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Defined ambition pension schemes

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Summary

This note looks at the Coalition Government's legislation for a new category of pension scheme – shared risk, or defined ambition – and its framework to enable schemes to provide collective benefits.

The background to this is that there are two main types of workplace pension scheme:

- Defined Benefit (DB) schemes that typically promise a pension linked to salary and length of service; and
- Defined Contribution (DC) schemes that pay out a sum based on the value of a member's fund on retirement.

A key difference between these scheme types is who bears the risk. In DB schemes, longevity, inflation and investment risks are borne by the employer, whereas in DC schemes they are borne by the employee and there is a very high level of uncertainty about the level of income they can expect in retirement.

The Coalition Government consulted on the possibility of encouraging the development of 'defined ambition' (DA) pension schemes, the aim of which would be to create greater certainty for members than is provided by a pure DC pension, but at less cost volatility for employers than current DB pensions.

As part of this, it looked at how collective defined contribution (CDC) schemes might work in the UK. Its proposed model had a fixed contribution rate for employers, a target pension income for employees (with provision for this to be adjusted if the scheme is under-funded); and pooling of scheme assets (rather individual funds for each member), with an income paid from this pool at retirement. It found that this approach could provide greater stability of outcomes for individuals than traditional DC, with pension incomes less dependent on market conditions at the point of retirement. However, certain conditions appeared necessary to enable them to operate successfully – in particular, large scale and strong governance. (DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013, chapter 5).

It legislated in the *Pension Schemes Act 2015* for a new category of 'shared risk' pension scheme and a framework for schemes to provide 'collective benefits'. The debates on the Bill are discussed in:

- SN 7030 Pension Schemes Bill 2014/15 – House of Commons stages (Dec 2014)
- SN 7105 Pension Schemes Bill 2014/15 – House of Lords stages (Feb 2015)

However, after the 2015 election, the Conservative Government put these proposals on hold, to enable the Government, industry, employers and scheme members to concentrate on the implementation of other reforms already in the pipeline – the new State Pension, auto-enrolment and the pension freedoms (HLWS 238, 15 October 2015).

Following consultation, it decided to legislate for a new framework for CDC schemes in the *Pension Schemes Bill [HL] 2019-20.*

1. Introduction

There are currently two main types of occupational pension schemes:

- Defined Benefit (DB) schemes, that typically promise to pay a pension linked to salary and length of service; and

- Defined Contribution (DC) schemes, that typically pay out a sum based on the value of a member's fund on retirement. The level of pension depends on factors such as the level of contribution paid and investment returns.

A key difference between these types of schemes is who bears the risk. In DB schemes, the risks inherent in pension saving – for example, those associated with longevity, investment and inflation - are borne by the sponsoring employer. In DC schemes, they are borne by the individual.[1]

1.1 Consultation process

In its November 2012 discussion paper, Reinvigorating workplace pensions, the Coalition Government set the context for its proposed reforms. It said that membership of DB schemes in the private sector had been in decline since its peak in the late 1960s. This had been the subject of much debate, with a number of complicated factors combining to make them more costly and less attractive to employers. However, the Government considered that:

> Given the very different economic and social environment in which workplace pensions now function, there is likely only to be a limited amount that can be done to revive DB schemes, at least in their pure, final salary form.[2]

While engagement with pensions might increase as auto-enrolment was implemented, many individuals would not be comfortable with the level of risk and uncertainty involved in saving in DC pension schemes. It was therefore keen to explore the scope for what it termed 'Defined Ambition' (DA) schemes, which would seek to give "greater certainty for members than a DC pension about the final value of their pension pot and less cost volatility for employers than a DB pension." [3]

In November 2013, it launched a public consultation, Reshaping workplace pensions for future generations (Cm 8410). This set out the challenges it thought Defined Ambition needed to respond to, as follows:

> **Structural**: the polarisation of risks represented by traditional DB and DC pension schemes creates the perception of an incomplete system, with the burden of risk falling wholly on the employer or, increasingly, being placed on the individual. DA should provide the space for a greater amount of risk sharing.
>
> **Regulatory**: the criticism that the DB promise brings too great a regulatory and funding burden to the employer. DA should consider reducing some of the regulatory requirements on DB and

1 DWP, Pension Schemes Bill Impact Assessment, June 2014, page 12, para 9
2 DWP, Reinvigorating workplace pensions, CM 8478, November 2012, chapter 2
3 DWP, Reinvigorating workplace pensions, Cm 8478, November 2012, p56

> any new DA framework should be clear about the limits of employer liabilities, and avoid creating new regulatory burdens.
>
> **Supply/demand**: demand from employers and employees for something between DB and DC is not being met by the market. There is a need to examine the extent to which Government intervention is needed to stimulate innovation.
>
> **Member-driven product design**: the extent to which uncertainty about pension savings and retirement incomes from a DC scheme (however good) is a disincentive to save in a pension.[4]
>
> It proposed a number of principles for their development:
>
> A DA scheme should be:
>
> **Consumer focused** – address consumer needs (members and employers).
>
> **Sustainable** – affordable to the stakeholders (employers/pension providers/members) over the long term.
>
> **Intergenerationally fair** – not biased to pensioners, but also take on board needs of future pensioners.
>
> **Risk sharing** – incorporate genuine risk sharing between stakeholders.
>
> **Proportionately regulated** – the regulatory structure needs to be permissive to enable innovation in risk sharing, while protecting member interests.
>
> **Transparent** – there should be high governance standards with clarity for members about any promise made and any associated risks.[5]

The Government said it would review the regulatory structure, with a view to enabling a more equitable sharing of risk:

> 13. The Government's role in private pensions involves regulating schemes, products, providers and employers in a number of ways – with member protection at the heart of these activities.
>
> 14. With automatic enrolment into workplace pensions, the Government is intervening to address the need for more people to be saving for their retirement, recognising that inertia can lead to individuals not saving.
>
> 15. With DA, the Government proposes to review the regulatory structure where it inhibits employers, or the wider market, innovating and providing pensions which meet consumer needs, while providing a more equitable sharing of risk and ensuring where promises are made, they are kept. This balance should ensure the voice of the consumer is heard while there is less prescription about the offer that employers or the market should make.[6]

From its discussions with employers, it had found that:

- Employers were positive about offering pensions but wanted schemes that were simple to set up, where costs will not increase in future;

[4] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013, p10
[5] Ibid p 11
[6] Ibid p 11

- They were concerns about generating a pension liability that would have an adverse impact on business accounts;
- In some sectors, a major factor influencing decisions on pension provision was what other employers were offering. Employers often positioned themselves to match the market rather than lead it;
- Willingness of employee benefit consultants to advise and recommend new products, and of established providers of pensions administrators to support them, was key to these products becoming established in the market.[7]

Key considerations were that the new schemes should not cost more than traditional DC and that there should be no funding liability on the employer's balance sheet.[8] For savers, the evidence suggested that a savings product that could provide more certainty about savings or about income in retirement might be better able to earn consumers' trust and confidence than individual DC products.[9]

An industry working group looked at a number of possible models, including: lighter versions of DB, DC pensions with an element of guarantee, and collective defined contribution schemes. These are discussed in more detail below.

In June 2014, the Government said the consultation had confirmed the need for a new framework that would "create a clear DA space with its own regulatory protections to encourage innovation in risk sharing and enable new kinds of collective models." It would retain its original approach, with some refinements:

> We intend to retain the overall approach and principles set out in the consultation document, with some refinements. We will continue, as intended, to establish mutually exclusive definitions for scheme type based on degrees of certainty for members. We will also ensure proportionate regulation by applying requirements to certain features – where there is a promise, for example, ensuring it is funded – while still maintaining transparency in the law so that employers are clear on the extent of their obligations. We are committed to avoiding legislation that is overly prescriptive; instead, we want to allow schemes to evolve and innovate.
>
> Where we have deviated from the ideas set out in the consultation, we have put additional safeguards in place to ensure the new schemes work to their full potential. We are introducing a new definition of collective benefit, which could be offered under DA or defined contribution (DC) schemes. We will refine the definition of DB scheme to take account of certain discretionary features which already exist in some DB schemes and broaden the definition of DC to cater for self-annuitising and CDC schemes (that do not provide a promise or guarantee during the

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[7] Ibid p13-14
[8] DWP, Government response to the consultation. Reshaping workplace pensions for future generations, Cm 8883, June 2014, p9 and 12
[9] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013, p15; See also NEST, Pensions insight – 2014

> accrual phase). Money purchase schemes will fall within the DC scheme definition.[10]

It said it had decided not to proceed with proposals for flexible DB. This was because, to make enough of a difference, the suggested changes would need to have applied to accrued rights, which was not the Government's intention.[11] Regarding its proposals for providing greater certainty for DC scheme members, it thought the detail of some of its proposals (capital and investment guarantee, retirement income insurance and pension income builder) should be worked out within the legal parameters of the new legislative framework.[12] It would also legislate for schemes to provide collective benefits. The issues connected the proposals are discussed in more detail below.

