Summary
- The cost of annuities and the risk placed on members with drawdown has caused the industry to consider whether new retirement products could be more beneficial to savers.
- Decumulation CDC would pool investment and longevity risk and provide a regular income until death, but without the income guarantee of an annuity.
- The need for scale and communicating the product structure effectively to members are challenges to CDC's creation.
- Decumulation CDC products may enter the market within a few years.

Rushing to the end stage

Collective DC (CDC) for accumulation is only in its infancy, yet already conversations are growing about the role it could have in the decumulation space. Laura Blows finds out why

After years of discussion and debate, collective DC (CDC) regulations covering single-employer schemes finally came into effect in August, enabling Royal Mail to set up the first UK CDC scheme and other employers to follow suit if they so wish. Having barely got off the ground, conversations are already moving onto how CDC could evolve, with the Department for Work and Pensions (DWP) consulting soon on how CDC regulations could be expanded for multi-employer and decumulation-only use.

"I think the reason everybody's talking about decumulation CDC is because of the train crash that's coming down the line for the Gen X retirees; the people who are sleepwalking into a huge standard of living plunge at retirement at the moment," Zedra head of proposition development, Mark Stopard, states.

"There is a recognition that DC decumulation options are in some way lacking," the Society of Pension Professionals CDC expert, Edd Collins, acknowledges. "It's a bit of a binary choice at the minute between annuities, which are very attractive in that they pay you a guaranteed income. But that guarantee comes with a cost that most individuals choose not to pay.

"People are then entering into drawdown, which allows them far greater flexibility and probably higher income levels but comes with the drawback that they've got to manage that income themselves for an unknown period of time, which is fraught with difficulty.

"So, there is a lot of work thinking about what some of the solutions to that are and decumulation CDC is one of those pieces of the puzzle."

Structure

CDC, already prevalent in a number of countries and now in the UK via Royal Mail's offering, pools contributions and investment returns, and shares longevity risk across members of all ages. It has a target, such as increasing income in line with CPI, instead of providing a guaranteed amount. The income it provides each year may increase or even decrease depending on investment returns, inflation and life expectancy. CDC provides less risk for the employer providing it for their employees compared to DB, while offering some greater certainty of income for members than standard DC saving. Yet questions have been raised about CDC, particularly around the scale required and the risk of

around the scale required and the risk of intergenerational unfairness.

However, using CDC only for the decumulation stage would work similarly to annuity purchase, WTW CDC director, Shriti Jadav, says.

"You would use your DC pot to buy a CDC pension at retirement, perhaps with some choice around the level of target increases and whether you want some income to be paid to a surviving partner after your death, and in return you would be paid an income for life.

"The key difference to an annuity is that the income provided by the CDC pension would be variable, depending on underlying investment performance and the combined demographic experience across all members. The CDC vehicle would target much higher income than from an insured annuity, through growth asset investments, and can do this because there is no insurance guarantee," she explains.

The value of CDC at decumulation is therefore in the pooling of retirement savings with others, Aon partner and head of collective DC, Chintan Gandhi, says. "Being able to invest in higher returning investments for a longer period of time, but also benefiting from the longevity of pooling means that they can expect to receive more in retirement, but for that money not to run out," he explains.

However, such a product would require enough people within the vehicle to pool risk and there are the costs of running the decumulation CDC to be managed and mitigated. Therefore, Collins states that existing providers or existing master trusts clearly have an advantage in terms of building scale "because they've got a naturally captive audience that they can market this to more easily than a fully new entrant into the market".

Gandhi also sees decumulation CDC typically being provided by existing master trusts, having a separate CDC decumulation-only section that they set up. "That means that savers who are saving towards a pension with that master trust can stay on; they'll have the option to take some money as tax-free cash, buy the CDC pension with some of their pot and maybe put the rest of it into drawdown. I also see this working very much in the retail space, where there will be some master trusts that provide this and people have choice as to which one they go to," he says.

Commenting on the idea of master trusts providing CDC at decumulation, HSBC Tomorrow Master Trust CEO, Alison Hatcher, says: "As master trusts continue to scale, the concept of collective DC is one that should be highly beneficial to members of pension schemes. Whilst there is a lot more work to be done around collective investments, CDC is a step in the right direction – all innovation has to be a good thing as we seek to enhance member value and retirement solutions."

Decumulation CDC sitting within the master trust sphere would see it regulated by The Pensions Regulator (TPR), with contract-based decumulation CDC regulated by the FCA. "A CDC decumulation option could work under either regulatory model but, in light of the progress TPR has made with the regulation and authorisation process for CDC so far, it would seem the natural initial home for at-retirement regulation," Jadav states.

Decumulation CDC would need to be regulated like any other scheme, "but there will need to be extra focus on the level of benefits being paid, as "it would be easier for the actuary setting the assumptions to defer bad news, rather than limit increases or even reduce benefits in the worst-case scenarios", Muse Advisory CEO, Ian McQuade, says.

