Kudos personal accounts update

August 2009

Last November, the pensions Act 2008 established the framework for Personal Accounts and pension scheme auto-enrolment. Our Personal Accounts update in January provided the basic details of this new legislation.

More in depth details of how personal accounts and auto-enrolment will operate are being released at a fast pace and this latest update will no doubt be followed by further updates during 2009.

Previous update can be found on our website:

www.kifs.co.uk

Auto-Enrolment

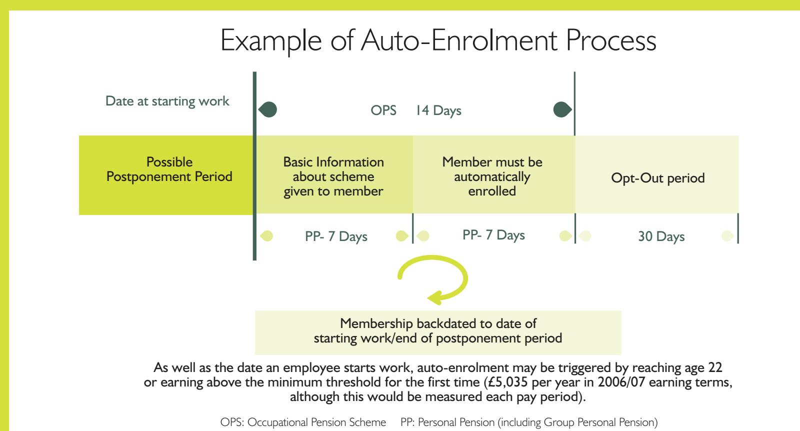
In the first of three such consultations planned for 2009, the Department for Work and Pensions (DWP) has commenced consultation on how auto-enrolment will work for employers.

The consultation ran until 3 June 2009.

As expected, the proposals permit a 90 day employee 'waiting period' for employers offering 'better quality' schemes – that is an exempt defined benefit scheme or a money purchase scheme, including a group personal pension (GPP), with a total contribution of 11% of qualifying earnings, including a 6% employer contribution.

In many respects the employer duties from 2012 are wide-ranging and highly prescriptive. This could have a significant impact on the administration of all types of scheme and increase employer costs.

The auto-enrolment and opt-out arrangements for Group Personal Pensions alone will add a good deal of complexity, not previously associated with these contract based arrangements.



Certification of 'Qualifying Earnings'

The original proposals in relation to the earnings band used to define a qualifying (exempt) pension scheme had prompted concerns for existing workplace pension schemes using a different 'Pensionable Earnings' definition (i.e. most schemes!).

Amendments were introduced to the Act to allow employers to 'self certify' that contributions based on a different earnings definition, such as basic pay, will nevertheless meet the minimum requirements for a qualifying pension scheme, over a 'pay reference period' of one year. The employer will complete a certificate in advance for the year which will need to say 'all active members in my opinion will satisfy the relevant quality requirement.' The regulations allow the use of a tolerance threshold – the current suggestion is 0.75% of basic pay. If contributions for the year fall below the legislative minimum but within the threshold, no top up is required. Where contributions fall outside the threshold the employer tops up the full shortfall.

This will help protect existing workplace pension schemes and avoid employers being forced into auto-enrolling borderline employees into the personal accounts scheme as a safety-first measure to meet legislative requirements.

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Impact on Employers

As more detail emerges, it's important that employers start planning ahead. They'll need to consider how to absorb the costs implied both in relation to administration and increased employee take-up.

However research has shown that many employers are blissfully unaware of the reforms. For example DWP research showed that perhaps a half of small employers (under 50 employees) had no knowledge of the pension reforms. Significantly employers preferred to rely on third party advice (IFA, accountant etc) to manage the reforms, rather than on Government material.

Many commentators expect employers to cut back on salary increases over a period of time to help pay for the increased pension liabilities.

Against this employers may need to benchmark any changes they make to pension provision against their competitors' response to personal accounts.

Impact on Employers – Cost

- **Pension Costs likely to increase as:**
  - **Some categories of staff may not be covered by pension scheme**
  - **Auto-enrolment will increase take-up across staff already offered pension (we believe this could be in the region of 55% to 80%)**
  - **Current scheme may not meet 8%,3% thresholds (i.e. 8% total contribution of which 3% has to be employer contributions)**
  - **Additional administration and compliance work**
- **Employers who don't have schemes, pension costs may increase payroll costs by 2 - 2.5%**
- **Employers who have current schemes – depends on take-up, contribution level etc**

Options to Offset Costs

- **Reduce contributions for all employees – obvious to staff and may involve changes to contract of employment**
- **Gradually auto-enrol staff in run up to 2012**
- **Use salary sacrifice to maximise tax and NI savings**
- **Reduce future salary rises**

Salary Sacrifice

Some commentators have suggested that a possible way for employers to absorb some of the costs of auto-enrolment could be to set up or amend workplace pension schemes, before 2012, on a salary sacrifice or salary exchange basis.

At a time when all company spending is under the microscope, and according to an Employee Benefits Magazine survey in June 2009, 98% of HR Heads have been tasked with looking to reduce benefit spend in 2009, we are seeing salary sacrifice arrangements becoming more widely used to help improve benefits and reduce spend.

At this stage it is not fully known what impact, if any, this new legislation will have on salary sacrifice arrangements. We will keep you informed in future updates.

Impact on Means-tested Benefits

The DWP published a report in February on whether individuals would benefit from saving in personal accounts.

It suggested that 95% of savers would get back more than they put in personally, allowing for 'claw-back' of means-tested benefits. Note this 'positive' return includes the value of employer contributions!

It found that the older the individual is, the greater their risk of experiencing lower returns. It's the same for those with limited state pension entitlement or living in rented accommodation.

