The truth – and myths! – about CDC

What can CDC offer - risk sharing, risk pooling, smoothing and decumulation solutions

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Prepared by Aon

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Before we start - the emerging types of CDC

- Firstly – CDC is not DA – Defined Ambition
  – DA is dead long live CDC!!
  – Pensions Act 2011 not Pensions Act 2015
- Legislation may emerge progressively to meet market demand
- **Phase 1** – Single Employer CDC (DB Lookalike)
  – Think Royal Mail
- **Phase 2** – Multi Employer CDC (Still DB lookalike)
  – Think USS?
- **Phase 3** – the Default Decumulation Pathway (Love Frank!)
  – What most people will (eventually) want from a DC scheme
  – Now into commercial considerations – an extra dimension

- Most myths – and truths – come when we compare CDC with individual DC

Truths and Myths of CDC

Better, more stable outcomes.

Unfair – to somebody

Better decision making

No appetite

Inconsistent with Freedom and Choice

Complements and completes Freedom and Choice

Needs locked-in mandatory membership

Flexible and transferable

Cuts happen

Cuts don't happen

Opaque and Incomprehensible

Ultimately transparent

Truths and Myths of CDC

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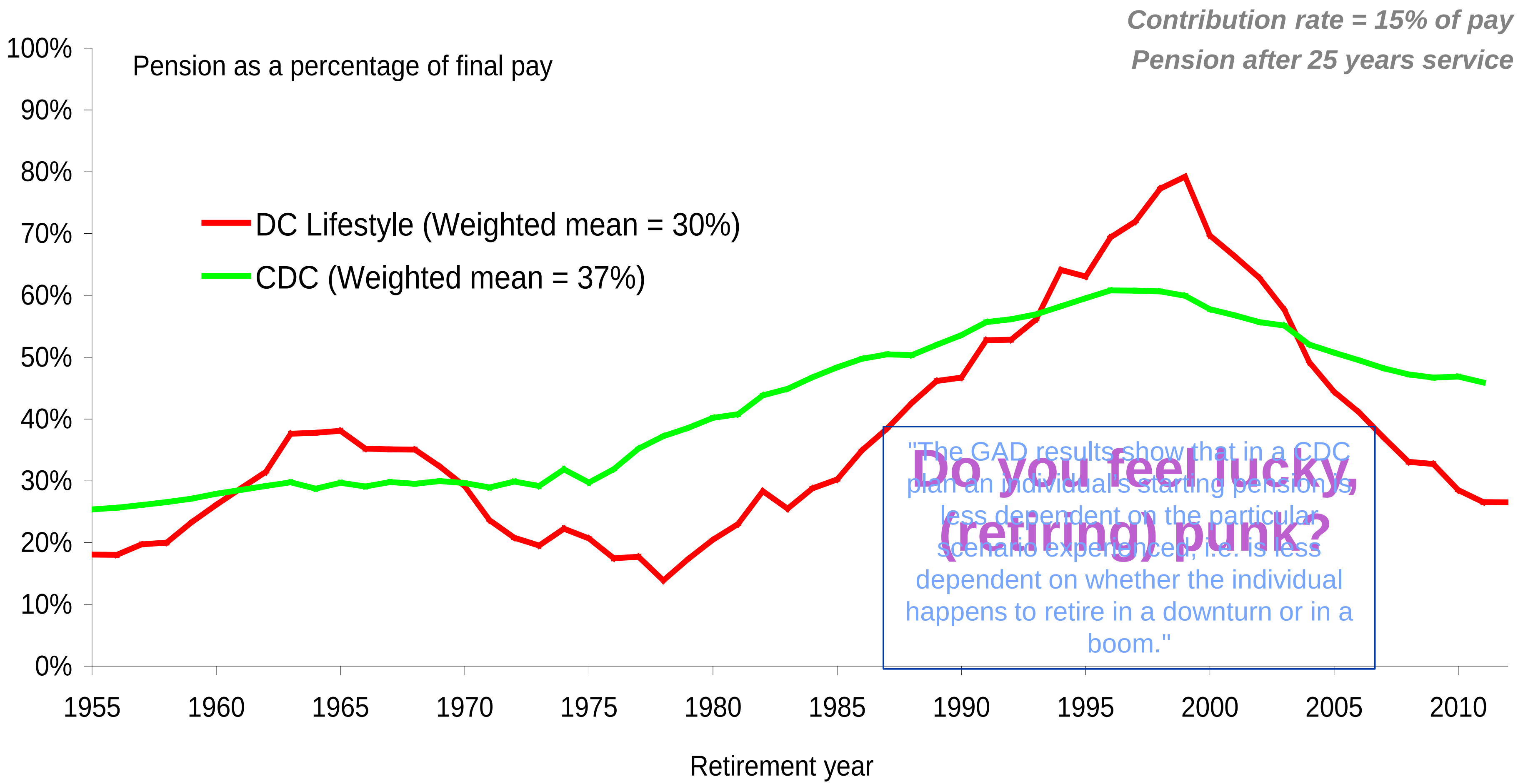
Past history – higher (than annuity) and more stable

