DELIVERING COLLECTIVE DEFINED CONTRIBUTION PENSION SCHEMES

RESPONSE FROM ICAS TO
THE DEPARTMENT OF WORK AND PENSIONS

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Background

ICAS is a professional body for more than 21,000 world class business men and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

Almost two thirds of our working membership work in business and in the not for profit sector; many leading some of the UK's and the world's great organisations. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

We currently have around 3,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in the UK and globally, always acting in the public interest.

ICAS was created by Royal Charter in 1854.

Introduction

The ICAS Pensions Panel welcomes the opportunity to comment on the Department for Work and Pensions (DWP) consultation on ‘Delivering Collective Defined Contribution Pensions Schemes’.

Back in December 2013, we responded to the DWP’s consultation on defined ambition pensions and we made the following observations on the concept:

“We support the concept of defined ambition pension arrangements and the need to make changes to the regulatory regime and the law to facilitate these. However, delivering this policy will be extremely challenging.

We believe that products which involve risk sharing between the employer and the employee have a limited prospect of being taken up. Employers, even those without Defined Benefit (DB) arrangements, are well aware of challenges around the sustainability of these arrangements. Therefore, we do not envisage a significant appetite amongst employers in the future for taking on any new pension-related risks. We believe that reforms which facilitate products where the risk is shared amongst members have a greater likelihood of success.”

Our position on Collective Defined Contribution (CDC) is broadly similar to our position on defined ambition but we have reviewed it in light of the pension freedoms which were implemented in the interim.

We believe that developing pension arrangements where longevity risk can be effectively managed without dependence on deficit contributions from employers is a laudable objective. However, we are not convinced that there is sufficient appetite for CDC Schemes in the UK for the DWP to be giving priority to developing a legislative and regulatory regime for CDC schemes, given the extent of recent and on-going pensions-related reforms and wider Government priorities.

The pension freedoms are a key development since the DWP put forward its initial proposals on defined ambition and CDC arrangements may not be compatible with these. The pension freedoms mean there is now an expectation that in future the many retirees who have no DB pension income but a significant DC pot will prefer to use their pension savings to purchase a drawdown product rather than an annuity. The pension freedoms are therefore effectively moving many savers away from risk sharing and towards relying on their own pension pot plus the State Pension. However, we recognise that this approach could lead to poor investment decisions at or after retirement, resulting in inadequate income in the later years of retirement, and CDC schemes may be a means of avoiding some or all of these challenges.

The quality of employer communication with employees about their pension offering is also key and the inherent complexities in CDC means that additional effort will be needed by employers to ensure that employees understand the risks and rewards. This brings to the fore the important role that employers have in a DC environment in relation to financial education, including the many ICAS members who are also employers.

Our comments to the consultation questions are included overleaf.

Any enquiries should be addressed to Christine Scott, Head of Charities and Pensions, at cscott@icas.com.

Responses to consultation questions

CDC schemes

Question 1
Are there ways in which the introduction of CDC schemes would give rise to different impacts on individuals with protected characteristics?

Response
We would expect CDC scheme rules to be compatible with the Equality Act 2010.

However, there are challenges to be thought through in relation to target incomes for men and women, who have the same pot size, due to differences in life expectancy. There is a similar challenge around how changes in life expectancy between older and younger scheme members could impact on expected years in retirement.

There is international experience to draw on. For example, in the Netherlands it has been necessary to reduce pensions in payment which with any CDC scheme is always a risk. Clearly the longer someone is in receipt of pension the more likely they are to experience this variability. There will always be difficulty explaining the complex nature of CDC to individuals and making sure they are aware of the potential variability in future pension income.

There will be a complex comparison at the outset to see if the CDC income model is suitable for an individual in comparison to alternatives. For example, it may be that a ‘standard life’ may do better from a CDC ‘pooled income’ however an ‘impaired life’ may not. It does seem incompatible with the objectives of freedom and choice that a CDC scheme could be in any way restrictive about the option to select a pension other than the CDC pension offered by the scheme.

We make additional comments in our response on the exercise of the pension freedoms at retirement in our response to questions 24 and 25

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?

Response
Yes, we agree that classification as a type of money purchase benefit is compatible with the policy objectives for CDC schemes. It is also less likely to discourage employers from setting up 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?

Response
Care needs to be taken in drafting CDC legislation, including any subsequent amendments, to ensure that it cannot be interpreted as giving rise to any type of guaranteed benefit. This would lead to classification as a DB benefit and presumably any such benefits would need to be protected by the Pension Protection Fund. Such a situation arose following a change in legislation in July 2015, when some DC benefits had to be reclassified as DB benefits.

