Collective DC
Mythbusters

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Collective DC Mythbusters

Introduction

Following the announcement in the Queen's Speech that the Government proposed legislation to permit the operation of Collective Defined Contribution (CDC) plans, there has been a positive deluge of articles criticising these plans — before they have even started! Many of these criticisms repeat popular misconceptions about how CDC plans operate, many assume they are doomed to repeat mistakes from history, most of the comments are from an uninformed or biased position (and none that we have seen have undertaken any modelling of potential outcomes) and many have obvious ulterior commercial motives. The publication of the Pensions Scheme Bill (the Bill) on 26 June 2014 addressed how the government proposed to deal with a number of the myths and misconceptions about how CDC plans would operate. This article sets out a compilation of the most common accusations against CDC plans — and sets out the truth of the matter. CDC plans offer the potential for better, more reliable pensions outcomes for many UK employees — for the sake of these employees, we will continue to argue in favour of CDC plans.

Aon
In conjunction with the Friends of CDC

Mythbusters
The Top Ten

Myth 1.

"CDC plans are just 'Ponzi con-tricks'. CDC requires young members to sponsor old. There is nobody to pay for CDC wind-up. CDC won't offer exit routes for employers and employees."

The accusation here is that CDC plans need to last forever, with a continual flow of new entrants, in order to sustain the risk-sharing and risk-pooling underlying the plans. Equivalently this myth says it would be impossible to run down a CDC plan fairly — bizarre to think that we are concerned about the ending of these plans, when we have not yet witnessed their beginning!

CDC plans work by sharing risks across the members of the plan. The smoothing mechanism means that individuals get more predictable levels of income and are not prone to sudden changes in their expected pension as a result of fluctuations in the value of investment backing the pension promise, and the cost of securing an income. Smoothing works best over longer time frames and so benefits from an open scheme with new members joining — but is this essential? How would a CDC plan be wound down in practice?

The first point to note is that if any individual CDC plan were to terminate, it would probably be encouraged to merge with another open CDC plan. Encouraging scheme mergers is very much the way the Dutch pension landscape has been transformed over the past decade, with the number of schemes moving from thousands, down to a much smaller number — a few hundred — of larger, better governed schemes. In Australia, smaller DC schemes ('super' schemes) have been encouraged out of existence by regulators for similar reasons. In the UK we have seen calls for the merger of smaller DC schemes.

If the CDC plan is not merged, then gradually the trustees will adjust the investment and bonus policy to become more secure with less emphasis on risky assets. This will not be an overnight process — the benefits will still be payable for many years in the future and so no immediate change is required.

There will still be a number of market cycles to make any adjustments, and so the smoothing mechanism can operate to the advantage of the remaining members. Over the longer term, as the investment policy becomes more defensive, this change could well suit the remaining members of the plan, who will be ageing alongside the plan itself.

And finally if any members do not want to remain in this closed CDC plan, they will always have the opportunity to transfer out into another arrangement of their choice. We propose that all members will have the right to a transfer representing their fair share of the assets of the plan — which is owned entirely by the members themselves. Transfers out in this fashion would ensure that leaving members and those who remain are treated fairly and consistently.

Myth 2. "CDC plans are just with-profits reinvented. CDC is with-profits version 2.0."

CDC plans do share many of the features of with-profits funds. Investment is undertaken on a collective basis, without the need for member choice or intervention. In a CDC plan, investment would be by trustees, acting purely in the interests of plan members, on professional advice. In the case of both with-profits and CDC plans, the underlying returns are smoothed out to give a steady return to each generation.

So if with-profits were seen to fail (and we can ask if they did), are CDC plans simply doomed to repeat their failures? We think not. One key difference is that we propose an exceptionally transparent and open approach to the regulation of CDC plans — all relevant financial information would be in the public domain, ideally on a publically accessible CDC website. Clause 34 of the Bill talks about Regulations for CDC plans that may impose requirements about the publication of any document relating to the plan. This information could include all actuarial reviews, all investment reports, all stress testing and details of how bonus decisions had been arrived at.

We do not believe that individual members would be interested enough (nor in general knowledgeable enough) to review this material — but we do expect the wider pensions community, including the current 'knockers' of CDC, to study this information with interest. So as well as having a Pensions Regulator looking over the finances of CDC plans, we would have the entire informed pension industry able to ensure that plans are doing in practice what they have told their members they would do. If this level of public transparency had been available during the with-profits era, we believe that many of the 'outliers' would have been identified — insurers where the bonuses awarded were inconsistent with the underlying investment returns being generated.

