Capital Cranfield

Written response to the Work and Pensions Sub-Committee Inquiry on Collective Defined Contribution ("CDC") pensions from Capital Cranfield Pension Trustees Ltd

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Executive Summary

We welcome the Work and Pensions Sub-Committee's ("WPSC") inquiry into CDC pensions and this opportunity to comment on it:

- It is important, from all perspectives, to be very clear on what definition of CDC is being proposed.
- CDC offers greater efficiency of provision than defined contribution ("DC") and, therefore, has at least theoretical advantages in the scenario where defined benefit ("DB") benefits are converted to DC.
- CDC might be a useful alternative to DB for future accrual of benefits. However it is difficult to see any way in which existing DB benefits could be converted either with or without member consent.
- We do not believe there is any appetite among employers to shift from DC to CDC, especially as it implies increased employer costs. Equally we are unclear that HM Treasury would support such an increase in tax relief costs or redirection of employer resources from a market perspective.

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Capital Cranfield is a Professional Trustee and governance firm. We have no ties with any other organisation, with all our shares being owned by our Professional Trustees and staff.

We have 37 Professional Trustees, working with us covering some 270 trustee appointments. We are submitting this response as we have a particular interest in DC with our appointments covering Master Trusts, Independent Governance Committees, stand-alone trust based DC arrangements and the DC elements of hybrid schemes.

The WPSC's key questions

You have asked a number of key questions and we offer our views and supporting evidence below.

Benefits to savers and the wider economy:

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

We start from a position of wanting CDC to work. In theory it should be a more efficient structure than traditional DC structures due to a combination of benefits of scale and spreading of risks (investment and longevity) between member cohorts and members and therefore provide better member outcomes. However the same could be said for significantly higher State pensions. The problems mostly lie in the practicalities, details and opportunities for selection by some members against others.

There is a lot of literature on the subject from a number of disparate sources, unfortunately often with vested interests, and terms are often used interchangeably, for example, when is "collective DC" really DC and when is it actually just conditional DB? In the UK, the CDC argument has not been helped by over-selling of the benefits and "heroic" assumptions (some of the comparisons quoted use DC charges of 1.5% pa as their DC benchmark – that is double the charge cap and up to three times typical comparable charges).

The work the Pensions Policy Institute ("PPI") produced in their November 2015 modelling report (together with their briefing notes BN 69 and 71 on the Dutch and Canadian

CDC regimes) is a clear summary of the potential benefits. In broad terms it ascribes a potential increase to outcomes of approximately 20% to CDC designs compared to DC. In principle, these gains are made by looking at the key elements of consolidation, wider pooling, etc, but most of these are already underway through other initiatives. For example, Pensions Act 2017 is predicted to see greater consolidation among master trusts and the FCA's work on asset management and platforms is likely to lead to some rationalisation in those sectors as well.

Nevertheless, the consensus view, with which we agree, is that even if CDC does not offer significantly better benefits than DC it is unlikely to result in worse benefits overall and is therefore definitely worth considering further.

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

Although the PPI work is exemplary, it focuses on provision of retirement income rather than lump sums at retirement. The benefits of longevity pooling account for a significant part of their assumed 20% outperformance. If, and it is a big if, "freedom and choice" results in long term choices predominantly being for a lump sum taken from pensions rather than an income spread over the member's remaining lifetime, the outperformance will largely disappear. However, once the DC (or CDC) market begins to mature in 10 to 20 years, DC pots will grow to a value where members will start to consider options other than "disinvest and spend".

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

This is a key question – one that the Dutch government wish they had addressed much earlier than they did (see PPI's Briefing Note 71 from October 2014). However, if potential members fully understood the risks and cross subsidies in advance would they volunteer for membership? One of the key principles of CDC is the risk pooling, but if younger members are taking the risks and older members gaining the benefits this is unfair unless some other equalisation factor is introduced (for instance paying those younger members increased returns to compensate). If that route is taken however, benefits for older members fall and the "20% outperformance" level reduces.

In addition, to be fair (and minimise the risk of age discrimination) benefit accrual rates should reduce for each £ of contribution as members age. This will obviously add to the complexity of design and communication.

Since the concept of the CDC was initially raised towards the end of the Coalition Government, we have seen the initial results to the introduction of automatic enrolment and the significant growth of the DC Master Trust. From a governance viewpoint the Master Trust is easier to run and simpler to understand by both Employers and its membership. In addition, the April 2017 Pension Act and the new proposed authorisation process currently being consulted on by DWP and TPR will add greater security to this type of DC vehicle

Having said all that, there may be scenarios in which CDC could work - but only if the risks and rewards are shared fairly between young and old, short tenure members and long etc. Otherwise you will need to make it compulsory to get younger members in, which brings in a whole new crop of problems. Equally, CDC as a form of group variable annuity scheme might work - so long as you avoid cross subsiding from blue collar workers in Glasgow to accountants from Surrey (or indeed, vice versa).

Converting DB schemes to CDC:

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

The Dutch have not really achieved "collective DC" as it has been widely reported that they faced quite a lot of resistance, particularly from younger member cohorts, but a handful of schemes (e.g. Shell) were actively looking at implementing it, largely in the decumulation space to address some of the failings of DC and what was a very restrictive annuity market in the Netherlands. Most of the benefits to members come from maintaining a decent amount of investment risk beyond the usual retirement age combined with pooling of longevity risk to ensure that an individual has sufficient funds throughout their retirement.

