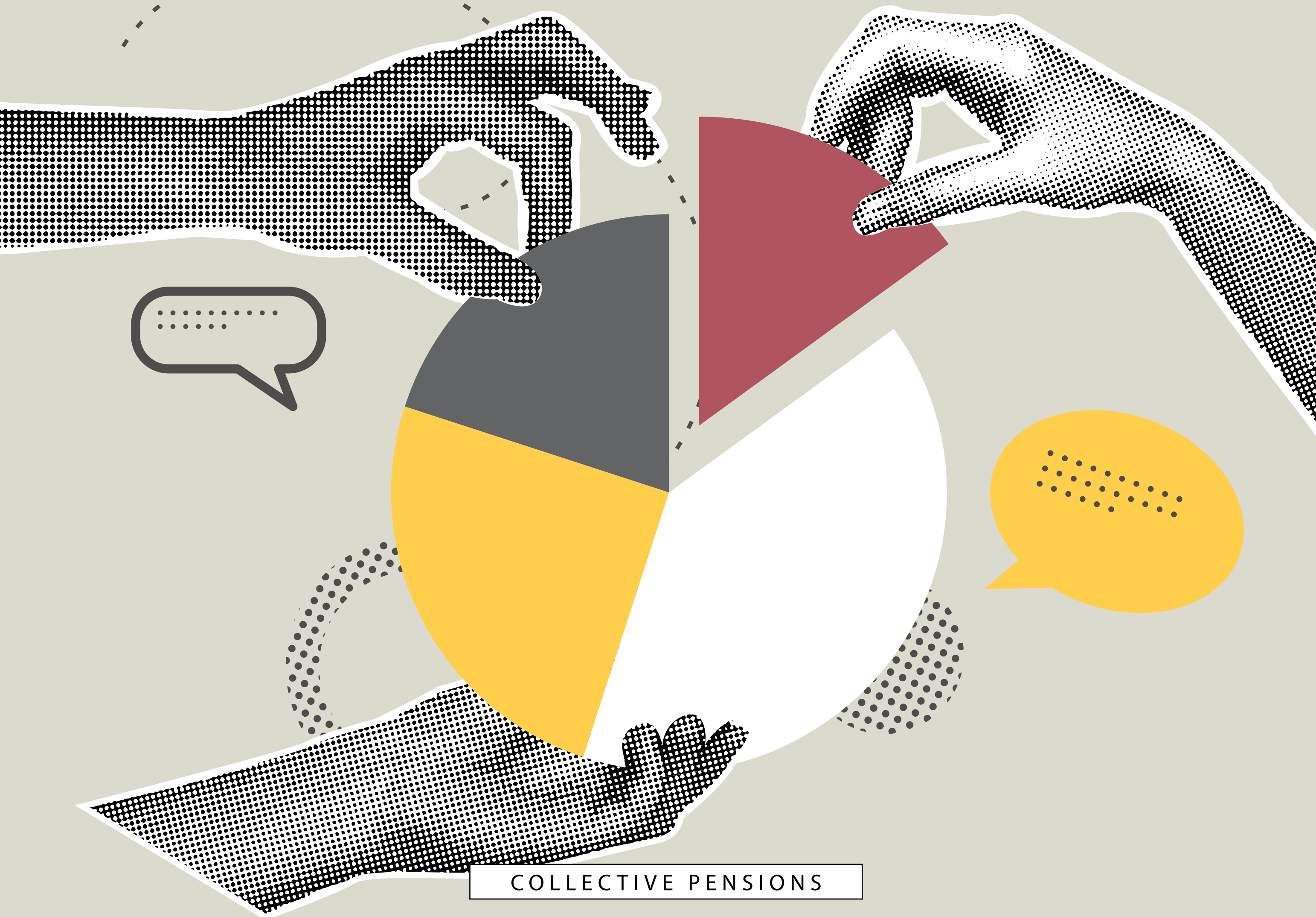


COLLECTIVE PENSIONS

Who shares wins

Collective sharing of risks or rewards form part of almost every national pensions system. As the UK launches a new type of collective defined contribution scheme, *David Adams* asks what policymakers, the pensions industry and employers can learn from the different ways collective elements are used in pension systems across Europe

The UK pensions landscape has seen a lot of change in recent years, including the introduction of auto-enrolment for workplace pensions, and multiple regulatory reforms. But might one of the less heralded changes prove to be one of the most significant – the development of new collective defined contribution (CDC) schemes?

