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Collective Defined Contribution (CDC) pension schemes are held up by some to be the miracle cure for the UK's pensions problems. This *Placard* issue debates the advantages and disadvantages of such arrangements.

Collective Defined Contribution – is it the future for the UK's pension arrangements?

CDC pension schemes provide a pension based on some sort of formula (typically a career average formula). This pension is subject to indexation only to the extent this is affordable, with the ability to also apply benefit reductions in the event of a funding shortfall. The 'DC' part of the name comes from the fact that contributions are fixed and the 'collective' part from the fact that all risks are spread across the membership through one pooled investment fund. These arrangements are probably best known for being the most common type of private sector provision in the Netherlands, although a number of other countries also adopt collective models. The Dutch pension system is often described as being one of the best pension systems in the world but are CDC arrangements really as good as they are cracked up to be?

Steve Webb, the Pensions Minister, is a strong supporter of CDC and it was recently reported that new CDC legislation is likely to appear in the pre-election Queen's Speech as the 'centrepiece' of a third Coalition Pensions Bill. It therefore seems rather ironic that some in the Netherlands are considering a move away from CDC arrangements to a UK-style system of individual pension pots, as we consider a move in the opposite direction.

The Netherlands have not always operated CDC schemes. Many people are not aware of the fact that most Dutch pension provision used to be defined benefit (DB) in nature but the rules were relaxed to allow many schemes to switch to CDC.

The more collaborative working culture in the Netherlands and the fact that they do not have the same legislative constraints as we do in the UK with regard to retrospectively amending benefits meant that such a change was legally and politically acceptable; such changes are generally a negotiated outcome through works councils or Unions.

It is widely claimed that the Dutch CDC system is better than our DC system and this is at least in part because CDC arrangements are meant to be able to provide a significantly higher pension (perhaps up to a third more) for an equivalent level of savings compared to defined contribution (DC) schemes in the UK. This is cited as being due to a number

of reasons: greater freedom of investment, less volatility due to the spreading of risks, not being tied to purchasing annuities in the open market and lower fees once scale is achieved. However, the Dutch model is not without problems. The cuts to members' benefits are discussed in detail in the second article of this *Placard* issue.

Interestingly, the Dutch pensions regulator De Nederlandsche Bank (DNB) and the Pensions Federation recently reported that fewer Dutch pension funds will need to cut pension rights than previously expected. However this was due to the fact that some employers have paid in additional contributions to plug funding gaps in their schemes rather than face adverse HR implications from cutting pensions!

The main challenge with the Dutch system is that it is potentially unfair across the generations; younger members bear the risk that their benefits will be reduced in future if older members' benefits are preserved today. Indeed in 2009, the Department for Work and Pensions (DWP) concluded that it would not pursue its investigations into CDC partly due to the risk of an unacceptable level of intergenerational unfairness. These unclear ownership rights and lack of transparency have tested the current system in the Netherlands and I am sure that this has played a part in a number of their pension schemes switching from CDC to pure DC arrangements.

As well as relying on a regular flow of new membership and the need for considerable scale, one of the other concerns with CDC for me is their regressive nature. Bizarrely, this element of CDC is rarely discussed. Members with higher incomes are typically likely to live longer than lower earners and therefore receive more pension over their lifetime. In the UK, individual pots mean that if you are likely to live longer, you need to save more. In CDC arrangements, a certain level of pension is targeted through pooling all members' funds, but the members bear the risk and thus the low earners are effectively subsidising the higher earners. Clearly there are a number of advantages associated with CDC arrangements; however, it is not obvious to me that they are the solution to all our pension woes.

In November last year the DWP produced a public consultation on 'Reshaping workplace pensions for future generations'. This consultation suggested a number of innovative proposals to reform the UK's pension system, which included CDC arrangements and other "DC plus" ideas (such as the 'pension income builder' model) which offered an alternative approach to risk sharing. In my view, proposals most likely to work are those that involve sharing the risks that are fair to share (those which can be efficiently shared or pooled) in a transparent manner, but not necessarily the other risks such as longevity.

