



Title of measure		Introduction of legislative framework for Collective Money Purchase (CMP) occupational pension schemes
Lead Department/Agency		Department for Work and Pensions
Planned coming into force /implementation date		2020
Origin (Domestic/EU/Regulator)		Domestic
Policy lead		Julian Barker
Lead analyst		Luke Montgomery
Departmental Assessment		Self-certified
Total Net Present Social Value (over 10 year period): Not provided	Equivalent Annual Net Direct Cost to Business (EANDCB) (over 10 year period): Not provided	Business Impact Status: Not quantified ¹
Summary - Intervention and impacts		
Policy Background – Issue – Rationale for Intervention – Intended Effects		
<p><u>Policy Background</u></p> <p>The existing UK workplace pensions legislative framework is, broadly speaking, binary in nature with employers enabled to offer only Defined Benefit (DB) and Defined Contribution (DC) occupational pension schemes. The two models place all the risks and associated costs – economic, financial, and longevity - with either the sponsoring employer (DB) or the individual member (DC). Following engagement with representatives from the pensions industry, and in particular a case that Royal Mail has presented, Government believes creating an option for the pensions industry to offer Collective Defined Contribution (CDC) occupational pensions could be beneficial to sponsoring businesses and individuals in certain cases. The legislative term for CDC is Collective Money Purchase (CMP), which will be the term used in this document. In CMP type schemes, these risks would be with the members but collectively shared between them.</p> <p><u>Rationale for intervention and intended effects</u></p> <p>The objective is to introduce more flexibility in occupational pension provision so that the pensions industry may offer a new type of occupational pension scheme that is:</p> <ul style="list-style-type: none"> • more sustainable for sponsoring businesses than a DB scheme; and • has the potential to give an income in retirement that is more predictable than is currently available to members of DC schemes who do not wish to purchase an annuity. <p>The rationale for intervention is to establish a secure regulatory framework within which the pensions industry can create CMP type pension schemes with adequate governance and safeguards in place for members and for employers.</p>		
Brief description of viable policy options considered (including alternatives to regulation)		
<p><u>Option 1: non-legislative:</u></p> <p>Legislation currently on the statute book is insufficiently clear on where CMP schemes fit into the current pensions framework. This lack of clarity means employers see a clear risk that they might be liable for any shortfall in the funding needed to pay for the target benefits if the legislation does not state otherwise. Employers will not want to commit to this new pension</p>		

¹ Outlined on page three and evaluated further in section 3 of this impact assessment.

arrangement if there is such a risk. Therefore, non-legislative options are not viable in making clear where CMP schemes fit into the current pensions framework.

Option 2: do nothing.

Our engagement with the pensions industry, and in particular the responses to the consultation *Delivering Collective Defined Contribution Pension Schemes*^{2,3}, demonstrates strong support from the industry for the legislative changes that would enable CMP type pension schemes to be created in the future. Based on the evidence and discussions to date, we believe that a well-designed CMP has the potential to offer a more predictable income in retirement for scheme members⁴ than for DC members who do not wish to purchase an annuity. It achieves this by pooling risks and smoothing pensions payments (for example softening the impacts during periods when investment returns are relatively low) whilst being more sustainable to sponsoring employers than DB. Doing nothing would mean the opportunity foregone and less choice and flexibility for both employers and workers.

Option 3 (the proposed option): introduce a legislative framework for Collective Money Purchase (CMP) pension schemes.

Introducing a legislative framework will enable the pensions industry to offer a new type of occupational pension (should any employer/scheme choose to do so). Following consultation and ongoing industry engagement, we believe that well-designed CMP has the potential to offer a more predictable income in retirement for scheme members than DC can offer for those who do not wish to purchase an annuity, whilst being more sustainable to sponsoring employers than DB.

Preferred option: Summary of assessment of impact on business and other main affected groups

In gross terms, businesses that choose to set up a CMP scheme will incur familiarisation, implementation, and scheme running costs. However, offering a CMP scheme will be optional. We expect that businesses will only choose to offer CMP type pension schemes if, on balance, it is more beneficial for them than their best alternative - i.e. the benefits outweigh the costs when compared against the counterfactual. **On this basis the proposal is classed as zero net cost to businesses.**

Where the counterfactual is DC, we do not envisage fundamental differences in direct costs to sponsoring businesses as in both DC and CMP all the risks and associated costs – economic, financial, and longevity - are with the members. However, CMP potentially offers more flexibility and stability for employees through shared risk. This might make CMP more attractive as part of an overall employee compensation package, and result in a more stable and motivated workforce, though we do not have any evidence to support this.

In the case of Royal Mail, the only business with clear plans to deliver CMP, we envisage that there will be higher initial costs of setting up a CMP scheme compared to a DC scheme (although we do not quantify these due to commercial sensitivity reasons). However, we also expect Royal Mail to experience wider benefits in terms of improved industrial relations. Although improved

² The consultation document is published here:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/756275/delivering-collective-defined-contribution-pension-schemes.pdf

³ The consultation response document is published here:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/786395/response-delivering-collective-defined-contribution-pension-schemes.pdf

⁴ Scheme member – a current or future pensioner.

industrial relations for Royal Mail are difficult to quantify with enough confidence. However, given the size of their workforce it is conceivable that, relative to their DC counterfactual, this benefit could exceed the £5m per annum *de minimis* threshold.

