Department for Work & Pensions

Delivering Collective Defined Contribution Pension Schemes

Government Response to the Consultation

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Ministerial Foreword

The UK has a world-class occupational pension system. But there is always opportunity for further innovation and improvement. I believe CDCs can be part of that improvement. I am grateful for the work done by the Royal Mail and the Communication Workers Union to agree a proposed Collective Defined Contribution scheme in the UK, in the belief that this will be advantageous to both the employees and the business itself.

Government has listened and brought forward our consultation, which applies not just to Royal Mail but other organisations as well. I was particularly delighted by the level of comment and overall support received from stakeholders and from the Work and Pensions Select Committee for our proposals for CDC schemes, as set out in the Government's consultation document, Delivering Collective Defined Contribution Schemes.

The vast majority of the responses to the consultation were supportive of the proposals and keen to see CDC schemes up and running in the UK. Respondents, stressed the need for good communications. We agree. Likewise, government urged good governance in these schemes, so that they are run well and members are helped to understand how their benefits work - including when adjustments will be made, including when adjustment will be made.

There were encouraging signs of a growing interest in CDC amongst employers and commercial providers, outside of the Royal Mail and CWU. I expect this will increase further as all parties become more accustomed to this type of provision. There are 140,000 postmen and women working for Royal Mail in depots up and down the United Kingdom. It is clear these employees, and the CWU are very engaged and supportive of CDCs.

Pension reforms in recent years have transformed pension saving in this country, whether it is auto-enrolment or the new state pension. However, there remains much

to be done to ensure that people receive the best possible retirement outcomes. We plan to strengthen security and increase transparency around pension schemes so that savers can be confident that their pensions are protected. We will improve information and guidance for pension savers so they can prepare for retirement with confidence. We will provide more options for employers to ensure that scheme members can adequately save for retirement and to better protect their income in later life.

My commitment to legislate for collective defined contribution (CDC) schemes is a key part of this work. CDC schemes will provide employers with new options for managing their pension obligations, with benefits for workers and employers alike. As I said in the forward to the original consultation, CDC schemes are not a catch-all solution to concerns around retirement outcomes. But I am confident that well designed and run CDC schemes can offer advantages for some employers and employees in the UK. Looking at the consultation responses, it has been heartening to see how many respondents – including employers, trade unions and pensions commentators - agree with this Government's proposals.

I am grateful for the comments and support received, and now intend to move forward with legislating to facilitate CDC provision as soon as Parliamentary time allows.

Guy Opperman MP, Parliamentary Under-Secretary of State for Pensions and Financial Inclusion

Chapter 1: Collective Defined Contribution Schemes

1. The consultation paper *Delivering Collective Defined Contribution Pension Schemes* discussed the government's proposals for the establishment of Collective Defined Contribution (CDC) occupational pension schemes. We set out our thinking on how such schemes would operate and asked for views on the practicalities of our approach.

2. This response document summarises the answers we received to the questions we posed in the consultation document.

3. We have been delighted by the quantity and the quality of the responses we received. Over 70 organisations and individuals responded, highlighting the level of interest in CDC in the UK. A list of respondents can be found at annex A. The vast majority of respondents were supportive of the establishment of CDC pension schemes, and felt that our approach was broadly correct. We were particularly pleased to see that, even where respondents disagreed with the details of our approach, they could often see the rational for them as a part of our overall design. In particular, our decision to introduce CDC provisions slowly, starting with the proposed Royal Mail (RM) scheme and building on this, was largely welcomed even by the many respondents who want to see different kinds of CDC provision such as multi-employer schemes or Master Trusts.

4. There was a clear consensus that communicating the variable nature of the pension income in a CDC scheme will be a huge challenge for schemes – but that misunderstanding around the nature of CDC benefits will be the single biggest risk a scheme will face. We are very alive to this issue, and fully recognise the challenges it poses.

5. A small minority of respondents felt strongly that CDC is not an appropriate form of pension provision for the UK, or presented very different scheme and benefit models which they believe would provide better outcomes.

6. We have thought carefully about these concerns. We have been clear throughout this consultation process that we know CDC benefits can pose risks to all parties, especially, as already highlighted, if there is confusion around the nature of the pension benefits CDC scheme members are entitled to. We have also been clear that the CDC model is not a

catch-all solution. Our initial priority is legislating for CDC schemes set up by single or associated employers. We intend to legislate as soon as Parliamentary time allows for the CDC model set out in our consultation paper, but aim to do so in a way that can quickly accommodate other models of CDC if appropriate in the future.

7. We have always been open that a major driver for introducing CDC benefits was to facilitate the establishment of a CDC scheme as agreed between RM and the Communication Workers Union (CWU). It is important to us that both RM and their employees are in agreement and neither is imposing a CDC scheme on the other. Provision for CDC pension schemes has had a complex history in the UK, with "collective benefits" forming part of the 2015 Pension Schemes Act. However, RM's proposals were developed after months of engagement between the employer, the workforce and the CWU. It is RM and CWU who have concluded that a collective scheme would suit their needs better than an individual DC scheme going forwards, not the government. We have been extremely impressed by the level of work that has been put into the proposal, and would not be facilitating this scheme unless we felt strongly that it offered opportunities for both RM and other employers.

8. We are therefore extremely heartened by the number of consultation responses arguing that the legislation should be widened to provide for other CDC models, including multi-employer schemes, mutuals, and commercial Master Trusts. Decumulation-only vehicles were also raised by several respondents. This demand came from across the spectrum of respondents, with trade unions, financial services providers and business consultancies all suggesting that such forms of CDC scheme could offer opportunities for improved pension outcomes for employers and employees.

9. It is clear from these responses that there is a genuine, strong appetite for CDC benefit provision in the UK. We will not be opening up our legislation to these other models immediately. As many respondents recognised, this is a very complex area of legislation and we need to be sure that we have got the detail right for the RM scheme before we extend provision to other, arguably riskier, models. However, we will begin working with interested parties to shape out legislation for wider models once the RM scheme has been established.

10. We should also be clear that we are not forcing anyone to adopt a CDC scheme. We know that many employers and members are happy with their current defined benefit (DB) or defined contribution (DC) arrangements. We are simply looking to provide a further option where there is demand for it. Members will also obviously have the right to opt-out of a CDC scheme if they wish, as they do for any occupational pension scheme – although we would strongly discourage this as it would not generally be in an individual's best interests.

11. CWU and RM both responded to the consultation. As might be expected, both were supportive of the approach we are taking, and agreed that the legislative framework, authorisation regime and disclosure requirements we proposed are appropriate and effective. RM have publicly welcomed the consultation as 'a major step forward'[1].

12. However, CWU emphasised the importance of member involvement in the running of a CDC scheme. They argued that strong member representation on the trustee board is of particular importance in CDC schemes, suggesting that 50% of a CDC scheme's trustees should be scheme members as this would ensure those affected by benefit reductions would have a strong role in decision-making. This issue is discussed at **questions 6 – 8** in chapter 3 below.

13. CWU also argued that CDC benefits provision should be opened up beyond large single employer schemes such as that proposed for their own members. CWU argued that we should work towards a legal framework that allows for different CDC models such as Master Trusts and multi-employer schemes. This would open up CDC benefits provision to more employers and therefore more employees.

14. Our current priority is, and must be, providing in legislation for the RM scheme. However, we welcome innovation in this area, and plan to engage with interested parties to explore different models of CDC benefits provision. This is discussed in response to **question 4** in chapter 3 below.

15. RM expressed particular concern that CDC benefits must be classified in law as money purchase benefits, with no possibility that the employer should later be found liable for the cost of any decline in the value of the fund. They argued that the risk of incurring a financial

[1] https://www.royalmailgroup.com/en/responsibility/our-focus-areas/our-campaign-for-cdc-pensions/

liability to the scheme will be a fundamental issue for any employer considering the provision of CDC benefits. We understand their concern and agree that this issue will be fundamental to the legislation around CDC schemes. This is discussed in more detail at **question 2** in chapter 3 below.

1.1 Collective Defined Contribution Pension Schemes

16. In a CDC scheme, financial contributions are invested in a collective fund. At retirement, individual members receive a regular pension income from the fund. This income will be based on the value of their contributions to the fund but is not guaranteed and will be subject to fluctuations in value depending on the fund's performance. Broadly, a particular member's pension would be calculated as follows –

    - estimating how much money is needed to meet the benefits already credited to each member;

    - adding up the values for each member to determine the total assets available to meet the credited benefits to all members;

    - If the assets available do not equal the benefits already credited in respect of all members, make corresponding adjustments to (i) the current payment of benefits to each pensioner member and (ii) the benefits credited to active and deferred member, so that the total value of benefits already credited is equal to the total value of the scheme's assets

17. As we said in the consultation document, the collective nature of a CDC scheme, and the way it adjusts the level of pensions and prospective pensions, should mean that the overall membership will enjoy an element of cushioning from volatility. This is because investment risk is adjusted for over time and longevity risk is pooled across the membership. As the fund is administered and managed on a collective basis, there is also no need for members to make choices about the investment of funds or the ways of converting that fund into an income stream in retirement.

18. Advocates suggest that such schemes can be attractive to members as they -

- Provide a savings and income in retirement option within one package that is potentially attractive to those people uncomfortable making complex financial decisions at the point of retirement

- Enable the sharing of longevity risk between members, thus providing each individual member with an element of longevity protection without the cost of accessing the insurance market

- May achieve greater scale than some non-pooled schemes and be able to invest at lower cost as a result. The recent emergence of Master Trusts in the individual Defined Contribution (DC) space has already shown some of the benefits of scale

- May allow the trustees to adopt an investment allocation which is tilted towards a higher proportion of higher return assets over the member's lifetime than may be usual in an individual Defined Contribution scheme, although the emergence of the draw-down market may see trends in the individual DC space follow a similar path over time

19. However, there are risks as well as potential benefits from such provision. The consultation paper highlighted the following key issues:

- Uncertainty around benefit levels, ensuring appropriate communication to members - a key principle of CDC schemes is that the benefit level offered can only ever be an estimate based on current facts. It is not guaranteed by the employer. Members will need to recognise from the outset that the benefit levels illustrated may not be achieved and that the level at which pensions are paid or prospectively payable may go down, while the rate at which benefits are uprated each year will be subject to a degree of uncertainty.

- Risk sharing and inter-generational issues - cross-subsidisation is an inherent feature of CDC schemes, with the type of cross-subsidy dependent on the scheme design. As in a DB scheme, the actuarial value of the benefits being built up can vary according to the age of the member. For example, where flat-rate contribution and accrual rates apply, accumulating credits within the scheme for younger members is likely to be less expensive because it is assumed that there is a longer time-period in which to achieve sufficient investment returns on the contributions paid before such members begin to receive a pension income. Older members, however, may be more costly for the fund because there is a shorter time-frame to achieve real investment returns.[2] However younger members may get less value from flat-rate contributions under such an approach if they decide to transform their credits within the scheme into a transfer value.

20. We made it clear in the consultation document that those designing CDC schemes will need to take account of these issues and ensure attention is given to the way in which the potential for differential impacts on different generations or groups of members is communicated to the membership.

21. In particular, the consultation document highlighted the debate around capital buffers. Some CDC scheme designs feature a mandatory 'capital buffer' or 'margin for prudence' which impacts on the assessment and application of member increases. In other words, benefits may be lower than the best estimate of what the assets will fund so as to allow a financial buffer of a set level to be built up within the scheme. This buffer reduces the chance of the scheme having to cut pensioner incomes in the future, but can impede the payment of increases once economic conditions improve if the capital buffer needs to be returned to a required level. While some members might appreciate this added level of predictability, these buffers have been viewed by some as unwieldy and problematic, particularly if they introduce risks or burdens on younger members (for example, through higher contributions or lower pensions).

[2] To put this another way, £100 invested for ten years should achieve a higher investment return than £100 invested for two years.

