In a nutshell - CDC

'CDC' = 'Collective Defined Contribution': first formally consulted on by the DWP in November 2013

What are the pros of CDC?

On retirement, members are paid a pension for life from the scheme, rather than having to make what they will of an individual pot. It's a target, not a guaranteed amount though. Because the assets are pooled, a longer-term investment strategy can be adopted than would be required by members with individual DC pots, especially when nearing retirement.

The key pros for employees are that:

- The outcome is likely to be a higher and more predictable income in retirement
- The individual bears less risk, particularly longevity risk and market risk

The key pros for employers are that:

- There are none of the risks borne in sponsoring a DB scheme; they have no liability beyond payment of an agreed rate of contribution
- There is no legacy burden: scheme administration and record-keeping can be designed to take full advantage of automation

What are the cons of CDC?

Those against CDC seem to be arguing their case mainly on a supposition that CDC schemes won't work, and that even if they were viable, no employer would want to go down that route. These reasons are simply not viable excuses anymore though, especially with increased interest from large employers, such as Royal Mail. Of course, there are some genuine disadvantages of the CDC system.

The key disadvantages for employees are:

- There is no recourse to the employer to make up any deficit (i.e. shortfall on the amount required to pay target pensions) if the investment strategy underperforms
- In the aforementioned situation, pensioners might have to forgo all or part of an anticipated annual increase, or even perhaps, as a final resort, take a drop in their pension
- The lack of individual choice of investment

What are the key risks, and how can you mitigate these?

There is a popular criticism, likening CDC to a Ponzi scheme: this is apparently based on the observation that a steady flow of contributions from new and active members is required to assure the outflow of pensions. There is nothing unusual in that; it is after all how banks operate, using a portion of funds deposited to make loans. It is not the case that later members are directly funding pensions for older members. A CDC scheme is a funded pension arrangement: in exchange for contributions members are credited with target benefits according to the scheme policy and on retirement receive a target benefit (and subsequent increases to that benefit in payment in line with scheme policy and investment performance).

The principal risk in practice is that intergenerational unfairness results from suboptimal investment returns: this might arise if the scheme decided to cut back target benefits for active and deferred members while leaving pensions in payment untouched.

However, it is not inherent in the CDC module that this has to happen. Schemes can mitigate risks through:

- Scheme design; and assuring a reasonable rate of influx of new members
- Dependence on new member contributions can be reduced by encouraging transfers in by individuals with DC pots accumulated elsewhere
- Target benefits should not be overstated: conservative assumptions in the beginning would be wise

Who is CDC right for, and what should schemes and their sponsors consider when deciding on the shape of their pension scheme?

- CDC will have greatest appeal to sponsors of DB schemes with substantial actuarial deficits who still wish their employees to receive a scheme pension in retirement
- To set up a CDC scheme from scratch could be more challenging because of the lack of assets in the early years, unless the members were all a long way off retirement
- However, some of the many employers who have abandoned DB for the GPP (Group Personal Pension) route in recent years – as well as their employees - may be attracted by the prospect of higher and more predictable scheme pensions for employees willing to pool their accumulated pots

Will CDC ever come to fruition?

Yes. Despite the loss of time and momentum in the four and a half years since the possibility was first floated. All sides in the Royal Mail case are determined that this is what they want, and some of the primary legislation is already in place (the rest has been promised by Pensions Minister Guy Opperman in a new Pensions Bill next summer). There seems to be some uncertainty over whether a great number of regulations are also required, or not. But as they say, '*Where there's a will, there's a way*', and a DWP consultation is due to be published any day now…

Meanwhile, it is important not to assume that the only extant model, and therefore the only available template for development of CDC here in the UK, is the Dutch model. The fact that the Dutch have experienced intergenerational inequity does not make it an intrinsic feature of CDC; rather, the benefit reductions which have attracted so much criticism arose from the design rules imposed by the Dutch Central Bank.

CDC pension schemes flourish in other countries, notably in Canada and Denmark.

About Aries Insight

Aries Insight deliver solutions and expert information systems to handle the complex regulatory environment for pensions in the UK. Combining a deep knowledge of pensions with well-honed systems engineering and a keen sensitivity to the needs of the pensions professional, the Aries Pensions System is the foundation of the pensions technical support service now used by around 130 organisations throughout the industry: consultants, administrators, life offices, pension funds and specialist providers.

Other Aries Insight solutions include SIPP and SMPI illustration programs and more information can be found at www.ariesinsight.co.uk

Media contacts

For all media enquiries please contact KBPR using the details below:

KBPR

Adam Sewell
07444 407138 | adam@kbpr.agency

Helena Jones
07958 270938 | helena@kbpr.agency

Sophie Smith
07376 902304 | sophie@kbpr.agency