

Collective bargaining

Hamish Wilson, HamishWilson, speaks up for employers' and members' right to choose their pension benefit design

These days freedom of choice is something we have come to take for granted (and expect) in the UK. However, one area where the right to choose remains sadly lacking is in pension benefit design and, more specifically, in whether or not we can choose risk sharing arrangements such as collective defined contribution (CDC). Collective DC, in a nutshell, is an evolution of traditional defined contribution (DC), or "raw DC", involving sharing risks between members. (It can also extend to employers, but only at their option.)

The UK government (on the advice of the Department for Work and Pensions (DWP)) has refused to acknowledge CDC is legal, citing European legislation as a barrier (though prominent pensions lawyers disagree) and a lack of demand (but how can there be demand for something that does not exist and where government is refusing to acknowledge its legality?). For many the concept of risk sharing is an attractive solution and many would argue that surely UK plc deserves the right to choose the most appropriate benefit design for its business and workforce.

Therefore we can conclude the future is DC... isn't it? This appears to be the case, but equally DC is far from perfect – indeed there must be a question about whether any form of retirement saving can be perfect! Set aside inadequate contributions, these arrangements are inefficient and there is significant volatility in the outcome. This makes DC in its purest form neither comprehensive nor sustainable for the members as they bear all of the risks and makes DC retirement provision akin to a lottery for all but the very few who take time out to understand *and* manage the situation and get it right!

Safety valves

So let us imagine a clean sheet of paper and consider what criteria would be

In a nutshell

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- CDC involves sharing risks between members
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needed for a good basis for retirement saving if we could start again from scratch, without the baggage of the past.

If we accept the future is workplace DC, we must strive to make it better. Firstly, it is crucial to respect the lessons of the past unless we wish to be condemned to repeat them. This means respecting the need to treat everyone the same irrespective of their age, sex or status (ie active deferred or in retirement) within the arrangement. This necessarily means basing their benefits on their career earnings (like DC) and crediting everyone with the same level of indexation on benefits credited in lieu of each year's contributions.

Like DC, with CDC the employer has the power to decide how much it is going to pay into the scheme and how long it pays that for (the pension age). It is fundamentally important the employer has the ability to cut its cloak according to its cloth – in other words, if an employer hits a rock in a few years' time, it has the right to alter future contributions (just as it has the right to change other terms of employment) if it deems this necessary for the future success or survival of the business.

It is equally important trustees have the ability to alter benefits in relation to past contributions should the need arise. This would be achieved according to "fair principles" and "best endeavours", accepting these are principles and do not amount to financial guarantees.



There are a number of safety valves in CDC meaning hasty "knee jerk" actions can be avoided. The first is time. As retirement income is being paid from the collective fund, there is no need to realise assets to buy annuities. This bypasses the danger of having to crystallise assets at the worst possible moment, for example, straight after a stockmarket crash. The second safety valve is the ability for retirement income to be adjusted according to the circumstances. This is essential to minimise cross-subsidies between generations and has implications for the calibre of trustees as well as their relationship with advisers – ie advisers advise; trustees decide. In addition it requires the trustees to recognise they must ask for advice in a way that avoids advisers pushing them into corners, perhaps



Wilson are we ready for risk sharing?

retirement income emerging for a given DC and introduce a two tier approach which strikes at the very heart of “collectivism”. A preferable approach is to allow a member the right at any time to take a transfer

allowing him to secure the added safety sought but at his cost.

Win win situation

So here is the best bit.

Hamish Wilson estimates CDC would, on average, result in between 35% and 45% higher benefits than under raw DC. This assumes the same input (ie contributions) over a full career. As important, this would be achieved with greater certainty, ie the outcome is more predictable there being less volatility in the outcome. The Government Actuary's Department (GAD) agrees with Hamish Wilson – its calculations suggested the advantage is 39% more benefits over a full career when compared to raw DC. These higher benefits are achieved through a combination of the benefits of collectivisation which includes a “level playing field” for all and so avoids the need to secure annuities. This has the added benefit of making it possible to be invested in growth assets for longer and avoid being a forced seller when times are tough. It is a win win situation.

Naturally, there are a number of challenges concerning CDC that do need to be addressed. One of the most controversial, for example, is if the employer enters tough times, trustees have the ability to take their foot off the accelerator for a moment by awarding lower indexation perhaps even pausing it. *In extremis* they could also reduce benefits. However, the likelihood of this eradicating the 35 to 45% advantage over raw DC is remote and ignores the reality that the action may be reversed if circumstances improve. So the question needs to be asked of whether it is right to deny society the opportunity to have CDC due to this risk? All types of pension arrangement contain risks of some description. And what many people forget is we already have an example of collective DC on our doorstep in the form of the Pension Protection Fund

(PPF), or *Partial* Protection Fund in this instance. So it seems to be a case of double standards to allow it in one area but to deny it to UK plc and its workforce.

A step in the right direction

Some people feel society is not ready for CDC and members should still have the option of buying an annuity upon retirement. But annuities (which carry a significant guarantee) are expensive and most people would not sign up to an arrangement whereby their peers might potentially benefit at their expense. Another question is whether we are ready for risk sharing. Or are we all inherently self-centred, ploughing our own furrow? The answer to this is the industry needs to become more long sighted; after all, we want the best for our children, including in retirement, and it is necessary to take action now.

However, there is a ray of hope. In June 2010 the Chancellor appointed Lord Hutton to undertake a review of public sector pensions. Following an interim report in October 2010, more radical options – including CDC – were put under the microscope. The final report in March earlier this year announced that DB was here to stay for the time being in the public sector, but the very fact Lord Hutton even included CDC was a step in the right direction. What we desperately need now is a similar review for the private sector carried out by a “private sector Lord”.

Making CDC happen is definitely the biggest challenge of all and everyone has to raise their game. The DWP confirmed CDC's efficiency over raw DC, but dropped the idea anyway. We could argue it is a case of be careful what you ask for. Instead of asking if it is possible, we should ask what conditions would be necessary to *make* it possible.

Ultimately change needs to be driven by the industry and a small seed has been planted in the form of the recently formed CDC Forum. We cannot sit back and wait for the next generation's objections; this is not to say that CDC is the answer to all our problems, but for some organisations in the UK, CDC could prove the best solution and surely these employers and members should have the right to make their own decisions.

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inadvertently. The third safety valve is around half of the fund is absorbed by the cost of indexation.

This means that having regard to all the safety valves, it is more likely indexation is adjusted to accommodate changes of a temporary nature with the core benefit being adjusted to accommodate changes that are perceived to be more permanent. Identifying the difference between temporary and permanent will be a challenge and a balance must be struck ultimately by the trustees.

What I have just described is CDC in its purest form. There are other arrangements out there masquerading as CDC which include guarantees or insurance of some kind. Both of these ratchet up cost and reduce the resulting