Where the counterfactual is DB, savings to sponsoring businesses may be substantial and, dependent on the scope and size of the business, could be above the £5m EANDCB *de minimis* threshold – although we are unable to quantify this (for reasons outlined below). However, where DB commitments already exist they cannot be broken and CMP will not alter this at all; so any potential savings would only relate to new / future pensions accruals – for which businesses already have an alternative (in the form of DC) and strong financial incentives to pursue it. Hence the DB counterfactual may only be applicable in a very limited and specific way - *see more detail / discussion in section 2 and section 3.2 of this impact assessment.*

Due to the significant uncertainty over the full impacts of the proposal, the Department for Work and Pensions (DWP) has not quantified an Equivalent Annual Net Direct Cost to Business (EANDCB)⁵. Specifically:

- The costs and benefits depend on the counterfactual (whether a firm’s employees would in future be enrolled in a DB scheme, a DC scheme or a hybrid DB/DC scheme) which is not possible to predict. Particularly in the case for DB employers, there are uncertainties as to whether they would switch to DC in the absence of CMP legislation.
- Consultation responses illustrated further interest in CMP amongst the wider pensions industry, but did not identify new plans to deliver CMP. Consequently, the potential take-up of CMPs from employers is currently an unknown with only the Royal Mail Group having clear plans to deliver CMP. Therefore, on the grounds of commercial sensitivity, we are not able to set out the direct impact to business.

Given the voluntary nature of this legislative change, we only expect businesses to incur any gross costs to create a CMP scheme if it were beneficial to do so compared to their next best alternative. As such, we assume this proposal to be zero net cost, as we are not able to quantify any potential net benefits.

At the regulation stage impact assessment, we will review whether the above uncertainties are still applicable, and seek to estimate the EANDCB if further data is available.

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Date: 13/06/19

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Date: 17/06/19

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Date: 14/06/19

Additional detail – policy, analysis, and impacts

1. The policy issue and rationale for Government intervention

The existing UK workplace pensions legislative framework is, broadly speaking, binary

⁵ See section 3 of this impact assessment for more detail.

in nature with employers enabled to offer only Defined Benefit (DB) and Defined Contribution (DC) schemes.

DB schemes offer greater certainty and predictability for income in retirement for employees, but place significant risks and costs on the sponsoring employer - economic, financial, and longevity. Conversely, DC schemes place similar risks and costs on the individual scheme member.

Following engagement with representatives from the pensions industry, and in particular a case that Royal Mail has presented, Government believes creating an option for the pensions industry to offer Collective Money Purchase (CMP) pensions could be beneficial to sponsoring businesses and individuals. In CMP schemes, the risks would be entirely with the members but shared between them collectively.

The objective is to introduce more flexibility in occupational pension provision so that the pensions industry may offer a new type of occupational pension scheme that is:

- more sustainable for sponsoring businesses than a DB scheme; and
- has the potential to give an income in retirement that is more predictable than is currently available to members of DC schemes who do not wish to purchase an annuity.

The rationale for intervention is to establish a secure regulatory framework within which the pensions industry can create CMP pension schemes with adequate governance and safeguards in place for members and for employers.

2. Preferred Option

Option 3 (the proposed option): introduce a legislative framework for Collective Money Purchase (CMP) pension schemes.

Introducing a permissive legislative framework will create a provision to enable the pensions industry to offer a new type of occupational pension. We believe that well-designed CMP has the potential to offer a more predictable income in retirement for scheme members than DC can offer without buying an annuity, and a retirement income that is on average expected to be significantly larger than a DC annuity (see section 5.1 below for more details), whilst being more sustainable to sponsoring employers than DB. Current legislation is insufficiently clear on where CMP schemes fit into the current pensions framework. This legislation will:

- Amend parts of the Pension Schemes Act 1993 to create a new sub-set of money purchase benefits which will allow pooled pension arrangements (collective benefit pension schemes), and to define the nature and quality features of schemes which can provide them. The current definition of money purchase benefits provides for individual rather than pooled accumulation.

- Provide powers to flesh out the technical aspects of the new regime, for example how schemes with pooled benefits should undertake valuations of their assets and liabilities.
- Provide powers to apply (with necessary modifications) existing pensions legislation to enable the Pensions Regulator to register and oversee pooled schemes.

In a CMP scheme, financial contributions are invested in a collective fund. When the member retires, they are paid a pension based on their share of that collective fund. The value of this pension will be based on the total value of the pot, and will increase or decrease according to changes in investment performance or other risk factors. For example, the scheme may target an annual pension equivalent to 1/80th of an individual's annual salary per year of employment increased according to the Retail Prices Index (RPI) – but this value may increase each year by more or less than RPI, or may in extremis decrease, depending on the value of the total pension fund and expectations of future investment returns, longevity and other relevant factors. So in essence a CMP scheme will have a target pensions level it will be aiming to pay their members based on their contributions. However, unlike in DB, that target is not a promise and can be increased or decreased depending on social and economic outcomes (mainly investment returns and longevity).

