

Latest developments

After several amendments, update and a change in Government the DWP announced in June 2010 that the government was to conduct a speedy review of how best to support the implementation of automatic enrolment into workplace pensions. The review was conducted by an independent team led by Paul Johnson of Frontier Economics, with David Yeandle OBE of Engineering Employers Federation and Adrian Boulding of Legal and General Group PLC as the other members. Following the publication of the review the government have agreed to take forward the recommendations made by the independent team. This document supersedes our previous updates on the subject and set out our understanding of the impending changes

This document, together with the previous updates can be found at: <http://www.kifs.co.uk/downloads.cfm>

Summary of proposed changes in the review

Eligibility criteria

Those aged between 22 and state pension age with earnings equal to or greater than the personal allowance (£7,475 from 2011/12) will be auto enrolled and will have contributions based upon earnings above the NI earnings threshold (currently £5,715 for 2010/11) with an upper limit (£38,185 for 2010/11). Those earning less than the personal allowance but equal to or more than the NI earnings threshold will be able to opt-in and receive an employer contribution.

Employer duties

Auto enrolment will apply to all employers and there will be no exemption based on the size of the employer.

Waiting periods

A period of up to three months will be permitted before an employee is auto enrolled. An employee who wished to opt-in during the waiting period will have the right to do so and benefit from the employer contribution.

Certification of contribution levels to defined contribution schemes

This can be achieved by one of the following methods:

- A minimum of 9% of pensionable pay (including 4% employer); or
- A minimum of 8% of pensionable pay (including 3% employer) provided pensionable pay constitutes 85% of total pay; or
- A minimum of 7% of pensionable pay (including 3% employer) provided pensionable equates to total pay

Stranded pots

The review team recognised that individuals typically have many different employments during the course of their working life and consequently may build up lots of small pension pots. They recommend the Government develop a straightforward transfer process for people to move their pension pot as they move employer.

The Government remain committed to the existing timescales; the first set of employers will be subject to the auto enrolment regulations from October 2012.

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Aim of workplace pension saving

Put simply, the government's aim is for savers to be better off in retirement having saved. An employer will have to choose which qualifying scheme* to use:

1. NEST scheme
2. Occupational pension scheme, or
3. Work place pension (e.g. GPP or GSIPP)

*A qualifying scheme must be registered with the Pensions Regulator and must make automatic enrolment available to eligible employees.

The following requirements must also be satisfied:

Money purchase arrangement

There must be a total contribution of at least 8% of "qualifying earnings" of which at least 3% must be employer. Phasing contributions is available for new joiners and existing members

Defined benefit scheme – contracted out
It must meet the "reference scheme test"

Defined benefit scheme – contracted in

It must provide an accrual rate of at least 1/120th for each year of service

Personal pension schemes

There must be a total contribution of at least 8% of "qualifying earnings" of which at least 3% must be employer. Phasing contributions is available for new joiners and existing members

Automatic enrolment

The main thrust of the government's aim to promote pension saving is by way of automatically enrolling jobholders into a pension scheme, either the government backed scheme or an good quality scheme already in place with the employer.

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From 2012 there will be an obligation on employers to auto-enrol their eligible employees into a pension scheme. It is acknowledged that it will not be possible to accommodate all the new joiners on day one so there will be a “staged” requirement to auto-enrol.

The intention is that employers will be responsible for automatically enrolling their eligible employees who are not already a member of an existing workplace pension arrangement.

Employers will be segmented based on their size and this will be assessed using Pay-As-You-Earn (PAYE) records from HMRC. The staging will apply to all employers operating PAYE prior to October 2012. Employers who start to trade after the staging process has ended will be required to automatically enrol a worker from the date they qualify for auto-enrolment. Employers with more than one PAYE scheme will have to implement auto-enrolment when the first PAYE scheme is obliged to offer auto enrolment.

A table detailing the timetable for auto enrolment is available within previous NEST update documents contained within our website [the link above refers].

Along with the staging approach to auto-enrolment the level of contribution paid for defined contribution schemes may be phased. The table below illustrates how the minimum contribution will be achieved.

Year	Employer contribution	Total contribution
First transitional until October 2016	1%	2%
Second transitional From October 2016 to October 2017	2%	5%
From October 2017	3%	8%

When contributions ultimately reach 8% the minimum employer contribution must be 3% with 4% paid by the employee together with 1% tax relief.

The intention is to give employers the opportunity to adjust gradually to the costs of the reforms. One possible danger for employees is that this could allow their employer to “dumb down” their level of contributions to the existing good quality scheme so as to match the required minimums; individuals could find their pension saving compromised as a direct result.

There will be an option for the largest employers to bring forward automatic enrolment but, not before July 2012, if it preferable to do so (business planning reasons).

