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Duties

COMPULSORY PENSION PROVISION

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NEW EMPLOYER DUTIES

1. Executive Summary

Whatever the outcome of the forthcoming UK General Election it seems likely that a package of private pension reforms will take effect in April 2012, compelling employers for the first time to make pension contributions for more or less all their employees. The main structure of the legislation will be on the statute book in April 2010.

In summary, the new regime will require all UK employers to make arrangements for automatic enrolment of all jobholders (which is drafted widely to include agency workers):

- aged between 22 and State Pension Age; and
- who have "qualifying earnings" (broadly gross earnings including bonuses) between £5,035 and £33,540 (uprated in line with earnings)

into a "qualifying scheme".

For this purpose a "qualifying scheme" can either be an occupational pension scheme or a workplace pension scheme, such as a group personal or stakeholder pension plan. In addition, it must be of a certain standard and this means for:

- Defined benefit schemes – that it is either contracted-out or provides at least 1/120th accrual and other benefits broadly equivalent to, or better than, a test scheme.
- Defined contribution schemes (personal or occupational) – the employer must make minimum contributions of 3% of qualifying earnings over a 12 month period.

The purpose of this paper is to help employers understand the current state of play with the 2012 reforms and ends with some practical steps for employers to consider.

2. Which employees must be offered benefits?

The new legislation, contained primarily in the Pensions Act 2008 and underlying regulations, refers to "*jobholders*". These are employees who:

(a) work mainly in the UK;

(b) are aged between 16 and 74; and

(c) are paid "qualifying earnings" - gross earnings above £5,035. Earnings need only be pensioned up to an upper limit (£33,540 in 2006/2007 terms).

Where a jobholder is aged between 22 and State Pension Age, the automatic enrolment provisions bite, although in some cases employers can postpone the application of the legislation for a period of three months after the jobholder's automatic enrolment date - see 6 below "*How does automatic enrolment work?*".

Voluntary savers

In addition, other employees, whom employers do not have to enrol automatically (for example, because they do not have qualifying earnings), will be able to serve notice on their employers requiring the employers to admit them to membership of a qualifying scheme. Once an employee has given such a notice, they are to be treated in the same way as someone who was automatically enrolled in the scheme. This includes complying with the minimum (equivalent) contribution levels, although contributions do not need to paid by an employer in respect of an employee who does not have qualifying earnings.

Opting out

Automatic enrolment itself is compulsory but once automatically enrolled, a jobholder has one month from becoming an active member to give the employer a valid opt out notice – see 6 below "*How does automatic enrolment work?*"

3. Will your existing scheme qualify?

The requirements for a scheme to "qualify" under the new statutory standard are laid down in legislation. Most existing schemes will meet the qualifying criteria, although it may still be necessary to amend the eligibility provisions – see 9 below "*What should employers be doing*?".

We summarise the requirements below:

Defined contribution schemes

Where employers operate defined contribution schemes, or direct payment arrangements for personal pension schemes, they must contribute at least 3% of the jobholder's qualifying earnings.

Total contributions, including tax relieved contributions from the jobholder and contributions from the employer, must be at least 8% of the jobholder's qualifying earnings. (The 8% breaks down as 4% from the jobholder, 1% of tax relief and 3% from the employer.)

Defined benefit schemes

Where employers operate defined benefit schemes, the scheme must either:

(a) provide sufficient benefits to allow members to contract-out of the Second State Pension; or

(b) provide pensions that are broadly equivalent to, or better than, the pensions that would be paid under a "test scheme standard".

The requirements are modified for other defined benefit schemes, such as cash balance or career average schemes.

Certification

Whichever type of scheme it operates, it is proposed that employers will be able to self-certify annually that its scheme complies with the qualifying criteria. Details of the self-certification process are set out in a combination of draft regulations and accompanying guidance for employers and actuaries.

The DWP has withdrawn the regulations and guidance on certification of defined contribution schemes for the time being while it consults further. The consultation process revealed significant problems with the methodology in the draft regulations.

