revaluation of Account	
			In Service	In Deferment
Final Salary	**Pension**	**% of pay**	**Pay**	**RPI**
Career Average/CARE	**Pension**	**% of pay**	**E.g. RPI**	**E.g. RPI**
DC	**Lump Sum**	**Flexible**	**Asset return**	**Asset return**
Cash Balance	**Lump Sum**	**Flexible**	**Flexible**	**Flexible**

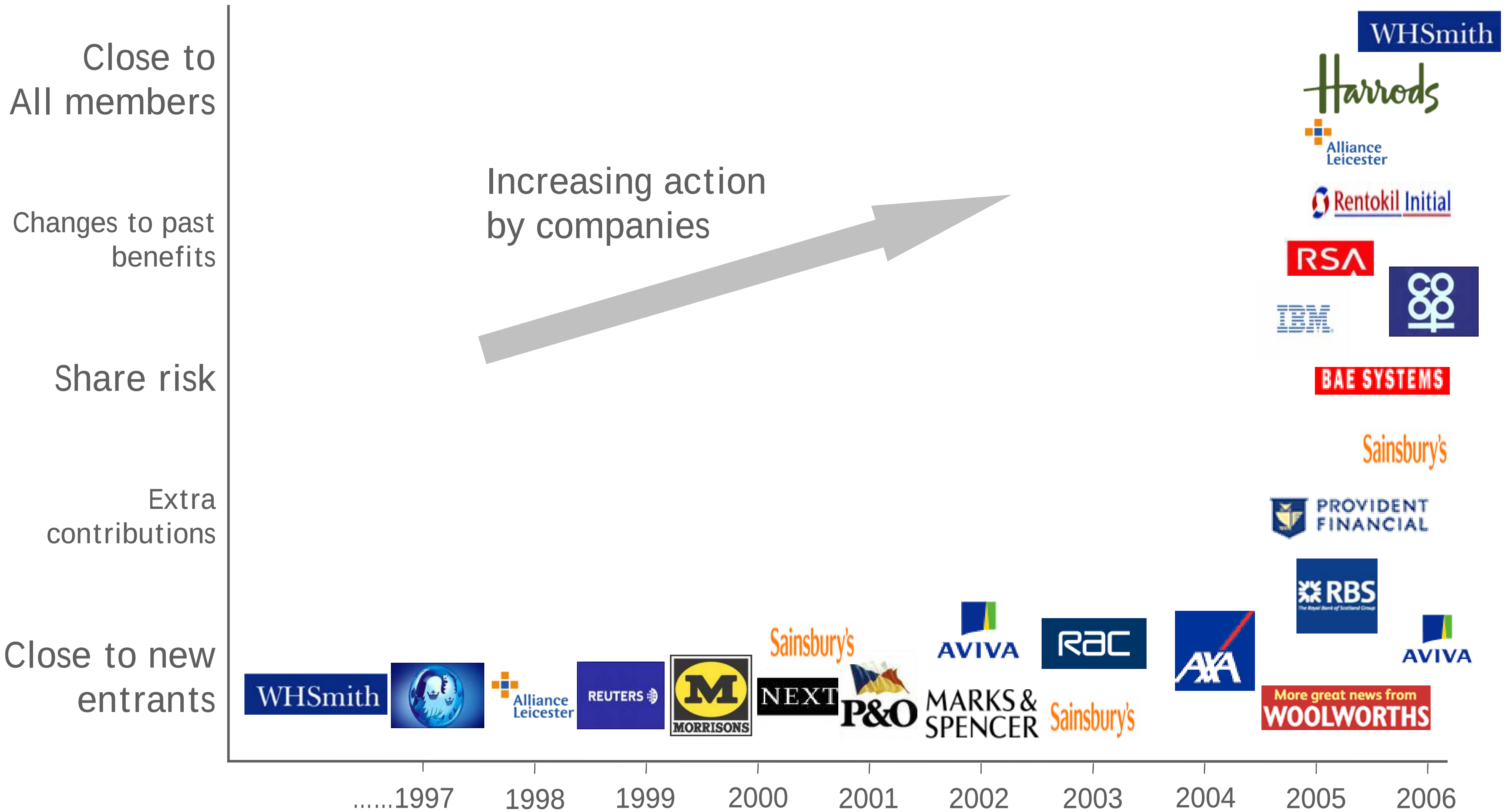
Source: Hewitt

Winners and Losers from Scheme Design

Category	Final Salary	Career Average	Cash Balance	DC
Stayers – i.e. long-term career staff	++		-	--
Leavers – these with broken careers	--			++
Younger members	--	-	+	++
Older members	++	+	-	--
Married members	++	++	--	--
Single members	--	--	++	++
Highflyers – higher pay increases	++	-	--	--
Moderate - or reducing pay increase	-	+	++	++
Healthier staff – higher longevity	++	++	--	--
Less healthy staff – lower longevity	--	--	++	++
Risk takers	--	-	-	++
Risk avoiders	++	+	+	--

