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The Legal Differences between CIDC and CDC

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Abstract

Both Collective Defined Contribution (CDC) and Collective Individual Defined Contribution (CIDC) schemes place any risks on pension scheme members instead of an external risk-bearer. In CDC schemes, assets are pooled collectively, allowing for risks to be shared between pension scheme members. In Individual DC schemes (IDC), the scheme members bear such risks individually. But CDC's collective nature leaves little room for individual risk management and the pension assets are allocated to scheme members via rules that are often complex and ambiguous. CIDC schemes strive to retain the desirable aspects of CDC and IDC schemes, while improving on some of the drawbacks. The drawbacks of a CDC scheme are mitigated by the introduction of 1) individually quantifiable pension pots through individual accounts, 2) individual risk management and 3) a simplified scheme. The drawbacks of an IDC scheme are mitigated by 1) mandatory participation, 2) collective management of assets, and 3) sharing of risks. It therefore seems that CIDC schemes have a number of important advantages over CDC schemes. CIDC scheme members should be clearly informed of their legal position vis-à-vis their employer and pension provider, and the contract should clearly define the risks. Scheme members appear to benefit from individual risk management and individually identifiable pension pots, while employers and/or pension providers seem relieved from risks and enjoy the security of fixed pension contributions. The possibility to take out a lump sum seems contrary to the collective sharing of risks in both CIDC and CDC schemes.

Introduction

In the simplest archetypes, pension schemes can be divided into Defined Benefit (DB) and Defined Contribution (DC) schemes.[3] They can be told apart easiest by remembering who – in principle – bears the risk: in a DC scheme, the scheme members themselves bear the risk; the employer commits merely to paying a fixed sum as a contribution. Pension benefits are determined by what has been paid into the scheme and the investment yield, minus costs. A pure DC scheme – also known as Individual Defined Contribution (IDC) – features no risk sharing, apart from statutorily required elements of solidarity,[4] and the sharing of investment risks that appears inherent to the collective management of the investments.[5] In a DB scheme, the risk bearer is typically the employer or a pension provider. The employer

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[3] P. Borsjé, H. van Meerten, 'Pension Rights and Entitlement Conversion ('Invaren'): Lessons from a Dutch Perspective with Regard to the Implications of the EU Charter', European Journal of Social Security, 2016, 18, p.46-73.
[4] E. Schols-Van Oppen, 'De collectieve beschikbarepremieregeling', in: *De CDC-Regeling: stand van zaken anno 2008*, Amersfoort: Sdu Fiscale & Financiële Uitgevers 2008, p. 8;
[5] D. Blake, *We Need a National Narrative: Building a Consensus Around Retirement Income*, Report: Independent Review of Retirement Income, 2016, p. 492.

commits to a certain level of benefits to be received by the employee upon retirement. In the Netherlands, the pension provider has a number of options to compensate for underfunding without increasing pension contributions, such as a benefit reduction or non-indexation.

In reality, few schemes conform to the description of either archetype, and can thus be placed on the spectrum that exists between them. On that spectrum, Collective Defined Contribution (CDC) and Collective Individual Defined Contribution (CIDC) schemes can be found. In the Netherlands as in other countries, a discussion questioning the sustainability of DB schemes and their pension promise is taking place, as well as on their complexity.

Defined Benefit schemes feature collective pension pots and the assets are managed collectively, making the identification of who owns what complicated. The link between benefits and entitlements in these schemes is not easy for a scheme member to understand, and these collective pots allow little room for tailor-made solutions to accommodate wishes and risk-appetites of various age-groups.

CDC

As a way to limit the risks stemming from DB schemes for employers, Collective Defined Contribution plans (CDC) were created.[6] These are hybrid schemes: a combination of elements of DB and DC. The premium is fixed for a number of years – a typical DC feature – and the level of pensions is typically defined in advance – a typical DB feature – with the explicit caveat that the level of pensions is guaranteed only to the extent that premiums paid are sufficient to reach that level of benefits. The risk that the premium is insufficient to achieve the pension benefits is borne by the scheme members collectively.[7]

In the Netherlands, CDC schemes of two types exist. In the first, an assessment is made annually of the annuity that can be purchased on the basis of the contributions paid. Most CDC schemes in the Netherlands, however, are based on a career average salary like traditional DB schemes, but with the clear message that no guarantee as to the level of benefits is given. The employer seems not burdened by any legal or economic risk regarding the level of pension benefits achieved. In the Netherlands, CDC plans *can* also qualify as defined benefit schemes if there is a sufficient amount of certainty that the agreed upon level of pensions will be attained.[8] Members of CDC schemes should be clearly informed of the manner in which the amount of the

