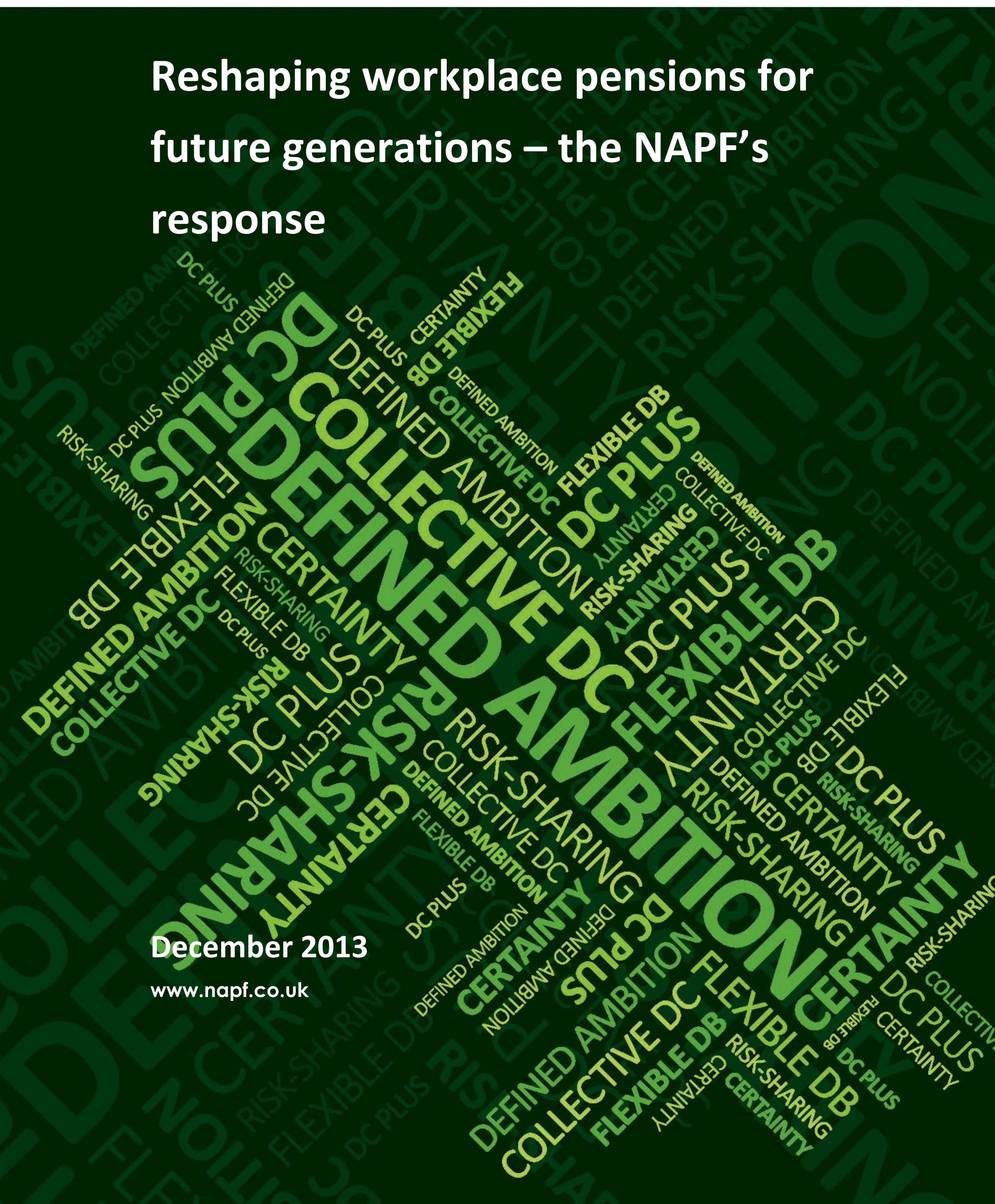
NAPF

Securing the future of pensions



Reshaping workplace pensions for future generations – the NAPF's response

December 2013

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Executive Summary

The NAPF has long argued for a more principles-based and less prescriptive regulatory regime for occupational pensions. One that encourages employers to offer good quality, sustainable workplace pensions that can better balance the risks of pensions saving between scheme members and their employers. The current regulatory landscape actively discourages employers from offering hybrid solutions as once an element of 'defined benefit' (DB) is introduced into the scheme employers have to comply with the full weight of DB regulations.

Defined Ambition offers a once in a generation opportunity to overhaul the tax and legislative system for occupational pension schemes and develop a legislative framework that allows a variety of models to develop in the future as our pensions landscape continues to evolve

DB pensions schemes have gone through a period of fairly rapid decline. This shift has been driven by a number of factors including increases in longevity, the regulatory burden and increasing employer sensitivity to the scale of pension scheme liabilities. Deregulation of DB pensions may encourage those currently considering closing their DB schemes to new members, or to future accrual, to keep their schemes open for longer or switch to more innovative risk-sharing models.

