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benefits that truly benefit

Pensions explained

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British Insurance Broker's Association – London & South East

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Businesses of Marsh McLennan

Agenda

1. The history of UK pensions – a brief guide
2. Legal structure of pension schemes
3. The main types of pension schemes
4. Retirement Living Standards
5. The savings gap
6. Automatic enrollment

The history of UK pensions

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History of pensions – a brief guide

- **1670s** First organised pension scheme for Royal Navy Officers
- **1908** Old Age Pensions Act - introduced first general old age pension paying a non-contributory amount of between 10p and 25p a week, from age 70, on a means-tested basis from January 1 1909 - "Pensions Day". This was introduced by Liberal politician David Lloyd-George. Sir William Beveridge, father of the welfare state, was an adviser.
- **1921** Finance Act - tax relief granted to pension schemes satisfying certain conditions.
- **1925** Contributory Pensions Act - set up a contributory State scheme for manual workers and others earning up to £250 a year. The pension was 50p a week from age 65.
- **1942** Sir William Beveridge publishes his "Social Insurance and Allied Services" report with state welfare proposals.
- **1946** National Insurance Act - introduced contributory State pension for all. Initially pensions were £1.30 a week for a single person and £2.10 for a married couple. Paid from age 65 for men and 60 for women, effective from 1948.
- **1947** Finance Act - limited the maximum amount of tax relief on pensions, and the proportion that could be taken as a lump sum.
- **1959** National Insurance Act - introduced a top-up state pensions scheme, based on earnings and known as the graduated pension. Covered earnings between £9 and £15 a week.
- **1975** Social Security Pensions Act - set up the State Earnings related Pension Scheme (Serps). Introduced in 1978, the scheme replaced graduated pensions. Rules for contracting out were also introduced, whereby workers with adequate private provision can give up all or part of the benefits of Serps. In return they pay lower National Insurance contributions.

History of pensions – a brief guide

- **1980** Social Security Act - Link between state pension increases and average earnings broken by Margaret Thatcher's Conservative government. If the link with earnings had not been broken, a basic state pension for a single pensioner would worth about £30 a week more.
- **1986** Financial Services Act - set out terms and conditions under which investment business could be conducted. Changes to contracting out.
- **1991/2** Maxwell scandal. Mirror newspaper proprietor Robert Maxwell had used about £460m from his group's pension funds to finance business dealings.
- **1995** Pensions Act - response to Maxwell, which set up regulatory and compensation schemes.
- **1997** Removed tax credits for pension funds on company dividends.
- **1999** Introduction of Minimum Income Guarantee (Mig), income support for poorest pensioners.
- **2001** Introduction of stakeholder pensions, a low-cost pensions scheme aimed at people on low to average earnings and helping women save for old age.
- **2002** Switch from Serps to the State Second Pension scheme.
- **2003** Introduction of the Pension Credit, a means-tested benefit designed to top up the incomes and savings of Britain's poorest pensioners.

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History of pensions – a brief guide

- **2004** First report of the government's Pension Commission, headed by Lord Turner, outlines some of the main challenges facing UK pension provision. The report suggests that either taxes will have to rise or people will have to work longer, save more or face old age poverty.
- **2005** The Turner commission report outlining solution to the pensions impasse published on 30 November, expected to recommend a higher state pension funded by a rise in the retirement age, and an automatic national savings scheme.
- **2008** The Pensions Act 2008 – paved the way for Automatic Enrolment.
- **2010** The equalisation of the State Pension Age begins with women retiring at the same age as men from 2020.
- **2012** Automatic Enrolment first introduced.
- **2013** The Retail Distribution Review required the re-qualification of advisers and removed commissions from pensions.
- **2015** Pension freedoms introduced
- **2016** The new single tier State Pension is introduced.
- **2018** The Automatic Enrolment contributions increase for employees and employers.
- **2019** The Automatic Enrolment contributions increase again for employees and employers.

History of UK pensions - summary

- There have been more changes to pension legislation in the last 100 years than there have been UK Governments.

- With more changes to pension legislation in the last 100 years than UK Governments, it is important that employers seek expert help from advisers in relation to pensions.
- The changing nature of the pension landscape means that clients should re-visit and review the suitability their workplace pension on a regular basis.

