ASSOCIATION OF CONSULTING ACTUARIES

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To whom it may concern

Delivering collective defined contribution (CDC) pension schemes

I am writing on behalf of the Association of Consulting Actuaries (ACA) in response to the consultation on CDC pension schemes. The ACA has not carried out any specific in-depth research or longitudinal study in this area and our comments are therefore intended simply to offer a contextual opinion from specialist practitioners.

The attached Appendix 1 includes our responses to the specific questions raised and Appendix 2 sets out brief details of the ACA, which is the representative body for consulting actuaries in the UK.

In brief, the ACA is supportive of the concept of CDC pension schemes. We welcome the Government's desire to facilitate this new type of scheme for the Royal Mail and can see that similar designs might be helpful elsewhere too. In particular, we see a future possibility of a decumulation vehicle for members with DC pots at retirement who could benefit from some pooling of risk (but who do not wish to buy an annuity).

We are concerned that the potential market for CDC schemes is more limited now than it was when the idea was previously mooted, as many employers have already moved from DB to DC schemes during the interim and may be reluctant to consider another change. However, we do not see any harm in establishing the option for a new type of pension scheme and CDC does have advantages that employers and members may benefit from where they do choose to participate. It might be that the value of these arrangements arises some time in the future when employers and employees realise that DC schemes with low levels of contributions fail to meet people's needs.

We believe it is vital that any new schemes are subject to robust governance and regulation to protect members. There are obvious issues that arise from the pooling of risk across the membership, though these are an inherent feature of existing pension schemes already. There will also be a particular challenge in communicating these new and unfamiliar schemes to members to minimise the danger that member expectations are not delivered. We confirm that actuaries have the relevant skills for helping to run these types of pension schemes.

Finally, we note that the key drivers of adequate pension provision are the level of contributions paid into the scheme over the years and the way that those contributions are invested, rather than the form of the pension arrangement. CDC schemes will remain reliant on adequate contributions and sound investment strategies to generate decent pensions, as is currently the case for DB and DC schemes. As an example, the Royal Mail proposals target a certain level of benefit but will sacrifice indexation if the investment returns do not prove sufficient to provide that target given the level of contributions paid.

I hope these comments are of interest and would be happy to expand or clarify if this would be helpful.

Yours faithfully

Tess Page

Tess Page
DC Committee
On behalf of the Association of Consulting Actuaries Limited

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APPENDIX 1

1. Are there other ways in which the introduction of CDC Schemes would give rise to different impacts on individuals in relation to one of the protected characteristics?

The cross-subsidy issues covered in the consultation document have been well-documented and represent the "obvious" considerations.

Other potential inequalities might emerge, but these will depend heavily on the way a CDC scheme is designed. For example, if a CDC scheme were to be set up using age related contribution scales (rather than the rate of accumulation that Royal Mail proposes for its scheme), the contribution received in respect of each member would need to be converted into some form of "CDC credit", in which case the conversion terms could potentially reflect a member's gender.

2. Do you agree that CDC benefits should be classified in legislation as a type of money purchase benefit?

We believe that it may be more appropriate for CDC schemes to have their own classification in legislation, allowing specific DB or DC-related regulations to be applied as appropriate. Other routes have the potential to create regulatory cross-contamination, legal confusion and disruption in the industry, as has happened recently, for example, over the application of DC governance rules to DB/DC hybrids and Additional Voluntary Contributions, and regarding the exact meaning of 'safeguarded flexible benefits'.

For example, the legislation should make it clear that the employer provides no guarantees and that there is no obligation on the employer to make additional contributions should the funding level fall short, and that the PPF would not 'underpin' CDC schemes. More importantly for employers is the need for the legislation to be drafted in such a way that a CDC scheme is clearly treated as "defined contribution" from a pension cost accounting perspective.

As regards a money purchase classification specifically, this approach would potentially undermine the clarity brought in by the Pensions Act 2011 as to what constitutes a money purchase benefit. We further note that there are important differences between collective defined contribution and money purchase benefits. Money purchase benefits depend solely on the contributions paid, resulting in an individual fund account which is used to purchase benefits - this will not be the case for CDC schemes. In addition to satisfying these conditions prior to payment, money purchase pensions in payment must be secured via an annuity contract or a policy taken out with an insurer. Again this will not be the case for CDC scheme benefits in payment. CDC schemes should therefore **not** be classed as money-purchase, although they **are** defined contribution, requiring no further support from employers other than those contributions.

