ASSOCIATION OF CONSULTING ACTUARIES

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DWP CDC Policy
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SW1H 9NA

Dear Sirs

Consultation by the DWP on Extending Opportunities for Collective Defined Contribution (CDC) Pension Schemes

I am writing on behalf of the Association of Consulting Actuaries in response to the above consultation.

We welcome these proposals for extending CDC opportunities. The proposed extensions will allow a much wider range of people to have the option to accrue or purchase a CDC pension, enabling them to access the benefits of CDC outlined in the Ministerial Foreword to the consultation.

Our key points are:

- The application of the charge cap should be more closely aligned with DC (see Q1);
- The existing legislation should be made more flexible (see Q2 and Q13);
- Restrictions on funding new CDC schemes and pre-agreements will inhibit new schemes (see Q3);
- Government should legislate for both commercial and sectorial non-associated multi-employer CDC schemes. To help build critical mass they should take care not to impede timely development of models that would require only minor regulatory change (see Q4);
- The winding-up process should be simplified (see Q18).

We strongly encourage the DWP to move forward with the legislation required to facilitate both whole-life multi-employer CDC schemes and decumulation-only CDC products as soon as possible.

Our responses to your specific questions are set out in the appendix to this letter.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me on 01372 733763 or at peter.williams@aon.com.

Yours faithfully

Peter Williams
Chairman, Pension Schemes Committee
On behalf of the Association of Consulting Actuaries Limited

APPENDIX

1. Do you agree with the key principles we have identified as necessary for the new types of CDC schemes and in particular whole-life multi-employer CDC models? If not, please set out why.

We support these key principles subject to the following comments.

There is a significant inconsistency between the application of the charge cap for DC schemes. For DC the cap is only applied to default funds in qualifying schemes – and therefore only applies to funds prior to retirement and only when the member has not taken an active decision on where to invest. This raises two issues of consistency:

- It would be consistent to apply the charge cap only where a CDC arrangements is the default option for members – if, in contrast, a scheme has a separate default option, perhaps DC, but the members can opt to join a CDC section, it is not consistent to apply such a cap.
- In principle, the cap should not apply to CDC funds post retirement. We recognise that this would present some practical difficulties for whole-life CDC schemes but these may be surmountable. We would strongly argue that it would be inconsistent to apply such a cap to decumulation only products.

Discriminating against CDC by applying the charge cap in wider circumstances than it applies for DC runs against the policy objective of supporting the establishment of CDC schemes.

In addition, for clarity, we note that the comment on the CDC charge cap in paragraph 17 is a simplification of the current position, and ignores the following existing flexibilities – which should be maintained:

- An 'equivalent combination charge' approach can be adopted, which may be important for CDC schemes, particularly in the early years;
- From April 2023, specific performance-based fees can be excluded from the charge cap to assist in broadening investment opportunities for DC and CDC schemes, aimed at allowing investment in long-term illiquid investment opportunities, that may be of particular interest to CDC schemes.

2. Do you agree with our thoughts on what requirements might need amending to accommodate these new CDC designs? What new triggers for sectionalisation other than a change to the actuarial plan do you envisage might be appropriate in these new schemes?

We agree that the current provisions requiring new sections in certain circumstances need to be made more flexible to accommodate new CDC designs – in particular we agree that designs which can vary accrual rates or contribution levels should be allowable within a single section as long as actuarial consistency is maintained – this should accommodate both:

- Allowing accrual rates to vary by age in the scheme design,

- Allowing accrual rates to vary over time to maintain consistency with financial conditions, including prevailing indexation, and to eliminate the potential for cross-subsidy between past and future service; and
- Allowing contribution rates to vary in respect of each member provided these contributions are used to buy accrual of CDC pension that is of equivalent value using the varying accrual rate principle above. This is necessary to facilitate menu pricing in the scheme (allowing different employers with different pension contribution budgets to pool together) and to facilitate the fair purchase of additional CDC pension through regular or one-off AVCs.

It should also be possible to offer benefits with and without, for example, a contingent spouses benefit or a five-year guarantee, within a single section (with variation in the required contributions to reflect the different attaching benefits).