However, the timing of any DA legislation will be critical, if employers contracting in their DB pensions between now and 2016 are going to be able to take advantage of this new framework. **The NAPF calls on the Government to legislate for the new DA framework at the earliest possible opportunity and to set out a clear timetable for employers so they have clarity about how they may be able to apply the new framework.**

The NAPF strong supports good quality, innovative defined contribution (DC) schemes that aim to maximise good member outcomes and one way of doing this is to provide guarantees to the member. However guarantees can be expensive unless significant scale is achieved. The NAPF believes this is one of the big failings of the Minister's automatic transfers policy. By dismissing the NAPF's proposed solution of a using a small number of aggregator schemes the Minister has missed a golden opportunity to build scale in the pensions system for the benefit of scheme members. **The NAPF urges the Government to reconsider its pot follows member policy in light of the wider impact on the ability to deliver innovative DC pension products.**

Guarantees are also not a substitute for good governance and adequate contributions. There are a number of ways the risks in DC pensions can be mitigated through good default fund design, risk diversification, better member engagement and advanced lifestyling. We must not get distracted from the task of getting good value for money out of this pension model. **The Government and the industry need to step up efforts to improve transparency around charges and ensure all schemes have effective governance in place.**

To encourage greater risk sharing we also **need to get the tax regime right**. The current regime discourages employers from entering risk sharing arrangements. The legislative and tax frameworks need to encourage innovative pension provision as our pensions landscape continues to evolve.

About the NAPF

The National Association of Pension Funds (NAPF) is the leading voice of workplace pension provision in the UK. We represent some 1,300 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. Ten million working people currently belong to NAPF member schemes, while around 5 million pensioners are receiving valuable retirement income from those schemes. NAPF member schemes hold assets of some £900 billion, and account for over one sixth of investment in the UK stock market. Our main objective is to ensure the security and sustainability of UK pensions.

NAPF Securing the future of pensions

Introduction

The NAPF has long argued for a more principles-based and less prescriptive regulatory regime for occupational pensions. One that encourages employers to offer good quality, sustainable workplace pensions that can better balance the risks of pension saving between scheme members and their employers.

The regulatory system for pensions in the UK has evolved over time as successive Governments have reacted to pensions crises and scandals, to economic and demographic challenges, and to new developments in the pensions market.

The sheer volume of current regulations – with around 1,000 pieces of legislation relating to pensions introduced since 1995 – imposes significant costs (both in terms of time and resource) on scheme sponsors. A survey of NAPF members conducted in Autumn 2011, as part of our response to the Government's Red Tape Challenge, confirmed this concern and showed that regulatory burdens continue to grow. Eight out of ten respondents thought that the costs to their scheme of dealing with regulatory and compliance issues had significantly increased over the previous three years and, of those, one in five respondents thought costs had increased by more than 25%.[1]

Creating the right regulatory environment is not just about stripping back unnecessary costs and burdens, it is also about encouraging better governance and greater innovation and risk sharing in the pensions structures on offer. The current regulatory landscape actively discourages employers from offering a hybrid solution as once an element of 'defined benefit' (DB) is introduced into the scheme employers have to comply with the full weight of DB regulations.

Therefore the Government's Defined Ambition (DA) proposals, as set out in *Reshaping workplace pensions for future generations*[2], herald a major step towards the creation of sustainable defined benefit and innovative defined contribution schemes. They will help create a framework to enable the development of a genuine mixed economy of pension provision, where employers are free to provide pensions which are right for them and their employees. They will go a long way towards deliver the Coalition Government's aim of reinvigorating workplace pensions.

We have responded to the detailed questions in the consultation in Annex A.

Flexible defined benefit

DB pensions schemes have gone through a period of fairly rapid decline. In 2000, 88% of DB schemes were open to new members. This has now fallen to just 14%, with 30% of schemes now closed to

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[1] Better Regulation – Responding to the Red Tape Challenge: An NAPF call for evidence.
[2] Reshaping workplace pensions for future generations, DWP, November 2013.

future accrual[3]. This shift has been driven by a number of factors including increases in longevity, the increasing regulatory burden and a challenging economic environment which, along with the associated monetary policy, has increased scheme liabilities.

There are signs of economic recovery: UK economic output rose by 0.8% in Q3 following a 0.7% GDP rise in the Q2, this is the best quarterly performance since 2010. Consumer spending appears to be rising gently as inflation comes down, and the housing market has been buoyed by the Government's Help to Buy scheme. Gilt yields are slowly recovering along with pension fund deficits and speculation about further QE appears to have eased. However there is an open question about how the Bank of England will unwind QE, which could impact upon inflation. Therefore, the overall outlook remains uncertain and this will impact on pension scheme funding and investment strategies.

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

There has been some more positive news on DB scheme closures in this year's NAPF Annual Survey. The rate of closure appears to have slowed with 12% of private sector schemes still open to new members compared to 13% in 2012[4].

However, the introduction of the single tier pension will put further pressure on employers with contracting out DB schemes as it will see the abolition of contracting-out and the end of National Insurance rebates. Employers with DB schemes that had contracted out of the State Second Pension will see their NI contributions increase by 3.4%, while employees will see them increase by 1.4%.

Our latest NAPF Annual Survey shows almost 90% of DB schemes still open to new members or future accrual are contracted out. Employers will be able to make use of a statutory override, allowing them to offset the additional cost by increasing employee contributions or altering future benefit accrual. However very few survey respondents thought the employer would do this.

But, there is still considerable uncertainty. Many employers and trustees have not yet discussed the change. And, where funds thought the employer was likely to recover the loss in some way, just under a third thought the employer might close the scheme.

