Summary
• Collective DC (CDC) has been described as a 'third way', blending elements of DB and DC.
• Its benefits include risk sharing of investment and longevity and providing a retirement income. However potential intergenerational unfairness and member understanding of potential cuts to income are concern.
• There is debate as to whether CDC is suitable for modern work and retirement.
• So far CDC interest has been low, but it is expected to be used by large employers as a DB replacement, and by DC providers wanting to offer a retirement income.

Changing time or wasting time?

Laura Blows considers whether collective DC will be the future of UK pension provision, or whether discussions around its implementation are simply distracting from efforts to solve other industry issues

The argument last erupted in 2015. It was never resolved; merely overtaken by other events. But now it's back. The past year has seen the debate about the merits of collective DC (CDC) return with a vengeance. Will CDC revolutionise the pensions industry, or will it once again be a case of all talk, no action?

A third way

CDC is a pension product currently unseen in the UK. While people's DC retirement savings are invested individually, CDC groups these together in order to pool investment risk and smooth volatility. And instead of the individual being left to make their own retirement income decisions, as is the case with DC, CDC provides an income in retirement. But while DB has its retirement income 'promise', CDC offers no such guarantees; pension payments can be cut if needed.

"If CDC schemes were enabled in the UK, this would be a fundamental change to the pensions landscape, offering corporates a 'third option' for employee retirement benefit provision," Willis Towers Watson director Simon Eagle says.

While always having its supporters, CDC has been little discussed since then-Pensions Minister Steve Webb advocated his CDC-type proposal of 'defined ambition' three years ago, with it included in the 2015 Pensions Act. However, a general election that year brought about political change, with Webb's successor, Ros Altmann, confirming that secondary legislation to enable CDC had been put on hold in order to introduce the freedom and choice reforms and bed in auto-enrolment.

Webb may have been 2015's biggest advocate of CDC, but now that accolade belongs to the Royal Mail and the Communication Workers Union (CWU) *[see page 65 for an interview with Royal Mail about CDC]*. Earlier this year it reached an agreement to replace its DB scheme with CDC, featuring a guaranteed cash lump sum, subject to government passing the necessary legislation to make this possible. Since then, both organisations have been lobbying the Department for Work and Pensions for this to occur.

Meanwhile, the Work and Pensions Select Committee opened an inquiry into CDC in November 2017, with calls for evidence closing on 31 January 2018. The inquiry is considering the merits of CDC, the role it could play within the pensions landscape, the potential benefits to savers and the regulatory framework that would be required to be successfully implemented.

Defining CDC

However, exactly 'what' is being requested is the first of many CDC debates. As Cardano head of DC Ralph Frank states: "If you were to ask 10 pension professionals what CDC is, you are likely to get at least 11 different definitions."

While considering the structure of CDC, eyes have understandably turned to the Netherlands, which established CDC as a replacement for DB in 2000.

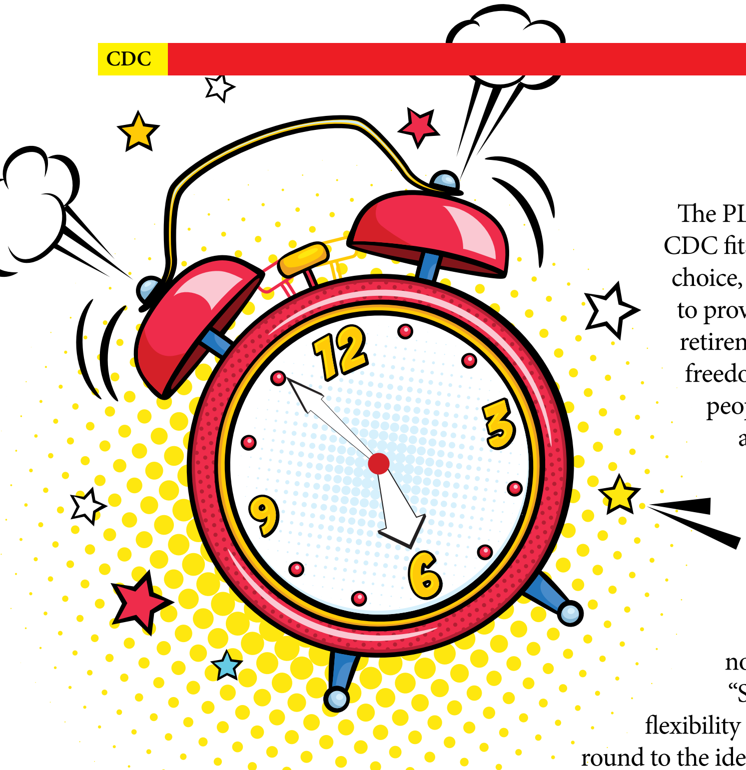
According to Barnett Waddingham partner Paul Hamilton, the CDC form in the Netherlands is actually very close to a DB scheme, with a very similar formula effectively used to allocate the pooled assets to members, but with members' benefits reduced, on some form of 'share of fund' basis, when the scheme has a 'deficit' compared to the target benefits.

