COLLECTIVE DEFINED CONTRIBUTION PENSIONS

2020 Pension Schemes Bill: establishing collective defined contribution pensions in the UK

Briefing note

DAVID PITT-WATSON AND DR HARI MANN

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About the RSA

The RSA (Royal Society for the encouragement of Arts, Manufactures and Commerce) believes in a world where everyone is able to participate in creating a better future. Through our ideas, research and a 30,000 strong Fellowship we are a global community of proactive problem solvers. Uniting people and ideas to resolve the challenges of our time.

About the project

The CDC Pensions Forum emerged from the RSA's Tomorrow's Investor programme which began in 2008. This examined the UK pension system and whether it could be improved to deliver better outcomes for savers and the wider economy. One of its recommendations was that the introduction of CDC schemes would provide a better income in retirement than most of the existing options available. Following the decision by Royal Mail and the Communication Workers Union to commit to delivering the UK's first CDC scheme in 2018, the Forum has aimed to support the policy debate and ensure that we take the opportunity to establish CDC plans that benefit the saver, within an effective regulatory framework and with appropriate governance. The Forum has published several publications to support this work and will host a series of events in 2020.

Acknowledgements

The authors are grateful to the Royal Mail for supporting this project. This briefing paper was written by RSA Fellows David Pitt-Watson and Dr Hari Mann, the team behind The RSA's Tomorrow's Investor project, with significant contributions from some of the leading legal and actuarial firms in the country. Special thanks go to Matthew Arends of Anon, Jeremy Goodwin of Eversheds, Simon Eagle of Willis Towers Watson, Derek Benstead of First Actuarial and Henry Tapper of Age Wage – their contact details can be found on page 14. This paper was proofread by Eleanor Toner and Mark Hall and typeset by Jillian Linton at the RSA. Any mistakes are the sole responsibility of the authors.

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Executive summary

On 7th January 2020, the government introduced a Pension Schemes Bill to the House of Lords, similar to the one introduced in October 2019. Part of the Bill will enable the establishment of Collective Defined Contribution (CDC) pensions, known as Collective Money Purchase (CMP) schemes in the Bill, in the UK. This measure was already promised in both Conservative and Labour Party manifestos,[1] and supported by the Work and Pensions Select Committee. Its immediate effect will allow the introduction of CDC, should companies and their employees wish to do so. Royal Mail and the Communication Workers Union (CWU) have already committed to CDC but the measure has potentially much wider implications for pensions in Britain. We therefore believe there are three key messages of which legislators might want to be aware.

1. For many years the RSA has campaigned in support of CDC in the UK. We believe it will make a very important contribution to pension provision. We therefore firmly support the Bill.

2. If CDC is to deliver its full benefits and avoid potential pitfalls, this must be done within an effective system of governance and regulation – this note discusses what those are and is generally positive that they are covered in the legislation.

3. CDC offers very considerable benefits. The present legislation will be effective for large employers such as Royal Mail, but its benefits could be spread more widely. It is important that those who are making pension policy have some vision of how CDC might be best encouraged to develop over the coming years, so that as many people as wish to can save in a cost-effective manner for a pension income which will last the length of their lifetime.

1. The Conservative Manifesto 2019 said “we will reintroduce legislation that… creates a new style of pension scheme which is more sustainable for workers and employers”. The Labour Manifesto 2019 said “we will legislate to allow the CWU-Royal Mail agreement for a collective pension scheme to proceed and allow similar schemes”.

Background

Our starting point is that, for many, **the ultimate goal of a pension is to create an income which lasts until the end of their life, typically starting when they retire. CDC is a good way to provide such a pension cost-effectively. This is particularly relevant in the private sector where there are few other ways to provide a cost-effective pension as an income for life.**

There are other pension structures for example state pensions, pensions for the Civil Service, the NHS, teachers, and the army. They are provided on an unfunded, pay as you go, basis. However, only the government can provide such pensions relatively securely since it has powers of taxation.

Alternatively, individuals can simply save for themselves, choosing their own investment strategy and choosing how to draw down from those savings in retirement. This is currently a common approach in the UK via ‘Defined Contribution’ (DC) pension funds or otherwise.

