CDC: International Insights

Pensions Policy Institute

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Introduction

Following the enactment of the Pensions Schemes Act 2021, Collective Defined Contribution (CDC) schemes are soon to become a reality, with trustees able to apply for authorisation to operate a CDC scheme from August 2022. While primary legislation is now in place to allow CDC schemes, there is still work to be done to establish the finer details of how these schemes will be designed and managed. The Pensions Regulator (TPR) is currently consulting on its regulatory framework and authorisation regime, but within proposed regulations there is scope for diversity in scheme design.

This Briefing Note explores insights from three of the most established international CDC systems: the Netherlands, Canada and Denmark. Informed by the lessons that can be learnt from international experiences, this Briefing Note sets out some of the key considerations and challenges facing those responsible for design of CDC regulation and schemes in the UK. Following a brief overview of the introduction of CDC in the UK, the Briefing Note is structured around four key areas, as summarised below.

Summary of key points

- **Valuation and benefit adjustments:** Establishing fair and transparent processes for valuations and benefit adjustments is vital to the success of CDC schemes. International experience suggests that clearly defined rules for actions that will be taken in response to changes in funding position and associated benefit adjustments are essential in order to mitigate the discretionary nature of benefits, and ensure fairness between different groups of members. Clearly communicating these rules with scheme members will also be an important component of scheme management.
- **Intergenerational fairness:** In order for CDC schemes to be fair and sustainable, the distribution of risks across cohorts will need to be carefully considered. The use of buffers or capital reserves in CDC schemes internationally can be a significant source of intergenerational inequity. UK schemes will not utilise buffers, instead using frequent, universal benefit adjustments to rebalance funding ratios on an annual basis. While this approach is likely to lead to greater volatility year-on-year, it is also likely to mean there is less cross-subsidy from younger to older members, and therefore less propensity towards intergenerational unfairness.
- **Sustainability in voluntary membership:** International examples of CDC schemes rely on mandatory membership to support their sustainability, but membership of UK schemes will be voluntary. This means it is even more important that schemes establish trust, transparency and fairness between different groups of workers, in order to ensure that opt outs and transfers out of the scheme do not threaten the scale and sustainability of the scheme over the long term.
- **Contribution rates and individual choice:** Both the level of contribution and the way in which contributions are converted into future benefit entitlement have implications for CDC scheme design. Contribution rates will need to be set at a level that is deemed reasonable to achieve the targeted benefits set out in the scheme design, while taking affordability into account. Individual choice relating to contribution rates and other elements of scheme activity, such as investment choice, could also be considered in the design of future CDC schemes.

The introduction of CDC in the UK

CDC schemes could offer a middle ground between Defined Contribution (DC) and Defined Benefit (DB) schemes, providing members with greater certainty about the retirement outcomes they will achieve than would be possible in a DC scheme, while providing greater certainty about costs for employers than a DB scheme. The aims of CDC include:

- The potential for higher retirement income for members (compared to individual DC).
- The potential for more predictable retirement income for members (compared to individual DC).
- Greater certainty about costs and liabilities for employers than DB, and potentially a more efficient way to offer employees a generous benefit than individual DC.

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In order for CDC schemes to be created within the UK pensions landscape, which was previously a binary system of DC and DB, legislation has been introduced setting out the legal status of CDC schemes, and a robust regulatory framework is currently being finalised (Box 1).

Box 1: CDC legislation and regulation in the UK

The Pension Schemes Act 2021 provides the legislative framework to establish and operate CDC schemes (referred to as Collective Money Purchase (CMP) schemes in the Act) in the UK. The Act also provides for TPR to produce a Code of Practice for the authorisation and supervision of CDC schemes.

TPR consulted on its proposed Code of Practice between January and March 2022. The proposed code established that authorisation will be subject to TPR being satisfied that:

- those involved in the scheme are fit and proper persons;
- the design of the scheme is sound;
- the scheme is financially sustainable;
- the scheme has adequate systems and processes to communicate with members and others;
- the systems and processes used in running the scheme are sufficient to ensure that it is run effectively; and
- the scheme has an adequate continuity strategy.[1]

TPR's response to the consultation and publication of the final Code of Practice is expected imminently, ahead of the authorisation process launching in August 2022.

