



BRIEFING | 011 | 07 JULY 2021

NEXT STEPS FOR CDC PENSIONS IN THE UK

Views on Collective Defined Contribution pensions



60 SECOND SUMMARY

For most private sector workers, it is impossible to save for a pension that will deliver a reliable, cost effective income for life in retirement. Collective Defined Contribution (CDC) pensions - enabled by the Pension Schemes Act 2021 - offer a solution to this problem.

In Summer 2021, we asked a wide cross section of the UK pensions community to respond to an online poll aimed at helping identify the demand for CDC, and the best architecture for any new system. We found at least three significant conclusions.

- 1 There is **overwhelming support for CDC outcomes**; in particular that **pensions should provide savers with an income which lasts for their life**. But while the principal benefits of CDC have strong support, there are a lower number of respondents who are contemplating introducing CDC arrangements in the immediate future.
- 2 **CDC should be made possible under multi-employer arrangements as well as by single employers**. If this is the government's ultimate intention it may be helpful to act soon, or at least signal if and when this will be introduced. The survey suggests legislative uncertainty may delay uptake.
- 3 There was a **wide range of views on the best structure for CDC**. There was also a concern about the potential complexity of CDC. This may indicate the need for work to be done which would help create a consensus on the best design for CDC. In the absence of consensus, the current survey would suggest **legislation for CDC should be quite 'open' in terms of structures and expectations**. Protection of savers would therefore best be achieved by (i) clear contingent rules on benefit entitlements which have been robustly stress tested (ii) communication and transparency (iii) trustee-style governance.

This research was conducted by the RSA CDC Pensions Forum, which was formed in 2021 to bring together stakeholders who would like to support the development of CDC pensions in the UK. The Forum is sponsored by Aon, First Actuarial, the Institute and Faculty of Actuaries, CMS and Lane Clark Peacock. This briefing is the work of its authors and does not aim to reflect the views of any of the Forum's sponsors.

BACKGROUND

Private pensions, and especially occupational pensions are particularly important in the UK. The state pension is modest. Around two thirds of household financial assets are set aside for pensions. They are the backbone of the British financial system, and critical to ensure the welfare of an ageing population.



Some ten years ago, the RSA commissioned research using ‘citizen juries’, to ask, “What would be the best framework for a private pension system in the UK.” The majority of savers said they wanted a pension system into which they could save their money, which they could trust would provide them with a retirement income. Some wanted greater involvement and choice. But for most, the desire was to “give their money to someone they could trust” which would then provide an income from retirement until death. In other words, a trustworthy default pension system which would maximise income in retirement.

Until this year the choice of a low-cost pension designed to provide an income for life was denied to most people in this country, despite the success of similar arrangements elsewhere in the world. For those working in the private sector, ‘defined benefit (DB)’ pensions, which paid a guaranteed income, are generally no longer available. Employers argued that the cost of the guarantee was too high or too risky for them to support. They have been replaced by ‘defined contribution (DC)’ savings plans, which give the saver a capital balance on retirement that can be drawn down during retirement or used to purchase an (expensive) insured annuity which will provide a guaranteed lifetime income.

CDC pensions offer a middle way, designed to provide a lifetime income but without the costly guarantees of DB or annuities. In the past CDC was not permitted in the UK. However, with the introduction of the Royal Mail Collective Pension Plan and the accompanying legislation in the Pensions Schemes Act 2021, the UK could build a pension architecture that should be able to deliver better pensions for current and future generations. A fuller briefing on how and why CDC works, can be found [here](#).

The key advantage of CDC pensions is that they are designed to give “an income for life in retirement” while remaining within the DC framework. All 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. In the UK where many DB Schemes are closed or closing, with many DC schemes not delivering the income needed in retirement, CDC provides fresh hope for the future of British Pensions.

Currently only one employer, the Royal Mail (supported by its union, the CWU), has publicly announced their intention to implement CDC. Others should also be able to benefit. However, with secondary legislation still to be written, it is important that there is a consensus on the next steps in the development of CDC. The report looks towards a roadmap for CDC in the UK, the challenges that need to be overcome and the work that needs to be done by policymakers and the industry to help ensure CDC realises its potential of giving British savers better pensions.