22. The Equality Act 2010 protects the following characteristics –

- age
- disability
- gender and gender reassignment
- ethnicity
- marriage or civil partnership
- pregnancy and maternity
- religion or belief
- sexual orientation.

We asked:

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?**

23. The majority of respondents agreed with us that age and inter-generational impacts are the most significant equality impacts for CDC pension schemes. A strong critic of CDC benefits puts it succinctly: 'it is nigh impossible to treat a 20-year-old member and an 85-year-old member equally'. However, other respondents pointed out that all pension schemes by their nature expose different cohorts to different risks. Indeed, a trustee representative organisation argued that 'the currency quite properly given to this concern [intergenerational unfairness] may be leading some to overlook the non-trivial inter-generational unfairness which is implicit in other sorts of arrangement but often unaddressed there'.

24. An actuarial organisation which is a strong supporter of CDC schemes sums up the issue as follows: '[b]ecause the cost of providing a pension varies with a member's age, and varies over time with market conditions, this approach to CDC does not necessarily have a direct connection between the contribution paid in respect of a member and the amount of pension credited.' However, if the scheme is 'operating on the principle of even accrual of pension for all', as in the RM scheme, 'the criterion of fairness is not the same cost for everyone, but the same pension for everyone. Provided that the pension awarded is

reasonable value for the member's contribution, the uneven allocation of employer's contribution between members supports the objective of an even benefit outcome for all.'

25. Respondents raised a number of other possible impacts on protected persons. These include the effects of career breaks (for example, maternity leave, carer's leave, periods of ill-health) on pension accrual, an area which tends to have a marked gender imbalance and also to disproportionately affect people with disabilities or long term-health conditions.

26. A further issue was raised by a couple of respondents in relation to religion. Because a CDC scheme will not offer members any choice around investment fund, some members may find that the scheme's investment portfolio is in conflict with their religious beliefs. Some DC schemes offer specialist investment funds for this reason. As one respondent put it: 'Certain religious groups may object to their benefits being invested in particular ways that conflict with their religious beliefs (such as objections to investments in the gaming or armaments industry), and CDC Schemes do not offer members any alternative investment options. However, this lack of investment choice applies equally to DB schemes.'

Our response:

27. Ensuring that schemes manage risk appropriately will be central to the authorisation regime we will put in place for CDC schemes (see questions 17 and 18 in chapter 5 below). This regime will require all schemes to have a sustainability and continuity strategy that assesses whether the scheme continues to provide value to members and properly addresses the risk of intergenerational imbalance. Schemes will also be required to have a robust member communications strategy setting out how a scheme will deliver fairness /value for members.

28. We are confident that our provisions for CDC benefits will not create new inequalities in the occupational pensions system. In any collective scheme designed to give a fair outcome to all the members, individual circumstances will inevitably mean that some individuals have better outcomes than others – in a DB scheme, or in a DC scheme where the members purchase annuities, for example, longer-lived members will 'gain' compared to those who have a similar contribution record but a shorter lifer expectancy. While accepting the reality that some differences in individual outcome may be unavoidable in

a real-world setting, it is important to ensure that a scheme is designed to avoid building-in unnecessary inequalities and that trustees are aware of the risks and manage and mitigate them appropriately.

29. Although it is accepted that there is the risk of variability in income in CDC schemes, such variability can also occur in the options offered to members of DC scheme. For example, if members go into drawdown arrangement, which according to the FCA's Retirement Outcome Review is increasingly an option for many, individuals' income outcomes will depend on the investment performance of their fund[3]. This may lead to the need to reduce income if investments do not perform as well and, of course, risks the fund being exhausted completely if either drawdown is taken too aggressively or investments perform poorly and income is not reduced.

30. It is also important to remember that membership of a well-run occupational pension scheme with employer contributions will ultimately be of direct, long-term benefit to almost all potential members. Having an income in retirement is inherently a better outcome for an individual than not having such an income.

31. Similarly, periods when a member is not working and therefore not accruing a pension as a result of caring responsibilities or ill-health will inevitably result in a lower outcome than could otherwise have been achieved. This will be true of any occupational pension scheme or work-based savings plan. Ensuring that people can access a good quality occupational pension scheme for the periods they are earning is one way of ensuring that they will have a more positive retirement outcome than might otherwise be possible.

32. The issue of religious discrimination is very similar to that faced by DB schemes. Employers may have an individual DC scheme offering a suitable investment option which an individual could choose to use; alternatively, an individual can chose to opt out of the pension scheme.

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[3] https://www.fca.org.uk/publications/market-studies/retirement-outcomes-review The FCA review looked at how the retirement income market has evolved since the pension freedoms were introduced in April 2015.

Chapter 2: Legislative Approach

33. The consultation document discussed the Pensions Schemes Act 2015 (the 2015 Act) which was drafted to provide for a range of new risk sharing options for employers and other pension providers, including 'Collective Benefits' such as CDC benefits, as part of the wider Defined Ambition (DA) framework.

34. As we said in the consultation document, the government decided to put the commencement of the DA framework on hold in 2015 following feedback from employers, pension schemes and the industry. Our thinking in this area has moved on considerably since 2015 and we have concluded that the 2015 Act does not contain suitable definitions or set out an appropriate framework for our proposed approach to CDC schemes. Fresh primary and secondary legislation is needed to deliver an appropriate legislative and regulatory framework for CDC schemes.

35. A couple of responses to the consultation questioned why we are not using existing powers in the Pensions Act 2011 (the 2011 Act) to provide for CDC benefits as a subset of money-purchase benefits. We have explored the powers set out in the 2011 Act, and have concluded that they are not wide enough to allow us to make the full range of provision necessary to ensure that CDC schemes will be subject to the necessary degree of regulatory oversight.

2.1 Brief Outline of Proposed Legislation

36. As we said in the consultation paper, we intend that CDC benefits will be a type of money purchase benefit so that employers have clarity about their liabilities to the scheme.

37. 'CDC schemes' will be defined in legislation so that we can attach an appropriate regulatory and assurance regime to them. Where appropriate, detailed provisions related to valuation, adjustment of benefits, transfers, wind up, disclosure and other technical requirements will be provided through secondary legislation. This will allow greater flexibility to adapt the legislation as needed as these schemes become more established in the UK or if issues emerge once the initial tranche of schemes are in operation. To the

extent that it is feasible and appropriate, these provisions will be based on what was set out in Part 2 of the Pension Schemes Act 2015, with appropriate modification as discussed in the chapters that follow.

38. We made it clear in the consultation document that CDC benefits should be categorised in legislation as a type of money purchase benefit, to provide clarity for members and establishing employers of CDC schemes. In the type of CDC schemes we intend to facilitate initially, pension income will be determined by reference to the overall value and assumed future performance of the collective fund and its membership. While the scheme will provide projections as to the level of benefits which it expects to pay out of the fund there is no obligation on the employer to make additional contributions should the funding level fall short of that needed to pay this level of benefits. This more closely resembles money purchase type provision

We asked:

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

39. The vast majority of respondents felt that it is necessary for CDC benefits to be classified as money purchase. It was widely agreed that a significant concern for employers will be the risk of CDC benefits being redefined as containing guarantees concerning ongoing benefit levels. This would mean that any reduction in the scheme's funding level resulting in the value of the assets being less than the value of the benefits accrued by the scheme members would become a scheme deficit, with the responsibility for making good the shortfall falling on the employer. Classifying CDC benefits as a form of money purchase benefits would help to minimise the risks of such a reclassification, as their legal status would be clearly defined. It would also automatically exempt employers from any of the scheme funding and employer debt provisions for schemes offering non-money purchase benefits set out in the 2004 and 1995 Pensions Acts. A pensions lawyers representative body, for example, emphasised that 'the definition of CDC must be in terms that employers have confidence that they will not be exposed to the risk of a future Court interpreting the definition' as non-money purchase. Another respondent stated they 'absolutely agree that […] employers would only consider CDC benefits if it is designed "without the risks and balance sheet impact of sponsoring a defined benefit (DB) plan" and if there is no

requirement for the employer to fund any shortfall'. A trade union agreed strongly that '[e]mployers will require certainty about the nature of the schemes they are establishing and making contributions towards. In particular, they will want to understand their future liabilities. Defining CDC benefits in legislation as a type of money purchase benefit appears to us to be a satisfactory way of achieving this.'

40. A small number of respondents felt that certification by the Pensions Regulator that a CDC scheme is a money purchase scheme would also be helpful to reassure employers.

41. Some respondents, however, felt that CDC benefits did not sit entirely comfortably within the money purchase framework, and that this would be difficult. Two pensions advisory organisations both felt that a new, third form a classification would be more suitable for CDC benefits. Both, however, could see the rationale for our position.

42. Attention was drawn to a court case in 2004-05 ('the KPMG case') which 'found that 'target' benefits are DB'. Aon Trust Corporation v. KPMG24[1] was a decision of the Court of Appeal in which a scheme that had been operated as if it were a money purchase scheme was reclassified as a non-money purchase scheme. As several commentators pointed out, 'reclassification by the Courts of a CDC Scheme as a defined benefit scheme would upset the fundamental basis on which the employer had established the CDC Scheme.' It was further argued that 'this "judicial reclassification risk" is removed by the use of a certificate issued by the Pensions Regulator which is conclusive that the scheme is a CDC Scheme.'

Our response:

43. The Pension Act 2015 set out a comprehensive redefinition of the UK pensions landscape, providing for three categories of pension schemes: 'defined contribution', 'defined benefit' and 'defined ambition', with CDC benefits categorised as 'defined ambition'. This categorisation explicitly precluded CDC benefits from being treated as money purchase benefits. We have reconsidered the idea of creating a third category of pension benefits to provide for CDC benefits. However, we feel strongly that classifying CDC benefits as money purchase is necessary if we are to give employers the assurance

[1] Decision of the Court of Appeal on 28th July, 2005 [2005] EWCA Civ 1004.

they need that CDC schemes will not give rise to future employer liabilities to the scheme. Classifying CDC benefits as money purchase benefits is a key provision to ensure employers have confidence in our proposals.

44. We know that RM, for example, will only be able to go ahead with establishing their CDC scheme if they know it is classified as money purchase benefits and exempt from the scheme funding and employer debt provisions set out in the 2004 and 1995 Pensions Acts. We also know that 'reclassification in law' is seen as a significant future risk by several respondents (see question 13 in chapter 4 below). We are therefore absolutely clear that we can only proceed with legislation on the basis that CDC benefits are classified as a type of money purchase benefits.

45. Pensions legislation contains the following definitions of 'money purchase benefits':

- The Pension Schemes Act 1993:

Section 181 *"money purchase benefits", in relation to a member of a personal or occupational pension scheme or the [widow, widower or surviving civil partner] of a member of such a scheme, means benefits the rate or amount of which is calculated by reference to a payment or payments made by the member or by any other person in respect of the member and [which fall within section 181B]*

181B (1) The section applies for the purposes of the definition of "money purchase benefits" in section 181(1).

(2) A benefit other than a pension in payment falls within this section if its rate or amount is calculated solely by reference to assets which (because of the nature of the calculation) must necessarily suffice for the purposes of its provision to or in respect of the member.

(3) A benefit which is a pension in payment falls within this section if–

its provision to or in respect of the member is secured by an annuity contract or insurance policy made or taken out with an insurer, and

at all times before coming into payment the pension was a benefit falling within this section by virtue of subsection(2).

(4) For the purposes of subsection (2) it is immaterial if the calculation of the rate or amount of the benefit includes deductions for administrative expenses or commission.

(5) In this section references to a pension do not include income withdrawal or dependants' income withdrawal (within the meaning of paragraphs 7 and 21 of Schedule 28 to the Finance Act 2004).

