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COLLECTIVE PENSIONS IN THE UK

DAVID PITT-WATSON
HARI MANN
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David Pitt-Watson
Harinder Mann

Tomorrow's Investor: creating effective pensions in Britain

Three years ago, the RSA began investigating the efficacy of the UK investment system. After in-depth research including using 'citizen juries', we concluded it was not fit-for-purpose. Pension saving in particular was high-cost, poorly structured and patchy. That was the bad news.

However, there was also good news. With some modest changes, the private pension system in Britain could be radically improved. This required two things: a system of low-cost, auto-enrolled pension provision and a recreation of collective pension structures which share risks and offer superior benefits.

Following the first of these recommendations, we welcomed the government's decision to adopt auto-enrolment, but noted that it needed to remove the artificial restrictions it had placed on NEST, the default provider established to ensure the policy could work. Further, it should encourage other providers who would offer similar terms to NEST. We are therefore happy that the Parliamentary Work and Pensions Committee is investigating the restrictions on NEST, and that the minister, giving evidence to the committee, agreed that without such restriction, NEST would be more effective and lower cost.[1] We are also delighted that two alternative low-cost providers have been established in the UK, one of them a former sponsor of the RSA's work.

As regards the creation of collective pensions, we are also pleased that the pensions minister has said he would "like to facilitate risk-sharing" in pensions,[2] a central element of our proposals, and has announced a consultation later this year to do precisely that. So while we await action, the debate is moving in the right direction.

Throughout our work, we have noted 'stakeholders' need to reach consensus on how best we provide pensions. So it is good news that the National Association of Pension Funds (NAPF) and the TUC have endorsed our proposals, and that the CBI has also helped. We are hugely encouraged that they are working together to protect collective pensions in the UK from the unintended consequences of ill-judged regulations.[3] We would also like to thank the financial press for the exposure they have

1. See evidence at www.parliamentlive.tv/Main/Player.aspx?meetingId=9968
2. See report of speech at http://ipe.com/news/webb-pledges-to-facilitate-pension-guarantees-risk-sharing-in-dc_42567.php
3. See www.ft.com/cms/s/0/397de0a2-5574-11e1-9d95-00144feabdc0.html#axzz1mTbjxzFF

given to these issues of cost; not just the RSA's reports but others' work as well. The tide of opinion is changing.

In this paper we want to look in more depth at why collective pensions are so much more effective that individual provision. Because if Britain is to have a private pension system equal to the best in the world, we need to 'reinvent' collective pension provision that is sustainable and works for employees *and* employers. We believe there is a huge opportunity to build on what has already been achieved, to allow the people of Britain to save for their retirement in a trustworthy and more efficient way. In this paper we explain how this is possible and discuss the issues and the pitfalls to be avoided.

Introduction

If a typical young Dutch person and a typical young British person were both to save the same amount for their pension; if they were to retire on the same day, and die at the same age, the Dutch person is likely to get a pension which is at least 50% higher than the British one.

Given that we spend 6.5% of the GNP on private pension savings, there would be a huge advantage to the economy if we could emulate the Dutch system in the UK.

There are several reasons for the superiority of the Dutch system. In this paper, we seek to explain one of them. That is, that in Holland, pension saving is typically still done *collectively*. In Britain a typical saver will have an *individual account* and upon retirement the sum saved will be used to buy a pension. However, this individual method of saving is inefficient. Indeed, the government actuary has concluded that:

> "Collective [pensions are] expected to deliver a retirement income … [that] … is 39% higher than the corresponding [individual pension] outcome."[4]

The actuary has also reported that a collective pension plan would be subject to less volatility than an individual one; that the pension paid would, on average be more predictable.

But why does collective saving make such a difference? This paper describes the difference between collective and individual savings: why the latter can be more efficient; what issues need to be addressed in setting up a collective saving system; and, critically, what the pitfalls are and how they can be avoided. Because, while collective pensions can offer better returns, they require a governance structure which ensures they are run in members' interests, and not subject to misselling or mismanagement. So, for example, they need to avoid the problems which emerged in endowment and 'with-profit' policies.

