

Department for Work and Pensions

Research Report No 623

Employer attitudes to collective defined contribution pension schemes

Elizabeth Jordan and Andrew Thomas

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for Work and Pensions

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Summary

Background and research aims

In 2006, the Government published the White Paper 'Security in retirement: towards a new pensions system'¹, which included an announcement of a rolling deregulatory review of private pensions legislation. Part of the deregulatory review comprised a pension scheme risk sharing consultation in summer 2008.²

One potential new approach to risk sharing in pension schemes are collective defined contribution (CDC) schemes. From the employers' perspective these CDC schemes would be similar in many respects to defined contribution schemes as the employer would provide no guarantee towards any level of pension and would have certainty about the level of its contributions. However, from the employees' perspective, the risks associated with a pure defined contribution scheme could be somewhat mitigated as contributions would be paid into a collective fund instead of individual savings accounts. The fund would be managed by a board of trustees.

Pooling members' investments would allow risk to be shared between members, thereby reducing the effect on those who retire at a time when asset values have fallen and potentially providing greater predictability of retirement income. The employer would bear no investment risk and could not be forced to increase their contributions.

The equivalent of the CDC scheme's liabilities would always be equated to the scheme's assets by changing the level of indexation or revaluing members' pensions. Therefore, no funding deficit could occur. If the value of the scheme's assets did not rise as expected, during a period of low growth for example, indexation could be reduced, or members' projected pensions (in particular younger members)

¹ <http://www.dwp.gov.uk/policy/pensions-reform/security-in-retirement/white-paper/>

² <http://www.dwp.gov.uk/docs/pensionrisksharing-consultation-june2008.pdf>

might be re-valued to ensure that the scheme's liabilities match its assets. The scheme's funds (and therefore younger members' projected pensions) should have sufficient time to recover losses and eventually restore these pensions.³

The consultation on risk sharing found broad ranging support for CDC schemes but qualitative research⁴ examining the concept of risk sharing amongst employers indicated that there was some reluctance to adopt a CDC approach.

In their response to the risk sharing consultation⁵, the Government decided to undertake further research to understand how CDC schemes might operate in the UK if they were to be enabled. The present research was commissioned by the Department for Work and Pensions (DWP) to explore employers' responses to potential CDC schemes in more depth. Unlike the earlier qualitative research, which looked at risk sharing in general, this project focussed exclusively on CDC schemes.

The research aimed to explore four key topics:

- employers' understanding of potential CDC schemes, including various aspects such as pooled funds, risk sharing and smoothing;
- employers' reactions to the practical aspects of CDC schemes, such as communicating CDC schemes to members, redistribution between members, investment strategies and administrative costs;
- whether employers would find CDC schemes appealing and, if so, under what circumstances; and
- whether employers would be willing to join with other employers to offer a CDC scheme.

Research methodology

The research adopted a wholly qualitative methodology, comprising 45 face-to-face in-depth interviews with employers. Employers were sourced from a number of business directories and commercial databases that are available to the public. Fieldwork was spread across England and took place between June and July 2009. Interviews were recorded and subsequently analysed using Matrix Mapping, a rigorous content analysis process, see Appendix C.

Employers were sent a descriptive summary of CDC schemes, designed by DWP and BMRB Qualitative Research, and asked to read the document before the interview as it would form the basis of much of the discussion, see Appendix A.

³ See Appendix A flowchart for further details.

⁴ Thomas, A. and Allen, A. (2008). *Employer attitudes to risk sharing in pension schemes: a qualitative study*. DWP Research Report 528.

⁵ <http://www.dwp.gov.uk/docs/govt-response-risk-sharing-consultation.pdf>

The sample of employers was structured according to three key factors: size⁶ (250-499, 500-999, 1,000+ employees), industry sector (manufacturing, retail, services, and other), and current pension scheme arrangements⁷.

The views of employers offering different types of pension schemes were examined to understand how employers' responses to CDC schemes differed depending on the type of pension scheme they currently provided or had provided.

Defined benefit schemes

Defined benefit (DB) (or salary-related) pension schemes guarantee members a retirement income that is related to the employee's earnings history, length of service and age, rather than depending on investment returns. This provides members with security as the level of pension is assured and predictable. However, if the pension fund does not deliver sufficient returns, the employer becomes liable to make up the difference. DB pension schemes require governance by a board of trustees.

Defined contribution schemes

In a defined contribution (DC) (or money-purchase) pension scheme, contributions are paid into an individual account for each member. Unlike a DB scheme, the amount of pension payable from a DC scheme is not guaranteed and depends on the investment performance of the pension fund and the annuity rates at the time of converting the pension fund into a retirement income. A DC scheme can either be trust-based or contract-based. A trust-based scheme requires a trustee board to manage the operation of the scheme; a contract-based scheme is an individual contract between a pension provider and the employee, to which the company contributes.

Key findings

Employer views about collective defined contribution pension schemes

CDC pension schemes would be designed to provide a more predictable level of retirement income whilst removing any financial liability due to poor investment returns for the employer.

⁶ As it is thought that only larger employers could offer CDC schemes without joining with other organisations, employers with fewer than 250 employees were excluded from the study.

⁷ The sample design included 19 employers who operated a trust-based scheme (requiring a board of trustees), 12 operated a trust-based scheme alongside a contract-based scheme and 14 who operated a contract-based scheme and had no experience of running a board of trustees. It was not possible to undertake analysis on other sub-groups due to small cell sizes.

Employers were asked to discuss a number of issues associated with CDC schemes: fixed contributions and governance cost; governance by a board of trustees; delivering greater security of retirement income; payment options; joining an industry-wide scheme; and how employees may respond.

Cost

When considering the cost of a CDC scheme, employers considered two aspects, the cost of pension contributions and the costs of managing the pension scheme:

- Fixed contribution rates for employers were considered an important feature of CDC schemes as fluctuating rates were a key reason why employers had closed down, or were considering closing, their DB schemes. Those operating a DC scheme would also not consider adopting a pension scheme where contribution rates could fluctuate. There was a concern, however, that should investments perform poorly, leaving some members with pensions that were lower than expected, employers might be placed under a moral obligation by employees to increase their contributions in order to maintain a minimum level of benefit. They were also worried that the Government might transfer liability to the employer to protect members whose pensions were lower than expected.
- Employers were also concerned that the benefits of a CDC scheme would be significantly outweighed by the cost of trustee management, which, together with advisers' fees, would significantly increase costs when compared to a contract-based DC scheme. This view was shared by employers that had closed their DB schemes, as well as those still operating open DB schemes. Employers operating a trust-based DC scheme did not cite governance costs as a concern.

Governance

Aside from the costs involved with the governance of CDC schemes, employers were concerned that trustees may not have sufficient experience to manage the scheme's funds effectively given the additional complexities of CDC schemes. Employers were concerned that there might be some financial liability, for poor investment choices, placed on trustees as their decisions (e.g. in reducing projected pensions in order to smooth risk across members) could have a direct effect on members' pensions.

Delivering greater security

Employers generally recognised that CDC schemes would aim to deliver greater security and less volatility of retirement income and this was seen to be a significant benefit. However, employers were concerned about the overall stability of the financial markets and were cautious about the concept that CDC schemes could provide greater predictability. In addition, members' pensions would not be guaranteed. As these schemes would offer no guarantees of retirement income, employers perceived the suggestion that there would be greater security to be potentially misleading.

There was some support for pooling as a mechanism for smoothing risk across members – because investment rates do not fluctuate greatly over long periods of time, CDC schemes may allow risk to be smoothed across many years. As a pooled fund, investments would have time to recover whereas individual DC pension pots may provide a pension much lower than had been predicted for members who draw a pension at a time when fund values have substantially fallen.

One possible risk sharing feature of CDC schemes would be to maintain the level of the pension fund of older workers by reducing the projected pensions of younger members, the assumption being that the pension funds of younger people have more time to recover. Although in principle employers thought that the built-in flexibilities of indexation and revaluation were a ‘sound’ idea, they were concerned that it might not work in practice. Specific issues raised by employers included:

- the potential impact of a sustained downturn and the effect of maintaining pensions in payment by revaluation of younger members’ pensions;
- the risk of scheme instability might be greater in an organisation with an ageing workforce; and
- there may be age discrimination issues if pension adjustments were based on length of service.

Payment options

The CDC scheme presented employers with two options for the payment of pensions: payment directly from the scheme fund, or using the individuals’ fund to purchase an annuity.

In principle, employers thought that paying pensions directly from the scheme’s funds should deliver a better retirement income compared with purchasing an annuity (where rates could be unfavourable during periods of economic uncertainty). However, there was a concern that in a long period of economic uncertainty or low growth, or if the scheme was poorly managed, there might not be sufficient funds to cover future pensions if payments were made directly from the scheme’s funds. This would be a particular concern where schemes had disproportionately high numbers of pensioners or members reaching retirement age.

In order to provide stability to employees, it was considered essential that pensioners’ income should remain stable or increase. Employers were concerned that paying pensions directly from the scheme’s funds might not offer security as pensions could be open to revaluation even when in payment.

