ABI response to Extending Opportunities for Collective Defined Contribution Pension Schemes

ABI response to DWP consultation

The UK insurance and long-term savings market and the ABI

The Association of British Insurers is the voice of the UK's world-leading insurance and long-term savings industry. A productive and inclusive sector, our industry supports towns and cities across Britain in building back a balanced and innovative economy, employing over 300,000 individuals in high-skilled, lifelong careers, two-thirds of which are outside of London.

The UK insurance and long-term savings industry manages investments of over £1.9 trillion, contributes over £16bn in taxes to the Government and supports communities across the UK by enabling trade, risk-taking, investment and innovation. We are also a global success story, the largest in Europe and the fourth largest in the world.

The ABI represents over 200 member companies, including most household names and specialist providers, giving peace of mind to customers across the UK. Please note we would be happy, and stand ready, to provide further information if this would be helpful to the Department for Work and Pensions.

For the purposes of this response, 'insurers' refers to insurance, reinsurance and long-term savings companies.

Executive summary

Ensuring people achieve a sustainable income in retirement is a critical policy goal, which DWP should consider further in its decumulation policy work. There are existing ways to deliver both security and flexibility, including by combining guaranteed income and drawdown. Collective Defined Contribution pensions could conceptually help more people receive a more predictable income for the rest of their lives but there are numerous regulatory, practical and consumer challenges that would need to be urgently resolved before provision should be extended to commercial schemes. We are supportive of innovation but any new models need to be well thought-out and regulated consistently. The proposals in the consultation paper are not sufficiently well thought out to enable the implementation of this concept in the real world.

Regulatory concerns

- Insurers are experts at pooling longevity and investment risk. However, insurers have not pushed for CDC as a new option because it does not fit well with the wider retirement options available, and it is unclear how it fits with the regulatory landscape.
- DWP legislation should allow for contract-based CDC solutions to develop, and CDC solutions offered by insurers within occupational schemes. To do that, DWP should work with the FCA and PRA to ensure an equal playing field, and that CDCs within occupational schemes are regulated appropriately, whether they are offered by an insurer or not, and that the same financial soundness and safety rules apply for all providers.
- The consultation paper alludes to little interest from contract-based providers, but if providers were to develop solutions in the future, the market would be skewed against them. Otherwise, FCA and PRA rules may set a higher bar for the firms they regulate, even if they only offer CDC through occupational schemes. Regardless of whether contract-based schemes do ultimately offer CDC, a future market for CDC could have impacts on the wider pensions market that affect FCA's and PRA's objectives, and it is therefore important they are closely engaged in the design of the regulatory framework.

Consumer protection

- It is unclear whether and how consumers would be protected if the scheme consistently undershoots the benefit target, or underestimates longevity, or ultimately fails. CDC members would not have access to PPF, nor FSCS from what we understand.
- These challenges and others set out in the decumulation section need to be resolved before provision is extended to commercial schemes (master trusts, or decumulation-only). DWP would benefit from separating these into prudential and conduct considerations, with more prescriptive prudential requirements, and conduct requirements including communications based on principles and outcomes.
- The industry has been working hard to address the fact that most consumers struggle to understand pensions, but at least in the case of DC and DB pensions, there are some safety nets like the PPF and FSCS. It is the complexity of CDC coupled with the lack of consumer protection that poses the biggest consumer risk.

Consumer understanding

- Explaining CDCs to consumers and ensuring they understand the product and the risks it entails is a significant problem, that left unaddressed, risks people disengaging with their pensions and distrusting the industry. CDC in a commercial environment will entail (at a minimum) decisions about whether or not to stay in them. To understand the risks they are exposed to, consumers need to understand that:
    - Their benefit targets may vary, that this means their benefits may entail cuts and there are no guaranteed floors.
    - Cross-subsidisation mechanisms (which may differ from scheme to scheme) mean that they may be advantaged or disadvantaged. However, it is unlikely people would understand this or the extent of cross-subsidisation considering only 35% of people know that their pension is invested in the stock market[1].
- There is merit in testing consumers' understanding based on scenarios before extending the legislation. The proposed requirements to discourage over-promising may not be enough to stop it from happening. Standardising the method of buy-in pricing would help, but that is a challenge in itself. The DWP-FCA value for money framework is a good starting point, but the FCA's Consumer Duty is also relevant and should be applied here; the Consumer Duty will apply to FCA-regulated firms offering CDC within occupational schemes where they can materially influence customer outcomes.