In terms of schemes' wider plans, the survey asked the 17% of private and 'other public sector' DB schemes that were still open to new members what changes they were likely to make in the next five years in respect of their new and existing members. The answers show that further significant change is likely. 56% of these schemes were planning further changes for existing members (Figure 1). Either respondents planned to retain their schemes on less favourable terms or to close them completely and switch to a DC scheme. 67% of these schemes were planning further changes for new employees

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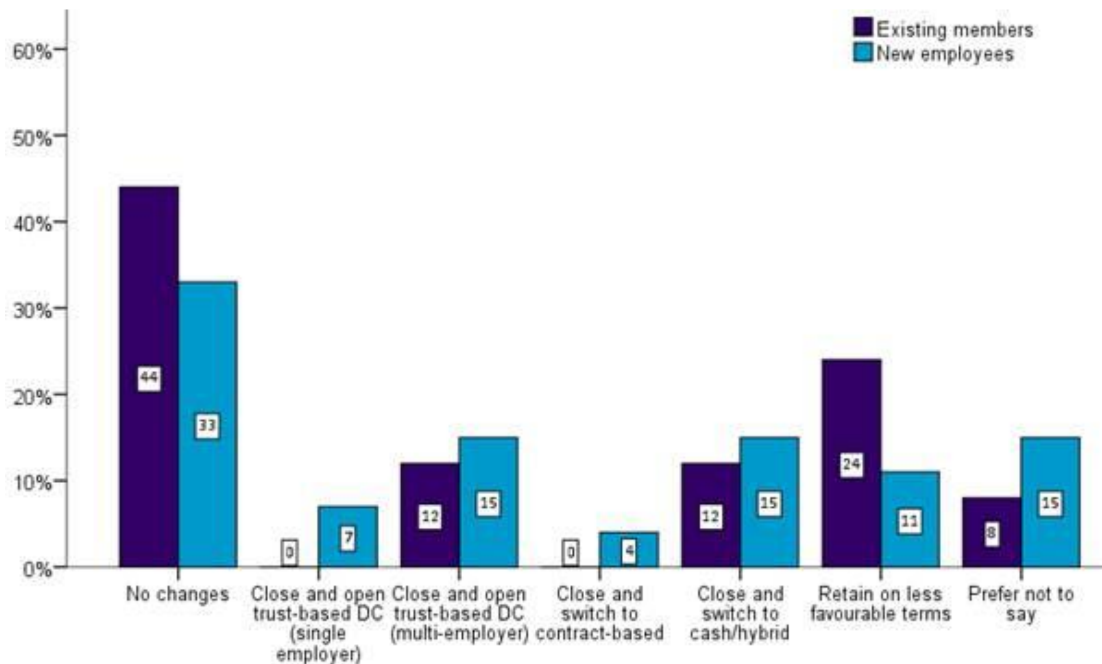
[3] The Purple Book, PPF/TPR, November 2013.
[4] NAPF Annual Survey 2013.

and potential new members, including 30% that were planning to close the scheme to new members and switch to a trust-based multi-employer DC scheme or a hybrid, and 11% that were planning to retain their DB scheme on less favourable terms.

Figure 1: expected changes to open private and 'other public sector' DB schemes



Base: 27 respondents

That is why the NAPF strongly supports the development of a framework that allows for more flexible models of DB pensions provision, in particular the removal of the requirements to provide an index-linked pension in payment.

However, the timing of any DA legislation will be critical, if employers contracting in their defined benefit pensions between now and 2016 are going to be able to take advantage of this new framework. **The NAPF calls on the Government to legislate for the new DA framework at the earliest possible opportunity and to set out a clear timetable for employers so they have clarity about how they may be able to apply the new framework.**

In the consultation document the Government says that they will consider whether to provide a statutory override to enable existing schemes to change the rules in relation to future accrual more easily. Whilst we recognise that such an override would help the employer looking to make easements to their scheme arrangements, trustees have expressed concern that if the override power is too broad it would give employers unilateral power to make sweeping changes to their schemes. Given the restrictive nature of the statutory override currently being developed to aid scheme contacting back in this feels like a significant change in approach from the Government. We would be interested in working with DWP on exactly how such an override might work.

Providing greater certainty for DC members

Automatic enrolment will see 5-9 million people saving into a pension for the first time by the end of this decade. The vast majority of these people will be saving into defined contribution (DC) arrangements where the members takes on all the investment, inflation and longevity risk. The NAPF strongly supports good quality, innovative DC schemes that aim to maximise good outcomes for members and one way of doing this is to provide guarantees to the member.

We also know that scheme members are willing to trade some additional cost in exchange for extra certainty about their pension outcomes. The NAPF workplace pension survey in October 2012 measured respondents' attitude towards risk in pension investments. Over half (55%) of respondents agreed with the statement that they would choose a lower return on investment if they were guaranteed a minimum income on retirement. Three in five (58%) of men agreed with this statement compared to 52% of women. However there is a wider concern that with too many products, each with their own specific rules and caveats (for example about the circumstances under which benefits can or will be transferred), the effort could backfire. One of the key issues will be the need to create better tax frameworks for these new models and therefore it may be better for the industry and government to concentrate on the development of a few core models that can be clearly explained to members.

Guarantees, however, can be expensive unless significant scale is achieved and transfers are kept to a minimum to better support illiquid investment. The issue of scale and the potential need for greater compulsion remain key to the potential success of DC plus but this should not stop us ensuring the legislation will allow these models to develop in the future if scale is achieved. The NAPF believes this is one of the big failings of the Minister's automatic transfers policy. By dismissing the NAPF's proposed solution of using a small number of aggregator schemes the Minister has missed a golden opportunity to build scale in the pensions system for the benefit of scheme members.

The consultation does propose exempting DC plus schemes from automatic transfers, but this rather misses the point as the potential to achieve DC plus will be radically diminished without scale in the first place. It will be restricted to those large employers or multi-employer schemes where there is a sufficiently large workforce providing regular cash flow. **The NAPF urges the Government to reconsider its pot follows member policy in light of the wider impact on the ability to deliver innovative DC pension products.**

The NAPF has some concern that the proposed charge cap only applies to DC schemes and not Defined Ambition (DA) pensions. The Government explicitly states in the consultation that DA schemes will not be subject to the charge cap. While the NAPF agrees that schemes offering some form of 'hard' guarantee are likely to have an AMC above the limit in any charge cap, we are concerned whether a high AMC in a DA scheme will provide value for money, or justify the guarantee on offer.

