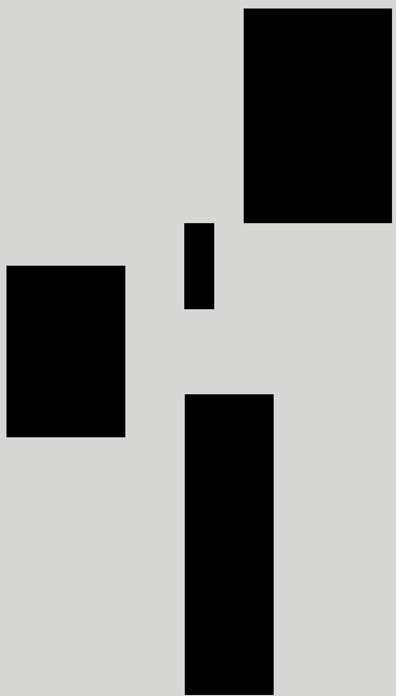
A guide to CDC pensions

A new type of retirement provision coming to the UK



A guide to Collective Defined Contribution (CDC) - a new type of pension provision coming to the UK

September 2020

This guide to CDC pensions covers off 15 commonly asked questions on CDC. This includes an introduction to what CDC is, an explanation of how CDC schemes will work, and a guide on whether CDC could be the right pension provision arrangement for particular workforces. We also include a case study on the first UK CDC scheme due to be set up by Royal Mail.

If you'd like to discuss CDC pension provision, please contact your usual Willis Towers Watson consultant or one of our CDC specialists listed at the end of this guide.

Summary

Collective Defined Contribution (CDC) is a new type of employee retirement provision under which employers pay a fixed rate of contributions into the scheme and members are paid pensions with variable increases. The law is due to change to allow UK employers to open a CDC scheme for their employees, potentially from as early as 2021. This will be a third option for employers, the two existing options being Defined Benefit (DB) pensions or Individual Defined Contribution (IDC) pensions.

CDC is likely to be most compelling for those employers where the following key advantages of CDC pensions are important:

1. Pension costs are fixed, so employers' pension budgets will not need to vary year-on-year
2. Expected pension levels are higher - for a given contribution rate, the expected CDC pension is on average 70% higher than from buying an insured annuity with an IDC pot, and 40% higher than provided under a typical DB scheme.

Also, a CDC scheme provides benefits in the form of a pension, so:

- market volatility is smoothed out so that member pension levels (both pre and post retirement) are relatively stable,
- members don't run the risk of running out of money (from a drawdown pot), and
- CDC is simpler for members than DC, as they don't need to make investment or retirement provision decisions.

Initially, employers wanting to provide CDC will need to do so through their own trust arrangement - employers with large workforces of over 5,000 employees would be best placed to open a cost-effective CDC scheme. In time further law changes could enable CDC multi-employer schemes or master trusts, making CDC more accessible for employers with less large workforces.

This Guide to CDC answers 15 commonly asked questions, including how CDC schemes will work and more information on whether CDC could be the best option for your workforce.

An introduction to UK CDC **2**
1. What is a CDC pension scheme? 2
2. How does a CDC scheme compare with other types of schemes? 3
3. How do CDC pension levels compare with other types of schemes? 4
4. In summary, what are the advantages of CDC? 5
5. What are the drawbacks of CDC? 5
6. Why is CDC coming to the UK now and when will it become an option? 5
7. Does CDC already exist outside the UK? 5

How will UK CDC schemes work? **6**
8. How will benefits be adjusted in a way which is fair? 6
9. Will pension levels usually be stable? 6
10. How are members' benefits protected? 7
11. What happens if a CDC scheme closes to new members or stops the build up of pensions? 7

Could CDC be the right pension provision arrangement for my workforce? **8**
12. How big does an employer need to be to provide CDC pensions? 8
13. Are there lots of different kinds of CDC pension schemes which could be introduced? 8
14. For which employers is CDC best suited? 8
15. How does an employer switch to providing CDC pensions, and will CDC become widely used in the UK? 9

Royal Mail Case Study **10**

An introduction to UK CDC

1. What is a CDC pension scheme?

The name breaks down as follows:

Collective	Members' retirement savings are pooled together into a single fund to share the risks of investing and of uncertain member lifespans.
Defined Contribution	The levels of contribution to be paid into the scheme are fixed in advance. Sometimes referred to as 'Money Purchase'.
Pension scheme	A fund which pays its members an annual income in retirement.