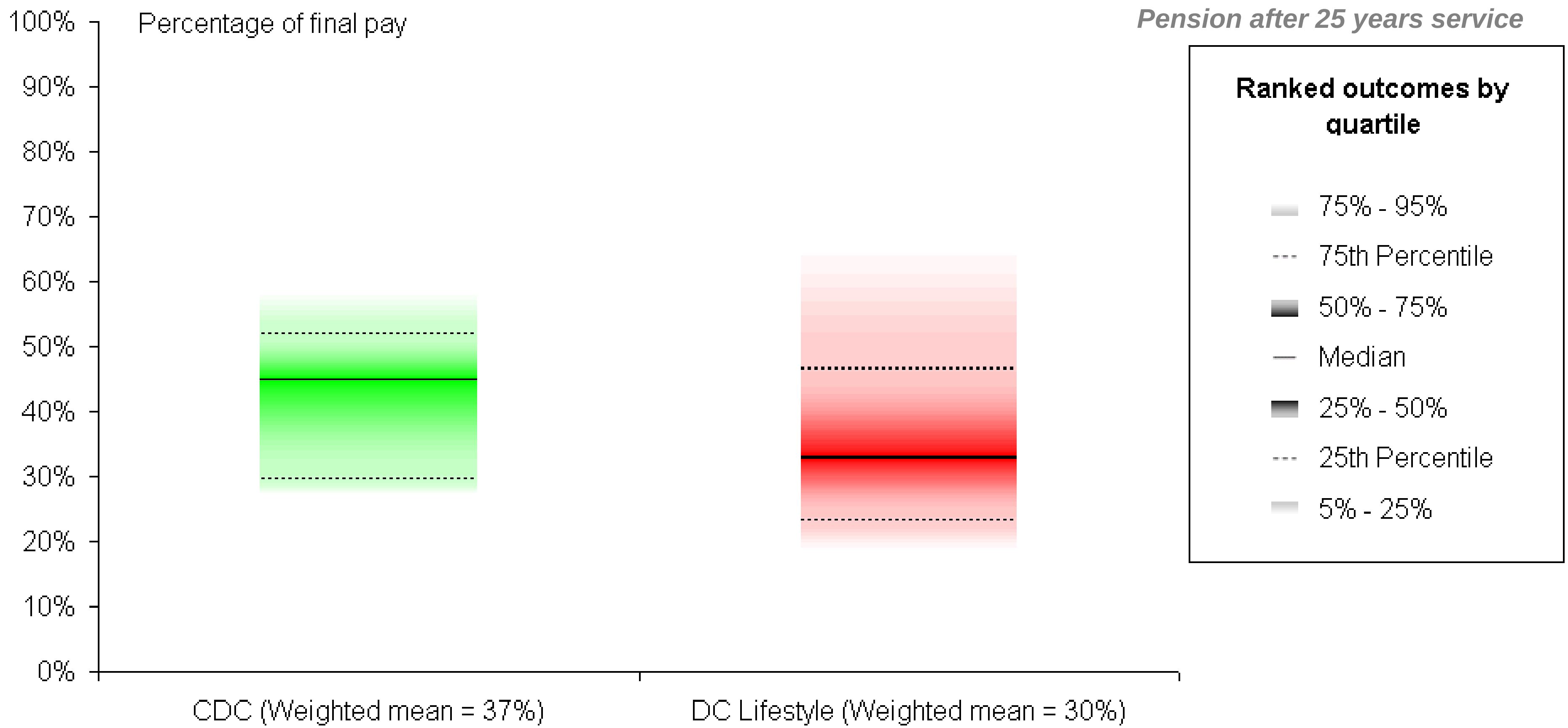


Average CDC outcome in retirement is expressed in real terms (relative to retirement date) to ensure comparability.