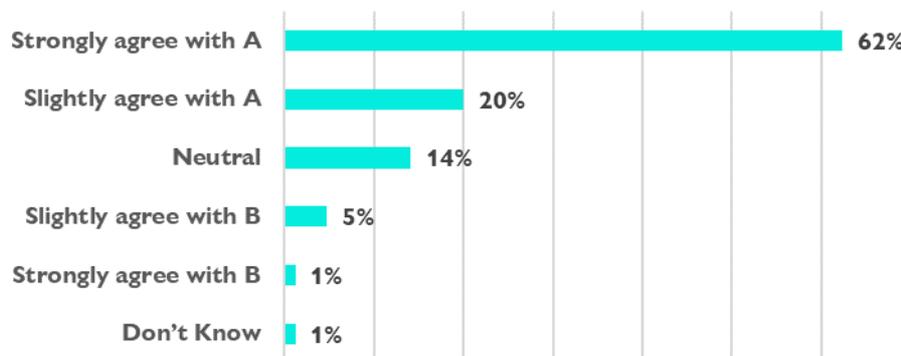
KEY FINDINGS

In summer 2021, we asked a wide cross section of the UK pensions community to respond to an online poll. Our approach is described in more detail in the Appendix to this report. We received the following responses:

1. The purpose of a pension should be to create an income that lasts for their life

Respondents overwhelmingly believed the purpose of a pension should be to “create an income”, not to “provide a savings balance in retirement”. Nearly two thirds felt strongly that the first of these should be the goal. Only 1% strongly favoured the latter. Since this is the key advantage which CDC offers over Defined Contribution (DC) pensions, this suggests a very considerable demand for the outcome provided by CDC.

Fig. 1 – What should be the purpose of a pension?



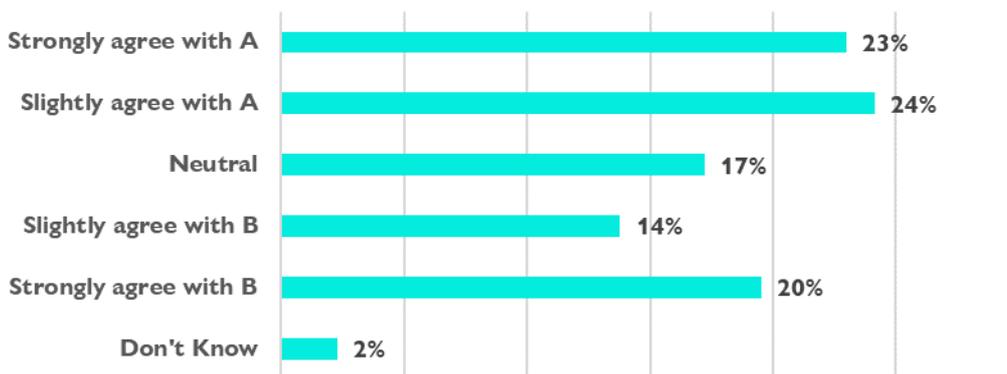
Statement A - Pensions should focus on creating an income in retirement

Statement B - Pensions should focus on providing a savings balance on retirement

The result is particularly notable because the majority of respondents were from companies who were mainly offering DC pensions. It is often suggested that the greatest demand for CDC will come from those companies closing DB plans, who feel they can no longer support the guarantee associated with DB. The research suggests a greater demand from those who recognise the need to improve DC provision.

We should offer a slight caveat to this. Typically, a key advantage of CDC is that the savings of those who die at a younger age can be used to support those who live to be older, so that money is there for those who need it. On one interpretation, a third of our respondents seemed not to want this to happen.

Fig. 2 - Where should scheme money go from those who die younger?



Statement A - Pension schemes should use the money from those beneficiaries who die young to provide pensions for longer-lived beneficiaries

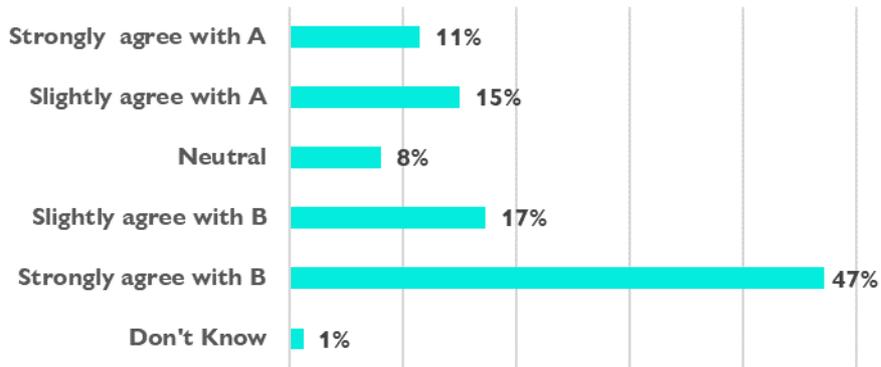
Statement B - Members who die at younger ages should leave their unused savings to their survivors

However, this could be interpreted as a quite appropriate call that CDC should offer dependents' benefits in the same way that DB schemes are required to provide a pension to an adult financial dependent in the event of the member's death. Indeed, that is a feature of the design of the Royal Mail pension plan.

