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PASA CDC Working Group

Initial Observations on CDC Developments

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Emma Watkins (Board Sponsor)	**PASA Board Director**
Helen Ball (Chair)	**Sackers**
Emma Douglas	**Aviva**
Kevin Wesbroom	**Capital Cranfield**
Tom Hargreaves	**Barnett Waddingham**

1 Introduction

The PASA CDC Working Group aims to monitor, comment upon and gather information about the administration implications of collective defined contribution (CDC) arrangements and their role within the pensions industry. This paper highlights recent policy and regulatory references to CDC arrangements and indicates where things may be heading next.

It's too early to know what model of CDC will evolve but, in addition to commercial and consumer considerations, the administration of any CDC arrangement will need to be integral to its design in order to be effective and deliver value for money. With this in mind, we've set out some initial administration considerations below.

In this paper we distinguish between what we see as the next two phases of CDC – namely, the expansion from single employer to multi-employer whole of life CDC schemes, and then to post retirement decumulation CDC schemes. It appears decumulation CDC schemes will need to overcome a greater number of hurdles than other CDC schemes before they can begin operating, but these hurdles need to be addressed to make CDC benefits accessible to a larger part of the population.

2 Background

During the last 18 months, references to CDC and the potential role it could play in a future DC marketplace have grown. These developments show momentum is building towards giving serious consideration to CDC as a potential solution to some of the current challenges facing pension savers.

- In July 2023 the Government published its response to a consultation proposing the extension of CDC from single employer to multi-employer and 'retirement only' pension schemes.
- The Chancellor's Mansion House speech in July 2023 and the Government's Autumn Statement in November 2023 led to a wider discussion about the role CDC could play in improving pension choices at retirement and in the policy decisions relating to default consolidators
- TPR issued two key updates in November 2023. The first explained we're on a journey towards fewer, larger, well run schemes. The second set out the five principles which will guide their approach when helping savers to access their DC pension savings. These principles included a call for innovation - to bring CDC schemes to the market, to extract greater value from DC pensions and help people with their retirement decisions
- In December 2023, HM Treasury and the FCA published policy paper DP23/5 with their proposals for closing the gap between financial advice and guidance
- Towards the close of the year, the Pensions Policy Institute (PPI) also added its voice to the mix, by publishing an independent research report specifically looking at the role of CDC in decumulation. This provided a detailed explanation of the challenges such schemes could face and what will need to be considered before they can slot into the current retirement market

It's clear policy makers and regulators are seeking to address important questions about the nature of pension saving and how innovation can be combined with scale, choice and support with decision-making, to provide new opportunities for improving saver outcomes. CDC is seen as a potential means of answering these questions.

However, this is a developing area which is heavily influenced by policy which could change direction if there's a change in government. Introducing some degree of cross-party consensus on the future of CDC could help ensure sufficient time is dedicated to dealing with the challenges of establishing a CDC market, while minimising concerns any time spent on development could be wasted.

3 Initial views

3.1 There's a growing interest in CDC as a potential solution

If we can find a way of collecting individual DC savers together to create scale, obtain value for money and provide better options at retirement, this could be an effective way of addressing some of the current problems in relation to DC savings.

There's a growing body of research showing CDC can provide better retirement outcomes for savers than existing DC solutions. Although it seems unlikely this will be a 'silver bullet' suitable for everyone. There will remain scenarios where some individuals could be worse off under CDC than under a traditional DC arrangement, and it may not be possible to know who those individuals are in advance.

We're starting from a premise CDC could be a good solution for many people, particularly in decumulation where savers don't want to, or can't, make informed decisions about how to spend their DC pot at retirement.

