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How much?!

Looking beyond headline CDC uplifts

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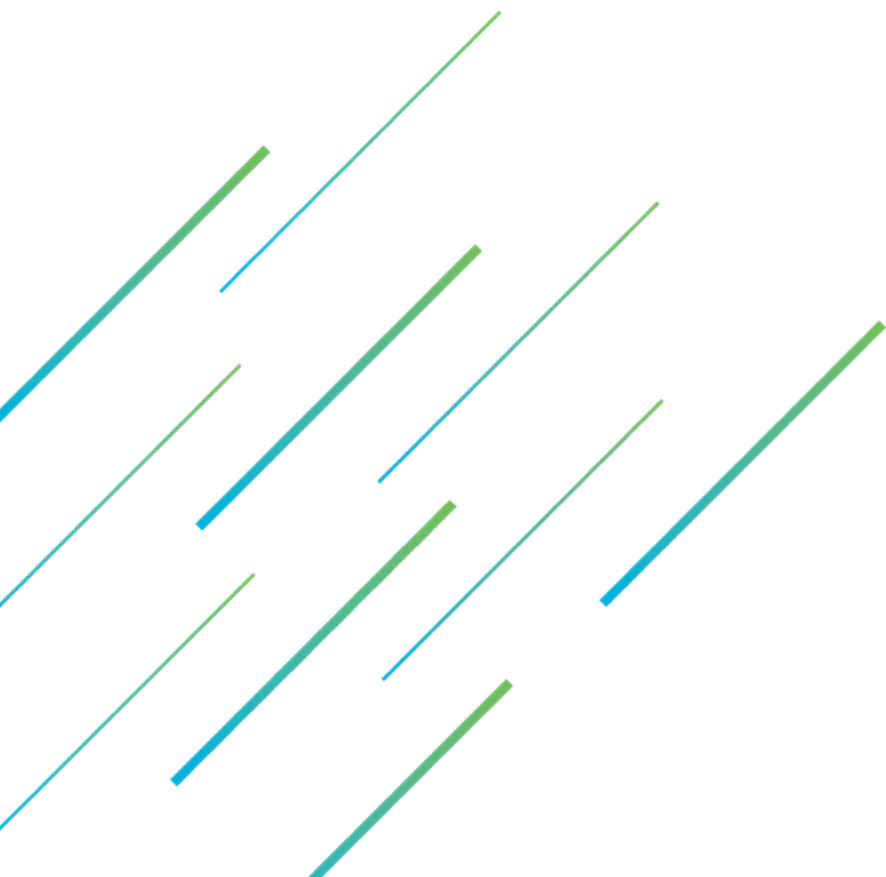
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Introduction

Much of the debate on collective defined contribution (CDC) schemes has focused on their potential to improve adequacy.

However, higher income is only one part of a good retirement outcome. Many people also value an income that lasts for life, certainty about how much they'll receive, flexibility to respond to changing circumstances and the ability to leave money to their family. Different retirement solutions balance those objectives in different ways, but none can optimise everything at once.

We also have Guided Retirement coming in the next few years. Its aim is to support better retirement product design and help more people access solutions that match their needs. As with auto-enrolment (AE), it's not just about what works academically but how it helps ordinary people achieve better outcomes in practice.

Millions of people in the UK are not saving enough for retirement, so anything that could provide a higher pension for the same contributions is understandably attractive. It's easy to see why policymakers and the pensions industry, while recognising some of the trade-offs relative to other products, are excited about the potential of CDC. The prospect of higher pensions from CDC can sound like free money – what's not to like?

This brings us to one of the most common questions asked about CDC: **how much more income can it provide?**

Different experts have quoted markedly different uplifts. Some of this is down to different assumptions or models. Some is down to different designs, but a big chunk is down to different perspectives.

Perspective affects how we experience reality. A regulator, a trustee, an employer and a member can look at exactly the same outcome and reach different conclusions about its value.

While CDC is reasonably tightly defined in legislation, you can still have quite different investment strategies and other design features under the hood. Defined contribution (DC) decumulation options are far more varied: annuities, drawdown, flex and fix and beyond if you go into the retail space.

The question we ask should not simply be “how much can CDC provide?” We should also ask, **compared to what, for whom, and against what objective?**



Comparing CDC with annuities

A single life annuity has just as much longevity pooling as a single life CDC pension in retirement. Both are designed to pay an income for life, but the nature of those incomes is different.

An annuity provides a higher level of income certainty than CDC. The insurer holds capital to support its promises, and that protection has a cost. Differences in provider margins, capital requirements, administration expenses and scale will all affect the comparison between an annuity and CDC.