There are a number of key differences between the UK's pensions landscape and CDC legislation compared to international examples of CDC regimes that should be highlighted at the outset of this analysis:

- UK CDC schemes will exist in the private pensions sector, whereas CDC schemes in Canada are part of the first pillar of pension provision (State-sponsored), schemes in Denmark feature in both the first and second pillar, and schemes in the Netherlands are part of the second pillar. This factor means that the Dutch model of CDC is the closest to the UK landscape, but there are still some key differences between the two.
- Participation in UK CDC schemes will be voluntary, whereas in the three international examples it is mandatory, with State-sponsored schemes in Canada and Denmark, and industry-wide mandatory arrangements in the Netherlands.[2]

The proposed Royal Mail scheme is likely to differ from CDC schemes established overseas in most ways other than essential characteristics – that is, collective and defined contribution. Other features of scheme design, such as the way that valuations and benefit adjustments are made, contribution rates, and benefit accrual, are all expected to be substantially different from established CDC systems overseas. Any further CDC schemes that are established in the UK are likely to use the Royal Mail scheme as a template rather than looking at international scheme design, particularly as UK CDC legislation has been structured to some extent around enabling the Royal Mail scheme in the first instance.[3] However, the experience of countries with established CDC schemes can provide some useful insights for consideration in the design of UK schemes.

Box 2: How do CDC schemes operate internationally?

The Netherlands

In the Netherlands, the vast majority of employees are members of industry-wide pension schemes. If an industry-wide pension scheme is set up it then becomes mandatory for the entire sector or profession, although employers can sometimes be exempted from participation if they meet certain criteria. Traditionally these schemes were DB, but many have now transitioned operationally into CDC schemes with the ability to respond to shifts in funding position by making adjustments to member benefits. The Dutch regulatory framework has required a high level of certainty and smoothing of benefits through the use of capital reserves or 'buffers'.

Denmark

In Denmark, the ATP is a compulsory funded CDC scheme based on flat rate contributions that covers almost everyone in the country. Contributions are subject to deductions made to account for the provision of lump sum payments to dependents in case of death and the ATP bonus potential, which is used to increase guaranteed lifelong pension amounts via bonuses and to cover longer than projected life expectancies. Once deductions have been made, the remaining part of the contribution is used to purchase a guaranteed annual pension.[4] In addition to the ATP, there are also occupational CDC schemes that have been introduced by collective agreement by the relevant employer associations and unions, and are compulsory for all companies covered by the agreement, with only limited opt-out opportunities.

Canada

In Canada, risk-sharing pension plans involve a number of participating employers and are union-negotiated, collectively bargained schemes with targeted benefits, contingent on the plan's financial position, and with members bearing 100% of the risk on a collective basis (as in a CDC scheme). Canadian risk-sharing schemes allow considerable flexibility in the design of the scheme, and, in particular, the level of target benefits and associated contribution rates.

Valuation and benefit adjustments

Establishing fair and transparent processes for valuations and benefit adjustments is vital to the success of CDC schemes

One of the greatest challenges associated with designing a CDC scheme is ensuring that processes for valuations and benefit adjustments are clearly defined, sustainable and, perhaps most importantly, fair. International CDC systems take different approaches to valuation and benefit adjustments, with Dutch CDC schemes particularly reliant on buffers (capital requirements) in order to satisfy strict rules for certainty of benefits. Danish schemes instead split contributions between guaranteed and ancillary benefits, and Canadian schemes focus on clearly pre-defined rules for responsive actions to changes in funding position, in order to mitigate the discretionary nature of benefits (Box 3).

Box 3: How are valuations and benefit adjustments made internationally?

