CDC: The pensions industry perspective

At Hymans Robertson we believe that, at its heart, Collective Defined Contribution (CDC) has the potential to offer higher and more certain incomes to many pension savers. CDC could also play a role in improving pension adequacy. And, if delivered consciously and carefully, it could improve the social pensions contract between generations.

We previously published an outline for the future development of CDC where we set out the key areas of focus needed to give CDC the best chance of success. The Royal Mail scheme is paving the way for CDC in the UK, but the Government has a key role in tackling actual and perceived barriers.

Following on from this, we held a roundtable with leading industry thinkers, including providers, trustees and unions, to explore what's needed to create a thriving CDC market. The discussion centred around the following questions:

- What are the challenges as the CDC market evolves and can these be overcome?
- What will be the optimal size and shape of the CDC market and how can the scale needed for CDC to be successful be created?
- What will CDC design look like?

Thanks to the following people and organisations for taking the time to participate and share their views:

Andrew Dobbie, Unison
Paul Eagles, TPT
Ruari Grant, PLSA
Esther Hawley, Standard Life
Richard Hubbard, Church of England, Capital Cranfield
Jack Jones, TUC

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Introduction

To begin, we need to take a step back and remember why CDC has been introduced and where we're starting from. CDC is a new type of pension arrangement in the UK. In this type of scheme, both the employer and the employee pay contributions into a collective fund. The collective fund is then used to pay an income in retirement. The income is not guaranteed, it will be a target pension (unlike DB where the pension is guaranteed). The fund is managed on a collective basis (unlike DC where individuals have their own savings pot).

CDC is being developed as it is expected to deliver higher incomes, estimated to be up to 50% greater than current DC savings. In 2018, the Government said that CDC schemes can "Provide a savings and income in retirement option within one package that is potentially attractive to those people uncomfortable making complex financial decisions at the point of retirement".

In October 2024 the Royal Mail scheme went live and the DWP published draft regulations for whole of life multi employer CDC schemes, paving the way for new CDC schemes. This round table was held Summer 2024 and so predated these developments.

The roundtable attendees acknowledged that the case for CDC was strengthened when you consider that:

- If DC does not work, our society will face considerable challenges. We will see more people with insufficient pension income than we have done in the past 10 to 20 years.
- People are already faced with complex decisions but there's not currently an adequate support framework.
- One of the hardest things for people retiring with a DC pension is that they have no idea whether they will need income for five years or 25 years.
- One of the greatest advantages of CDC is the ability for individuals to have some certainty on retirement income.

However, there are challenges associated with CDC progression:

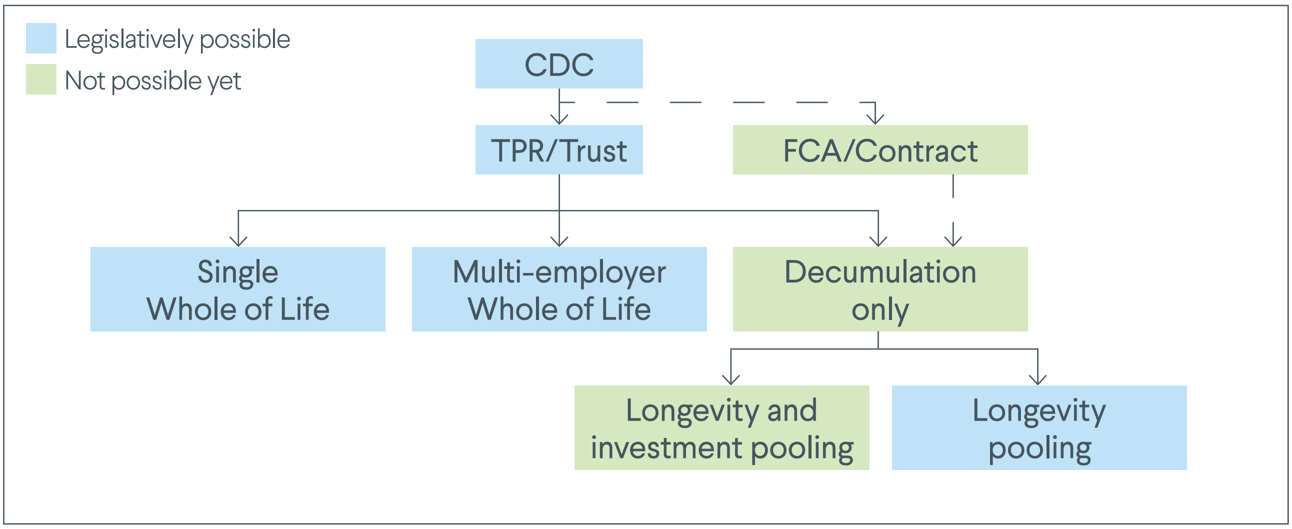
- **The need for scale -** Single employer CDC will only really be suitable for a handful of the largest employers on their own, so the extension to multi-employer is needed for accessibility.
- **Flexibility -** There's a current lack of flexibility in the regulations to allow for different scheme designs which is a barrier to development.
- **Exit strategy -** For CDC to be attractive, for some stakeholders there's a need for the comfort of an exit strategy before taking the leap of faith.