It would be helpful if the DWP could confirm that the existing age discrimination exemptions already provide for such designs (or if this is not considered to be the case, make any changes necessary to accommodate CDC contributions rates or accrual rates that vary by age).

We also agree that single employers should be able to access these new design flexibilities e.g. where accrual rates can vary by age and over time (although, for the avoidance of doubt, not all of the new requirements discussed below should be applied to single employer CDC schemes).

3. Should the definition of "operates" at section 7(5) of the 2021 Act be amended for whole-life multi-employer CDC schemes? If you agree, please set out how.

In our view, there should be significantly more flexibility over the funding required to establish CDC schemes – either flowing from prospective participating employers or from commercial providers. There does not appear to be a compelling reason for any such restrictions in legislation and unnecessary complexity could well inhibit new schemes being set up.

In our view prospective employers should not be prevented by legislation from contributing towards set up costs – whether this is through payment to a trust or meeting expenses outside of the trust (perhaps before the trust has been set up).

Similarly, there does not appear to be any compelling argument for legislating to prevent potential commercial providers meeting these costs.

In addition to meeting initial costs, funding will be required to set up an appropriate reserve for possible future wind-up expenses. Similar flexibility will be required over contributions from prospective employers and third parties to meet these reserving requirements.

We also see no reason why (as suggested in your paragraph 36) pre-agreements should be a concern "as part of member and employer protection measures" prior to authorisation:

From a member protection perspective, the existence of such agreements should not influence the authorisation decision by the Pension Regulator (except to the extent that it may provide some additional confidence on the future plans for the scheme), which would ensure members are protected.

From an employer protection perspective, we would expect such agreements to cover scenarios in which the application for authorisation is successful or unsuccessful, and set out what would happen in each scenario. Employers should be able to assess whether to enter into such an agreement on a commercial basis.

Prohibiting such pre-agreements will also unnecessarily inhibit new schemes being set up. We are therefore strongly against the proposal in paragraph 36 that such agreements be prohibited.

4. How might legislation capture persons performing the functions listed at paragraph 39 in commercial and sectorial schemes so that they are within scope of the fit and proper persons test? Are there other persons that should be brought within scope of the fit and proper persons test for these new schemes?

We agree that the 'fit and proper' considerations are likely to differ between single/associated employer schemes, and non-associated employer schemes and Master Trusts, for the reasons you identify in paragraph 38.

We agree that the definitions of 'scheme funder' and 'scheme strategist' used for DC Master Trusts would be a suitable starting point for commercial schemes. In practice these might well be the same entity but this would not necessarily always be the case.

Some sectorial schemes might be closer to single employer schemes in nature - perhaps a group of employers with paternalistic intent rather than a particular entity taking the lead on funding a strategy with a profit motive. As a general concept, Government should take great care not to impede timely development of such multi-employer models, which may prove important to generate overall critical mass.

However, we do not think this warrants drawing a legislative distinction between commercial and sectorial non-associated multi-employer schemes (for which, in any case, we think it would be very difficult to draft a workable legislative distinction).

5. Do you agree that those marketing and promoting CDC schemes should be within scope of the fit and proper persons test where certain conditions apply, and if those conditions should be similar to those in Master Trust schemes?

Yes, this seems reasonable.

6. Are any changes or additions needed to Schedule 1 of the 2022 Regulations in respect of matters to be taken into account by TPR, as part of the fit and proper test to reflect the new roles envisaged to exist in sectorial and commercial schemes?

The list seems reasonably comprehensive.

We agree that it would be reasonable to require those making business decisions relating to the commercial activities of the scheme to have expertise and experience to act in that capacity.

To mitigate the potential for conflicts of interest to arise in commercial scheme, remuneration policies covering those governing CDC schemes could be disclosed to TPR, and there could be a more stringent evaluation of the scope for potential conflicts to arise for everyone being assessed.

7. Are the current scheme design requirements including the tests still appropriate for assessing soundness in the new whole-life multi-employer schemes? Are there any additional soundness considerations or tests needed in light of the new designs?

Generally, the scheme design requirements do read across to whole-life multi-employer schemes appropriately, and we agree there should be an expectation of inflation-proofing at initial authorisation stage for these new forms of CDC design.