Employers that offer access to a defined benefit scheme will not be required to auto-enrol eligible workers during the 3-year staging process. However, a jobholder will be able to opt into a qualifying scheme at any time during the transitional period.

Should an employer close their defined benefit scheme during the transitional period they will be required to enrol their jobholders in an alternative qualifying scheme. If the replacement scheme is a defined contribution scheme there will be a requirement to back-pay missed employer contributions.

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Waiting periods

Following a recommendation by the review an employer will be permitted to operate a waiting period of up to three months before automatically enrolling employees into a qualifying pension scheme. This will provide a welcome easement for employers that have a high turn-over of employees, especially those that employ seasonal workers.

An employee who wished to opt-in during the waiting period will have the right to do so and will also be entitled to benefit from the employer contribution.

At the end of the waiting period, should the employer choose to operate one, the employee will be automatically enrolled and the employer must provide information about the scheme including how to opt out.

Employee eligibility

Only eligible employees, those aged between 22 and state pension age with earnings equal to, or greater than the income tax personal allowance (£7,475 for 2011/12)* will need to be automatically enrolled. It will be necessary for an employer to identify employees that need to be included. This will be comparatively straightforward for employees with regular earnings; however some workers have irregular patterns and this makes the requirement to auto-enrol less clear. To assist employers, pay reference periods will be used to help identify employees that must be auto-enrolled.

A pay reference period will be defined as the period over which the employee receives their regular wage or a period of one week. An employer may use a pay reference period of 12 months to measure whether some of their employees who may, in exceptional circumstances, earn enough during isolated periods to have qualifying earnings but over the whole year do not: these people would not be auto-enrolled.

There are some employees who will not be automatically enrolled that may wish to join a pension scheme, for example those aged between 16 and 22; those over state pension age but under 75; or workers with income at or below the personal allowance threshold. An employer will be obliged to inform their employees about details of the scheme and should they wish to join, the employer will be obliged to enrol them into the scheme.

*The aim of the new government is to increase the personal allowance to £10,000 by the end of this parliament.

Certification of contribution levels

Having auto enrolled employees the employer must ensure that the contributions paid will be sufficient to meet the minimum required. For a defined contribution scheme this means that, with the exception of the initial transitional period, 8% of qualifying earnings**, of which at least 3% needs to be employer, must be paid.

Many existing schemes base contributions on actual salary and exclude overtime, commission and bonuses. However, qualifying schemes require a minimum contribution based on qualifying earnings and employers will need to demonstrate that will be met. This has been a difficult issue to resolve so the DWP have decided to adopt the simplified options recommended by the review team.

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An employer will be able to certify that contributions are meeting the required minimum by choosing one of the three following methods:

1. A minimum of 9% of pensionable[‡] pay (including 4% employer); or
2. A minimum of 8% of pensionable pay (including 3% employer) provided pensionable pay constitutes 85% of total pay; or
3. A minimum of 7% of pensionable pay (including 3% employer) provided pensionable equates to total pay

Employers will be allowed three months flexibility around re-enrolment dates for opt-outs (a six-month window meaning they can deal with the issue three months before or after the re-enrolment date).

The introduction of the ability to certify contributions will certainly ease the burden and administrative requirement on employers.

** Qualifying earnings are PAYE earnings between £5,715 and £38,185. Qualifying earnings include salary, wages, bonus, commission, overtime, maternity pay, paternity pay and adoption pay plus anything else the Secretary of State subsequently cares to specify via regulations.

[‡] Pensionable pay, will in most cases, mean basic pay.

For defined benefit schemes to meet the quality requirements employers must:

1. For a contracted out scheme, satisfy that it meets the “reference scheme test” (RST):

The RST is where an employer is required to apply successfully for a certificate from the scheme actuary stating that the scheme provides benefits which are “broadly equivalent to or better than” benefits provided by the reference scheme.

The reference scheme is defined as:

- Accrual rate of $1/80^{\text{th}}$ x years of pensionable service x final pensionable salary, up to a maximum of 40 years with a normal retirement age of 65, which includes a survivors pension of 50%
- Final pensionable salary = average of “qualifying earnings in the last three tax years
- Qualifying earnings = 90% of band earnings (earnings between the lower and upper earnings limit).
- Indexation on pensions in payment in line with RPI increases capped to differing levels dependant on dates.

2. For a contracted in scheme the annual rate of accrual must be:

- $1/120^{\text{th}}$ of average qualifying earnings in the last three tax years preceding the end of pensionable service, multiplied by the number of years of pensionable service, up to a maximum of 40.

