

DC Spotlight

June 2011

Introduction

The Pensions Regulator (the Regulator) has started writing to UK employers regarding auto enrolment. In the next 6 months, nearly 600 of the largest organisations employing about a third of the UK workforce will have received letters from the Regulator marking 18 months to their duty date. Many more will receive letters shortly thereafter. It is now time to plan to identify, understand, quantify and mitigate the costs and risks faced.

Whether contributions are mandatory or not, we would suggest that employers seek to optimise their return on investment in the pension benefit they provide. We have therefore considered how best to build an effective savings strategy to optimise employees' perceived value of the benefit provided.



Regulator's countdown to auto enrolment

The Regulator has started writing to the UK's biggest employers, alerting them to their new pension duties, which are introduced on a gradual or 'staged' basis according to their size.

In the next 6 months, nearly 600 of the largest organisations employing about a third of the UK workforce (around 10m employees) will have received letters marking 18 months to their particular duty date. In due course, every employer in the UK will receive at least two letters as they approach their duty date.

To assist your planning we have set out a 15 stage plan below:

1. Assess your workforce

Identify your duties in relation to each of your workers. You will need to provide your employees with certain information, which will be identified by this assessment. In particular, you should find out whether you are likely to have an automatic enrolment duty, as this will require preparation.

Employers will be obliged to conform to the auto enrolment requirements from 'Staging Dates' which will depend on the size (number of employees) of their PAYE payroll. The largest employers, who are scheduled to be brought into the reforms in October and November 2012, will be allowed to commence auto enrolment ahead of the planned start date of October 2012, and as early as July 2012, if they wish to do so. ▶



Employers with less than 50 employees will have a Staging Date dependent on the letters in their PAYE code. However some such employers will be randomly chosen to commence their staging from 1 March 2014.

Once the Staging Date (fig.1) is reached, all eligible employees must be auto enrolled into a suitable workplace pension arrangement or the National Employment Savings Trust (NEST).

2. Identify who to automatically enrol

Employees who need to be automatically enrolled are called 'eligible jobholders.' The location of the employer is not relevant when considering if a worker is an eligible jobholder. Neither is the worker's nationality or the length of their stay in the UK. What is relevant is whether the employee is working, or ordinarily working, in the UK. When considering an employee's earnings, salary, overtime, commission, bonuses, sick pay, maternity, paternity and adoption pay need to be considered.

All employees aged between 22 and State Pension Age (SPA) will have to be auto enrolled if they have earnings above the auto enrolment threshold. The auto enrolment threshold is to be increased and aligned with the income tax personal allowance (£7,475 for the tax year 2011/12). Contributions will then be payable on all Qualifying Earnings.

Qualifying Earnings are defined as taxable earnings between the NIC primary threshold and £38,185 (2010/11 terms).

Workers aged between 16 and 22, and those who have attained SPA, but are under age 75, who have earnings above the auto enrolment threshold may opt to become members of a

	2011	2012	2013	2014	2015	2016	2017	2018
Minimum Contributions (Qualifying Earnings)								
Employer	1%	→	→	→	→	2%	3%	→
Employee	1%	→	→	→	→	3%	5%	→
Staging Date								
Payroll Numbers	50,000+	800+	50+	→	→	All	→	→

fig.1

Qualifying Scheme, requiring employer contributions. Similarly any employee earning between the Qualifying Earnings threshold (£7,228 for 2011/12) and the auto enrolment threshold will have the right to opt in and receive an employer contribution. Those aged between 16 and 75, but earning below the Qualifying Earnings threshold will also be able to demand membership of a pension scheme. However there will be no requirement for their employer to contribute. Please note that the thresholds quoted above reflect the Government's original intentions but are subject to confirmation.

Employers will be able to wait up to three months before automatically enrolling a new employee into a pension scheme, rather than having to do so straight away. This will be welcomed by most employers and particularly those with a high turnover of temporary staff.

This delay may lead to a greater number of opt outs if members get used to a certain level of pay before having contributions deducted in their fourth month of employment (Employees will not be able to opt out of a Qualifying Scheme, until they have been made a member of the scheme).

However, if they prefer, workers can elect to opt in and receive an employer contribution as soon as they start a new job.