This paper should be of interest to any sizeable company which is aiming to provide the best value pensions for its employees. It should also be of interest to trade unionists or other worker representatives seeking good pensions for their members. And, of course, it should be of interest to pension trustees and those who advise them.

Because if the government's figures are not mistaken, there are highly productive pension solutions available, which are not currently used by British employers.

4. *Modelling Collective Defined Contribution Schemes*, Government Actuary, December 2009

Some history

Britons are familiar with collective pension savings. When the country's leading employers set up their pension plans last century, they were organised as big collective pots into which employer and employee both contributed. The contribution aimed for, but did not promise, a pension at a level usually related to final salary. And the government offered handsome tax advantages to stimulate pension saving.

In the 1990s, pension schemes seemed well-funded. Employers therefore asked to take 'contribution holidays', since it was felt no more would be needed to meet the pension promise. And, indeed, the government encouraged them to do so, to avoid the loss of tax revenue. Of course pension trustees were keen to ensure the aims of the funds would be met, and so asked for an assurance from the sponsoring employer that it would guarantee the target pension would be paid; that it was a defined benefit (DB) to be met under all circumstances.

However, over time, longevity increased and returns from investment fell. Accounting treatments made explicit the scale of pension deficits, on a 'mark to market' basis, which proved quite volatile. Many sponsoring companies felt they could no longer sustain the pension promise and so closed their DB pension plans to new employees, instead offering them a 'defined contribution' pension. Employer and employee still made contributions, but these were made into an individual savings account, where the scale of the benefit depended on the amount saved and the size of the pension it could buy at retirement age. These were known as individual defined contribution (IDC) pensions; the saver was responsible for his or her own saving.

So Britain ended up with a two-tier pension system of DB and IDC pensions. But there were other ways to fill the gap between DB and IDC pensions. One was to go back to a system of target benefits, where all members of the pension plan pooled some of the risks, rather than individuals carrying the full burden. Such a system would be known as collective DC (CDC). And there could be other variations, such as where the employer also shared some of the risks – known as hybrid pensions. These pension characteristics are illustrated in Table 1; so for example, in a DB scheme there is a known benefit, in hybrid and collective DC it can only be a target, in individual DC the benefit is not known.

Table 1: Pensions – some variants

Defined Benefit	Hybrid (eg conditonal Indexation)	Collective DC	Individual DC
Known Benefit	Target benefit		Unknown benefit
Sponsor guarantee		No sponsor guarantee	
No link to funding	Indexation conditional	Benefits conditional	100% link to funding
Sponsor has all risks	Member/sponsor share risks	Members share risks	Each member has own risks
Collective	Collective	Collective	Individual

There are therefore many different types of collective provision. We will now focus on collective DC, where only the plan members share the risk, though we recognise different forms of risk-pooling may be appropriate in different circumstances.

Why does collective DC provide high returns?

Collective investment provides better returns, in part because it is relatively low-cost to administer, but also, and more important, because it allows savers to pool their risk.

Most of us are familiar with investment advice telling us not to put all our eggs in one basket. Of course, one investment may turn into a gold mine, but equally it might be a dud; at the point when you invest you do not know and the expected return from different investments may look the same.

If the risk of making only one investment is high, all else being equal, it makes sense to invest in a few, different opportunities. The *expected return*[5] will be the same but the risk will be lower. This investment theory is known as diversification. Used properly, it is fundamental in maximising the reward relative to the risk from investment management.

What is true for managing investment assets is also true for managing pension liabilities. Imagine two young people about to save for their pension. They intend to retire at 65, and expect to live, on average, until they are 80. But they know it is likely one will live to 70 and the other until they are 90 – they just don't know who will be the lucky one. What should they do? To be on the safe side, they could start saving until they have enough set aside for a life expectancy of 90, which means they will live for 25 years in retirement. But that will cost them both a great deal.

Alternatively, they could 'insure' their lifetime income by buying an annuity when they retire; that is a promise of an income throughout their remaining life. But this annuity will be costly. According to government statistics, if someone who expects to have a normal life expectancy buys an annuity to provide them with a real retirement income, about 25 pence in the pound from their purchase will go on costs charges and reserves set aside by the annuity provider. So a quarter of their possible retirement income disappears.[6] The sensible thing would be for our pension savers to save together. If one lives to 90, they will be provided for by the savings of the other. Both will have a secure income in retirement, but at a very much lower cost.