Employers, therefore, were more in favour of purchasing an annuity because it was seen as providing greater certainty for both the employer (because the cost of retirement would no longer act as a liability for the scheme) and employee (because an annuity would provide a guaranteed minimum level of benefit). They were still concerned however, that suddenly being exposed to variable annuity rates

seemed to be in direct contradiction to the risk sharing concept and undermined the CDC claim to greater security.

Views about industry-wide CDC schemes

There is a perception that some organisations may be too small to benefit from a CDC scheme. Smaller employers, with less than 500 employees, might find that it is beneficial to join an industry-wide scheme.

Employers thought that joining with other organisations would be beneficial as this would increase economies of scale, although there were some concerns:

- uncertainty about trustee selection and representation of employers;
- the effect on other employers, if an organisation chose to leave the scheme or could not maintain its level of contributions; and
- some organisations, particularly charities, would need to agree on an ethical investment strategy before joining up with other employers.

Employers' views about how employees would respond to a CDC scheme

Employers were asked to consider whether CDC schemes would be more or less attractive to employees compared to their current pension provision. Employers thought that employees were generally becoming increasingly disengaged from their pension scheme. There were five reported reasons for this:

- changes to DB schemes such as increasing the retirement age, adjusting accrual rates and increasing employee contribution rates;
- reductions in the value of projected pensions;
- media coverage of pensions as volatile and insecure;
- some groups of employees were uninterested in pensions, particularly young people, staff on lower incomes or in organisations or sectors with a high staff turnover; and
- a perception that employees find pensions difficult to understand.

Therefore, there was a perception that pension schemes need to deliver a stable and predictable retirement income in order to re-engage employees. While employees may appreciate that CDC schemes would be designed to deliver better security of retirement income, it was thought that concepts such as indexation and revaluation would be difficult for employees to understand. As a consequence, employers thought that there might be a negative response from younger members, if the value of their pensions were reduced to maintain the level of older workers' pensions.

Additionally, as CDC schemes would not offer a guaranteed level of pension, employers thought that employees might not consider the scheme to be any more valuable than a DC scheme.

Unlike contract-based DC schemes, investment choices for CDC schemes would not require any involvement from members, which employers thought would be viewed as a positive feature of the scheme by the majority of employees. For a minority of employees, who are informed and engaged with the investment of their pension fund, this might however be seen as a disadvantage.

Employers' views about CDC schemes in comparison to DB and DC schemes

Employers were asked to consider CDC schemes in comparison to their current pension scheme arrangements and the conditions under which they would or would not consider switching to a CDC scheme if they were enabled.

CDCs in comparison to a DB scheme

Employers who provided a DB scheme were more likely to express a paternalistic attitude to the provision of a pension scheme. However, some employers felt that they could no longer continue to provide a DB scheme.

There was a perception that CDC schemes could provide a middle ground between a DB and a DC scheme as CDC schemes transfer responsibility for investment decisions from the member to the board of trustees and may reduce the level of risk on individual members.

However, employers were concerned that pensions provided by a CDC scheme would be much lower than a DB scheme and were liable to fluctuate. For those considering switching from a DB scheme, a CDC scheme would be no more attractive than a DC scheme unless it was possible to incorporate a mechanism which shared part of the risk between the employer and employee and provided a guaranteed minimum level of benefit.

CDCs in comparison to a trust-based DC scheme

For employers that operated a trust-based DC scheme, the costs of operating the board of trustees were not raised as a concern. However, these employers were concerned that the governance of CDC schemes would be more complex than trust-based DC schemes due to the necessity of revaluation to ensure that assets matched liabilities. CDC schemes might place greater responsibility on trustees as their decisions would have a direct impact on the value of pensions whilst individual members would no longer have any influence over the choice of fund. Employers who operated trust-based DC schemes were therefore concerned that it might be more difficult to recruit trustees for a CDC scheme than a DC scheme.

CDCs in comparison to a contract-based DC scheme

Employers who provided a contract-based DC scheme might consider switching if current DC schemes continuously deliver low levels of pension or if CDC schemes were adopted by their competitors and were therefore expected by employees. With the exception of employers that felt they were not currently able or willing

to take on any additional costs, employers who provided contract-based DC schemes said that they would consider switching to a CDC scheme, but with four important conditions:

- the employer liabilities were fully described and guaranteed not to change;
- the benefits of a CDC scheme were demonstrable to both employers and employees;
- the additional administration costs (trustee board, advisers' fees, etc.) were fully ascertained and did not outweigh the benefits of a CDC scheme in terms of delivering a greater level of pension for employees; and
- future pension reductions were borne solely by the members.

Conclusions

Employers recognised that CDC schemes would aim to provide financial security to employees without transferring the financial risks and liability to employers, and so offered a middle ground between a DB and DC scheme. However, they were seen to offer no greater security than a DC scheme because pensions would not be guaranteed and employers thought that they were unlikely to provide a level of pension comparable to a DB scheme. Compared with a contract-based DC scheme, there were also the additional costs of a trustee board and professional advisers which could be substantial. There was a perception amongst employers who had moved to a trust-based DC scheme that the level of responsibility and potential liability on CDC scheme trustees might be greater as their decisions would have a direct effect on members' pensions.

Employee engagement could be a key driver which might motivate employers to adopt a CDC scheme. Employers thought that employees had become increasingly disillusioned with pensions as a way of securing a reliable retirement income. If CDC schemes could be shown to deliver greater security by reducing the volatility for employees reaching retirement this may reassure employees and demand for alternative pension schemes may increase.

Consequently, employers indicated that although the CDC concept had its appeal they would be unlikely to consider switching to a CDC scheme unless the running costs and trustees' liabilities were commensurate with its ability to deliver longer term stability and greater financial return.

1 Introduction

1.1 Background

In 2006, the Government published the White Paper '*Security in retirement: towards a new pensions system*⁸', which included the announcement of a rolling deregulatory review of private pensions legislation. The aim of the review was to make the private pensions regulatory framework simpler and seek to recommend changes for the future that would make running schemes easier, lighten regulation and reduce bureaucracy and cost while maintaining adequate protection for members. It was to consider a range of measures affecting both administrative costs and the costs of provision. Part of the deregulatory review comprised a pension scheme risk sharing consultation⁹.

One potential new approach to risk sharing in pension schemes are collective defined contribution (CDC) schemes. From the employers' perspective, these CDC schemes would be similar in many respects to defined contribution schemes as the employer would provide no guarantees towards any level of pension and would have certainty about the level of its contributions. However, from the employees' perspective, the risks associated with a pure defined contribution scheme could be somewhat mitigated as contributions would be paid into a collective fund instead of individual savings accounts. This would create economies of scale and potentially provide greater predictability of retirement income for individual members by sharing investment risks between them.

Pooling members' investments would allow risk to be shared thereby reducing the effect on members who retire at a time when asset values have fallen. Should the value of the scheme funds fall, due to poor performance of investments, the effect on members reaching retirement age could be minimised by reducing indexation or revaluing younger members' pensions. The scheme's funds (and therefore younger members' projected pensions) should have sufficient time to recover losses and eventually restore these pensions.

⁸ <http://www.dwp.gov.uk/policy/pensions-reform/security-in-retirement/white-paper/>

⁹ <http://www.dwp.gov.uk/docs/pensionrisksharing-consultation-june2008.pdf>

The consultation on risk sharing found broad ranging support for CDC schemes as a possible risk sharing approach. However qualitative research¹⁰ examining the concept of risk sharing more broadly amongst employers indicated that there was some reluctance to adopt a CDC approach, particularly when employers had established defined contribution (DC) or group personal pension (GPP) schemes.

In their response to the risk sharing consultation¹¹, the Government decided to undertake further research to understand how CDC schemes might operate in the UK if they were enabled.

This research was commissioned by the Department for Work and Pensions (DWP) to explore employers' responses to CDC schemes in more depth. Unlike the aforementioned qualitative research, which looked at risk sharing in general, this project focussed exclusively on CDC schemes.

1.2 Research aims

The aim of this research was to examine employers' attitudes to, and understanding of, CDC schemes as well as their willingness to adopt the scheme, should it be enabled in the UK. The research aimed to explore four key topics:

- employers' understanding of CDC schemes, including various aspects such as pooled funds, risk sharing and smoothing;
- employers' reactions to the practical aspects of CDC schemes, such as communicating CDC schemes to members, redistribution between members, investment strategies and administrative costs;
- whether employers would find CDC schemes appealing and, if so, under what circumstances; and
- whether employers would be willing to join with other employers to offer a CDC scheme.

1.3 Research design and conduct

The research adopted a wholly qualitative methodology, comprising 45 face-to-face in-depth interviews with employers. The fieldwork was spread across England and took place between June and July 2009. Employers were sourced from a number of business directories and commercial databases that are available to the public. Respondents were those involved in decision making regarding the pension provision within the employing organisation.

¹⁰ Thomas, A. and Allen, A. (2008). *Employer attitudes to risk sharing in pension schemes: a qualitative study*. DWP Research Report 528.