The legal structure of pension schemes

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Occupational pension schemes

"A scheme established by an employer, or on behalf of a group of employers, to provide pensions and/or other benefits for or in respect of one or more employees on leaving pensionable service or on death or retirement."
(Source: Pensions Management Institute – Pensions Terminology)

- A trustee body is established to look after the interests of the members.
- A scheme established for a number of employers is called a Master Trust. As such, the scheme rules are standardised and other costs such as accounting and trustee duties are absorbed in the overall structure. Typically, this type of scheme will have a group of independent trustees.

Contract-based pension schemes

Personal pension schemes are contract-based schemes set up on a defined contribution basis. The contract is between the individual and the provider of the personal pension.

A Group Personal Pension scheme is defined as:

"An arrangement made for the employees of a particular employer, or for a group of self employed individuals, to participate in a personal pension scheme with the same pension provider. Each member has a separate policy with the pension provider, but contributions are collected together."
(Source: Pensions Management Institute – Pensions Terminology)

- By grouping policies together the scheme provider can reduce costs making the GPP option usually much cheaper than individual pensions, and often with enhanced features on offer as well.

The main types of pension schemes

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Final salary

“An occupational pension scheme where the benefit is related to the amount that the member is earning at the time of retirement, death or leaving pensionable service and to the period of pensionable service.

The earnings taken into account are often an average over the last few years of pensionable service.”
(Source: Pensions Management Institute – Pensions Terminology)

- Members accrue/earn pension based on the scheme’s accrual rate for each year of pensionable service, e.g. 1/60th or 1/80th.
- Tax-free cash is normally provided by giving up (called commuting) some of the pension that the member has earned.
- In some public sector schemes (such as LGPS prior to 1 April 2008) tax-free cash is provided in addition to the pension earned but the accrual rate tends to be lower.

Final salary – an example benefit calculation

- A member receives a benefit at retirement equal to 1/60th of his/her final pensionable salary for each year (and complete months) of pensionable service, where final pensionable salary is the highest pensionable salary in the last 3 years.

  Pensionable Salary is defined as basic salary each 1 January.
- Calculation:
  - Date Joined Scheme = 10 January 1998
  - Normal Retirement Date (NRD) = 1 April 2014
  - Basic Salary at 1 January 2012 = £30,000
  - Basic Salary at 1 January 2013 = £33,000
  - Basic Salary at 1 January 2014 = £32,000
  - Pensionable Service = 16 years and 2 months
  - Final Pensionable Salary = £33,000
  - Pension at NRD = 16.167 / 60 x 33,000 = £8,891.85 pa

Final salary – characteristics

- Typically, the benefits are funded by a fixed employee contribution with the employer paying the balance of the cost. Some schemes share the cost in fixed proportions between members and the employer.
- Therefore the employer costs increase if:
  - Members live longer than expected
  - Investment returns are worse than expected
  - Salary increases are higher than expected, as benefits already earned are linked to final salary
- These schemes have high running costs as they needs specialist advice (actuarial, legal and investment) as well as day-to-day administration. The costs are typically borne by the employer.
- Employees have a “known” pension income in retirement, i.e. as a % of final salary.

Career Average Revalue Earnings [‘CARE’]

“An occupational pension scheme where the benefit for each year of membership is related to the pensionable earnings for that year revalued by reference to an appropriate index during and after pensionable service.”
(Source: Pensions Management Institute – Pensions Terminology)

- CARE schemes work in a similar way to final salary schemes except
  – The benefit earned in any one particular year is not linked to a member’s final salary
  – Instead, it is linked to the salary in the year earned with indexation increases thereafter
  – Typically, increases in Consumer Prices Index (‘CPI’) are used

‘CARE’ – an example benefit calculation

- A member receives a benefit at retirement equal to 1/60th of his/her final pensionable salary for each year (and complete months) of pensionable service, where pensionable salary is defined as basic salary each 1 April and benefits are increased in line with the increases in CPI each year.

- Benefit earned at the end of year 1
  - Basic Salary at 1 April 2014 = £20,000
  - Benefit earned in 2014/15 = £20,000 / 60 = £333.33

- Benefit earned at the end of year 2
  - Basic Salary at 1 April 2015 = £24,000
  - Benefit earned in 2015/16 = £24,000 / 60 = £400.00
  - CPI increase = 2.5%
  - Total benefit earned by end of year 2 = £333.33 x 1.025 + £400.00 = £741.66

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‘CARE’ – characteristics

- Typically, the benefits are funded by a fixed employee contribution with the employer paying the balance of the cost.
- Therefore the employer costs increase if:
  - Members live longer than expected
  - Investment returns are worse than expected
  - Increases in inflation are higher than salary increases (typically in the past, salary increases have always been greater than inflation)
- These schemes have high running costs as they needs specialist advice (actuarial, legal and investment) as well as day-to-day administration. The costs are typically borne by the employer.
- For employees the amount of pension income is less predictable than for a final salary scheme.

