The Power of Pooling

Collective Defined Contribution (CDC) as a Decumulation Solution

November 2022

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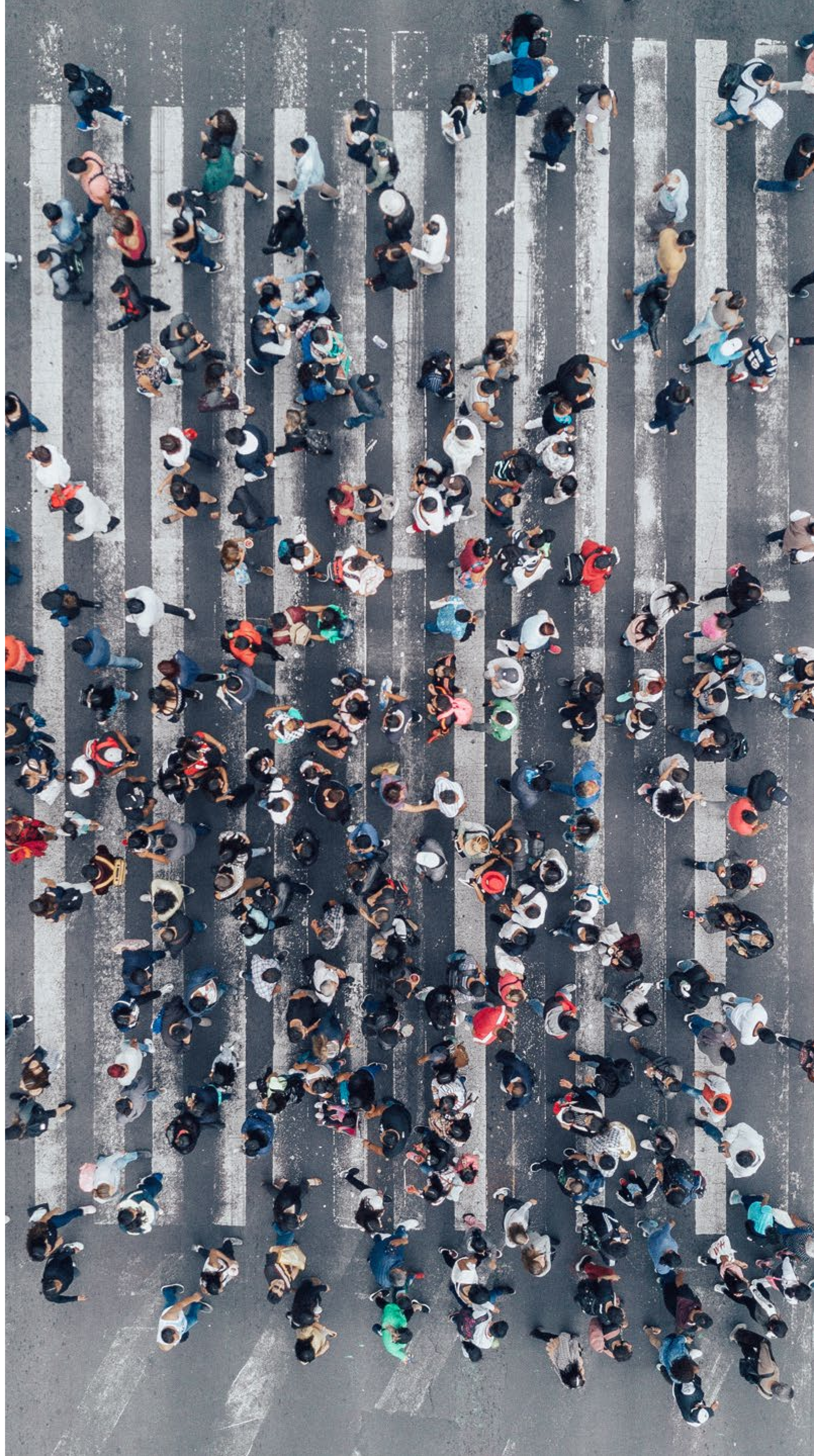

Executive Summary

Collective Defined Contribution (CDC) introduces another option to the UK pensions landscape, which we believe will help many millions of people achieve a better retirement. Through the power of pooling, CDC pension schemes will also help solve some of the problems that over a decade of low investment returns, and increasing life expectancy, have created in the pensions industry.