¹¹ <http://www.dwp.gov.uk/docs/govt-response-risk-sharing-consultation.pdf>

As employers were unlikely to have very much familiarity with CDC schemes, a descriptive summary was designed by DWP and BMRB Qualitative Research and sent to employers prior to the interview. This briefly explained what a CDC scheme was, how it could function and some of the potential benefits for both an employer and employee. Employers were asked to read the document before the interview as it would form the basis of much of the discussion. A copy of the summary can be found in Appendix A.

The interviews were structured using a topic guide (see Appendix B) and recorded for analysis purposes.

1.4 Sample design

The objective of the study was to understand the circumstances under which an employer may consider switching to a CDC scheme. Consequently it was important to explore the views of employers with different types of existing pension schemes. The research examined the views of employers who had a defined benefit (DB) scheme, a trust-based DC scheme or a contract-based DC pension scheme.

1.4.1 Defined benefit schemes

DB (or salary-related) pension schemes guarantee members a retirement income that is related to the employee's earnings history, length of service and age, rather than depending on investment returns. This provides members with security as the level of pension is assured and predictable. However, if the pension fund does not deliver sufficient returns, the employer becomes liable to make up the difference. DB schemes require governance by a board of trustees.

1.4.2 Defined contribution schemes

In a DC (or money-purchase) pension scheme, contributions are paid into an individual account for each member. The contributions are invested, for example in the stock market, and the returns on the investment (which may be positive or negative) are credited to the individual's account. A DC scheme can either be trust-based or contract-based. A trust-based scheme requires a trustee board to manage the operation of the scheme; a contract-based scheme is an individual contract between a pension provider and the employee, to which the company contributes.

Unlike a DB scheme, the amount of pension payable from a DC scheme is not guaranteed and depends on the investment performance of the pension fund and the annuity rates at the time of converting the pension fund into a retirement income. Consequently, employees who purchase an annuity from their pension fund when fund values have considerably fallen may have a retirement income which is considerably lower than they had anticipated. As employers are not required to maintain a minimum level of benefit their contributions are fixed and therefore future costs of the scheme are predictable.

1.4.3 Sample structure

The views of employers offering, or who had offered, different schemes were examined to understand how employers' responses to CDC schemes differed depending on the type of pension scheme they currently provided. This included employers who operated an open DB scheme or who operated a closed or partially closed DB scheme alongside a DC scheme.

DC schemes were divided into trust-based and contract-based schemes, reflecting their experience of this. This study involved: employers who had only operated trust-based schemes including, an open DB scheme, a trust-based DC scheme and a trust-based DC scheme that had resulted from a closed or partially closed DB scheme; employers who had operated a trust-based scheme and then adopted a contract-based scheme (contract-based DC that had resulted from a closed or partially closed DB) and employers who had no experience of operating a scheme which required a board of trustees (a contract-based DC scheme).

As it is thought that only larger employers could offer CDC schemes without joining with other organisations, employers with fewer than 250 employees were excluded from the study.

The sample was designed to ensure full coverage of key employer sub-groups and was selected to include a range of variables:

- **Employer size:**
 - 250 - 499 employees;
 - 500 - 999 employees;
 - 1,000+ employees.
- **Current pension scheme:**
 - Trust based;
 - of which DB only;
 - of which DC and a closed or partially closed DB scheme;
 - of which DC only;
 - Contract-based DC and a closed or partially closed DB scheme;
 - Contract-based DC scheme only.
- **Industry sector:**
 - manufacturing;
 - retail;
 - services;
 - other industries.

1.5 Sample profile

The profile of employers interviewed was as follows:

Employer has the following pension scheme/ schemes	Employer size			Total
	250-499	500-999	1,000+	
Trust-based only	6	5	8	19
of which DB only	3	3	5	11
of which DC and a closed or partially closed DB	2	1	3	6
of which DC only	1	1	0	2
Contract-based DC and a closed or partially closed DB	3	5	4	12
Contract-based DC only	6	3	5	14
	15	13	17	45

It was not possible to undertake analysis by sub group, e.g. employer size within scheme type as the cell sizes were too small.

1.6 Analysis of findings

Verbatim transcripts, produced from digital recordings, were subject to a rigorous content analysis (Matrix Mapping), which involved systematically sifting, summarising and sorting the verbatim material according to key issues and themes within a thematic framework. These analytical charts formed the basis of the evidence reported in the following chapters. Further details of the analytical process used can be found in Appendix C.

Adopting a qualitative approach has made it possible to report on the range of views, experiences and suggestions of participants. Where possible, distinctions have been drawn between different sub-groups. The purposive nature of the sample design and the small sample size, however, means that the study does not provide any statistical data relating to the prevalence of these views. The aim of qualitative research is to define and describe the range of emergent issues and explore linkages, rather than to measure their extent.

The findings have been illustrated and illuminated with the use of verbatim quotations. The quotations have been edited for clarity but care has been taken not to change the respondents' meaning in any way – alterations are shown using parenthesis and ellipses.

Quotations are attributed, anonymously, using the following convention:

(Pension scheme provided, employer size)

1.7 Content of the report

This report outlines the findings from the qualitative research in three further chapters:

- **Chapter 2** focuses on employers' views about CDC pension schemes;
- **Chapter 3** considers from the employers' perspective how CDC schemes differ from the pension schemes they are currently offering and explores whether employers would switch to a CDC scheme and under what conditions;
- **Chapter 4** draws together the findings and provides a set of conclusions.

2 Employers' views about collective defined contribution pension schemes

Employers were asked for their views about collective defined contribution (CDC) schemes and whether they would consider adopting a CDC scheme were they to be enabled in the future.

CDC schemes would be similar to defined contribution (DC) schemes as employers' contributions would be fixed and employers could not be asked to increase their contributions to fund members' pensions. However, unlike a DC scheme, the investment funds of individual members would be pooled. The pooled fund would be managed by a board of trustees. As the scheme funds would be pooled, CDC schemes could stay invested in riskier assets for longer than an individual in a standard DC plan typically would, and therefore deliver higher returns. They might also provide members with greater security through the possible use of risk-sharing and smoothing mechanisms. This would be achieved through adjusting the pension entitlements of members in a way that results in smoother outcomes, with younger members potentially seeing greater adjustments than older members.

The equivalent of the CDC scheme's liabilities would always be equated to the scheme's assets by changing the level of indexation or revaluing members' pensions. Therefore, no funding deficit could occur. If the value of the scheme's assets did not rise as expected during a period of low growth for example, indexation could be reduced, or members' projected pensions might be re-valued to ensure that the scheme's liabilities match its assets. Younger members' pensions in particular may be revalued, the assumption being that the pension funds of younger people have more time to recover. Therefore the investment risk would be wholly borne by the members.¹²

¹² See Appendix A flowchart for further details.

Prior to the interview employers were sent material which introduced the CDC scheme. This briefly explained what a CDC scheme was, how it could function and some of the potential benefits for both an employer and employee. Employers were then asked to discuss the material as well as their attitudes to CDC schemes.

In the following sections, employers' views about the following various issues of CDC schemes are discussed:

- cost;
- governance;
- delivering greater security through investment pooling, indexation and revaluation;
- payment options;
- industry-wide CDC schemes;
- employers' views about how employees would respond to a CDC pension scheme.

2.1 Cost

When considering the potential costs of a CDC scheme, employers considered two aspects: the cost of pension contributions and the costs of managing the pension scheme. Each of these is discussed in turn below.

2.1.1 Fixed contribution rates

Fixed contribution rates for employers were considered an important feature of CDC schemes. Employers that had closed their defined benefit (DB) scheme said that they had moved to a DC scheme because contribution rates were fixed and could not be required to be increased to meet a funding deficit. These employers cited their principal reason for closing their DB scheme to be the unpredictability of the future costs of the pension scheme.

'The cost, but also I think the uncertainty over cost. All our competitors have it so we have to operate a pension scheme, so we all know we have a cost there and I think if you know what the cost is, that's fine. It's the uncertainty and the volatility over costs, I think is the real problem.'

(DB and contract-based DC, 500-999 employees)

Therefore, employers who had experience of DB schemes considered it to be essential that in order to change their pension provision, their contributions would be fixed. Employers who currently operated a DC scheme would also not consider adopting a scheme where contribution rates could fluctuate.

2.1.2 Financial liability

Although employers understood that CDC schemes would remove the financial liability from them, they were concerned that future legislation might transfer the financial liability back to the employer in order to protect members whose pensions were lower than expected.

In addition, as CDC schemes were seen to be managed in a similar way to DB schemes, with a board of trustees responsible for the investment decisions, employers felt that even if there was no legal liability to guarantee a level of pension, they might be placed under a moral obligation to maintain a minimum level of benefit by employees. There was also a concern the Government might transfer liability to the employer to protect members whose pensions were lower than expected.