There is a problem with drawdown that has been observed in Australia and South Africa where it is more established - if everyone saves enough to last them until the upper end of the range of their possible lifespan, most people will save more than necessary; if everyone saves enough for an average lifespan, half of them will run out of money in old age when most vulnerable.

That is why the most effective pension systems allow individuals to share ‘longevity risk’. Individual savers can currently do this by buying an annuity when they retire. Indeed historically, individual pension savers were, in effect, forced to buy an annuity. Annuities can be expensive however, and in 2015 measures were introduced to allow DC pension savers to use their money in other ways.

An alternative way to share longevity risk is through a ‘Defined Benefit’ (DB) scheme. In the past this was the backbone of the UK occupational pension system and the way in which the majority of workers were provided with occupational pension benefits. When DB originally became popular in the middle of the 20th Century, DB pensions had a degree of flexibility in the way in which they were operated and the benefits they provided. However, during the 1980s and 90s, DB pensions looked like they had more than enough to meet their needs, and companies took pension contribution holidays. In response, legislation and other factors successively hard wired the DB pension promise, including ensuring that they were largely inflation proof. With falling asset returns, rising inflation levels, and lengthening member longevity these guaranteed inflation-proof pensions ultimately became unaffordable for private sector employers, and most DB plans are now closed or closing.

CDC offers a middle ground. Similar to early DB, it offers an income in retirement but with some flexibility in the pension paid. Like DC, the pension can only be paid from the money which has been subscribed. Legislation needs to be clear that a CDC pension scheme cannot ask the employer for further funds beyond those which it is already committed. Versions of this system operate in the Netherlands, Denmark, and other countries which are generally considered to have some of the best pension systems in the world, albeit all have encountered issues with their pension systems which offer important lessons for the UK.

Benefits versus pitfalls of CDC

The benefits of CDC are considerable. CDC is likely to provide a much higher income in retirement than the alternative of individual saving and then buying an annuity. All studies suggest that CDC will give at least a 30% higher retirement income than a conventional DC scheme with an annuity. This is achieved through its ability to share risk to support targeting higher asset returns than is possible for an annuity provider (a summary of these studies is provided in Appendix 1).

In the build up to retirement CDC can also offer a more predictable outcome than an annuity for which the level depends on asset values and annuity prices on the day it is purchased, making it fairer. It can provide a pension to members by default, without each individual needing to choose their own investment strategy or choose between a wide range of options at retirement.

There are some potential pitfalls. There is no guarantee on the level of a CDC pension. Whatever pension is paid by the pension fund must be met by the resources of the fund itself. Unlike DB, it cannot go back to the employer and ask for more. So, it needs to be possible for CDC pensions to vary if future events prove better or worse than predicted. Such changes may not be very dramatic and can generally be accommodated by raising pensions by more or less than inflation. However, sometimes pensions, including those in payment, might need to be reduced. For example, following the 2008 financial crisis the Dutch reduced CDC pensions by 2% on average.[2] Those enrolled in a CDC pension plan need to know the nature of their pension, and feel justifiably confident that the design of the scheme will result in pensions which are fair for all.

2. Marriage, M. (2014) Dutch defend Queen's UK pension plan. *Financial Times,* [online] June 7. Available at: https://www.ft.com/content/c17af398-ec92-11e3-8963-00144feabdc0

The Pension Scheme Act 2015

The benefits of a more flexible pension system have been apparent for some time. In 2015, with cross party agreement, Parliament passed an Act which would have allowed CDC and 'Defined Ambition' pensions. However, the Act was constructed in such a way that it was designed to change the entire pension system. Therefore, it was never acted upon.

In 2018, Royal Mail and its unions agreed they would like to establish a CDC structure to replace the closing DB scheme. Their advisors noted that although such a structure could not yet be established, Parliament had agreed in principle to it being introduced.

The key thing was to establish a practical mechanism to do so. That is what the 2020 Bill seeks to do.

The Pension Schemes Bill 2020

The 2020 Bill (the Bill) covers three main topics: CDC, Pension Dashboard, and other measures to protect DB pensions. This briefing relates only to CDC.