The product would also require extra regulatory effort to avoid claims of mis-selling, as the decumulation CDC providers would offer different target pensions and different levels of indexation, backed by different investment strategies. "So, it's going to be very important for the communications and marketing of these to be regulated robustly, so that members can make informed choices to suit their needs," Gandhi says.

A regulatory balance would also need to be struck between ensuring adequate protection and not being so stringent as to restrict the model.

Stopard suggests allowing decumulation CDC to be a default or a soft default option, so that it can be bought by the mass market without advice, "because as soon as you go into the advice space I think everyone is going to want control, leading people towards drawdown".

The name of these products should also be a serious consideration.

"Decumulation CDC obviously is a complete mouthful; nobody's going to buy that," Stopard says. "We need to settle on a name that works, that people can buy into. The best way of doing that is if the DWP or the regulators come up with a name and that will then get picked up by the industry. Otherwise, you'll have different providers coming up with different versions of pooled retirement income, lifetime retirement income, pooled lifetime retirement income, etc and we'll all end up completely confused."

Benefits

It may take a lot of time, cost and effort to get decumulation CDC to market, but there are many reasons why this could be a worthwhile endeavour.

"The main reason for introducing this is to bridge the gap that exists between drawdown and annuitisation. It can provide an 'income for life', but without some of the guarantees (and protections) that exist with annuities. It protects members against running out of income in retirement under the drawdown option and doesn't price in all the guarantees of an annuity, so therefore provides a higher initial pension. It also negates the need for an individual to

drawdown to annuity, which may pose a difficulty for those in later years who have suffered a degradation in cognition," McQuade says.

While the income from decumulation CDC would be a target that can go up or down, Gandhi suggests it could provide 30 per cent better outcomes compared to annuities. Also, the pooling of investments and the long-term horizons that CDC will be able to take naturally aligns it with investing in a responsible, sustainable ESG oriented way, he adds, along with being able to invest in illiquid assets.

One of the main benefits of offering CDC as a master trust decumulation option is so employers can offer CDC without a complete overhaul of their current pension provision or 'defaulting' people into CDC, Jadav says.

"This is a simpler route for a smaller employer trying to provide their employees with more options at retirement, without the need to worry about changing the current DC accumulation. Additionally, separating the accumulation phase from decumulation would give individuals greater flexibility around the investment of their DC pot and their decumulation choices at retirement," she adds.

As well as solving future problems, decumulation CDC may also help with an issue today. While CDC would remove the creation of small DC pots, decumulation CDC could absorb the number of the small pots that exist today, Collins suggests.

According to Hymans Robertson partner, Kathryn Fleming, a CDC decumulation solution might be well suited to an individual who is looking for a stable income, is in good health and has access to other sources of income to smooth out the financial lumps and bumps of retirement.

Jadav agrees that decumulation CDC would primarily be for people who want to stretch their money as far as possible to provide an income that will last for their lifetime – "for example, someone in good health at retirement and with a £100,000 pot, who would otherwise find it difficult or impossible to provide for themselves and their spouses in retirement".

Of course, decumulation CDC is not the answer to all retiree's needs. Some will take it all as cash, other will want the flexibility of being able to access money from their drawdown pot whenever they choose, or the potential to bequeath unused funds, whilst individuals favouring an annuity may prefer the protection from fluctuations in their income. Others may wish to split their pension pots into some/all of these products.

Risks and barriers

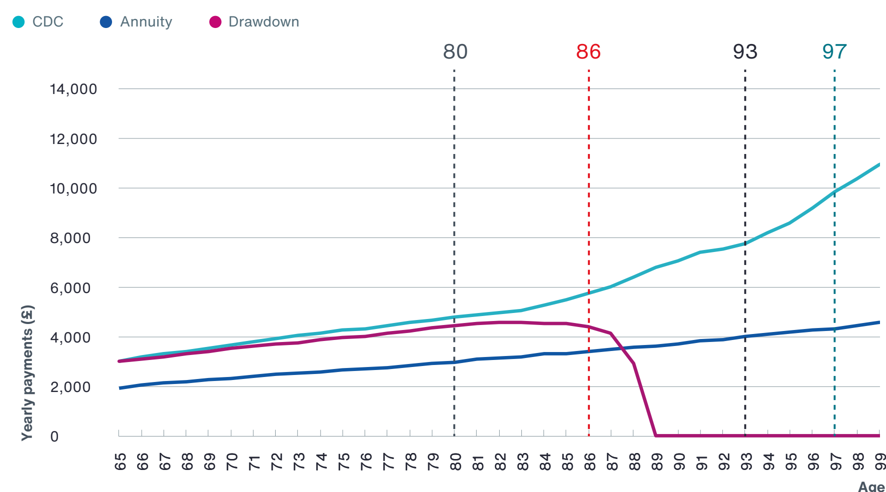
Indeed, the DWP may be looking into CDC for decumulation, but speaking at the PLSA Annual Conference in October, DWP head of CDC policy, Julian Barker, warned: "The government believes that CDC has an important part to play in the helping pension scheme members get better outcomes than they would otherwise do in standard DC schemes, at a fixed cost to both the member and employer, but it is not magic bullet."