The Netherlands

Valuations and benefit adjustments in Dutch schemes are regulated by the Financial Assessment Framework (FTK), which sets out how liabilities have to be calculated, the required amounts for the buffers, the contributions for a scheme, and the risks that schemes must take into account:

- Valuation: The valuation of both assets and liabilities must be done on a fair value basis. This means that assets are valued using the daily market prices and liabilities are determined by discounting the expected cash flows with the risk-free rate derived from market data.
- Capital requirement: The level of this first capital requirement set out by the FTK is defined by the amount of risk taken by the fund and must show that there is a 97.5% certainty that the fund will not become underfunded within one year.
- Minimal capital requirement: The second capital requirement is set at a minimum capital of 105% of the value of the liabilities at all times, in order to ensure that the scheme will have enough assets to pay their liabilities in the future.
- Recovery plans: When a scheme does not meet one of the capital requirements, it must set out a plan for recovery. If the first capital requirement is not met, a long-term recovery plan is required to set out how the scheme will return to a position where it meets this requirement within ten years. If the minimal capital requirement is not met for five consecutive years, the scheme will have to make immediate benefit reductions to return to the minimum funding requirement. Benefit reductions may be smoothed over a period of no more than 10 years. Each year that a recovery plan is in place it is reassessed alongside the need for benefit reductions.
- Indexation: Inflationary increases are dependent on the scheme's funding ratio and schemes can choose whether their ambition is to increase pensions in line with price inflation or wage inflation. Schemes may finance indexation through capital reserves, provided these exceed the capital requirement outlined above. Partial indexation can be granted if funding ratios are between 110% and 130%, with full indexation granted when funding ratios are above 130%.[5]

Denmark

In Denmark's ATP scheme, contributions are divided into two parts:

- 80% is designated a 'guaranteed contribution', which is the basis for the guaranteed nominal pension the member will receive.
- 20% is used as a 'bonus contribution' which goes into a collective reserve or buffer used to provide future indexation of both pensions in payment and accrued pension entitlements on a conditional basis if the funding ratio exceeds 120%.

Canada

The Canadian model of CDC prescribes funding and risk management goals, including financial stress tests and projected funding ratios, with pre-determined responses to changes in the scheme's funding position. These are achieved through cuts or increases to benefit payments, changes to employer and employee contributions and changes in asset allocation.

Canadian CDC schemes include an employer guaranteed minimum of base benefits, defined using career average salary. Depending on the scheme's funding position, ancillary benefits may also be provided. These can include the difference between benefits based on career average and final salary, as well as post-retirement cost-of-living increases.[6]

Stress testing is required when the scheme is established to ensure there is a reasonable probability that the targeted benefits can be delivered and that contribution levels are designed to match the targeted benefits using reasonable assumptions. At the time the plan is set up, stochastic testing must be used to illustrate that there is at least a 97.5% probability that base benefits will not need to be reduced over a 20-year period (the primary risk-management goal) and that, on average, at least 75% of the value of targeted ancillary benefits will be paid over this period (the secondary risk-management goal). These stress tests must also be carried out at certain other times, such as when permanent changes are made to benefits or contributions. Annual stress testing is also required at the time of annual actuarial valuation of the scheme's funding position to determine whether actions set out in the funding policy must, or may, be taken in any given year.[7]

UK CDC legislation focuses on regular and universal adjustments, requiring that:

- valuations are undertaken using a central estimate methodology that does not seek to be overly optimistic or to build in prudence;
- valuations and benefit adjustments are carried out on an annual basis in order to balance the scheme's funding ratio regularly, so that there is no funding deficit or surplus;
- any adjustment of benefits applies to all members without variation; and
- any increases in benefits resulting from the valuation are sustainable.

The legislation also requires transparency regarding valuations and benefit adjustments, with the method for calculating the rate or amount of benefits set out in the scheme's rules, alongside how the scheme assets are valued, how the amount expected to be required for providing benefits is determined, and how benefits will be adjusted.[8]

Clear communication of scheme rules with members will be an important component of scheme management

Because of the variable nature of benefits within CDC schemes, clear communication and engagement with members is especially important. Communications must ensure that members understand the nature of their income entitlement within the scheme and the possibility that this could be reduced under some circumstances. Scheme communications will need to be explicit about the potential risks associated with future indexation and benefits, and clearly explain the measures that will be taken by trustees to address any changes in the funding position. The extent to which communications are effective will also be dependent on the level of trust that members have in the scheme.

