

Career Average Revalued Earnings (CARE) Scheme (the Scheme)

APPENDIX 1

CARE SCHEME REVIEW FACTSHEET – INFORMATION AND OPTIONS

This paper provides background information on the CARE Scheme and the issues the Scheme faces. Please consider this when completing the questionnaire which accompanies it.

Section 1 of this appendix sets out the main results of the actuarial valuation as at 30 September 2007. Section 2 provides background on some of the issues that the scheme faces. Section 3 considers some of the scheme design options which might form part of this review.

Further information on the actuarial valuation and the issues and options covered in this paper, including examples of benefit accrual methods, will be provided at the CARE Employer Day being held on 23 September 2008.

Section 1 – Actuarial Valuation as at 30 September 2007

1.1 Actuarial valuation results - Table

	2004 Results	2007 Results
Liabilities	£1,620,000	£9,388,000
Assets	£1,886,000	£10,932,000
Surplus	£266,000	£1,544,000
Funding level (ratio of assets to liabilities)	116.4%	116.4%
Total future service contribution rate (including expenses)	12.7%	14.4%
Average member contribution rate	4.3%	4.3%
Employer's standard future service contribution rate	8.4%	10.1%

1.2 Actuarial valuation results – Notes and analysis

The results above show the 'ongoing' valuation results, on the basis that the Scheme is expected to continue in its present form.

In 2004, the required employer contribution rate to meet future benefits alone was 8.4%. Employers have continued to pay 10.0%. Contributions in the scheme have been paid since its inception on the basis that they meet the benefit requirements and build up some surplus, which *may* be used to provide member bonuses. However, in accordance with the Trustee's bonus policy (see section 2.2 below), no bonuses have been paid to members. This has contributed towards a growing surplus in the scheme.

Strong investment performance has also contributed to the strengthening of the scheme.

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As a consequence, the scheme's surplus has increased to £1.544 million.

The ratio of assets to liabilities (the funding position) is (by coincidence) unchanged between the two valuations at 116.4%.

The scheme's funding position at 30 September 2007 is therefore very strong, although investment performance and other factors in the period since 30 September 2007 will mean that the current position is considerably less favourable.

1.3 Future service contribution rate

The future service contribution rate required to finance future accrual of benefits has increased from 12.7% to 14.4% of total pensionable salary.

The increase in the future service contribution rate is primarily due to improvements in life expectancy (longevity) and an increase in the assumed long-term inflation rate.

Based upon an average employee contribution of 4.3%, the required employer contribution rate would be 10.1%. This would be the amount required that would be expected to maintain the current surplus of £1.544 million.

Employers currently pay 10.0%. It can be seen from the valuation results that the surplus that has been built up will start to decline on the basis that the cost of benefits accruing has, for the first time, overtaken the contributions being paid into the scheme. The (10.0%) employer contribution level, set at the outset of the scheme, was on the expectation of a build-up of surplus, which could potentially be provided to members by way of a bonus.

Whilst the build-up of surplus has taken place, the likelihood of paying a bonus has been reduced significantly by other factors, covered in section 2 below.

1.4 Scheme specific investment strategy

The benefits of the scheme are paid out of the scheme's assets. The scheme has two sources of income – investment returns and contributions.

Essentially, the more the scheme is able to generate from investment returns, the less is required from contributions and, in turn, the lower the amount required to be set aside now to cover the Scheme's liabilities.

When the Actuary values the liabilities on the ongoing basis, he takes account of the investment returns likely to be available on the scheme's assets. The Actuary allows for the fact that a significant proportion of the assets are invested in equities, which are expected to generate a higher return than, for example, fixed interest bonds.

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The scheme's investment strategy is currently 65% equity, 7.5% property and 27.5% fixed interest bonds.

If the Actuary assumes a greater level of more cautious investments (such as fixed interest bonds), then the assumed investment returns would be lower and a proportionately greater level of income would need to come into the scheme by way of contributions.

1.5 Discontinuance solvency valuation

At each valuation, the Actuary also produces results based on the estimated cost of buying out the past service benefits with an external insurer if the Scheme had been wound up. On this basis, as at 30 September 2007, the total liabilities were calculated at £16.666 million with a shortfall of £5.734 million. This represents a funding level of 66%.

The investment return assumptions used in the buy-out valuation are considerably more cautious than those used for the ongoing valuation. This is because an insurer will take significantly less risks in its asset investment and so will discount the value of future liabilities on a more prudent (and therefore expensive) basis.

