The pensions revolution

Stephanie Hawthorne explains how employers need to prepare for the 2012 pension reforms

Harnessing inertia is the big new pensions idea. Today if you do nothing you will retire empty handed – in 2012 you will retire on a pension. For employers, however, there is no such luck, and they have no option but to make changes to comply with new laws. They have much to do to prepare for the coming changes heralded by the Pensions Bill currently going through Parliament.

The Bill introduces a national system of personal accounts, possibly the most ambitious and far reaching social reform for decades. This low-key sounding name, 'personal accounts', belies the changes which will have a major impact on the finances of every firm in the UK. Contributing to a pension by the employer will no longer be voluntary. From 2012 companies will have to pay towards the pensions of many more of their workforce, unless employees opt out.

More players

The government is introducing these reforms to 'widen the net'. Currently around 11.1 million workers save enough in a pension to ensure a comfortable retirement, while 7.9 million have no pension at all. According to Joanne Segars, chief executive of the National Association of Pension Funds, the 'reform package, auto-enrolment and mandatory employer contributions in either the best of today's workplace pension or personal accounts will revolutionise pension saving'. Three-quarters of existing workplace pensions will be affected.

Former banker and current chief executive of the Personal Accounts Delivery Authority Tim Jones is charged with implementing the scheme by the proposed date of 2012. Eventually the delivery authority will transform into a Personal Account Board to run the scheme. Although Pensions Regulator, a government agency, will enforce compliance with the new law, it is intended that personal accounts will be run independently of government.

If employees aged between 22 and state pension age earn more than £5,000 they will be automatically enrolled in a pension scheme. This auto-enrolment is a sort of inertia selling – employees will have to take positive steps to opt out of their firm's pensions provision. One of the problems with 'inertia selling' is that personal accounts are not suited to everyone. It is pointless saving for a pension that grows at 7 per cent a year if you have credit card debts growing at an interest of 15 per cent a year. Equally, far too many people are means-tested on retirement so they could be penalised twice, taking home less pay today and less again after being means-tested on retirement.

Many firms already use auto-enrolment and where in place, the pension take-up is uniformly high. The logic is inescapable – vastly increased employee pension participation leads to more costs. Indeed the NAPF has predicted that auto-enrolment could add £2bn to the corporate pensions bill.

Employees will contribute 4 per cent from earnings between £5,025 and £33,540 (ie the primary threshold and the national insurance upper earnings limit 'qualifying earnings'). This will be indexed each year in line with earnings and will be matched by a 3 per cent employer contribution plus tax relief of 1 per cent, phased in over three years. In the first year just 1 per cent of employee earnings will be deducted, 2 per cent in year two and 4 per cent in year three. If personal accounts are brought in to coincide with an annual pay increase, the idea is that employees will not notice any numerical reduction in their pay. A 4 per cent chunk taken out of earnings straightaway would send many employees rushing to their HR department demanding to be taken out immediately.

Stark choice

Clearly this mass entry into pensions presents opticians with a stark choice: either prepare for an increased employment budget or seek ways to restrict employee costs elsewhere – whether by controlling pay increases, reducing head count, restricting non-pension benefits or reducing future pension benefits for staff currently in a workplace pension scheme.

Failed stakeholders

One glimmer of light is that firms will no longer have to offer access to designated stakeholder accounts. Every employer with five or more workers had to provide a stakeholder pension for their workers but many of these were just 'empty boxes' with no employer contribution and no take-up by the workers.

John Lawson, head of pensions policy at Standard Life, says: 'It is thought that as many as 80,000 employers are currently breaking the law by failing to designate a stakeholder and the government has signalled that it intends to get serious with tardy employers when personal accounts are introduced in 2012.'

There will be no escape, as the Pensions Regulator charged with enforcement can fine employers up to £50,000 initially, with that fine increasing by up to £10,000 a day if an employer fails to comply with the new rules. Even employers of temporary workers from the EU working for just a few months will be caught by the new legislation if their wages are more than £100 a week (but at first enforcement will be a comparatively light touch).

The £100bn fund

It is hoped to keep management charges of personal accounts low to around just 0.3 per cent a year because there will be huge funds under management – ultimately between £50bn to £100bn – and there will be great economies of scale compared to many personal pensions where typical charges are 1.5 per cent. The number of investment fund choices has yet to be decided but there will be a default fund where it is expected more than three-quarters of contributions will go if the pension holder has not indicated an investment preference. There will also be a small number of other funds – probably an ethical fund and a Sharia fund for Muslims but no decisions have been taken on investment strategy.

