

Defined Contribution

Collective DC – digging a deeper hole



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Executive Summary

If your children try to build a sandcastle this summer on slightly too wet sand, they are likely find themselves digging ever more sand to shore up the walls of the castle before they collapse in on themselves. As any parent knows, this is futile because the deeper they dig, the wetter the sand gets.

Collective DC (CDC) has recently been highlighted by the UK government as a potential route to lower charges and higher pensions. Pensions minister Steve Webb has suggested that it will 'feature prominently' in his upcoming *defined ambition* paper¹.

In this article we examine the pros and cons of CDC and explain why we think that this is a classic case of 'dig deeper and you'll find yourself in a very big hole'.

What is Collective DC?

The idea behind CDC is that members pool their assets in order to:

- receive a smoothed return (rather than the return on an individual's DC account as in traditional DC),
- benefit from lower fees and expenses, and
- receive a pension from the CDC fund rather than purchasing an annuity from an insurance company.



This results in financial risk sharing and mortality risk sharing.

All sounds too good to be true? That's because it is. Dig deeper and you will find the sand gets wetter.

Risk sharing is not the answer to the capital risk problem

Suffering very large capital losses just before retirement is a serious problem for DC members. They don't have enough time to make up the losses before they retire and so either have to retire on a lower pension or have to work past their planned retirement age. Traditionally this issue has been managed by moving from higher risk/higher return assets to lower risk/lower return assets in lifecycle and target date fund designs as the member approaches retirement. This is to reduce the risk that the assets behave differently from the way in which an annuity is priced (annuity conversion risk). It results in switching from growth assets 5 or 10 years from retirement and arguably this is too conservative (therefore reducing returns).

¹ Financial Times – June 2013

In a CDC arrangement, the risk sharing and smoothing approach means that equities can be held for longer² so that expected returns are enhanced compared to traditional DC. Members do not suffer large capital losses if growth assets perform poorly because the returns are smoothed from year to year. Typically this works by holding back some return when assets perform strongly, which are then used to top up returns in periods when returns are poor. Someone needs to decide the smoothed return that the member will receive. Not only does this sound very similar to with-profits arrangements (which spectacularly slipped out of favour in the early 2000s with Equitable Life's collapse) or endowment mortgages where the return expectation of the 1980s and 90s has not been delivered in the 2000s. The with-profits concept required an 'estate' or free reserve assets to support the smoothing of investment returns. The 'estate' is built up over a period from retained returns from participants' assets. Therefore at the outset a CDC participant could expect that an element of the returns achieved on 'their assets' would be retained to support the future smoothing process; this could be considered in a similar way to tax on the initial entrants. An additional challenge with smoothing is the daily-dealing environment, as someone will need to decide the smoothed return on a daily basis or, say, set it for a year.

In Australia, Superannuation funds typically have a crediting rate approach that passes on the full market-linked return rather than a smoothed return because members are permitted to move between providers and funds. This results in members having a transparent and 'fair' return.

There is also the potential for educated and engaged members to select against the plan, choosing to transfer in/out when returns are being smoothed positively (i.e. if returns in the market have been poor, the smoothed return will be higher and the member may choose to remove assets having just received a higher-than-market return).

Additionally this approach requires the system to work indefinitely³ and for compulsory (non-opt out) contributions. With a shrinking population in the UK⁴, the younger people are likely to be covering a larger proportion of the risk per person than older generations. Performance smoothing must cut both ways – some will win and some will lose.

Collective DC is not the only way to gain economies of scale

It is true that if you can aggregate larger amounts of assets, lower fees can be negotiated with investment managers and administrators through economies of scale. However it is not necessary to risk share in order to get these benefits. This can be achieved through industry-wide plans, union plans, master trusts etc. where DC plans are governed by one group, selecting a small number of options and a default, in which all the underlying plans participate. The NAPF supports the use of 'Super Trusts'⁵ which would be large-scale DC pension arrangements that could 'remain low cost due to their independent governance and buying power resulting from scale'.

Industry-wide not-for-profit industry wide funds exist in Australia (with the largest having assets of around £45 billion). These started out representing only their union or industry constituents but many are now 'public offer', i.e. open to everyone.