Decumulation-only CDCs vs annuities

- Creating a product that is perceived to be similar to an annuity and is not regulated as one raises concerns of regulatory arbitrage. Since the consultation, some pension organisations have explicitly promoted CDC as an alternative to annuities, and discussed the likelihood of CDC having guarantees attached in order to attract customers. However, there has been little or no consideration of the capital that would be required to back such guarantees.

- This also raises consumer protection risks. There is a danger that consumers may understand the targets to be guarantees. Consumers should not be misled to confuse the two products, nor focus solely on comparing annuity rates with target benefits of CDCs. CDCs can be part of a solution, but are not the only solution to decumulation, as they would not be appropriate for everyone when considering their health, risk aversion and preferences.

- Beyond this consultation, DWP need to decide on what support people should be given in decumulation. We think there is merit in pursuing some form of choice architecture and CDCs would need to be integrated as one of the options available, with the same communications requirements applying to CDC schemes. Given the risks and uncertainty that define these products, careful thought would need to be given to the formulation of such guidance to ensure consumers understand them.

Technical challenges

- There are also challenges around varied life expectancy. Customers with poor health will either enter CDC and be disadvantaged, or avoid CDC and disadvantage others in the scheme. There is a risk of adverse selection for schemes, whereby consumers who are more likely to live a longer life would want to buy in and stay in the scheme. Another key issue is consumers in ill health choosing to transfer out leaving behind a pool of people with higher longevity than previously expected. To address this challenge and ensure that consumers who would be better served by

[1] Hargreaves Lansdown survey, conducted by Opinium, https://corporate-adviser.com/only-a-third-of-people-know-that-their-pension-is-invested/

enhanced annuities are not sold CDCs, there is merit in requiring CDC providers to carry out mortality underwriting. This would, however, reduce the benefits of pooling and embed adverse selection. It would be easier to achieve for decumulation-only CDC than for whole-life CDC.

- The rules on transferring out would need to strike a balance between stability of the scheme and fairness. Careful consideration will have to be given to designing CDCs to avoid well-informed or advised consumers buying out in a market peak disadvantaging the others in the scheme; and to ensure that consumers who transfer out in adverse market conditions are aware of the reductions they would face – this reflects FCA expectations about explaining the significance and likelihood of a market value adjustment in a with-profits contract.
- A high number of transfers out could destabilise the scheme, or significantly reduce the value of benefits of the remaining members. Scheme design can help reduce the chances of a high number of transfers out in a period of poorer performance, by:
    a) smoothing out benefit increase and reductions over a period of time and
    b) keeping transfer values largely dependent on the reduction in asset value suffered by the fund

  However, the success of this approach also depends on consumers' understanding and trust that assets would recover over time, otherwise these friction mechanisms would not prevent transfers out of panic. In addition, the parameters for smoothing would need to be set out in regulation, as they would have an impact on cross-subsidisation.
- Another option is not allowing transfers out in decumulation, but it could leave consumers unhappy with a product (which may be significantly undershooting the target) and unable to transfer out. While annuities are also products that consumers cannot transfer out of, they will always have been chosen by the customer, they provide guarantees, and are covered by the FSCS. This raises the question of consumer protection and the trust of consumers in the industry overall.
- CDCs are difficult to explain to consumers in a clear and transparent way and involve risks that are hard to assess; in addition, transferring out in decumulation may not be permitted. All of these raise the question of whether consumers should require advice to buy or transfer out of such a complex product.

Question 1: Do you agree with the key principles we have identified as necessary for the new types of CDC schemes and in particular whole-life multi-employer CDC models? If not, please set out why.