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[6] E. Bergamin et al., "Collectief stelsel met meer maatwerk en minder generatieconflicten", in: M. Bijlsma et al. (eds.), *Jaarboek Koninklijke Vereniging voor de Staathuishoudkunde 2014*, The Hague: Sdu Uitgevers 2014, p. 56.
[7] Ibid., p. 9.
[8] M. Heemskerk, *Pensioenrecht*, The Hague: Boom Juridische Uitgevers 2015, p. 59.

contributions have been determined and how likely it is that these premiums will achieve the indicated level of benefits.[9]

In a *Collective* Defined Contribution scheme, the assets are pooled collectively. Such collective pooling allows for risk sharing between members "both within the same generation of members (i.e., intra-generational risk pooling) and risk sharing between different generations (i.e., inter-generational risk sharing)."[10] For instance, if one scheme member lives longer than expected, the increased cost of that scheme member's good fortune can be financed through another's misfortune of living shorter than expected.

In contrast, in "pure" DC schemes, or IDC schemes, the scheme members bear the risks largely *individually*. In collective schemes without sponsor guarantees like CIDC and most CDC schemes, surpluses or deficits are not transferred back to the sponsoring undertaking or made up by it, but are rather shared by the scheme members collectively between young, old and future generations "by adjusting either contributions, or benefit levels or both, which leads to inter-generational transfers."[11] *Ex ante*, the contributions are set in such a manner that a newly entering generation funds its own retirement, but *ex post*, it may turn out that a given generation is a net payer or a net receiver.[12] It is clear, then, that in comparison to a DB scheme, any risks are transferred to the scheme members. This need not be a problem in itself, although the scheme members should be duly informed of their new economic and legal position.

Although CDC schemes allow risk sharing, their collective nature appears to have as a consequence that little room is left for tailoring such risk management to the needs of individuals. A criticism leveled at such schemes is that the pension assets are allocated to scheme members via rules that are "typically incomplete [read: unclear] and often modified", and the collective nature of CDC schemes makes determining an individual's pension assets and risk-sharing arrangements ambiguous.[13] The rules according to which these risks are shared can be complex and arbitrary.[14]

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[9] https://www.vvpensioenrecht.nl/download/werkgroepmemo_juridische_aspectien_cdc.pdf

[10] D. Blake, *We Need a National Narrative: Building a Consensus Around Retirement Income*, Report: Independent Review of Retirement Income, 2016, p. 492. http://www.pensions-institute.org/IRRIChapter6.pdf

[11] J. Cui, F. de Jong & E. Ponds, 'Intergenerational risk sharing within funded pension schemes', *Journal of Pension Economics and Finance* 2011, 10(1), p. 4.

[12] *Ibid.*

[13] L. Bovenberg & R. Gradus, "Reforming occupational pension schemes: the case of the Netherlands", *Journal of Economic Policy Reform* 2015, p. 248; E. Bergamin et al., "Collectief stelsel met meer maatwerk en minder generatieconflicten", in: M. Bijlsma et al. (eds.), *Jaarboek Koninklijke Vereniging voor de Staathuishoudkunde 2014*, The Hague: Sdu Uitgevers 2014, p. 56.

[14] Bergamin et al. 2014, p. 56.

In addition, for a CDC scheme, the premiums are not determined individually but collectively.[15] In the Netherlands, a system of so-called average premiums is used for DB and most CDC schemes, whereby all pension participants – regardless of their age – contribute the same percentage of their salary and receive a set percentage of accrual in return. This system of average accrual has been under discussion recently in the context of talks on pension reform,[16] as it is said to be unfair to young employees whose contributions still have years of investment returns ahead of them, while those of older employees do not – yet under the current system, they are valued the same.[17] This system finds its origins in the post-war era, when it was necessary to enable older employees to build up a decent pension in a relatively short period of time.[18] The Netherlands Bureau for Economic Policy Analysis (CPB) notes that this system is "not ideal or even problematic", as it leads to a structural redistribution from younger to older scheme members, and from scheme members with low life expectancy to those with a high life expectancy.[19] This system hinders portability and labor mobility.[20]

CIDC

CIDC schemes strive to retain the desirable aspects of CDC and IDC schemes, while improving on some of the drawbacks.[21] A CIDC scheme features a fixed premium and collective asset management (as in a CDC scheme), but with individual pension accounts. The individual account appears to allow for clear definition and individualization of the sum in the scheme member's pension pot and the risks involved.[22] In a system without average contributions (back-loading), the accrual of pension rights would be actuarially fair: the benefits correspond directly to the contributions and their investment returns.[23]

