

INDEPENDENT REVIEW OF RETIREMENT INCOME
CONSULTATION PAPER

David Blake and Debbie Harrison

24 November 2014

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BACKGROUND

On 29 May 2014, Rachel Reeves MP, the Shadow Work and Pensions Secretary, launched an **Independent Review of Retirement Income** to look at how to boost defined contribution (DC) savers' retirement income. She invited Professor David Blake, Director of the Pensions Institute, to lead the review, with Professor Debbie Harrison of the Pensions Institute as a senior consultant.

The terms of reference are as follows. "The **Independent Review of Retirement Income** will consider how to support a pensions market that works for all, retaining flexibility and choice on how savings are accessed and drawn down, while ensuring all savers, including those on low and modest incomes, are able to secure a decent and reliable retirement income.

Specifically, this will include:

- How to ensure that the workplace pension retirement products available to people are those best suited to ensure they have security and confidence in retirement
- The support savers need to make the right choice at retirement for them and their family and how to build on the lessons of auto-enrolment
- How savers can be helped to manage longevity risk
- The role of the National Employment Savings Trust (NEST) in helping savers to access good quality retirement products
- The role of collective pension schemes and how these could be introduced in the UK"

The Review will consult widely, drawing on the advice and input of senior experts in relevant fields and is working closely with the CBI and the TUC to ensure that employers and employees are engaged and their perspectives represented.

The Review team are members of the Pensions Institute. The Pensions Institute is an independent academic research centre. We believe that the subject of this Review is crucial to the long-term success of auto-enrolment, a policy objective which has cross-party support. We are interested in generating good consumer outcomes in the face of the significant structural and social challenges facing people at retirement.

CONSULTATION PROCESS

As part of the consultation process, we have prepared a consultation paper (CP). In this CP, we raise a series of questions that will help us address the above remit. We welcome responses from all interested stakeholders, including practitioners in the market (e.g., scheme and product providers, advisers, consultants, lawyers, trustees, Independent

Governance Committees), trade unions, employers, think-tanks, regulators, and consumer organisations. We stress that respondents should feel free to be selective in the questions chosen for comment. Key questions are in **bold**; the rest are intended principally for specialists. We also welcome responses from consumer research organisations (which have collected evidence on the issues we have raised) and from organisations from other countries (which are in a position to share international experience on the issues we have raised).

The CP is posted on the Pensions Institute website, together with a template for comments contained in a word document (www.pensions-institute.org). Please use only this template for replies which should be emailed to:

Marilyn Parris-Bell (Marilyn.Parris-Bell.1@city.ac.uk)
Secretary to the Independent Review of Retirement Income
106 Bunhill Row
London
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If you have any queries about the CP please email them to Marilyn. The closing date for submissions is **20 February 2015**. The Review team will report in summer 2015.

INTRODUCTION

'Good' defined contribution (DC) pension schemes produce predictable, although not guaranteed, lifelong retirement incomes from members' contributions. Good DC pension schemes also provide value for money for every pound saved in the scheme.

The remit of the **Independent Review of Retirement Income (IRRI)** is to examine and evaluate the predictability and value for money of the lifelong retirement income produced for a given level of planned pension savings in DC pension schemes, the type of pension schemes that most workers in the private sector now have in the UK.¹

We seek to answer the following questions:

- (1) Can we design a pension system that produces lifelong retirement incomes that are more predictable than existing systems?, and
- (2) Can we generate the best possible value for every pound saved?

If the answer to both these questions is 'yes', then there is a third question to answer:

- (3) Can we ensure that the options that people are encouraged, nudged or defaulted into are both well designed and well regulated?

We believe the answers to these questions lie in understanding the risks involved in the generation of retirement income from pension savings and then finding the most efficient ways of dealing with those risks.

