HYMANS ROBERTSON

Delivering collective defined contribution pension schemes

Consultation Response

January 2019

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Introduction

Hymans Robertson provides independent pensions, investments, benefits & risk consulting services, as well as data & tech solutions, to employers, trustees and financial services institutions.

We welcome the proposal to introduce Collective DC pension arrangements in the UK. There are undoubtedly benefits from pooling risks in order to drive better outcomes for members of UK registered pension schemes. We comment on the specific question raised in the consultation document later in our response but our key points are:

- The proposals are very restrictive, only enabling single employer schemes covering both pre and post retirement. We would prefer a broader framework making way for Master Trusts to offer CDC sections. In particular, feedback from our clients suggests that this would be attractive.
- We believe the benefits of CDC are greatest in the areas of longevity and investment risk pooling post retirement. As such, we recommend that post retirement only arrangements are permitted, with the option to accept transfer in from traditional DC schemes. This would help DC members better manage their savings post retirement in a market that is currently not well served.

Our details

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1 Collective Defined Contribution Schemes

Question 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?

Yes, although these impacts already exist in relation to traditional Defined Benefit arrangements.

The main issues relate to the cross subsides already highlighted in the consultation document. In addition, there is potential for cross subsidies in volatility in that, under the Royal Mail proposals, market volatility will be taken into account by adjusting all future benefit increases (and may, occasionally result in a benefit decrease). If this rate of increase is applied uniformly across all members, younger members will effectively be cross subsidising older members due to the differences in the duration of their expected benefit payments.

The CDC concept introduces longevity risk sharing across the scheme members. If contribution / accrual rates are fixed for all members, this could give rise to disability type discrimination where individuals with clearly lower life expectancies are paying to subsidise those with higher life expectancies.

A possible way to reduce some of the cross subsidies would be to introduce some form of differential pricing (member contributions) or accrual to reflect certain member characteristics (a form of underwriting). However, this might equally be seen as discrimination if there are overt pricing differences for different members (for example if women typically had higher contribution rates).

2 Legislative Approach

There are no questions within this section to which to respond.

We understand the DWP's caution in initially proposing legislation which would permit only a very limited style of CDC scheme as proposed by Royal Mail. However, feedback from our clients suggests that that other designs and vehicles could be attractive, such as:

- Master Trust vehicles, enabling smaller employers to access the scale required for a CDC scheme or larger employers who have already moved to a Master Trust vehicle
- Post retirement only CDC schemes, offering alternative longevity and investment pooling vehicles for members retiring from traditional DC schemes. Indeed, we believe this is where CDC offers the greatest benefits to members

It is important that any new legislation leaves opportunities to introduce additional types of CDC scheme in the future.

3 Fitting CDC Schemes into the UK Pensions Landscape

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

Yes.

If CDC benefits were classified as anything other than a money purchase benefit then there is a risk of challenges to the sponsor with expectations of promised or guaranteed benefits, undermining the design of a CDC scheme. We suspect this would be a strong deterrent to any employer establishing a CDC scheme.

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

Yes.

The current definition of money purchase benefits states that 'its rate or amount is calculated solely by reference to assets'. By definition, the benefits provided in a CDC scheme are not defined solely by the underlying assets, instead targeting a specific retirement benefit which can by altered by reference to assets.

Given the nature of CDC, it would be necessary to require the appointment of a Scheme Actuary (not currently required for money purchase schemes).

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

We agree with the majority of the conditions specified in the consultation document, with the exception of:

"70. Whilst CDC schemes will be based on some familiar foundations, we will incorporate new conditions specific to CDC schemes. The initial framework is intended to facilitate provision by single or associated private sector employers who wish to consider alternative pension provision options following appropriate consultation with their workforce and trade unions where relevant. The legislation will therefore initially restrict CDC benefit provision to such schemes."

Under this provision, the vast majority of UK employers are unlikely to have sufficient scale to implement a CDC scheme. We therefore believe this should be relaxed to also permit Master Trusts (with a suitable authorisation regime) to offer CDC benefits. Small and medium sized employers could then offer CDC benefits to their employees. Also, larger employers who have already moved to a Master Trust vehicle may be reluctant to establish their own trust for CDC but could do so within a Master Trust.

"72. We do not feel it is 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."