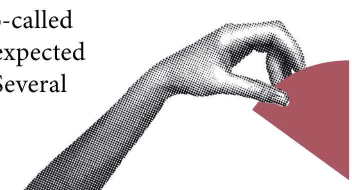
The UK version of CDC doesn't offer scheme members a guaranteed level of pension, which is good news for employers seeking to escape financial risks associated with DB schemes. But it could give individuals a higher retirement income than an equivalent DC pension, in part because it allows active and retired members to benefit from collective investment returns derived from larger allocations of higher risk, potentially higher growth assets.

In both a whole-of-life CDC arrangement, covering accumulation and decumulation phases, and collective arrangements for decumulation (this is called retirement CDC in the UK), longevity risks are also pooled, freeing individuals from needing to make choices about how to use their DC savings based on their likely life expectancy.

"I think the principle of longevity pooling is such an obviously good idea that finding some way to make it work has to happen," says Gallagher global head of quantitative modelling, Alex White. "Something with longevity pooling is obviously better than DC."

Pension systems across Europe already use collective elements in a range of different ways, with the design and operation of workplace or multi-employer – sometimes industry-wide or sector-wide – schemes often negotiated between employers and social partners.

In the UK, The Pensions Regulator (TPR) has published an updated Code of Practice for CDC schemes and is allowing applications to run multi-employer CDC schemes; while the UK government has clarified legal and regulatory requirements. Further regulatory announcements related to the decumulation phase – so-called retirement-only CDC – are expected within the coming months. Several employers and pension providers have now expressed an intention to set up new CDC schemes or incorporate CDC elements in existing schemes or products.



"THE PRINCIPLE OF LONGEVITY POOLING IS SUCH A GOOD IDEA THAT FINDING SOME WAY TO MAKE IT WORK HAS TO HAPPEN"

"Collective solutions do not suit everybody," says PensionsEurope Secretary General and CEO, Matti Leppälä. "Using collective solutions means you cannot have individual freedoms to the same extent, but collective solutions can be much more cost-effective, and lead to better outcomes."

The benefits of solidarity

The Netherlands is often said to have the best pensions system in the world, and arguably the collective elements of the system are a crucial factor in its success. Its second pillar is based on many industry or sector-wide DB schemes, alongside DB or DC company schemes. Membership of at least one occupational scheme is mandatory for all Dutch employees.

But, as elsewhere, during the 21st century the effects of increased longevity, intergenerational unfairness, and an unstable financial and economic backdrop undermined the financial sustainability of many second pillar schemes, forcing reforms intended to safeguard schemes, and reduce both intergenerational unfairness and the financial risks faced by employers.

A new second pillar system, based on the 2023 Future Pensions Act, or Wet Toekomst pensioenen (Wtp), is largely DC-based but retains some collective risk-sharing. There are two types of DC arrangement: 'solidarity' or 'flexibility' schemes. The solidarity model, by far the most popular option, retains collective investments and risk-sharing. Contributions tend to be set at similar levels to those used in DB schemes, and investment returns are distributed among members in different age groups according to a predetermined formula.

During decumulation Wtp schemes provide, in effect, a collective variable annuity: an income for life, the level of which is determined by investment returns. Schemes also include a capital buffer, to be drawn upon if investment returns are lower than expected, so avoiding, or minimising, any need to cut pension benefits.