As discussed in the Government's White Paper 'Protecting Defined Benefit Pensions'⁶, evidence shows that although the DB sector as a whole remains sustainable, the associated costs are high and higher than what was expected at the time the DB schemes were introduced (see section 3.2 of this IA for more detail). Currently, only 12% of all DB schemes (including hybrid schemes) are open to new members, down from 43% in 2006⁷. DB pensions are gradually being replaced with DC, where all the risk is concentrated with each individual member, making them more sustainable for the sponsoring employers but more risky and uncertain for the scheme members.

In CMP, the risks are placed with the members but unlike in DC they are pooled and shared among the members, thus allowing to smooth pensions provision out during different economic times. Also, CMP differs from the traditional DC schemes in that it does not produce an individual "pension pot", which members then have to decide how best to use for their retirement, but pays out a regular retirement income from the collective fund. Thus, whilst members are expected to be able to transfer out their share of the fund at any point before they start drawing a target pension, CMP schemes take the big central decision of pension freedoms out of retirement planning, and also much of the risk as members who stay in the scheme can rely on a regular, if variable, income throughout retirement.

⁶ Protecting Defined Benefit Pension Schemes (White Paper). February 2018, Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/693655/protecting-defined-benefit-pension-schemes.pdf

⁷ Pension Protection Fund. 'Purple Book 2018', figure 3.3. Available at: https://www.ppf.co.uk/sites/default/files/file-2018-12/the_purple_book_web_dec_18_2.pdf

A high level comparison of CMP against the existing forms of occupational pensions – DB and DC – is presented in table 1 below.

Table 1. A high level comparison of DB, DC and CMP key principles.

	DB	DC	CMP
Longevity risk	With the employer	With the members, individually	With the members, shared collectively
Investment risk	With the employer	With the members, individually	With the members, shared collectively
Pension level	Promised level ⁸	A function of individual pot and decumulation strategy	Target level ⁹

Any lack of clarity in the current legislation brings the risk that a future court might rule that what was thought to be a CMP was in fact DB. It is concerns about this point which has lead the DWP to believe that the Pension Schemes Act 2015 cannot be relied upon by employers and that we need fresh primary legislation to make the employer’s lack of liability for deficits unambiguous.

3. Expected level of business impact

Alongside the *Delivering Collective Defined Contribution Pension Schemes* consultation, DWP produced a consultation stage impact assessment (IA)¹⁰. In this, DWP set out its intention to calculate an Equivalent Annual Net Direct Cost to Business (EANDCB) in the final stage IA. However, the consultation did not provide any further evidence on which to estimate a counterfactual, or level of industry demand, and therefore we are not able to produce a robust EANDCB. Specifically:

- The costs and benefits depend on the counterfactual (whether a firm’s employees would in future be enrolled in a DB scheme, a DC scheme or a hybrid DB/DC scheme) which is not possible to predict. Particularly for DB

⁸ Depends on salary and years of contribution only; does not depend on longevity outcomes and investment returns.

⁹ Not a promise, actual pensions can be higher or lower depending on investment and longevity outcomes and will be adjusted by a formula in the scheme rules so that liabilities match assets.

¹⁰ Available at:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/754329/impact-assessment-delivering-collective-defined-contribution-pension-schemes.pdf

employers, there are uncertainties as to whether they would switch to DC in the absence of CMP legislation. In any counterfactual all employers with eligible employees will be required to set up a workplace pension and automatically enrol eligible employees. We have good data on how many employers currently offer DB, DC, and hybrid schemes, but we do not know what employers will choose to do in the future in relation to their scheme choice for occupational pensions. We have seen a steady decline in the number of Pension Protection Fund (PPF) eligible schemes¹¹, and the number of active members in private sector DB schemes from 7,800 and 3.6m in 2006 to 5,450 and 1.3m in 2018 respectively¹². Moreover, we have seen a significant shift in the DB landscape by the status of the scheme – see *table 2 below for more details*.

- Consultation responses¹³ illustrated further interest in CMP amongst the wider pensions industry, but did not identify new plans to deliver CMP. Consequently, the potential take-up of CMPs from employers is currently an unknown with only the Royal Mail Group having very clear plans to deliver CMP. Therefore, on the grounds of commercial sensitivity, we are unable to quantify any potential net direct cost to business.

Table 2. Distribution of private sector DB schemes by scheme status (including hybrid schemes)¹⁴

Year/Percentage of Schemes	Open	Closed to New Members (CTNM)	Closed to Future Accruals (CTFA)	Winding up
2006	43%	44%	12%	1%
2018	12%	46%	41%	1%

As table 2 shows, of the 5,450 private sector DB schemes that remain, 87% of them (46% + 41%) are unavailable to new members, up from 56% (44% + 12%) in 2006. Therefore, there is a reasonable assumption that more DB schemes will close in future, although no data or official projections currently exist.

Therefore, DWP has not been able to produce a robust EANDCB. Given the voluntary nature of this legislative change, we only expect businesses to incur any gross costs to create a CMP scheme if it were beneficial to do so compared to their next best alternative. As such, we assume this proposal to be zero net cost, as we are not able to quantify any potential net benefits.

