KILSBY WILLIAMS & GOULD

TECHNICAL BULLETIN

"Helping our clients to achieve their personal financial objectives through our integrity, skill, diligence and experience"

November 2012

Pensions – a hornet's NEST for employers?

This bulletin will shed light on the impact of the new pension legislation on employers and provide hints on how to prepare appropriately. The legislation has been introduced with effect 1st October 2012 and at some point over the next 5 years all employers will need to offer access and make payments to a pension for their employees.

Kilsby Corporate Financial Planning will be launching on 1 January 2013 to assist companies with employee benefits packages. Equipped with extensive experience and expertise in the industry, we will deliver financial services advice to companies and their owners.

If you would like any further information please contact me.

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Auto enrolment - the biggest pensions reform for a generation

On the 1st October 2012 we witnessed a huge change in the pension landscape which will result in millions of UK workers saving into a pension for the first time; their employers will be expected to both encourage participation and contribute.

So why is pension reform needed?

There are three main reasons:

1. The government estimates about 7 million people are not saving at all towards their retirement or not saving enough.
2. Life expectancy is increasing and therefore larger personal savings are required to fund retirement.
3. The government cannot afford to maintain state pensions at their current level in the longer term.

The government is encouraging people to save for retirement with 2 major pieces of legislation:

i. The staged introduction of the National Employment Savings Trust (NEST), auto enrolment of employees and compulsory contributions. Those companies with 100,000 employees will be automatically enrolled from 1st October 2012 with the smallest companies impacted from April 2017 at the latest.

ii. The introduction of a flat rate State Pension of £140 per week, and no entitlement to 'means tested' pension credit. This is designed to ensure that those who save personally for retirement will have the same State pension provision as those who have saved nothing.

How will the reforms affect you and your staff?

Companies will have to automatically enrol staff who are aged between 22 and state pension age, earn more than £8,105, and have worked for the company for more than 3 months into a qualifying pension scheme on their staging date.

Any member of staff aged at least 16 and under the age of 75 who earns more than £5,564 but less than £8,105 and wishes to join will need to be enrolled and company contributions made. Those staff members who earn less than £5,564 can be enrolled into the scheme but companies do not have to make contributions.

If your company already offers employees access to a pension scheme then it may be possible for this scheme to qualify if it meets minimum criteria. The qualifying scheme could be an occupational pension scheme, personal pension scheme or NEST.

Companies will be free to choose which type of pension scheme they wish to use to meet the legislation. Once a scheme is selected the company will need to notify the Pension Regulator (this will usually be done by the personal pension provider if this is the chosen scheme), auto enrol all eligible employees into the scheme and pay contributions. If companies do not comply heavy fines can be expected.

Can employees opt out of the pension scheme?

Any staff member enrolled into a scheme has a statutory right to opt out within one month of becoming an active member in the scheme. Where they do so, they will be treated as if they never joined the scheme and will be entitled to a refund of their contributions. If the member wishes to opt out they must notify their employer in writing within 1 month. This opt out notice must be held by the employer for 4 years. Members must be re-enrolled into the pension scheme after 3 years where the opt out process starts again.

What are the cost implications of meeting the new pension reforms?

Like the company staging date, minimum contribution levels will be staggered. The following minimum contribution level must be met: -

	OCTOBER 2012 - OCTOBER 2017	**OCTOBER 2017 – OCTOBER 2018**	**FROM OCTOBER 2018**
EMPLOYER	1%	2%	3%
EMPLOYEE	1%	3%	5%
COMBINED	2%	5%	8%

Please note if a company is offering to make a pension contribution of 5% of salary with no employee contribution then the minimum contribution will be met until October 2018 when the contribution will need to increase to 8%.

Key points for companies to consider

- When is the company staging date? Negotiations on pay and benefits should take into account the increased burden on the company from the staging date.
- If there is an existing scheme in place does it meet the legislation? If not what changes are necessary?
- Which employee(s) are going to be tasked with administering the pension? Do they need training? Should this service be outsourced to a third party?