4. When do the reforms take effect?

A staggered implementation of the reforms over a three-year period is proposed, starting with the largest employers and moving to the smallest over 25 stages. Employer size will be ascertained by the Regulator using PAYE data from HMRC. Employers with more than one PAYE scheme will be required to bring in all of their schemes as soon as their first scheme is subject to the new duties.

It is proposed to bring a small test group of randomly selected small and "micro" employers into the duties within the three year implementation period, ahead of other similar sized firms.

It is helpful that the DWP has not gone with the "big bang" approach of introducing the reforms all on one day. But larger employers will nevertheless need to start thinking about meeting their duties soon.

The Regulator will write individually to all employers about 12 months and again three months in advance of the date when the automatic enrolment duties arise (the "Staging Date") to tell them when they need to take action and what they need to do to comply. Some employers may wish to bring forward their Staging Date if it is helpful to do so, for example, to align with administration processes.

5. Transitional arrangements

Employers will experience transitional periods of different lengths depending on their Staging Date.

Employers should consider whether they would like to take up this option. This may be particularly relevant for large groups comprising several employers who may have different Staging Dates.

Defined contribution schemes

The minimum contribution requirements for defined contribution schemes will be phased in over two transitional periods in order to help employers and individuals adjust to the additional costs gradually. It is proposed that employers and jobholders will be required to pay contributions as follows:

Transitional periods	Employer contribution (of qualifying earnings)	Jobholder contribution (of qualifying earnings)*
From October 2012	1%	1%
From October 2016	2%	3%
From October 2017 onwards	3%	5%

* including tax relief

Defined benefit and hybrid schemes

The Government proposes to allow employers sponsoring qualifying defined benefit and hybrid schemes to delay automatic enrolment for a period of four years. However, the relevant jobholders will be able to opt into a qualifying scheme at any point during this transitional period.

Employers who close their defined benefit scheme during the transitional period must automatically enrol employees into an alternative qualifying scheme. Where that alternative is a defined contribution scheme they will need to pay employer contributions with effect from the original Staging Date (which could amount to four years' worth of contributions).

6. How does automatic enrolment work?

Employers must automatically enrol eligible jobholders into a qualifying scheme. An individual who does not wish to participate has the right to opt out.

The employer must ensure that, within one month of the automatic enrolment date, the jobholder becomes an active member with effect from the automatic enrolment date. This date will be the earliest of:

- *the employer's Staging Date*, for all employees over 21 who have qualifying earnings;
- *when an employee starts work*, where he or she is over 21 and has qualifying earnings;
- *when an employee reaches 22,* where he or she has qualifying earnings; or
- *when an employee first has qualifying earnings,* where he or she is over 21.

Re-enrolment

Employers have a duty to re-enrol jobholders once every three years for those members who have opted out. The regulations require the employer to choose a re-enrolment date within one month of the three year anniversary of the Staging Date and then within one month every three years after the first re-enrolment date. However, where a jobholder opts out within 12 months of the re-enrolment date there will be no requirement to re-enrol that jobholder until the next three year anniversary.

Given the significance of the Staging Date for re-enrolment obligations, employers may want to bring forward the Staging Date to align this with administration processes – see 4 above "When do the reforms take effect?".

The employer must give the enrolment information (set out in the regulations) to the jobholder and the jobholder information (also set out in the regulations) to the trustees.

Opting out

Automatic enrolment itself is compulsory but once automatically enrolled, a jobholder has one month from becoming an active member to give the employer a valid opt out notice. Upon opting out, any contributions deducted from the jobholder's qualifying earnings must be refunded. The duty to provide refunds lies with the employer (and not the scheme), and there are prescribed timeframes for repayment.