Consultation responses

The responses to the consultation indicated a general support for creating a new space in the legislative framework for DA pensions to develop. The RSA, for example, argued the case for a new type of pension provision:

> Britain is witnessing the collapse of its Defined Benefit pension system throughout the private sector. Individual DC pensions are struggling to fill the gap. But they alone cannot provide an efficient pension savings system for everyone. Collective, pooled pensions such as Target Pension Plans provide employers with an alternative way to offer pensions that meet the needs of their employees, without taking on additional burdens themselves.[13]

The National Employment Savings Trust (NEST) also welcomed proposals for DA, arguing that it was unlikely that any traditional DC scheme could give satisfactory answers to three basic questions put by savers:

> What will I get out at the end?
>
> What happens to my money when it's in the scheme ('where does my money go?')
>
> How safe it my money?[14]

The ABI welcomed the opportunity to debate a "range of alternative ways to improve certainty for pension savers."[15]

The TUC questioned whether a new legislative framework to enable innovation would be enough:

> While we welcome changing the law to allow Dutch-style target pensions, this will not automatically result in any being set up. We need government action to ensure that workers have access to target pensions as the bigger they are, the better they work.

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10 DWP, Government response to the consultation. Reshaping workplace pensions for future generations, Cm 8883, June 2014
11 DWP, Government response to the consultation. Reshaping workplace pensions for future generations, Cm 8883, 24 June 2014, page 28
12 DWP, Government response to the consultation. Reshaping workplace pensions for future generations, Cm 8883, June 2014, chapter 2
13 RSA, Collective pension plans briefing note, 2014
14 NEST, Reshaping workplace pensions for future generations – consultation response, 2014
15 'ABI response to the DWP Defined Ambitions Pensions consultation', 7 November 2013

> Leaving it to the market is never a solution when it comes to pensions.[16]

The National Association of Pension Funds (now the Pensions and Lifetime Savings Association (PLSA)) agreed it was important to have a legislative framework that would develop as the pensions landscape continued to evolve."[17] However, the focus must remain on providing good outcomes for DC scheme members:

> CDC may well have a role to play in this, but the fundamentals still apply. Good outcomes for members are built on strong governance, low charges and investment strategies based on members' needs. The real goal here has to be schemes operating at scale. Scale is a necessary precondition for CDC but it also enables a much wider range of member benefits. As a result of automatic enrolment we are already seeing the emergence of large pension schemes in the form of master trusts, which are able to offer their members high quality investment strategies and great value for money.[18]

Unite stressed the importance of employer contribution rates and action on charges to improve outcomes for DC scheme members.[19]

Age UK said that new proposals should not distract from other priorities, such as the 'guidance guarantee' announced at the 2014 Budget:

> These new proposals must not distract us from the major changes happening now. The Government's clear priority must be to deliver on its commitment to provide high-quality, impartial pensions guidance, to help people to be more secure in later life.[20]

There are also, of course, a range of views on specific proposals. These are discussed in more detail below.

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[16] 'Pensions bills pull in opposite directions, says TUC' 4 June 2014
[17] NAPF, Reshaping workplace pensions for future generations – the NAPF's response, December 2013
[18] NAPF comments on Queen's speech, 4 June 2014
[19] Unite response to Reshaping workplace pensions, December 2013, p11
[20] Age UK's response to Queen's Speech, 4 June 2014; HC Deb 19 March c793

2. Proposals for more flexible DB

2.1 Background

In its 2007 report on the changing landscape for private sector Defined Benefit pension schemes, the Pensions Policy Institute explained that regulation to protect scheme members had added to the cost of pension promises in some cases:

> The number and scope of legislative and regulatory rules have been increasing since the 1970s. The aim of much legislation affecting pensions has been to increase the protection of early leavers' and pensioners' rights, and to make occupational pension scheme provision fairer and more transparent. The Government would argue that the policies have helped maintain public confidence in pensions. But in certain cases, critics have argued that these rules have added to the cost of pension promises.[21]

A Deregulatory Review of Private Pensions set up by the Labour Government in 2007. The background to this was that:

> 3. The present regulatory system governing occupational pensions has grown incrementally over the course of the past thirty years. It is now, by common consent, lengthy, complicated and hard to understand. Although each successive layer usually had the aim of protecting scheme members or simplifying the regulatory structure, there have been unintended consequences, leading to undesirable outcomes. Whilst by no means wholly attributable to the growth of regulatory burdens, there is little doubt that the weight of regulation has contributed to a belief by some employers that the costs and risks of having their own pension schemes are becoming too great.

Its objective was to reduce legislative burdens while recognising that there was a balance to be struck between reducing legislative complexity and protecting members' interests.[22]

In their report, published in December 2007, the independent reviewers said that if the two problems of DB schemes (regulatory burden and open-ended risk) could be alleviated sufficiently, this would make it easier for companies to consider DB schemes, or at least an element of DB provision, once again. They had placed the emphasis in their recommendations on:

- encouraging the introduction of risk-sharing DB schemes, where the employer is unwilling to bear all the risks on an open-ended basis;
- removing or easing regulatory obstacles in DB schemes which are hindering sensible courses of action by companies (such as some of the employer debt regulations, and regulations restricting to an unreasonable extent the ability of the employer to reclaim any surplus which arises);
- moving towards simple outcome-related principles in some areas of regulation, leaving companies and trustees free to

[21] PPI, The changing landscape for private sector Defined Benefit pension schemes, October 2007, p25-7

[22] DWP, Deregulatory review – Government response, October 2007, p35

> achieve these outcomes in their own ways, with resulting economies and efficiency, and hopefully a greater understanding by pensions professionals of what outcomes are required.

None of their recommendations would affect accrued rights. They suggested that, in addition to looking at ways to deregulate DB schemes, the Government should also "examine ways in which some of the risks for the members of DC schemes could be lessened where the company is willing to do so." [23]

In its response, the Labour Government said it was "difficult to strike the right balance between removing legislative burdens and protecting members." It did not believe that there was "a single measure or even a series of measures which would guarantee that employers would continue to provide and even strengthen their existing pension provision."[24] It agreed with the reviewers that "it would not be appropriate to make changes which would affect rights which have already accrued."[25]

Following further consultation, it legislated in the *Pensions Act 2008* to:

- reduce the cap applying to the revaluation of deferred pension rights from 5% to 2.5% (intended to apply to future rights, accrued from January 2009); and
- repeal the rules on "safeguarded rights", which currently apply when a pension is shared on divorce or dissolution of a civil partnership.[26]

As part of a consultation on risk-sharing launched in June 2008, it asked whether to allow conditional indexation (where indexation depends on the financial health of the scheme).[27] However, it decided against this on the grounds that the consultation had not provide sufficient evidence that it was likely to make the significant impact on the level of DB provision to justify overriding the concerns of member representatives. [28]

For more detail, see Library Note SN 4515 Deregulatory Review of Private Pensions (September 2009).

2.2 The Coalition Government proposals

The Coalition Government's motivation for a "lighter version of DB" was to stem the long-term decline in DB pension provision:

> Without government intervention to allow more flexibility and reduce constraints for employers sponsoring DB pensions, DB is

[23] Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions, July 2007; Foreword
[24] DWP, Deregulatory review – Government response, October 2007, Executive Summary
[25] Ibid
[26] Sections 101 to 102
[27] Ibid, p3-4
[28] DWP, 'Risk sharing consultation: Government response', December 2008, page 2

> likely to disappear almost completely from future pension arrangements.[29]

However, it did not think that employers should have the power to transfer or modify accruals built up under the previous arrangements into new arrangements, beyond what was allowed under existing legislation. This meant that:

> […] deferred and pensioner members, and the past accrued benefits of active members, would not be affected as a consequence of introducing DA pensions.[30]

Flexibilities already available for DB scheme sponsors included switching to schemes providing benefits on the basis of career average revalued earnings rather than final salary or moving to a cash balance scheme.[31] In addition employers could place a cap on the level of earnings that would count as 'pensionable pay'. However, these features were not in widespread use.[32]

As part of the development of its proposals for DA, the Government considered three specific proposals for flexible DB: the ability to pay fluctuating benefits, automatic conversion to DC when an employee left the scheme early, and the ability to change scheme pension age.