- The Pensions Act 2008:

Section 99 *"money purchase benefits", in relation to a member of a pension scheme, means benefits the rate or amount of which is calculated by reference to a payment or payments made by the member or by any other person in respect of the member and which fall within section 99A*

Section 99A *(1) This section applies for the purposes of the definition of "money purchase benefits" in section 99.*

(2) A benefit other than a pension in payment falls within this section if its rate or amount is calculated solely by reference to assets which (because of the nature of the calculation) must necessarily suffice for the purposes of its provision to or in respect of the member.

46. The focus of the definition in the Pension Schemes 2008 Act is on the individual member in the context of automatic enrolment. The definition in the Pension Act 1993 Act was formulated for wider legislative purposes.

47. We intend to make amendments to these definitions to include CDC benefits.

48. We are not convinced that the risk of legal reclassification by the courts can be completely removed as any test of CDC benefits will ultimately depend on the definition and how it is applied. We will therefore continue to engage with RM and legal experts to ensure that the definition of CDC benefits that is presented to Parliament is appropriate and captures their proposed scheme.

49. We will also seek to legislate so that the definition of CDC is tightly drawn to enable employers and members to have clarity around liabilities and responsibilities. We will provide for regulations to assist in ensuring and maintaining that clarity should that prove necessary.

We asked:

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

50. The consultation paper itself set out a list of areas which we have identified as needing changes to allow CDC schemes to fit within them. The vast majority of respondents agreed with our analysis.

51. Respondents provided a helpful and detailed list of possible areas we might need to consider. These included specific CDC scheme disclosure of information requirements for:

- Statutory Money Purchase Illustrations - the existing requirements on projections and their calculation is not relevant to CDC members;
- preservation of benefits – some details may not be appropriate in a CDC scheme where the expectation is that the member will draw a pension within the scheme;
- the schemes chair's statement - cost and charges illustrations and value for money explanations would need to be considered further;
- the Statement of Investment Principles – only a default SIP is relevant;
- retirement options on signposting and the open market option – these would not be relevant in a CDC scheme where the expectation is that the member will draw a pension within the scheme;
- pensions advice allowance - unlikely to be relevant to a CDC scheme
- bulk transfers without consent;
- early exit charges - unlikely to be relevant to a CDC scheme
- DC investment constraints - unlikely to be relevant to a CDC scheme

52. The way in which CDC might best fit into the tax framework for DC benefits was also raised by several respondents. Concern was expressed that members of CDC schemes might not receive equitable treatment compared to members of individual DC schemes – for example, that the annual and/or lifetime tax allowance thresholds might be more problematic for them. As one respondent put it: 'new legislation will be required to make it clear how the annual allowance and lifetime allowance regime applies, and to ensure that pensions paid from a CDC scheme can fluctuate without triggering additional tax charges'. Equally, some respondents were alert to the possibility of CDC schemes gaining any 'undue tax or legislative favour as compared to existing schemes.'

53. How CDC benefits might fit with pensions freedom and choice was raised by a number of respondents. It was argued that the ability to access DC savings flexibly is now an 'accepted part' of the UK pension system, and that it would be unacceptable not to allow CDC scheme members to benefit from these flexibilities. A couple of respondents had concerns that 'it is still uncertain how CDCs will work coherently alongside pension freedoms.'

Our response:

54. We are looking closely at the legislative details which we will have to amend to ensure that CDC schemes can operate effectively. The suggestions raised by respondents have been extremely helpful in this regard.

55. In terms of disclosure of information requirements for CDC schemes, we agree that, although CDC schemes will be money purchase schemes, they should be subject to more tailored communication requirements that better reflect their unique benefit structure and scheme design (see also **questions 11, 19 and 20** in chapters 4 and 5 below). We will work with interested stakeholders to inform future draft legislation in these areas and also with the Pensions Regulator to ensure their supporting guidance (in the short-term) and Codes of Practice (in the longer term) fully supports trustees in CDC schemes in delivering effective communications.

56. HMRC aids looking carefully at all responses which discuss the tax treatment of CDC schemes. HMRC are aware of the potential tax issues around CDC benefits and are working with their lawyers to ensure that CDC benefits can fit within the tax framework.

57. We agree that members of CDC schemes should be able to access pensions freedom and choice – members of private sector DB and DC schemes can benefit from these flexibilities, and there is no reason why members of CDC schemes should not be able to do likewise. Members of CDC schemes will have a statutory right to transfer out into a DC scheme: this is discussed in more detail in response to **questions 24 and 25** in chapter 5 below.

3.1 CDC schemes

58. We said in the consultation document that CDC schemes will be required to be occupational trust-based pension schemes with their main place of administration in the UK. They will also need to be registered with HMRC for tax purposes, and be authorised by the Pensions Regulator before they can receive contributions.

59. We will require CDC schemes to undertake annual actuarial valuations in order to determine whether benefit adjustments are required, and specify principles that will apply to those valuations.

60. We argued that it would not be appropriate for CDC schemes to be accrual-only vehicles, as feedback suggests that it is the combination of smoothed investment and pooled longevity risk which is likely to generate interest in CDC schemes.

61. We also argued that CDC schemes will need sufficient scale to be able to pool longevity risk across the membership.

We asked:

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

62. The vast majority of respondents agreed with us that CDC schemes need to be trust-based occupational pension schemes. As one respondent put it, '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'.

63. Respondents could see a clear logic in 'focussing legislation initially on Royal Mail and similar large companies that might wish to be early movers'. As one group of commentators argued, providing for a limited model now 'could form the basis on which CDC schemes may be developed'. A large financial services provider similarly felt that 'it makes sense to adopt a test and learn approach through single or connected employer schemes'.

64. One respondent went as far as to suggest that '[r]oll out of CDC pensions more widely […] should not contemplated until there has been experience of their performance through a market downturn.' This would give future providers a model for managing risk in a

downturn, and would ensure that schemes were able to weather difficulties as anticipated before provision was rolled out more widely.

65. However, the vast majority of respondents also argued strongly that we are being too ‘timid’ by limiting CDC provision to single employer schemes. We were very struck by the across-the-board nature of this argument: unions, financial services providers and employer representatives all felt strongly that CDC provision should be opened up to multi-employer schemes, mutuals, Master Trusts, decumulation-only vehicles and other commercial models. One large legal firm, for example, argued that ‘we can also see a longer-term demand for CDC schemes in wider industry’ and that we also need to allow for ‘“decumulation-only” vehicles, where members with money purchase pots could transfer into a pooled fund at retirement and receive a target “wage for life” […] which we believe could provide a creditable new “end game” alternative for large numbers of current UK retirees’. Another law firmly similar argued that ‘we do not think that CDC schemes should be restricted to single or associated private sector employers. Given that commercial Master Trusts will have gone through a similar authorisation process to that proposed for CDC schemes, we consider it logical to allow them to expand and provide CDC benefits in separate sections of their current schemes. Master Trusts have the size and commercial expertise to make a success of CDC. They should be allowed to do so on an equal footing with private group schemes’. A large financial services provider expressed support for multi-employer schemes ‘should there be a market demand’, while several trade unions argued for a ‘new wave of collective pensions’ which might include both multi-employer, perhaps industry-based, schemes and provision for the self-employed’; another financial services provider noted that ‘CDC arrangements could be potentially attractive for a range of employers, but we consider / that, for most employers, the barriers and costs of selling up a single employer scheme are too great. To address this, we believe it should be possible for CDCs to be delivered via Master Trusts, or industry bodies, as soon as practically possible.’ NEST and other Master Trust providers were raised, with respondents arguing that commercial Master Trusts could and should be able to provide CDC schemes and/or decumulation-only vehicles.

66. In this context, the lessons that could be learned from the RM scheme where again mentioned as a positive. A financial services provider argued that ‘[i]t seems unlikely that a solution designed for the needs of that particular workforce [RM] would be a blueprint

that could easily be replicated widely, although some of the learnings to be gained could help inform which of the component parts might have wider application.'

Our response:

67. We are delighted to see the scale of support for a wide range of CDC models. It is particularly encouraging to see interest coming from respondents as diverse as trade unions and financial services consultants. This clearly indicates that there is appetite for CDC benefit provision beyond RM.

68. Our immediate priority must remain getting the RM scheme bedded in as a first test of CDC provision. However, we will structure our legislation to allow us to move promptly to other forms of CDC benefit provision. Once the RM scheme is in operation, we will begin working with interested parties to develop a legislative framework for some of the other models suggested, particularly decumulation-only vehicles and DC Master Trusts.

We asked:

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?**

69. There was a general consensus among respondents that scale is important for a CDC scheme. This is because of the pooled nature of risk in the scheme. As one commentator pointed out: '[i]n order to capitalise on any pooled risk benefits of a CDC scheme, and to manage some of the risks around transfers out and intergenerational risk transfers, there must be a significant degree of scale in the membership.' Similarly, an employer representative felt that 'some critical mass would be required in order to ensure a CDC scheme can function effectively. It would be helpful to consider how government could work with Royal Mail and any other early adopters to develop a better understanding any minimum size requirements.' Insufficient scale was also felt to be a possible driver of higher administrative costs: an existing pensions provider commented that '[i]rrespective of the fundamental design, there should be a minimum membership size, to avoid situations where the costs of running the plan become unviable.'

70. However, there was little appetite among respondents for a legal limitation on scheme size. Many respondents felt that a minimum viable membership would arise naturally as a result of administrative costs and scheme design. The way in which a scheme is designed to manage risk for benefit reduction, for example, should act as a natural barrier to a small membership, as actuarial models will not work below a certain level. As one respondent with a background in pension scheme management commented, minimum size 'should be depends on the scheme profile (in particular the age distribution of the membership - there needs to be a good number of younger members), size of contributions, charges in running the scheme etc.'

71. This therefore led some respondents to suggest that minimum size was a question for a scheme's actuary, and might be better addressed as a part of an individual scheme's authorisation process. For example, one respondent with knowledge of insurance provision argued that 'the authorisation process should require an independent statement of actuarial size, obtained from an independent professional to determine whether the scheme is of sufficient scale'. Another respondent with actuarial experience suggested that '[f]or 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.'

72. Accepting that scale will be important in determining a scheme's long term success, several respondents argued that our requirement for a CDC scheme to have a single employer based structure will severely limit the scope for CDC provision in the UK, because very few employers will have the scale necessary to achieve a successful CDC scheme. As one respondent argued, '[t]he current proposals as they stand are only intended to apply to single or associated employers and this may limit the number of employers that are able to sustain a large enough CDC scheme. The government should consider extending the legislation to cover non-associated employers, for example, by allowing industry-wide schemes.'

73. The need for demographic 'scale' was also raised. As a pensions administration organisation, argued: 'big is beautiful when it comes to CDC arrangements (Royal Mail has over 140,000 employees), but it is not just about the number of members but also their demographic profile. Risk sharing will only function effectively if there is a generational mix of members.' A legal organisation similarly commented that '[t]he age spread of the membership will also be a relevant factor as a mature scheme could lead to younger members being invested in safer assets over a long period.'

Our Response:

74. Our key priority is to ensure that schemes are sustainable and capable of managing risk adequately, not prescribing whether they are a particular size. It seems clear from responses that specifying a minimum viable scheme size in legislation would be ineffective as a way of helping to ensure scheme sustainability.

75. The argument that a minimum size will arise as a result of scheme design and actuarial assessment seems to us convincing. As recongised by several respondents, limiting CDC benefit provision to schemes set up by a single employer will therefore inevitably act as a check on minimum scheme size, Equally, however, we do not anticipate that small employers will want to take on the cost of setting up a CDC scheme.

76. Our priority at the immediate moment is to legislate for RM's single employer scheme. However, we welcome innovation, and will work with interested parties to explore a legislative framework for other models such as Master Trusts and decumulation-only vehicles once the RM scheme is in operation.