The regulations contain a deliberately prescriptive method by which a jobholder can opt out. For example:

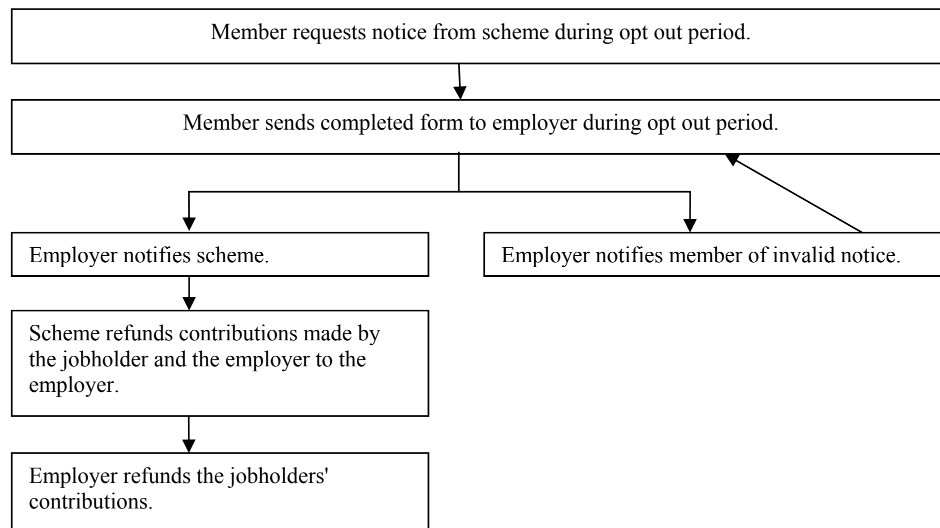
(a) the opt out notice is only valid if it is in the form prescribed by the regulations;

(b) a jobholder must approach the scheme directly for an opt out notice, not the employer (except where the jobholder is an active member of an occupational pension scheme and that scheme has, in its trust instrument, expressly delegated all its administrative functions to the employer);

(c) the opt out notice must by signed by the jobholder and contain certain prescribed wording; and

(d) the notice must be returned to the employer and not the scheme or provider.

The opt out process can be illustrated as follows:



Postponement for high quality schemes

The automatic enrolment requirements are relaxed if the qualifying scheme meets a certain standard.

The draft regulations allow an employer to postpone the automatic enrolment of a jobholder regardless of contract length for a period of three months after the jobholder's automatic enrolment date provided that the pension scheme the jobholder will be enrolled in is either:

(a) a defined contribution arrangement where employer contributions are at least 6% of qualifying earnings, and the total contributions for and in respect of the jobholder are at least 11% of qualifying earnings; and

(b) any qualifying defined benefit scheme.

However, postponement is prevented for any individual who has already been postponed by that employer within the previous 12 months. This measure is to balance the concern that some workers may never be automatically enrolled if they only ever work on a series of short-term contracts for employers operating postponement schemes.

7. How will the new national scheme work?

The national scheme, known as the National Employment Savings Trust ("NEST"), is an alternative to an employer's own scheme. NEST will be established under trust as a registered pension scheme. It will be a multi-employer scheme with a huge number of participating employers. The trustee, a trust corporation named NEST Corporation, will have a statutory obligation to accept any employer that wishes to use the scheme to fulfil its statutory duties.

Large parts of existing pensions legislation will apply to the scheme and trustee, subject to some modifications.

For example, the scheme will not have to appoint member-nominated trustees or consult with employers on changes to its statement of investment principles (but see below on the appointment of a members' and employers' panel).

(a) There has been recent consultation on the draft scheme “order and rules” that will govern how NEST operates. The main features of NEST are as follows:

(b) The annual contribution limit (the maximum amount of contributions which may be made by, or on behalf or in respect of, a member of the scheme in a tax year) is £3,600 (based on the average earnings index for December 2005, and to be adjusted by the trustee in accordance with changes in the average earnings index).

(c) There will be no differentiation between active and deferred members. All members will be able to make contributions until they draw benefits.

(d) Self-employed workers will be able to participate in the scheme.

(e) A members’ and employers’ panel will be established to allow the trustee to engage with the diverse membership and employers. The employers’ panel will have to be consulted on changes to the scheme’s statement of investment principles.

(f) Benefits are drawn by way of a lifetime annuity and tax free cash sum at any age between 55 (or earlier, where the member is suffering ill-health) and 75.

(g) Lump sum death benefits are payable in accordance with a member’s expression of wish form (but are likely to be subject to inheritance tax).