The ability to pay fluctuating benefits

For example, employers could choose to provide additional benefits - such as indexation - above the simplified DB level when the scheme funding position allowed. Legislation to enable this could include:

- Changing the legislation on requirements such as preservation, revaluation, scheme funding, employer debt and the Pension protection Fund levy so that they applied only in respect of statutory provisions and benefits that were required to be paid under scheme rules, not in respect of the discretionary elements;
- Reviewing governance requirements to ensure employers, trustees and scheme managers were properly equipped to deal with such discretion;
- A 'statutory override' to enable schemes to change rules in relation to future accruals more easily.[33]

Automatic conversion to DC for early leavers

In this scheme design, active scheme members would build rights to pension benefits during a period of employment as now. However, if they left the employment before retirement, the amount of pension accrued in the scheme would be crystallised and the cash value transferred to a nominated DC fund. The Government considered that a

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[29] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013 p16
[30] Ibid p25
[31] In a cash balance scheme, the employer specifies the pension fund amount for the member for each year they work, so the size of the member's overall pension fund is defined, with the actual value dependent upon the revaluation factor specified in the scheme rules. When the member retires the total pension fund is then available for the purchase of an annuity. (Cm 8478, p31)
[32] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013
[33] Ibid p19

number of safeguards would need to be put in place: employees would need to have a clear explanation of how accrued benefits were valued at crystallisation; there would need to be regulatory protection for members; and measures address risks of avoidance activity, such as prescribing the time by which employers would be required to calculated and transfer benefits when a member leaves employment.[34]

Ability to change scheme pension age

The Government proposed to give employers greater flexibility to manage risks by adjusting their normal pension age:

> 35. This would enable future pension provision to be based on the projected number of years in retirement, rather than being tied to a fixed age that does not take into account changes to longevity. From the date the model is implemented, the age at which members are entitled to the full scheme pension could be adjusted in line with changes to longevity assumptions, so that members would be expected to spend broadly the same length of time in retirement, regardless of changes to life expectancy.[35]

To enable this, the Government proposed to make it easier for schemes to link their normal pension age with the State Pension age if they chose, but also to require the Government Actuary's Department to publish, at predetermined intervals (say every three years) an objective index on pension ages based on the latest longevity assumptions.[36] Pensioner members would not be affected, and there would need to be protection for those closest to retirement – for example, a prohibition on changes affecting people already within ten years of the scheme's existing normal pension.[37] Numerous respondents to the consultation thought it was already possible to adopt this scheme design under current legislation.[38]

Responses

The Manufacturers' Organisation (then EEF, now Make UK) said employers who had gone through the difficult process of closing a DB scheme were unlikely to consider another form of DB in future:

> The future of workplace pensions therefore is one where DC schemes will be the predominant workplace pension platform. The reasons why employers have chosen DC schemes are the costs and liabilities incurred in offering DB schemes.
>
> Many EEF members have closed their DB schemes in recent years, and others are on a flight-path towards closure. Their views provide a useful barometer of the consultation proposals. For employers who have firstly incurred a sharp increase in their liabilities for a DB scheme, and then gone through the very difficult process of closing such a scheme, they are very unlikely to consider in the future another form of DB scheme.
>
> In addition, they will be unlikely to consider a different form of DC scheme which exposes them to a future liability, particularly if that liability cannot be quantified and limited. In discussions with our

[34] Ibid p20-21
[35] Ibid p22
[36] Ibid p23
[37] Ibid p 24
[38] DWP, Government response to the consultation. Reshaping workplace pensions for future generations, Cm 8883, 24 June 2014, page 34

> members then, we have not found any desire for a model of risk-sharing, where the employer shoulders any liability for a defined level of future retirement income.[39]

However, the PLSA argued that deregulation might encourage some existing providers to keep DB schemes open for longer:

> […] it is unlikely that we will see a dramatic revival of DB pensions as employers increasingly shift investment, inflation and longevity risks off their balance sheets. However, ambitious deregulation of DB pensions might encourage those currently considering closing their DB schemes to new members or to future accrual to keep their schemes open for longer or switch to more innovative risk-sharing models.[40]

Trade unions were sceptical that this would be the result and were concerned about the impact on scheme members. The TUC said:

> Employers willing to accept pensions risk already have many ways to negotiate changes to reduce costs, and we are particularly opposed to abolishing indexation as that just means pensioners getting poorer every year.[41]

The Government's response

In June 2014, the Government said it would not proceed with the proposals for flexible DB:

> It was clear that there are already flexibilities available to employers, such as linking the scheme's normal pension age with State Pension age, to reduce cost and volatility without the need for new legislation. We have therefore considered the consultation responses and have concluded that introducing new legislation, to make it easier to sponsor DB schemes, will not be our priority at the present time.
>
> Separate research findings have shown that, to make enough of a difference to employers, the suggested changes would need to apply to accrued pension rights. We are absolutely clear that we will not be making changes that affect past accruals that could reduce the pension benefits that individuals have already built up with their employer.
>
> The view most respondents expressed was that the greater prize was to deliver changes that enable collective schemes and greater ability to share risks in the DC world.[42]

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39 EEF response on reshaping workplace pensions for future generations - summary

40 NAPF, Reshaping workplace pensions for future generations – the NAPF's response, December 2013

41 TUC welcomes paper on defined ambition, 7 November 2013; UNITE, 'Response to Reshaping workplace pensions for future generations', December 2013; See also NASUWT, Consultation response, Reshaping workplace pensions for future generations, 19 December 2013

42 DWP, Government response to the consultation. Reshaping workplace pensions for future generations, Cm 8883, June 2014, page 28

3. Proposals for providing greater certainty within DC

DWP research on consumer perspectives on defined ambition found that the concept of providing greater certainty held an overall appeal. However, when specific models were discussed, questions were raised around issues such as cost.[43] Research by NEST also found a strong biasamong savers for certainty:

> For unpensioned workers retirement planning is about safety and securing the future, and therefore at odds with ideas of chance, risk and uncertainty.
>
> For the automatically enrolled member risk is inherently negative and is more to do with the chance of making a loss than making a gain.
>
> Similarly, uncertainty is always perceived in a negative light and suggests the possibility of a disappointing or worst-case scenario outcome, rather than the possibility of getting a better outcome than expected or even just slightly less.[44]

As part of the Government's work on this issue, an industry working group considered a number of models, in particular: a money back guarantee; capital and investment return guarantee, retirement income insurance and pension income builder.[45] A common feature of these models (and of collective DC) was that none place any risk on the employer. In each case, the employer would determine their level of contributions into the scheme but take no further risk.[46]

3.1 Money-back guarantee

The 'money-back guarantee' model was intended to ensure that the amount of accumulated savings at retirement did not fall below the nominal value of contributions made to the scheme. In practice, the probability of such a low level guarantee being exercised were small. However, the Government said it was unlikely that the market would offer this sort of guarantee and that government intervention did not seem justified.[47] Consumer research found that although the principle was initially greeted with enthusiasm by risk-averse individuals, on reflection they thought that "such a guarantee suggested that the pension scheme was a poor investment." Concerns were also expressed about "the likely cost and who would pay." [48]

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[43] Defined Ambition: Consumer perspectives. Qualitative research among employers, individuals and employee benefit consultants, DWP RR 866, June 2014, Executive summary
[44] NEST, Pensions insight – 2014
[45] Cm 8710, chapter 4
[46] PPI, Defined Ambition in workplace pension schemes, December 2013
[47] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013, p42
[48] Defined Ambition: Consumer perspectives. Qualitative research among employers, individuals and employee benefit consultants, DWP RR 866, June 2014 section 5.1

In its response to the consultation, the Government said this model could operate within the new DA space. However, it did not intend specific legislation to enable it.[49]

3.2 Capital and investment return guarantee

The 'capital and investment return guarantee' model would offer guarantees at the mid-point of the pension cycle: when a member had built up a sum and was concerned to protect the loss of capital, while still maintaining a need to grow the fund further. The guarantee would be purchased by a fiduciary, on behalf of the member, by securing a guarantee against part of the capital and possibly the investment return, for a fixed period.[50] Consumer research found that only highly risk-averse individuals were attracted by this model. Questions were raised about cost and how it would work in practice .[51] The trade union Unite argued that a better way of building member confidence would be to increase employer contribution rates and take action on charges.[52] In its response to the consultation, the Government said detailed design features could be worked out within the new legislative framework.[53]

3.3 Retirement income insurance

'Retirement income insurance' would involve insuring a minimum level of income, which would grow each further insurance was purchased. At retirement, the saver draws their pension from the fund and only if their fund is only reduced to zero does the income guarantee kick in. Products of this type exist in the United States. However, the Government thought it was unlikely that it could be introduced in the UK in the short to medium term. Reasons scale (lower than in the US due to the fragmented UK market) and the cost of prudential regulation requirements.[54]

3.4 Pension income builder

In the 'pension income builder' model (similar to the Dutch General Practitioners' pension fund and the Danish mandatory ATP scheme) contributions are used for different purposes. A proportion is used to purchase a deferred nominal annuity each year, payable from pension

[49] DWP, Government response to the consultation. Reshaping workplace pensions for future generations, Cm 8883, June 2014, p13
[50] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013, p32
[51] Defined Ambition: Consumer perspectives. Qualitative research among employers, individuals and employee benefit consultants, DWP RR 866, June 2014 section 5.2; PPI, Defined Ambition in workplace pension schemes, Briefing Note Number 65, 22 December 2013;
[52] Unite, Response to reshaping workplace pensions, December 2013, p11-12
[53] DWP, Government response to the consultation. Reshaping workplace pensions for future generations, Cm 8883, June 2014, p13
[54] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013, p32

age. The residual proportion is invested in a collective pool of risk-seeking assets.[55]