Source: Hewitt

Hybrids in practice in the UK



Some Hybrid Designs

Barclays

- Cash Balance
- Members pay 3%: Account credited with 20%
- Guaranteed LPI revaluation
- Bonus allocations up to further 2%
- In house conversion rates

BAE Systems – Existing Members

- Variable accrual rate
- $1/60^{th}$ * Factor
- Factor = Future Life Expectancy)/(Current Life Expectancy)
- Members can pay extra to fund the drop in pension

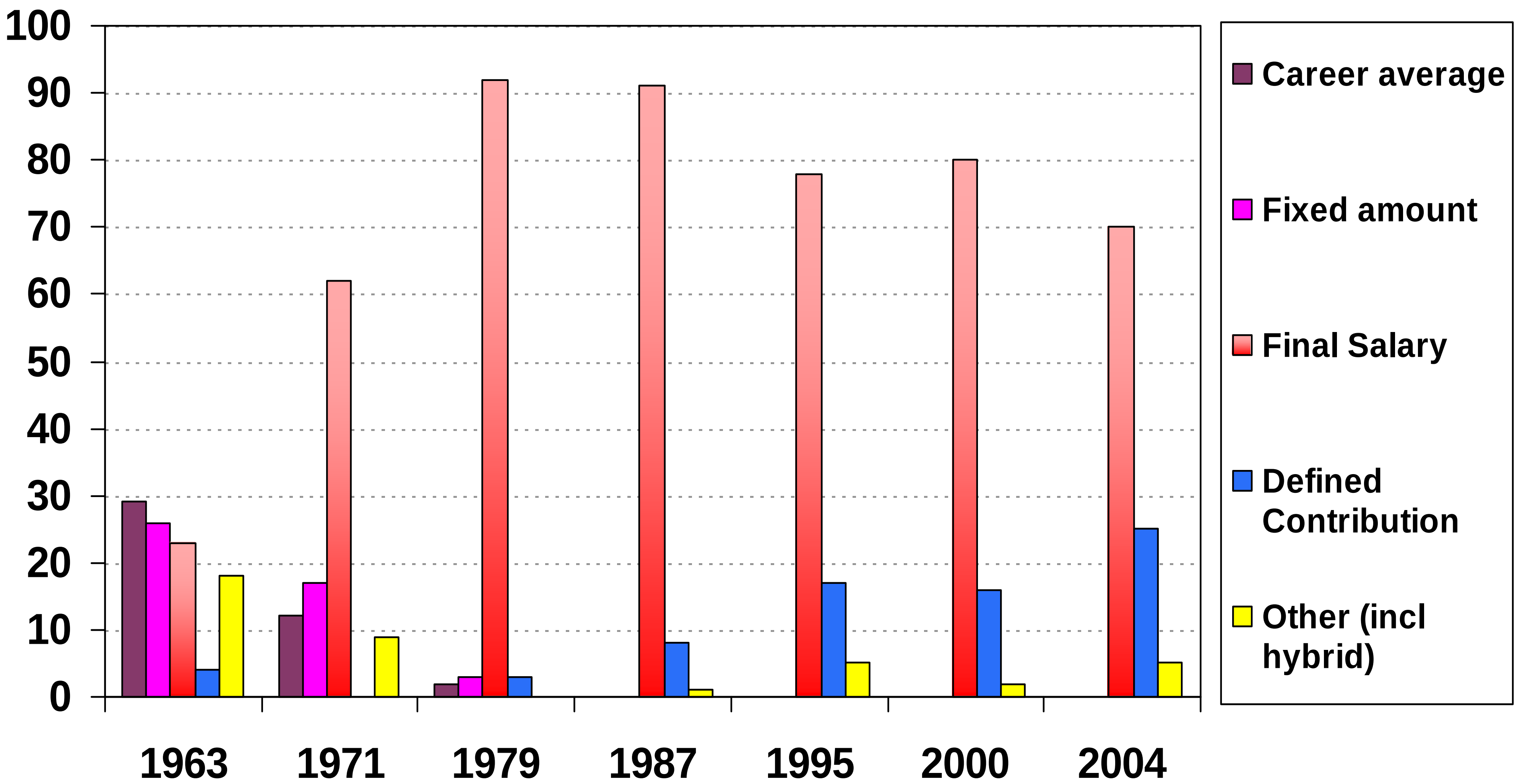
Unilever

- CARE up to £30,000 salary
- 12.5% DC above this level

BAE Systems – New Entrants

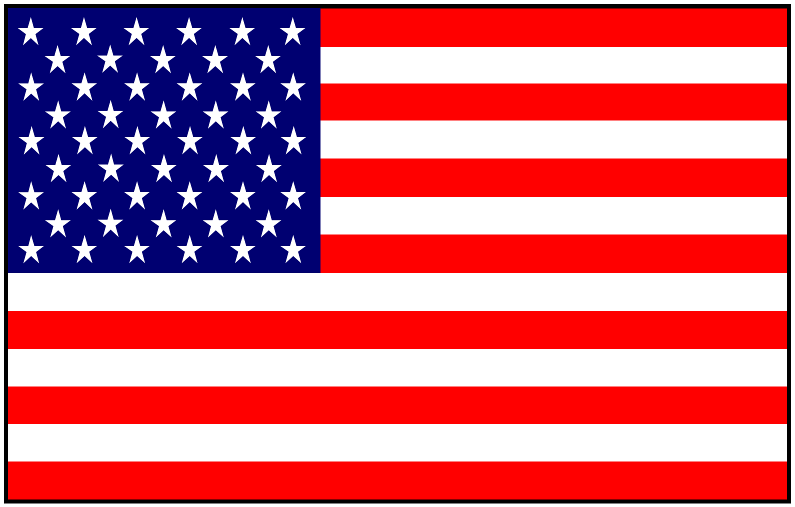
- $1/100^{th}$ Final Salary
- 2% DC on top
- Sits on top of state benefits

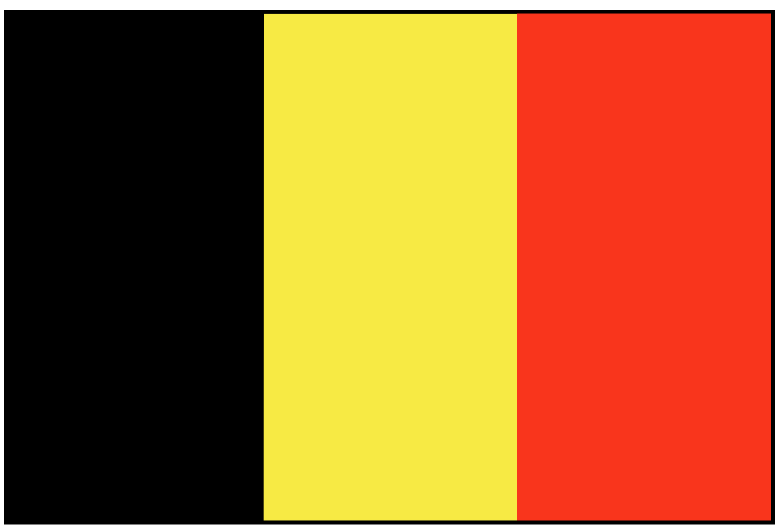
The UK - Back to the Future?