2. The majority of respondents' views resonated strongly with the key pooling and risk sharing features of CDC

CDC also entails some flexibility in the benefits paid—albeit that this is likely to be modest, particularly when set against the higher expected income. 65% of respondents were supportive of having no guaranteed benefits

Fig. 3 - How might CDC benefits be paid?

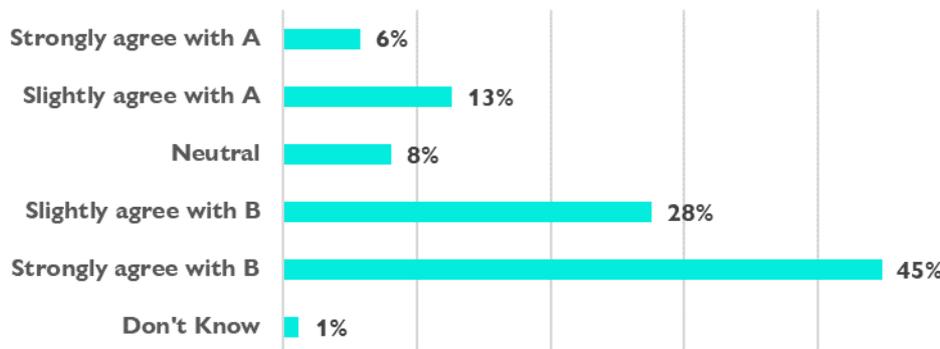


Statement A - The prospect of a lifetime income should not be offered unless it is guaranteed by an insurer or an employer, even if the cost means pensions have to be lower

Statement B - Pensioners can accept some risk of pensions not rising as planned, or even being cut, if that is expected to give them a better expected overall income in retirement

Over 70% agreed that investment decisions should made centrally.

Fig. 4- Should members have control on their investment decisions?



Statement A - Members should be able to control how assets are invested

Statement B - Members aren't investment experts. Someone else, working on their behalf should take investment decisions for them

These views resonate strongly with the key pooling and risk sharing features of CDC.

3. However there were some features desired from a minority of respondents which may be more difficult to accommodate

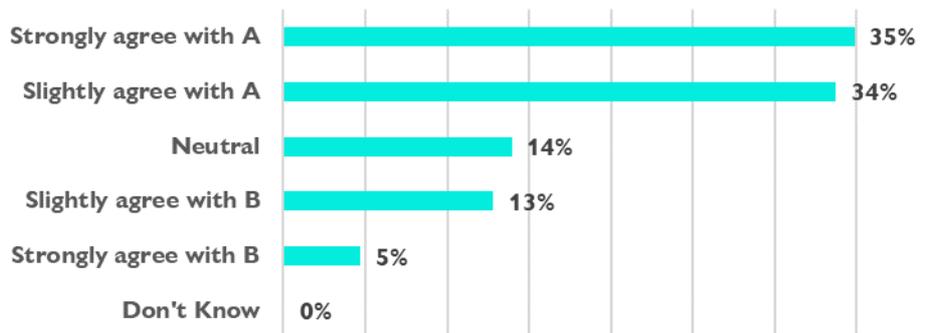


For example, a minority (25%) of our sample wanted some level of guarantee, which would have to be provided through some external vehicle (such as insurance) because guarantees are not part of CDC. (Fig. 3 above) And 18% of our sample wanted to give individuals control over investment decisions. To a degree these objectives can either be incorporated within CDC structures, or can be provided separately. (Fig. 4 above). But that may require a degree of flexibility, or that there may, in some circumstances, be interest in providing CDC benefits alongside traditional DB or DC benefits.