Past history – distribution of outcomes

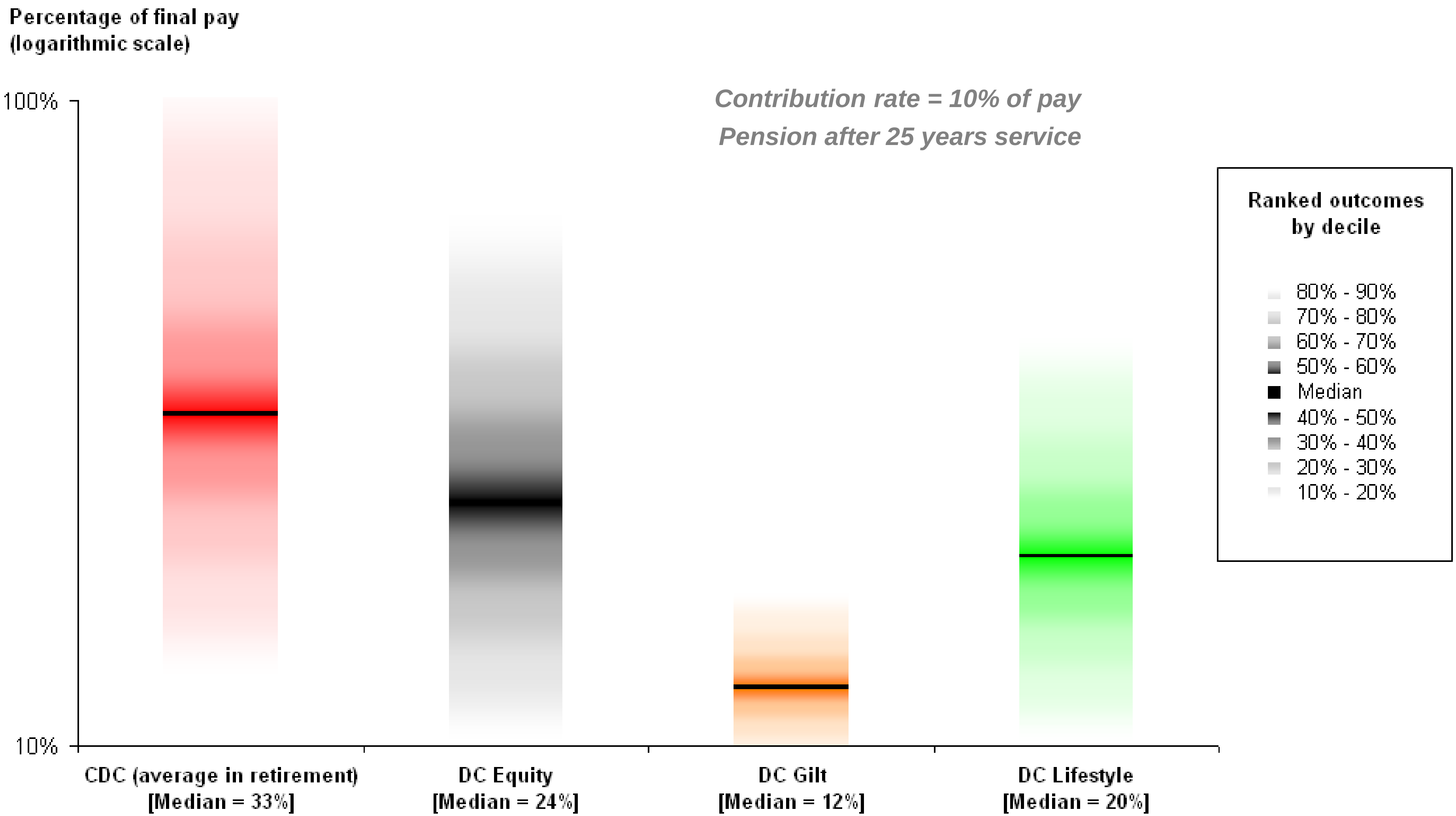
Contribution rate = 15% of pay

Pension after 25 years service



Average CDC outcome in retirement is expressed in real terms (relative to retirement date) to ensure comparability.

Stochastic - Projected outcomes



Our modelling – what was not included!

- Lower charges for CDC than DC
  - Can get economies of scale from DC - but many don't!
- No investment out performance of CDC vs DC
  - Can get (most) best ideas in DC - but many don't!
  - Illiquids and daily pricing
  - Member led inertia?
- The Weakness of DC is the member!
  - Unwilling and unable to take the required investment decisions*
  - And especially confused when taking spending decisions

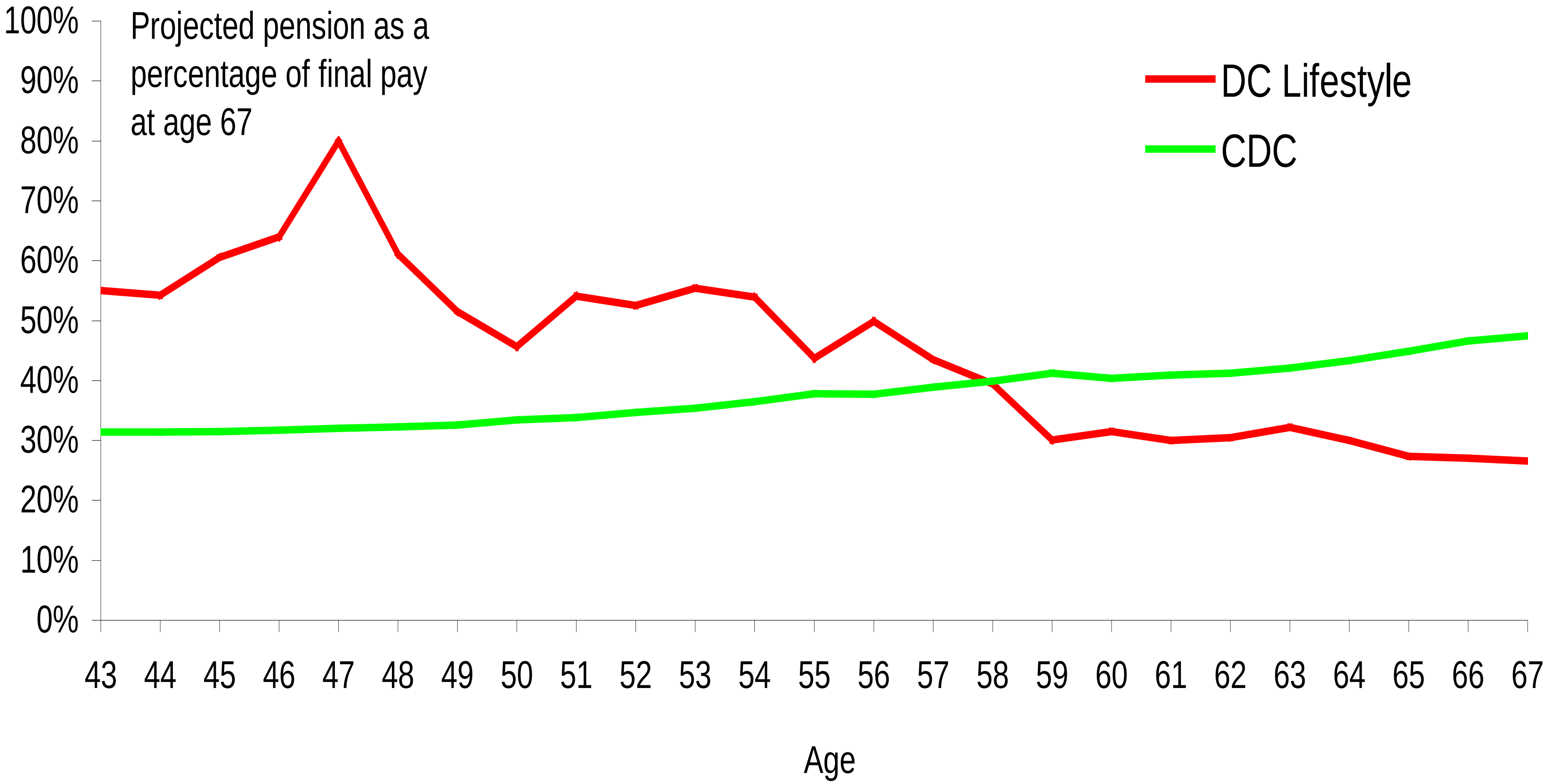
- Not Included – Income Drawdown
- What does a fair comparator look like?

* Eg Byrne, A.; 2007, *Employee Saving and Investment Decisions in Defined Contribution Pension Plans: Survey Evidence from the UK*, Financial Services Review, Vol. 16, No. 1.