And if you imagine hundreds of thousands of people all saving together, there are all sorts of risks, and benefits, they can reasonably share. For example, as they reach retirement age, there would be less need to sell out

5. That is the return expected before the event, calculated as the return from all outcomes multiplied by the probability of achieving those outcomes.

6. See ,Cannon, Edmund and Tonks, Ian, *Money's Worth of Pension Annuities,* Department for Work and Pensions Research Report No 563, 2009

of all risky investments and turn them into cash to buy an annuity. So returns could potentially be higher.

Several studies have been done on where the advantage of collective investment derives from. All conclude that it provides a huge uplift in benefit. We discuss these below, and have illustrated the approach taken, and the outcome of each of the studies, in Table 2.

Table 2: Recent studies on the advantage of collective investment

Title	Author	Study approach	Study question and method	What uplift in pension will collective provision provide?	Comment
Risk sharing in defined contribution schemes[1]	De Haan, van der Lecq, Oerlemans, Van der Wurff	Compare DB and IDC.	Without annuitisation, how much more will need to be saved to be 97.5% certain that a DC outcome will cover a DB, promise Monte Carlo simulation.	+145%	This study method may exaggerate the benefit from CDC by assuming people have to "over save" to insure against longevity, rather than buy an annuity.
Bang for the Buck, 2008[2]	Almeida and Fornia	Ditto	Ditto	+83%	Ditto
Modelling Collective Defined Contribution Schemes, 2009[3]	Government Actuary	Compare CDC to IDC. Uses appropriate assumptions on costs and investment policy to project outcomes.	Monte Carlo simulation.	+39%	This study assumed some cases where benefits were fixed. As a result, in extreme cases, the pension could go bankrupt. CDC schemes can never be designed with foolproof guarantees, though they should be able to hit targets.
Collective Pensions in the UK 2012[4]	David Pitt-Watson Harinder Mann	Ditto	Assuming different levels of returns and costs	+37%	(This paper)
Private Study[5]	Hamish Wilson	Ditto	Ditto	35–45%	
DWP Risk Sharing Consultation, June 2008[6]	Hewitt Associates	Ditto	Ditto	+25%	See footnote

7. Quoted in presentation by van der Lecq, to Conference on Risk-Sharing in Defined Contribution Schemes, University of Exeter, January 2010

8. Almeida, Beth and Fornia, William, A Better Bang for the Buck, *The Economic Efficiencies of Defined Benefit Pension Plans*, National Institute on Retirement Security, August 2008

9. *Modelling Collective Defined Contribution Schemes*, Department for Work and Pensions, December 2009

10. Pitt-Watson, David J, Mann, Harinder, Collect*ive Pensions in the UK*, RSA, July 2012

11. Quoted in article by Hamish Wilson, *Collective Bargaining,* Pensions World, November 2011

12. Tables b.5 and B.6, *Risk-Sharing Consultation,* Department for Work and Pensions, June 2008. Note both tables show significant upside and less risk from CDC. Table B.5. shows the advantage before modelling the lower costs of CDC. This gives a 15% premium, with lower costs. Table B.6. shows a 25% premium. If comparisons were made on an equal risk basis, the upside from CDC would be higher.

What generates pension costs?

However, before turning to this evidence, it is important to reflect on how the costs and returns from pension investment build up. This is because very small differences in annual costs or investment returns make very big differences to pension outcomes.

Let's imagine two 25-year-olds who begin saving for their pension. Both invest the same amount in real terms every year. They both retire at 65 and die at 85. Inflation is 3% and both get a 6% return on their savings. The only difference is that one saver, Ms Canny, ensures that the pension charge is kept at 0.5%, while Ms Hasty allows herself to be charged 1.5% per annum. So how much more pension does Ms Canny receive? Her pension will be nearly 50% higher. A small difference in charging compounds over the years to give a substantial difference to pension outcomes.

What is true for costs is also true for returns. A 1% higher return will, over the 60-year lifetime of Ms Canny or Ms Hasty's pension, lead to a 50% higher pension.

