COLLECTIVE DEFINED CONTRIBUTION PENSIONS

The next steps to successful adoption of Collective Defined Contribution pensions in the UK

Briefing Note

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The current mission of the RSA is '21st century enlightenment; enriching society through ideas and action'. We believe that all human beings have creative capacities that, when understood and supported, can be mobilised to make the world a better place for all its citizens.

Central to the RSA's current work are the concepts of convening and change-making. The RSA has also developed a distinctive approach to change: 'Think like a system, act like an entrepreneur' which now runs through most of our projects. Our work combines rigorous research, innovative ideas and practical projects.

About the project

The CDC Pensions Forum is part of the RSA's long standing 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 recent decision by Royal Mail and the Communication Workers Union to commit to delivering the UK's first CDC scheme, the Forum aims 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 will host a series of events and publications to develop this work.

Acknowledgements

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Foreword

Royal Mail and The Communication Workers Union (CWU) have agreed to implement the first Collective Defined Contribution (CDC) pension scheme in the UK, restarting the debate around how best these schemes should be implemented. The RSA's *Tomorrow's Investor* programme has campaigned for over ten years on the benefits to savers that CDC pensions could bring to the UK economy. Welcoming the decision by Royal Mail and CWU, a forum of stakeholders from industry, regulators and the civil service came together to hear the views of the Minister for Pensions Guy Opperman MP. The meeting talked about the key areas that need focused discussion, consultation and solutions to be developed to ensure CDC is successful for the Royal Mail and for those that follow in its footsteps. For this to happen policymakers, savers, pension sponsors, and the investment industry must work together to ensure the right regulatory framework is put in place. This paper covers some of the issues involved and is informed by that discussion.

Harinder Mann and David Pitt-Watson

Briefing

Executive summary

Collective Defined Contribution (CDC) Pensions offer an alternative to existing UK pension schemes, and have the potential to provide a higher income in retirement for members than individual Defined Contribution (DC) schemes. Schemes based on similar principles have a good track record in other countries and their introduction enjoys broad and growing support among UK businesses, trade unions and financial experts.

There are practical issues to be addressed in order to move towards implementation.

1. Legislative considerations: Legislation needs to be clear that these schemes would sit outside the Defined Benefit (DB) framework and be future-proofed, so that sponsors of CDC pensions can be assured it will be consistently applied in coming decades. Flexibility on detailed design of schemes can exist within a tight authorisation and governance framework and protection against future legal re-characterisation. Initial funding requirements should not be a prohibitive barrier.
2. Governance framework: schemes should be governed by trustees acting for the benefit of beneficiaries. The existing MasterTrust regime could be adapted for CDC Pensions at a later stage.
3. Protecting savers: the highest possible levels of transparency and clear, comprehensible communications with members is critical. Each pension plan will need to be clear how it will deal with changing events. For example, uncertain returns, changing life expectancy, or what would happen in the event of corporate failure. It should be designed to minimise the risk of intergenerational bias.
4. There are other issues which need to be resolved. But many of these can borrow from existing pension practice in the UK, or can learn from examples elsewhere in the world where similar schemes are already in operation.

Moving ahead with successful introduction of CDC Pensions to the UK has the potential to transform the retirement prospects of millions of workers and improve the productivity of the 6.5% of GDP set aside each year for pension contributions.

The CDC Forum has been convened by the RSA as a business, union, professional and civil society collaboration to support the introduction of CDC Pensions.

Background

For the past ten years, the RSA (Royal Society for the encouragement of Arts, Manufactures and Commerce), a leading social change organisation and award winning think tank, has sponsored a programme known as Tomorrow's Investor. One of its key recommendations was that Britain should allow the introduction of collective pensions, often referred to as "Collective Defined Contribution" or CDC pensions. This choice is denied to people in this country, despite the success of similar arrangements elsewhere in the world. Significant support has developed for this reform over the past decade.