Cash Balance

“An occupational pension scheme in which a guaranteed cash sum is built up for each employee on the basis of a known formula and which is directly related to that employee's pensionable earnings in each year of membership.

The resulting "cash balance" is then used to purchase an annuity at retirement.”
(Source: Pensions Management Institute – Pensions Terminology)

- In a cash balance scheme the employee pays in a fixed % of their pensionable salary each year.
- In return, the employer guarantees that for each year the member will receive a fund at retirement to purchase benefits, equal to a (higher) fixed % of their pensionable salary increased in line with an index. Typically, CPI is used as the index.
- The guaranteed fund is then used to provide benefits at retirement.

Cash Balance – example benefit calculation

- A member pays 5% of their pensionable pay, which is defined as basic salary, each year into the scheme.
- The employer guarantees that the member will receive a fund at retirement equal to 16% of pensionable pay for each year of service increased in line with CPI (maximum 2.5%).

- Fund earned at the end of year 1
  - Basic Salary at 1 April 2014 = £20,000
  - Fund earned in 2014/15 = 16% x £20,000 = £3,200

- Fund earned at the end of year 2
  - Basic Salary at 1 April 2015 = £24,000
  - Fund earned in 2015/16 = 16% x £24,000 = £3,840
  - CPI increase = 2%
  - Total fund earned by end of year 2 = £3,200 x 1.02 + £3,840 = £7,104

Cash Balance – characteristics

- Typically, the benefits are funded by a fixed employee contribution with the employer paying the balance of the cost.

- Therefore the employer costs increase if investment returns are worse than expected

- These schemes have high running costs as they needs specialist advice (actuarial, legal and investment) as well as day-to-day administration. The costs are typically borne by the employer.

- For employees, the level of pension income is unpredictable (as for a defined contribution scheme) although the amount of fund built up is more predictable than for a defined contribution scheme.

Defined Contribution

"A scheme in which the provision of an individual member's benefits are by reference to contributions paid into the scheme by or in respect of that member, usually increased by the investment return on those contributions."

(Source: Pensions Management Institute – Pensions Terminology)

- Can be occupational pension schemes or contract-based pension schemes.
- In a defined contribution scheme both the member and employer pay in a % of the member's pensionable salary each year.
- The member's fund increases/decreases in line with investment returns (less charges).
- It is impossible for the member to predict how much will be in his/her fund at retirement and how much pension income it will provide.

Defined Contribution – characteristics

- The benefits are funded by pre-determined employee and employer contribution rates
- These schemes have lower running costs as they do not require the same level of advice required as for final salary, CARE and cash balance schemes – in particular, actuarial and legal advice.
- The administration and investment management costs are typically borne by the employee. The employer pays the cost of advice on provider/investment management selection and in relation to the governance of the scheme
- For employees, the amount of fund built up and the level of pension income is unpredictable.

Number of employers using schemes

Defined Contribution schemes (Trust and Contract) represent >98% of all schemes used for Automatic Enrolment.

Up to 2019	Small (<30 members)	% of scheme types (<30 members)	Large (>30 members)	% of scheme types (>30 members)	Total
Defined Benefit	3,371	0%	9,159	9%	12,530
Hybrid	925	0%	1,492	1%	2,417
Defined Contribution (Trust)	662,176	89%	55,133	55%	717,309
Defined Contribution (Contract)	77,378	10%	34,140	34%	111,518
Unknown	164	0%	62	0%	226
Total	744,014	100%	99,986	100%	844,000

The Pensions Regulator, Automatic enrolment Commentary and analysis: April 2018-March 2019

Retirement Living Standards

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Retirement Living Standards – overview

The Pensions and Lifetime Savings Association (PLSA) has published its Retirement Living Standards which are designed to help people picture the lifestyle they want when they retire, and to understand how much this will cost.

The PLSA stated that "research shows 51% of people focus on their current needs and wants at the expense of providing for the future and only 23% of people are confident they know how much they need to save".