3. Are there any other areas where the current money purchase requirements do not fit, are inappropriate or could cause unintended consequences?

- Investment governance requirements, in particular the requirement to have a 'default' investment strategy.
- Bulk transfer values without consent requirements that apply to 'pure' money purchase benefits would be inappropriate.

- A number of disclosure requirements would not make sense, for example:
    - Elements of the standard Statutory Money Purchase Illustrations.
    - 'Flexible benefits' signposting.
    - Signposting to Pension Wise in a DC context.
    - Potentially the disclosure of costs and charges, although we believe that a modified version of the DC requirements in this respect would be valuable to ensure transparency.
- The requirement for schemes to offer an open market option.
- The lack of a requirement for a Scheme Actuary.
- Governance and administration regulation. For example, the need to annually assess value for members and to ensure that all core financial transactions have been processed accurately and promptly.
- Tax issues will require consideration and we note from paragraph 84 that these are to be the subject of a separate consultation.

4. Do you agree that the initial CDC schemes should be required to meet the conditions described above?

Single/associated employer occupational trust based scheme

- We recognise that it would be simpler for the DWP to restrict the initial roll out of CDC to such schemes. However, this could limit the opportunities for CDC schemes to become the third mainstream option for employers, and risks setting a precedent that restricts innovation.
- In particular, there will be significant costs associated with the design and set up of a new CDC scheme or section of a scheme, which will be a barrier not only to small schemes in general, but also to a high proportion of larger schemes and to small to medium sized providers, advisers and other industry participants when developing solutions and advice models.
- The DWP could therefore either expand the initial phase or seek to move quickly to the next phase of allowing appropriately supervised multi-employer schemes (including commercial providers) to set up their own CDC schemes, akin to the regime that now applies to master-trusts in the DC market.

"Accrual only" or "decumulation only" CDC not permitted

- The DWP considers that the combination of smoothed investment and pooled longevity risk is the central attraction of CDC. Whilst together those factors are expected to deliver enhanced benefits for savers, we believe that taken separately they also offer the prospect of providing benefits superior to those achievable on average by members in standard money purchase arrangements.
- A decumulation only CDC scheme in particular offers potential. This would allow individuals overwhelmed by retirement choices (having relied on defaults throughout their working lives) an option that may well offer a better outcome than an annuity without the individual risk and financial literacy demanded by drawdown. Recent

Australian produced designs provide precedents here. A "CDC drawdown" might well be a useful default option.

- Decumulation only CDC schemes could also be more palatable to employers and to providers who might wish to develop such products.

5. Is there a minimum membership size for CDC scheme below which a scheme could not be viewed as having sufficient scale to effectively pool longevity risk to the benefit of the membership?

There is a reasonable argument for a minimum size, to ensure effective pooling of risks. However, it would be difficult to decide how this should be set – any threshold would need to allow for future growth, for example. We also acknowledge that the cost, governance and regulatory overheads would likely make a small scheme unviable in any case so a legislative threshold may not be essential.

A further issue (versus membership size) is that of concentration of risk, which can occur in any size of scheme if, for example, a high proportion of liabilities attach to older members, although we note that the Royal Mail's design would lead to a greater share of matching assets being held in the CDC scheme as the proportion of "older" pensioners increase.

6. Do you agree with the proposed approach to TKU for CDC schemes?

The proposals seem appropriate in relation to the types of CDC scheme under consideration in the consultation.

We would however support more 'up front' training for those charged with oversight of the first CDC schemes. There are few genuine industry experts on CDC and in the early stages of development trustees will need to be fully cognisant of the risks associated with CDC. In addition, current UK DB and DC trustees (including professionals), will not generally have had any experience of running a CDC scheme. Since CDC includes elements of both DB and DC, competent trustee boards will need to have knowledge and experience of governing both.

Clearly, the Pensions Regulator should keep this under review to ensure the requirements are robust as the market evolves.

