Collective Defined Contribution

Response from NEST Corporation

Introduction

NEST is pleased to contribute this response to the Work and Pensions Select Committee inquiry on Collective Defined Contribution (CDC) pension schemes.

We recognise some of the well-documented challenges with CDC schemes, which we outline briefly below. However, we're very supportive of the underlying principles behind CDC and believe there's scope to incorporate elements of CDC into the UK pensions landscape to help improve member outcomes. Innovative ideas are particularly important since the introduction of Freedom and Choice, which has created an opportunity to rethink and put members at the heart of the entire savings and income journey.

The benefits of CDC schemes include sharing longevity, market risks among cohorts of savers. This risk sharing can provide more predictable outcomes, reduce the dispersion of those outcomes across and within generations, and protect individuals from losing out because of events that are unforeseeable and outside their control. CDC schemes are also associated with economies of scale and more efficient investment approaches, which can help contribute to better member outcomes.

As we describe below, however, large DC Master Trusts like NEST already access many of the investment efficiencies and benefits that come with scale and pooling of assets.

We therefore caution against seeing CDC as a distinct product category within a DB-CDC-DC spectrum as it obscures more fundamental questions about how to manage and apportion risk and harness the benefits of scale. These issues will become increasingly important as DC becomes the primary vehicle for mass market retirement saving.

We encourage the Committee to focus on the fundamental principles behind CDC and consider how risk can be better managed for the benefit of members in schemes across the spectrum, including in DB and DC schemes.

In considering how some of these principles can be applied in current settings, the Committee may want to consider the benefits of hybrid models that pool risk at certain key points in members' savings journeys, particularly during the crucial 'transition' years when members are moving from saving to taking an income from their pension. If a portion of members' assets were allocated to a risk sharing fund in the run up to and into retirement, and a portion remained in members' individual pots, this could be a way of keeping 'risk on' for longer and potentially realising greater returns. Pooling longevity risk among members who've reached a certain age could be another way to reap the benefits of CDC, without falling into some of the more evident problems with pure 'end to end' CDC models.

Internationally, there are other examples of innovative approaches to managing the risk of members 'retiring at the wrong time'. An example of this is TIAA's Traditional Annuity, in which scheme members build up guaranteed amounts of retirement income throughout their working lives. Each contribution made during accumulation locks in a guaranteed minimum annuity rate which will be disbursed in decumulation.

There are also DC schemes that share market risk amongst savers through products such as With-profit funds. In these, a proportion of returns are held back in good performance years so that pots can be topped up when performance is poor.

Other examples of existing DC schemes making use of some of the principles of CDC include NEST, which defaults members into Target Date Funds. Rather than being in individual mechanistically managed funds, scheme members' assets are pooled into group funds according to their age, allowing us to reduce investment costs, improve diversification and manage risk dynamically in line with market and economic realities. This reduces dispersion of outcomes amongst cohorts and gives members greater certainty.

We think these types of ideas could be extended and explored further in the new retirement landscape created by Freedom and Choice.

In turn, pure CDC schemes are not without their problems and can't be seen as a magic bullet to improving outcomes. The benefits should be understood in context and the drawbacks also recognised.

There have been a number of studies which conclude that, due to their ability to continue to invest in growth seeking assets without lifestyling, pure CDC schemes are able to deliver greater investment returns for members.[1] A study for the Royal Society of Arts, for instance, suggested that member returns could be 37 per cent higher than in a pure DC model.[2] However the study attributed more than half of these gains to the fact that an annuity would not have to be purchased at retirement. Clearly in a post-pension freedoms world this is no longer necessary and DC schemes can think much more creatively about the investment strategy for the transition from work to retirement. As mentioned above, returns could be improved by leaving a proportion of assets invested in growth assets as members approach and in the first few years of retirement. NEST's proposed retirement solution outlines how this could be achieved.[3]

Other studies which model greater returns assume a fairly high allocation to growth seeking assets, such as equities. A study by Aon Hewitt assumes 60 per cent allocation to equities.[4] In practice we have observed a certain degree of cautiousness in allocation strategy amongst pure CDC schemes. Faced with the challenge of meeting commitments made to beneficiaries and being in some way accountable for the returns 'promised', Trustees in the schemes we observed opted for stable returns over high octane equities strategies. This may indicate a number of things, not least that behaviour and attitudes towards risk and return can change dramatically depending on who is taking the risk and who is responsible for the returns.

More significantly, when pure CDC schemes pool investment and economic cyclical risks across very diverse age groups, trustees face difficult decisions about cutting benefits when returns are lower than expected. In these situations, trustees tend to show an understandable bias towards protecting those in or approaching retirement at the expense of younger savers. In countries such as the Netherlands this has led to criticisms of intergenerational unfairness and of complexity and opacity around how decisions are made.

