Lessons from across the pond:
Defined contribution retirement plans in the US and the UK

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The 401(k) plan, also known as a “defined contribution” or “DC” plan, is now firmly entrenched as the primary employer-based retirement vehicle in the US. Defined contribution plans have likewise become the primary workplace pension vehicle in the UK. As a result, participation, investments, and distributions have become key concerns for employers, employees and policymakers on both sides of the Atlantic. As the search for new and innovative solutions takes on increasing importance, it is helpful to reflect on the ways in which workplace defined contribution retirement plans have evolved in the US and the UK and to learn from examples of best practices in each jurisdiction.

Plan landscape

In the US, the most prominent type of employer-sponsored defined contribution plan is a 401(k) plan, named after the tax code section that provides the plan’s tax-deferred nature. A 401(k) plan is based on employee contributions and employer matching and profit-sharing contributions that are generally tax-deferred upon contribution and invested in accounts over which the employee has investment control. Unfunded supplemental plans, sometimes referred to as top-hat plans, are permitted for executives and other highly paid employees. This article focuses on 401(k) plans, but certain types of employers can sponsor other defined contribution plans.

In the UK, the most common forms of employer-sponsored defined contribution plans are occupational defined contribution pension plans, group personal pension plans, and master trusts. Like in the US, amounts held in these plans are tax-favored, the plans are funded through employee and employer contributions, and employees generally have an array of investment options from which they can choose. In order to benefit from favorable tax treatment, a plan must be a ‘registered pension scheme’ meeting certain requirements. Employers also may operate unregistered schemes to enhance the benefits provided to senior executives.
Participation

Because defined contribution plans are funded in part (and in some cases, entirely) by employee contributions, employers and policymakers have recognized that broad participation is crucial to the success of these plans. The US and the UK have approached this problem in similar ways, but with different enforcement mechanisms.

US

In the US, one method of encouraging participation that has grown in popularity is auto-enrollment. Under this approach, newly hired employees are enrolled in the plan and are deemed to elect deferrals at a specified percentage (e.g., 3% of pay) unless they opt out. The power of inertia results in many employees simply going along with the contribution percentage.

A variation on this approach is auto-enrolling all employees, including existing employees, at a specified rate (usually excluding employees who are already participating). Some employers have instituted auto-escalation, in which the contribution percentage of an automatically enrolled employee is automatically increased each year by a specified percentage (e.g., a 1% additional contribution per year) up to a capped amount, unless the employee opts out.

Auto-enrollment and auto-escalation are optional and not mandated by law. However, employers have an incentive to implement these features. The US tax code requires 401(k) plans to satisfy annual contribution testing. This testing, referred to as the “ADP test,” mandates that as a condition of tax-favored treatment, the employer’s highly compensated employees, on average, cannot contribute significantly more than the non-highly compensated employees, on average. Because the most highly compensated employees strongly prefer to maximize contributions to the plan, employers are motivated to find ways to encourage broad and meaningful employee participation. Of course, employers also want employees to contribute to 401(k) plans because it is in the best interests of their employees.

UK

The UK also has recognized the benefits of auto-enrollment, but it has gone a step further by mandating that all employers automatically enroll eligible workers in a qualifying pension plan that meets certain minimum quality requirements, including a minimum rate of employer contributions. The requirements were phased in, starting with the largest employers, and are now also applicable to smaller and micro employers. The requirements will apply to all employers (including those with just one worker) beginning February 1, 2018. Approximately every three years, employers are also required to automatically re-enroll workers who have opted out and who continue to meet the eligibility criteria.

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Investments

A critical difference between a traditional defined benefit pension plan and a defined contribution plan is that the employee bears the investment risk in a defined contribution plan. If the employee makes a poor investment choice or a chosen fund performs poorly, the employee ultimately will have less funds for retirement. For this reason, and others, there has been a great deal of attention to investment options in both the US and the UK.

US

In the US, 401(k) plans offer investment options selected by a plan fiduciary. The fiduciary is usually a committee of company employees with financial expertise, often assisted by an outside financial adviser. Plans usually offer a diversified menu of investment options.

Investment options are generally selected based on financial performance, rather than social or other factors. The US Department of Labor has taken the position that non-financial factors are generally not relevant in the fiduciary decision-making process, although it has acknowledged that environmental, social, and corporate governance factors can have an impact on financial performance and can therefore be relevant in a fiduciary’s evaluation of the investment.
As a part of their fiduciary duties, plan fiduciaries closely monitor the amount of fees charged for investment management and recordkeeping. There has been a great deal of litigation in the US asserting that fiduciaries have failed to adequately monitor and limit fees, resulting in numerous costly settlements by plan sponsors. As a result, this is a topic of increasing importance and focus for plan fiduciaries, and many plan fiduciaries have made efforts to negotiate lower fees and improve the transparency of plan fees.

