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CDC – What you need to know so far

Where did CDC come from?

Collective Defined Contribution (CDC) pension schemes have been around in various forms in other parts of the world, but they are a new feature in the UK. They are expected to provide higher incomes than DC schemes, while offering employers a more affordable option with less volatile contributions compared to DB schemes. In 2018, the Government said that CDC schemes can:

> “*Provide a savings and income in retirement option within one package, designed to simplify decision-making at the point of retirement.*”

In the UK, CDC schemes will be set up under Trust and will be authorised by The Pensions Regulator. And after many years of preparatory work, we now have our first UK CDC scheme, introduced by Royal Mail.

What does it do and what do we mean by collective?

At their core, CDC schemes are a means of pooling risk between a group of members, in order to deliver more value than an individual saver alone.

Our modelling shows that CDC may deliver a retirement income between 20% and 50% more than traditional (individual) DC with drawdown in retirement.*

*Based on a 20 year old earning £15,000 and accepting a 1 in 4 risk of ruin (ie a 25% chance of running out of money in retirement).

In a CDC scheme, both the employer and the employee pay contributions into a collective fund. The fund is managed on a collective basis (unlike DC where individuals have their own savings pot). The collective fund is then used to pay incomes in retirement. The income is not guaranteed, and is treated as a target pension (unlike DB where the pension is guaranteed). CDC schemes must aim for annual increases of at least CPI inflation, but actual increases may vary depending on scheme experience and could even be negative.

Collective investment

Collective investment in CDC gives trustees the ability to invest in riskier assets for longer, by seeking greater returns over the lifetime of members. There will be risk sharing across accumulation and decumulation and across active members, deferreds and pensioners. This potential for greater risk-taking is based on the idea that older members have a lower risk tolerance, passing the risk on to younger members of the scheme. It is also the premise that with investments pooled over generations, members can tolerate more volatility than they do in many of today's DC schemes. The nature of the collective investment, over time and with scale, makes it easier to invest in less liquid assets, again with the aim of increasing returns.

Collective longevity

CDC schemes manage longevity risk collectively, by paying pensions based on the average life expectancy across the plan members. This means that members who don't live as long are subsidising members who live longer. This happens as the contribution paying for the benefits does not account for their life expectancy exactly. If a member's life expectancy is underestimated, they get more out of the scheme, and if member's life expectancy is overestimated, they are likely to die before they receive an equivalent value of benefit. The concern here is the perceived link between longevity and wealth, potentially shifting retirement income from those who 'have not' to those who 'have'.

However, from a longevity perspective, we should not lose sight of the fact that CDC schemes provide each individual member with strong longevity protection, as they will receive an income for the entirety of their retirement. This is a feature that members regularly say they want from their pension, and is not an inherent outcome from DC.

What are the different CDC schemes?

There are whole of life schemes and decumulation only schemes. There are three main types of whole of life CDC schemes:

1

Single employer CDC

This is for companies such as Royal Mail and other employers large enough and so minded, to operate a scheme solely for their workforce.

2

A sector specific scheme

This is designed for industries that have a large number of similar employers, like areas of transport, retail or the care industry, with a scheme potentially operating on a non-commercial or not for profit basis.

3

Commercial CDC schemes

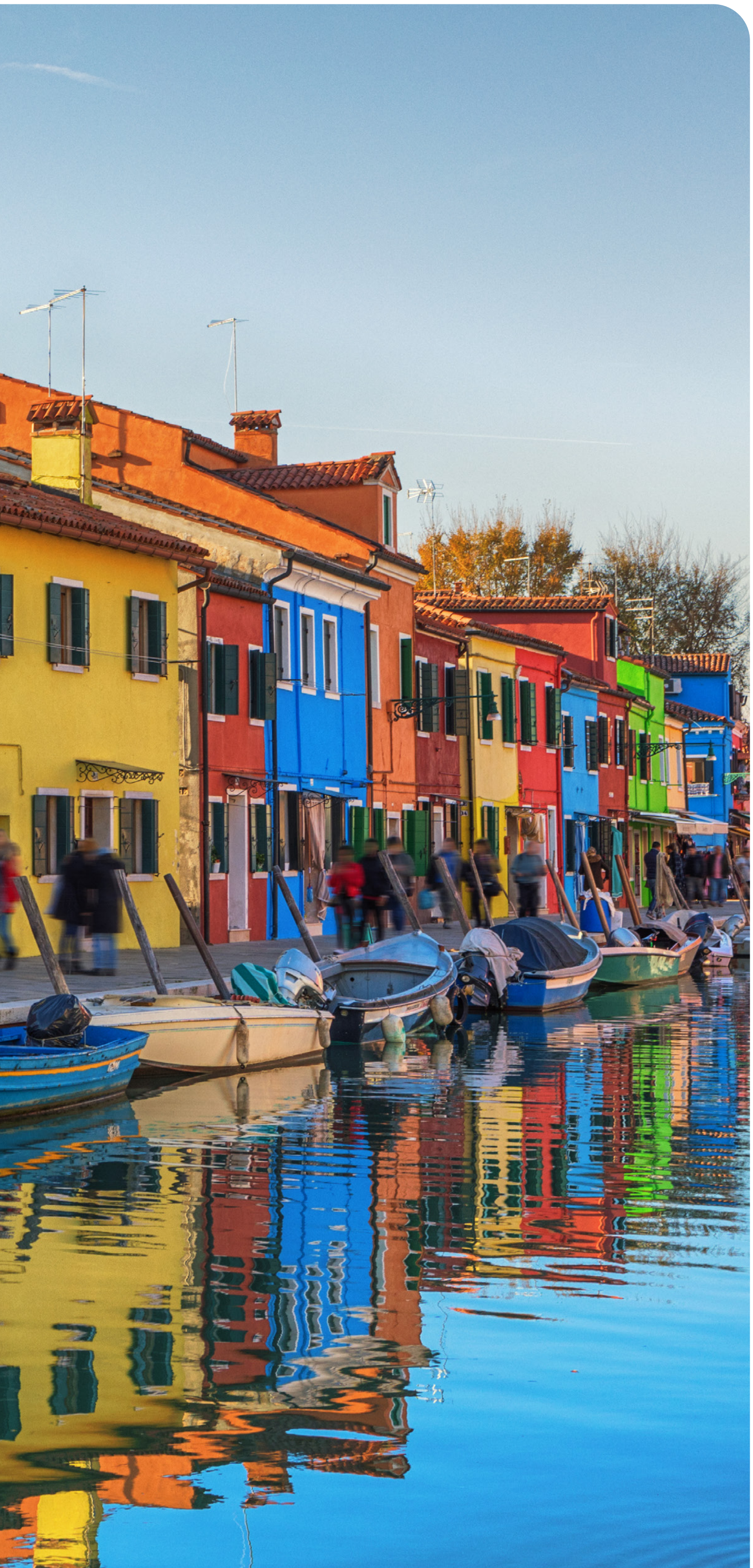
These will be set up to take a wide range of different employers for profit, much like the DC Master Trusts do today.