¹¹ The PPF provides compensation to the members of certain DB occupational pension schemes and DB elements of hybrid schemes in the event of the sponsoring employer becoming insolvent and where benefits, at least equal to the level of compensation provided by the PPF, cannot be secured. For more details on eligibility see here: <https://www.ppf.co.uk/your-scheme-eligible>

¹² Pension Protection Fund. 'Purple Book 2018'. Available at: https://www.ppf.co.uk/sites/default/files/file-2018-12/the_purple_book_web_dec_18_2.pdf

¹³ See footnotes 2 and 3

¹⁴ Pension Protection Fund. 'Purple Book 2018', figure 3.3. Available at: https://www.ppf.co.uk/sites/default/files/file-2018-12/the_purple_book_web_dec_18_2.pdf

At the regulation stage impact assessment, we will review whether the above uncertainties are still applicable, and seek to estimate the EANDCB if further data is available.

At this stage we are only aware of Royal Mail as having developed plans to operate a CMP. For this impact assessment we assess the counterfactual for Royal Mail to be DC on the basis of the initial 2017 proposal for Royal Mail to move to a DC scheme¹⁵, and subsequent agreement with the union to pursue a CMP option.

3.1 Costs to businesses

As above, costs to business will largely depend on the counterfactual. Whether in the absence of CMP the scheme would otherwise remain as a DB scheme (DB counterfactual), or whether the scheme would otherwise move to, or remain as a DC scheme (DC counterfactual).

DB counterfactual

Where the counterfactual is DB, we envisage there to be savings rather than costs to the employer – see *section 3.2 for more details*.

DC counterfactual

Where the counterfactual is DC, we do not envisage fundamental differences in direct costs to sponsoring businesses as in both DC and CMP all the risks and associated costs – economic, financial, and longevity - are with the members. Having said that, we acknowledge that there may be some differences, e.g. in CMP pension levels will need to be revalued more regularly, which may result in some differences in scheme running costs (e.g. actuarial), when compared against DC.

Whether the employer has enrolled their employees into a DB or DC or hybrid scheme, for those businesses that choose to set up a CMP scheme, there will be gross costs in terms of familiarisation, implementation and scheme running costs. However, we assume that businesses will only choose to offer CMP type pension if they expect the benefits to outweigh the costs when compared against their counterfactual.

Royal Mail case

In the case of Royal Mail, we assume that the counterfactual, in the absence of a CMP option, would be a move to a DC scheme as described above. As outlined above, we assume there will be higher initial costs of setting up a CMP scheme compared to a DC scheme (although we do not quantify these due to commercial sensitivity issues – as previously discussed). However, as offering a CMP scheme will be optional, we expect the business will only choose to offer a CMP type pension

¹⁵ Royal Mail written evidence to Work and Pensions Select Committee
<http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/collective-defined-contribution-pension-schemes/written/77717.html>

scheme if, on balance, it is more beneficial to them than their best alternative. Therefore, we assume that this is a zero net cost measure to Royal Mail.

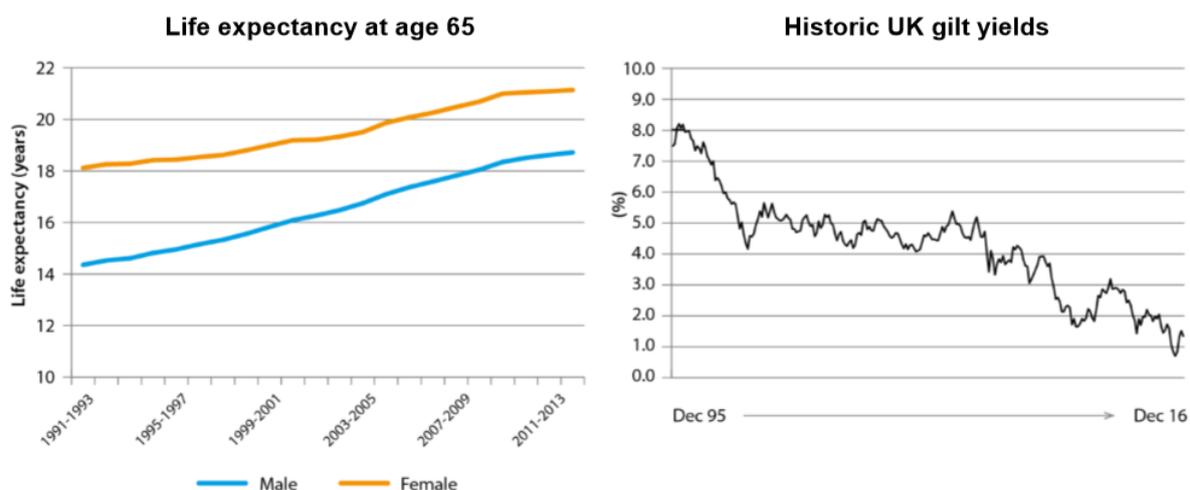
3.2 Benefits to businesses

DB counterfactual

Where the counterfactual is DB, savings to sponsoring businesses may be substantial. New private sector DB schemes are no longer being created in practice. And where DB promises already exist employers cannot break them; however, they may choose to close their schemes to new members and/or future accruals. The introduction of CMPs will not alter this. However, in practice pension provision may be subject to negotiations between the employer and its workforce / labour union, and there may be situations where DC is not an acceptable alternative to DB for future accruals and / or new members but CMP is¹⁶.