"That form of CDC would almost certainly need legislative changes to be done *[in the UK]* within a tax-approved vehicle, but I am not convinced this form of CDC would work well here," he adds.

Benefits

However, there are many in the industry who believe CDC could provide benefits to the UK.

"The main potential attractions of CDC would be scale (if it can be attained) and long-termism – if money is invested over a period of decades and smoothed between and within groups of workers



then there might be the potential for better returns," former Pensions Minister and now Royal London director of policy and external communications Webb explains.

Aon's CDC scheme modelling finds that CDC can improve standard DC outcomes by a third to double. The PPI's CDC model found that in the long term, once CDC schemes are mature and the scheme population is stable, a relatively low contribution rate of around 10 per cent results in better outcomes than DC.

For its evidence to the select committee, the PMI conducted a member survey into CDC, which found that 54 per cent of respondents think that CDC would improve the standard of workplace pension provision, with its main benefits being higher pensioner incomes and members being free of investment decisions.

Member involvement

However, this lack of individual involvement could also be considered a downside to CDC. After all, the freedom and choice reforms were a success because they allowed people to engage with and make decisions as to what they want to do with their retirement savings. Any new product that takes away this choice is unlikely to be popular.

The PLSA is sceptical that CDC fits with freedom and choice, "given that CDC aims to provide an income in retirement and the pension freedoms provide options for people to take their money as lump sum".

ABI head of retirement policy Rob Yuille believes that CDC and freedom and choice can coexist, "but it's not a comfortable fit".

"Savers who value the flexibility of DC and are coming round to the idea of owning their own pension may regard CDC as a backward step," he warns.

For Hargreaves Lansdown senior analyst Nathan Long, there are also concerns about how CDC would suit today's flexible workforce.

The CDC modellings that have found collective investing over a long period of time, generating better returns and therefore income payouts assumes people stay in the pension scheme from the point of joining through to the day that they die, he says.

"The reality is that with modern working patterns, pensions need to be flexible to cope with the retire-as-you-go needs of people as they reduce hours, require lump sums and potentially change their work entirely. Our experience is that people will want to keep control of their circumstances as they traverse through their later years, mindful that retirement can last for many years and their circumstances will change."

Therefore any new pension product, such as CDC, must allow people to transfer out and take their funds, if it is to have any hope of success.

This, according to Simplitium head of pensions business development Tom Hibbard, is not a problem.

"CDC allows you to invest collectively, but still own a slice of the total assets," he explains. "This 'equitable interest' can be valued at any point, giving members an instant transfer value that they can take under freedom and choice without having any effect on the value of other members' pensions."

However, this would need to be designed in such a way as to reduce the risk of 'system gaming', Slaughter and May partner Sandeep Maudgil warns.

Along with the level of member engagement required, the extent of member understanding could also be an issue. Indeed, it was considered CDC's biggest risk according to the PMI's survey.

The PLSA acknowledges that some people may find it hard to understand the intricacies of CDC. "That said, it is also hard to understand how DB or DC works," it points out.

The repercussions of this lack of understanding in CDC are less far-reaching than in DC however, Hibbard states, as the member does not have to make a decision at retirement if they do not want to, "which means there is a lesser need for financial knowledge".

The biggest problem with low member engagement would occur if/when pension payments were to be cut. A reputational risk to CDC, and pension saving more widely, could occur if members did not adequately realise this could happen.

