Commentary on...

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Collective Defined Contribution - Sharing Risks Between Members

Collective Defined Contribution (CDC) was put forward as one of the options in the November 2013 DWP consultation paper 'Reshaping workplace pensions for future generations'. In CDC schemes, investments are pooled and the benefits received by members are dependent on the funding level of the scheme.

Like other types of pension scheme, CDC schemes can have a variety of different benefit structures. Employer contributions can be fixed or potentially flexible within a certain band. Increases to pensions in payment are dependent on the funding level within the scheme, and in the extreme case pensions in payment can be reduced. These and other potential features are discussed below.

How does it work?

As mentioned above, in the accumulation phase, member's contributions are invested collectively. The benefit of a larger collective fund compared to an individual defined contribution (DC) account, is that there is greater scope to negotiate lower fund management charges and the ability to invest in larger individual assets that would be unavailable to members with individual DC accounts (such as direct property investment).

Before retirement, CDC members may have a target benefit that they can expect to receive in retirement, in which case they will be kept informed of progress against this target. This target benefit may then change depending on the experience of the scheme.

Commonly in CDC schemes, during the decumulation phase, assets remain invested within the scheme and pensions are paid straight from the fund (similar to income drawdown). This removes the need for members to secure annuities, and they are therefore not subject to the restrictive investment strategies, and volatile pricing, underlying such insurance policies.

It is possible to secure annuities for CDC members at (or during) retirement, but this has two drawbacks; the loss of investment freedom and the loss of a key pressure valve if and when future scheme experience is poor (see section below for further discussion on this). Nevertheless annuities may still be purchased for older members. At any point in time CDC funds can be notionally allocated to members based on current pensions in payment and target benefits for non-pensioner members.

In the case where employer contributions are fixed, there will be more variation in the allocated funds and therefore more variation in the target benefits. Increases to benefits will tend to be discretionary depending on whether funds permit (conditional indexation). If low funding levels persist then pension amounts (both those in payment and target benefits for non-pensioners) can be reduced. These two elements are essential 'pressure valves' that are needed to ensure that the CDC scheme does not get into difficulty.

What are the benefits of CDC?

As mentioned above, the pooled investment should mean that CDC has lower charges than DC. Much has been made recently of the compounding effect of charges and the difference it can make to member's retirement funds. Some of this will be offset by higher ongoing administration charges, incurred due to CDC schemes needing to monitor ongoing funding levels.

One of the most important features of CDC is the investment freedom. In DC schemes, members tend to move from growth assets into matching assets as they approach retirement, in order to try and match annuity prices in a process known as lifestyling. As CDC schemes do not need to annuitise, there is no need to reduce exposure to growth assets in this phase to the same extent to match annuity prices, and over the long-term this prolonged exposure to growth assets should mean that CDC funds would grow at a faster rate than conventional DC schemes and thus be able to provide higher pensions.

By annuitising, ordinary DC members are effectively reducing their investment risk to that of government bonds (thereby removing the potential for any outperformance from growth assets) and also contributing to insurance company profits. Some members can expect to be in retirement for thirty years or more, and in such cases this removal of investment risk may not be entirely appropriate. As CDC schemes can continue to pay pensions from the fund, this means that some of their liability can continue to be backed by growth assets which should again lead to increased pensions.

If these more volatile growth assets do fall in value, then reductions to pensions (and therefore risk) are shared with younger members. DC members do have the ability to remain in growth assets in retirement through income drawdown accounts, but they bear the risk of falling markets on their own.

As mentioned above, because of the pooling of assets, CDC schemes are able to invest in illiquid assets such as property or infrastructure projects. These projects should deliver higher returns due to their illiquid nature (which a CDC scheme can accommodate as a long-term investor). This type of investment would not be available in individual DC accounts.

The DWP's 2009 study 'modelling Collective Defined Contribution Schemes' suggests that by remaining invested in equities for longer results in an average improvement of 20-25%, although their modelling gave results that pensions in CDC schemes on average would be 39% higher than the corresponding DC pension.

There is also evidence presented in the DWP study that the pensions paid from CDC schemes are less volatile than DC schemes. This is due to the intergenerational risk sharing between members. As mentioned above, rather than pensioners suffering the full extent of down turns in markets this is shared with younger members of the scheme. Equally, some returns can be kept back in good years. This results in smoothed outcomes, similar to how with-profits funds are managed by insurance companies.