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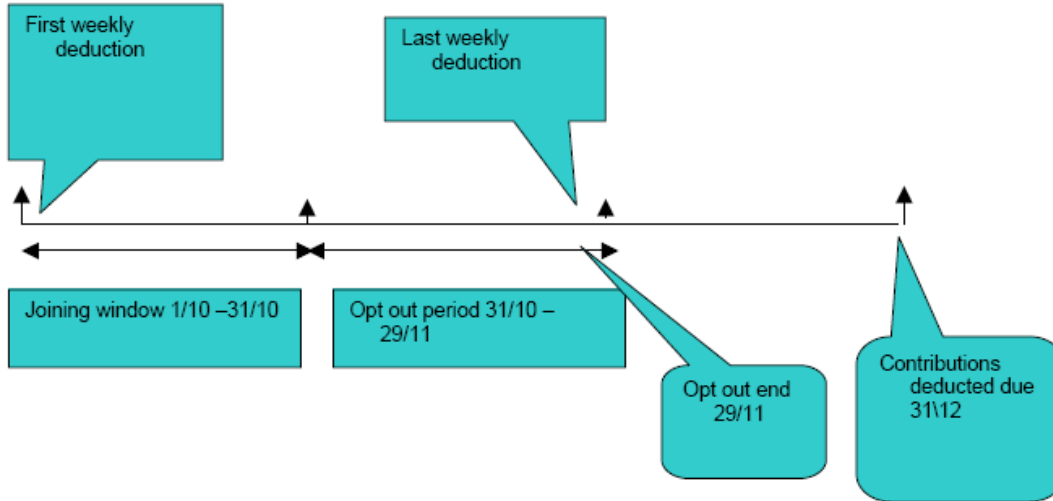
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Opting out

Automatically enrolled employees will have the opportunity, should they wish to exercise it, to opt-out of the scheme. When an individual becomes eligible to be automatically enrolled, their employer will be obliged to provide them with details about the scheme within one month. On receipt of this information the individual will have one month to opt-out. An employee could exercise their right to opt-out up to two months from being eligible or conversely in as little as one day providing all the necessary documentation has been passed across and completed. Their employer must refund contributions deducted during this period to the individual.

An employer will not be able to hold on to opt-out letters because they may be tempted to exert undue influence on their employee to opt-out. Instead, the employee will need to approach the pension scheme administrator directly to obtain the opt-out letter, complete it, then pass it to their employer. As soon as the jobholder becomes eligible to join, contributions will be deducted from their pay at the end of each pay reference period (for example, if paid weekly at the end of each week). Normally, an employer will be required to pass across contributions by the 19th day of the month following the month that they are deducted from pay. However, when a jobholder is auto-enrolled the employer is not obliged to pass across contributions until the last day of the second month following the month in which automatic enrolment applies.

The following diagram helps to explain how this works.



The intention of this process is to prevent employers having to reclaim contribution back from the pension scheme in respect of those jobholders who have decided to opt out.

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Automatic re-enrolment

As part of the Pensions Act 2008 there will be an on-going requirement for employers to automatically re-enrol jobholders who have opted out or ceased being members of the scheme. The requirements for re-enrolment will broadly be the same as those for automatic enrolment. A jobholder will be automatically re-enrolled if they continue to work for the same employer.

An employer will be required to conduct the re-enrolment process every three years from the date their duties first apply (their staging date) and every three years going forward. Following the review it has been recommended that an employer has a three month window either side of their re-enrolment date to perform this duty. This should help employers that may find the actual re-enrolment date falls at a particular busy time for them so provides them with added flexibility.

Any jobholder who opted out in the twelve months before the automatic re-enrolment date will not be subject to re-enrolment. However, if they remain opted out they will be caught at the exercise of the next automatic re-enrolment, in effect it could be nearly four years before they are re-enrolled.

Charges

There will be two charges under NEST, a contribution charge and an ongoing annual management charge.

The contribution charge has been set at 1.8%, this will effectively be a reduced allocation for all contributions paid, i.e. for every £100 paid £98.20 will be invested in the individuals' policy.

The annual management charge will be 0.3%.

These charges will be relatively comparable to a good quality contract based pension arrangement.

Default investment fund option

A qualifying scheme using automatic enrolment must have at least one default fund. The default fund is to be used when an individual does not specify investment choice.

The provider of a qualifying workplace pension (GPP or GSIPP) will be referred to as an "Operator"; the Operator will be required to follow high-level principles when designing a default fund.

The Operator will be required to provide ongoing responsibility in respect of the default fund for:

- Design - Operator, should as necessary, liaise with the employer on design. The fund should be affordable. The fund should involve a de-risking mechanism (element of lifestyling). Asset allocation should be diversified (no more than 5% in employer company). Initially it was proposed that the default fund should be stakeholder charge capped but that requirement was subsequently dropped following consultation.
- Implementation - the employer should be presented with a targeted and manageable set of options
- Governance – Operator will be responsible.

- Communication – Explanation of the default fund should be provided to members setting out the objective and rationale together with an explanation of how the de-risking mechanism will work. An ongoing commitment to communicate any changes is also required.

