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Extending CDC to unconnected multi-employers and decumulation-only arrangements

This latest DWP consultation on collective defined contribution (CDC) schemes has been launched as part of a broader suite of consultations aimed at creating "fairer, more predictable, and better-run pensions" and comes six months after the 1 August 2022 effective date for single or connected employer schemes.

It considers a potential CDC policy framework for accommodating whole-life multi-employer occupational pension schemes (including master trusts) and explores a CDC decumulation-only option.

Background

The Pension Schemes Act 2021 introduced the legislative framework for CDC schemes. The DWP's response to its consultation on regulations was published in December 2021 and The Pensions Regulator's response to its consultation on the code of practice about the authorisation and supervision requirements was published in June 2022. This is the legislative and regulatory framework for single-employer or connected-employer CDC schemes which took effect from 1 August 2022.

The main feature of CDC schemes is that contributions are defined, like defined contribution (DC) schemes, but the future benefits are expressed as a target pension rather than an investment-linked "pot" like a DC scheme.

The contributions are not invested in individual member funds. Instead, the contributions are pooled in a similar way to defined benefit (DB) schemes. The target pension is calculated actuarially based on contributions from the employer and members, investment returns and anticipated mortality of the membership.

Crucially, unlike DB schemes, the target pension is not guaranteed and can be adjusted up or down by the scheme, depending on long-term economic factors.

The DWP's expectation is that, by providing target benefits rather than guaranteed benefits, CDC schemes can harness economies of scale and pooling of risk to generate higher retirement incomes for members than DC schemes can achieve, whilst avoiding the financial obligations associated with DB schemes for sponsoring employers.

(The legislation refers to CDC as "collective money purchase" to ensure that CDC schemes sit clearly within the money purchase provisions of existing legislation. However, the DWP uses CDC in the consultation and The Pensions Regulator uses CDC in the code of practice.)

New CDC designs and challenges

The DWP has been involved in many discussions with stakeholders (including The Pensions Regulator and the Financial Conduct Authority) over the last 12 months about other forms of CDC. It has concluded that there is "strong interest in whole-life CDC schemes catering for multi-employer schemes" and also "interest in the potential for CDC decumulation-only arrangements". ("Whole-life" refers to accumulation and decumulation within the same arrangement.)

Multiple unconnected participating employers participating in a CDC scheme would be looking to minimise cross-subsidies and would want flexibility in terms of contribution and accrual rates, for example, to account for different demographics and rates of pay.

The challenges include:

- who would be allowed to establish a whole-life multi-employer CDC scheme;
- the design features and sectionalisation;
- the risks and challenges in a commercial market;
- how to ensure the schemes are resilient and sustained in the long-term;
- how to accurately and effectively communicate the design and risk to both employers and members; and
- how decumulation-only arrangements would work.

Key principles

The consultation proposes some key principles:

- CDC benefits must be collective money purchase benefits (and not defined benefits), accessed through a trust-based occupational pension scheme;
- authorisation would continue to be through The Pensions Regulator and subject to an authorisation application fee;
- inclusion of an aspiration to deliver increases in line with the Consumer Prices Index (CPI);
- annual valuations and adjustments (which would be made without variation across the membership) would apply so that assets and benefits remain in balance; and
- the CDC fund of whole-life CDC multi-employer schemes would be subject to the 0.75% CDC charge cap.

Qualifying benefits and schemes

In the Pension Schemes Act 2021, qualifying benefits include the payment of a pension – this would continue to be the case. Changes would need to be made to the existing qualifying scheme requirements to allow unconnected participating employers, but public service pension schemes would continue to be excluded. Schemes could be allowed to offer both CDC and non-CDC benefits through separate sections.

Authorisation

The DWP is proposing that the requirements for authorisation continue for whole-life multi-employer CDC schemes. However, there are likely to be some changes.

The DWP wants respondents to consider the definition of “operating” (i.e. operating without authorisation is prohibited under the current Act). Payment of contributions into a CDC scheme that has not been authorised would not be permitted, but the DWP wants to consider allowing employers to pay set-up and authorisation costs, particularly where the scheme is established by a provider and where the employer would be purchasing an off-the-shelf product.