The Retirement Living Standards are pitched at three levels:

Level	Annual amount for a single person	Annual amount for a couple	Description
Minimum	£10,200	£15,700	Covers all needs with some left over for fun
Moderate	£20,200	£29,100	Gives more financial security and flexibility
Comfortable	£33,000	£47,500	Gives more financial freedom and luxuries

The Retirement Living Standards are being adopted by many of the pension providers, including Mercer, to help members understand more about how much they need to save for their retirement.

Points to consider

1. MMB is talking to the pension providers to understand how they are adopting and incorporating the Retirement Living Standards into their management information and communications. Further information on this will follow.

2. Using the Retirement Living Standards may be a way of improving member engagement.

Retirement Living Standards – so what is included …

When assessing each level, the PLSA based it on a basket of goods and services, from food and drink to holidays.

EXPENDITURE	MINIMUM		MODERATE		COMFORTABLE	
Income per annum	Single: £10,200	Couple: £15,700	Single: £20,200	Couple: £29,100	Single: £33,000	Couple: £47,500
HOUSE	DIY maintenance and decorating one room a year		Some help with maintenance and decorating each year		Replace kitchen and bathroom every 10/15 years	
FOOD & DRINK	A £38 weekly food shop	A £67 weekly food shop	A £46 weekly food shop	A £74 weekly food shop	A £56 weekly food shop	A £91 weekly food shop
TRANSPORT	No Car		3-year old car replaced every 10 years		2-year old car replaced every 5 years	Two cars, each replaced every 5 years
HOLIDAYS & LEISURE	A week and a long weekend in the UK every year		2 weeks in Europe and a long weekend in the UK every year		3 weeks in Europe every year	
CLOTHING & PERSONAL	£460 for clothing and footwear each year	£460 per person for clothing and footwear each year	£750 for clothing and footwear each year	£750 per person for clothing and footwear each year	£1,000 - £1,500 for clothing and footwear each year	Up to £1,500 per person for clothing and footwear each year
HELPING OTHERS	£10 for each birthday present		£30 for each birthday present		£50 for each birthday present	

Further information can be found in this link: https://www.retirementlivingstandards.org.uk/

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The savings gap

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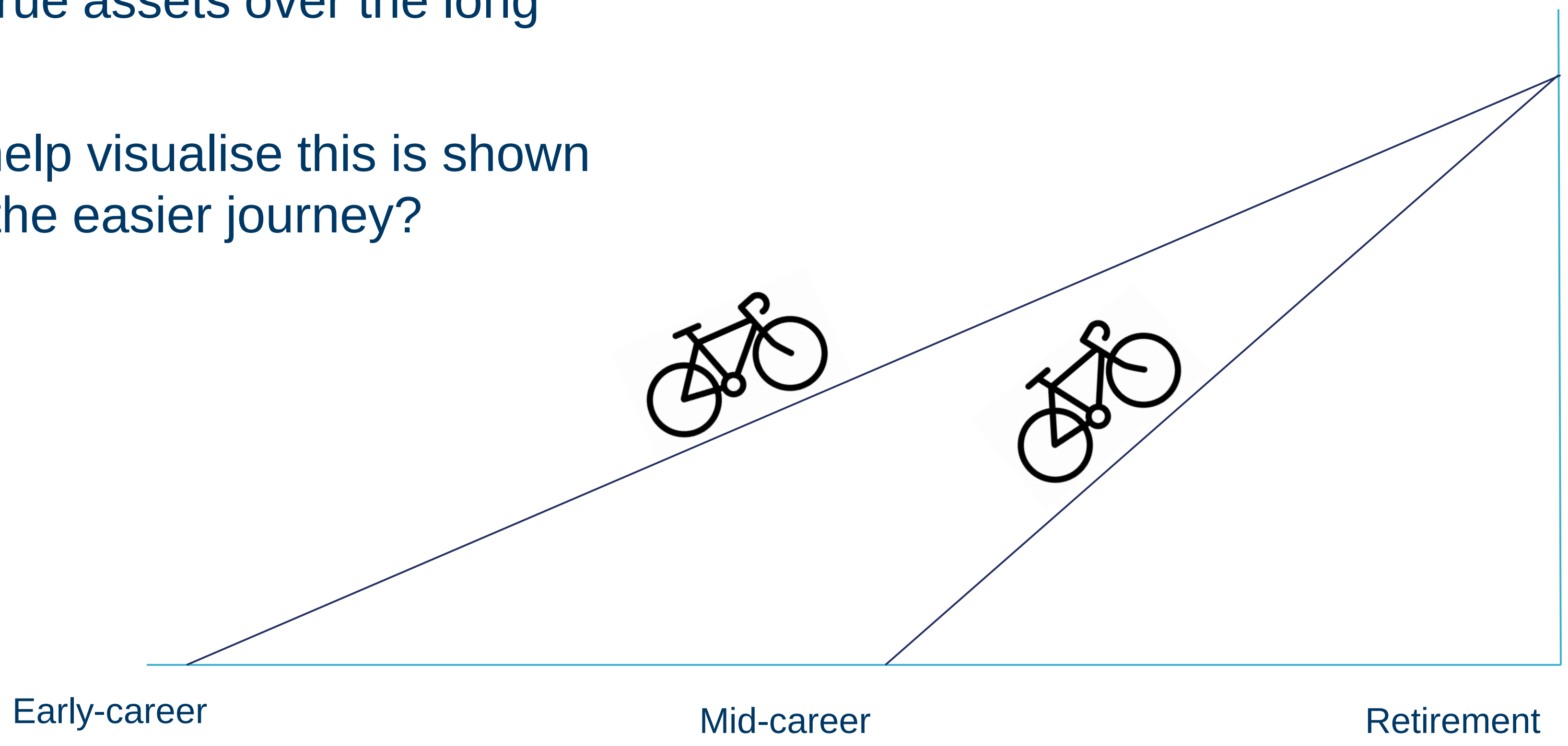
Understanding the cost of delaying saving