3.2 There are some potential pitfalls

Before we open the gateway to using CDC multi-employer schemes and/or CDC decumulation only schemes in practice, there are risks to guard against. For example:

- **Building scale** – a CDC arrangement is much more vulnerable without scale, and poor performance in early years could limit the extent to which a 'commercial' multi-employer arrangement can grow. In a whole-life arrangement this means getting employers who have already moved to DC to move 'back' to CDC. This is unlikely to be attractive during the accumulation phase. In decumulation-only arrangements this might mean looking at ways to 'seed' the scheme. The PPI report notes it may take 30 years for membership to become stable. However, policymakers and market players could explore ways to make this transition more quickly

- **Competition** – multi-employer arrangements may either come from industry groups or commercial providers such as master trusts or group contract arrangements. Without commercial competition, there won't be a thriving decumulation CDC landscape. However, the more of these arrangements which exist, the harder it will be for each individual arrangement to reach scale. So although we need competition, there mustn't be too much

- **Communication** – savers will need to understand how CDC benefits work in practice, and particularly the possibility of lower than expected increases to their income, and even potential decreases. The way the PPI envisages CDC operating could lead to higher levels of volatility than had previously been expected. This is because instead of simply increasing or reducing the rate of future pension increases, there could be additional 'one off' adjustments which keep the rate of increase within 2% of CPI. This means in good/bad years the income levels could go up or down significantly, increasing the overall income volatility. Past industry experience suggests any reduction to income received from a CDC scheme could be followed by challenge from savers, regardless of how well the possibility of income reduction is communicated in advance. We've seen this, for example, with pushback from pensioners in occupational pension schemes against the concept of capped pension increases during a period of high inflation. It'll be important to manage saver expectations and understanding of the risk of reductions (which doesn't always mean those will be material reductions)

- **Commercial constraints** – if providers offering CDC are to be rated in any way (perhaps to assist with employer or member decision making), the prospect of reductions in income levels resulting in a 'poor' rating could make it an unattractive product for a provider to develop. If nobody will buy the product it could adversely affect the wider reputation of the organisation

- **Fair risk sharing** – the existing market provides some benefits of pooling on the investment side but CDC builds on this and adds longevity pooling. From a social perspective this means those with lower life expectancies subsidise those with higher life expectancies. Underwriting may be possible in a decumulation-only environment (as discussed in the recent PPI paper), but the more CDC becomes 'individualised' and bespoke, the probability increases of losing the collective benefit or value to be gained. This is worth bearing in mind as we go along, or we could spend a great deal of time and energy creating something which doesn't meet the original design brief

- **Investment** – it's been suggested investment performance is the biggest determinant of outcome, which means a saver could get lucky (or not) in their choice of CDC scheme. The PPI report suggests there will need to be a trade-off between volatility of income and growth of income with decumulation CDC schemes. The closer a scheme needs to cling to its security blanket though, the more it looks like an annuity but without the guarantees. If the product gets too close to an annuity it could start to become unattractive because it no longer fills a gap in the market, making it a solution nobody wants to buy. Even if people buy the solution, it could make it an offering which providers suffer 'regret risk' from at a later date, as they will worry about justifying the outcome to their customers

- **Advice requirement** – It's an open question as to whether decumulation CDC schemes need to be treated as an advised purchase. Given CDC's irrevocable nature – once you join, you can't leave, and it can't be passed to future generations as part of wealth planning – and given it's not a simple product, it's likely advice or at least guidance or the new 'tailored support' being proposed by HMT/FCA will be needed. If something stronger than guidance is needed, this could shrink the market and its commercial attractiveness to providers. Alternatively,

there are some who feel strongly decumulation CDC shouldn't be an advised product. Rather it should be a default product for savers who don't or can't make an informed choice. If this is the direction of travel and, as a result, savers end up in a scheme which they're unable to leave (because their membership becomes irrevocable) this would run contrary to the principle underpinning pension freedoms. It poses difficult questions for us all to consider. This is a wider question outside the scope of this paper and will ultimately be determined by policy makers