CDC can provide what the majority of pension savers want in retirement: a target, inflation-linked income, which is payable for life and does not require them to make complex financial and investment decisions.

From 2024, employers of all sizes will be able to offer their workforce CDC pensions, including by providing CDC as a retirement, or decumulation, option alongside annuities and drawdown.

This short paper covers how CDC as a decumulation option looks set to transform the pensions industry.

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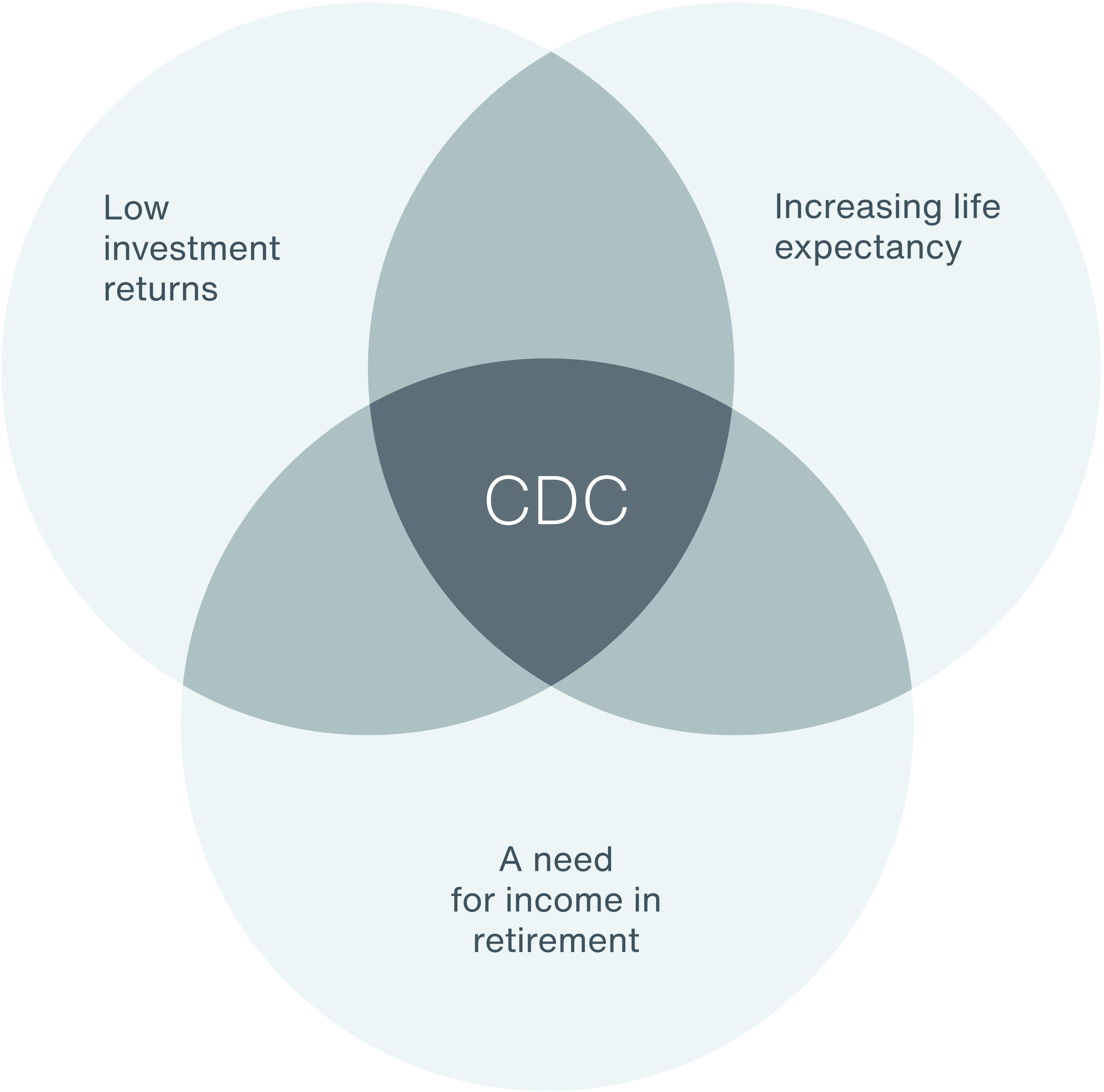
Why Are CDC Pensions Needed?