4. The majority of respondents (68%) were keen on a degree of risk sharing

Some elements of risk sharing - that of longevity - is part and parcel of the advantage of CDC. The sharing of other risks amongst members may be more controversial. For example, it is important that intergenerational risk is managed to stop one age group benefitting at an unfair cost to another. However, as Fig. 5 demonstrates, on the face of it, respondents seemed to want to incorporate a greater sharing of risks.

Fig. 5 - Attitudes towards risk sharing



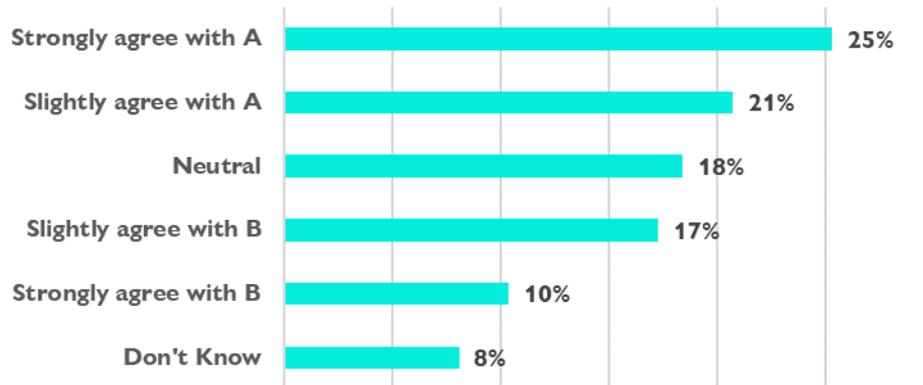
Statement A - Members should share investment outcomes over the long term – to smooth out good luck and bad luck

Statement B - Sharing investment risk is too difficult in practice. It is better if individual members experience investment gains or losses themselves

5. The majority (50%) believed that benefits earned from the equal contributions of young and old should create different target benefits

It is notable that in one key area — the benefit derived from payments by young and old, the majority (50%) believed that, in keeping with actuarial soundness, benefits earned from the equal contributions of young and old should create different target benefits — since the contributions of young people will be saved for a number of years before the benefit is paid.

Fig. 6 - Attitudes towards inter-generational fairness



Statement A - Treating employees of different ages fairly means that: ... similar contributions paid for young and old create different target pensions

Statement B - Treating employees of different ages fairly means that: ... the same target pension is created for otherwise similar employees of different ages

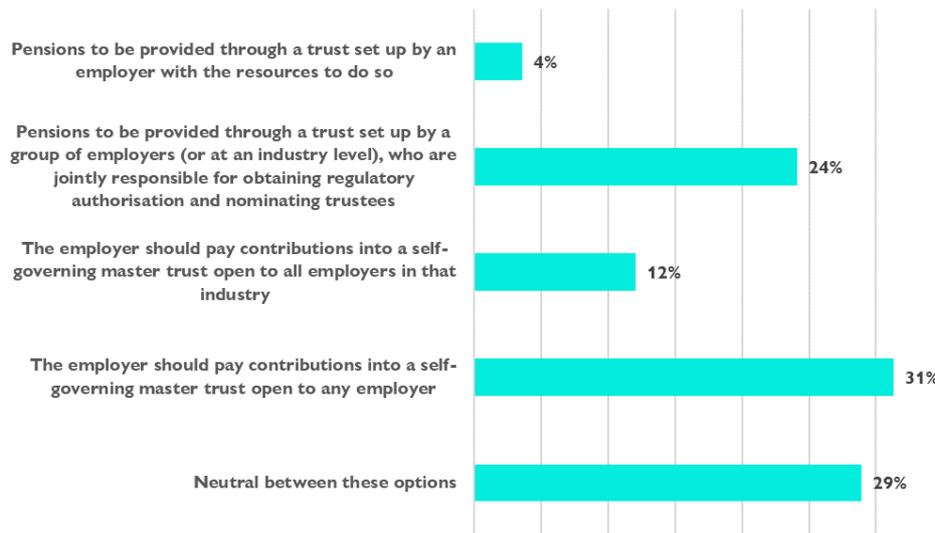
We would note this is not the design used by Royal Mail. , A sizeable minority (28%) favoured a benefit structure like Royal Mail's where each active member adds each year a target pension that is the same fraction of pay regardless of age (Fig. 6). Both these designs are credible ways of designing a CDC scheme.

- At present, there are differences in the way our respondents would design their ideal CDC system. In particular there was a desire for multi-employer provision. There was also a call for 'decumulation CDC' as a way for current DC savings to be converted into an income for life.

