Aon Hewitt

Collective Defined Contribution Plans

A new opportunity for UK pensions?

Summary

Steve Webb MP, the Minister of State for Pensions, is looking to reform the UK's pension system by exploring 'Defined Ambition' (DA) pension plans. One of the variations of DA is the Collective Defined Contribution (CDC) plan. These are risk-sharing plans widely used in several other countries but not currently permitted in the UK.

Aon Hewitt has conducted significant research into the design of CDC plans which demonstrates that as well as offering cost certainty to employers, CDC plans can provide better average pension incomes to members than conventional defined contribution (DC) schemes. In addition to this, CDC plans can provide members with a much better idea of their income in the run up to retirement compared to a conventional DC scheme.

The flipside of risk-sharing is that, in extreme circumstances, benefits may need to be reduced in order to restore full funding. However, the experience of these plans in the Netherlands is that in the recent past these reductions have been very small and substantially lower than the equivalent reductions UK DC members have had to bear.

We encourage employers – particularly those with over 1,000 employees – to consider whether a CDC plan might meet their retirement needs. The current DWP consultation represents a window of opportunity to influence the Government's thinking and consequently the future UK pension design.

If you would like to discuss the Government's proposals further, or would like more information, or see how a CDC design would compare with your current pension scheme, please speak to your usual consultant or one of Aon Hewitt's CDC team:

- Kevin Wesbroom
- Matthew Arends
- David Hardern

Contact details are provided on the back page.

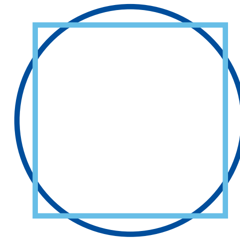
Background

Steve Webb MP, the Minister of State for Pensions, has acknowledged the UK's pension system is in need of reform. In November 2013 he presented his strategy for 'reinvigorating workplace pensions'.

This paper identified Collective Defined Contribution plans (alongside variations on traditional DB and DC designs) as candidate Defined Ambition plans.

What is a Collective DC plan?

For the sample CDC scheme that we have modelled extensively, the employer pays a **fixed contribution rate** while the member gets a **DB-like target pension** – a 1% career average revalued earnings (CARE) pension (with CPI linked revaluation before and after retirement), payable from age 65, in our example below.



So what is the catch? How are we managing to square the circle between a pension that is DC for the employer, but feels like DB to the employee?

The CDC pension is **conditional**:

- Revaluation (before and after retirement) is not guaranteed
- Even the core pension is not guaranteed in extreme situations
- Benefits are adjusted to ensure the employer's cost stays constant and the funding level remains close to 100%.

Consequences of the CDC design

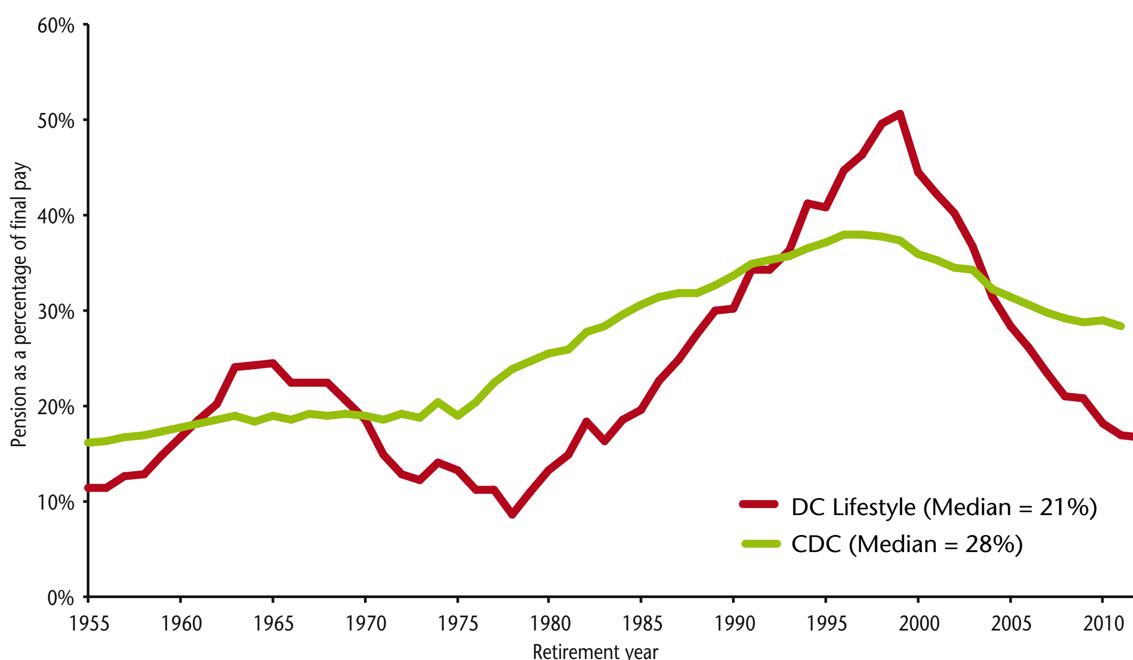
If investments perform better than expected, members could see benefit increases – before and after retirement. However, investment underperformance – or, for example, an unexpected increase in life expectancies – could lead to a reduced level of increases, or even a benefit cut if conditions are sufficiently bad.

