Institute
and Faculty
of Actuaries

# Reshaping workplace pensions for future generations

Department for Work and Pensions

## Consultation Response

23 December 2013

**About the Institute and Faculty of Actuaries**

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

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23 December 2013

Dear Sirs

**DWP Consultation: Reshaping workplace pensions for future generations**

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to this consultation. The IFoA is the UK's professional body for actuaries and has members working in a range of roles across the pensions industry. This response has been prepared by a number of our members who have experience of working within both the Defined Benefit (DB) and Defined Contribution (DC) sectors. Some of these members work for providers who deliver pensions products to employers, trustees and scheme members. Other members work for consultancies which advise trustees and employers. The IFoA was a member of the Defined Ambition (DA) Industry Working Group and remains committed to working with the Government to deliver the best pensions for employees.

The IFoA notes that this consultation is the latest in a series of major consultations affecting the future of pension provisions. These consultations have effectively been simultaneous with short response periods. We would encourage the DWP to offer more time for responses to ensure that all these significant matters have the maximum attention given to them.

The IFoA recognises the need for a greater focus on pension provision and on the different forms that it could take. We understand that any of the proposed designs could work in practice, but only if the legislative framework is established that creates the appropriate level of flexibility in benefit design. Such a framework should also have to consider the degree of protection offered to scheme members. This is a difficult balance to achieve, but the IFoA would be delighted to continue to work closely with the DWP to achieve the desired outcomes for members.

The IFoA would strongly urge the DWP to consider how the provision of guarantees (in whatever form) can sit alongside the possible use of a charge cap for pensions. Somebody must pay for guarantees, whether that is employers, members or providers. It does appear that a charge cap could limit the options open to members. The IFoA will continue to work with the DWP to ensure that any charge cap would not prevent members achieving possible better outcomes by means of DA arrangements.

The IFoA recognises that any aspect of public policy is subject to change or amendment. Pensions is no different and we recognise that any future government could legislate to overturn the implementation of any of the options in the paper. The DWP should recognise the extent to which legislative change could be taken into account by advisors and decision makers when establishing pension schemes.

**1. Do you agree that a greater focus on providing members with more certainty about savings or preferably income in retirement may increase confidence in saving in a pension?**

The IFoA recognises that some pension scheme members may value having much more clarity about the income they can expect to receive in retirement from workplace pensions. As more employees participate in schemes as a result of auto-enrolment; providers, employers and trustees will have an increased responsibility to provide those employees with the best explanation of what they may expect to receive in retirement.

For many employees new to pensions, or indeed new to any commitment towards long-term saving, there should be a focus on providing some certainty. If that certainty is centred on fund size, ensuring that a member's fund does not fall in value, there is a risk that a member will pay too much attention to fund size rather than the ultimate retirement outcome. We would encourage any focus to be on providing good retirement outcomes, noting that certainty cannot provide these without the payment of sufficient contributions.

We also recognise that for many new members of DC pension schemes the most significant means of achieving greater continuing participation in pension schemes is through a growing pension fund. We note the DWP's reference in 2.18 that evidence suggests consumers are risk averse and react badly to loss. Given that members may require some complexity in their selected funds to prevent loss over a defined period of time, we would welcome any emphasis on educating members about investment returns and the associated risks. We would note that this is only one factor of many that would increase confidence in pensions.

Such education would require members to understand that protection of short-term fund values does come at a cost, not only the price of any investment guarantee. Such cost is the likelihood that a short-term investment horizon would not provide the best retirement outcome for members.

**2. As an employer, do you have experience of, or can you envisage any issues with, employees being unable to retire due to DC pension income levels or certainty about income levels?**

The IFoA has no answer to this question.

**3. Do you have any further evidence or research planned which might help inform the development of DA pensions?**

We have two working parties in place at present. Both these working parties consist of IFoA members.

The Defined Ambition Working Party is investigating further what Defined Ambition would look like in practice. This working party would expect to provide some initial findings in late spring. The Communicating Defined Ambition Working Party is developing a different theme. It is considering how to inform scheme members what DA would offer to them. This working party expects to report early in 2014.

If the DWP was interested in the results of these working parties' findings, we would be delighted to arrange meetings with members of the working parties to discuss their reports further.

**4. What are your views on the feasibility of this scheme design?**

This scheme design might be feasible, although there is complication. This simplified DB scheme was the norm before the introduction of preservation requirements in 1985. The subsequent decade developed the legislative structure around DB schemes in such a way that the benefit provided by schemes by the end of the 1990s was significantly different to that from before 1985. The protection of benefits for deferred and pensioner members resulted in big increases in the cost of providing benefits.

The challenge in setting the requirements for this scheme design is therefore:

- To provide sufficient flexibility to be attractive to employers
- To provide adequate protection for members; and
- At the same time avoiding employer behaviours or member outcomes that future governments would find unacceptable and which would, as a consequence, trigger a new cycle of legislative reform.

