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CDC – a new era for UK retirement

In October 2024, collective defined contribution (or CDC) finally became a reality in the UK. It had taken more than five years from when the then Conservative government had given the green light to Royal Mail's and the Communication Workers Union's joint plans to launch a single employer CDC arrangement. However, within just a few days of the launch of Royal Mail's scheme, the new Labour government had signalled its enthusiasm for CDC by starting the long-delayed consultation on multi-employer CDC arrangements, with the first schemes mooted for launch in early 2027.

What does CDC do?

Like a defined contribution (DC) scheme, contributions in a CDC arrangement are defined, so the employer is not on the hook for any additional contributions. Like a defined benefit (DB) scheme, longevity and investment risk are pooled and members are provided with an income for life in retirement. But unlike DB, where these risks are borne by the company via its future contributions, in CDC it is future annual increases (for active, deferred and pensioner members) that depend on scheme experience. CDC schemes must target annual increases of at least CPI inflation but actual increases will be higher or lower than the target, depending upon experience, and can even be negative. The table below summarises how CDC sits between DB and DC provision.

	DB	CDC	DC
Employee contributions	Fixed	Fixed	Fixed
Employer contributions	Varies	Fixed	Fixed
Trustee oversight	Yes	Yes	Sometimes
Benefit accrual	Fixed/stable	Fixed/varies	Undefined
Benefit/funding risk with	Company	Member	Member
Member flexibility	Limited	Limited	Wide
Income security	Very high	High	Low

What does this mean for likely benefits?

Our modelling shows that CDC may deliver a retirement income between 20% and 50% more than traditional (individual) DC with drawdown in retirement.*

*Based on a 20 year old earning £15,000 and accepting a 1 in 4 risk of ruin (ie a 25% chance of running out of money in retirement).

This is attributable to the benefits of longevity pooling (those who die sooner than expected subsidise the pensions for those who live longer than expected) and intergenerational risk sharing (being able to take greater investment risk through the retirement journey as compared with individual DC).

Automatic enrolment (AE) may have been a success in significantly increasing the coverage of DC pensions, but DC members on current AE minimum contributions are unlikely to find they have adequate retirement outcomes.** With this backdrop, CDC could be a game changer for the current adequacy crisis in UK pensions.

** For further insights, **see our blog** on how longer working lives and higher contributions are essential to achieving adequate retirement outcomes.

How does collective funding affect CDC scheme design?

As well as pooling longevity and investment risk, there is another form of pooling that happens in CDC – collective funding. This is a key issue to consider when settling on the design of a CDC scheme.

Collective funding has always been a fundamental part of DB schemes, but there the employer is meeting the balance of the cost of providing the benefits. In CDC it's the members who are carrying the risk of poor performance. In a CDC arrangement like the Royal Mail's, which has a uniform 1/80th accrual rate for the same level of member contributions across all ages, there will be significant inter-generational cross-subsidies (the younger members subsidising the older). That may be acceptable if workers tend to stay with the employer for the long term and there's confidence that the workforce itself will be relatively stable over that timeframe. But CDC doesn't have to involve such a level of inter-generational cross-subsidies – for some employers, a more sophisticated scheme design may be needed. That will certainly be the case for multi-employer CDC.

Is CDC for all?

As we've seen from our modelling, for a fixed employer contribution CDC has the potential to offer a higher level of retirement income than individual DC, although actual results may vary. If that sounds too good to be true, it may well prove to be for some employers.

To be cost-effective, single employer CDC will probably require a workforce of at least 5,000 employees, and some confidence that the workforce won't decline over time. Multi-employer schemes will make CDC accessible for much smaller employers but, by definition, that will mean they will have little control over plan design, investment strategy, governance and a range of other factors (in much the same way as in a DC Master Trust, which large numbers of employers are in today).

Given that the advantages of CDC stem mainly from the areas where it resembles DB, this raises a question about how much of what CDC offers could be achieved under the existing, or a revised, DB framework. This is particularly relevant for the minority of employers with a sizeable DB scheme who are contemplating running on their scheme to generate surplus rather than buying out the liabilities. Does DB have a role to play here, not just in terms of the management of their legacy assets and liabilities, but also in terms of future retirement provision? Whilst CDC protects the employer from having to pay more than its fixed level of contributions, it also deprives the employer of any opportunity to benefit from the upside.

Could DB make a comeback?

Let's start by making it crystal clear that we are not thinking there'll be a return to DB as we knew it in the past! However most companies in the private sector have simply not thought about possible DB designs for future service for many years. By contrast, in the public sector, there are plenty of DB schemes which are open to accrual and new members – and they are generally in good financial health. In part, that's because, with long-dated fixed interest gilt yields in the range of 4% to 5% over the past two years (albeit they are even higher just now), the company's share of the cost of DB accrual is comfortably less than half of what it was three years ago (when yields were between 1% and 2%).

DB scheme design is also very flexible. Most of the constraints of traditional DB no longer exist. With no contracting-out, there's no reference scheme and therefore no requirement to provide any particular level of accrual, nor to provide an automatic spouse's pension. DB schemes do still have to provide some indexation of pensions in deferment and in payment – in line with CPI capped at 2.5%.

However, even employers who now feel confident about managing their past service liabilities are likely to think twice before starting to offer DB accrual again. The main problem is that a DB scheme cannot properly hedge its future service liabilities against a fundamental and long-lasting reduction in gilt yields.

But there are still ways that the company can protect itself against falling gilt yields. One such design is to offer dynamic accrual rates – an accrual rate that flexes up and down as market conditions change.

Perhaps a better way to do this would be for the company to start by setting its contributions budget, out of which it provides a modest level of career average DB accrual plus the balance of the budget as a DC contribution. If gilt yields reduce, this pushes up the cost of DB accrual and reduces the member's DC contribution – and vice versa. If long-dated gilt yields were to fall back to 1% to 2% (which is where they were for most of the period from 2016 to 2021), the cost of the chosen DB accrual might take almost all the company's budget.

Although it is not the easiest design to communicate, this would give employees the chance to earn a base level of DB pension whilst essentially capping the company's contributions.

Simplifying DB for the future

There are two main areas where the Government could make it easier for companies to contemplate offering DB accrual again.

1

It would be helpful if the Government was prepared to remove the requirement for any guaranteed indexation in payment (and possibly revaluation for active and deferred members before retirement too?), allowing schemes to provide discretionary pension increases when they can afford it. After all, increases are not guaranteed in CDC. Clearly, such a change would need to work in conjunction with a well-defined surplus-sharing mechanism. So the company gets rewarded for the risk it takes in providing DB benefits, whilst value is shared with members to provide pension increases in payment (and possibly revaluation pre-retirement too).

2

A second, more radical, area of new flexibility would be to allow DB schemes to flex pension amounts in line with longevity changes, ie allowing schemes to adjust pensions in payment if life expectancy increases faster (or slower) than anticipated. Combined with a normal retirement age set equal to State pension age (which it's already possible to do), this would provide schemes with a good measure of longevity hedging both before and after members' retirement.

Summary

CDC has arrived and will provide a genuinely new form of retirement provision for some employers. It is designed to provide an attractive combination of better outcomes for members than individual DC, for a fixed employer contribution.

But companies should not discount DB as a possibility for future accrual. This is particularly true for companies who are contemplating running on their existing DB schemes, aiming to generate surplus for themselves and their members. In that context, we would encourage the Government to get on with making it easier for companies to access surplus in their DB schemes and also to look at ways to make DB provision itself more flexible.

If you would like to discuss further, please do get in touch.

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