Written evidence from the Royal Society of Art (APS0024)

About the RSA

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About the project

The Collective Defined Contribution (CDC) Pensions Forum emerged from the RSA's Tomorrow's Investor programme. The Tomorrow's Investor programme was established in 2008 and chaired by Sir John Banham. It examined the UK pension system and whether it could be improved to deliver better outcomes for savers and the wider economy. It began with a series of citizen juries, where (inter alia) jurors expressed a strong desire for a cost-effective pension which delivered an income lasting from retirement until death. Such pensions are not readily available in the UK. We believe the DWP Select Committee has an important role in helping resolve that problem.

Acknowledgements

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The opinions expressed are the sole responsibility of the authors.

Executive summary

We write in response to the call for evidence of the Work and Pensions Committee's inquiry into pension freedoms. In particular, we address the first three questions asked:

1. Do people have access to a range of pension options to meet their needs for later life and how might these needs change in the future?
2. Are there other pension options, not currently available in the UK, which would better meet people's needs in later life?
3. Are there barriers to providing other pension options which meet a need and are not currently available in the UK?

We believe that:

1. Most people working in the private sector today do not have access to a range of options to meet their needs. In particular, they do not have access to a cost-effective predictable income which will last them throughout their life. It seems extraordinary that a sophisticated pension savings system such as the one we have in the UK, is unable to offer this basic pension service.

2. There are other options, not currently available in the UK, which would provide for this need, and which could and should be added to the existing pension savings system.
3. There are some barriers to providing these options, but they are modest. The general structure for providing income-for-life pensions has just been approved by parliament with full cross-party support, in the 2021 Pension Schemes Act. The principle intent of the Act is to allow whole-life pensions, including both savings and decumulation, which will offer savers a predictable lifetime income in retirement. It does this by allowing the establishment of 'collective defined contribution' (CDC) pensions, where members of a pension plan share 'longevity risk'. In doing so their average life expectancies can be estimated, and hence every member can know with some certainty that their pension will not run out. It is to be adopted by Royal Mail for their employees, of whom there are over 100,000. This system of pension provision is equally applicable to 'decumulation-only' pensions, purchased at retirement.

We believe that the introduction of a decumulation-only collective pension structure, would be an effective way of allowing people to have access to a predictable income for life in retirement. It could fill what is a huge gap in Britain's pensions architecture.

The political barriers to doing so should be modest, since parliament has already agreed the principle of whole-life CDC pensions. Secondary legislation for the 2021 Act is currently being drafted. However, there are practical issues:

- Discussions would need to take place with DWP and The Pension Regulator (TPR) about how the rules can best be set for a decumulation-only CDC plan. This might best be structured to offer pensions to the employees of more than one employer - this is contemplated in the 2021 Act but will require new secondary legislation, which is not currently timetabled for implementation.
- CDC pensions require effective regulation. Lessons from other countries which successfully operate CDC teaches us that such regulation - on management, governance, actuarial oversight, communication - is important to CDC's success.
- Providers of CDC pensions would need to be found. We would note that any sponsor of a CDC plan should owe a fiduciary duty only to the members of the plan. That means that while market forces will be helpful, effort will be required to ensure the right institutions and regulation are in place to deliver this, more effective pension system.

1. Background

Our starting point is that, for many, **the ultimate goal of a pension is to create an income which lasts until the end of their life, typically starting when they retire**. **That basic service is not available for most people working in the private sector, where there are few ways to provide a cost-effective pension as an income for life.**

Of course there are other pension structures, for example state pensions, pensions for the Civil Service, the NHS, teachers, and the army. They are provided on an unfunded, pay as you go, basis. However, only the government can provide such pensions relatively securely since it has powers of taxation.

Alternatively, individuals can simply save for themselves, choosing their own investment strategy and choosing how to draw down from those savings in retirement. This is currently a common approach in the UK via 'defined contribution' (DC) pension funds which are then drawn down.

There is a problem with drawdown that has been observed in Australia and South Africa where this is more established - if everyone saves enough to last them until the upper end of the range of their possible lifespan, most people will save more than necessary; if everyone saves enough for an average lifespan, half of them will run out of money in old age when most vulnerable.