2.1.3 Administration and governance costs

Employers thought that the governance and administration costs of CDC schemes would be similar to those of trust-based schemes which were considered to be high as they required professional input, trustee time and additional administration costs. There was also a concern that the governance of a CDC scheme might be more complex than a trust-based DC scheme due to additional complexities associated with balancing assets with liabilities (the perceived complexity of reducing indexation and revaluing projected pensions is discussed in Section 2.3). Unless there could be demonstrable benefits in terms of an increased pension, or some form of guaranteed pension that would not require additional employer funding, employers could not see that CDC schemes provided any advantage over a DC scheme.

'The minute you start going back to trustees you're increasing costs dramatically.'

(Contract-based DC, 500-999 employees)

In particular, those with contract-based DC schemes were concerned that the benefits of a CDC scheme would be significantly outweighed by the additional costs of running the scheme when compared to their current scheme. Specifically, employers thought that the cost of trustee management, together with advisers' fees, would significantly increase costs.

They thought that the additional costs associated with a board of trustees would be prohibitive, particularly at a time when most organisations were trying to reduce the costs of their pension schemes. Smaller employers also indicated that the necessity of having a board of trustees might be more problematic because of the time-cost of employees having trustee duties.

Employers that had moved from a DB to a contract-based DC scheme indicated that their primary motivation was because providing a DC scheme meant that the costs were manageable and predictable. The lack of a trustee board and all the associated costs of employee time and advisers' fees was an added motivator to close their DB scheme.

'When we introduced the group personal pension, we could have adopted a trust-based defined contribution plan, but we went down the GPP route, because it was the cheapest and less hassle for the company to run.'

(DB and contract-based DC, 500-999 employees)

'The main driver was the cost. But it does involve a huge amount of management time as well for the trustee. Our chief operating officer gets quite heavily involved. And all the professional fees. The actuary and investment consultants. It's just a huge task. Keeping up with the new investment products [...] it is an onerous task to keep running.'

(DB and contract-based DC, 500-999 employees)

When discussing their views on governance of CDC schemes, employers operating trust-based DC schemes did not cite governance costs of operating a CDC scheme as a concern. However, these employers were concerned that trustees' decisions would be more directly linked to the value of employees' pensions which might place greater responsibility on trustees of a CDC scheme in comparison to trustees of a DC scheme.

2.2 Governance

Aside from the cost involved, employers discussed other concerns relating to governance of CDC schemes. Employers were concerned that trustees might not have sufficient experience to manage the scheme funds effectively given the additional complexities of CDC schemes. There was also a concern that trustees might hold some liability for poor investment choices as their decisions would have a direct effect on members' pensions.

2.2.1 Trustee expertise

Employers generally thought that having investment decisions managed by a board of trustees would be beneficial to most members who have little financial expertise or who were not actively involved in managing the investment of their funds. For employees currently contributing to a contract-based DC scheme, particularly those who had adopted default investment options, employers suggested that CDC schemes may deliver better returns because the scheme funds would be managed by a board of trustees. Trustees may be more likely to make better investment decisions, although this would be dependent on the experience of the trustee board and given the added complexities of risk smoothing employers were not confident this would be sufficient. This may be compounded in organisations where there is high staff turn-over, as trustees might leave the company before they have acquired sufficient experience.

Owing to the complexities of CDC schemes, there was a general view that any trustee board would require very detailed guidelines as well as considerable professional advice. These additional costs, as discussed above, were seen as a significant disadvantage of operating a board of trustees.

2.2.2 Trustee liability

Employers that operated, or had operated a DB scheme in the past, thought that the responsibilities placed on trustees of CDC schemes would be more complex

than those associated with trust-based DC and DB pension schemes. CDC schemes were perceived to be more complex because trustees' decisions around indexation would directly affect members' level of pension provision, whereas the pensions of members of DB schemes were guaranteed by the employer.

Employers were concerned that there might be some financial liability, for poor investment choices, placed on trustees. Consequently, trustees might be reluctant to make the riskier investment choices necessary to recover losses as they may be concerned about future liability or the damage to members' pensions.

'That will make trustees err on the side of caution. [That] is because you think every ten years or so we're going to hit a disaster.'

(DB and contract-based DC, 250-499 employees)

As a consequence of trustees potentially perceiving the role to be more difficult than a board of trustees for a DB scheme and a risk of being liable for their decisions, employers expected that recruiting trustees would be more problematic. This was further evidenced by employers with DB schemes that found it increasingly difficult to recruit new trustees.

2.3 Delivering greater security through investment pooling, indexation and revaluation

Employers generally recognised that CDC schemes would aim to deliver greater security of retirement income by pooling the pension investments of individual members. Particularly for employers who provided a DC scheme, the key advantage that employers saw in CDC schemes would be in delivering a better pension, and less volatility of projected pensions.

'What [the level of] pension it [CDC schemes] might provide, I can see that would be an advantage as long as it wasn't really volatile...As long as it was a smoother prediction with realistic assumptions.'

(DB and trust-based DC, 1,000+ employees)

Employers recognised that, because investment rates do not fluctuate greatly over long periods of time, CDC schemes would allow risk to be smoothed across many years. As a pooled fund, investments would have time to recover whereas individual pension pots in a DC scheme may provide a pension which is much lower than had been predicted for members who draw a pension at a time when fund values have substantially fallen.

One possible risk sharing feature of CDC schemes is to maintain the level of the pension fund of older workers by reducing the projected pensions of younger members, the assumption being that the pension funds of younger people have more time to recover. Employers' responses to this potential mechanism were that it was a 'sound idea' in principle. They considered that risk smoothing would be a significant benefit, if it were shown to deliver greater security. However, they were concerned that it might not work in practice as it was dependent on three factors:

- the future stability of the employer and the longevity of the scheme, in that employers were concerned about the security of the pension scheme if the employing organisation became bankrupt;
- a relatively young work force with a regular intake of new members as risk sharing across members was dependent on there being sufficient time to recover the pensions of younger members;
- a significantly large number of active members, comparable to public sector schemes and much larger than is possible for most employers.

Employers' attitudes towards the security of long-term investments in response to the current economic downturn also affected their perception of CDC schemes. Employers who thought that the investment of pension funds might not reliably deliver sufficient returns to fund projected pensions, usually those who had offered a DB scheme, tended to be more cautious about the concept that a CDC scheme could provide greater predictability. To them, potential CDC revaluation mechanisms were seen as 'robbing Peter to pay Paul'. Ultimately, if the company could not survive a major downturn, the scheme would collapse with it because there would be no more employer and employee contributions to increase current members' pensions.

Employers were concerned that adopting a CDC scheme would require a degree of trust that the board of trustees would be able to manage the schemes' funds in order to recover any losses. Employers felt that it would be difficult for employees and employers to trust that risk smoothing mechanisms would be able to maintain a good level of pension for all members.

Employers also thought that risk smoothing mechanisms might be difficult to communicate to employees, especially if they see that their pension fund has been reduced through the indexation and revaluation mechanisms.

Specific issues were raised by employers which would need to be addressed in order to increase confidence in the capacity of CDC schemes to deliver greater security:

- despite some employers recognising that in the long-term pension investments should recover, employers were still very concerned about the potential impact of a sustained downturn. Maintaining pensions in payment by revaluation of younger members' pensions was seen as deferring the issue and members were nervous that future pensions may be undermined in order to protect members who were retiring;
- employers were concerned that the stability of the scheme might be in greater danger in an organisation with an ageing workforce;
- employers were concerned that there may be age discrimination issues if pension adjustments were based on length of service;
- there would need to be guidelines for investment practices put in place; and

- pension funds would need to be 'ring-fenced' so that trustees cannot invest funds in their own company, to protect the scheme if the employer became bankrupt.

In the event of a sustained economic downturn, employers were concerned that the indexation and revaluation processes could leave some members without a pension.

'Because you'd always be worried, if things go wrong, you could end up with pensioners still getting their money, and all the new ones, well there's none left.'

(Contract-based DC, 250-499 employees)

Overall, employers understood how indexation and revaluation could work in principle. However, some employers indicated that they would only consider adopting such mechanisms if other employers had shown that it worked in practice, or if they were provided with very detailed information that demonstrated how employees' pensions would be affected in a sustained poor economic climate.

2.4 Payment options

The CDC scheme presented employers with two options for the payment of pensions: payment directly from the scheme fund, or purchasing an annuity.

In principle, employers thought that paying pensions directly from the scheme's funds should deliver a better retirement income for members compared with purchasing an annuity (where rates could be unfavourable during periods of economic uncertainty). However, there was a concern that in a long period of economic uncertainty or low growth, or if the scheme was poorly managed, there might not be sufficient funds available to cover future pensions if paying directly from the scheme's funds. Employers thought that this would be a particular concern where schemes had a disproportionately high number of pensioners or members reaching retirement age and few younger members joining the scheme.

'If you were paying it straight out of the pot, it could get to a stage where you've got no new joiners or the scheme has closed, and it would just get to a stage where it would just eventually run out of money.'

(DB and trust-based DC, 1,000+ employees)

In order to provide stability to employees it was considered essential that pensioners' income should remain stable or increase. Employers were concerned that paying pensions directly from the scheme funds might not offer security as pensions could be open to revaluation even when in payment.

