DC plans in the UK and the Netherlands: exchanging experiences

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Welkom!

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Agenda

- UK pension system
- Recent reforms to private-sector pensions
- What was the outcome?
- Types of collective pension schemes
- How collective pension schemes might be introduced in the UK
- Analysis and issues to discuss

UK pension system

UK pension system

	Pillar 1	Pillar 2	Pillar 3
	Single-tier state pension	Occupational pension	Additional voluntary pension
Unfunded	√		
Funded		√	√(Small)
Defined benefit	√	√ (Historically)	
Defined contribution		√ (Currently)	√(Small)

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Dramatic changes in UK pension system since late 1990s

- Single-tier state pension replaced basic state pension in 2016
  - Replacement rate raised from 17% to 29%
  - Aim to reduce means testing
  - Triple lock indexation
    - Max (price inflation, wage inflation, 2.5%)

- Public-sector occupational DB schemes moved from final salary to career average

Dramatic changes in UK pension system since late 1990s

- c8000 private-sector DB schemes gradually closed
  - replaced mainly by DC with low contributions
  - many part-time employees and self-employed uncovered
- Reasons:
  - low interest rates
  - inflation uplifting of pensions in payment
  - frequent updating by actuaries of longevity projections
  - introduction of market-consistent valuation methods
  - increased accounting transparency of pension assets and liabilities
  - increased intervention by the regulator (TPR)

Recent reforms to private-sector pensions

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Recent reforms to private-sector pensions

- Auto-enrolment introduced in 2012
  - 10mn unpensioned workers auto-enrolled into DC schemes by 2018
  - 5mn self-employed excluded
- From 6 April 2015 (‘Freedom & choice’):
  - DC members no longer need to buy annuities
  - DB members can transfer to DC
- Government allowed ‘defined ambition’ schemes to be introduced
  - Pensions Schemes Act 2015

‘Freedom and choice’

- Government wished to:
  - introduce greater flexibility in how people can take income from DC schemes to reflect the changing pensions and workplace environment
  - encourage more pension saving
  - encourage product innovation
- Increasing complaints about ‘poor value’ annuities
  - 70% of retirees did not buy annuities in open market
  - bought internal/rollover annuities from existing accumulation insurer
  - could have got 30% more

‘Freedom and choice’

- *Changes from April 2015:*
- No restriction on how benefits can be taken after minimum pension age:
  - can withdraw entire amount
  - purchase an annuity or
  - buy a drawdown product
- Tax free lump sum of 25%
- Any remainder taken taxed at individual’s marginal rate
  - whether as lump sum, annuity or drawdown

‘Freedom and choice’

- Minimum pension age initially set at 55
  - State Pension age (SPa) *minus* 10 years
  - increases with SPa

- F&C applies to all pension schemes
  - DB members can move DB assets (over £30k) to DC arrangements
    - excludes public sector
  - if suitable on the basis of ‘appropriate independent advice’ from IFA

What was the outcome?

What was the outcome?

- Since April 2015, more than 1mn DC pension pots have been accessed and £16bn withdrawn
  - in 70% of cases by people under 65
- 50% of the pots accessed have been fully withdrawn:
  - 90% < £30,000
- Over 50% of fully withdrawn pots were transferred into a current account or ISA
  - although most of the people doing this had other sources of income
    - such as a DB pension
    - in addition to the state pension

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What was the outcome?

- Before pension freedoms, over 90% of pots were used to buy annuities.
- Now twice as many pots are moving into drawdown than into annuities.
- However, little evidence of shopping around
  - with 95% of non-advised drawdown sales made to the existing customers of insurers
- Average withdrawal rate is between 3-4%
  - although some are withdrawing 6% pa
- High charges in some drawdown products
- Mass market reluctant to pay for advice

What was the outcome?

- Annuity sales have fallen from £12bn pa at their peak to around £4bn
- Annuity providers are leaving the open annuity market
  - reducing choice for consumers who do shop around.

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What was the outcome?

- Very little of the product innovation anticipated back in 2015 has materialised.

- One example was guaranteed drawdown
  - in effect a combination of drawdown and an annuity

- But demand for this product has been low and several providers have withdrawn from the market
  - e.g., Met Life and Aegon

What was the outcome?

