

# COLLECTIVE PENSION PLANS

## Briefing Note

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- **The government has recently announced its intention to allow Collective, or Target Pensions in Britain. The opposition also agrees with this policy, as do many stakeholder bodies.**
- **Over the past four years, the RSA has researched the advantages and pitfalls of Collective Pensions. It has advocated that these should be allowed in the UK, provided that there is an appropriate legal and regulatory framework.**
- **The government's announcement is an important one, but to some may seem somewhat technical. In this briefing note, we aim to set out in simple terms how Target Pensions work, their advantages and their pitfalls.**

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# Briefing

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## Introduction

Target Pension Plans are a new type of pension plan for the UK. Also known as Collective Defined Contribution (DC) plans, they work on a pooled basis, where members collectively share the risks and rewards of saving for their retirement. They give members higher and more certain pensions than would otherwise be available to them. They deliver a reliable base level of income during retirement, which helps members plan for their retirement, and will help employers with their workforce planning.

Two studies, one undertaken by the Government Actuary, the other by one of the leading actuarial companies in the world suggest that Target Pension Plans can give a retirement income which is more than 30 percent higher than one where the saving is made individually. In addition, the pension will be more predictable, allowing savers better to target their retirement income. A study by the RSA on the cost differences of collective and individual pensions has given similar results.

Instead of having individual accounts, under a Target Pension Plan the investments are pooled together, and managed by trustees taking professional advice. Investing collectively reduces costs and means that a longer time horizon can be taken - benefits for members will be superior to individual arrangements. The pooling process means that these benefits are more stable than individual schemes, and can smooth out the ups and downs of investment markets. Because they are managed by trustees acting on behalf of all members, Target Pension Plans do not require members to take investment decisions – decisions that many members find difficult and are unwilling or unable to take.

Target Pension Plans pay out a regular pension to members after they retire. Until this year's budget most people used their pension savings to buy an annuity - that is a regular pension payment for life. Annuities have recently been very costly, and their price can vary significantly from one year to another, so the lifetime pension could be very different for members who have saved the same amount, but who retire just a few years apart. In the budget, the government decided that savers should no longer be forced to buy an annuity, and will now have full flexibility. This will make choosing what to do even more difficult and individuals will find it very difficult to budget how much of their pension pot to spend each year. There is no need to take complicated decisions under the Target Pension Plan, which will pay out a secure income for life, with protection against the effect of inflation on the pension.

Such pensions are main-stream in Holland and Denmark, countries which are generally considered to have the best pension systems in the

world. However, legislation makes them difficult to establish in the UK. The government has signalled its intention to allow this type of plan. We believe it is important that they do so soon to help address the immense pressures now facing the British pension system.

In this note we explain why we need this new approach. We explain how Target Pension Plans work, and why they give better and more reliable pension incomes. We also compare them with current pension arrangements. We offer some guidance on the proper way for them to be regulated, in order to ensure that they offer a safe and secure solution. Finally, we address a number of questions which people might have about how these new plans would operate.

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### **What is the problem with the current private pension system?**

A generation or more ago, private sector employers offered pensions which guaranteed a regular retirement income. The guarantee was underwritten by the employer. These plans are known as Defined Benefit (or DB) pensions. From the savers' point of view, these were excellent since people knew the income they would receive in their retirement.

But underwriting the guarantee proved costly. As a result, employers have been unwilling to support DB pensions and so have switched to individual pension saving. Over the next five years, most observers expect remaining private sector DB plans to close.

Individual pensions will then become the only choice available. With such individual pensions you, and probably your employer, put cash into your own pension pot. This is invested on your behalf by your pension scheme. But investments can go down as well as up. If you retire in an 'unlucky' year then you will do much worse than someone retiring in a 'lucky' year, even if you have both saved exactly the same. These individual pensions are known as 'Defined Contribution' (or DC) pensions, because you know how much money has been saved, but you don't know how much pension it will provide you with.

When you retire with a DC pension, you decide how you will use your savings. Until this year's budget most of that money needed to be used to buy an annuity- that is a regular pension payment until you die. But because annuities are so expensive, the government decided that savers should no longer be forced to buy one. If you don't buy an annuity it is very difficult to budget how much of your pension pot to spend each year, because you have little idea how long you will live. If you want to be sure you have enough pension (if you live into your nineties), then you either need to save a lot, or take only a small pension each year.

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### **What are Target Pension Plans?**

Target Pension Plans are new for the UK, but are well established in other countries such as the Netherlands (where they are called Collective DC plans), Denmark and Canada.

