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Collective Defined Contribution (CDC) schemes

The DWP has published a consultation on draft regulations that set out further detail to support the provisions in the Pension Schemes Act 2021 (PSA21), including what CDC schemes must do to become authorised, to operate effectively in the market under regulatory supervision, and what happens if changes need to be made to their schemes.

The consultation closes on 31 August 2021.

Background

Under the existing UK workplace pension framework employers can offer their employees either a defined benefit (DB) or a defined contribution (DC) scheme. DC schemes give a less predictable retirement income for scheme members and DB schemes can create significant financial burdens for employers.

The PSA21 creates a third type of scheme known as Collective Defined Contribution or Collective Money Purchase (in the legislation). Both employers and employees will contribute to the collective fund from which retirement income is drawn. The funding risk would be borne collectively by scheme members and the employer would carry no financial risk. CDC schemes offer a targeted income in retirement rather than a specified income. Where a scheme is under (or over) funded, pensioners' benefits can be adjusted to ensure the assets of the collective fund are equal to the liabilities relating to the target incomes.

The provisions in the PSA21 are designed to accommodate the launch of the CDC scheme that Royal Mail had agreed with the Communication Workers Union in 2018. The draft regulations have been designed for this purpose but are intended to allow for rapid amendment to facilitate other forms of CDC provision which may follow.

The Pensions Regulator is to be responsible for the ongoing supervision of CDC schemes and it will produce detailed practical support for schemes through operational guidance and a Code of Practice. In addition, HMRC are making the necessary changes to the tax regime to provide for CDC schemes.

Authorisation

Criteria

The Regulator will assess an application for authorisation against the following criteria: fit and proper persons, scheme design, financial sustainability, member communications, systems and processes for effective governance and adequate continuity strategy.

The draft regulations give some details as to the criteria, but more will be set out in the Code of Practice that the Regulator must issue.

Application fee

The PSA21 enables the Regulator to charge a fee for the cost of the authorisation process. Whilst the fee has yet to be finalised it is expected to be a maximum of between £50,000 and £120,000.

Where a section of a scheme is already authorised, any further section applications will each be charged on a cost recovery basis at the discretion of the Regulator.

Timescale

The Regulator has six months from the date it receives the application to reach a decision on the authorisation and notify the applicant of the decision.

Operation

Ongoing supervision

Following authorisation, a CDC scheme is required to demonstrate to the Regulator that it continues to meet the authorisation criteria on an ongoing basis. Where it fails to do so the Regulator may withdraw authorisation.

As part of that process the Regulator can require trustees of CDC schemes to submit a supervisory return. It is expected that this will be in the form of an annual return although the content, form in which it must be submitted, and timescales, are yet to be determined by the Regulator. Further details are expected in its forthcoming Code of Practice.

Triggering events

The Regulator must be notified in writing by trustees / sponsors and other specified people, as soon as reasonably practicable, if they become aware that a significant event has occurred in relation to an authorised CDC scheme, that may affect the ability of the scheme to continue to meet the authorisation criteria.

Risk notices

The Regulator may issue a risk notice to the trustees of a CDC scheme if it considers that there’s an issue of concern in relation to the scheme and that the scheme will breach the authorisation criteria, or is likely to breach them, if the issue is not resolved.

The purpose of this is to enable the Regulator to resolve issues at an early stage and hopefully avoid having to withdraw a scheme’s authorisation, which may not be in the best interests of members.

The risk notice requires trustees to set out how the issue will be resolved by submitting a resolution plan to the Regulator. Penalties will apply for non-compliance further regulatory action is likely if they are not resolved. Progress reports must then be provided to the Regulator to ensure that the appropriate action is being taken.

Scheme changes

CDC schemes will be subject to an annual actuarial valuation and benefit adjustment process to keep the value of assets held and the projected costs of benefits in balance.

All CDC schemes will have to follow strict rules on benefit adjustment to ensure fairness to each group or cohort of members. This will require:

- valuations to be undertaken using a central estimate methodology that does not seek to be overly optimistic or to build in prudence
- any adjustment of benefits to apply to all members without variation
- any increases in benefits resulting from the valuation to be sustainable

Where scheme rules allow, cuts in benefits can be smoothed over three years to avoid sudden benefit reductions to pensioners.

Comment

While the proposals on CDC schemes are, for the moment, designed to enable Royal Mail to put in place a CDC scheme, the intention is that they are wide enough to accommodate other future CDC schemes for single employers, or connected multi-employers. Sponsoring employers concerned that traditional DC schemes may not provide a sufficient income in retirement for employees, but who do not wish to run the financial risks associated with DB schemes, will have a third option available – perhaps as early as 2022.

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