1. Why are these in the news?
Shortly before the 2015 General Election, the government adopted primary legislation permitting CDC but did not have time to complete the legislative package. In the recent industrial dispute between Royal Mail and CWU over future pension provision, the parties agreed to pursue a CDC solution and are pressing the government to complete secondary legislation. The DWP Select Committee has also opened an inquiry into CDC.

2. What is CDC?
It is a pension scheme in which the members own a proportionate share of the aggregated collective investments rather than an individual share of the underlying assets as is the case in individual DC. The significance of this difference is that the investment paths in the scheme can be quite different.

In an individual defined contribution (IDC) scheme, as a member approaches retirement, her holding needs to switch to a greater or lesser degree from higher earning but more volatile assets to safer assets with a more predictable return. Pension freedom and the switch in preference from annuities to drawdown, modifies this only to a degree. In collective DC, the scheme can remain in less liquid and higher risk assets as long as the scheme as a whole can generate enough cash flow to meet pensions in payment.

3. Is CDC better than IDC?
The best way to think about this is to break down pensions into a saving phase and a retirement income phase.

In the saving phase, there’s no reason why CDC should necessarily outperform IDC. However, if an IDC has an investment glidepath for moving to bonds in order to mitigate investment risk for the individual heading into retirement then CDC will outperform IDC.

In the retirement phase, an individual in IDC may sell their IDC assets and buy an annuity or a drawdown product. This has a cost. If there has been no glidepath then there is also a risk to the individual that the market falls at that point and they will buy a retirement providing a lower income stream for the rest of their retirement. In CDC, there is no need to make any costly or risky transition.

4. Does CDC have any other benefits?
Yes, CDC can be managed in a way that ensures that pension outcomes can be smoothed. People do not benefit quite as much from market highs but they also avoid market lows. An AON Hewitt 2013 study found that if CDC had been in place over the last 50 years in the UK that it would have delivered a fairly steady 28% of salary whereas DC retirement outcomes had a similar average but were more volatile, delivering between 17% and 61% of salary.

5. Does CDC have any downsides?
The governance of CDC has to be very robust and the provider skilled. Those running the schemes have a great deal of discretion as to outcomes. There is some risk of those running schemes transferring a fair share of losses away from those in retirement to those saving. Strong regulatory rules need to be in place to prevent this and ensure that those governing the scheme run it in the interests of all the members.

6. Do CDC schemes provide guaranteed income in retirement?
No, a scheme with a full set of guarantees, backed by a sponsor, is a defined benefit scheme. The 2015 Act provides for two types of CDC schemes. Defined ambition (also known as DB-) schemes, where there is a guarantee for some retirement benefits but not for others, and, defined contribution collective benefits schemes (also known as DC+) where there are no guarantees at all. Regulation would need to make sure that schemes only offered guarantees where there was backing from a sponsor.

7. What’s needed for providers to offer CDC in the UK?
In order to offer defined ambition or DB- schemes, secondary legislation to implement the 2015 Act would have to be passed. Such secondary legislation is not required to offer DC+ but would be advisable in order to set up a robust regulatory regime before this can be offered. The complexity of operating a DC+ scheme suggests that government should put in place an authorisation regime, like that mandated for mastertrusts last year. Regardless of regulatory rules, in order for DC+ schemes to be offered in compliance with tax rules, there would need to be a tweak of a definition in the Finance Act 2004.

Other one-pagers from The People’s Pension can be found at www.thepeoplespension.co.uk/onepagers. You are also welcome to contact Andy Tarrant, Head of Policy & Government Relations at andytarrant@bandce.co.uk or 07515 121204.