Institute and Faculty of Actuaries

Collective Defined Contribution Pension Schemes Inquiry

IFoA response to Work and Pensions Committee

24 January 2018

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.

Rt Hon Frank Field MP
Work and Pensions Committee
House of Commons
London
SW1A 0AA

24 January 2018

Dear Mr Field

IFoA response to Work and Pensions Select Committee's Collective Defined Contribution Inquiry

1. The Institute and Faculty of Actuaries (IFoA) supports the Committee's efforts to consider mechanisms for risk pooling and providing scheme members with greater certainty than current defined contribution (DC) arrangements provide. Based on our members' expertise in working with both defined benefit (DB) and DC arrangements, we agree that collective defined contribution (CDC)-type schemes could be a useful offering within the current pensions environment. Many designs for CDC are possible and the framework for establishing collective pensions should not be limited to one approach.

2. It is sensible that the Committee is questioning appetite for CDC amongst employers and the UK pensions industry. Whilst Royal Mail has already indicated an interest in CDC, there are a number of barriers to widespread demand. Therefore, the level of appetite should indicate the level of priority given to CDC. Particularly if there is a risk that developing CDC proposals could detract from other initiatives that would have a broader impact.

3. However, care should be taken to ensure that this type of mechanism is not used as a means of transferring risk from an underfunded DB scheme. Allowing DB schemes to transfer the risk of past service obligations in this way would create significant moral hazard issues. Therefore we recommend that the Government disallows this type of transition within any legislation for CDC.

Benefits to savers and the wider economy:

Would CDC deliver tangible benefits to savers compared with other models?

4. CDC has the potential to deliver tangible benefits to savers. However, it is important to note that CDC is not the only reform that has the potential to benefit savers. For example, reforms to DC in line with the recommendations from the Automatic Enrolment Review published in December 2017 also have the potential to deliver tangible benefits to savers. Therefore, whilst we agree that CDC could play an important role, we ask the Committee to consider any potential reforms regarding CDC within the wider context of, not just freedom and choice as listed in the inquiry's terms of reference, but also automatic enrolment.

5. Establishing a framework for collective pensions should not be limited to one approach. Depending on how the risk is shared, various approaches to CDC could offer greater certainty for both scheme members and employers than traditional DC arrangements. Other tangible benefits include:
    a. The smoothing of returns has the advantage of greater predictability, and limits scheme members' exposure to short-term volatility. This is the most significant advantage to members, as it offers greater confidence both in fund accumulation and during retirement where the retiree chooses drawdown rather than buying an annuity.
    b. Employers' exposure is like that of a DC arrangement and limits their exposure to unforeseen, or unintended, rising costs of mandatory benefit payments. This gives employers greater certainty of the cost of the scheme.
    c. In addition, CDC schemes are able to invest in growth assets for longer periods than individual DC schemes; this could make it possible for CDC schemes to generate higher average investment returns and therefore higher pensions for their scheme members than DC schemes.

How would a continental-style collective approach work alongside individual freedom and choice?

6. CDC could help scheme members to manage their longevity risk in retirement, which is a notable omission from the "freedom and choice" agenda. As CDC schemes pool funds, they are able to pay pensions through drawdown, whilst making adjustments to ensure the individual is able to be paid for the duration of their lifetime, in addition to balancing the solvency of the scheme. The introduction of CDC could therefore help to address our primary concern around the freedom and choice reforms, namely, that people are not able to judge how long they will live and as a result how long their savings will need to last. The impossibility of knowing exactly how long any one individual is going to live means that there is an increased risk of individuals either:
    a. running out of money in retirement and facing a reduced quality of life in the latest stages of retirement; or
    b. under-providing for themselves during retirement and unintentionally leaving money at the time of death.

7. Whilst this approach would work akin to drawdown, i.e. the individual does not have to purchase an annuity, international evidence suggests that for this type of mechanism to be viable individuals would not be permitted the same level of flexibility as they are currently.[1] This is because it could lead to adverse selection, whereby those who anticipate a reduced life expectancy (e.g. if they are in ill-health) exit the scheme at or after retirement, and this fundamentally undermines the effects of pooling mortality. This would go against the pension freedoms.

[1] Blake, David (2016) *Independent Review of Retirement Income – We need a National Narrative: Building consensus around retirement income* {Available online: https://www.pensions-institute.org/IRRIReport.pdf]

8. Therefore, if the Government does not want to reduce individuals' "freedom and choice" within CDC-style arrangements, alternative models for CDC may need to be explored in a UK-context, for example, allowing members to exit the arrangement before or at the point of retirement (and possibly after the point of retirement) to make use of the freedoms. This is not a CDC only consideration and the same could be said for DC. Individuals with known health conditions or behavioural traits that could reduce life expectancy are able to purchase impaired life or enhanced annuities and this can mean that annuity rates amongst the 'general' annuity population are reduced.

Does this risk creating extra complexity and confusion? Would savers understand and trust the income 'ambition' offered by CDC?