Remember that you need not be alone in preparing for auto enrolment. We are here to help those who wish to prepare.

Back to Basics

Pensions are shrouded in mystery and complexity, meddled with by governments, explained in small print by product providers, and over-egged by silver tongued salesmen...so is the view of many…and yet business owners are now tasked with the responsibility of ensuring that their work force are offered access to a 'work place' pension.

Where does the business owner start? Our view is that choosing a pension scheme is a buying decision like any other….and successful businesses generally make good buying decisions based on;

(a) Price
(b) Quality
(c) Service

The skill in the negotiation is getting a fair price for an appropriately robust product that is fit for purpose, with an adequate service from the provider to ensure the process continues as smoothly as possible (or a problem is fixed as quickly as possible if things go wrong).

Now let me apply this to pensions.

(a) Price – a pension arrangement will have a direct product charge taken by the pension provider. This charge will be used to cover costs of administration (for example premium collection, allocation of monies to investment funds, and transfers if people choose to leave), and fund management (a manager is employed to generate returns for the investor).

In the past the costs of meeting the salesman's costs/commission were also met within the price. However, to make a true buying decision, this cost should be separated from the product cost, be clearly visible and providing a fair reward for the work undertaken. This includes advice to company and its employees, payroll and premium collection, new joiners and leavers.

(b) Quality of Product – a pension is generally a long term investment and therefore it is important to choose a provider with a strong reputation and balance sheet, and that provides information in an open and customer friendly format. The performance of the fund is obviously important but too often the financial services industry promotes performance on the grounds of what has happened in the past, and within timeframes that suit the most generous period of return. This results in unrealistic expectation from investors, returns that disappoint, and ultimately disillusionment with pensions.

(c) Service – it is important that members have access to information on line where they can see the money being invested, track the performance of their plan, project their retirement income, etc…..the secrecy should be unveiled. Secondly, if something goes wrong then the employer should be able to turn to someone who can put it right with the minimum of fuss.

Finally buying decisions should be reviewed as things change. In the pensions world this will manifest itself as changing legislation, changing company circumstances, new products and providers – as well as keeping the workforce happy by answering their questions about their future.

I would advocate that employers establish a 'pension committee' who are tasked with assisting the employer with the buying decision and reviewing the decision. In our experience the pension committee should be made up of a company director, and employee representative's) (a sensible choice would be someone who is interested in pensions, and even better if they are elected by the employees).

So what is possible……..

Let us look at a company with 30 employees, an average salary of £20,000 per employee, and a commitment to contribute 8% of salary between the member and employer (say 4% member and 4% company).

Direct costs: for a quality product with a reputable pension provider it is possible that the provider and fund management costs can be fixed at 0.8% per annum. So in this example if contributions total £1,600 per annum and the pension fund grows by 5% per annum then over a 10 year period the pension provider receives £736 and the member is left with a fund of £19,390. Over a 25 year period the pension provider receives £7,906 and the member is left with a fund of £68,500.

Your adviser should negotiate a fee directly with you depending on the level of assistance required. However, you should expect both an initial cost and an ongoing maintenance cost.

Initial work would usually include an analysis of the company circumstances and finances, proposal of a tax efficient funding strategy, the recommendation of an appropriate company and funds, the provision of a report detailing the conclusions, presentation of the scheme to the members and meeting with members and the pension committee to answer questions, and bed down the pension arrangement.

Annual maintenance would usually include a meeting with the pension committee to review the recommended arrangement and discuss any changes; the provision of a valuation and review letter to members, and an annual surgery with members to answer questions.

Finance Directors should also take note that the current tax rules can allow a National Insurance saving to the company which will possibly be sufficient to meet the adviser costs.

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The Benefits of Salary Exchange Schemes

Being offered something for nothing generally sounds too good to be true and leads you to question where the catch is. However, sometimes is it possible to save cash and indeed get more value for your money by changing the way you do things and nowhere is this truer than in the area of planning remuneration packages.

Squeezing the maximum benefit from a business' overall wages bill and looking at innovative ways to provide the workforce with enhanced benefits is particularly relevant at a time when funding pay rises is hard, if not impossible.