Members' sharing of risks means the scheme can hold assets which are aimed at achieving higher returns than most pension schemes, to generate a good level of pension from the contributions paid.

Since contribution levels are fixed, pension levels must vary (up or down) depending mainly on the scheme's investment returns and member lifespans, so that the scheme always has the right amount of money to pay the pensions.

Under the current draft primary UK CDC legislation (the Pension Schemes Bill 2019/21, "the Bill"), CDC is referred to as "Collective Money Purchase (CMP)".

2. How does a CDC scheme compare with other types of schemes?

Currently, there are two main options in the UK for retirement provision, Defined Benefit and Individual Defined Contribution. The features of these compare with CDC as follows:

Current option	How does it normally work?	How would CDC differ?
Defined Benefit (DB)	▪ Pays a regular annual income in retirement.	▪ CDC also provides regular retirement income.
	▪ Each member's pension level is based on their service with the employer and rate of pay, with inflation-linked increases subject to caps and floors.	▪ CDC would determine benefit levels in a similar way, except increases could be higher or lower than inflation (and possibly negative if necessary).
	▪ This pension level is guaranteed by the employer. The employer is obliged to pay more into the scheme if past pension promises are costing more than originally estimated.	▪ The pension level is adjusted so that the CDC scheme is self-sufficient, and does not rely on further contributions from the employer to pay past service pensions.
	▪ If the employer becomes insolvent, pension levels can be reduced, although not below the levels provided by the Pension Protection Fund.	▪ If the employer becomes insolvent, no more pensions will build up in the scheme, but otherwise it would either continue to pay pensions in the same way as before, or the pensions would be transferred to another arrangement.
Individual Defined Contribution (IDC)	▪ Contribution rates are fixed in advance, and employers don't have an obligation to top up past payments.	▪ As for IDC, contribution rates are fixed in advance.
	▪ Each member builds up a pot of retirement savings, which they invest as they choose.	▪ Each member is due annual retirement income. The savings are invested collectively and members do not need to make investment decisions.
	▪ At retirement, members can: 1. take the pot as cash, 2. keep it invested and draw it down gradually, or 3. use it to buy a guaranteed pension ("annuity") with an insurance company.	▪ CDC instead provides a pension by default. Members will not have to make detailed decisions around how to convert their retirement savings into income. If they wish to have more flexibility through IDC options, they can transfer out to an IDC scheme before they retire.
	▪ If members choose to buy an insured annuity, the level of pension they get will depend on their asset value and annuity prices on their day of purchase.	▪ CDC does not feature an insurance transaction, and so pension levels are smoother in this regard.
	▪ If members opt to draw-down their pot, they will need to decide how to invest their savings and the pace at which to draw them down. To do this, they would ideally consider their risk preferences, forecast their spending needs and the potential length of their retired life. Pension levels could be volatile as a result. If they live for shorter than expected, they leave extra money to bequeath to dependants, whereas if they live longer than expected they would need to spread their remaining pot over a longer period.	▪ CDC members will not have to make decisions on their benefits once they have retired and are being paid a pension. CDC pension levels are usually relatively stable, due to the way in which investment experience is smoothed out over time. Also, pensions are automatically paid over member lifetimes; pension costs over shorter lifespans average out with longer lifespans.
	▪ Members typically reduce investment risk in the run up to retirement, by selling return-seeking assets.	▪ Because risk is shared between members and over time, CDC schemes would not need to reduce investment risk as early as for an IDC pot, so assets targeting higher-returns (and thus higher pensions) can be held for longer.

3. How do CDC pension levels compare with other types of schemes?

The level of pension from an arrangement is a function of the level of contributions paid into it, the level of asset returns achieved on the funds, and the way in which benefits are determined.

Compared to IDC schemes, CDC schemes will typically aim for higher levels of investment returns particularly for the in-retirement period; they can do this because of the way risk is shared between members and over time. Also, for IDC members who buy an insured annuity, the pension level is relatively low because the insurer must invest prudently to manage the risk of being unable to afford the payments. Because of this a typical CDC pension would be expected to be around 70% higher than an insured annuity.