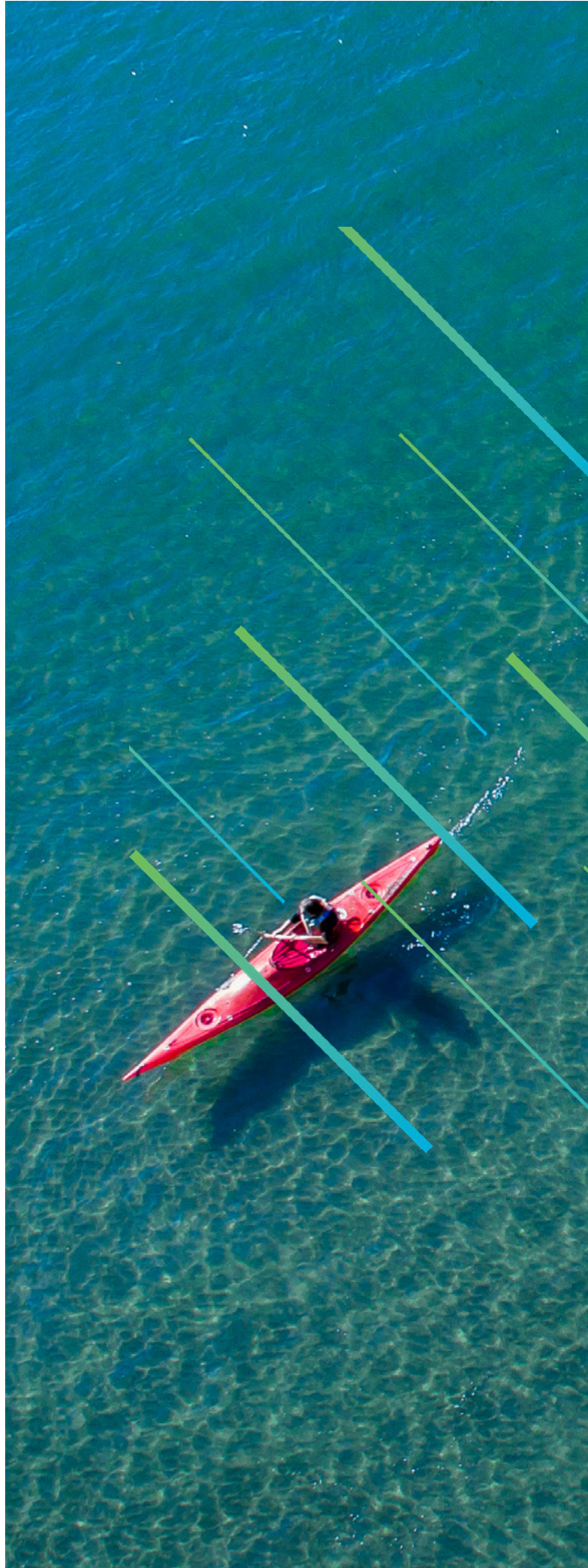
However, the most significant difference is likely to be investment strategy. A whole-of-life CDC scheme might target returns of 3% pa above what an annuity might deliver. Compounding that difference over a whole retirement can make a huge difference to member outcomes.

It also depends on which numbers you look at. On average a CDC pension might deliver 30% more from the same pot than an annuity, but in the worst 5% of cases an annuity might deliver 20% more.

This is where perspective becomes important. If we focus on average outcomes, CDC delivers more. If we instead focus on the worst 5% of outcomes, annuities deliver more. There is no rule on the risk metrics to use: we could look at the worst 25% or worst 1% of outcomes, each leading to different comparisons. Each could be relevant to different members with different risk appetites and different abilities to withstand lower incomes. For some members, a lower income might lead to fewer holidays; for others it could lead to not being able to afford to heat their home in winter.

So depending on your perspective, you might say a CDC pension can deliver anything from 10% less to 30% more income than an annuity. And of course, the full range is much wider than this.

This range is not evidence that one of the figures is wrong. It demonstrates that expected income and income certainty are different objectives. CDC and annuities lead to different outcomes for both.



Comparing CDC with drawdown

The comparison with drawdown is even more complicated.

Annuities and CDC pensions both last for life. Drawdown offers greater flexibility, but there's a risk that the money will run out.

Modelling drawdown requires several subjective decisions:

- 1 What risk of ruin do you accept on a member's behalf?
- 2 How do you model how a member will change their income withdrawals when investment returns are better or worse than expected?
- 3 Do you make any allowance for the poor decisions that some members make in drawdown, such as paying unnecessary tax when withdrawing their whole pot in one go, investing in very low-risk assets, or spending at seemingly unsustainable rates?