The most important risks are:

- Contribution risk – the risk that pension contributions (and hence pension savings) are lower than planned, e.g., because the scheme member becomes unemployed, is unable to work due to ill health, or is unable to pay off their debts.
- Investment risk – the risk that investment performance is worse than expected or the risk that investments do not generate incomes in a way that matches the desired pattern of consumption in retirement.
- Inflation risk – the risk that inflation is higher than anticipated.
- Interest rate risk – the risk that interest rates are low at the point of annuity purchase.

¹ Adequate pensions require high levels of pension savings over long periods. It is generally not possible – due to the risks involved – to achieve this objective from low levels of pension savings that rely on unrealistically high real rates of investment return being realised over extended periods. The IRRI has not been asked to address the question of the adequacy of pensions or the adequacy of pension savings (which many commentators have said are inadequate in the UK). Nor will it address long-term care and the interaction of this with DC decumulation.

- Longevity risk – the risk that the individual savers live longer than their life expectancy (i.e., idiosyncratic longevity risk) and the risk that savers as a whole live longer than anticipated (i.e., systematic or aggregate longevity risk).
- Cost risk – the risk that the total costs of running the pension scheme during accumulation and decumulation are higher than expected or understood.
- Political risk – the risk that the government changes the rules in an adverse way (e.g., reduces the level of tax relief).
- Regulatory risk – the risk that regulations change in an adverse way (e.g., the regulator increases regulatory capital requirements, which has the effect of reducing annuity rates).
- Demographic/cultural risk – the risk that younger cohorts refuse or are unable to honour the implicit intergenerational contract that underlies many pension schemes. For example, the next generation of workers refuses – or is unable – to pay the pensions the retired generation expects to receive, because they are unwilling to honour the implicit contract or because there are too few of them in relation to the size of the retired population. Also, an arrangement that works in one culture (e.g., Holland) might not work in another (e.g., the UK).
- Market conduct risk – the risk that those who provide services to the scheme act in a way that disadvantages scheme members (e.g., investment managers subject to a charge cap negate the effects of the charge cap by increasing portfolio turnover, or the benefits of economies of scale go to scheme providers' shareholders rather than to members).
- Behavioural risk – the risk that scheme members behave in a way that is not considered to be rational (i.e., not in their long term interests, since they make short-term decisions that they subsequently regret); included here would be the risk that members fail to understand the risks they face.

There are a number of ways of dealing with such risks in general:

- The risks can be assumed or 'run' – this might be deliberate (e.g., in the case where a scheme member increases the level of investment risk in their pension fund in the hope of achieving a higher investment return and, hence, a higher pension) or unavoidable (e.g., in the case of contribution, political or regulatory risk).
- The risks can be regulated against – effective regulation can reduce cost and market conduct risk, for example.
- The risks can be educated against – by explaining behavioural biases and nudging people towards making optimal decisions.
- The risks can be reduced – by careful design of the scheme. For example, demographic risk can be reduced by ensuring inter-generational fairness, while by careful design of the investment strategy, investment risk can be reduced.

- The risks can be pooled amongst members of a given cohort (known as intra-generational risk pooling) – idiosyncratic longevity risk can be pooled and hence made more predictable, but this, in turn, requires scale (i.e., only large pension schemes can do this).
- The risks can be shared between members of different cohorts (known as inter-generational risk sharing) – investment returns can be smoothed across different cohorts using a smoothing fund.
- The risks can be hedged if there are suitable hedging instruments – inflation and interest rate risk can be hedged using inflation and interest rate derivatives, but systematic longevity risk cannot currently be hedged due to the absence of longevity bonds.
- The risks can be managed within a carefully designed default plan into which the members are auto-enrolled. When someone first starts work, this will be a default accumulation plan with a default contribution rate and investment strategy. When someone retires, this could be a default retirement expenditure plan.
- Finally and most worryingly, the risks can be ignored.