1. The second principle set out in the consultation is that CDC benefits should only be offered in a trust-based environment for the time being and this would need to be revisited should an appetite for contract-based products emerge in the future. We don't think this is the right approach. Creating a regime that works only for trust-based CDC without taking into consideration how the FCA and PRA would view and regulate CDCs contract-based schemes offered by insurers is very likely going to skew the market (our focus is on insurers offering CDC, but it could plausibly be offered by other FCA-regulated firms). In addition, DWP should engage closely with the FCA and the PRA to understand how they would regulate insurers who offer trust-based CDCs. Key to this is whether the PRA would require insurers to hold capital against targets if they offered CDCs, making the same proposition a lot more expensive to deliver. Having layers of regulation from different regulators is also inefficient and costly to comply with. The FCA and the PRA should be involved in the development of a regime that is broadly aligned for trust-based and contract-based.

2. Regardless of whether contract-based schemes do ultimately offer CDC, a future market for CDC could have impacts on the wider pensions market that affect FCA's and PRA's objectives, such as consumer protection, competition and safety and soundness. This is particularly the case if decumulation-only CDCs offered guarantees based on underwriting factors personal to the individual, as has been described by prospective CDC providers or consultants.

3. CDCs would also need to be integrated in the decumulation framework. All FCA requirements in the lead up to retirement, which we expect to be extended to occupational DC schemes, should also apply to CDCs scheme, such as retirement option statements from age 50 and signposting to Pension Wise.

   Therefore, it is important that DWP and regulators engage now in the policy development and regulatory framework.

4. Another key principle proposed in the consultation is that any adjustments made to benefits will be made without variation across the membership. According to research by Prof Catherine Donnelly [2], adjustments to benefits without variation result in a risk transfer from the older generation to the younger generation. This transfer is difficult for scheme members to understand, yet is key to them being able to evaluate their risks and options and therefore, represents a considerable challenge from a communications perspective.

Question 2: Do you agree with our thoughts on what requirements might need amending to accommodate these new CDC designs? What new triggers for sectionalisation other than a change to the actuarial plan do you envisage might be appropriate in these new schemes?

Question 3: Should the definition of "operates" at section 7(5) of the 2021 Act be amended for whole-life multi-employer CDC schemes? If you agree, please set out how.

Question 4: How might legislation capture persons performing the functions listed at paragraph 39 in commercial and sectorial schemes so that they are within scope of the fit and proper persons test? Are there other persons that should be brought within scope of the fit and proper persons test for these new schemes?

5. We agree that the proposed persons should be within the scope of the fit and proper test.
6. In addition, senior managers responsible for signing off actuarial calculations should be subject to the test. With no backstop, any mistake leaves consumers without protection.

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[2] Professor Catherine Donnelly, How does Royal Mail's CDC scheme 'smooth' pensions? https://blog.actuaries.org.uk/how-does-royal-mail-s-cdc-scheme-smooth-pensions/

7. Senior managers responsible for marketing, promoting and member communications should also be subject to fit and proper tests. This is because CDCs are a complex product without the same consumer protections that other products enjoy and getting communications right is important.

Question 5: Do you agree that those marketing and promoting CDC schemes should be within scope of the fit and proper persons test where certain conditions apply, and if those conditions should be similar to those in Master Trust schemes?

8. Yes, promoters or/and marketers should be within the scope of the fit and proper persons test. However, we don't think that the conditions that currently apply to DC Master Trust – of influence and financial motive – should be applied to CDCs. The risk of over-promising, the variable targets, and the opacity of the risks to which members are exposed as well as the lack of consumer protection, make the promoter/ marketer's role more important than in other types of schemes. All senior managers who have these roles should be subject to the test.

Question 6: Are any changes or additions needed to Schedule 1 of the 2022 Regulations in respect of matters to be taken into account by TPR, as part of the fit and proper test to reflect the new roles envisaged to exist in sectorial and commercial schemes?

Question 7: Are the current scheme design requirements including the tests still appropriate for assessing soundness in the new whole-life multi-employer schemes? Are there any additional soundness considerations or tests needed in light of the new designs?

9. We agree that the scheme actuary has to be satisfied that the actuarial advice being used to underpin key communications is properly used, including employers' and prospective employers' communications. To ensure communications are not misinterpreted by members, especially considering the complexity of CDCs, mechanisms to test the understanding of members, such as regular member surveys and member fora, should be required, in line with the FCA's Consumer Duty principles. Gathering, evaluating and taking into account member feedback is already included in the factors that TPR would consider in order to decide whether the scheme meets the member communications requirements. We suggest that rather than being encouraged, such mechanisms should be required.
10. There are other considerations for schemes' soundness that may be even more important in a commercial environment and in the absence of a single employer: firstly, longevity risk, measured over a longer period than the next five years; and secondly, the risk of transfers out undermining the scheme.
11. The viability report and certificate require the evaluation of the scheme's actuary. Considering the lack of a backstop or consumer protection, there is merit in considering an independent actuarial evaluation.