In this issue of *Placard*, **Kevin Wesbroom** (Partner, Aon Hewitt) explains why he supports CDC and **Richard Jones** (Principal, Punter Southall Transaction Services) points out some of the myths with CDC and discusses some of its potential drawbacks.

Editorial Introduction by Catherine Love Soper *Editor*

Collective Defined Contribution: Give it a Chance!

By Kevin Wesbroom

One of the features we have learnt from behavioural finance is the importance of framing or anchoring when a subject is introduced. The first time people hear about Collective Defined Contribution (CDC) plans, they are likely to hear comments along the following lines:

Isn't that like with-profits? Is that some sort of Ponzi scheme that needs a regular flow of new entrants? Don't we need to become socialist like people on the continent? Isn't that the type of plan where the Dutch have to keep cutting pensions?

All of these statements are regularly repeated in relation to CDC plans and after even the most superficial of analyses are in fact shown to be false.

Suppose instead that the concept was introduced along the following lines:

As an employer, would you like an opportunity to enable your members to get a one third bigger pension than DC plans provide, with greater stability and without taking on any risk yourself? Would you like a system that does not force people to buy annuities in current market conditions? Is there a better approach to investment than having individuals who are unwilling and generally unable to take investment decisions being forced to take complex decisions?

Sounds appealing! So what is it we are talking about here? We will continue to use the term CDC plans, although as we will see later there are perhaps some better descriptors that may help put the concept across more readily. The key point regarding these plans is the defined contribution (DC) element; if these plans are to succeed then this needs to be confirmed to employers. These plans must be seen to carry no balance sheet risk for employers and no retrospective adjustment of contributions. Memories of defined benefit (DB) schemes are simply too painful for employers to contemplate being burnt again.

Kevin Wesbroom

Do CDC plans fit with what members want?

On the other hand if we ask members what they want from pension saving, it would generally be a predictable secure retirement income that offers them some protection from inflation. These are, of course, exactly the types of benefits we are used to seeing in defined benefit plans. So, how do we square the circle between a plan that is DC for the employer yet DB-like for the employee?

The answer is that the benefits have to be flexible. Benefits under CDC plans, which will be paid out in the form of regular payments after retirement (or pensions as we used to call them), have to

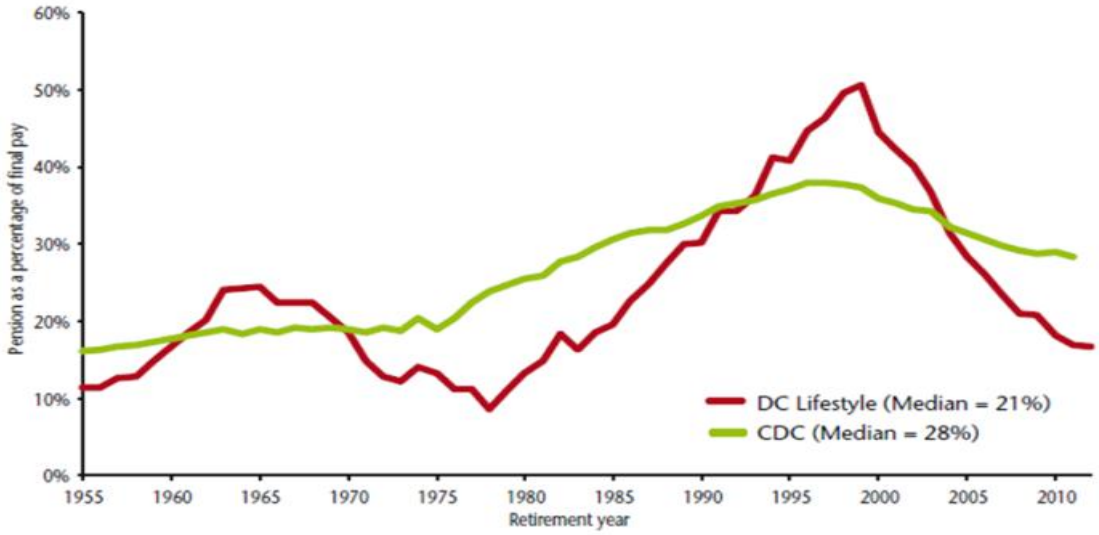
be capable of adjustment so that their value is close to the amount of assets in the plan. There should be no requirement for the employer to top up the plan and so the benefits have to become the balancing item. Does this mean that benefits will inevitably be cut? Of course not! This is because there is significant flexibility in the funding of a CDC plan.