To ease the comparison, we ignore point 3 in our modelling and assume for both point 2 and 3 that members set a target level of income at retirement and keep taking that income (increasing with inflation each year).

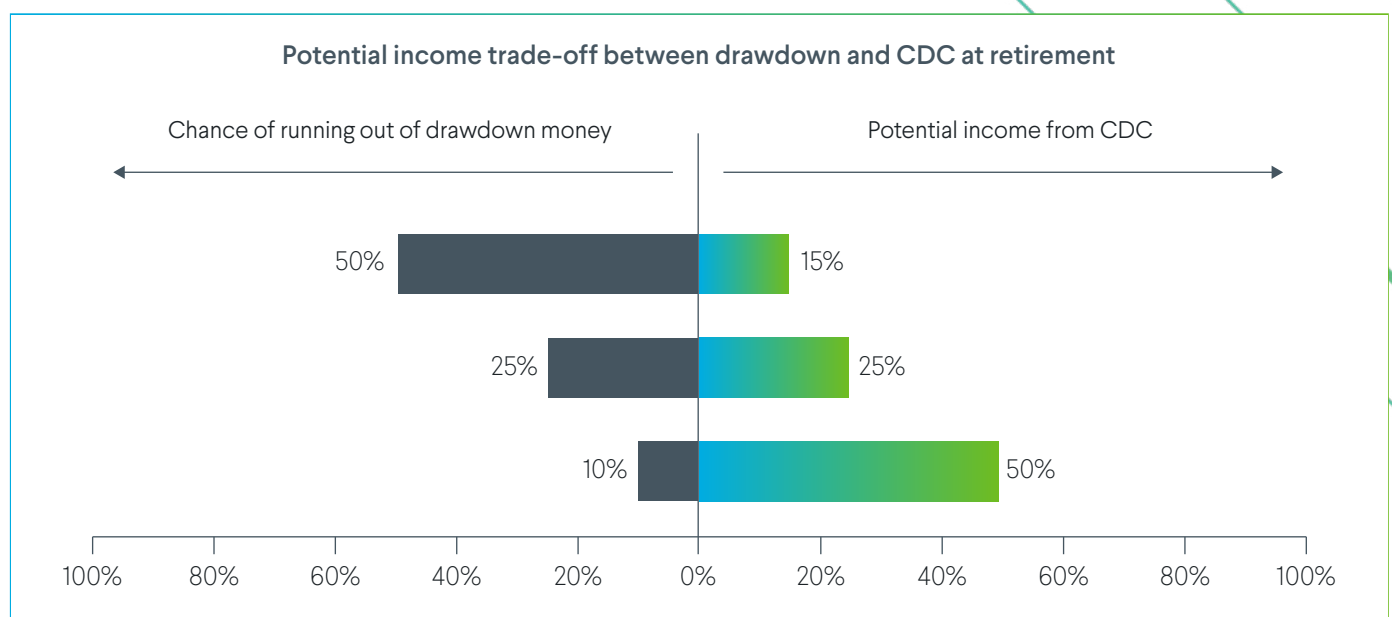
That still leaves us with a question about how much risk we model on behalf of members. In drawdown, reducing the chance of running out of money means taking a lower level of income. This makes CDC relatively more favourable for more risk-averse members seeking greater certainty of an income for life.

The chart below illustrates this trade-off, showing how the uplift from CDC relative to drawdown changes at different ruin probabilities for a 60-year-old member, assuming the same investment strategy and returns in both approaches.

So depending on your perspective, you might say CDC can deliver between 15% and 50% higher income than drawdown. Again, neither end of that range is necessarily right or wrong. They answer different questions about the level of risk a member is willing and able to bear: the more certainty someone wants about having an income for life, the bigger the apparent CDC advantage.

There is also another important trade-off. In drawdown, any money left when the member dies can usually be passed on. In CDC, the assets supporting members who die earlier than expected remain within the collective and help provide higher pensions for other members. That pooling is part of the reason CDC can support a higher lifelong income, but it means the member generally gives up the opportunity to pass on a remaining individual pot. The numbers don't allow for the value of any remaining pot that is retained in drawdown.

All of this is before you start considering spouse's pensions, different investment strategies, income flexibility and more. So the range of uplift figures you could see is far wider than this. Comparing drawdown with CDC based on a single figure can become misleading.



What about pre-retirement savings?

So far we've only been looking at retirement income. Some commentators quote much larger uplift figures based on whole-of-life CDC. To understand those, we need to look earlier in the member journey.