The Government's definition of a DC plus scheme as those only offering a 'hard' guarantee, also actively excludes DC schemes which are trying to move their members through sophisticated and

targeted investment strategies, excellent engagement programmes and at-retirement support services. Guarantees are also not a substitute for good governance and adequate contributions. The key DC risks are annuity rate risk and investment risk. There are a number of ways these risks can be mitigated in DC through good DC default fund design, risk diversification, better member engagement and advanced lifestyling. Good communication and governance also have a central role to play.

That is why the NAPF is concerned that a cap on charges could inhibit such innovation and prevent members securing value for money pension provision that delivers better outcomes. Schemes operating such investment strategies are going above and beyond the minimum to improve member outcomes, yet they are not able to operate outside a charge cap. There is also a longer term concern that the charge cap will prevent the insurance industry from developing the types of DA products the Government would like to see, stifling the innovation the DA framework is seeking to enable. The NAPF continues to support greater transparency around charges to enable those governing schemes to make a judgement about whether these provide value for money to members. But more still needs to be done - **the Government and the industry need to step up efforts to improve transparency around charges and ensuring all schemes have effective governance in place.**

Legislative and tax framework

Ultimately, the NAPF believes that there should be uniform principles across all types of pension provision to avoid regulatory and fiscal arbitrage. The DA church, as described in the consultation, is a broad one, encompassing everything from a DC scheme with a money back guarantee to a scheme that is defined benefit unless one leaves employment before retirement age. We do not believe that this requires a new category of DB pension to be created in legislation as we believe that all such schemes should be categorised as 'DA'. If the requirement for indexation is taken away it could be argued that there is no need for a DB category and in fact by changing the mandatory requirements in non-money purchase the distinction between scheme designs less necessary. We are concerned about the retrospective effects of creating a new category of 'DB' and what this might mean for historic scheme practice, something that has been a particular issue following the changing definition of money purchase.

We think that in fashioning a new, less restrictive space for "defined ambition" schemes, the Government should give some thought to allowing more breathing room for schemes where risk-sharing is being tried on a smaller scale – schemes where employers are willing to guarantee a minimum investment return on contributions, give an underpin, or guarantee a cash balance at retirement for example. Unfortunately, employers who have been willing to experiment with these sorts of designs under the current regime continue to be punished. In the draft regulations released as part of the Bridge consultation that is proceeding concurrently with this one, the framework under which these benefits were operating has been radically overhauled, and retrospectively at that. Definitions are being changed and confusing new rules regarding transfers, revaluation, and the treatment of these benefits in payment are being inaugurated, all with retrospective effect. This is inconsistent with the policies enunciated in this consultation. These schemes in which small steps

towards risk-sharing have been taken should be given sanctuary in the broad church of Defined Ambition rather than attacked through over-regulation.

The next step should be to re-examine the way that funding and PPF protection, as well as tax legislation, is applied to cash balance schemes and schemes where there is an investment guarantee. These incremental approaches have been discouraged unnecessarily and should not be left by the wayside in pursuit of the next Big Idea.

For those ideas that require scale, and probably scale beyond any single UK employer, then legislation may be useful. Significant input from the FCA, which has experience with prudential regulation and insurance-based solutions, will also be necessary.

The final hurdle in the DA race is the area on which the consultation is largely silent– the tax regime. The current tax regime discourages employers from entering existing risk sharing arrangements currently available to them, in particular cash balance schemes. A member in a cash balance scheme uses up his or her annual allowance more quickly than he or she would with a benefit of similar value in either a money purchase or final salary arrangement. As a result of this and incongruent regulation under Pensions Act 1995 and Pensions Act 2004 (they are regulated as though they were final salary schemes in many instances), the few employers who ventured on this path have grown discouraged and closed the schemes to new members as they are too expensive to maintain. We need to get the tax regime right to it does not provide disincentive to share risk and innovate.

Conclusion

The NAPF has long argued for a more principles-based and less prescriptive regulatory regime for occupational pensions. One that encourages employers to offer good quality, sustainable workplace pensions that can better balance the risks of pensions saving between scheme members and their employers.

Therefore the Government's Defined Ambition (DA) proposals, as set out in Reshaping workplace pensions for future generations, herald a major step forward.

But we have to be honest - DA will not be for everyone. Millions of people are going to be automatically put into a defined contribution pension, many for the first time. We must not get distracted from the task of getting good value for money out of this pension model. We have to step up efforts to improve transparency around charges and explore the benefits of economies of scale.

Workplace pensions schemes regulation has increased exponentially over the last 20 years and we believe Defined Ambition offers a once in a generation opportunity to overhaul the tax and legislative system for occupational pension schemes. There are issues around scale, trying not to create too much complexity, and the need for excellent governance and communications; but none of this

should not stop us ensuring we secure a legislative framework that allows a variety of models to flourish in the future as our pensions landscape continues to evolve.

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Annex A: Consultation questions

Question 1: Do you agree that a greater focus on providing members with more certainty about savings or preferably income in retirement may increase confidence in saving in a pension?

Yes, the NAPF workplace pension survey in October 2012 measured respondents' attitude towards risk in pension investments. Over half (55%) of respondents agreed with the statement that they would choose a lower return on investment if they were guaranteed a minimum income on retirement. Three in five (58%) of men agreed with this statement compared to 52% of women. However there is a wider concern that with too many products, each with their own specific rules and caveats (for example about the circumstances under which benefits can or will be transferred), the effort could backfire. One of the key issues will be the need to create better tax frameworks for the new models and therefore it may be better for the industry and government to concentrate on the development of a few core models that can be clearly explained to members.

