Written evidence from Association of Member Nominated Trustees AMNT (CDC0032)

The Association of Member Nominated Trustees (AMNT) very much welcomes the opportunity to provide input to the Work and Pensions Select Committee inquiry into Collective Defined Contribution pension schemes.

AMNT was established in 2010 as an organisation run by and for member-nominated trustees, directors and representatives of private sector and public sector pension schemes. We now have over 700 members from about 500 pension schemes that have collective assets of approximately £750-billion, which is approximately one-third of the UK's pension scheme assets.

The Association congratulates the Select Committee for taking the initiative in holding this inquiry. From our formation in 2010 we have asked our members what their main concerns are. The overwhelming concern of trustees of DC schemes has consistently been the long-term outcomes for members of DC schemes. Ordinary working people who either face the closure of their DB schemes, or who never had that benefit in the first place, should have a better option available than the standard defined contribution scheme, referred to below as "current DC". We have therefore worked with others to support the entry of collective defined contribution schemes into the UK market. Our answers below also reflect soundings with our members since the Committee's inquiry was announced.

Benefits to savers and the wider economy:

- **Would CDC deliver tangible benefits to savers compared with other models?**
  AMNT is clear that ordinary working people without sophisticated financial knowledge would warmly welcome CDC when compared with current DC. In our view what most ordinary workers want is what DB pension schemes offer: a pension that is reliable, from which they know roughly what they are likely to get, and to which they can simply pay in their money without needing to make any complicated financial decisions or pay an independent financial adviser.

  Under the current DC system an individual is expected to decide how their money is to be invested – the vast majority of current DC savers never make that decision and so their money is invested in a default fund which may not be the best option for them. Upon retirement they are required to make such decisions as whether they wish to purchase an annuity, drawdown or withdraw a lump sum. They are advised to pay for independent financial advice to help them make the most appropriate decision for them. Such is the mistrust of pensions and the financial services industry, many choose not to pay for advice and try to make these decisions on their own.

  Under CDC most of this burden is lifted from the ordinary person who simply wants a pension without any hassle. As their money is invested collectively on behalf of the members the individual is not required to make any investment decisions during a period of active or deferred membership. And when retirement benefit becomes payable, the pension scheme itself will, unless the individual positively decides otherwise, pay the pension directly from the asset pool in a manner which will provide a more reliable return than would current DC default arrangements following retirement. The reliability comes from the pooling element which is of particular benefit during adverse market conditions. Investing alongside those from a different generation means that pensioners' withdrawals as a percentage of the total pool are much smaller than would be the case if they withdrew the same amount from a personal pot.

In addition, by removing the requirement to purchase a retirement option from a third party there is no fund leakage to third party pension providers and this in itself will significantly cut costs.

Money is also saved by the ability of CDC administrators to use the cash from contributions to pay out directly to pensioners. This means the scheme has to make fewer trades in the market – selling assets to realise the money to pay the pensions – so it incurs fewer transaction costs compared to current DC where individual scheme members' assets will be moving on a monthly basis as their contributions are added to their pot and (dependent upon the investment structure) annually as their investment mix changes with their age.

The lack of a guarantee has been flagged up as a risk to pension scheme members. But, in countries such as the Netherlands with an existing CDC system, in practice a quarter of their schemes were forced to reduce benefits by just 1.9%[1] between 2009-12 as a result of the market turmoil. Given that only a quarter did this it could be said that, crudely, benefits were reduced by just under 0.5% across the whole market. The cost of buying annuities, however, increased by 29%[2] over the same period.

Alternative options could remain open to individuals but the new default option at retirement could be the same as for existing DB savers – that they simply receive their pension, in this case paid directly from the scheme, and the only decision they need make may be how big a lump sum they wish to take (depending on how the CDC scheme is set up).

There are further benefits to savers. The CDC approach, being a collective vehicle, enables less volatility of outcomes as stated above. For the same reason it enables better diversification into investments which would be unsuitable for someone making investment decisions for their own individual pot. Alternatives with large minimum investments, and very long term assets such as infrastructure, would be available for the first time, or at least with less expensive intermediation than at present.

It is for all the above reasons that several studies have concluded that CDC could have delivered substantially better pension outcomes than traditional DC. The RSA/ Aon Hewitt study, referred to within the terms of reference, suggested that the outcome could be 33% better, while an earlier study *Collective Pensions in the UK* (2012) by David Pitt-Watson and

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1 *Dutch Central Bank figures*

2 *ONS, 2013*

Hari Mann states: "If a typical young Dutch person and a typical young British person were both to save the same amount for their pension; if they were to retire on the same day, and die at the same age, the Dutch person is likely to get a pension which is at least 50% higher than the British one."