In defined benefit (DB) pension schemes (which generally promise to pay guaranteed inflation-linked pensions for life) the cost of meeting members' pensions has become increasingly expensive. This is because investment returns on low risk assets have been hard to come by, and members have continued to live longer than expected. As a result, DB schemes have fallen out of favour with employers in the private sector.

In defined contribution (DC) schemes, this combination of relatively low interest rates and increasing life expectancy means that anyone who wants to use their individual DC pension pot to secure an income for life in retirement through an insurer's annuity policy, also has to pay for the guarantee that provides. As a result, individual annuities on retirement for DC pension savers have also fallen out of favour.

However, as Aon's 2020 DC survey revealed, around **60%** of DC members do still want an income for life in retirement.

The only other way to currently achieve this is through income drawdown. However this requires members to not only engage with their pensions, but also the ongoing complex decisions needed to balance the pace at which they take their retirement savings against their own life expectancy.

As shown below, a 65 year old has a 50% chance of their actual lifespan lying somewhere within a 13 year range. Regardless of the size of their pension pot at retirement, that means they have a very material challenge to decide how to budget for this uncertainty.

How Long Might You Live?

Average life expectancy for a 65 year old is

86 years albeit:

With a 25% chance of dying before **80**

With a 25% chance of living beyond **93**

With a 10% chance of living beyond **97**

Source: Office for National Statistics' Life Expectancy Calculator

Trying to manage personal longevity risk is likely to be the biggest challenge society faces in retirement.

- Over-estimate life expectancy and you risk a lower standard of living in retirement than might have otherwise been possible.
- Under-estimate life expectancy and you risk running out of money.

These challenges suggest to us that what employees want is an efficient and cost effective way to be able to secure a lifelong income in retirement, without them having to make complex decisions.

We also believe that many employers want to provide this for their employees, provided it is done through defined contributions. A CDC arrangement could also be a powerful tool to help their employees retire on time, bringing workforce management and operational efficiency benefits.

CDC also represents a differentiator in the labour market, helping employers attract and retain top talent, and also rewarding employees in a way that aligns with wellbeing strategies. For example, reducing the complex decisions employees need to take as they approach and reach retirement will help promote financial and emotional wellbeing.

The existing options of DB and DC, with annuity purchase or income drawdown, do and will clearly work for some. However there are now many millions of pension savers who don't have access to a DB pension, but do still want an income for life in retirement.

We therefore believe CDC provides these pension savers and their employers with a new, attractive, option to help meet their goal of achieving a lifetime income from their DC savings.

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How Would a CDC Option At Retirement Help?