7. Are there any additional TKU requirements that should be placed on the trustees in CDC schemes?

See question 6.

8. Are there any TKU requirements that should be relaxed for the trustees of CDC schemes?

No

9. Which of the two AE tests would be more appropriate for CDC schemes, and how might either test best be modified to better fit CDC schemes?

For the proposed structure of the Royal Mail scheme, the DB tests make a natural starting point. However, other designs might be more suitable to a DC-type test.

10. What issues might arise from having no in-built capital buffers in the scheme design?

The lack of a capital buffer is likely to increase the level of volatility in target benefits. Each year the target benefits will change based on investment returns achieved and best estimates of the future. There would be no scope to 'smooth' results using part of a capital buffer in bad years and then (hopefully) replenish the buffer in better years.

Any surplus or deficit identified at each annual valuation would give rise to increases or reductions in the targeted benefits directly. Assuming that targets include some form of inflation protection, it is this which would be adjusted first.

Increased volatility may make the communication of benefit expectations more difficult (see also 11 below) as this might change more significantly from year to year.

There are likely to be cross-subsidies whether or not a capital buffer is used, as best estimate assumptions are very unlikely to be exactly borne out in practice. The key principle is that there should not be an "intended bias" between generations in the scheme design. A capital buffer can build in a cross-generational subsidy (if the initial population pays for the buffer) and arguably makes the process less transparent and more difficult to explain to members.

11. How can schemes best communicate with members to ensure they understand the risk that their benefits could go down as well as up, even when in payment?

Communication and transparency will be key. One fundamental issue is whether the focus should be on the targeted benefits or on the benefits which are more certain (which are likely to be much lower).

Plain English will be essential, and we caution against overly "compliance heavy" requirements. One "one pager" would be valuable. The key message that the benefit is not guaranteed to be at the target level (or at the pension accumulated to date) should be repeated prominently in all communications, to ensure that this remains clearly understood by members (including any occasions when experience has been positive and benefit payments are higher than the original target).

Schemes should supply simple communications, in multiple formats to meet the needs of different member preferences, setting out the basics of how a scheme operates. Explanations should be available of how the annual adjustments will be made, including some "people like me" case study examples.

Successful communication will require a team effort across the industry, including DWP, TPR and the media.

Whilst the current DC SMPI statements will not be suitable for CDC, a simple annual statement should still be made available.

Aside from benefit details, good explanation of a scheme's governance arrangements and its documented pursuit of "fairness" between members will make a big difference to trust and confidence levels.

12. What additional issues may arise from using a best estimate basis for valuation, and how should those issues be addressed?

"Best estimate" will inevitably be a matter of judgement.

In a traditional DB scheme, assumptions impact employer contributions and adjustments can be made at subsequent valuations – if it turns out that experience is better than anticipated in the assumptions the 'over contribution' can be used to offset future contributions. In other words, the assumptions only generally affect the pace of funding.

In CDC, the assumptions used will directly affect the benefits that will be paid to members immediately and consequently there may be pressure on advisers when setting the assumptions. The requirement for independent peer review set out in paragraph 96 will help to address this point.

13. Should we restrict CDC scheme designs to those schemes which would be sustainable without continuing employer contributions?

This seems sensible.

14. We would welcome feedback on how best to manage risk generally going forwards.

We comment here only on "CDC specific" or particular risks, recognising that the main risks associated with pension schemes (investment, inflation, etc) apply to traditional DC and DB already.

- Regulatory risk – employers and providers will be concerned that the temptation to impose additional obligations on them as CDC scheme sponsors will ultimately prove irresistible to future governments. What kind of future guarantee can be written into the legislation to reassure employers that this sort of drift won't happen?
- Risk to other changes to legislation which indirectly impact CDC e.g. the Government changes rules for pensions to bring more pre-retirement flexibility (e.g. using pensions for debt repayment) and some CDC members want to take advantage of this, or LISA portability etc.
- Selection risk – where those who expect lower life expectancy leave the scheme at or after retirement, and this undermines the effects of pooling mortality.
- Risk of perceived unfairness (or actual unfairness) – needs to be addressed at the design stage, must be rules based and tested robustly under a variety of scenarios, which we understand has been the case for Royal Mail's proposed design. Must be transparent and explained to members.
- Communication risk – members don't fully understand the nature of the scheme and are dissatisfied with the outcomes. See question 11 above.
- Future accounting standards risk – changes in these standards may alter the way employers view CDC.

