Institute and Faculty of Actuaries

Delivering Collective Defined Contribution Pension Schemes

IFoA response to the Department for Work and Pensions

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The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

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16 January 2019

Dear Sir/Madam,

IFoA response to DWP consultation: Delivering Collective Defined Contribution Pension Schemes

Executive summary

The Institute and Faculty of Actuaries (IFoA) welcomes the DWP's consultation on Collective Defined Contribution (CDC) schemes. A summary of the main points we make in our response is as follows:

- The enablement of CDC would be a positive development for the provision of UK pensions, which would be in the public interest.
- DWP's new primary legislation should be drafted so as to allow further secondary legislation to facilitate other types of CDC schemes beyond the scope of the initial legislation, should that be deemed desirable in future, for example master trusts.
- Even though the proposed legislation has some restrictions, it would appear to allow several different designs, in particular it does not definitively require contribution rates or accumulation rates to be flat for all members. We see this flexibility as a helpful start to the introduction of CDC.
- Without diminishing the role of other parties, the role of actuaries will be critical to ensure CDC is fair and sustainable both in the design of each scheme and then in the increases awarded.
- In addition the Pensions Regulator will have an important role in authorising new CDC schemes and providing ongoing supervision; the Pensions Regulator will need sufficient resources to apply appropriate scrutiny.
- Appropriate member communications are critical to ensure members understand the nature of the vehicle in which they are investing. In particular, it is essential that members understand that there may be times when their pension increases must reduce or their pensions must be cut.

Because actuarial aspects are so fundamental to CDC scheme design, the IFoA would like to meet with DWP at an appropriate stage to comment on the draft legislation and help ensure that it does not have any unintended actuarial consequences. In addition, we would like to discuss the governance process for the setting of annual valuation assumptions (for determining the increases), and the guidance that will be needed for actuaries acting in the new CDC actuary statutory role.

General comments

UK pension provision currently involves a stark choice between Defined Benefit (DB) and individual Defined Contribution (DC) designs, and the enablement of CDC would represent a third option which could better suit many workers compared with standard DC provision if their employers are not willing to bear all the risks associated with DB. Government support and a robust enablement of CDC would therefore be in the UK public interest.

The IFoA is the UK's professional body for actuaries, who are uniquely placed to assist in the design of and assessment of retirement solutions.

CDC comes with advantages to employers, employees and the self-employed; fixed costs for employers, while enabling the pooling of investment and longevity risk between members to help provide retirement incomes with less uncertainty than individual DC outcomes and without the costs of purchasing an annuity under the insurance regime. There is the potential for millions of workers to benefit from greater retirement security via CDC vehicles, provided there is an acceptance that the level of pension is not guaranteed and may change or reduce where there are insufficient funds overall.

A CDC scheme is unlike a DB scheme where typically there is recourse to a plan sponsor for additional funds, or a DC scheme where the individual member bears all the risks and has many choices including where to invest. For a CDC scheme, decisions are taken which impact the members collectively. It is the trustees who run the scheme on behalf of the members and therefore there must be sufficient member representation on the trustee board, and consultation with members about significant decisions that affect them.

We believe that any new potential pensions vehicle should be approached with an open mind. We consider that the fundamental approach proposed by the DWP is a good, workable option, which applies lessons from the UK DB and insured with-profits arrangement experience of the past and also CDC experience outside of the UK.

Nevertheless the details of the design of each scheme will be critical; each new CDC scheme must be carefully designed, with significant actuarial (and legal) input and then examined for approval by the Pensions Regulator to ensure the design is financially sustainable and demonstrably fair to members, which is essential to help build levels of trust.

We note that the DWP is keen to bring forward legislation as soon as is practical, and for this reason is proposing initial legislation which would facilitate a 'first tranche' of UK CDC schemes with a particular design to be set up as trusts by individual employers.

Many designs of CDC are possible, some being better suited to different kinds of workforces, and we would ask that once the DWP has enabled this first tranche, it is open to adapting the new legislative framework to allow other feasible CDC designs, which could include for example and not limited to:

- Other designs of CDC schemes which have different mechanisms to adjust benefits for the level of funding.
- CDC Mastertrusts which would provide much greater access to CDC for workers, including those employed by smaller employers which do not have the resources to set up their own trust, and the self-employed. This could include industry-wide CDC schemes, which could be particularly suited to those industries where employees tend to frequently change employer.
- CDC decumulation vehicles which could provide alternative pension options for members with individual DC pots at retirement.

