A First Class Delivery: the Royal Mail CDC Scheme

Monday 7 October 2024 may strike you as a fairly non-descript day in the calendar, unless it is your birthday or that of someone you know. A quick trawl online throws up that it is UN World Habitat Day, Labour Day in parts of Australia, the final day of National Holiday week in China and allegedly National Kale Day in the UK. 'Lettuce' post another milestone for this year: the date the Royal Mail Collective Defined Contribution (CDC) scheme is officially launched. Formally, the scheme name is the Royal Mail Collective Pension Plan, shortened to 'the Collective Plan' in online content and scheme literature.

This marks the first such scheme in the UK with eligible employees automatically joining on the start date. As this is something worth writing home about, the Aries team thought it would deliver a snapshot of the Collective Plan by addressing the why, what, who and how. Fingers crossed, it receives your stamp of approval.

Why

Back in 2018, a predicted significant increase in costs for the defined benefit (DB) Royal Mail Pension Plan (RMPP) was deemed unaffordable. Negotiations between the Royal Mail, the Communication Workers Union (CWU) and the Unite Communication Managers Association (CMA) sought to settle on a suitable alternative. Using the existing Royal Mail Defined Contribution Plan (RMDCP) was not considered a viable option so discussions began about a trust-based scheme that would invest money collectively and automatically give members a lump sum and income in retirement. There was more to the process than outlined here, as shown by this extract from the UK Parliament website.

CDC schemes do exist in other countries, such as the Netherlands, Denmark and Canada, but there was no legal basis for them to be established in the UK. The Pension Schemes Act 2021 laid the foundations for the new scheme type with an authorisation process subsequently being developed by TPR. At the time of writing, the Collective Plan is the only one listed as authorised. It is worth noting that the legislation uses the term 'collective money purchase' (CMP) but CDC is more widely used in practice.

What

It is possibly best to think of a CDC scheme sitting in between a DB and defined contribution (DC) scheme. CDC provides members with a retirement income similar to a DB scheme, so does not offer the flexible benefit options of DC. However, income levels are not guaranteed, which is more akin to DC than DB. The income provided is for life meaning there is no prospect of a member's funds running out as could happen with drawdown. Depending on a CDC scheme's investment performance and funding position, benefit adjustments may be made before and after retirement.

The main attraction for employers is that pension costs year-on-year should remain largely fixed. For employees, there is no requirement to make investment choices plus there are straightforward retirement choices when taking benefits. Although, there is the prospect of downward benefit adjustments being made, any volatility should be smoothed out, thus keeping accruals and payments as stable as possible.

Other considerations include:

- All else remaining equal, CDC income levels should be higher than an annuity as a benefit level guaranteed for life carries a risk premium. On the downside, CDC income is not guaranteed as the aim is only to provide a target level of pension. Scheme assets may fall in value or the cost of providing incomes could increase.

- Compared to drawdown, the chance of a CDC scheme running out of funds is spread over a large population (benefitting those living longer). The collective nature of a CDC scheme means income is based on average life expectancy of members. On the flipside, members dying younger effectively subsidise the pensions of those living longer. Some members could theoretically be worse off than if they were in a DC scheme with their own arrangement.

- Investing collectively allows a CDC scheme to invest at low cost and achieve greater economies of scale. There could be better returns than an individual's DC pot as it does not all need to be moved to low risk, highly liquid investments when members approach retirement.

- Transfers represent a risk where members with a lower life expectancy seek a transfer out of a CDC scheme. Being able to transfer at full value could impact the funding position for those remaining in a scheme.

More commentary on the advantages and disadvantages of CDC schemes can be found in a House of Commons Library Research Briefing.

As you would expect, the Collective Plan is an occupational pension scheme that will be overseen by trustees, with Royal Mail being the sponsoring employer. The trustees' role is similar to that of any other occupational scheme: to act in line with the scheme's Trust Deed and Rules and in the best interests of members and beneficiaries.

The Collective Plan will comprise of two main sections: an income for life section (the CDC section) and a guaranteed lump sum section (the Defined Benefit Lump Sum (DBLS) section). Each will have its own investment strategy that will see employee and employer contributions pooled together into investments such as equities, bonds, commercial property and money market instruments. Investments will aim to balance risks and maintain pace with the cost of living.

Employees will have the option to pay "booster contributions" into the DBLS section or additional voluntary contributions (AVCs) into a separate scheme run by a pension provider. Initially, no transfers will be allowed into the Collective Plan but this stance could be reviewed at a later date.

Only the income being accrued in the CDC section can increase, stay the same or reduce. Lump sums accrued in the DBLS section could increase or stay the same but cannot be reduced. As the lump sum is effectively a guaranteed benefit, there will be a greater emphasis on lower-risk growth in the DBLS section.

Who

Essentially, Royal Mail employees will become eligible to join the Collective Plan once they reach twelve months continuous service. At the launch date, employees in the RMPP and those paying standard contributions to RMDCP will start contributing to the Collective Plan instead. Benefits accrued in the RMPP and funds held in the RMDCP will remain where they are and will continue to be subject to the rules relevant to each scheme.

Other changes are being made to how automatic enrolment (AE) will operate for Royal Mail employees. The AE scheme will change from RMDCP to the National Employment Savings Trust (NEST). In practical terms, when an employee becomes eligible to be automatically enrolled they will join NEST. Once twelve months continuous service is reached, an employee will become a Collective Plan member. NEST will be the alternative if an employee elects not to join the Collective Plan.