15. Does the proposed CDC scheme framework, as set out in this consultation document, address concerns about risk transfer between generations? We welcome thoughts on any other measures that could also address this.

The best estimate approach seems to minimise the risk of transfer between generations, at the expense of additional volatility. However, as the best estimates are unlikely to be precisely correct, some generations will inevitably profit at the expense of others. The best estimate approach should at least ensure that we do not **expect** one generation to profit at the expense of another looking forward (ie there is no deliberate bias in the design between those participating in the early years and those joining the scheme later).

It is difficult to ensure, if at all, that the contributions and benefits agreed at outset are appropriate for the long term, and that a number of years down the line there won't be a need to re-adjust member expectations in relation to future indexation of benefits up to date and/or the target benefits for future service.

16. We would welcome thoughts on appropriate wind up triggers and how best to manage associated risks.

- Need to accommodate both automatic triggers and voluntary triggers.
- Under what circumstances shouldn't the scheme be allowed to continue and what benefits would those members be given in whatever scheme they are offloaded to?

17. Are there any elements of the proposed regime that it is not appropriate to apply to CDC schemes?

Tax treatment requires consideration, which we understand is the subject of a separate consultation.

18. Are there any additional authorisation requirements that should be placed on CDC schemes?

We believe that the proposals set out in the consultation document would form a sensible framework for authorisation.

19. Are there any other investment requirements that should be required in addition to those proposed above?

There are no other investment requirements that we wish to highlight here.

20. Are there any other disclosure of information requirements that should be required in addition to those proposed above?

This has been covered in our previous responses above.

21. Do you agree that CDC schemes should be administered under the requirements for money purchase benefits, but with added requirements to appoint a scheme actuary and carry out annual valuations?

As discussed, the core requirements can be based on the money purchase regime, with additional DB-type requirements as appropriate. However, we strongly believe that CDC schemes should have their own separate classification.

22. Do you agree that CDC benefits should be subject to a similar cap to the automatic enrolment charge cap?

Whilst we support competitive charges that deliver value for scheme members, a cap might limit innovative investment strategies (one of the potential benefits of CDC), particularly if it includes the costs of (quite complex) administration, and potentially actuarial valuations and communications. This would leave minimal budget for investments. As such we do not believe a blunt cap should be adopted. If there is a cap, the level applicable to DC may not be appropriate and some allowance would need to be made for the early years in which the accumulated funds under management are relatively low in relation to costs.

Our strong preference would be for value for money obligations and transparency.

23. Do you agree with the proposal that charge cap compliance should be assessed on the value of the whole scheme's assets?

This proposal is reasonable if a cap is being used but may prove challenging when schemes are small and growing (see also Q22).

A percentage cap may also be seen as an anchor point. For a large mature scheme, a charge close to this level may well provide unnecessarily high compensation to providers.

24. What would be an appropriate approach to handling transfers out of or into CDC pension schemes?

The proposals seem reasonable in principle but they are likely to be difficult to implement from a practical perspective.

25. Should transfers be restricted in any way – for example, to take account of the sustainability of the fund?

We do not believe that transfers should be restricted before benefits come into payment. We consider that it would be reasonable to calculate a transfer amount on a best estimate "share of fund" assessment based on the most recent actuarial valuation.

We believe that, following consultation with the employers, trustees should be able to decide whether and how to deal with transfers-in. If the trustees wish to do so, we do not see any reason why transfers-in could not be accepted for deferred members as well as those who are "actually accruing benefits". This could help some individuals with small historic DC pots consolidate them into a single pension vehicle.

Appropriate financial advice requirements will be important to ensure that individuals understand their choices and are able to make informed decisions.

Response by:
Association of Consulting Actuaries Limited: 16 January 2019

APPENDIX 2

About the Association of Consulting Actuaries (ACA)

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes.

The ACA is the representative body for UK consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

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