These additional designs would make CDC available to many more workers than the current proposal, which would be feasible only for employers with the resources (and appetite) to set up their own scheme. For this reason we have set up a new CDC working party of our members and other pensions professionals to look at wider application of CDC, and investigate and report on these other options in 2019.

To help the DWP design the initial CDC legislative regime so that it might be adapted in due course to allow other kinds of CDC schemes such as the above, we have included reference in our answers below to the above alternative CDC designs where relevant.

Response to consultation questions

1. **Are there other ways in which the introduction of CDC Schemes would give rise to different impacts on individuals in relation to one of the protected characteristics? (i.e. age, disability, gender and gender reassignment, ethnicity, marriage or civil partnership, pregnancy and maternity, religion or belief, sexual orientation)**

In our view CDC schemes are no different from most other collective schemes (such as DB schemes) with regard to equality. CDC design can have one of two basic forms:

- The same rate of benefit accumulation for all members, such as Royal Mail's scheme providing 1/80th of each year's pay and with the cross-subsidy features described in the consultation document.
- For each member, each contribution is converted to a CDC pension credit at an accumulation rate appropriate to the member's circumstances (for example, age) and market conditions.

The second form of CDC raises a question for the DWP: can the terms for converting contributions to CDC pension take account of the member's gender?

In the second form of CDC, there's a case for taking account of broad underwriting factors (at a basic level: occupation, salary, location), namely to reduce foreseeable cross subsidy between those expected to be shorter lived and longer lived. A CDC decumulation scheme (as mentioned in our introduction above) focusing on receiving transfer values at retirement to pay a CDC pension from transferred-in funds would very probably need to underwrite individual applicants, for fairness and because such a scheme's terms would naturally be compared with those in the annuity market where underwriting is the norm.

Overall it is important that the new primary legislation is not drawn up too narrowly so as to preclude a future expansion into other types of CDC arrangements.

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

We expect that employers will choose CDC pension provision only if it is clear that their contribution rates are fixed, and they are not guaranteeing a certain level of pension benefits. We are not lawyers. However, we would expect that classifying CDC in legislation as a money purchase benefit would help to achieve that, albeit not all aspects of legislation applying to money purchase schemes will apply in their current form to CDC schemes.

In addition, we expect employers would wish to reflect CDC schemes in their accounts on a defined contribution basis reflecting the nature of the scheme. Classifying CDC schemes as money purchase in legislation would assist with this.

In both the above cases, we note that it is the defined contribution aspect that makes CDC lean towards a "money purchase" definition. We note however that CDC schemes will not be "money purchase" in a common understanding of the words, and suggest that member communications do not use the term "money purchase".

3. Are there any other areas where the current money purchase requirements do not fit, are inappropriate or could cause unintended consequences? (i.e. in addition to automatic enrolment, revaluation of deferred benefits, subsisting rights and transfers of benefits between schemes).

This is a legal matter. However, we comment that it will need to be clear that CDC assets can be pooled to provide collective benefits rather than being held in individual accounts.

As noted in the consultation document, money purchase legislation will also need adapting to require CDC schemes to have an actuary. We note that a CDC "scheme actuary" would be performing quite a different role from that of a DB scheme actuary, and for clarity we recommend that a different term could be applicable, for example "CDC actuary".

The actuary's role is critical to ensure the design of each CDC scheme is fair and sustainable, and it will be for the CDC actuary to advise on the level of benefit increases (or cuts) to be applied periodically. The IFoA would welcome working with the DWP to formulate guidance and regulation for the new CDC actuary statutory role.