3. Review scheme design

The Government has stated that it wants to make it easier for employers to be sure that their existing DC schemes satisfy the relevant requirements, even if the contributions under the scheme are not based on total earnings (basic pay, shift pay, bonus and commission). It is therefore proposing to simplify the requirements so that a scheme can be certified as meeting the requirements if contributions are a minimum of:

- 9% of basic pay (at least 4% from the employer); or
- 8% of basic pay (at least 3% from employer) provided that total basic pay is at least 85% of the total earnings for all relevant individuals; or
- 7% of pensionable pay (3% from employer) provided that the total pay bill is pensionable.

Whichever basis is adopted by an employer, the cost of employing people will inevitably rise. However, given that all employers will be subject to the same pension requirements, it should not affect an organisation's competitiveness against other UK employers.

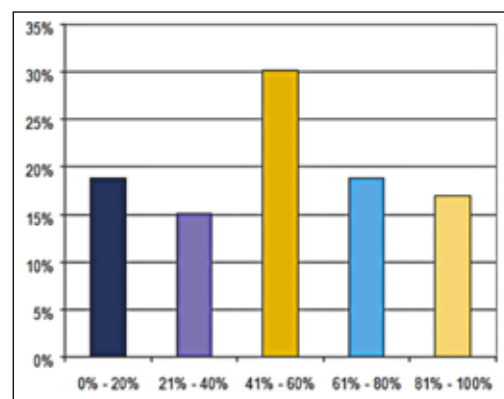


fig.2

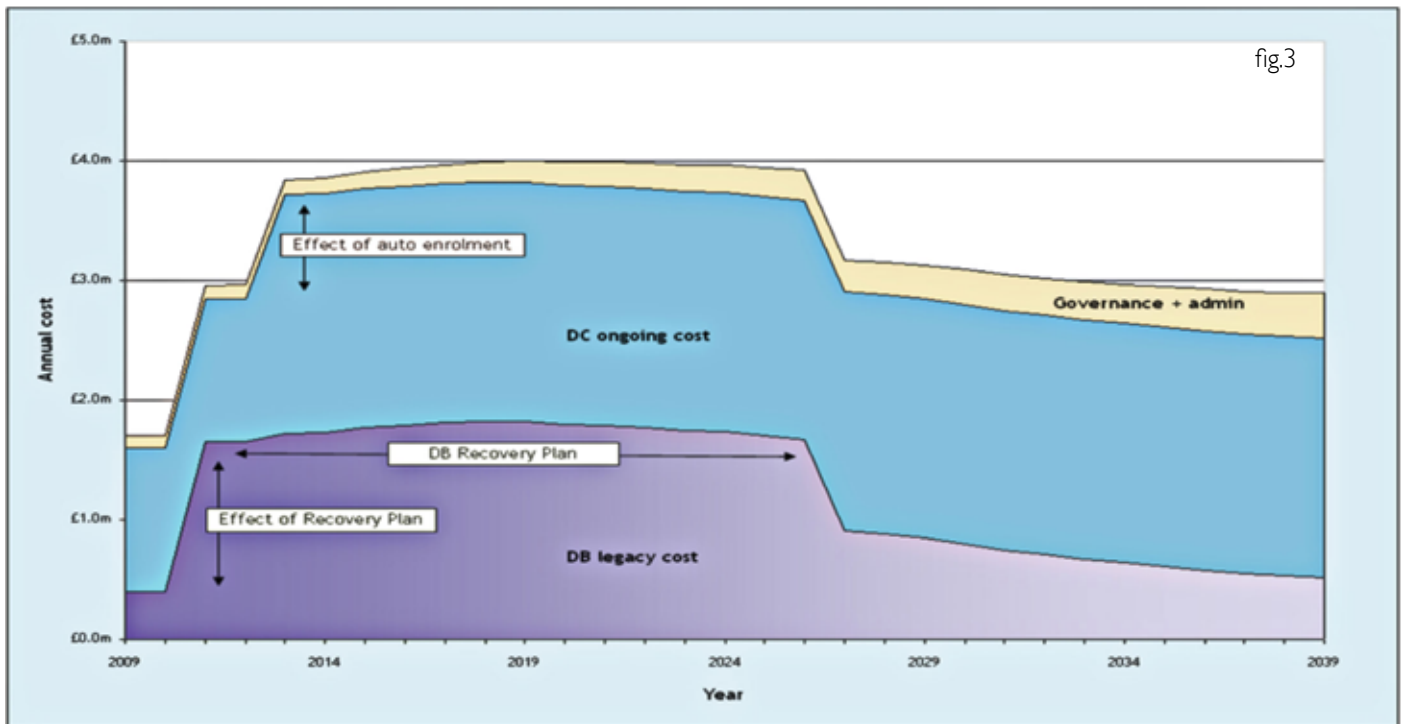


fig.3

Financial Assumptions		
Equity Return	7.00%	◀ ▶
Bond Return	5.00%	◀ ▶
Price inflation	2.50%	◀ ▶
NAE inflation	4.00%	◀ ▶