DB schemes are also collectives. However, they are usually constrained by having to protect from the risk of a sponsoring employer being unable to make good any deficit, and as a result most DB schemes hold lower proportions of return-seeking assets than a typical CDC scheme. Because of this, based on our analysis, for a given level of contributions, a CDC pension would typically be expected to be higher than that of a DB scheme, on average by around 40%. For those employers with particularly low risk DB schemes, CDC pensions could be twice the size or even more.

In other words, for a given amount of contributions, for each £10,000 payable from an insured annuity bought with a DC pot, on average the DB scheme would pay £12,000 and the CDC scheme would pay £17,000.

Note that we have only analysed central expectations of benefit levels; although CDC pension levels are *expected* to be higher, because CDC pension levels are variable there are some possible risk scenarios where CDC pensions are ultimately not higher.

To further explain how we have arrived at these two figures, we have separately published via a download a document titled ***Analysis: How CDC pension levels compare with other types of schemes***

Alternatively, an IDC member who chooses the drawdown option could invest their pot in the same way as a CDC scheme to aim to achieve the same level of pension. If any money is left over when they die, it could be left to their dependants. However, the downside of doing this is that members would bear all the investment risks themselves and would also risk running out of money if they live longer than they expected – the CDC design solves these problems.

4. In summary, what are the advantages of CDC?

Drawing on the features described above, the advantages of CDC are in summary:

1. Pension costs are fixed for employers and employees

2. The sharing / spreading of experience in CDC means that:

   a) Target investment returns can be higher than in nearly all DB / DC arrangements, and so, for a given contribution rate, the level of pension is expected to be materially higher.

   b) Market volatility is smoothed out so that member pension levels (both pre and post retirement) are relatively stable.

3. The scheme provides benefits in the form of a pension, so:

   a) members don't run the risk of running out of money (from a drawdown pot)

   b) it is simpler for members than IDC as they don't need to make investment or retirement provision decisions.

5. What are the drawbacks of CDC?

So that pension costs can be fixed, pension levels must be variable. CDC differs from Defined Benefit and insured annuities in this regard. CDC scheme design and governance will need care to ensure the benefits are being determined in a way which is transparent and fair to the members. Also, member communications will need to make it very clear that pension levels, or their rate of increase, may go down in some years and could be smaller than expected across retirement as a whole.

There is also an element of preference here. If an employer wants to provide annual retirement income cost effectively and at fixed cost, CDC is the way to do that. However, some employees might prefer to be able to make decisions about how to invest and draw down their retirement savings, in accordance with the "pension freedoms" introduced by the Government in 2015, in which case an IDC pot might be better for them.

6. Why is CDC coming to the UK now and when will it become an option?

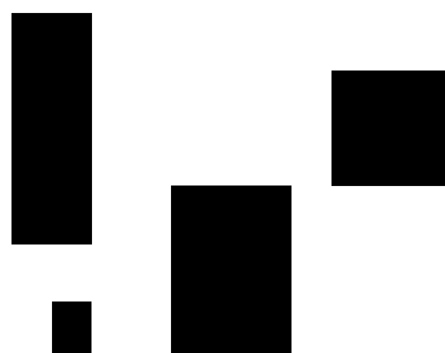
To date, UK legislation has allowed registered pension schemes to be either DB or IDC (as described in 2 above). The background to CDC's introduction now is a 2018 pension review by one of the UK's largest employers and its trade union, Royal Mail and the Communication Workers Union (CWU) – they agreed that DB was not affordable but IDC provided retirement savings in a form which was not suitable for Royal Mail's workers, and so that CDC was the best pension provision for Royal Mail's workers. They agreed to work with the Government to change the law to allow CDC schemes. Please see the case study at the end of this guide for more information.

Some other UK employers are also interested in providing CDC schemes, once the law allows it.

UK employers will be able to open CDC schemes once the new legislation is complete, which could be during 2021.

7. Does CDC already exist outside the UK?

Some other forms of CDC are prevalent in the Netherlands, Denmark and part of Canada, and are beginning to be introduced in Germany and Japan. The Dutch and Danish pension systems are typically rated as among the best in the world. The Dutch have identified some issues with the way in which CDC pensions are determined under their legislation, and so are looking to make changes to this as described in a Willis Towers Watson article **here**. The UK design of CDC is different to the Dutch design, in a way which is intended to learn from the Dutch experience.