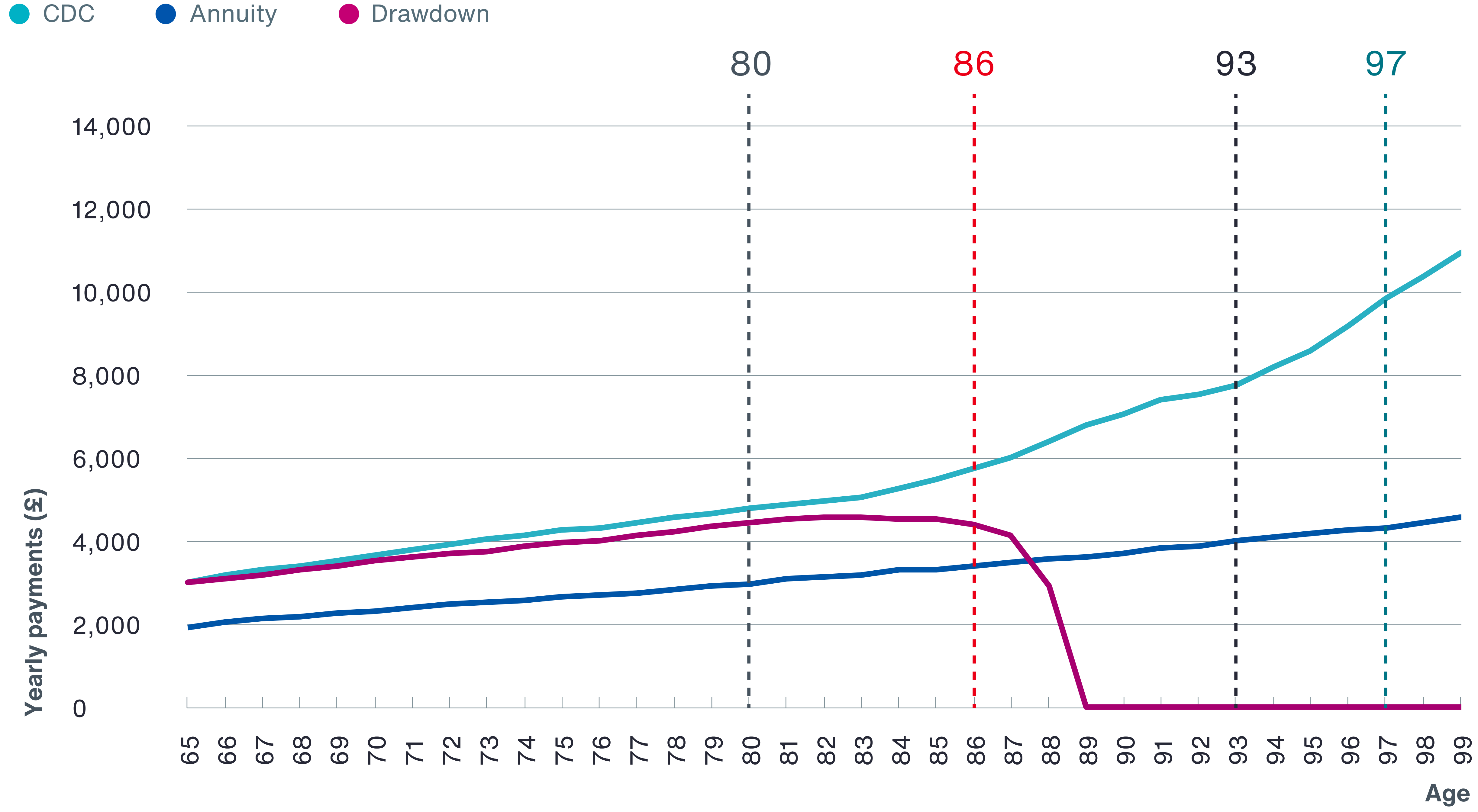
Given the material challenge retirees will face in deciding how to budget for uncertainty in retirement, we show below how a CDC option could help them to balance their retirement spending needs.

Chart 1 shows how a CDC option at retirement compares with annuity purchase and income drawdown, for a member retiring at age 65 with a £75,000 pension pot, having already taken their 25%, or £25,000, tax-free cash lump sum at retirement.

This chart shows annual income along the left-hand vertical axis, and age across the horizontal axis.

Chart 1: Retirement at Age 65

Comparison of Median Projected Payments



Our analysis suggests that our sample member could:

- **Buy an inflation-linked annuity, shown by the blue line, of £2,000 per annum.**

  As expected, this provides them with a guaranteed inflation-linked income, payable for life.

- **Or they could buy a CDC pension, shown by the teal line, of £3,000 per annum — which is worth about 50% more than an annuity.**

  The power of pooling retirement savings with other members means CDC provides them with an income for life, and because CDC does not guarantee inflationary increases, there is more freedom to invest in higher returning assets over longer periods of time in retirement. It comes as no surprise, then, that we expect CDC schemes to provide on average higher pensions throughout retirement than annuity purchase.