DC Scheme		
Employer Contributions	30 and under: 2.00%	30 to 39: 2.00%
Matching Base	2.00%	2.00%
Matching Ceiling	4.00%	6.00%
Matching Proportion	100%	100%
Member Contributions	2.00%	4.00%
Investment Portfolio	Balanced	

DC Scheme		
Employer Contributions	40 to 49: 2.00%	50 and up: 2.00%
Matching Base	2.00%	2.00%
Matching Ceiling	6.00%	7.00%
Matching Proportion	100%	100%
Member Contributions	6.50%	8.00%

Defined Benefit Details		
Scheme	F. Salary	◀ ▶
Pagroll	£7.6m	◀ ▶
Open/Closed - N.Ents	Closed	◀ ▶
Open/Closed - F.Acrru	Closed	◀ ▶

Defined Benefit Costs	
Recovery Period	15 years
Contributions (p.a.)	£1m

Statistics for Maximum Service	
Maximum Service	40 years
DB Pen @ SPA / Salary	58%
DC - S2P @ SPA / Salary	529%

Some employers may consider meeting the increased costs by providing salary growth in the form of pension contributions, whilst others may spread current pension spending more thinly. However, with all employers being required to provide pension contributions, those who want to differentiate their offer will need to work hard so that employees understand why their employer's offering is better than those of their competitors.

It is important to remember that the new minimum contributions will only deliver a retirement income at the very bottom of the range most people aim for. For a comfortable retirement, most people will have to save considerably more. Whilst the focus of auto enrolment is about paying a minimum level of contribution by a certain date for all eligible employees, we would suggest that this should not be the sole consideration, particularly given competitors may offer much more. Benchmarking reviews are important.

Employers should also consider the impact that other changes to the taxation system, retirement flexibility, removal of default retirement age and equality legislation may have on scheme design.

4. Consider total pension costs

Xafinity's research indicates that on average 60% of employees generally join their employer's pension arrangement (fig.2)

It is estimated that on average, auto enrolment will increase this take up rate to 80%. It will therefore be important for employers to review the total pension costs against what they can afford and, ultimately, need to pay to recruit and retain employees. Scheme design and ways of reducing costs and risks should therefore be considered:

- Increasing number of active members that have either historically opted out or not elected to join the employer's plan;
- Increasing contributions to meet minimum requirements (if applicable);
- Increased administration of monitoring and effecting auto enrolment at the Staging Dates and every 3 years thereafter;
- Increased cost of deferred member management due to increasing membership turnover;
- Impact that any changes to the funding assumptions of an employer's DB scheme (if relevant) may have on the employer's annual 'pension spend' (e.g. Recovery Plan).

It is important that these factors are considered and modelled in order that the employer can assess the likely impact that auto enrolment and other scheme design changes will have on total pensions expenditure. (fig.3) ▶

fig.4

	NEST	Contract	Trust	Mastertrust
Governance Responsibility (including investments)	NEST Trustees	Employer Governance Committee	Employer and Member Nominated Trustees	Professional Trustee
Refunds of Contributions Allowed?	No		Yes. Employer can "re-use" contributions	
Higher rate tax-relief at source?	No		Yes (subject to limits)	
Contribution Limits	£4,300*	None		
Transfers-in / out permitted	No*	Yes		
Investment Approach	Defensive 'one size fits all'	Flexibility to tailor investments to members		
Lump sum death benefits subject to inheritance tax?	Yes (up to 40%)	No		
Retirement Option Flexibility (excluding 25% cash)	Lifetime Annuity must be purchased	Choice of retirement options such as annuity, income drawdown or phased retirement		
Waiting period for new employees	Not allowed	Up to 3 months (depending on contribution rates)		
Member education / support	Generic. Web based	Generic. Tailored for additional cost	Scheme specific and tailored to employer's requirements	
Charges	0.3% AMC plus 1.8% initial charge	Depends on scheme (usually no initial charge)		
Track Record	None	Proven track record		

* May be amended in 2017

5. Choose a pension scheme

Consider which type of pension scheme to use for automatic enrolment. (fig.4)

Employers might use an existing scheme, set up a new one or perhaps use NEST. Whether the scheme an employer uses for automatic enrolment is new or not, it must meet certain, specific criteria set out in legislation. The scheme cannot:

- Impose barriers, such as probationary periods or age limits for members
- Require staff to make an active choice to join or take other action, eg having to sign a form or provide extra information to the scheme themselves, either prior to joining or to retain active membership of the scheme.