Apart from the actual wage bill itself, National Insurance Contributions (NIC) which adds another 13.8% to the wages bill is an unwelcome overhead for most businesses. As a result, many employers have introduced a remuneration package which is tax efficient for them and their workforce parties by
focusing on ways of saving NIC.

The solution to reducing the NIC bill is to work with employees to develop a salary exchange scheme – which results in a win-win position if the overall savings are shared.

Most commonly the arrangements are implemented where employees exchange or 'sacrifice' a part of their salary to subsidise either pensions or improve other staff benefit packages.

For the employee, a salary exchange for an employer pension contribution will mean a larger pension pot for the future and the potential to pay NIC and income tax each year. The employer also gains by paying less NIC.

The idea is for the employee to sacrifice a part of his salary, with the amount sacrificed being paid directly into a pension plan by the employer, rather than being paid to the employee in salary.

As a result of the employee receiving a lower salary, NIC is saved and, as part of the salary sacrifice deal, the employer may also pay some or all of the NIC savings into the employee's pension plan.

As an example, an employee earning £30,000 a year decides he wants to 'sacrifice' £1,000 of his salary. His new salary is £29,000, with his employer paying the £1,000 sacrificed, together with the NIC saving, into the employee's pension plan. Assuming a return of 3% per year, this would result in an extra £170,000 added to the employee's pension pot at the end of his career, assuming a saving of 40 years.

The employee pays less NIC and, in some cases depending on the structure of the scheme, less Income Tax because his salary is lower. The employer also pays less NIC on his employee's lower salary and may pay a percentage of the saving into the employee's pension plan.

As an example of how this can be achieved let's assume the same employee earning £30,000 a year currently contributes 3% of his salary each year to a personal pension scheme. If instead of doing this he enters into a salary sacrifice arrangement with his employer who contributes the 3% to a pension scheme on his behalf. As a result of restructuring the contributions, the employee's net pay increases by £108 and the employer saves £116 – see below.

Salary exchange illustration

	Net Pay £	**Salary Exchange £**
Salary	30,000	29,100
PAYE	4,379	4,199
Employee NIC	2,689	2,581
Pension contribution (cash payment)	720	-
Net cash	22,212	22,320
Employee pension contribution (including tax relief)	900	-
Employer's NIC	2,882	2,766
Employer's pension contribution	-	900
Total cost to employer	32,882	32,766

Depending on the circumstances, the employer can share some or all of the NIC saved with the employee (after allowing for the administrative costs of implementing the change).

Another effective form of salary exchange can see an employee sacrificing a portion of his monthly pay and receiving the equivalent in childcare vouchers instead, which saves income tax.

It's important that a salary exchange is implemented properly in order for it to be effective for tax purposes. However, all employers should ensure that they have not overlooked the obvious benefits that can be achieved without adding any costs to their bottom line.

If you would like advice on how to structure your remuneration package more tax-efficiently, please contact Mary McDonagh on 01633 653 164.

Pre-Retirement - Fund Selection and Risk of Funds

Selecting an appropriate fund for long term investments such as pensions is just as important as selecting a suitable pension provider.

After all, the intention is that pension contributions paid by you and your employees will be invested into a fund to provide maximum growth for the future benefit of your employees. So how can you as an employer be sure to select an appropriate fund suitable for your entire workforce? This can become something of a worry where there is a diversified range of employees; each with their own opinions, risk profiles, and age.

This is where a default fund can add value and is suitable for individuals in the absence of an investment instruction or where individuals do not want to choose where their own pension contributions are invested.

A default fund allows monies to be invested in line with a timeframe until retirement, meeting the requirements impacted on employers under NEST obligations whilst investing within an agreed mandate for investment risk.

Over the long term, a young employee may be prepared to take a higher level of risk with their pension funds than an older employee simply due to the length until their selected retirement date. Pension contributions will be invested for a longer period so are less affected by short term volatility and the impact of inflation.

