CDC: Sharing investment risks and rewards

With Royal Mail's collective defined contribution (CDC) scheme set to launch in October, Paige Perrin examines how the risk-sharing nature of CDC schemes could enable greater investment opportunities

Summary
- CDC schemes offer greater investment potential through risk-sharing.
- They avoid the need to de-risk, staying in growth assets longer.
- Adoption challenges include regulatory clarity and scale issues.
- Experts urge further regulatory support to broaden CDC use.

Discussions around collective defined contribution (CDC) pension schemes in the UK have intensified since 2018, particularly with the upcoming launch of Royal Mail's single employer CDC scheme, marking a significant milestone as the UK's first CDC scheme.

Industry experts seem optimistic about the potential of CDC schemes, with recent LCP research finding that the expected pension from a whole-of-life CDC scheme could be 50 per cent higher than traditional DC schemes with the same contribution levels.

LCP attributes this to the risk-sharing nature of CDC and the greater investment freedom this generates, creating the potential for "significantly higher pensions" at retirement.

So, how does the risk-sharing nature of CDC schemes allow greater 'freedom' to be taken with investments?

Investment

WTW head of CDC, Simon Eagle, explains: "In CDC schemes the member is in a pool of thousands of people and they will each receive income for as long as they live, basically because there's enough money to pay the income over the average lifespan."

He highlights that this pooled approach removes the "enormous individual longevity risk" present in traditional DC scheme drawdown.

Hymans Robertson head of DC markets, Paul Waters, says: "The risk pooling aspects of CDC mean that higher growth for longer, and therefore potentially higher volatility, can be sustained into retirement.

"Arguably, therefore the need to de-risk, as is seen within traditional DC, disappears almost completely, provided you maintain a stable shape of younger and older members in the scheme."

Additionally, Pensions and Lifetime Savings Association senior policy lead, Ruari Grant, explains there is no need to de-risk as someone nears retirement "because you're not dealing with individual pots that someone might want to withdraw cash from or buy a retirement product with".

Grant says: "For members in the growth phase, investment strategies will look similar – both DC and CDC will have high allocations to equities, and, increasingly, to private markets."

However, he suggests the difference is that CDC schemes have a "longer investment horizon" so there is no need to de-risk into gilts and bonds as someone nears retirement.

"Therefore, funds can stay invested in higher risk assets for longer, meaning more growth," he adds.

Society of Pension Professionals CDC Group chair, Edd Collins, echoes this: "CDC schemes provide the ability to invest in growth assets for the long term, and potentially in less liquid assets than may be the case for a traditional DC scheme. Over time, this would be expected to deliver better outcomes for individuals."

Unlike DC schemes, which Pensions Management Institute director of policy and external affairs, Tim Middleton, says, "need to start switching as they are closer to that decumulation phase", CDC schemes "can be invested significantly in growth assets" throughout retirement, as Association of Member Nominated Trustees co-chair, Maggie Rodger, notes.

Due to this, Rodger argues that CDC can "consider *[investing in]* infrastructure and other less liquid assets that DC struggles with and which offer better long-term returns".

Middleton and Grant both emphasise that the risk-sharing nature of CDC ensures members receive an income for life, eliminating the need to ‘gamble’ on life expectancy and avoid the risk of the member running out of money or having excess funds when they die.

CDC popularity

Despite the benefits of CDC schemes, several pension experts say that they feel the pension industry is not ready for CDC schemes yet, despite the industry discussions on the topic ramping up since 2018.

Eagle acknowledges there’s still not a “high level” of understanding of CDCs in the pension industry.

“Although a lot of people are in favour of it now, I think many don’t fully understand what it is and how it can work and therefore they don’t necessarily have a high degree of trust in it yet,” he remarks.

Collins adds that clarity is needed on the regulatory environment that will apply for broader adaptation of CDC schemes, arguing that “without that, employers are unable to commit to developing CDC schemes”.

LCP head of CDC, Steven Taylor, says that the main challenges facing CDC are the “ability to build up scale and the fixed costs of getting a scheme off the ground”.

He highlights that because of the scale of CDC, it could be “hard for smaller companies to participate”.

Despite the challenges, Taylor suggests that there are opportunities CDC offers, including helping “bridge the savings gap for the next generation of savers and that naturally invests in growth-focused assets that are good for the economy”.

In addition to this, Middleton argues: “CDC provides an entirely seamless journey for members, with everything operating by default through the induction to the accumulation phase.

“When they come to retire, CDC will by default start paying out a pension for them, whilst the amount of pension might not be guaranteed, the fact that it will be payable for the remainder of the individual’s life is a considerable advantage over the current situation of conventional DC.

“They will be simple from the member’s perspective, which makes them more attractive than DC.”

However, Walters believes that, at this time, CDC becoming more popular than standard DC looks unlikely as “DC already has scale and momentum that is unlikely to slow”.

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Future outlook

With a new government, there have been discussions about the need for further regulatory adjustments and government action to encourage a broader adaption of CDC schemes.

In particular, Grant says: “We are currently awaiting draft regulations for multi-employer schemes. The government is also working on regulations for decumulation-only schemes.”

Despite the advancements in recent years, Eagle argues that further adjustments are necessary because the current system doesn’t allow multi-employer schemes and master trusts.

However, he notes: “The Department for Work and Pensions, under the previous government, said they are looking to allow them, and we are hoping the new government will carry on that path, maybe even more enthusiastically.”

Several industry experts have said it is important for the new government to

“pick up the pace” on CDC and “quickly pick up where the past government left off if CDC is to be a quick success”.

Taylor says to help smaller companies participate in CDC schemes the government could set up “a statutory scheme (perhaps linked to the existing Nest or Pension Protection Fund models) that would allow smaller groups of employees to join CDC schemes”, suggesting it might also “help to encourage other commercial models”.

He also expects the second round of regulations shortly after the summer recess, stressing the importance of this, as he says, “the initial regulations were designed with just the Royal Mail scheme in mind”.

Waters suggests the priority should be a change in regulations to increase the flexibility of what can be offered under the CDC umbrella, “taking away any uncertainty will give confidence to other employers and providers that are keen to introduce their own flavour of CDC”.

Whereas Middleton stresses the importance of making sure the CDC schemes are run properly, “it’s crucial that The Pensions Regulator has quite a tight regulatory regime for them”.

However, Rodger warns: “The regulations themselves do not cover a myriad of other decisions about the design of a scheme essential to its successful implementation.”

Therefore, Collins argues that it’s “essential” that the government brings forward its planned consultation at the “earliest possible opportunity”, and then looks further to develop regulations for a decumulation-only version of CDC.

Written by Paige Perrin