What if You Ran a DC Plan Like a DB Plan? The UK May Be About to Find Out

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AUTHORS: David W. Powell

Optimal pension design to take into account the best features of both defined contribution and defined benefit plans has been a hot topic worldwide. In the US, designs such as the Variable Annuity Plan, Sustainable Income Plan and Market Rate of Return Cash Balance Plans have all been getting attention. Across the Atlantic, the UK is now poised to test a proposal along those lines of its own.

In March 2019, the Department for Work and Pensions ("DWP") of the UK government issued a proposal to allow a new form of pension scheme, called a collective defined contribution scheme or "CDC", with the first to be opened for the 140,000 employees of the Royal Mail ("RM"), backed by the Communication Workers Union ("CWU"). The law must be changed to allow this, and the DWP states that it intends to introduce legislation as soon as parliamentary time allows. Of course, without knowing whether the government may change, there is some uncertainty.

The intent is that the RM plan will be the trial, and once issues have been ironed out with that CDC plan, the UK government will look to expand CDCs to other employers, as well as master trusts and multi-employer pension schemes.

Design of a CDC Plan

In a CDC scheme as envisioned, financial contributions are to be invested in collective funds. At retirement, individual members receive a regular pension income from the fund. This income will be based on the value of their contributions to the fund, but is not guaranteed and will be subject to fluctuations in value depending on the fund's performance. As the fund is administered and managed on a collective basis, there will be no need for members to make choices about the investment of funds or the ways of converting that fund into an income stream in retirement.

One of the major questions that the DWP grappled with, as described in its proposal, is whether there should be a "capital buffer" to smooth volatility in the underlying investments. Such a buffer would

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probably make the plan a DB plan under most definitions. In the RM plan, however, the DWP decided against that, making the plan a money purchase defined contribution plan. The DWP indicated that not having a buffer would make the plan more transparent and protect it from claims that it is stockpiling too sizeable a surplus for future members at the expense of increases for current members. However, the proposal also indicates that they do not want to preclude or legislate against buffers in CDC in general, rather that a plan's approach to having and managing a buffer should be a key part of its scheme design and authorisation.

The DWP proposal notes that they will particularly need to tailor current law to CDC schemes in the areas of disclosure of information and tax requirements. The proposal further provides that CDC schemes will be trust-based, though it will not require professional trustees, and members will have a right to transfer out into a traditional DC scheme.

The RM Plan Design – Contributions, Benefits and Investment Structure

The RM scheme, as currently understood, will have company contributions of 13.6 percent of salary, and member contributions of 6 percent, though this seems subject to change. The CDC scheme will undertake annual actuarial valuations in order to determine whether benefit adjustments are required, and specify principles that will apply to those valuations. The RM have designed their proposed scheme for it to be funded at sufficient levels to provide inflation increases in distributions of CPI plus 1 percent per annum.

Under the RM plan, participation will begin on 12 months of continuous service. The contributions are designed to support an annual benefit distribution calculated at a rate of 1/80th of pensionable pay for each year of service at normal retirement age of 67. A survivor benefit equal to 50% of the member's pension is provided, and small lump sums and ill health (disability) payouts are also provided. Different distribution options offered would be based on actuarial equivalence. The RM scheme investments are intended to be invested into two portfolios, one of return–seeking assets and the other of low-risk assets. Amounts will be invested 100% in return-seeking assets until age 67, and then gradually shifted to the low-risk portfolio over the following 23 years, with 100% in low-risk assets from age 90 onwards.

An important piece is the "Pension Adjustment Mechanism." As currently planned for the RM scheme, annually, the value of the plan assets, excluding a reserve for future operational expenses, is compared to the liability for all accumulated pensions if there were no further increases. This is known as the "Parity" funding level. If "above Parity", the benefits may increase. If "below Parity", pension cuts are required to bring the plan back to Parity.

In the event of such a downturn, RM's proposed would limit reduction of benefits to no more than 5 percent for up to 3 years more as a way of reducing volatility in the scheme, though larger reductions would be permitted if necessary to bring the plan back into Parity within 3 years. A drop of 5 percent

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or less in a year would be applied as a single reduction. Increases or decreases in benefits would be applied uniformly across the entire membership.

Cessation of Contributions

Another design assumption is that CDC schemes should be sustainable without continuing employer contributions, because they are money purchase benefits and will not have recourse to the Pension Protection Fund for DB plans. CDC schemes will have to demonstrate that they would be sustainable should ongoing employer contributions cease as a part of the Pensions Regulator's ("TPR") authorisation and oversight process.

Fees and Expenses

The DWP proposal provides that it will have a charge cap to help to drive down member-borne costs, whilst still allowing flexibility in terms of asset diversity and delivering tailored services. In addition, large schemes, such as the RM plan, are expected to have the economies of scale to take advantage of the most competitive market rates. The initial proposal is for an annual charge cap set at 0.75% of the value of the whole CDC fund, or an equivalent combination charge. However, the proposal indicates that the DWP will continue to explore the shape and form that CDC scheme specific cap and charges regime might take.

Of course, more changes could occur, in politics and design, before we see how the new CDC plan design will work in practice. But this may be a trend to watch, and if successful, we could see more plans of similar design worldwide.

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