Evidence shows that although the DB sector as a whole remains sustainable, the associated costs are high and higher than what was expected at the time the DB schemes were introduced, with longevity growing faster than expected and investment returns staying low for a sustained period of time – see figure 1 below for illustration.

Figure 1. Social and economic environment over time



Source (secondary): Security and Sustainability in Defined Benefit Pensions, 2017¹⁷.

According to MQ5 data¹⁸, over the calendar year 2017, sponsoring businesses of DB schemes paid normal contributions worth around £20.9 billion, and special

¹⁶ For example, a situation discussed in this publication:

<https://www.professionalspensions.com/professional-pensions/news/3025820/royal-mail-and-cwu-agree-to-introduce-uks-first-cdc-scheme>

¹⁷ Security and Sustainability in Defined Benefit Pensions (Green Paper). February 2017, Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/693655/protecting-defined-benefit-pension-schemes.pdf

¹⁸ Office for National Statistics. 'Investment by insurance companies, pension funds and trusts (MQ5)'. Table 4.3. 2018. Available at: <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/datasets/mq5investmentbyinsurancecompaniespensionfundsandtrusts>

contributions¹⁹ worth around £15.7 billion, in total. Over the same time period, DC scheme sponsoring businesses paid about £5.3 billion of normal contributions, and about £0.13 billion of special contributions (and there are more DC than DB schemes, and the number of members is broadly similar).

DB sponsoring businesses may also incur indirect costs associated with the natural uncertainties arising from their commitment to sponsor a DB scheme. For example, any changes in life expectancy and/or investment return forecasts would alter their estimated DB pension liabilities and thus their balance sheets, making them more uncertain and volatile, and in turn potentially making their business less attractive to potential investors or creditors. Replacing DB with CMP would result in a saving in this sense as well. There is a strong financial incentive for DB sponsoring businesses to switch to CMP, but it is not possible to know how many of these would have switched to DC in the counterfactual scenario with no CMP option.

DC counterfactual

Where the counterfactual is DC, as discussed previously in section 3.1, we do not envisage fundamental differences in direct costs to sponsoring businesses so there are no anticipated savings to business in terms of lower pension scheme costs. It is possible that moving from DC to CMP would result in benefits to employers in terms of improved employee retention, but we do not have any robust evidence to estimate this.

An occupational pension is part of an employee compensation package. More flexibility in its provision means that employers will be better able to optimise it given their individual circumstances and business strategies, potentially resulting in a more stable and motivated workforce.

Royal Mail case

In the case of Royal Mail, while there would be no expected direct benefit of a CMP compared to DC scheme as the contribution levels would be expected to be the same, there is a wider benefit for Royal Mail in terms of improved industrial relations comprising benefits to their business, their customers and their workforce.

It is not possible to quantify these impacts with enough confidence to score against an EACNB at this stage. Although to put this into context with regard to Royal Mail, over 65% of all 110,000 CWU members employed by Royal Mail voted in favour of industrial action over their decision to move their employees into a DC pension scheme, in addition to issues surrounding pay²⁰. However, following consultation and continued

¹⁹ In simple words, additional payments needed to sustain their schemes.

²⁰ Out of the 110,000 CWU members who are employed by the Royal Mail Group, 89.1% voted in favour of the motion, with a turnout of 73.7%, resulting in 65.6% (73.7% * 89.1%) of CWU members employed by the Royal Mail Group voting in favour of industrial action. For more details, see here: <https://www.cwu.org/news/record-yes-vote-threshold-smashing-turnout/>

engagement by the department, CWU support the introduction of a CMP pension scheme for their members²¹.

Given the potential improvement in industrial relations as a result of Royal Mail introducing CMP pensions to their employees, relative to Royal Mail's large workforce, it is conceivable that their potential benefit is greater than £5m per annum. Therefore, as we cannot quantify the benefits to business to be less than £5m per annum, we cannot apply the *de minimis* exemption to this measure.

4. Key assumptions/sensitivities/risks

At this stage there is a significant uncertainty over the impact of the proposal.

The key uncertainties relate to:

- Estimating the counterfactual (in particular, whether DB employers would switch to DC in the absence of CMP legislation).
- Estimating demand for CMP schemes (at the time of writing only the Royal Mail scheme has confirmed interest. Though there is strong support from the wider industry which suggests more DB employers could come forward, we do not know whether there would be any employers interested in making the switch from DC to CMP).
- Estimating the benefits to employers (and members), which would be highly scheme specific and speculative.

5. Wider Impacts

Impacts on the affected parties other than businesses, and wider economic impacts are discussed below.