Many CDC designs would prioritise making good any benefit cuts as investment conditions improve.

Does the CDC design work?

Yes.

Our modelling shows that CDC plan designs can provide higher average incomes than current DC schemes, and with more predictability. The top chart demonstrates this, based on back-testing of individuals retiring on the dates shown after 25 years' pensionable service, with the same contribution of 10% of pay having been paid to the CDC plan or DC scheme.



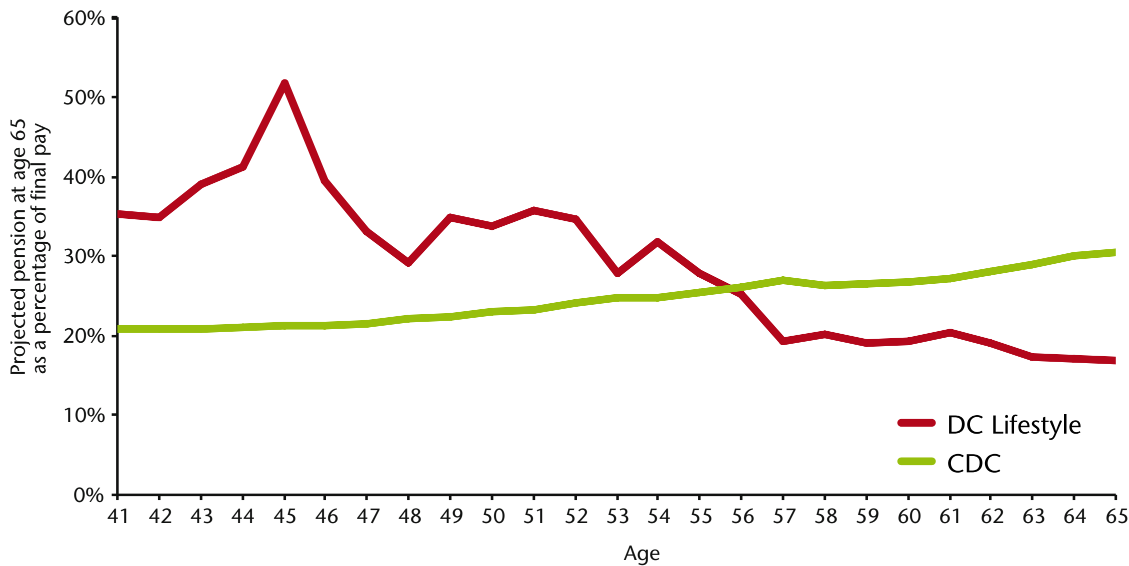
The green line shows the average CDC income in retirement and the red line the average DC income using a lifestyle investment strategy. The chart shows just how variable the outcomes can be from conventional DC arrangements.

The green line is visually more stable over time than the red while the average is also superior.