² Government Actuary's Department modelling for the DWP (2009) and Optimal risk sharing in a collective defined contribution pension system- Bams, Schotman and Tyagi (January 2013)

³ Collective Defined Contribution Schemes: An assessment of whether and how collective defined contribution schemes might operate in the UK (December 2009) and Optimal risk sharing in a collective defined contribution pension system- Bams, Schotman and Tyagi (January 2013)

⁴ The Total Fertility Rate in the UK has been stable between 1.90 and 1.94 (replacement level of 2.1 is required to maintain the population) – Office for National Statistics, 17 June 2013

⁵ Enabling good members outcomes in work-based pensions provision: a response by the NAPF (April 2011)

Annuity purchase

One of the benefits highlighted by proponents of Collective DC is that pension payment can be provided from the plan rather than an annuity from an insurance company, therefore saving around 22%⁶ in costs (although this number has been widely debated as an overestimate). We believe that it is better not to force members to buy an annuity. They should have more flexibility and this could allow the plan to continue to invest in growth assets post-retirement, maintaining members within the plan as is the case with ‘through’ target date funds in the US⁷.

Annuity provision means that members often do not make a decision at retirement because they automatically default into an annuity from the ‘selected’ provider of the plan. Despite the Open Market Option (where members are permitted to choose an annuity from any provider), not all take this up⁸. This results in complacency and lack of true competition of annuity providers at retirement. If annuities are to be compulsory, forced decision making may be one way to improve this (i.e. the pension is not provided until the member makes a positive decision about the annuity that he wants to purchase).

A CDC could offer either:

- a pension paid from the plan,
- provide a collective annuity from within the plan or
- purchase an annuity on behalf of members at retirement.

If a pension is provided from the CDC, it will be subject to funding requirements similar to a Defined Benefit (DB) plan, with the associated solvency requirements and concerns about underfunding or underestimated longevity for the pension group. This approach partially worked in DB pensions but only because the Sponsor stood behind the plan to provide a guarantee (which they found to be increasingly expensive due to improved longevity). With no such guarantor other than the CDC itself, this is likely to drive investment into assets far less risky than just equities, and so negate some or all of the perceived benefit in investment risk sharing. Besides, any new members joining an underfunded CDC plan have to, in effect, bail out the previous generation before they start saving for themselves.

If annuities are provided from within a CDC in a collective annuity approach, assets would be transferred from the pre-retirement members into a separate post-retirement asset pool. This would effectively create a with-profits fund prior to retirement and an insurance company post-retirement within the CDC. The annuities would be provided from this pool, resulting in mortality risk sharing among the retirees only, removing investment risk sharing between savers and pensioners. The CDC could choose whether to use a market rate to calculate the annuity or use a smoothed annuity rate. With a collective annuity approach, the CDC is likely to be subject to the same rules as a life insurance company with a need to reserve (hence increasing cost) and demonstrate the assets being held are appropriate for the retirees. Again, this is likely to result in much less risky assets than just equities. The collective annuity approach results in significant event risk at the time of transition between the pre- and post-retirement pools. Annuity smoothing, like performance smoothing, must cut both ways – some will win and some will lose.

⁶ Collective Pensions in the UK – David Pitt-Watson, Hari Mann, July 2012

⁷ Investment Perspectives – Lessons learnt in DC from around the world – Schroders (June 2012)

⁸ UK data from Just Retirement for 2012: £14 billion annuity sales, around £8 billion Open Market Option, around £4 billion enhanced/impaired

In both examples above, small CDCs are likely to be more exposed to the risk of an individual living longer than expected compared to if the risks are shared among more members.

If annuities are purchased by the CDC, then the issues discussed earlier come into play and the element of mortality risk sharing is negated. There is a pricing risk which would generally be out of the control of CDC and this would impact the perceived smoothing. Retirees with the same nominal savings experience could receive very different benefits, depending on annuity prices at their retirement date.

Therefore another of the arguments for collective DC becomes redundant if flexible retirement options are permitted.

Collective DC requires trust

In order for CDC to work, members need to trust that the ‘return’ they receive will be calculated fairly, especially when they move between fund options or leave the plan. If the plan does not have compulsory contributions, it may be difficult to maintain the plan if members withdraw all their assets or stop contributions due to the lack of transparency⁹ and perceived unfairness. A study in the Netherlands¹⁰ found that smoothing success was very sensitive to the target return assumption chosen.