5.1 Wider impacts - impacts on members

Publications by the pensions industry offer mixed views but suggest that subject to being well designed there are potential benefits to members²². For example, according to Willis Towers Watson, *with fixed contribution rates and the merits of collective long-term investing, CDC [CMP] schemes could offer attractive outcomes for both employers and employees. But a key challenge for CDC [CMP] design is the framework for the variable allocation of the assets to provide member pensions; from our work so far we believe a robust framework is achievable*²³.

²¹ Available at: <https://www.cwu.org/news/cwu-royal-mail-welcome-cdc-pensions-green-light/>

²² For more detail on the views of those in the pensions industry, please see the consultation response document (footnote 3).

²³ WTW Corporate and Trustee Briefing, 08 July 2018. Available at: <https://www.towerswatson.com/en-GB/Insights/Newsletters/Europe/UK-Corporate-and-Trustee-Briefing/2018/07/collective-defined-contribution-schemes>

5.1.1 Benefits to members.

Our assessment (in line with consultation responses) is that a CMP that is sufficiently well designed, run and regulated can provide a more stable outcome for members at a lower cost than individual DC. There are a number of reasons for this:

-Ability to smooth out shocks from the investment market to provide more stable pensions.

This is an inherent feature of CMP. The expectation is also supported by existing modelling-based evidence. For example, a study from the Netherlands ‘Benefits of Collective Risk Sharing in Defined Contribution Pension Systems’²⁴, suggested ‘up to 15 per cent higher pension payments in ‘bad’ economic scenarios than the individual contract’. In contrast, however, the ability to smooth out shocks in ‘bad’ economic scenarios also means smoothing out in ‘strong’ economic scenarios too – see section 5.1.2 for more details.

-Ability for members to share their individual longevity risk with other members, so that they avoid the risks of either outliving their savings or being unnecessarily frugal with their savings.

This potential benefit arises from the concept of longevity pooling. Individuals cannot accurately predict how long they will live. Those who turn out to underestimate their life expectancy risk outliving their savings by withdrawing too much / too fast from their pot, and those who overestimate may end up underusing their pensions pot. However, pooling means that those who would otherwise be outliving their savings and those being unnecessarily frugal with their savings balance each other out, at least to some extent.

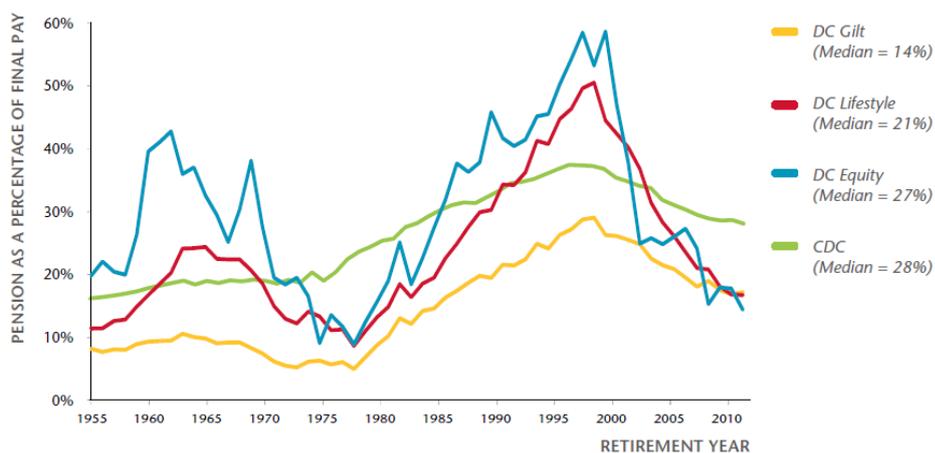
-Potentially higher pensions overall (but not for all).

The primary underlying theoretical reason for the potentially superior performance of CMP (compared against DC) is that CMP schemes can invest a high proportion in growth assets (e.g. equities) throughout their whole lifetime, whereas typical DC schemes tend to move into safer, lower-returning assets as the member approaches retirement. Also, de-risking in DC may mean purchasing annuities during ‘adverse’ times, e.g. when gilt yields are low; whereas in CMP, annuities are not necessary to provide a lifetime stream of pensions income.

AoN Hewitt have modelled the historic behaviour of an illustrative CMP plan compared with DC schemes over the period from 1930 to 2012. The outcomes of their modelling (Figure 2) suggest that over the period CMP reaches a better outcome than DC.

Figure 2 – Historic CMP [CDC] and DC outcomes

²⁴ By Marcel Lever and Thomas Michielsen, Sept 2014. Available at: https://www.netspar.nl/assets/uploads/P20161100_occ009_Lever_Michielsen.pdf



Source: AoN Hewitt, *The Case for Collective DC*, 2013 (page 31)²⁵

Based on a different set of assumptions and approach, Cass Business School’s modelling²⁶ suggested that a CMP scheme can generate a pension that is 30% higher, and volatility per unit of return in the CMP scheme is just 16% of that in the individual DC scheme. An additional study from the Royal Society of Arts’ study in 2012²⁷ showed an improvement of 37% in pension outcomes from a move to collective pension provisions.

Moreover, a DWP commissioned a study²⁸ by the Pensions Policy Institute (PPI), which compared a CMP scheme similar to that modelled by AoN with various individual DC alternatives, found that CMPs outperformed individual DCs in terms of the average income replacement rate in almost all the modelled scenarios.