CARE is still a very young scheme, with the majority of liabilities being in respect of non pensioners. As such, these more prudent assumptions have an even greater impact on the Scheme than would be the case with a more mature scheme.

Section 2 – Issues facing the scheme

2.1 Employer Debt Regulations

2.1.1 When the Scheme was introduced

When the Scheme was introduced in 2001, employers that ceased to participate in a multi-employer occupational pension scheme providing defined benefits were only required to pay a debt on their withdrawal calculated on the Minimum Funding Requirement (MFR) basis. As the Scheme was fully funded on the MFR basis, there was no employer debt arising in the event of withdrawal from the Scheme.

However, the MFR was flawed because even if a scheme was 100% funded on the MFR basis, it may not necessarily have had sufficient assets to cover the full benefit entitlement of all members in the event of the Scheme winding up.

A solvent employer could still wind up its scheme if it was fully funded on the MFR basis, even if this meant that members would receive lower benefits than their entitlement under the Scheme rules. Indeed, there were several high profile cases of this happening.

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2.1.2 What has changed?

In June 2003, Regulations were introduced that prevented employers from walking away from their obligations. The new Regulations required employers that withdrew their support from the Scheme to pay the estimated cost of securing the benefits with an insurance company, otherwise known as the buy-out basis. These Regulations only applied to single employer schemes.

On 2 September 2005, new Regulations were introduced, which applied to employers within multi employer pension schemes such as CARE. This changed the method of calculation of the withdrawal debt from the MFR basis, to the estimated cost of securing member benefits on a buy-out basis. This brought multi-employer schemes into line with single employer schemes.

Employers are effectively deemed to have withdrawn from the Scheme when the last active member leaves the Scheme, though a period of grace may apply in the event that a small employer has their last scheme member leave but expects to replace that individual.

As mentioned in Section 1, the assumptions used to value the liabilities on a buy-out basis are far more prudent than on an ongoing basis, resulting in higher liability values. The current contribution rate falls well below the level that would be required to fund the benefits on a buy-out basis (which would be in excess of 20%). Consequently, as your Scheme members build up further pension benefits this will create additional contingent liabilities on the buy-out basis. These liabilities would of course only crystallise in the event that you subsequently withdraw from the Scheme.

You will be aware of the contingent debt amount calculated for your organisation as at 30 September 2007, which was issued to you on 10 June 2008.

The following question is covered on the Questionnaire (Appendix 2). In relation to 2.1, please use the tick boxes provided on the Questionnaire to complete your answer.

- How concerned are you about the continued accrual of contingent buy-out liabilities?

2.2 Importance of fixed contribution rates and member bonuses

2.2.1 When the Scheme was introduced

One of the key objectives of the Scheme was to limit employer contributions to a maximum of 10%. The underlying assumptions used to calculate the contribution rates were deemed to be sufficiently prudent, so that the combined employer and member contributions would meet the defined benefits of the Scheme and

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potentially provide bonuses to members out of surplus funds. Member bonuses would be paid into an individual defined contributions account, which would be used to purchase additional benefits at retirement.

2.2.2 What has changed?

Prior to September 2005, the intention was to pay member bonuses when the Scheme was over 120% funded on an ongoing prudent valuation basis. However the basis for this target was strengthened following the introduction of the requirement for an employer to pay a debt on withdrawal, meaning that payment of a bonus will only take place in the event that the scheme is in a strong funding position on a buy-out basis.

Also, as stated in Section 2.1, the multi-employer debt regulations have created significant buy-out liabilities **if** an employer withdraws from the Scheme. It would not be prudent to provide bonuses to members, which would immediately reduce the level of scheme assets and thus increase the contingent liability for each employer.

In addition, as you will have noted from the valuation results, the employer future service contribution rate required to finance future accrual of benefits is now 10.1%. The main reason for the increase is due to the fact that life expectancy has increased, which in turn increases the cost of benefits in the Scheme.

The following questions are covered on the Questionnaire (Appendix 2). In relation to 2.2, please use the tick boxes provided on the Questionnaire to complete your answers.

- How important is it to you that the current contribution rates are not increased?
- Would you be willing in future to accept a limited increase in employer contributions to maintain the current benefit structure?
- Would you be willing to accept an increase in contributions shared between employers and employees?
- Bearing in mind that the payment of a bonus would lead to an increase in your contingent buy-out liabilities, how important is it to you that the Scheme retains a bonus objective?

Section 3 – Scheme Design Options

This section sets out some potential benefit options, which might be considered as part of the review of the CARE Scheme. Further information on the options covered, including some worked examples, will be provided at the CARE Employer Day being held on 23 September 2008.