Employers also have to trust the government and future governments that CDC plan deficits will not be handed back to them in the future. The DWP¹¹ highlighted this as a concern as a result of the research they carried out with employers into their attitudes to CDC.

The mis-selling scandal of the future?

Clear parallels can be drawn between with-profits funds, the origins of DB pensions and CDC. The return being provided is a ‘target’ return and not a guarantee. This requires intergenerational risk sharing and a concept of social solidarity¹². Perversely, this works well when smoothed values are perceived as above, or broadly in line with, actual accrued returns but members may be less convinced when their returns are reduced. This was the case recently in the Dutch Collective DC system based on a risk sharing structure, where a quarter of these types of plans had to reduce benefits in order to maintain the required level of funding¹³, therefore creating a review of the whole structure.

Collective governance compared to plan governance

The assets are generally managed in one of two approaches: a trust approach or shareholder approach. The trust approach (e.g. as intended in the UK) tends to result in less suitably experienced people involved with managing the plan (particularly in the smaller companies) and often slower to implement new ideas. A shareholder model (e.g. DC in Mexico) can result in misaligned incentives, which are generally very detrimental to an individual’s DC retirement account.

⁹ Principles for better pensions: lessons from the Netherlands – Laros and Lundbergh (March 2012)

¹⁰ Optimal risk sharing in a collective defined contribution pension system- Bams, Schotman and Tyagi (January 2013)

¹¹ Collective Defined Contribution Schemes: An assessment of whether and how collective defined contribution schemes might operate in the UK (December 2009)

¹² Sharing Risk: The Netherlands new approach to pensions – Eduard H.M. Ponds and Bart van Riel (April 2007)

¹³ De Nederlandsche Bank (DNB) – 66 of 274 Dutch funds had to reduce benefits to meet the 105% funding requirement (as at the end April 2013)

Governance of a larger amount of assets should result in the ability to attract better talent to manage the assets according to the NAPF5, but in the DWP's research¹¹ employers were sceptical that 'given the complexity of CDC schemes, trustees would have sufficient experience to make investment decisions and that the recruitment of trustees would be difficult'.

In Australia, Superfunds are managed under a trustee approach. We observe that the largest Superfunds are generally very professionally managed with experienced teams either managing assets internally and/or selecting managers.

Investment choice

Most of the studies of CDC assume that contributions will be automatically invested into a single fund with no investment choice. While this is not unreasonable given the high proportion of members that default in the UK, it will be a significant departure from the current model where choice is provided. The governors of the CDC face the risk that a single investment option will not be suitable for all members but members cannot choose anything different.

Summary

Advantages	Disadvantages
Risk sharing, mortality sharing, investment risk pooling – should result in lower costs and a higher pension on average	Intergenerational risk sharing - the UK has a shrinking workforce so the system is likely to get more expensive
Economies of scale result in lower cost of investment management (although this can be achieved through any industry-wide plans)	Target pension is not a guarantee but might be misinterpreted as a guarantee
Collective administration should result in lower costs (however this has not been the case in Australia due to lack of investment in systems)	Longevity risk is likely to require reserves and longevity risk-sharing could become onerous in smaller CDCs
Growth assets for longer and greater investment freedom should lead to higher returns on average	Requires the trust of the members
Collective governance should be more capable than individual DC members	Employers don't trust that deficits won't be handed back to them (possibly via innovative taxation or a levy similar to the PPF structure)
Keeps the pension timebomb ticking for a little while longer....	Smoothing must cut both ways – some will win, some will lose
	Lack of transparency may lead to members withdrawing
	Compulsory contributions (and control of switching and selection measures) are required to make it work
	No choice of investments?
	Will collective governance lead to good product and administration innovation?
	Actuary needs to decide the rate of return and reserves
	Portability issues – how will this work in a daily priced environment?
	Potential anti-selection by joiners and leavers

Conclusion

Collective DC provides some apparent benefits but we believe that the disadvantages far outweigh these benefits. As we have clearly outlined, most, if not all, of the benefits can be provided using other approaches so that transparent individual DC accounts can be maintained.

Most importantly members are unlikely to believe that CDC is 'fair' forever. It requires compulsory contributions and controls around switching or investment choices. As the number of members reduces due to a shrinking population, smoothing of returns and longevity risk sharing is likely to result in a disproportionate amount of the costs being borne by the young.

Do we want our children (and grandchildren) to be trapped into digging more wet sand forever?

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