

A bitesize guide to CDC

A short beginner's guide to Collective Defined Contribution (CDC) pensions

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Introduction

There is growing focus on how Defined Contribution (DC) schemes can support better retirement outcomes, with calls from the pensions industry for improved adequacy and Government plans to introduce “Guided Retirement” DC scheme requirements to provide default retirement income solutions.

Collective Defined Contribution (CDC) schemes are still relatively new to the UK, with Royal Mail opening the first scheme in 2024. CDC schemes both improve adequacy and provide an income for life and so align closely with Government policy objectives.

As Guided Retirement proposals draw closer, we anticipate some will want to explore CDC as a potential retirement option for the first time. That is why we have published this short beginner’s guide — to outline what CDC is, the key attractions and challenges and the types of CDC design that are already available or expected to be enabled soon. It is designed for anyone seeking a straightforward foundation before looking at more detailed technical material.

If you are interested, or would like to know more, please contact one of the authors:



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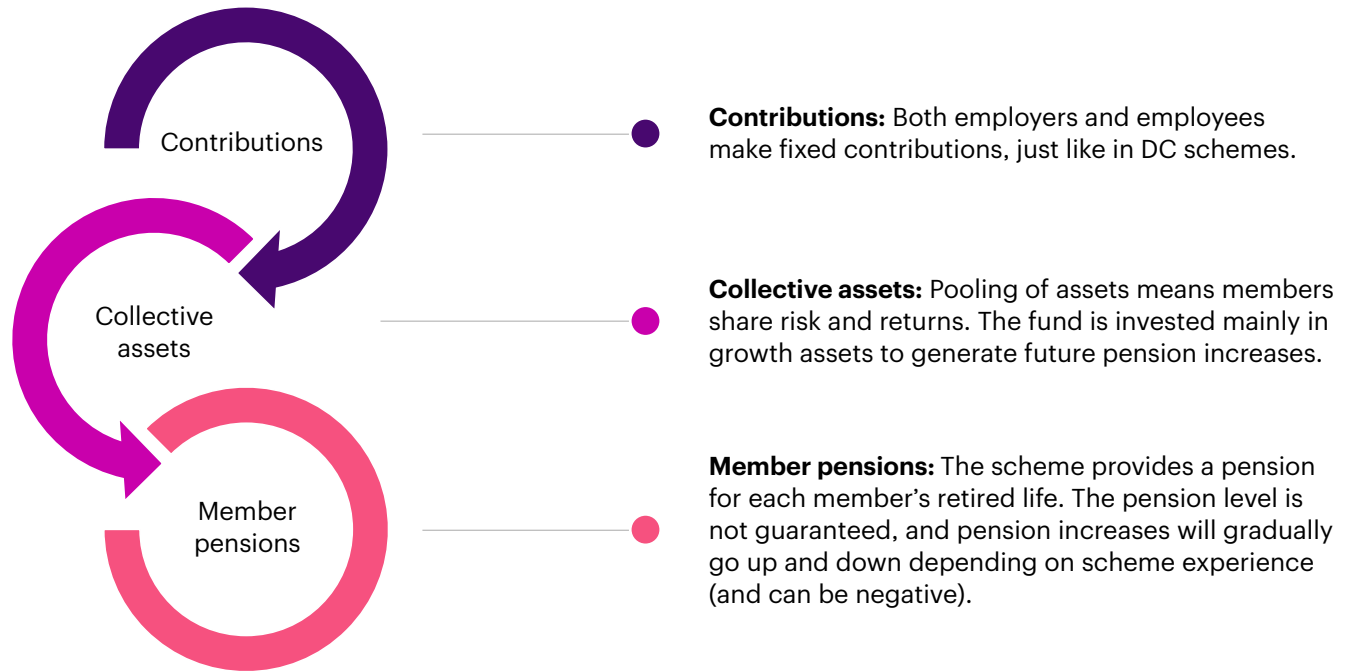


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What is a CDC scheme?



Key advantages/challenges of CDC



Fixed cost

Fixed contributions mean the employer's pensions accounting is DC-style under UK GAAP and IFRS. Plus, most CDC designs allow flex in DC rate by member, like individual DC.



Significantly higher expected pension levels

Expected retirement income 40% – 55% higher than individual DC with annuity purchase,* improving adequacy and assisting with workforce planning.



Provides an income throughout retirement, managed by Trustees

So members don't need to make difficult decisions in their retirement, schemes are run by independent Trustees



Pension increases vary with scheme experience (and could be negative)

Mitigated through benefit design, robust transparent governance processes, clear member communications and regulator oversight.

*Due to higher target asset returns – Source: [A new era for UK DC retirement solutions](#).