We recognise some of the key challenges that CDC could address, not least the challenge of retirement decision making, where people could move seamlessly into an income solution they can have confidence won't run out.

- Ruari Grant, PLSA

CDC market size and shape

There are many potential variations of CDC scheme, with further potential for design variations. Will we need them all?



Single employer whole of life
This will be relevant for large employers. The single whole of life trust type scheme is the one that's most familiar as this is the Royal Mail scheme.

Multi-employer whole of life
An approach like this will be crucial for smaller employers and could work well for use by homogenous industry sectors. Very few employers are able to invest and establish a single CDC scheme so multi-employer options will be needed for CDC accessibility.

Decumulation only
A solution like this is seen as something that would help those retiring now. It's seen as a mass market retail option that would be available without connection to an employer. But this is much more of a challenge to introduce without collaboration between the Pensions Regulator (TPR) and the Financial Conduct Authority (FCA).

Longevity pool
This is possible today through existing DC pension vehicles, meeting the needs of DC members who want to prioritise achieving the largest retirement income possible from their pot, at the expense of passing on any remaining DC pot on death.

When you look through the lens of stakeholder needs, a more nuanced picture emerges. The roundtable attendees noted that some poorly pensioned and lower wages sectors, such as the care sector, with auto-enrolment level of contributions would deliver a far larger financial outcome when paid into a CDC scheme.

Other sectors were discussed noting there is a benefit from pooling a number of small employers into a single scheme, where individuals have a career for life. The vision would be a scheme where an individual may change employer within the sector, but they would not then need to change their pension arrangement. This pooling could be successful with sectors like transport, utilities and retail.

Single sector based CDC also makes sense in terms of fairness with people in similar circumstances who are likely to have similar life expectancies. This could be captured at design level meaning we could have fewer but larger schemes.

There is a need for multi-employer schemes as there will be different employers, in different sectors, who want different accrual rates and contribution rates, for example.

When we also considered what we can learn from the Master Trust market, Nest had a very specific purpose and was set up with a public service obligation to take on any employer who chooses the scheme, including those with low paid workers and/or those on short term contracts. In the same way, there could be a population of people that would benefit from CDC that will not be able to access it. If that is the case, there's clearly a benefit from having a non commercial "take all" provider in the CDC space.

Some points of caution:

- There was nervousness that CDC can be seen as an opportunity to close a DB scheme, which otherwise would not have been the case and therefore, not necessarily the best overall outcome for members.
- The Royal Mail CDC scheme shouldn't anchor CDC design and the regulations shouldn't limit the breadth of future CDC approaches.
- Intergenerational value transfer considerations are a concern.

> *As soon as you have got one employer where people are living to 95 and another group to 60, there's inherent unfairness unless you prevent the latter subsidising the pensions of the former.*
>
> *- Ruari Grant, PLSA*

In summary, there's going to be value in having a range of different CDC schemes. There was a divergence of views on the five year picture, and the need for a non-commercial take all-type arrangement.

It may be safer to say that in 10 years we could have a handful of large single employer CDC schemes, like the Royal Mail. We could also have a similar number of sector based schemes and ideally, a small number of diverse multi-employer schemes.

> *We think the end goal should be to establish sector wide schemes in areas that would suit that model, like social care and utilities, for example. We're also hopeful that we have some more single employer trusts up and running and it'd be great if more employers can be persuaded to get on that kind of route as well. It would also be great if there was a market for whole of life CDC master trusts - and establishing a universal provider would be a good way to kickstart that. And we do see a role for decumulation only CDC for those who have already built up DC savings.*
>
> *- Jack Jones, TUC*

The commercial side of CDC

If we stick with a 10 year vision, what's the challenge for commercial providers?