There would be governance challenges around any reductions in pensioners' incomes as has been experienced in the Netherlands. Flexible benefits are not as simple as a flat-rate benefit as neither the sponsor, nor recipient, can determine how one decision at any time would affect future decisions.

**5. Are employers likely to be interested in providing benefits in addition to a simplified flat-rate DB pension on a discretionary basis or otherwise?**

Within the new automatic-enrolment regime, there is no obligation on employers to provide pensions to employees other than basic DC schemes. Employers providing more than the minimum have done so voluntarily. Given the historic prominence of pension schemes within total reward packages, it is clear that many employers had been willing to offer a minimum level of defined benefits. It is not entirely clear as to the "tipping point" beyond which employers have become less willing to offer higher benefits.

Our members' experience with employers suggests that there may be an appetite for simplified DB schemes (assuming simplified means no section 75 type guarantees, nor the imposition of undue or volatile costs); however, it is unclear that employers would be willing to accept the risk of future governments legislating to protect members' benefits beyond what would be offered in a simplified scheme. Any such steps would again lead to a spiralling of costs and would be more likely to cut off any enthusiasm for DA schemes.

The consultation recognises this dilemma for employers in paragraphs 6.56 to 6.58. Even identifying a separate framework for DA schemes (6.58) may not be sufficient for some employers to pursue that route, especially if they were operating schemes within two regulatory regimes.

Given the current trend towards DC and, in many cases, a corresponding reduction in costs, we also recognise that persuading employers to grant additional guaranteed benefits will in many cases require a reversal of this trend.

**6. What role do you see for scheme trustees in relation to discretionary payments? For example:**

- **Should they be involved in deciding whether a discretionary payment is made at all?**
- **Should they be involved in setting out how these payments are apportioned to members or should this be down to the employer?**

Providing employers with flexibility may mean that there is scope to establish a very low level of guaranteed benefits (e.g. £1 as an extreme example). All other benefits would be regarded as discretionary and payment of those benefits would be subject to termination at employer choice. This extreme level of flexibility would not be in the interest of scheme members and is unlikely to be acceptable to government or members. It seems likely that some kind of constraint on employers removing discretionary benefits may be required, perhaps linked to funding levels (although there may then need to be constraints on employers reducing contributions in such a way as to engineer a lower level of funding, which, in turn, would allow cessation of discretionary benefits).

Such constraints may involve giving trustees a role to play in simplified DB schemes, especially in relation to the funding and/or the cessation of discretionary benefits. However, employers may not be willing to accept any control that trustees could have in the payment of discretionary benefits.

If a benefit is payable but it is not clear to whom (for instance to dependants after a member's death) then Trustees are well placed to determine the appropriate beneficiary, as opposed to the employer, but this is not the only possible model.

**7. Do you agree that our starting point should be to keep regulatory requirements around discretionary benefits to a minimum?**

As we suggested in our response to the earlier questions, pension provision in excess of a minimum DC arrangement is a voluntary act by employers, so they should be free to determine the form of that voluntary provision. Limiting the requirements would also bring pensions into line with the provision of other employee benefits, where there is little legislation about minimum benefits, or preservation of benefits for leavers. However, as noted under question four, until 1985 there were minimal regulatory requirements around pension benefits. This was comparable in many ways to the structure of Design 1. As we also highlighted, this led to a cycle of regulatory interventions to curb what governments at the time saw as unacceptable outcomes. The challenge, therefore, is to balance this flexibility with providing adequate protection for members to try and avoid employer behaviours, or member outcomes, which future governments would find unacceptable, while at the same time ensuring employees understand the flexibility in benefits.

**8. How do you see funding for the non-discretionary DB element being sufficiently protected while allowing for extra discretionary benefits? For example, is there a risk that paying discretionary benefits could threaten the funding for non-discretionary DB benefits for younger scheme members?**

As we discussed in our response to question six, there needs to be a balance between protection for members and flexibility for employers. If discretionary benefits are paid from an under-funded scheme, this could have an impact on the security for future benefits (including non-discretionary benefits). This is no different to the payment of benefits from similar funds, such as with-profits and will likely either need the Scheme Actuary to have significant authority to determine an appropriate funding level or for there to be a statutory funding basis for the non-discretionary benefits.

**9. What are your views on the feasibility of this scheme design?**

We understand that the current legislative framework permits some aspects of this design. Although there would be a requirement for a new framework, there does not currently appear to be any restriction on the feasibility of this design. However, there are protections that may be required for members in terms of funding limits, or guaranteed benefits paid in advance of discretionary benefits. These may start to impose constraints on the feasibility.