DWP noted that this model entailed genuine risk-sharing. However, it needed to operate at large scale for some of the key benefits to be realised and the issue was how to achieve this in the UK. Possibilities included a multi-employer scheme or single employer with a large and relatively stable workforce.[56] Other issues for consideration included: who would stand as guarantee provider; how to balance the interests of different cohorts of members and the requirement for a strong governance framework and regulatory oversight. It was also legitimate to debate whether members would be better served using their contributions to seek higher returns. However, it could address the desire of consumer for greater certainty.[57]

Unite thought that, of the four models outlined for providing an element of guarantee through a conventional DC vehicle, the pension income builder had the most potential to produce beneficial outcomes for members. However, it thought collective DC was the most promising proposal overall.[58]

[55] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013 p7 and chapter 4; See also, Lars Rohde, Using a Hybrid Pension Product in a Collective Framework to Distribute Risk: Denmark's ATP in Governance and Investment of Public Pension Assets, The World Bank, 2011

[56] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013 p39-40

[57] Ibid chapter 4

[58] Unite response, Reshaping workplace pensions, December 2013, p12

4. Proposals for collective benefits

The Government considered Collective Defined Contribution (CDC) schemes as a possible structure for Defined Ambition, drawing on experience of occupational pension provision in the Netherlands. Key features of the schemes were that they feature risk-sharing between members and cost certainty for employers through a fixed contribution rate. The Government's proposed model for the UK would have important differences – it was not proposing compulsory participation for employers in industry-wide schemes, for example.[59]

4.1 Occupational pension provision in the Netherlands

The Dutch pension system has three pillars. The first pillar is the state old age pension (AOW), the second is constituted by occupational pensions, and the third by individual savings for retirement.[60]

In arrangements dating back to 1949, participation in the second pillar is mandatory for employers where the government has agreed that it should be so, in response to a request from a sufficiently representative portion of an organised industry or sector.[61] For employees, participation is mandatory through their contract of employment. These arrangements have resulted in extensive coverage, with more than 90% of employees covered by supplementary funded pension schemes. They have also helped to ensure industry-wide funds with sufficient economies of scale, enabling cost efficient management of schemes: more than 80% of active scheme members are in sectoral funds.[62] The bulk of assets are managed by non-commercial pension funds, which are legal entities separate from the employer. They are usually trust-based, governed by employer and employee representatives.[63]

The dominant model originated from a pure DB system. However, whereas in traditional DB the sponsoring employer generally stands behind the pension promise, in the Dutch model it depends on returns in the financial markets, interest rates and inflation rates.[64] An overview of the system by the Dutch associations of pension funds explains:

> The majority of the Dutch DB (Defined Benefit) pension schemes are in fact not pure DB schemes, but are hybrid schemes. This means that if a fund gets into financial difficulties, all parties

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59 DWP, Reinvigorating workplace pensions, Cm 8478, November 2012, p39
60 For more detail, see OECD, Pensions at a glance 2017: country profiles – the Netherlands; Dutch Association of Industry-wide Pension Funds and Dutch Association of Company Pension Funds, The Dutch Pension System: an overview of the key aspects, 2010
61 O.W. Steenbeck and SG Van der Lecq, *Costs and Benefits of Collective Pension Systems*, 2007, chapter 10
62 Lans Bovenberg, Roel Mehlkopf and Theo Nijman, The Promise of Defined-Ambition Plans Lessons for the United States, Network for Studies on Pensions, Aging and Retirement, March 2014
63 OW Steenbeek and S.G. van der Lecq eds, *Costs and Benefits of Collective Pension Systems*, 2007
64 Broeders D and Ponds E, Dutch pension system reform – A step closer to the ideal system? CESifo DICE Report 3/2012, 65-78

> involved, employer, employees and those drawing their pension, contribute to the recovery.
>
> > *The pension contributions can be increased*. This will increase the wage costs for the employer and decrease the net salary for the employee. Another option is that the employer commits paying the extra contributions required to incidentally pay an extra contribution.
>
> > *The indexation can be limited.* Most pension schemes include a clause stating that indexation is conditional. Each year the pension fund's executive board will decide whether the fund's financial position will permit indexation of the pensions and accrued rights. In indexed average salary schemes such indexations constraints affect pensioners, members still contributing and early leavers.
>
> > *An extreme measure is to reduce the pension rights.*
>
> In many pension schemes the contribution amount as well as the level of indexation depends on the coverage ratio. This is known as intergenerational risk sharing for pension funds. Furthermore, when determining the investment mix a balance must be found between the needs of those drawing a pension for security and on the other hand, the needs of the younger contributor for the opportunity to achieve a good return on investment.[65]

The effect of these arrangements is that investment and longevity risks are borne collectively rather than by the individual. If a scheme becomes underfunded, its governing body decides how to restore it to a full funding position over a period of three years (extended to five recently). The minimum funding level is 105% (i.e. assets exceed liabilities by 5%). In addition, the fund must have buffers to be able to cope with financial setbacks. The average pension fund needs to be 125% funded, with the exact level dependant on factors such as the scheme's investment strategy and the age profile of its members.[66]

In general, scheme participants are treated uniformly. This means that scheme members accrue benefits at the same rate (around two per cent of salary a year), all active members contribute at the same rate and the indexation rate is the same for all participants, although some funds differentiate between active members and retirees.[67] Contribution rates are high, as are the benefits provided. In 2012, the average contribution rate was about 17.5% (6.2% from employees and 11.3% from employers). In 2013, schemes typically aimed at an annuity level of about 80% of average pay (including the AOW) after 40 years' service.[68]

Reforms have been introduced over time in response to funding pressures. In 2003, there was a shift to providing pensions based on career average rather than final salary, and the introduction of a

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[65] Dutch Association of Industry-wide Pension Funds and Dutch Association of Company Pension Funds,
The Dutch Pension System: an overview of the key aspects, 2010
[66] Ibid
[67] Broeders D and Ponds E, Dutch pension system reform – A step closer to the ideal system? CESifo DICE Report 3/2012, 65-78
[68] Lans Bovenberg and Raymond Gradus, Reforming Dutch occupational pension schemes, 2014

conditional indexation mechanism, whereby accrued rights would only be increased in line with inflation if the scheme was fully funded.[69]

Further reforms have been under consideration following the financial crisis in 2007-08, when the funding level fell in many schemes. A fall in the total funding from 130% to 95% in 2008, meant many funds had to put in place recovery plans and take action to restore funding levels.[70] A recent academic study explained the effects:

> The biggest wave of cuts in pensions in payments occurred in 2013. During that year, 68 pension funds (out of 415) were required to cut nominal pension rights. The cuts in 2013 affected around 2.0 million active participants (who pay contributions), 1.1 million retired participants and 2.5 million inactive participants who neither pay contributions nor receive benefits.[…] Around 2 million participants faced a relatively large cut of 6 to 7 per cent. A cut of 7 per cent is observed frequently because the Dutch government allowed pension funds to cap the level of pension cuts in 2013 at 7% and defer the remainder to 2014.
>
> Moreover, most pension funds have been unable to provide (full) indexation in recent years. […] on average retirees have experienced a decline of around 10% of their replacement rates as a consequence of inadequate indexation. This decline is expected to increase further because the current low funding rates will not allow pension funds to provide full indexation in the near future.[71]

Funding levels have since recovered somewhat and were expected to reach an average of 112% in May 2014.[72] Thirty funds had to curtail pensions in April 2014, affecting 200,000 retirees, 300,000 members and 600,000 early leavers (people with non-contributory entitlements that remain with previous employers).

These difficulties led to proposals for reform. In 2010, the social partners - employers and trade unions - agreed in a Pension Accord that pension contracts needed to be modified.[73] In particular, it was agreed that:

- unexpected increases in life expectancy should be met by changes in pension rights rather than in recovery contributions paid by employers and workers;
- the new pension contracts should be transparent and complete and pension funds should communicate to participants the risks implied by the pension contract (including investment policies); and

[69] Theo Nijman, Pension Reform in the Netherlands: Attractive options for other countries? Bankers, Markets and Investors No 128, January-February 2014
[70] IMF Country Report No. 11/209, July 2011 - Netherlands: Publication of Financial Sector Assessment Program Documentation - Technical Note on Pensions Sector Issues
[71] Lans Bovenberg, Roel Mehikopf and Theo Nijman, The Promise of Defined Ambition Plans – Lesson for the United States, Netspar Occasional Papers, March 2014
[72] 'Dutch pension funds at three-year high as ratios improve', *Financial Adviser,* 26 June 2014
[73] Stichting van de Arbeid, Memorandum Detailing the Pension Accord of 4 June 2010

- eligibility for the public pension (AOW) and the accrual rate in occupational pensions would be linked to life expectancy.[74]

An academic study from 2014 explained that, following the financial crisis, some funds had to cut nominal pension rights (affecting active, deferred and pensioner members) and most funds were unable to provide full indexation:

> The biggest wave of cuts in pensions in payments occurred in 2013. During that year, 68 pension funds (out of 415) were required to cut nominal pension rights. The cuts in 2013 affected around 2.0 million active participants (who pay contributions), 1.1 million retired participants and 2.5 million inactive participants who neither pay contributions nor receive benefits.[…] Around 2 million participants faced a relatively large cut of 6 to 7 per cent. A cut of 7 per cent is observed frequently because the Dutch government allowed pension funds to cap the level of pension cuts in 2013 at 7% and defer the remainder to 2014.
>
> Moreover, most pension funds have been unable to provide (full) indexation in recent years. […] on average retirees have experienced a decline of around 10% of their replacement rates as a consequence of inadequate indexation. This decline is expected to increase further because the current low funding rates will not allow pension funds to provide full indexation in the near future.[75]

The regulator took action and reforms are to be introduced from 2020.[76]

The Netherlands and Denmark (which also has CDC as a significant part of its pensions landscape) are widely recognised as having among the best pension systems in the world.[77]

4.2 Proposals for the UK

In its November 2013 consultation document, Reshaping workplace pensions for future generations, the Coalition Government said that some employers currently sponsoring DB schemes were interested in CDC as an alternative.[78] It set out the core characteristics of the models under discussion for the UK. These included:

- **No liability to the employer beyond a fixed rate of employer contribution,** and no balance sheet risk;
- **Asset pooling.** Rather than being retained in an individual fund for each member, or each member having rights to their own specific contributions and investment returns attributable to those contributions, in a CDC scheme assets are pooled. When they retire, members do not select an individual retirement income

74 Lans Bovenberg, Roel Mehikopf and Theo Nijman, The Promise of Defined-Ambition Plans – Lessons for the United States, Netspar Occasional Papers, March 2014, Section 6
75 Lans Bovenberg, Roel Mehikopf and Theo Nijman, The Promise of Defined Ambition Plans – Lesson for the United States, Netspar Occasional Papers, March 2014).
76 Pension reform in the Netherlands, Bastiaan Starink Tilburg University, 2018
77 Work and Pensions Select Committee, Collective Defined Contribution Schemesv, July 2018, p7 and footnote 22
78 DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013

product, rather the income is paid from the asset pool. The rights of a CDC scheme member are therefore not related to the contributions made by or on behalf of that member;

- **Large scale** – necessary for efficiencies in the costs of administration and investment management and to enable the collective element to function more efficiently ("more members there are, the greater the opportunities for risk sharing");
- **Target retirement income.** In one of the main models of the scheme, individuals are provided with a target pension income they might receive in retirement (often including a fluctuating conditional indexation payment). The actual pension income received is dependent on the available assets in the scheme. If funding is insufficient, there are a number of pressure valves to enable the scheme to continue to deliver benefits, such as not paying the conditional indexation element or reducing the target pension income for members, with a decision to be made on how risks are shared between different classes of members. One form of CDC includes the possibility of benefits in payment being reduced in order to manage the fund. An alternative would be to fix a core part of the pension which cannot be changed once it is in payment, so it would be only the conditional indexation payments that could be cut.[79]

In its response to the consultation published in June 2014, the Government said it would legislate for a framework for CDC schemes in the UK, drawing on experiences in other countries and prioritising clarity and transparency:

> Collective schemes are complex and can be opaque – because of the indirect relationship between contributions and benefits. This necessitates strong standards of communication and governance. We intend collective schemes to be overseen by experienced fiduciaries acting on behalf of members, taking decisions at scheme level and removing the need for individuals to make difficult choices over fund allocations and retirement income products.
>
> We will also introduce a robust regulatory regime in respect of targeting benefits and internal accounting, providing regulators with the appropriate mandate and tools to supervise schemes properly. We believe it is crucial that members fully understand the risks associated with collective arrangements when they join the scheme, and while it is not for the state to determine the benefit design of these schemes, we will ensure that schemes set out clearly (to members) in advance how their rights are defined, what they can expect from the pool, and how positive and negative shocks will impact on their pension benefits.
>
> Collective schemes, as with all DC arrangements, do not come without risk, but with proper standards of governance and a suitable regulatory regime, we believe that we can mitigate these appropriately. A definition of collective benefits and associated key requirements will be included in the Pensions Bill while secondary legislation is likely to include more detailed provisions in

[79] Ibid, p45-6

> relation to areas such as benefit targeting, risk management, communications and governance.[80]

4.3 Debate

Differing views on the possible advantages and disadvantages to providing pension benefits on a collective basis are discussed below.

Outcomes

An assessment of how CDC schemes might work in the UK conducted by the Labour Government in 2009 found that CDC schemes could produce higher pensions and greater stability in outcomes for individuals:

- In the median case, CDC schemes produced higher pensions than standard DC schemes. This was mostly due to the fact that CDC schemes could remain invested in equities throughout the entire accumulation period, whereas typical DC schemes tended to move into safer, but lower-returning assets as the member approached retirement.[81]
- There was greater stability in outcomes for individuals i.e. an individual's starting pension was less dependent on whether they happened to retire in a downturn or a boom. However, there was uncertainty about indexation throughout retirement, as it was only granted when investment returns permitted. [82]

A report published by the RSA in November 2013 included modelling to show that:

> On the best like-for-like comparison, a collective pension would on average have outperformed an individual pension by 33%
>
> That in 37 of the past 57 years, a collective pension would have outperformed the individual pension
>
> That the variability of the pension, and thus the risk the saver would have taken, would be lower with a collective rather than an individual pension.[83]

Modelling for the Coalition Government showed CDC to out-perform individual DC. This was primarily driven by lower costs and remaining for longer in risk-seeking assets, factors not necessarily inherent to CDC:

> 14. There is a lively debate within the industry around the theoretical benefits of CDC plans compared to individual DC plans; in particular, the extent to which CDC outperforms DC. This was explored by the DWP and GAD in 2009. The modelling indicated that there was a good likelihood of better outcomes compared to individual DC, although this arose from CDC following a more aggressive investment strategy over time, which is not inherent in the design, and the same strategy could be replicated in DC. It also indicated that a stable active membership was required to keep the scheme sustainable. The modelling also

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[80] DWP, Government response to the consultation. Reshaping workplace pensions for future generations, Cm 8883, June 2014
[81] Ibid para 3.2
[82] DWP, Collective Defined Contribution Schemes – An assessment of whether and how such schemes might operate in the UK, December 2009
[83] David Pitt-Watson, Collective Pensions In the UK II, RSA, November 2013

> indicated this effect was radically diminished where there was no continuing stream of ne member contributions.
>
> 15. As part of the Department's current work on CDC, consultants Aon Hewitt have modelled the position of an individual who for 25 years set aside 10 per cent of their salary for a pension. It then looked at how they would have fared had they retired in 1955, and then in every other year up until the present.
>
> 16. The median of the average salary replacement has been compared for the 13following; (i) a CDC plan invested 80 per cent in equities and 20 per cent in bonds; (ii) an all equity individual DC plan; and (iii) a lifestyle individual DC plan. In Aon's results the average replacement rate for the CDC plan is 32 per cent, for DC equity it is 27 per cent, and for lifestyle it is 22 per cent. The dispersion of the individual DC plans is significantly greater than for the CDC.
>
> 17. Our understanding is that out-performance is driven primarily by lower costs and remaining invested for longer in risk-seeking assets. Neither of these is inherent to CDC schemes and it is possible to achieve both low costs and to hold risk-seeking assets for as long as desired in individual DC schemes. [84]

However, it said the ability to share risks amongst members did seem to create more stable outcomes than are possible in individual DC: and the greater the ability to share risk and so the lower the dispersion in outcomes.[85]

Viability of CDCs in the UK

When the Labour Government looked at this in 2009, it decided to take no further action. Part of the reason for this was that it thought demand from employers would be low:

> […] employers (including DB scheme sponsors considering closing their schemes) seem to be reluctant to subscribe to a new type of pension scheme which their employees may not fully understand and remain sceptical of their potential liability if investment performance is poor.[86]

However, in November 2013, the Coalition Government said some employers were interested in CDC as an alternative to DB:

> We know that some DB employers are interested in CDC as an alternative to DB schemes, rather than moving to individual DC schemes. CDC schemes may also be feasible as multi-employer schemes, perhaps sector based as in the Netherlands. Longer term, once established they might enable smaller employers to participate, offering them and their employees the benefits of scale.[87]

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[84] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013, p46
[85] Ibid para 18
[86] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013, p12
[87] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013, p44

CDC schemes performed better on a larger scale both because of economies of scale and the greater opportunities for risk-sharing among members.[88]

The Pensions Policy Institute suggested that intervention by industry or Government may be needed for sufficient scale to be achieved.[89]

There might also be cultural barriers. Morten Nilsson, CEO of Now: Pensions, pointed out that such schemes in the Netherlands and Denmark operated in a very different context:

> Whilst innovations such as collective DC schemes have been successful in Denmark and the Netherlands, both of these markets are highly unionised and have had mandatory or quasi mandatory pension saving for many years. The populations are relatively homogenous and the collective DC schemes operate on an occupational basis with people from similar professions sharing risk with one another – a much fairer approach than manual workers sharing risk with white collar workers. The UK is a much more fragmented market and while changing legislation to allow these schemes could have merit, in many ways it feels as though we are running before we can walk. Like it or not, UK companies have limited appetite for pension liabilities and consumers have limited interest in locking themselves up in risk sharing arrangements. As the market grows and matures, this position might alter but I think we have some distance to travel."[90]

