THE GUIDE
FOR PENSION TRUSTEES
PRESENTS
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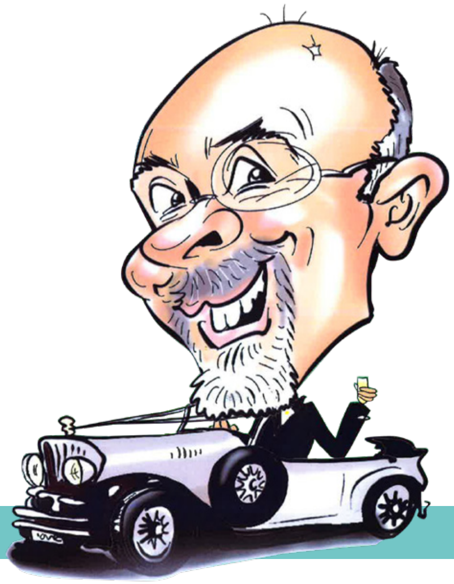

In search of better retirement outcomes

There are widespread pensions industry concerns over the level of retirement income faced by much of the UK population. The issue has now moved into mainstream consciousness, with surveys consistently showing a picture of undersaving in DC schemes and growing concerns amongst individuals that they face poverty in retirement.

Worryingly however, the surveys also paint a picture of a population lacking the skills to address the situation. This is frequently evidenced in the absence of effective decision-making around investment of individual funds, with assets not being worked as hard as they should be and is unsurprisingly appearing in decisions on retirement drawdown amounts.

This leads to vague statements such as that they are reconciled to continuing to work on into retirement and hopes that the state or some other factor or benign entity might somehow come to their rescue. One key factor that would help – putting aside more money now to fund higher retirement benefits - does not seem to feature as often as it should.

There are a number of reasons for this, not least human nature. But it is also clear that lacking knowledge and financial skills also contributes to undermining confidence in diverting financial resources away from current consumption into a poorly-understood arrangement with an uncertain future return. The success of automatic enrolment is an indication of how individuals will respond positively if someone else who is regarded as trustworthy takes control. This paternalistic control is present in DB schemes, but is lost with the move to individual DC arrangements, which has hit baby boomers particularly hard where they have been moved from DB to DC part way through their working lives.

At the same time, the reaction of employers to the pressures of providing a DB scheme is understandable, and although at least some may see the potential benefits of providing a level of predictability of benefit for employees, concerns about contribution volatility and uncontrolled costs will continue to deter DB provision.

So, a scheme design that offers the potential of a *degree* of predictability for members, with minimal requirement for financial knowledge-based input, combined with the cost certainty for employers that comes with DC arrangements, is worth serious consideration. The recent DWP consultation document on Collective DC (CDC) is therefore to be welcomed. Understandably it has received a mixed reaction, with concerns being expressed around the possible impacts of some likely features. Does CDC offer any solutions to the great retirement income dilemma?

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What would CDC look like?

The details of a UK CDC regime are yet to be settled – hence the DWP consultation. But the paper does give some useful pointers towards a sensible structure and flags up some of the key issues to be addressed by any future legislation and practice, if CDC is to work.

Key features would involve large schemes with pooled assets for critical mass and economies of scale, run by trustees and subject to strong regulatory oversight. Although using a DC basis, meaning set contribution rates and no guarantees on benefit amounts, there would be an aspirational benefit level, set on a conservative basis. The "collective" aspect allows pooling of funds and equitable sharing of returns across the membership, possibly including holding a buffer fund against future investment return fluctuations. This means no direct link between individual member benefits and the funds held to provide them. For a close example, think "with profits" funds.

Silver bullet?

Although CDC alone will not solve the UK's pensions problems, it does offer significant potential. However, whatever the design details made possible by future legislation, in order to avoid some of the traps that have undermined other financial options it will be necessary to learn from past mistakes.

Key among those will be governance issues, particularly around the allocation of funds between individuals and between generations. Critics of CDC point to past bad experiences in with-profits arrangements. However, the principle of with-profits funds is sound: the problems were largely due to poor governance, allowing providers' pursuit of market share to override sensible caution over investment market norms. With the proposed completely new legislative and regulatory provisions, the use of trustees and the requirement for regular and independent actuarial reviews, CDC should avoid such traps.

Managing members

Critical to the success of CDC schemes will be member understanding of the way in which their scheme will work, and what that will mean for their benefits. Without member confidence, voluntary contribution levels will not increase. There will undoubtedly be challenges in communicating this effectively, given the current low levels of understanding of "simple" DC arrangements. A particular challenge awaits with communicating the concept of fluctuations in benefit levels. Volatility exists now with individual DC and although members appear to recognise it as an issue, the decisions they make are often at odds with an understanding of its implications for their retirement income and how to address them. Surely a system bringing some stability and predictability, where possible outcomes calculated on a conservative basis only are communicated, will be a step forward?

One of the problems of such volatility with DC is the failure of reality to match (often unreasonable) expectations. Here employers, the pensions industry and Government must each bear a proportion of the responsibility. Many switches from DB to DC workplace schemes sold (explicitly or implicitly) DC schemes as savings arrangements where members have control over their own money with the opportunity to invest to obtain market-beating returns. The freedom and choice tax revolution reinforced that story.

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If the full downside financial implications of that system in practice have not yet fully dawned on members, they will eventually. If CDC is to be successful, we must move away from the "savings scheme" ethos in favour of "retirement benefit". This refocusing of members' expectations will allow for the acceptance of more realistic outcomes, and (while allowing for some, albeit hopefully reduced, volatility) would be consistent with survey responses highlighting the importance placed by members upon predictability of retirement income.

A force for good

That there are significant issues to overcome in devising an effective CDC option is beyond question. Nevertheless, the benefits from getting it right, in terms of finding a solution that plots a course between the extremes of DB and individual DC, softening the negative aspects of both, are surely worth an investment of effort. CDC may not provide a universal solution for retirement poverty, but it has the potential to become a force for good.