That is why the most effective pension systems allow individuals to share longevity risk. Individual savers can currently do this by buying an annuity when they retire. Indeed historically, individual pension savers were, in effect, forced to buy an annuity. However, the combination of low interest rates, and the (natural) insistence that any annuity should be rigorously contracted, meant that by 2015 they had become very expensive indeed. **That was why the government introduced pensions freedoms allowing DC pension savers to use their money in other ways. What was not established was any alternative way to turn pension savings into an income for life. That remains one of the biggest gaps in the UK private pension system.**

Historically, both private (and several public) pensions had been provided through a 'defined benefit' (DB) pension schemes, which do offer an income for life. In the past this was the backbone of the UK occupational pension system and the way in which the majority of workers were provided with pension benefits. When DB originally became popular in the middle of the 20th century, DB pensions had a degree of flexibility in the way in which they were operated and the benefits they provided. However, during the 1980s and '90s, DB pension schemes looked like they had more than enough assets to meet their needs, and companies took pension contribution holidays. In response, legislation and other factors successively hard wired the DB pension promise, including ensuring that they were largely inflation proof. With falling asset returns, rising inflation levels, and lengthening member longevity these guaranteed inflation proof pensions ultimately became unaffordable for most private sector employers, and most DB plans are now closed or closing.

CDC offers a middle ground. Similar to early DB, it offers an income in retirement but with some flexibility in the pension paid. Like DC, the pension can only be paid from the money which has been subscribed. Versions of this system operate in the Netherlands, Denmark, and other countries which are generally considered to have some of the best pension systems in the world, albeit all have encountered issues. These offer important lessons for the UK. However, these CDC pension systems in other countries have been established over generations and are designed as whole-life pension plans. In Britain we have an existing, and successful auto-enrolled DC stem. Given the development of the occupational pension system in the UK, we believe that, in addition to allowing whole-life pensions as envisaged in the 2021 Act, CDC might usefully be applied as a decumulation-only pension; similar to an annuity, but without the very high costs associated with annuity contracts.

Benefits versus pitfalls of CDC

The benefits of CDC are considerable. CDC is likely to provide a much higher income in retirement than buying an annuity. All studies looking at whole-life pensions, suggest that CDC will give at least a 30 percent higher retirement income than a conventional DC scheme with an annuity. This is achieved through its ability to share longevity and investment risk, and to support targeting higher asset returns than is possible for an annuity provider (a summary of these studies is provided in Appendix 1). We estimate that perhaps two thirds of the benefit of CDC is captured in the decumulation phase. So, while we would urge that further study be done, we think it likely, on the best available evidence that a decumulation CDC might create a 20 percent higher pension than available from an annuity.

CDC can also offer a more predictable outcome than an annuity for which the level depends on asset values and annuity prices on the very day it is purchased. It can provide a pension to members by default, without each individual needing to choose their own investment strategy or choose between a wide range of options at retirement.

However, to be successful, pension savers need to understand that there is no guarantee on the level of a CDC pension. Whatever pension is paid by the pension fund must be met by the resources of the fund itself. Unlike DB or an annuity, the pensioner cannot rely on a guarantee from an employer or an insurance company. It needs to be possible for CDC pensions to vary if future events prove better or worse than predicted. Such changes may not be very dramatic and can generally be accommodated by raising pensions by more or less than inflation. However, sometimes pensions might need to be reduced. For example, following the 2008 financial crisis the Dutch reduced CDC pensions by around 2 percent on average.[1] Those enrolled in a CDC pension plan need to know the nature of their pension, and feel justifiably confident that the design of the scheme will result in pensions that are fair for all.

Coronavirus. As an example, the DWP Committee may be interested in how a CDC structure might have responded to the movements in capital markets following the coronavirus pandemic. It provides an interesting test case. Willis Towers Watson, a leading actuary, modelled how a CDC pension would respond to reflect the fall in capital values over the first quarter of 2020.[2] They did their calculations based on the Royal Mail's whole-life scheme design. On their estimate, there would have been limited effect on CDC pension levels, with this year's increase, and projected annual increases in the pension reducing by 0.25 percent per year. By comparison, the cost of an annuity had risen by 8 percent over the same time period. So a CDC design would have been relatively robust in a whole-life scenario. While the effect on a longevity-only CDC might be greater, this provides some reassurance on the robustness of CDC design. Should the DWP Select Committee be so minded, we could ask for this study to be done again for a decumulation-only pension.