Perhaps one reason for this is that CDC is still in early development, and discussion has not yet been had about what a sensible 'default' CDC might look like.

There would be considerable benefit in having that discussion, particularly given the desire for multi-employer suppliers, as illustrated in Fig. 7. Only 4% of the respondents preferred setting up their own CDC pension plan.

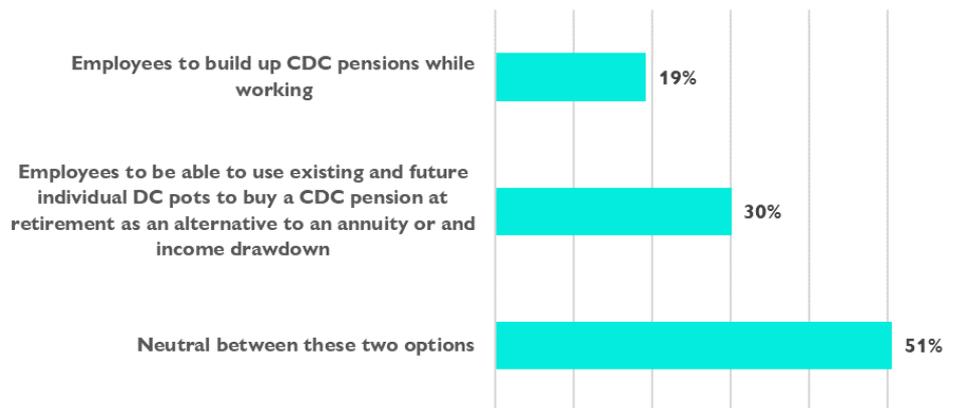
Fig. 7 – Preferences for CDC design 1: If your organisation (or one you are connected with) was to provide CDC pensions, would there be a preference for any of the following?



Two thirds preferred a multi-employer option, either for an industry, or for any employer. Around 30% expressed no preference. Multi-employer plans are likely to be lower cost, and more effective if they can offer standardised benefits that are fair for the members.

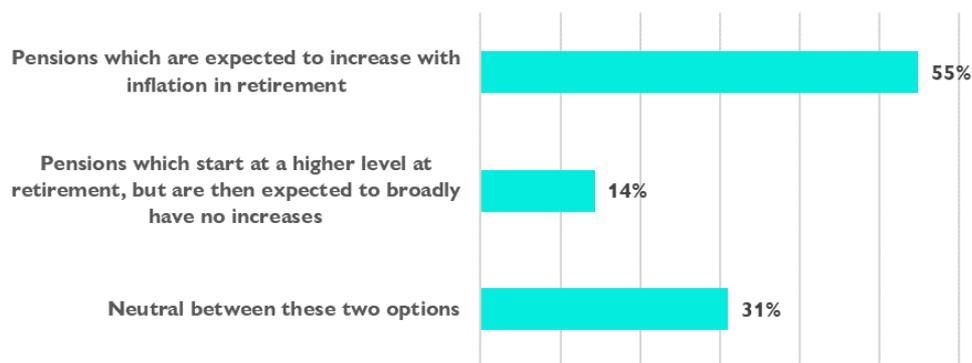
There was also interest in decumulation-CDC's. These would offer members with DC savings the ability to purchase a CDC pension in retirement, and hence could dovetail with existing DC arrangements. 30% saw this as their preference vs 20% for 'whole life' CDC. 50% were neutral between these options.

Fig. 8 - Preferences for CDC Design 2: If your organisation (or one you are connected with) was to provide CDC pensions, would there be a preference for any of the following?



7. Respondents envisaged that any CDC plan would best target retirement incomes which rose with inflation

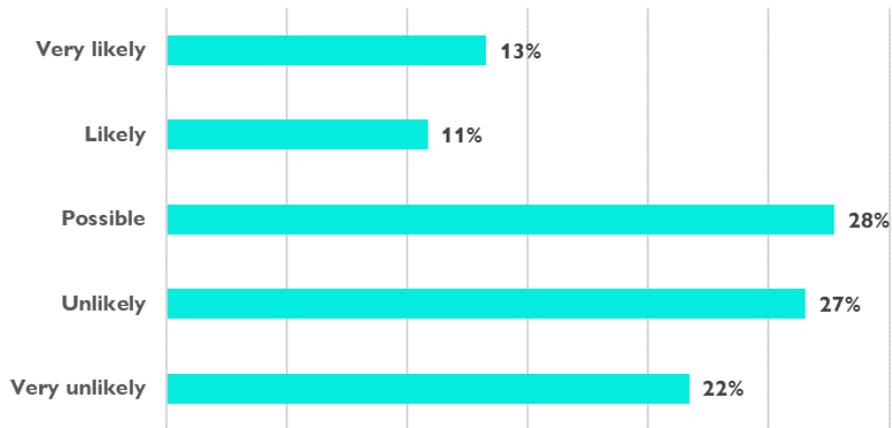
Fig. 9 - If your organisation (or one you are connected with) was to provide a CDC pension, focused on an income throughout retirement, would you have a preference for?