Intergenerational equity

A number of commentators objected that CDCs were unfair to younger contributors. Huw Evans of the ABI said, for example:

> CDC schemes work by sharing risks between all members, pooling the investment in one fund. This brings down overheads but involves transferring risks from old to young, with younger scheme members bearing the risk of reduced future payouts to ensure the benefits of older members are preserved.[91]

The Government acknowledged this as a potential issue but pointed out that the way in which risk is shared depends on scheme design:

> 11. CDC schemes share risk between members. Scheme design governs which members bear risk and how much of it. For example, in a scheme where the design reduces the benefits of active and deferred benefits before it does so for pensioners, the risk in relation to investment returns and funding position is borne to a greater extent by younger members where the target is reduced. The variation on this design – to make a promise on the pension in payment – would increase the element of intergenerational risk transfer further. This intergenerational risk sharing, which arises from collectivisation, requires a considerable increase in the level of trust required from members of those running these schemes in comparison to traditional DC.[92]

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[88] DWP, Reshaping workplace pensions for future generations, November 2013, Cm 8710, chapter 5

[89] PPI, Defined Ambition in Workplace Pension Schemes. PPI Briefing Note 65, 2013

[90] Now:pensions comments on pension proposals outlined in Queen's speech, 4 June 2013

[91] Huw Evans, Ten things you should know about CDC, ABI blog, 28 January 2014

[92] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013

This was borne out by recent analysis of proposals for reform of CDCs in the Netherlands, which said:

> Typically, in case of high funding ratios, the elderly benefit from excess indexation. They also stand to gain from a higher discount and contribution rate. These measures will increase pay outs in the short run. By contrast, at low funding ratios, benefit cuts, a less ambitious indexation target and more prudence are favorable to the young. The young stand to gain from benefit cuts at low funding ratios, greater prudence via more buffering and a less ambitious indexation target, which will all reduce benefit pay-outs in the short run.[93]

Uniform accrual rates and contribution rates, as in the Netherlands, could in themselves entail a transfer from younger to older workers. For example, the contributions of a younger worker participating in a scheme early in life will generate returns over a long period, whereas those of an older worker will generate lesser returns. So, a younger worker who left the scheme early to become self-employed might have gained more by saving in an individual DC scheme. In contrast, an older worker who left their free-lance work to join the scheme later in their career would benefit from the relatively low premium they were required to pay. Questions about the fairness of this sort of effect were more likely to arise in a fluid labour market. Consideration of possible remedies, such as age-related accrual rates or premiums, would need to take account of equality legislation. [94]

Compatibility with the pension freedoms

Others questioned whether CDCs would be compatible with the 'pension freedoms', announced in Budget 2014 (giving people aged 55 and over more flexibility about when and how to draw their defined contribution pension savings).[95] The then Shadow Pensions Minister, Gregg McClymont argued that intergenerational risk-sharing would become extremely difficult, if people left the system at age 55.[96]

Craig Berry of the Sheffield Political Economy Research Institute, for example, said the risk that a large number of savers could choose to take their money in a lump sum would make the CDC business model unworkable on the kind of scale needed to make a difference:

> The CDC business model depends, fundamentally, on retirees' pensions being paid directly out of the scheme's funds, rather than via an externally-held annuity. This means cash can remain invested in high-return assets right until the very moment it is needed to be used to make monthly pension payments. It also

[93] D Broeders and E Ponds, Dutch pension system reform – A step closer to the ideal system? CESifo DICE Report, 3/2102, 70DW

[94] J B Kune, Solidarities in collective pension schemes, in O.W. Steenbeek and S.G. van der Lecq (Eds), Costs and Benefits of Collective Pension Systems, July 2007; Lans Bovenberg and Raymond Gradus, Reforming Dutch occupational pension schemes, 2014

[95] HM Treasury, Budget 2014, March 2014, para 1.164-5; :Library Briefing Paper CBP 6891 Pension flexibilities: the freedom and choice reforms (Sept 2018)

[96] HC Deb 20 March 2014 c953

> means members must be required to take their pension from the scheme rather than "shopping around".[97]

Towers Watson said people could be allowed to transfer their money out if the value was adjusted first:

> Portability and individual control were at the heart of the Budget reforms, but are called into question with CDC. You can allow people to transfer out of a CDC fund, but that is likely to mean adjusting the value of their savings first. How this is done must be transparent and could prove controversial. It's also unclear whether starting to receive a CDC retirement income will be a big one-off decision that you cannot reverse, like buying an annuity. If retirees can cash out their CDC pensions at any point, that could play havoc with the longevity risk-sharing they are meant to provide.[98]

However, it also pointed out that there were possible implications for risk-sharing between generations. One of the features of collective DC schemes is that if they become underfunded, they take action to address this – for example, by increasing contribution rates, reducing or suspending indexation or reducing pensions in payment. If members fear their pensions may be reduced, they might be tempted to transfer their savings out of the scheme. This would presumably be one of the factors a scheme would account of when deciding how to restore scheme funding levels.

[97] Craig Berry, The Queen's speech leaves pensions in a royal muddle, The Conversation, 4 June 2014
[98] Towers Watson, Collective pensions are no magic wand, 4 June 2014

5. *Pension Schemes Act 2015*

5.1 Background

In November 2013, the Coalition Government proposed creating a specific defined ambition (DA) space in legislation. It would also create a definition for DB schemes, in the hope that this would give greater clarity about which requirements applied to which schemes:

> 3. Historically, pensions legislation has broadly classified schemes as either money purchase or non-money purchase, with a money purchase scheme being one which only offers money purchase benefits. Although money purchase schemes are commonly referred to as DC, they are not defined as such in legislation.
>
> 4. With the introduction of DA there is the opportunity to recast the legislation, distinguishing between DB and DA schemes in the non-money purchase space. We therefore propose to create a specific DA space in the legislation, taking the opportunity to move away from the polarity created by the existing definitions and giving explicit recognition in legislation to the potential for innovation in risk sharing in the middle ground.
>
> 5. At the same time, we propose to define DB schemes in their own right. With the creation of new definitions of DA and DB schemes, distinct from each other and from money purchase schemes, we can more easily provide clear and proportionate regulation according to scheme type, giving clarity and reassurance to employers and providers.
>
> 6. To enable schemes to evolve and change, we do not propose to create entirely new and separate legislative regimes for the different types of schemes, but instead will use the new definitions to help make clear the distinct requirements that apply to each type of scheme. We see ease of transition as vital to make DA attractive to employers.
>
> 7. The aim would be to create a conceptual linkage for the different types of pension scheme that would fall within the DA space and set out the common requirements that recognise their characteristics as distinct from DB and money purchase schemes.
>
> 8. It would represent a shift in the legislation, setting out an approach based on the scheme as a whole. This could encourage innovation and act as a greater incentive for schemes to offer a mix of benefits. It would also provide a very clear space for us to set out the characteristics of being a DA scheme, and make it easier for existing schemes to change shape in relation to future accruals.[99]

A change in the status of schemes would result in schemes becoming subject to different requirements.[100]

It said that for DA schemes issues such as governance, member communications and funding would need special attention:

> […] We believe that the areas of governance, member communications and funding will need special attention, because in DA schemes where some benefits may be discretionary or

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[99] DWP, Reshaping workplace pensions for future generations, Cm 8710, November 2013, p50

[100] Ibid, p55-6, para 43-6

> where the outcome for the member is less certain than in DB schemes but more complex than in money purchase schemes, there will be new responsibilities for the trustees or those running the schemes, and a need to explain to members clearly what the benefits and risks of the schemes are, and what any guarantee means.[101]

In terms of governance, it said:

> […] there could be a case for introducing requirements to ensure that where there is discretion in a scheme, trustees or scheme managers give proper and regular consideration to the exercise of that discretion.
>
> 35. In addition, given the extra responsibilities on those running such schemes, there is a strong case for imposing different requirements to reflect the greater emphasis on discretion and risk sharing – for example in relation to the levels of knowledge and understanding required and internal controls and processes. There may also be a need to make clearer the expectations about how trustees should manage DA schemes as long-term propositions – with appropriate mechanisms for allowing schemes to evolve.[102]

For communications, it said that the nature of DA schemes might mean there was a clear case for a specific set of information requirements. This was because they offered a degree of guarantee but not absolute certainty, so the "nature of the pension promise may be harder to understand and more complex to communicate without being misleading."[103]

As regards funding requirements, the element of guarantee inherent in DA meant there would inevitably be some degree of overlap with DB schemes in relation to scheme funding requirements. However, the requirements would depend on the extent of any promise or guarantee and who stood behind it:

