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CDC Pensions and Spotify – More in Common than You Might Think

Collective Defined Contribution, or CDC, could transform the retirement experience, argues First Actuarial's Henry Tapper

Services like Spotify have revolutionised the way we consume music, by giving music fans what is effectively a radio station with a difference – they, not the DJ, get to choose the music they listen to.

To understand what on earth Spotify might have to do with the distinctly un-musical world of pensions, we need look no further than the growing popularity of Collective Defined Contribution schemes, or CDC, in what is already a crowded space.

Let's start with Defined Contribution pensions

One of the hardest things to explain to someone with a DC pension is that it's not a pension. People save money throughout their working lives and accumulate what is really a 'pot' – a reservoir of capital, the result of a lifetime of regular saving. The average DC pot saved is less than £40,000.

That £40,000 average will creep up in time as:

- more people use DC as their primary means of retirement saving
- auto-enrolment kicks up the savings rates
- more people engage with what is still the best long-term savings show in town.

But many people with small pots will need to convert those pots to pension income sooner than that.

Top tier DC pension-holders – living with a mixed blessing

What of that small but growing group of DC wealthy individuals who have either been saving into a well-funded DC plan and are now mature savers? Or people who have taken their transfer values and are now savings-wealthy? For those people, the options are advised drawdown, non-advised drawdown, robo-drawdown, or an annuity.

I speak with quite a few senior pension managers in my line of work. The word on the street is that employees reaching their last decade of work with large sums of pension savings are not satisfied that those drawdown choices provide them with the 'wage for life' implied in term 'workplace pension'. Nor are they happy with the low income provided by an annuity.

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Ironically, many of these 'wealthy' savers are not wealthy at all. I met a number of steel

workers in Port Talbot in the midst of the recent pension scandal there. They were shocked to be told they needed wealth management skills in order to manage their pension pot themselves.

I fear that for many of them the novelty of being savings-wealthy will wear off quite quickly. Indeed, during the recent market wobble, the visibility of their online fund values led one steel worker to tell me he'd lost in a week what he expected to earn in a year. His capacity for loss was put to the test.

The Royal Mail pension dispute – CDC comes of age

The problems of imposing either restrictive annuity arrangements or inappropriate wealth management solutions on people with limited appetite for risk or financial capability, is one that exercised the minds of the Communication Workers Union. I can say that with certainty, as First Actuarial advised its senior officials during the protracted pension dispute with Royal Mail.

From an early stage in the dispute, it was clear that the Royal Mail lacked the financial strength to support ongoing accrual of the defined benefit scheme on its balance sheet. As 2017 wore on, it became obvious that even a watered-down DB scheme, with limited guarantees, was a burden that Royal Mail could not carry. At best, Royal Mail could only partly guarantee a cash sum at retirement – which employees would have used to buy an annuity or transfer into a wealth management solution.

Critically though, the postal workers were telling the CWU they did not want a lump sum or an annuity or a drawdown plan. Instead, they wanted a 'wage in retirement', which roughly translated into a stream of monthly payments paid until they died. 89.1% of the vote supported the CWU pushing for a wage for life over a cash sum – or 'pot' – at retirement.

The first breakthrough in the negotiations, which by autumn 2017 had reached the reconciliation service ACAS, was an acceptance by both sides that a CDC pension was the only way forward in terms of corporate finances. The DC element, as in defined contribution, of CDC would impact Royal Mail's cashflow, but not its balance sheet. The second breakthrough was a recognition that upgrading the plan from DC to CDC also made it possible to provide a wage for life or 'pension' for the scheme membership.

What is a Collective Defined Contribution (CDC) pension scheme?

It is a scheme in which the defined contributions are not paid into a separate investment account for every member, but are held in one pool, collectively. An actuarial plan decides what target benefits can be afforded from the assets and contributions.

Why is CDC a good idea?

Collective investment can be both more rewarding and less risky. In a DC scheme, an individual is always either accumulating or decumulating, with the attendant exposure to market value volatility and high cost of annuity purchase.

In an open collective scheme, benefits are paid out of contributions and asset income, with minimal exposure to short-term market value volatility. Collective investment has a longer time horizon than individual DC investment, making it possible to invest more rewardingly, and on average provide higher, more reliable benefits.

There is not the space in this article to go through every detail of this agreement, but the

two sides accepted that targeting pensions, rather than guaranteeing them, gave both workers and employer the common ground they needed to stay at work and build a broader agreement that would help Royal Mail recover after a bruising year.

Recover it has indeed done, and in spectacular fashion. Its share price has rebounded by 50% since November 2017, primarily on the news that a resolution to the pension dispute has been found. Royal Mail's return to the FTSE 100 looks like a foregone conclusion, and nearly £2bn has been added to its capitalisation.

This recovery is fragile though, as the settlement is dependent on the completion of secondary regulations for this DC upgrade to happen. At the TUC pensions conference in February 2018, the Pensions Minister warned that there is still a long way to go before the CDC scheme can be set up, and in the meantime Royal Mail will be operating an interim cash-balance solution.

But I sense an urgency in Whitehall to make this deal stick. There aren't many good news stories in this period of fraught Brexit negotiations, and that £2bn increase in Royal Mail stock has great political capital.

That then is the story of how Royal Mail, its union and its staff came to avoid a strike, find favour with the markets, and reach what all sides hope will be a lasting pension settlement.

Does this have broader relevance? Well it wouldn't surprise me to see organisations operating well-funded DC schemes, or DB schemes with high cash equivalent transfer value (CETV) take-up, keen to find a way to upgrade DC. When news gets out of the Royal Mail settlement, even the large own-occupation DC schemes might start looking at the cost of a DC upgrade.

Great news – but what about Spotify?

Spotify has achieved success not by adding anything new, but simply by providing a better way to access what people value most. CDC may only be a DC upgrade, but it offers the potential to do to workplace pensions what Spotify has done to the way we listen to music. It could make retirement easier, and more rewarding, for millions of people.

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About us

First Actuarial LLP is a nationwide partnership with more than 250 staff covering five offices. Each office provides our full range of services.

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