

“Delivering Collective Defined Contribution Pension Schemes” consultation - Response from the Pensions Policy Institute

Summary

- Designed effectively, Collective Defined Contribution (CDC) schemes could provide members with greater certainty and potentially higher retirement incomes compared to individual Defined Contribution (DC), while providing employers with greater certainty about costs and liabilities than Defined Benefit (DB).
 - CDC has the potential to provide benefits for both members and employer sponsors compared to existing forms of pension provision
 - Pension Policy Institute Modelling suggests that a CDC scheme can produce improved and less volatile replacement rates than an individual DC scheme, particularly if the scheme is mature and stable
- However, there are hurdles which must be overcome in design and operation if CDC schemes are to realise and deliver these benefits.
 - Ensuring the fair distribution of risks between generations is a hurdle CDC scheme design will have to overcome
 - Communicating the targeted nature of benefits to members will be a vital part of running any CDC scheme
 - Establishing high levels of member trust will be an important component of CDC, although this is a challenge for any type of pension scheme

Response

1. This is the Pensions Policy Institute’s response to the Department of Work and Pension’s (DWP) “Delivering Collective Defined Contribution Pension Schemes” consultation.
2. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique as it is independent (no political bias or vested interest), focused and expert in the field, and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

3. This submission does not address all of the specific questions in the consultation. Rather, the response provides an overview of the findings of a recent PPI report “What is CDC and how might it work in the UK?” which seeks to demystify CDC and its implementation, drawing on existing literature and overseas experience. It also presents evidence from 2014 PPI modelling of CDC schemes commissioned by DWP.
4. A copy of the full PPI report “What is CDC and how might it work in the UK?” is attached. This research was sponsored by Royal Mail Group and the Defined Contribution Investment Forum (DCIF).
5. A summary of 2014 PPI modelling on CDC is also attached.

CDC has the potential to provide benefits for both members and employer sponsors compared to existing forms of pension provision

The benefits CDC may offer include:

- Potential for higher retirement income compared to individual DC
- Potential for more predictable retirement income compared to individual DC
- For employers – greater certainty about costs and liabilities than DB, and a potentially more efficient way to offer employees a more generous benefit than individual DC

PPI Modelling suggests that a CDC scheme can produce improved and less volatile replacement rates than an individual DC scheme, particularly if the scheme is mature and stable

In 2014 the PPI were commissioned to construct a model to attempt to replicate previous work by Aon Hewitt, to help aid understanding of the potential benefits of CDC schemes. The model compared the outcomes from a variety of different CDC schemes against various DC alternatives featuring either the purchase of an annuity (level or CPI-linked) or the use of income drawdown after retirement.

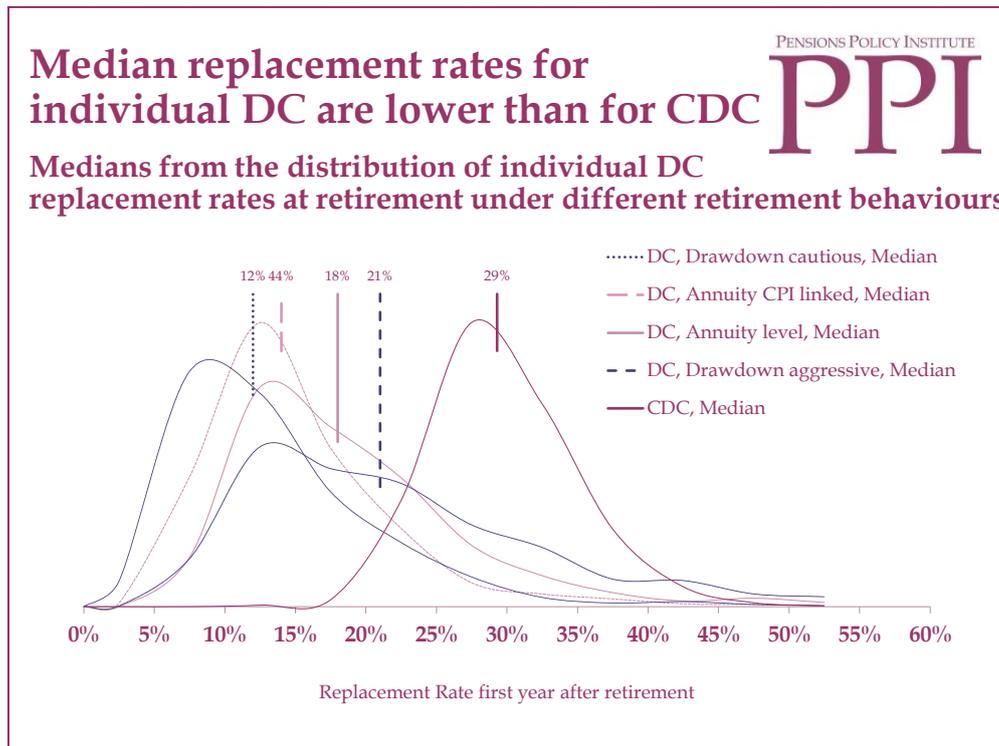
The modelling suggests that:

- In the long-term, once the modelled scheme is mature and the scheme population stable, CDC produces better outcomes (a replacement rate of between 27% and 30%) than individual DC (a replacement rate between 12% and 21%), assuming a 10% contribution rate (Chart 1). The PPI modelled CDC scheme also requires a relatively low contribution rate (compared to the cost of DB provision) to maintain these outcomes.
- In the short-term, with no initial pre-funding (which is likely to be the case for a new scheme), the benefits of the modelled CDC scheme may need to be revised down. The replacement rate outcomes from an unfunded

scheme are still better than a CPI-linked annuity and similar to the outcomes of aggressive drawdown.

- However, the CDC scheme is less likely to run out of money during retirement so it can be considered to be more secure than an individual drawdown account.

Chart 1: The distribution of replacement rates achieved with an individual DC scheme under the same economic circumstances as the CDC scheme



These improved and less volatile outcomes may be attributed to a number of components:

- **Economies of scale** resulting in reduced investment and administrative costs. CDC schemes are likely to be more able to deliver improved returns if they achieve economies of scale. They're likely to work more effectively with large memberships as they can share costs and risks across a broader base of people. This means that CDC schemes may function best if they are associated with a single large employer, industry wide plans or master trust arrangements.

Achieving very large scale is not necessarily an inherent feature of CDC schemes. Although very large schemes are observed internationally, where it is common for CDC schemes to be sector or industry wide, it is

possible for CDC to be established by an individual employer, as we are now seeing in the UK with Royal Mail.

Royal Mail is one of the UK's largest employers, directly employing more than 140,000. Smaller employers interested in CDC may need to look to shared arrangements in order to access sufficient scale. In regards to shared arrangements, the rise of master trusts as a result of automatic enrolment means that economies of scale and the associated benefits are increasingly accessible in individual DC.

- **Longer investment horizons**, with no need to de-risk as members approach retirement. Because investment risk is pooled between active and retired members, CDC schemes should facilitate a longer-term investment perspective than would be appropriate for individual scheme members, particularly those in retirement. This means that CDC schemes may be able to invest in riskier assets for a longer period of time as there is no need to de-risk for individual members. Although it's important to note that this primarily applies to schemes in a stable state. Schemes with increasing dependency ratios may need to de-risk as more members reach retirement if there are not similar numbers of active members joining the scheme.
- **A more diversified investment strategy**, with the ability to invest in more illiquid asset classes. Linked to the previous point, because of longer investment horizons, CDC schemes may have the ability to invest in a wider range of illiquid long-term investments, such as infrastructure, to obtain an illiquidity premium. Larger funds may be able to achieve improved returns by implementing a more sophisticated investment strategy and diversifying their portfolio in order to access alternative asset classes that are not highly correlated conventional indices. As well as scale and longer investment horizons, CDC schemes may find it easier to invest in illiquids if they revalue member benefits on an annual basis, as there will be less perceived need for daily pricing.
- **Balance between contributions and drawdown**, with assets drawn down during retirement being replaced by contributions of younger cohorts so the core asset amount upon which returns can be earned does not reduce as it would in an individual DC scheme. When an individual DC member enters drawdown, there are no future contributions made after retirement and the amount left to earn investment returns decreases. By contrast, in a CDC scheme returns can be earned on the whole asset pool aggregated across individuals.
- **Smoothing of investment performance between generations**,

While CDC may potentially offer improved member outcomes, there are also hurdles which will need to be overcome or mitigated in order for a CDC scheme to be designed and operated successfully to deliver these benefits

As with any type of pension scheme, be it DB, DC or CDC, there are challenges and trade-offs that will need to be considered when designing a CDC scheme and subsequently operating it. These are important considerations and not to be ignored as taking the wrong approach could inhibit the scheme's ability to realise potential benefits and ultimately threaten the sustainability and efficiency of such a scheme. If CDC can overcome these hurdles, it could offer a valuable third option for pension provision in the UK. The most fundamental hurdles for CDC schemes are likely to be issues of intergenerational fairness, communication and governance.

Ensuring the fair distribution of risks between generations is a hurdle CDC scheme design will have to overcome

Smoothing of returns between those who experience better than expected and those who experience poorer than expected can be viewed as a benefit of CDC as it helps to protect members from experiencing particularly poor outcomes. However, in certain forms smoothing can be understood as an intergenerational subsidy. This can encourage the notion that one cohort is benefiting unfairly at the expense of another which can cause conflict between different generations of members and in the extreme discourage younger generations from entering the scheme. In the Netherlands, more than four in five (84%) employer sponsors believe that the current pension system is more beneficial for older employees, compared to 22% who believe it is beneficial for younger employees. This may, however, create a false dichotomy, ignoring the real possibility that CDC could provide better outcomes for all members, not necessarily one generation over another.