While the need to reduce or stop indexation, or to make cuts to nominal benefits, will always come as a disappointment to scheme members, ensuring that members understand the process for valuation and adjustment of benefits should help to mitigate this. In order to prepare them for future fluctuations in their pension benefits, members will need to have a prior understanding that benefits could be adjusted up or down. This can be done through well-communicated pre-set rules, such that all members know beforehand what will happen in each scenario and how it will affect their contributions and benefits. As such, there need to be pre-agreed rules on how these calculations will work - and this needs to be clearly communicated to scheme members.

'Complete' contracts, in which trustees' responsibilities and actions when in a position of under and over funding are agreed and communicated in advance, can help to manage expectations, with the adjustment of benefits based on a mechanism set out in scheme rules, rather than trustee discretion. Any mechanism for adjustment is likely to still involve some degree of judgement or discretion, however - for example around the selection of actuarial assumptions or the extent to which different adjustments are used. However, the Canadian approach of defining in advance a clear sequence of action to take when the scheme funding position changes helps to limit the potential bias from human judgement that could lead to unfair treatment of different groups of members.[9]

The experience of the Netherlands, in particular, resulting from the financial crisis in 2008, highlights the need for contractual agreements and members' expectations to be fully aligned from the outset in order to avoid negative reactions. A key part of the communication problem in the Netherlands was that employers thought they had entirely fixed costs, as in a traditional individual DC scheme, while members thought they had a guaranteed level of income, as in a DB scheme – neither of which was the case. Unlike in the UK where CDC schemes will be brand new entities separate from previous DB schemes, in the Netherlands the transition has been more gradual and less clear, with existing DB schemes increasingly operating as CDC schemes, but in a non-transparent unpredictable way.[10] The impact of the financial crisis in 2008, and the subsequent reaction from scheme members, led to the introduction of the Financial Assessment Framework (FTK) in 2014 in order to clarify the statutory financial requirements for schemes and create a more transparent and better understood system.[11]

In the Netherlands, communications to CDC scheme members failed to align members' expectations with the possibility that conditional indexation may not be paid out in all future years and that, under certain circumstances, benefits may even be cut. This was compounded by a subsequent series of positive valuation cycles, which meant that members were shocked when nominal cuts were made for the first time. The longer a CDC scheme functions without having to make cuts to inflation or nominal benefits, the more likely that members will perceive target benefits as promises and the greater the communication challenge for the scheme. The proposed UK approach of annual valuations and immediate corresponding adjustments to contingent benefits in order to rebalance the scheme's funding position should help members to better understand the variable nature of their entitlement.

While communication with CDC members in the Netherlands has not always been effective, changes are being made to improve understanding. The new Dutch pension agreement, which is expected to come into force by 1 January 2023, requires schemes to present members with three different scenarios for their pension entitlement – an expected scenario, a more optimistic scenario and a more pessimistic scenario.[12] This change in communications should help members not only to understand that their level of benefits is not guaranteed, but also give them a better understanding of the way in which their entitlement level may change under different funding scenarios.

Additional regulation is expected in the UK stipulating standards for communication and risk disclosure to CDC members. As a minimum, this is likely to include that:

- the basic scheme information must contain specific information on the CDC scheme design and relevant 'risk warnings';
- a CDC specific annual benefit statement must be provided, including relevant risk warnings and signposting to other useful information; and
- pensioner members must receive annual information in advance of any changes to their expected payments, again with repeated risk warnings for potential future changes.[13]

Intergenerational fairness

In order for CDC schemes to be fair and sustainable, the distribution of risks across cohorts will need to be carefully considered