**10. If employers are able to use scheme designs 1 and 3, do you think it is still helpful for legislation to allow for this scheme design?**

If the policy intention is that employers should not have schemes with large numbers of deferred members, this design would be beneficial. Subject to an appropriate framework, there is no reason that this structure could not work within other designs. Legislation should not be drafted in a way that restricts scheme design unnecessarily.

**11. Do you think this scheme design could be extended to permit employers to automatically transfer members out of the scheme at retirement?**

This option to purchase annuities currently exists for schemes, although the cost of purchasing annuities at retirement may not be appealing to trustees and/or employers as it does not reflect the cost to the scheme of purchasing annuities. Purchasing annuities reduces the funding of schemes (unless schemes are fully funded on solvency bases); thus, the security for non-pensioners and non-transferring pensioners is reduced. As with the current option for purchasing annuities, funding on a basis that is weaker than a solvency basis would reduce the security for non-pensioners.

**12. What would be the most suitable way for benefits to accrue under this model? And how might this best be communicated to ensure members understand the value of their pension benefits?**

There should be a distinction between the accrual of benefits and the valuation of benefits. The consultation paper in 3.28 suggests that the accrual of a defined benefit would appear similar to the current accrual of a defined benefit, whatever form that may take. The consultation does highlight the difficulty between establishing an understandable link between benefit accrued and the value of benefit accrued.

Members should receive communication that is easily understood and has the information they require to make decisions. As the most significant factor is what happens if a member were to leave employment, any communication must clearly indicate the differences between the annual amount of benefit due from continuing employment and the equivalent value of those benefits on leaving employment.

**13. Assuming a CETV would not represent 'fair value' for the accrued rights when the member leaves or retires, how might it best be calculated? Should the basis for calculation be different when the transfer is initiated by the employer (for example on redundancy)?**

This question may require a definition of "fair value". There should be consistency between the value of benefits the day before retirement and the day of retirement. Therefore, the transfer value may be best calculated by considering the cost of purchasing an annuity on retirement. That would still leave the option to use a discount rate that allows for growth assets prior to retirement.

Consideration would be required as to whether CETVs would be reduced when the scheme is not fully funded against aggregate CETVs. This is allowed under current DB schemes, but members have the option of deferring the transfer until the funding level improves and a full CETV is payable. Under the proposed design, members would not have the option of delaying the transfer until a full CETV becomes available, which could be difficult to justify. However, paying a full CETV for a leaver while the scheme is under-funded will reduce the security for remaining members, which generates other issues.

**14. For schemes providing a lump sum benefit, what are your views on how the cash value should be calculated for members who leave before retirement? Should the net present value of the lump sum be calculated on how many years away from pension age they are?**

Employers should have the flexibility to take these decisions as part of their scheme designs.

**15. Could the accrual rate and pension value be along similar lines to existing cash balance arrangements?**

There should be flexibility concerning the benefit structure, although it may be similar to current cash benefit arrangements.

**16. What forms of regulatory requirements would be needed to:**

- **prevent avoidance activity?**
- **ensure the scheme has access to sufficient funds to enable a transfer when a member leaves?**

We note that the issues mentioned here are responsible for many of the legislative changes to pensions since 1985. Before considering the necessary regulatory requirements, the government will need to consider (and ideally consult on) exactly how much protection it considers to be adequate. There should be no risk of avoidance activity if the options around scheme design are communicated clearly.

**17. What are your views on the feasibility of this scheme design?**

The design is feasible (some employers adopt versions of it), but it may be considered a less favourable option than the other potential designs due to managing active member expectations and the greater likelihood of administrative complexity.

**18. It could lead to more schemes having proportions of accrued pension payable at different pension ages. Would this further complexity outweigh the benefits?**

This will depend on how the scheme is established. If normal retirement age is fixed in relation to accrued rights the, provided retirement age is reviewed infrequently, the number of different retirement ages would be low. It is not clear to us whether employers would regard this as an obstruction to benefit provision. However, we note that whilst complexity is unlikely to outweigh the benefits from a member's perspective, increasing complexity is likely to gradually act as a deterrent to employers considering such schemes (as has been demonstrated in the past).

**19. What role do you see the scheme trustees playing? Should they be involved in setting a new NPA, or should this be down to the employer and the employer's actuary?**

Trustees would still have the role of acting on behalf of the beneficiaries and balancing members' interests against the employer's (but only in relation to their accrued benefits as prescribed by the scheme rules and overriding legislation). If the change in retirement age were set in accordance with a pre-determined mechanism (question 20), trustees would have no change in their role. However, trustees may not wish to have the responsibility to change scheme rules to determine when benefits should be paid.

**20. What are your thoughts on how future pension ages are set?**

- **For GAD to publish a standard index based on longevity assumptions?**

- **Or do you prefer schemes linking their NPA with the State Pension age, so that when the latter changes, the scheme's pension age automatically changes in line with this?**

Our preference is for employers to have flexibility about how the arrangement is established.