Question 2: As an employer, do you have experience of, or can you envisage any issues with, employees being unable to retire due to DC pension income levels or certainty about income levels?

As part of our research into Automatic Enrolment: One Year On, we found that for many employers who underwent automatic enrolment in the first 12 months of implementation, one of the key objectives was the opportunity to remedy their concerns about low participation and the chance to extend a good pension scheme to a greater proportion of their workforce so they would have a better chance of a decent income in retirement. In many cases, automatic enrolment was a mechanism to bring pensions to those groups that had always been hard to reach[5].

Question 3: Do you have any further evidence or research planned which might help inform the development of DA pensions?

The NAPF Annual Survey showed there has been some more positive news on scheme closures. The rate of closure appears to have slowed with 12% of private sector schemes still open to new members compared to 13% in 2012. This is much slower than the drop from 18% in 2011. But, there is still considerable uncertainty. Many employers and trustees have not yet discussed the potential impact of the abolition of contracting out. And, where funds thought the employer was likely to recover the loss in some way, just under a third thought the employer might close the scheme.

We do not have any further specific research planned at this time.

[5] Automatic enrolment: one year on, NAPF, October 2013.

Design 1: Ability to pay fluctuating benefits

Question 4: What are your views on the feasibility of this scheme design?

If the requirement to index defined benefit pensions accrued in the future is lifted we could see that many employers would include an ability to apply discretionary increases in their rules, for times of higher than expected inflation. However, many employers have encountered difficulties with discretionary increases (for example, in respect of pre-1997 accruals) ranging from bad publicity and pensioner outcry to wrestling with trustees concerning affordability, which may cause them to approach such a discretion with caution.

The main challenge with the introduction of a flexible DB scheme is to ensure the fairness between different cohorts in the collective. There should be clear mechanisms for how both surpluses (and deficits) are shared between the members in a fair way.

Question 5: Are employers likely to be interested in providing benefits in addition to a simplified flat-rate DB pension on a discretionary basis or otherwise?

Some may be, and we think that many would be interested in including discretion. How the discretion is applied would vary.

Question 6: What role do you see for scheme trustees in relation to discretionary payments? For example:

- **Should they be involved in deciding whether a discretionary payment is made at all?**

- **Should they be involved in setting out how these payments are apportioned to members or should this be down to the employer?**

Inasmuch as it is the trustees who must shepherd the assets and the employer who is responsible for meeting the balance of the funding, we would expect the exercise of the discretion to be a joint decision between the employer and the trustees. This would also be covered in the Trust deed and rules .

Question 7: Do you agree that our starting point should be to keep regulatory requirements around discretionary benefits to a minimum?

Yes, although it might be helpful to set out a few paradigms of the sorts of discretions that the Government would like to encourage. The problem will be that if there is a profusion of different discretions, the likelihood increases that members and the public generally will misunderstand them.

Question 8: How do you see funding for the non-discretionary DB element being sufficiently protected while allowing for extra discretionary benefits? For example, is there a risk that paying discretionary benefits could threaten the funding for non-discretionary DB benefits for younger scheme members?

This is an existing risk for any defined benefit scheme, and trustees and employers are getting better at managing that risk. There is always a temptation to be overly optimistic about the availability of assets in the future, but that does not mean that the risk cannot be managed. Internal fairness is very important to avoid that the young have to pick up the bill. This requires that a risk based accounting framework is applied within the fund restricting the maximum allowed indexation.

Design 2: Automatic conversion to DC when member leaves employment

Question 9: What are your views on the feasibility of this scheme design?

The concerns with this particular model is how to ensure fair treatment of all members and that the added complexity of trying to ensure the DC pot is of fair value would outweigh the benefits of the flexibility it would give the employer. If the primary outcome for most members is larger than the usual defined contribution pot, this could be achieved more simply and less arbitrarily through higher contributions to a defined contribution scheme.

Question 10: If employers are able to use scheme designs 1 and 3, do you think it is still helpful for legislation to allow for this scheme design?

An arbitrage free transfer valuation of the members benefits would probably be considered too expensive for most pension funds. The effort that would go into getting this process right would not be worth it, in our view.

Question 11: Do you think this scheme design could be extended to permit employers to automatically transfer members out of the scheme at retirement?

Trustees can do this by buying an annuity already, albeit usually at the level promised under the scheme rather than at the level that could be purchased by a cash equivalent. It could be argued that the whole idea with DB is that it is self-annuitizing. If that is taken away, why not move completely into a DC+ with guarantees.

Question 12: What would be the most suitable way for benefits to accrue under this model? And how might this best be communicated to ensure members understand the value of their pension benefits?

As stated above, we think this is too complicated and introduces too many variables to be practical for, or understood by, members.

Assuming a CETV would not represent 'fair value' for the accrued rights when the member leaves or retires, how might it best be calculated? Should the basis for calculation be different when the transfer is initiated by the employer (for example on redundancy)?

Question 13: Assuming a CETV would not represent 'fair value' for the accrued rights when the member leaves or retires, how might it best be calculated? Should the basis for calculation be different when the transfer is initiated by the employer (for example on redundancy)?

Question 14: For schemes providing a lump sum benefit, what are your views on how the cash value should be calculated for members who leave before retirement? Should the net present value of the lump sum be calculated on how many years away from pension age they are?

We think that both questions 13 and 14 demonstrate how complex this arrangement would be. An arrangement that requires so much intervention and presents so many complicated questions will not be adopted by employers, who are already weary of regulatory gyration.