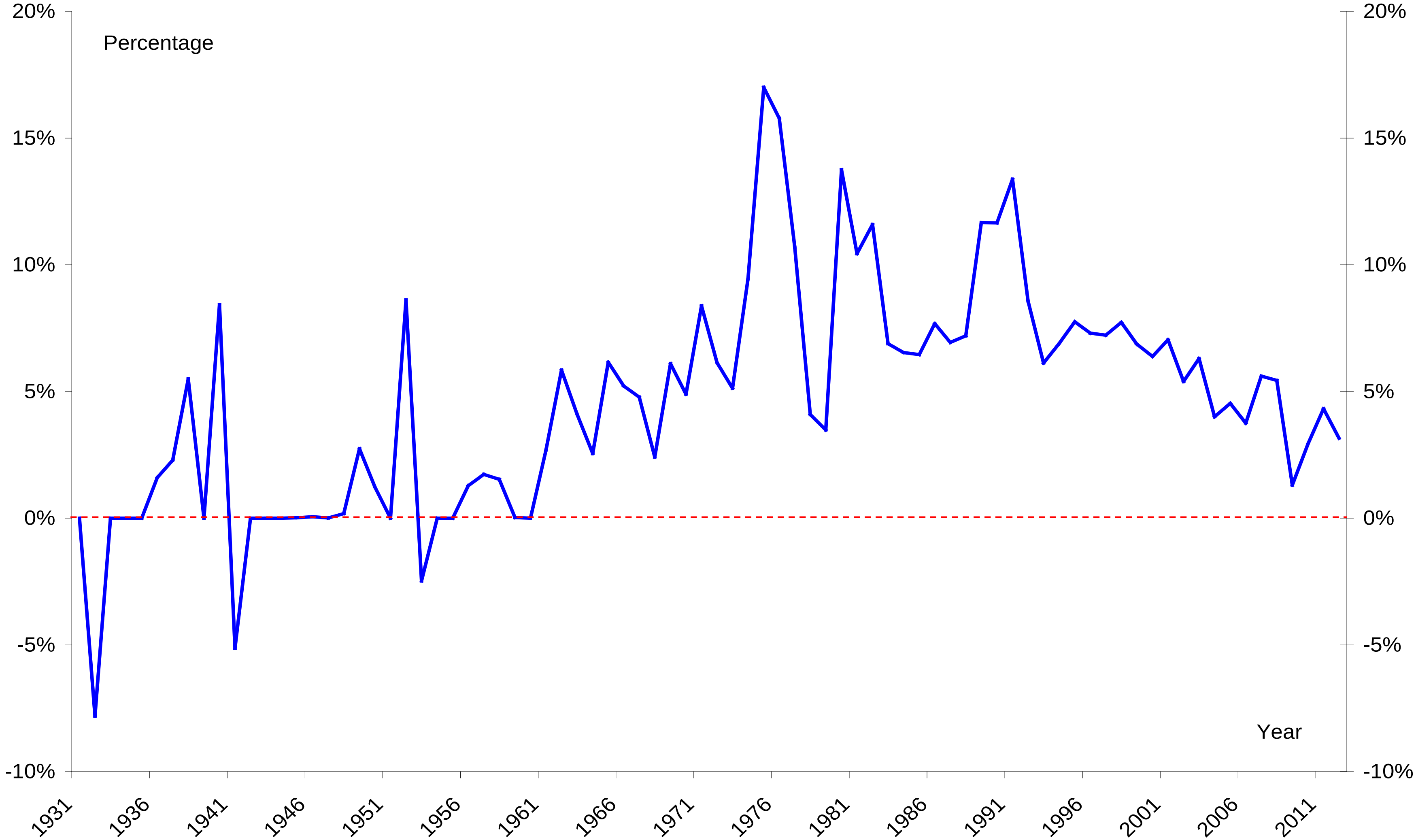
What does stability feel like for the member?