3.2 Trustee Duties and Requirements

77. In the consultation document, we argued that the current trustee knowledge and understanding (TKU) requirements for trustees of occupational pension schemes, alongside general trust law, should be sufficient to ensure that trustees are sufficiently skilled to run a CDC scheme. Given the potential significance of the trustee role in relation to CDC schemes, we also said that we are minded that the Pensions Regulator will need to consider the collective expertise and experience of the trustees in a CDC scheme.

78. However, we also said that we recongised that there could be a case for expecting higher levels of governance in CDC schemes, and would be considering this further in the light of responses to this consultation.

We asked:

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

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

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

79. Discussion around trustee knowledge was extremely wide-ranging. A clear split emerged in the responses between those felt that the existing TKU requirements are suitable for CDC trustees; those who argued strongly for more rigorous TKU for CDC schemes; and those who cautioned that overly rigorous TKU could exclude member-nominated trustees, whom it was argued would play a particularly important part in the governance of a CDC scheme.

80. For example, one respondent, themselves a DB scheme trustee, commented that '[t]he demands on trustees of a CDC scheme would be more onerous than either those of a DB or DC scheme […] Notwithstanding the requirement for professional advice, the responsibility for interrogating and reviewing the quality of that advice is much greater for CDC trustees and qualifications / experience requirements should be adjusted to suit.' A financial services provider similarly argued that CDC schemes 'demand a very particular skill set with a strong bias toward actuarial science, investment expertise and volatility management.'

81. By contrast, several trade unions and trustee representatives argued strongly that '[t]he inclusion of member nominated trustees is essential and care should be taken so as to avoid their exclusion as a result of TKU requirements.' A member representative organisation pointed out that, because '[t]here could be occasions when difficult decisions

have to be taken and balancing differing member interests is necessary, […] sufficient member representation important for the smooth operation of the schemes and maintaining trust in the system.' Several trade unions therefore suggested we require CDC schemes to have a minimum of 50% member nominated trustees on their trustee board.

82. An adaptation of the existing TKU requirements was generally agreed to be a sensible approach, with the Pensions Regulator's handbook and training generally felt to be helpful to trustees. It was suggested that the Pensions Regulator should review its TKU requirements for trustees of CDC schemes as such schemes develop.

83. Member communications was an area of trustee knowledge which many respondents raised as particularly important. As discussed at **question 11** in chapter 4 below, ensuring that members understand that their pension income is not guaranteed and can be reduced will be the most important challenge that CDC schemes will need to overcome. Many respondents were very clear that trustees will need to ensure member communications can meet this challenge. Additional TKU based around communication skills were therefore proposed by several respondents.

Our response:

84. We agree that current provisions and general trust law are sufficient for the single employer CDC model we are proposing. Current TKU requirements are expressed in terms of a trustee's knowledge being sufficient for the particular scheme of which they are a trustee, and should therefore be flexible enough to incorporate CDC requirements.

85. We believe that it would be inappropriate to prescribe professional trustees as a requirement for a CDC. A good trustee board should be looked at in terms of collective expertise, systems and processes, which should be suitable for the scheme's purposes, and not pose an unreasonable risk of member detriment.

86. Alongside TKU, there will be other requirements seeking professional input on certain matters – for example, the appointment and participation of the scheme actuary.

87. We do not believe that the current requirement around member nominated trustees should be changed for CDC schemes. It is important that scheme members can have

confidence in those on the trustee board. However, this is a different question to members' and trade unions' involvement in the development of the scheme itself, which would seem more a matter of best practice on the part of any large employer moving towards establishing a CDC scheme.

3.3 Tax Treatment of CDC Schemes

88. The government is clear that individuals and employers paying into CDC schemes will have opportunities to register and benefit from tax relief in a similar way to those with DB or DC benefits. CDC scheme pension payments will be subject to income tax in the normal way. If a CDC scheme makes payments that are not authorised for tax purposes, tax charges for the individual and the scheme will apply as they do in connection with similar payments made out of other registered pension schemes. Changes to tax legislation may be needed to ensure that CDC schemes receive equivalent tax treatment: HMRC are currently determining how CDC schemes can best be slotted into the tax framework.
89. HMRC intends to publish a consultation in due course on the technical details of any necessary tax changes.

3.4 Automatic Enrolment Requirements

90. Automatic enrolment (AE) aims to help more people save for later life by making it compulsory for employers to automatically enrol their eligible workers into a qualifying pension scheme. It is apparent that employers wishing to set up CDC schemes will want to use them to meet their obligations in respect of AE and, as with any AE scheme, it is important CDC schemes meet the legal quality requirements, so that employers are able to use them to comply with their AE duties.
91. As our consultation explained, there are already quality tests set out in AE legislation, which allow employers to determine whether an existing occupational pension scheme operated by their business can be used for AE.
92. In broad terms the most common test for a UK-based individual DC scheme is linked to minimum contribution levels for each individual based on a percentage of that individual's prescribed earnings, whilst, for UK-based DB schemes, the test is usually framed in terms

of meeting a benchmark for a jobholder’s entitlement to benefits, or for the cost of providing those benefits.

93. We asked for views on the type of AE quality test that might best suit CDC schemes, including the scheme design proposed by RM in which flat rate contributions are paid into a collective fund, but the value of the benefits being accrued by each individual member will typically vary by their age. We suggested that in such a scheme, a quality test which considered the scheme-wide cost of accrual, for example, might be a more suitable option.

We asked:

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?**

94. Respondents agreed that CDC schemes should meet minimum standards and quality requirements if they are to be used by employers in discharging their automatic enrolment obligations under 2008 Act.

95. Most respondents acknowledged that a quality test which considered the scheme-wide cost of accrual might be a suitable test for a Royal Mail type scheme, rather than one based on minimum levels of contributions in respect of individuals. It was acknowledged however that our legislation should have sufficient flexibility to impose alternative tests for other scheme designs – such as one based on minimum levels of contributions - should these be needed at some point.

Our response:

96. We agree that a cost of accrual type test is worth exploring further and we are currently discussing what level of accrual rate might be appropriate for CDC schemes with colleagues from the Government Actuary’s Department (GAD).

97. We also recognise that future CDC designs and models may warrant a different type of quality test – perhaps linked to minimum contributions – so we intend that legislation will be flexible enough to encompass alternative tests should these be needed in the future.

98. Other minimum standards will also apply to CDC schemes, as they do for current DC schemes used for AE:

- there should be no barrier to the employer automatically enrolling a jobholder – for example, there should not be an inappropriate age barrier in scheme rules preventing this;
- jobholders should not be required to provide information or make choices in order to remain an active member of the scheme;
- the scheme should meet obligations in respect of the intended cap on member-borne charges in CDC schemes (see **questions 22 and 23** in chapter 5 below).

99. We will bring forward draft regulations for consultation in due course.

Chapter 4: Target Benefits and Scheme Valuations

100. We said that we will require CDC schemes to undertake annual actuarial valuations once they have been authorised in order to determine whether benefit adjustments are required and to test the overall sustainability of the scheme. Given the complexity of CDC schemes compared to individual DC schemes, we also argued that it would be appropriate for the trustees to be required to appoint a scheme actuary.

4.1 Managing Fluctuations in Scheme Funding and Communicating Variations in Benefits

101. Some existing CDC schemes outside of the UK are designed to deliver greater predictability around payment of a 'base rate' level of benefits, through the inclusion of mandatory financial buffers. The consultation document discussed the advantages and disadvantages of buffers, and came down in favour of a' no buffers' approach. A scheme would pay out benefit levels based on the current total value of the fund (i.e. without reserving some of it to use as a buffer). Members' benefits would be adjusted each year in light of the most recent valuation. This model gives the membership less predictability than a buffer model. However, under this approach the scheme would be more transparent and would protect it from claims that it is stockpiling a sizeable surplus at the expense of increases for current members.

102. We were very clear that members will need clear and effective communication to understand the extent to which their benefit levels will be subject to fluctuations and may decrease.

We asked:

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

103. The decision not to require a capital buffer opened up a great deal of debate. Although the majority supported our approach, a considerable number of respondents felt very

strongly that CDC schemes need to operate with capital buffers, and that our approach is too open to risk.

104. The key argument made in support of capital buffers was that the use of a buffer can mitigate against volatility in benefit levels. A buffered scheme will use its reserves to smooth over small variations in fund value, so that members do not see small changes in their pension income from year to year. One commentator suggested that, '[i]f there are no built in capital buffers in the scheme design (and best estimate assumptions are used), it follows that there will be increased variability of outturns relative to the target retirement income level communicated to scheme members. From a psychological perspective (loss aversion), the reduction in the "nominal" level of the target retirement income communicated to members will, particularly if at any material level, lead to a perception that someone is at fault in relation to the disappointment of that expectation. That disappointment creates political risk, reputational risk for the employer and, where applicable, the recognised trade union or other promoter of the scheme as well as the potential for legal risk.' A respondent with experience of DB scheme governance felt that '[v]olatility in benefits, particularly for retired members, is undesirable and in the absence of capital buffers might lead to a sub-optimal investment strategy, excessively focused on avoiding volatility despite the underlying advantage from long-term risk pooling.'

105. Other respondents, however, felt equally strongly that a no-buffers approach is the right one. These respondents fully accepted that not having buffers will lead to greater year-on-year volatility in the scheme. However, they argue that increased volatility is off-set by greater parity of outcome for different member cohorts.

106. As one legal services provider argued, '[i]n-built capital buffers allow for greater predictability […] However, we acknowledge the argument that having a buffer is expensive and could lead to claims from members that schemes are "stockpiling" surplus instead of increasing current member's benefits. While there is an obvious advantage to having a buffer (i.e. protecting members' benefits from drastic decreases), there are clearly disadvantages that need to be taken into account (expense etc.)'

107. A response from an actuarial services provider put it more forcefully: 'The issue here is holding money back in a capital buffer may give rise to inter-generational unfairness. A CDC scheme is a mutual arrangement, buffers can only be built up from money withheld from members. CDC is DC, therefore spend the contributions on members, do not hold

back some of the contributions in capital buffers. A smoothing mechanism involving buffers may also give rise to a risk of overspend, in expectation of a later market recovery rebuilding the buffer, as has been observed in the past in with profits funds.'

108. A pensions commentator further argued that '[c]ollective savings vehicles typically include some form of risk buffer, or shock absorber, to ride out investment performance volatility (or any other adverse change, such as an improvement in longevity that exceeds modelled expectations). It takes the form of excess assets (relative to the liabilities), akin to a bank's capital base, which are depleted in "down" markets and, in theory, replenished in "up" markets. But emerging evidence, particularly from Dutch CDC schemes, indicates that in practice the onus for replenishment falls on younger (and future) scheme members through, for example, higher contributions or lower pensions.'

109. Several commentators pointed to the way in which different definitions of 'fairness' around member outcomes in a CDC scheme would drive different attitudes to buffers. For example, if CDC schemes are intended to provide a benefit replicating fixed DB outcomes as closely as possible, a buffered approach will allow the scheme to deliver more stable outcomes to current pensioners, but may build up affordability concerns for later generations; if CDC schemes are seen as a form of collective money purchase / DC scheme, greater volatility in benefit outcomes spread across all members is arguably more appropriate. Discussion around different approaches to 'fairness' and member outcomes are discussed in more detail at **question 15** in chapter 4 below.

110. The challenges of ensuring members understand the way the scheme operates were also discussed. Ensuring that members understand the level of benefit volatility inherent within a no-buffers scheme was raised as a particular challenge which must be met if the scheme is to successful. Equally, however, some commentators argued that a no-buffers approach is in fact easier for members to understand than a buffered scheme, because it could be difficult to explain to members that a portion of their contributions may be held back as a buffer against future benefit reductions. A pensions commentator, for example, argued that a no-buffers model would result in a 'higher degree of scheme transparency.' Another respondent argued that 'target pensions will be more volatile [in a no buffers approach], but this is a good thing as it reflects the underlying CDC economics.' A response from the investment and life assurance industry suggested that 'the presence of a buffer could be misconstrued by members as a form of guarantee.'