Question 8: If a scheme funder equivalent is introduced for the new whole-life multi-employer CDC schemes including Master Trusts, should similar scheme funder requirements to those in the DC Master Trusts regime apply? Are there any changes needed to ensure there is a clear focal point for TPR's scrutiny and liability for meeting the relevant costs?

Question 9: Should business plan requirements, similar to those for Master Trusts, be introduced for commercial and sectorial CDC whole-life multi-employer schemes? What, if anything, should change? Who should be responsible for preparing the business plan?

12. If CDC Master Trusts aspire to targets that at least keep in line with inflation, their financial sustainability plan should reflect that.
13. A key risk for CDCs schemes is that they might fail to achieve a level of scale required to become sustainable. That is why schemes should have clear plans for generating scale, as well as plans for what happens if they fail to do so or if they see significant numbers leaving the scheme later on.

Question 10: Do you agree that the existing requirements should apply to new whole-life multi-employer schemes and are additional requirements needed to help ensure that communications used in promoting and marketing the scheme are not misleading? How might Schedule 4 of the 2022 Regulations be amended to achieve this?

14. Clearly explaining CDCs to members is one of the biggest challenges that CDCs face and that can make an impact on consumer trust in the industry overall. We support the additional requirements and, as noted in the answer to Question 7, there is merit in considering a stronger requirement for testing members' understanding and drawing on FCA rules where relevant.

Question 11: Are any changes or additions needed to the requirements in Schedule 5 of the 2022 Regulations to reflect the new designs and relationships anticipated in the new whole-life multi-employer schemes?

Question 12: Do you agree that it is reasonable for the existing requirements in regulations 15 and 16 of the 2022 Regulations to apply to the new whole-life multi-employer CDC schemes, and that the continuity strategy should include an aspiration to operate the scheme as a closed scheme?

15. Being able to run closed schemes, when they are no longer commercially viable, requires reserves. It also raises the question of scale, given that the closed scheme could have transfers out, leaving the scheme more and more exposed to risks.

Question 13: Do you agree that most of the existing requirements can read across to the new whole-life multi-employer schemes? What changes including the one proposed above do you think should be made to the existing requirements and why?

Question 14: Do you think that the list of events in regulation 23 of the 2022 Regulations needs amending for the new whole-life multi-employer CDC schemes? If so, why? Are there new events that should be added or current events that should be removed?

Question 15: Do you agree that the list of triggering events that apply to single or connected employer CDC schemes needs some revision to accommodate whole-life multi-employer CDC schemes? Are there new events that should be added or current events that should be removed?

16. We agree with the suggestion of removing the insolvency of an employer from the list of triggering events and introducing the trigger event of a scheme being at risk of failure. This underlines the need for close and continuous supervision to prevent failures with a clear plan in place where there is risk of failure. In addition, not obtaining a viability report or certificate should be added to the list of trigger events.

Question 16: Is a similar approach to the wind up commencement time (and the cessation of contributions/accruals) appropriate in respect of the new whole-life multi-employer schemes? If not, why not? Given AE obligations, how might participating employers be provided with sufficient opportunity to make alternative arrangements, before contributions are prohibited in the whole-life multi-employer CDC scheme being wound up, whilst managing risks to members?

17. Treatment of pensions in payment in the event of wind-up is a particularly important consideration, given that there may be very few CDC schemes and the reasons for the wind-up of one scheme may also affect other schemes.

Question 17: Are the current default and alternative discharge options sufficient for the new whole-life multi-employer CDC schemes?

Question 18: Do you agree that the existing framework for the wind up of a CDC scheme can read across to the new whole-life multi-employer schemes? What changes, other than the ones mentioned above, do you consider should be made for these new schemes?

Question 19: Do you agree that the existing requirements, outlined in Chapter 10, which apply to single or connected employer schemes can be read across to the new whole-life multi-employer CDC schemes, other than where a modification

has been highlighted?