Contribution rate = 15% of pay

Member retiring in 2011



Historic modelling – benefit adjustments

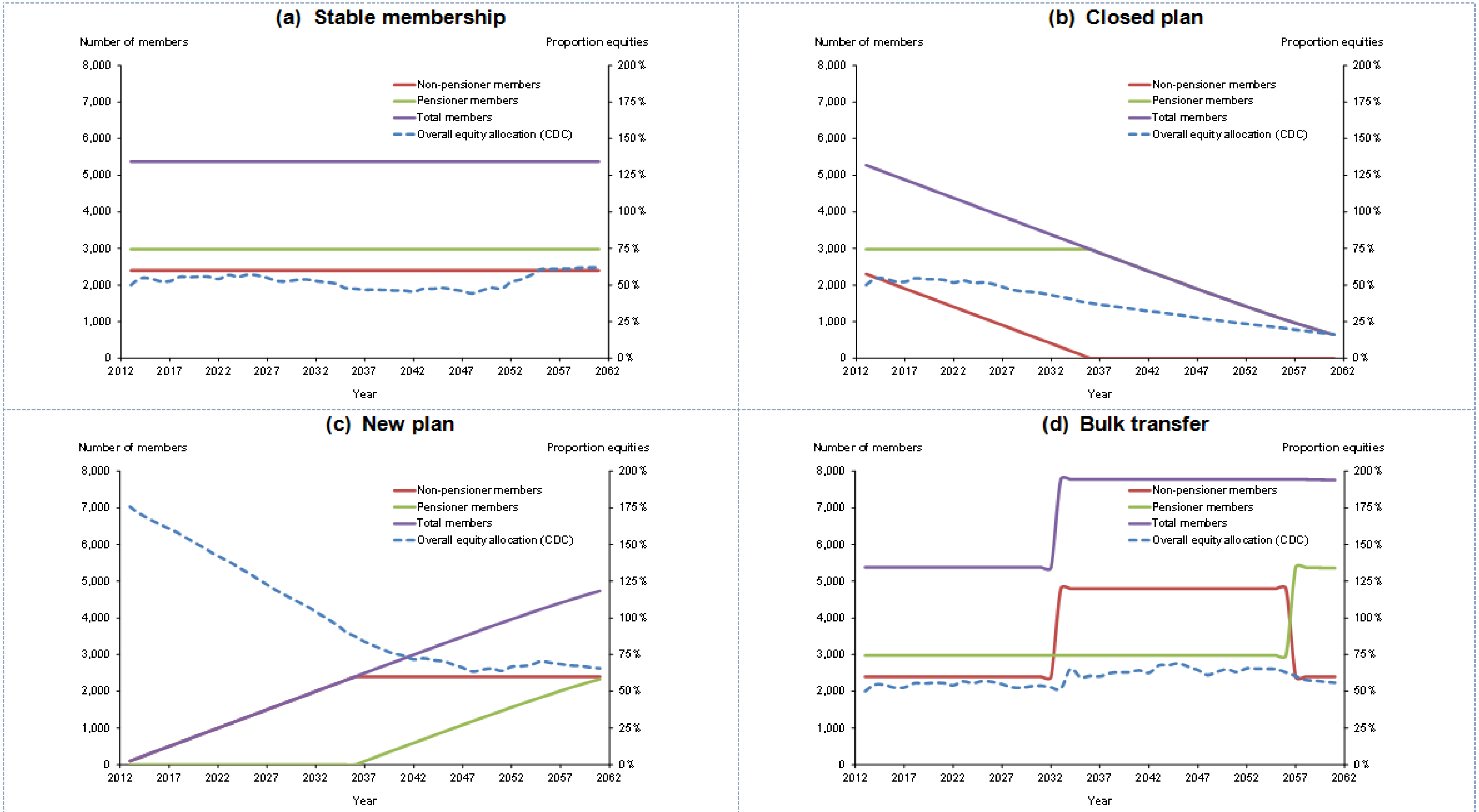


CDC is unfair to somebody …

- EG (Many) submissions to Frank Field
  - *CDC can be unfair to the first and last members*
  - *Young versus old needs balancing factors*
  - *Rather than reduce risk, CDC transfers a greater amount of risk to younger members.*
  - *Dutch protected older members at the expense of the young*
  - *Concerns amongst younger generations that they will end up subsidising the retirement income of the older generation*

- Young versus Old – return to this
- First versus last - inequity is not necessary
- Depends on the Bonus Policy aka Benefit Adjustment Policy
- CDC can still outperform individual DC

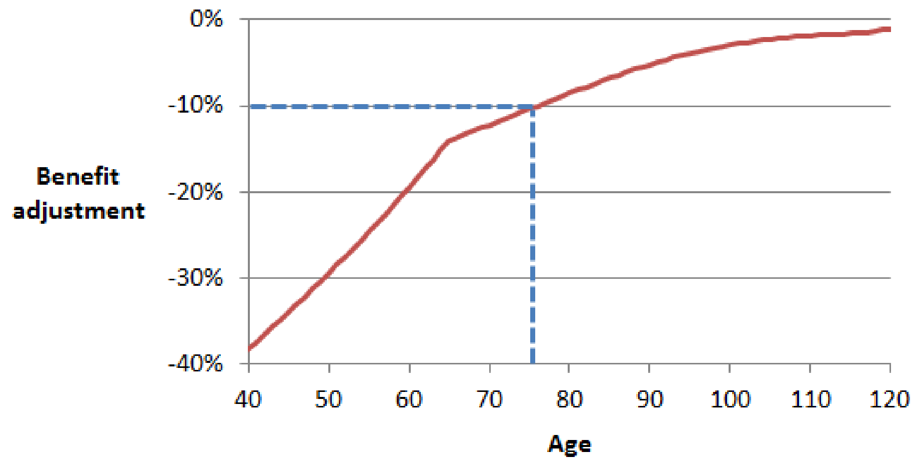
Sensitivity to Changes – further modelling



Consistency of benefit adjustment and investment policy

Dynamic investment strategy

- Equity/bond split varied each year based on the age profile of the plan
- Equity exposure at each age set to match the sensitivity of the liability at that age to changes in the revaluation lever.
- Portfolio delivers a stable risk exposure for each member regardless of the other membership of the plan at a given point in time.



Benefit Adjustment Policy

Benefits are then adjusted to maintain a funding level of 100%, by (in order):

(i) adjusting the target rate for future benefit revaluations (up to and after retirement) by a fixed margin, within the range CPI ± 5% (with revaluations subject to an overall annual minimum of 0%);

and then (if necessary)

(ii) applying a one-off percentage adjustment to accrued benefits (both those in payment and those not yet in payment). This is based on a scale of adjustments that reduces with age in proportion to the sensitivity of liabilities to movements in the revaluation lever.

Plan performance is largely immunised against changes in membership profile.