For a commercial provider, there are a significant number of risks, trade-offs and costs to consider. And, while we expect that there will be a number of providers in the market, this is not simply a numbers game. It's about the risk appetite and ability to deliver. A number of points were circulated.

Viability

CDC founder's business plans need to be entered into anticipating a likely 10-15 year breakeven period (if we're following a similar path as commercial Master Trusts). They also need to have business plans that endure periods of low demand versus their peers as well as periods of success.

Transfers in

To make this most attractive for a commercial provider, it has to be easy to get DC pots across. There has to be flexibility to transfer benefits in.

Governance

To attract employers, the governance model will need to be right. Starting in a trust based environment allows CDC schemes to leverage from the best practice developed from running Master Trust schemes. An environment that is already familiar and largely working well.

Trustees

For the governance to really work, trustees will need to have true independence of decision making to make the right decisions around benefits cuts or uplifts, and access to independent advisors to support. The attendees could foresee challenges where trustees will be in really difficult situations, facing decisions that might ultimately threaten the commercial viability of the scheme.

Safety net

To get employers to take that leap of faith, there needs to be a safety net position in case a provider takes the decision that the CDC scheme is no longer commercially viable. Consolidation may not be an option given the low numbers of CDC schemes expected. So, there may be a role for the PPF as a lifeboat scheme, or a not for profit scheme as a consolidator option.

Not for profit schemes

For members, a default not for profit scheme brings two obvious advantages. Firstly, it would widen access to CDC as far as possible and, secondly, it could play a role as a default provider for CDC schemes that wind up. This should not be seen as a pre-requisite for CDC, and would be a long time in the planning and establishment. Perhaps if we start off with a not for profit CDC scheme, we can learn how to develop a commercial version.

In summary, CDC schemes have to be attractive to all – which requires design flexibility, but not so much that it's too complicated to operate. In addition, there's likely to be a much closer link between trustee decision making and commercial viability than what is currently experienced in the Master Trust market.

If we get something like CDC - or something that has a lot of benefits of CDC - that would be great, and we want to be part of that solution. But we also have a problem now. We need to help today's generation of DC retirees to retire better and the timescales with CDC do not work for them.

- Esther Hawley, Standard Life

It's about trying to not add too much complexity to the overarching scheme design when bringing in many different sectors, geographies, while making it as fair as possible.

- Paul Eagles, TPT

Scale

Scale can deliver the benefits of both longevity and investment pooling. Our research provides insight into what can be achieved in terms of risk reduction and investment strategy, as well as showing the level of scale that has the greatest impact.