> 41. Schemes which make a promise in relation to the benefit will need to be funded to be able to meet that promise, but funding requirements should only apply to the extent of the promise or guarantee, and the nature of the funding obligation will depend on who is standing behind the promise.
>
> • An employer-sponsored occupational pension scheme which offers a salary-related pension with discretionary indexation would need to be funded in accordance with the current scheme funding requirements which apply to occupational pension schemes, equal to the technical provisions – but only to the levels needed to cover the basic pension liability.
>
> • A Regulatory Own Fund vehicle offering deferred annuities and discretionary benefits would need to be funded to the level required to meet the discounted capital value of the liabilities (technical provisions) plus an appropriate buffer.
>
> 42. Where the employer stands behind the promise in an occupational pension scheme, Pension Protection Fund protection and employer debt obligations would continue to apply as now. These provisions will however need amendment to reflect the different structures of DA schemes and to take account of altered

[101] Ibid, p54 para 33
[102] Ibid p55, para 34
[103] Ibid p55, para 37

> employer obligations. While Pension Protection Fund levies would continue to apply, they would need to be calibrated to reflect the liability accruing as a result of the given promise.[104]

The Government also set out its thinking in relation to ongoing initiatives in relation to DC scheme quality, automatic transfers and auto-enrolment.[105]

In June 2014, it said it had made some changes to its proposed approach:

> Where we have deviated from the ideas set out in the consultation, we have put additional safeguards in place to ensure the new schemes work to their full potential. We are introducing a new definition of collective benefit, which could be offered under DA or defined contribution (DC) schemes. We will refine the definition of DB scheme to take account of certain discretionary features which already exist in some DB schemes and broaden the definition of DC to cater for self-annuitising and CDC schemes (that do not provide a promise or guarantee during the accrual phase). Money purchase schemes will fall within the DC scheme definition.[106]

5.2 Legislation

The *Pension Schemes Bill 2014/15* was published in the House of Commons on 26 June 2014 and had its Second Reading on Tuesday 2 September 2014.[107] The House of Commons Library briefing paper for Second Reading was RP 14/44 Pension Schemes Bill (August 2014). The debates on the Bill are discussed in:

- SN 7030 Pension Schemes Bill 2014/15 – House of Commons stages (December 2014)
- SN 7105 Pension Schemes Bill 2014/15 – House of Lords stages (February 2015)

The *Pension Schemes Act 2015* received Royal Assent in March 2015.

Part 1 contained provisions for a new framework for the categorisation of pension schemes, with three mutually-exclusive definitions based on the type of promise. The Government explained:

> These 3 categories describe what is promised to members, while they are saving, about what they will get when they access their savings or receive their retirement income.
>
> **Defined Benefit**
>
> These schemes offer a full promise while members are saving for their pension about what their income will be from that pension.
>
> **Shared Risk (also known as Defined Ambition)**

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[104] Ibid p55

[105] Ibid p57. For more detail, see Library Note SN 6956 Improving outcomes for DC pension savers

[106] DWP, Reshaping workplace pensions for future generations: government response to the consultation, Cm 8883, 25 June 2014

[107] HC Deb 2 September 2014 c195-250

These schemes offer a promise while members are saving for their pension about some of the outcome from the scheme, but not all. For example, it might promise:

- some, but not all, of the income the member will receive
- the size of the savings they will accrue based on a contribution level
- the rate of income their savings will buy them

'Shared risk' schemes offer more certainty to members while they are saving about the outcome than a Defined Contribution scheme does.

Defined Contribution

These schemes don't offer a promise while members are saving for their pension about what their income will be from that pension.[108]

Part 2 defined the concept of collective benefits and made provision for regulation-making powers, covering matters such as: the setting of targets in relation to benefits, valuation, reporting requirements, transfer values, winding-up and governance. The Government said:

> The Act includes measures that will enable workplace and personal pension schemes to provide 'collective benefits'. These are provided by allowing schemes to be run in a way that shares risks among members by pooling their assets. This means that when a member retires, they can receive an income from the shared assets of the scheme.
>
> Evidence from other countries suggests that by sharing the risks among members, schemes providing 'collective benefits' may provide more stable outcomes than individual Defined Contribution schemes currently available in the UK. For example, while members are saving for retirement they can get some degree of protection from fluctuations in the financial markets.
>
> Under the new definitions introduced in the Act, 'collective benefits' could be a feature of a Shared Risk or a Defined Contribution scheme.[109]

The Explanatory Notes give the following overview of the provisions in Part 2:

> **Section 8: Introduction and definition**
>
> 60.Section 8 sets out the defining characteristics of a 'collective' benefit.
>
> 61.Where, in all circumstances the rate or amount of the benefit payable to or in respect of a member depends entirely on (a) the amount available to pay that member's and other members' benefits and (b) factors used to determine what proportion of that amount is available for the provision of the particular benefit, these benefits are defined as 'collective' in the Act. The definition also provides that a benefit which is a money purchase benefit is not a collective benefit.
>
> **Section 9: Duty to set targets for collective benefits**

[108] Gov.UK, Pension Schemes Act 2015
[109] Ibid

62.Section 9 provides that regulations may require that trustees or managers of pension schemes offering collective benefits set targets in relation to the rate or amount of those benefits. In particular, regulations can be made about, amongst other things, the way that targets are expressed, recorded and published. The intention is that members of a scheme with collective benefits should be provided with a reasonable estimate of the benefits that they can expect to receive from the scheme; in the absence of a well defined pot over which the individual has clear ownership, the target is a way of illustrating for the member what they might receive. Regulations may also require trustees or managers to set initial targets at such a level that the probability of meeting the target will fall within a range specified in regulations and for this to be certified by an actuary. The setting of targets is to ensure that schemes providing collective benefits operate in a transparent manner and provide some assurance to members in relation to those benefits.

63.Section 9(3) provides that regulations may, in particular, make provision for matters to which the actuary should have regard, and may require trustees or managers to provide the actuarial certificate to a specified person. Regulations may also make provision about the content of the actuarial certificate and require the trustees or managers to obtain the certificate from an actuary who has certain qualifications or meets other specified requirements.

Section 10: Policy about factors used to determine each benefit Section 11: Powers to impose requirements about factors used to determine each benefit

64.Section 10 provides that regulations may require trustees or managers to have a policy on the factors used to calculate members' benefits and to implement that policy. Section 11 allows the Secretary of State to make requirements about the factors to be used.

Section 12: Payment schedule Section 13: Overdue contributions and other payments

65.Section 12 provides for a power to make regulations which may require trustees or managers to prepare a payment schedule which shows the contributions due for payment to the scheme in respect of any collective benefits, and the dates on which those contributions are payable. Section 13 gives a regulation making power to require a specified person to be notified in the event of any payment shown in a payment schedule becoming overdue. Regulations can also make provision for the recovery of overdue payments.

66.Section 12(4) and 13(3) provide that regulations may make provisions corresponding, or similar, to those set out in sections 87 and 88 of the Pensions Act 1995 (which deal with schedules of payments for money purchase schemes).

Section 14: Statement of investment strategy Section 15: Investment performance reports

67.Sections 35 and 36 of the Pensions Act 1995 (together with the Occupational Pension Schemes (Investment) Regulations 2005) outline the requirements and principles governing investments for trust-based schemes, including a requirement for the trustees to draw up a statement of investment principles. Amongst other things, this statement must cover the trustees' policies in relation to the kinds of investment to be held, the balance between different kinds of investment, risks, and the expected return on investments.

68.Section 14 gives a regulation making power to require trustees or managers of a scheme to produce a statement about the investment strategy to be followed in connection with the provision of collective benefits.

69.Section 14(3) gives a power for these regulations to make corresponding or similar provision to that which applies to trust-based schemes under the 1995 Act. Regulations may make specific requirements about what must be included in the statement of investment strategy, and how frequently the strategy should be reviewed.

70.Under section 15 regulations may be made requiring the trustees or managers of schemes to obtain regular reports on the performance of investments held for the provision of collective benefits. Regulations may provide for how frequently the investment performance reports should be obtained, from whom they should be obtained and what the reports must include.

Section 16: Investment powers

71.Under this section regulations may make provision in relation to investment powers of trustees or managers of schemes containing collective benefits. The regulations may also make provision allowing trustees or managers to delegate decisions about investments to another person and about the investment powers of any person to whom such decisions have been delegated. In this way trustees or managers can delegate powers to those with investment knowledge to act in an appropriate way. These regulations may make similar provision to section 34 or 36 of the Pensions Act 1995, which contain provision relating to powers of investment, delegation and choice of investments for occupational trust-based schemes.

Section 17: Restriction on borrowing by trustees and managers

72.This section provides a power to make regulations to prohibit trustees or managers of schemes containing collective benefits from borrowing money or acting as a guarantor, except in specified cases. This also applies to anyone to whom the trustees or manager have delegated decisions about collective benefit investments.

Section 18: Investment powers: duty of care

73.This section provides a power to make regulations to ensure that trustees or managers of schemes which contain collective benefits, and those who have had investment functions delegated to them, cannot be excluded from liability when exercising their investment functions involving collective benefit investments. This requirement will help to ensure that those responsible for collective benefit investments cannot avoid their duty of care in respect of how they manage the funds, in turn helping to ensure the funds are properly managed and providing a safeguard for members. This section allows current restrictions that apply under section 33 of the Pensions Act 1995 to trustees of trust-based occupational schemes in relation to investment functions to similarly apply in relation to those running schemes which offer collective benefits.