Ensuring the fair distribution of risks between generations is a key challenge within CDC scheme design. Highlighting the issues of intergenerational unfairness that had arisen for CDC schemes in the Netherlands, the Work and Pensions Committee's report on CDC schemes stated that the 'extent to which people perceive that they will be fairly rewarded for the contributions they make at every stage of their working life' would be essential to the adoption of CDC in the short term, and the ongoing success of schemes over the longer term.[14]

CDC schemes can 'smooth' returns in order to absorb financial shocks and protect members from experiencing particularly poor outcomes. 'Smoothing' essentially transfers subsidies from the generations who experience financial markets which generate better returns, to those generations who experience poorer returns.[15] However, unless carefully designed and managed, this can give rise to issues of intergenerational unfairness, and there have been concerns expressed about this in the implementation of Dutch CDC schemes. CDC schemes in the Netherlands have allowed contributing members to subsidise pensioner members through their use of capital buffers and contribution rate responses to funding.

There are also questions around the most appropriate length of smoothing horizons. International smoothing horizons vary substantially, from 10 years in Dutch CDC schemes to 75 or even 100 years in Canadian schemes.[16] The shorter the horizon, the lower the scheme's capability of absorbing shocks, but the more stable the scheme's funding level is.[17]

The use of buffers or capital reserves in CDC schemes can be a significant source of intergenerational inequity. This is because buffers must be accumulated in the first instance and then replenished after instances of depletion. In the former case, the contributions of an earlier generation have been used by a later generation, while in the latter case, the contributions of a later generation are needed to replenish the capital reserve that has been used by an earlier generation.

In response, UK implementation of CDC schemes will not utilise buffers. This means a scheme cannot set up a reserve in case of future economic downturn, as setting this up is a cost to contributing members. Additionally, there is no provision for either an employer or members to make up any funding shortfall out of future contributions in the manner of a DB scheme. This approach is likely to lead to greater volatility year-on-year than observed in the Dutch system, but having no funding buffers and universal adjustments is likely to mean there is less cross-subsidy from younger to older members, and therefore less scope for a sense of intergenerational unfairness.[18]

As highlighted above, the UK CDC system will aim to minimise challenges of intergenerational unfairness using three core principles:

- Adjustments to benefits required by under or over funding take place frequently, for example annually;
- All cohorts of members are treated the same when adjustments are made; and
- Adjustments to benefits are not perfectly smoothed using buffers, with valuations being undertaken using a central estimate methodology that does not seek to be overly optimistic or build in prudence.

In addition to questions around intergenerational fairness, there may also be issues of socio-economic inequality involved in CDC, because lower earners die earlier on average than higher earners. This means that lower earners may, in effect, subsidise the pensions of higher earners in their CDC scheme who are likely to receive pension payments for a longer period. For contributions made at similar percentages of salary, the assets in the scheme may end up being used disproportionately to pay pensions to higher income members. This is a feature inherent across longevity pooling mechanisms, whether DB, CDC or an annuity purchased through an insurance provider.

Sustainability in voluntary membership

International examples of CDC schemes rely on mandatory membership to support their sustainability, but membership of UK schemes will be voluntary

In the Netherlands, Canada and Denmark, participation in CDC schemes is mandatory, and it has been suggested that mandation may be necessary to reap the benefits of intergenerational risk sharing.[19] In contrast, including the right to opt out or transfer out at a later stage in the UK may present challenges for scheme design. This means it is even more important that schemes establish trust, transparency and fairness between different groups of workers in a landscape where workplace pension participation is not compulsory.

The voluntary nature of membership in the UK could present a potential threat to the scale needed for an efficient CDC scheme, as well as the sustainability of the scheme over the longer term. However, automatic enrolment is likely to mitigate this to some extent. While automatic enrolment acts as a strong nudge towards saving, there is a risk that members being enrolled during periods of market downturn, when negative benefit adjustments are being made, may be more likely to opt out. UK schemes will need to monitor opt-out rates in order to understand the impact these may have on the scheme's long-term sustainability.