Question 15: Could the accrual rate and pension value be along similar lines to existing cash balance arrangements?

We think that if this is the direction of travel, we would be better off removing some of the elements of current law that discourage cash balance schemes, which would achieve the same result for members at less expense.

Question 16: What forms of regulatory requirements would be needed to:

- **prevent avoidance activity?**

- **ensure the scheme has access to sufficient funds to enable a transfer when a member leaves?**

Once again, these questions simply underline how unworkable this suggestion is.

<u>**Design 3: Ability to change scheme pension age**</u>

Question 17: What are your views on the feasibility of this scheme design?

We think that allowing the pension age to fluctuate once accrued will introduce uncertainty for both employers and members. It is not clear to us that take up of such an approach would be great, and we can foresee questions arising concerning individuals with shorter than expected life expectancies if we are going to pay a pension based on life expectancy rather than age. However, we support the establishment of a GAD longevity index, which could be used both by those who wish to fix retirement age while benefits accrue, but change it going forward from time to time based on longevity projections; and those who would take the more radical step proposed.

Question 18: It could lead to more schemes having proportions of accrued pension payable at different pension ages. Would this further complexity outweigh the benefits?

It could also lead to fewer schemes having accrued pension payable at different pension ages, as benefits earned after the new method was adopted would accrue to a uniform age as at retirement rather than accruing to changing ages from year to year based on the index, as can now be the case.

Question 19: What role do you see the scheme trustees playing? Should they be involved in setting a new NPA, or should this be down to the employer and the employer's actuary?

It is very difficult to see what role trustees would have if they were not part of the decision making process on such an important aspect of the benefit.

Question 20: What are your thoughts on how future pension ages are set?

- **For GAD to publish a standard index based on longevity assumptions?**

- **Or do you prefer schemes linking their NPA with the State Pension age, so that when the latter changes, the scheme's pension age automatically changes in line with this?**

Linkage to state pension age raises age discrimination concerns inasmuch as state pension ages are not uniform and will not be for some time. However, it could link to the SPa of a specific cohort. The linkage could also be to projected longevity.

Question 21: How might the decision to change the NPA work in multi-employer schemes?

We do not think that this would be appealing in a multi-employer scheme that involved a number of unrelated employers.

Question 22: As an alternative to opening a new scheme, do you agree it should be possible for an employer to modify the rules of an existing scheme so that it can be re-designed as a Flexible DB scheme in relation to new accruals, for example, it is possible to change the NPA and/or introduce automatic conversion to DC when a member leaves?

The normal rules of changing scheme rules would apply here. Obviously any changes would only apply to new accruals.

Question 23: Do you agree that employers should not have the power to transfer or modify accruals built up under previous arrangements into a new arrangement, beyond what is allowed under current legislation?

We think that the introduction of some additional flexibility for transfer or modification would be justified and that the Incentive Exercises code should be applied.

Question 24: Should there be a requirement to provide independent financial advice in all cases where an employer offers to transfer a member's accrued rights from a traditional DB scheme to a new arrangement?

It depends on what the arrangement is to which the transfer is being made and, of course, whether the member must consent. Some changes should not require consent, and the move to some defined ambition proposals would represent a greater change than others.

Question 25: Do you think having more certainty than traditional DC would be welcomed by members, and help generate consumer confidence and persistency in saving?

Yes we do, so long as the promises are easy to understand and are not oversold, or over-regulated to the point that they cannot be easily explained or delivered. The NAPF workplace pension survey in October 2012 measured respondents' attitude towards risk in pension investments. Over half (55%) of respondents agreed with the statement that they would choose a lower return on investment if they were guaranteed a minimum income on retirement. Three in five (58%) of men agreed with this statement compared to 52% of women. However there is a wider concern that with too many products, each with their own specific rules and caveats (for example about the circumstances under which benefits can or will be transferred), the effort could backfire. One of the key issues will be the need to create better tax frameworks for these new models. Therefore it may be better for the industry and government to concentrate on the development of a few core models that can be clearly explained to members.

Question 26: As an employer, if these products mean there is no funding liability, only the requirement to contribute as for a traditional DC scheme, would you be interested in offering these products to employees?

N/A

Question 27: In relation to medium- and long-term guarantees outlined in model 2 (capital and investment return guarantee), and model 3 (retirement income insurance), would removal of the legislative barriers be sufficient to stimulate the development of market-based solutions?

We do not believe that there are too many legislative barriers keeping this sort of scheme from operating. Large employers and insurers could offer something of this nature to employees now, although there could be some issues around transfers and the appropriateness of PPF protection, as there is now around cash balance schemes. However, it is probably correct that these models would be more appealing if there is sufficient scale for costs to be brought down and if the decumulation phase is made more flexible. In order to come up with the standardised terms that are mentioned in the consultation, it would seem that some product regulation by FCA may be required.

Question 28: As insufficient scale has been identified as a barrier to providing affordable guarantees, is there a role for the Government in facilitating different types of pension vehicles that would create greater scale for this purpose?

If financial guarantees are backed by cash flow matching assets, scale is not a critical issue. Scale is a much more important factor when it comes to marketing and distribution. However, we believe that if the insurance industry had an appetite for these products it would have ventured here before, so yes. The NAPF believes this is one of the big failings of the Minister's automatic transfers policy. By dismissing the NAPF's proposed solution of a using a small number of aggregator schemes the Minister has missed a golden opportunity to build scale in the pensions system for the benefit of scheme members.

The consultation proposes exempting DC plus schemes from automatic transfers, but this rather misses the point as the potential to achieve DC plus will be radically diminished without scale in the first place. It will be restricted to those large employers or multi-employer schemes where there is a sufficiently large workforce providing regular cash flow.