How will UK CDC schemes work?

8. How will benefits be adjusted in a way which is fair?

CDC schemes will need to ensure they distribute funds as income in a way which is fair and not biased towards one group of members in favour of another. There are different ways in which CDC scheme designs could achieve fairness.

As an example, the details of the first potential CDC scheme in the UK were published by Royal Mail and CWU in November 2018. We worked with them and other stakeholders to design this scheme – see the Case Study at the end of this guide. Under their design, fairness is achieved in terms of £ pa pension amounts, as follows:

- Each member builds up pension at the same rate (1/80th of pay for each year of service)
- In a given year, every pre-retiree and retired member receives the same pension adjustment (usually an increase). This reflects the best estimate of the increase that the scheme's assets are sufficient to provide every year in the future
- There is no bias in the design, so no expectation that some generations of members will receive higher increases than others. In practice there will be variations in benefit levels, however that will be due to circumstances at the time such as asset performance and changes in members' lifespans.
- The scheme's pension adjustment rules and investment strategy have been designed so that pension level expectations and volatility are not materially affected by a change in circumstances of the scheme (such as material change in active population, or closure).

Other CDC designs could achieve fairness in different ways. The regulations are expected to include some design requirements as part of ensuring fairness. In addition, the Pensions Regulator will review the design of each CDC scheme before it opens, and could review fairness of benefit design as part of that process.

9. Will pension levels usually be stable?

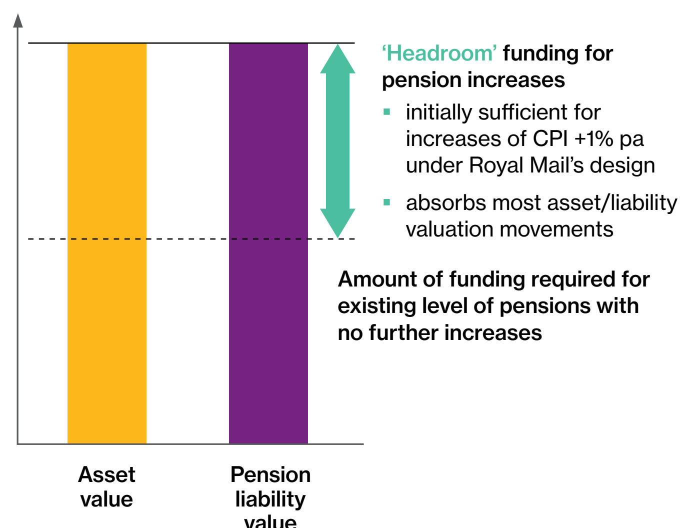
It is important that the expected level of stability of CDC pensions is communicated to members. Well-designed CDC schemes would expect to provide a pension which is relatively stable over periods of a few years, since it is undesirable for pensioners to be uncertain of their retirement incomes.

Under the Bill, the CDC scheme actuary will need to certify whether the scheme design is sound, which we suggest includes an assessment of whether its member communications are consistent with its benefit design, including statements on pension stability. The Pensions Regulator would also assess this aspect before authorising the scheme.

As an example, under Royal Mail's design, movements in asset markets are spread over the long term through a change in the long-term rate of increases, so that pensions are expected to be stable in the short term. This is illustrated in the Figure 1 below.

Because CDC schemes have fixed contributions, pension levels over the long term will ultimately depend on how successful the scheme has been at generating asset returns, and on members' actual lifespans. At the point of opening a CDC scheme, an estimate would be made of the pension levels the scheme will provide, if asset returns are as targeted and life expectancy does not change.

Figure 1: **How pension increase work under the Royal Mail design**



10. How are members' benefits protected?

CDC schemes will be set up under trust. Trustees with appropriate knowledge and skills will be nominated to operate the scheme in accordance with its rules. They will need to ensure the promise made to members, of how their money will be invested and benefits will be determined, is kept.

The trustees will be required to appoint an actuary to help determine the level of pensions which the scheme can afford to pay. This assessment will be subject to oversight from the Pensions Regulator. The results of this assessment and assumptions used to complete it will be published for transparency.