However, selecting a fund investing 100% in higher risk investments (equities for example) for all employees would be unsuitable as this could be of great detriment to older employees closer to their retirement date as there is less opportunity for investment losses to be recovered.

By selecting a ‘lifestyling’ option within the fund the level of risk being taken with pension funds as individuals near their retirement is gradually reduced. This protects the value of pension funds in the short term until employees wish to take retirement benefits.

This is done by reducing the level of higher risk investments such as equities in favour of lower, less volatile investments such as cash and gilts. The end game in terms of ‘lifestyling’ is to replicate an appropriate fund allocation in preparation for a pending annuity purchase by holding 75% of the fund in bonds and 25% in cash ready to pay the tax free lump sum payment. Of course this route may not be appropriate for everyone and can be dealt with at a pension surgery.

A suitable default fund should consist of a diversified portfolio of investments which can include property funds, UK and overseas equities and other lower risk investments to balance the level of risk being taken with the pension funds. The table on the next page illustrates the performance of each of these sectors over the last 22 years.

(Source Trustnet 23 October 2012)

A = Property B = Global Equities C = Cash D = UK Equities E= Gilts

As you can see, over the long term equities have considerably outperformed cash and other sectors, however it is these asset classes that are more volatile, experiencing large gains and dramatic losses when compared to the consistent (lower) returns generated from cash and bonds.

Real value can be added by an advisor when selecting a default fund which meets the needs of the workforce as a whole. Naturally there maybe some employees who wish to pick their own funds. This facility should also be made available.

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Income expectation at retirement

Having assisted employees to build pension funds for their retirement employers should endeavour to ensure that all that hard saving is not wasted by a poor choice being taken at retirement by the employee. One should be minded that different individuals will have different circumstances, retirement objectives, and attitudes to risk. As you read this article please consider the retirement choice faced by the following 3 examples:

(i) Enid age 65 who is widowed with no financial dependents; she has very little in savings, is entitled to a full Basic State Pension of £5,600 per annum, and has built up a private pension pot of £100,000. Enid now wants to fully retire.

(ii) Brian age 65 who is married with no financial dependents; he has considerable savings, a full Basic State Pension of £5,600 per annum, a final salary pension from a previous employer of £15,000 per annum, and a private pension pot of £250,000. Brian now wishes to fully retire.

(iii) Sue who is 58 and married and her children have recently left home. As a director in the family company she now wishes to cut her working week to 3 days and fully retire in 7 years time. She is a shareholder in the company, and has some savings and a private pension fund of £400,000. She needs some income now to supplement her reduced salary from work.

For those approaching retirement the number of options open to them with regard to their pensions can appear bewildering. In broad terms, the options divide into two separate categories; secured pensions in the form of an annuity or unsecured pensions in the form of income drawdown.

Secured pensions – annuity

At retirement the most popular route of converting a pension fund into income is via an annuity. An annuity represents a promise of income for life bought with a sum of capital built up within a pension fund.

The most common form of annuity is a lifetime annuity; the purchase of a lifetime annuity should be considered very carefully as once the annuity is bought it cannot be transferred to another provider, cannot be changed to a different type of annuity and cannot be altered in any way for the rest of the annuitant's life.

It is a common misconception that you can only purchase your annuity from the current pension provider; this is not the case and you are free to shop around to obtain the most competitive rate just as you would for car or home insurance. This is known as the 'open market option'. Utilising the 'open market option' is essential retirement planning as all would wish to maximise their retirement income.

In the last 20 years the annuity market has developed considerably, and the following options are now available:

(i) A 'conventional' annuity provides a guarantee of income for life to the annuitant. At retirement the pension plan holder passes the pension pot over to the annuity provider (usually after 25% of the fund to provide a tax free lump sum) who provides the guaranteed income. The annuity becomes a liability of the annuity provider, and to ensure this liability is covered the most common investment made is into UK Government GILTS.