Question 29: Are there any additional legislative barriers that stand in the way of innovation of products with guarantees?

We believe that many employers would be willing to provide limited guarantees and underpins, and that this would be a small step towards greater member security at very little cost to employers. However, as a result of the change in the definition of "money purchase benefits", such schemes now will be governed by onerous and ill-fitting regulation that was written for final salary schemes.

Tax laws disfavour cash balance schemes. A member in a cash balance scheme uses up his or her annual allowance more quickly than he or she would with a benefit of similar value in either a money purchase or final salary arrangement. As a result of this, and incongruent regulation under Pensions Act 1995 and Pensions Act 2004 (they are regulated as though they were final salary schemes in many instances), the few employers who ventured on this path have grown discouraged and closed the schemes to new members as they are too expensive to maintain.

We know there are several insurers who have introduced retirement income insurance products into the UK market. However, our understanding is that the tax laws regarding drawdown (and the constant change to those tax laws) have made those products much more expensive in the UK than they are in the US.

Question 30: Do existing protection arrangements for DC products provide sufficient protection for members in the event of provider insolvency?

We think that regardless of the outcome of this consultation, it would be worthwhile to examine FSCS compensation and determine what FSCS will and will not cover, as well as analysing what would happen in the event of industry-wide catastrophe. As it is, trustees and members have little information about how the system is supposed to work, and no assurance that it will work. The NAPF plans to look at the security of assets framework as part of our 2014 work programme.

Question 31: Would any protection mechanism need to apply in order to provide extra security for members and reassurance for the employer that it would not be liable in the event of any deficits arising?

It is likely that unless the scheme is one that pools risk among many employers, any employer would believe that it must make up any deficit arising. However, our assumptions from the model description is that the guarantees will be insured and therefore additional protection is not required. Presumably insurers will be required to meet FCA prudential standards and therefore there will already be a degree of confidence about the level of security for that members' assets.

Question 32: Are these models likely to be an attractive option for employers and members?

It depends on the price of the guarantee, and of course the small print concerning when the guarantee would apply and any restrictions, for example, on exit. In principle, they would be appealing.

Question 33: On model 4 – pensions income builder – what are your views on this model in which members are in effect deploying their own capital to guarantee their own entitlements?

We think it's very appealing, but will only provide value for money where there is sufficient scale in the fund. Both of these may present significant barriers in the UK market, where traditionally the member could take their assets from any pension arrangement.

Question 34: Do you agree that CDC schemes have the potential to provide more stable outcomes on average than traditional DC schemes?

There are no silver bullets. A badly designed CDC scheme can be worse than a well-designed DC scheme with guarantees (and the other way around). As discussed above the stability and value for money of CDC schemes themselves depends a good deal on scale and the entry and exit rules. They are likely to be more appealing where there is participation across a large numbers of employers.

Question 35: Given there is no tradition of risk sharing between pension scheme members in the UK, are individuals going to be willing to share the benefits of protection from downturns in the market and increased certainty of outcome, with the potential disadvantages of intergenerational risk transfer?

There has been some tradition of risk-sharing in with-profits schemes, although the reputation of with-profits has been damaged. However, the with-profit scandals could have been avoided if there would have been an risk-based legislative framework regarding guarantees and strong enforcement. So long as there are clear rules and transparency around the way in which the risk is being managed so that those managing the plan do not succumb to Ponzi-type financing mechanisms, the risk transfer itself should not be problematic. Benefits in payment may also be cut, or their rate of growth as compared to inflation slowed, in order to ensure that benefits are proportionate to the assets supporting them, so not all of the downside is placed with the younger generation. The problems

evolve where there is excessive optimism about the likelihood that assets will grow to support promises to those who have a long time to wait (and therefore aren't watching closely).

CDC solutions without guarantees, still needs an internal risk based framework to ensure fairness between members in the collective. This is necessary to create resilient CDC solutions.

Question 36: Is a CDC scheme designed to manage funding deficits by cutting benefits in payment going to be acceptable in the UK where traditionally maintaining the value of benefits in payment has been an overriding priority?

One way to manage this is to ensure that the possibility that income in retirement is reduced is managed by ensuring that the projected income is realistic and the possibility of a decrease will need to be emphasised. The pension income builder (which provides an element of guarantee) is more resilient than CDCs in adverse economic scenarios. T.

Question 37: What levels of funding do you consider would be appropriate to ensure that a CDC scheme has sufficient capital to meet the liabilities and minimise the risk of benefits in payment being cut?

We do not have sufficient information to answer this question.

Question 38: Given the need for scale and an ongoing in-flow of new members to ensure the sustainability of a CDC scheme, will it be possible to set up a scheme without some form of Government intervention?

We think that some sort of Government support will be necessary.

Question 39: As a mutual model, it has been suggested that CDC schemes might prove attractive to the trades unions and other social partners – might this be an option worth exploring?

Yes, we think that organisations that have strong ties to members would be well placed to run or take part in such schemes, although the political pressures on these groups will be greater. Some base of support among the public will be necessary, however, and it is difficult to see particular employers being first-movers in this area without a push from trade unions or other social partners.

Question 40: Do you agree that creating a unified and identifiable legislative framework that brings together the legislation relating to DA schemes would be preferable to simply amending existing legislation?

The DA church, as described in the consultation, is a broad one, encompassing everything from a DC scheme with a money back guarantee to a scheme that is defined benefit unless one leaves employment before retirement age. We do not believe that this requires a new category of DB pension to be created in legislation as we believe that all such schemes should be categorised as 'DA'. If the requirement for indexation is taken away, that is a quick win for scheme design no matter what the scheme is called, and in fact makes distinctions between scheme designs less necessary. We are

concerned about the retrospective effects of creating a new category of 'DB' and what this might mean for historic scheme practice, something that has been a particular issue changing the definition of money purchase.