In reality the implementation of a default fund is nothing new, it has been a long standing practice for defined contribution pension schemes to operate a default fund, with most Kudos clients who operate a defined contribution scheme already benefiting from this.

The use of group self invested personal pensions (GSIPP) for automatic enrolment

In their initial consultation document the DWP proposed that a GSIPP can be used as a workplace savings vehicle as long as those automatically enrolled into it are only placed into the default fund. Jobholders should not be automatically offered a self-investment option at automatic enrolment. Once automatically enrolled into the default fund the individual may choose other retail pooled funds at comparable charging levels to GPP; alternatively they may choose to self-invest.

However, following responses by the industry the DWP have decided that it will no longer treat GSIPPs any differently than other workplace pension arrangements. The original proposal that all those auto-enrolled into a GSIPP must invest into the default fund will be dropped.

Employer compliance

The Pensions Regulator (TPR) will be responsible for compliance. TPR will focus on education rather than imposing fines for non-compliance. Employers will first be told to put things right; failure to comply will lead to fines proportionate to the non-compliance and could ultimately end in criminal prosecution.

Employers will be required to register with TPR within nine weeks of their staging date. Once staging has been completed in 2016 new employers will be required to register three months after PAYE income is payable on behalf of their first worker. Thereafter an employer will be required to re-register with TPR every three years.

Record keeping

TPR will require employers, trustees and managers of pension schemes to keep certain records.

- Employers: details of the pension arrangements, enrolment of jobholders opt-in and opt-out processes, contributions made.
- Occupational pension schemes and pension providers: records of enrolments and opt-outs.

TPR may require these records to be produced on request. Records need to be kept for six years.

Time limits on inducements compliance action

Employers are prohibited from inducing individuals to leave a pension scheme. If an alleged incident does occur an employee will have up six months to complain to TPR.

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Ensuring payment of all contributions due

TPR already has powers to deal with late payment. All employer and worker contributions must be paid over by the 19th day following the month in which workers' contributions were deducted from pay with the exception of the first two months.

Failure to comply could result in the employer paying their workers' contributions (as well as their own). Employers would have three months to sort out "teething" problems before TPR instructs the employer to make good their breach of regulations. TPR will also have discretionary power to order the employer to add interest for late payment.

Education is always TPR's first course of action; they will only start to impose fines if there continues to be non-compliance with the regulations to pass contribution over in time. The fines will, in the first instant, be a fixed penalty proposed at £400 and intended as a "wake-up call".

Failure by the employer to remedy non-compliance may then lead to escalating fines:

Size of PAYE scheme	Penalty
1 - 4 worker:	£50 per day
5 - 49 workers:	£500 per day
50 - 249 workers:	£2,500 per day
250 - 499 workers:	£5,000 per day
500+ workers:	£10,000 per day

Third parties could also be liable to charges if they contributed to the employer's failure to comply. Initially this will be a fixed fine of £500 escalating at £200 per day.

Separate fines will apply to an employer who prohibits recruitment of individuals who would want to save in a qualifying workplace pension.

Size of PAYE scheme	Penalty
1 - 4 workers:	£1,000
5 - 49 workers:	£1,500
50 - 249 workers:	£2,500
250+ workers:	£5,000

The person issued with the notice will have 28 days to make an application for a review.

Unresolved issues

Stranded pots

Over the course of a working life an individual is likely to have worked for a number of different employers (on average eleven different employers). Consequently, and compounded by auto enrolment, many employees will build up small pension fund pots which they will leave in a scheme when they change

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employment. Although outside the scope of the review team they have recommended that the government urgently address this issue by undertaking a further review so that it is made easier to transfer these small “stranded” pots; individuals will then be better able to consolidate their savings as they change employment over their working life. As part of their recommendations they suggest that the government backed NEST scheme be able to make and receive transfers from 2017.

Regulatory arbitrage

The review team have also identified important issues between contract and trust-based schemes and have recommended that the government urgently address these. The most serious issue relates to the issue of short-service refunds; where a member leaves within two years a trust-based scheme is able to offer a return of contributions whereas a contract-based scheme cannot. In addition a trust-based scheme can commute pension pots that are less than £2,000, which again, a contract-based cannot do. These differences create an un-level playing field and provide an incentive for employers to set up trust-based schemes.

What happens next?

The government has concluded that the independent review team’s recommendations represent a sensible and balanced package of proposals.

The government will now proceed with the implementation of the reforms on this basis.

Full details of the independent review can be found at:
<http://www.dwp.gov.uk/policy/pensions-reform/workplace-pension-reforms/automatic-enrolment/>

Every care has been taken to ensure that this information is correct and in accordance with our understanding of the law and HM Revenue & Customs practice, which may change. However, independent confirmation should be obtained before acting or refraining from acting in reliance upon the information given. The above should be seen as information only and should not be construed as advice.

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