- **Or they could use the general income drawdown "rule of thumb", where they take 4% of their starting pot as income, give themselves some inflationary increases each year and see how long this lasts them in retirement. This is shown by the purple line.**

  Our analysis suggests that drawdown can get members reasonably close to outcomes they could receive from buying a CDC pension. However drawdown runs the risk of retirees running out of money just after age 86, which is the average life expectancy of a 65 year old.

  This will concern many people in retirement, especially those who believe they will live longer than average. For those retirees who enter income drawdown, and live beyond 80 with a quickly diminishing drawdown pot, they may also lack the cognitive capacity to make effective decisions around how much to slow down their spending in retirement.

Our analysis shows the value of CDC as a decumulation solution for members at retirement. CDC provides on average higher outcomes than annuity purchase, and provides the income for life that drawdown cannot provide.

However CDC is unlikely to suit all pension savers at retirement. For example:

- Those with relatively low wealth may prefer to cash out their pension savings if the state pension is expected to provide them with sufficient income to meet their retirement spending needs.
- Those with relatively high wealth at retirement may prefer to put all of their pension savings into drawdown, if they feel they are unlikely to rely on their pension savings in retirement. This gives flexibility to only dip into their pension savings if required, and allows any unused pension savings to be passed on to their dependants when they die.
- Those who expect to die earlier than average may also prefer drawdown, so that their unused pension savings can be passed onto dependants.

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> This is what we mean by the 'power of pooling' in CDC: pension savers can expect more for their money, without the risk of it running out.

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Chart 2 shows the same decumulation options as Chart 1, with the addition of the grey bars and scale on the right-hand vertical axis. These show how much money our sample member, who chooses the income drawdown option indicated by the purple line, would have remaining at the end of each year of age in retirement.

For example, if our sample member dies at age 80, arguably income drawdown would have been the more attractive option at retirement. This is because when they die, their unused pension pot of around £30,000 can be passed onto their surviving dependants.