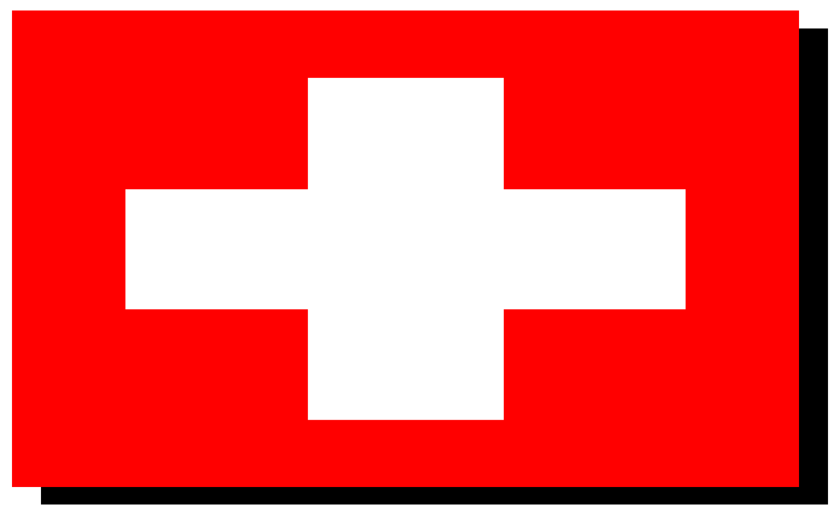


Source: Government Actuary's Department surveys

Hybrids around the (small subset of) World







US

- General pension trend is similar to UK
  - closing, freezing, terminating
- Cash balance plans since 1980’s
- Better understood and appreciated by employees than traditional DB.
- About a quarter of major US employers now offer such a design.
- Similar to UK model
  - but revaluation typically related to yields on long-dated government bonds
- Often introduced as a replacement for more conventional DB plans
- Major issues now clarified around transitions from final average pay plans
  - age discrimination, ERISA, fiduciary responsibilities
  - but not enough to stem the DC tide?