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

The conditions described in 3.2 are:

- Occupational trust based pension scheme
- Main place of administration in the UK
- Registered with HMRC for tax purposes
- Authorised by The Pensions Regulator at the point of opening the scheme
- CDC assets segregated from any non-money purchase assets
- Single or associated private sector employer sponsors
- Annual actuarial valuations to determine benefit adjustments
- Not "accrual only" schemes without a decumulation vehicle
- Sufficient scale to pool longevity risk
- Regulations to include sufficient flexibility to allow later adaptation for multiple unconnected employers or commercial provision

Some of the conditions will require a legal view, but we do not fundamentally disagree with them. However, two points that we would make are:

- As they are not DB, CDC schemes should be capable of operating without an employer sponsor. For example, if the employer became insolvent, the CDC scheme should be capable of running on for many years paying CDC pensions. Also, if CDC schemes are available as decumulation vehicles then this will give individual workers another option at retirement, as an alternative to buying an annuity, taking cash or drawing down an income. Some workers might choose to take a CDC option because of the higher expected income than an annuity (although that income will not be guaranteed), or because a CDC pension will be payable for life unlike drawdown (albeit without the flexibility of a drawdown account). Such a vehicle would not need an employer sponsor.
- It is noted that CDC assets and liabilities need to be segregated from any non-money purchase assets and liabilities but they will also need to be segregated from other "normal" money purchase

assets and liabilities.

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

All else being equal, a larger scheme is better for pooling longevity risk. For a CDC scheme for a smaller membership there is scope for a small number of highly paid members to become an excessive proportion of the scheme and, if they live longer, at the disproportionate expense of other members.

The annual and lifetime allowances could help manage this concentration of longevity risk to some extent, however if further mitigation is required one approach when designing the scheme is to introduce a salary cap for the CDC accumulations (another form of benefit could be offered on excess salary).

However, where scale is important is in meeting the operational costs of running the scheme in a way that meets the charge cap and is intergenerationally fair. For employers with smaller workforces, it might not be cost effective to set up their own CDC trust; a master trust option, if made available, might be preferred. Any smaller CDC schemes which do arise might have a need to meet operational expenses partly from funding outside of the scheme (for example a reserve set up by the employer), and the actuaries designing the scheme would need to consider this (and the Pensions Regulator might be expected to take this into account in deciding whether such a scheme could be authorised).

Given this, we recommend that there is no need to specify in the legislation a minimum CDC scheme size.

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

See 7 and 8 below.

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

We note that some existing UK DB schemes have conditional increases, in our view similar TKU requirements to those for DB trustees would be appropriate for CDC trustees.

However, two areas where we suggest the Pensions Regulator should be encouraged to provide additional TKU module(s) or guidance for CDC trustees are:

- what current best practice looks like for the governance of CDC schemes, and
- how trustees can best communicate how CDC schemes work to their scheme members.

We would expect the Pensions Regulator might refine its expectations as experience of CDC schemes develops. In addition, if other forms of CDC schemes are enabled over time, the TKU requirements for those will need to be considered.

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

Trusteeship of a CDC scheme as described in the consultation document would in some ways be less onerous than trusteeship of a DB scheme because contributions are fixed, there is no reliance on covenant, and the pension increase mechanism is prescribed. It might be appropriate to relax the existing TKU requirements in some of these regards.

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

CDC design can have one of two forms, and the answer depends on the form provided:

- A flat benefit accumulation rate for all, such as Royal Mail's scheme providing 1/80th of each year's pay, consistent with the DWP's proposals. In this case the current DB "cost of accruals" test for AE is well suited to the scheme noting that, as for DB schemes, the contribution rate is flat across members but the actuarial value of accrual for each individual member is different. When the CDC scheme is designed and the Pensions Regulator authorises it, this could include consideration of whether the accumulation rate is unreasonably small for auto-enrolment purposes.

- The contribution for each member is specified, and each contribution is converted to a CDC pension credit on terms appropriate to the member (such as age) and market conditions. In this case, the actuarial value of the CDC accrual for each member is equal to the contributions paid for them, and so the same minimum AE contributions as are used for individual DC can be used for CDC.

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

Capital buffers are used in some other CDC regimes outside of the UK, where DB benefits were converted to CDC, to reduce the risk of having to reduce pensions. In summary, such capital buffers typically work by allocating a portion of the assets as a 'prudence margin' which is held in excess of the central estimate of the cost of paying the benefits; the capital buffer is therefore not taken into account when assessing the level of increases funded by the assets, but can be taken into account when assessing whether a benefit cut is required. The capital buffer is therefore a reserve that is used to avoid a pension cut (unless the reserve runs out).