11. What happens if a CDC scheme closes to new members or stops the build up of pensions?

Treating members fairly includes ensuring benefit adjustments are not materially affected by a change in circumstances of the scheme such as material change in active population, or closure. Unless the employer is able to provide a high degree of certainty of a stable continuing active population, we would expect a CDC scheme's investment strategy, valuation and benefit adjustment rules to be designed to ensure that there is not a material reliance on continued stable levels of accumulations. For example:

- The investment strategy to feature sufficient levels of low risk assets supporting pensions in payment so that, were the scheme to run on as a closed scheme and become mature, benefit levels remain within acceptable limits of volatility. (However, this would still not be as low risk as seen in most DB schemes, or insurance holdings for IDC annuities.)
- The valuation approach to set benefit adjustments will anticipate the future switch to low risk assets, so that carrying out that switch does not reduce benefit levels.
- The valuation approach to be based on past service accumulations only, so that a closure to future service accumulations does not have an immediate effect on benefit adjustments.

At the point of closure to accumulations, the trustees will need to consider whether to run on the scheme as a 'closed scheme' or whether it is better to transfer the benefits to another arrangement. Where the scheme is sufficiently large to run cost effectively, we would expect it to usually continue to run on as closed scheme, paying CDC pensions, unless there is a CDC scheme to which the benefits can be transferred which would improve benefit levels. Under the Bill, each CDC scheme will need to maintain a "Continuity Strategy" to set out plans to deal with events such as closure in a way which ensures members' benefits are adequately protected.

Could CDC be the right pension provision arrangement for my workforce?

12. How big does an employer need to be to provide CDC pensions?

The main constraint of employer size will be consideration of cost effectiveness of a CDC scheme. The employer's CDC scheme set up costs will include the costs of applying for and achieving authorisation from the Pensions Regulator. Once open, CDC schemes will have operational expenses including investment, administrative and actuarial, which would usually be met from the scheme's collective assets. CDC schemes will need to be well governed, and would ideally have a sophisticated investment strategy in order to target relatively high returns with diversification of risks. CDC schemes will be subject to a charge cap similar to that applicable to IDC schemes, and smaller schemes are more likely to have a constrained investment strategy or need support from the employer to meet expenses.

Based on cost estimates and CDC scheme size projections, we would expect 10,000 active members to be more than enough for the scheme to be well run and operate self-sufficiently within the constraints of the charge cap. 5,000 active members would also usually be feasible with limited additional support from the employer to meet expenses in the first few years. For employers with fewer than 5,000 active members, to provide high-quality CDC pensions the employer would be more likely to need to put in place a more material reserve to meet operational expenses while the scheme is young and building its asset base, depending on the details of the scheme design and operation.

A scheme for 1,000 or fewer active members would be likely to require a prohibitively large reserve from the employer. Also, for smaller schemes within this category the membership base would be smaller than ideal for pooling longevity risk. A CDC master trust, if available, would be likely to be the better option for employers in this category.

13. Are there lots of different kinds of CDC pension schemes which could be introduced?

The Bill requires CDC schemes to have collective assets, and apply regular adjustments to benefits so that there is a 'balance' between assets and liabilities. In isolation, this would allow a wide range of CDC schemes, subject to certification by an actuary that the design is sound in accordance with the member communications to be issued, and subject to approval of the design by the Pensions Regulator.

As described in 8 above, it is important that CDC schemes determine benefits in a way which is demonstrably fair. The Royal Mail design is an example of how this can be done, however we would expect a variety of different designs to be feasible to meet the needs of different employers, subject to regulations which support this. For example, some employers could prefer a model in which the accumulation rate varies by age (so that the actuarial value of accumulations is equal for each employee), or an approach with lower levels of potential cross subsidy across generations of members.

The Government is currently working on the CDC regulations, and we understand they will consult on which CDC designs the regulations might allow.

