

corporate briefing



Auto-enrolment and Personal Accounts – the consequences of pensions for all

Summary

The Pensions Act 2008 will require almost all employees to be auto-enrolled into a pension scheme from 2012, with the provision of minimum levels of contributions or benefits.

Key factors to consider:

- what pensions arrangements should be offered to current non-members
- existing DC arrangements may require a re-design
- there will be an increase in the administrative burden to support these changes.

Introduction

On 26 November 2008, the Pensions Bill completed its journey through Parliament and received Royal Assent. It is this piece of legislation which will impose a duty on all employers to auto-enrol almost all employees into a pension arrangement. This may be either an employer-sponsored pension scheme that meets minimum conditions, or the new Personal Accounts scheme. The new duty is currently expected to apply from 2012, although may be staggered according to business size.

Employers must enrol all employees who earn at least £5,035 a year (in 2006-07 terms), and who are aged between 22 and State Pension Age (SPA).

Agency, temporary or contract workers fulfilling these criteria must also be enrolled automatically, with the obligation for doing so falling on whoever has responsibility for paying the worker.

Conditions that must be met to qualify for exemption from offering Personal Accounts

Any type of employer-sponsored pension plan, either occupational or contract-based, may qualify provided it meets certain conditions.

The conditions are linked to a band of "qualifying earnings". This is, in effect, gross earnings, including all contractual and statutory income (maternity pay, for example) between £5,035 and £33,540 a year (in 2006-07 terms). The intention is that these limits will be reviewed annually and increase in line with average earnings.

Defined benefit (DB) schemes

The scheme must either be contracted-out or provide a pension from age 65 of at least $n/120$ ths of average qualifying earnings in the previous three tax years. Employers will be allowed to 'phase in' employees who had previously chosen not to join the scheme (opt-outs).

Defined contribution (DC) schemes

The exemption for all types of DC scheme will primarily be based on the contribution structure and will require minimum total contributions of 8 per cent of qualifying earnings. This contribution rate will be phased in over a period of at least three years following the introduction of the requirements.

Most DC schemes use a different definition of pensionable earnings from qualifying earnings. This could give rise to problems in ensuring compliance with the 'minimum contribution' requirements. However, employers with DC schemes will be able to meet these requirements on the basis of an annual check.



➤ Furthermore, they will be permitted to certify at the beginning of each year that the contributions to be paid will meet the test. If they do this, they will not be required to make retrospective reconciliation payments at the end of the year, unless the detriment to an individual exceeds a minimum threshold. Unfortunately, this still appears to require employers to undertake a test at the end of the year in respect of each individual to compare actual contributions with the statutory minimum. Details of the test will be set out in regulations.

Employer contributions

The employer must contribute a minimum of 3 per cent of qualifying earnings, although this will be phased in over at least three years – 1 per cent initially, then 2 per cent, and finally 3 per cent.

Employee contributions

Employees will be required to make contributions to top up the employer contributions to the overall minimum (8 per cent after the initial phasing-in period). Employees will receive tax relief on their contributions. The level of employee contribution (assuming the employer pays the minimum) will also be phased in over at least three years. The aggregate amount received by the arrangement will be 1 per cent, then 3 per cent and finally 5 per cent (inclusive of basic rate tax relief).

Investment options

In addition to the contribution requirements, DC schemes will need to implement a default investment option to ensure auto-enrolment is possible. There might also be requirements in relation to the fund choices available to members.

Hybrid schemes

The Government will make regulations to specify which of the above tests (or a combination of them) apply to hybrid schemes.

Joining process

Auto-enrolment into an employer's scheme must normally be effective from the date that an employee starts employment. However, an employer-sponsored scheme that provides demonstrably better benefits than the minimum, is expected to be able to apply a waiting period before admitting employees to the scheme. For example, the Government has suggested that an employer contribution of 6 per cent to a DC scheme should be sufficient to allow a deferral period of up to three months. Longer deferral periods might be possible, although payment of back contributions is required when the employee finally joins the scheme.

Employees who are under the age of 22, or over SPA (but under the age of 75), whilst excluded from automatic enrolment, may elect to join at any time and, where this is the case, the employer will be obliged to provide minimum levels of benefit.

Opt-outs and refunds

Employees may opt-out of membership of their pension arrangement at any time. However, any opt-out lasts for only a maximum of three years and following this period the employer will need to automatically re-enrol the employee (who may then opt out once again!).

The Government has indicated that employees who opt-out of any of the above arrangements within 30 days will be entitled to receive a refund of their contributions. The option of a refund for leavers with between three months' and two years' service in an occupational scheme is expected to continue to be available, but with no such option from personal pension type arrangements.