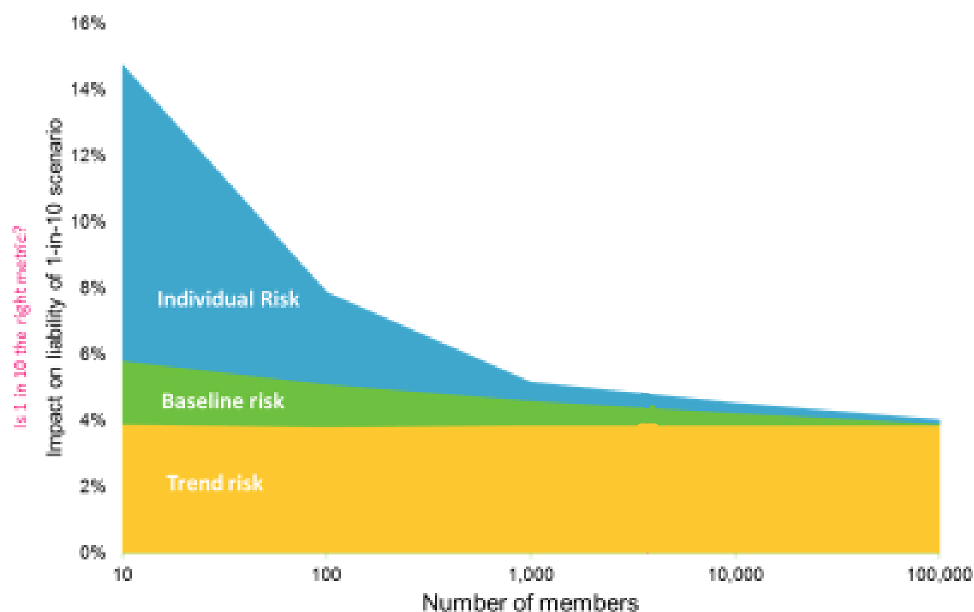
We agree that CDC schemes should not be accrual only vehicles. However, the benefits of smoothed investment returns and pooled longevity risk would still be achieved through post retirement, decumulation only CDC schemes and so we suggest that the option for allowing CDC to take place post retirement only should be considered. By permitting post retirement only CDC schemes, traditional DC members could also benefit from this pooling once they start to access their retirement savings.

Question 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?

Longevity risk can be split into the following three areas:

- Individual risk – for smaller schemes, this tends to be the dominant risk but rapidly reduces as membership grows. From around 1,000 members upwards, individual risk tends to be the lowest element of overall longevity risk.

- Baseline risk – this risk is relatively low for all but the smallest schemes, though it will reduce at much larger numbers.
- Trend risk – general this is the highest risk once individual risk has been mitigated by a large number of members.



Based on our extensive experience from Club Vita, we believe a scheme with over 1,000 members would be sufficient to benefit from the pooling of longevity risk.

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

Yes. Whilst the proposal is rather general and could benefit from clearer and more specific guidance, the approach as a whole allows for a reasonable level of requirements without becoming too difficult to meet.

We believe it is important that the authorisation process considers the expertise and experience of the proposed board for a CDC scheme and also that it should ensure a strong governance framework is established at the outset of such a scheme.

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

As the definition is broad and can cover a specific requirement this initial approach should be sufficient. However, there will need to be a lot of thought around codes of practice and further guidance, not just around TKU but other governance requirements.

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

No.

Question 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?

Based on the style of benefits proposed by Royal Mail, the defined benefit test seems most appropriate, perhaps with a caveat that the employer should provide a minimum proportion of the total contributions. This would clearly not apply to any post retirement only CSC schemes.

4 Target Benefits and Scheme Valuations

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

Having no in-built capital buffers *may* help to reduce inter-generational unfairness, which is the reasoning behind Royal Mail's proposal. But as stated within the consultation document, no buffer means the CDC schemes will also run the risk of being very volatile depending on how the assets perform. However, the Royal Mail proposal spreads volatility across future benefit increases and so it is unlikely to be a significant concern as actual current benefit reductions are unlikely to occur (as opposed to a lower rate of future increases).

Question 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?

Regular communications will be needed for all members which should include the following:

- Communications before joining the scheme to explain how the scheme works and is run. This is particularly important if there are restrictions on transfers or flexibility offered within the scheme, as members may prefer the flexibility that alternative schemes could provide;
- Clear explanations on how their benefit might change from the target amount. Care should be given to ensure that the member is aware of all possible changes whether positive or negative;
- How the scheme is funded and where their contributions are being invested, as well as how these contributions will provide for their pension; and
- Regular information about the funding position of the scheme and the impact of this on their pension, whether they are still employed or in receipt of their benefits.

The above list is not intended to be exhaustive and whilst a lot of information will need to be communicated to members, it is crucial that they are not overwhelmed by communications resulting in confusion and misunderstanding.

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

In 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.