A second difference with CDC plans is that we support a governance structure involving a board of trustees whose sole objective is to support the interests of members. This provides a separation from the management of investments with clear lines of accountability — something that has not always been evident in with-profits funds.

Another complaint laid at the feet of the with-profits history is that the returns delivered were not those 'promised' to members. In this sense, with-profits funds were no different to conventional DC plans — benefit projections given to members were overly optimistic with the benefit of hindsight. DC statutory projections in the 1980s and 1990s were based on rates of return of up to 13% per annum — surely this was blatant miss-selling? It is important to remember the context — during these decades, equities had given returns of over 20% per annum for extended periods of time — a common complaint at the time was that 13% per annum was excessively cautious!

The lessons to be learnt for CDC plans are that projections are just that — they are not a guarantee. Any literature to members will make it clear that they are not entitled to any underlying guaranteed benefit and will probably try to convey some sense of the underlying uncertainty of potential outcomes. Benefit illustrations will focus on incomes in retirement (rather than capital values) and will be expressed in 'real', inflation-adjusted, terms (rather than nominal benefits). Both of these features should give less volatile results, which can progressively adapt to changes in the underlying economic circumstances.

The Bill talks about requiring trustees of a CDC plan to set targets in relation to any collective benefits — where they define target as "a target, relating to the rate or amount of a benefit that is unenforceable". Trustees are asked to focus on the probabilities of meeting those targets and having a policy for dealing with 'deficits' or 'surpluses' in relation to meeting these targets, and an explanation of the effect of their policy on members in different circumstances. The conceptual framework is thus well established in the legislation, and will need careful communication to members, to ensure they appreciate the difference between targets and guarantees, which was a key issue in the with-profits debate.

Myth 3.

"Employers will fear retrospective changes in legislation, imposing DB style obligations on them from CDC plans. CDC won't be supported by employers who won't take on guarantees / extra costs."

This has been a concern from the very first days of consideration of CDC plans and one we believe can be adequately addressed in the legislation. The concern is that sponsors will be reluctant to establish CDC plans because they fear that, at some unspecified future date, legislation governing them will become progressively tightened or amended and convert them to something more onerous than anticipated.

Sponsors cite the legislation covering defined benefit schemes — for example, the obligation to provide benefits to early leavers, to provide inflation protection to benefits in payment, to indexation and revaluation of early leavers' benefits, pension protection fund levies and so forth.

We have worked with leading pension lawyers to help the DWP address this concern both in the legislation and in the CDC plan documentation. The introduction to CDC in the DWP response to the defined ambition consultation states: "A key feature for a CDC scheme is that it provides certainty for the employer who pays a fixed rate of contributions and has no liability to the scheme... and no balance-sheet risk." This strong statement of principle needs to be followed through into the detailed legislation.

We believe that CDC plans should operate on the basis of a licence from the Pensions Regulator — and the face of that licence will state categorically that the employer has no liability to pay any further amounts to the scheme other than contributions already paid. This is analogous to the way in which a limited liability company receives a certificate of its limited nature from Companies House. In other words, there is already a statutory precedent for an Act of Parliament providing for a statutory limitation of liability. This should address the concern that under English law, a government cannot bind its successors — but it can make them stop and think before going against an express provision of previous legislation.

The second level of control for employers would be the equivalent of a 'Big Red Button' in the plan documentation. The trust deed and rules would contain a provision for the automatic conversion of all benefits back into money purchase benefits immediately before any future legislation might take effect which would result in any increase in employer liability in relation to the scheme. If such a clause were triggered then the scheme would automatically move from being a CDC plan to being a conventional DC plan, with each member receiving a fair share of the assets available.

Myth 4.

"CDC plans will not get the scale they require. CDC will compete with good quality master trusts."