14. For which employers is CDC best suited?

Given the form of retirement benefits as described in 2 above, and cost effectiveness considerations in 12 above, we would expect CDC to be particularly well suited to employers with at least some of the following characteristics:

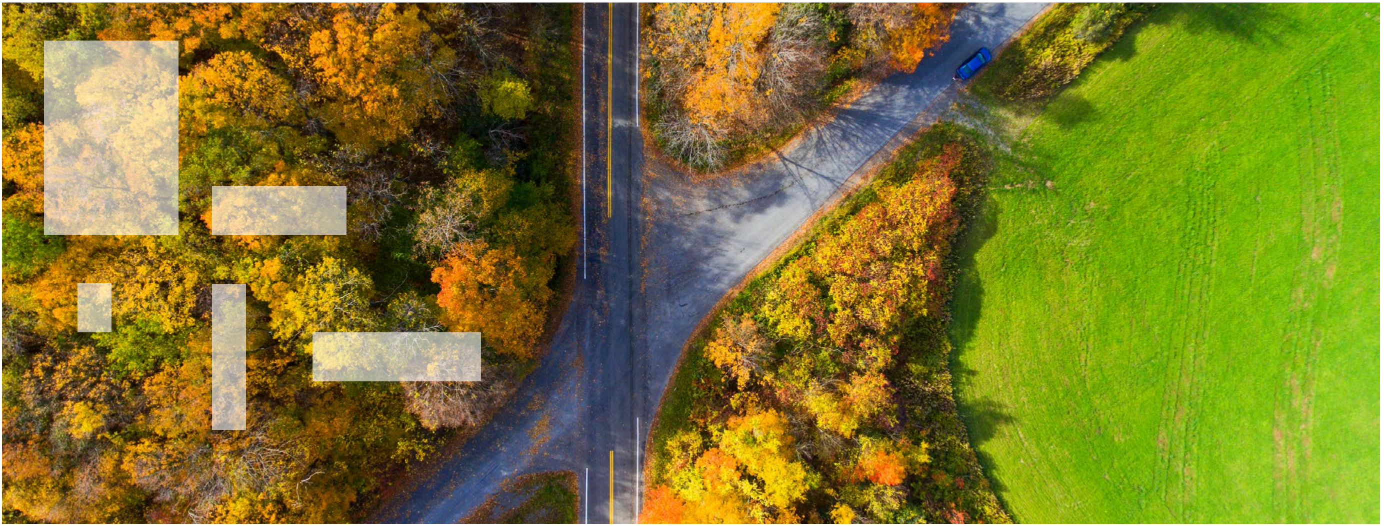
a. Employers where employee remuneration is a large part of operating expenses, so fixed pension costs are important.

b. Relatively large employers (ideally over 5,000 employees), unless CDC master trusts become available (see 15 below).

c. A workforce who would like retirement benefits in the form of an annual retirement income without the need for each member to make pensions management decisions.

d. Companies where a good level of retirement provision is important for staff recruitment and retention or to help employees retire before old age.

e. Employees typically stay with the employer for more than a few years, so that it is worth building up a CDC pension; unless there is a CDC industry scheme or master trust that allows members to continue building up CDC pension even if they change employer.