They, in turn, quote the Government Actuary's 2009 study *Modelling Collective Defined Contribution Schemes*: "Collective [pensions are] expected to deliver a retirement income … [that] … is 39% higher than the corresponding [individual pension] outcome".

There are several reasons for this. Investing in a pool means there is no need to switch from equities to bonds to cash, and the money can continue to be invested up to the point of death, while most members will be more comfortable leaving the investment decisions to the pension scheme. And the design of CDC schemes is more efficient in that their economies of scale, compared with current DC, reduce leakage of money to the financial services industry via fees and charges on accumulating pots, financial advice to individuals, annuity charges and so on.

AMNT knows that there are many employers in the UK who genuinely wish to ensure a decent retirement for their workers and we believe the advent of this new type of pension system would be welcomed by many companies that have wished for a better alternative than the current DC system.

While the major disadvantage compared to DB schemes is that there is no guarantee, there are advantages. There is no reliance on employers: if the employer becomes insolvent the scheme is self-sufficient. It could be possible for a worker to keep their pension in one place under CDC perhaps through automatic pot-follows-member provisions.

Employers would welcome balance sheets that would not carry DB-linked liabilities, and members would not face cuts to their future benefits in order for the employer to repair a deficit. It would also mean that liability matching would be unnecessary so there would be less reliance on gilts and bonds.

One of the biggest drawbacks of the current DC system in practice has been the prevalence of employer and employee contributions too small to enable an adequate pension to be achieved. A new CDC system should aim to emulate the DB system in that adequate contributions should be expected or even required from the start. The new system should aim to be the Marks & Spencer or John Lewis of pension schemes rather than a British Home Stores.

- **How would a continental-style collective approach work alongside individual freedom and choice?**
  Individual freedom and choice in pensions is an option most likely exercised by those with greater financial sophistication and possibly larger pension pots. Members could be allowed to transfer out of a CDC scheme without detriment to the remaining members. But what it should do is create the kind of default retirement option that for most people is the best and easiest option. This is the norm in DB schemes: people can retire with their pensions paid directly from the pension scheme. Freedom and choice in pensions exists but not everyone wants to exercise it: what most people want is simply a pension they can rely on without needing a qualification in finance to operate it. People should also have the freedom to do nothing and stay put with a high-quality pension paid directly from the fund – the most cost-effective option for the great majority of them.

  Does this risk creating extra complexity and confusion? Would savers understand and trust the income 'ambition' offered by CDC?
  It has been suggested in some quarters that introducing a whole new type of pension scheme would gratuitously add a further complexity to the system. Sometimes this is heard from people who are well served by providing the status quo and unable/unwilling to engage seriously with innovation. AMNT argues however that, while at the level of pensions professionals CDC may create new complexities, it is a much simpler system for savers to participate in. The challenge will be to explain to working people the difference between the "ambition" in CDC on the one hand and the targets of current DC (or the "guarantee" of DB on the other. Countries such as the Netherlands and Canada have had these models in place for several years and Germany is now also looking at its viability.

  Any challenge in explaining what is new in CDC should not prevent its introduction as in our view it is a more cost effective, efficient option for working people. It is also a positive development for the government which has recognised the pressing need for millions of working people in current DC schemes to have far better financial education and access to independent financial advice for the current DC system and freedom and choice to work. This is not going to be achieved any time soon. This is also going to get worse as growing numbers of current DC savers reach retirement and need to make crucial financial decisions. A pension system that requires the re-education of millions of people is not a system that is working in their interests. Far better to create a new system that cuts out many third parties, saves money, does not require members to have elevated financial knowledge nor dependence on independent financial advice and thus creates better outcomes for working people. The level of member re-education that CDC would require is far less challenging than that still facing current DC.

  AMNT recognises the necessity that savers should feel able to trust the income ambition offered by CDC. We assert therefore that it should be established by regulation that collective defined contribution schemes must be trust-based and that scheme members should be represented on the board by member nominated trustees. The Work and Pensions Committee has itself acknowledged the general level of mistrust and disengagement with pension plans. Given the lack of a guarantee with CDC pensions it is absolutely vital that members have confidence that all decisions about the level of pension are fair and transparent and in the members' interests. Having member representatives on the board is a crucial part of this. A profit-oriented company setting up a pension scheme with no member representatives on the board is unlikely to inspire trust from members in the current climate. The very low level of engagement with members that is required of master trusts seriously weakens confidence in that model. USS, Railpen and Pensions Trust are just three of many multi-employer schemes that have no problem recruiting member representatives.