8. 25% of respondents said they were likely or very likely to introduce CDC pensions

Given the enthusiasm for the outcomes of CDC, at first glance it is perhaps surprising that, over the next five years only 25% of respondents said they were likely or very likely to introduce them. A further 28% thought it possible they would introduce them within five years.

Fig. 10 - With satisfactory legislation in place, how likely is it that your organisation (or one you are connected with) would provide CDC pensions in the next 5 years?

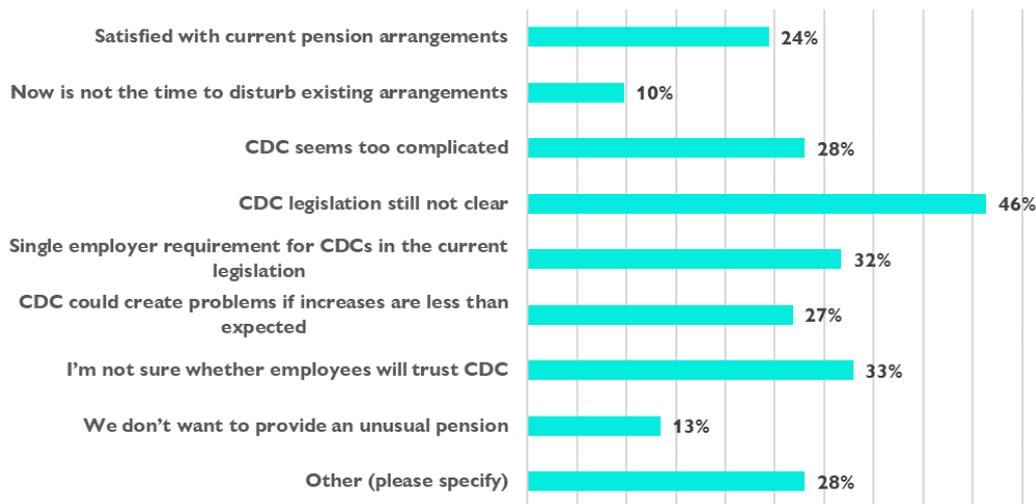


Nevertheless, given the scale of UK pensions, with contributions amounting to 6% of the annual GDP, a 25% adoption rate would be very significant indeed, particularly at this early stage in CDC development.

9. The most common reason cited for not adopting CDC is that legislation is still unclear (46%)

However, given the gap between the desire for the outcomes of CDC, and the more limited plans to implement it, the reasons cited for not adopting CDC are of particular interest. The most common is that legislation is still unclear. The fact that there is no multi-employer provision was also a significant impediment. Both these barriers can be overcome.

Fig. 11 – Are there any barriers stopping your organisation (or one you are connected with) providing CDC or risk sharing pensions?



The second set of reasons are about knowledge and confidence in CDC structures; that they may be “too complicated”, that they could create problems if pensions are not increased as expected, and they might not be trusted. Again, some of these barriers could be addressed with open discussion and debate, particularly amongst representatives of members. We would note that bodies representing the workforce — such as trade unions or the Association of Member Nominated Trustees — are generally big supporters of CDC, and that as CDC develops it will be important to build on that support.

NEXT STEPS: CDC PENSIONS

It is clear that there is an overwhelming demand for the outcomes of CDC: that is that pensions provide an income for life. It seems that there is a big preference for multiemployer CDC plans. The authors would support that call. Large, properly governed, multi-employer plans should offer lower cost and better outcomes. Indeed, they are a necessary condition for the offer of CDC to small employers, and to currently under-represented groups in pension saving e.g. the self-employed.

