LCP's response to DWP Consultation on extending Collective Defined Contribution

Issued on 19 November 2024

This document sets out LCP's response to the DWP's consultation document on draft legislation to extend Collective Defined Contribution (CDC) provision to whole-life unconnected multiple employer schemes and other related provisions published on 8 October 2024 (the "Consultation").

Executive summary

Who we are

LCP is a firm of financial, actuarial, and business consultants, specialising in pensions, investment, insurance, energy, health and business analytics. We have around 1,100 people in the UK, including over 170 partners and over 300 qualified actuaries.

Our core business is the provision of actuarial, investment, covenant, governance, pensions administration, benefits advice and directly related services. About 80% of our work is advising trustees and employers on all aspects of their pension arrangements, including investment strategy and selection of investment managers. The remaining 20% relates to insurance consulting, energy, health and business analytics.

Our high-level comments on the consultation proposals

We are very supportive of the extension of CDC to cover whole-life unconnected multi-employer schemes and believe this is essential for the development of a CDC market in the UK.

In general, we believe the draft legislation for unconnected multiple employer schemes will allow the development of this market, which could have a transformative impact on members' retirement options. However, we have two main concerns on how the policy intent interacts with not-for-profit CDC schemes that are established by existing trusts.

1. Governance Structure for groups of unconnected employers currently operating collective occupational schemes

It is clearly important that CDC has an appropriate level of governance and in a commercial setting we believe the proposed new role of Scheme Proprietor is appropriate.

However, for existing trust based schemes for "unconnected employers" that operate in a not-for-profit environment and may now wish to open a new CDC section, we believe the proposed requirements for the role of Scheme Proprietor are unlikely to be proportionate for either the employers or scheme members in terms of benefit security or value for money.

In particular, trustees of not-for-profit schemes that currently operate in a trust based occupational pension scheme environment are already regulated under defined benefit and/or defined contribution governance regimes. It would be natural for the trustees of many of these schemes to seek to open new CDC sections to benefit their members and employers. However, under the draft legislation, a substantially different governance structure involving a Scheme Proprietor would then be required, which does not fit naturally into established governance structures. We believe it would be far more proportionate in these cases to apply governance principles consistent with the single and connected employer CDC scheme governance structure and which would be more aligned to the existing governance models in these schemes.

We recommend that DWP considers enabling the Pensions Regulator to decide, on a more individual basis, whether in such circumstances a CDC scheme could operate under the governance principles of the "connected" employer regulatory framework from a scheme governance perspective, but still allowing the kinds of benefit structures envisioned in the unconnected employer regulations. We would also anticipate that the associated new tests would still apply to minimise cross subsidy between employers.

We expand on this in our response to question 7.

2. Communications which might be considered "marketing" for not-for-profit schemes

Unlike commercial schemes, the line between marketing and general communications between employers and potential employers, trustees, and members and potential members may not always be clear cut. For example, whether there is a difference between providing information about the creation of a new CDC section to employers currently participating in the DB section of the same scheme, compared to information given to employers within the industry who previously did not meet the criteria of joining the existing DB section of the scheme. We expand on this in our response to question 8.

It is also very likely that current participating employers of the DB section, and perhaps employers who met the criteria of joining the DB section but have not done so, would be involved in the development of the new CDC section. This could range from simple communications by the scheme designer to gauge interest, to being actively engaged in the scheme design itself. These communications would be appropriate at the stage of scheme development, but unlikely to reflect the final product. Regulations and guidance must be clear when "marketing" requirements begin.

Chapter 2: Legislation for unconnected multiple employer CDC schemes

Question 1: Do you think draft regulation 25 delivers the policy intent for the opening of a new section for unconnected multiple employer CDC schemes?

Our understanding of the policy intent is for a "material" change to the qualifying benefits or adjustments due to a change to the investment strategy to be a proxy for a change to the nature and intention of the expected indexation over the lifetime of the scheme. For example,

- An investment strategy that is linked to the maturity of the scheme, whereby the investment strategy became more cautious as the scheme matured, would not be considered a "material" change; however
- Implementing a more cautious investment strategy that targets lower increases for the entire membership would be considered a "material" change.

Assuming this interpretation is correct, then we agree that using investment strategy as a proxy could deliver the policy intent.

However, as drafted, we think the regulations could be difficult to interpret. A definition or examples of "material" would be useful either in legislation itself, in the Regulator's code of practice, or in separate guidance. Paragraph 9(1)(c) of Schedule 2 could also be difficult for the trustees to provide: for example, changes in investment strategy as a reaction to market movements cannot always be envisaged.