While primary legislation can be changed and there can be no absolute guarantee that a future Government will not seek changes, employers will need convincing that no major changes to the fundamentals underpinning CDC schemes are likely in the longer-term.

Today’s DB schemes emerged from pension provision which was only intended to pay benefits capable of being funded by the assets of the scheme. However, pension law has evolved in such a way that benefits must be defined and guaranteed by the employer (if it is still solvent), and it is possible that employers may see the risk of history repeating itself to be too great to consider establishing a CDC scheme.

Consideration also needs to be given to the applicability of aspects of legislation relating to the accountability of trust-based money purchase schemes to scheme members of CDC schemes. For example, whether the requirement for a chair's governance statement is needed. If so, the chair's statement requirements would need to be adapted.

CDC schemes

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

Response
We understand the desire for initial CDC schemes to be limited to single or to associated employers and accept this approach as a reasonable way to introduce CDC. However, given the scale and contribution levels needed for CDC schemes to be viable, and the likely associated initial set up costs and on-going running costs, there could be a limited appetite among employers (both in the initial phase and any future phases) to move away from existing DC arrangements, especially those participating in DC master trusts or providing employees with a contract-based DC arrangement.

Annual actuarial valuations could be costly and would need to be agreed more quickly than triennial valuations for DB schemes, so that any necessary adjustments could be made to benefits without undue delay. The timetable and process for agreeing an annual valuation, including for agreeing any amendments, will need to be properly planned and there will need to be an appropriate degree of oversight by the trustees

Although we understand that improvements in actuarial IT systems mean that such valuations can now be set up in a manner that will allow much quicker and more cost-effective monitoring of a scheme's funding position. However, the actuarial profession is better placed to comment on the proposals for annual valuations.

Also, there is no reference within the consultation document as to whether members who leave an employer and move to another employer participating in a different pension arrangement, can continue to make member-only contributions to their old employer's CDC scheme. We believe that this should be ruled out as an option.

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

Response
We do not have a specific minimum membership size in mind for CDC schemes.

For CDC schemes to remain viable in the longer term, we believe there would need to be a recurring pipeline of new members, at least in the initial years. The ratio of contributing members to retired members will also be a factor.

As the proposal is for CDC schemes, at least initially, to be employer based, the long-term sustainability of the scheme would appear to us to be very much linked to the long-term sustainability of the employer. However, there is no consideration of the future strength of the sponsoring employer in the document or of modern working patterns. Individuals are more likely to move employers more frequently than in the past and to work more flexibly.

The consultation uses the term 'associated employer' and it is not clear how this is being defined for the purposes of this consultation. The reference in paragraph 70 to associated employers also makes reference to trade unions, which suggests it is the DWP's intention for CDC schemes based around employers in the same industry to be covered by the first wave of legislation. While this is not stated explicitly in the consultation paper, experience elsewhere, namely in the Netherlands, demonstrates that industry-based risk sharing arrangements can work.

Trustee duties and requirements

Question 6
Do you agree with the proposed approach to Trustee Knowledge and Understanding for CDC schemes?

Response
Yes. The Trustee Knowledge and Understanding (TKU) required for CDC schemes effectively combines many of the current requirements for DB and DC Trustees. CDC trustees will also need an understanding of the CDC legislative framework.

The DB requirements relevant to CDC trustees are at a simpler level as they will not incorporate statutory triennial valuations, integrated risk management, Section 75 debts, PPF levies etc. CDC trustees will, however, need to understand pooled longevity risk and smoothed investment returns, etc (and possibly also employer covenant risk). In addition to understanding how pooling works within their scheme, the trustees will need an understanding of other options which may be available to CDC schemes and the specific funding basis used compared with potential alternatives.

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

Response
See our response to Question 6 above.

Question 8
Are there any Trustee Knowledge and Understanding requirements that should be relaxed for the trustees of CDC schemes?

Response
In comparison to DC schemes we do not believe there are any TKU requirements that should be relaxed for CDC schemes but there would need to be some relaxation compared to DB schemes (see our response to Question 6 above).

Tax treatment of CDC schemes

Question 9
Which of the two automatic-enrolment tests would be more appropriate for CDC schemes, and how might either test be modified to better fit CDC schemes?

Response
This question begins to illustrate how challenging it will be to develop a legislative and regulatory framework which will bring CDC to fruition.

Classifying CDC as a money purchase scheme makes sense as a guaranteed retirement income is not being offered. Applying a cost of accrual test to contributions for auto-enrolment purposes could be excessively complex and therefore it may be necessary to apply the minimum contribution test and for the related risks to be accepted by policy-makers, in the context of their objectives for auto-enrolment, and for those risks to be clearly communicated to employees. We believe this is an area which requires further detailed consideration.