Flexibility

Imagine that you are funding for a career average plan with CPI indexation before and after retirement. The reserve that you are holding in respect of that future indexation will be a significant part of the total. As conditions change in the markets, you can flex the indexation to retain the financial stability. Our modelling shows that only in extreme circumstances would it be necessary to go back and cut into the underlying benefit itself in order to remain fully funded. These extreme circumstances include conditions such as the Great Depression and World War II, when our contention is that any forms of pension saving will be under significant threat. And to kill the myth of Dutch benefit cuts being a killer blow for CDC plans, it turns out that the majority of these have taken place in what we in the UK would refer to as DB plans! The Dutch system enables cuts in defined benefit plans even for solvent employers, as their legislative framework is very different to ours. We can learn from their system but we do not have to follow it slavishly.

The higher benefits from CDC plans compared with conventional DC plans come from being able to take a broader perspective on risk. Under current DC plans, typical lifestyle arrangements will give exposure to return seeking assets for a limited period only, followed usually by annuity purchase and investment in lower yielding bonds during retirement. That may have been a fair strategy when retirement was expected to be a 15 year business, but with increasingly longevity offering the prospect of 30 years or more in retirement it becomes a very poor investment decision. CDC plans spread the risk collectively across members and across generations, enabling both the smoothing of temporary market anomalies and a better risk profile for any individual member. Of course inter-generational risk sharing is quite a big "ask" since it requires trust. That trust can often be broken, as we believe is visible in the Netherlands where what is happening is not so much sharing of wealth, but more the transfer of wealth from young to old. This would be a classic case where we can learn from their mistakes.

The graph below shows the typical pension size (as a percentage of final pay) obtained from a CDC plan compared to that from an average DC plan, for members retiring on dates between 1955 and the present day after 25 years' service.



CDC plans do pose some significant challenges, the greatest of which is potentially the governance question. In other words, somebody has to be responsible for deciding when benefits should be adjusted (either up or down). Analogies with the discredited with profits market are easy to make, but surely we can learn from their mistakes?

We propose a transparent system under which CDC plans would be subject to active intervention by an empowered regulator; reasonable because the nature of these plans is that there will be significantly fewer of them than existing DB or DC schemes. More than that, we propose that the financing of the plans should be in the public domain so that informed pension commentators can readily identify plans where the benefit actions are not supported by the investment policy and the returns being obtained.

CDC plans deserve to exist!

CDC plans offer economies of scale although we accept that many of these can be attained within existing DC vehicles. The fact that they are not attained can be addressed by tackling the DC market directly, but CDC plans offer a viable alternative and deserve to have their opportunity to exist alongside DC plans.

Economies of scale can also encompass economy of thinking: with investment being made on a collective rather than an individual basis, access to best thinking and the best investment categories would be available to plan members. Asset categories that are difficult to deal with under individual DC arrangements, such as infrastructure or other illiquid categories which can offer stable yet relatively generous returns, can be readily incorporated into CDC plan investment strategies.

Events in recent years in relation to both equity markets and long-term interest rates have shown just how volatile the outcomes from conventional DC plans can be. Retirement incomes for those forced to retire today are barely half of what would have been available to their counterparts retiring 10 years ago for exactly the same inputs into their DC plans. This intergenerational inequity is rarely mentioned when the generational sharing that is inherent in CDC plans is discussed. CDC plans enable greater certainty of outcomes for members who can hence make better planning decisions for their retirement, building on top of a (finally) stable state pension system.