How

Employees will have to contribute 6% of their pensionable pay with Royal Mail contributing 13.3%. Those eligible will see contributions automatically made using "pension salary exchange" (PSE), which is the term being used for salary sacrifice. Pension contributions will remain at the same level after sacrifice with take-home pay being increased. As salary sacrifice may not be suitable for everyone, employees will be able to opt out of PSE.

Notional splits of contributions into the CDC section and DBLS section are provided in Collective Plan literature. The employee split is shown as 4% into CDC and 2% into DBLS whereas the employer split is quoted as 11.2% into CDC and 2.1% into DBLS. Pensionable pay is basic pay, but can also include overtime, allowances and bonuses depending on an employee's contracted hours and terms of employment.

Royal Mail will also pay 0.3% of pensionable pay towards ill-health premiums. These will go to an insurer, so do not form part of the Collective Plan. The booster option will allow employees to pay an extra 1% into the DBLS section, which will be matched by Royal Mail.

Accrual in the CDC section will target 1/80th of pensionable pay for each year that contributions are made. In the DBLS section, the accrual rate will target 3/80ths of pensionable pay per year. Normal retirement age is age 67 although it will be possible to take benefits earlier or later than that. Taking benefits early could be possible from normal minimum pension age (NMPA), which is currently 55 but will increase to 57 from 6 April 2028. Benefits can be taken before NMPA if a member is deemed to be in ill-health. There is no upper age limit on when benefits can be taken whilst a member keeps working and paying into the Collective Plan.

Death benefits are payable from the Collective Plan should a member die before or after taking benefits. A member can choose to transfer out of the Collective Plan before taking benefits, as you'd expect. The independent advice requirement does not apply to CDC or guaranteed lump sums, but financial advice will be encouraged before any decision to transfer.

Separate income for life and lump sum examples demonstrate how the accrual process will operate. For a member earning £26,000 pa:

- In year one, this could secure £325 in yearly income (£26,000 divided by 80) from age 67 and £975 as a lump sum (£26,000 multiplied by 3/80) at age 67.

- If the annual salary in year 2 has increased to £26,500, this could secure another £331 (£26,500 divided by 80) in yearly income and £994 as a lump sum (£26,500 multiplied by 3/80).

- Booster contributions of 2% will boost a member's lump sum by 2.2% of pensionable pay, although this could change in the future. So, if £200 in total gross contributions was paid as a lump sum booster in one year, this would add £220 as a lump sum at age 67.

Benefits will continue to accrue this way annually with the intention to increase the pension benefits over time to keep up with the cost of living. CDC income will be subject to income tax with the DBLS lump sum likely to be tax-free as a pension commencement lump sum (PCLS). Some members may have paid booster contributions to enhance the DBLS lump sum available and some may have AVC benefits, which could be taken as income or as a lump sum separate from the Collective Plan benefits. Typically, all benefits will be expected to be taken at the same time. A case study on benefit accrual is provided based on a fictional employee.

Perhaps the trickiest part to get to grips with relates to the adjustments that may be made following an annual review of the scheme's investment performance and funding position. Essentially, this will assess the value of the Collective Plan's investments plus any estimated growth against the money forecast to be needed to pay the benefits and increases that have built up. Separate reviews will be made for the CDC and DBLS sections. Annual reviews will be conducted by the trustees to work out if any adjustments need to be made to benefits being accrued or to income that is in payment. This exercise will require input from the Collective Plan's actuary.

In simple terms, if there is more money in the CDC section than is thought to be needed, then incomes can go up. If there is less, incomes can go down. The latter is crucial as it means that Royal Mail as sponsoring employer could not be called upon to contribute more to the CDC section. It is worth noting that a decrease in excess of 5% could be split over two or three years.

For the DBLS section, the review process is similar but the lump sums accrued cannot decrease. Adjustments in the DBLS section could be different to those applying to the income section. Another important distinction is that if there is not deemed to be enough assets to pay the current lump sums for all members at age 67, the assets of the DBLS Section could need to be topped up by Royal Mail.

Any adjustments will take effect on 1 April each year. The CDC section is not protected by the Pension Protection Fund (PPF) because it is technically a 'money purchase scheme' and thus ineligible. Conversely, the guaranteed benefits in the DBLS section are protected by the PPF.

The first annual benefit statements will have to be issued no more than 12 months after the effective date of the first actuarial valuation, which itself must be within the first year. The information will also be available on a bespoke online portal.

In summary

To round off our summary, it also worth noting developments in the pipeline to enhance the scope of CDC schemes. Currently, CDC schemes can only be set-up on a single or connected employer basis, meaning they will only be of interest to employers with large, stable workforces. Early last year, the DWP declared an intention to permit multi-employer CDC schemes. Additionally, proposals were also mooted for decumulation only CDC arrangements. Both are still at the initial stage of development with a DWP consultation response from July 2023 being the last meaningful activity.

At this stage, the Collective Plan represents a step into the unknown for the UK pensions industry. Will different types and sizes of organisations be interested in CDC and how many schemes will actually be established? Other factors could also have an impact such as ongoing initiatives for consolidation, the push for pensions to invest in UK productive finance and the Government's pensions review.

Further reading

Aries Members have access to a CDC module in the Aries Knowledge Base, which contains sections on the definition of a CDC scheme; authorisation criteria; benefit adjustments; ongoing supervision; disclosure; and benefit statements. TPR's Code of Practice on CDC is also a good website address to note for reference.

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