Question (3) above is probably the most difficult question to answer. It requires those saving in a pension scheme to understand that confronting and dealing with risks are unavoidable aspects of building up pension savings over a 40-year (or longer) working life and then running down those savings over a retirement period that could be 30 years or more. But if people can have confidence that those designing and regulating the pensions system have dealt with these risks in the most efficient and cost-effective ways possible, then it might be possible to nudge (or even default) savers into making the right choice at retirement for them and their family. To do this, we will need to build on the lessons of auto-enrolment and, in particular, the issue of having a well-designed default decumulation process at retirement.

Finally, we note the different classes of DC savers and decumulators:

1. Members of DC auto-enrolment schemes: active, deferred and pensioners.
2. Defined benefit (DB) scheme members who transfer to the DC regime. Those who take advantage of the DB-to-DC transfer rules might use the DC scheme offered by their employer, if this includes a drawdown facility. In many cases, they will already be members for accumulation.
3. The self-employed.
4. Workers with employment contracts that do not qualify them for auto-enrolment.

We will examine the characteristics and challenges presented by each group in relation to achieving good retirement outcomes. Our main emphasis will be on the first group, although we will consider how DB-to-DC transferees, the self-employed and those with employment contracts that do not qualify them for auto-enrolment can also be helped.

CONSULTATION QUESTIONS

The IRRI's report will focus on five key areas and we would welcome your responses to the following questions listed under each of the section headings. We would like you to note that longevity risk is discussed in a number of these sections. This is unavoidable, since it is a key risk in retirement and cuts across products, the decisions savers make, savers' understanding of this risk, and providers' capacity to bear it.

1. How to ensure that savers can get the best products in retirement

Until now, most members of DC pension schemes were required to buy a lifetime annuity at retirement. The 2014 Budget has changed that requirement as well as opened up the possibility that new types of retirement products will become available. Not all of these will be suitable, especially if they can lead to people spending all their pension savings before they die. We will examine the new products to see which are most suitable, given the new pension flexibilities, and whether there is a case for extending the governance and quality standards developed for the accumulation stage into (some) of the decumulation options. We will also consider how 'longevity insurance' (e.g., a deferred or immediate lifetime annuity) can be combined with 'scheme drawdown' to provide a cost-effective retirement income product that allows for flexibility in spending during retirement while ensuring that savers do not run out of money before they die.

Consultation questions:

- 1. (a) What should be the primary aims of a 'good' DC scheme? Please explain.**
(b) If the provision of a predictable income should be a primary aim of a 'good' DC scheme, how should this be defined?
(c) If value for money should be a primary aim of a 'good' DC scheme, how should this be defined?
- 2. (a) Do you agree with the breakdown of risks listed in the Introduction?**
(b) Are there any important risks we have not identified?
(c) To deal with political risk, would it make sense to have an independent Pension Commission to set pension policy (similar to the independent Monetary Policy Committee)?
- 3. (a) Do you expect products with longevity insurance (e.g., a lifetime annuity) to remain an essential component of a well-designed retirement programme?**
(b) How should those individuals who continue to buy lifetime annuities be assisted to obtain the best value products for their circumstances?
(c) If individuals do not purchase lifetime annuities, how does an individual hedge their longevity risk in retirement?
- 4. (a) Where annuities are purchased later in retirement, what are the most effective and efficient products for providing income in the period between retirement and the age at which the longevity insurance comes into effect?**