For this reason, we do not believe that schemes should be looking to share investment and economic risks across multiple generations. It is challenging enough to try and manage the risk of market performance over a normal economic cycle (5-10 years). It is more difficult to accurately plot global economic growth over a 50-year period. In attempting to do so those managing the sustainability of a CDC scheme risk either underpaying to existing pensioners or more likely paying too much and risk the need to cut benefits for future savers. However, we believe that risk could more easily be shared amongst intra-generational cohorts e.g. 5-10 years, particularly in and approaching retirement. This would be far more achievable and reduces the risk of inter-generational unfairness.

[1] See for example Aon Hewitt (2013) 'Collective defined contribution plans: A new opportunity for UK pensions?; Pitt-Watson, D. and Mann, H. (2012) Collective pensions in the UK; Government Actuary's Department (2009) Modelling collective defined contribution schemes
[2] Pitt-Watson, D. and Mann, H. (2012) Collective pensions in the UK
[3] NEST (2015) 'The Future of Retirement: A retirement income blueprint for NEST's members'
[4] Aon Hewitt (2013) 'Collective defined contribution plans: A new opportunity for UK pensions?

Responses to specific questions

Benefits to savers and the wider economy:

Would CDC deliver tangible benefits to savers compared with other models?

We recognise that due to their size and collective approach 'pure' CDC schemes have been able to realise economies of scale and follow more efficient investment approaches, which in some cases have led to superior outcomes for members.

However, we caution against some of the claims that have been made about the theoretical gains pure CDC schemes could realise. Since Freedom and Choice, some of these gains could be realised in DC schemes, as discussed in our introduction. Other investment benefits of CDCs may be hard to realise in practice due to the behavioural consequences of trustees having to fulfil pensions promises to beneficiaries.

We don't think it's helpful to view CDC schemes as a homogenous and distinct product category. CDC schemes cover a spectrum of approaches and risk sharing can be delivered in a variety of ways. For example, we believe risk could be shared amongst intra-generational cohorts e.g. 5-10 years, particularly in and approaching retirement. This would be far more achievable and reduces the risk of inter-generational unfairness.

How would a continental-style collective approach work alongside individual freedom and choice?

Freedom and Choice, by abolishing the need for annuities, has provided an opportunity to look again at how savers go from saving up to taking an income and how to improve overall outcomes for members. We believe that high quality, well governed default options, straight through from accumulation to decumulation, can incorporate elements of risk sharing at appropriate times and among appropriate groups of members, while still being consistent with individual savings pots.

We are already delivering efficiencies of scale associated with pooling assets in our default accumulation strategy, with members grouped into pooled funds by age. We've also looked at how it could work if those default pathways continued right through into retirement and how risk sharing might play a role, particularly in solving the challenge of longevity risk. We believe these straight-through default pathways will be critical in providing the comfort and peace of mind to most members that they'll get good outcomes from their pension savings, without undermining their freedom to opt out or the choice to do something different.

Does this risk creating extra complexity and confusion? Would savers understand and trust the income 'ambition' offered by CDC?

Evidence would suggest that one of the drawbacks of CDC schemes is their opacity to members and the difficulty in communicating an 'ambition' that is not a solid guarantee. The governance boards of 'pure' collective schemes which keep all assets invested in higher risk funds are tasked with making fair decisions about levels of pensions in payment, but in practice show a bias towards protecting members close to retirement from cuts in entitlement.

Regulation, governance and industry issues:

How would CDCs be regulated?

We don't have a view on this but would state again that we don't see CDCs as a homogenous or distinct product category. There is already legislation in place that allows for 'shared risk' schemes or 'defined ambition' schemes, as well as schemes 'offering collective benefits'. The former offer some sort of pension promise, with risk shared between the member and a third party such as their employer. The latter share risk among members with no third-party liability standing behind the targeted benefit.

We believe there is significant scope to deliver many of the benefits associated with CDCs, such as reduced costs and improved risk adjusted returns, via well-governed DC schemes operating at scale. Indeed at NEST we are operating a scheme that offers collective benefits. Through our scale and scheme design, we've been able to deliver significant sophistication in our investment approach at low cost, while smoothing returns for members.

Is there appetite among employers and the UK pension industry to deliver CDC?

We haven't seen any evidence of an appetite among employers to deliver CDC so far, but we know that employers are thinking about and interested in how to help their employees have a smoother path into retirement.

Would CDC funds have a clearer view towards investing for the long term?

One of the benefits of CDC schemes is certainly the ability to invest in illiquid assets that can deliver good diversification and long term return opportunities. We agree that these investments represent attractive opportunities that UK DC savers should have exposure to. Indeed at NEST we already invest in more illiquid assets than have traditionally been used by UK DC schemes, such as property, and are looking into alternative asset classes further at the moment. As we have previously stated, we believe many of the benefits associated with CDC models can be achieved by well-governed DC schemes operating at scale.

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p13751-v1 13750 01/18