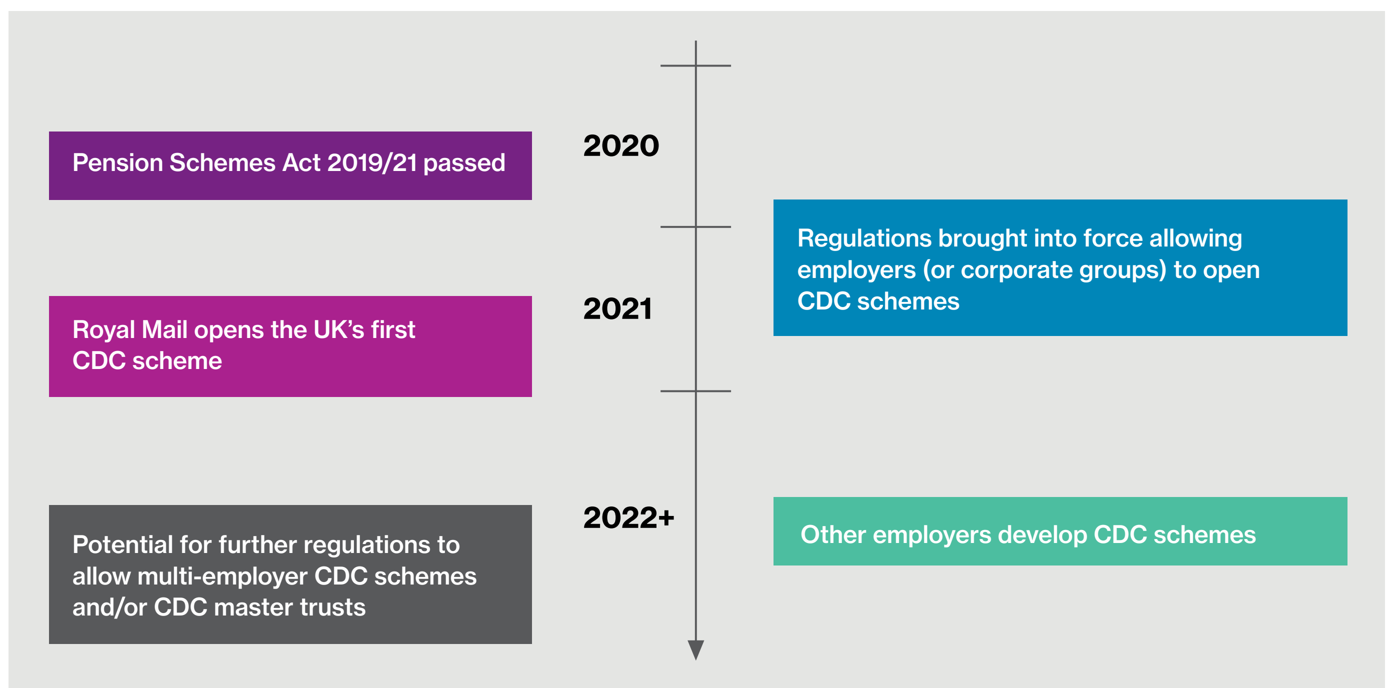
15. How does an employer switch to providing CDC pensions, and will CDC become widely used in the UK?

CDC is new to the UK, and time will tell how many employers choose to provide CDC pensions for their employees. Based on polling we carried out of CDC webcast attendees in 2019, 13% thought their organisation was likely (or very likely) to adopt CDC by 2025. In the Association of Consulting Actuaries (ACA's) *Pension Trends Survey* published January 2020, 48% of employers supported the CDC option being introduced although only 8% said they would currently consider introducing a CDC scheme.

Under the initial CDC legislation, employers who want to provide CDC will need either a new trust arrangement through which to do so, or to create a new CDC section in an existing pension trust. Before the CDC scheme can operate, the trustees will need to secure authorisation from the Pensions Regulator. This process is expected to be similar to that for DC master trust authorisation. This is likely to be an involved process, perhaps limiting initial CDC access to only well-resourced employers. Royal Mail have agreed with their workers that they will do so, and we are engaging with some other employers who are interested in providing CDC pensions.

As set out in the diagram below, the CDC regulations are likely to be in place to allow employers to open CDC schemes from a point in 2021. Government has said it is keen, in time, to allow industry-wide CDC schemes, or for pension providers to set up CDC master trusts. This would make CDC much more accessible to smaller employers and the self employed. This would be likely to be necessary for CDC to become prevalent among UK workers. This would need further regulations, and so we expect this will not be an option until 2022 or beyond.

Figure 2: **How is CDC expected to develop from here?**



Royal Mail case study

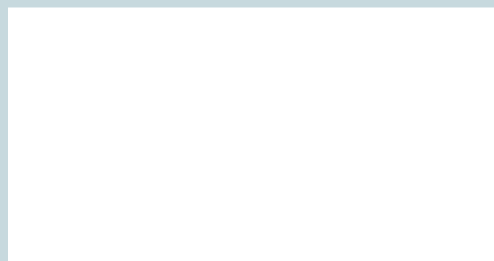
We've been very pleased to work with Royal Mail on their journey to introducing CDC.

It started in 2017 when Royal Mail identified that the cost of Defined Benefit (DB) pensions accrual was about to become unaffordable, and that they would need to close their DB scheme to new accrual and find an appropriate replacement scheme for current employees.