- (b) Should such products have a maximum recommended level of income withdrawal?*
- (c) If so, how should that level of income be determined?*
5. *What are the advantages and disadvantages of scheme drawdown (i.e., where the scheme provides an income to the retired member prior to the purchase of an annuity)?*
 6. *(a) Should decumulation default products provided by, say, large-scale master trusts, be subject to the same trustee-based governance and quality standards that apply to the accumulation default fund?*
(b) Where decumulation products are offered by contract-based schemes, should they be included in the requirements for the new Independent Governance Committees to provide governance and quality standards and to assess value for money?
 7. *(a) What could be the typical total expense ratio (TER) for a default drawdown product provided by a large-scale master trust?*
(b) How might this TER compare with individual drawdown products sold in the retail market?
(c) Can you give any examples of TERs for retail drawdown products?
 8. *(a) Should scheme default drawdown products be subject to the charge cap?*
(b) Should this be the same as for accumulation (i.e. 0.75%) or is there a case for a higher cap? If higher please explain why and what the difference might be?
 9. *Retail drawdown products will be sold via regulated advice and they will be purchased via non-advice (execution-only). Is there a case for:*
(a) Higher quality controls and consumer protection in relation to risk and costs? Explain.
(b) Making retail products subject to a charge cap? Explain.
 10. *What is the optimal investment strategy in scheme drawdown prior to the introduction of longevity insurance?*
 11. *What are the advantages and disadvantages of institutional annuitisation (i.e., where annuities are provided on a bulk basis either by the scheme (self annuitisation) or by an insurance company, rather on a retail basis as currently)?*
 12. *Could institutional annuitisation deal with the individual underwriting of annuities and still encourage competition from providers in the open market to maximise consumer outcomes (e.g. in the case where a retired member has a medical condition which reduces their life expectancy)?*
 13. *(a) Would a market for advanced life deferred annuities be viable?*
(b) What is the likely demand for advanced life deferred annuities?
 14. *Is there likely to be demand for inflation protection?*
 15. *What are your views on the proposals by HM Treasury to allow annuities to have more flexible payment terms by:*
(a) allowing lifetime annuities to decrease

- (b) allowing lump sums to be taken from lifetime annuities*
- (c) removing the ten-year guarantee period for guaranteed annuities*
- (d) allowing payments from guaranteed annuities to be paid to beneficiaries as a lump sum, where they are under £30,000?*
- 16. *What are your views on U-shaped or J-shaped annuities?*
- 17. *Should DC retirement products and decumulation strategies be linked to the single tier state pension? If so, how?*
- 18. *What other retirement products do you expect to become available? Please provide details if possible.*
- 19. *Is there a case for designating certain retirement products as ‘safe harbour’ products? Explain.*
- 20. *Following the impact of the Budget 2014 tax changes on annuity providers, do you have any concerns about supply-side contraction or other developments in the annuity market that might make it less competitive?*
- 21. *(a) What is the best way to deal with stranded pots? Explain.*
(b) Two approaches have been put forward to date: ‘aggregator’ and ‘pot-follows-member’. Do you have preference for one over the other? Explain.
(c) Would ‘scheme-follows-member’ be feasible? Explain

2. Supporting savers to make the right choice at retirement for them and their family and how to build on the lessons of auto-enrolment

It is generally agreed that the optimal drawing down of retirement assets is a considerably more complex activity than the initial task of accumulating those assets, in part, because people’s circumstances differ. We will investigate whether it is possible to design a good default option at retirement which will be suitable for most savers, in the same way that a good default investment strategy in the accumulation phase can be designed. Even if this is possible, we accept that more people might opt for a different retirement income plan than the estimated 10% of people who reject the default accumulation fund. For example, some retirees might be in poor health and so might choose to access their funds in full at the date of retirement – or over as short a period as possible (staggered to avoid paying unnecessary income tax). Given the complexities of retirement expenditure decision making, we will examine the support that savers need to make the right choices for them and their family. Building on the lessons of auto-enrolment, we will examine what nudges or defaults would be useful to move people towards making optimal decisions.

The 2014 Budget and subsequent consultation on the part of HM Treasury² introduces a new tax regime for decumulation, which takes effect in April 2015 and which confers

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https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/294795/freedom_and_choice_in_pensions_web_210314.pdf and the consultation response in

greater freedom in the way DC savers draw their retirement income.³ As a result, from April 2015, it is expected that DC decumulation at the point of retirement in many cases will take the form of cash and income withdrawal, with annuity purchase deferred until later life.