Although we hear much of the Netherlands in relation to CDC plans, they are rapidly being adopted in many other locations around the globe, particularly Scandinavia and several Canadian provinces. Our Canadian colleagues who are heading the development of their version of CDC plans have taken to calling them ‘Target Pension Plans’ and talk about building a sustainable pension model. Rather than necessarily a single contribution rate for an employer they have developed the concept of a limited ‘zone’ of cost, say between 10% and 12% of pay. This allows for an element of variability in costs, but the key point is again that there is no come back or retrospective adjustment for the employer after the contribution has been paid. This enables the plans to be sustainable as they can consistently, through both favourable and adverse circumstances, deliver an **appropriate range** of benefits within an **acceptable range** of costs. That sounds like a clarion call for a pension system that is superior to both of the systems we have tried, and which have failed, in the UK to date.

CDC plans or target pension plans deserve to have the legislation to enable them to improve outcomes for generations of UK workers. As consulting actuaries, we have to ask ourselves if we have done a stunning job for pensions to date; if Steve Webb gives us the lead, we, the advocates of CDC plans, believe we should embrace it wholeheartedly.

Collective Defined Contribution: Not fit for purpose!

By Richard Jones

Collective Defined Contribution ("CDC") may be one of the hottest topics in pensions but CDC is not a particularly accurate definition for something that is not new in concept. CDC would perhaps be better described as being "adjustable defined benefit". Such approaches have a long history and demonstrate the actual and potential problems with CDC which mean it is unlikely to lead to a renaissance of pension provision.

Richard Jones

The key advantages of CDC proposed for employers and employees, excluding of course the somewhat tenuous benefits of economies of scale and the apparent ability to take more investment risk, are certainty of cost for employers and predictability of retirement benefits for employees. Examples of CDC arrangements operating in practice suggest that such purported benefits may be illusory.

CDC fails employers…

Starting with the employer perspective the key benefit here is that CDC purportedly only requires the employer to make the specified annual contribution, much like a defined contribution arrangement, with no residual liability arising. If the contributions are insufficient to meet the benefits then benefits are scaled back but equally positive experience for the scheme leads to higher benefits. The risk sits with the employees albeit that the risk is spread across all members and shared inter-generationally.

Bringing these strands together we can refer to the case of *Aon Trust Corporation Ltd v KPMG (a firm) & others* from 2005. The predecessor firms to KPMG had established a scheme in 1949 that was based on a fixed contribution from the employee and employer being converted into a notional pension amount and this to be up-rated or reduced in line with experience to maintain a balanced position.

This was therefore a CDC arrangement in all but name. Unfortunately this arrangement was deemed to fall foul of the Pensions Act 1995 and thus was converted to a defined benefit arrangement by default. We can see from this that CDC arrangements are not new even in the UK and the big risk for employers is that the contingent promise made in the past may become crystallised as an actual guarantee in the future. This is not a trivial point and has happened before to final salary arrangements on numerous occasions – the debt on employer legislation, the requirement for revaluation and statutory pension increases.

It is also worth considering the experience of the Netherlands where industry wide CDC arrangements have been in place for many years. Let us consider the experience of the industry wide arrangement for the metals and electricity engineering industry, the *Pensioenfonds van de Metalektro* ("PME"). This is a standard CDC arrangement in the Netherlands providing a defined benefit salary related formula with conditional indexation and the ability to reduce benefits

in the event of funding shortfalls that cannot be dealt with by conditional indexation.

The experience of employers in PME has not been ideal with the required contribution rate increasing from 22.0% of salary in 2008 to 27.1% from 2013 (excluding the cost of the phased out early retirement uplift programme). This increase reflected the growing cost of providing the formula pension in each year and thus provides an immediate contrast with a standard defined contribution arrangement for an employer.

…And fails employees

The recent experience of members meanwhile has been catastrophic. PME aims to provide indexation on benefits in line with Dutch CPI but, after providing indexation every year since 1971, has only provided one indexation increase since 2006 in an attempt to balance the books. Indeed additional remedial action was required in 2013 when, as well as no indexation being provided, the benefits of all members were cut by 5.1%. Just considering a member who retired in 2007, then the real value of their PME benefits has fallen by 15% - 20% when they reasonably expected that their retirement income would be stable in real terms. These plans are, after all, designed to provide inflation protection.