One of the concerns with decumulation CDC's creation is the need for scale.

"It's very easy to see how this could work once you've got 10,000 members in it, all in the pool, all taking their lifetime income. But when you've got 50 members in it, the income is going to be hugely variable," Stopard says.

"That is much more like a basic tontine where the income's going to go up and down significantly. Not so much based on the investment performance, but just based on the chance of who's alive and dead at any particular point in time.

"So, what is the way to start one of these things off, until you get that scale? It's going to need additional capital, which someone's going to have to provide. People providing capital are going to need a return on it, so that's going to dilute some of the benefits. You could have a fund seeded, or you could leverage an insurer's or reinsurer's balance sheet to start the thing off. But then you start to run into fairness issues,



Income comparisons for a member retiring at age 65 with a £75,000 pension pot, having already taken their 25 per cent tax-free cash lump sum at retirement. ***Source: Aon CDC in Decumulation - The Power of Pooling, November 2022***

as people who joined the pool down the line don't need the same amount of capital support as those who've joined initially. So how do you make sure that that's fair and people pay their fair share?" he asks.

Even if initial challenge of scale can be overcome, decumulation CDC may still have some risks once up and running.

"The obvious risks are the sensitivity of member outcomes to payments, investment design and perhaps the more complex area of member profiling and using underwriting to achieve an element of equity," Fleming states.

"At the extreme, if a member transfers in a fund in order to receive an income for life, and that ends up not being the case, the fallout could be catastrophic," she adds. "Independent industry analysis and debate will certainly help quantify, navigate and manage these downsides. Where I have less confidence is the ability to manage member expectations. If it is viewed as a 'do it for me' solution, any changes in income further down the way, or even no change in income at all, could cause confusion due to simple lack of understanding and as an industry we are still grappling with pensions engagement."

According to Jadav, this variability will need to be explained to individuals in an unbiased way and which allows comparison between competing products, compliant with the new regulations to be developed by DWP. "And the scheme will need to be governed by the trustees to a high standard, with oversight from TPR, to ensure that pension increase decisions treat retirees of all ages fairly."

For the member, they need to be able to easily compare different CDC options and make informed choices," she adds. "An extra dimension with CDC is that individuals will need to be able to compare the extent of variability across different options. Good communication with retirees and some form of consistent way to make comparisons between products will be key to enable retirees to make informed decisions."

Another potential barrier is industry engagement, or lack thereof.

"We need the industry to be ultimately developing the solutions because government can legislate for it, but they're not going to provide products for decumulation CDC"

"We need the industry to be ultimately developing the solutions because government can legislate for it, but they're not going to provide products for decumulation CDC," Collins says. "So I think it's important that we get the industry bringing ideas, working together, developing solutions, and I guess helping DWP through the regulations as well."

Without this engagement, "there is the risk that decumulation CDC could be a great idea in theory but never achieves enough traction in practice to really get off the ground", Jadav warns.

As Fleming says: "Regulations aside, there has got to be a viable commercial business case for pension providers to want to offer this as a solution. It will be imperative to be clear on what the member outcomes will look like under the range of decumulation solutions, current and evolving, and whether CDC will be a realistic fit for a pension provider's membership profile and strategic ambitions. Currently, there are plenty of creative alternatives being developed, so there is a risk that CDC for decumulation will just not take off as providers are committed to other ideas."

Existing annuity providers may be slightly unhappy at this new offering, McQuade warns, as decumulation CDC is similar to an annuity, but without the guarantees and some of the same solvency protections that are in place. "As those changes mean it can offer a higher initial payment, so existing annuity providers may feel that it skews the market against them, albeit that they may decide to enter the market," he says.

Timeline

The current restrictions to decumulation CDC could be overcome with products entering the market within a couple of years, Jadav predicts.

"With a fair wind, following DWP's initial consultation on principles in Q1 next year, DWP could consult on new regulations towards the end of 2023, with the possibility of providing a new CDC option from 2024," she says.

"However, launching a new CDC offering is a big endeavour, needing expertise in a variety of disciplines, and so we expect some providers will hang back and wait for a first vehicle to be launched, then consider whether to adapt the design for their own offering. We'd hope that, within a few years, there might be several offerings, so that employers and individuals can choose between them."

A slow start is not unusual for the industry.

"It wouldn't surprise me if it was similar to when master trusts were first introduced," Stopard says.

"That started off very slowly, with a lot of suspicion and uncertainty, even though a lot of people thought they clearly were the answer. Hey presto, 10 years later it has been proved they are the answer and they've taken over. So, I could see decumulation CDC going nowhere for a long time and then taking off with a bang."

Written by Laura Blows