Frank notes that the five largest Dutch CDC schemes, which account for more than half of the assets in the Dutch pension system, have failed to deliver the much-needed increases to pensions over the past 10 years.

"Not only have the increases granted by these Dutch pension schemes fallen short of price inflation over the period but three of the five also cut pensions in payment at different times. In other words, some scheme members have not only experienced a real-term loss in income but also in nominal terms. A large part of this was due to poor risk management, notably in this case a lack of interest-rate hedging during a period when long-term interest rates fell sharply," he explains.

For Hibbard, cuts are certain to occur in cases of prolonged market downturns, but as long as they are understood to be a natural part of pension saving and that it is widely understood that overall people are still better off on average than in any alternative, then it shouldn't be an issue.

"In the 07/08 recession, across all Dutch CDC structures, only 25 per cent made cuts and on average the level of these cuts was 1.9 per cent. Compare this to market downturns of 40 per cent, which would directly hit DC fund structures," he says.

Aon backs this up, finding that cuts are rare, with its CDC modelling suggesting only after world wars. "Failure to cut is more of a risk than cuts," its partner Matthew Arends adds.

However, understanding when cuts may occur would be difficult.

"Within CDC someone is taking some decision about how assets are being allocated to individuals, which is by definition a much more opaque situation from the members' points of view," Hamilton finds.

Governance

To alleviate this issue, a strong CDC governance system would need to be established. A trust-based arrangement is considered the most likely solution.

Maudgil points out that as the assets are entirely the members', there will need to be clear controls on the use of assets for anything other than benefit provision.

In its select committee evidence, Cardano expressed concern that CDC members will lose out compared to a DC arrangement, due to the higher costs of administering the risk-sharing and the greater volumes of member communications required to explain this.

"In the interests of transparency, would the scheme need to tell members that, for example, 'your fund achieved a return of 8 per cent this year, but has been increased by 4 per cent'? It's not difficult to imagine the issues this could cause, particularly for members who had not been through a time when negative returns had been smoothed upwards for their benefit," PTL director Alison Bostock says.

"I expect that these decisions, together with those about cutting back or reducing increases to pensions in payment, would rest with the trustees. This would be a totally new kind of duty and responsibility. Whilst trustees currently make financial decisions that affect the profitability and sustainability of the employer, the balance of power is somewhat different as the employer can take its own professional advice and is equipped to provide meaningful debate and challenge. In CDC, trustees would effectively be in the position of balancing the interests of different cohorts of current and future members, who could not all be properly represented in a debate," she adds.

Intergenerational fairness

Ensuring intergenerational fairness would also be a challenge. According to Eagle, trustees would need to perform a delicate balancing act across generations of members when setting benefit levels.

Some select committee respondents, such as the ABI and Cardano, have expressed concern that CDC either relies upon new entrants to continue to join the scheme, or for the scheme to reserve sufficient funds to wind up over a very long period.

However, the PLSA states that the need for a continual flow of younger members would not be an issue, provided that contributions from existing members were sufficient to keep the scheme's funding ratio stable.

Hibbard agrees that the risk of intergenerational unfairness is not an issue. "If the scheme ever got to the point where it was too small to efficiently continue, the assets could be transferred instantly to another CDC structure or be wound up and put back into a DC type pension," he states.

Attention

Clearly, successfully establishing CDC would require more than the government just generating the secondary legislation. It would also require a great deal of time and dedication spent to its structure.

"It doesn't follow that just because something is new and difficult, we should not try it," Bostock says, "but arguably we have tried *[CDC]* and it doesn't always work as everyone hopes – remember with-profits endowment policies?"

For some, spending time on CDC is diverting attention from solving issues currently facing the UK pensions industry. Especially as, they argue, CDC does not offer unique solutions to these problems, which instead could be achieved through existing structures – eg auto-escalation to increase contributions, and annuities for a retirement income, while CDC's much-heralded benefit of investment pooling could be achieved through GPPs or master trusts.

However, B&CE, provider of The People's Pension master trust, states in its evidence to the select committee that CDC would be a beneficial addition to current products available to providers.

According to the the PLSA, CDC may have a useful role to play in providing a decumulation option for master trusts.