- **Transfers out** - It currently appears it won't be possible to transfer out of a decumulation CDC scheme, as this would require individual underwriting on the way out (which could be very difficult to obtain in practice). This makes any decision to join such a scheme at retirement an irrevocable decision, which increases the need to ensure a saver is aware of the consequences of entering into such a scheme

- **Exit** – There could be a systemic issue if the market experiences underperforming CDC schemes. It raises questions as to whether some form of regulatory intervention would be needed from TPR to force a wind-up or merger into another CDC scheme. The November 2023 DWP paper on Trends in the Defined Contribution trust-based pensions market and our experience gained from working with master trust consolidations to date, shows even when dealing with vanilla DC scheme benefits in master trusts, such wind-ups and mergers aren't straightforward. Further thinking will need to be given to a range of potential scenarios related to exit, to ensure appropriate regulatory provisions are built into any expanded CDC remit

3.3 Impact on administration

It's too early to know what model of CDC will advance through the various prototype stages of development to materialise as a fully-fledged working model.

There are different kinds of CDC benefit models and each will require different types of data to be captured, and different systems to be applied in order to calculate, process and administer the chosen benefit design. Working on the basis any CDC scheme would require quite a different – and simpler – approach to the current large scale DC arrangements, administration of CDC may more closely resemble the administration of a large DB scheme in some respects.

The practical impact of the chosen CDC benefit model on administration must be built into the regulatory framework. This will avoid costly mistakes and ensure we end up with a user friendly product which is sufficiently attractive to marketed commercially. Otherwise, all the effort to get the concept off the ground could be wasted.

In an ideal world, the administration of CDC arrangements will need to:

- be simple and flexible enough to avoid unnecessary complication (and therefore costs)
- be capable of automation and digitisation

- be able to work within or alongside existing 'scaled up' solutions which now dominate the automatic enrolment and wider DC market, such as master trusts and GPPs
- avoid a solution which relies heavily on input from what could be a limited resource, such as actuaries, advisers and experienced administrators
- be efficient and future proofed, which includes being able to answer questions such as:
  - what's the current value of the saver's entitlement or transfer value? This will be needed for modelling tools, annual benefit statements, and responses to dashboards search requests
  - what happens on the death of the saver? For example, will there be any kind of guarantee or return of premium due to a saver of a decumulation CDC scheme on death?
- be capable of integration with other systems and processes, to create a seamless 'product' from an end user perspective, particularly the actuarial and communication elements of CDC design. For example, if there's an individual transfer value request, it wouldn't be a simple question of looking up the saver's pot value because the CDC scheme calculation would look and feel more like a DB transfer value. In a multi-employer CDC context, this might require the administrator to put a daily figure on the level of sustainable future increases expected in the saver's particular benefit section. Actuarial judgment may need to be built into the calculation process. The integration of administration and actuarial systems could therefore be crucial to the ability to effectively and efficiently operate the CDC scheme

4. Where to next for CDC?

Draft regulations for multi-employer CDC arrangements are expected in 2024 and this will hopefully shed more light on how government intends to develop CDC schemes. It would be helpful to have cross-party consensus on this to ensure the industry can have the confidence to commit to moving this forward.

In a recent DWP call for evidence regarding more radical proposals for the future of pensions savings, it's been suggested CDC could act as a 'lifetime provider' in the longer term. However, it would take considerable time and political goodwill to bring such a model to market. There's a long way to go before this kind of model is likely to be in operation by either a DC or CDC provider. Given we're still only in the foothills of CDC development, this crossover territory between lifetime provider and CDC models would be something to revisit when the CDC market has become more developed.

In the meantime, we expect to see further analysis from the industry on the potential benefits and hurdles of developing CDC in the UK. As thoughts are fine-tuned this will give more scope to work on how these arrangements should be administered. PASA is keen to speak to other groups and organisations to assist with their work as those discussions progress.

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Get in touch:

info@pasa-uk.com

www.pasa-uk.com

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Company number: 6597097