(ii) Those in ill health or those where their lifestyle may affect their life expectancy may qualify for an enhanced annuity that will provide a higher pension income. An enhanced annuity will only be available to you through a specialist annuity provider; your existing pension provider will usually quote only on standard rates. Lifestyle factors such as smoking, drinking and being overweight, or relatively mild health conditions such as high cholesterol may qualify as well as more severe conditions such as certain cancers and types of heart disease. Even your postcode could have an impact.

(iii) For those individuals who wish to take some investment risk with their annuity income it is possible for the underlying investment to be held in equity (share based) or property funds. Rather than a steady, consistent level of income the annuitant can expect a volatile income that could fall considerably, however, there is also the prospect for the income to grow and perhaps counter the impact of inflation over the longer term. These annuities are commonly referred to as 'unit linked'; for those who would prefer a less volatile income, but still take some risk for the potential of greater reward a with profits annuity could be considered.

(iv) A recent innovation within the annuity market has been the development of short term annuities of say 3 or 5 years. At the end of the period there remains a significant fund which is then used to either buy another short term annuity or move into a lifetime annuity.

The final matters to consider are the particulars of the selected annuity, for example is it a single life or does the annuitant wish to ensure that income continues to his spouse if he predeceases her. If so how much protection is appropriate – a third, a half, or two-thirds? If a conventional annuity is chosen is it to remain level for life or increase each year? If it is to increase then by how much – 3%, 5%, or inflation?

These choices will have an impact on the initial level of the annuity.

Unsecured pensions – income drawdown

The alternative to giving up the pension capital to an annuity is to take an 'income' in the form of withdrawals of capital, directly from the pension fund. These arrangements are typically referred to as 'drawdown' or 'income withdrawal'.

It is possible to 'drawdown' on a pension fund until death. There are two types of drawdown:

(a) Capped Drawdown: There is a maximum annual income limit which is based on 100% of the equivalent annuity rate calculated using the Government Actuary Department (GAD) tables.

(b) Flexible Drawdown: For those individuals who meet the 'Minimum Income Requirements' (MIR) of £20,000 per annum will be able to drawdown unlimited amounts from their pension funds. The definition of secure income which can qualify for the MIR includes income from state pension benefits, lifetime annuities and scheme pension such as final salary pensions.

The table below illustrates the difference in the income payable from the alternative options based on a pension pot of £100,000.

Option	Annual Income Male – Age 65	Annual Income Female – Age 65
Conventional annuity on standard terms	£5,580	£5,360
Conventional annuity on enhanced terms	£6,685	£6,340
With Profits annuity (maximum 5% bonus assumption)	£7,082	£6,797
Capped Drawdown	Max = £5,300 Min = £0	Max = £4,900 Min = £0
Flexible Drawdown	Unlimited	Unlimited

The amount of income payable from a pension at retirement is dependent on the following factors:

(i) The size of the fund

The amount that is paid into the pension will of course have a significant impact on this. The NEST work based pension scheme is being introduced on a staggered basis between 1st October 2012 and April 2017. The enrolment date alone will have a significant impact on the fund size available at retirement.

For example, Member A enrols in the scheme now whereas Member B does not join the scheme until 2015. Assuming both members are aged 25 and have a retirement age of 65, salary of £25,000 and a commitment to contribute 8% of salary, and their pension funds grow by 7% per annum.

Member A would have built a pension fund of approximately £400,000 whereas Member B's fund would be £320,000. Assuming a conventional single life, level annuity were purchased today Member A could expect an income of £22,320 per annum whereas Member B gets £17,850 per annum.

Member A had £6,000 more paid into his pension fund by starting 3 years earlier, and as a result gets an income of nearly £4,500 per annum more for life. The average life expectancy for a man age 65 in 2012 is 20 years so Member A has a reasonable chance of an additional £90,000 of income over Member B at a cost of £6,000!

(ii) Prevailing annuity rates

Conventional annuity rates have been on a downward slope for the past five years due to the falling yield on gilts (British government bonds). This too has had an impact on the maximum allowable income that can be taken under income withdrawal.

As I hope you can see the choices faced by Enid, Brian, and Sue are complex ones and advice is required to ensure that the pension income chosen has the greatest chance of meeting their retirement needs.

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