Under Royal Mail's published intended design, there is a different approach to reducing the risk of pension cuts. Pensions would usually be stable while the funding includes 'headroom' for future pension increases – because it is the long-term rate of pension increases which is varied with experience. The "headroom" might typically be projected to be half of the assets – in other words, the CDC pensions without any further increases might be about 200% funded. It is only if the funding is well behind track and this headroom is lost, that benefit levels might be subject to cuts to ensure the benefits remain at least 100% funded by the assets. All else being equal, absence of a capital buffer (on top of increase headroom funding) does increase the risk of pension cuts, and it is crucially important that members understand that their pensions could be cut and that future increases are in no way guaranteed, in order to manage their expectations. We comment more on communications in 11 below.

Based on the above 'increase headroom' approach, we agree that CDC schemes do not need to have in-built capital buffers, noting that the design and the Pensions Regulator's authorisation process will include consideration of whether the planned amount of headroom gives sufficiently low risk of instability through pensions cuts. CDC schemes can instead be required to remain 100% funded for the level of increases it is awarding (ie with whatever increase headroom is held at that time), without setting aside some of the assets to act as an additional capital buffer.

Requiring schemes to have buffers would cause problems for multi-employer schemes and decumulation only schemes if, in time, they were to also be established. These schemes should be required to remain 100% funded but without any buffer above this, because:

- If CDC schemes need to aim to build up a buffer, different generations of members would pay different amounts into a buffer, and receive different amounts from it, which we expect would be

seen as unfair. For example, when the scheme is new a buffer would have to be built up, funded by the first generation (either from contributions or from the employer's assets). The buffer would then be held until it is needed (which might, for example, be for the second generation of members – requiring a third generation of members to pay for a new buffer once the scheme has recovered).

- If CDC schemes need to aim to build up a buffer, unless CDC membership was compulsory as is the case for some CDC schemes in the Netherlands, the size of the buffer could act as an incentive or disincentive to join the scheme. In particular, if the buffer is low, members might leave the CDC scheme en masse, in order to join another with a higher buffer at that time. Equally, the employer might cease accumulations in the CDC scheme. Either way, this would remove the source of funding to restore the buffer, and so this form of CDC design would not be sustainable.

There is a separate but related question of whether an expense reserve is required. As DWP notes in paragraph 125 of the consultation, this could be part of a CDC scheme's strategy to ensure it is sustainable without reliance on continued accumulation contributions. We consider that this would be appropriate for CDC schemes. The expense reserve could be funded by seed capital, or built up over time if the scheme is large enough to be able to pay expenses within the charge cap.

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

One of the lessons from the Dutch CDC experience is that high quality member communications are critical for the successful running of a CDC scheme. We have recruited a communications specialist to our CDC working group for this reason, who has assisted with our response below.

DWP will need to consider the CDC member communication requirements to be prescribed in legislation, and those subject to regulatory guidance on best practice. Given the importance of communication to CDC schemes we recommend that comprehensive regulatory guidance is provided at an early stage.

In order for members to accept the risk that their benefits could go down as well as up, even when in payment, they will need to feel confident that the scheme is well designed and run. They will want reasonable assurances on how the scheme will invest their money, and confidence that the assets will be distributed as pension benefits in a way which is fair. They will also want assurance that the scheme design means that their benefits can't entirely disappear in years to come (although they will know annual pension rates can reduce). Good communications will enable members to weigh up the advantages and the risks to them, personally, and yet maintain their faith in the scheme up to and into retirement.

When communicating, CDC schemes should consider their members' experience of other pension schemes to ensure that they understand the key distinctions between DB or DC and CDC.
Our working group is investigating best practice for member communications for CDC schemes. Based on our work so far, we suggest that best communications that enable members to understand the risks and advantages of their CDC scheme would take four forms:

1. A member's handbook that sets out clearly the governance and mechanics of the scheme and the consequences for how risk is shared between members. The communication would refer to the relevant legislation, the authorisation and supervision by the Regulator, the role of the trustees and the use of expert advisers (such as actuaries and auditors).