- More than £43m stolen by scammers
- The greater flexibilities have done little to increase savings into DC schemes:
  - the average total (member plus employer) contribution rate is just 4.2%
- In addition, around 250,000 DB scheme members have transferred to DC
  - withdrawing £50bn
  - an average of £250,000

Key implications

- Complete individualisation of risks as a result of
  - Move from DB to DC in accumulation
  - F&C in decumulation
- Key risks:
  - Investment and reinvestment risks
  - Inflation risk
  - Longevity risks
  - Interest risk
- Can we do better than this?

Types of collective pension schemes

Motivation for collective schemes

- Investment, inflation and longevity risk
  - these risks might be more effectively managed if they are pooled and shared
- Two types of pooling/sharing
- Risk pooling within each cohort of members
  - requires scale
  - common diversified investment fund will give everyone the same return
    - but no pooling or sharing of other risks

Motivation for collective schemes

- Risk sharing between cohorts of members, in order to make the retirement incomes of each cohort more predictable
  - requires the agreement of all cohorts
- Two types of collective scheme
  - Collective DC (CDC)
  - Collective Individual DC (CIDC)

Collective DC

CDC schemes

- Main benefits claimed for CDC are:
  - greater risk sharing within & across generations
  - lower operating costs
- It is claimed that as a result CDC pensions can be 30% or more higher than in pure DC schemes

CDC schemes: features

- However:
- No risk sharing with employer who pays fixed contributions
  - in the region of 10-12% of earnings
- Important to understand that a CDC scheme offers a target pension
  - not a promised pension
  - no guarantees

CDC schemes: features

- They manage both accumulation and decumulation phases
  - in contrast with DC
    - which just manages accumulation
- Each member has a target pension
  - typically related to career average revalued earnings (CARE)
    - with accrual rate of 1% of earnings
  - also with-profit variant

CDC schemes: features

- CDC schemes
  - through management of both accumulation and decumulation phases
- can invest for longer periods in growth assets than DC schemes
  - such as equities
  - which conventionally only used in accumulation period

CDC schemes: features

- The extra investment risk that arises from an extended growth phase needs to be shared in an efficient and equitable manner
  - e.g., via smoothing/reserve fund:
    - when investment returns are very good, some of the return is held in a reserve fund.
    - when investment returns are very poor, the scheme draws on the reserve fund
  - shocks can be smoothed over many generations

CDC schemes: features

- Longevity risk is pooled in CDC schemes.
- One way of doing this is through scheme drawdown
- But cost of buying retail annuities avoided

CDC schemes: criticisms

- A number of criticisms have been made of CDC:
- Higher and/or less volatile potential pension comes at the expense of severe restrictions on choice flexibility
  - CDC schemes appear to work only if people stay in for life and draw an income from the scheme
    - rather than take lump sum at retirement

CDC schemes: criticisms

- Members of a CDC scheme have no identifiable pension pot
  - so valuation of each member's claim in CDC scheme as challenging as in DB scheme
- Members who transfer out of a CDC scheme when they change jobs might experience a reduced transfer value via a market value adjustment (MVA)
  - if scheme has an implicit deficit

CDC schemes: criticisms

- If the risk sharing in a CDC scheme is not fair between generations, it could turn into a Ponzi scheme
  - with older members taking out more than their fair share at the expense of younger members
- Follows because effective contributions are age-related and 'transferred' within scheme from young to old
  - given that cost of providing a target benefit for 55-year old is twice that for a 40-year old
  - will younger generation accept this?

CDC schemes: criticisms

- CDC schemes cannot work without an ‘estate’ or initial reserve that can be used for smoothing returns
  - Supporters of CDC schemes might argue that, with good governance, it is not necessary to have an estate.
- The risk-sharing rules lack transparency
  - Especially true in CDC schemes that operate on similar basis to with-profit schemes.

CDC schemes: criticisms

- According to Ralph Frank (Cardano):
- Five of the largest Dutch CDC schemes have not given pension increases above inflation over the last 10 years
- Three have cut pensions
- Main reason: failure to hedge interest rates
  - These schemes account for more than 50% of total assets

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Sources of higher returns in CDC schemes

- Possible to show that CDC scheme can generate pension that is 30% higher than in DC scheme:
  - 0.5% additional annual return from avoiding de-risking glide path
    - totalling 5% over 10 years
  - 1.5% additional annual return from maintaining investment in growth assets between 65 and 75
    - totals 15% over 10 years
  - CDC scheme could set up its own annuity business and pass its profits onto members
    - could lead to higher returns of 5-10%.