Importantly, none of this modelling assumes inherently better returns or lower charges from CDC than DC. The primary reason for the superior CDC performance is that pensions are paid from the plan (without the need for an annuity being purchased at retirement) enabling a higher proportion of investment in growth assets, and avoiding being forced to invest in lower yielding assets at inappropriate times (which is what annuity purchase in current times of low yields implies). Collective investment by trustees on behalf of all CDC plan members enables longer-term decisions to be taken, such as investment in infrastructure, mortgages and long-term illiquid assets which are not readily incorporated into DC schemes with their daily unit pricing. Many of the advantages of CDC plans could be incorporated into DC schemes if they adopted the leading edge practices in relation to investment strategies, and if we witnessed some significant innovation in the decumulation market.

"CDC plans can offer advantages of cost certainty to employers and better average pension incomes to members than typical current DC schemes"

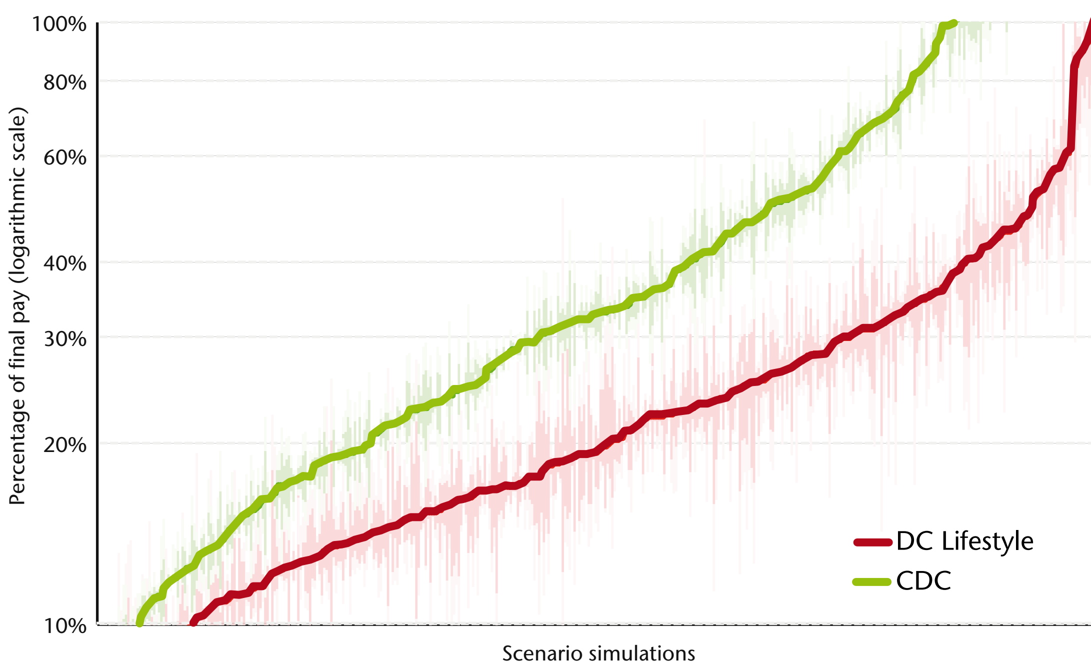
The chart at the top of page 5 shows how much the projected pension at age 65 (for an individual member retiring in 2011) varies from year to year as the member progresses through their career. The CDC design gives members a much clearer idea of their retirement income than lifestyle DC – their pension journey is more stable and contains fewer surprises.



The DC member would have been told to plan on a pension of one third of their pay as they entered the scheme – a few years later they might have expected a pension of one half of their pay – but the eventual outcome was around one fifth of final pay. In contrast, CDC expectations were much more steady, rising gently and progressively from around 20% of pay to 30% of pay – the pension journey was much smoother, and the member would be able to plan much more effectively for a suitable standard of living in retirement.

It is one thing to design a pension plan that copes well with past history, but any new design also needs to work in the future. So we have also modelled the expected future performance of CDC plan designs against DC. In the chart, we have looked at the average outcome (solid line) and the range (shading around this line) from our modelling scenarios in order. We have focused on the central 80% of outcomes – in the top and bottom 10% of outcomes members do (respectively) very well or very poorly regardless of the plan design.