Question 2: Do you think the definition of connected in draft regulation 22 can work effectively to establish whether a scheme is a single or connected employer CDC scheme or an unconnected multiple employer CDC scheme?

We have no comment on the legal drafting of regulation 22. However we note that it is not clear from this or draft regulation 3 what happens to a single-employer scheme if it needs to transition to being a scheme for "unconnected employers", for example because an unconnected employer wishes to join the scheme, or the requirement in regulation 22(1)(d) or (e) is no longer applicable.

Non-commercial unconnected multiple employer collective occupational pension schemes already exist, and for some their governance structures is much closer aligned with single-employer CDC schemes than that proposed for unconnected multi-employer CDC schemes. The proposed new governance structure could create significant challenges for these groups.

We understand it is not the DWP's policy intent to distinguish between commercial and not-for-profit multi-employer schemes. However, we hope the DWP could consider a mechanism by which the single-employer governance structure could be applied to these existing schemes.

Question 3: Do you have any comments on the draft regulations on the fit and proper person requirements?

We agree with the addition of the scheme proprietor, promotor and chief financial officer to the fit and proper persons test as set out in draft regulation 7. We also agree that a chief investment officer should be included in the test, where they are distinct from scheme trustees (but see 4 below).

We also agree that it is appropriate to use the same tests for unconnected multiple employer CDC schemes as for Master Trusts and single employer CDC schemes, as set out in Schedule 1. We note the addition of paragraph 3(2) of Schedule 1, where individuals are assessed for their experience and professional competence (sub-paragraph 1(d)), which appears to us (as non-legal professionals) to be potentially inconsistent with the requirement for collective expertise and experience for these roles (sub-paragraphs 1(e)-(g)).

Question 4: Do you agree with the functions we have identified for the role of the Chief Investment Officer?

Yes, although we would expect the functions listed in paragraph 32 could be performed by the trustees of not-for-profit schemes.

Question 5: Does the drafting of the scheme design tests deliver the policy intention of providing a sensible measure of whether a scheme's design is sound, at initial application and on an ongoing basis?

In general we agree that the drafting meets the policy intent.

We note that the scheme design tests include the viability report requirement, which sets out the requirement for trustees to explain the changes to the investment strategy that would require a new section to be established (please see our response to question 1 above). We also have some concerns that there could be situations where approval of the viability report by the Scheme Proprietor may create some conflicts of interest, and suggest that there should be a list of events that mean a viability report must be revised, or a periodic revision is required, and that the Scheme Proprietor should not refuse approval of the viability report without good reason.

There is no provision in the draft regulations to bulk transfer out of the CDC scheme without member consent. We suggest that how a scheme might handle bulk transfers, especially for commercial schemes where employers might change providers, be included as part of the scheme design, and legislation and/or guidance setting out the process, calculations and certifications also be included.

Question 6: Do you have any comments on the drafting of the actuarial equivalence test? Is it clear that the scheme actuary must use the methods and assumptions used in the most recently completed valuation to satisfy the test?

We think the assumptions used for the test requires clarification, either in the regulations or by the Pensions Regulator. In particular, a clearer direction on the level of details required for a "member level" test is needed: we would normally expect mortality assumptions based on age to be sufficient, but this could be interpreted to include gender, size of pension, postcode, smoker status etc.

It is not clear why the wording of regulation 32(9) (actuarial equivalence test) would be different from the wording of regulations 32(6)-(7) (second gateway test and live running test). In particular

- The inclusion of "calculated on actuarial basis" is repeated in reg 32(10)(a), and would appear unnecessary.
- The meaning of "in accordance with the scheme rules" is not clear – for example, is this in relation to the benefits, or an actuarial calculation method; or whether the actuary should follow the scheme rules if these are, or become, contradictory to legislation.
- the sentence "(not including contributions made by or on behalf of the employers other than any contributions made as a result of a salary sacrifice arrangement)" is omitted from the actuarial equivalence test, and while a lack of exclusion would normally suggest that it should be included, as this is a change in drafting from regulations 32(6)-(7), it would be helpful if the intension is clearly stated.

It is also not clear that methods and assumptions used in the most recently completed valuation should be used for this test, although we note that this is the same wording ("expected to be used for an actuarial valuation") as for the second gateway and live running tests. It would be useful if this is stated.

Question 7: Do you have any comments on the draft regulations on financial sustainability?

We have no comment on whether the drafting of the regulations on financial sustainability delivers the policy intent, but agree that it should be similar to the Master Trust regime as far as possible for commercial CDC schemes. We suggest that any further requirements should be set out in the Regulator's code, again following the Master Trust regime as far as possible.