Each pension scheme will have its own rules, but all employers will need to provide their scheme with certain information about the person who is being automatically enrolled.

6. Consider the default investment option

Auto enrolment will require a regular review of the default investment option that members will be auto enrolled into, given the principles set out by the Investment Governance Group and the guidance published on 24 May 2011 by the Department for Work and Pensions (DWP). The DWP guidance applies to both contract and trust based arrangements when governing, designing, reviewing and communicating the default option.

Whilst the DWP's guidance is non regulatory, the DWP has said that it will consider issuing statutory instruments to uphold it and protect members' interests if there is evidence to suggest it is being ignored or if it is not having the desired effect of promoting good practice.

7. Engage with your Payroll Provider

Payroll software is expected to play a key role in accurately assessing employees' earnings and making pension contributions. However, some systems may not be able to support the full range of employer duties. It is important that employers seek confirmation from their payroll provider (or software provider if payroll is 'in house') about the extent that their existing software will support them in complying with their duties.

8. Communicate with members!

Auto enrolment compliance is likely to involve a change in process and procedures for all employers, even those that already operate auto enrolment. The new requirements are prescriptive in the manner in which members are communicated with, particularly around any 'alternatives' that the employer may offer employees that could be construed as incentives to opt out e.g. flexible benefit arrangements that allow members to 'flex down'.

Auto enrolment compliance will likely involve many employers contributing millions of pounds to DC pension arrangements. Articulating the value of these benefits to members and how and where members need to engage will be an important aspect of benefit delivery to ensure that members value the benefits that are being provided.

It is important to remember that information provision is not the same as communication. If this is not recognised and addressed, members will 'turn off' to DC pensions, putting their financial futures at risk and reducing the value that they place on the benefit. Given the costs invested, this cannot be in the sponsoring employer's interest.

9. Make contributions

Once employers have passed their Staging Date they will be required to pay the contributions within the requisite timescales, enrol employees when they become eligible and re-enrol employees that have previously opted out on each subsequent third anniversary following the employer's initial Staging Date.

10. Process any opt-out notices

Workers who have been automatically enrolled will have the right to opt out of the employer's pension scheme. There is an opt out period of 1 month, where any deductions made from their salary will be refunded. The worker can choose to cease membership at any time, although they may not be entitled to a cash refund of contributions after the end of the 1 month opt out period (unless contributions are being made to a trust based scheme).

To opt out, workers must give notice via a document called an 'opt out notice' to the employer. These notices will usually only be available from the pension scheme and not the employer, so that workers do not feel pressured into opting out.

When employers receive a valid opt out notice within the 1 month period, they must pay back any contributions deducted from the worker's pay. Equally, any contributions the employer has made must be refunded to the employer by the pension scheme.

11. Process opt in or joining requests

As well as automatically enrolling eligible jobholders, employers must also put certain other employees into a pension scheme, if these individuals ask. What the employer will need to do depends on the type of worker.

Certain employees will have a right to 'opt in' to an automatic enrolment scheme and the employer will be required to arrange this and make employer contributions.

Other workers will have a right to 'join' the scheme, but there will be no requirement on the employer to make employer contributions in respect of these workers; although the employer must set up the deduction of the worker's contributions from pay.

12. Maintain records

From 2012, there will be a new legal requirement on employers to keep records about their workers and the pension scheme used to comply with the employer duties. Electronic or paper filing systems can be used to store any records, as long as these records are legible or can be produced in a legible way. Records must be provided to the Regulator upon request. Most records will have to be kept for 6 years; those that relate to opting out must be kept for 4 years.

13. Avoid inducements and prohibited activity

It is important that any employee's decision to opt out of a scheme, or stop saving for retirement altogether, should be taken freely and without influence by the employer.