The Bill provides the legislative framework for CDC Pensions. It is written in a way which makes clear the areas where regulation will be required. It also outlines the foundations on which that regulation will be made.

The present legislation is intended to allow the Royal Mail proposal to proceed and allow other private sector organisations to create similar arrangements. It does not allow for unrelated companies to work together, to create a single CDC pension plan. Since effective pensions require some economies of scale, this in effect excludes small companies from the option of CDC, at least for now. Clause 47 gives the government powers to allow multi-employer CDC schemes and/ or providers to offer CDC Master Trusts, to remove this constraint for small employers. In our view, once employer schemes are up and running and working well, we would encourage the government to act on this.

Regulatory and governance issues to be addressed

The Bill covers regulatory and governance issues points. However, we believe further discussion is warranted. In this briefing, we touch on the most significant issues, and why they are important.

Trustee governance:

Pension systems are best operated by entities which owe a duty only to work in the interests of the beneficiaries. This is particularly important where choice is complex and suppliers can be tempted to behave in a way which is not in beneficiaries' interests. It can be achieved by ensuring the pension fund is governed by trustees – particularly those nominated by the members. Of course, such trustees can and should employ professional advisors, administrators, and fund managers where they can offer a better service. But they do so only in the interests of beneficiaries. In a world where savers are often unaware of how their pension fund is managed the protection provided by effective trustee governance is important.

Actuarial expertise:

CDC pensions require careful calculation of what is the appropriate level of pension to pay. Such actuarial calculations are common in the financial system, for example for life insurance premiums. They also need to be incorporated within a CDC system to be sure that pensions are fairly delivered in accordance with the mechanisms established at the outset of the scheme's design and as communicated to its members.

Communication with members:

This is particularly important in CDC. CDC pension levels are not guaranteed; instead there is a promise to pay CDC pensions in accordance with the rules explained to the member when they join the scheme. During stable times, CDC payments may seem very reliable, however when any unexpected change is made this may be met with concern. This is what happened in the Netherlands after the 2008 financial crisis. On average where there were reductions, pensions in payment were reduced by 2%. One fund had to reduce by 6%, to make the actuarial calculations balance. The Dutch system had seen no adjustment for many years, nor had the potential for reductions been clearly communicated, so the reduction caused much furore.

Protection of the sponsor:

DB pension plans were closed because they proved risky and unaffordable by the companies sponsoring them. Additionally, under DB, pension liabilities were recognised on the company's balance sheet. Many companies felt that the pension legislation that was introduced created obligations to which they had never agreed. They are unlikely to back CDC pensions if there is any likelihood that new obligations could be placed upon them through reclassification in future. Legislation needs to be clear that this will not happen.

Linkage to other parts of the UK pension system:

Legislation should be drawn up in a way which fits with other parts of the pension system. CDC pensions should be transferable, for example, so that the DC pension freedoms are available to CDC members. The communication of the potential CDC pension level could in part be adapted from the approaches currently used in DC, and it is desirable that the tax treatment of CDC pensions is based on a combination of current DB and DC pension tax treatments, as appropriate.

Transferring pensions:

In establishing transfer rules it is important to get the balance right. Savers should have pension freedoms but the transfer system should not be such that CDC savers are encouraged to transfer out without properly assessing whether it is in their interests - individually and collectively - to do so. There is a provision in the Bill to allow the Regulator to temporarily ‘pause’ the transfer option, which mitigates the risk of large-scale transfer out of the system due to misinformation. This would allow the trustees time to explain to members why the CDC pension still represents good value for money. Consideration is also required to transfer advice requirements in a way which is practical for independent financial advisory firms to meet.

What can and cannot be achieved:

All these potential issues surrounding CDC can be addressed - we know this since they operate successfully in other countries - but none can be addressed perfectly, because the future cannot be predicted with certainty. As one observer of the Dutch system noted “all are better off but some are better off than others”. In designing CDC systems, it is important that its design is simple, so that it can be easily understood. It is also important that any material difference in benefit levels result from unforeseen uncertainties, not from the design of the pension plan itself so that younger or older people don’t benefit at the others’ expense, for example. Trustee governance, expert actuarial guidance, clear communication, simplicity, and integration into the existing pension system will be key elements in the successful development of CDC.