[1] Marriage, M. (2014) Dutch defend Queen's UK pension plan. Financial Times, [online] June 7. Available at: www.ft.com/content/c17af398-ec92-11e3-8963-00144feabdc0

[2] Eagle, S, Swift, A & H Parker (2020) How would recent market falls have affected members approaching retirement in a CDC scheme? Willis Towers Watson [online]. May 12. Available at: www.willistowerswatson.com/en-GB/Insights/2020/05/how-would-recent-marketfalls-have-affected-members-approaching-retirement-in-a-cdc-scheme

2. CDC in UK - history over recent years

The benefits of a more flexible pension system have been apparent for some time. In 2015, with cross party agreement, Parliament passed an Act that would have allowed CDC and 'defined ambition' (DA) pensions. However, the Act was constructed in such a way that it was designed to change the entire pension system. Therefore, it was never acted upon.

In 2018, Royal Mail and the Communication Workers Union (CWU) agreed they would like to establish a CDC structure to replace the closing DB scheme. Their advisors noted that although such a structure could not yet be established, Parliament had agreed, in principle, to it being introduced. They agreed a proposal for the establishment of a CDC pension for Royal Mail employees and encouraged the passage of the 2021 Act. They are pioneers and are committed to implementing their pension plan once the secondary legislation is in place. We know of others who would also be keen to consider CDC.

The present legislation is intended to allow the Royal Mail proposal to proceed and allow other private sector organisations to create similar arrangements. It **does not allow for unrelated companies to work together, to create a single CDC pension plan, and nor does it mention decumulation-only CDC. However, Clause 47 of the Pension Schemes Act 2021 gives the government powers to allow multi-employer CDC schemes** and / or providers to offer CDC master trusts, to remove this constraint for small employers. Since effective pensions require some economies of scale, this, in effect, excludes smaller companies from the option of CDC, at least for now. It would also be likely to hamper the development of a decumulation-only CDC. In our view both are significant opportunities, and subject to consultation, we would encourage the Committee to ask the government to act on this.

If they were to do so, we believe this would have considerable support amongst master trusts providing today's DC pensions. Currently they are offering decumulation products, which stitch together different elements to create a lifetime income. For example, National Employment Savings Trust (Nest) will offer a drawdown product until the retiree is (say) 85, backed up by a deferred annuity, in case the saver lives beyond that age. This aims to create an income for life, however, it is rather cumbersome and costly in comparison to a well-designed CDC plan.

3. Important regulatory and governance issues

Like all pension plans, the design of CDC requires careful regulation. The 2021 Act specifies many of these, but many are left to secondary legislation. The Committee may want to understand these and consider how they might be applied in a decumulation-only pension, and whether they might therefore want to guide the DWP's current work. We outline the most significant issues, and why they are important below.

a) **Trustee governance**. Pension systems are best operated by entities which owe a duty only to work in the interests of the beneficiaries. This is particularly important where choice is complex and suppliers can be tempted to behave in a way that is not in beneficiaries' interests. It can be achieved by ensuring the pension fund is governed by trustees – particularly those nominated by its members. Of course, such trustees can and should employ professional advisors, administrators, and fund managers where they can offer a better service. But they do so only in the interests of beneficiaries. In a world where savers are often unaware of how their pension fund is managed the protection provided by effective trustee governance is important.

b) **Actuarial expertise**. CDC pensions require careful calculation of what is the appropriate level of pension to pay. Such actuarial calculations are common in the financial system, for example for life insurance premiums. They also need to be incorporated within a CDC system to be sure that pensions are fairly delivered in accordance with the mechanisms established at the outset of the scheme's design and as communicated to its members.

c) **Communication with members**. This is particularly important in CDC. CDC pension levels are not guaranteed; instead there is a promise to pay CDC pensions in accordance with the rules explained to the member when they join the scheme. During stable times, CDC payments may seem very reliable, however when any unexpected change is made this may be met with concern. This is what happened in the Netherlands after the 2008 financial crisis. On average where there were reductions, pensions in payment were reduced by 2 percent. One fund had to reduce by 6 percent, to make the actuarial calculations balance. The Dutch system had seen little or no adjustment for many years, nor had the potential for reductions been clearly communicated, so the reduction caused much furore.[3]

d) **Protection of the sponsor**. DB pension plans were closed because they proved risky and unaffordable by the companies sponsoring them. Additionally, under DB, pension liabilities were recognised on the company's balance sheet. Many companies felt that the pension legislation that was introduced created obligations to which they had never agreed. They are unlikely to back CDC pensions if there is any likelihood that new obligations could be placed upon them through reclassification in future. Legislation needs to be clear that this will not happen.