Our understanding of that work (from Amsterdam based consultants who have advised a number of such schemes) is that unless you have very well defined contracts and manage members (both active and pensioners) expectations from the outset some party, at some point, is going to be disappointed. In practice CDC is seen, in the Netherlands, as DB (including the option to cut benefits in payment) but with DC accounting standards. In the conditional DB style models (Dutch and Canadian models) there are still a lot of judgements that need to be made by trustees and stakeholders around how funding levels are assessed and discount rates are set. The Danish ATP model seems the most transparent and stable but requires some solvency buffers to be in place to the extent that a hard guarantee is being offered to members.

Also, trustees may be reluctant to agree to any conversion of underfunded DB benefits to CDC when considering the additional protections/remedies that are available to underfunded DB schemes. Firstly, trustees' must look to the DB scheme's sponsor as the primary agent for addressing funding deficits and unless the trustees (or the Pensions Regulator) believe that the sponsor will not be able to meet all its obligations, the assumption is that the scheme will ultimately become fully funded, Even if it is felt that that the employer will not be able to fund the shortfall, there are usually remedies to help the members whether that's through changing indexation (the RPI v CPI debate), reducing other benefits or ultimately the PPF if an insolvency event occurs. Conversion to CDC raises the question of what protections would then be available to members.

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

There are two broad methods potentially available for converting members' DB to CDC – with consent and without consent.

Before we consider these, we would note that before any such conversion legislation would need to account for, and make very clear to members, exactly what falls into the definition of DB. We assume that the WPSC is considering this definition, having regard for how the status of a scheme can differ between a pension definition and a tax definition. So, for instance, a cash balance is DB for pension legislation purposes but DC from a tax legislation perspective.

Apart from significant questions over introducing further complexity to these definitions (and the interaction with freedom and choice), if it is being suggested that DB benefits can be converted to CDC without member consent then this raises a number of tricky points, for example:

- We already have a process for dealing with DB schemes where the employer has failed, in the form of the PPF. Where the employer has not failed, it would seem contrary to public policy that their employees with DB benefits could be worse off as a result of compulsory conversion to any form of DC than those whose employer is insolvent.
- Which stakeholders would decide whether benefits should be switched to CDC without member agreement? It is not a choice that trustees of a scheme with a solvent sponsor would find easy to exercise and therefore they are unlikely to welcome such a power. In most cases, if the members would be better off in the PPF, the trustees are likely to want to refuse to convert the benefits and wait for insolvency. If it is an employer choice, how would this interact with its implied duties of trust and confidence and meeting the pension promise that it has given to employees? In addition, what checks and balances would be in place to ensure that the choice was one of financial necessity rather than prudent cost saving? Would conversion only be available if the employer covenant was weak – if so, how and by whom would this be assessed?
- On conversion, would the members bear the whole cost of the underfunding or would this be split with the employer picking up some of the pain? The former would seem to go against all the legislation on section 75 and present clear moral hazard implications in a number of respects. Depending on the magnitude, the latter could jeopardise the viability of the employer.
- It is not clear how you would navigate section 67. Currently conversion from DB to DC is a protected modification that requires member consent. Even if that requirement were removed in the case if CDC, it is difficult to see how the conversion would meet the actuarial equivalence requirement.
- If the proposal is that accrued DB rights can only be converted to CDC by following the s.67 route, we do not see much incentive for employers to favour CDC over closure to DB accrual followed by DC for future service. The more paternalistic employers may possibly investigate the concept, but the bulk will stick with the safe option (for the employer) of DC.
- All of the above issues are complex both in terms of regulation and calculation of risk versus reward. If such a conversion was only available with member consent we have real concerns over the ability of members to properly understand the relevant factors and make an informed decision.

Regulation, governance and industry issues:

How would CDCs be regulated?

We referred earlier to the difficulties in UK legislation of defining DB and DC benefits from both a pension and tax perspective. Introducing yet another version will be problematic to say the least. If an insurer were to offer such a product, would it fall into the category of contract based pension rather than trust based occupational pension?

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

We believe that CDC may be feasible for some large employer sponsors, however it is our understanding that there has only been limited interest openly expressed to date. This may be part due to the inherent complexities and it is hard to gauge how much appetite there would be once the questions we raise earlier are resolved. The inertia factor could also be relevant in existing DC arrangements – if there was no incentive to the employer in moving from DC to CDC, the time and expense that the conversion would take might well make them loathe to embrace the idea. By contrast, consultants would probably have appetite to encourage CDC as the work advising their clients would generate additional income.

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

DB schemes already have clear long term investment objectives. We are not clear how CDC would help other than a shift from bond like investments to other asset classes. It can be argued that this would be a good thing despite the reduced correlation to liabilities. If the WPSC is clear that this an objective then a simpler route would be to mend existing regulation in respect of DB schemes.

Other areas:

Could CDC be a realistic alternative to DC?

Rather than reopen the whole debate on "CDC" for the third time in recent years the more productive ground for the WPSC might be to identify where some of the potential benefits of CDC can be transposed across to the existing UK landscape (e.g. innovative at scale solutions for DC decumulation that allow for longevity pooling, and conditional indexation for what DB schemes are still open and can change any of their terms going forward). There also needs to be a discussion about accrued rights – if those remain untouchable under S.67 then there may be a lower incentive for DB schemes to go through the pain of restructuring or "converting" to CDC. As we recall the Canadian plans were able to make changes to accrued rights as well.

Queries

Should you have any queries or need any clarification on the points we have made please contact Neil McPherson on 0207 012 8700 or n.mcpherson@capitalcranfield.com.