Section 19: Valuation reports Section 20: Valuation process

74.Section 19 gives a regulation making power which may require those schemes offering collective benefits to obtain a document, prepared by an actuary, which values the assets held by the scheme for the purposes of providing collective benefits and assesses how likely it is that the scheme will be able to meet any targets in relation to those benefits. This document is defined in the Act as a 'valuation report'. Among other matters, the regulations may make provision about the content and frequency of valuation reports, may require that the actuary preparing the report must have particular qualifications or meet other requirements and may require the actuary to certify whether the probability falls within the required probability range or not.

75.Section 20 provides for a power to make provision about the methods or assumptions to be used by an actuary when drawing up a valuation report. Regulations made under this section may require an actuary to have regard to guidance when preparing the valuation report and may impose other requirements on the actuary.

76.The section also contains a power to require the trustees or managers to decide which methods or assumptions the actuary should use and a power for regulations to set out matters that the trustees or managers must take into account, or principles they must follow, when making that decision. These principles might, for example, state the parameters of the economic and actuarial assumptions that must be used.

Section 21: Policy for dealing with a deficit or surplus

77.Under this section, regulations may provide that trustees or managers of schemes offering collective benefits are required to have a policy for dealing with circumstances where the probability of a scheme meeting a target in relation to a collective benefit is outside of the required range of probability set out in regulations - termed in the Act as 'deficit' or 'surplus'.

78.Trustees and managers will usually have some flexibility and discretion about how they react to a 'deficit' or 'surplus', therefore the section sets out powers which may require the policy to contain provision for a 'deficit or surplus' to be dealt with in one or more of a range of ways. Regulations may require the policy to contain an explanation of the possible effect of the policy on members in different circumstances and to be drawn up with a view to achieving certain results within a specified period of time. Regulations may require consultation with members about the policy and any changes to it, and may make provision for the policy to be regularly reviewed or revised. Regulations may also make provision about the content of the policy and set out matters or principles that trustees must take into account or follow in setting the policy.

Section 22: Power to impose requirements about dealing with a deficit or surplus

79.This section provides for regulations to set out circumstances in which a deficit or surplus must be dealt with in a particular way. The regulations can set out specific things trustees or managers must do and the time within which they have to do them.

Section 23: Deficits attributable to an offence or the imposition of a levy

80.This section sets out a regulation making power to allow an amount to be treated as a debt due from an employer to a scheme offering collective benefits in situations where a deficit in relation to a target benefit has resulted from a specified offence or the imposition of a specified levy. In this context, section 23(2) provides that regulations may mirror, or be similar to, any provision made by section 75 of the Pensions Act 1995 (amounts deemed to be debts due from an employer).

Section 24: Payment of amounts out of collective benefit funds

81.Regulations under this section will ensure that assets held in relation to collective benefits are used to provide those benefits. However there is a power to make exceptions to this general rule. It may be that there are some limited circumstances when it may be appropriate for an employer or some other party to be entitled to some share of any surplus from the scheme. For example where an employer wishes to assist a collective benefit scheme that falls into difficulty by putting some extra funds in, then to encourage such an action there may be arrangements in place to allow the possibility of full or partial repayment to the employer if the scheme has a future surplus. Regulations made under this section may make similar provisions to existing provisions in section 37 of the Pensions Act 1995 (payment of surplus to employer).

Section 25: Policy for calculating cash equivalent of benefits

82.This section contains a power to require trustees or managers of a scheme offering collective benefits to have and to follow a policy for the calculation and verification of cash equivalents of collective benefits. The cash equivalent is used for the purpose of calculating transfer values and for valuing rights for sharing pensions on divorce.

83.Regulations under this section may require trustees or managers to ensure that the policy is consistent with any requirements imposed by regulations under section 97 or 101I of the Pension Schemes Act 1993 or section 30 of the Welfare Reform and Pensions Act 1999 or any other specified requirements. Regulations may also make provision about the content of the policy, the review and revision of the policy and may require trustees or managers to consult about the policy. The regulations can also set out the sort of things trustees or managers must take into account or principles they must follow in setting the policy.

Section 26: Winding up

84.This section provides for regulations about the winding up of schemes providing collective benefits. The regulations can also apply to part of a scheme providing collective benefits.

85.The regulations can make provision about the distribution of assets between members, the operation of the scheme during wind up, discharge of liabilities, and excess assets on wind up. The Pensions Act 1995 already makes provision in relation to these areas for some occupational pension schemes.

86.The section therefore provides for regulations to disapply, amend or otherwise modify the application of sections 38, 73, 73A, 73B, 74 and 76 of the Pensions Act 1995, which concern the winding up of occupational pension schemes. It also provides regulation making powers to make provision corresponding or similar to any provision made by sections 38, 73, 73A, 73B, 74 and 76 of the Pensions Act 1995.

Section 27: Requirement to wind up scheme in specified circumstances

87.This section provides for regulations to set out circumstances in which the trustees or managers must wind up either the whole or part of a scheme providing collective benefits. The powers have been drafted to ensure that any wind up required under this provision will be as effective as if it had been made under powers conferred by the scheme. Regulations made under this section may also override any other legislation, rule of law or provision of a scheme that would otherwise prevent wind up, and override any need for any consent or procedure that would otherwise be required.

Section 28: Policies about winding up

88.Under this section, regulations may provide that trustees or managers of schemes offering collective benefits are required to have a policy for dealing with wind up of a scheme providing collective benefits and to follow the policy.

89.The regulations can require trustees or managers to consult about the policy and to make provision for reviewing and revising the policy.

90.The regulations can also make provision about the content of the policy and can set out the sort of things trustees or managers have to take account of or the principles they have to follow when putting the policy together.

91.The regulations can require the policy to include an explanation of when trustees are required to wind up the scheme and the circumstances when they have the power to decide when to wind up. If they have the power to decide when to wind up, regulations can require the policy to set out how they intend to use that power.

92.The regulations can also require the policy to include an explanation of how assets will be distributed, and if the trustees or managers have the power to decide how to distribute assets, how they intend to use that power.

Section 29: Working out which assets are available for the provision of which benefits

93.This section provides for regulations to set out how to work out which assets are available for the provision of collective benefits, which assets are available for the provision of which collective benefits (for example if there is more than one section in a scheme providing collective benefits) and which assets are available for the provisions of benefits other than collective benefits.

Section 30: Requirement to obtain actuarial advice Section 31: Sub-delegationSection 32: Publication of documents etc Section 33: Enforcement

94.Section 30 provides that regulations may require trustees or managers to consult an actuary who has specified qualifications or meets other specified requirements before making a specified decision or taking other specified steps.

95.Section 31 provides a power for regulations to confer discretion on a person in relation to the provisions in Part 2 of the Act, for example regulations may make provision for the methods or assumptions to be used by an actuary but leave some discretion about these matters to the actuary.

96.Section 32 provides that where regulations made under Part 2 of the Act require the trustees or managers to prepare or obtain a document or to have a policy, regulations may also impose requirements about the publication of that document or policy and require copies of that document or policy to be sent to certain persons.

97.Section 33 provides a power for the regulations made under this Part of the Act to provide for civil penalties to apply where a person breaches requirements in those regulations.

Section 34: Overriding requirements

98.This section allows for regulations made under this Part of the Act to override any conflicting provisions in scheme rules.

5.3 Implementation put on hold

However, after the 2015 election, the new Conservative Government put plans for collective benefits on hold in order to be able to concentrate on the implementation of other reforms already in the pipeline, such as auto-enrolment. Pensions Minister Baroness Altmann explained.

> That is why we have decided that the time is not right to implement Defined Ambition, Collective Benefits and Automatic Transfers. The time is not right to ask the pensions industry to absorb the new swathe of regulation that would be needed to make such further reforms work effectively. The market needs time and space to adjust to the other reforms underway and these areas will be revisited once there has been an opportunity for that to happen.[110]

This remains the Government's position. In its July 2018 report on CDC schemes, the Work and Pensions Select Committee said:

> 42. Though the 2015 Act appears to offer a ready-made solution for CDC, it has not yet been implemented. The provisions that would enable CDC are embedded in wider changes to the legislative framework for all private pensions. Commencement of the 2015 Act would therefore depend on a "wholesale rewriting of pensions legislation", through regulations to support all existing and new forms of pension provision envisaged by it. In October 2015, the Government announced that the implementation of the 2015 Act would be postponed indefinitely to enable Government and the pensions industry to focus on other pension reforms.This remains the Government's position. The DWP said that to implement the 2015 Act now would be complex, time-consuming and disruptive to tens of thousands of other pension schemes. This would be an "unacceptable" price for enabling CDC schemes, especially given the "uncertain demand" for them.[111]

In its response in September 2018, the Government said it was working with Royal Mail and the Communication Workers' Union on an appropriate legislative, governance and regulatory regime for CDC.[112]

110 HLWS 238, 15 October 2015
111 Work and Pensions Select Committee, Collective defined contribution schemes, HC 580, July 2018, para 42
112 Letter from Pensions Minister to chair of Work and Pensions Select Committee, September 2018

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