So what is the difference in costs and returns of collective and individual pensions? Research from the Dutch Central Bank showed that the costs for a collective pension in Holland were, on average, 0.15% of total assets. For a corresponding individual Dutch DC plan, these costs are 1.27%.[13] This is not to say that individual DC plans are bad. They are, for example, the only option for those who have no-one with whom to share their pension risk, or who want a pension tailored to their specific needs. IDC offers a huge range of choice which may be preferred by those who are sophisticated investors.

But if the aim is to provide the highest income, for the same risk, to individuals who do not want actively to manage their pension plan, a properly constructed collective scheme will give a better outcome.

It is difficult to make like-for-like comparisons between CDC and IDC pensions because at some point, the IDC pension is used to buy an annuity. However, we can make some intelligent estimates of the differences.

Let us start with the same assumptions about saving period, annual returns and retirement age we used for Ms Canny and Ms Hasty. Let us assume that during the saving period, the IDC pension costs 0.3% per

13. The study is discussed in Bikker and de Drue, "Operating Costs of Pension Schemes", from Steenbeck and van der Lecq, *Costs and Benefits of Collective Pension Systems*. The figures quoted exclude a further 1.08% profit taken by the insurance company offering the individual pension. Caution should be used in interpreting these figures, since some of the insurance plans were relatively small and immature. Therefore in this study, a much narrower gap between IDC and CDC costs has been used.

annum more in total charges, both declared and not declared during the saving. And assume that, in the five years running up to retirement, the IDC pension is invested more conservatively and, as a result, loses 1% of its return. It is then used to purchase an annuity which, after all costs, yields 80 pence in the pound.

This scenario does not include any advantage a collective pension might have due to a more aggressive investment approach, other than in the five years leading up to retirement. So these are fairly conservative assumptions, and we believe they compare good CDC schemes with good IDC schemes. Table 3 shows how each of these differences affect the pension outcome.

Table 3: Improvement in pension outcomes from a move to collectivity

Lower Cost (0.6% vs. 0.3%)	+10%
No Annuitisation (Annuity Cost 80%)	+22%
Less Conservative Investment (1% for 5 years)	+5%
TOTAL	**+37%**

The result is startling. The CDC pension offers around a 37% better outcome than the IDC. These figures are in the same ballpark as the Government Actuary's study and the other studies shown in Table 2.

The assumptions made can be varied; perhaps there is a greater or a lower cost advantage, perhaps annuities can be more or less cost-effectively purchased than government statistics suggest. A CDC provider may make considerably higher returns. Further, it may be possible to run pensions which have some IDC and some CDC characteristics; for example, by having collective annuity provision. But they clearly illustrate the huge advantage collective investment can give.

What are the pitfalls with CDC?

So, if CDC pensions are such a good idea, why doesn't everyone have them? There are two reasons.

The first is that, from the beneficiaries' point of view, CDC schemes need to be particularly trustworthy. Everyone will be saving into a common pot and after retirement some will be taking money out. Who decides how much they can take out? If you set that number too low, older people will subsidise younger ones; too high and the opposite happens. So beneficiaries have to accept that someone working on their behalf will make the best judgement possible. This can cause some tensions. If, for example, life expectancy fell relative to expectations, the younger generation benefits – and they will suffer, if the opposite happens. How these issues are managed is a point of active debate in Holland. However, the point is this: if a system can generate such a level of trust, it will be 37% more efficient than one which only depends on contract. Good governance and appropriate regulation are needed for CDC pensions to work.

What must be avoided is that the person managing the pension can do so to *their* own benefit, but not to that of the pension savers. For example, a scheme sponsor cannot use unexpectedly good investment returns to attract new customers. It must keep charges low; as we have seen very small changes in pension terms and conditions can make huge differences to the outcome. Without protection from these sorts of problems, collective pensions will suffer the problems experienced by 'with profit' insurance and endowment policies.

So, CDC pension schemes need trustee management. That is, to be managed by those whose interest is, first and foremost, the beneficiary, and not their own profits. Indeed, this may be one reason why so little is heard about the advantages of collective provision – because they have little incentive to find new customers. Those who establish and run collective pensions must limit the profit they take from them. There is little 'market' incentive to promote collective provision. So collective pensions require a 'sponsor', such as an employer or employee organisation, willing to act in the beneficiaries' interests .