Employers and employees contributing to money purchase arrangements can choose to make contributions in excess of the minimum required by law for auto-enrolment purposes. Therefore, we can see a role for a cost of accrual test in enabling employers and employees to understand the level of contributions needed to achieve a certain level of income in retirement.

There are wider tax issues which will need to be considered in designing a CDC model. For example:

- DC master trusts can operate on a relief at source basis or a net pay basis. Net pay arrangements have been criticised as workers eligible to be auto-enrolled who are not tax payers do not receive the basic rate relief top up which is available to equivalent workers enrolled into schemes operating on a relief at source basis. This means such workers in net pay arrangements will have relatively smaller pots. The sums involved at the moment are small but will increase in future as the annual allowance for income tax increases and minimum auto-enrolment contributions increase. Potential changes to the scope of auto-enrolment to 18 year-olds and the removal of the minimum income threshold on contributions would further impact on relative pot size. We are not suggesting limiting CDC arrangements to relief at source but believe that the Government should be seeking an innovative way of ameliorating the impact of this issue on those participating in any pension arrangement operating on a net pay basis.
- The lifetime allowance is assessed differently for DB schemes than for DC schemes, with the effect that a DB scheme member assessed as having reached the lifetime allowance would have a higher income than someone with only DC savings who had reached the lifetime allowance. This is inherently unfair and a decision would need to be taken as to how a CDC pot would be measured vis-à-vis the lifetime allowance.

It is widely expected that there will be changes to the structure of pension tax relief at some point given its cost to the public purse. Where tax relief on contributions is paid into the scheme and therefore impacts on an individual's pot size, any assumptions made about the level of contributions needed to meet their target income would be impacted either positively or negatively by changes in the structure of pension tax relief depending on whether the individual is a basic rate, higher rate or top rate taxpayer. Therefore, it may be timely to consider the implications of this for the design of CDC and any communication requirements imposed on employers running CDC schemes.

Managing fluctuations in scheme funding and communicating variations in benefits

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

Response
Without a capital buffer, contribution levels needed to meet target incomes and retirement incomes themselves would likely be more volatile. This could undermine member confidence in CDC. One possible requirement may be to monitor the funding level of the scheme between annual valuations and to report to the trustees if a significant event has happened (e.g. a substantial fall in investments, significant change in interest rates, etc). Similar such warnings are now given to approved individual investment arrangements.

Any in-year monitoring arrangements would need to be accompanied by contingency planning arrangements so trustees would need to consider in advance what events would be significant and what action they would intend to take in the circumstances, bearing in mind the long-term nature of pension investment.

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 when in payment?

Response
We agree that good member communication is very important, and that communications should be clear and simple, although we recognise that achieving this is not easy.

Regarding a related matter, where a CDC arrangement is being offered by an employer as the only option available to a new member of staff and the employer is bound to abide by the requirement that they do not encourage employees to opt out, employers may find themselves walking a bit of a tightrope with regard to explaining the risks.

Where an employee is thinking of transferring a DC or DB pot into a CDC scheme, risk warnings and, where appropriate, independent financial advice will be vitally important as it is in the best interests of the employee (and the employer) to understand the relative merits of leaving funds where they are or moving them. If there is a possibility of transfers out being prevented in certain circumstances, this will also need to be explained adequately to any employee seeking to transfer funds into a CDC scheme. The regulatory framework for regulated financial advice will also need to be updated to reflect CDC rules on transfers.

In paragraph 108, it states that parameters for making adjustments to pensions in payment should be set out in the scheme rules. However, the impact on schemes and members of RPI being discredited as a measure of inflation and the favouring of CPI highlights that difficulties can arise where external matters impact/influence the measurement of pensions benefits. This means that great care needs to be taken in how adjustments to pensions in payment are handled within scheme rules.

Meeting of benefits – high level of probability versus ‘best estimate’

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

Response
We have not considered this issue in sufficient detail to recommend a particular approach. However, one possible model would be to pay prudent pensions but with a bonus available depending on investment performance and longevity experience. The investment strategy post retirement will affect this, however, for example, if the investments are predominantly gilts and bonds, then the level of pensions can be predicted more accurately and there would be less need for bonuses (or falls in the level of pensions).

It is likely that in the early years of any CDC scheme actuaries would make prudent assumptions about income in a bid to build up a ‘buffer’. However, this could result in inter-generational unfairness over time. In the event that a ‘buffer’ is built up, later members would benefit from any surplus through having higher benefits than earlier ones.