e) **Linkage to other parts of the UK pension system**. Legislation should be drawn up in a way which fits with other parts of the pension system.

f) **What can and cannot be achieved**. All these potential issues surrounding CDC can be addressed – the system operates successfully in other countries - but none can be addressed perfectly, because the future cannot be predicted with certainty. As one observer of the Dutch system noted "all are better off but some are better off than others". In designing CDC systems, it is important that its design is simple, so that it can be easily understood. It is also important that any material difference in benefit levels result from unforeseen uncertainties, not from the design of the pension plan itself so that younger retirees or older ones don't benefit at the others' expense, for example. Trustee governance, expert actuarial guidance, clear communication, simplicity, and integration into the existing pension system will be key elements in the successful development of CDC.

[3] Royal Mail carried out actuarial modelling of their scheme design. It suggests that it would not have to have reduced pensions after the 2008 crisis (instead, pensions increases would have reduced). Nevertheless, a reduction in pensions is possible after severe or sustained falls in markets., and members need to know that this is a possibility, particularly when such adjustments have not been apparent for many years.

4. Where concerns have been raised about CDC

There has been some opposition to CDC. Some arises from the belief that there will be **little demand** for CDC. **The RSA and the advisors to Britain's pension funds and master trusts, including those who have helped in preparing this paper, believe that there is latent demand for both whole-life and decumulation-only CDC. In particular, there is a demand amongst master trusts, to establish decumulation-only CDC pensions. However, this is unlikely to be very apparent until there is a commitment to allow such pensions under the law.**

Other opposition has arisen from **turning a blind eye to the advantages of CDC and focusing on whether the considerations above may prove unmanageable**. For example, some talk about intergenerational unfairness and have said that trustees will never take the difficult decisions to reduce pensions, and hence overspend in the short term, leaving younger members disadvantaged. Others have focused on the reduction in payments in the version of CDC in the Netherlands, post-2008, missing the point that for the main alternative of DC pensions, pension expectations started at a lower point and also typically fell before retirement under the same circumstances. Technical details have been raised, such as how a CDC scheme could be closed. Many of these are perfectly sensible issues to raise and debate. Similar issues exist with other pension and life insurance arrangements and clearly the governance and regulatory system must be designed to cope with them.

Opportunities

As discussed, the immediate focus of the 2021 Act is on whole-life single employer CDC plans such as that of the Royal Mail. However, CDC is potentially a very big opportunity for pension policy. Academic and actuarial studies suggest that, over time, whole-life CDC will yield 30 percent+ higher pensions than are currently available through individual savings and annuities. We estimate that two thirds of that could be captured in the decumulation phase. This is an enormous sum. About 6 percent of GDP is spent on private pensions—they represent £3tn of accumulated savings.[4] A more effective pension system could make a huge contribution to addressing welfare and poverty in old age. It could also be a source of capital for renewed investment.

Ideally, we would want the design of whole-life and decumulation-only CDC plans to be carefully thought through, so that we end up with a system which is designed to be fit for purpose. For example, **this might mean that we should design a system which encouraged a limited number of funds each of which enjoys economies of scale. We might encourage similar administrative and other systems, so that people can readily move their pension when they change employers or enter self-employment**.

As regards decumulation-only pensions, we would argue that it should surely be possible for groups of employers (such as those in the same industry) to get together to introduce CDC.

As noted above, the biggest gap in Britain's pension system is not in the savings phase; automatic enrolment has proved a success in getting most employees to save but there is a gap when people

[4] ONS and RSA analysis.

retire. People generally say they want a regular retirement income,[5] but most aren't buying insured annuities presumably because of their relative expense.[6] CDC could readily be a popular model to allow people to buy with their DC savings a cost-effective – albeit non-guaranteed – pension which will last for the rest of their life.

As regards providers of decumulation-CDC, the National Employment Savings Trust already provides a default pension saving fund for the accumulation stage. Might they, together with others, offer a cost-effective system for decumulation, as described above? In both cases, these could be offered alongside other providers.