UK

In the UK, most defined contribution plans offer a range of investment options. The trustees of the plan (who are required to act independently of the employer) or the third-party providers are responsible for selecting the investment options available under the plan and for monitoring fund performance and ongoing suitability. An employer’s role, if any, is limited. Under UK law, trustees are required to evaluate environmental, social and corporate governance (ESG) factors in their investment decisions when these are, or could be, “financially significant.” They also may consider ESG factors when they conclude that a particular factor or fund feature would be supported by an overwhelming majority of employees. It is now common in the UK for a defined contribution plan’s investment options to include an ethical investment option and a Sharia law compliant fund.

ESG factors are generally a more significant aspect of fund selection in the UK than in the US, and this emphasis is expected to increase in the UK in future years. Beginning in 2019, a new European Directive on workplace pension plan governance will increase the need for trustees and providers to consider and record policies for assessing ESG risks in their plans. This directive is likely to impact the UK, regardless of the outcome of the Brexit negotiations.

With millions of people having been automatically enrolled in their employer’s pension plan, the UK government is concerned about plan fees and, in recent years, has introduced the following additional requirements:

i. a cap of 0.75% on the annual fees (excluding transaction costs) that can be applied to an individual’s savings held in the default fund under an automatic enrollment pension plan; and

ii. a requirement that those responsible for overseeing defined contribution plans assess and provide annual reporting on the extent to which the fees under the plan represent a good value for employee money.

Unlike the US, to date the UK has not seen extensive litigation over the amount of fees in defined contribution plans. However, this is something that could change as fees come under increasing scrutiny.

Distributions

The success of a defined contribution plan as a retirement vehicle is dependent in many respects on the manner in which employees draw down their account balances. Early and rapid distributions can lead to inadequate funds for retirement and imprudent financial choices. As a result, employers and policymakers in the US have implemented measures to encourage extended, deliberate distribution patterns in defined contribution plans. In the UK, savers have had greater freedom over how they use their retirement savings held within defined contribution plans since April 2015. Employers, providers and policymakers are still evaluating how best to support savers in this new environment of increased choices.

US

In the US, 401(k) plans generally allow distribution in the form of a lump sum upon termination of employment. The lump sum can be taken as a taxable cash amount or rolled over on a tax-free basis into an individual retirement account (also called an IRA), from which distributions in a variety of forms can be taken. Some 401(k) plans also offer installment distributions and, more rarely, the ability to purchase an annuity with the account balance.

The expense, additional administration and fiduciary risk of offering features such as installments and annuity purchases have discouraged some employers from offering any forms of payment other than lump sums. The US government has taken some regulatory actions to try to encourage 401(k) plan sponsors to offer these distribution features. One action was designed to reduce the fiduciary exposure for selecting an annuity product to offer under the plan. Another action was intended to provide a clear path to offering a new annuity product called a “qualified longevity annuity.” This product is designed to be purchased with only a portion of the employee’s account balance and pays an annuity benefit only if the employee lives past a certain age. This hedges against the risk that the employee will exhaust his or her account balance prematurely. Although this product has not yet been adopted widely due to concerns over administration and portability, among other things, over time it may become an attractive way to offer employees the best of both worlds—an account balance that they control, as well as protection in the event they outlive their assets.

UK

Generally speaking, individuals in the UK can access their defined contribution plan savings without penalty from age 55 (rising to 57 by 2028) or earlier if they are suffering from ill-health. Since April 2015, individuals have had much greater freedom over distributions from their defined contribution plan savings, beginning at age 55. The tax rules prior to April 2015 allowed savers to take up to 25% of their savings as tax-free cash and then use the rest to buy an annuity. Individuals who took more than 25% of their savings as cash prior would have had to pay a 55% tax charge on the excess over 25%. As a result, very few people took this action. In addition, systematic withdrawal options were only available to individuals with large amounts of pension savings. However, significant changes were made to the tax rules in April 2015, which mean that (1) there are now no restrictions on who can make use of systematic withdrawal options, and (2) there is substantial flexibility to take any form of distribution.
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Conclusion

The US and the UK face similar challenges with respect to the critical role of defined contribution plans in retirement planning. The countries have implemented some common solutions, but in other cases the approaches are quite divergent. Employers and policymakers in each jurisdiction would benefit by considering the experiments, successes and issues that each country has encountered in this area.

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