The key advantage of CDC pensions is that they are designed to give "an income in retirement" from within the scheme while remaining within the DC framework. Studies show that for the same contributions, CDCs provide a pension which can be 30% higher than the closest alternative available today; that is a Defined Contribution (DC) pension which is used to buy an annuity.[1] Following research undertaken by the RSA, consensus was reached with the Confederation Of British Industry, Trade Union Congress, Pensions and Lifetime Savings Association (formerly National Association of Pension Funds), and the Association of Member Nominated Trustees supporting the concept of CDC in the UK. In 2014, the RSA also led a delegation of interested employers to the Minister for Pensions to demonstrate demand for such pensions and to highlight the need for an effective legal framework.

The government responded with the 2015 Pensions Act. This gave the government powers to allow "Defined Ambition" pensions including CDC. The Act was passed with full cross party support. Therefore, Parliament has agreed to the introduction of CDC and similar pensions. The task now is to establish a regulatory framework to allow them to operate effectively. This year, the Work and Pensions Select Committee noted the significant benefits CDC could bring, and supported the government in taking early action.

Last year, the Royal Mail, and its partner union, the Communication Workers Union (CWU), agreed they wanted to introduce a CDC scheme. The government and the opposition is keen to facilitate this by introducing an appropriate framework which will work for Royal Mail and its employees, as well as others who might wish to follow in their path. In this note, we describe some of the issues which will need to be addressed in introducing such a framework.

This note is informed by a meeting of policy makers, practitioners, pension experts, pension funds, industry and workforce representatives recently convened by The RSA under the banner of the "CDC Forum". Their aim was to discuss the key areas that should be addressed to ensure that CDC can be successfully implemented by Royal Mail and that there is the opportunity for other employers to follow Royal Mail's example.

1. These include studies by the Government Actuary, the Pension Policy Institute, AON Hewitt and the RSA. They complement work done internationally, such as that by the National Institute on Retirement Security in the USA. References to these studies are discussed in the RSA publication, Collective Pensions in the UK II, see https://www.thersa.org/discover/publications-and-articles/reports/collective-pensions-in-the-uk-ii

What is envisaged for the implementation of CDC pensions in the coming years?

Today, most private sector workers who provide for their retirement do so through a DC savings plan. This is an individual retirement savings account, which depends on investment returns to produce growth through the accumulation phase until retirement. If the saver then wishes to secure an income which will last until they die, they either need to draw down on this retirement savings account cautiously (in case they live for a long time), or else convert it into an income stream by buying an annuity. The former limits their retirement income. The latter is very expensive, and its cost unpredictable.

Collective pensions overcome this problem by allowing people to save collectively, and to share "longevity risk" among themselves. Therefore, those who die younger help pay for others, but all will receive an income until the day they die. But, in order to sustain a CDC pension, it must be accepted that pensions may be of variable amounts, sometimes increasing by less or more than inflation. Indeed, in Holland, where forms of CDC are common, pensions in payment were actually reduced (by about 2%) following the global financial crisis. This reduction should be set against the projected 30% higher pension payments that CDC schemes can achieve compared with using a DC fund to purchase a protected annuity.

CDC pensions would exist together with other types of provision and sit comfortably with other forms of pension.

1. Legislative considerations

CDC pensions could have broad applications. So, one question which will need to be addressed is how broad the scope should be of the legislation which introduces them. Clearly there is an advantage to breadth. But there is also the danger of allowing the best to become the enemy of the good. The mood of the meeting was that it made sense to **prioritise Royal Mail, but that any legislation should be amenable for other, similar organisations.** There was also a sense that this solution could have wide applications, and help address pension issues for smaller companies, and for those retiring with a lump sum. So, while these may not be today's priority, legislation should be **framed in a way which can be built upon for the future.**

These considerations are apparent when reflecting on the 2015 Pension Act. Although it had the intent of allowing CDC pensions, the drafting of the Act sought to rewrite the entire definitional framework of pensions legislation in the UK. Therefore, other legislation will need to be used.

The timetable for this is likely to begin with a consultation which will take place this Autumn. Legislation is likely to follow after.

