Pensions Policy Institute

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Welcome

Making CDC work for the UK

A collaborative project between

Pensions Policy Institute PPI

King's College London

This project has been funded by the Nuffield Foundation, but the view expressed are those of the authors and not necessarily the Foundation.

Nuffield Foundation

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www.pensionspolicyinstitute.org.uk

Chair's Welcome

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Kathryn Fleming

Partner and Head of DC Consulting

Hymans Robertson LLP

& PPI Trustee

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The PPI Pillars of Purpose

We're the UK's leading independent authority on pensions and retirement policy.
We conduct rigorous, impartial, evidence-based research that shapes better retirement outcomes for everyone.

OUR VISION

BETTER-INFORMED POLICIES AND DECISIONS THAT IMPROVE LATER LIFE OUTCOMES

OUR MISSION

WE PROMOTE INFORMED, EVIDENCE-BASED POLICIES AND DECISIONS FOR FINANCIAL PROVISION IN LATER LIFE THROUGH INDEPENDENT RESEARCH AND ANALYSIS

WE ARE A TRUSTED SOURCE OF INFORMATION

We balance the argument by providing objective and accessible information on the extent and nature of later life financial provision, and any associated implications.

WE LEAD THE DEBATE

Through contributing impartial analysis and commentary to the policymaking process.

WE ENCOURAGE RESEARCH

Both at the PPI and in collaboration with others, which in turn informs policy and decision-making.

WE MODEL IMPACT OF POLICY CHANGES

We analyse long-term outcomes under the current UK pensions system and the impacts of possible reforms.

Event overview

The event today is the official launch of the final report in the series,

Collective Pensions with Investment Choice: Making CDC work for the UK

This report examines the relative impact of risk sharing amongst members and presents comparable risk adjusted measures of member outcomes for different pension scheme designs including individual DC and alternative approaches to CDC.

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Key Findings

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John Upton

Policy Analyst

Pensions Policy Institute (PPI)

Co-Investigators Team

Why does CDC matter?

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- CDC has the potential to fill gaps in the current UK retirement landscape.
- DB is no longer viable for most employers, with increased life expectancy, higher bond prices, and stricter regulations.
- DC leaves savers with complex decisions, and high levels of investment risk and longevity risk.

What is the current state of CDC?

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- Single employer schemes: 1 operational scheme
- Multi employer schemes: 1 planned scheme
- Decumulation only schemes: Consultation open

How is UK CDC designed?

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- Current UK CDC designs have some common design features.
- All attempt to pool longevity risk.
- All attempt to pool investment risk.
- They can differ in what a member gets when they make a contribution. They can be thought of as DC+ or DB-.

Longevity pooling

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- Longevity protection is provided by other members.
- Compared to DB and annuities, there is less guarantee. Benefits depend on scheme performance.
- However, this is a favourable trade off: members still receive some longevity protection, the scheme can invest in a return-seeking way, and employers are not liable if people live longer than expected.

Investment risk pooling

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- UK CDC designs attempt to pool investment risk by using a “shared index”.
- This means that during times of poor investment performance, all members receive a benefit cut, across generations.
- However, this does not achieve effective investment risk pooling in practice. It can also lead to pricing errors.

Flat accrual

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- In a DB scheme, all members receive the same retirement benefit for the same contribution, regardless of age. This gives a sense of equity but creates a small cross subsidy effect.
- “DB+” CDC tries to replicate this to preserve this equity.
- However, this leads to significant cross subsidy, because it is exacerbated by CDC’s more return-seeking investment profile.

What does this mean for the future of CDC schemes?

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- Communication challenges
- Cross subsidy and fairness concerns
- Poorer performance
- Can schemes live with these issues?

Alternative scheme designs

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- KCL have developed an alternative scheme design, called Collective Drawdown.
- It pools longevity risk, but does not attempt to pool investment risk.
- It outperforms Shared-index CDC.

Alternative scheme designs

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- There are barriers to implementation.
- There are not explicit legal provisions for this new design.
- There may be issues around communication and framing to members.

Summary

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- Collective pensions offer a real chance to improve adequacy, provide longevity protection, and simplify retirement for pensioners.
- The UK currently has one scheme. Other variants or designs may cater to larger markets or different priorities.
- For CDC to become available to UK savers, a wider evidence base is needed, as well as commitment from different stakeholders.