Level of interest

Yet CDC needs to be of interest to more than just master trusts to justify its establishment.

So far, Royal Mail has been the only provider to have come to government seeking the implementation of CDC, current Pensions Minister Guy Opperman informed the select committee. Despite this, any potential CDC legislation would need to "accommodate everybody", not just the needs of Royal Mail, he added.

There have been rumblings of more interest though. While not described as a CDC scheme, last month the CWU agreed a deal with BT that saw its DB scheme close and members moved into a 'hybrid' scheme, combining elements of DB and DC.

However, March also saw university strikes resume as members of the University and College Union rejected an agreement between the union and Universities UK that would have included a promise to look at CDC in the future.

Yet current low interest in CDC may not always be the case.

"Right now demand is low as those managing pensions have so many other things to think about," Hibbard says.

"Unless they feel that they can influence policy, there is no need to do anything but sit and wait to see what happens. The effect on the employer between DC and CDC is effectively nothing, so there will be no vested interests on the employer side acting against it – alternatively, if it is advocated as a better form of pension provision, many will seek to adopt it as an additional means of enticing the top talent to work at their company."

Maudgil notes that the first cohort of pure DC retirees have not occurred yet, and if it turns out that they cannot afford to retire, then employers, as well as members, may appreciate the more predictable retirement income expectations that CDC provides over DC.

Figures back this up. In the PMI's survey, 53 per cent saw employer appetite for CDC schemes as either a long-term replacement for other schemes designs, or in addition to existing designs.

Some appetite for CDC may need to be limited, as many respondents to the select committee's call for evidence stressed that CDC cannot be used as a 'dumping ground' for employers struggling with DB. It would not be suitable for this purpose anyway, Cardano's committee evidence points out, as "CDC will not resolve the issues faced by seriously underfunded DB schemes as it cannot create assets that do not exist".

Future

So, if a framework for CDC were to be established, would it be used by the many, or the few?

Predicting a 'niche offering' is the PLSA, which, barring a large AE provider implementing CDC, expects only a small number of employers moving from DB and wanting to offer something more than DC. "Whilst a minority, these employers still make up an important part of the pensions landscape in the UK, who are generally ignored by current policy makers so anything that can be done to help their position is to be supported," Hamilton says. Large DC providers wanting to provide a CDC decumulation option to their offerings is also expected to add to CDC's popularity.

Meanwhile, Webb is cautious, stating that while it is perfectly reasonable for CDC to be part of the pensions landscape, it does require employers to be willing to make a stronger commitment than under individual DC. "Employers who have been stung by large and volatile DB costs are likely to be very wary of standing behind anything that 'looks and smells' like a guarantee, even if it is only an aspiration," he warns.

In contrast, Hibbard predicts there to be mass take up of CDC, with traditional DC becoming the niche product "for the super-rich who can accept a degree of uncertainty, have a good understanding of finance and want to manage both their investments before and in retirement more personally".

So who's right? The only thing that can be agreed upon with CDC is that every aspect of it is subject to intense debate. Will it become the 'saviour' of freedom and choice, generating the desired regular income in retirement currently lacking, or will it at best be a niche product for a few large, still paternalistic, employers who cannot continue with DB but want to provide more security than DC? Is CDC the answer to key problems within the UK pensions industry, providing a fair 'middle ground' of risk sharing between DB and DC, or would it simply add complexity to an already complicated pensions structure?

Only time will tell.

Written by Laura Blows

CDC or CIDC?

Cass Business School's Pension Institute Director David Blake recently stated that collective individual defined contribution (CIDC) schemes are 'better' than CDC, being the only form of collective pension scheme that is feasible in the short term.

"CIDC schemes maintain individual accounts, they are better able to deal with sudden cash withdrawals than CDC schemes, yet are still able to exploit economies of scale to the full, which lowers costs, eg through automatic enrolment and the pooling of investment and longevity risks," he said.

However, Simplitium head of pensions business development Tom Hibbard disagrees, stating that as CIDC maintains individual pension accounts, it removes the element of risk sharing.

"[CIDC] would be quicker to implement, but it takes away most of the benefits of CDC (longer-term saving horizon, risk sharing and not being required to have pensions knowledge at retirement), all of which contribute to a better outcome in the majority of cases," he says.