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

Yes. The main principle in Royal Mail's proposal is that benefits are adjusted so that the scheme is fully funded at all times. We believe this is an important principle for CDC schemes to succeed.

It would also be preferable for CDC schemes to include an expenses reserve in their liability calculations to ensure that the scheme would be viable in the absence of future contributions.

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

In our view, annual valuations and no funding buffers create a rigorous framework for good risk management. The only exception may be that, at time of extreme market volatility, it may be preferable to have more frequent valuations and this could be added as an "emergency" provision.

We believe that CDC schemes should establish strong governance frameworks and utilise Integrated Risk Management (IRM) processes as part of authorisation. This should then be continued in regular reviews (at least

annual) and by continuous monitoring. There should be a requirement to submit certain information relating to the scheme's risk management and what processes are in place to the Regulator as part of the scheme return each year.

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

The main argument for CDC is risk sharing and so it's inevitable that there will be some inter-generational risk transfer. However, the lack of capital buffer proposed by the CDC consultation document seeks to minimise this risk. Whilst in many ways the proposed approach is reasonable, consideration must be given to the other areas in which inter-generational unfairness may arise.

It's possible these risks could increase as a CDC scheme matures as the scheme's investments might be expected to de-risk, reducing the prospective future returns. Older, retired members will have already benefitted from stronger returns earlier on in their careers while younger, active members will not have the same chance of achieving this benefit.

Significant medical developments changing baseline longevity might also create risk transfer between generations and may need further consideration.

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

We believe that appropriate wind up triggers for a CDC scheme could be:

- The scheme reduces in size so it is no longer a cost effective arrangement; or
- Legislation changes, undermining the suitability of CDC.

In the event of the former, the ideal solution would seem to be a bulk transfer into another CDC arrangement. Careful consideration would be needed to consider differences in the two arrangements' rules and operations, possibly requiring two separate sections to be maintained. This would seem a more viable option if Master Trust or decumulation only type CDC schemes have been introduced.

Building up an expense reserve for the scheme could help mitigate this risk but there would still likely be a size below which a CDC scheme is not cost effective.

5 Specific Requirements for UK CDC Schemes

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

We support the proposed regime in the context of CDC schemes. However, as highlighted above, we believe certain requirements (such as being a single employer scheme) are unduly restrictive and would prevent broad adoption of CDC.

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

No.

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

Yes.

Whilst the current requirements for Statements of Investment Principles (SIPs) are reasonable and CDC schemes should have the same standards as a minimum, it may also be worth considering whether there should be regular reporting on strategy in conjunction to each annual valuation. For instance, in annual scheme returns the trustees of CDC schemes would have to indicate that they had considered the investment strategy and its suitability in line with the maturity of the scheme. Any changes made as a result of such a review (for instance changes to the scheme's risk appetite) should also be stated clearly.

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

No, although we note that the language and tone of disclosures need to be understandable to members to a greater extent than might be the case for traditional DB schemes.

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

Yes, although there may need to be some refinements to reflect the nature of CDC benefits compared with DC schemes.

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

Whilst we agree that some form of charge capping is desirable, simply imposing the current DC charge capping may not be appropriate. One benefit of CDC schemes is that it may facilitate exposure to broader asset classes (such as infrastructure), not easily included in existing DC schemes. There may be high set up costs associated with such investments but, given investments in CDC schemes will generally be held for the longer term, these might still represent good investment opportunities. Any charge capping needs to have enough flexibility to enable such investments to be made by CDC schemes.

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

Yes.

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

Transfers in and out should be undertaken on a cost neutral basis, consistent with the scheme's best estimate valuation basis reflecting market conditions at the time of transfer. In this way, they would not impact on the scheme's fully funded status.

It is important that any benefits granted on transfer in are defined in the same way as the regular accrual under the scheme so that future adjustments could be applied uniformly to all benefits.

There is a risk of selection against the CDC scheme if, for example, members with shorter life expectancies choose to transfer out of the scheme at retirement. However, if this were perceived to be an issue, the underlying assumptions for transfers out could be adjusted to reflect shorter life expectancies (and the converse could be done for transfers in).

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

Yes.

Were a high volume of transfers to be experienced, this could cause cash flow strains or result in the forced sale of assets at unfavourable times. It may therefore be reasonable to permit a delay in the settlement of transfer values if volumes increase to too high a level. This would be particularly an issue for a CDC scheme which has closed to future accumulations, where there is no flow of new contributions. A related issue for such schemes is that large volumes of transfers out might result in the scheme size reducing to a level which is no longer cost effective to run. Consideration should be given to whether Trustees should be permitted to suspend transfers out if the scheme size reduces to a level which might risk sustainability.

Although 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.