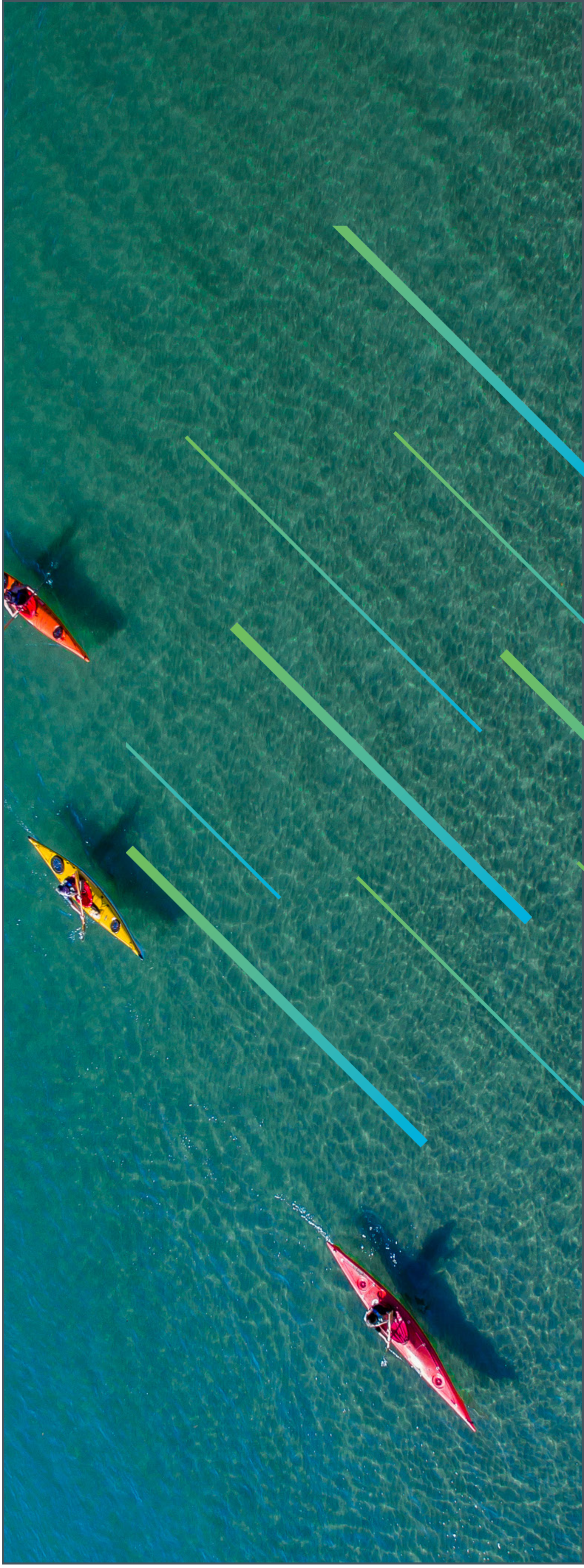
Shape and scale

We used a stochastic longevity modeller to assess a variety of different CDCs from a population of one member to 10,000. Our aim was to gain an understanding of where benefits of longevity pooling plateau, and where adding scale to the membership continues to add value.

The modelling has shown that 'big' is not necessarily as large as it might be expected to be. There's a vast improvement in the reduction of risk up to a point of between 1,000 and 10,000. From here, the idiosyncratic risk drops dramatically – to virtually zero when you get to 10,000 – and then the remaining trend and baseline risks present are virtually impossible to mitigate against.

Another idea to think about is the shape of the membership, not only the size. It's important to assess the patterns of contributions, withdrawals, and the trends in active and deferred membership levels. This understanding will help determine the shape of membership needed for CDC to be successful. So, shape is more important to the success of CDC than scale.

> *Auto-enrolment DC has meant large numbers of poorly-paid people giving up badly-needed present income in return for a paltry sum at retirement. Moving to CDC could make this investment worthwhile for many more of these people, especially if organised on a sectoral basis.*
>
> *- Andrew Dobbie, UNISON*



Investments and scale

Investment scale is similar to what is available in DC today. Scale matters and drives operational efficiency (lower charges) and investment sophistication (higher risk adjusted returns).

With the investment strategy, CDC schemes could potentially take advantage of a spectrum of choice. At the smaller end, they could consider a very basic multi-asset like glidepath approach. With this approach however, they wouldn't have the scale to add private markets, nor could they leverage their size to gain more favourable terms on fees. In our analysis, this smaller CDC scheme was our baseline and we've assessed the other ones in relation to this.

As scheme size increases, so too, does sophistication and we anticipate integration of private markets becomes a viable option. The prospect of an entirely growth asset concentrated portfolio is attractive enough to facilitate liquidity pressures. So, larger assets under management, improved terms of fees as well. We have used 65 basis points (bps) and then 55 bps for the two largest sizes in our modelling.

There's an improvement in outcomes which can be substantial. With an investment strategy in growth assets, we can see an increase in median fund value of up to 40%. This provides evidence that not only are median outcomes are likely to improve, but CDC could reduce the downside risk for members.

The argument of the shape of the membership features here, too. From a liquidity perspective, the level of drawdown and stress that can be sustained by each of these different strategies, if there was a market downturn, and the ability for the scheme to endure that while paying benefits out and still recover after.