We think that in fashioning a new, less restrictive space for "defined ambition" schemes, the Government should give some thought to allowing more breathing room for schemes where risk-sharing is being tried on a smaller scale – schemes where employers are willing to guarantee a minimum investment return on contributions, give an underpin, or guarantee a cash balance at retirement for example. Unfortunately, employers who have been willing to experiment with these sorts of designs under the current regime continue to be punished. In the draft regulations released as part of the Bridge consultation that is proceeding concurrently with this one, the framework under which these benefits were operating has been radically overhauled, and retrospectively at that. Definitions are being changed and confusing new rules regarding transfers, revaluation, and the treatment of these benefits in payment are being inaugurated, all with retrospective effect. This is inconsistent with the policies enunciated in this consultation. These schemes in which small steps towards risk-sharing have been taken should be given sanctuary in the broad church of Defined Ambition as well rather than attacked through over-regulation.

The next step should be to re-examine the way that funding and PPF protection, as well as tax legislation, is applied to cash balance schemes and schemes where there is an investment guarantee. These incremental approaches have been discouraged unnecessarily and should not be left by the wayside in pursuit of the next Big Idea.

For those ideas that require scale, and probably scale beyond any single UK employer, then legislation may be useful. Significant input from the FCA, which has experience with prudential regulation and insurance-based solutions, will also be necessary.

Question 41: Do you have any comments on how to characterise the defining characteristics of DA pensions?

DA pensions as discussed in the consultation are diverse and their defining characteristic now is that they do not fit comfortably within the money purchase definition. It may be that within the DA legislation that there is regulatory guidance provided on the most common likely DA models so that schemes which to move to DA understand how any funding requirements, for example, are likely bite. This will help more widely in educating members as to what kind of scheme their employer has.

Question 42: Do you agree that it makes sense to define DB schemes in their own right rather than simply by contrast to money purchase?

We do not believe that this requires a new category of DB pension to be created in legislation as we believe that all such schemes should be categorised as 'DA'. We are concerned about the retrospective effects of creating a new category of 'DB' and what this might mean for historic scheme practice, something that has been a particular issue from changing the definition of money purchase. Trying to regulate DA prototypes such as cash balance schemes and schemes with guaranteed

investment returns by working from models that were set up for final salary schemes has cluttered their regulation and strangled their growth.

Question 43: Do you agree that defining DA, DB and money purchase schemes should facilitate clear and proportionate regulation according to scheme type?

We think that there should just be DA and money purchase categories.

Question 44: Do you have any comments in relation to the suggested definitions of DA, DB and money purchase schemes?

In addition to the DA category we think there should be regulatory guidance on the most common forms of DA schemes, for example:

- Salary-related (final salary and CARE schemes);
- Money purchase schemes (plain-vanilla defined contribution with no bells and whistles, as defined in Pensions Act 2011);
- Cash balance (where the goal is to have a defined pot of money at retirement as opposed to a particular income);
- Guaranteed Money Purchase (where the benefit is the contributions, subject to a guarantee as to the investment return, which may be exceeded);
- Specifically named DA schemes, for example:
- Collective Defined Contribution; pension income builder, etc

Question 45: Are you aware of any schemes operating in the UK under the Regulatory Own Fund provisions?

No

Question 46: Aside from Regulatory Own Funds vehicles, are there any other vehicles which might be appropriate for the provision of collective CDC which offers some form of guarantee or promise?

An insurance product might be appropriate if properly constructed.

Question 47: Do you think that setting up a CDC scheme should be subject to formal approval, for example licensing by a regulator?

Yes. There will need to be strict prudence and governance oversight.

Question 48: Do you think that CDC schemes which do not provide a guarantee or promise should also be licensed?

The NAPF believes that multi-employer schemes that are looking to operate at scale should be well-regulated. We have suggested in our multiple aggregator policy that one way to ensure that scale operators are well governed and have robust business and risk management plans is for them to be licensed by the appropriate regulator. That said, where there is no guarantee or promise made, or an expected target set out, it needs to be made clear to members that there will be no compensation should things go wrong.

Question 49: Do you agree that such CDC schemes should also be subject to DA requirements on governance and member communications?

We believe that all schemes should be subject to rules requiring good governance and member-oriented communications.

Question 50: Should there also be an option for schemes that currently offer DC to convert to CDC?

So long as there is an option for members to transfer out, and this is made easy for the members who wish to go with the flexibility of DC. We are aware of schemes with guaranteed investment returns that are making it easier for members to move to plain-vanilla money purchase arrangements because those arrangements would be advantageous for the member in the event of insolvency.

Question 51: In the absence of both a guaranteed pension entitlement and an individually defined pool of assets, how should assets in a CDC scheme be apportioned such that pension accruals can be measured for tax purposes against the Annual Allowance and the Lifetime Allowance?

We would caution that this has been a tricky area for cash balance schemes, wherein measurement against the annual allowance is less favourable than it is for either money purchase or final salary schemes.

Question 52: What specific areas should we address in relation to governance and member communications for DA schemes?

Governance will depend on the form of the body that provides the benefit. If there are a number of models that come into the market, explaining to members what they have will become very difficult. We think it makes sense to concentrate on a few of the very best ideas, and name those ideas and their parameters clearly. Otherwise, there will be too much room for misunderstanding.

Question 53: Do you have any comments on the assumptions in relation to scheme funding requirements?

No.