Types of CDC: Whole of life and retirement

Summary of the two main types of CDC scheme design

Here we compare the two ways of designing a CDC scheme, and compare their key features.

	Whole of life CDC	Retirement CDC
Overview		
	Employees gradually accrue CDC pension while in service, payable from when they retire.	DC savers purchase a CDC pension at retirement, with all or part of their DC pot.
Typically for	A replacement for Defined Benefit accrual for future service, at fixed (and usually lower) cost.	Introduced as a new option at retirement for DC savers, to give a cost-effective income for retired life.
	Some employers might prefer it to existing DC, for the same (or lower) cost.	Potential default retirement income offering when required as part of Guided Retirement.



Types of CDC:

Single employer and multi-employer/master trust

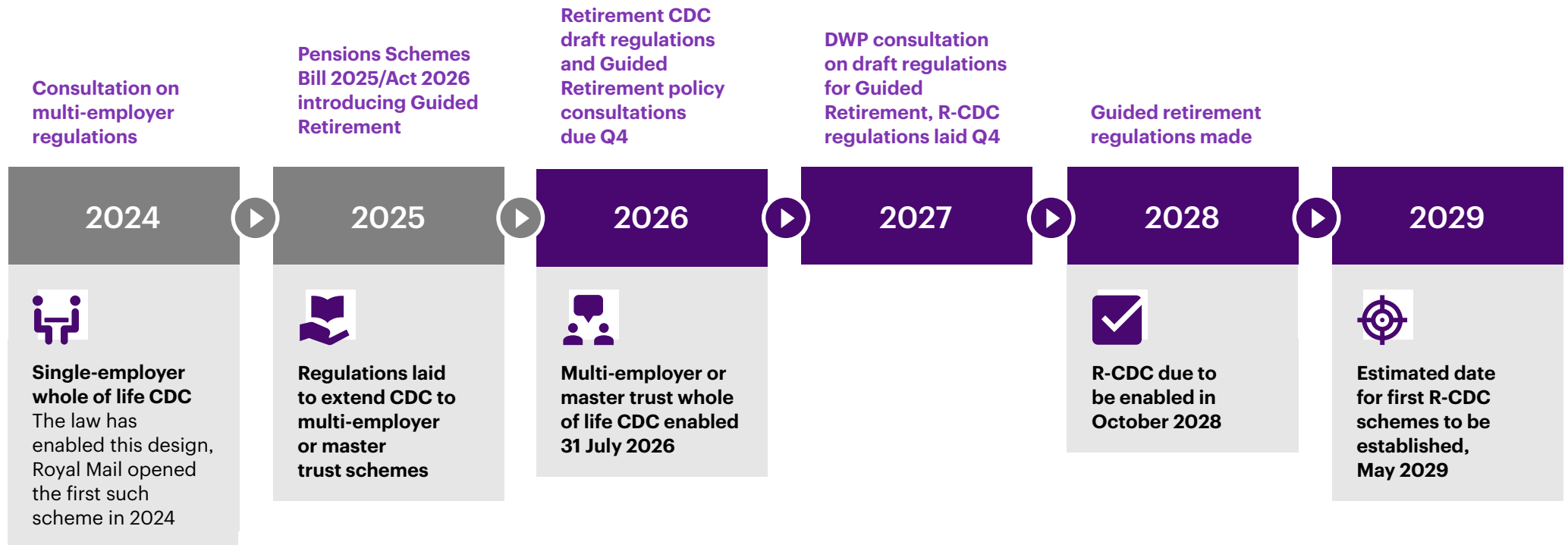
Employers could either provide CDC through their own trust, or join a multi-employer scheme.

Here we look at the pros of each option, and which employers each are typically suitable for.

	Single employer	Multi-employer/master trust
Benefits		
	Employer control over scheme design and influence over operations.	Larger scale so more cost effective.
	Could operate within employer's own existing trust (and potentially employer contributions can be taken from any existing DB surplus).	Off-the-shelf design for employer's use.
Typically for	Employers with workforces of over 5,000.	Smaller employers.
	Employers with long servers.	Industries with high turnover of staff between employers.



When can CDC schemes be opened?



Frequently asked questions

1. Can you really expect 40% – 55% higher retirement outcomes from a CDC scheme than through purchasing an annuity from a DC pot?

Whole of life CDC

In the years before retirement, a typical DC scheme follows a “lifestyling” strategy i.e. gradually reducing investment risk in advance of retirement to prepare for annuity purchase or drawdown. This level of derisking is not necessary in a whole of life CDC scheme where **there is no change in benefit at retirement.**

After retirement, a whole of life CDC scheme does not provide a guaranteed level of income and so is able to continue to invest in return-seeking assets longer into retirement before more gradually derisking.