While the tax reform legislation has been broadly welcomed, in terms of the greater freedom it confers on DC savers at retirement, it has also raised concerns that the new regime will be more complicated, costly and risky, in terms of the wider product choice and tax planning, for example. To help DC savers avoid making poor decisions, the government has also introduced the guidance guarantee, a new service that will be free and impartial and which aims to will help individuals consider their options and make informed choices.⁴

Consultation questions:

22. It is now recognised that many people face a number of behavioural barriers which prevent them behaving optimally. When it comes to decumulation, what are the key barriers?

23. We need to recognise that retirees: have different expenditure needs during different phases of their retirement; need to pace their spending throughout retirement in order to optimise the use of their lifetime assets and income and their ability to make intended bequests; and need a choice architecture that reflects the market segment to which they belong.

(a) What is your understanding of the regulatory consumer market segmentation and is this appropriate in relation to the needs of DC retirees?⁵

(b) What nudges and choice architecture do people need to deal with these issues and overcome the behavioural barriers they face?

24. (a) What lessons from auto-enrolment in the accumulation phase can be brought to the decumulation phase?

(b) Given the importance of income security for the elderly and the existence of longevity risk, is there a case for defaulting people into buying longevity insurance via auto-enrolment (i.e., drawdown with longevity insurance becomes the default retirement strategy)? Consider the advantages and disadvantages of such a strategy.

(c) What would be the likely annualised cost of such products for individuals?

(d) How could the default principle, upon which the success of auto-enrolment is predicated, be best reconciled with the individual freedoms for DC decumulation introduced in the 2014 Budget?

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/332714/pensions_response_online.pdf

³ <https://www.gov.uk/government/publications/draft-legislation-the-taxation-of-pensions-bill>

⁴ <https://www.gov.uk/government/news/millions-guaranteed-the-right-to-free-and-impartial-guidance-on-their-new-pensions-choices>

⁵ Traditionally, the UK market was segmented into the mass market, the mass affluent market and the high net worth market, but this is changing.

- 25. What are the implications of the Chancellor's announcement in September 2014 effectively ending the 55% tax rate on inherited pension pots?**
- 26. What are your views on the guidance guarantee and how effective it will be?**
- 27. (a) Will other forms of guidance and advice be needed?**
(b) For DC savers who prefer to make their own decisions, what is the best way to build on the guidance guarantee to help individuals avoid buying retail products that are inappropriate (e.g., in relation to risk) and/or poor value (e.g., in relation to price)?
- 28. (a) What specific risks should regulatory safeguards aim to address in relation to financial decisions made at retirement?**
(b) At what point does individual choice cease to be a regulatory concern/responsibility?
- 29. Some DC customers might draw down all their pots in the early years of retirement, a decision they might subsequently regret. What is the most effective way of assisting DC customers to act in their best long-term interests?**
- 30. (a) What is the best way of ensuring that any DB-to-DC transferees only undertake such a transfer when it is in their best interests?**
(b) What are your estimates of the number of DB-to-DC transferees (deferred and also active) and size of assets involved?
(c) Is the requirement for regulated independent advice for such transferees adequate?
(d) Can/will the guidance guarantee process cope with DB active/deferred members who seek help in considering their options?
- 31. Are there other ways of supporting pension savers to make the right choice at retirement for them and their family?**

3. Helping savers to manage longevity risk

A particularly important issue in retirement income provision is longevity risk. There are two components to longevity risk. The first is the uncertainty over how long any particular scheme member is going to live after retirement. This is known as idiosyncratic longevity risk. The second is uncertainty over how long members of a particular age cohort are going to live after retirement. This is known as systematic or aggregate longevity risk.

Research has found that most individuals underestimate how long they are going to live, often by many years.⁶ This is hardly surprising, given the complexity of quantifying longevity risk: even official agencies, like the Office for National Statistics, whose job is to forecast life

⁶ Chris O'Brien, Paul Fenn, and Steve Diacon (2005) How long do people expect to live? Results and implications, Centre for Risk and Insurance Studies, Nottingham University Business School, CRIS Research Report 2005-1.

expectancy in the UK, systematically underestimate how long people are going to live.⁷ What all this means is that longevity risk is a risk that the majority of individual savers will not realistically be able – and therefore should not be expected – to manage themselves. To protect them from outliving their resources, most savers are likely to need longevity insurance at some stage in retirement – the possible exceptions being those with very significant wealth or those with a serious life-shortening medical condition but without dependants, for example.

