ASSOCIATION OF CONSULTING ACTUARIES

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Work and Pensions Committee
via online submission

Dear Sir / Madam

Inquiry into "defined ambition" pension schemes

I am writing on behalf of the Association of Consulting Actuaries in response to the above named inquiry which we understand is concerned with a specific form of defined ambition scheme – namely collective defined contribution (CDC) schemes. You may wish to expand your inquiry to consider other forms of risk sharing.

Our comments on the specific questions raised in the consultation are set out in the Appendix. We have prepared our answers on the premise that the CDC model you have in mind involves risk sharing between members, with no risk being undertaken by the CDC provider or scheme sponsor.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful.

Yours sincerely

David Everett

David Everett
Chairman, Pension Schemes Committee
On behalf of the Association of Consulting Actuaries Limited

APPENDIX

Inquiry into "defined ambition" pension schemes

Benefits to savers and the wider economy

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

Yes. We believe that CDC models can provide more stable outcomes than pure DC schemes, but their downside risks for scheme members (which may be less than DC but more than DB) do need to be recognised from the outset and communicated clearly to them.

We also believe that CDC models can provide better outcomes than pure DC schemes due to the pooling of investment risk, access to more investment opportunities and the likelihood of remaining in return-seeking investments for longer. However, given that the trustees will need to smooth investment returns over time when delivering benefits, similar concerns may arise in due course as led to the downfall of with profit contracts – opacity allied with a concern that trustees will be overcautious in allocating surplus, because of reluctance to have to deal with deficits. Having said this, the comparison against with profits cannot be taken too far. Unlike with profits, the trustees of CDC schemes can scale back an overly generous award at some future point.

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

We are not convinced that the climate currently exists in the UK for such a continental-style collective approach to be a success in the medium term even if legislated for; and particularly so now that we have the "freedom and choice" approach to retirement savings in play. However, we caveat this by saying that we are not sure that sufficient research has yet been carried out in the UK into individual attitudes to collective schemes to enable this question to be answered properly.

There is, of course, no tradition in the UK of risk sharing between pension scheme members. Just because such systems operate elsewhere, such as in the Netherlands, does not mean that CDC could be a success in the UK. The Netherlands has different traditions of industry-wide provision and greater unionisation than the UK. Arguably we favour personal choice over social provision to a greater extent than in the Netherlands. And in any case, we understand that the Netherlands is currently revisiting its CDC model.

CDC schemes may well need a certain scale in order to operate successfully. So they may only appeal to the largest of employers. As importantly there needs to be a shared mutual trust between those participating – ie everyone agrees to share the risk and accept the consequences. A CDC scheme also needs stability in the demographic make up of its membership and through this a predictable flow of contributions. This may make such schemes unattractive as an employer-sponsored entity. It could be that only master trust type structures will wish to develop CDC offerings. Parallels can then be drawn between the forthcoming regulation of DC master trusts and that of CDC offerings – with issues such as high levels of governance, strong capital reserving and endgame plans needing to come to the fore.

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

We don't see why facilitating such collective schemes should necessarily lead to extra complexity and confusion insofar as scheme members are concerned, but CDC schemes will require more member communication and explanation than is necessary for current models of pension provision. In particular, members will need to have a clear understanding that the projected income levels are only an ambition, the potential causes of that ambition not being realised and risks that can crystallise even when the income is being taken. It will almost certainly be necessary for these messages to be repeated over time, with regulatory action as necessary to ensure that they don't get hidden in the small print. There is a clear danger that if the risks do not materialise for some years, that when they do, they will be found to be unacceptable to members due to a misunderstanding by them of the nature of CDC schemes.

A further issue that the trustees of CDC schemes will need to grapple with is intergenerational equity, particularly when it comes to allocating surplus and deficits.

Converting DB schemes to CDC

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

We don't see CDC as a potential solution to a stressed DB scheme. Rather, such a DB scheme could potentially look at implementing a benefit restructuring exercise, through which the DB promise is reconfigured to a level that is more manageable in relation to the employer covenant, whilst remaining above PPF levels. Converting accrued rights from DB to CDC would be as fundamental as conversion from DB to DC – ie with loss of the employer covenant and PPF eligibility.

It should, of course, be possible, perhaps as part of a reconstruction exercise, for DB members to be given an option to transfer to a CDC scheme, but that in essence would be no different to being given an option to transfer to a particular DC scheme.

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

Any direct switch from DB to CDC would be highly complex and prone to moral hazard, making an appropriate regulatory solution very difficult to deliver. We have not explored this further as we don't see the need for such a facility.

Regulation, governance and industry issues

6. How would CDCs be regulated?

The model that was being constructed through Part 2 of the Pension Schemes Act 2015 would need to be extended. This concerned itself with matters such as trustee duties to set targets, policy on factors used to determine benefits, contributions, investment and valuation, as well as the all important rules that would be needed to govern the distribution of deficits and surpluses. All of this would need to be fleshed out in regulations (on which work would likely have taken place had the result of the 2015 General Election led to the continuation of the Conservative-Liberal Democrat coalition). But in addition to this, it is likely that further primary legislation will be needed, as intimated in our answer to question 2.

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

We are not aware of any appetite amongst employers for CDC schemes, but this could change over time, especially if clear failings emerge within pure DC schemes which result in a number of employees seeking to work beyond ages that employers find acceptable.

Employers are likely to be concerned about “legislation creep”, turning a model within which risk is shared between scheme members into one in which the employer is expected to provide some guarantees. Having said this, it should not be as easy for politicians to do this with CDC as they did with DB.

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

Potentially yes as they should not need to be in a position under which all their funds needs to be sold at any point in time, but it will very much depend on the regulatory regime that they operate under.

About the Association of Consulting Actuaries (ACA)

Members of the ACA provide advice to thousands of pension schemes, including most of the country’s largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries’ Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes.

The ACA is the representative body for UK consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.