Pensions Policy Institute
PPI

Roundtable Write Up

Quantifying multi-employer and single employer CDC outcomes

Overview

On Tuesday 19th November 2024, the PPI hosted a roundtable event to launch the Briefing Note **Quantifying multi-employer and single employer CDC outcomes.**[1] This is the second Briefing Note in this project which is a unique collaboration between the PPI and KCL, funded by a grant from the Nuffield Foundation. The aim of the research is to determine how CDC funds should operate within the UK pension environment and identify the potential benefits and challenges.

The event was chaired by **David Fairs, LCP, and chair of the project advisory group**. It was attended by around 40 people representing a cross section of the industry.

This roundtable will explore the potential design and implementation of multi-employer CDC schemes, showing how the operating principles may need to diverge from those of a single employer scheme. The research quantifies how member outcomes might differ, and explores questions of potential unfairness within multi-employer schemes that stem from the principles they must employ.

John Upton, Policy Modeller, PPI presented the key findings from the briefing note. He gave an overview of the key conclusions from the research:

- A single employer CDC scheme outperforms an equivalent Defined Contribution (DC) scheme regardless of economic conditions, but to varying degrees.
- A multi-generational cross subsidy effect, which is also observed in an equivalent Defined Benefit scheme, is present in the single employer scheme. This leads to later generations subsidising the earliest generations in the scheme.
- A multi-employer CDC scheme outperforms a single employer scheme and offers a higher retirement benefit, owing to different operating principles.
- There exists a potential for cross-subsidy between demographic groups with different mortalities. This could be addressed by either:
    - Creating multiple sections within the scheme each with a homogeneous membership;
    - Underwriting each member and pricing benefits accordingly, but it may not ensure fairness as reliably as keeping different memberships separate.

Dr John Armstrong, Principal Investigator of the project, KCL gave a response and introduced further conclusions from the research.

- The difference between single and multi-employer scheme stems in part from the membership profiles developing over time.

[1] Upton, J. (PPI), (2024), *Quantifying multi-employer and single employer CDC outcomes.*

- The sensitivity of members to investment returns and discount rate allows the transfer of risk from older to younger generations. This transfer of risk implies a transfer of value.
- The time value of risk quantifies a subsidy from younger to older scheme members. This is quantified through calculating the value of implied derivatives between members.
- Single employer schemes offer an immediate profit or loss to members depending on their age, similarly to a DB scheme. The observed effect is 4x greater than for a CDC scheme than an otherwise equivalent DB.
- Single employer schemes build up an immediate debt which must be paid off over the lifetime of the scheme to the detriment of later members. This drag has greater impact on a CDC scheme as the interest rates involved are greater than a DB scheme.
- Multi-employer schemes also generate intergenerational cross-subsidies. Some of this stems from the difference between central estimate and derivative pricing techniques. The difference is not symmetrical.
- An employer contribution is needed to ensure that membership of a multi-employer CDC scheme is in the best interests of the member at all ages.
- The target indexation of a multi-employer scheme is not a useful design tool as experience of market conditions will step the actual indexation away from the target. There is no method of managing this without additional consequences (such as altering the risk profile of investments to target different returns).

Roundtable discussion

The following areas were addressed during the discussion which was held under the Chatham House Rule

Pricing

- The implications of using a derivative based pricing mechanism against a central estimate pricing mechanism.
- Reflections upon the impact that the current state of the scheme determines pricing which may generate a potentially significant discrepancy.
- An investment strategy matching the risk profile to the liabilities can help mitigate the volatility of outcomes against contributions.

Fairness

- Individual fairness
  - It is particularly challenging to offer individual fairness and shared indexation at the same time.
  - For complete individual fairness it becomes necessary to track individual contributions at the cost of the collective nature of the scheme.
  - The degree to which age-based unfairness can be addressed through risk profiling and pricing.
- Current measures of fairness are hard to justify in a single employer CDC scheme:
  - The relative difference in value between younger and older members
  - The same arguments can be levelled at a DB scheme which is reliant on cross subsidy
- This would suggest there is an acceptable amount of cross-subsidy in a single employer CDC scheme.

- If single employer CDC invested similarly to a DB scheme:

- How the cross-subsidies, fairness and outcomes for members would be more similar;
- It would be hard to justify such similar investment strategies with the different scheme ambitions.

- Whether that the perception and treatment of fairness in a CDC scheme (when compared to the alternatives) was being used unfairly against CDC schemes.

Multi-employer CDC schemes

- Communication with members brings new challenges:
  - Two members, of close ages, may look at their relative pricing in a multi-employer scheme and because of difference in ages and risk profiling will be offered different benefit prices. It will be hard to communicate the reason for the difference in their prices.
  - How expected returns are applied and used to derive benefit prices.
- Pricing of multi-employer schemes:
  - Pricing difference comes from the complexity of the current state of the scheme.
  - Pricing will account for risk pricing but cannot track the current state of the scheme.
  - The use of annual valuations may not account for all the risk necessary for the pricing as there will be divergence over the year and the price may no longer adequately reflect the scheme status.
- There is no official comment on the use of gender-based underwriting / pricing.

An employer's view upon multi-employer CDC schemes

- Where an employer may place members in a scheme for a limited period:
  - Age based accrual can still result in significant loss in a particular year. This is in limited scenarios and over a lifetime do cancel out significantly.
  - For an employer who is interested over a lifetime value is maintained.
  - For an employee who is a member for just a single year there is a risk of receiving a less than acceptable pension.
- An employer's contribution can make up for the value of the benefits against an employee's contribution.
- Performance of multi-employer CDC is better than individual DC, so despite any shortcomings of a CDC scheme there remains a benefit to the member from using CDC.

An INDEPENDENT Briefing Note by the Pensions Policy Institute

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