There would be value in progressing the timetable. Other pension funds, some of whom are considering their future, could be interested in CDC. However, they need to have some sense of the framework through which it might be introduced.

If the legislation is to make CDC attractive not just for Royal Mail but other larger employers in similar situations, there was a strong feeling that it must have **protection against judicial** (**and to the extent possible, legislative**) **re-characterisation.** In past generations, some organisations which thought they had developed more flexible CDC-type arrangements later discovered that the law had changed, and they were now bound by a hard promise. They will need protection against this happening again.

There was also a feeling that any legislation should **limit the amount of "hardwiring" in the operation of CDC pensions, but insist on a tight regime of authorisation, and a governance system which represented beneficiaries.** This would ensure the fitness and propriety of those running any fund, the systems and processes by which it was run, the communication with members, the limitation of any hard liability claim on client money, and how continuity would be maintained. But within these sorts of parameters, legislation should then allow a sensible level of choice for the pension plan itself. Critically, while there may be some funding required to ensure continuity, it would be important that CDC, which will be a not-for-profit, trustee governed system, without any hard liability, can be established without a prohibitive initial funding requirement.

2. Governance and legal framework

CDC pensions need to ensure they are run only for their members. Because benefits are not guaranteed, and can go down as well as up, members need assurance that the benefit calculation and variation mechanisms will be operated on the basis of rules which are clearly stated at the outset and in the context of strong governance mechanisms, and that plan assets can only be used for benefit provision to meet authorised expense payments (rather than being, for example, returned to scheme sponsors). Other financial products which were theoretically attractive and had similar flexible characteristics, such as with-profits policies, did not have appropriate governance and were abused. The central protection against such abuse is that **the operators of any CDC plan should be trustees, and owe fiduciary duties to the members of the plan** (**the beneficiaries**). They would in turn be able to hire fund managers and others who might be profit seeking. But regulators must play a role to guard against the management of CDC pensions falling into the hands of the wrong sorts of people.[2]

The recent **MasterTrust** regime might appear at first sight to be an appropriate legal framework for future CDC arrangements covering non-connected employers. However, any MasterTrust would have to demonstrate that it had appropriate trustee governance. The legislation for MasterTrusts may have been written for commercial operations, and it would be important to be sure that these did not create impediments, for example on funding, or loopholes which would either prevent the establishment, or undermine the mission of a CDC pension.

2. One possible problem with trustee governance is finding people who are willing to serve. This might not be such a big problem if the regimes which develop are for a limited number of large schemes that have the resources to provide high levels of support and training for Trustees.

3. Protecting savers

Savers into CDC pension plans need protection. First they need to know the nature of their savings, how they are managed, and what pension it is likely to provide. This is no easy task. Despite accounting for 70% of household financial assets, there is a paucity of knowledge among consumers about pensions and pension entitlements.

There was agreement that CDC pensions should be fully transparent. In particular

- They should be **clear with members and prospective members about the nature of the pension they are getting**, in particular, that it can be varied.
- That pension funds **declare up front how benefits will vary in response to positive or adverse experience.**
- The plan would need to show **how it deals with potential intergenerational transfers**, in relation to payments and entitlements throughout the savers' lifetime.
- That any calculations are **subject to actuarial oversight.**
- That **statements showing anticipated pension** should be regularly provided.

There was also a strong feeling **that provision should be made for unforeseen events.** On this point CDC should be much less difficult to deal with than DB since there is no ongoing employer liability, or reliance on an employer covenant. So, on the bankruptcy of a company, rather like a DC pension, a CDC pension could continue and simply be run down over time as employees retired and passed away. A closed scheme being run down would need to adopt an appropriate investment strategy; indeed the last retiree would have effectively have a DC pension and annuity. This scenario should not be too difficult to deal with, but it will be important to be clear at the outset how such issues will be tackled.