The modelling outcomes depend on several assumptions, among them those associated with the design of the CMP plan. Also, investment behaviours are driven by a complex set of factors, and given that CMPs do not exist in the UK, the underlying modelling assumptions are theoretical and / or based on international evidence²⁹. It is not possible to accurately predict outcomes for future UK CMP schemes, but the available modelling evidence suggests that CMP, if well-designed, has the potential to deliver a higher level of overall pensions than individual DC.

²⁵ Aon Hewitt. ‘The Case for Collective DC: A new opportunity for UK pensions’. (page 31). 2013. Available at: http://www.aon.com/unitedkingdom/attachments/aon_hewitt/dc/Aon_Hewitt_The_Case_for_Collective_DC_Nov13.pdf

²⁶ Independent Review of Retirement Income: Report, David Blake, March 2016. Available at: <http://www.pensions-institute.org/IRRIReport.pdf>

²⁷ The RSA. ‘Collective Pensions in the UK’. 2012. Available at: <https://www.thersa.org/discover/publications-and-articles/reports/collective-pensions-in-the-uk#>

²⁸ Modelling Collective Defined Contribution Schemes, PPI, 2015. Available at: <http://www.pensionspolicyinstitute.org.uk/publications/reports/modelling-collective-defined-contribution-schemes>

²⁹ For information on international examples of CDC please see Appendix One of the Pensions Policy Institute’s report on “What is CDC and how might it work in the UK?”. Available here: <https://www.pensionspolicyinstitute.org.uk/media/2904/20181129-what-is-cdc-and-how-might-it-work-in-the-uk-report.pdf>

-Converting DC pots into an income stream for members without the high costs of guaranteeing income through an annuity.

Annuities are insurance policies which pay an annual income for life in exchange for a lump sum. DC members can use their pension pot (or part of it) to buy an annuity and have a guaranteed stream of income for their whole lifetime. But buying an annuity may be costly as the price has to cover not only the insurer's costs of providing it but also the insurer's premium and other fees. For example, Longevity³⁰ say that 'an insurer in the UK will typically charge around 5% more than it expects the annuity to cost'. In CMP, a lifetime stream of 'target' level pensions could be provided without the need for the member to buy annuity so CMP represents a potential efficiency saving.

"Hands off" access to a professionally managed investment strategy.

DC members have more discretion and responsibility for managing their pension strategies. Depending on individual preferences, some may consider this to be in their best interest but some may prefer "hands off" access to a professionally managed investment strategy, which CMP type schemes can offer. For example, the UK section of the 2013 AoN Hewitt Global Pension Risk survey received 241 responses, of which 46% mentioned 'members don't need to be involved in investment' when asked 'What do you see as the biggest positives of Defined Ambition plans?'³¹. This was among the key arguments presented to DWP by the CWU for why their members support CMP.

5.1.2 Costs to members.

On an individual basis some members may incur costs associated with the introduction of CMPs. Where the counterfactual is DB, all members are expected to face greater uncertainty in their pension income under CMP given that all the risks and associated costs under CMP are with them rather than their employer. Where the counterfactual is DC, members may be worse off for the following reasons:

-Not all members will gain from CMPs.

Any collective scheme will smooth, to a certain extent, outcomes between members and outcomes over time. So whilst overall members might benefit, some may experience a worse outcome than under an individual DC. One reason for this is that a member could be due to retire in 'strong' economic conditions and potentially may have received a higher income from annuitizing (even after accounting for the high costs noted above) than under the smoothed CMP benefits. However, the risk of the member retiring in 'strong' economic conditions is placed solely on the member.

³⁰ Available at: <https://www.longevity.co.uk/site/informationmatrix/areannuitiesexpensiveenough.html>

³¹ Aon Hewitt. 'The Case for Collective DC: A new opportunity for UK pensions'. (page 11). 2013.

Available at:

http://www.aon.com/unitedkingdom/attachments/aon_hewitt/dc/Aon_Hewitt_The_Case_for_Collective_DC_Nov13.pdf

A further reason is that the member may die at a young age. This is an inevitable consequence of pooling risk and happens in both DB schemes and annuities where those that die young subsidise the pensions of those that live longer.

Again, it is important that members are communicated with in ways that ensure they understand the nature of the scheme they are in.

-Cases where there is an opportunity foregone for those that would rather have an individual DC.

A person's preference between an individual and collection pension not only depends on objective expected outcomes, such as income level and risk / volatility, but also their subjective preferences around risk aversion and, more generally, their lifetime utility function. For example, some members may want to take higher risk investment strategies, alternatively, others may want to invest in Environmental, Social and Governance (ESG) funds if this is not already undertaken by their scheme. Following a well-designed CMP framework, certain employers who currently offer a DC scheme to its employees may choose to offer a CMP scheme. Although this may be preferred by the majority of the members, they may be individuals that prefer a DC scheme but would no longer have that option. In this case then members would either have the option to potentially moving jobs to an employer that would still continue offering a DC scheme, transfer out of the CMP scheme itself or negotiate with their employer to contribute to a separate scheme, as is currently the case for members of occupational schemes that are not happy with their current pension arrangements. An example where this could occur is in a situation where, from the individual's point of view, there are undesirable transfers and subsidies, for example, from young to old or from poor to rich.