111. An actuarial organisation highlighted the way in which a ‘no buffers’ approach can be designed to manage volatility in benefit levels: ‘[u]nder 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.’

112. One respondent, a trade union, argued that different approaches to buffers may be appropriate for different schemes and employers. They noted that ‘whilst we have not deemed them appropriate for the Royal Mail CDC scheme, they may be suitable in other workplaces […] We believe there should be flexibility in the legislation to allow for capital buffers in CDC schemes if employers and their workforces wish to use them.’

Our response:

113. We do not want to preclude or legislate against buffers in CDC schemes - there are perfectly good reasons why employers and workforces may wish to provide for a scheme that mitigates volatility in this way, and we agree that a buffered scheme could be appropriate in some circumstances. Indeed, the Pension Schemes Act 2015 provided for buffered CDC schemes in order to protect members against volatility of benefit outcome. We would expect that a scheme’s approach to managing a buffer would be a key part of its scheme design and authorisation, as would be the case for risk-management in any other CDC scheme design.

114. However, our work on CDC schemes, focussing on the RM model, has demonstrated that a ‘no-buffers’ approach also has strong arguments in its favour. Their approach seeks to address some of the inter-generational fairness issues buffers can create, whilst smoothing volatility and seeking to deliver the best possible pensions overall by minimising the inevitable costs of eliminate volatility.

115. RM have designed their proposed scheme for it to be funded at sufficent levels so that taverage expected increases are good inflation increases (CPI +1% per annum). This means in practice that the ability to adjust inflation increases for all classes of member up or down will absorb and effectively buffer all but the most extreme volatility without needed

a specific buffer to address volatility. Modelling suggests volatility in the RM model is lower than individual member volatility in individual DC benefits, but we are aware that 'no-buffers' models, depending on design, may at times result in a greater amount of benefit volatility than a buffered approach.

116. This is an intentional feature of the model, which prioritises intergenerational parity and efficiency over stability of benefit outcome. We have been very clear that communicating the volatile nature of their benefits will be a key challenge for the scheme which they must manage successfully if the scheme is to succeed.

117. RM's published scheme outline also discusses a 'parity programme' to stagger severe reductions to benefits of 5% or more as a way of reducing volatility in the scheme[4]. In the RM's design, a cut of 5% or less would be applied as a single reduction. A reduction of over 5% would be applied via a "Parity Programme", which would run for a period of up to three years as required. Reductions would be applied to all pensions credited up to the valuation date before the application of the reduction (i.e. the valuation on which the increases or reductions are based), including pensions which are credited during the Parity Programme. Therefore, there would be planned cuts that have not yet been applied during this period. The scheme Actuary would assume that the remaining planned reductions (where still required) would be applied, meaning that the funding level would therefore remain at 100%. Once factored into the scheme's funding profile, year two and three reductions will be imposed as a new baseline for benefit levels. Any improvement in fund value leading to increases in benefit level would then be calculated from this new parity programme baseline to ensure that balance is maintained in the scheme.

118. We are aware that significant volatility in annual benefit levels may be difficult for some people to manage and can therefore see merit in RM's parity programme approach to staggering significant benefit reductions, which will allow members an opportunity to plan for this impact. Provided the funding level remains at 100% according to an actuarial valuation, we are content with RM's approach. If a scheme is actuarially sound and meets all legal and regulatory obligations, the details of scheme design will be a matter for the employer, the workforce and their advisors, not government. As with buffers, the details

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[4] https://www.royalmailgroup.com/media/10542/scheme-design-summary-booklet.pdf

of how different schemes operate will be a matter of individual employer and member circumstances.

We asked:

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?

119. As we would expect given the importance of effective communications, respondents overwhelming agreed that CDC scheme prospective members, members (active and deferred) and pensioner members will need clear and transparent information so they can understand that their benefits can fluctuate. This was seen as key to managing risk and contributing to the success of a CDC landscape.

120. The vast majority of respondents stressed that all communications (regulatory or otherwise) must be in plain English, simple language and layered as appropriate. Also emphasising the importance that members are provided with adequate prominent explanations ('risk warnings') repeated consistently at every stage of their journey. Principally mentioning details with regard to:

- projected benefits are a not guarantee;
- benefits (including pension payments) can go down as well as up;
- the scale of potential fluctuations;
- the distribution of risks between members;
- that risks are borne by members rather than the employer; and
- ultimately, that members have limited control over the attribution of losses and surpluses.

121. It was also suggested by some that to help build and maintain confidence in the CDC scheme it would be beneficial to:

- include an explanation of the added value of a CDC scheme, opposed to an IDC scheme.
- provide reasonable assurances on the design and governance of the schemes, including: how the scheme will invest money; confidence that the assets will be distributed as pension benefits in a way which is fair; assurance that the scheme design means that their benefits can't entirely disappear in years to come and how a pension will be provided.
- include signposting to other areas for helpful information (for example the Single Financial Guidance Body and the Pensions Ombudsman).
- ensure trade unions are able to obtain relevant information, as they do in DB schemes, so they can productively engage with their members.

122. A number of respondents helpfully provided recommendations of the types of communications that should be provided, including a combination or variation on the following.

(1) Before, on becoming a member and on request thereafter.

- A comprehensive member booklet, that as well as existing regulatory requirements, also sets out the 'risk warnings' and assurances as set out in **paragraphs x and x** above along with additional information on the CDC specific design explaining the outline methodology for adjusting benefits and also further explaining member's rights (for instance on transfer, early, normal and late retirement, survivor's benefits on death, full commutation of trivial benefits or on ill health).
- A "one pager" to support the member booklet that predominantly displays the key 'risk warning messages' and assurances.
- A range of case studies/scenarios based on the actuarial valuation. For instance, 'people like me' that illustrates how various financial situations may impact and cause both favourable and reductions in benefits (with suggestions of 'a one-off shock to the scheme's assets', 'members living longer than expected', 'the membership reducing significantly' and also

explaining the probability of benefit cuts with for example a suggestion of a 'traffic light system'.

(2) Annual communications in the accumulation phase.

- A CDC benefit specific annual benefit statement (to active and deferred members), set out in real terms, that includes: the member's pension level for the previous year; their current pension level; what it is expected to be at retirement; an explanation of why this may have changed since the previous statement; how variable it could be in the future; and also prominently reiterating the 'risk warnings' involved. Other comments suggested including a transfer value and the level of benefit lump sum that would be available if the fund wound-up immediately.
- Recommendations that the case studies/scenarios are reviewed and updated annually by reference to the latest actuarial assumptions and that these could be given to members along with their benefit statement or alternatively signposted and placed on a publicly available website.
- A few respondents also suggested regular information about the funding position of the scheme (CDC scheme equivalent of a DB Summary Funding Statement) and the impact of this on their pension.
- A couple of respondent also suggested an annual newsletter, 'similar to the ones well run DB schemes send now' that are a 'short-form version of the scheme accounts, an update on current issues and a foreword from the chair of trustees' that 'would also provide the platform to report on the sustainability review and any dislocation in scheme finances'.

(3) Annual communication in retirement. It was also recommended that as benefits in payment could also fluctuate it was vital that pensioner members must also receive annual notifications of their expected pension each year, including the relevant 'risk warnings' and that they receive these in advance, for example, providing this a minimum of 6-12 months before any reduction/increase so that members have time to plan for the change in income.

123. Other related comments from various respondents also suggested that:

- Schemes must have unambiguous rules, set at the outset and which can be communicated clearly to members.
- Members should be able to contact the scheme if they wanted to ask more in depth questions into how trustees had reached decisions.
- Careful consideration is needed on the language and terminology used, including non-English alternatives.
- Testing membership knowledge and understanding is key, need to test communication materials on potential members at an early stage.
- Consideration should be given as to how CDC scheme information will be presented on dashboards.
- Employers and trustees should be encouraged to use a variety of media as different members respond differently to various forms of communication, including social media, presentations, modelling tools or on-line access to key information.
- Employers should engage with unionised workforces to collaborate closely with their unions to produce simple and effective communications.
- The Pensions Regulator should issue clear guidance on what and how CDC schemes should communicate.

124. Some respondents however cautioned against overly heavy regulatory requirements recommending that in particular communication design should be left for trustees so that they are able to tailor them to their own scheme member's specific needs.

Our response:

125. As stated in the consultation paper, we agree that effective communication with all CDC members throughout their pension journey is critical for them to understand their benefits, build trust in their scheme and be able engage with their pension savings. It is important that all members, no matter their type of pension receive clear, simple, accurate and consistent communications.

126. The proposals that respondents have presented above on the types of ‘risk warnings’ that must be provided, and for communications to provided at joining and annually, appear sensible and pragmatic. We will consider the details further and work with industry and the Pensions Regulator to ensure that we take a proportionate approach the necessary regulatory changes; we will also look at whether guidance in certain areas would be more practical. Also considering how this can feed into the development of the Dashboard, as appropriate for CDC scheme information.

127. We will consult further on draft regulations which will set out the specific details. Although as a minimum we would expect to amend the Occupational Pension Schemes (Disclosure of Information) Regulation 2013 so that:

- The basic scheme information must contain specific information on the CDC scheme design and relevant ‘risk warnings’;
- A CDC specific annual benefit statement must be provided including relevant risk warnings and signposting to other useful information.
- Pensioner members must receive annual information in advance of any changes to their expected payments, again with repeated risk warnings for potential future changes.

128. All of which will be aided by the proposed annual actuarial valuation process and report, which will provide a relevant source of information required on the principles and target benefit assumptions**.** (Further details specifically on governance related disclosure can be found at **question 19 and 20** in chapter 5 below).

4.2 Universal Application of Benefit Increases and Decreases

129. We made clear in the consultation paper that any increase or decrease in benefits (both payable to pensioner members and credited to non-pensioner members) resulting from scheme performance or changed assumptions should be applied across the entire membership. In other words, if a 1% adjustment up or down to benefits is applied, this should be reflected in accrued prospective pension income for active and deferred members and in the pensions in payment to pensioner members. The approach to adjusting benefits should be clear and unambiguous in the scheme rules, be

communicated clearly to members, and should be based on a mechanism set out in scheme rules, rather than trustee discretion.

4.3 Meeting Benefits - High Level of Probability versus ‘Best Estimate’

130. We will expect schemes to consider how best to manage volatility in the design of their projected benefits. Once a scheme’s design is finalised, supporting calculations and assumptions, including the underlying investment strategy, will need to be submitted by the scheme’s actuary to the Pensions Regulator as part of the authorisation process.

We asked:

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

131. There was a majority consensus that a best estimate basis was the right approach to scheme valuation. However, a number of significant caveats were raised by respondents.

132. In particular, concern was raised that ‘best estimate’ is not sufficiently well defined. One financial services consultancy commented that, ‘[i]n principle, we believe a best estimate approach to valuations is fair and transparent and consistent with the CDC concept. However, there can be a big divergence of views on what a best estimate is and it might be helpful to include some definition of what the intent of a best estimate is. It would be important to have full disclosure over actuarial assumptions and methodologies to help build confidence and understanding of the operation of CDC schemes.’ Similarly, a financial services provider argued that ‘there is considerable scope for subjectivity in setting best estimates.’ An actuarial representative body suggested that ‘best estimate’ might be a loaded term meaning ‘different things to different people, and we’d expect some of the public to interpret it as “highest estimate”’. This respondent suggested the use of ‘alternative terms […] such as “central estimate” or “neutral estimate”’.

133. As one pensions provider pointed out, ‘[a] best estimate relies on the model being accurate. The credibility of any model needs it to be trusted.’ Several respondents, commented on whether a peer review (as suggested at paragraph 96 of the consultation) might be helpful in providing confidence in the underlying actuarial assumptions where a best estimate basis is applied. One actuarial representative body suggested that as ‘the

assumptions used will directly affect the benefits that will be paid to members immediately and consequently, there may be pressure on advisers when setting the assumptions. They went on to suggest that a requirement for an independent peer review would 'help to address this point.'