The CDC outcome is typically higher than the DC outcome, and the variability around the central outcome is much less – showing that CDC delivers a higher average pension and with greater certainty.



> "As well as delivering a higher expected retirement income, the level of income is more stable for the member"

The pros and cons of CDC plans

It is clear that CDC plan designs have several distinctive features in comparison to DC schemes. Through our discussions with employers and other stakeholders, we have identified the following main attractions and concerns with the CDC design. The percentages shown in the table are the proportions of the 241 pension professionals who identified these top four factors in our 2013 Aon Hewitt Global Pension Risk Survey.

Attractions		Concerns	
Employers get fixed contribution rates: it is a DC plan not a DB plan	75%	Changes by a future government that could make it a DB plan	76%
Greater predictability of outcomes for members	71%	Presenting "soft" member guarantees (target benefits not promised benefits)	73%
Members don't need to be involved with investment decisions	46%	The possibility of cutting benefits	38%
Greater investment efficiency and economies of scale (eg no need to purchase annuities on retirement)	44%	Cross subsidies between generations	35%

"Predictability of income was seen as a major attraction of CDC plans"

The attractions of CDC

Some of the advantages in the table have already been covered. Below, we explore the remaining features our survey participants identified, with particular emphasis on why these features are seen as positive.

Certainty of cost

Among our pension professionals, this was the single greatest attraction of our CDC plan design. This finding accords with our discussions with employers from which it is very clear that a significant majority (but admittedly not all) employers have had extremely bad experiences with the volatility of DB pension plan costs and so pension cost certainty is now a necessity.

The member perspective

Aon Hewitt research shows that over 80% of DC members are invested in the default option. This is a symptom of the complexity of the decisions required and the lack of engagement members feel in pensions and investment matters.

By contrast, CDC plans do not require specific member involvement in the key issues of investment choices and annuity purchase. As a pooled arrangement, a CDC plan trustee board sets the investment strategy and pays out benefits, including pensions to pensioners so that individual annuity purchase is avoided. This enables greater use of, and broader access to, growth assets for longer. The result is better expected performance leading to better member outcomes.

A further by-product is that member benefits are expressed in terms of income, not by size of pot. This is important in setting members' expectations: a member with a pot of £100,000 in a DC account may feel a significant source of security from his pension saving, but converting this into an income of a mere £50 per week may feel less than satisfactory.

"Having access to a wider range of growth asset classes for longer means the assets are invested more effectively, leading to better member outcomes."

Isn't this too good to be true?

We have looked at the attractions of CDC, so let's look at the perceived risks.

The biggest issue... future intervention

The biggest issue surrounding CDC plans is often expressed as a concern that future governments would intervene or change policy in a way that adversely impacted employers.

However, the issue goes beyond this because there are bodies outside the Government's control, such as accounting standards boards, that could decide to treat CDC plans as DB.

Some exploratory work has been done to mitigate this risk, with one possible route being to change legislation to give greater protection to the sponsors of CDC plans. It is early days, but the signs are positive. What is clear is that employers will not adopt CDC plan designs without this risk being resolved.

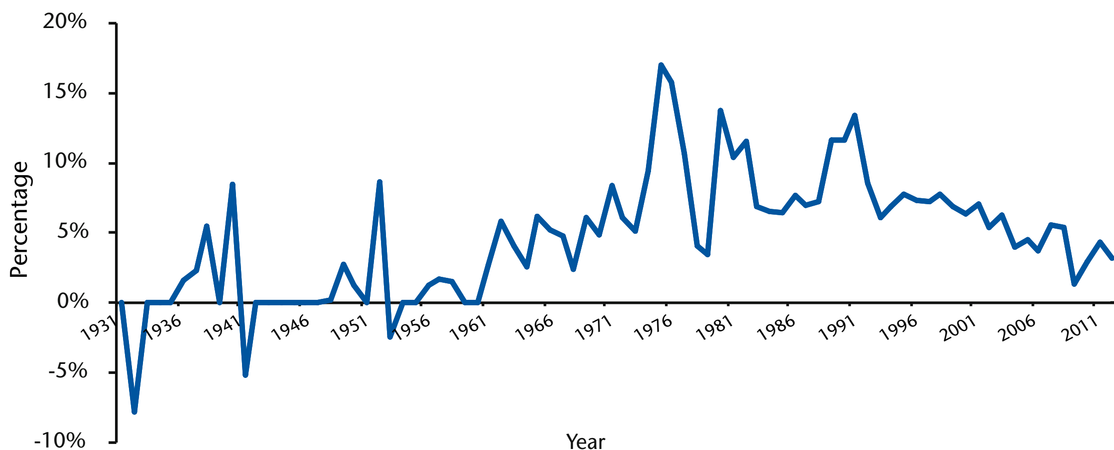
'Soft guarantees'