When you think about pre-retirement savings:

- ◆ Longevity credits pre-retirement will be relatively small compared to post-retirement. Any gains will be offset, partially or entirely, by the cost of providing pre-retirement death benefits.
- ◆ Investment strategies during the growth phase for DC could be broadly comparable to investment strategies in whole-of-life CDC schemes, although there can be some differences. CDC schemes invest over a longer future time horizon and so may be able to support slightly higher allocations to private markets. CDC schemes also don't need to de-risk as individual members approach retirement, which can drive higher CDC pensions depending on the length and degree of investment de-risking in any DC consolidation phase.

So we don't see, on average, material differences between DC and CDC in the accumulation phase. But that isn't the whole story.

Part of the promise of whole-of-life CDC is down to intergenerational risk sharing. The argument is that members can shoulder more investment risk in retirement and so benefit from higher expected returns in retirement.

Also, being in a whole-of-life CDC scheme avoids the need to make a major transition at retirement. Whether that means moving into retirement CDC, an annuity, flex and fix, or anything else. This aspect of whole-of-life CDC could well be appealing to less engaged members, and help protect against poor decision-making. It also removes the need to de-risk investments before retirement (reducing returns and outcomes) and other frictions for providers and trustees concerned about defaulting disengaged members into a new product.

Finally, and most importantly from an uplift perspective, you get a wide funnel of outcomes when you look at younger members. There is more uncertainty when looking over a longer future time horizon. This results in a lower drawdown income to target a reasonable chance of not running out of money in retirement. If you do that comparison for a very wide funnel, you can end up quoting a very high uplift for CDC.

The CDC uplifts will be heavily influenced by the exact drawdown comparator used. If you compare CDC with a dynamic drawdown* strategy, your CDC uplifts will be lower. There is also a question of whether any comparison is meaningful for the youngest members where there is significant uncertainty.

** A dynamic drawdown strategy is one in which the level of income is adjusted year on year in response to factors such as asset performance, remaining life expectancy and the size of the remaining pot.*

Some may look at this and say CDC can provide a significant improvement in retirement incomes. Others may say drawdown is not the best comparator if the focus is on providing a sustainable income for life.

Conclusion

The question of how much more income CDC can provide sounds straightforward. In practice, it isn't.

The answer depends on what we're comparing CDC against, what assumptions we make about member behaviour, how much we assume members will take, and ultimately what outcome you're trying to optimise.

A member seeking the highest possible expected income may reach a very different conclusion from one who values certainty, flexibility or the ability to leave money behind to their family.

That's why experts can quote very different CDC uplift figures and all be right. They're often looking at the same problem through different lenses.

Rather than searching for a single CDC uplift number, we should focus on the trade-offs that sit behind it. How much uncertainty are members willing to accept in exchange for higher expected income? How important is flexibility? What value should be placed on income for life? And how much importance do members place on preserving an inheritance? Those questions matter far more than whether the answer is 20%, 30% or 40%.

Perhaps most importantly, some of the largest headline uplifts say as much about today's retirement market as they do about CDC itself. If members want a sustainable income for life, then comparing CDC with highly cautious drawdown strategies may tell us that many people are not currently reaching retirement solutions that best match their objectives. In that context, the success of Guided Retirement could prove more important than any single product design.

CDC has some compelling characteristics, particularly for members who value lifelong income and are willing to accept some uncertainty and volatility in their level of income in return for higher expected outcomes. But boiling its value down to a single uplift figure risks oversimplifying a much more important conversation about what good retirement outcomes look like.

To help schemes, providers and policymakers explore these trade-offs more consistently, we have developed our CDC AIR™ Outcomes Modeller. It compares whole-of-life CDC and retirement CDC with DC retirement pathways, including drawdown, annuity purchase and blended solutions. It helps assess expected income, downside risks and the range of potential outcomes under different assumptions. While no model can capture every aspect of a retirement decision, it can provide a more consistent basis for comparing retirement solutions.

To find out more about CDC, or to discuss how our CDC AIR™ Outcomes Modeller could support your scheme or retirement proposition, please [get in touch](#).

Modelling note

The figures shown in this article are illustrative and are intended to demonstrate how different metrics, assumptions and comparator products can affect the results of CDC comparisons. They're not intended to represent forecasts of future outcomes or to quantify the benefits of any particular CDC design. Results will vary depending on factors such as investment strategy, longevity assumptions, member behaviour, product design and market conditions. The examples are based on modelling undertaken using Hymans Robertson's CDC AIR™ modelling framework.





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