Employers therefore, were more in favour of purchasing an annuity rather than making payments directly from the collective fund. This was seen to provide greater certainty for both employer (because the cost of funding retirement would no longer act as a liability for the scheme) and employee (because an annuity would provide a guaranteed minimum level of benefit).

They were still concerned however, that purchasing an annuity undermined the risk smoothing concept as this would expose the member to fluctuations in annuity rates. As the purpose of reducing indexation and revaluing the pension scheme is to reduce uncertainty by smoothing losses over a long period, suddenly being exposed to variable annuity rates seemed to be in direct contradiction to the risk sharing concept.

2.5 Industry-wide collective defined contribution schemes

There is a perception that some organisations might be too small to benefit from a CDC scheme. For risk to be smoothed adequately across members it seems that it might be necessary to have a large number of younger members. Smaller employers, with less than 500 employees might find that it is beneficial to join an industry-wide scheme. An umbrella CDC scheme, managed by a third party and incorporating industry bodies or trade unions should provide the benefits of economies of scale. Risk sharing may also be more stable as the scheme would be more likely to maintain a good age spread and have a sustained base of younger members. Employers' views were sought about this.

Employers thought that joining with other organisations would be beneficial as this would increase economies of scale, although there were some concerns:

- there was some uncertainty around how trustees could be selected which caused employers to question whether all organisations would be fairly represented;
- concerns about the effect on other employers, if an organisation chose to leave the scheme or could not maintain its level of contributions; and
- some organisations, particularly charities, would need to agree on an ethical investment strategy before joining up with other employers.

2.6 Employers' views about how employees would respond to a collective defined contribution pension scheme

Employers were asked to consider whether CDC schemes would be more or less attractive to employees compared to their current pension provision and whether this would have any impact on their willingness to adopt a CDC scheme.

Although employers continue to provide a pension scheme, they reported an increasing sense of disengagement on the part of their employees. There were five reported reasons for this:

- employers operating open DB schemes found that members became increasingly negative when changes had to be made such as increasing the retirement age, adjusting accrual rates, and increasing employee contribution levels;

- finding that the value of their pension fund had reduced, because of poor investment returns;
- media coverage, which had portrayed DC pensions as volatile and insecure;
- some groups of employees were uninterested in pensions, particularly young people, those on low incomes and staff in organisations or sectors with a high staff turnover; and
- employees were described as finding pension schemes difficult to understand and ill-equipped to judge whether they will receive a reasonable level of retirement benefit.

Employers recognised that pension schemes need to deliver a stable and predictable retirement income in order to re-engage employees. Therefore CDC schemes might be more appealing to employees if the level of pension provided was more stable.

'I think employees need to have some degree of certainty [...] in order to sell the idea to them. I think one of the big problems at the moment with pensions is, with everything that has happened there is uncertainty [...] people can say "You don't know what you are going to get, you are not going to get your money back, you are going to be worse off as a result" [...] I think what you need is the degree of certainty.'

(DB and contract-based DC, 1,000+ employees)

However as CDC schemes would offer no guarantees of retirement income, the suggestion that there would be greater security was perceived to be misleading by employers.

'They would almost see it as if they would be guaranteed this pension, like a DB scheme. I can see people getting the impression that they're going to get X amount and if it doesn't happen then I think it causes a lot of problems.'

(DB and trust-based DC, 1,000+ employees)

Employers thought it was essential to be entirely transparent about the risks involved in CDC schemes and to reinforce the message that the pension fund would not be guaranteed; employees should also be aware that the pension fund might or might not recover in value.

While employers thought that employees would understand and appreciate that CDC schemes would be designed to deliver greater security, they thought that concepts such as indexation and revaluation would be difficult for employees to understand. As a consequence, employers thought that there might be a negative response from younger members if the value of their pensions were reduced to maintain the level of older workers' pensions.

'You would be telling the old members they're alright and the young ones, well you might not be getting as much as this and when they say why? Well, we've got to pay the old boys.'

(DB and contract-based DC, 250-499 employees)

In addition, as CDC schemes would not offer a guaranteed level of pension, employers thought that employees might not consider the scheme to be any more valuable than a DC scheme.

Due to pooling of funds, employers thought it might be easier to communicate the effect of investment performance on their pensions to members. However, as the workforce would be affected equally by any reduction in the value of the collective fund, employees might respond negatively en masse to any reduction in projected pensions. As the investment of pensions would be managed by a board of trustees and individuals would have no input into investment choices they might perceive CDC schemes to be similar to DB schemes in that the employer should redress any loss of pension and therefore members might demand a higher minimum contribution from the employer.

'It's a sort of a mass of people and the same thing's happening to them all, whereas at the moment, the firm makes a fixed contribution, we [the members] all make different contributions, we invest in the default funds or different funds and everybody individually looks at what their particular fund is doing, but you don't have a collective feeling that, oh, the trustees have made a bad choice, therefore our employer should rectify that.'

(Contract-based DC, 250-499 employees)

Investment choices for CDC schemes would not require any involvement from members, which employers thought would be viewed as a positive feature of the scheme by the majority of employees who adopt life-styled options when starting a pension scheme. Assuming that risk smoothing meant that employees' projected pensions were not too volatile, employees would value having less responsibility for managing their own investments. However, for a minority of employees, who are informed and engaged with the investment of their pension fund, this might be seen as a disadvantage.

3 Employers' views on the benefits of CDC schemes compared to DB and DC schemes

Employers were asked to consider collective defined contribution (CDC) schemes in comparison to their current pension scheme arrangements and the conditions under which they would or would not consider switching to a CDC scheme if they were to be enabled.

3.1 CDCs in comparison to a DB scheme

Employers who had provided a defined benefit (DB) scheme to their employees were more likely to express a paternalistic attitude to pension provision. These employers thought that it was important to offer a pension scheme as they felt a duty to help provide for employees in their retirement and to encourage a savings culture.

'Nowadays I think they still expect it to be honest, but it is partly because we want to provide one so that we are seen as a caring employer, and also that there's a way of making sure people provide for their future, and don't just spend everything they get.'

(DB and contract-based defined contribution (DC), 500-999 employees)

Employers who had closed, or were considering closing their DB scheme, felt that they had a responsibility to continue to encourage employees to contribute to a pension scheme and to offer a scheme which could provide a reasonable level of benefit. However, DC schemes were not seen to currently be able to deliver the level of benefit of a DB scheme even with comparable contribution rates for both employer and employees.

'When we closed the final salary scheme we said right, we're not trying to save money, we're trying to reduce risk, but we'll put in a similar amount, in a sliding scale.'

(DB and contract-based DC, 1,000+ employees)

There was a perception that CDC schemes could provide a middle ground between a DB and a DC scheme as CDC schemes would transfer responsibility for investment decisions from the member to the board of trustees and they may reduce the level of risk on individual members. Therefore CDC schemes might be preferable for employers who were closing a DB scheme but who wanted to provide greater stability of retirement income than a DC scheme.

'If the employer really wanted to provide a certain level of benefit but they couldn't afford a full DB scheme then this would be the next option for them, they could not guarantee that they could provide this but reassure the employee more than you can [with] a DC scheme.'

(DB and trust-based DC, 1,000+ employees)

However, employers were concerned that pensions provided by CDC schemes might be much lower than those provided by a DB scheme and employees would continue to see the value of their pension scheme fluctuate. There was a perception that the scheme might not provide greater predictability without taking on some of the aspects of a DB scheme.

'Although I can see the benefits and what it's trying to achieve, I can't see how it would actually physically work without turning back into a defined benefits scheme.'

(DB and trust-based DC, 1,000+ employees)

If a CDC scheme could provide a guaranteed minimum level of benefit employers thought that this would be seen as a definite advantage over DC schemes. There was a perception that employers who currently provided a DB scheme might consider moving to a CDC, rather than a DC scheme if it were possible to incorporate a mechanism which shared part of the risk between the employer and employee in order to provide a guaranteed minimum level of benefit. This would reduce the liability on employers currently operating a DB scheme, whilst still allowing a minimum level of pension to be guaranteed for employees.

In order to consider switching to a CDC scheme, employers that had moved from a DB scheme to a DC scheme required further reassurance that the principle of CDC schemes worked in practice. They wanted to see a full description of the CDC scheme, a working model and a cost-benefit analysis.

3.2 CDCs in comparison to a trust-based DC scheme

Unlike employers with a contract-based DC scheme, employers with a trust-based DC scheme were much less concerned about the costs associated with

the running of a CDC scheme. Their principal concern was regarding governance of the schemes. Reducing indexation and revaluation of pensions and ensuring that liabilities matched assets, was considered to be complex. Therefore, it was thought that governance of CDC schemes would place greater responsibility on trustees than trust-based DC schemes.

'You are pushing the responsibility of all this to the trustees. To me, this is what the proposal is. Take it away from the employer, taking it away from the pension provider, and the scapegoat will be the trustees in years to come.'