(h) There will be one or more default funds for members that do not wish to make active investment decisions.

A key aim of the scheme is to have low management charges and costs. Charges will be consistently applied to all members irrespective of their age or earnings.

8. Enforcement

Employers will not be able to offer financial inducements to jobholders to opt out, nor will they be able to ask job applicants at interview whether they plan to do so.

If a jobholder suffers any detriment because his or her employer breaches the regime, he or she will be able to claim in the employment tribunal.

Employers will be required to register their compliance by providing information about how they have met the automatic enrolment duties. Current proposals are that employers must register within two months of their Staging Date and that, in order for the Regulator to have an up-to-date set of employer information, employers will be required to re-register every three years within two months of the re-enrolment date.

In addition, employers and trustees will be required to keep records relating to the pension arrangements they have made, the enrolment of jobholders, the opt out process, the opt in process for voluntary savers and the contributions made.

The Regulator will be charged with ensuring that employers comply with their new obligations. It will be able to issue a range of compliance notices and penalties, including a flat-rate fixed penalty of £400 as a “wake-up call” to employers who have not responded to earlier warnings.

Where an employer breaches specific statutory duties, such as failing to comply with the basic statutory duty to enrol jobholders automatically, officers of the employing company are liable to a statutory fine or, in serious cases, for imprisonment for a term not exceeding two years.

The Regulator will consult on a draft enforcement strategy later in 2010.

9. What should employers be doing?

While the DWP continues to consult on and revise the legislation, many employers are planning ahead on the design of future pension provision. Issues that may be relevant to employers are as follows:

(a) Employers will want to check whether existing pension arrangements meet the criteria for qualifying schemes.

The position is not always straightforward. For example, defined contribution schemes may not qualify where generous employer contributions are linked to optional member contributions, or where contributions are based on basic salary but employees receive a large element of pay as bonus or commission.

(b) Employers will want to consider whether to use an existing scheme, by amending it if necessary, to comply with the new requirements.

Changes may need to be made to a scheme's benefit rules and eligibility provisions. Many schemes require employees to provide information or make investment choices. This will not be allowed under automatic enrolment.

(c) The potential cost of automatic enrolment should be assessed.

Employers, particularly those with a low take-up of pension provision, will want to consider the potential increase in costs where large numbers of employees do not opt out. They should then consider what, if any, steps they may want to take in advance of automatic enrolment to reduce salaries or other benefits (pensions or otherwise) to compensate for the increased cost. Legal advice should be obtained before attempting to reduce benefits.

(d) Employers will want to understand whether their pension arrangements would enable them to postpone automatic enrolment for new joiners.

This is likely to be important for employers that currently operate a waiting period to join a pension arrangement, or other employers who have a high turnover of staff.

(e) There may be issues to consider where an employer has temporary or seasonal workers, or employs workers whose salaries are likely to fluctuate above and below the minimum level of qualifying earnings.

For employers with low earners, administration systems may have to allow for automatic enrolment where an employee's salary increases above qualifying earnings.

(f) Where administration of benefits is carried out in-house, employers may want to amend the scheme's trust deed and rules to explicitly provide that administration is carried out by the employer.

This would allow opt out forms to be provided by the employer.

(g) Employers and high-earners will want to ensure that the automatic enrolment requirement does not result in any employees with enhanced protection inadvertently losing the benefit of such protection.

We have made representations to the DWP that legislation should be introduced protecting members with enhanced protection.

(h) It will be necessary to review employment documentation ahead of 2012 to ensure that the statutory requirements are met.

The draft automatic enrolment regulations require employers to provide data about employees to the scheme. Employers may be concerned about data protection issues where information is passed on to scheme administrators, and may wish to put explicit consent to the use of personal data in the employment contract.

(i) Looking further ahead, the opt out and automatic enrolment processes are likely to be complicated. Employers will want to consider the changes to administration systems needed to be made to ensure that the timescales are met and contributions are paid.

In conclusion, there is plenty of time for employers to be fully prepared for the new compulsory contributions regime if they start planning now.

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