As above we believe that CDC plans will work best where there are larger numbers of members, so that costs and risks can be shared across a broad group of members. As such we can see three routes under which these plans will develop:

- **An individual larger employer, who will have the size of membership to make this type of plan feasible** – this might be a few thousand employees. This group might include employers wishing to make the move away from conventional DB schemes, but who do not want to transfer all of the responsibility for decision making to members, in a way that conventional DC schemes do.
- **Industry wide plans** – where again there could be more desire to support members, and less perceived benefit from having an individual plan. The experience in Holland and Australia has been that these larger, industry wide plans have significant appeal to both employers and employees alike.
- **Mastertrust arrangements** – this is where an individual employer of any size joins with a number of other non-associated employers in a collective scheme. Provided the governance arrangements are consistent with emerging best practice in the conventional DC Mastertrust arena, we believe this will be a very attractive route for employers, who want to avoid the overhead of setting up their own plans – and also want a sense of distance from the underlying pension, for fear of changes in legislation, as in Myth 3 above.

Myth 5.

"Flexibilities announced in the Chancellor's Budget make CDC obsolete. CDC operates to individual Scheme Rules and runs contrary to the new pension freedoms."

The 2014 Budget stopped the 'requirement' to purchase an annuity. Technically, it has not been a requirement for a long time, but it has been the only effective option, and a powerful default option, for most retiring DC members. But the Budget has not taken away the need for a large number of people to **generate an income** from their DC pension savings, and CDC has a key role to play here.

For many people, the Budget flexibility will give them an opportunity to 'cash out' at retirement. This will typically be individuals at both ends of the income scale. For people on low incomes, with relatively small savings pots, their best strategy will almost certainly be to cash out their savings and to spend it in a relatively short time. These people are protected from poverty in retirement by their reliance on the enhanced Single State Pension — now set above the means testing threshold. Pensions savings will make very little difference to their standard of living in retirement, and is a way of accumulating a lump sum that can be spent fairly soon after retirement.

At the other end of the income scale, people with very large DC pots will probably roll over out of their employer's plan to a SIPP or other decumulation strategy offered by their adviser or other intermediary. They will value the new found flexibility and can incorporate it into a personalised financial planning strategy that will continue throughout their retirement. And no doubt, many will use the cash — perhaps drawn out over a number of years to manage their tax liability — to be able to purchase that buy-to-let property. The British obsession with property will be back with a vengeance, accompanied by all its downsides, such as illiquidity and concentration of risk.

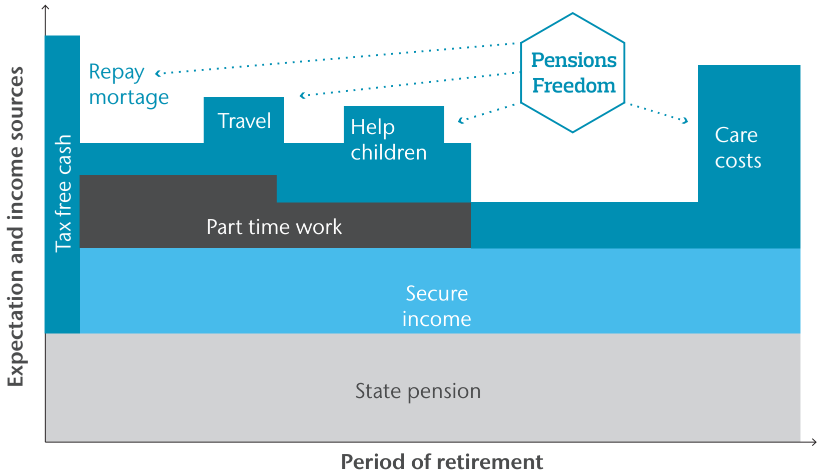
As ever, the true need for pensions will centre around the 'squeezed middle'. These individuals will want to use their retirement savings to generate an income to live in retirement — but they will also want to use some of the Budget flexibilities to cope with life after they retire. They could use part of their DC savings to buy an annuity — but many will not, or will defer this until much later in life, e.g. at age 85 to provide some long-term insurance against outliving their savings. There will be a need for some form of income generating solution from DC pots to replace annuity purchase — and we can expect a proliferation of market innovation to fill this need, with guaranteed products, with-profits annuities, variable annuities and newer strategies all coming into play. CDC has a role to play here.