(Trust-based DC, 250-499 employees)

In addition, these employers were already experiencing difficulties recruiting trustees and they considered that it was due to the additional responsibility and the direct effect that trustee decisions had on employees' pensions. They thought that recruitment of trustees for a CDC scheme would be far more difficult.

Employers with a trust-based DC scheme thought that switching to a CDC scheme might be attractive for employers who were considering closing a DB scheme and were willing to retain a trustee board, and the associated costs. However, employers that have adopted a trust-based DC scheme would be reluctant to adopt a scheme, such as a CDC scheme, which would place further responsibility on trustees.

3.3 CDCs in comparison to a contract-based DC scheme

Employers who operated a contract-based DC scheme were less likely to express a paternalistic attitude to pension provision than employers who operated a trust-based DC scheme or a DB scheme. Rather, these employers thought that it was necessary to provide a pension scheme in order to recruit and retain staff. Therefore, these employers suggested that they would consider switching if CDC schemes were offered by their competitors and were expected by employees.

Some employers operating a contract-based DC scheme felt they were not currently able or willing to take on any additional costs and so would only consider a CDC scheme if governance and administration costs were covered by members or incorporated into a fixed charge based on a percentage of the value of the scheme.

Employers who thought that they might consider the option of switching to a CDC scheme suggested that they might adopt a CDC scheme if their current pension scheme continued to deliver low levels of pension and a CDC scheme could be shown to deliver a greater level of pension.

'...if in the next couple of years we have got members who are retiring, leaving with virtually nothing, then we would have to consider whether we are providing the best possible pension plan to those people and whether switching to a CDC would mean that those people who are near retirement could leave with a better pension plan.'

(Contract-based DC, 500-999 employees)

With the exception of employers that felt that they were not currently able or willing to take on additional costs, employers with a contract-based scheme said they would consider switching to a CDC scheme, but with four important conditions:

- the employer liabilities were fully described and guaranteed not to change;
- the benefits of a CDC scheme were demonstrable to both employers and employees;
- the additional administration costs (trustee board, advisers' fees, etc.) were fully ascertained and would not outweigh the benefits of a CDC scheme in terms of delivering a greater level of pension for employees; and
- future pensions reductions would be borne solely by the members.

However, these employers did indicate that if a CDC scheme could be managed by an external provider (including the trustee board) and that the costs were acceptable to them then they might consider switching. The critical issue for them would be the scale of any additional costs.

4 Conclusion

This section of the report brings together the overarching themes from the discussions with employers about collective defined contribution (CDC) pension schemes and draws a set of conclusions.

Employers recognised that CDC schemes would aim to provide financial security to employees without transferring the financial risks and liability to employers and so potentially offered a middle ground between a defined benefit (DB) and defined contribution (DC) scheme. However, CDC schemes were seen to offer no greater security than a DC scheme because pensions would not be guaranteed and employers thought that they would be unlikely to provide a level of pension comparable to a DB scheme. Compared with a contract-based DC scheme, there would also be the additional costs of a trustee board and professional advisers. Employers with experience of DB and trust-based DC schemes indicated that these costs could be substantial. There was a perception amongst employers who had moved to a trust-based DC scheme that the level of responsibility and potential liability on trustees of a CDC scheme would be greater than for trustees of a DC scheme as their decisions would have a direct effect on members' pensions.

There were two key areas of uncertainty for employers in considering switching to a CDC scheme:

- Employers agreed that CDC schemes could deliver more protection for members because the financial risks could be smoothed over time and the pooled fund would have more time to recover than individual accounts. However, employers needed considerable convincing that a CDC scheme would work in practice. They did not think that trustees would have sufficient experience to make complex indexation and revaluation judgements; they were concerned about the effect of revaluation on younger members' pensions in periods of sustained low growth; and were not convinced that the increase in the value of pensions, in comparison with contract-based DC schemes, would justify the additional cost of the trustee board and professional advisers.

- Employers felt that it would be important to have safe-guards in place that would protect both the employer and the employee. The mechanisms for risk sharing across members were seen as complex and there was a concern that all the risk may ultimately be deferred onto younger members. Clear guidelines, which set out best practice for managing the fund, would be needed to protect the pensions of younger members. In addition, employers wanted a guarantee that they would not be financially liable if employees' pensions were much lower than expected.

Employee engagement could be a key driver which might motivate employers to adopt a CDC scheme. Employers thought that employees had become increasingly disillusioned with pensions as a way of securing a reliable retirement income. If CDC schemes could be shown to deliver greater security by reducing the volatility for employees reaching retirement this may reassure employees and demand for alternative pension schemes may increase.

Consequently, employers indicated that although the CDC concept had its appeal they would be unlikely to consider switching to a CDC scheme unless the running costs and trustees' liabilities were commensurate with its ability to deliver longer-term stability and greater financial return.

Appendix A

A copy of the descriptive summary sent to employers prior to interview¹³

Collective defined contribution schemes

This document represents the Department for Work and Pensions' (DWP) current understanding of how collective defined contribution schemes could function in the UK. Different options exist as to the structure of a collective defined contribution scheme and those represented here do not form an exhaustive list. Furthermore, these ideas are not yet set in stone. We would welcome your views on all aspects and any further ideas you may have.

1) What is a collective defined contribution scheme?

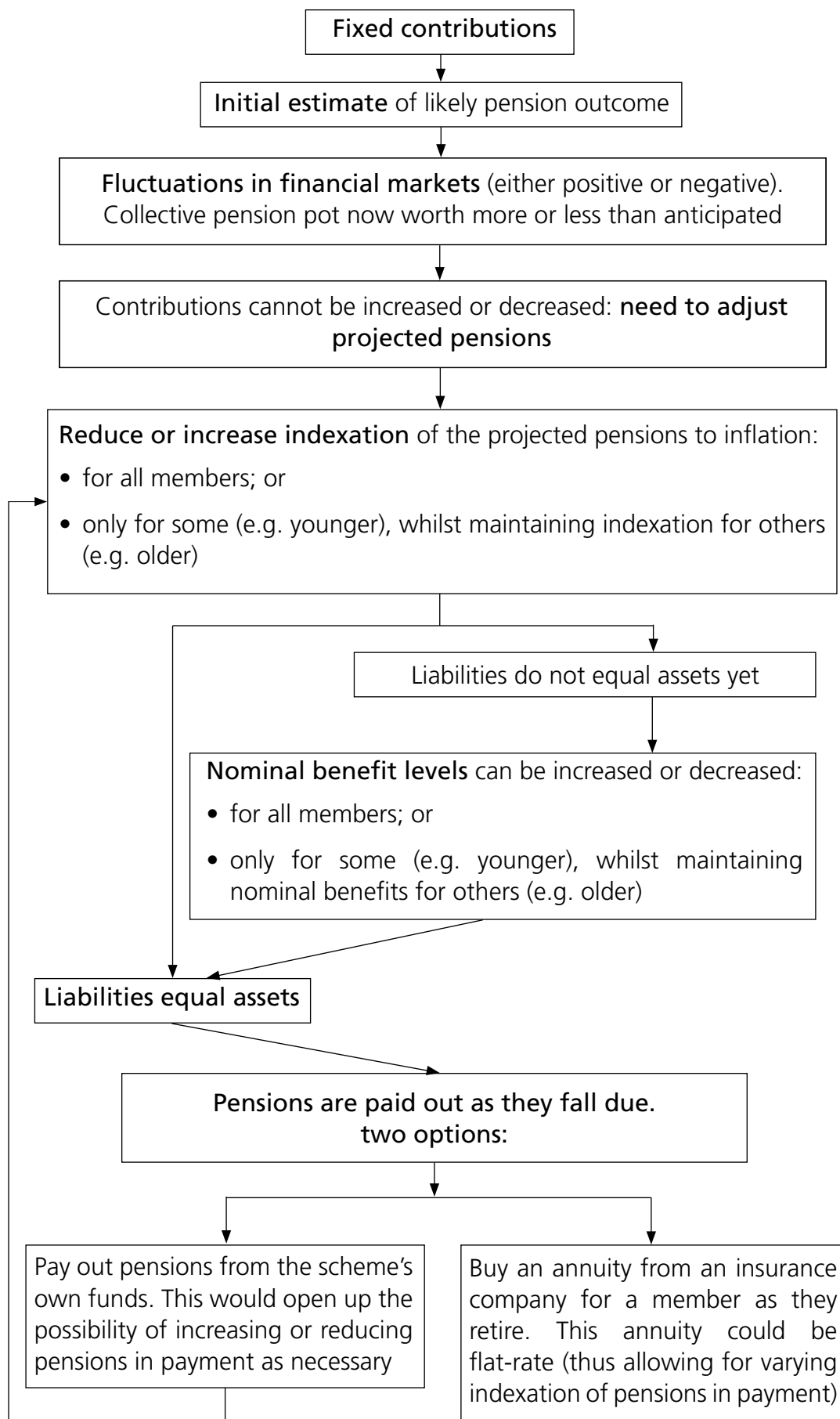
- a) Collective defined contribution (CDC) schemes try to bring together some of the most desirable characteristics of both defined benefit (DB) and defined contribution (DC) schemes.
- b) For the employer, it is similar in many respects to a defined contribution scheme. The employer provides no guarantees towards any level of pension and has full certainty about the level of its contributions.
- c) For the employee, however, the risks associated with a pure defined contribution scheme are somewhat mitigated as contributions are paid into a collective fund instead of individual savings accounts. This creates economies of scale and potentially provides greater predictability of retirement income for individual members.