The report does not find any readily identifiable group in the working age population whose members would not, on average, gain back more than they put into a pension.

The issue has not completely gone away however, because a number of the assumptions used by DWP have come in for some criticism.

For example in one modelling scenario, the real yearly rate of return on contributions is assumed to be 3% after allowing for inflation and charges. Some have questioned whether this is a realistic expectation.

It ignores the potential impact of compulsory employer contributions on salaries (which could increase by less as employers absorb the cost of compulsion).

No account is taken of the value to the individual of the 'pound in the pocket' and loss of access to capital.

Unfortunately no report or set of assumptions will ever give a definitive answer to this issue. It is a question of promoting confidence that saving is worthwhile. In that respect the report does a reasonable job. What will a means-tested retirement look like in future? Nobody knows.

The Personal Accounts Scheme

No higher first-year contribution or additional lump sums

The contribution cap for the personal accounts scheme is £3,600 in 2005 'money'. This will probably have increased to around £4,500 by 2012 when the reforms are expected to take effect. The cap is intended to ensure that the personal accounts scheme attracts its target market: low to median earners with little or no pension provision.

The Government had considered allowing a higher contribution limit of £10,000 in the first year of personal accounts and to allow additional ad-hoc lump sums – the idea being to encourage saving before 2012 and allowing for broken work patterns/career breaks etc.

However, the Association of British Insurers successfully lobbied for this to be overturned as it was feared that it would lead to 'blight' under existing personal pensions and stakeholder plans. Helpfully this also simplifies pension advice given to clients prior to 2012.

The decision will be revisited in 2017 at the same time that the ban on transfers in and out of the personal accounts scheme is reviewed.

Decumulation

Consultation has also taken place on decumulation from the personal accounts scheme; in other words, the type of benefits that members can expect to receive upon retirement

Although the lifetime annuity route will be most appropriate for the majority of scheme members, it is expected that alternative options will be available – similar to other registered pension schemes. This could include transferring to another scheme from age 55 in order to take benefits (such as an unsecured pension).

The default retirement age will be 65 although members can choose another date in the age range 55-75. Like other registered pension schemes, 'wake-up' packs will be sent not later than six months before retirement age.

Open Market Option (OMO)

Members will be encouraged to use the OMO, i.e. giving the member the option of shopping around from the market place for the best annuity rate. Otherwise it is proposed that a simplified 'focused' annuity choice can be obtained through the scheme from a chosen panel of providers.

The scheme aims to keep costs down and make retirement a 'largely self-service customer experience'. The scheme will be limited to providing generic information on retirement options, but will draw members' attention to the need to take advice, so that they make appropriate decisions.

Charges

No final decision has yet been reached on either the level or the shape of the charging structure for the personal accounts scheme. The latest suggestion is that there will be an annual management charge of 0.5%. However nothing will be confirmed until after the Administration tender process has been completed.

The merits of simplicity will need to be weighed up against the need for the scheme to be self-financing. The impact, in terms of the knock-on effect on other schemes, will also be considered.

Significantly, a clear principle has emerged that the scheme will not be unfairly advantaged compared to other pension schemes – for example Government support for the scheme will be limited by European rules.

Personal Accounts Administration

There are 4 organisations on the shortlist to run the administration of Personal Accounts:

- **Tata – Diligenta**
- **Logica & IFDS**
- **Great West & Canada Life**
- **Arbejdsmarkedet Tillaegspension (ATP)**

We can only hope that PADA get the decision of administration provider right as the Government's track record of outsourcing such projects has not been great over the last few years.

Investment Options

Consultation has commenced on the investment options within the personal accounts scheme.

The Personal Accounts Delivery Authority (PADA) is considering the innovative idea of offering target-date funds instead of traditional lifestyling. The default fund is likely to be cautious in its objectives.

Low cost is again a key driver with a possible outcome being restrictions on switching between funds.

Separately the Department of Work and Pensions has published research into the possible use of funds with a guaranteed return. The combination of the cost of guarantees and the drag on returns appears to make the inclusion of this option unlikely.

No Deviation or Variation

In general the scheme will work pretty much like any other multi-employer occupational pension scheme. However, PADA's consultation on its structure and rules (also now under way) does highlight one or two interesting variations or deviations from the norm.

Instead of member-nominated trustees, there will be a 'member's panel' to represent their interests with the 'Trustee Corporation'.

It seems there won't be any 'trustee discretion'. Instead lump sum death benefits go to the deceased's estate as of right. So inheritance tax could apply to the lump sum.

Contributions can continue even after the members have left employment of a participating employer. The self-employed can also contribute.

Tax relief will be given via the 'relief at source' method (typically used only in personal/stakeholder pension schemes).

More than ever, it's going to be important to make sure that, post 2012, schemes continue to 'give value for money' and meet both the employer's and employees' needs.

Soft Launch?

The reforms are set to come into force in 2012. Note this has been assumed for personal accounts administration tendering purposes as October 2012, rather than April.

But the final date has not been confirmed and could still change.

It is also understood that it may commence on a voluntary basis a year earlier in order to 'stress test' the processes. And, due to the scale of the undertaking (around 1 million employers and 6 million employees), it may take 12-18 months after the official launch to bring everyone on board.

The Future

The success of the reforms depends to an extent on a benign economic and fiscal environment.

However with the recession and increased Government borrowing leading to the prospect of higher corporate and personal taxes and tightened belts, some commentators feel that the launch may need to be delayed.

Alternatively political expediency may have an impact, particularly if there is a change in Government after the next general election.

Tax and legislation are likely to change. The information provided here is based on Kudos Financial Services understanding of law and HM Revenue & Customs practice at date of publication and the legislation we believe will apply from 6 April 2012.

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