134. A number of respondents suggested that a best estimate approach would be more transparent, and therefore easier for members to understand. A financial services provider argued that '"Best estimate" valuations and the absence of buffers could help members understand that benefits are variable and that what they own is, in effect, a share in a pool of assets which are allocated each year to all members in accordance with clear rules.'

135. A small number of respondents argued that a best estimate approach was too risky. One respondent compared the dangers of a best estimate approach to the failure of Equitable Life 'as an example where such an approach had disastrous consequences.'

Our response:

136. We remain committed to the best estimate framework as the most suitable way of assessing a scheme's funding. We are thinking carefully about any legal requirements to place around review of actuarial estimates. We envisage that the trustees will be required to provide evidence to satisfy the Regulator that they have taken actuarial advice with appropriate certifications and have undertaken robust modelling to support a view that underlying assumptions are within expected levels of variance to allay concerns that these are too optimistic or too prudent. The issue of actuarial peer review is discussed further in relation to **questions 17 and 18** below.

4.4 Managing Risk Going Forward

137. The consultation document was very clear that employers wishing to set up these schemes must establish them on sound foundations underpinned by realistic assumptions and planning. We intend to legislate for an appropriate regulatory framework to that end - this should include evidence that the scheme's design is robust to changes in scenario, and a strategy to manage operational risks should they arise over the lifetime of the scheme. Once a CDC scheme is up and running, we will then expect the annual actuarial valuation process to consider emerging risks and threats, and to look at whether these risks significantly impact on the probability of projected benefits being met to an extent

that calls into question the viability of the scheme. In such a scenario, we envisage that the scheme actuary would consider whether it is appropriate to recommend that the scheme be discontinued on sustainability grounds.

138. We also indicated in the consultation paper that we are aware there have been some concerns expressed within the industry that poorly designed CDC schemes could pose a greater risk to particular groups - for example, younger members who may become exposed to significant risk of reduced benefits if contributions coming into the scheme reduce below a sustainable level. We were clear that schemes will need to develop a mitigation strategy, and that scrutiny of this strategy and of scheme design more widely will be part of the initial authorisation process.

139. Annual valuations will then need to be submitted to the Pensions Regulator as part of the intended regime. If sustainability concerns arise during or between valuations, trustees will be required to notify the Pensions Regulator, who will consider whether action is needed to protect members.

We asked:

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

140. Among those who answered this question, there was near-unanimous agreement that a scheme would have to be sustainable without continuing employer contributions.

141. In particular, clear concern was expressed that younger member cohorts would be placed at a significant disadvantage if the scheme was to become unsustainable following a cessation of employer contributions. A pensions commentator therefore argued that ‘[i]t is essential that the likelihood of intergenerational transfers […] is constrained to the highest possible degree. One way of achieving this end would be to require that CDC schemes are designed not to be reliant on continuing contributions from active members or the employer.’ An actuarial representative body commented that, if a CDC scheme was not sustainable without continuing contributions, ‘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.'

142. A comparison with DC Master Trusts was made by several respondents, with one financial services provider arguing that 'schemes must be able to demonstrate that they will be sustainable without continuing employer contributions, in the same way as authorised Master Trusts must demonstrate a sustainable model.'

143. However, a couple of respondents expressed concern that the requirement for a scheme to be sustainable without ongoing contributions would severely limit the number of CDC schemes which could be set up. They argued that schemes would need to be very large from the onset in order to be sufficiently well-funded, therefore limiting the number of employers able to establish a CDC scheme. It was suggested by one respondent that extending CDC provision to multi-employer and Master Trust models would resolve this problem.

144. Several respondents suggested that a scheme would need a wind-up fund or escrow account to manage eventual wind-up costs in the event of running on without a contributing employer. Wind-up costs would otherwise have to be met by the members themselves.

Our response:

145. It is essential that CDC schemes are sustainable without continuing employer contributions. It would defeat the purpose of a CDC scheme as a long-term pooled investment if it was forced to wind-up immediately on closure to ongoing contributions. Because CDC benefits will be classified as money purchase benefits, CDC schemes will not have recourse to the Pension Protection Fund, and it is therefore vitally important that a scheme can continue in the absence of a contributing employer, in order to protect younger members of the scheme.

146. We will therefore require all CDC schemes to demonstrate that they would be sustainable without ongoing employer contributions as a part of the Pensions Regulator's authorisation and oversight process.

We asked:

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

147. Respondents were generally in agreement that the consultation paper explores risks and risk management satisfactorily. Investment risk arising from an overly cautious or otherwise unsuitable investment approach was raised, as was the possibility of member confusion around their benefit entitlement.

148. Clarity and transparency in governance and communications were highlighted as the best ways of managing potential risk. A respondent with experience as a trustee commented that '[a]ssumptions on future returns, investment strategy, asset allocation, actual returns should be made publicly available for all CDC schemes alongside annual stewardship reports from advisors and trustees.'

149. Several respondents suggested that the experience of with-profits funds could provide a useful case study in risk and risk management. The transparency requirements for with-profit funds were highlighted by a financial services provider as a possible model for CDC schemes to be required to follow: 'independent oversight of a properly constituted fund management committee, similar to an insurer's with-profits committee, along with documented policies within a document equivalent to a Principles and Practises of Financial Management (PPFM), should be mandatory for CDC schemes. We believe this independent oversight will lead to more prudent scheme management and more predictable outcomes for members.' A financial services provider suggested that the Pensions Regular should conduct a publically available sustainability review of individual CDC scheme. A respondent with legal expertise argued that 'a CDC benefit design, including the underlying actuarial assumptions, would be rigorously modelled and stress tested in a range of scenarios (including variation in the age composition of members and low investment returns and high inflation scenarios); subject to peer review prior to the application for authorisation being made to the Pensions Regulator; and subject to pre-authorisation scrutiny by the Pensions Regulator.'

150. However, there was some concern that CDC schemes will need flexibility around risk management. One trustee organisation commented that 'it would be good to avoid requiring such a procedure in black letter law, but rather to rely on the Pensions Regulator's approval procedures, guidance and monitoring, and on the scheme actuary's discharge of her/his duties, to see that the risk is managed appropriately.'

151. A number of possible unanticipated risks were raised, including future changes to pensions legislation such as a further increase in freedom and choice, and future changes to accounting standards. Concern that 'target' benefits could in future be changed in law to 'promised' benefits was also raised.

Our response:

152. Managing risk going forwards is a key priority for any pension scheme. The Pensions Regulator is experienced in monitoring and assessing scheme risk; employers and scheme trustees will need to prioritise risk management in the design and day-to-day running of a scheme. The CDC authorisation regime will ensure that all parties are focussed on risk from the scheme's inception, and that effective risk management remains a key priority. The Pensions Regulator has very clear requirements for DB schemes around risk management. Authorisation by the Pensions Regulator is discussed in **questions 17 and 18** in chapter 5 below.

153. We agree that communication and transparency will be central to managing risk in a CDC scheme. This is why **question 11** in chapter 4, above, explored how schemes can best communicate with members. We will impose transparency requirements on CDC schemes as a part of their governance and authorisation framework.

We asked:

> **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.**

154. Risk transfer is extremely contentious, and was discussed at length by many respondents.

155. Several respondents felt that the CDC model is not suitable as a pension saving model as a result of the risk transfers between generations. One critic of CDC benefits described CDC schemes as 'structurally flawed' as a result of the inter-generation risk transfer. A number of respondents proposed alternative pension structures on an individual DC model which they felt would better manage the issue of inter-generational risk transfers. Even one long-term advocate of CDC benefits in the UK noted that 'ensuring the fair distribution of risks between generations is a hurdle CDC scheme design will have to overcome'.

156. However, the majority of responses were supportive of our approach, and felt that the proposed scheme design did satisfactorily address inter-generational risk.

157. In particular, several respondents emphasised that the question of 'fair' transfer of risk is not unique to CDC pensions. A financial consultancy analysed the issues as follows: 'Any form of smoothing or pooling will involve a financial transfer from one demographic to another. It is important to consider how smoothing would work in multiple possible futures and be able to demonstrate that the expected change is not skewed in favour of one demographic; but it is also worth being aware that the realised change will be skewed in that way. Additionally, we believe CDC offerings should be judged against alternatives, rather than against theoretically perfect structures.' A trustee organisation similarly commented that, 'the currency quite properly given to this concern [inter-generational risk transfer] may be leading some to overlook the non-trivial inter-generational unfairness which is implicit in other sorts of arrangement but often unaddressed there.' A respondent with a legal background further argued that any discussion of risk transfer 'depends on how far "fairness" is to be pursued and recognising other aspects of the overall social contract may preclude the pursuit of what, for some, may be viewed as "perfect fairness" in this area.'

158. Comparisons were drawn with different definitions of 'fairness' implicit within both DC and DB schemes. A financial services consultancy argued that 'DB structures can be skewed towards older members as the scheme is dependent on the sponsor and, all else being equal, a strong sponsor will weaken through time. The risk can therefore be disproportionately borne by younger members, and the changes that can be made (e.g. changing indexation from RPI to CPI) may affect younger members more. This is especially true when PPF rules are considered. We see generational risk transfer as an issue in CDC, but equally it is an issue in DB, and CDC is likely to have a better solution in this regard. DC is fundamentally fair apriori, but by not allowing pooling it does make longevity protection expensive.' In contrast, a response from an actuarial approach similarly discussed the different definitions of 'fairness' in terms of pension contributions and pension outcomes and concluded that 'the status quo, of closed to new entrants or closed to accrual defined benefit schemes and open defined contribution schemes mostly with inadequate contributions, involves a deep inter-generational divide in benefit expectations and risk. Different generations of retirees from individual DC schemes will have very different benefit outcomes. Each retiree will have value for money for their

contributions, but for the same contribution history, one generation of DC retires may receive a small fraction of another generation's pension outcome, as little as one fifth.'

159. Several respondents also suggested ways in which a scheme could help to mitigate risk. Investment profile and clear member communications were raised, as was the importance of transparent, rigorous governance. A transparent, mechanistic system for managing benefit adjustments, as described in our consultation paper, was seen by several respondents as a strong mitigation against inter-generational risk.

Our response:

160. Evidence shows that a no buffers, best estimate approach mitigates the risk of inter-generational unfairness that has emerged in some CDC schemes. We are pleased that the majority of respondents agree with us on this approach.

161. We will monitor the first tranche of CDC schemes carefully to further develop risk mitigation strategies as and when we open CDC provision up to other models such as multi-employer schemes and Master Trusts. We will expect to see discussion of inter-generational risk as a key part of scheme documentation.

162. Debate around 'fairness' is a very complex and subjective area. As many respondents recognised, a 'fair' outcome can mean very different things to different people. Ultimately, however, we are clear that a good quality, well-managed occupational pension scheme is the best outcome for everyone, regardless of age cohort.

4.5 Potential Scheme Wind-Up

163. While we hope that CDC schemes will be in place for many years to come, we know that schemes can be forced to wind up for various reasons. We will require scheme rules to be clear on what will prompt the winding up of a scheme, including a trigger relating to scheme sustainability. CDC schemes will also be required to have an accompanying strategy explaining how this process will work, including how members will receive a share of the pooled fund.

We asked:

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

164. The majority of respondents felt that sustainability concerns were the obvious and key wind up trigger for CDC schemes, and agreed that there should be clear triggers, reporting requirements and contingency plans in place to assess and address this risk and the potential fall-out from it.

Our response

165. We agree that sustainability concerns are an obvious trigger, and – as discussed in other sections - intend that the CDC framework will include suitable checks and balances so that this risk is regularly assessed and reported on - from initial authorisation to annual valuations. We will also require appropriate contingency plans to be in place as part of the initial and ongoing authorisation regime - setting out how this will be handled.