It is likely that a standard index would not be consistent with the experience of individual schemes. Mortality experience will be subject to industry and geographic factors (amongst others) which would reduce the link between the index and each scheme.

The advantage of using the SPA is that it is much easier understood and members will be aware of when they should expect to receive their State Pension. The age at which benefits would be paid would be independent of all factors other than the result of any review into the SPA. However, there is again not necessarily a link between scheme retirement age and SPA and SPA may be amended for other reasons not driven by changes in life expectancy.

**21. How might the decision to change the NPA work in multi-employer schemes?**

Having different options for multi-employer schemes would increase the administrative burden for schemes, although there will only be a finite range of ages at which benefits would be paid. However, if the intention is for each employer to determine pension age, it would appear reasonable that the same options should be extended to multi-employer schemes. If the administration were too complex, it would be possible to establish a new scheme, although this may not be an ideal solution and may not be cost effective. In practice, additional complexity may just discourage such pension provision.

As highlighted in our response to question 18, employers should have the ability to address this.

**22. As an alternative to opening a new scheme, do you agree it should be possible for an employer to modify the rules of an existing scheme so that it can be re-designed as a Flexible DB scheme in relation to new accruals, for example, it is possible to change the NPA and/or introduce automatic conversion to DC when a member leaves?**

Offering the possibility of changes to future benefits within a single scheme, or trust, would appear to be a useful option for employers and trustees. One obstacle to change could be stopping accrual in one scheme and starting another. The simplest solution may be enable employers to adjust future accrual in existing schemes. However, there are difficulties that could arise with a mixed benefit scheme, although they could be overcome by sectionalising schemes, albeit with some additional protections.

If Design 1 is the preferred option, care would be required to understand how funding regulations would apply to discretionary benefits. Clarity would be required to identify the interaction between discretionary benefits and mandatory benefits and the conditions that applied to the award, or non-payment, of discretionary benefits.

Design 2 may introduce issues about priority orders if it were a non-segregated part of the scheme, since payment for leavers would advance leavers in the priority order, ahead of members of the legacy arrangement, or those remaining under the new design. Further, consideration would be required as to the payment of CETVs from an under-funded scheme. This is considered under question 13 above, but the issues are more complex where Design 2 is operated as a non-segregated part of a scheme containing standard DB benefits.

**23. Do you agree that employers should not have the power to transfer or modify accruals built up under previous arrangements into a new arrangement, beyond what is allowed under current legislation?**

The IFoA does not consider providing this additional power would be beneficial for scheme members. While it may be appealing for employers to revert to the position they intended to be in from scheme inception, in effect, employers would be removing protections on which members have come to depend.

**24. Should there be a requirement to provide independent financial advice in all cases where an employer offers to transfer a member's accrued rights from a traditional DB scheme to a new arrangement?**

Members are likely to benefit from advice that provides understanding of what would be given up from the traditional DB schemes and what they could expect to receive from the new arrangement. If it is envisaged removing protections which currently apply to accrued benefits (and we assume this is not the case), there would be much less need to legislate for alternative DA structures.

**25. Do you think having more certainty than traditional DC would be welcomed by members, and help generate consumer confidence and persistency in saving?**

Whilst certainty is likely to be welcomed by scheme members, the challenge is to provide that certainty without a level of complexity that would deter members from saving (and also to provide this certainty at an acceptable cost). Many members are likely to desire certainty without realising that someone must pay for it. The consequence of "purchasing" certainty will have the effect of reducing future retirement income from what it could have been, unless employers are willing to pay for it.

One way of generating confidence and persistency in the savings market would be communicating to consumers that there are savings products to which they can commit funds which gives them a return whilst protecting their capital. At the same time, there is opportunity to illustrate that other products might, depending on conditions, provide better returns, albeit with other associated risks. Whilst we agree that education is not the sole method of encouraging a savings culture, it will be essential to allow consumers to consider and compare complex products and guarantees in a relatively simple way.

Having more certainty is not a panacea; many members, if asked, will agree that achieving certainty is welcome, although we would question whether they would be willing to pay for it. Many other members will have a lack of interest in pension saving because of other more immediate financial needs. Locking money away for a long time will generally not be a priority if members believe they will require access to funds at a stage in life before retirement.

**26. As an employer, if these products mean there is no funding liability, only the requirement to contribute as for a traditional DC scheme, would you be interested in offering these products to employees?**

Employers are seeking cost certainty and lower volatility, as evidenced in the transition from DB to DC provision. The inevitable question that employers will consider is whether these products would be brought into the defined benefit funding regime over time. Consequently, would employers eventually have to stand behind guarantees or promises made for their employees' pension provision? The consultation document itself acknowledges that nothing can stop future governments moving the goal posts. Whilst employers could take a neutral stance on the answer to this question, it remains open to debate if employers would accept additional risk while risk-free (pure DC) alternatives are available.