Key Findings

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Dr John Armstrong

Reader in Financial Mathematics

King's College London (KCL)

Project Principal Investigator

Risk-adjusted outcomes

Outcomes for a member who invests 8% of their salary from 25-65. Their salary grows with wage inflation.

Group	Design	Certainty Equivalent
Personal	DC + Annuity	35%
	DC + Flex then Fix	51%
Collective – shared-indexation	Flat-accrual CDC (e.g. Royal Mail)	≤44%
	Dynamic-accrual CDC (Multiemployer)	≤45%
	Statistically calibrated CDC	≤52%
Collective	Collective Drawdown	62%

- These represent the best possible results for our choice representative investor
- Shared-indexation designs provide no investor choice, so this is an upper bound

Collective drawdown

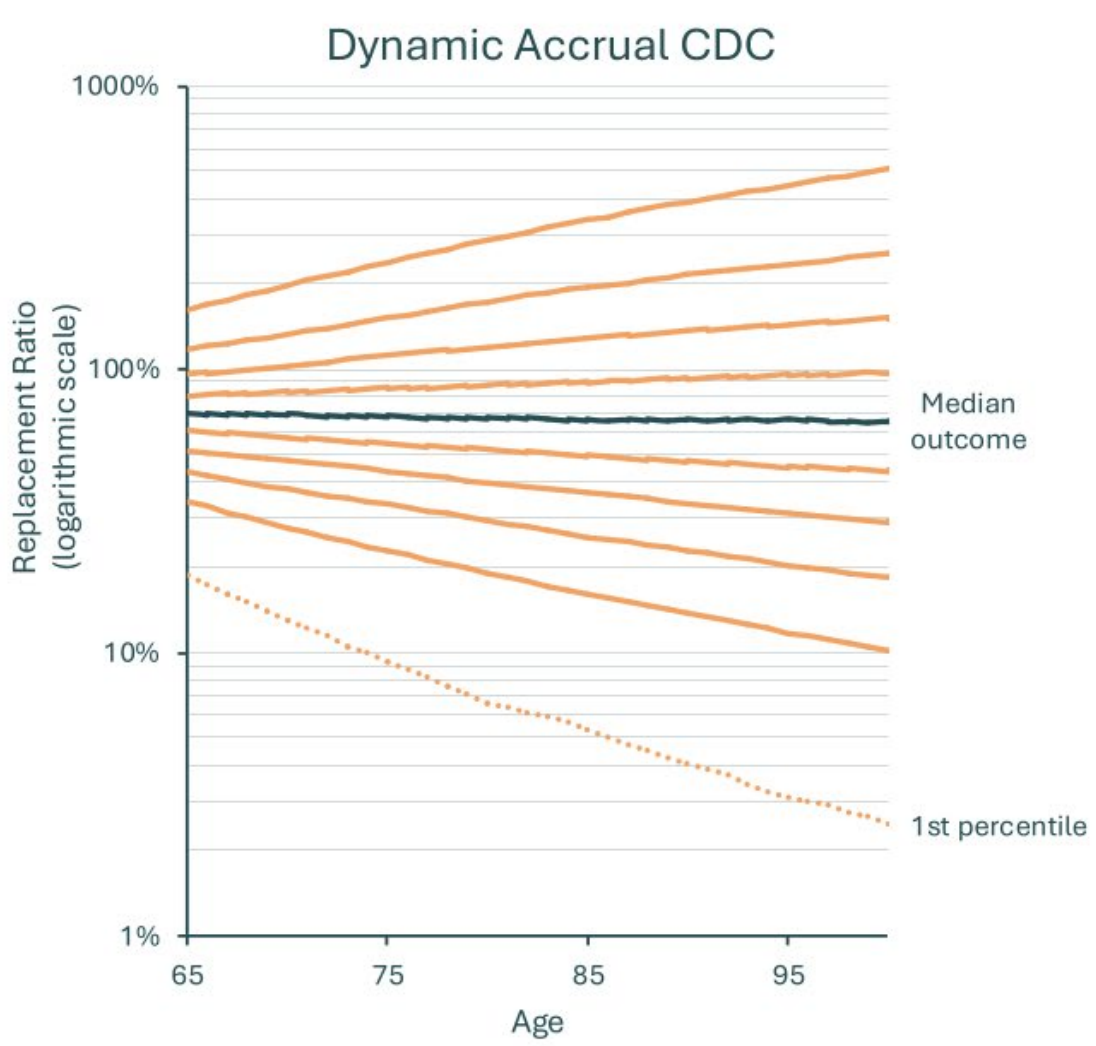
Collective drawdown = Good investment advice + Longevity insurance