Further questions relate to:

- the fit and proper persons requirement that applies under the current Act and whether that is appropriate for the new CDC designs (similar to the conditions for master trusts);
- the role of The Pensions Regulator;
- the current prescribed requirements relating to design, viability and financial sustainability;
- a requirement for a scheme funder and a business plan (equivalent to the concepts for master trusts);
- the systems and processes to support effective member communication and maintain a good standard of administration and governance; and
- a requirement for a continuity strategy (including a section setting out the levels of member-borne administration charges), with also consideration given to the new CDC designs including in their continuity strategy an aspiration to run the scheme as a closed scheme.

Applications

The current requirement for applications to be made to The Pensions Regulator and the decision to be made within a six-month deadline would continue.

The fee structure would be reviewed at a later date, with consideration given to the interaction between the two authorisation regimes when an application for CDC is made by a master trust.

Valuations

The current regulations ensure there is an annual actuarial valuation (using a central estimate methodology that does not seek to be overly optimistic or to build in prudence), a benefit adjustment process that applies to all members, and any increases in benefits to be sustainable.

The DWP considers a modification to the existing requirement for an actuarial valuation to be undertaken before an increase can be applied and capping increases so that excess surplus can be removed.

Ongoing supervision

As for authorisation, the DWP is proposing that the requirements for ongoing supervision continue for whole-life multi-employer CDC schemes. However, there are likely to be some changes in the significant event and triggering event requirements. The existing requirements relating to the implementation strategy of a CDC scheme would be carried forward to the new CDC designs.

Continuity options

The current Act includes a continuity options framework to protect members following a triggering event. These include: discharge of liabilities and winding up; resolving the triggering event; conversion to a closed scheme.

There are some challenges with this framework for multi-employer CDC schemes, which the DWP asks respondents to consider along with the current default and alternative discharge options.

Other policy considerations

In this section of the consultation, the DWP considers some other matters that apply to single-employer or connected-employer CDC schemes, to see how these would apply to multi-employer schemes.

For example:

- transfers out and in would be permitted, but the actuarial calculation of a member's share will need to take into account the factors considered in the scheme's actuarial plan such as age and accrual rates;
- the existing CDC charge cap and other charge control measures would apply in the same way;
- the statutory transfer protections introduced under the current Act would apply to members who transfer out of (or into) CDC schemes;
- the existing subsisting rights provisions, as well as the disclosure of information requirements, would apply in the same way; and
- the automatic enrolment quality requirement introduced for single-employer or connected-employer CDC schemes will need to be revisited for multi-employer CDC schemes.

Decumulation-only arrangements

The idea of a CDC decumulation-only arrangement is that members would only transfer to the scheme at the point of decumulation. It would be the value of the retirement savings that they are transferring in that would determine what pension income the member might then receive; they may receive an income for life, but the benefit level is not guaranteed. Having said that, the DWP is minded to include an expectation that CDC decumulation-only arrangements would aim to provide inflation-linked increases.

As decumulation products have historically been regulated by the FCA there are implications and risks to consider for trust-based schemes.

The DWP asks questions about the following:

- the costs of establishing the arrangement;
- how the arrangements might establish scale to realise the full benefits of CDC and deal with the matter of small pots;
- what rules would be needed for establishing a fair and simple buy-in pricing mechanism and how mortality underwriting would be factored in; and
- the steps taken to ensure communications to members and the marketing of the arrangement is not overly optimistic about the risks and benefits to avoid a mis-selling scenario.

Comment

There are 24 questions in this consultation, which has a closing date of 27 March 2023. There are no timescales proposed for the introduction of either multi-employer CDC schemes or decumulation-only arrangements.

Although the legislation governing single-employer or connected-employer CDC schemes took effect from last summer, the first CDC scheme in the UK (for Royal Mail) is unlikely to begin operating until 2024, according to Laura Trott, the Minister for Pensions, in the Ministerial Foreword.

There is, without doubt, an appetite to consider alternatives to the traditional DB and DC routes to pension provision, as well as a real concern for the retirement outcomes of members with DC pensions. The DWP appears to be ready to consider extending CDC beyond the existing legislation provided the requirements cross over without major issues, although further regulations will be necessary.

There has been a lot of debate about the various forms that decumulation-only CDC options could take, and it is welcome that the consultation recognises this variation. The consultation proposes approaches which could work with single-employer, connected-employer and unconnected multi-employer schemes, although is likely that decumulation-only CDC schemes would likely be introduced first within a commercial product (like a master trust).

Laura Trott ends by encouraging “interested parties to respond and play their part in helping improve outcomes for tomorrow’s pensioners” and declares this consultation “an opportunity to help shape the next stage in one of the most significant developments in UK pensions”.