In the short term, the IFoA recognises these types of guarantees may only be attractive to paternalistic employers that do not want to go to pure DC. However, there is a case for considering a longer term view that in a pure DC world, employers may view guarantees as a means of differentiating their schemes for attracting and retaining employees.

The difficulty of communicating the merits of these products should not be underestimated. Product providers could already provide some of these alternatives as investment options for trustees and/or employers.

**27. In relation to medium- and long-term guarantees outlined in model 2 (capital and investment return guarantee), and model 3 (retirement income insurance), would removal of the legislative barriers be sufficient to stimulate the development of market-based solutions?**

Whilst a reduction in legislation surrounding retirement provision in the UK is to be welcomed and would be an initial step to making the market more attractive to providers and understandable for consumers, it should not be the sole driver for market-based solutions. Solutions must be acceptable to the demand and supply sides of the market. They must be cost-effective to the end user and sufficiently profitable for the providers to design, market and distribute products. This is the real challenge of guarantees: the market must be profitable for sufficient providers to enable a partially commoditised product that is affordable to consumers. Given the comments in the consultation around the scale of the market, an alternative approach may be required to provide the solution (our response to question 28 refers).

Legislation already allows the use of capital and investment return guarantees (in the form of with profits) and retirement income insurance (in the form of deferred annuities), so the underlying issue is not only with legislative barriers, but also around innovative products that consumers understand and want to buy.

**28. As insufficient scale has been identified as a barrier to providing affordable guarantees, is there a role for the Government in facilitating different types of pension vehicles that would create greater scale for this purpose?**

By introducing the National Employment Savings Trust ("NEST") a low cost limited functionality provider, government has stimulated the auto enrolment market by means of competitors, existing and new, with more sophisticated models. The introduction of NEST was a stimulus for the "master-trust" auto enrolment market. There is no reason to suggest that a similar approach to stimulating a guarantee backed defined ambition product market would not have the same desired outcome. There is a major stumbling block around State Aid which could limit the extent to which government could stimulate the market; therefore, government would have to be a facilitator rather than a provider. If a low cost, but secure, vehicle with limited functionality could be facilitated by government, other providers may see an opportunity to provide more complex, higher value offerings as an alternative.

Section 4.63 highlights the "low number of scenarios in which the risk could occur". If the intention is to address the psychological barriers to saving and protecting against losses in the short term is there a potential role for government guaranteeing or underwriting the guarantee? Perhaps any guarantee should only cover **the members' contributions**

**29. Are there any additional legislative barriers that stand in the way of innovation of products with guarantees?**

As set out in the consultation document, the legislation governing auto-enrolment would require alterations to ensure new types of products are qualifying schemes.

The complexities of the annuity provider market and the advent of Solvency II will have an impact on the ability of providers to enter this market-place. The capital requirements imposed on financial institutions seeking to provide "guaranteed" products to consumers will be significant. Such capital requirements may further increase demand for the highest rated assets, which would, in turn, do little for other aspects of pension provision, such as annuity purchase.

**30. Do existing protection arrangements for DC products provide sufficient protection for members in the event of provider insolvency?**

The principal protection for DC members comes from the Financial Services Compensation Scheme (FSCS). However, this protection does not apply uniformly to all members and depends on the size of scheme and the type of business under which the investments fall. In practice, members in schemes of large employers may not have any protection, may be covered up to different limits, or the limits may apply to the scheme as a whole as opposed to each member. There may be additional complexity in understanding the extent of coverage to members who access investments through platforms, or through reinsurance policies. The rules applied here must be straightforward, applied consistently and communicated clearly.

**31. Would any protection mechanism need to apply in order to provide extra security for members and reassurance for the employer that it would not be liable in the event of any deficits arising?**

If employers still fall within the defined benefit funding regime, the attraction of the alternative forms of DC benefits is very likely to be lessened relative to pure DC. Any legislation designed to attract employers into a DA provision for members must clearly identify the conditions under which employers may face future funding restrictions.

Clearly, should there be even a remote possibility of additional liability, employers will be concerned about the counterparty risk faced by their employees who enter in to any guaranteed DA contract which could lead to issues similar to the mis-selling of swaps and derivative based products to smaller employers.

Where the risks have been communicated properly, there should not be any retrospective. If there is an indication that employers would be held responsible for mis-selling, or poor communication, there is less possibility that there would be significant take-up of the products.

**32. Are these models likely to be an attractive option for employers and members?**

If the communication is clear and understandable, the products are transparent and if the guarantees are reliable, the products could be viable. However, we would refer again to our responses to questions 25 and 26.