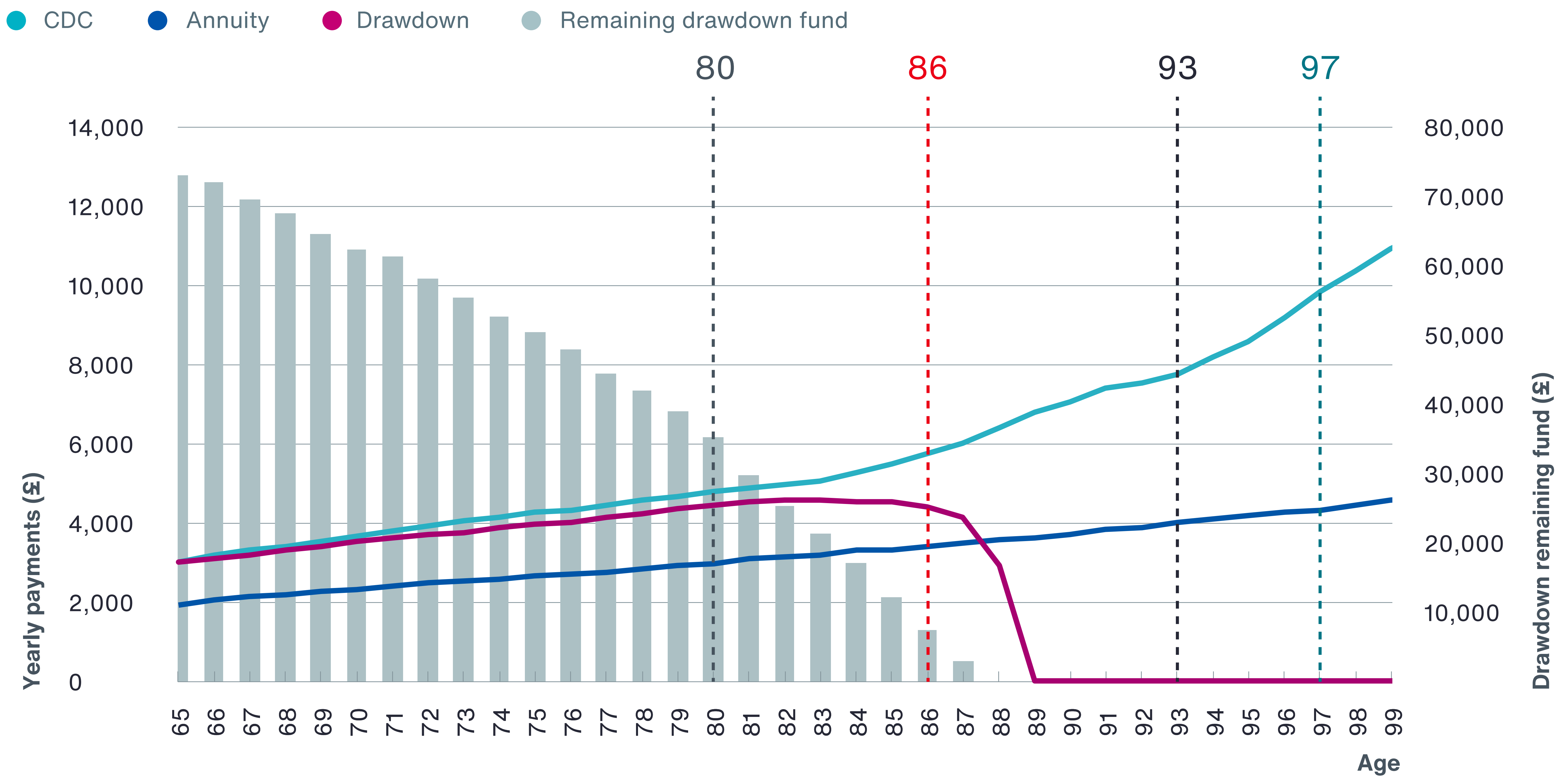
However, we expect CDC pensions to have attaching dependants' benefits — for example a dependants' pension of 50% of the member's pension at death. A member who expects to die earlier than average may therefore still prefer to buy a CDC pension in practice. This is because it can provide financially for those they leave behind, without also passing on the complexity of managing their unused pension pot.

As a result, we believe many people in the UK will see the attraction of CDC as a pension decumulation solution.

We may even see demand for CDC to become a default decumulation option. This does not currently exist at an industry level in DC, yet the value of a decumulation default is widely recognised in a culture where pension savers have not been required to make any decisions during the build up (or accumulation) of their pension.

Chart 2: Retirement at Age 65

Comparison of Median Projected Payments



4 How Might CDC Improve Choice at Retirement?

Like annuity purchase and income drawdown, CDC does not need to be an 'all or nothing' option at retirement.

Perhaps the greatest value CDC brings as a decumulation solution, is when used alongside existing options at retirement — in particular alongside income drawdown.

For example, the introduction of CDC could see our sample retiree splitting their DC pot as follows:

- **25%** taken as a tax free cash lump sum
- **60%** used to buy a CDC pension, to supplement state pension
- **15%** put into income drawdown

For our sample member at retirement, this may strike a sensible balance between cash up front, flexibility during retirement, and the comfort of knowing they will have an income that supplements their state pension and lasts until the day they die, without having to make any decisions in retirement. This combined lifetime income in retirement can then be used to budget and enjoy the retirement they have worked so hard toward.

CDC may also be an attractive option for those who have already decided to transfer out their DB pension. In doing so, their default retirement strategy is currently income drawdown (the purple line and grey bars in our charts above). However, could CDC offer them an extra choice, enabling them to make better decisions to suit their retirement needs?

For example, CDC may help this group of retirees bridge the gap between taking all of their retirement savings:

- As a lifetime income, which is the default if they stayed in their DB scheme; and
- Through flexible drawdown, which is the current default if they transfer out of their DB scheme.

Regardless of whether retirees have built up their pension saving in DB or DC schemes, we believe CDC as a decumulation option paves the way for a very exciting future for UK pensions.