Idiosyncratic longevity risk can be reduced by pooling and taking advantage of the law of large numbers. Systematic longevity risk, however, cannot be reduced in this way. It is a trend risk and can only be hedged with a hedging instrument such as a longevity bond. We will consider the role that longevity bonds might play in helping pension scheme providers hedge the systematic longevity risk they face when they provide longevity insurance.

Consultation questions:

- 32. *What evidence is there of individuals' ability to reliably estimate how long they are going to live?***
- 33. *How easy is it for individuals to quantify longevity risk? What evidence is available on this question?***
- 34. *Is longevity risk a risk that individual savers are able – and should be expected – to manage themselves?***
- 35. *Where people receive tax incentives to save into pensions, should people be required to secure a minimum lifetime income in retirement?***
- 36. (a) *Do you believe that the DC retirement income market could benefit from the introduction of a market in longevity bonds? Explain.***
(b) *Do you believe that a market in longevity bonds is viable (in the sense of having sufficient demand to justify its introduction)? Explain.*
- 37. *Do you have a preferred design for a longevity bond?***
- 38. *Is there a case for the government to issue longevity bonds? Explain.***
- 39. *Are there alternatives to longevity bonds to hedge systematic longevity risk? Explain.***
- 40. *Are there other ways of helping savers to manage longevity risk?***

4. The role of the National Employment Savings Trust (NEST) in helping savers to access good quality retirement products

The introduction of NEST has been a game changer for the provision of good-value, well designed and governed pension schemes for low- and medium-income savers in small and medium-sized companies. It has brought institutional standards – in terms of low charges, good governance and a well-designed default investment fund – to the formerly high-cost,

⁷ David Blake (2014) The consequences of not having to buy an annuity, Pensions Institute, June (www.pensions-institute.org/workingpapers/wp1409.pdf).

poor-value world of retail customers.⁸ It has also encouraged the entry of new multi-employer trust-based schemes, such as Now: Pensions and The People's Pension.⁹ However, under current legislation, once members of these and other auto-enrolment schemes retire, they have to go to the retail market to buy annuities on an individual basis. Even under the proposed new decumulation regime for April 2015, those who do not wish to buy an annuity might end up buying a retail income drawdown product, which at present can be very expensive and suffer from both poor investment strategy and poor governance. Could institutional standards – in terms of charges, governance and design – be brought to the retirement income space and what role could NEST play in achieving this?

Consultation questions:

- 41. Should NEST provide retirement income products to its members?**
- 42. (a) Should NEST provide a default decumulation product (e.g., scheme drawdown or annuitisation)?**
(b) If so, what quality standards should apply (e.g., in terms of charge caps, governance)?
- 43. Are there any other ways in which NEST can help savers to access good quality retirement products?**
- 44. In an aggregator model for stranded pots:**
(a) Would it be desirable for NEST to act as one of the aggregators?
(b) Which other schemes could act as aggregators?
- 45. Could NEST do more in decumulation for the self-employed and workers excluded from auto-enrolment?**
- 46. (a) Could NEST become a collective pension scheme? Explain.**
(b) Should NEST become a collective pension scheme? Explain.

5. The role of collective pension schemes and how these could be introduced in the UK

The analysis of the risks outlined in the Introduction suggests that these might be more effectively managed if they (or at least those that can be) are pooled and shared. This requires scale and, at present in the UK, DC pension schemes are treated as individual accounts. While the contributions of scheme members can be invested in a common investment fund, so that all members with the same length of membership in the same fund get the same return, there is no pooling or sharing of risks.

⁸ In July 2014, the government announced that in 2017, it would remove the contribution cap and lift the transfer ban imposed on NEST.