Whatever approach is adopted, however, the valuation basis for pensioners should be close to current annuity rates, as otherwise, pensioners may see a significant drop in income and/or security if the employer goes bust. This may again mean that employer covenant assessments would be called for, especially if any of the wind up triggers materialise (or are close to materialising).

Managing risk going forward

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

Response
This would be the ideal scenario but we question how realistic this is. It is difficult to see how this could be achieved without the benefit of hindsight. Without a substantial capital buffer, the probability of a scheme being sustainable without continuing employer contributions in the long-term would seem slim if ‘sustainable’ means that the absence of on-going employer contributions in themselves would not be a contributing factor in any reduction in pensions in payment or any reduction in ‘preserved’ benefits due to deferred members.

In a CDC scheme, employer contributions would only be made if there were on-going contributions from active members. This means that CDC schemes would essentially be designed to exist in perpetuity with a sponsor which also operates in perpetuity.

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

Response
In response to this question, we would just like to emphasise the importance of scale. In respect of our comments in response to question 13, the sustainability of CDC may depend on schemes being open to unconnected employers in the way that DC master trusts are.

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

Response
We understand the reasons why the DWP is concerned about addressing inter-generational fairness. However, the absence of a capital buffer creates other challenges for the CDC model as we refer to elsewhere in our response.

CDC may be workable for public service schemes as scale is needed to achieve inter-generational fairness by enabling pension payments to be smoothed but we appreciate that there are no plans to reform public service schemes.

Annuities, by design, smooth pension payments. However, low interest rates, increased longevity (up until recently) and loss of scale mean that the cost of annuities has increased, weakening the relative purchasing power of pension pots.

Dutch CDC schemes are having to reduce pensions in payment due to low annuity rates and this illustrates the very real risk that retirement incomes could be lower than targeted or reduced while in payment.

Potential scheme wind-up

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

Response
We have no specific comments to make on wind up triggers and the management of associated risks at this time.

Specific requirements for UK CDC schemes

Questions 17 and 18
Are there any elements of the proposed regime that it is not appropriate to apply to CDC schemes?

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

Response
We would expect CDC schemes to prepare an annual report and accounts and for the accounts to be audited. We also have a preference for annual reports and audited accounts to be filed with The Pensions Regulator (TPR) and to be publicly available. A penalty regime should be established for late filing.

We believe that the absence of filing arrangements or publication requirements for pension scheme accounts should be a requirement more generally. While it may not be appropriate for all pension scheme accounts to be published (for example, schemes with 100 members of less) or to extend existing audit requirements, all scheme accounts should be filed. Late accounts could act as a ‘canary in the mine’ meaning that these could indicate wider problems requiring the attention of TPR.

Consideration will need to be given as to how the requirement to obtain an auditor’s statement on contributions would apply to CDC schemes.

Also, there could be similar constraints placed on employers as those applying to DB schemes, for example, through requiring clearance for takeovers or mergers, etc.

Investment requirements

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

Response
We have no additional investment requirements to propose.

Disclosure of information

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

Response
We set out our views on the publication and filing of pension scheme accounts earlier in our response.

Administration

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?

Response
We have no additional comments to make in response to the proposed requirements on administration. We have mentioned previously some issues for consideration around annual actuarial valuations.

Member-borne charges

Questions 22 and 23
Do you agree that the CDC benefits cap should be subject to a similar cap to the automatic enrolment charge cap?

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

Response
Given the more onerous general administration requirements of CDC, greater consideration should be given to determining member-borne costs and how the responsibility for adequately funding DC benefits is imposed on the employer – considering all costs including, for example, legal costs, actuarial costs, trustee costs, member communication costs, etc.

Transfers of benefits between schemes

Questions 24 and 25
What would be an appropriate approach to handling transfers out of or into CDC pension schemes?

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

Response
We believe that members should be able to transfer in and transfer out funds. We have made comments elsewhere in our response on the importance of ensuring members transferring funds into a CDC arrangement understand the risks involved.

It is possible that scheme members participating in a CDC scheme during the accumulation phase may prefer to rely on their own pension pot during their retirement. Transfers out of DB schemes are not uncommon even though DB provides certainty of income in retirement. Therefore, it is likely that CDC scheme members will expect the same freedoms and may be more likely to transfer their pot at retirement as CDC schemes won't guarantee a particular level of retirement income. Nevertheless, we agree that trustees should have the ability to suspend transfers especially as there will be no ability for the trustees to approach sponsoring employers for additional contributions. Communications to members on this point should be clearly given in advance, especially if transfer values can be reduced or suspended.

This is an important area where the consultation provides little detail on DWP policy or initial views on transferring funds into and out of CDC schemes.