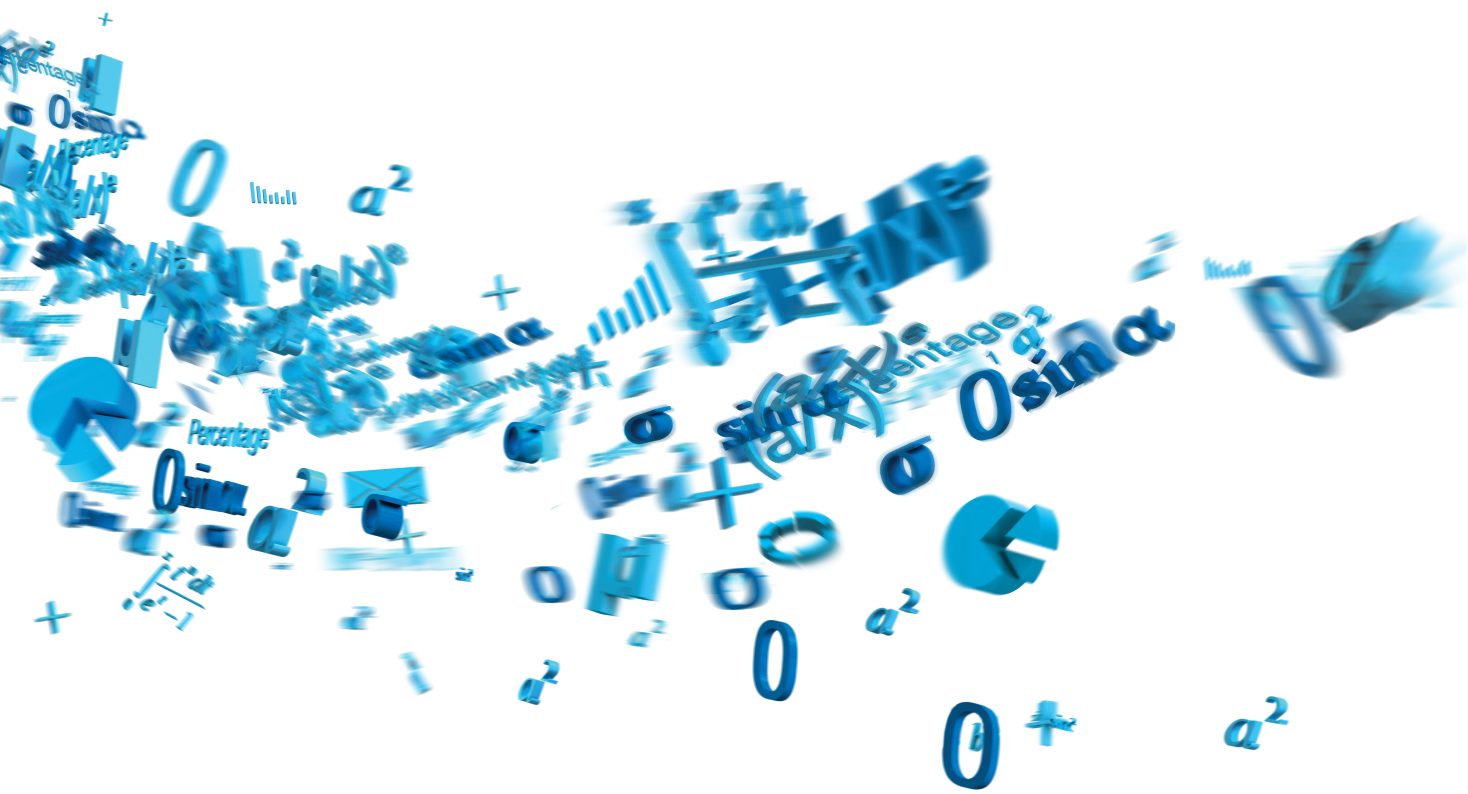
Some employers will take the view that their role in pension savings is simply to contribute — what individuals choose to do with their retirement savings is no concern of theirs. Others will see that their role is to help individuals to generate a stream of income in retirement — we could call that a pension! This is more than paternalism — it is recognising that it suits employers if their employees can retire in an orderly fashion.

Employers set up pensions today because they can do a lot of the thinking for individuals, and arrange matters better on a group basis than an individual basis. That is why they negotiate better investment solutions on behalf of members, and why some of them will look to put in place better retirement income solutions for members. Market innovation will undoubtedly give rise to multiple decumulation approaches. A CDC plan deals not just with the investment process — more effective on a collective basis than an individual basis — but it also takes away what will become an increasingly complex decision-making role in relation to decumulation.