- The sooner people start saving the easier it is for them to accrue assets over the long term
- A simple way to help visualise this is shown below. Which is the easier journey?



The World of UK pensions (pre-Automatic Enrolment)

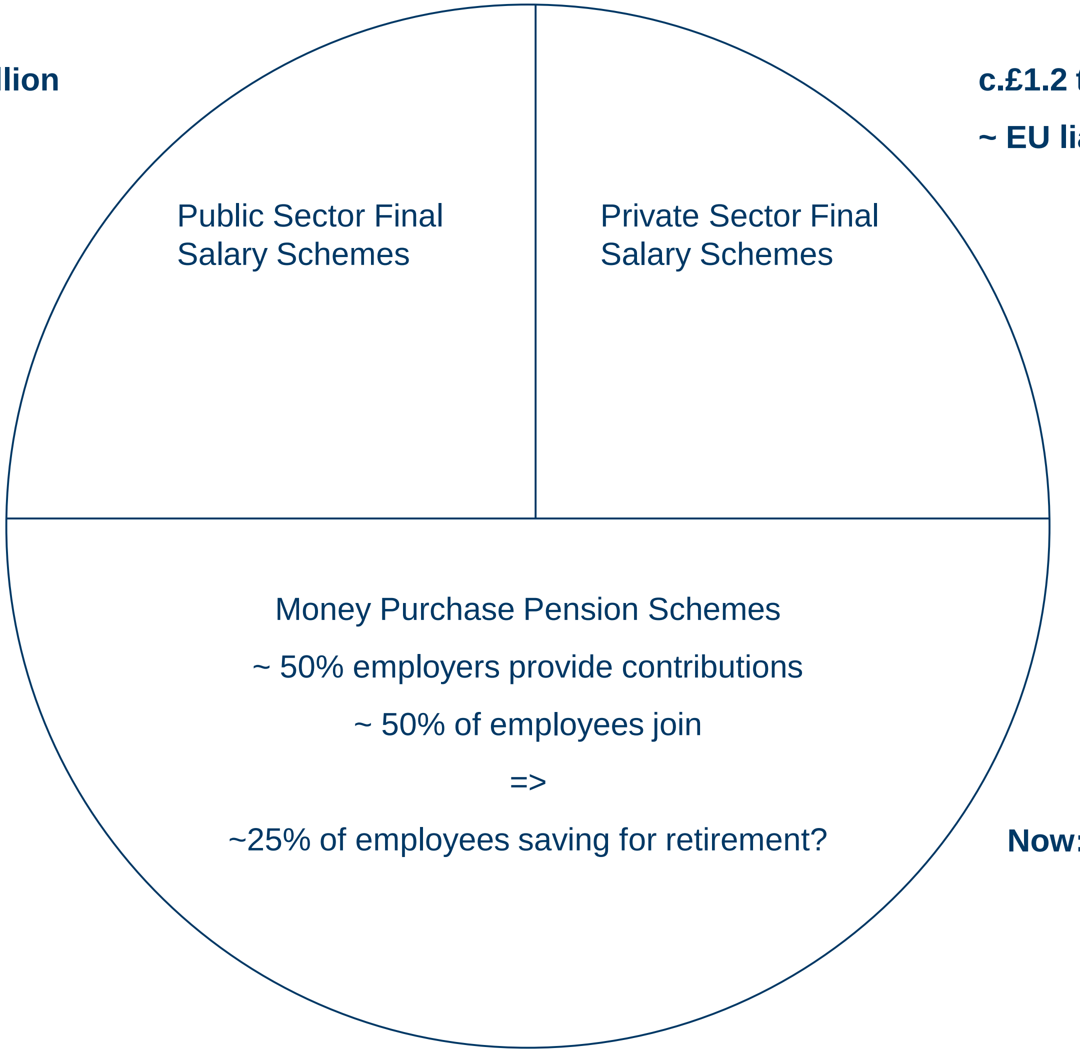
c.£950 billion

Now: Est. £1.25 trillion*

c.£1.2 trillion liabilities

~ EU liabilities x 2

Now: Est. £2 trillion*



Now: Est. £240 billion*

**Source: Pensions in the national accounts, a fuller picture of the UK's funded and unfunded pension obligations: 2010 to 2015*

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Automatic enrolment

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Automatic enrolment

- The Pensions Act 2008 paved the way for the introduction of Automatic Enrolment
- Automatic Enrolment introduced in 2012 for the largest employers and by 2017, all existing employers had to comply
- Automatically enrols certain employees into a Qualifying Workplace Pension Scheme

What does it mean for employees

Annual earnings	Age 16 to 21	22 to State Pension Age	State Pension Age and older
Less than £6,240		Entitled Worker	
£6,240 - £10,000		Non-Eligible Worker	
Over £10,000	Non-Eligible Worker	Eligible Worker	Non-Eligible Worker

Earnings limits based on 2021/22 rates and are subject to change

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Categories of worker – eligible workers

Age / Annual earnings	16 to 21	22 to State Pension Age	State Pension Age and older
Less than £6,240		Entitled Worker	
£6,240 - £10,000		Non-Eligible Worker	
Over £10,000	Non-Eligible Worker	Eligible Worker	Non-Eligible Worker

- Automatically Enrolled
- Employer contribution is mandatory
- Employee contribution is mandatory
- Employee can opt out

Categories of worker – non-eligible workers

Age / Annual earnings	16 to 21	22 to State Pension Age	State Pension Age and older
Less than £6,240		Entitled Worker	
£6,240 - £10,000		Non-Eligible Worker	
Over £10,000	Non-Eligible Worker	Eligible Worker	Non-Eligible Worker

- Not Automatically Enrolled