3.1 Background to the current design

3.1.1 When the Scheme was introduced

The Scheme was designed to provide members with a block of pension each year equal to 1/80th of that year's pensionable salary. Employers pay 10% of salary and members pay age-related contributions. Members are contracted-out of the State Second Pension (S2P) Scheme, which means that they do not receive the S2P benefit in full. Instead the Scheme must provide benefits which are at least broadly equivalent to the benefits that the member would have received had they not been contracted-out. In return, members pay lower National Insurance contributions, as do employers.

3.1.2 What has changed?

A combination of regulatory requirements on the Trustee to adopt prudent funding assumptions, as a consequence of the new funding regime, and the increased longevity of Scheme members, is starting to put a strain on the ability to maintain the current benefit package within the original cost structure.

Coupled with the pressure on costs is the continual build-up of buy-out liabilities (as mentioned under Section 2.1). As can be seen from the valuation results, the size of the Scheme has increased significantly since the last valuation and the funding shortfall on a buy-out basis has increased to £5.734 million.

Although this is of greatest concern to employers that are thinking of withdrawing from the Scheme, there may be a desire to limit this build-up, particularly with the requirement to account for contingent liabilities such as pension buy-out costs.

There are a number of options that can be considered which reduce or cease the growth of these liabilities and/or reduce future service costs.

3.2 Alternative Scheme benefit structures

3.2.1 Option 1 - Reduce pension accrual rate for future benefits

One way of reducing both the cost of pension benefits and the build-up of future liabilities is to reduce the rate at which members earn future service benefits.

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A possible option would be to reduce the pension accrual rate from 1/80th of each year's salary to 1/100th of each year's salary. At the same time, the Scheme would switch from being contracted-out of S2P to being contracted-in. This would mean that members would, in future, receive the full S2P **on top of** the CARE pension. National Insurance contributions would revert to the full rate for both members and employers.

Advantages:

- There will be a reduction in the rate at which contingent buy-out liabilities will be expected to increase (as future pension accrual within the Scheme will be lower), however these will still increase.
- Contracting out of S2P is not as beneficial to employers as it was when the Scheme commenced in October 2001 – hence contracting back into S2P will remove some of the hidden cost of contracting out.
- Contracting back into S2P will be more beneficial to low earners, which make up the majority of members within the Scheme.

Disadvantages:

- Potential new recruits *may* be less inclined to take up an offer of employment due to a perceived reduction in benefit package.
- Members and employers will pay higher National Insurance contributions through contracting back into S2P.
- Employers will still continue to build up future service liabilities (albeit at a lower level than currently) and increase the contingent buy-out debt.

3.2.2 Option 2 - Close the Scheme to new members

A further option for reducing the build-up of contingent buy-out liabilities is to close the Scheme to new members. By closing the Scheme to new members, employers will be limiting the build-up of future contingent buy-out liabilities, as these will be restricted to the future service benefits for the current membership. New members of staff will need to be offered an alternative pension arrangement, perhaps on a defined contribution basis.

Whilst closing the Scheme to new members will reduce the build-up of buy-out liabilities, it will result in an increase to the contribution rate for existing members. In an open scheme, the membership profile is expected to remain fairly constant with retirees and leavers being replaced by (generally) younger new

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recruits. In a closed scheme, the age profile of the membership will increase year-on-year, increasing the cost of benefits. This is likely to add around 3% to the contribution rate.

Closing the Scheme to new members will also advance the date on which you will cease to have an active member contributing to the Scheme, which would trigger a debt calculated on the full buy out basis that you would be required to pay.

This option could also be considered in conjunction with Option 1.

Advantage:

- There will be a reduction in the build-up of contingent buy-out liabilities as the continuation of defined benefit pensions will be restricted to existing members only.

Disadvantages:

- Closure to new members will advance the date on which an employer will cease to have an active member contributing to the Scheme. This will trigger a withdrawal debt that would be payable based on an employer's share of the full buy-out costs.
- An estimated 3% loading will be applied to employer contributions with immediate effect to reflect the additional cost of funding the Scheme for the ageing membership.
- The burden of setting up and running an additional pension scheme for new employees, which may be on a defined contribution basis. Potential new recruits may be less inclined to take up an offer of employment due to reduction in benefit package.
- Possible HR issues of having a 'two-tier' workforce – some members still accruing defined benefit pensions and some others perhaps accruing defined contribution pension benefits.
- Employers will still continue to build up future service liabilities, albeit for existing members only.