However, that demand may require a degree of consensus about how CDC plans should be structured. As noted above, if policy makers were to respond to the results of this poll there would be a tendency to allow that many different types of terms and conditions be allowed for CDC. If so, protections would need to be achieved by (i) clear contingent rules on benefit payments that have been robustly stress tested (ii) transparency



and clear communication and (iii) trustee-style governance.

However, our poll was undertaken before there has been much debate about the best design for CDC. The Royal Mail plan is the only one whose terms are publicly known. We believe there may be a greater consensus possible if there were a greater understanding of the benefits and the trade-offs involved in the design of collective pensions. The aim would be to create the greatest possible choice for the minimum cost.

In particular, one weakness of CDC is that, in the event of a severe drop in asset values, pensions in payment might need to be reduced, albeit modestly. Communication is therefore essential; members need to understand and be confident their pension is well managed, and that benefits, and expectations of benefits are fair. But discussion and research is needed on the best way to explain how CDC works, and how changes in expectations should be communicated.

There is a more ambitious conclusion one might reach. The savings aspect of pensions (accumulation) is now quite well catered for, thanks to auto-enrolment. However there is still a profound gap in UK pension provision. That is how that saving can be converted into 'an income for life' (decumulation). The architecture for auto-enrolment was developed from the Pensions Commission, which established new rules and institutions. Might there be a similar role for some sort of commission to address how the current pensions architecture can be built upon to cater for both an effective system of accumulation and decumulation? Given the scale of the pensions industry, the benefit from getting this right would be very great. However, we would not want 'the best to be the enemy of the good' or delay current CDC implementation.

NEXT STEPS: CDC FORUM

The purpose of the CDC Forum is to support the development and implementation of collective pensions so that British pension savers enjoy the benefits they provide. CDC is not a silver bullet that will solve all of the UK pension woes. No pension system is perfect, and CDC has limitations, and requires good regulation and governance.

The Forum will help build a consensus between different industry players including employers, trustees, master-trusts, lawyers and actuaries. The consensus must also include those representing the employees, particularly the trade unions. It should involve those who campaign for better pension outcomes. Finally, it will involve the government, regulators and the political parties to help contribute to the direction of future legislation. One of the main roles that the Forum will play will be in bringing these groups together and developing projects that further explore how CDC could be implemented in the UK.



Secondly, the Forum will continue its research work to understand how CDC might evolve, addressing questions around the nature of scheme design, scheme communications and the fairness of outcomes. The Forum will also support research by others. For example, collective arrangements may have great benefits for the self-employed. Their permanent nature would help support investment in infrastructure. Their scale would give them a voice in sustainable and responsible investment.

However, all these benefits require collective arrangements to become a significant part of the UK pensions system. This research suggests that the demand for CDC outcomes is certainly there. Translating it into reality is the next challenge

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APPENDIX

Rationale for research

This research aimed to understand the nature of the likely demand for CDC in the UK. There are many directions in which CDC provision could go. For example, it could be designed only to serve large employers, or to serve many through multi-employer schemes. Individual CDC plans can be designed in many different ways. For example in the nature and flexibility of the target pension. This research has sought to understand these factors, and where the demand lies for CDC. Its goal is to help inform the next wave of policy development and initiatives within the industry, so that they can best match the needs of pension fund sponsors and members.

For policymakers and those involved in regulation, the prize of helping to build CDC provision into the UK system is a unique opportunity. CDC structures are a significant component of the best pension systems in the world. They also exist in isolation in countries which have much poorer overall pension provision. Thus getting the policy and regulatory structure right is important. Well designed, CDC could enjoy wide spread adoption, and allow employers to provide their employees with better pension outcomes.

With the introduction of the Royal Mail scheme, the UK is setting its own trajectory. Pensions need to be designed to work with the unique structure and history of the UK pensions system. Reforms will work best if they understand and respond to the needs of British pension savers. It will require dialogue to ensure that as many as possible are signed up to the direction that policy and industry initiatives might take. As a starting point, we offer this short poll of opinion about CDC and its future direction.



Methodology

We asked a wide cross section of the UK pensions community to provide their answers to the questions we discussed in this briefing. This was a short poll, using Survey Monkey. Respondents had an opportunity to undertake the poll anonymously if they chose to in order to provide us with a set of results that reflected their views of CDC without having to worry about the current situation of their own schemes. That sample was supported by the early partners of the Forum, namely Aon, First Actuarial, the Institute and Faculty of Actuaries and CMS. The data therefore is from individuals who are currently active in the UK pensions system across both DB and DC systems.

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