The drawbacks to the IDC and CDC schemes are addressed in a CIDC scheme in the following ways.[24] The drawbacks of a CDC scheme are mitigated by the introduction of 1) individually quantifiable pension pots through individual 'semi-legal' (see below) accounts, 2) individual risk management through tailored investments, enabled by individual accounts and 3) a simplified (and therefore more

[15] E. Schols-van Oppen 2008, p. 50.
[16] https://www.rijksoverheid.nl/documenten/kamerstukken/2017/07/14/advies-raad-van-state
[17] A.J. van de Griend, H. van Meerten, 'Hervorming pensioenstelsel: degressieve opbouw in uitkeringsovereenkomsten en vlakke premies in premieovereenkomsten', *Sociaal Economische Wetgeving,* 2017, 5, p. 189-198.
[18] CPB, *Eindrapportage Voor- en nadelen van de doorsneesystematiek*, 2013, p. 8.
[19] CPB 2013, p. 99.
[20] Bovenberg & Gradus 2015, p. 249.
[21] G. Beechinor & C. Hoekstra, 'CDC Focus: Has CDC already had its day?', https://www.globalhrlaw.com/resources/cdc-focus-has-cdc-already-had-its-day, 2014.
[22] Bovenberg & Gradus 2015, p. 250.
[23] R. Gradus, 'Bouwstenen voor een toekomstig pensioenstelsel', *PensioenMagazine* 2014(4), 30-34
[24] R. Gradus, 'Bouwstenen voor een toekomstig pensioenstelsel', *PensioenMagazine* 2014(4), 30-34.

understandable) scheme. The drawbacks of an IDC scheme are mitigated by 1) mandatory participation, 2) collective management of assets, leading to scale economies and 3) sharing of risks, such as investment and certain longevity risks. Longevity risk is shared by redistributing leftover funds from scheme members who pass away early into a "collective pool", to the benefit of surviving scheme members,[25] just like in a CDC scheme, but in a CIDC scheme only risks are shared, that can be shared, such as micro-longevity (A gets to be older than B).[26] Furthermore, a CIDC scheme is fully funded per definition.

The collective nature of DB and CDC schemes leaves fairly limited room for individual freedom of choice for scheme members:

"CDC plans pursue the same uniform investment policy for all participants, even though older participants would typically make a more conservative trade-off between risks and return than younger participants."[27]

Contrariwise, younger scheme members could benefit from a more aggressive investment strategy. In a system in which more and more risk is shifted to the scheme member, a dearth of options to adapt the scheme to personal preferences could be problematic.

The individual accounts in CIDC schemes make individual tailoring of investments possible. This also makes it possible to share only those risks that are appropriate to share, such as micro-longevity risks that occur within a certain collective rather than macro-longevity risk.[28]

Even though IDC schemes can afford scheme members with more options for personal decisions, they do not insulate such members from the potentially far-reaching consequences of the many decisions they must potentially make in such schemes. Default options can provide solace in such situations, but the absence of risk-sharing in such schemes can place scheme members at risk of adverse developments in, for instance, financial markets or life expectancy. Future needs are difficult to anticipate and the future consequences of decisions made in the present are difficult to foresee: individuals are left to invest in the "unknown and unknowable".[29]

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[25] Bovenberg & Gradus 2015, p. 251.

[26] T. Hulshoff, H. van Meerten, G.C.M. Siegelaer, F.R. Valkenburg, "Individueel eigendomsrecht in een beschikbarepremieregeling", Pensioen Magazine 2016, p. 7.

[27] L. Bovenberg & R. Gradus, 'Reforming occupational pension schemes: the case of the Netherlands', *Journal of Economic Policy Review* 2015, p. 250.

[28] T. Hulshoff, H. van Meerten, G.C.M. Siegelaer, F.R. Valkenburg, "Individueel eigendomsrecht in een beschikbarepremieregeling", *Pensioen Magazine* 2016, p. 7.

[29] Zeckhauser, R. (2010). Investing in the Unknown and the Unknowable. In F.X. Diebold, N.A. Doherty, and R.J. Herring, eds., the Known, the Unknown, and the Unknowable in Financial Risk

Conclusion

Both CDC and CIDC schemes aim to fix the afflictions of the current pension system in the Netherlands. From the perspective of the employer and/or the pension fund (the scheme sponsor(s)), an appealing feature is the absence of a guarantee of a certain level of pension benefits, and the contributions are fixed for a number of years. The risks in both schemes are transferred unambiguously to the scheme members, and they should be clearly informed of that. It seems, however, that CIDC schemes hold a number of advantages over CDC schemes for scheme members. The more individual nature of CIDC schemes not only makes the identification of a scheme member's pension pot easier, it also allows for more individualized risk management and appears to afford more scope for personal freedom of choice.