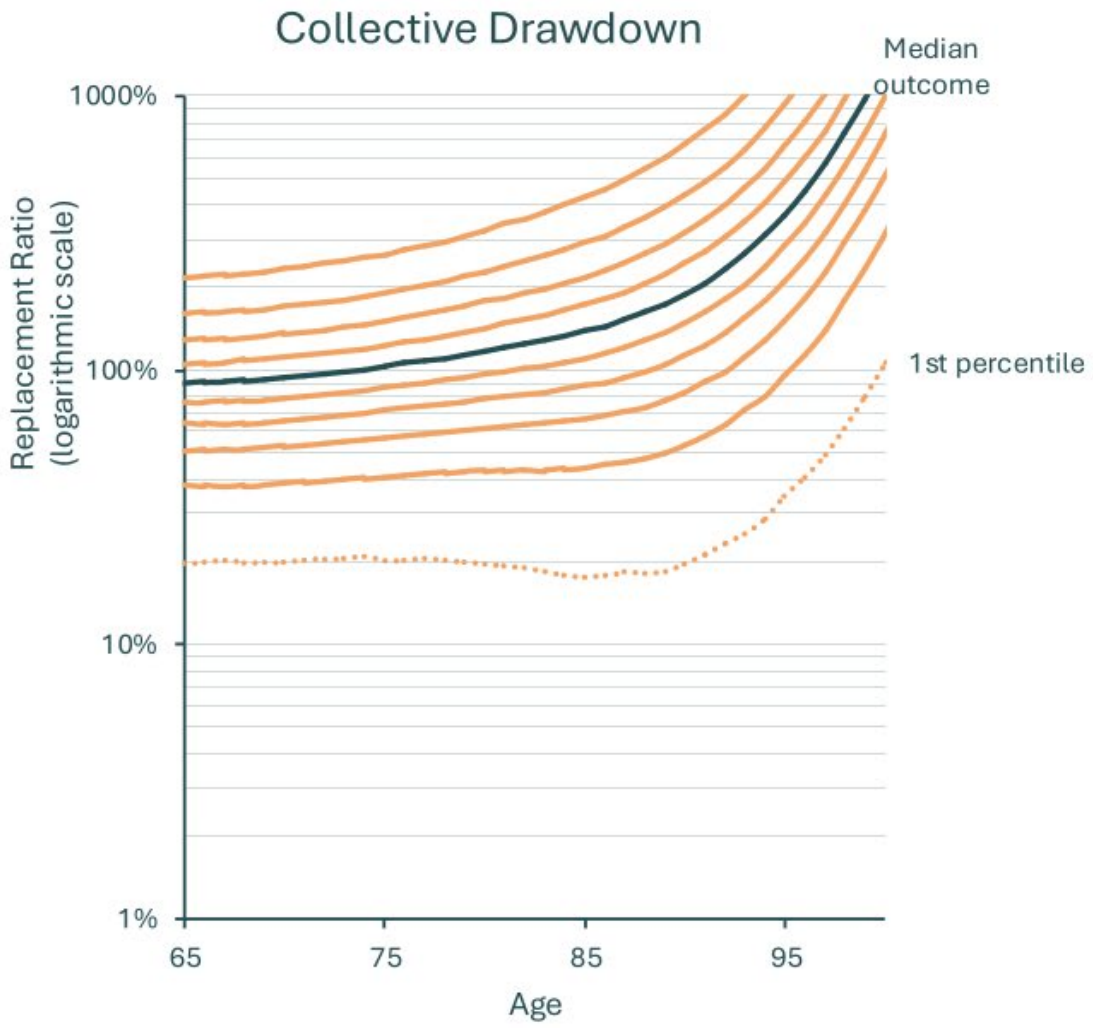
Name	Age	Asset growth	Pot (start year)	Pot (year emd)	Prob dying	Contribution
Alice	70	4%	£200,000	£208,000	2%	£4160
Bob	80	-2%	£150.000	£147,000	6%	£8820
Cyril	100	2%	£10,000	£10.200	36%	

Cyril dies, leaving £10,200.