We can envisage that CDC will form part of a core retirement income delivered by an employer. Consider the changing income needs of a pensioner, and how individuals will meet those needs — the diagram below sets out what we expect to be a typical strategy.

On top of the newly enriched Single State Pension will sit a CDC ‘core’ — paid for by the employer, with no cash option, and with contributions of say 8% of pay. Individuals can save more themselves — perhaps even matched by their employer. These individual savings will be highly tax efficient: tax relief on the way in, tax free roll up, tax free out (up to 25% of total pension value, including employer contributions) with full unfettered access to the remainder of their DC pot, after the Budget. The Budget flexibility means that individuals can address their variable, changing needs in retirement, with the security of a basic retirement income from the CDC core and their state pension.





Myth 6.

"The figure of 30% higher outcomes is just pie in the sky. CDC plans will not outperform always by 30%."

Correct – CDC will not always outperform and we have never asserted that. What we have said is that 'on average' retirement outcomes from CDC plans will be higher than conventional DC plans where individuals annuitise on retirement. CDC outcomes are more predictable. That is the inherent smoothing nature of the plan's design. If you were lucky enough to have retired from a DC scheme at the end of the 1990's after a huge stock market rally and when interest rates were still reasonable, you would have done better than under a DC plan. But if you retire today, when the market has not yet attained pre-crash levels, and when annuity rates are at the lowest they have ever been, you would not do so well. To do well in a DC scheme, you need to be able to choose when to retire, and how to cash out. CDC smoothes out market fluctuations and delivers a higher – on average – more stable outcome, where members do not have to take investment and retirement decisions.

The modelling that led to our 30% figure was based on conditions prior to the 2014 Budget, and assumed that individuals would opt to purchase an annuity with their pension pot on retirement. Is this comparison still valid after the Budget freedoms? Of course, we cannot predict what will become a typical or normal decision to convert a retirement pot into an income – including cases where individuals take their pension pot as a cash lump sum; they still have to generate an income to live off. It seems reasonable to assume that individuals will invest in a higher proportion of return seeking assets than conventional annuities. Even though this comes with the risk of an individual outliving their savings, or being forced to liquidate at times of market dips, we should assume superior returns – which might reduce the advantage offered by CDC plans, but will not eliminate it altogether. A reasonable comparison for, as yet, unspecified post Budget income solutions would be that the CDC 30% advantage will be reduced to say 15–20%. However, a key difference is that in a CDC plan, longevity risks are pooled, while in a DC plan they are, of necessity, borne by the individual. Collective arrangements offer superior solutions.

Myth 7.

"CDC plans can't be good because they are based on Dutch plans, and Dutch plans have cut pensions in payment."

Please — can we stop going on about the terrible cuts to the Dutch system! The Dutch Regulator showed that on average for those schemes that had cut benefits in 2012 the cuts were around 1.9%. So that's not a cut of 50% in their regular pension — but a drop from €1000 per month to just €981 per month. True, this is less than the inflation-linked increase members may have been expecting — to around €1020 per month. But these cuts have been restored in a number of Dutch CDC plans, as markets have improved across 2013 and 2014. Part of the Dutch system is that restoring pension cuts can have the highest priority from improved conditions, if benefits have needed to be cut. And as a technical point, what the Dutch call CDC plans have only been around for a relatively short period of time — most of these benefit cuts have taken place in what they call Defined Benefit plans! Dutch DB plans can reduce benefits to help restore funding, in certain circumstances in the Dutch system. Ironically, the true CDC plans have been in existence for a relatively short period of time, and few have had to reduce benefits in payment. The Dutch system — and their nomenclature — is different to ours: we should not look to copy it, but we can learn from it!

So how have the corresponding members fared under the present UK system? Those fortunate enough to have retired from an open DB scheme — around 1.5 million out of a private sector workforce of over 20 million — will have received their full benefits, plus inflation proofing. If their employer had gone bust, then their benefit would have been reduced on entry to the PPF — by perhaps 10% on a permanent basis plus likely lower (or no) increases in future. And what of DC members who have been unfortunate enough to have bought annuities in the past five years? They are locked into those rates forever — rates that are about 30% lower than annuity rates five years ago.