Chapter 5: Specific Requirements for UK CDC Schemes

5.1 Scrutiny and Authorisation by the Pensions Regulator

166. The consultation paper set out the outline of an authorisation process for CDC schemes, overseen by the Pensions Regulator. CDC schemes will need be authorised before they can begin to take on contributions. We listed some areas which we believe a CDC scheme specific authorisation process will need to cover.

167. These included:

- *Fit and proper*: whether the individuals who have a significant role in running the scheme can demonstrate that they meet a standard of honesty, integrity and knowledge appropriate to their role.

- *Systems and processes*: does the scheme have sufficient IT systems and processes to enable the scheme to run properly and are there robust processes to administer and govern the scheme.

- *Continuity strategy*: is there is a plan in place to protect members if something happened that may threaten the existence of the scheme, including how the scheme would wind up, if appropriate.

- *Financial sustainability*: does the scheme have a business plan and enough financial resources to cover set up, running costs and also the cost of winding up the scheme if it fails, without materially impacting member benefits.

- *Communications*: do these set out what is reasonable for members to expect from the scheme under all circumstances (including transfer values); do these explain how benefits will be accrued for members of

different ages / how different age groups are treated / how value for members is achieved.

- *Investment/funding/increase arrangements*: what is the basis on which contribution rates are expected to be adequate to provide the target benefit levels with the scheme's investment strategy (including certification by the scheme actuary); what is the relationship of contributions to benefits; and how are adjustments and valuations carried out, and do these deliver adjustments on a universal basis.

- *Member options*: how has the actuary determined individual transfer values and decided the member's share of the fund.

- *Further winding up provisions*: including how pensioner members are treated - for example, a pension in payment could be converted to a DC drawdown fund, or be used to secure an annuity.

168. The consultation paper also listed further requirements which we think it might be necessary to include in the authorisation regime. These included:

- A CDC scheme specific Chair's Statement.
- Additional significant events reporting requirements.
- Specific annual CDC scheme returns (including valuation, adjustment to benefits).
- Accompanying obligations on specified persons to provide this information.

169. We also explored whether the Pensions Regulator needs additional powers in order to regulate CDC schemes effectively, for example to –

- obtain further information as needed.

- apply penalties for providing false or misleading information to the Pensions Regulator or in member communications.
- commission a skilled persons report (paid for by the CDC scheme).
- amend target benefits or set appropriate valuation assumptions / adjustment rates.
- close a CDC scheme to new entrants/future accrual.
- wind up the scheme other than in circumstances that would generally apply.

We asked:

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

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

170. Respondents agreed that CDC schemes should be subject to authorisation and ongoing supervision by the Pensions Regulator, and that the current Master Trust framework provides a useful template in respect of such schemes. However, respondents also acknowledged that the pooled approach inherent in CDC schemes meant that some adjustment to the quality criteria and considerations undertaken by the Pensions Regulator is needed, for example to better consider the adequacy of systems and processes and the robustness of the assumptions underlying the scheme's approach to benefits.

171. Respondents also felt it was important that legislation was sufficiently flexibility so that the authorisation regime can be adapted in future to reflect the demands of emerging models or alternative providers, where these are justified.

Our response:

172. While we agree that the Master Trust regime contained in the Pension Schemes Act 2017 and the subsequent Occupational Pension Scheme (Master Trust) Regulations 2018 provide a useful starting point, its provisions will need modification to better encompass the risks and considerations appropriate to CDC and non-commercial provision. To avoid confusion, we intend to provide for a bespoke authorisation regime for CDC schemes, although it will resemble many elements of the Master Trust approach.

173. The envisaged quality criteria and supporting information requirements are likely to fall under broad headings which will be familiar to many trustees of Master Trusts – i.e. fit and proper persons, sustainability and continuity strategy, and systems and processes. However, we envisage that we will need a new quality criteria/heading linked to the viability of the scheme (see below).

174. Again, some aspects of the considerations undertaken by the Pensions Regulator will be familiar to trustees, whilst others will be adapted to better suit CDC or employer established models.

175. The details are still being developed in discussion with the Pensions Regulator, but we envisage, for example, that the Pensions Regulator will need to be satisfied amongst other things, that-

Fit and proper persons

- all individuals who have a significant role in relation to the establishment or operation of the scheme meet a standard of honesty, integrity and knowledge appropriate to their role

Sustainability and continuity strategy

- the scheme has financial resources to cover set up, running costs (and cost of winding up the scheme if it fails), without materially impacting on members
- there is an appropriate plan in place to periodically assess the viability of the scheme – i.e. whether the scheme continues to provide value to members and properly addresses the risk of intergenerational imbalance, if appropriate

- there is an appropriate plan in place from the outset to protect members if something threatens the existence of the scheme, including a winding up strategy setting out what happens to members' benefits, and how this will be communicated to members

Viability of the scheme

- the initial underlying assumptions in respect of investment returns combined with contributions have been adequately tested and considered to be sustainable to provide the indicated CDC benefit levels throughout the expected lifetime of the scheme (this should include certification by the Scheme Actuary)
- there is an appropriate plan in place setting out how adjustments, annual valuations and ongoing viability assessments will be carried out. This should include triggers and actions to be taken, including, for example when trustees consider the scheme to be no longer viable.

Systems and processes

- there are IT systems in place to enable the scheme to run properly
- there are effective processes to administer and govern the scheme
- there has been due diligence on appointment of service providers / advisers, for example the scheme actuary.

Communications strategy

- there are effective communications to members covering key matters, for example what it is reasonable for members to expect from the scheme under all circumstances, including:
    - how benefits accrue for members of different ages
    - how benefits are adjusted
    - fairness /value for members
    - how transfer values are calculated
    - annual benefit projections to members – adapted to reflect the funding level and any resulting adjustments to benefits

- there are effective communications to members covering key matters such as -

- what it is reasonable for members to expect from the scheme under all circumstances
- how benefits accrue for members of different ages
- how benefits are adjusted
- fairness /value for members
- annual benefit projections to members – adapted to reflect the funding level and any resulting adjustments to benefits
- how transfer values are calculated

176. These are an early indication of some of the matters the Pensions Regulator is likely to wish to consider, but we will consult further in due course on draft regulations setting set out these requirements in more detail as well as those in respect of:

- The formal application and decision making process – how trustees should apply and how they can expect the Pensions Regulator to respond;
- The ongoing supervision regime so that CDC schemes continue to meet the required standards in order to remain authorised – including regular and event-triggered reporting requirements and actions, for example the Chair's Statement and the notifiable events reporting regime, as well as an annual valuation and scheme returns reporting processes.

177. Finally, we intend that our legislation will be sufficiently flexible to allow us to modify the authorisation regime to address emerging threats or alternative providers and CDC models in future.

As mentioned, we also consulted on whether every CDC scheme's assumptions in respect of its benefits should undergo an independent peer review prior to the scheme's trustees making an application for authorisation.

178. However, we think that making this an explicit requirement is disproportionate given the considerations envisaged to form part of the authorisation regime overseen by the Pensions Regulator described above. Under sectorial guidance such as the Actuarial Profession Standards issued by IFOA, an actuary must already consider whether to apply

a Work Review, and whether this should be in the form of an Independent Peer Review, to actuarial work for which they are responsible.

179. We do not therefore intend to impose this additional layer of activity and associated expense on CDC schemes as a matter of course, but if CDC schemes feel that this is helpful to their scheme design process and eventual application for authorisation, then they are free to seek the input they feel is necessary

5.2 Investment Requirements

180. The consultation paper argued that an investment fund used for CDC benefits should be required to produce a Statement of Investment Principles (SIP) modelled on that currently required for a default DC SIP. Where CDC benefits are offered alongside non-money purchase benefits, such as a closed DB section, a SIP would be required for the whole scheme's investments, and for the CDC benefits. Where a scheme only offered CDC benefits, the SIP and the default SIP would have an identical scope.

We asked:

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

181. Of those that commented the majority agreed with the proposals that a CDC scheme should not be treated differently from other money purchase schemes and that a SIP should be produced and published on a public website as part of the transparency requirements for the CDC arrangement. One respondent however disagreed and thought that the CDC SIP should be based on the DB model, with the investment strategy outlined in the scheme design and the SIP more operationally and tactically focussed.

182. It was also recognised that a CDC scheme is akin to a 'default arrangement' and therefore a default SIP might be appropriate. A number of respondents however did question whether two separate SIPs (albeit perhaps published as a single document) would be required for a CDC scheme when they only have one investment arrangement

and that the SIP and default SIP for a CDC scheme were likely to be identical in scope. It was suggested therefore that only one SIP, a 'default SIP' was required.

183. It was also suggested that a CDC scheme should have its own SIP, or certainly a separate CDC section, as if there were also money purchase or DB benefits then these (as per paragraph 69 in the consultation document) need to have segregated assets and in effect treated as a separate scheme.

184. A few other respondents suggested that, as CDC scheme arguable have characteristics similar to with-profits funds, we should adapt the FCA's with-profits template, Principles and Practices of Financial Management (PPFM), rather than a SIP. They suggested this would add a greater level of detail than might be included in a SIP, including the principles to be applied to deal with under or over performance as well as the aims of the fund. An alternative suggestion made by a legal representative organisation was to 'extend the SIP requirements to cover the interactions between investments and the expected pensions for the members.'

Our response:

185. We are confident that a CDC SIP modelled on a DC default SIP is the most appropriate option for CDC schemes. We are persuaded that where CDC benefits exist as part of a hybrid scheme a separate CDC SIP will be required and that only one CDC SIP will be needed. We will however continue to consider and engage further with industry on whether any amendments are required to the Occupational Pension Schemes (Investment) Regulations 2005 to take account of the specific CDC regulatory and operational framework, including any lesson learned from with-profits and the FCA's PPFM template.

5.3 Disclosure of Information

186. The consultation paper set out that most of the existing disclosure requirements for money purchase occupational pension benefits (as set out in the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013) will apply to CDC schemes. CDC schemes will be required to publish this key information on a publicly accessible website so that it is freely available to all.

187. We also said that the Annual Report produced by CDC schemes will contain all of the appropriate information - for example, details of the last annual valuation by the scheme actuary, a SIP, and a Chair's Statement (including publication of relevant information on cost and charges and investment duties).

We asked:

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

188. The vast majority of respondents agreed with the proposed overall disclosures framework, and also that it provides a high degree of scheme transparency for CDC schemes (see **question 11** in chapter 4, above, for detailed comments on member specific disclosure requirements). They particularly welcomed the publication of key information including the SIP (with specific mention that CDC schemes, as other money purchase schemes, should also publish how they integrate environmental, social and governance considerations into their investment decisions) and the existing details in the chair's statement (relating to value for money and costs and charges specific requirements).

189. There were additional suggestions on the need to publish:

- All generic member communications.
- A scheme communication strategy.
- The performance of the fund.
- The actuarial valuation – including actuarial assumptions and valuation principles.

- The actuarial adjustment mechanism for adjusting benefits up or down to reflect the results of the annual valuation, including actuarial advice leading to the benefit adjustment recommendation and analysis of probability of benefit reductions.

- The actuarial model used to determine any benefit illustrations for the annual statement.

- Quarterly funding statements showing the value of target pensions, on a prescribed bond basis.

- Winding-up strategy.

Our response:

190. We continue to advocate the publication, free of charge, of key scheme documentation to ensure an open and transparent environment for employers, trustees, members and commentators alike. We continue to propose that, as CDC schemes will be a sub-set of money purchase schemes, they will be subject to the same publication requirements as these schemes.

191. We continue to envisage that the proposed annual actuarial valuation report will be published. As draft regulations are developed we will also consider which other key documents should be made publically available, such as other administration reports like the auditor's accounts and winding-up strategy. CDC schemes can of course also publish voluntarily any material they feel would be beneficial tailored to their own member's.