Intergenerational issues are not the sole concern of CDC, but because of distribution of risk across generations and uncertainty about benefits, it may be a risk that is more prominent in CDC members' minds. As such schemes will need to be careful about the mechanism they use for smoothing, as some are more prone to issues of intergenerational inequity than others.

The collective buffer mechanism used in many CDC schemes overseas can be particularly problematic as it can lead to clear cross-subsidisation between generations. For example, if good investment returns on previous generations contributions have built up a large buffer, benefits accrued could exceed contributions. However, if poor historical returns have depleted collective buffers, future generations could have to pay implicit taxes on their pension contributions in order to replenish buffers.

If a scheme uses buffers and there is no initial reserve upon establishment of the scheme (for example provided by the sponsoring employer), there could also be issues of fairness regarding the scheme's first cohort of members. A portion of these members' contributions would have to be used to build up the buffer section of the fund in the first instance. This means they would receive a lower level of retirement income than is justified by their contributions and the fund's investment performance, while it is likely to be future cohorts who benefit most from this.

Royal Mail's proposal for a CDC scheme which relies on best-estimate annual revaluations rather than capital buffers is likely to somewhat mitigate issues of intergenerational fairness. However, clear rules for adjustments and smoothing, which ensure that that no generation benefits a priori at the expense of another, will need to be established from the outset to ensure that trustee discretion does not give rise to intergenerational subsidies (likely from younger active members to retirees, as there is generally a reluctance to cut retiree benefits unless unavoidable).

Communicating the targeted nature of benefits to members will be a vital part of running any CDC scheme

Because CDC schemes are perceived as falling somewhere on the spectrum between DB and DC (although in the UK they will be entirely DC legally speaking), there may be confusion among members about which elements of each their scheme has adopted. CDC schemes provide members with more certainty about the level of retirement income they may achieve than in an individual DC scheme. However, communications must ensure that members understand that there is still not as much certainty of retirement income as in a DB scheme.

The need to reduce or stop indexation and cut nominal benefits will always come as a disappointment to scheme members. However, the experience of the Netherlands highlights the need for contractual agreements and members' expectations to be fully aligned from the outset in order to avoid negative reactions. There also needs to be explicit communications about the potential risks to members' future indexation and benefits and the measures that will be taken by trustees (or other decision-makers) to address any changes in the funding position. It appears that in the Dutch model there was a failure from the outset 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. It therefore came as a shock when nominal cuts were made for the first time.

Members need to have a prior understanding that benefits could be adjusted up or down. This should 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 (as in the New Brunswick Shared Risk Plans in Canada, for example) can help to manage expectations but will inevitably still involve some degree of judgement or discretion, for example around the selection of actuarial assumptions or the extent to which different adjustments are used. Establishing and communicating an unbiased set of rules from the outset can also help to mitigate issues of intergenerational fairness.

In identifying the right level of detail, form and frequency for member communications, there is likely to be some trade-off between the need to ensure that members fully understand the risks but also presenting this in a simple way which members are more likely to take the time to read and understand. Finding the right balance between these competing factors will be a significant hurdle for schemes in the early days of CDC especially but also going forward.

Establishing high levels of member trust will be an important component of CDC, although this is a challenge for any type of pension scheme

If scheme members do not feel they can trust those running the scheme, any feeling of collectivism and solidarity is likely to be overcome by the feeling that they are being let down by someone who has done a bad job. In order for collective schemes to be successful, they would need to continually demonstrate that the governance of the scheme is beyond reproach, so that the necessary elements of risk sharing between individuals can be understood by members, rather than viewed as a management failure.

General trust in the pensions industry is relatively low for all types of pension scheme, so this is not an issue which is unique to CDC. However, given the uncertain nature of benefits and the potential for members to misunderstand their benefits as being guaranteed, trust will be especially important in CDC.

Establishing strong and transparent governance structures with clearly communicated mechanistic rules will likely be a key component of differentiating CDC schemes from historical with-profit policies and as such enhancing member trust.

CDC schemes would need to have a certain level of continuity and long-term perspective in relation to governance, with targets being set and revisited regularly, as well as being communicated to members on a regular basis. The existing requirements in respect of trustees of occupational pension schemes are flexible enough to accommodate the needs of CDC schemes. However, given the different challenges CDC trustees are likely to face, they may require specific skills not necessarily required for acting as a trustee of existing scheme types. This will need to be considered within any authorisation regime to ensure that CDC trustees are able to operate the scheme effectively.