2. Regular, personalised communications (including an annual statement) that set out in real terms

how the member's individual pension is accumulating within the scheme. The figures should set out their current benefit levels and provide illustrations of future benefit level increases to enable the member to understand and compare, from year to year, how their benefits in payment might fluctuate. It will need to be made very clear that benefit levels are not guaranteed and future pension increases could be higher or lower than those recently awarded.

If in a given year pension increases fall, or if a cut has to be made, it is important that members are given an explanation for this. For example, if a cut is required due to a severe global recession, members are less likely to react negatively to the cut if they understand that other savings vehicles investing in growth assets have suffered similarly.

3. Communications about a member's benefits being put into payment, for example early, normal or late retirement, transfer out, survivor's benefits on death, full commutation of trivial benefits or on ill health. These communications will need to clearly explain the benefits and, when an option is being considered, the consequences of either taking or not taking the option.

4. Appropriate engagement with members around changes to the scheme. For example, how members are involved in selecting member-nominated trustees and how the trustees take account of member views on investment issues, in line with current legislative requirements.

All generic member communications should be available on a public website and be open to public scrutiny and debate. In addition to the above, we believe it will be helpful for the Government and the pensions industry to describe CDC in a consistent way, being clear about the risks as well as the advantages.

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

We consider that a "best estimate" basis is a good approach for determining benefit increases, thereby providing benefit increases that are assessed to be sustainable in the long term without applying a prudence margin (ie without a capital buffer such as that discussed under question 10) and without deliberately over-distributing pensions through over-optimistic assumptions. Whilst a CDC scheme would provide more variable benefit level outcomes than traditional DB plans, there is less variability before retirement than there is under a comparable traditional DC plan.

On a point of terminology, we note that "best estimate" means different things to different people, and we'd expect some of the public to interpret it as "highest estimate". We suggest alternative terms are used such as "central estimate" or "neutral estimate".

There is a wider issue relating to the governance for the annual setting of actuarial assumptions to determine benefit increases. The future is, of course, uncertain and judgement is required to determine appropriate valuation assumptions. In particular, if there has been a market downturn and reasonable valuation assumptions would lead to pension cuts, it is important that the scheme faces up to that need and applies the cuts, rather than avoiding them by choosing assumptions tinted by optimism (which would be expected to require even larger cuts in the future to return the scheme to an appropriate level of funding). Whatever governance structure, we recommend that the valuation report and assumptions used should be published to ensure transparency and to facilitate public debate and discussion. Our thoughts on some governance options are as follows:

1. Similarly to the current UK DB funding regime (as it applies to most DB schemes), the Trustees could choose the assumptions having taken actuarial advice. The principles used to determine the assumptions could be recorded in a published "Statement of Valuation Principles", for which

any changes to principles must be justified by a change in economic, demographic or legal circumstances. It would be important that Trustee Boards have due regard to their CDC actuary's advice and have sufficient expertise to be the ultimate decision maker. However, experience in the Netherlands indicates that Trustee Boards could in some circumstances bend to pressure from members to avoid a cut, and it would be difficult to guard against this possibility, although the requirement to publish the assumptions (and their justification) would help to some extent.

2. The CDC actuary could be the decision maker, without a Trustee role (other than to appoint the actuary). The CDC actuary would need to act within the requirements set by legislation and the actuarial profession. It would need to be ensured that the members see the process as credible, and also that the CDC actuary feels sufficiently able to make a decision which affects immediate benefit levels. As for 1 above, the published information could include a "Statement of Valuation Principles" so that any changes in the assumption-setting principles adopted by the actuary are made transparently. An additional feature which could help would be for the trustees to commission a benchmarking exercise, perhaps of three other experts / actuaries and on a triennial basis to ensure it is proportionate, for any particularly subjective assumptions (such as the discount rate), which the actuary could have reference to when making their decision. This would be for similar reasons to the "peer review" that DWP propose for the actuarial modelling behind the initial design of the scheme.