Although mandation can help CDC schemes to achieve scale and sustainability, it can also be problematic. For example, if the scheme is underperforming and benefits cut, members may be dissatisfied with being forced to remain in a scheme which they did not explicitly choose to join in the first place. This has been observed in the Netherlands, where levels of trust in CDC schemes have decreased and social support for intergenerational risk sharing is not as strong as it used to be, following cuts to benefits.[20]

While adverse financial conditions that require negative benefit adjustments could lead to increased opt-out rates in voluntary CDC schemes in the UK, communication of the benefits of membership and the potential for improved outcomes compared to an individual DC scheme could help to mitigate this. Members of younger cohorts working in the private sector are unlikely to have access to the generous benefits of a DB scheme. If CDC schemes have the potential to provide younger cohorts with better retirement outcomes than they would be able to achieve using an individual DC scheme, members may be more accepting of more challenging financial periods and corresponding adjustments to benefits. The argument can also be made that fluctuations in benefits may be more palatable to scheme members in a voluntary system, rather than one in which they have been mandated to participate.

Rules around transfers will also be important considerations within CDC scheme design, especially in the context of pension flexibilities

In order to be compatible with the policy of pension flexibility introduced in the UK in 2015, as with existing DB schemes, CDC schemes will need to allow members to transfer out of the scheme if they choose. Schemes will need to be designed in such a way that they have clear rules in place for the calculation of transfer values and the circumstances under which this will be permissible, while ensuring that there is minimal negative impact on remaining members.

Transfer values could be calculated either by the member's own contributions to the scheme with interest added, or the value of the member's accrued benefit rights multiplied by the funding ratio of the scheme at that time. Some CDC schemes are designed so that the higher of these two values is offered to the member - for example, 'termination values' in CDC schemes in Canada are calculated in this way.[21]

Schemes would have to incorporate demand for transfers out into their funding and investment strategy approaches, needing to ensure that they hold sufficient liquid assets to accommodate possible transfers out. CDC schemes may also need to have clear rules in place for potential transfers in and the way in which DC pot sizes would be actuarially converted into benefit entitlement in these circumstances.

Freedom to transfer out of CDC schemes may lead to selection risks. For example, people with shorter life expectancies may be less likely to participate. As automatic enrolment makes participation the default, this may not be a significant problem if opt-out rates remain low. However, if a CDC scheme is perceived to be unfair or underperforming, opt-out rates and transfers out of the scheme are likely to increase.

Contribution rates and individual choice

Both the level of contribution and the way in which contributions are converted into future benefit entitlement have implications for CDC scheme design

Contribution rates observed internationally are relatively high, which enables their CDC schemes to reach a critical mass, in terms of assets under management, to benefit from cost reduction and economies of scale. The way in which contributions are converted into benefit entitlements differs across international examples of CDC (Box 4).

Box 4: International contributions and conversion to benefit entitlement

The Netherlands

In Dutch CDC schemes, all members make contributions at the same rate, with no account taken of individual differences, such as age, gender or income, when setting the contribution rate. All members accrue the same fixed percentage of their pay each year for this contribution. Advocates of this approach suggest that it creates solidarity between groups of participants. However, contributions made by younger members will generate returns for much longer periods than contributions made by older members, meaning that younger members' contributions are paying for the same benefit accrual at a much higher price.[22]

As part of the new Dutch pension agreement, flat-rate contributions will be replaced by a system of degressive accrual, in which older members will accrue fewer pension rights for the same contribution as a younger member.[23] This approach has been chosen over increasing contributions as members age in order to avoid putting older workers at a disadvantage in the labour market due to higher pension contributions required by the employer.[24]

Denmark

In the Danish ATP scheme, contributions are set by the social partners (employers and employees organised into various types of association that have a large degree of influence on employment policy in the Danish labour market), with one third paid by the employee and two thirds paid by the employer. During periods of unemployment or economic inactivity, contributions are covered by an unemployment insurance fund, the municipalities, or the Government.[25]

Canada

In Canadian target benefit plans, employer contributions are capped at contractually required rates, which can vary within a predefined range. Increased employee contributions can be used as an instrument for rebalancing the scheme funding positions, alongside benefit adjustments. However, scheme rules must clearly define the circumstances under which contributions would be adjusted, in the same way that processes regarding benefit adjustments must be clearly defined. Most Canadian schemes do not include contribution adjustments as a standard predefined instrument for rebalancing the scheme funding ratio, but contributions may be adjusted through bargaining procedures with members.