Interestingly, delegates at our 2013 Spring Pension Conference series were relatively balanced about the prospect of having to explain what might be called 'soft guarantees' to members – this would be where there is an intention to pay a particular benefit level which might not – in extreme circumstances – be paid in full. In all, 44% of 757 delegates said they thought this challenge could be overcome, with 56% saying it could not.

As with any type of pension plan, good communication with members is important. What is crucial with CDC plans is that communications with members do not duck the issue that benefits are only targeted, not guaranteed. Indeed, this is just one aspect of transparency of CDC plans that we see as pivotal to their acceptance in the UK – something that we return to below.

Benefit cuts and cross-subsidies

This chart shows the absolute level of benefit increases that would have been awarded from our CDC plan over its past history.



Our modelling shows that cuts to core benefits are very occasionally necessary but only in fairly extreme conditions such as significant recessions. In fact, our CDC design sees benefit cuts averaging 7% in only three years out of the last 70 with two of those taking place during the Great Depression and the Second World War.

The Dutch experience

A quarter of Dutch CDC plans reported* having to cut pensions by an average of **1.9%** in 2012 to restore their funding level.

These benefit cuts will have priority for restoration, if and when financial conditions improve.

In the UK, by contrast, the cost of buying an annuity increased by **29%** over the three years 2009-12 – giving a permanent reduction in retirement income.

The reason the Dutch member experience is better than the UK's is down to intergenerational cross-subsidies. Seeing this as an advantage not a disadvantage is important – something that can be achieved through effective communication.

** De Nederlandsche Banke; 25 April 2013, DNB assesses pension funds' recovery plan evaluations*

Age tapering benefits cuts

One way to address the issue of potential benefit cuts is to taper the impact of benefit cuts by age. We have modelled a design where those aged over 75 see no cuts whereas 65 year olds and below are exposed to the full effect.

The modelling shows that this is an effective strategy and clearly provides enhanced security to older pensioners. The consequence of immunising older members in this way is that the uplifts and cuts for younger members are magnified. However, the modelling shows that this is a reasonable trade of risk for reward for the younger members too.

> "Older pensioners could be protected from the risk of pension cuts by tapering the benefit cut policy by age"

Transparency

One potential issue with CDC plans could be a lack of transparency – both to members and generally – about the policies and position of the plan. For example, if one CDC plan were to award bonus benefits at the same time that a second plan were cutting benefits, this would be a source of confusion.

We advocate a governance process for CDC plans that sees a high degree of public scrutiny. This could take the form of a centralised website where funding levels, asset allocations and benefit awards are published.

Such an approach would encourage greater engagement by the plan membership. Perhaps more importantly, though, it would help to prevent individual CDC plans from consistently over- or under-distributing bonuses compared to their peers, something that might be an indicator of future problems.

Actions

Aon Hewitt has carried out significant research into CDC plan designs and is actively consulting with the DWP on the implementation of CDC in the UK.

We are interested in hearing your thoughts on how pension provision should evolve in the UK. We would also relish the opportunity to talk to you about our work in the CDC arena, both to get your input into the subject and to continue to evolve our CDC template design.

If you would like to discuss any of the Government's proposals further, see further details of our research or would like more information, please speak to your usual consultant or one of the CDC team:

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Further reading

The material in this paper is derived from Aon Hewitt's proprietary research. This is described in more detail in our White Paper **"The Case for Collective DC"** which is available from: www.aonhewitt.co.uk/collectivedc

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