3. The assumptions could be centrally mandated or 'tramlined' by an appropriately expert body. We understand the Dutch system features a maximum best estimate return for CDC recovery plans, set by an academic body, and a similar body could be established in the UK to set "central" estimates for use by CDC schemes. The assumptions would have to be broken down into relevant components, which could be combined in the right proportions to reflect the specifics of the CDC scheme (eg expected returns per asset class). The ultra-long time horizon that is relevant to CDC may justify a more prescriptive approach. The expert body would need to strike a balance between giving enough parameters so that schemes' assumptions are specific to their investment strategies/ time horizons, and keeping the work manageable. This approach would avoid the need for discretion by the trustees or actuary and removes any potential risk that any pressure to avoid pension cuts might bias the assumptions towards optimism. However we note that this approach would require more investment of time to set up the expert body (for what at first is likely to be relatively few CDC schemes) and would need funding. We would prefer one of the other approaches subject to being satisfied that these are not expected to lead to material bias in the assumptions.

This is an area that we would like to discuss further with DWP.

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

Yes, we favour a CDC design such as the one Royal Mail intends to adopt, which is not reliant on continued employer contributions. Otherwise, if the scheme were to close to accumulations (for example, if the employer changed its pension provision, or became insolvent), the benefits payable to the last generation of members could be affected and this would not be intergenerationally fair.
We note it is possible that if a small-scale scheme were to close to accumulations after a relatively brief period since opening it might never get big enough to be sustainable, and would need to be wound up. Each CDC scheme should have plans in place to ensure fair value is provided to each member on winding up, and that wind-up benefits are provided in an appropriate form. See our response to question 16 regarding the potential for bulk transfers to other CDC schemes. This would help ensure an orderly

wind-up while allowing other CDC schemes to attain a sustainable scale.

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

Section 4.4 of the consultation document focuses on the risk to members of volatile or low pension amounts. In our view the DWP's valuation, investment and regulatory proposals for managing these risks are sound. We question whether the risk review envisaged in paragraph 115 is needed, noting that an appropriate mechanism for cutting benefits ensures a scheme is financially sustainable in the most basic sense (i.e. it cannot run out of money, provided there are adequate provisions for an emergency review of benefit levels), and the other provisions ensure that it is sustainable in a fair way.

We could see sense in the Regulator having powers to intervene in a CDC scheme which it believes is no longer sustainable, as a backstop in case the governance of the scheme has unforeseen problems.

There are other risks to members or other stakeholders that CDC schemes will need to manage through the design or ongoing governance of the scheme, for example:

- Risk of member dissatisfaction – good member communications are critical, as described in 11 above
- Risk of legal change, which could alter the running of the scheme, the benefits that have to be provided, and / or the relationship with the scheme's employer – robust wording of the legislation will be important to give employers comfort that the initial legislation is clear. This risk will need to be considered in the design of the scheme.
- Risk of the scheme no longer providing accumulations which meet the employer's objectives, for example an objective for increases to have some level of price inflation linkage. This should be considered by the employer when designing the scheme.
- Risk of change in accounting treatment for the employer. Legislation and rules which ensure it is clear that the contribution rates are fixed will help to manage this risk.

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

The point of a collective arrangement is to allow sharing of risk, and some level of cross subsidy. Examples of cross subsidy are those arising from the collective application of pension increases (irrespective of when a member paid into the scheme), and the longevity pooling – i.e. longer payment periods to members who live longer. We see no problem with these, as long as the resulting cross subsidies are intergenerationally fair. In particular, although increases can (and will) vary over time depending on the scheme's experience, such as asset returns, there should be no bias in the scheme's increases – i.e. not an expectation of materially higher increases to one generation resulting from the scheme's design. In our view the DWP's proposals set out the fundamentals of a valuation and investment approach which achieves this.

We suggest also that, when the scheme is being designed, the employer or other corporate body should take actuarial advice on the types of risk sharing and cross subsidy that a proposed design would provide, so that they can decide on an informed basis whether to open the scheme. In addition, the members' handbook should be clear on how risk is shared between members.
Part of the risk sharing is driven by the approach used to set the valuation assumptions, which is discussed under 12 above.

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

A CDC scheme could need to wind up if it became unsustainable either due to legislative change or due to it shrinking to a very small scale (for example, many years after a closure to accumulations), so that it is no longer a cost-effective vehicle. As the DWP notes, CDC schemes should therefore have clear rules on winding-up triggers and on the benefits payable on winding up.