Target Pension Plans allow members to share the risks and rewards of pensions saving. This sharing starts when you begin saving and lasts until you die.

One important risk members share is how long they are going to live for, after retirement, and hence how much they will need to save. When you begin saving for a pension you don't know if you will live until you are 70 or until you are 100. So you don't know how much you need to set aside. But you can be pretty sure about how long, on average, a large group of people will live for. It is a bit like an insurance policy, designed to make sure you have an income, no matter how long you live.

Target Pension Plans are designed to provide a regular pension payment until you die, sharing the risk of living longer than you expect and therefore running out of pension.

They also help overcome one particular difficulty with individual pensions. With individual pensions, people who retire one year may do much worse than those who retired a year earlier because they are unlucky with their investments, or the cost of securing an income has risen. Target Pension Plans work on a collective, pooled basis and so these gains and losses can be evened out over time, because the pension money stays in the fund.

And this works in everyone's favour because it means pension pots can still be invested in ways that grow as you approach retirement, rather than being put in safe but low growth investments that protect individual pots from the bad luck of retiring in a poor year for investments. That in turn is good for industry, because patient long term capital is more likely to build a strong economy than short term investment.

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### **Will a Target Pension Plan guarantee my retirement income?**

Your pension payment from a Target Pension Plan aims to keep its spending power by going up in line with inflation. But this is a target, not a guarantee.

Nevertheless by sharing and smoothing the ups and downs of investment, Target Pension Plan members should expect to get inflation linked increases most years. And while nothing is guaranteed, what is most likely to happen if the economy does badly and investments do not do well, is for payments to be frozen, or not increase fully in line with inflation. Target Pensions Plans do not have guarantees, but they do have targets and they will be on target more often than not - as has been proven in other countries that have operated these plans for many years.

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### **Will collective saving through a Target Pension Plan give a higher pension?**

On average it will. Studies suggest pooled pensions provide a 30 percent plus higher pension payment than individual pensions where savers buy an annuity. Of course there are some years, (when investments have done well and annuities are cheap), when individual pensions outperform. But it is a lottery as to which those years will be, and if members retire in a bad period, they are stuck with the consequences for life. The recent changes in the budget mean

that savers don't have to buy annuities, but since there is no other reliable way to secure a pension, Target Pensions still retain their 30 percent advantage.

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### **Will this provide me with a more certain pension?**

It will. A study looking at how Target Pension Plans would have performed relative to individual pensions in the UK in the past 80 years, show much less variability than individual pensions. Over the last 15 years alone, the cost of purchasing a pension income has more than doubled for many individual savers.

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### **So what are the problems with Target Pension Plans?**

The main issue for Target Pension Plans is that the pension is a target, not a promise. So beneficiaries need to trust the decisions about any adjustment to the target are not so radical as to upset their retirement plans and that decisions are always made in the beneficiaries' interests, not in the interests of those managing the pension plan.

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### **Why do Target Pension Plans need to be managed by trustees?**

Decisions within a Target Pension Plan need to be made in the interests of the members as a whole. If they are not, then there is indeed a danger that things can go wrong. That is what happened to 'with-profits' insurance policies. Decision made by the trustees of Target Pension Plans will be subject to public scrutiny, as well as by the Pensions Regulator, to ensure that all decisions fairly represent the interests of all members.

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### **Didn't Dutch pensioners experience a drop in their pension income recently?**

They did. In response to the financial crisis, Dutch pensions were cut, on average by 2 percent. A few dropped by as much as 6 percent. This had rarely happened in the past, and in most cases these cuts have now been restored as markets have improved. But they do illustrate the need to ensure that people understand the nature of their pension; that it is a target not a promise. It should also be remembered that over the past 10-15 years, annuity rates in Britain have fallen by up to 50 percent.

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### **Does this end up with young people subsidising older people or vice versa?**

Not necessarily. This will ultimately depend on the decisions of the trustees. In the event that there is either very good or bad news, benefits will be raised or lowered. Trustees should explain beforehand how they would

intend to react to such events. The plan rules might require that they spread the benefit or the pain evenly. In the event of small changes however, they might want to preserve pensions in payment, and give extra benefit or cost to younger savers since they have time to adjust their savings to compensate for such events. One study has been done of Dutch pensions, noting that some groups can benefit at the expense of others, but it concluded that all groups were still better saving collectively than individually.

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### **Could I end up losing my savings because it has all been paid out to someone else?**

Not in a well regulated system. In Holland, the system has worked well for 70 years. It is not perfect by any means. But it has given higher and more predictable pensions than those available to most people in Britain today.