Where concerns have been raised

There has been some opposition to CDC. Some arises from the belief that there will be **little demand** for CDC. **The advisors to Britain's pension funds contributing to this briefing believe that there is latent demand, however it is not very apparent while CDC pensions are still being written into law.**

Other opposition has arisen from **turning a blind eye to the advantages of CDC and focusing on whether the considerations above may prove unmanageable.** For example, some talk about intergenerational unfairness and have said that trustees will always pay out too much to existing pensioners, and younger members will be disadvantaged. Others have focussed on the reduction in payments in the version of CDC in the Netherlands, post 2008, missing the point that for the main alternative of DC pensions, pension expectations started at a lower point and also typically fell before retirement under the same circumstances. Technical details have been raised, such as how a CDC scheme could be closed should the sponsor fail. Many of these are perfectly sensible issues to raise and debate. Similar issues exist with other pension and life insurance arrangements and clearly the governance and regulatory system must be designed to cope with these issues.

In general, we believe that the Bill provides a good framework for the introduction of CDC for Royal Mail and other employers, particularly noting that the Regulator will act as a gatekeeper to ensure only well-designed CDC schemes can open. If we had two detailed points which legislators might review they would be:

- That authorisation requirements for opening a CDC scheme, and the process to certify ongoing viability, do not prove too cumbersome.
- That there is a proper balance of prescription in scheme rules and trustee, actuarial, and regulatory oversight. We think there is, but this governance issue is worthy of debate.

The more important issue is how CDC might develop in the future. It is on this point where we think a continuing dialogue between the government and Parliament would bear most fruit.

Opportunities

The immediate focus for CDC is with Royal Mail. However, CDC is potentially a very big opportunity for pension policy. Academic and actuarial studies suggest that, over time, CDC will yield 30%+ higher pensions than are currently available through individual savings and annuities. This is an enormous sum. About 6% of GDP is spent on private pensions—they represent £3 trillion of accumulated savings.[3] A more effective pension system could make a huge contribution to addressing welfare and poverty in old age. It could also be a source of capital for renewed investment.

There are several opportunities for its broader introduction. All need to be carefully thought through, so that we end up with a system which is designed to be 'fit for purpose'. For example, **this might mean that we should design a system suited to a limited number of funds each of which enjoys economies of scale. We might encourage similar administrative and other systems, so that people can readily move their pension when they change employers or enter self-employment.**

How might things develop in the future?

- It should surely be possible for groups of employers (such as those in the same industry) to get together to introduce CDC. Otherwise smaller companies are placed at a disadvantage as they cannot access CDC cost effectively.
- The biggest gap in Britain's pension system is not in the savings phase; automatic enrolment has proved a success in getting most employees to save but there is a gap when people retire. People generally say they want a regular retirement income,[4] but most aren't buying insured annuities presumably because of their relative expense.[5] CDC could readily be a popular model to allow people to buy with their DC savings a cost-effective – albeit non-guaranteed – pension which will last for the rest of their life.
- The National Employment Savings Trust (NEST) already provides a default pension saving fund for the accumulation stage. Might they be encouraged to provide a CDC default particularly for smaller employers? And might they, together with others, offer a cost-effective system for pensions in payment, as described in the bullet above? In both cases, these could be offered alongside commercial providers.
- We currently lack an effective pension system for the self-employed. CDC Master Trusts could be a solution for them, just as it is for those in employment.

Conclusion

If the 2020 Pension Schemes Bill and accompanying regulations are appropriately finalised and enacted, this will allow Royal Mail and other employers to introduce CDC. This is an important step forward.

However, there are other important areas where CDC can help ensure the UK has an occupational pension system which is fit for purpose; that it provides an income for the rest of your life. The UK has yet to develop a clear consensus about how this might best be achieved. While we support for passage of the Bill, we believe it is an opportunity to begin that discussion.