Truths and Myths of CDC

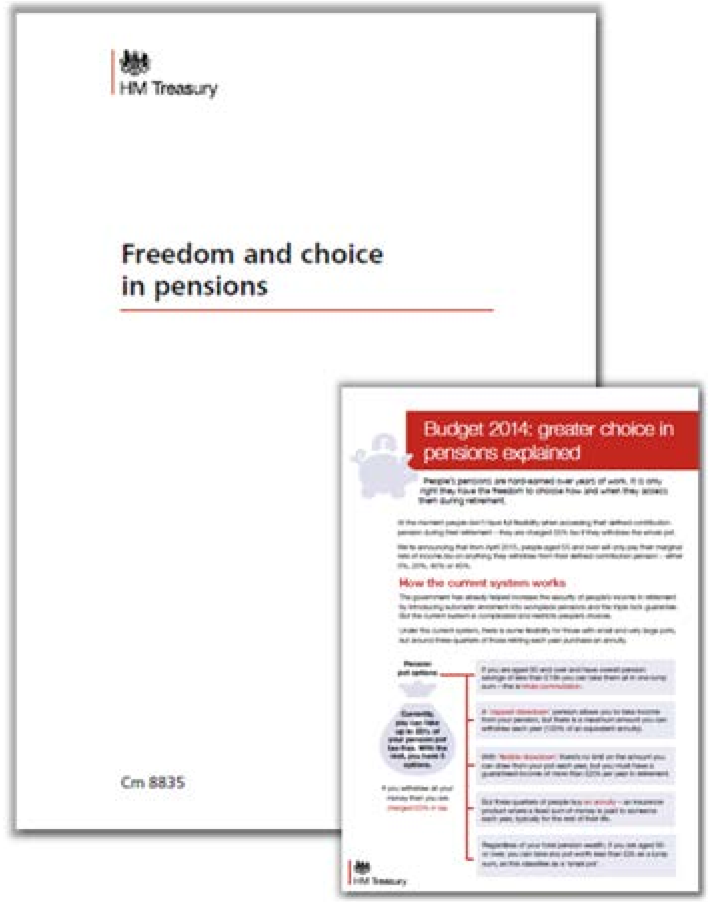
Better decision making

No appetite

- Decisions not made by members!
  - Why do we ask them to become pension experts?
- Decisions made by independent competent trustees
  - No vested interests except equity between members
  - Can access latest thinking and innovations
  - Can implement quicker than individuals
- Can access collective risk management tools
  - Such as pensioner longevity swap

- Royal Mail disproves this – 140,000 members
- Others in the open DB camp?
  - Small numbers but large numbers
- Many employers would like to see a good decumulation solution
- Market still to evolve
- The past and present no reliable guide to the future
- CDC as an underpinning role?

Truths and Myths of CDC



Inconsistent with Freedom and Choice

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Your Spending Choices – Simples!

What do We Want?

How will DC pots be spent?

Certainty Seeker 28%

Steady Spender 35%

Flexibility Foremost 19%

Early Spender 12%

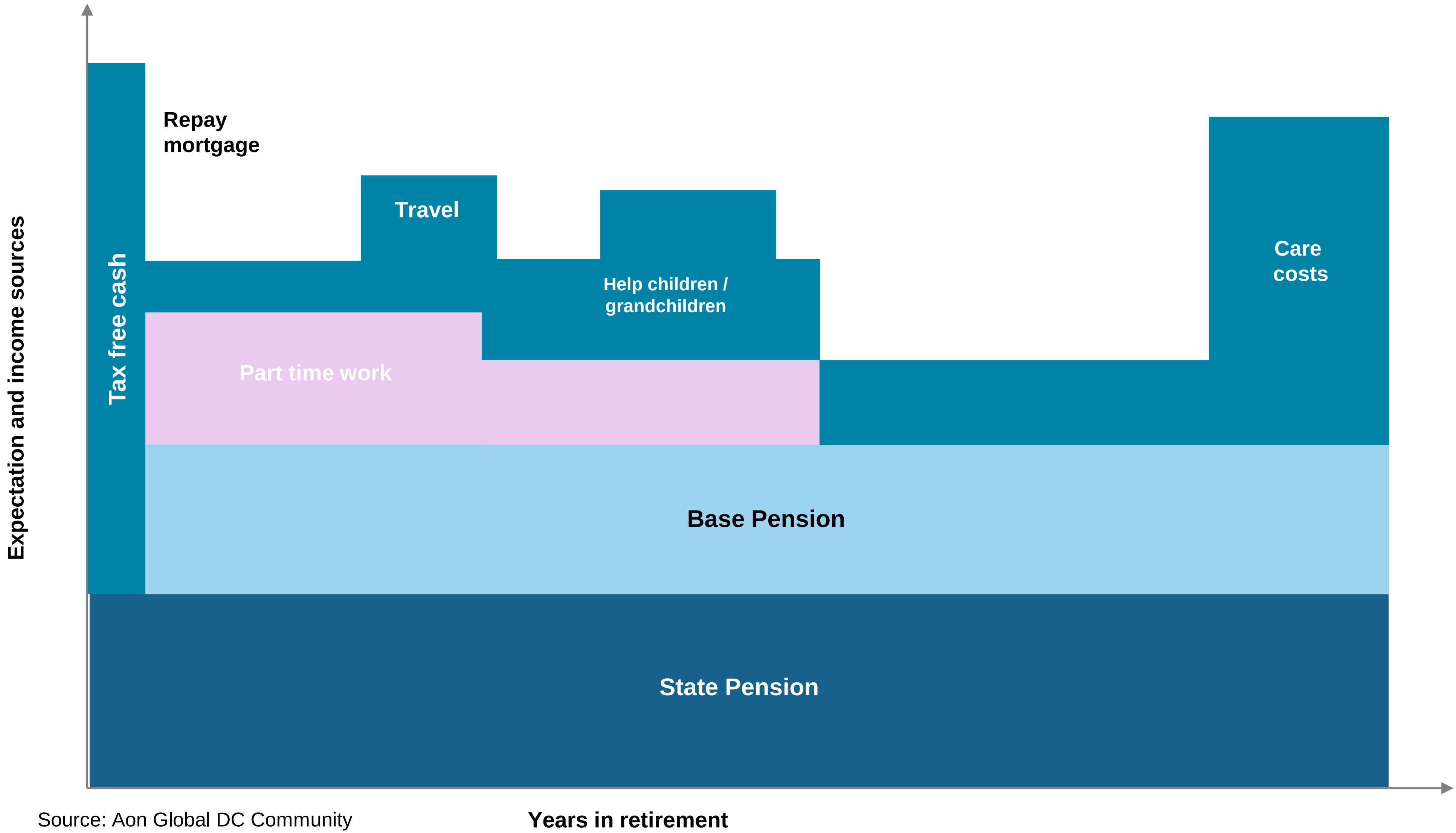
Residual Required 6%

BUT !

Why don't people choose annuities?

Source: Aon Hewitt DC Survey of 2004 DC members

Is this what we mean by flexibility?