Ideally it would be possible to wind up a CDC scheme by means of a bulk transfer to another similar CDC scheme, to ensure minimal disruption to the benefits payable. This would be possible only if the Government facilitates CDC schemes which do not need to have a sponsoring employer and which contain members who were not originally employed by a sponsoring employer. Otherwise, on winding up CDC benefits would need to be converted to benefits in an alternative form, for example individual DC pots before retirement and drawdown pots after retirement or, if the scheme is very mature and holds a large proportion of low risk assets, insured annuities might be appropriate.

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

In our view the elements of the proposed regime are appropriate. In this response we suggest some additional elements such as those relating to valuation assumption setting and member communications.

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

The proposals seem comprehensive, as long as the Regulator has the resources to apply sufficient scrutiny for authorisation.

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

We do not suggest any investment requirements on trustees in addition to taking investment advice and the production of, and then following, a Statement of Investment Principles ("SIP") setting out the strategic asset allocation and how the assets will be managed.

We agree that a trust which provides CDC benefits should always document and follow a SIP for the CDC section ("CDC SIP"), which is also published on a public website as part of the transparency requirements for the CDC arrangement, and which meets the existing requirements that would apply to either a SIP or default SIP.

We understand that under the Royal Mail design there will be a pre-set asset allocation strategy within which the trustees will operate. We see that as helpful, to the extent it is practical to set robust rules for a long-term investment vehicle, so that members will know the fundamentals of how their money will be invested, and so that trustees have clear guidelines within which to operate the investments.

We also comment below on our initial high level views on an investment strategy which might typically be appropriate for a CDC scheme.

A CDC scheme will have fixed contribution rates for accumulation, no covenant reliance, and would typically provide pension benefits with variable benefit increases (rather than variable contribution rates). Its purpose is to generate cost-effective pensions, and it spreads risk over time in the way it is reflected in benefit amounts, which allows it to aim for relatively high returns. There must be acceptable resulting level of volatility and also the sustainability of the scheme must be ensured, however these will provide less constraint on the investment strategy than would typically apply to an occupational

pension scheme. This means that a high level of growth assets is likely to be appropriate, subject to holding some lower-risk assets as appropriate to generate additional cash flow and protect against market falls as mentioned in the consultation document.

In addition to generally-recognised growth assets, such as listed equities, a CDC scheme can take advantage of investments which have a longer investment horizon such as infrastructure and potentially offer the best longer-term returns over the duration of the scheme liabilities. This, together with the large scale (and therefore buying power) that is likely to feature in most CDC schemes, will allow CDC schemes a wide range of investment opportunities, subject to taking an acceptable level of risk.

As a long term investor, a CDC scheme will be subject to significant variation in prevailing investment environment. The asset allocation should vary in response to circumstances, for example the ability to switch out of holdings which become adverse investment environments.

Derivatives should be allowed as appropriate for hedging (such as exchange rate hedging) and for efficient portfolio management.

The IFoA's working group is further investigating investment strategies that would typically be appropriate for CDC schemes.

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

The DWP's proposals are comprehensive, although to be clear we would suggest that the annual valuation reports and pension increase rules are published (rather than just being made available to members) to assist with the transparency of the scheme.

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

Yes with regard to the high-level administrative requirements, subject to our comments on the scheme actuary role as set out in our answer to question 3 above. We presume that there will also be differences in the detailed administrative requirements, for example record keeping and member benefit illustrations, to reflect the different nature of the benefits.

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

A charge cap would help to ensure and demonstrate value for money for members and we agree that some form of charge cap should apply to CDC schemes. However, the investment circumstances of a CDC scheme are different from that of a DC scheme, and we recommend that the appropriate form and level of charge cap needs to be considered afresh for CDC.