5.2 Wider impacts - intergenerational fairness

In principle, CMP plan design involves risk sharing, which is likely to occur both between the members of the same cohort and between different cohorts. Critics of CMPs often claim that they are inherently unfair towards younger generations as older people may have first call on the pooled fund to pay their pensions and workers may have to make up any shortfall with increased contributions. The main lesson to be learned from abroad is the Dutch experience. The Dutch regulatory system for CMPs requires a very high level of certainty that target benefits and inflation increases can be paid by prescribing large funding buffers. Slow growth in asset values means that when the buffers were expended in the financial crisis, they could only be restored through increased contributions from younger workers³².

We believe it is possible to design a CMP scheme model to mitigate these risks. A possible solution, as presented to us by Royal Mail, could involve ensuring that: (a) adjustments to benefits are not perfectly smoothed, (b) that adjustments to benefits

³² House of Commons: Work and Pensions Committee. 'Collective Defined Contribution Pensions: Sixteenth Report of Session 2017-19'. 2018. Available at: <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/580/580.pdf>, page 22

required by under or over funding take place frequently (e.g. annually), and (c) that all cohorts of members are treated the same when adjustments are made. This means no funding buffers, and no need for additional funding from younger members to pay out pensions to older workers. In that case it is highly likely that members would see more volatility year on year than in the Dutch system, but an initial analysis and advice provided to us by Royal Mail suggest that in almost all years pensions in payment, and target pensions for those yet to retire, could increase by inflation plus or minus 1 or 2%³³, per year.

Some other views from the pensions industry also seem to suggest the risk of intergenerational fairness is solvable. AoN Hewitt, for example, mention that *dealing with these issues of smoothing requires very careful communication to members and good actuarial processes*³⁴.

CMP schemes will be required to have processes in place to ensure their members can understand that benefit levels will be regularly adjusted accordingly. We anticipate that CMP schemes will make use of modern methods of communication, including social media and video to help ensure members can access the information they need to do this in the most appropriate way for them.

5.3 Wider impacts – wider economic and societal impacts

CMPs could bring investment benefits to the wider economy. As mentioned above, CMP schemes are expected to be able to invest (over their lifetimes) a greater proportion in acyclical, long-term returning assets than DC. These might include, for example, investing in infrastructure projects. However, investment choices and their impacts on wider economy are always complex and hard to assess / predict.

Additionally, the introduction of CMPs could allow for improved industrial relations between employers and their workforce and labour unions, particularly in the case of negotiations regarding pension provision, across the relevant workforces. In the case of Royal Mail specifically, this extends to improving industrial relations with up to 140,000 employees. As such, there is the potential for improved economic output to the wider economy – this is especially the case given the nature of postal services provided by Royal Mail. However, estimating the extent to this is beyond the scope of this Impact Assessment given its complexity.

5.4 Small and Micro Business Assessment (SaMBA)

There is no evidence of any disproportionate cost on small and micro businesses for this legislative change. This proposal creates the option for employers to enrol their employees into a CMP pension scheme. Therefore, businesses will only undertake

³³ Based on internal debate and material provided to DWP by Royal Mail. To be treated as indicative and for illustrative purposes only.

³⁴ Source: AoN Hewitt, The Case for Collective DC, Nov 2017. Available at: http://www.aon.com/unitedkingdom/attachments/aon_hewitt/dc/Aon_Hewitt_The_Case_for_Collective_DC_Nov13.pdf

the associated costs of enrolling their employees into a CMP scheme if they believe it to be beneficial for them to do so relative to the next best alternative.

Moreover, although all businesses will have the option to do this, we expect large employers to be more likely to undertake this option due to the advantages of economies of scale, the pooling of risk among a larger group of members and the greater the ability to undertake more long-term investment strategies. This opinion is supported by industry in the consultation responses.

6. Monitoring and evaluation plan

The proposed legislative framework will provide transparency about the operation and effectiveness of CMP schemes and will require the publication of certain scheme information. In addition, The Pensions Regulator (TPR) will collect and monitor data on CMP schemes in the same way as they currently do for occupational DB and DC schemes, looking at schemes, members and assets. DWP will monitor how the first CMP schemes operate and their performance and effectiveness at providing pension incomes, using this information.

The authorisation and supervision process will require schemes to set out and report on their on-going viability informed by their annual valuations and taking account of any requirements produced by the Institute and Faculty of Actuaries. This will allow an assessment of these schemes to provide the level of income they aspire to, to be made on an on-going basis.

In addition, we will engage proactively with employers, workforce representatives and schemes to identify any issues they are having around the new regime as it beds in, and seek views from schemes and TPR to provide assurance on the effectiveness of the authorisation framework. Investment and providing pension income is a long-term proposition and as such monitoring will be on-going.

The consultation responses clearly indicated that there was significant interest in offering other types of CMP pension products in the future. Those respondents were clear that lessons should be learned from the experience of the first CMP schemes and we intend to take that approach before extending legislation to facilitate other types of CMP scheme.