We currently lack an effective pension system for the self-employed. CDC master trusts could be a solution for them, just as they are for those in employment.

5. Conclusion

The Committee asked whether, following pension freedoms, savers had access to effective pensions solutions. They do not. This is a huge gap in Britain's pensions architecture.

But it can be bridged if the collective structures envisaged 2021 Pension Schemes Act and accompanying regulations are adapted for decumulation-only pensions.

We do not pretend that this is straightforward. Indeed it may even make sense to establish a Commission to flesh out all the details of how best we can promise that those who have saved during their working life can have access to an occupational pension system which is fit for purpose; one that provides an income for the rest of your life. The prize for doing so will be very high indeed.

Further information

For further information on the RSA's CDC Forum or Tomorrow's Investor programme please contact Mark Hall, deputy head of engagement, RSA at Mark.Hall@rsa.org.uk.

For further information on any of the issues raised in this briefing please contact David Pitt-Watson at david@pitt-watson.com or Dr Harinder Mann at Harindermann@hotmail.com.

[5] Aon, for example, reported in their 2021 DC Survey that almost 60 percent of DC savers wanted an income for life in retirement. See link here for survey: {c1ea96eb-cf36-4b36-ba50-0668e0fc314e}_Aon_DC-pension-and-financial-wellbeing-employee-research-2021.pdf (aonunited.com) Data is shown (albeit not numerically) in chart entitled 'How workplace pension will be used at retirement' – the almost 60 percent is the sum of those 'certainty seekers' and 'steady spenders' responses.

[6] See the FCA's retirement income market data 2018/19 www.fca.org.uk/data/retirement-income-market-data, which showed that 11 percent of at-retirement DC product purchases in the year to March 2019 were annuities.

Appendix 1: review of studies about CDC outcomes

The following is a review of recent studies which compare the outcome of CDC pensions to alternative forms of DC pension saving. Most suggest an 'upside' of more than 30 percent over individual savings.[7] That means that for the same cost, pension savers will have a 30 percent+ higher income in retirement in a CDC arrangement than if they try to provide for themselves as they do in today's DC plans. How is this possible?

Small differences in costs and / or returns can make an enormous difference and pooling can produce such differences over time. Over 60 years, a charge of 1 percent per annum on total assets will absorb around 25 percent of the possible pension earnings, or put another way, those who avoid such a charge would enjoy an income that was 33 percent higher.[8] A 2 percent charge will take nearly half of the pension, so avoiding it will almost double the saver's retirement income. The same is true in reverse for returns. If hiring a professional manager or investing in a more appropriate portfolio can together give a 1 percent greater return, those who have done so will have a 33 percent higher pension.

Scholarly studies of the advantages of CDC pensions offer more sophisticated evidence than this simple math, and all of them suggest a much better pension will be provided if pooling is used. A study for the National Institute on Retirement Security estimated for a group of 1000 schoolteachers, with typical demographic characteristics, that for the same cost, a pooled arrangement will deliver a pension which is 85 percent higher, with one third coming from sharing longevity risk. The remainder stems from a more balanced and better performing investment portfolio. Even in the study's model, one in 10 of the teachers who saves individually, will run out of funds before they die, illustrating a further benefit of eliminating longevity risk.[9] Note that, those who save individually and who die young will leave an inheritance, but that is not the purpose of pension saving.

Other studies have compared the benefits of pooled CDC plans against DC plans with individual savings followed by an annuity purchase. The following represents some examples of more recent rigorous recent studies:

[7] The main studies on this topic are cited below.

[8] Imagine a saver who, at the age of 25 and for the following forty years saves £1,000 per year into their pension and receives a 4 percent return. Upon retiral at 65 they will have a portfolio worth £95,026. If they buy an annuity which lasts 20 years, also giving a 4 percent return, that will provide an income of £6,992. Now imagine a 1 percent charge reduces the return to 3 percent. The portfolio upon retirement will be worth £75,401, and the annuity will be worth £5,068, which is 27.5 percent less. If the return falls to 2 percent, the pension would be £3,694, a fall of 47 percent.