**33. On model 4 – pensions income builder – what are your views on this model in which members are in effect deploying their own capital to guarantee their own entitlements?**

Model 4 seems to provide a framework for defined ambition which is theoretically already available by members securing periodic deferred annuities en-route to retirement. In a market where consumers are accustomed to allocating funds to investments, a diversion of funds to an "insurance" arrangement may not be clear. Customers may not obviously determine value for money and may consider the DC provision with risk-averse investment strategies as offering the opportunity of better outcomes for their longer term savings. Members are also taking the counter-party risk of the guarantee provider defaulting. Finally, there is a cost/value issue around the cost of insuring the risk and providing deferred annuities over a longer term for younger savers.

**34. Do you agree that CDC schemes have the potential to provide more stable outcomes on average than traditional DC schemes?**

CDC schemes have potential to provide more stable outcomes than traditional DC schemes, provided certain conditions are met, including relatively stable membership and investment markets. However, in order to smooth investment returns and provide more stable outcomes, scheme members may receive lower benefits than traditional DC schemes depending on their attitude to risk and subsequent investment decisions. However, if the degree of smoothing in a CDC scheme is relatively small, then the pension outcomes may be similar to an equivalent DC scheme.

The design of a CDC scheme will not consider varying attitudes to risk amongst scheme members. For example a CDC scheme can only cater for a single attitude to investment risk (e.g. low to medium) so it may not be suitable and could deliver lower outcomes for some scheme members than is possible under a DC scheme.

In addition, whilst CDC has the potential to provide more stable outcomes on average, there would be occurrences when traditional DC could outperform CDC. If both operate alongside each other, consumer views may become negative in times when traditional DC provides a better outcome.

Members of a CDC scheme would also be subject to different types of uncertainty around their pension benefits to which they would not be accustomed within a traditional DC scheme. For example, members would now face uncertainty around the smoothing of investment performance and the distribution between:

- Different generations of members, e.g. members with 20 or 5 years to go before retirement;
- Pre-retirement and post-retirement members, e.g. how discretionary increases to pensions in payment are decided;
- Active and deferred members; and
- Historic and future members.

There may also be issues for CDC schemes if members wish to transfer out to traditional DC schemes. At times of market lows the CDC scheme will probably have to take steps to protect other CDC members from the impact of any members wishing to transfer out.

**35. Given there is no tradition of risk sharing between pension scheme members in the UK, are individuals going to be willing to share the benefits of protection from downturns in the market and increased certainty of outcome, with the potential disadvantages of intergenerational risk transfer?**

There has previously been a strong tradition amongst UK pension scheme members for some intergenerational risk sharing as pension scheme members invested a significant proportion of funds into with profits funds. Historically, some of these have also included guaranteed annuity rates. Although there remains a significant amount of pension assets invested in with profit funds, most new pension contributions are not invested in them because with profits funds are now unpopular, particularly in the advised market.

To help design and develop a good and successful CDC proposition we can draw on some of the following lessons the pensions industry has learnt from selling with profits funds:

- Advisers and members did not trust the intergenerational transfer of risk;
- There was a lack of transparency;

- The need to apply market value reductions when the market was suffering from low returns made it more difficult for members to leave the fund; and
- Dealing with the significant capital estate they can build up, with unclear ownership between different generations of members.

A further challenge with CDC scheme design is how to handle the current working environment where people may have a significant number of jobs during their lifetime. Members might expect the CDC scheme to have the flexibility to allow members to transfer out and to transfer in, but this is unlikely to be straightforward given the nature of the benefits in the CDC scheme compared to the scheme to which the member is transferring.

Overall, it may be difficult to promote CDC schemes at the current time without further work on the scheme designs or customer testing. However, we recognise that the drawbacks may not be of great relevance to a new generation of pension scheme members.

**36. Is a CDC scheme designed to manage funding deficits by cutting benefits in payment going to be acceptable in the UK where traditionally maintaining the value of benefits in payment has been an overriding priority?**

If pensions in payment within a CDC scheme are reduced, this will be seen as a significant disadvantage relative to a traditional DC scheme where most pension members tend to buy an annuity so that this risk is removed, unless it can be demonstrated that incomes on average will be higher. This introduces a new uncertainty to which most UK pension scheme members are currently unaware.

If this design is permitted without proper consideration of the practicalities and communication of the risk, it could significantly undermine the appeal of CDC schemes as pension members are normally unable to generate additional income whilst in retirement.

In addition, product providers have a duty to Treat Customers Fairly (TCF) and meet customers' reasonable expectations. Historically even if providers have had the right to cut customers' benefits, they typically have not been cut reflecting current typical customer expectations not to have any cuts. For CDC schemes where pensions in payment could be cut, customers' expectations would need to be very clearly set to ensure a clear understanding for all stakeholders, which may be hard to achieve.