We believe that if the cap is set at exactly the same level as for individual DC, it could unduly constrain the investment options for the scheme. Individual DC schemes are naturally subject to other investment constraints, namely the small scale of individual pots, and the need for daily valuations / liquidity, and can offer more sophisticated investments through non-default funds which are not subject to the charge cap; and so the individual DC charge cap has not unduly limited the investment choices for them. A CDC scheme is different; in some circumstances it would be optimal to take advantage of its scale and invest part of its assets in more sophisticated illiquid arrangements such as infrastructure to target high net returns - but as well as coming with higher expected net returns these investments come with higher

investment fees that would be charged directly to the scheme. Also, some CDC investment types such as private equity investments are suited to performance-related fees, which are problematic under a charge cap structure which is annually flat.

Consideration could be given to other forms of a CDC charge cap, for example a combination of:

1. Have a separate (higher) CDC charge cap which applies to illiquid assets such as infrastructure or other private market holdings, so as not to constrain such investments which would target high net returns.
2. Have a CDC charge cap (which is lower than that for individual DC) which applies to operational expenses excluding investment expenses, and require a separate test of investment efficiency that takes into account expected net returns.
3. Assess the charge cap over periods which are longer than annual, so as for example not to constrain the high set up costs that might be required for an investment in infrastructure.

Were the individual DC charge cap to apply without adjustments, it would constrain material holdings in assets (such as direct infrastructure holdings) with large set up costs of a few %. We suggest that a quantification of the costs and assessment of their impact on CDC investment choice is carried out, so that an appropriate decision can be made on the CDC charge cap. Our working group is assessing this. Ultimately, the DWP will need to decide whether the imposition of a cap is a better solution than obligations on trustees regarding value for money and transparent disclosure to members.

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

Yes, so that the assessment is sensible and practical, but only if the imposition of a cap is ultimately deemed to be the correct route.

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

Transfers into or out of a CDC scheme should be assessed at a fair value, which is not expected to affect the level of increases on other members' benefits. This would typically be using the same "best estimate" basis that is used for the annual actuarial valuation, updated to market conditions for the date of the transfer.

It is possible that CDC schemes could experience 'selection' against the scheme, whereby members who choose to transfer out are those with shorter life expectancies (and therefore would not expect to benefit as much from the CDC scheme's longevity pooling), and *vice versa* those with longer life expectancies might be more likely to transfer in to the CDC scheme. Anecdotally we are aware of studies carried out by large DB schemes that have found no past evidence of such selection, and it is thought that such transfer in / out decisions have, in the past, instead been driven by other factors.

However, if a CDC scheme had reason to believe that there was such selection against the scheme, we suggest that the scheme is able to make allowance for this in the actuarial assumptions for the transfer (for example, by adjusting the longevity assumption to reflect the average life expectancy for transferers), so that transfers are still not expected to affect benefit levels for other members.

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

As for other UK occupational schemes, transfers out should be allowed before pension payments have started so that members can choose the type of benefits they wish to receive at retirement or can

consolidate their pension benefits if they wish. Transfers in to CDC schemes could be allowed if the scheme rules are written to permit them.

Members need to be sufficiently well informed to decide whether to transfer into or out of a CDC scheme. DWP will need to consider what is required to achieve this but as a minimum we suggest that there should be a strong recommendation to take advice from an IFA. We note that a transfer out of a DB scheme is usually a material and irreversible decision for a member, and by doing so they are giving up the sponsoring employer's guarantee of the DB benefit levels, and converting their benefits into a very different form (usually individual DC); for this reason, members taking material transfers out of DB schemes of over £30,000 are required to take advice from an IFA. A transfer from a CDC scheme would often be less of a material decision; the benefits would typically be DC before and after the transfer; the transfer could be to another CDC arrangement; if the transfer is to an individual DC arrangement, there might be later opportunities to transfer again into another CDC arrangement such as a decumulation vehicle we describe in our preamble.

We do not think there should be any restriction on transfers linked to the sustainability of the fund. It is important that members have the choice to transfer out to a different scheme if they wish to receive a different type of benefit. As transfer terms should be cost neutral (per 24 above), the only effect on the scheme of a transfer should be on its scale. The provisions to ensure the sustainability of the fund, or wind it up if not sustainable, as described under 13 and 16 above, should make allowance for the possibility of transfers.

Should you want to discuss any of the points raised please contact Henry Thompson, Policy Manager (henry.thompson@actuaries.org.uk / 020 7632 2135) in the first instance.

Yours sincerely,

John Taylor
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