Source: Aon Global DC Community

Truths and Myths of CDC

Needs locked-in mandatory membership

- *Theoretical models say CDC only likely to be sustainable if everyone joins.*
- *Theoretical models say CDC only likely to be sustainable if everyone remains for life*
- "Evidence" includes the observation that Netherlands has CDC and Netherlands has (largely) locked in mandatory membership!

Flexible and transferable

- Members can transfer out on the basis of a fair share of assets
- For DB style schemes this will be similar to cash equivalent transfers of Target Benefits
  - Adjusted for funding level
  - Could provide transfers in payment, but longevity more of an issue
- Who will transfer out?
  - The impaired lives?
  - The healthier lives?
  - That leaves – the average?

Truths and Myths of CDC

Cuts happen

Cuts don’t happen

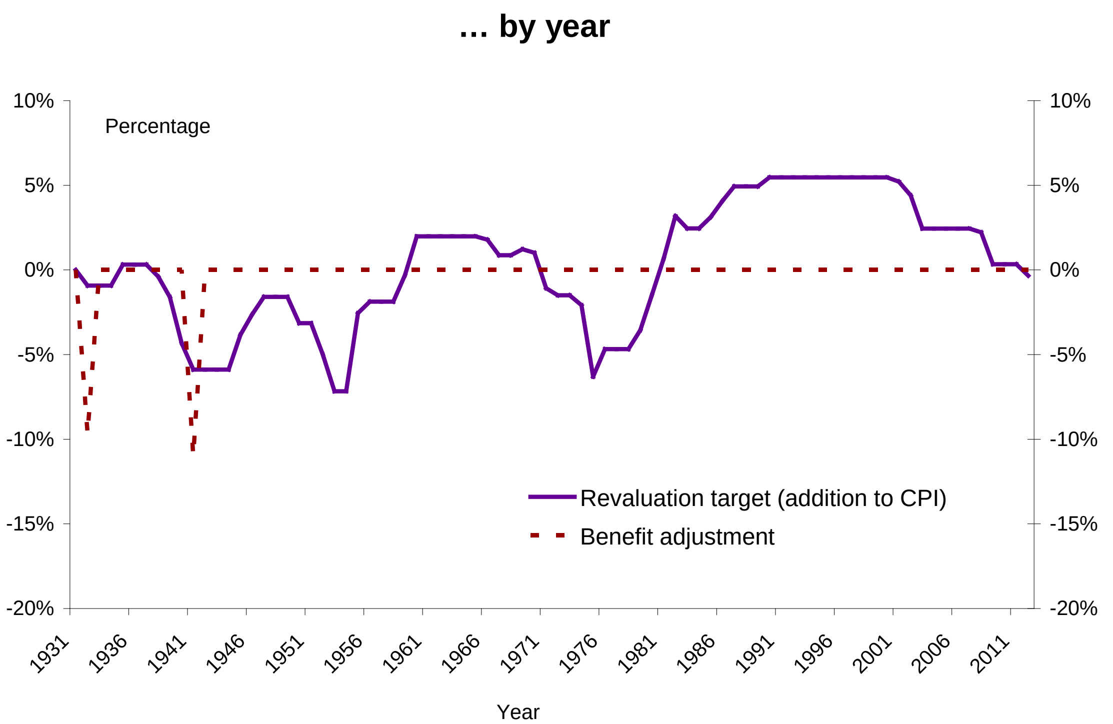
Benefit Cuts – a Big Concern for CDC

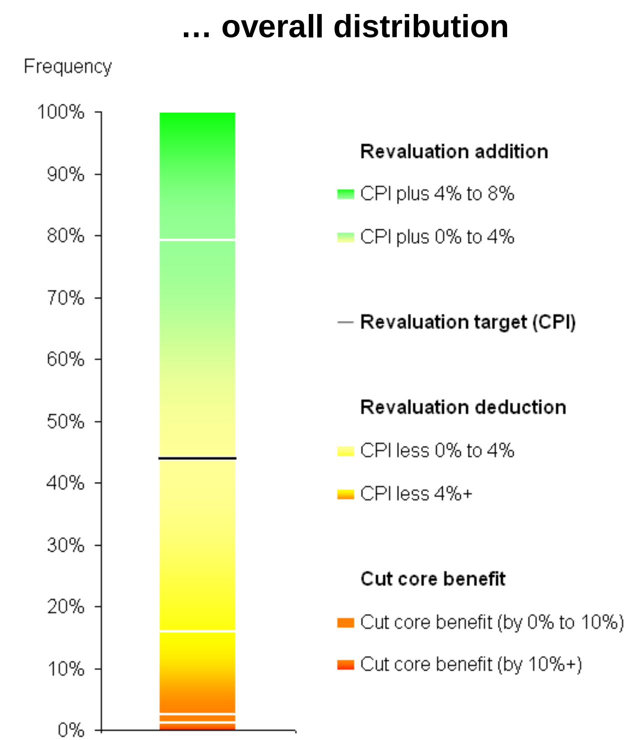
- Cuts to Pensions - especially pensions in payment
  - They are an essential part of CDC
- Look how bad the Dutch have been!
- One quarter of Dutch CDC plans reported* having to cut pensions by an average of **1.9%** in 2012 to restore their funding level.
  - These benefit cuts had priority for restoration, as financial conditions improved.
- In the UK, by contrast, the cost of buying an annuity increased by **29%** over the three years 2009-12.
  - People retiring from a DC plan in 2012 and buying an annuity would have seen a **permanent** drop in their retirement income of compared with their 2009 colleagues
  - Three years later this was down to just **HALF**
  - No prospect of subsequent review or readjustment
- Control the Benefit Adjustment Policy?
- We modelled alternative tapered exposures to benefit adjustments that “ran out” at age 80
- Has to be compensated by higher risk budget for younger members

** De Nederlandsche Banke; 25 April 2013, DNB assesses pension funds’ recovery plan evaluations, accessible at http://www.dnb.nl/en/news/news-and-archive/nieuws-2013/dnb290230.jsp#*