In terms of communication to prospective employers of a sectoral of commercial whole-life multi-employer CDC scheme, employers could be faced with a choice between two or more providers of CDC schemes, and the one offering the highest level of benefit for a given level of contribution is likely to be adopting a higher level of investment risk by investing a higher proportion of assets in growth. Employers will need advice in these circumstances, to assess the benefit levels and associated levels of risk. However, this is not an issue which we think needs to be addressed through legislation.

8. If a scheme funder equivalent is introduced for the new whole-life multi-employer CDC schemes including Master Trusts, should similar scheme funder requirements to those in the DC Master Trusts regime apply? Are there any changes needed to ensure there is a clear focal point for TPR's scrutiny and liability for meeting the relevant costs?

We agree that provisions similar to the scheme funder provisions for DC Master Trusts could be applied for commercial/sectorial schemes.

9. Should business plan requirements, similar to those for Master Trusts, be introduced for commercial and sectorial CDC whole-life multi-employer schemes? What, if anything, should change? Who should be responsible for preparing the business plan?

We agree that business plan requirements should apply for commercial/sectorial schemes. As noted in our response to Q4, we do not think there should be a distinction between commercial and sectorial non-associated multi-employer CDC schemes.

In relation to CDC authorisation applications from existing Master Trusts in general, given the significant costs and reserving that DC Master Trusts will have already gone through to gain authorisation, we would expect significantly lower additional costs and reserving to gain authorisation to establish a CDC section within the existing arrangement.

10. Do you agree that the existing requirements should apply to new whole-life multi-employer schemes and are additional requirements needed to help ensure that communications used in promoting and marketing the scheme are not misleading? How might Schedule 4 of the 2022 Regulations be amended to achieve this?

We agree that the existing requirements should apply to new whole-life multi-employer schemes.

We also agree that there are additional risks to be considered for whole-life multi-employer schemes. However, in terms of communication with members (which is the focus of Schedule 4), once an employer has taken a decision to participate in a particular scheme the risks in relation to member communication are similar than for a single/associated employer scheme.

One additional risk is that there may be a commercial incentive to grow the membership of the scheme whilst not adequately resourcing to meet this growth. The level of growth might be more difficult to predict than in a single/associated employer scheme.

11. Are any changes or additions needed to the requirements in Schedule 5 of the 2022 Regulations to reflect the new designs and relationships anticipated in the new whole-life multi-employer schemes?

The requirements set out in Schedule 5 appear to be comprehensive.

12. Do you agree that it is reasonable for the existing requirements in regulations 15 and 16 of the 2022 Regulations to apply to the new whole-life multi-employer CDC schemes, and that the continuity strategy should include an aspiration to operate the scheme as a closed scheme?

We agree the requirements in regulations 15 and 16 are reasonable to apply to whole-life multi-employer CDC schemes.

We do not agree that the continuity strategy should be required to include an aspiration to operate as a closed scheme, as this may not be in the interests of members and may also have unintended consequences:

- It may discourage sponsors from setting up CDC schemes, which is against the policy objective;
- It may encourage sponsors to maximise the profit to be taken whilst the scheme remains open, in the knowledge that closure at some future date could result in significant losses;
- Ultimately, the closed scheme could be run by individuals with minimal interest in its operation, which could result in poor outcomes for members.

The best continuity strategy is likely to be to transfer to another CDC scheme that is as similar as possible to (or better than) the original scheme. The current options of transferring to another connected scheme or converting to a DC pot can be alternative options but should not be the default. In our view, paragraph 2(1) of schedule 6 of the 2022 Regulations should be amended to reflect this position.

If NEST was to set up a CDC section that could receive transfers (or be required to operate such a section), such transfers might be an attractive option for continuity strategies of other CDC schemes.

For the avoidance of doubt, running on as a closed scheme should be an option, where the trustees believe this to be in the members' best interests.

13. Do you agree that most of the existing requirements can read across to the new whole-life multi-employer schemes? What changes including the one proposed above do you think should be made to the existing requirements and why?

Yes, we agree that the provisions can broadly read across to multi-employer schemes.

