XPS Pensions

Briefing

Note No. 16
December 2018

Government fires starting pistol for collective DC schemes

In brief

- DWP has published a consultation on CDC schemes, which allow risks to be shared between members
- There would be a target level of benefits, which might be adjusted (up or down) in light of the results of annual valuations
- CDC schemes would be subject to an authorisation regime similar to that for master trusts
- The consultation runs until 16 January 2019
- The intention is for legislation to be introduced to Parliament as soon as possible

Next steps

- Employers interested in offering a CDC scheme in future should consider responding to the consultation

On 6 November 2018, the Department for Work and Pensions (DWP) published a consultation on implementing collective DC (CDC) schemes. This followed a request from Royal Mail for UK legislation to be amended to allow CDC schemes in light of its agreement with the Communication Workers Union (CWU).

Background

In CDC schemes, risks are shared between members. This compares to traditional pure defined contribution (DC) schemes (where the member bears the bulk of the risks, such as investment performance, mortality and charges) and defined benefit (DB) schemes (where the employer takes on the risks).

In February 2018, Royal Mail and the CWU announced that they had agreed to work towards replacing their current DB and DC schemes with a CDC scheme for around 142,000 employees as soon as possible. However, this was subject to the proviso that the Government would need to legislate to allow for such schemes. The DWP has now published its consultation on implementing CDC schemes. At this early stage, this is a consultation on the direction of travel rather than one on detailed proposals.

Legislative approach

The Pension Schemes Act 2015 contains legislation which could be used to provide for CDC schemes. However, these provisions were designed to introduce the wider Defined Ambition framework, and using them would significantly change the existing pension regime. Consequently, the Government has concluded that new primary and secondary legislation is required instead.

CDC benefits are intended to be a form of money purchase (MP) benefit, so that it will be clear to employers that they will not have to fund any shortfall in benefits that might arise. Consequently, CDC schemes would not be eligible for entry into the Pension Protection Fund (PPF) in the event of employer insolvency. Similarly, CDC schemes will be required to communicate clearly with members to ensure they understand that the level of benefits is not guaranteed and will depend on various factors, including the performance of scheme assets. The Government intends that they will be trust-based private sector schemes and no changes to the categorisation of existing schemes will occur. (So CDC schemes will be for new benefits only). Initially, the regulatory framework will just allow for CDC schemes of the broad form and nature of the one proposed by Royal Mail. However, the intention is that the DWP could modify the framework in light of future experience without an Act of Parliament being required.

Authorisation by TPR

CDC schemes will be subject to an assurance and regulatory regime (similar to that for master trusts) and therefore will be scrutinised by the Pensions Regulator (TPR) before they are authorised (and can receive contributions). As with master trusts, the costs of authorisation would be met by the scheme.

The authorisation process would look at various matters including the scheme's continuity strategy, its financial sustainability, the robustness of its systems & processes, and whether individuals significantly involved in its running are 'fit and proper'.

It would also consider the level of target benefits relative to contributions, how benefit adjustments are carried out, how transfer values are determined, and how communications explain to members what they might expect from the scheme.

The DWP is also considering whether other requirements, such as a CDC Chair's Statement and a CDC annual scheme return, are needed, as well as possible additional powers for TPR to request information, amend valuation assumptions/target benefit levels, or trigger wind up. Legislation will include provisions enabling such additional requirements to be added later if necessary.

The DWP intends that CDC schemes will be occupational trust-based pension schemes with their main place of administration in the UK. Before a CDC scheme can accept contributions, it will also have to be registered with HMRC for tax purposes. (The DWP notes that some tweaks to the tax regime might be needed, although this might prove to be complex.)

Adjusting benefits/managing risk

Before a CDC scheme can approach TPR for authorisation, an independent actuary will be required to peer-review the actuarial assumptions underlying the scheme's design. Once authorised, a CDC scheme will be required to appoint a scheme actuary and carry out annual actuarial valuations to assess whether benefit adjustments (either up or down) are needed and to test the scheme's overall sustainability.

The DWP considers that such adjustments should apply across the entire scheme membership (i.e. to accrued pensions as well as pensions in payment) and should be the result of a mechanism set out in the scheme rules, not trustee discretion. Scheme rules will be required to be clear on what will trigger the winding up of the scheme. Possible triggers will have to include one that relates to the sustainability of the scheme.

Some other countries require CDC schemes to have compulsory capital buffers, which aim to give greater certainty to the level of retirement income. However, the DWP favours a 'no buffer' approach, noting that a buffer might burden younger members.

The DWP is also considering whether to require CDC schemes to be sustainable without future contributions.

Trustee duties

The DWP believes that the current Trustee Knowledge and Understanding (TKU) requirements should suffice for CDC schemes. However, it is minded that TPR is likely to consider the collective expertise and experience of the proposed trustees as part of the authorisation process.

If prospective CDC scheme sponsors emerge that are not large, well-resourced employers with experience of providing pensions, the DWP will consider whether higher levels of governance are required. It also intends for the legislation to be flexible to allow more stringent TKU requirements in future.

Charge cap

As CDC benefits will be a form of MP benefit (where members bear all the investment risk), the DWP proposes that CDC schemes will be subject to the same charge cap applying to standard MP schemes. Although the cap will be set at the same level (i.e. 0.75% p.a. on funds under management), it will apply to the scheme as a whole instead of to an individual member's pot.

Where a CDC scheme is used for auto-enrolment, it will be subject to a restriction to the charging structures that will be permitted in the same way as for traditional DC schemes.

Transfer values

The DWP acknowledges that the existing basis for calculating transfer values from an MP scheme (which uses the value of the assets in the member's individual pot) might need to be amended for CDC benefits. One possible approach would be to base transfer values on the member's share of the total fund (as determined at the most recent annual actuarial valuation).

Other matters

Disclosure: most of the existing framework will apply but some tweaks might be needed, in particular to ensure the risk of reductions is clearly communicated to members.

Auto-enrolment: the DWP is considering what minimum quality requirements should apply to a CDC scheme.

Conclusion

CDC schemes would be a new addition to the pensions landscape. Although the DWP intends to legislate as soon as possible, given the current pressures on Parliament and Government, it might be some time before the necessary framework is in place. It also remains to be seen how much demand there is amongst employers to use a CDC scheme for their pension provision.

For further information

Please get in touch with William Fitchew.

@xpsgroup.com

company/xpsgroup

t 01483 330 100

e william.fitchew@xpsgroup.co.uk