- **Could seriously underfunded DB pension schemes be resolved by changing their pension contract to CDC, along Dutch lines?**

- **How would this be regulated and how would the loss of DB pension promises to scheme members be addressed?**

We would answer these two questions together, noting first that there are various levels of serious underfunding in DB schemes.

First, there are those schemes which are so far beyond the capacity of sponsors to fund properly that their entry into the PPF is inevitable. If the sponsor continues to employ workers afterwards, AMNT would clearly see CDC as a better solution for future benefit accrual than current DC. If enrolment in a new scheme of that kind is regarded as a change in the old scheme's pension contract, then the answer to the first of this pair of questions is in AMNT's view is "Yes" – though we should not be wedded to the Dutch model in detail.

CDC will not, however, magically make good a deficit that the sponsors of a DB scheme cannot.

This guides our response also in relation to the two other levels of serious underfunding in DB schemes: (1) schemes which are in real danger of entering PPF but might be saved at the expense of a reduction in members' <u>accrued</u> rights under them which still offer those people a retirement income in excess of their prospective PPF compensation; and (2) those which the sponsor can fund in respect of accrued rights but is unable or unwilling to fund for future accrual.

AMNT does not believe it would enhance the future of pension saving in the UK to legislate for the breaking of contracts entered into by scheme sponsors and their workers, maintained by the former and relied on by the latter often over decades. It is bad enough that workers were rarely educated in the past to understand that if their employer went bust they might lose some accrued pension as well as current employment. Are workers now to be told that they may incur such a loss willy-nilly because their employers, while solvent, have other priorities? If the pensions world suffers from a lack of trust, it would deservedly suffer all the more if accrued pension rights were interfered with, even if that might – though with some difficulty – be squared with the Human Rights Act.

It may be that in some circumstances of difficulty active (or even deferred) members could be persuaded that a solution involving some abatement of accrued DB is preferable to any alternative. It is conceivable that something akin to CDC might provide a form of abated guarantee, but considerable care would be needed to ensure that repair of any deficit relating to the pure DB period remained the responsibility of a sponsor or its third-party guarantor. But we consider both these scenarios to be beset with difficulty in practice and we emphasise that any changes to the pensions promise *must* require the consent of the scheme members.

The normal route from DB to CDC would involve the closure of the DB scheme to future accrual and the enrolment of current and future workers as active members of a separate CDC scheme. The trust of younger workers in particular would be enhanced if no suspicion could arise that the ambition of the CDC scheme might be thwarted by the righting of deficiencies from the DB past.

Regulation, governance and industry issues:

How would CDCs be regulated?
AMNT would argue that CDC schemes should be regulated by The Pensions Regulator and that if that body were to require extra resources to take on this extended role, it would be firmly in the public interest that they be provided.

Is there appetite among employers and the UK pension industry to deliver CDC?
It has been difficult to gauge appetite, for where some interest has been expressed, it has generally been extinguished hitherto by the lack of legal framework arising from the absence of any settled date for the coming into force of section 3 and Part 2 of the Pension Schemes Act 2015 (on "defined ambition") and from ignorance of the secondary legislation that would be made under that Part. A most helpful initiative of the Select Committee would be to press the Government to go ahead sooner rather than later, without waiting to be half-drowned by a chorus of demand. It is encouraging that the Royal Mail pension scheme stakeholders are exploring this option. This clearly indicates that there is some appetite. While they reportedly believe that they can move ahead within the existing regulatory framework, we believe that in many other cases this would not be straightforward and in some cases not even possible. We believe, however, that the Royal Mail will be followed by many more, once stakeholders in other schemes begin to recognise this as a possibility. The principal barrier will be that a viable CDC scheme must acquire a certain critical mass within a short time of its inception.

Would CDC funds have a clearer view towards investing for the long term?
Most definitely. The advantage of CDC, assuming that the CDC system is designed from the outset to achieve economies of scale, would be that they could invest in a far wider range of investments and in the far longer term, for example in infrastructure projects that can last

up to half a century. Such investments would give CDC schemes access to risk and return that are not available in a current DC scheme. And whereas in current DC members are slowly transferred from equities to bonds to cash as they approach retirement, CDC allows for members to be exposed to higher risk assets not only up until retirement but also through retirement, the risk being mitigated by the overall intergenerational risk sharing nature of CDC.

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