9. Yes, introducing CDC would carry the risk of greater complexity within the scheme and between schemes. However, the concept that a scheme member's pension fund can both rise and fall dependent on the market is a concept that we must work harder to explain in a DC environment. This is the same risk from a scheme member's perspective regardless of whether they are in DC or CDC, albeit the mechanisms for sharing risk and determining the fund value are more complex in a CDC arrangement. In particular, care would need to be given to explaining that an "ambition" is not the same as a "guarantee". The history of with-profits has shown that consumers haven't always understood this distinction.

Converting DB schemes to CDC:

Could seriously underfunded DB pension schemes be resolved by changing their pension contract to CDC, along Dutch lines?

10. No, not in respect of past service obligations. We do not think that this type of mechanism should be used to resolve underfunded DB pension schemes. If this were allowed it would create moral hazard issues, whereby there might be pressure to transition from DB to CDC where it may not be in members' best interests.

11. However, CDC is potentially a mechanism for managing the financial and longevity risks for future service. As an alternative to a pure DC arrangement, it has features that might have greater appeal to both members and employers who are reluctant to change from a DB structure to a DC structure.

How would this be regulated and how would the loss of DB pension promises to scheme members be addressed?

12. We do not recommend that the Committee proposes CDC for benefits that have already been accrued within DB schemes. If the Government were to pursue CDC for future service accruals, we would recommend that the regulatory framework should prevent the same rules being applied to accrued benefits as would be the case for future accruals.

Regulation, governance and industry issues:

How would CDCs be regulated?

13. We do not think that the Government should legislate for the particular design of CDC schemes and it should be left to the industry to develop innovative models of risk sharing. It is worth acknowledging that some options will be more expensive than others. Therefore, if these types of schemes become available, information will be necessary to help members, employers and Independent Governance Committees or Boards of Trustees to decide which type of CDC arrangement would work best for them / their employees / scheme members.

14. Regardless of their structure, CDC schemes will require an informed and impartial expert to calculate the fund value and each scheme member's share of the fund. This will be particularly important in achieving intergenerational fairness, where there might be pressures to favour the benefits of one generation over another. This could be done by an Independent Governance Committee or Board of Trustees dependent on whether the scheme is contract or trust based (respectively). Both pensions and with-profits actuaries would be well-placed to undertake these calculations. The Work and Pensions Committee might even consider creating a statutory role, as was the case for with-profit funds.

Is there appetite among employers and the UK pension industry to deliver CDC?

15. When defined ambition was legislated for in the 2015 Pension Schemes Act, it was our opinion that there was not significant appetite amongst industry for this type of arrangement. Therefore we welcome that the Committee is reviewing whether there is appetite for these reforms. The level of appetite should dictate the level of priority to be given to CDC, particularly if there is a risk that it could detract from the progress of automatic enrolment.

16. It is possible that the appetite for CDC will increase as more people come to have a greater proportion of their pension, if not all of their pension, savings in the form of DC and they seek greater confidence around the likely value of their pension. We are already seeing evidence that CDC may be attractive in heavily unionised industries, such as Royal Mail, because it provides a middle ground between DB and DC.

17. However, we remain concerned that there is limited evidence that demand would be widespread. One potential barrier is that employers are concerned that, having agreed to share risk with their employees, future pressures mean that this ambition becomes a commitment of provision and therefore becomes akin to DB. We have seen this happen in UK legislation before and so this concern would not be unreasonable.

18. Another vital component for CDC to be successful in pooling funds and sharing risk is achieving sufficient scale. One way of achieving scale is through industry-wide, multi-employer schemes. This would mean that CDC arrangements would not have to be tied to a single employer. Having reassurance that they would not be called on for additional funding in the future (i.e. CDC ambitions becoming akin to DB promises)

would help to gain buy-in from a sufficient number of employers to achieve the scale necessary for this type of arrangement to be viable. The growth in master trusts as a result of automatic enrolment means that to a large degree the mechanisms for this type of arrangement would already be in place.

19. Another barrier, facing some, but not all, CDC scheme designs at the outset, is that an initial capital buffer will be required, otherwise there is a risk that the first generation of retirees will receive less than could be deemed fair. Intergenerational fairness overall is an important consideration for CDC. As the risk is shared across generations, it is important that the outcome for multiple generations is considered. From a practical perspective this may involve asking one generation to change their benefits so that the risk is shared in a way that would be deemed as 'fair' across generations. For example older generations may be asked to defer their retirement age, or make changes to the indexation of their pension if the scheme experiences a deficit.

Would CDC funds have a clearer view towards investing for the long term?

20. Yes, CDC funds should have a clearer view of investing for the long term than individuals under existing DC arrangements as they are considering outcomes for multiple cohorts. However, to enable CDC schemes to take a long-term view politicians, regulators and scheme members need to be prepared to be in deficit at times, or face cuts to benefits. They also need to allow periods of unused surplus. If they are not prepared to do this, it would likely result in funds being designed with more cautious investment strategies, which would overrule the gains made through collective investment, or having to offer windfall benefit augmentations which would affect long-term benefit security.

Should you wish to discuss our response any further please contact Rebecca Deegan, Head of Policy, on rebecca.deegan@actuaries.org.uk.

Yours sincerely,

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