As noted in paragraph 84, schemes should be allowed to provide 'one-off' increases to benefits where projected future affordable increases are above a certain threshold. CPI+2% seems a reasonable threshold – but the specific threshold should be an option for benefit design, rather than

a legislative requirement. This additional flexibility should apply to both the existing single employer regime and the multi-employer regime.

In both cases, we would suggest that the regulations should provide for the principle of a thresholds, leaving the Regulator to set the actual level of the threshold that it would accept.

14. Do you think that the list of events in regulation 23 of the 2022 Regulations needs amending for the new whole-life multi-employer CDC schemes? If so, why? Are there new events that should be added or current events that should be removed?

Generally, the existing listed events should also apply to multi-employer CDC schemes.

15. Do you agree that the list of triggering events that apply to single or connected employer CDC schemes needs some revision to accommodate whole-life multi-employer CDC schemes? Are there new events that should be added or current events that should be removed?

Yes, we agree that the triggering events will require some amendment and with your outline of the changes likely to be required.

16. Is a similar approach to the wind up commencement time (and the cessation of contributions/accruals) appropriate in respect of the new whole-life multi-employer schemes? If not, why not? Given AE obligations, how might participating employers be provided with sufficient opportunity to make alternative arrangements, before contributions are prohibited in the whole-life multi-employer CDC scheme being wound up, whilst managing risks to members?

A similar approach to that adopted for DC Master Trusts would seem appropriate.

Alternatively, we would have no concerns if a short period of continued accrual was allowed after winding-up commences, to assist participating employers in finding alternative arrangements in order to satisfy their AE obligations.

17. Are the current default and alternative discharge options sufficient for the new whole-life multi-employer CDC schemes?

We do not have any suggested additions.

18. Do you agree that the existing framework for the wind up of a CDC scheme can read across to the new whole-life multi-employer schemes? What changes, other than the ones mentioned above, do you consider should be made for these new schemes?

The existing CDC scheme wind-up framework is unnecessarily onerous and we would argue that a simplified approach should be allowed for both the new schemes and single/associated employer schemes.

Our preferred approach would be based upon members' benefits being decollectivised as the point that wind-up commences.

Simplifying the wind-up process is likely to have a significant impact on the reserves required to be held at inception and is therefore likely to support the policy objective of supporting the establishment of CDC schemes.

19. Do you agree that the existing requirements, outlined in Chapter 10, which apply to single or connected employer schemes can be read across to the new whole-life multi-employer CDC schemes, other than where a modification has been highlighted?

Yes - generally the provisions can simply read across to the new schemes, subject to the highlighted modifications.

Additional consideration might be appropriate in respect of transfers into CDC schemes. If the new regime for whole-life schemes is not implemented at the same time as for decumulation-only options, and there is no restriction on transfers into whole-life schemes, this could enable such schemes to act as a decumulation-only arrangement for a large number of individuals. One possibility might be to prohibit transfers in close to normal minimum retirement age, except for members actively accruing benefits in the whole-life scheme (at least until the framework for decumulation-only arrangements is put in place).

20. Who would be responsible for meeting the costs of establishing the arrangement and the short-medium term operating costs?

Decumulation arrangements could be set up by either employers or commercial providers. Existing DC Master Trusts may open a CDC section (either whole-life and/or decumulation) which is likely to involve lower set-up costs.

Commercial providers would clearly only be interested in setting up such arrangements if the charges flowing over the long term are projected to be sufficient to meet all their costs, including the costs of setting up the arrangement. If legislation prevents this, there are unlikely to be any commercial providers of CDC arrangements, which seems counter to the policy objective.

21. How could such arrangements establish scale and what evidence is there to support this? In addition, until such schemes achieve and maintain scale do commercial providers envisage providing the funding needed to smooth volatility and deliver the aspired to pension benefits? How would the potential issue of small pots be addressed?

Commercial providers are likely to note the large number of individuals reaching retirement with an increasing proportion of DC pension wealth, who are currently faced with a choice between an expensive annuity (often purchased with no inflation protection) or managing drawdown, with complex financial decisions required for maintaining that approach and the ongoing risk that they might run out of money if they live to an advanced age. In contrast to those options, the prospect of a pension which is expected to keep pace with inflation and provide a predictable level of income without requiring any financial management on behalf of the individual, is likely to be extremely attractive.