	DB	CDC	IDC	CIDC
Guaranteed level of benefits?	Yes (in principle)	No	No	No
Claim on plan sponsor?	Yes	No	No	No
Quantifiable pension pot?	No	No	Yes	Yes
Fixed contribution?	No	Yes	Yes	Yes

Table 1. Different systems and some of their characteristics.

	DB	CDC	IDC	CIDC
Accrual actuarially fair	No	No/Yes	Yes	Yes
Clear individual property rights	No	No	Yes	Yes
Tailor-made intergenerational risk management	No	No	Yes	Yes
Scope for individual choice	No	No	Yes	Yes
Mandatory saving	Yes	Yes	No	Yes
Collective procurement	Yes	Yes	No	Yes
Collective sharing biometric risks	Yes	Yes	No	Yes

Table 1. Source: Bovenberg & Gradus 2015

In addition, there appears to be a lower risk of inequitable transfers between generations.

Management: Measurement and Theory Advancing Practice. Princeton NJ: Princeton University Press, pp. 304-46.

Since 2015, UK pension scheme members have the option of withdrawing the funds in their pension pot as a lump sum for DC schemes.[30] The result of such a withdrawal is that those choosing the lump sum withdraw themselves from a pool in which risks can be shared. Other options – such as a fixed-term annuity or a drawdown arrangement – appear to allow for (limited) risk-sharing, but a lifelong, fixed-rate annuity does not appear possible without some form of external risk bearer. In the case of a flexible annuity or a fixed-term annuity, the risk can stay with the scheme members within their risk pool and an external risk bearer does not appear strictly necessary. In that case, the amount of the annuity can fluctuate based on the investment returns and life expectancy.

However, opting for a lump-sum would mean not only an end to risk-sharing in the payout phase – in which the sharing of longevity risk seems most important – but it seems to be contrary to the idea of a CIDC scheme (and indeed a CDC scheme). Such schemes are meant to share such risks: if not, the first 'C' in the CIDC/CDC name will become meaningless. The UK legislator could bar the possibility for taking out a lump sum for CIDC or CDC schemes. In the Netherlands, the qualification of CDC and CIDC schemes is not always clear.

The Dutch Central Bank (DNB) requires those CDC schemes which are based on an average career salary to comply with the same funding requirements as a 'conventional' average salary DB scheme, which – in principle – guarantees a level of pension benefits.[31] DNB states in its guidelines that the maximum premium for CDC schemes should not be fixed for a longer period than five years. This is in contrast to a DC scheme, for which the DNB allows a fixed premium for an indefinite period.[32] No explicit guidelines appear to exist for CIDC schemes, but it seems that DNB's approached could be extended to these schemes as well.

We would like to conclude with a caveat. In the Netherlands, the discussion on the revision of the pension system to a certain extent revolves around creating a system that allocates "clear and individual property rights" to pension scheme members, and CIDC schemes are favored by some because they are said to be able to provide such rights.[33] However, such terminology is confusing as the assets in the scheme do not *belong* to the scheme member as such. In a DC and CIDC scheme, it is possible *value* an individual's pension pot, but that is not the same as saying that the participant *owns* that sum.

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[30] https://www.gov.uk/government/news/pension-changes-2015

[31] E. Schols-Van Oppen 2008, p. 12.

[32] http://www.toezicht.dnb.nl/en/3/51-228388.jsp

[33] Social and Economic Council of the Netherlands, Advice 2015/01, pp. 40-42; A. van den Brink et al., "Collectieve Solidariteit, individuele zekerheid: Naar een toekomstbestendig pensioencontract voor Nederland", Position paper by Rabobank Pensioenfonds, Syntrus Achmea and Cardano, 2015.

It is therefore best to avoid the term "ownership" in the context of pensions,[34] as that term is of no consequence in relation to pensions either in the Netherlands[35] or the UK, where occupational pensions are typically operated by trusts.[36] It is therefore not a *legal* property right – not even in EU law terms – but an *economic* right to the sum defined in the individual account: it is typically the pension provider or trust fund that owns the pension capital.[37]

[34] M. Heemskerk & J. Tangelder, *Pensioen wijzigen: klem tussen eigendomsrechten en vetorecht?*, Pensioenmagazine 2016.
[35] Ibid; M. Heemskerk, R. Maatman & B. Werker, "Heldere en harde pensioenrechten onder een PPR", *Netspar Design Paper 46* 2016.
[36] https://www.gov.uk/guidance/pension-trustees-appointment-and-role
[37] T. Hulshoff, H. van Meerten, G.C.M. Siegelaer, F.R. Valkenburg, "Individueel eigendomsrecht in een beschikbarepremieregeling", *Pensioen Magazine* 2016, p. 7.