4. Other considerations

1. **Demand**: It is difficult to assess the demand for CDC, since it is very unlikely that companies will propose such a solution before they are sure that they will be adopted and be accepted by both regulators and workers. Meanwhile, workers are generally not sufficiently equipped to demand new forms of pension arrangements that require specialist knowledge to fully understand. With DB schemes being closed, it was suggested that **the earlier the government can launch its consultation, and demonstrate it is serious about action, the better.**
2. Knowledge and member communications: **Members need to understand the nature of a CDC pension**, but the concerns about this are **not unique to CDC.** There was a strong feeling that people needed to better understand their existing benefits in DB and DC and what these types of pensions would, and would not, provide.
3. **Interaction with other policies**: CDC will need to interact with other government policies - taxation, for example. However for most of these **there is already a regime in place for DB or DC,**

which can most likely be adapted for CDC. Policies on pensions freedoms and transfers would need to be established, and might be similar to DB.

4. **Other regulations**: These might include rules on audit and actuarial requirements and restrictions on investment, which m**ight also borrow from existing DB or DC regulations.** There may be behavioural biases, which it is important are not abused; for example, savers might be persuaded to take a higher nominal drawdown or annuity, rather than one which aims at a real income. But again, the issue is similar to that encountered in DB plans. Since these would be trustee governed funds, the most appropriate regulation would come through the Pensions Regulator. This may require additional resources, but any increase is likely to be small initially.

Conclusion

There are many issues to be addressed in setting up an effective framework for CDC, but all of them can be addressed. Lessons can be learned from Canada, Holland and Denmark, where forms of CDC provision have operated for many decades.

The prize is huge. The Royal Mail pension plan alone affects 140,000 people. 6.5% of our GDP is set aside each year for personal pensions. If savers are looking to achieve an income in retirement, all the studies we have reviewed suggest that CDC will create 30% higher outcomes in retirement than the available alternatives.

We therefore echo the Work and Pensions Select Committee in welcoming the action by the government. We note the cross party agreement on this matter, and the cooperation between Royal Mail and its workforce. The members of **CDC Forum are ready to help raise and address the implementation issues which will be encountered, and to guide those with an interest in these matters to appropriate sources of knowledge and expertise.**

Over the coming months, the RSA expects to host a series of events and publications to help support this agenda. For further information please contact tom.harrison@rsa.org.uk

Further information

For more information by the RSA regarding CDC Pensions, please refer to the publication list below:

- Pitt-Watson, D. (2009) *Tomorrow's Investor: Pensions for the People*. The RSA. Available at: https://www.thersa.org/globalassets/pdfs/reports/tomorrows_investor_pensions-for-the-people.pdf
- Manthorpe, R. (2008) *Tomorrow's Investor*. The RSA. Available at: https://www.thersa.org/discover/publications-and-articles/reports/tomorrows-investor-report
- Pitt-Watson, D. (2009) *Tomorrow's Investor: Building the consensus for a People's Pension in Britain*. The RSA. Available at: https://www.thersa.org/globalassets/pdfs/blogs/rsa-ti-report-pensions.pdf
- Pitt-Watson, D. & Mann, H. (2012) *Seeing through British Pensions*. The RSA. Available at: https://www.thersa.org/discover/publications-and-articles/reports/seeing-through-the-british-pension-system
- Pitt-Watson, D. & Mann, H. (2012) *Collective Pensions in the UK*. The RSA. Available at: https://www.thersa.org/globalassets/pdfs/reports/collective-pensions-in-the-uk.pdf
- Pitt-Watson, D. & Mann, H. (2012) *Collective Pensions in the UK II*. The RSA. Available at: https://www.thersa.org/discover/publications-and-articles/reports/collective-pensions-in-the-uk-ii
- Pitt-Watson, D., Stanley, N. & Webroom, K. (2014) *Collective Pension Plans: Briefing Note*. The RSA. Available at: https://www.thersa.org/discover/publications-and-articles/reports/collective-pension-plans-briefing-notes

The RSA (Royal Society for the encouragement of Arts, Manufactures and Commerce) believes that everyone should have the freedom and power to turn their ideas into reality. Through our ideas, research and 29,000-strong Fellowship, we seek to realise a society where creative power is distributed, where concentrations of power are confronted, and where creative values are nurtured.

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