Switzerland

- Virtually all plans are effectively hybrid plans because of legislation
- DC plans are required to offer a guaranteed minimum annual investment return
- DB plans are subject to a DC “underpin” on a certain slice of salary
  - underpin may be underwritten by an insurance company
  - employee gets a hybrid plan
  - employer has a DC plan (for accounting purposes)

Netherlands

- 50% of Dutch employees were members of final salary plans in 2003 but this declined to 10% in 2004.
- Replacement designs are either
  - revalued career average benefits,
  - “combination” hybrids offering revalued career average benefits up to a salary limit and DC on salary over the limit.
- Employers have regained flexibility via “conditional indexation”
  - indexation is only given if financial conditions permit.
  - which offers some funding flexibility, but greater benefit certainty

Belgium

- Legislation has led to the majority of plans being hybrid plans
- All DC plans have to offer a guaranteed minimum annual investment return.
- Most DB plans now define their benefit in lump sum terms
  - transfers post-retirement mortality risk to the employees.
  - sometimes called "pension equity" plans in US

Global issues

- Analysis of taxation environment and regulatory issues
  - Age/sex discrimination
  - Preservation / vesting
  - Revaluation
  - Minimum funding requirements
- Global drivers and barriers
  - Local legislation
  - Reluctance of employers to “rock the boat”
  - The perceived complexity and difficulty of communication
  - Absence of eg insurance companies to offer guarantees
  - Members suspicious of new designs and choice

