

“Collective defined contribution pension schemes inquiry” - Response from the Pensions Policy Institute

Summary

- In 2014 the PPI were commissioned by the DWP to construct a model to attempt to replicate the Aon Hewitt work to help aid understanding of the potential benefits of CDC schemes.
- In the long-term, once the modelled scheme is mature and the scheme population is stable, CDC produces better outcomes than DC. The PPI modelled CDC scheme also requires a relatively low contribution rate 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 can be underfunded. However, the CDC scheme does benefit compared to equivalent DC schemes in that it is less likely to run out of money during retirement so it can be considered to be more secure.
- Both Canada and the Netherlands have some experience of different types of risk sharing Defined Ambition and Collective Defined Contribution schemes, but both started in different places and have different historical cultures of pension saving to the UK.
- Nevertheless, there are important lessons that can be drawn from both countries for the UK, in particular surrounding need for clarity, transparency, and a shared appreciation of the respective roles and risks of the partners involved in the pensions - individuals, sponsors and Government.

Response

1. This is the Pensions Policy Institute’s response to DWP Work and Pension Committee’s “Collective defined contribution pension schemes inquiry”.
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 inquiry. Rather, the response provides an overview of the findings of recent PPI research “Modelling Collective Defined Contribution Schemes”, “Risk Sharing Pension Plans: The Dutch Experience” and

“Defined Ambition in workplace pension Schemes” that provide relevant evidence to assess the impacts of Defined Ambition schemes.

4. A copy of the full PPI presentation “Modelling Collective Defined Contribution Schemes” is attached. This presentation outlines the results from the PPI modelling using PPI’s bespoke CDC (Collective Defined Contribution) model.
5. A copy of the full PPI Briefing Note “Risk Sharing Pension Plans: The Dutch Experience” is attached. This Briefing Note considers the implementation of CDC schemes in the Netherlands and how this could be applicable to the UK market.
6. A copy of the full PPI Briefing Note “Defined Ambition in workplace pension schemes” is attached. This Briefing Note considers the possible impact of some of the DA (Defined Ambition) pensions proposals for DB (Defined Benefit) schemes’ members.

Benefits to savers and the wider economy

7. In an Aon publication (Aon Hewitt (2013) *The case for collective DC*), the report found that CDC produces outcomes ranging from a third higher to over double than that achieved from DC. This corroborated findings from an earlier report by the RSA (RSA (2013) *Collective pensions in the UK II*).
8. However, in a Cardano and PPI roundtable with Dutch experts in December 2014, the benefit was calculated as 1% higher for CDC schemes compared to DC. There was also other disagreements on the benefits of CDC based on the technique used to compare the results.
9. In 2014 the PPI were commissioned by the DWP to construct a model to attempt to replicate the Aon Hewitt work to help aid understanding of the potential benefits of CDC schemes. The Model compares 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.
10. All the findings in this response are from that modelling, and are based on a specific interpretation and a particular design of CDC model. It is possible to design different models and use alternative assumptions that could lead to different outcomes.
11. The PPI modelling is designed to give an indication of outcomes from a specific modelled CDC scheme, but as it was designed to closely replicate the Aon approach (which predated UK legislation) it does not match up directly against the provisions of the Pension Schemes Act 2015.
12. For example PPI have used funding gates to maintain the current funding balance in the scheme, whereas the legislation requires an actuary to assess

the ability of the scheme to meet its target benefits within a probability range. Full details of the model used and the parameters of the CDC schemes modelled can be found in the final report for the DWP (attached to this submission).

13. The PPI modelling suggested that in the long-term, once the scheme is mature and the scheme population is stable, CDC produces better outcomes (a replacement rate of between 27% and 30%) than DC (Defined Contribution) (a replacement rate of between 12% and 21%, assuming a 10% contribution rate). The PPI modelled CDC scheme also requires a relatively low contribution rate to maintain these outcomes.
14. PPI modelling has shown that in the short-term, with no initial pre-funding (which is likely to be the case for a new scheme), the modelled CDC scheme can be underfunded. The replacement rate outcomes, after the same period of time as the fully funded modelled CDC scheme, are still better than a CPI linked annuity and is similar to the outcomes of aggressive drawdown. However, the CDC scheme does benefit compared to drawdown in that it is less likely to run out so can be considered to be more secure.
15. There are several design factors identified which can contribute to the modelled CDC scheme achieving better outcomes than DC:
 - With drawdown, there are no future contributions after retirement and the amount left to earn investment returns decreases. By contrast, in the modelled CDC scheme, returns can be earned on the whole asset pool aggregated across individuals.
 - As the returns on equities vary more than on gilts, in years of low equity returns pre-retirement the modelled CDC scheme is affected to a lesser extent than DC, which is 100% invested in equities pre-retirement.
 - Post-retirement the modelled CDC schemes can remain invested in 60% equities and continue to benefit from the higher returns, while in DC drawdown schemes, funds are de-risked to reduce the equity exposure.
 - In the modelled CDC scheme, assets taken by the retired cohort are being replaced by new entrants. In drawdown, the core asset amount is reducing, thus the return on this amount is also reducing.
 - The size of the modelled CDC schemes are large, with a mature population. This means there can be cross subsidisation as the younger cohort fund the retired and continuous new entrants ensure the funding level is sufficient.