While changes in contribution rates can be used to improve funding ratios in international CDC schemes, UK CDC schemes will use only benefit adjustments, with a key focus on ensuring contributions are defined and stable. UK CDC legislation makes clear that CDC schemes will operate as money purchase schemes and there will be no recourse for increased liability to employer sponsors of these schemes to rebalance funding ratios.

Contribution rates in UK CDC schemes may depend on whether the scheme has replaced a DB or DC scheme. In cases where the CDC scheme replaces an existing DB scheme, employer sponsors may be willing to contribute at a more generous rate, similar to or slightly lower than current DB contributions, appreciating the defined nature of the contributions to the new CDC scheme will mean they are not liable for further increased contributions in future. Whereas, in cases where the CDC scheme replaces an existing DC scheme, in which employer contributions are lower on average, employer sponsors may opt to contribute at a lower level compared to previous DB sponsors. However, whichever type of scheme the CDC scheme replaces, contribution rates will need to be set at a level that is deemed reasonable to achieve the targeted benefits set out in the scheme design, while taking affordability for both scheme members and sponsors into account.

Individual choice relating to contribution rates and other elements of scheme activity, such as investment choice, could be considered in the design of future CDC schemes

In addition to considerations of affordability and adequacy of contributions, it is also worth considering whether there could be any flexibility for members to increase their contribution rates, and how this could be translated into benefit accrual. Individual member choice in other aspects of the scheme could also be explored in CDC scheme design. For example, member choice in relation to investment strategy is an area which has not yet been widely explored in relation to CDC schemes, but could provide the opportunity for investments to better match individual members' risk tolerance, and potentially deliver improved outcomes than a single central strategy more heavily focused on smoothing volatility. However, most members would likely benefit from remaining in the default strategy within the scheme.[26] Individual investment choice of this nature would, however, require that individual members' entitlement to benefits in the scheme would be adjusted to reflect the performance of their chosen investment portfolio. This would add additional complexity around valuations and adjustments, as well as communications with members. As individual choice is an important component of the UK pensions system, and valued by some savers especially, understanding how increased elements of individualisation could be introduced into CDC design presents considerable scope for further research.

Conclusions

International experiences of established CDC systems emphasise the importance of establishing a clearly defined and transparent scheme design that distributes risks and benefits fairly among different groups of members. While primary legislation is now in place to allow CDC schemes and the regulatory framework is soon to be finalised ahead of the authorisation process beginning from August 2022, there are still some key challenges to be considered by TPR and those responsible for designing specific CDC schemes. The UK's legislation and proposed regulation for CDC schemes draws on lessons from international systems. For example, UK policymakers have recognised the intergenerational issues associated with buffers, and instead stipulated the use of frequent and universal benefit adjustments as an alternative to this approach that can mitigate both issues of equity between cohorts and communication challenges regarding the varying nature of CDC benefits. However, other areas of scheme design could benefit from further investigation as to the most effective approach and likely impacts.

Specific challenges that could benefit from further research include the following:

- The impact of voluntary membership on CDC scheme sustainability.
- How to determine contribution rates at a level such that they do not encourage increased opt-out rates, but are reasonable to achieve targeted benefits.
- How flexible employee contribution rates could be converted into variable benefit entitlements.
- The design of transfer rules and calculation of transfer values, both in terms of the implications for scheme investment strategy and for remaining members in the scheme.
- How to effectively approach clear and timely communication to members to manage expectations and build trust.
- The scope for individualisation within CDC schemes, whether relating to contribution rates, investment choice or other factors.

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