If the employer chose to fix their contributions (i.e. not share any funding risks) then from their perspective the scheme would bear no more risk than a DC scheme. If they decided to contribute within a certain band then the risks vary according to the size of the band, and can be set according to the employer's attitude to risk.

What are the limitations of CDC?

Many of the benefits mentioned above rely on a critical mass of members and a stable membership structure, which in turn requires a steady stream of new entrants. These schemes may prove difficult to continue to operate when closed or the stream of new entrants is reduced. Effectively the scheme will be similar to a closed defined benefit (DB) scheme and may need to reduce the risks taken in the investment strategy (although not completely, as unlike DB schemes benefits could still be reduced). The subsequent reduction in return removes one of CDC's key advantages, although charges should still be lower than individual DC so the benefits are not entirely diminished.

Reducing pensions already in payment is difficult and the process would need to be carried out with very clear communication. However CDC schemes would be severely compromised if operating under a structure that prevented their reduction.

There is evidence from other countries that suggest pensioners have been unprepared for cuts to their benefits, which they had believed to be guaranteed. This scenario could have been improved with superior communication with members, and would clearly form a significant part of ongoing scheme governance.

There is a need for strong governance in CDC schemes, as the assumptions used to value the target benefits will directly affect member's pensions. Broadly, the more cautious the assumptions are, the worse the funding will appear and current pensioners may see their benefits cut. If assumptions are optimistic, the funding position appears healthy and it may be the case that younger members will see benefits cut in the future if experience is not as expected. This can lead to pressure to change assumptions from various sections of the membership, and increases the need for a clear transparent policy on deriving assumptions. It would also make changing assumptions difficult.

Many employers fear 'legislatory creep' with regard to pensions, having experienced increasingly onerous pension legislation over the past few years. There may be a concern for employers that the target benefits in a CDC scheme may be turned into a hard promise in the future, thereby turning a CDC scheme into a DB scheme. The DWP consultation mentioned above (and subsequent statements) states that it is not possible to restrict future governments on this point, although any future government will presumably be keen not to repeat the recent mistakes made with DB legislation.
To achieve the necessary scale CDC schemes may need to operate as multi-employer or industry-wide schemes.

Why might CDC need new legislation?

The DWP's Industry Working Group is currently investigating where CDC schemes should sit within our legislative framework, and the extent to which legislation would be needed to enable this type of scheme to operate in the UK.

One of the biggest issues that they need to consider is how to approach the ability to reduce pensions in payment. Without the ability to reduce pensions in payment, CDC schemes would fall under the existing DB legislation.

Another issue is the collective pooling of pension funds – allowing an individual's share of the collective fund to go down as well as up.

Why do we not already have CDC in the UK?

Up until the introduction of 1995 Pensions Act, DB schemes were closer to CDC than they are now; pension increases were discretionary, and if schemes were not well funded enough on the closure of the scheme then benefits would be reduced. This legislative strengthening of the DB promise was arguably the beginning of its demise. Subsequent amendments have further strengthened the DB promise, making it costly and driving employers to look for alternatives.

CDC does exist in other countries, most notably in the Netherlands and Denmark, although CDC is also being explored elsewhere. Where CDC exists or is being trialled, schemes have been able to convert DB promises into CDC schemes, thereby starting the schemes with the scale that they require. This is unlikely to be an option in the UK.

In 2009 the DWP produced a study 'Collective Defined Contribution Schemes' and concluded that it would not be possible to implement CDC under current legislation.

The DWP assumed that pensions in payment would not be able to be reduced (as per UK legislation), a key pressure valve as mentioned previously. Without this ability, the DWP concluded that the downside risks were too great. The study also concluded that employer demand for CDC schemes would be low.

Will CDC happen in the UK?

CDC was included in the DWP consultation 'Reinvigorating workplace pensions'. This has coincided with a number of positive studies detailing the benefits of CDC. Steve Webb, Pensions Minister has also indicated that CDC will be included in the Pensions bill.

There is no reason to suspect that CDC cannot be as successful in the UK as it has been in other countries, provided it has the necessary structure and legislation supporting it.

Barnett Waddingham has developed a vision for the design and operation of CDC schemes in the UK, and we would be happy to discuss this with any interested parties.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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MARCH 2014
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