¹³ This summary represents DWP's understanding of how collective defined contribution schemes could function in the UK as at June 2009.

2) How could a collective defined contribution scheme function?

- a) The fixed employer contributions are pooled into a collective fund. The trustees calculate what projected pension can be afforded with these contributions and invest accordingly.
- b) Should fluctuations in the financial markets (positive or negative) result in the collective pension pot being worth more or less than previously anticipated, projected pensions must be adjusted to balance the books as contributions cannot be increased or decreased.
- c) These adjustment decisions could be taken in a number of ways, creating risk-sharing or risk-smoothing potential between members. Different options include varying degrees of trustee discretion or automaticity of adjustments.
- d) Risk-sharing could be enabled by allowing those approaching retirement to be less heavily impacted by investments performing badly. The value of some members' projected pensions (e.g. members nearing retirement) could be affected relatively less than others (e.g. younger members). The hope would be that the value of the assets would, in time, increase so that the projected pensions which had been more substantially reduced could be increased in the future.
- e) Adjustments to pensions in case of investments performing badly could be made by reducing indexation of pensions and projected pensions as a first step. If this were not deemed enough to balance the books, nominal benefits and projected benefits would need to be reduced.

The following flowchart shows a simple, linear decision-making tree with regard to the way projected pensions are adjusted.



CDC: The employer's perspective

- 1) **Fixed contributions:** The employer pays fixed contributions into the scheme and cannot be required to increase contribution rates to sustain pensions (although as with traditional DC schemes, it would be open to the employer to increase contributions if they so wished).
- 2) **Balance sheet:** Similar to a DC scheme, a CDC scheme does not appear on the employer's balance sheet.
- 3) **Trustees:** Under a CDC scheme, the employer would simply pay their contribution and then it would be up to trustees to manage the scheme and to communicate scheme benefits to members.

CDC: The member's perspective

- 4) **Higher expected rewards:** Pure DC schemes tend to invest in lifestyled funds, where investments are gradually moved into safer assets (such as gilts and bonds) closer to retirement. Because investments are pooled, CDC schemes can instead invest in more risky assets throughout the lifecycle (i.e. up to retirement age) and seek out higher expected rewards that can be gained from those assets.
- 5) **Economies of scale:** Efficiencies can be gained from economies of scale in administration and investment management.
- 6) **Investment decisions:** CDC schemes are collectively managed by trustees, thus avoiding bad decisions by individual members who are less likely to have the required financial knowledge.
- 7) **Risk sharing or smoothing:** As illustrated in the flowchart, a CDC scheme could avoid significant negative impacts on those happening to retire in a downturn. There is potential for less volatility in the level of retirement income as one approaches retirement, but without the reduced investment returns resulting from individual lifestyling.

Switching to a CDC Scheme

The scheme will need to establish a trustee board. Trustees would make investment decisions on behalf of the members. This would incur the associated costs of recruiting and training trustees, as well as the use of their time. The trustee board would be expected to take professional advice from investment professionals and actuaries about the running of the scheme.

I currently provide a DB pension to my employees: Administration costs are likely to be similar to that of a DB scheme. The scheme would require a trustee board and be expected to take advice from actuaries and investment professionals. Under current legislation, we expect that DB accrued rights would not be able to be transferred into the scheme, so the closed DB scheme would still need to be maintained.

I currently provide a DC pension to my employees: If your current DC scheme does not operate with a trustee board, we expect that you would need to establish a trustee board to run such a scheme. This board would need to seek advice from professional advisors, such as actuaries and investment managers. The funds from the existing DC scheme might not be able to be transferred, so the existing scheme may need to be maintained.

FAQs¹⁴

Are CDC schemes appropriate for all employers?

The Department for Work and Pensions (DWP) is looking into this. It is currently thought that CDC schemes would not be feasible for employers with less than 100 active employees. We expect that employers with 1,000+ employees should be able to run a CDC scheme on their own. Smaller employers could join up with other employers to offer such a scheme. However, research results are still outstanding on these figures.

Would a collective defined contribution scheme qualify as an eligible scheme when auto-enrolment comes in?

Yes, if collective defined contribution schemes were to be implemented into the UK pension landscape, they would qualify for automatic enrolment.

NB: In the future, employers will have the duty to automatically enrol all eligible workers between the age of 22 and state pension age into a good quality workplace scheme and to provide a minimum contribution to those who remain enrolled.

What happens to the pension when an employee leaves the company?

As with any other scheme, the employee will be able to request a transfer value calculation from the scheme, and make a decision based on this calculation.

Can contribution holidays be taken?

From the employer's side this is not possible. However, you will have the certainty of paying a fixed contribution rate at all times and will never be required to contribute more.

Would employees have the choice between CDC and an alternative pension scheme?

In theory this would be possible, but a CDC scheme would require a certain minimum number of members in order to be viable. Offering a choice to employees could therefore prevent the scheme from reaching its critical mass.

¹⁴ These FAQs relate to DWP's understanding of how collective defined contribution schemes could function in the UK as at June 2009.

What would an annual statement look like?

We would expect annual statements to show a projection of the amount of pension the individual may receive under a certain set of assumptions, like those currently required for existing traditional pension schemes. It would need to stress that such an outcome was in no way guaranteed.

Produced on 24th June 2009

Appendix B

Topic guide

DWP CDC Scheme (45108951)

Topic guide (Employers) FINAL

Core objectives

The primary objective of the study is to explore employers' attitudes to a new type of pension scheme in comparison to schemes the respondent currently operates and the level of interest in the scheme should it be introduced

Specifically, the research aims to explore:

- Employers' understanding of collective defined contribution (CDC) schemes, as set out in the pre-material and discussed during the interview, including various aspects such as collective funds and risk sharing
- Employers reactions to the practical aspects of CDC schemes such as communicating CDC schemes to members, redistribution between members, investment strategies, administrative costs, etc
- Whether employers would find CDC schemes appealing and under what circumstances
- Whether employers would be willing to join a group of employers that would offer CDC schemes

Key questions	Notes	Approximate timing
<p>1. Introduction, current pension schemes and role of interviewee</p>	<p>Welcome: Orientates interviewee, gets respondent prepared to take part in the interview</p>	8 minutes
<p>Introduction</p> <ul style="list-style-type: none"> • Thank interviewee for taking part • Introduce self and BMRB. Explain study commissioned by Department for Work and Pensions and explain the aim of the interview: <ul style="list-style-type: none"> - The DWP would like to understand your views on a possible new type of pension scheme called a collective defined contribution scheme (CDC). - A CDC scheme has fixed contributions from the employer and provides the potential for greater predictability of retirement income for members because contributions are pooled in a collective fund. - The DWP would like to know how this scheme compares with the types of pension schemes currently offered by your organisation and whether you would consider adopting a CDC scheme. • Role of BMRB – independent research organisation, gather all opinions: all opinions valid, disagreements OK • Confidentiality: reassure all responses anonymous and that information about individual cases will not be passed on to any third party (e.g. DWP) • Get permission to record – transcribe for quotes, no detailed attribution. 	<p>Outlines the ‘rules’ of the interview (including those we are required to tell them about under MRS and Data Protection Act guidelines)</p>	
<p>1.1 Organisation information</p> <ul style="list-style-type: none"> • Industry sector and nature of business 		
<p>1.2 Role of interviewee</p> <ul style="list-style-type: none"> • Nature of work • Time in role • Role in relation to pension scheme; degree of involvement 	<p>Just to get interview started and get the interviewee settled</p> <p>Explore the respondent’s role, both within organisation and within the pension scheme briefly.</p>	
<p>1.3 Current pension schemes</p> <ul style="list-style-type: none"> • Check how many pension schemes currently offered to employees • Types of pension scheme <ul style="list-style-type: none"> - Defined Benefit, Defined Contribution or Group Personal Pension? - Is the DB scheme open or closed to new members? 	<p>Need to establish interviewee’s level of involvement with pension scheme, their autonomy and whether pension services are their principal responsibility</p>	

Continued

Key questions	Notes	Approximate timing
<ul style="list-style-type: none"> - Do they operate a DC or GPP scheme in parallel with a DB scheme • For each scheme: (This information requested at recruitment). <ul style="list-style-type: none"> - Length of time established - Current numbers; members (active, deferred, pensioner) - Participation rates - Contribution rates 	<p>Obtain a picture of firm's pension provision.</p> <p>Definitions:</p> <p>A defined benefit pension plan is a type of pension plan in which an employer promises a specified monthly benefit on retirement that is predetermined by a formula based on the employee's earnings history, length of service and age, rather than depending on investment returns.</p> <p>In a defined contribution (or money-purchase) pension scheme, contributions are paid into an individual account for each member. The contributions are invested, for example in the stock market, and the returns on the investment (which may be positive or negative) are credited to the individual's account.</p> <p>A group personal pension is an arrangement with a personal pension provider, set up by the employer on behalf of their employees, which allows a group of individuals to take out a personal pension on a group basis. This can result in the scheme making lower administration charges</p>	

