jch: investmentmanagement

WORKPLACE PENSION REFORM AND AUTOMATIC ENROLMENT

Why You Need to Know:

From October 2012 the Government will introduce automatic enrolment for all employees into a pension on a phased basis. This can be into any qualifying pension scheme, including the National Employment Savings Trust (NEST) which will be a centralised scheme, designed for those who are not served by the current pensions market.

The changes mean that all employers will need to review any pension provision they offer staff, or start to provide pensions for the first time. There will be significant cost and administration implications for employers, and these will affect decisions being made now about their pension arrangements.

This Need to Know document provides you with a brief overview of the key changes, including the rules for automatic enrolment and the key features of the NEST scheme.

What You Need to Know:

Automatic enrolment

(a) Basic employer duties

Employers will have to automatically enrol all staff aged 22 or over and earning over £5,035 a year (increased with earnings inflation from April 2007) into a qualifying scheme.

Each employer will have a staging date, which will be between October 2012 and September 2016, when they must automatically enrol existing staff. After that new staff will be automatically enrolled when they join the company, or when they first meet the age and earnings criteria. The largest companies will be the first to be brought into the new regime.

Employers will have to register with The Pensions Regulator, and demonstrate how they are meeting the requirements.

(b) Requirements for qualifying schemes

Defined benefit schemes will have to meet minimum benefit requirements, which correspond to the existing Reference Scheme rules for contracted-out schemes, and are similar for contracted-in schemes, except that the accrual rate is 1/80ths instead of 1/120ths.

From October 2017, the minimum contribution level for defined contribution arrangements (including personal and stakeholder pensions) will be 8% of qualifying earnings, with at least 3% being paid by the employer. If the employer contributes the minimum amount, the employee must contribute at least 4% of qualifying earnings, with a further 1% coming from tax relief. Before that, the minimum will be 2% total (including 1% employer) until September 2016, then 5% (including 2% employer) until September 2017.

Qualifying earnings are those between £5,035 and £33,540 a year (increased with earnings inflation from April 2007). They include overtime, commissions, bonuses and other earnings. Discussions are continuing with the Government to allow employers who use a different definition of pensionable earnings to certify that they meet the minimum standard without having to check individually for all staff.

Defined contribution arrangements must have a default investment for those who do not make a choice.

(c) The automatic enrolment process

Employees must normally be enrolled as soon as they start work if they are over the age and earnings thresholds. However, employers can delay automatic enrolment by 3 months as long as they contribute at least 6% of qualifying earnings within a minimum of 11% in total being paid into the scheme.

Employers have a month to enrol the employee into the scheme (backdated to day 1) and provide him or her with required information. The employee then has up to a month to opt-out.

The employer cannot provide the opt-out form to the employee. However, any paper forms have to be returned to the employer who is responsible for informing the scheme about the opt-out. Electronic forms will go direct to the scheme with an instant copy to the employer.

The employer will be responsible for deducting contributions for the employee from the first payday, and for making a refund if necessary if the employee opts-out. The employer can delay making payments to the pension scheme until after the opt-out period ends, but otherwise will have to reclaim from the scheme.

Employees who opt out will have to be automatically re-enrolled every three years. There will be a single re-enrolment date every three years for each employer.

The National Employment Savings Trust (NEST)

NEST is a centralised scheme established by the Government, and initially developed by the Personal Accounts Delivery Authority (PADA). It is designed to be simple and low-cost, so that it is particularly suitable for those who are not served by the current pensions market. The contract for administering NEST has been awarded to Tata Consulting Services (TCS), but has a break point in October 2010 and is being reviewed by the new Government.

NEST has a duty to accept contributions at any level from any employer on the same terms. It has been announced that the likely charging structure is an annual management charge of 0. 3% of the fund value with an additional charge of 2% of each contribution until start-up costs for the scheme have been recovered.

There will be limited investment choice, including ethical funds. The default fund is likely to be cautiously invested, and may feature 'target date' funds where investment is designed for those retiring in a particular year. However, the final decision on investment strategy will rest with the NEST Corporation, which will replace PADA in July 2010.

To protect existing pension arrangements, contributions to NEST for each member will initially be restricted to £3,600 (in 2005 terms). In addition, there will be no transfers in or out of NEST before 2017 except in a few strictly-defined circumstances.

There will be no scope to pay advice costs out of NEST charges, but there will be an extensive advertising campaign for the scheme and communications material designed to appeal to the target market.

Issues for employers

Among the aspects that need to be considered by employers are the following:

(a) Cost of automatic enrolment

Many employers may well believe that their existing pension arrangements are better than the minimum automatic enrolment requirements. However, they are still likely to face extra cost when automatic enrolment is introduced. For those with defined contribution arrangements:

- They will have to meet the minimum requirements on contribution rate.

- They will have to automatically enrol staff as soon as they join the company or reach the age and earnings thresholds. It is very common for employers to have a 'waiting period' so that those who do not stay with the company for long do not join the pension scheme. This will be limited to a maximum of 3 months, and will then permanently double the minimum employer contribution rate to 6%. Employers will have to decide whether to bear this cost or automatically enrol new staff immediately.

- Employers typically base pension contributions on basic salary. The new requirement will be to include overtime, commissions, bonuses and other elements of earnings, although the first £5,035 (in 2006/07 earnings terms) can be ignored. Employers who have significant numbers of staff with earnings on top of basic salary may have to change their earnings definition or increase the contribution rate to ensure they meet the minimum contribution level.

- When employees have to take action to join a pension scheme many will never get round to it, but with automatic enrolment they will be in the scheme unless they act to opt out. This is likely to increase participation rates, and cost to the employer, significantly.

(b) NEST or another pension scheme

In one sense NEST is simply a low-cost pension scheme, but it is likely to become the biggest in the country quite quickly and employers will want to consider whether it is appropriate to their needs.

Among the attractions of NEST will be that it is a very simple scheme, and it may well build a strong brand identity through television advertising and publicity in the press. It will also be low-cost, particularly over long terms, although initially at least it will not be much cheaper than many larger employer schemes.

On the other hand, investment choice will be very limited, and many employers will want to offer a range of investment options to staff, possibly including self-investment for those with more substantial pension savings. It will also be a very standard arrangement with no tailoring for individual employers, and no opportunity for employers to present it as 'their' scheme with communications particularly relevant to their staff. Where the company has high earners as well as those on more modest incomes, it will probably want to pay in more than the NEST maximum contribution for some of its staff, which will be possible with most schemes but will require an additional pension arrangement if NEST is the main company provision. And, of course, there will be no advice to the company or individuals unless a fee is paid to the adviser.

(c) Possible employer responses

Some employers may simply accept any extra costs required under the new regime, or perhaps factor them into salary negotiations. However others may look for ways to save costs.

One option may be reduce contribution rates for existing members to fund contributions for those joining for the first time. While possible, this could cause ill feeling among current members.

A second possibility could be to retain the current basis for existing members, but enrol some or all new members at a lower contribution rate, possibly into NEST. This would be similar to the approach adopted by many employers when they closed defined benefit schemes to new members.

A third possibility would be to close existing arrangements completely and move everyone to NEST. This is hopefully unlikely to be the choice of most employers.

Whatever the eventual outcome, employers should review their pension arrangements sooner rather than later to check whether they meet the new requirements and consider what changes may be needed.

For further information please contact:

jch investment management limited
1 Henley Way
Doddington Road
Lincoln
LN6 3QR

t. 01522 697310
f. 01522 697350

enquiries@jchim.co.uk

www.jchim.co.uk