There are safeguards in place from 2012 intended to protect the rights of individuals to have access to pension provision. These safeguards mean that employers must not take, or fail to take, any action, with the sole or main purpose to attempt to induce

a jobholder to opt out of a pension scheme. Equally, an employer must not try to screen out job applicants on grounds relating to potential pension scheme membership, or suggest that a job applicant's success could depend on whether or not they opt out of a pension scheme.

14. Keep everything under review

The nature of auto enrolment means that compliance will not be a one off exercise; it will be a continual process and employers should therefore keep all aspects under review.

15. Start again!

Any employees that opt out will have to be auto enrolled on the third anniversary of the Staging Date (or 3 months either side of this date). All of the steps outlined above will have to be reconsidered.



Building an Effective Savings Strategy

At face value, DC pension provision is straight forward if you simply offer your employees a vehicle to contribute to and tell them to make all the decisions themselves. However, without effective support employees are unlikely to engage with, understand or fully value the benefit that is afforded.

There is much that can be done to increase both the perceived, and actual, value of the benefit to employees, without increasing overall costs to the employer. Effective DC provision is not really about being a paternalistic employer; its about being a commercially focussed employer: one that wishes to optimise its return on investment in its key resource; its employees.



Contributions and costs

Levels of contributions to a pension scheme are important, but they shouldn't be the sole consideration.

This principle applies to all aspects of employee benefit reward – the cost of the benefit is important and we should do all we can to mitigate costs. However, from a recruitment, retention and motivational perspective, cost can only really be assessed against the perceived value placed on that benefit by our employees.

Effective reward provision involves developing and maintaining a sustainable strategy that takes into account affordability, the complexities of tax and other regulations and the expectations of our employees in order to achieve the ultimate objective of optimising the return on investment in employees.



Affordability and Sustainability

Affordability and sustainability are important and we should do all that we can to mitigate unnecessary costs. To do so, we need to understand:

- what legally has to be done, now and in the future (e.g. auto enrolment);
- what benefits competitors offer;
- which aspects of design employees appreciate, or would value if they understood them.

We also need to consider:

- any tax savings that can be achieved; and;
- what level of benefits the scheme will provide. This is something that the media and unions are increasingly focussing upon and thus so will our employees.

Once we have the answers to these questions we can consider what is affordable and required to pay to recruit, retain and motivate the workforce.

For example, when it comes to auto enrolment, we would suggest that employers make use of interactive financial modellers (fig.5) to assess the financial impact that auto enrolment will have and how, by amending scheme structure, an employer can assess its scheme's affordability in the short, medium and long term.

Taxation

Successive Governments have done much to complicate the tax planning of pension arrangements.

In the past year, the Government has cut the Annual Allowance to £50,000 and introduced a three year carry forward principle for tax efficient contributions. It has also announced that the Lifetime Allowance will be reduced to £1.5m in 2012. In addition, increased retirement flexibility has been introduced, anti tax avoidance legislation increased and proposals announced for further reforms to State Benefits, National Insurance Contribution (NIC) rates and income tax. Now that's simplification!

This year, NIC rates have been increased and the level at which 40% income tax is payable has been cut, and will be frozen until 2014, meaning an increase tax bill year on year for over 4 million workers.

From 2013, the Government intends to cease paying Child Benefit to 1.2 million households. By earning just £1 more than the 40% income tax threshold, a household with 3 children, after tax, could be £2,450 per annum worse off. And for those individuals who are fortunate enough to earn over £100,000 a similar issue arises as they start to lose their Personal Allowance. Fortunately, there is much that can be done to mitigate complexity and reduce costs.

Implementing Salary Exchange alongside a clear and effective communications programme is a good start. First, it removes both the employees' and employer's requirements to pay NICs on the value of members' pension contributions. For those earning over £100,000, such an approach could allow them to make a pension contribution, reducing their taxable earnings and thus allow them to benefit from their full Personal Allowance once again. And from 2013, those with eligible children, who earn above the 40% tax threshold, could contribute to a pension and continue to receive Child Benefit meaning that their disposable income could actually increase by joining the pension scheme.

One of the main potential downsides to Salary Exchange may also be removed. Plans to combine the Basic and State Second Pensions into one flat rate pension, would mean that State pension benefits would not be impacted by Salary Exchange. The removal of DC contracting out from 2012 will also make Salary Exchange more efficient.

These are just a few examples of the many measures that can be taken. The benefits that both the employer and its employees can receive from effective tax planning and, importantly, clear communications, are substantial.