**37. What levels of funding do you consider would be appropriate to ensure that a CDC scheme has sufficient capital to meet the liabilities and minimise the risk of benefits in payment being cut?**

To minimise the risk of cutting benefits, CDC schemes could be designed to have relatively modest guarantees or to include a reasonable proportion of discretionary benefits. However, CDC schemes which minimise the risk of cutting benefits will generally tend to offer lower levels of guaranteed benefits which may not be acceptable to members looking for the best outcome.

The funding rules will also need to consider what reasonable actions need to be taken during periods of adverse market movements. These actions would need strong governance and be clearly communicated to stakeholders. For example, with profit funds can apply market value reductions if customers decide to withdraw their funds prematurely. Equivalent aspects will need to be considered with CDC designs.

**38. Given the need for scale and an ongoing in-flow of new members to ensure the sustainability of a CDC scheme, will it be possible to set up a scheme without some form of Government intervention?**

At this stage it is anticipated that for CDC to take off it would need to be supported and promoted by the government to build trust, which could be achieved by:

- A model like a government endorsed CDC scheme;
- A kite marked model where all schemes are operated using an equivalent basis so employees could easily consolidate their assets from various CDC schemes into one preferred CDC scheme; or
- Specific regulation.

Within the UK there may be an option to offer CDC as an alternative, but specific, investment strategy within existing DC schemes by means of a unit linked model. This would create a number of large CDC "funds" accessible by existing schemes from current DC pension arrangements. The unitised with profits model already in existence could form a framework for this option. However, scheme would have to be very large to minimise the impact of a medium sized employer withdrawing all its members.

Product providers have the potential to do this given their existing infrastructure and experience of running with profits funds. However, significant confidence of scale and a clear view of the regulatory approach, in particular to conditional targeted benefits, would be needed.

The government could also help by putting in place some form of consumer and/or provider back up protection for accredited CDCs to give more confidence to consumers, while enabling the capital requirements to be kept sensible to encourage more industry product development.

Introducing CDC into the existing DC landscape within the UK seems to be the best opportunity for this to happen. The benefits we already have in DC should not be lost, in particular the ability for members and schemes to move between providers as they seek to achieve the best value for money and outcomes for their members.

**39. As a mutual model, it has been suggested that CDC schemes might prove attractive to the trades unions and other social partners – might this be an option worth exploring?**

This option may be worth exploring but employers with a highly unionised workforce will need to proactively move to CDC pension provision. However, given that a number of these employers (e.g. public sector) currently have DB provision based on career average or final salaries, the move to CDC provision is likely to be resisted by trade unions. We note that the cessation of contracting-out may force employers to consider whether they wish to continue with DB schemes.

Trade unions and other social partners could play a valuable role helping to inform and educate pension scheme members. They could also help to deliver a strong governance structure as a key stakeholder.

**40. Do you agree that creating a unified and identifiable legislative framework that brings together the legislation relating to DA schemes would be preferable to simply amending existing legislation?**

It is almost universally accepted that the current legislative framework for pensions is too complicated. This has certainly not helped to drive innovation in pension scheme design and may well have inhibited such innovation. Consequently, we are supportive of a new, simplified legislative framework which readily caters for DB, DC and DA schemes. We would very much hope that such a framework would be sufficiently flexible to enable the market to continue to develop different products and schemes in the future.

We note, however, that designing a legislative framework along these lines whilst avoiding undue complexity will not be a straightforward task.

**41. Do you have any comments on how to characterise the defining characteristics of DA pensions?**

We believe that the current proposed definition of DB schemes is too narrow and, consequently, that of DA schemes is too wide.

The proposed definition of DB schemes suggests that the member is given complete certainty as to the benefit. However, this is rarely the case in DB schemes:

- Many schemes have some element of pension increases that is not guaranteed, but rather is provided on a discretionary basis from time to time.
- All, or almost all, schemes include provision for the employer and/or the trustees to change commutation factors, early retirement factors, etc. from time to time.
- The benefits payable in practice depend on the employer's existence and willingness to pay in future, and there will always be uncertainty around these.

Our view is that such schemes are clearly DB in nature, and should remain as such, rather than being reclassified as DA. This would require a more subtle distinction between DB and DA schemes, but we would hope that this is achievable. We do not believe that it would serve anyone's interests to reclassify current DB schemes and thereby subject them to different legislative requirements from those to which they are currently subject.

One exception to this would be final salary cash plans, where the defined benefit is a lump sum at retirement based on salary and service and this lump sum is then used to secure an annuity on the open market.

**42. Do you agree that it makes sense to define DB schemes in their own right rather than simply by contrast to money purchase?**

Yes, but it depends on how it is achieved.

**43. Do you agree that defining DA, DB and money purchase schemes should facilitate clear and proportionate regulation according to scheme type?**

We would be supportive of introducing new legislative definitions for DB, DC and DA schemes, provided the legislation did not create a more complex environment. However, simply introducing these definitions will not, in itself, guarantee clearer regulation. Rather, it will be vitally important to ensure, to the maximum extent possible, absolute clarity in all legislation surrounding all types of schemes. Avoiding the difficulties caused by a lack of clarity in money purchase schemes would be essential to successfully creating the appropriate legislative environment.