As the indexation and benefit adjustments are applied equally to all members it can be seen that the CDC structure does not actually allow members to better predict their retirement income than a defined contribution arrangement – it just appears to be that way as the initial pension put into payment is a fixed amount. What happens to the pension payable once established is unknowable and unpredictable.

We can contrast the position of a pensioner of a CDC scheme with that of a traditional defined contribution scheme. The member of the defined contribution scheme has significant uncertainty as they approach retirement as to their final fund value and the pension this might provide. However, assuming that the exact date of retirement is a choice as it typically remains, then they can always defer retirement until they have built up a larger fund if they so wish. Once they are content with the retirement income they can retire safe in the knowledge that the insurance company with which they have secured this income will deliver the promised level of indexation and that no benefit cut will ever be applied.

The CDC pensioner may have greater clarity on their retirement pension, being whatever was shown on the last benefit statement plus additional service and any indexation, but once they start drawing this pension there are no guarantees. A 65 year old retiring on what they believe to be a reasonable income may find when they reach 75 or 80 that the real value of what they receive has been eroded by a lack of indexation and benefit reductions and is no longer adequate. At this point the member may have no option to return to the workforce and accrue some further pension benefits or income.

Simplistically therefore it seems to me that the uncertainty as to retirement income as you approach retirement (but certainty after retirement) that is delivered by the traditional defined contribution arrangement is preferable for most pensioners to the greater predictability of the CDC arrangement as retirement is reached but with complete uncertainty as to what income will be received in retirement. At least in the period leading up to retirement members usually still have the option to defer retirement to fix the problem. There is little that an older pensioner can do other than cut back their expenditure if their retirement income falls short of expectations.

It seems to me, therefore, that from both an employer and employee perspective it is arguable that CDC is less attractive than a defined contribution arrangement of the equivalent cost.

The other misunderstood ‘benefits’

Reverting to other supposed potential benefits of CDC, we can all see clearly that economies of scale can be achieved with any benefit structure including traditional

defined contribution. This is therefore a non-point.

The ability to take more investment risk, through both a higher equity weighting and the removal of any requirement to purchase annuities, clearly has the potential to allow a CDC arrangement *on average* to provide a higher level of pension than the equivalent contributions going into a DC arrangement. This expectation of greater benefits being deliverable under CDC comes of course at a higher degree of risk which is justified by the ability of a CDC arrangement to spread risk across generations. The main concern with such a supposition is that no detailed consideration has been given to how such risks will arise and their consequences for different cohorts of members.

It is clear from the experience of PME, having granted indexation every year from 1971 to 2006 and thereafter pensions have lost value, and of the KPMG scheme, which provided indexation broadly in line with RPI from 1949 to 1999 followed by zero indexation thereafter, that the additional risk taken by a CDC arrangement is likely to manifest in "clumps". For many years a CDC arrangement may, similar to the historic experience of PME and the KPMG scheme, proceed smoothly declaring indexation in line with expectations. But when things go wrong a long period of zero indexation (perhaps combined with benefit cut backs) will be required to set the CDC arrangement back on an even keel. Clearly some groups of members will do extremely well out of a CDC arrangement whereas some groups of members will unfortunately take the majority of the downside risks. One has to question whether this approach is fairer than that of a defined contribution arrangement.

Of course members of defined contribution arrangements can also face prolonged periods of poor market conditions but the point is these cohorts of people do not give up a portion of their diminished pension to fund earlier cohorts' pensions. Little consideration seems to have been given in the debate to how risks will manifest in CDC arrangements and the impact on different cohorts of such risks arising.

Whilst it is to be welcomed that the Government propose to allow those employers who are persuaded of the merits of CDC to implement such arrangements, the actual and potential flaws in the CDC model suggest to me at least that it is extremely unlikely to become popular.

If the actuarial consulting profession wishes to devise a new and better pension solution then that which exists today, more innovative thinking than the longstanding CDC model are going to be required. True innovation is unlikely to come from adopting existing models to solve the problems of the UK pension market.

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