The second reason CDC pensions have not been universally adopted is, from the sponsor's point of view, the concern that CDC schemes would leave them with a liability. As we have seen, sponsoring employers have abandoned DB pensions because they feel they cannot accept the risk of taking on the liability of the pension promise. In the past, the legal situation made this particularly problematic. Many felt the courts would interpret any collective provision as though it included a defined benefit.

Therefore, many experts assumed C DC, where risk was shared among the beneficiaries but not by the sponsor, would be illegal.

We are delighted that this situation is now changing.

Now there is a range of different legal models which incorporate the characteristics of DC and DB pension provision in differing degrees. The key features of CDC pension provision include:

- Targeting a particular level of benefit, but without any guarantees.
- Investing contributions in a collective fund.
- Smoothing or adjusting benefits on a discretionary basis to target benefit levels.
- Providing an internal annuity in whole or in part, to maximise investment returns beyond the members' retirement dates.

In June 2011, the Supreme Court's decision in *Bridge v. Houldsworth* upheld the principle that a pension scheme with some or all of the above features could be a DC scheme, and so sponsors would not be faced with an unexpected liability. In particular, the Supreme Court found that the provision of an internal annuity and investment guarantees was not incompatible with a DC scheme.

This represented a potentially significant change to UK law, and perhaps one which might have negative as well as positive consequences. The government therefore legislated to ensure there was still a clear separation between pensions offering a defined promise, and those which did not. That, of course, leaves open the possibility of a collective DC regime, provided it is clear the pension is an 'expectation' which can vary should circumstances change, and not a legal promise.

At around the same time the pensions minister told the NAPF conference: "I would like to facilitate as best I can any element of risk-sharing, any element of promise or guarantee." And the government has the powers to do precisely that.

So, properly constructed, collective DC pensions are already legal in the UK.

The key issue is to ensure that it is impossible for a funding deficit to arise in respect of any benefit the CDC plan offers. So, for example, if the plan incorporated a life insurance policy, this would need to be separately contracted for. So it is possible to design CDC pension schemes which fall within the DC regime, not DB legislation. And there appears to be a political will to go further, and allow other hybrid risk-sharing to take place.

This suggests a new future for British pensions built on some of the lessons learned from Holland. UK law does allow us to provide much more productive pensions than are currently on offer here, and millions of people can be provided with a better retirement income at lower cost.

As an aside, we would note that, even if this were not the case, it would still be possible to set up Dutch-style pensions in the UK, simply by establishing the pension in Holland or in some other European jurisdiction where collective DC pensions are understood and case law is clear. The EU treaty makes such pensions legal in the UK, just as there are many other investment products which can be sold throughout the EU as a result of European competition law.

Who should be thinking about CDC pensions?

These conclusions are of profound importance to employers and employees. In offering workplace pensions, employers wish to provide a benefit to their employees. Designed within a collective framework, those pensions can be worth much more than if they are offered individually. So, if an employer recognises a certain level of benefit as being good for their employee (dependent on salary and length of service), they can provide that benefit at a much lower cost through CDC than through IDC. Neither will crystallise a liability on the balance sheet.

However, to establish a collective pension requires an adequate number of participants to begin the 'collective'. This means that, until joint employer schemes can be established, small employers may find less value from a collective approach. And those wanting to offer defined contribution pensions to new employees only may also be constrained by lack of numbers. This does not preclude either of these groups from establishing CDC pensions, though it makes it more complex.

But there is one group for whom collective defined contribution should be of clear and immediate benefit. That is employers considering the closure of their DB pension plans to existing members. If they take this action and move to an IDC framework, then even if they pay exactly the same amount, the expected pension benefit they offer will be substantially less, because of the move from collective to individual provision. So employees not only lose their pension guarantee, they can also expect that their pension will be about 30% less.

However, that drop in the expected value of the pension can largely be avoided by continuing with collective provision, albeit without a defined benefit promise. CDC is therefore the natural replacement for Britain's DB pension system, and the best long-term solution for preserving adequate pensions while avoiding employers being faced with a potentially unsupportable pension liability.