- Alice receives £3,265
- Bob receives £6,935

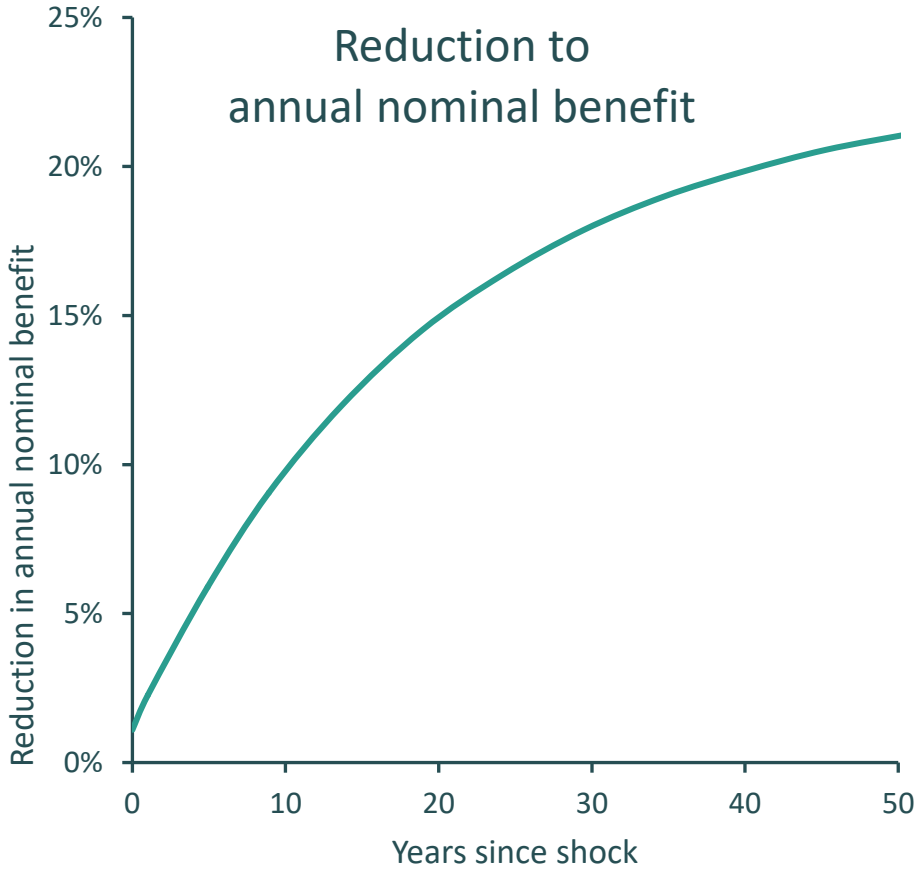
Collective drawdown vs. Shared indexation





Shared indexation

- All assets pooled and invested together – no individual pot
- Every member accrues a *nominal benefit amount*
- Each year, every member receives the same adjustment to their nominal benefit amount



Inefficiencies in shared-indexation designs

Dynamic-accrual designs (multi-employer)

- Pricing formula for new benefits sometimes undervalues, sometimes overvalues
- Errors of up to 50%
- Creates an unnecessary risk, reducing efficiency

Flat-accrual designs (similar to Royal Mail plan)

- Large cross subsidies by age (Up to a factor of 9)
    - Time-value of money
    - Market price of risk
- Leads to drag: some generations receive less than they pay in

Can be partially remedied with statistically calibrated accrual which computes prices more accurately.

Human Factors

Common Concerns

- Collective investment relies on not leaving a bequest
- Uncertainty

Additional challenges for Shared Indexation

- Very difficult to understand
- Projected benefits are not the same as nominal benefits
- Intergenerational unfairness
- Drag
- Mispricing

Additional challenges for Collective Drawdown

- Draws attention to longevity pooling

Ease of operation

Collective drawdown

- Enables pension choice
- Can operate across diverse employers
- Does not rely on employer contributions
- Makes transferring in and out easy to price
- Works well when starting up and winding down
- Works as a decumulation-only design

Conclusion

- Shared-indexation designs can achieve better results than DC + Annuity
- Shared-indexation designs are comparable to DC + Flex-then-fix
- To achieve the full potential of collective pensions, consider collective drawdown.

Thank you

To Nuffield Foundation

The Foundation has funded this project, but the views expressed are those of the authors and not necessarily the Foundation.

- Kathryn Fleming for chairing the event
- John Armstrong the Project Principal Investigator
- Project Co-Investigators, Chris Curry, Dr Suzy Morrissey and Tim Pike (PPI)
- The academic authors and the wider project team
- John Upton for presenting on behalf of the project co-investigators team
- Our panel, Rob Yuille and Ruari Grant

Thank you for attending today