Drivers of Change and Prospects for the UK

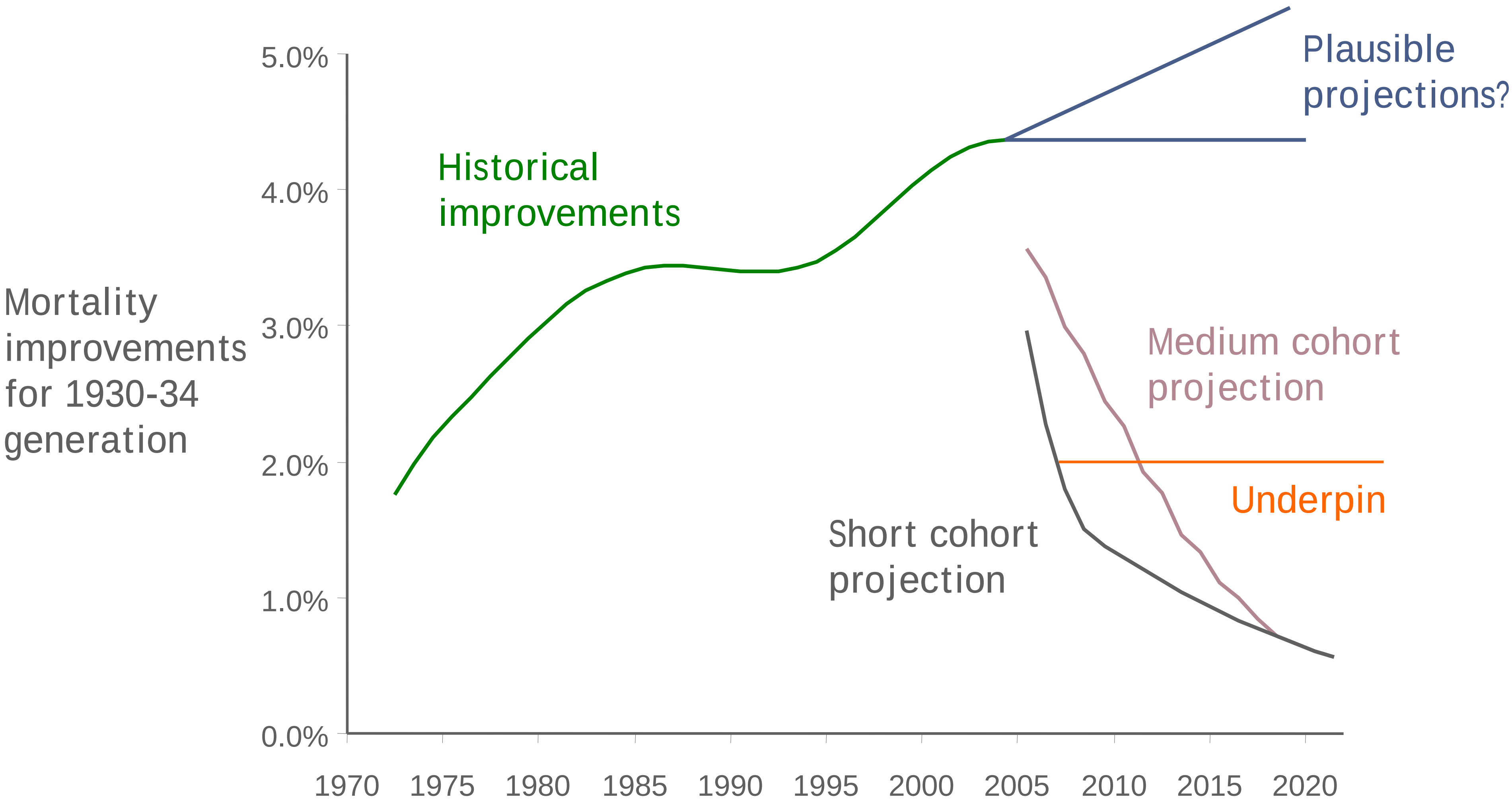
The Decline of DB

- Mark to market accounting
- Lower interest rates
- Lower (negative) investment returns
- Improved (and unknown) longevity
- Tax changes
- Administrative complexity
- Conversion of discretions into guarantees.

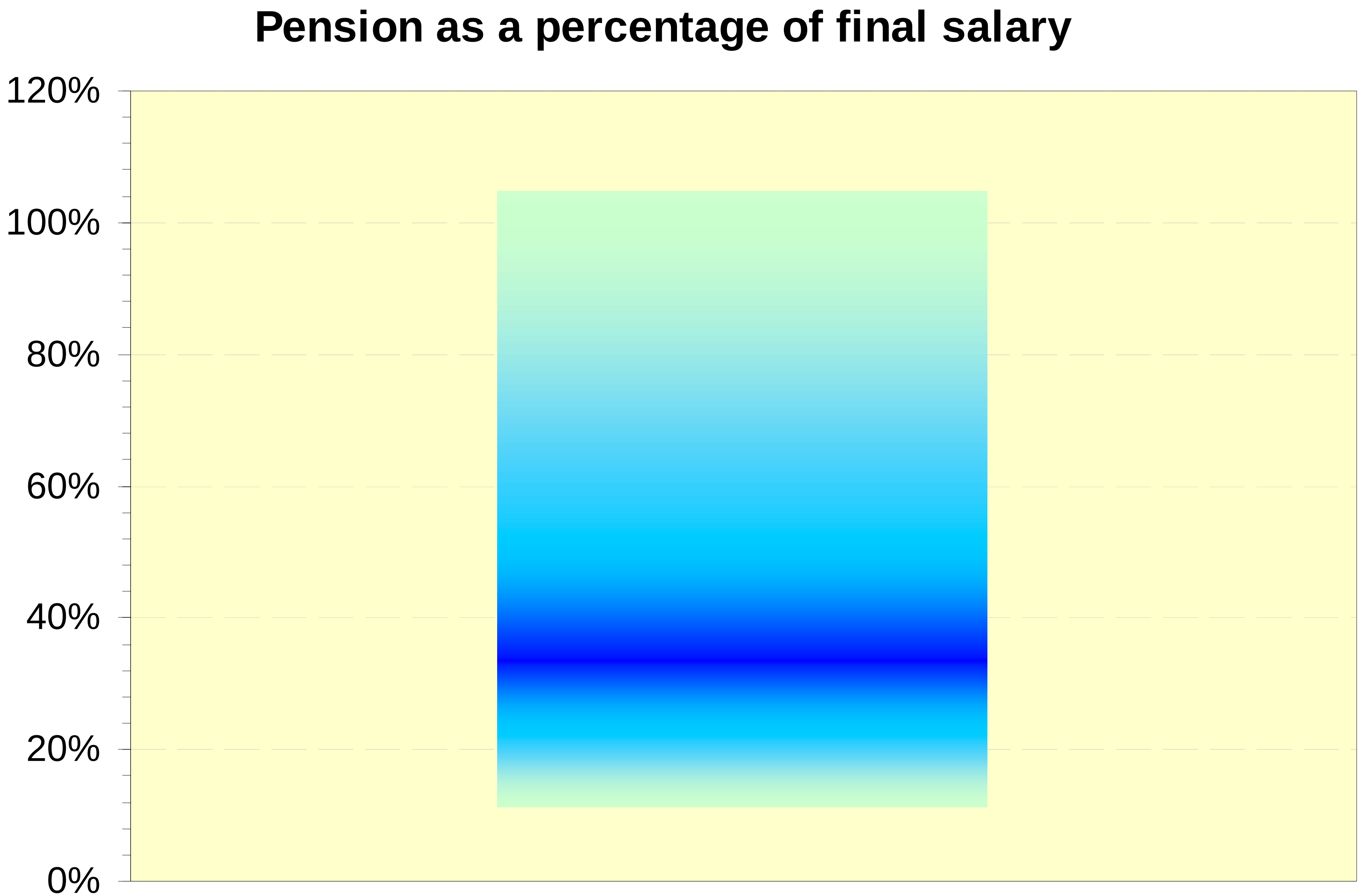
The Move Away from DC?