Decumulation only CDC schemes are not yet in regulatory scope, multi-employer schemes are currently being consulted on and single employer schemes are legislatively possible today.

Single vs multi-employer

There are interesting points of difference emerging between single and multi-employer schemes in terms of design and member outcomes, largely as a result of the need for different operational approaches and as a result of differing legislative requirements.

A simple single employer CDC scheme design would let all members earn benefits at the same rate for the same level of contributions through their working life. This is (relatively) easy to communicate and straightforward to implement, but can have a high degree of cross subsidy and transfer of value between members.



The draft consultation for unconnected multi-employer schemes doesn't allow this scheme design feature. This means the multi-employer solutions will have much lower cross subsidies than are allowed in the single-employer regime. But in doing so, it gives the industry a sizeable communication challenge to make all this transparent enough to manage members' expectations.

How long people can expect to live depends on factors such as sex, health, lifestyle, and affluence. One size doesn't fit all. Analysis from leading longevity data analysts, Club Vita, indicates that the difference in life expectancy for today's retirees can be as much as 10 years.

Longevity analysis needs to be a key component in any multi-employer CDC scheme to avoid unintentional cross subsidies. It must be sophisticated enough to provide a realistic assessment of members' life expectancies, and efficient enough to apply at scale and minimal effort for members.

From a design perspective, when establishing a single-employer scheme, the benefit design is considered first. For example, how much benefit will a member accrue each year, will it have a spouse element, benefits on death – and then how much will that cost given the trustees approach to investment strategy, to then get the fixed contribution rate. In a multi-employer scheme, it is much more likely that the approach taken will be to look at a contribution first and then what level of benefit this will buy, so it can then be communicated to prospective employers. To be attractive to a wider range of employers, they might also need a degree of flexibility on design items like the inclusion/exclusion of spouse death benefits and the requirement for an AVC facility.

It is also worth noting that multi-employer schemes on set up may not fully understand the number of employers/employees and overall profile of their likely membership in the future. This will be important for the approach to setting assumptions.

To maintain a sense of fairness, the draft rules require prospective schemes to satisfy a number of tests:

1. Benefits must be expected to rise with inflation, so members maintain purchasing power over time (before and after retirement).
2. There shouldn't be cross-subsidies between employers.
3. There should either be no cross-subsidy between members, or if there is, each members' benefits must at least match the value of their contributions.

The principle of actuarial equivalence is intended to eliminate cross subsidies between employers.

Decumulation only

At this stage, we do not have draft regulations to consider in great detail for decumulation only schemes. However, there are a number of theoretical points to consider, such as:

Can they deliver the greater income expectations when the investment strategy is dealing with a shorter time horizon (e.g. it no longer covers whole of life)?

What degree of volatility in the income would be expected in a decumulation only scheme, given the shorter time horizon, to get higher implied incomes. Do you need to take greater risks? And to what extent will this volatility be visible to members in their income payments?

If this is an option open to all UK savers, will a degree of underwriting be required to ensure there is fairness, and therefore attractiveness for a saver to actively select it?

Where would decumulation only schemes sit in the regulatory environment when we typically see decumulation solutions regulated by the FCA instead of TPR?

How does it compete with the blended solution in place and being developed across the pensions industry (e.g. hybrid drawdown and annuity solutions)? Would decumulation CDC add value in an already rich choice landscape?

In summary

There are a number of benefits expected from CDC:

1. Members will receive a secure income for life, with a target income that is more predictable and relatable than savings from a DC pot.
2. The investment strategy is set across the scheme as a whole, enabling greater incomes in retirement, meaning savers do not need to make complex investment decisions on their own.
3. Contributions are fixed and there are 'no surprises' in terms of additional calls on employer funding.
4. Higher pension incomes are expected in retirement compared to current DC schemes, which is critical given current levels of under saving in the UK.

This article has featured in the Financial Times Advisor.

But there are number of hurdles still to navigate:

- Regulations are not yet in place for all versions of CDC and what we have seen so far suggests that greater flexibility within the regulations will be required for CDC to reach its maximum potential.
- A good communication strategy will be needed to manage member expectations on the fact that the benefit is a target, and it is not guaranteed.
- Employers will want a multi-employer scheme option to make CDC accessible and affordable for the widest range of employers.

CDC adds diversity to the pensions landscape and provides greater optionality for employers and members. We are now at the beginning of a journey that will shape its overall success.

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