"It's a relatively small buffer, but it generates a lot of security for members," says PwC Netherlands senior director and pensions adviser, Willem Eikelboom.

A spokesperson for the Dutch Federation of Pension Funds (Pensioenfederatie) says this form of collective risk-sharing "ensures that millions of participants are stronger together than if they were

to bear such risks individually. By pooling contributions and investments, risks are shared, costs are controlled, and economies of scale are leveraged."

The Danish pensions system, also well-regarded internationally, includes sector-wide occupational schemes that offer many workers a choice of DC or CDC-like arrangements. Danish technology provider Festina Finance CTO, Jesper Lauritsen, believes many people opt for the CDC-like approach because this means they do not have to make investment decisions. But he also thinks a collective approach is popular in both Denmark and the Netherlands in part because it is aligned with widespread attitudes to sharing financial risks and rewards.

He notes that much of the debate in the UK has focused on the possibility that CDC pension schemes could deliver higher investment returns and pension benefits.

"Actuaries in Denmark might also say that this is the case, but I don't hear that argument here or in the Netherlands," he says. "In both countries it's more about having a collective mindset in a broader sense."

Different routes to a common goal

There are collective elements in use in the pensions systems of a number of other European countries, but the positive effects they may have on some aspects of the system are sometimes overshadowed.

"In Germany, what looks like quite a good model has been slowed down by some of the unions," says LCP partner and head of CDC pensions, Steven Taylor. "The German system means you have to be within a unionised environment to use CDC." This has restricted access to these pensions significantly: currently there are about 10 in operation, serving only about 100,000 members in total.

In other European countries, such as Finland or Sweden, collective elements in occupational pensions take different forms. In Finland, a basic state pension is combined with a compulsory occupational pensions system based on company or industry-wide schemes. In Sweden, the second pillar of the pensions system is dominated by a handful of very large schemes reserved for different sets of public and private sector workers, governed by collective agreements with trade unions and other social partners.

The UK is not building a model for CDC pensions based on compulsion. But UK policymakers are in favour of further consolidation of the country's many small workplace schemes.

"BY POOLING CONTRIBUTIONS AND INVESTMENTS, RISKS ARE SHARED, AND COSTS ARE CONTROLLED"

Increased use of both whole-of-life and retirement CDC may encourage further consolidation, which may make regulation of the country's pensions system more straightforward.

"In the UK we have 5,000 DB schemes; and in a few years' time there might also be 10 or 20 CDC schemes in the UK, so regulating those is going to be easier," says Taylor. "Are they individually slightly more complex? Yes, but if you've got similar benefit structures being delivered by a smaller number of collective schemes it becomes easier to notice specific issues affecting individual schemes."

PwC UK partner and pensions consultant, Minesh Rana, is not so sure: He points out that in the UK regulation of CDC schemes is considerably more complex than regulation of DC schemes, and will involve multiple regulators, with TPR in charge of trust-based workplace schemes, while the Financial Conduct Authority oversees pension providers' retirement CDC products.

One aspect of that regulatory complexity will be the rules governing how schemes and providers communicate with CDC scheme members, while also explaining how the CDC model works.

"You need to focus on clearly articulating to members what they are getting: a targeted pension, most likely a higher pension than they would get with DC – but there are no guarantees," says Taylor. "It's important to get that message across in a way that is not scary."

Leppälä wonders if the persistence and redevelopment of collective elements in pensions represents a pushback against the trend in recent years of forcing more individuals to take on more risks through membership of DC schemes. He points out that the Wtp schemes in the Netherlands retain risk-sharing within a DC framework and suggests that we may see similar trends in other countries in future.

Whether via DC or CDC arrangements, "sharing longevity risks is crucial for people entering the retirement phase," says Leppälä.

"These risks don't go away; they come back to these individuals – and to society, in the end – if they can't be shared. We hope that policymakers in Europe and elsewhere understand that."