- Low Contributions
- Variability of Outcomes
- Retirement age at risk

Mortality uncertainty



Variability of Outcomes

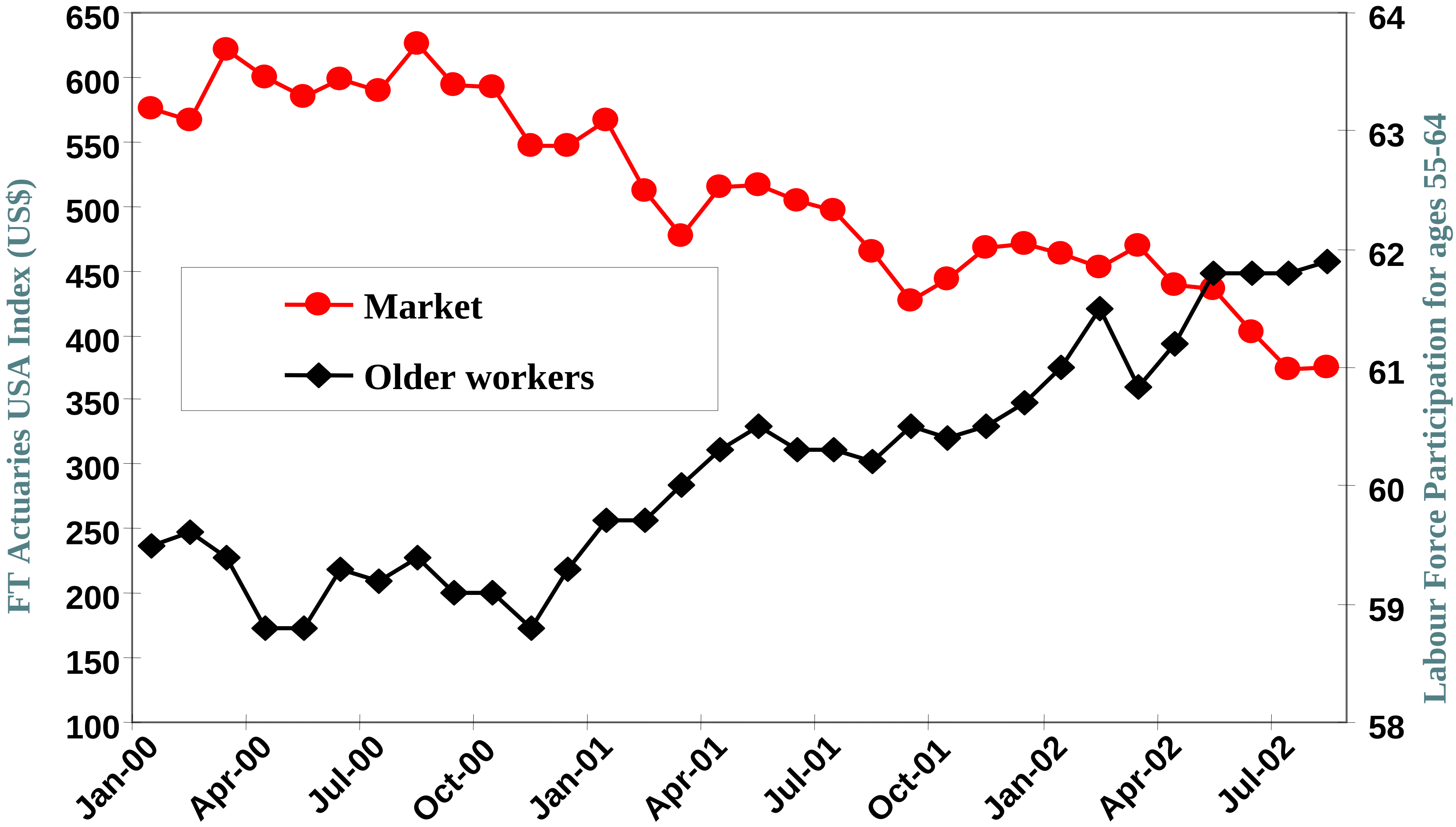


Source: Hewitt

…or variability of retirement?