Continued

Key questions	Notes	Approximate timing
<p>2. Evaluating current schemes</p> <p>2.1 Reasons for chosen scheme/s (Briefly)</p> <ul style="list-style-type: none"> • Reasons for offering current pension scheme/s <ul style="list-style-type: none"> - Recruitment - Retention - Fixed cost/fixed contribution rate - Level of benefits for members <p>2.2 Value of offering pension scheme/s</p> <ul style="list-style-type: none"> • How important is it to the company to offer a pension scheme? • What do they think employees think about the scheme? • Effect of pension scheme on image and perception of organisation • If they did not have a pension scheme, would they still be able to recruit/retain staff of the same calibre? • If they did not have THEIR CURRENT type of pension scheme, would they still be able to recruit/retain staff of the same calibre? <p>2.3 Changes to schemes</p> <ul style="list-style-type: none"> • Have there been changes to the type of pension scheme offered in the past ten years? • If changed from a DB to a DC or GPP <ul style="list-style-type: none"> - Why change? - Were alternatives considered? - What advice was sought? • Have changes been made to how schemes are funded? <ul style="list-style-type: none"> - What changes and why? • Have changes been made to how benefits are paid or how the value of benefits are calculated? <ul style="list-style-type: none"> - What changes and why? 	<p>Interviewer should focus on any and all schemes but ensure that interviewee clarifies which scheme is being discussed.</p> <p>To understand specific reasons for chosen scheme as well as more general reasons for offering a pension scheme.</p> <p>To explore the perceived value of a pension scheme to the employer and the employee. Explore how committed employers' are to pension schemes and whether it is an integral feature of their remuneration package or provided only because competitors also offer a pension scheme</p> <p>To understand what changes have been made to pension schemes and the drivers of change, i.e. level of benefits, level of liability for employer, cost of contributions, mergers and takeovers etc.</p>	8 minutes

Continued

Key questions	Notes	Approximate timing
<p>3. Awareness, understanding and views about CDC schemes in comparison to current schemes</p>		25 minutes
<p>3.1 Prior Awareness (before pre-material)</p> <ul style="list-style-type: none"> • Discuss their prior knowledge and preconception of CDC schemes before receiving the pre-material • Sources of knowledge • Prior attitude to CDC schemes • How does the pre-material differ from earlier information? • Did pre-material change their attitude to CDC schemes? (How/Why) 	<p>Explore any existing knowledge prior to receiving pre-material to understand whether their preconception of CDC was positive or negative, whether they were already warm to the scheme and whether the pre-material has changed their attitudes</p>	
<p>3.2 Understanding CDC schemes</p> <p><i>Having read the material that we sent to you, what are your views about CDC pension schemes in comparison to schemes that they already operate?</i></p>	<p>Introduce the pre-material to prompt/guide discussion of their understanding of the schemes</p>	
<ul style="list-style-type: none"> • What do they see as the advantages of a CDC scheme? <ul style="list-style-type: none"> - Why are they advantages; to whom are they advantages (employer, employee)? • Can they see any downsides to a CDC pension scheme <ul style="list-style-type: none"> - Why are they downsides; to whom are they downsides (employer, employee) • What do they think about: <ul style="list-style-type: none"> - Fixed contributions for employer (page 3 section 1) - Greater predictability of retirement income for members (page 1 section 1c) <ul style="list-style-type: none"> • Risk sharing or smoothing mechanisms (page 3 section 7) • Collective fund (page 1 section 1c; page 3 section 4) • Economies of scale (page 3 section 5) • Higher predicted returns (page 3 section 4) - Role of trustees (page 3 section 3) - Process for adjusting pensions in response to fluctuations in the financial market (page 1 sections 2d and 2e and page 2 flow chart) <ul style="list-style-type: none"> • Probe on feelings about reducing indexation and/or nominal benefit levels for <ul style="list-style-type: none"> • Active Members • Deferred members • Pensioners 	<p>Use references to direct respondent to specific points in the pre-material</p>	

Continued

Key questions	Notes	Approximate timing
<ul style="list-style-type: none"> - Options for payment of pensions <ul style="list-style-type: none"> • Purchase an annuity upon retirement • Pay pensions directly from CDC scheme fund (page 2 flow chart) - Trustee management (page 3 sections 3 and 6) 		
<p>3.3 Employees understanding of CDC schemes</p>		
<ul style="list-style-type: none"> • How well do they think employees understand current pension scheme? • How do they communicate the features of their current scheme to employees? <ul style="list-style-type: none"> - What features are easy to communicate - What features are difficult to communicate - Reasons why • Do they think employees would find it easier or more difficult to understand CDC schemes? <ul style="list-style-type: none"> - What features would be easy to understand? - What features would be less easy to understand? • What features of CDC might be attractive/unattractive to employees? • How does this impact on their attitude towards switching? 		
<p>3.4 Comparison with current schemes</p>		
<ul style="list-style-type: none"> • How does a CDC scheme compare with their current scheme(s)? <ul style="list-style-type: none"> - Features of CDC scheme that are advantageous - Why are these features advantageous - Features of CDC scheme that are disadvantageous - Why are these features disadvantageous 		

Continued

Key questions	Notes	Approximate timing
<p>4. Willingness to join up with other employers</p> <p>4.1 Willingness to switch Thinking about CDC schemes as we described in the pre-material and your current scheme[s]</p> <ul style="list-style-type: none"> • Would they consider switching to a CDC scheme? • Under what circumstances would they consider switching to a CDC scheme? • What would motivate them to switch to a CDC scheme? • Are there any barriers to switching to a CDC scheme? <p>4.2 Willingness to join up with other employers</p> <ul style="list-style-type: none"> • Would they consider switching to a CDC scheme with other organisations (if their organisation is not large enough to operate independently?) <ul style="list-style-type: none"> - What sort of employers would they consider joining with? 	<p>Focus on the actual circumstances in which respondent would switch to a CDC scheme rather than whether respondent is interested in principle.</p> <p>Explore any communication issues regarding current pension schemes to understand the importance of employee comprehension and appreciation of benefits in joining a scheme.</p> <p>Use the pre-material to prompt discussion of aspects which may be easier or more difficult to communicate a CDC scheme in comparison with existing schemes</p>	<p>9 minutes</p>
<p>5. Feedback to DWP</p> <ul style="list-style-type: none"> • 3 key points they would like us to feedback to DWP <ul style="list-style-type: none"> - Anything else respondent would like to raise or discuss in relation to topics spoken about • Any comments or thoughts on the pre-material <ul style="list-style-type: none"> - Usefulness - Easy to understand - Suggested improvements 	<p>Focus on good points about scheme or how scheme could be improved, how DWP can encourage or help organisations adopt scheme.</p> <p>Any learnings on how well employers can understand this info.</p>	<p>10 minutes</p>

Appendix C

Qualitative analysis using Matrix Mapping

Material collected through qualitative methods is invariably rich but unstructured. Much of it is text based, consisting of verbatim transcriptions of interviews. Moreover, the internal content of the material is usually in detailed and micro form (for example, accounts of experiences and inarticulate explanations). The primary aim of any analytical method is to provide a means of exploring coherence and structure within a cumbersome data set whilst retaining a hold on the original accounts and observations from which it is derived.

The analysis of the in-depth interviews was undertaken using a qualitative content analytic method called 'Matrix Mapping', which involved a systematic process of sifting, summarising and sorting the material according to key issues and themes.

The first stage of 'Matrix-Mapping' involved familiarisation with the data (in the form of verbatim transcripts) and identification of the emerging issues. Based on this preliminary review of the data, as well as the coverage of the topic guide and the researchers' experiences of conducting the fieldwork, a thematic framework was constructed.

The analysis then proceeded by summarising and synthesising the data according to this thematic framework that comprised a series of subject charts displayed in Excel.

Data from each interview and group discussion transcript were summarised and transposed under the appropriate subject heading of the thematic matrix. The context of the information was retained and the page of the transcript from which it came noted, so that it was possible to return to a transcript to explore a point in more detail or to extract text for verbatim quotation. Once the data had been sifted a map was produced which identified the range and nature of views and experiences, sought associations and patterns within them and provided explanations and underpinning factors.

The mapping process is similar regardless of the topic being considered. The analyst reviews the summarised data; compares and contrasts the perceptions, accounts, and experiences; searches for patterns or connections within the data and seeks explanations internally within the data set. Piecing together the overall picture is not simply aggregating patterns, but weighing up the salience and dynamics of issues, and searching for structures within the data that have explanatory power, rather than simply seeking a multiplicity of evidence.