Companies with good pension provision and a high take-up rate will be best placed in the new era. Some firms will be particularly hard hit if their scheme currently has low take up, low company contributions or restricted eligibility criteria.

Surveys already show that wider coverage may result in smaller contributions. Association of Consulting Actuaries research indicates some 16 per cent of schemes would revise them to mitigate against the extra costs of auto-enrolment, with a further 9 per cent possibly abandoning their scheme altogether in favour of personal accounts. Indeed, several MPs have highlighted the real danger that existing schemes could reduce contributions to the personal accounts level.

Avoid 'double jeopardy'

Jill Clucas of lawyers Lovells points out that employers can avoid 'double jeopardy' – having to pay an extra 3 per cent contribution to personal accounts for staff who are already accruing benefits in an occupational scheme or group personal pension if the employer's current arrangement fulfils the criteria for a qualifying scheme. It must meet a minimum benefit (or contribution) test and, for occupational schemes, eligible employees must be automatically enrolled.

A total contribution of at least 8 per cent of qualifying earnings, of which employer contributions must make up at least 3 per cent, and automatic enrolment for all staff is likely to be sufficient to ensure exemption for defined contribution (DC) schemes (where the employee bears the risk of under-performance).

One possibility is to introduce a pension scheme now or update a scheme to meet the minimum criteria. From a public relations and employee morale viewpoint, firms can get some benefit/appreciation for them rather than be seen to be forced to do them.

Traditional DB schemes

For the traditional defined benefit (DB) or final salary schemes, all contracted out of the state second pension schemes will gain exemption if they auto-enrol members. Contracted-in schemes must offer an accrual rate of at least 1/120th of pensionable earnings to do so. DB schemes will bear the brunt of auto-enrolment costs as the effects of widening scheme membership will usually be more financially painful than those with DC schemes.

Companies here could offer personal accounts to those currently excluded from the DB scheme. Remaining contracting-out is becoming less and less financially sensible (though the scheme design consequences of contracting back in are significant).

PERSONAL ACCOUNTS – IN A NUTSHELL

- A system of individual pension accounts will be established, run by a centralised body (currently the Personal Accounts Delivery Authority)
- From (we expect) 2012, employers must enrol their workers into a Personal Account, subject to certain exceptions
- The requirement will not apply to workers aged under 22 or above pension age, or who earn less than, broadly, £5,000 pa
- The employer must contribute at least 3 per cent of 'qualifying earnings' (currently earnings between £5,035 and £33,540 pa)
- Total contributions by the employer and worker must equal at least 8% of the worker's qualifying earnings
- Tax relief (for employers and workers) will be available on contributions to Personal Accounts
- Employees (not employers) may opt out of a Personal Account, but will be automatically re-enrolled after a prescribed period, expected to be at least three years
- Personal Accounts will be money purchase arrangements, subject to the tax regime for registered pension schemes, and may provide the same benefits as are allowed under the registered schemes tax regime
- Employers may be exempt from the Personal Accounts requirements in respect of workers for whom they provide alternative workplace arrangements

Source: Lovells

PENSION CHECKLIST

- Be seen to act ahead of the game rather than coerced later
- Take advice from a good consultant or independent financial adviser
- Set up a pension scheme that meets exemption criteria now if your firm does not currently make retirement provision
- If your company does not contribute to a pension for your staff, budget for increased costs of up to 3 per cent of payroll a year (staged from 2012) by:
  1 cutting head count
  2 reducing non-pension benefits
  3 curbing pay increases
- Make sure the existing pension scheme meets exemption rules
- Offer personal accounts to members currently excluded from final salary (defined benefit) provision

WHERE TO GO FOR ADVICE

- www.dwp.gov.uk – for up-to-the-minute legislation
- www.thepensionservice.gov.uk – helpful government site
- www.napf.co.uk - leading company pensions lobby group
- www.unbiased.co.uk – find an independent financial adviser
- www.aca.org.uk – find a consulting actuary
- www.actuaries.co.uk – the actuaries' professional body
- www.thepensionsregulator.gov.uk – pensions regulation enforcer
- www.pensionsadvisoryservice.org.uk – helpful site on state and personal pensions (free advice)

Many firms run DB and DC schemes alongside each other. Here the DC scheme will usually be the one that is open to new entrants 'so make sure that has exemption for otherwise three schemes will have to be dealt with', says Chris McWilliam, senior consultant at Aon Consulting. Above all, he says, keep your employees in the picture.

The Pensions Bill currently before Parliament is establishing the fine detail on personal accounts but don't wait until the dust settles. Although 2012 seems a long way off, start training for this savings marathon now if you want to bring home a pensions gold medal.

● **Stephanie Hawthorne** is the editor of *Pensions World*