So perhaps a fairer assessment of the 'terrible' Dutch cuts is that they have been a temporary 1.9% reduction versus a permanent 30% for UK DC annuity purchasers? The Institute of Public Policy Research (IPPR) tested the concept of benefit cuts with real individuals, via some in-depth focus groups. Their conclusion, based on these conversations was:

"The fact that retirement income could fluctuate in a collective scheme was cause for concern. However, if the scheme was run by a non-profit organisation with proper governance arrangements, respondents felt that falls of 5 (or even 10) per cent could be manageable — particularly if the fall was being faced by all members Because of the assumption that, on average, Collective Defined Contribution would provide a higher income in retirement in the first place, the possibility of an annual fall was felt to be worth accepting."

Myth 8.

"Individual accounts are part of the British culture. CDC only works in a highly unionised environment."

This argument is that we can only launch a Dutch style system — or is that a Danish style system? — if we adopt the entire characteristics of that country. Now this might work if we tried to copy the Dutch at football — but it hardly seems sensible in relation to pensions. Apart from anything else, what about the other countries around the world that have adopted CDC style plans — such as Canada? Do we have to adopt their characteristics too? What is a Dutch/Danish/Canadian culture like? And heaven forfend that even the Americans have proposed legislation that would launch CDC style plans in the land of the free! The fact is that CDC plans have been adopted in a variety of different jurisdictions and different cultures, as ways to improve retirement outcomes for members. We can pick the best from these and apply it in our culture and our jurisdiction.

Interestingly, the Institute of Public Policy Research carried out some in-depth interviews with individuals about their attitudes towards retirement saving and the concept of collective schemes. Rather than the individualistic approach suggested in this myth, many people preferred the concept of a collective arrangement. Several respondents said that they liked the solidarity of a collective scheme — meaning they didn't face the fear of making the 'right' decision alone.

Respondents felt protected against responsibility for their individual pensions, and several voiced the idea that pensions should be a 'social policy', and that a collective scheme was a more appropriate vehicle for it. The responsibility involved in the annuity process was universally disliked: respondents felt they had to make a decision they weren't adequately equipped to make, which would be time-consuming and troublesome, and would have a big impact on the rest of their lives.

There was a great fear of 'getting it wrong', and concern about the administration involved in making a decision. And remember that post Budget, the range of retirement options will become bewilderingly large — way beyond simply choosing an annuity.

The IPPR research mentioned above came to the conclusion that there would be public support for a collective style system:

"There is public appetite for a form of defined-ambition pension that minimises some of the risks associated with Defined Contribution. In particular, participants in our research preferred a Dutch-style collective scheme that shares the risk among all members and removes the need for an annuity, and that incorporates some form of smoothing into the accumulation phase."

Myth 9.

"Companies do not want more choice. Companies want clear design and defined cost. The market will not innovate until there is clear demand."

Employers may not want more choice — but after the Budget that is exactly what they have, in spades. There will be a multiplicity of post retirement 'solutions' in the market place, to replace annuities — what will be right for their members? At a fundamental level, companies will have to decide if they want to get involved in this aspect of pensions savings. Some will no doubt decide that if they deliver a cash lump sum on retirement, then how the member chooses to spend it is none of the company's business. Others may conclude they would like members to have an income in retirement, at least with part of their overall retirement savings.

These companies will need to decide how they will support members in converting capital into income. CDC plans do this automatically and may well appeal to employers, for all or part of their workforce, and for all or part of the retirement savings.

We agree whole-heartedly that employers want a defined cost — that is why CDC has no underlying guarantees. Our strongly held view is that employers will not be prepared to tolerate any balance sheet or P&L exposure from Defined Benefit schemes.

The market will not innovate until there is a demand? Isn't this chicken and egg? Until we know there is a better way to organise DC arrangements, why would employers ask for it? Did anybody ask for an iPod before they had been invented? What we can ask is whether employers would be interested in a pension system that gave better, more stable outcomes to their members, at no additional risk to themselves? Would there be a clear demand for this product?

Myth 10.

"CDC plans are just a job creation scheme for actuaries."

It's a fair cop! CDC plans do have an actuarial control process at their hearts, to ensure the fair distribution of returns among generations of participants. But unfortunately there will not be very many of these plans! As we have said above, CDC plans need scale to operate effectively — so while we may have created some jobs for actuaries, the number of jobs will be fairly small — certainly significantly lower than the number of Scheme Actuaries for existing defined benefit schemes. So yes, the cunning job creation scheme for actuaries has been rumbled — but it wasn't exactly a seismic shift in long-term actuarial employment prospects!

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