Source: Hewitt

Market driven retirement



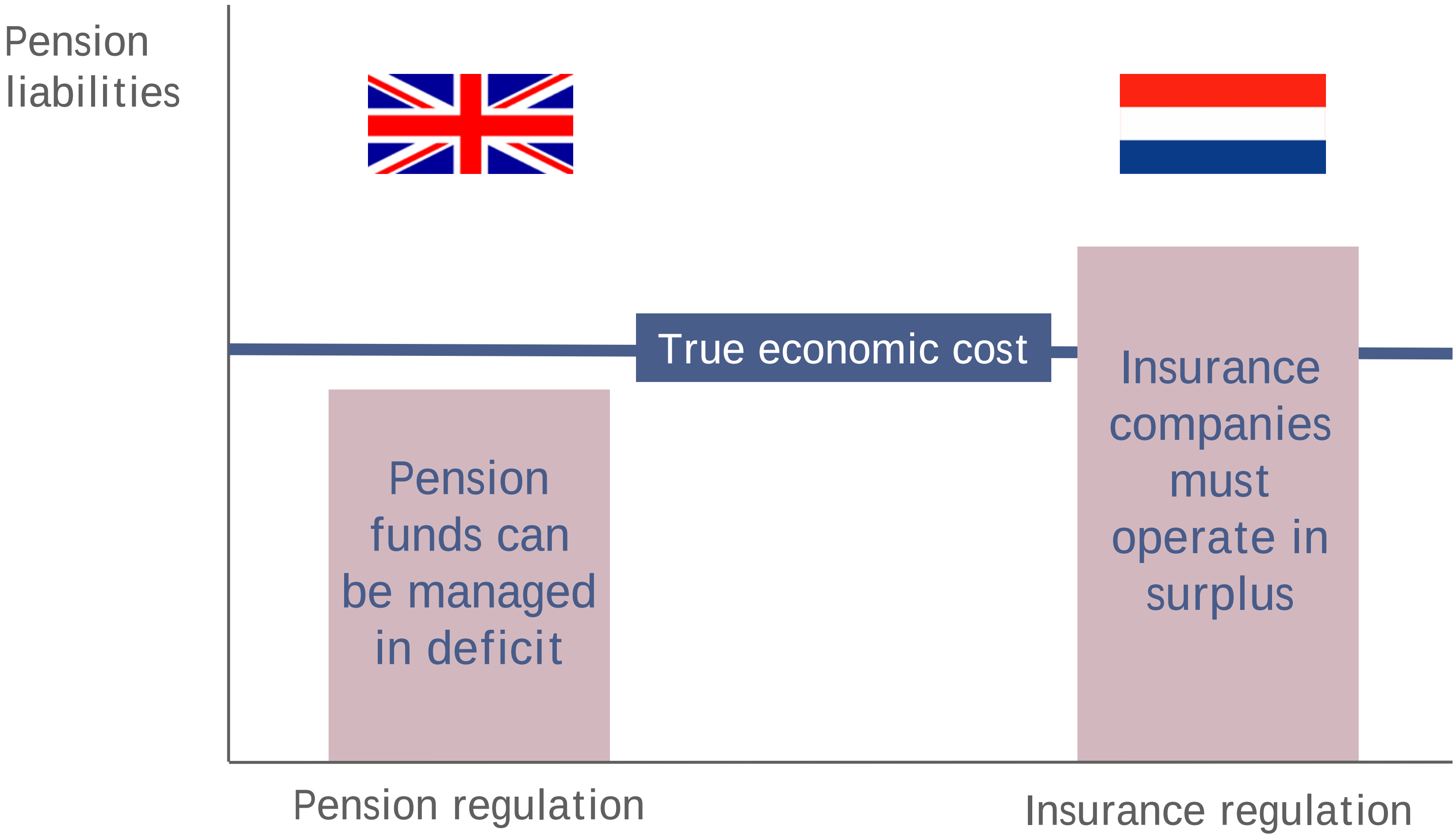
Source: **Eschtruth & Gemus, 2002**

Final thought – a new type of hybrid?

	Return Seeking	Risk Reduction
Philosophy	Strong employer, well able to withstand volatility	Not rewarded by shareholders for operating DB pensions
Ultimate goal	Provide DB benefits as a source of competitive advantage	Buy out all DB pension liabilities, subject to price
Contribution strategy	Pay in the minimum (cash invested in the business will generate higher returns than portfolio investments)	Greater contributions, heading towards buy out (pension funds are debt which should be repaid as soon as possible)
Investment policy	Return orientated (eg equities)	Risk averse (eg bonds)
Accounting implications	Low but variable pension costs. Volatile balance sheet (deficits) – not material at the entity level	Higher pension costs. Balance sheet deficits minimised
Member security	Security of strong employer backing	Greater funding and eventual buy out