We note on the drafting that Paragraph 2(f) of Schedule 3 of the draft regulations appear to be redundant – similar paragraphs from the single-employer CDC regulations have been removed when copied across to the multi-employer regulations.

We have two further observations on the set up and role of the Scheme Proprietor.

The Scheme Proprietor only carries out activities that relate directly to the scheme (regulation 14C(3) and paragraph 76 of the consultation document)

This requires a new legal entity to be set up. We expect this would likely be a wholly-owned subsidiary of a commercial provider (for example an insurance company), or a subsidiary of a current Trustee Board or an employer (for not-for-profit schemes). While the activities of the new legal entity may be separated from the parent company, with a separate board of directors, given the commercial relationship between the parent and subsidiary we would not expect the new legal entity to be entirely independent, or that such a set up would successfully "avoid any potential conflicts of interest" (paragraph 76). As such it is not clear to us the purpose of requiring a separate legal entity to act as the proprietor, compared to, for example, a dedicated function within the commercial provider or existing Trustee Board. Setting up and running a separate legal entity would also have associated costs.

We also note the requirement to produce full accounts (regulation 13 and paragraph 82 of the consultation document). While we agree that full accounts of the commercial provider or Pensions Board are necessary (reg 13: amending section 26A(3)(b) of PSA21), we are not sure the relevance of full accounts of the Scheme Proprietor whose only operation is in respect of the scheme. Again this would also increase the cost of running the scheme.

It is not clear to us whether a wholly owned subsidiary of a Pensions Board that would act as trustee to the scheme, while none of the directors are trustees of the scheme, is a permitted set up for a Scheme Proprietor.

Finally, if the Scheme Proprietor can only carry out activities that directly relate to the scheme, draft Paragraph 20 Schedule 1B to PSA21 seems redundant.

The Scheme Proprietor is liable to provide costs of setting up and funding the scheme (regulation 10: section 14B(2)) and not a trustee (regulation 10: section 14C(4))

We agree this is sensible, and necessary, for commercial schemes as a protection to members and trustees.

However, there are situations where this might not be appropriate for not-for-profit schemes. This is particularly the case where there is a current Trustee board running DB and/or DC schemes for a group of unconnected employers, and which holds a central pool of surplus assets that could be used for set up and running costs of the new CDC scheme/section (ringfencing for this purpose if necessary). We expect in such cases there may not be willing proprietors independent of the trustees, as they would be liable for the costs but have no access to the funds already in the pensions trust. It also seems unnecessary for these assets to be transferred out of the pensions trust to the proprietor, only to enable to proprietor to deposit to a separate account in the name of the trustees (section 14C(6)(a)) – as well as pay associated costs to do so, which in aggregate would potentially reduce the trustees' security.

As an existing pensions trust there are also likely to be agreements and/or guarantees in place with some or all of the employers to provide funding should the assets turn out to be insufficient. If the proprietor is not part of the current governance structure, then these relationships will have to be re-established and negotiated, which might also undermine existing trusted governance relationships.

Question 8: Do you have any comments on the draft regulations on promotion or marketing?

We have no comments on whether the draft regulations reflect the policy intent.

We agree that there is clear potential for conflict of interest between the promotor and the trustees of a commercial scheme. However, for a not-for-profit / industry scheme, this is much less clear, and there is a trade off between potential conflicts and the detailed knowledge and process that is already in place within a pensions trustee board to carry out such activities effectively and accurately. As drafted the legislation seems to prevent trustees having any involvement in the promotion process.

We also note that while the draft regulations defines "promotion or marketing" in regulation 5 (inserting s5(7) to PSA21), it is not clear what constitutes "inducement" in the context of not-for-profit schemes. For example, would stating the overarching benefits of running a CDC scheme, such as risk sharing and expected higher returns, when compared with the existing DB scheme, be considered inducement? Specifically, are the following actions considered promotion or marketing, or providing information?

- Employers who are current participating employers of the DB section of the scheme, who are being informed of the new CDC section.
- Employers who met the criteria of joining the existing DB section of the scheme but had not done so, and now receive communications about the new CDC section.
- Employers within the industry who previously did not meet the criteria of joining the existing DB section of the scheme, but now wish to join the CDC section of the scheme.

We expect the third point above would be considered promotion or marketing, but the first two points as provision of information. It would be helpful if this could be clarified. It might also be helpful if the Regulator could agree the boundary at the authorisation stage. We note Master Trusts may also have similar concerns when communicating about the new CDC product with current participating employers.

Employers in the first group above may also be involved during the development stage of the new CDC scheme. Clarity is needed on whether any information provided at this stage would be considered "promotion or marketing", as while the information provided would reflect the new scheme's design at that particular stage of development, it is unlikely to be the final product.