5.4 Administration

192. In keeping with our treatment of CDC benefits as a type of money purchase benefits, the consultation paper stated that, in most circumstances, the money purchase administration requirements should apply. However, we also proposed that CDC schemes should have broader legal duties than money purchase schemes, and that we will dis-apply the exemption for money purchase schemes from appointing an actuary where any of the money purchase benefits are CDC benefits.

We asked:

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?

193. The majority of respondents agreed that CDC should be administered under the framework in place for money purchase benefits, with appropriate adjustments such as the requirement for actuarial valuations. A legal representative organisation commented that the proposals set out in the consultation paper are 'sensible and reasonable'; an actuarial organisation similarly felt that 'the proposals appear proportionate.'

194. A small number of respondents additionally suggested that due to the special nature of CDC benefits, and the need to distinguish them from both money purchase and non-money purchase benefits, CDC benefits should operate within their own legally distinct set of provisions. As one pensions provider argued, 'this is an appropriate stopgap approach to cover Royal Mail and the handful of other major corporates that may choose to go the CDC route. Should the government look to expand CDC beyond its current narrow base, we think that a fuller revision of benefit categories would be appropriate to ensure that CDC is distinctive from individual defined contribution.'

Our response:

195. We have considered this question carefully. We recognise the need for clarity about CDC benefits and schemes and the provisions which relate to them and what that means for employers and members, and therefore we plan to set out clear definitions in law.

196. However, we believe that creating a separate and distinct set of legal provisions apart from the existing non-money purchase provisions on administration would only serve to add complexity and could seed doubt and confusion about where a scheme or its benefits sit. We therefore are minded to treat CDC benefits as a subset of money purchase benefits with the modifications we have discussed elsewhere.

5.5 Member-Borne Charges

197. Because CDC benefits will be a type of money purchase benefit, the consultation paper argued that CDC benefits will be subject to a similar charge cap to DC schemes, although the detail of how the charge cap is applied is likely to need adjustment to reflect the nature of pooled benefit provision rather than individual pots. Charge cap compliance as it applies to CDC schemes should be determined by one test applied to the whole of the scheme's CDC benefits. This would calculate all charges taken from the pooled assets of the CDC scheme (and those charges taken from membership and employer contributions to pooled assets) divided by the assets of the scheme, on a regular ongoing basis.

198. Where schemes are used for automatic enrolment, the consultation paper proposed to limit the permitted charging structures in the same way as for individual DC schemes. These are a percentage of the funds under management charge, and a funds under management charge combined with either, but not both, of a contribution charge and a flat fee.

We asked:

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

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

199. Respondents agreed that tackling high and unfair charges is an important part of delivering value for money for members of CDC schemes, and that a charge cap based on the value of the whole scheme's assets would seem a logical approach. Some respondents felt that the level of the cap should not act as a brake on optimum investment, whilst others felt that it should be extended to encompass transaction costs. Many respondents were keen that there was greater transparency in respect of charges, generally.

Our response

200. As we saw from our examination of the charge cap in 2017, a charge cap helps to drive down member-borne costs, whilst still allowing flexibility in terms of asset diversity and delivering tailored services. In addition, large schemes – such as those envisaged to form the initial tranche of CDC schemes - will have the economies of scale to take advantage of the most competitive market rates, as has proven to be the case for large Master Trusts.

201. Nevertheless, we recognise that this issue requires careful consideration, and we are exploring further the shape and form that a CDC scheme specific cap and charges regime might take. Nevertheless, our proposal remains an annual charge cap set at 0.75% of the value of the whole CDC fund, or an equivalent combination charge. The cap would have the same scope as the DC cap.

5.6 Transfers of Benefits Between Schemes

202. The consultation paper discussed various options for calculating the transfer value of a CDC pension. One potential approach discussed in the paper was to require CDC transfer values to be determined as the member's share of the total fund reflecting investment performance to date and any benefit from risk sharing and efficiencies up to the point of transfer but no further. The member's 'best estimate' share of the total fund would in effect be determined as part of each annual valuation, adapted by the scheme actuary to determine the transfer value.

We asked:

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

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

203. The vast majority of respondents agreed that transfers out of a scheme must be permitted where the member is not yet in receipt of a pension from the scheme. While many respondents felt that the monthly retirement income paid by a CDC scheme was a key advantage over individual DC schemes, they also noted that some people will want, and indeed benefit from, the ability to access benefits flexibly through DC freedom and choice. As one financial services provider argued, '[t]o take away the option of transferring out would run against much of the spirit of recent reforms in pension, in particular the introduction of freedom and choice.' A pensions commentator similarly felt that 'in the context of the Pension Freedoms, some scheme members will undoubtedly want to move their funds into drawdown or indeed secure the certainty of an annuity.'

204. Transfers into a CDC were approached with more caution, although many respondents could see potential benefits to both schemes and transferees. It was cautioned, however, that individuals transferring into a CDC scheme would need to be clearly aware that the benefits are not guaranteed and can decrease in value.

205. The importance of scheme discretion over transfers was emphasised. A pensions provider commented that transfers 'should be a matter for the design of the scheme / trustees. It should not be one for legislation.'

206. Several respondents cautioned that transfers should not be permitted in or out once a member has crystalised their pension – as is the case in DC and DB schemes.

207. The way in which a transfer value would be calculated was a matter of considerable debate.

208. Some respondents argued that members should receive a transfer value equal to the total value of their contributions to the scheme plus investment growth, as would happen if an individual was transferring out of an individual DC scheme.

209. However, the majority of respondents agreed that the pooled nature of the fund means that a best estimate share of fund approach would be more suitable, actuarially adjusted if necessary to take account of member demographics. An actuarial services body commented that transfers in or out '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.’ As one financial services provider argued, ‘[v]aluations of transfers out would need to be subject to up-to-date market-value adjustments, reflecting current investment performance […] There may also need to be actuarial adjustments applied to transfers-out when annuity rates vary from long-term assumptions, to keep outcomes close to the long-term average.’

210. Concern was raised about the impact of transfers on scheme sustainability, with one respondent simply stating that scheme sustainability ‘comes first’ above individual member rights to a transfer. Because it is anticipated that CDC schemes will take a relatively longer-term, more illiquid approach to investment than individual DC schemes, a respondent with experience of pension trusteeship argued that a scheme’s approach to transfer requests has to take into account ‘the impact on investment strategy and the constraint that an unrestricted transfers policy places on investing in long-term, illiquid asset classes.’ A pensions advisor organisation cautioned that transfers out ‘could create a financial skew in scheme funding that would most likely require the actuary to make downward adjustments to transfer values’, while an actuarial advisory provider similarly argued that ‘CDC trustees should have a permissive power to calculate transfer values allowing for the possibility of such anti-selection, in order that they can balance the interested of transferring and non-transferring members.’

211. Schemes are required by law to ensure that a member has taken independent financial advice before transferring out non money purchase benefits with a cash equivalent value of £30,000 or more. Several respondents suggested that individuals seeking to transfer out CDC benefits should be required to take similar advice. As one financial services consultancy argued, ‘[a]lthough CDC is likely to be established as a money purchase benefit, CDC is more complex than traditional DC and we therefore believe that transfers should be treated similarly to transfer from DB scheme, requiring members to take independent financial advice if their transfer exceeds a certain threshold.’

Our response:

212. Members of CDC schemes will need to be able to transfer out of the scheme in order to make use of the pension freedoms introduced in the Pension Schemes Act 2015.

Increased flexibility around pension access has been of benefit to many people in the UK, and we would not wish to restrict this for members of CDC schemes.

213. We remain convinced that a share of fund approach is the best mechanism for calculating the transfer value of CDC benefits. The pooled nature of the fund means that a transfer value equal to the total value of an individual's contributions to the scheme plus investment growth would not be appropriate: the scheme has to be able to take the total value of the fund and its investment and longevity profile into account when making an assessment of an individual transfer value. It is important to remember that the primary purpose of a CDC scheme is to provide an income in retirement until death, not to provide a cash sum.

214. We recognise there are a number of activities being taken in relation to both transfers and advice. Industry is looking to speed up the transfer process and FCA have introduced a range of measures in relation to advice when transferring from defined benefit schemes. These include action to improve the quality of advice and ensure the test is appropriate and provides a fair comparison of the comparative value of the benefits in the receiving and ceding schemes. FCA are also considering the role of contingent charging. We can see that there are strong arguments for requiring members of a CDC scheme to take advice before transferring out. However, we are also conscious that suitable financial advice may be very difficult to find before CDC schemes become fully established in the UK pension landscape. We will continue to review developments in this area as we develop the legislation for CDC. We intend that this will include powers to make appropriate provision in secondary legislation to protect members at the point of transfer.

215. We are persuaded that transfers into a scheme should be a matter for scheme discretion. There are potential benefits to transferring into a CDC scheme for both the scheme as a whole and the transferee. However, there can also be risks to both parties, especially if the transferee is unclear as to the variable nature of the benefits. Schemes should therefore have discretion in this area.

Chapter 6: Next Steps

216. We are grateful for the quantity and quality of the responses we have received to our consultation. We have analysed these responses carefully in order to strengthen our understanding of the issues and solutions and further develop the technical details of our CDC approach.

217. We will be seeking to bring forward legislation to provide a framework for the setting up of this form of CDC scheme as soon as Parliamentary time allows.

218. Many of the details of the CDC scheme requirements will need to be set out in secondary legislation (regulations). We will be bringing draft regulations forward to follow on from the necessary primary legislation. Using regulations to set out the details of CDC schemes will allow us to focus carefully on precise technical issues; it will also give us the flexibility to adjust the provisions more easily as CDC schemes bed-in and become more established, and as we learn from the experience of the first tranche of these schemes.

219. We are delighted by the level of interest in other forms of CDC provision such as Master Trusts. Once the RM scheme is established, we will begin working with interested parties to develop an operational and legislative framework for other models.

Annex A: List of Respondents

The following individuals and organisations responded to the consultation

Andrew Brunskill

Andrew Slater

Association of British Insurers

Association of Consulting Actuaries

Aegon

Age UK

Alliance Burnstein

Anna Tilba

Association of Member Nominated Trustees

Aon

Association of Pension Lawyers

Aviva

B&CE

Barnett Waddingham LLP

Bernard Casey

Ilja Boelaars

Cardano

Confederation of British Industry

Centre for Financial Technology and Innovation

Christine Haswell

Community

Communication Workers Union EQ

Con Keating

Paymaster

Eversheds

Financial Reporting Council

First Actuarial LLP

Gowling WLG

Hargreaves Lansdown

Henry Tapper

Hymans Robertson

Iain Clacher

Institute of Chartered Accountants of England and Wales

Institute of Chartered Accountants of Scotland

Institute and Faculty of Actuaries

Investment and Life Assurance Group

Industry Super Australia

JLT Benefit Solutions Ltd

John Ralfe

Just Group

Lane Clarke and Peacock LLP

Law Debenture Pension Trust

Law Society Scotland

Legal and General

M&G Prudential

Mercer

Michael Johnson

National Federation of Occupational Pensioners

Paul Davey

Pensions Management Institute

Pensions Ombudsman

Philip Bennett

Phoenix Group

Pinsent Masons

Pensions and Lifetime Savings Association

Pensions Policy Institute

Prospect

Redington

Renaldo Bosch

Ron McDerment

Royal Mail Group

RSA

Scottish Widows

Secure Pensions Solutions Ltd

Smart Pension

Society of Pension Professionals

Squire Patton Boggs

Standard Life

Stuart Fowler

TISA

Single Finance Guidance Body

Supertrust

Trades Union Congress

UNISON

Unite the union

Universities and Colleges Employers Association

University of Cambridge

Willis Towers Watson

XPS Pensions Group

Department for Work and Pensions

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