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### **How would I be able to subscribe for a Target Pension?**

As with an individual pension, your employer would offer such a pension.

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### **How can I be sure that this doesn't end up another mis-selling rip-off?**

Trustee management is one protection. We have recommended that providers of Target Pension Plans will need to be licensed by the Pensions Regulator. In order to gain a licence, they will need to show that they are properly managed, that they have qualified professional advisers, that they make public the way they intend to run the plan and deal with pension adjustments, and how they will communicate with their members. As with individual pensions there should be limits on the amount which they can charge. There is less likelihood of mis-selling of collective trustee-governed pensions, than individual private pensions.

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### **If I want to use my pension savings in another way, is that possible?**

As with an individual pension, if a saver wanted to take their money out of the pension fund, and take the cash elsewhere, or give it to another provider that would be possible. However, one of the big advantages of collective saving through a Target Pension Plan is that it provides for a pension-for-life. Savers who did not want this might prefer individual savings, or indeed simply use an ISA.

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### **We have had a lot of reform recently; shouldn't we just allow it to bed down?**

No. Right now Britain is witnessing the collapse of its Defined Benefit pension system throughout the private sector. Individual DC pensions

are struggling to fill the gap. But they alone cannot provide an efficient pension savings system for everyone. Collective, pooled pensions such as Target Pension Plans provide employers with an alternative way to offer pensions that meet the needs of their employees, without taking on additional burdens themselves.

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### **What needs to happen now, for Target Pension Plans to be possible in Britain?**

Legislation making them possible needs to be introduced through Parliament. This must ensure a number of things. First, that any employer establishing a Target Pension Plan will not discover it has become a DB pension. Second, that the principal governance structures, regulatory oversight and management approaches discussed in this note are established.

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### **Who is supporting Target Pension Plans?**

There is now a large group of organisations supporting Target Pensions. These include the TUC and CBI. Professional and industry associations such as the National Association of Pension Funds, the Association of Member Nominated Trustees and the Association of Pension Lawyers have added their support. A delegation of eight large pension funds and sponsors visited the Pension Minister last year asking for reform. Actuarial companies, including the giant Aon Hewitt, have given support. And it has been championed by think tanks, including the RSA and IPPR.

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### **Is anyone opposing their introduction? If so, why?**

While not formally opposing Target Pension Plans, the Association of British Insurers have made negative comments about them. These mainly focus on the problem of balancing payments between young and old members, and on the cuts in pensions in Holland, which are addressed in this paper. These are important considerations, but hardly a reason to ban pensions which can give better outcomes, and which are a central pillar of provision in Holland and Denmark, rated as the two most successful pension systems in the world.

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### **Where might I turn to if I want to know more about Target Pension Plans?**

For more information on Target Pensions we would suggest the following sources.

First, for an overview of the evidence on the performance of collective pensions, the works by the RSA, *Collective Pensions in the UK* and *Collective Pensions in the UK II* give a good perspective, and reference most of the studies done comparing collective pensions, including that done by Aon Hewitt, *The Case for Collective DC*.

Second, citizen attitudes to Collective Pensions have been studied by the IPPR in their report, *Defining Ambition: Shaping Pension Reform around Public Attitudes*.

Links to these four publications are given below.

The most extreme criticisms of Target Pensions are found in *Money Marketing*, a weekly publication for financial advisors. Links to those criticisms, by the ABI, together with a response to them can also be found below.

- [http://www.thersa.org/\\_\\_data/assets/pdf\\_file/0020/750161/Collective-Pensions-in-the-UK.pdf](http://www.thersa.org/__data/assets/pdf_file/0020/750161/Collective-Pensions-in-the-UK.pdf)
- [http://www.thersa.org/\\_\\_data/assets/pdf\\_file/0007/1534606/RSA\\_Collective\\_Pensions\\_in\\_the\\_UK\\_II\\_Nov\\_2013.pdf](http://www.thersa.org/__data/assets/pdf_file/0007/1534606/RSA_Collective_Pensions_in_the_UK_II_Nov_2013.pdf)
- <http://www.aon.com/unitedkingdom/defined-contribution/collective-dc.jsp>
- <http://www.ippr.org/publication/55/11684/defining-ambitions-shaping-pension-reform-around-public-attitudes>
- <http://www.moneymarketing.co.uk/opinion/david-pitt-watson-abi-wrong-to-attack-collective-dc/2005948.article>



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