Capital requirements

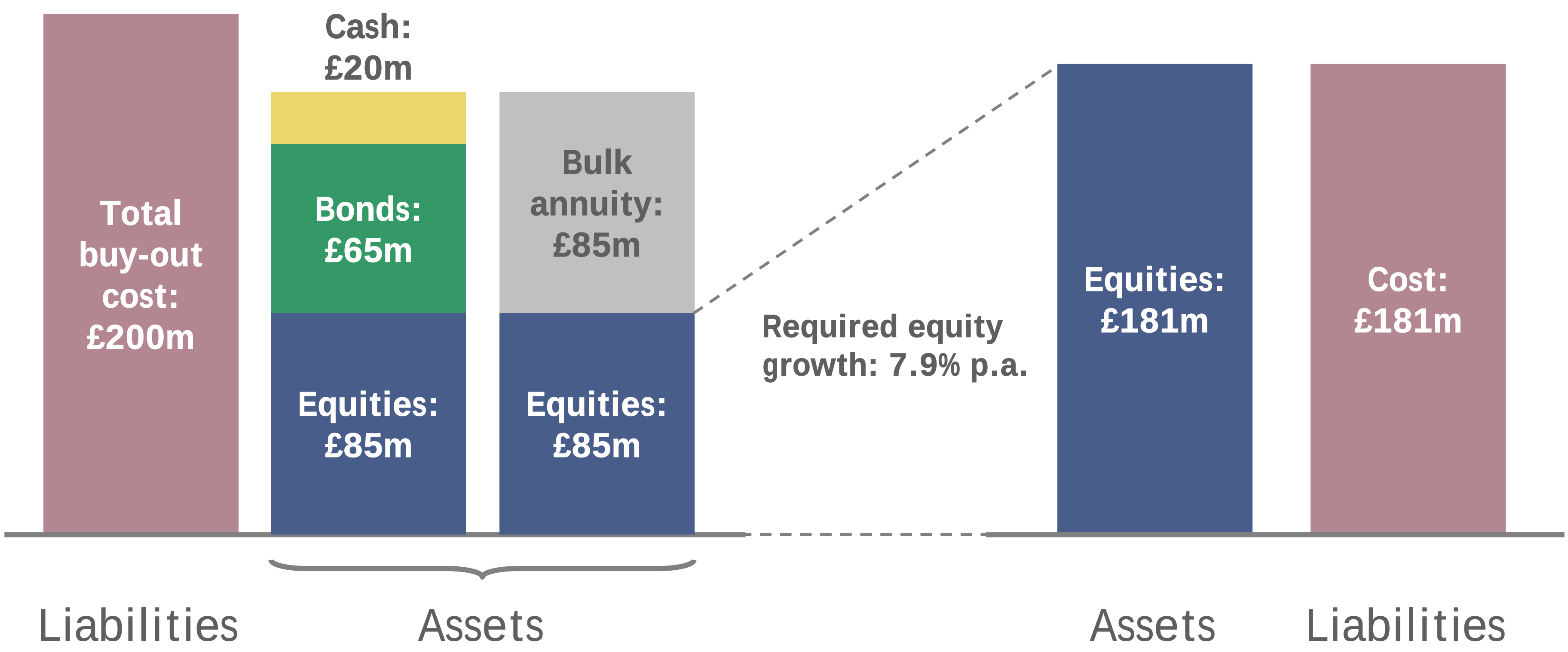
**Two regulatory regimes govern the same pension promise in the UK;
Will these regimes converge?**



Hybrid buy out strategy

OUTSET: Initial premium

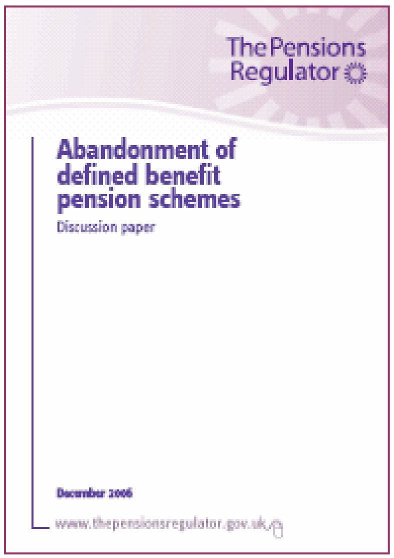
YEAR 10: Balance of buy out cost



To meet premium in year 10, equity portfolio must grow at 7.9% p.a.

“Abandonment” is such a harsh word…

- Just say “yESS” to Employer Substitution Schemes



The Pensions Regulator

Abandonment of defined benefit pension schemes

Discussion paper

December 2006

www.thepensionsregulator.gov.uk

Retiree Benefits

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Retiree Benefits acquires and manages portfolios of pension benefits obligations from corporations that have frozen their plans and desire a more cost-effective and flexible alternative solution to plan termination

The seller benefits because the transaction is structured to achieve accounting "true sale" status thereby relieving the seller of further liability on its retiree defined benefit obligation

Retiree Benefits becomes the new parent of the existing plan sponsor and assumes mortality and investment risk associated with plan assets and liabilities as well as fiduciary responsibility for its retirees

We commit to maintaining the highest professional standards

Retiree Benefits' only business is the acquisition and management of pension plans. Our retirees benefit from having their assets in a bankruptcy remote, credit enhanced structure, managed primarily for their benefit. The guiding principle in our business is to enhance the wellbeing of our retiree customers. We do well if they do well and not if they don't. This is as it should be. We serve and protect our retirees.

A Future Role for Actuaries?

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