

A Pension Bill's progress

Pensions reform 6

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Introduction

The Pensions Bill, which sets out employers' new pension responsibilities from 2012, is currently progressing through Parliament. Having passed through the House of Commons, it's now being debated in detail in the House of Lords. This factsheet outlines the current situation.

The main points

- Discussions between the government and the European Commission mean that automatic enrolment of workers into group personal pensions after 2012 will be consistent with EU law.
- The proposed minimum contribution test for exempt defined contribution pension arrangements will pose new problems for employers who currently base their contributions on basic salary.
- The Personal Accounts Delivery Authority (PADA) has consulted on the charging structure for personal accounts, and plans three other consultations.
- Financial advisers and employers now need to start considering options for current schemes, as well as how to implement these in the run-up to 2012 to help employers manage their costs.

Automatic enrolment

The two main principles of pensions reform are that employers must automatically enrol employees into a pension scheme and that they must pay a contribution for them.

European legislation currently prevents employers automatically enrolling employees into contract-based personal pensions, such as group personal pensions (GPPs), group self-invested personal pensions (GSIPPs) and group stakeholder plans (GSHPs). The government has now confirmed that, following discussions with the European Commission, automatic enrolment into contract-based schemes after 2012 will be consistent with EU law. However, there'll be no change to the enrolment rules before 2012.

The Pensions Bill is currently being amended to allow contract-based schemes to be classed as 'qualifying schemes'. These new sections should replicate the terms for exempt occupational schemes.



Minimum contribution test

In an exempt defined contribution pension scheme (whether a personal pension or an occupational scheme), each member's contribution must at least equal what they would have received in the personal accounts scheme. The contribution to personal accounts is 8% of **qualifying earnings**, where the employer pays 3% and the employee pays 5% (including tax relief). 'Qualifying earnings' is defined as an employee's full earnings (including bonus, commission, overtime and statutory payments, but not P11d earnings) between £5,035 and £33,540.

The total contribution to the exempt scheme must be at least equal to the personal account contribution, and the employer has to pay at least 3% of qualifying earnings. Currently, though, most employers work out contributions to private pension schemes using basic earnings. It's rare for them to base contributions on full salary, and even rarer to only pay contributions on a band of earnings.

To make sure they comply with their proposed responsibilities, employers will probably have to compare every contribution they make for each member with the personal account contribution. In most pension schemes the contribution will always pass the test. But under certain pay structures (for example where a large part of employees' take-home pay comes from bonuses or commission), employees may sometimes fail the test.

Carrying out the contribution test

Carrying out the test shouldn't be very difficult: software providers will change payroll systems to build the test in and work out any shortfall.

But challenges arise when the shortfall has to be paid.

- Employers will have to notify employees of any shortfall.
- Employers can make up all the shortfall. Alternatively, as long as their contribution is above 3% of qualifying earnings, employers can share the cost with the employee, or even ask the employee to make up the whole shortfall.
- However, if the employer makes up all or part of the shortfall, discrimination issues could be raised if they pay a higher contribution for some employees than for others.
- If the employee is to contribute towards the shortfall, their terms and conditions will need to be changed to allow the employer to deduct any additional contributions. Alternatively, employees will need to give their approval (probably in writing) before a deduction is made.

Employers may instead decide to change the terms of their pension scheme to base contributions on full earnings, so avoiding any shortfalls.

The industry is continuing to press for changes. Although it doesn't seem likely that the government will allow an alternative test of 8% of full basic earnings (with no lower offset of £5,035), it may consider allowing the minimum contribution test to be carried out either on a yearly basis or when the contribution payment is made.

The industry's concerns are that the current proposed test is at odds with the way most employers work, and asking employers to change the terms of their pension schemes could result in them levelling down contributions and access. This could mean many employees – particularly women and the lower paid – receiving lower incomes in retirement. We'd like the government to reconsider this proposal.



Charges and financial management of the personal accounts scheme

In the long term, the government wants the personal accounts scheme to be self-sufficient, using member charges to pay costs. Earlier this year, the Personal Accounts Delivery Authority (PADA) consulted on the shape of the charging structure that should be adopted for the personal accounts scheme (see *Pensions reform factsheet 5*). PADA recently issued a summary of the responses it received to this consultation. Although the government is responsible for deciding both the shape and level of the personal accounts charging structure, PADA will advise it on this.

We think it's crucial the charging structure is financially sustainable, and PADA's modelling shows this will require some form of upfront or contribution charge. So we believe the best way to provide financial sustainability is a charging structure that combines a modest percentage contribution charge with an annual management charge, as this most closely reflects the timing between costs incurred and charges collected.

It's also important that the government separates the policy formation phase from the actual design and building of the personal accounts scheme. It should be transparent what financial aid is given for each phase, and on what terms and conditions the aid for the secondary phase will be repaid.

We strongly believe the marketing costs for the personal accounts scheme should be met by the scheme itself, rather than by the government as part of its overall public service messages.

Other consultations by PADA

PADA plans to carry out three other consultations.

Investment

PADA will probably consult in the autumn on the design of the default fund. This is critical, as the vast majority of personal account members aren't expected to make an active investment decision. PADA will also consult on how many additional fund choices the scheme should offer.

Taking the benefits

PADA will also consult in the autumn on the rules covering what benefits can be taken at retirement and how. We expect this consultation to touch on areas such as whether trivial commutation will be allowed, whether members will be offered help or advice at the point of retirement, and whether there will be a true open market option or a restricted choice of providers.

Scheme terms

The final consultation, due in early 2009, will cover the scheme terms and rules, including setting any contribution cap. We currently expect this to be £3,600, set in 2005 and rising to just under £5,000 once increased by earnings to 2012. The consultation will also cover whether this cap should be increased for the first year to £10,000, whether members should be allowed to pay in lump sums, and whether there will be an initial ban on transfers both in and out of the scheme.



Preparing employers

The detail for pensions reform has yet to be decided. We'll know more once the Pensions Bill receives Royal Assent in the autumn, but some legislative details will need to be settled by regulations.

However, financial advisers can begin to discuss the broader picture with employers now, talking to them in general terms about their options. If either employers' or employees' contributions are to be increased, then starting this process as soon as possible will help employers to manage their cash flow by phasing in costs over a period of time.

Pensions reform will also mean increased take-up of existing pension schemes. The legislation is unlikely to set a specific date in 2012 on which members must be automatically enrolled into pension schemes. Instead, the new system will probably be phased in over a period of probably 12 to 18 months. Even so, this is the biggest cost employers face, and they may wish to start encouraging gradual take-up of scheme membership in the run-up to 2012 to help spread costs.

What this means for you

All employers will need to take action to comply with their new responsibilities under pensions reform and the Pensions Bill 2008. They'll have the choice of automatically enrolling employees into private pension schemes, the personal accounts scheme, or a mixture of the two.

By keeping up with the debate on the terms for exempt existing pension schemes, as well as the development of the personal accounts scheme, you'll be able to discuss the options with your corporate clients.

Designing an implementation plan for the run-up to 2012 will be a crucial part of helping employers stay on the right side of the law and meet their new responsibilities cost-effectively.

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