5 Remind Me How a CDC Scheme Works?

Fixed Contributions

Employers and employee contributions are fixed, giving cost stability.

Pooled Assets

Pooling the assets provies more investment freedom, enabling higher returns, and solves members' personal longevity risk problem.

Target Benefits

Benefits are not guaranteed. Members have a target pension with variable (+/-) adjustments.

CDC schemes will harness the power of pooling.

By pooling contributions and investment returns, and sharing risk across members of all ages, CDC schemes will have scale and a typically longer time horizon than the lifespan of an individual DC member.

A cornerstone of CDC is that benefits are not guaranteed. CDC schemes will, at outset, target increases at least in line with inflation. However actual adjustments to pensions each year will vary depending on investment returns, inflation and life expectancy. We expect pensions to increase in most years, but there is a chance that benefits could be reduced in extreme circumstances.

By pooling risk and not providing a guarantee around inflationary increases, CDC schemes can seek greater investment returns through investing in different types of assets, and doing so over a longer period of time than individual DC and closed DB schemes.

All of this means that **we expect CDC to deliver higher average outcomes in retirement** than DC, where annuities are used to secure lifetime income.

That's the power of pooling, and our analysis above show just how valuable we expect this to be.

We also believe the nature of CDC naturally aligns with investing in a sustainable, responsible way. We expect to see CDC schemes invest in ESG-oriented asset classes, as well as in more illiquid investments, including infrastructure and private markets. CDC can therefore help accelerate ESG strategies for employers.

You can read more about how CDC schemes work, and the value they provide to both UK employers and pension savers, in our previous thought-leadership publications:

- CDC explanatory guide, which provides an overview of what CDC is.
- CDC in adverse markets, which showcases the resilience of CDC schemes and demonstrates how they might have fared over the last 90 years.
- Our CDC white papers, accessed via our CDC homepage, which demonstrate both the case for CDC and evidence how well-designed CDC schemes can offer both stability and fairness for members.
- Finally, take our CDC quick quiz to help identify which flavour of CDC might best suit your circumstances.

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When Will CDC Legislation be in Place?

The timeline below sets out how we currently expect CDC to evolve in the UK.

1 August 2022
'Own Trust' CDC

Regulations come into effect: TPR can accept applications for own trust CDC schemes.

Q4 2022
Consultation On Principles

2023
Consultation On Regulations

Covering CDC for:

- multi-employer / industry-wide schemes.
- Commercial master trust, including decumulation-only, solutions.

DWP are currently engaging with interested employers / providers.

2024
CDC For The Masses

Expect regulations covering wider forms of CDC to come into effect.

From 1 August this year, regulations and TPR's Code of Practice covering single-employer CDC schemes come into effect. From this date Royal Mail, and any other employers looking to set up a similar CDC scheme, can apply to do so.

Beyond single-employer CDC designs, there are a number of other employers and industries who are looking to create multi-employer / industry-wide CDC schemes.

There are also a number of commercial master trusts exploring how they can offer CDC, either as a whole of life pension solution or as a decumulation-only solution, for members retiring with DC pots or those who have transferred out of DB schemes.

These wider forms of CDC will need the government to expand its existing CDC regulations. The good news is that the government is currently seeking views from industry and interested parties on how these other CDC schemes could work, and have previoiusly committed to consulting on the principles that they intend to regulate for by the end of this year (2022). They have also committed to consulting on the proposed regulations next year (2023).

Therefore, from 2024, we expect to see CDC open up fully, for non-connected employers and commercial master trusts. This includes CDC decumulation-only solutions, which are the focus of our earlier analysis.

Key Takeaways

The future of UK pensions has arrived

1

Employers, employees and pension scheme members will find CDC provides a good fit for their retirement needs.

2

From 2024, employers of all sizes can offer CDC for their workforce, including as a decumulation option.

3

CDC should now be an option on the table for all employers and pension schemes to consider.

4

Employers and pension schemes should consider communicating CDC to their DC members as an additional 'at retirement' option.

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