Employee Expectations

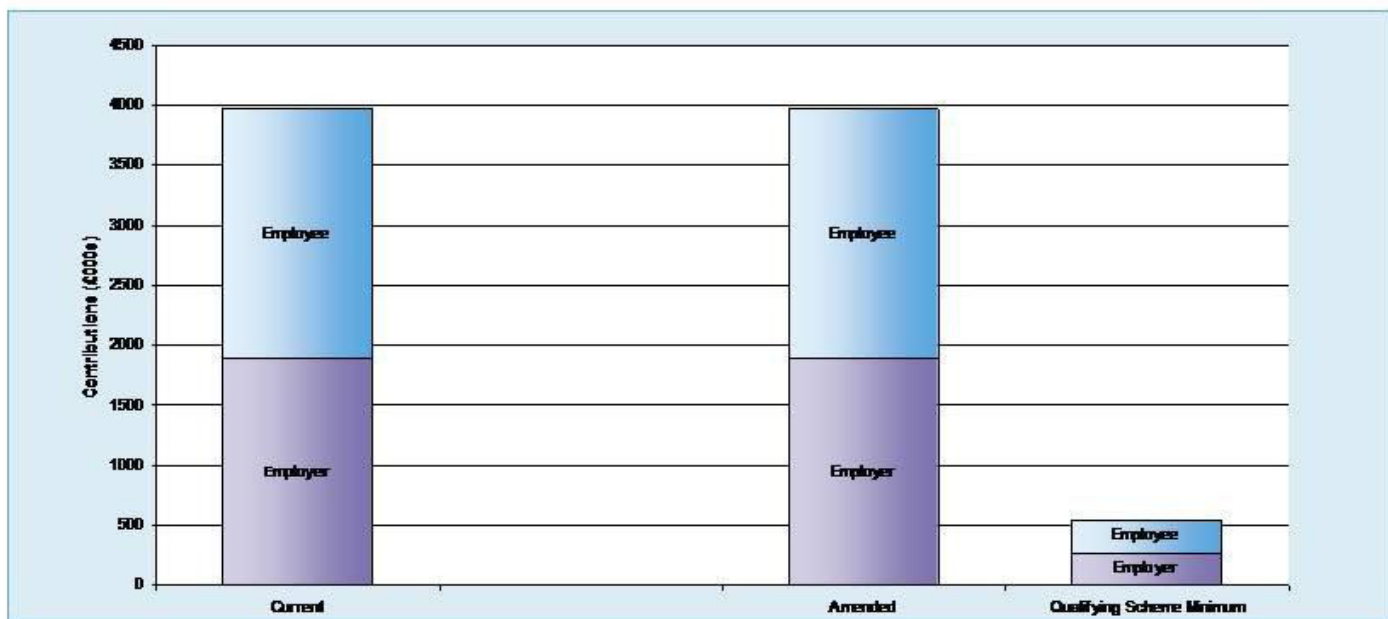
Employers frequently tell employees that retirement planning is the employee's responsibility. However, employees typically ignore this, and it's not surprising given the complexity involved.

First, employees may be asked whether they want to invest in an ISA, pension or simply take the benefit as cash. But do members truly appreciate the merits and constraints of each?

For example, whilst ISAs may be accessible prior to retirement, do members appreciate that they could be missing out on income tax and NIC relief, and from 2013, perhaps forfeiting Child Benefit payments, if they pay into an ISA rather than a pension arrangement that is administered on a Salary Exchange basis?

Next, members are asked how much they want to pay and where they want to invest. In effect they are asked to perform an individual actuarial valuation and investment strategy review upon joining the scheme and regularly thereafter. Whilst actuaries may relish this challenge, the rest of us do not. It is perhaps not a surprise, therefore, that many DC members are disengaged, never reviewing the retirement income they will require, when they wish to receive it, the level of contributions they pay nor the funds they invest in.

Consequently, employees may not value the benefit provided as highly as they could, or perhaps should. ▶



Membership Details		Contribution Schedule				Compliant Members			Current Conts (£)	
Payroll Members	0	Cat	Eer Conts	Eee Conts	Members	Qualifying	Quality	Employer	1,895,400	
Scheme Members	1188	A	2%	2%	91	91	2	Employee	2,088,400	
Non-Qualifying Members	(41)	B	2%	3%	13	13	1	Additional Cost (£)		
Total for auto-enrolment	1147	C	2%	4%	17	17	1	Employer	0	
Relevant Dates		D	2%	5%	11	11	0	Employee	0	
Notification Date	1 July 2013	E	2%	6%	9	9	0	<input type="button" value="Default"/>		
Staging Date	1 August 2013	F	2%	7%	2	2	0			
Staging Date	<input type="text" value=""/>	G	2%	8%	3	3	0			
		H	2%	10%	2	2	0			
		I	3%	3%	131	131	30			
		J	3%	4%	26	26	3			
		K	4%	4%	148	148	148			
		L	Qualifying Categories		694	694	608			
					1147	1147	793			

fig.5

Reduce complexity

The answer, we would suggest, is to remove as much of the complexity as possible in order that employees may engage at the level at which they feel comfortable.