Decumulation only

Question 20: Who would be responsible for meeting the costs of establishing the arrangement and the short-medium term operating costs?

18. The provider should be responsible.

Question 21: How could such arrangements establish scale and what evidence is there to support this? In addition, until such schemes achieve and maintain scale do commercial providers envisage providing the funding needed to smooth volatility and deliver the aspired to pension benefits? How would the potential issue of small pots be addressed?

19. Schemes should only be able to offer decumulation-only CDC once they have scale. As the consultation says, "there is likely to be less certainty about future on-flows into a decumulation only CDC arrangement. This has significant implications for the sustainability of the arrangement and what that might mean for pensioner benefits." A CDC scheme would have features of a Ponzi scheme if it did not have sufficient scale or reserves to deliver the benefits without reliance on flows from new customers. As the SEC describes it, "Ponzi schemes require a constant flow of new money to survive. When it becomes hard to recruit new investors, or when large numbers of existing investors cash out, these schemes tend to collapse."
20. The 'minimum value of benefits' live running test for CDC schemes is that "the value of the benefits expected to be provided to each active member in respect of the five-year period beginning with the effective date of the viability certificate is at least equal to the contributions payable to the scheme by the member over that period". A similar test would presumably apply to decumulation-only CDC, but over a longer period than 5 years; and this effectively means that schemes would need to hold capital against this minimum value.

Question 22: What mechanism should be used to determine the price at which people might buy into a decumulation only CDC arrangement and what can be done to ensure individuals are treated fairly? In addition, should mortality underwriting be a feature of these arrangements, and how would this best be done?

21. DWP will need to decide on which factors it hopes CDC schemes will compete, and this relates directly to prudential and conduct regulatory questions:
    - Whether mortality underwriting and personalised pricing is permitted – if so, this would reduce the benefits of risk pooling and should feed into the approach to prudential regulation; if not, this increases the adverse selection risk and raises fairness questions for people with lower life expectancy, who could buy a product that does not deliver a good outcome for them. There have been a number of interventions related to this in the retail annuity market. To ensure consumers who could buy enhanced annuities are not getting a suboptimal outcome and address adverse selection, there is merit in personalised pricing based on mortality underwriting.
    - If underwriting is permitted, whether a spouse's income must always be included, the extent of mortality underwriting of spouses, and the extent to which this is a choice for the member to make.
    - Whether add-ons are permitted, as have been proposed by prospective CDC market participants, such as money-back guarantees or guaranteed periods, and what capital requirements would be put in place to back these guarantees.
    - How close these features are to those of lifetime annuities, and therefore how it could affect the annuity market, and why its regulation should differ.

Question 23: What steps can be taken to ensure communications to members help them understand how these new arrangements will work and how can consistent standards be achieved in the way commercial arrangements market their products to prevent over-promising?

22. Over-promising is a difficult challenge as CDCs do not have guarantees; therefore having a consistent buy-in pricing

mechanism is necessary. Two points of fundamental importance are not mentioned in the paper in relation to decumulation-only CDC: longevity risk, and transfers out once pensions are in payment. These are critical factors for scheme members to be aware of and for the policy and regulatory framework to manage clearly.

23. One option in relation to over-promising is setting out the target alongside the expected returns and expected volatility, and presenting them as central (target) and optimistic and pessimistic scenarios, or a target with a ceiling and a floor. Schemes promising high returns would equally have to set out lower pessimistic scenarios. The danger with this is that pessimistic scenarios or floor may be mistakenly understood by consumers as guarantees.
24. Whatever mechanisms against over-promising are decided on, supervisory scrutiny is essential to ensure they are effective.
25. The difficulty of communicating this model to consumers in a clear and transparent way, of assessing the risks that they are exposed to and the likely inability to transfer out in decumulation raise the question of whether consumers would require advice to buy or transfer out of such a complex product. The very concept of CDCs is meant to give a simple solution, a pension for life, that does not require customers to make complex decisions like choosing their investments or managing their savings to have enough for their whole life.

Question 24: What other changes in addition to those set out in this document, do you think need to be made to ensure the effective and fair operation of decumulation only CDC arrangements?