The extended exposure to growth assets means significantly higher outcomes can be expected — by up to around 55%.

Retirement CDC

For members joining a Retirement CDC scheme i.e. purchasing a CDC pension at retirement, post-retirement assets can also remain invested for longer, leading to higher expected outcomes. Additionally, even though members could be in the same DC scheme pre-retirement, their investment strategy would sensibly stay “on risk” for longer if it is known that the strategy is to move into CDC rather than to purchase an annuity. Overall, we estimate this approach would deliver on average 40% higher expected outcomes compared to an annuity, of which around 15% relates to pre-retirement investment strategy.

We explain this more in our white paper from 2024 “[Reimagining Pensions](#)”.

2. How are CDC scheme pension increases worked out?

When you join a CDC scheme you will be told what the target, sustainable level of pension increases is — this will typically be linked to CPI inflation, and is the rate of increase that is expected to be able to continue to be paid each and every year into the future based on the current population. The level of pension increase is not guaranteed.

Each year, the scheme checks whether its assets are sufficient to cover the expected cost of pensions already built up, using the current target pension increase and **best estimate assumptions.**

If the value of the assets is higher than the cost of providing the pensions, then pension increases rise (both the current increase and the target for future years). Similarly, if the value of the assets is lower than the cost of providing the pensions, then pension increases reduce.

For example, if a scheme was fully funded and had target pension increases of CPI, but then suffered a market shock, leading to, say, a 20% fall in asset values. Assuming the average term to payment of pensions was 20 years, this 20% asset loss could be made good by applying increases of CPI less 1% going forward, rather than CPI, for the scheme to remain fully funded.

This mechanism is how scheme experience is smoothed over time.

3. What happens if CDC schemes are closed to new members or accrual?

Because pension increases are always set on the current population, and increases are calculated based on what is affordable over the lifetime of the current scheme, with sufficient scale they can cope with closure by running on without affecting current income levels. If a CDC scheme became too small to be cost effective to run on, it could wind up — providers must hold assets to meet the expenses of this.

4. Do other countries have CDC pensions?

Yes. Several countries already operate CDC pension arrangements or similar, particularly in retirement CDC.

Canada has long-standing Retirement CDC arrangements, most notably the University of British Columbia Faculty Pension Plan, which has paid variable lifetime incomes for decades. Recent legislative changes have also enabled new longevity-pooling (tontine-style) products.

The Netherlands has used collective risk-sharing pensions for many years and, under its new pension system, will continue to provide variable incomes for life through collective pools in retirement. Although labelled as DC, these arrangements function as Retirement CDC schemes.

Australia does not formally use CDC, but policy and regulation are increasingly encouraging retirement income products that pool longevity risk, and collective lifetime income solutions are an active area of development.

So while the terminology differs, CDC-style risk-sharing schemes already exist internationally, particularly to provide lifetime income in retirement, and they offer useful lessons for the UK.

5. How is CDC different to ‘with profits’ annuities?

With profits schemes have been widely criticised for being opaque — and in the past, the increases or bonuses awarded were on a largely discretionary basis allowing room for commercial judgements to be made. CDC is more transparent for a number of reasons:

- **The approach to setting increases is mechanistic.** A CDC scheme always pays increases based on its funding position, so that the assets equal the liabilities at each valuation — there is no scope for discretion to pay any more or less. Communication around this is very clear — there is no expectation that CDC is guaranteed
- **The assumptions for calculating the increase must be set on a ‘central estimate’ basis.** The regulations require no bias or discretion in the way the increases are calculated. There is no allowance for prudence, or buffers, and less scope for commercial judgement
- **There are various documents that have to be published around annual increase determinations.** These must be publicly available, allowing scrutiny of the underlying assumptions, the calculations and the increase awarded. This makes the determination very transparent
- **All decisions are made by Trustees.** This creates a layer of independence, particularly with the latest draft regulations making clear the Trustees cannot be involved in the commercial operation of a CDC scheme

6. Why is the collective nature of the scheme important?

The collective nature of the scheme means that investment and longevity risk is shared between large groups of members. This enables the provision of a smoothed income over the whole of each member’s retired life and the potential to invest in return-seeking assets for longer, meaning a higher expected outcome.

It also means that like a DB scheme, some members will get greater benefit from being part of the scheme than others. For example, those that live longer will receive more pension payments in total i.e., short lived members subsidise the long lived, a “cross subsidy”. All members benefit from the safely net a lifetime pension provides.

Single-employer CDC designs are also like DB schemes in that older members build up pensions of higher actuarial value than younger members.

When there are periods of higher or lower asset returns, the effect of these is spread over time, and affects younger members more than older members. In single employer schemes it also affects members who built up pensions at different times.

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