“ Employers won't be able to induce employees to opt-out ”

▾ Compliance

The Pensions Regulator will be able to take action against employers for failing to comply with their new duties. In particular, the regulator may issue a 'compliance notice' to an employer if it considers that the employer has taken action for "the sole or main purpose" of inducing an employee to opt-out.

Employers will need to consider how any information provided to employees could be perceived by the regulator in this regard. Furthermore, the regulator might consider it 'unlawful' for employers to offer employees an option to exchange 'compulsory' employer pension contributions for alternative benefits, for example though a flexible benefits package. Therefore, many employers might feel obliged to revise these arrangements.

Personal Accounts

The Personal Accounts scheme will be a low-cost, no frills, occupational pension scheme set up under trust, and is not intended to compete with existing pension provision. However, it is very likely to become a de facto benchmark against which all DC schemes will be compared. Consultation on the rules of the scheme is expected to take place in early 2009. The proposed structure is:

Contributions

The 'minimum contribution' requirements for Personal Accounts will be the same as for other DC schemes. There will be a phasing in of the contribution requirements over a period of at least three years as described above.

Employees may contribute more than the minimum, but a maximum combined employer and employee level is likely to be enforced to guard against Personal Accounts competing with, and ultimately damaging, existing pension provision. It is expected that this will be £3,600 a year, increasing in line with average earnings from the date that the new pension system was announced in 2005.

Collection and onward transmission of contributions might present a new administrative burden. Use of the PAYE system for collection and transmission would minimise that burden but, unfortunately, the Government is of the view that it is unlikely to be suitable for this purpose.

Joining process and opt-outs

The joining process is expected to be the same as that for employer-sponsored arrangements, with the exception of deferral periods, which are unlikely to apply.

The Government has indicated that only employees who opt-out of Personal Accounts within 30 days will be entitled to receive a refund of their contributions. The same 'anti-inducement' requirements as above will also apply.

Charges

The Government's intention was that the Personal Accounts scheme would have a 0.3 per cent annual management charge and be self-financing. This is now widely considered unachievable, at least at the outset. No decisions will be made on these issues until the Government has considered recommendations arising from the consultation earlier this year on the most appropriate charging structure.

Investment options

Personal Accounts are likely to offer a limited range of investment choices. This could include options such as social, environmental and ethical investments, as well as branded funds.

For those not wishing to make an investment choice, there will be a default fund. Members will be automatically enrolled into the default fund if they do not choose an alternative from the Personal Accounts portfolio.

“
The Personal Accounts scheme will be a no frills scheme, designed not to compete with existing arrangements
”



Employers will need to consider a re-design of current arrangements



↘ A consultation on potential approaches to investment is expected to be launched in 2009.

Benefits

Consultation on the benefits to be paid from Personal Accounts has already started. It is proposed that members (aged between 55 and 75) will be able to secure a retirement income through a lifetime annuity or income drawdown. Members who do not want to choose an annuity on the open market will be able to choose a limited range of products from a panel of providers. These providers must satisfy certain conditions, including accepting **all** business that the Personal Accounts scheme generates.

As with other DC schemes, members will be able to take up to 25 per cent of their fund as a tax-free lump sum and those with 'trivial' funds will be able to commute them in accordance with the current HMRC rules. The proposed trivial commutation limit of £2,000 (announced in the 2008 Budget) is also expected to extend to members of the Personal Accounts scheme. Members may also be able to amalgamate their Personal Accounts fund with other pension funds.

The proposals in relation to the information to be provided to members prior to retirement appear to go beyond that required for existing DC arrangements.

Actions required

Employers will need to quantify the cost of auto-enrolling all employees into a pension scheme, and consider whether any re-design of current arrangements might be needed to meet the exemption criteria and whether, in practice, defaulting to the Personal Accounts scheme might be appropriate.

Factors which need to be taken into account include:

- the potential cost of extending pension scheme membership to all employees
- the consequences of any re-design of existing schemes
- the administrative burden of auto-enrolment and the other new requirements
- the potential benefits of having a single scheme for new employees
- the level of staff turnover and the consequent availability (or otherwise) of refunds of contributions.

If you would like to discuss any of the matters raised in this briefing, please either call your regular consultant or contact:

Paul Macro

+44 (0) 161 833 7243

paul.macro@watsonwyatt.com

Janine McGahon

+44 (0) 1737 274552

janine.mcgahon@watsonwyatt.com

To manage the regular publications you receive from Watson Wyatt, please email 'subscribe@watsonwyatt.com' or 'unsubscribe@watsonwyatt.com' with the name of the publication in the title bar. Alternatively please visit www.watsonwyatt.com/membership

Authorised and regulated by the Financial Services Authority.

The information in this publication is for general interest. No action should be taken on the basis of any article without seeking specific advice.

© Watson Wyatt Limited
December 2008

Ref: 2008-COR-MKT06