⁹ Debbie Harrison, David Blake and Kevin Dowd (2012) *Caveat Venditor: The brave new world of auto-enrolment should be governed by the principle of seller not buyer beware*, Pensions Institute, October (www.pensions-institute.org/reports/caveatvenditor.pdf) and Debbie Harrison, David Blake and Kevin Dowd (2014) *VfM: Assessing value for money in defined contribution default funds*, Pensions Institute, January (www.pensions-institute.org/reports/ValueForMoney.pdf).

Collective DC (CDC) pension schemes that pool and share risks are not currently allowed in the UK. However, in the 2014 Pension Schemes Bill, the government is introducing legislation that is expected to change the traditional UK DC system in several important ways. The Bill includes provisions for new risk-sharing strategies for DC schemes that aim to improve the predictability of the retirement income. This is enabling legislation only; it does not include the full regulatory details. Effective regulation will be crucial, as the following extract from an article published in the Financial Times notes:¹⁰

Regulation is especially important because, unlike DC pots, individual CDC members have no clearly defined property rights. And unlike DB pensions, there is no sponsoring employer standing behind it, so target pensions can only be paid from a CDC's own assets. For members to judge the likelihood of their target pensions actually being paid, it is crucial that they can understand the scheme's overall funding position easily.

The current bill, however, says nothing specific about CDC regulation. In particular, CDC trustees, advised by actuaries, are left to decide for themselves how target pensions for all members should be valued, so overall funding can be measured against the market value of assets.

This "DIY" approach means there is no objective and consistent benchmark for CDC members to judge the likelihood of their target pensions being paid. "Trust me, I'm an actuary" is not good enough as the basis for a wholly new and untested type of pension.

We will examine overseas examples of collective schemes that pool and share risks and hence make incomes in retirement more predictable (at least in principle).¹¹ Broadly speaking, there are two types of CDC scheme in existence: one that is a form of DB replacement and one that is a form of DC replacement. Because collective schemes claim to have economies of scale that are additional to those of individual-account-based DC schemes, we will examine whether this model for 'collective' schemes can also boost incomes in retirement or at least make such incomes more stable across different cohorts of members. We will investigate how their performance might compare with standard DC schemes. We will also consider how the ability of the member to transfer out and also the greater flexibility in drawing on the pot in retirement can operate in tandem with a CDC pension.

Consultation questions:

47. What should 'collective' mean in the UK context (e.g., collective in terms of scale and governance, and collective in terms of risk-sharing)?

¹⁰ John Ralfe, CDC pensions will work only if strictly regulated, FT 16 November 2014, <http://www.ft.com/cms/s/0/d34f4288-69b8-11e4-8f4f-00144feabdc0.html?siteedition=uk#axzz3JEGV13Nk>

¹¹ CDC schemes are common in Netherlands, Denmark and Canada.