Historic revaluation and benefit cut levers

Lever outcomes…



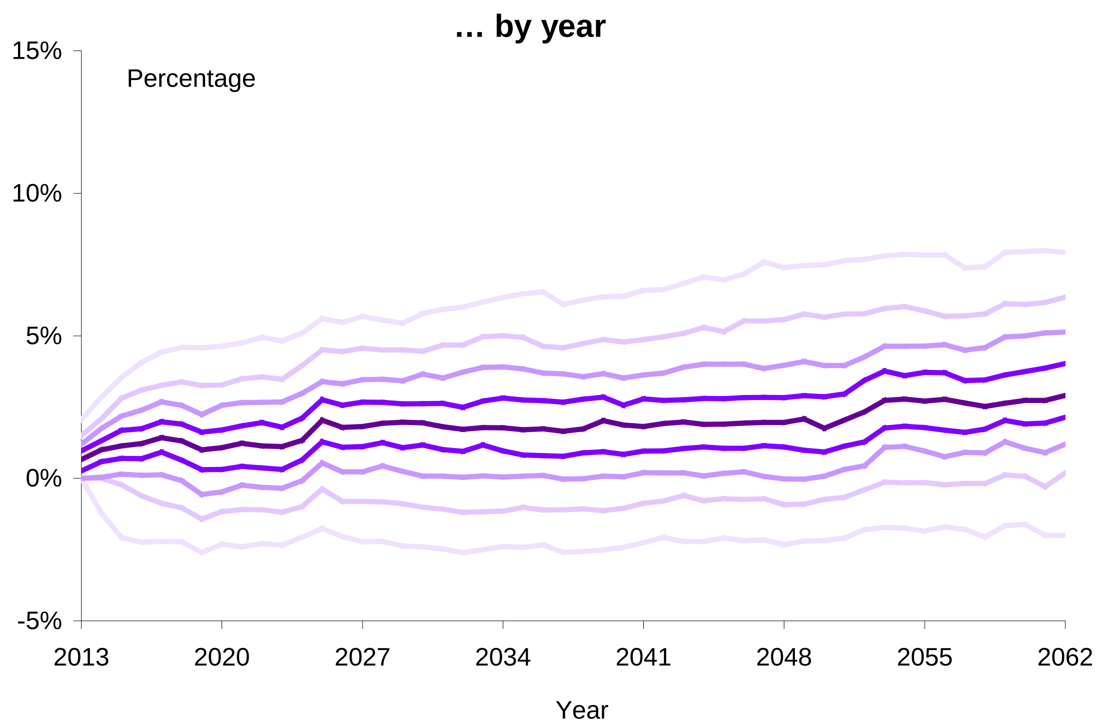


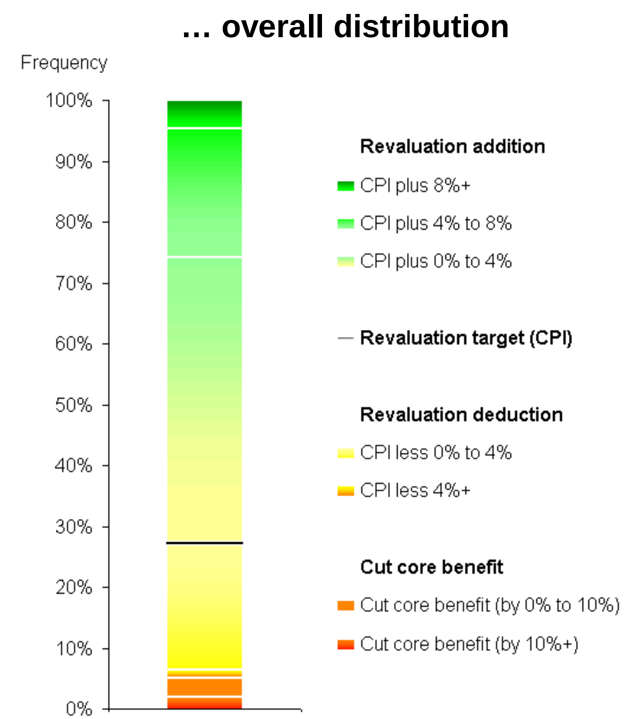
Revaluation and benefit cut levers (period 1930 to 2012)

- Median revaluation target is CPI + 0.3% p.a.
- Two benefit cuts are required in the 82 year history (10% in 1932, and 11% in 1941)

Stochastics - revaluation and benefit cut levers

Lever outcomes…





Benefit cut lever (period 2013 to 2062)

- In around 95% of years no reduction is applied
- In around 3% of years a reduction is applied of between 0% and 10%
- In around 2% of years a reduction is applied of more than 10%

Revaluation lever (period 2013 to 2062)

- Median revaluation target is CPI + 1.8% p.a.
- In around 2% of years revaluation target is greater than CPI + 10% p.a.

Truths and Myths of CDC

Opaque and Incomprehensible

- People won't understand CDC
  - But do they understand DB or DC?
- CDC is like with-profits?
  - was it the product or the implementation that was wrong?
  - don't people want this sort of thing – complicated under the bonnet, but simple delivery?
  - Emphasise the upside and bonus nature
  - My contention: the failure of with profits was a failure of disclosure

Ultimately transparent

- Full public disclosure on an open section of tPR website
  - Statement of Investment Policy & regular reports
  - Statement of Funding Policies & regular actuarial updates
  - Statement of Benefit Adjustment Policy & regular updates on bonus policy in action.
  - Statement of Risk Management Policies & regular stress testing
- Everybody can comment – and keep the trustees honest

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All we are saying …..

le mieux est l'ennemi du bien (Voltaire)

This presentation references Aon analysis of CDC, which is contained in two papers:

- *The Case for Collective DC,* 2013
- *Collective DC – Stability and Fairness,* 2015

Both of these whitepapers are available from our website:
http://www.aonhewitt.co.uk/collectivedc

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