- Employee has the option to opt in
- Employer contribution **is** mandatory if employee opts in

Categories of worker – entitled worker

Age / Annual earnings	16 to 21	22 to State Pension Age	State Pension Age and older
Less than £6,240		Entitled Worker	
£6,240 - £10,000		Non-Eligible Jobholder	
Over £10,000	Non-Eligible Jobholder	Eligible Jobholder	Non-Eligible Jobholder

- Not Automatically Enrolled
- Employee has the option to opt in
- Employer contribution is not mandatory

Some key points to consider

50% of 10,000 employers analysed had data errors	*(Source: Pensionsync, Sept 2018)*
The Pension Regulator has imposed 126,651 Fixed Penalty Notices and 39,562 Escalating Penalty Notices for non-compliance	*(Source: The Pension Regulator, Compliance and enforcement quarterly bulletin October to December 2020)*
With employee contributions increased to 5% from April 2019, salary sacrifice represents a good opportunity for employers and employees if not already used	*(Note: potential National Insurance savings for employers and employees)*

An example of how it can go badly wrong

Judge Shant ordered Workchain (formerly known as Smart Recruitment UK Ltd) to pay a £200,000 fine and £60,930 costs. Tong and Hinkley were each given a four-month prison sentence suspended for two years and were ordered to complete 200 hours of community service and to pay £11,250 costs. Armson was given a two-month prison sentence suspended for two years, a five-month overnight curfew and was ordered to pay £1,500 costs. Neal was given a two-month prison sentence suspended for two years and was ordered to do 200 hours of community service and to pay £1,500 costs. West, Tomlinson and Thorpe were each given a two year community order and were ordered to do 150 hours of community service and to pay £500 costs.

(Source: https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/court-hands-recruitment-firm-largest-fine-and-first-custodial-sentences-to-follow-a-tpr-prosecution)

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