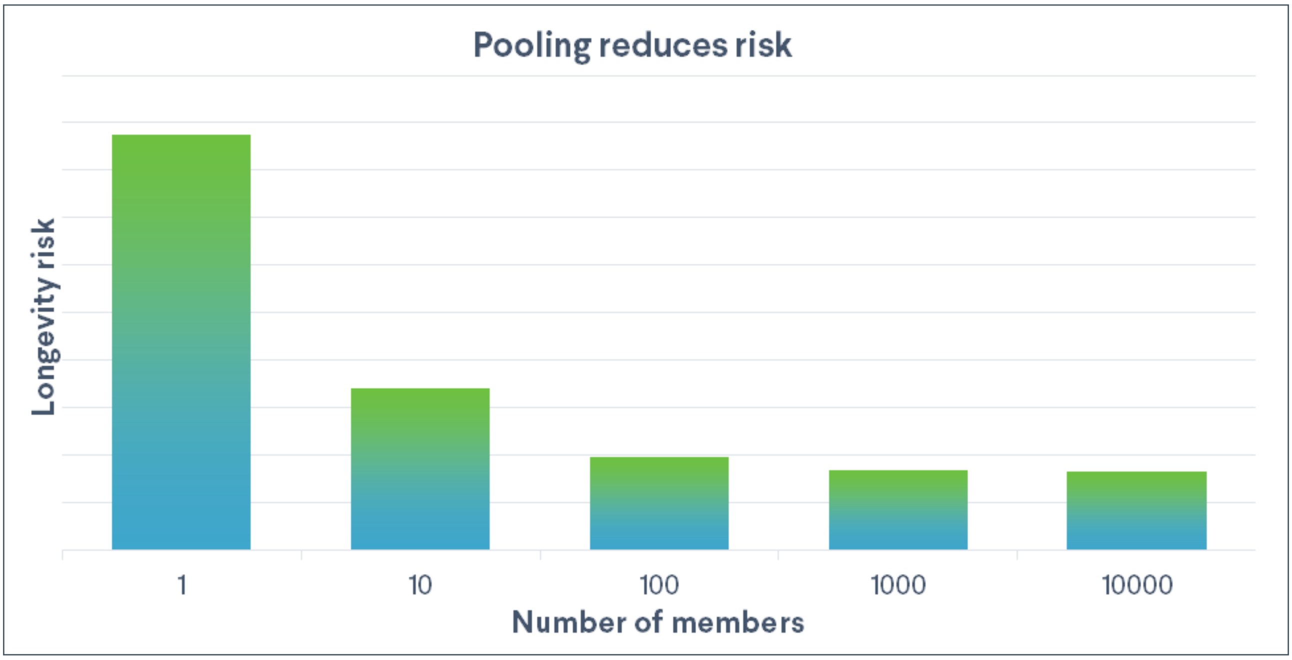
25 year old £25k salary £0 starting value 8% conts Retirement age 65	**£500m scheme** No private markets	**£5bn scheme** Multi asset pooled private markets	**£50bn scheme** Single sleeve private markets across asset classes	**£50bn risk on** 100% growth assets Private markets across asset classes
Glidepath return Net of fees	7.8%	8.4%	8.6%	8.8% (no glidepath)
Median fund value at retirement (today's money)	£252,000	£292,000	£311,000	£354,000
%∆ in median fund value at retirement relative to £500m scheme	-	+16%	+23%	+40%
Fees assumed	75bps	65bps	55bps	55bps

Longevity pooling

Longevity pooling is highly effective from 1,000 lives. Benefits of additional scale from here are modest (evidence through our analysis). Day one scale to start a scheme will not be a barrier (needs to have a growth trajectory to be commercially viable and cost effective, say 1,000 on day one with planned growth to 10,000 plus). But equally that shows that the benefit of scale with CDC is likely to be more from the scale on investment than from scale with longevity pooling.

A lot of the benefits of scale in CDC is not necessarily to do with longevity pooling, as you get the benefit of longevity pooling with quite low numbers. The real benefits of the scale are the same as the real benefits of scaling DC, which is, you can have a much more stable investment strategy with illiquids and a much more long term horizon, and depths in your asset pool.

- Esther Hawley, Standard Life



CDC is still an unfamiliar concept to most people. We need to help people understand and get comfortable with it. As an industry, through CDC we can deliver substantially better retirement benefits that work well for the majority of people.

- Paul Waters, Hymans Robertson

Conclusion: what are we calling for?

- We believe that CDC will deliver better outcomes, but as an industry we have to ensure that CDC is made accessible.
- To do that, we need the broad range of types of CDC and multiple providers of schemes.
- Single employer/sector based CDC is more straightforward than wider multi-employer.
- A non-commercial "take all" multi-employer CDC scheme would provide both security (in the event of other schemes failing) and impetus for the growth of CDC in the UK.

If you have any questions, or would like to discuss further, please get in touch:

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