Citations from previous page:

3. ONS and RSA analysis

4. WTW, for example, reported that their Global Benefits Attitudes Survey 2017 (UK polling) revealed that 60% of members want a guaranteed monthly payment (although this detail was not included in the published global summary).

5. See the FCA's retirement income market data 2018/19 which showed that 11% of at-retirement DC product purchases in the year to March 2019 were annuities. Available at: www.fca.org.uk/data/retirement-income-market-data.

Further Information

For further information on any of the issues raised in this briefing please contact Mark Hall, Deputy Head of Engagement at the Royal Society of Arts (RSA) at mark.hall@rsa.org.uk.

You can also find details of the key contacts at those organisations who provided input for this briefing below.

Aon	Matthew Arends, Head of UK retirement policy at Matthew.arends@aon.com 020 7086 4261
Eversheds	Jeremy Goodwin, Pensions Partner at JeremyGoodwin@eversheds-sutherland.com
Willis Towers Watson	Simon Eagle, Head of CDC (GB) and Senior Director at simon.eagle@willistowerswatson.com 01737 274670
First Actuarial	Derek Benstead, Senior Consultant at Derek.benstead@firstactuarial.co.uk
Age Wage	Henry Tapper, Founder at henry@agewage.com

Appendix 1: Review of studies about CDC outcomes

In this Appendix we review the studies which have been done to evaluate CDC. All show a 30 percent plus upside for CDC over DC saving plus annuity, which we believe is the best like-for-like comparator. Indeed, the latest study commissioned by the DWP suggests a higher upside than that.

Almeida and Fornia simply look at how much more you need to save individually if you want to be 97.5 percent sure that you will not run out of funds before you die. They compare that with a situation where longevity risk is shared and effectively eliminated. They conclude that the cost of the former is more expensive by **83 percent.** This is equivalent to a comparison of DC plus drawdown.

www.open.ac.uk/ikd/sites/www.open.ac.uk.ikd/files/files/events/financial-institutions-and-economic-security/a-better-bang-for-the-buck.pdf

In reality, a saver can buy an annuity. The **Government Actuary** modelled this some years back. Part of their model though assumed that a CDC scheme had made hard promises and so could become insolvent (that should never be part of the design). However, their upside for an open CDC scheme compared to DC was **39 percent.**

See first paper in this zip file:
http://data.parliament.uk/DepositedPapers/Files/DEP2009-3147/DEP2009-3147.zip

At **the RSA** we did a very simple 'cost accounting', looking at where the upside comes from in terms of cost and return. We calculated an upside of **37 percent.**

www.thersa.org/globalassets/pdfs/reports/collective-pensions-in-the-uk.pdf

The RSA with Aon then worked on the modelling of DC versus CDC, starting from 1930. This models what would have happened to an individual who saved for 25 years and then retired, comparing DC and CDC outcomes. Our publication also reviews other literature.

www.thersa.org/discover/publications-and-articles/reports/collective-pensions-in-the-uk-ii

Aon's full study explains their assumptions. It yielded a **33 percent** upside, on the best like-for-like comparison.

www.aon.com/unitedkingdom/attachments/aon_hewitt/dc/Aon_Hewitt_The_Case_for_Collective_DC_Nov13.pdf

www.aon.com/unitedkingdom/attachments/retirement-investment/defined-contribution/Collective-DC-Stability-and-Fairness.pdf

Finally, the government asked the **Pensions Policy Institute** to do another modelling in 2015. It compared a mature and stable CDC scheme with individual DC. The former produced an income replacement of 27 percent to 30 percent. The latter, a lower and more varied rate of 12 percent to 21 percent. Taking the median, outcome of CDC is 28.5 percent, and DC 16.5 percent. That means CDC gave a **73 percent** better outcome.

www.pensionspolicyinstitute.org.uk/publications/reports/modelling-collective-defined-contribution-schemes

Other Bibliography

Parliamentarians may also be interested in a book by Dutch academics called *The Costs and Benefits of Collective Pension Systems*. This points out that some element of intergenerational transfer may mean that under CDC "all are better off but some are better off than others".

www.amazon.co.uk/Costs-Benefits-Collective-Pension-Systems/dp/3540743731

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

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