- 48. What are the main benefits of CDC schemes over individual DC schemes?**
- 49. What are the main disadvantages of CDC schemes over individual DC schemes?**
- 50. CDC schemes may be able to generate incomes that are higher than individual DC schemes as the latter are currently operated.**
- (a) Are there reasons why an individual DC scheme could not follow the same investment or decumulation strategy as a CDC scheme?**
- (b) Would trustees of an individual DC scheme be willing to accommodate the greater investment risk, given the need to enable members to transfer out and to take their pension pot with them?**
51. (a) Would a CDC scheme have any additional risk-sharing advantages over a large master trust DC scheme which followed the same investment and decumulation strategies where possible?
- (b) Can the benefits from any additional sources of risk sharing available to CDC schemes be quantified?
- 52. (a) What is your preferred design for a CDC scheme, in terms of targeted benefits? (e.g., a CDC scheme that is intended to replace a DB scheme and hence would be earnings-related (specify accrual rate, earnings measure, pre-retirement indexation rule, post-retirement indexation rule); or a CDC scheme that is intended to replace an individual DC scheme and hence would be with-profit and a target return, unit-linked and a target return, etc).**
- (b) Explain why**
- 53. (a) What is the best estimate contribution rate to achieve the target benefit?**
- (b) How should the contribution rate be shared between employer and member?**
54. (a) Can a CDC scheme work with a planned contribution rate that is fixed independent of a member's age or is an age-dependent member contribution rate required?
- (b) If the latter, is a change to equality legislation required?
- 55. What investment strategy would be appropriate for CDC schemes: (a) in accumulation and (b) near retirement and (c) in decumulation?**
56. What are the main benefits of a CDC scheme in terms of intra-generational risk pooling?
57. What are the main benefits of a CDC scheme in terms of inter-generational risk sharing?
58. (a) Over how many generations should risk be shared?
- (b) Explain why this is optimal
- 59. How should the risk-sharing rules in a CDC scheme be defined?**
- 60. How much discretion should a CDC scheme's managers have when it comes to smoothing or adjusting benefits to target benefits, or should the rules be fully transparent?**
- 61. (a) If the actual pension is above the target pension, when should adjustments be made?**

- (b) How and in what order should the adjustments be made (consider adjustments to pension indexation, pension amount in payment, investment strategy, active member contribution rate, active member retirement age)?**
62. (a) *If the actual pension is below the target pension, when should adjustments be made?*
 (b) *How and in what order should the adjustments be made (consider adjustments to pension indexation, pension amount in payment, investment strategy, active member contribution rate, active member retirement age)?*
- 63. What mechanisms are needed to ensure that no CDC scheme becomes insolvent? For example, a CDC scheme might try to use a high target return to attract more customers.**
64. *Is it necessary for a CDC scheme to start with or build up a reserve fund to give it credibility?*
- 65. CDC schemes in other countries (e.g., Holland) have virtually no flexibility with respect to member choice (e.g. contribution rate, investment strategy, retirement date, form of decumulation (i.e., pension). Do the freedoms and flexibilities introduced by the 2014 Budget render CDC schemes unfeasible or more risky in the UK? Explain why not or, alternatively, how freedom and flexibility would need to be tailored in the context of CDC schemes?**
66. *One of the biggest growth areas prior to the 2014 Budget was the medical underwriting of annuities and the growth of enhanced annuities. But in a standard CDC scheme, everyone gets the same pension irrespective of health status.*
 (a) *Would it be feasible in a CDC scheme to medically underwrite the pension in retirement?*
 (b) *Would it be desirable to do this?*
67. *How should a CDC scheme best be organised: (a) on a company-wide basis, (b) an industry-wide basis, or (c) a nation-wide basis?*
- 68. What is the minimum number of members in a CDC scheme to make it viable? Explain this figure.**
- 69. Effective regulation, governance and quality standards will be crucial, given the absence of member property rights (which apply in standard DC schemes) and also the absence of a sponsoring employer that guarantees benefits (which applies in DB).**
 (a) **What regulation is required to protect members' benefits?**
 (b) **What governance mechanisms and quality standards are needed in CDC schemes, especially to ensure inter-generational equity?**
70. *Could CDC schemes operate both on a trust basis and a contract basis? Explain.*
71. *Could a 'for profit' organisation run a CDC scheme? Explain.*
72. *What communication strategy would be appropriate for CDC schemes (a) in accumulation and (b) near retirement and (c) in decumulation?*

73. What measures should the government take to make CDC attractive to: (a) potential sponsors, and (b) potential members?

74. How should transfer values be treated in CDC schemes, both in and out?

75. Is it possible for a CDC scheme to work within a charge cap of 0.75%?

6. Other issues

The five sections above reflect our initial expectation of the areas that would need to be covered, and the issues that would need to be addressed, in our response to the remit set out the beginning of this document. However there may be other issues you would like to raise or areas you think we should be looking at.

76. With the remit in mind, please tell us if there is anything else you think we should be considering that is not covered in the sections and questions above.