16. The precise design of the CDC scheme can be important in determining the variation in outcomes that different members might experience. For example, allowing funding levels to vary more widely before intervening through changes in contributions or benefits can narrow the distribution of outcomes. This is caused by the extra smoothing that can occur. However, this means the funding level can move significantly below 100% and relies much more on subsidisation by the younger cohort and also hoping that future returns on assets will be positive enough to fill this gap.

Converting DB schemes to CDC

17. The modelling undertaken by the PPI compares outcomes achieved under a CDC scheme to those achieved through a DC scheme. However many of the necessary assumptions reflect conditions that may be currently experienced within a DB scheme.
18. The fully funded assumption may be more valid where, for example, significant assets are transferred from existing DB/DC schemes into CDC, or where an initial capital injection is provided.
19. The size of the modelled CDC schemes are large, with a mature population. This means there can be cross-subsidisation as the younger cohort fund the retired and continuous new entrants ensure the funding level is sufficient.
20. In the long-term, a modelled CDC scheme which is mature, large and fully funded may achieve a better replacement rate compared to DC. A 10% contribution rate was also sufficient to maintain this scheme.

Regulation, governance and industry issues

21. There are a number of potential lessons for the UK from existing schemes in Canada and the Netherlands in terms of the design and governance of these plans, their scheme rules, investment strategies and how they are communicated to members, funded, and run. Specific considerations for the UK include:
 - the potential for shared-risk or collective benefit arrangements to extend to relatively small employers and pension plans if the significant governance overheads can be shared;
 - the challenges in persuading employers to set up shared risk or collective benefit arrangements where they need to meet certain requirements (under UK legislation) to convert existing DB rights over to these new pension plans;
 - the need to establish trust, transparency and intergenerational fairness between different groups of workers in a landscape where workplace

pension participation is not compulsory (unlike in Canada and the Netherlands);

- the desire for “freedom and choice” from both employers and employees—with private sector employers likely to be attracted to different levels of contributions and benefits for their workers, and with employees likely to want to retain the option announced at Budget 2014 to access their pension savings from age 55 onwards;
- the appropriate tax and accounting treatment for these plans—with the tax treatment of target or collective benefits that can potentially be changed in future (subject to the funding position of the plan) yet to be confirmed.

Lessons from Canada

22. Defined Ambition and collective schemes are used in Canada, and the way in which recent plans have been set up might provide useful lessons for the UK. There are a wide range of structures in place across the different provinces, but also across industries, sectors and by types of employer, with newer plans predominantly being set up in the public sector. In some cases rights in existing defined benefit (DB) plans are being converted across to different forms of shared-risk or target benefit plan structures, or new plans are being set up to replace existing DB plans, while in other cases “specified” multi-employer plans have been in operation for decades under their own sections of the legislation.

Lessons from the Netherlands

23. Since the early 2000s, the Dutch pension system has seen a shift away from Defined Benefit (DB) pension plans based on a final salary structure in favour of career average structures where annual indexation is subject to the levels of funding within the plan, and where benefits may be reduced if necessary in order to agree a recovery plan.

24. However, since the Global Financial Crisis in 2008 and the associated low interest rates and funding deficits that arose, there has been a lively national debate in the Netherlands around the long-term sustainability of these collective plans and, linked to that, the transparency of the existing contractual arrangements and members’ individual property rights.

25. The mandatory participation in occupational or “second-tier” pensions in the Netherlands, along with a highly unionised collective bargaining environment, create some important distinctions between the workplace pensions landscape in the Netherlands and the UK. The Dutch pension system has been built on principles of collectivism and solidarity. These experiences may affect the attitudes to benefit security and appetites for

risk across the two countries, with the Dutch system developed from DB plans with a history of high benefit security compared to the DC plans that are now more prevalent in the UK. The two systems may move closer together in future, with the debate in the Netherlands increasingly focusing on the issues of freedom and choice.

26. The recent experience of the Netherlands offers lessons for plans with similar risk-sharing or collective elements that could be established in the UK, including:
- The need for contractual agreements and members' expectations to be fully aligned from the outset, and for there to be explicit communications about the potential risks to members future indexation and benefits and the measures that will be taken by trustees (or by other decision-makers) to address any changes in the funding position;
 - The need for clearly defined individual property rights at fair market prices in a pensions landscape without being mandated and with freedoms for members to stop their contributions, withdraw at retirement, or exit the plan altogether;
 - The collective 'benefits' of scale that can also be delivered through DB and DC schemes, even in the absence of collective risk sharing or pooling;
 - The potential for innovative ways of pooling individual longevity risk for the in-retirement benefits for plans, either in a fully collective plan, or in a plan which is DC in the accumulation phase but has collective elements in retirement.