If large numbers of prospective CDC arrangements are put forward for authorisation, the Regulator could take this into account in deciding on how many and which arrangements are likely to be viable, and should be authorised.

In relation to the impact on small pots, individuals who are attracted to CDC may decide to transfer all their DC savings (which may include several small pots) to a CDC arrangement. Alternatively, using their main DC savings to purchase a CDC pension benefit, may provide confidence to cash out some of their residual small pots. Having said that, each CDC decumulation arrangements should be able to decide what level of transfer in is commercially viable and set a threshold below which it would not accept small transfers.

22. What mechanism should be used to determine the price at which people might buy into a decumulation only CDC arrangement and what can be done to ensure individuals are treated fairly? In addition, should mortality underwriting be a feature of these arrangements, and how would this best be done?

To ensure fairness, the calculations for transfers-in should be consistent with the central estimates used for scheme valuations. Any variations would need to be justified and, in principle, assumptions should represent the central estimate for the particular individual.

On transfer in, schemes could carry out underwriting with a view to offering a higher pension to those likely to be in poorer health (and vice versa). This seems reasonable – although we are not sure that all decumulation arrangements would want to adopt this approach. We do not think that any legislative constraints need to be imposed.

The legislation should not prohibit designs which:

- Can provide joint life / single life CDC decumulation-only pensions in the same pool
- Offer something analogous to DB 5yr guarantees provided this is priced in at entry

From the perspective of treating people fairly, in may be necessary to allow a cooling off period similar to annuity products. However, once members have purchased a CDC pension and gone beyond their cooling off period, they should not have any statutory right to transfer out / take flexible withdrawals *except* in the case of a pension sharing order on divorce, and in this instance the transfer value should be based on the central estimates used elsewhere in CDC legislation, but these assumptions could reflect the individual circumstances of the case.

23. What steps can be taken to ensure communications to members help them understand how these new arrangements will work and how can consistent standards be achieved in the way commercial arrangements market their products to prevent over-promising?

Many of the issues around communication of risks are similar to those that have had to be addressed for single/associated employer schemes. These requirements should be mirrored for decumulation arrangements. Benefit projections should be based on central estimates.

There are additional considerations, because individuals may be choosing between multiple decumulation options, including more than one CDC decumulation provider.

Our main concern is that a CDC arrangement with a higher proportion of growth assets (and hence a higher expected return, albeit with higher volatility/risk) is likely to be able to offer higher benefits – and may therefore appear more attractive to prospective members - than a CDC scheme adopting a

strategy with a lower proportion of growth assets. It will therefore be important to communicate risk to individuals in a way that will enable them to compare different providers. We think this means it is likely to be necessary to legislate for how risk should be communicated for decumulation arrangements, at the point at which a prospective member is considering a transfer in (in particular if there is more than one CDC decumulation arrangement to select from). Such legislation may need to consider both the form of disclosure of risk and the underlying calculation, to ensure consistency.

Communication would also need to clearly set out the expected rate of further increase and any attaching benefits, to enable individuals to make comparisons between different options.

24. What other changes in addition to those set out in this document, do you think need to be made to ensure the effective and fair operation of decumulation only CDC arrangements?

Applying the charge cap to CDC decumulation arrangements would be inconsistent with the treatment of other decumulation options, as noted in question 1.

We would also suggest that the legislation makes it clear that the pricing of a CDC decumulation pension should not differentiate by gender, consistent with the requirements for annuities (and also for contributions to whole-life CDC pension schemes).

As noted in our response to question 19, if the new regime for whole-life schemes is not implemented at the same time as for decumulation-only options, this could enable whole-life schemes to act as a decumulation-only arrangement for a large number of individuals by offering transfers in. This may make it difficult for new decumulation providers to enter the market as other schemes will have had a 'head start'. We repeat for completeness our suggested to prohibit transfers in close to normal minimum retirement age, except for members actively accruing benefits in the whole-life scheme (at least until the framework for decumulation-only arrangements is put in place).

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