Sources of higher returns in CDC schemes

- Should not expect significant cost differences between large DC scheme and CDC scheme.
- Default fund in large DC scheme can achieve same degree of risk pooling as large CDC scheme.
- Increasing the number of members in the same cohort cannot increase the degree of diversification in either type of scheme
  – since every member of cohort has same investments.

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Sources of higher returns in CDC schemes

- So any additional benefits in terms of investment diversification that CDC scheme has over DC scheme can only come from diversification across generations
  - i.e., risk sharing between different cohorts of members in the CDC scheme.
- It is possible to show that there are clear benefits from investment risk sharing using a smoothing fund across a number of cohorts of members.
- But the claimed higher returns of CDC (cf DC) are the result of much higher risk taking within each generation

Collective Individual DC

CIDC schemes

- ‘Collective individual defined contribution’ (CIDC) scheme.
- In CIDC scheme, collective features that promote economies of scale and lower costs are maintained, e.g.,
  - automatic enrolment
  - pooling of investment and longevity risks.

CIDC schemes

- However, there are key features that are specific to each individual member and which make the scheme easy to understand:
- CIDC scheme maintains individual accounts for all members in the accumulation phase
  - so it is easy to value each individual's pension pot

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CIDC schemes

- Contribution rate set to be actuarially fair to each member
  - implying direct relationship between contributions that individual pays into scheme and pension they eventually receive
  - contrasts with CDC schemes in which contributions are averaged on collective basis to meet target average salary pension
- Each individual has their own de-risking investment strategy in the lead up to retirement.

CIDC schemes

- CIDC scheme avoids intergenerational and other cross-subsidies that CDC schemes can involve
  – while maximising benefits of economies of scale.
- Also consistent with F&C flexibilities
- Personal de-risking investment strategies could be designed to enable members to take pension as lump sum from age 55

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CIDC schemes

- Large CIDC scheme using scheme drawdown could also avoid costs of retail annuities
  – yet still pool longevity risk
- Could also allow individual medical underwriting of longevity risk
  – in a way that CDC schemes cannot

How collective pension schemes could be introduced in the UK

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How new collective schemes might be introduced into the UK

- *Evidence to DWP select committee Feb 2018:*
- Sandeep Maudgil (Slaughter & May):
  - Law must treat these schemes as unambiguously DC
  - But without imposing specific design requirements
  - Also needs specific governance, transparency and communications requirements

How new collective schemes might be introduced into the UK

- David Pitt-Watson (LBS, Collective Pensions in the UK, RSA, 2012):
  - Get the governance right, get the communication right, and make sure the people doing this have the scale and trust
    - includes trustees whose only duty is to the member of the scheme
  - 50% increase in pension cf DC, due to
    - no de-risking prior to retirement
      - if contributions coming in, benefits can be paid out
    - save annuity provider costs by self-annuitising

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How new collective schemes might be introduced into the UK

- Hilary Salt (First Actuarial):
  - TPR should provide a dashboard so everyone can compare CDC schemes and pull them apart
    - including academics
  - Important to have lay trustees as well as professional trustees
    - who just protect their own backs and are really affected by herd instinct
  - No reason why transfers are not possible

How new collective schemes might be introduced into the UK

- Nathan Long (Hargreaves Lansdown):
  - Pension freedoms could see cross-subsidies:
    - from the poor to the rich within one generation
    - across generations
  - If those with large pots and lower longevity exercise their freedoms, the shared pooling of risks is weakened
  - Real danger of mistrust of the system if people perceive they are locked in
  - People want to own their own retirement

How new collective schemes might be introduced into the UK

- Royal Mail - UK's first CDC scheme
- Replaced DB scheme
- Agreed with Communication Workers Union
- Both sides prioritised member communication:
  - What is being offered is a target not a promise
  - What can change
  - What members can do

Analysis and issues to discuss

Analysis

- CDC schemes could generate smoother pensions across different cohorts of members than DC schemes
- Evidence for this comes from both:
  - theoretical models of intergenerational risk sharing in an overlapping generations framework
  - stochastic simulation models using CDC designs that are typical of those in use in the Netherlands
    - such as career average revalued pensions with conditional indexation.