Royal Mail and the Communication Workers Union (CWU) agreed that Individual DC would not be appropriate for Royal Mail's workforce. Royal Mail and the CWU did not want employees to have the burden of choice of investment strategies and retirement options that IDC represents. Providing employees with an annual retirement income was preferred to providing a retirement savings pot. Although IDC members can buy pensions from insurance companies, this was not satisfactory in Royal Mail's case because of the variability in pension levels in the build up to retirement, and the high cost of pensions in the insurance market in recent years – pensions bought through this route were not thought to be adequate.

Royal Mail and the CWU looked at what kind of arrangement would best meet their requirements for pension provision. The answer was a scheme providing annual retirement income, with variable pension increases so that it could be at a fixed cost, with assets invested to target the generation of relatively high pensions. It was identified that similar designs existed outside the UK and these were known as CDC schemes. However there was a hurdle to this solution - UK legislation allowed employers to provide only DB or individual DC occupational retirement schemes.

As a result Royal Mail and CWU are working with Government to introduce CDC schemes. In 2018 we worked with them and other stakeholders to design the scheme. 2019 involved much engagement with Government and others, while the Bill to enable CDCs was tabled in Parliament in January 2020. This could lead to the necessary legislation being in place to allow CDC schemes to launch in 2021. Some of Royal Mail's workforce are currently accruing IDC benefits, and others cash balance benefits; both groups would be enrolled into a single CDC scheme.



Contact details

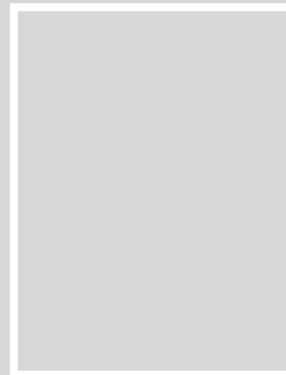
We hope you have found this a helpful guide to CDC. If you would like to know more, please contact your usual Willis Towers Watson consultant or one of our CDC specialists who would be happy to assist you.

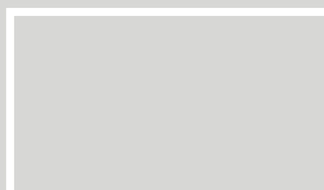
CDCuk@willistowerswatson.com

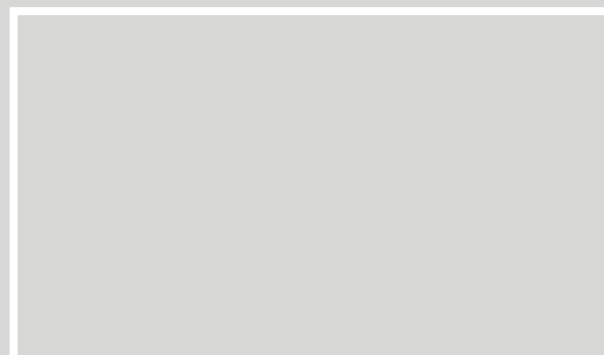
Simon Eagle
simon.eagle@willistowerswatson.com
01737 274670

Shriti Jadav
shriti.jadav@willistowerswatson.com
020 7170 2685

Luna Fadayel
luna.fadayel@willistowerswatson.com
01737 274227





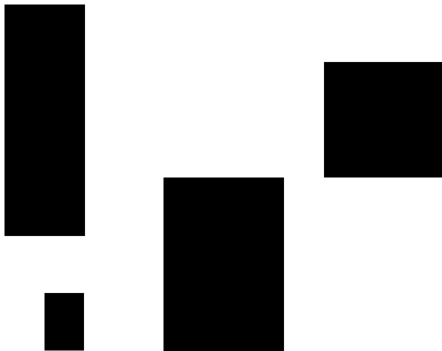


Use of this Guide

Towers Watson Limited has published this guide for general marketing purposes only. It does not represent advice which falls within the scope of the technical actuarial standards (TASs) published by the Financial Reporting Council.

This note may not be modified without our prior written permission. In the absence of our express written permission to the contrary, we accept no responsibility for any consequences arising from any third party relying on this presentation or the opinions we have expressed. This note is not intended to form a basis of any decision by a third party to do or omit to do anything.

Towers Watson Limited is authorised and regulated by the Financial Conduct Authority.



About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 45,000 employees serving more than 140 countries and markets. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

willistowerswatson.com/social-media

Copyright © 2020 Willis Towers Watson. All rights reserved.
WTW-10070

willistowerswatson.com

Willis Towers Watson