Finally, we note that personal financial products promoted to the retail market are covered by the FCA's consumer duty standards. While multi-employer whole of life schemes are not expected to be promoted to individuals, the DWP might like to consider some level of consistency where relevant, especially where commercial providers could go on to develop decumulation only products for the retail market in the future.

Question 9: Are the draft regulations clear that a trustee's ability to pursue continuity option 3 must not be unduly constrained or fettered and how this would be evidenced to the Regulator?

As drafted we agree that this is clear.

Question 10: Are the draft regulations clear on how valuation and benefit adjustments should happen?

From an actuarial perspective, the draft regulations are mostly clear. We would like to make the following comments:

- It is not entirely clear what "change to such adjustment" means in reg 38(4)(c)(i). This could, for example, be a percentage change to the target annual increase, or an actuarial equivalence; whether one group within the same section could be in a multi-annual reduction period while another could be receiving an increase. We also note that this does not state a requirement that the difference should be in relation to scheme performance, despite the policy intent (paragraph 116). This could also be very difficult to communicate between the scheme actuary and trustees, and between trustees and members.
- We note the list of relevant bodies an actuary must have regard to (reg 39) does not include the FRC, and specifically TAS310 at this time.
- We note the actuarial valuation (reg 40(4)) does not explicitly require any change to adjustments (reg 38(4)(c)(i)) for different employers to be stated, where this is used.

Question 11: Do you think that the significant events listed in draft regulation 44 will provide the information the Regulator needs or are there other significant events that should be added?

We agree that the additions in reg 44(1)(o)-(v) are appropriate. We note:

- As mentioned in question 5 above, a change that requires revision of the viability report may need to be reported if proprietor approval is not forthcoming.
- We suggest that persons that are considered fit and proper, ie the scheme proprietor, promotor/marketer, CFO and CIO (reg 7) should be included in the list of persons who have the responsibility to make a significant events report (section 28(2) of PSA21).

Chapter 3 Consequential and Miscellaneous Amendments

Question 12: Do you have any comments on the draft regulations that provide for ongoing supervision of unconnected multiple employer CDC schemes?

We have no comments on the drafting.

Question 13: Do you agree with the changes in Part 6 of the draft regulations?

We have no comments on the drafting.

However, we are not aware of current or proposed legislation that might require an individual seeking to transfer out of a CDC scheme to require independent advice for transfers over £30,000, as set out in section 48 of PSA15 for "safeguarded benefits", as CDC benefits fall within the definition of money purchase benefits thus not "safeguarded". This seems slightly surprising and we would appreciate confirmation that either this is intentional, or that the legislation will be amended.

Question 14: Do you agree with the changes in the Miscellaneous Amendment CDC Regulations 2025?

We have no comments on the drafting.

Chapter 4 Impacts

Question 15: What are the financial costs required to establish and run an unconnected multiple employer CDC pension scheme? Please outline any one-off and ongoing costs.

We expect this to be much higher for commercial as opposed to not-for-profit schemes. However for a not-for-profit scheme that already has an established set up (eg via an existing trustee board with various DB and DC schemes), we expect there would still be substantial costs at set up, including legal and actuarial advice costs, new in house administration and IT system set up, and costs of a Proprietor as a separate legal entity.

Question 16: Considering the draft regulations and criteria for authorisation, could you estimate the costs of preparing the information required for authorisation? Please outline the extent and cost of external contractors where they may be required.

We have no comments on the drafting.

Question 17: How many members do you consider to be a viable minimum in an unconnected multiple employer CDC scheme? Please also include any information you have on target scheme size and source of members.

Once set up, we expect around 3,000 members would be required for a viable scheme that is not overly affected by individual member experiences. For the per-member charges to cover ongoing costs (potentially a more natural long term measure of sustainability), we expect around double that number might be required, assuming that the set up costs are available from elsewhere or could be recouped over an extended period. For a commercial scheme, substantially larger numbers would be required to recoup the set up costs and still be profitable.

Question 18: Considering potential numbers of schemes, employers and members, do you have any information on the likely size and shape of the unconnected multiple employer market once established?

Over the next 3-5 years, we expect there could be around 10 major unconnected not-for-profit schemes emerging through different industries. We also expect Master Trust options will also be set up as whole-of-life schemes, but expect many current Master Trusts will also be interested in the development of decumulation options and how these might fit with each other or run in parallel.

Question 19: Do you have a) any comments on the impact of our draft regulations on protected groups and/or how any negative effects may be mitigated? b) any other comments about any of our draft regulations

We have no comment.

We would be happy to answer any questions you may have about our response and if an informal discussion could be helpful, do get in touch with me using the contact information below.

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