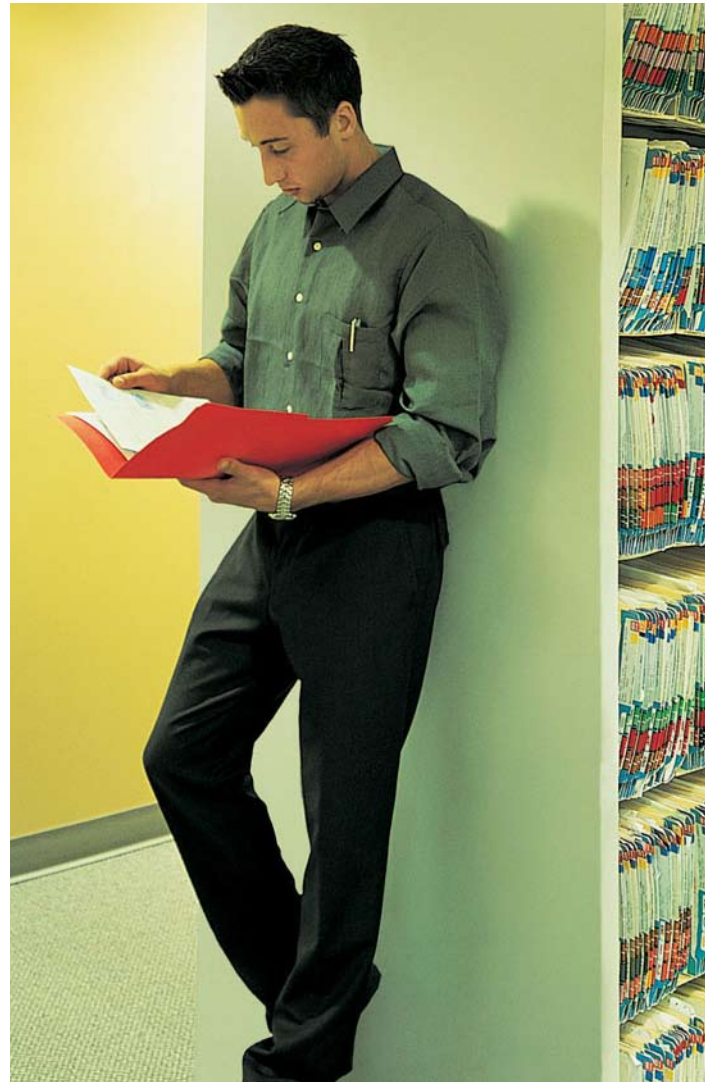
We would suggest that employees should be helped to understand, at the point of joining, what level of income they will need in retirement to pay for necessities such as housing and utility bills and luxuries such as holidays, wine and beer.

Now that they have a target to aim at, effective modellers can help employees to illustrate what they have already saved up and, based upon their current contributions and investments, what additional levels of saving they will need to make.

We would suggest that employees should be able to choose between a range of perhaps 3 multi asset lifestyle investment strategies, designed to minimise volatility for different levels of targeted return. These strategies could be regularly reviewed by the Governance / Trustee Board to ensure the asset allocations and managers remain appropriate. And at the point of retirement, employees should be supported to select the most appropriate form of benefit for them personally and achieve the most competitive terms and conditions available.

The advantage of this approach, we find, is that individuals are able to engage with and understand conceptually what the investments and retirement options do, without having to understand in detail the mechanics of how they work.

Our experience suggests that such an approach can significantly increase the level of member engagement and appreciation of the value of the benefits provided. And after all, when it comes to employee reward, that is what DC provision is all about.



To find out more about how Xafinity can help you achieve more from your DC arrangements, contact your usual Xafinity consultant or Ken Anderson on 0118 918 5457 or email ken.anderson@xafinityconsulting.com

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