Analysis

- Theoretical models also suggest that CDC schemes are only likely to be sustainable in long run if:
  - everyone joins
    - i.e., participation is mandatory
  - everyone remains in scheme for life
- These two conditions potentially break down in the UK context.

Analysis

- Pension freedoms could also mean the benefits from CIDC schemes could be quite small
  - cf CDC or even DC schemes
- It would appear that the biggest benefits from collective schemes do come from inter-generational risk sharing
  - Not de-risking prior to retirement
  - Using new contributions to pay benefits

Issues to discuss

- We can all probably agree that in order to improve on DC:
  - Costs to the employer should be fixed and predictable
  - Risks should be shared/pooled
  - Economies of scale should be exploited

Issues to discuss

- But how best to share risks within or between cohorts of members
  - that is fair to different cohorts of members
  - does not turn into a Ponzi scheme
  - or enable members to game the system
    - time inconsistency problem
  - allows pension freedoms
  - and secures member trust even if there is no guarantee or individual ownership

Issues to discuss

- Finally, there seems to be a different definition of CDC depending on who you talk to
- Ralph Frank (Cardano) says:
  - ‘If you ask 10 people how they would define CDC, you will get 11 different opinions’

09.30AM	**David Blake (Cass/Pensions Institute) – Welcome; pension reforms in the UK; the way ahead – DC or CDC or CIDC**
10.15AM	Bastiaan Starink (Tilburg University/Netspar) – DC plans and pension reforms in the Netherlands
11.00AM	Tea / coffee
11.30AM	Jenny Hall (Royal Mail) and Derek Benstead (First Actuarial) – Royal Mail's journey to CDC
12.15PM	Ed Westerhout (Netherlands Bureau for Economic Policy Analysis / Netspar) – Intergenerational fairness in Dutch DC plans
1.00PM	Lunch
1.45PM	Robin Ellison (Pinsent Mason) and Julian Barker (Department for Work and Pensions) – Regulatory issues (including effective communication to help prevent people making sub-optimal choices at different stages)
2.30PM	Kevin Wesbroom (Aon) The truth – and myths! – about CDC. What can CDC offer - risk sharing, risk pooling, smoothing and decumulation solutions
3.15PM	Tea / coffee
3.45PM	Stefan Lundbergh (Cardano) – How to design a universal good DC plan: Evidence from Sweden, Netherlands, Chile and Australia
4.30PM	Panel discussion (chaired by Stefan Lundbergh) – What can we learn from each other with Maiyuresh Rajah (State Street Global Advisors, UK), David Pitt-Watson (London Business School, UK), Alwin Oerlemans (APG, NL), Michael Visser (Tilburg University, NL), Paul Brunger (PwC, UK) and Anouk Bollen-Vandenboorn (Maastricht University, NL)
5.30PM	Closing remarks
5.30PM	Drinks

Thank you

‘Defined ambition’ schemes

‘Defined ambition’ schemes

- Pensions Schemes Act 2015
- ‘Defined ambition’ workplace pension schemes combine some of the risk pooling/sharing benefits of DB
  - but zero liabilities on sponsoring employer
- Aims:
  - to provide more predictability for members than typical DC scheme
  - to ensure less cost volatility for sponsors of DB schemes than with traditional DB

‘DB-lite’

- Replace statutory indexation of pensions in payment with conditional indexation
  - which will depend on scheme’s funding position
- Change scheme’s normal pension age in line with changes in longevity assumptions
- Automatically convert benefits to a DC pension when a member leaves the scheme
  - with choice between cash equivalent transfer value and full buy-out

‘DC-heavy’

- Money-back guarantee (MBG)
  - members receive same amount that they paid in
    - i.e., they get at least their money back
- Capital and investment return guarantees (CIRG)
  - members receive back contributions plus minimum investment return

‘DC-heavy’

- Retirement income insurance (RII)
  - uses part of member’s fund to purchase insurance that guarantees minimum level of income
  - insurance is triggered if member lives long enough to exhaust their fund

‘DC-heavy’

- Pension income builder (PIB)
  - uses part of contributions to purchase deferred annuity which provides minimum pension in respect of that year
    - can be bought from insurer or provided from within fund
  - rest of contribution goes to common pooled fund
    - invested in riskier assets
    - used to generate growth and pay conditional indexation

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'DC-heavy'

- Collective defined contribution schemes (CDC)

- None of these options involves any risk to the employer