**44. Do you have any comments in relation to the suggested definitions of DA, DB and money purchase schemes?**

Please refer to our comments for question 41, with regard to the definitions of DB and DA schemes. We would also note the importance of ensuring that, whichever definition is eventually agreed for DA schemes, it is sufficiently flexible to allow future innovation in scheme design.

We do not agree that personal pensions that provide "defined benefits" (e.g. because they are provided by non-profit policies) should be in the same regulatory regime as one that applies to DB schemes. The key to whether a scheme is DB is the entity that stands behind the security of the benefit.

We are supportive of the proposed definition of money purchase schemes.

**45. Are you aware of any schemes operating in the UK under the Regulatory Own Fund provisions?**

We are unaware of any such schemes.

**46. Aside from Regulatory Own Funds vehicles, are there any other vehicles which might be appropriate for the provision of collective CDC which offers some form of guarantee or promise?**

The IFoA is unaware of any other appropriate vehicles.

**47. Do you think that setting up a CDC scheme should be subject to formal approval, for example licensing by a regulator?**

In light of the recent focus of both the DWP and the pensions industry on governance and member outcomes, we believe that there must be appropriate regulation for CDC schemes.

We suggest that consideration is given to some form of kite-marking, or similar, of CDC schemes. This would ensure that all such schemes meet a minimum set of criteria in areas such as governance, communication, charges, etc. and is similar to the arrangements for Stakeholder schemes and those under consideration for Master Trusts.

**48. Do you think that CDC schemes which do not provide a guarantee or promise should also be licensed?**

In light of the recent focus of both the DWP and the pensions industry on governance and member outcomes, we believe that there must be appropriate regulation for all CDC schemes, whether or not they provide a guarantee.

A system of kite-marking may be appropriate, as detailed in our answer to question 47.

**49. Do you agree that such CDC schemes should also be subject to DA requirements on governance and member communications?**

Yes, we believe that this is important for the same reasons outlined in our responses to questions 47 and 48.

**50. Should there also be an option for schemes that currently offer DC to convert to CDC?**

DC schemes should be able to convert to CDC, or at least be able to offer a CDC option. Please see our response to question 38.

**51. In the absence of both a guaranteed pension entitlement and an individually defined pool of assets, how should assets in a CDC scheme be apportioned such that pension accruals can be measured for tax purposes against the Annual Allowance and the Lifetime Allowance?**

The question highlights that since CDC has elements of DB and DC structure, there will be situations where existing legislation may not be appropriate for CDC. However, in testing against the Annual Allowance and Lifetime Allowance, CDC appears to be more similar to a DC arrangement, albeit with smoothed investment returns. The target level of benefits may not be attained by a member, with investment returns the key factor that influences the actual benefits received. The simple test for the Annual Allowance could be contributions paid, which is the current test for DC arrangements.

For the test against the Lifetime Allowance we suggest the use of the transfer value at the point it is crystallised.

A CDC arrangement would need to define a 'transfer value' measure, if members wished to move to another pension scheme, or for use in assessing divorce settlements. This could be equal to the notional fund value with the application of a market value adjustment that would reflect market conditions.

**52. What specific areas should we address in relation to governance and member communications for DA schemes?**

The IFoA would recommend the following would apply to key governance issues:

- The required governance standards should be no lower than those required under DC.
- The application of discretion by those managing schemes will be a key feature of DA schemes and it is a fundamental policy decision as to the extent that the application of discretion is constrained by legislation. We recommend that the legislative requirements should be principles based and not overly prescriptive.
- In order to protect members, there would inevitably need to be requirements around treatment of different groups of members (active members, deferred pensioners, pensioners etc.) and acceptable levels of funding.

We would understand the key communications elements to be as follows (please note the additional work that our working party has undertaken):

- There is clear understanding of the target level of benefits.
- Clarity around what elements of the benefits are "guaranteed" and what happens in the event that such guarantees cannot be met (e.g. employer insolvency, low level of scheme funding, etc.)
- Explanation of what elements are not guaranteed; the circumstances which affect the level of benefits or contributions and which parties are taking the associated risks.
- Any communication must be understandable and engaging.

**53. Do you have any comments on the assumptions in relation to scheme funding requirements?**

The IFoA would wish the legislation to be consistent between DA and DB schemes where applicable.

**54. What specific areas should we address in relation to governance and member communications for DA schemes?**

See our response to question 52.

If you wish to discuss any of these comments further, please contact Philip Doggart, Policy Manager at the IFoA, on 0131 240 1319 or at Philip.Doggart@actuaries.org.uk.

Yours faithfully

**Nick Salter**
President-Elect, Institute and Faculty of Actuaries