3.2.3 Option 3 - Close Scheme to future accrual

If employers are looking to remove as much risk as possible, the option of closing to future accrual would certainly meet this aim. Under this approach, no further members would be able to join the Scheme and all existing members would be treated as leaving service. There would be no further build-up of defined benefit contingent buy-out liabilities, however employers would still be

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responsible for the past-service contingent buy-out liabilities that have been accrued up to the date of closure to future accrual.

The Scheme would continue to operate in a 'paid-up' form and benefits earned by members up to the date of closure will become payable from the Scheme as and when each member retires.

Closing the Scheme to future accrual will, again, necessitate the setting up of a new pension arrangement for your staff.

Advantages:

- Closing the Scheme to future accrual will not result in the triggering of any employer buy-out debts. Employers will be able to continue to participate in the Scheme on a paid-up basis and past-service contingent buy-out debts will be run-off over a (long) period of time.
- There will be no further build-up of contingent buy-out debt as no further defined benefits will be earned by members.

Disadvantages:

- Members will no longer enjoy continued defined benefit accrual, which may have recruitment and retention implications.
- Members and employers will pay higher National Insurance contributions as they will no longer be contracted-out of S2P.
- Some form of alternative pension arrangements will need to be set up for employees, which may be on a defined contribution basis.
- There *may* be problems with your contracts of employment that make it difficult to move away from the current defined benefit scheme for existing employees.

3.2.4 Option 4 – Alternative risk sharing options

This section considers the risks of funding defined benefit arrangements and considers how developing the concept of risk sharing *might* form part of a review of the benefit structure.

Under a Final Salary Scheme, the scheme and employer bear the risk that investment returns in practice fall short of the expectation, requiring higher contribution levels. This is known as the investment risk. The scheme also bears the risk that members will live longer than expected (longevity risk) and the risk that members' earnings close to retirement will significantly exceed expectation and increase benefits disproportionately (earnings risk).

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In a defined contribution scheme, all of these risks are borne by the member. Under a CARE Scheme, the scheme (and so the employer) bears the investment and longevity risk, but the member bears the earnings risk (because benefits are not all based on the member's final salary). The CARE basis is a form of "risk sharing".

In view of the concerns regarding further debt accrual and potential for further increases in the future service contribution rate, alternative methods of pension accrual which share the risk also need to be considered.

One of the key means by which risk can be shared would be to introduce a Cash Balance accrual method.

Under the CARE basis, at retirement the member is provided with a defined amount of pension per annum, based on salary and service. Under a cash balance method, instead of being provided with a defined amount of pension per annum, the member is provided with a defined amount of cash at retirement with which to purchase a pension.

Like CARE, the amount is based on the member's salary and service in the scheme. Under CARE 80^{ths}, a member accrues a pension per annum of 1/80th of pensionable salary. Under Cash Balance, the member might (for example) accrue a cash fund per annum at retirement of 25% of pensionable salary to obtain a similar level of benefit.

To obtain broadly the equivalent of CARE 100^{ths} (contracted-in), the member might accrue a cash fund at retirement of 20% of pensionable salary each year.

As with CARE pension, the amount of defined cash at retirement would be subject to revaluation each year and 25% of the fund would be available as tax free cash at retirement, with the remainder used to purchase an annuity.

Under a cash balance arrangement, the member bears the longevity risk. In other words, if during the member's working lifetime, life expectancy improves, the scheme and employers would not bear any cost increases as the member's fund at retirement is used to purchase an annuity on the basis of annuity rates at *that* time.

There are a number of ways in which the benefit basis can be varied. Normal retirement age, accrual percentage and revaluation method all influence these and the expected cost will vary accordingly.

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- The member shares more of the risks with the employer.
- There would be a reduction in the rate at which contingent buy-out liabilities increase, as future pension benefits will be lower, however these will still increase.
- At retirement, the purchase of an annuity on the open market removes the contingent buy-out liability on the employer at that point.

Disadvantages

- Employers will still continue to build up future service liabilities (albeit at a lower level than currently) and increase the contingent buy out debt.
- Although cash balance arrangements are not a new concept, they are not as straightforward to understand as final salary, CARE or defined contribution.

The following questions are covered on the Questionnaire (Appendix 2). In relation to 3.2, please use the tick boxes provided on the Questionnaire to complete your answers.

- Would you support a reduction in pension accrual rate for future benefits?
- Would you support the closure of the Scheme to new members?
- Would you support the closure of the Scheme to future accrual?
- Would you support the introduction of a Cash Balance accrual method as a form of risk sharing?