[9] Almeida, B and Fornia, W (2008) A Better Bang for the Buck, NIRS. Open University, [online]. Available at: www.open.ac.uk/ikd/sites/www.open.ac.uk.ikd/files/files/events/financial-institutions-and-economic-security/a-better-bang-for-the-buck.pdf. As noted in the text, in the NIRS model, even with the 85 percent upside, they allow that 10 percent of DC savers will run out of money. Using their longevity model, and assuming a 2 percent real return, even setting aside differences in investment return, it will cost the DC saver 68 percent more to be sure, if they are the longest lived, that they don't run out of funds, compared to a pooled plan which can be based on average life expectancy. To be 97.5 percent sure of maintaining and income, 61 percent more savings will be needed. Of course, some may argue that it is unfair to make this comparison. If a pension saver dies young, any excess saving will be inherited, whereas in DB or CDC, the pension entitlement ceases when the beneficiary (or their dependents) pass away. This is a fair criticism if it is aimed at pension provision for those who will never run out of funds no matter how long they live. In a sense, such people do not, strictly speaking, need a pension. But for anyone who might run out of funds, and indeed for others who want a minimum income guaranteed, pooled arrangements provide a much better solution. Nor is the criticism relevant for the other studies cited.

UK Government Actuary. The UK Government Actuary modelled various scenarios of longevity, asset returns etc, in a Monte Carlo simulation to evaluate the outcome of CDC. They calculated that CDC would pay a 39 percent higher pension, compared to DC plus an annuity. In their modelling they noted that if the CDC plan made guarantees, and hence fixed some of its liabilities that would mean that it could go bankrupt if things went wrong. Any such hard promises, of course, must not be part of a CDC design[10], since it must be possible to vary any pay-out to meet the assets available.

RSA. The royal society for arts, manufactures and commerce conducted a simple cost accounting of CDC plans, which looked at where the upside comes from. It noted the higher charges made to individual savers, and from government statistics the theoretical profit taken by providers of annuities, over the bonds required to defray the cost of providing the annuity. It did not include any advantage from a more productive underlying investment portfolio. Nevertheless, CDC had an upside of 37 percent.[11]

Aon Hewitt / RSA joint study. Aon Hewitt undertook a study, published jointly with the RSA. It examined the outcomes that would have been achieved by a retiree who had begun saving since 1930. It assumed that this fictitious individual saved for 25 years before retiring and invested in a simple equity / bond portfolio. It compared the outcome with that of a saver who had saved through a DC plan and purchased an annuity. The study shows an average upside of 33 percent. The study also noted that CDC plans provided a more predictable outcome for the saver, particularly since these plans insure against timing risk.[12]

King's College London. Another study commissioned by the UK government was undertaken by the London University's Pensions Policy Institute, modelling different return and drawdown scenarios. Its base case comparison suggested that for a pooled / CDC pension the upside was from 40 percent to over 100 percent.[13]

Willis Towers Watson published a forward-looking analysis in 2020 which concluded that CDC pensions were expected to average **70 percent higher** than DC annuities based on market rates at the time. Further, for the same rates of contributions, CDC pensions were expected to average **40 percent higher** than a DB scheme with a typical risk-averse asset strategy[14].

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<u>Other bibliography</u>

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[11] Pitt-Watson, D, and Mann, H (2012). Collective Pensions in the UK, RSA, [online] Available at: www.thersa.org/globalassets/pdfs/reports/collective-pensions-in-the-uk.pdf

[12] Pitt-Watson, D, and Mann, H (2013). Collective Pensions in the UK II, RSA, [online] Available at: www.thersa.org/globalassets/pdfs/reports/rsa_collective_pensions_in_the_uk_ii_nov_2013.pdf

[13] Popat S, Curry C, Pike T, Elles C, (2015). Modelling Collective Defined Contribution Schemes, Pensions Policy Institute. [online], Available at: www.pensionspolicyinstitute.org.uk/media/2999/modelling-collective-defined-contribution-schemes.pdf (see slide 30).

[14] Willis Towers Watson (2020). [online], Available at www.willistowerswatson.com/en-GB/News/2020/10/collective-defined-contribution-pensions-would-on-average

Parliamentarians may also be interested in a book by Dutch academics called Costs and Benefits of Collective Pension Systems. This points out that some element of intergenerational transfer may mean that under CDC "all are better off but some are better off than others". See: www.springer.com/gp/book/9783540743736

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