And collective DC may also have attractions to occupational individual DC plans which are of adequate scale, and where the members are concerned about the level of benefit they offer.

But why has there not been a louder chorus demanding the creation of collective DC in Britain? To answer this question requires an understanding of the difficult position in which employers, and indeed worker representatives, find themselves when they contemplate a change in pension provision.

The politics of DB provision

The establishment of Britain's occupational pension system has been a great example of what consensual politics can achieve. Anyone who has sat at a pension trustee meeting will understand that it is almost always a place where employers and employees work hard to find a common point of view.

But there are certain circumstances where a common point of view is very difficult to achieve. One of these is any fundamental change to the pension's terms and conditions.

In this paper, we have suggested that the most obvious place to introduce collective DC would be in place of existing DB schemes. That does not mean that CDC is better than DB from an employee's point of view; it is not. In a DB regime, the employee has a guarantee, underpinned by the sponsor and by the Pension Protection Fund. So it offers lower risk, even if the expected return is similar to that of CDC.

While a CDC plan may not be as good as a DB plan from the employee's point of view, it is much better than an individual DC plan, which, for the same cost, will give both higher risk and lower return. So employers and employees find themselves in a difficult position. Employers are reluctant to discuss the closure of DB schemes with employees. Employees are unwilling to discuss CDC in case it suggests they are supporting the closure of DB. Already, we have seen that the DB system is being allowed to wither on the vine as most DB plans are now closed to new entrants. But worse than that, there is now an increasing expectation that we are likely to see a flood of DB plans being closed even to their existing members.

If this is to happen, we urgently need a dialogue between employers, employees and their representatives that finds an effective replacement to the DB system of pensions; one which offers adequate pensions, but which does not ask the sponsor to take on unrealistic obligations.

Breaking the logjam

The work of the RSA's Tomorrow's Investor project has therefore sought make sure that employer, employee, trustee and consumer groups are closely involved with our work. We are delighted at the consensus which still exists among these groups. At the launch of our last paper,[14] we received the warmest and most constructive welcome from the CBI, the TUC and the NAPF.

All welcomed the opportunity to introduce collective DC.[15]

It seems to us that such openness to reform, in particular by the premier organisation representing working people, suggests that the trust and cohesion necessary to build an effective system of collective pension provision are still evident in the UK. We also note the strongly supportive voices coming from the newly formed Association of Member Nominated Trustees.

The message is clear: if sponsoring employers are willing to do so, it is possible to provide much higher pensions for most employees of large companies and to do so at equal cost. The law, though complex, allows this to happen; politicians and worker/pensioner bodies have shown their support in principle.

Unfortunately, there is little incentive for 'market forces' to encourage suppliers who promote the introduction of collective pensions. But with intelligence and goodwill, with dedication and integrity, we are convinced those involved in constructing occupational pension provision can find a way forward.

To that end, the RSA will be happy to offer whatever support it reasonably can in terms of expertise, of contacts and of background research. We can be reached on the email address below.[16]

Over the past year we have seen marked progress in many pension policy areas on which the RSA has been campaigning. For example, we now have two suppliers of individual DC pensions which are offered on similar terms to NEST, but without the restrictions the government placed on the latter. And the restrictions themselves are now the subject of a parliamentary inquiry.

But there is another important reform which will be needed if Britain's occupational pension system is to rival the best in world. That is the reinstatement of collective provision at the heart of our pension system. We hope this short paper goes some way to explaining to those responsible for pensions why this debate is so important, and how it might best be moved forward.

14. Tomorrow's Investor: *Building the consensus for a People's Pension in Britain,* RSA, 2010
15. See discussion at www.thersa.org/projects/enterprise/tomorrows-investors
16. harinder.mann.consultant@rsa.org.uk

And we trust that, in the future, if a Dutch and a British person save the same for their pension, they will enjoy comparable incomes in retirement.

The RSA: an enlightenment organisation committed to finding innovative practical solutions to today's social challenges. Through its ideas, research and 27,000-strong Fellowship it seeks to understand and enhance human capability so we can close the gap between today's reality and people's hopes for a better world.

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Projects

8 John Adam Street,
London WC2N 6EZ
+44 (0)20 7930 5115

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