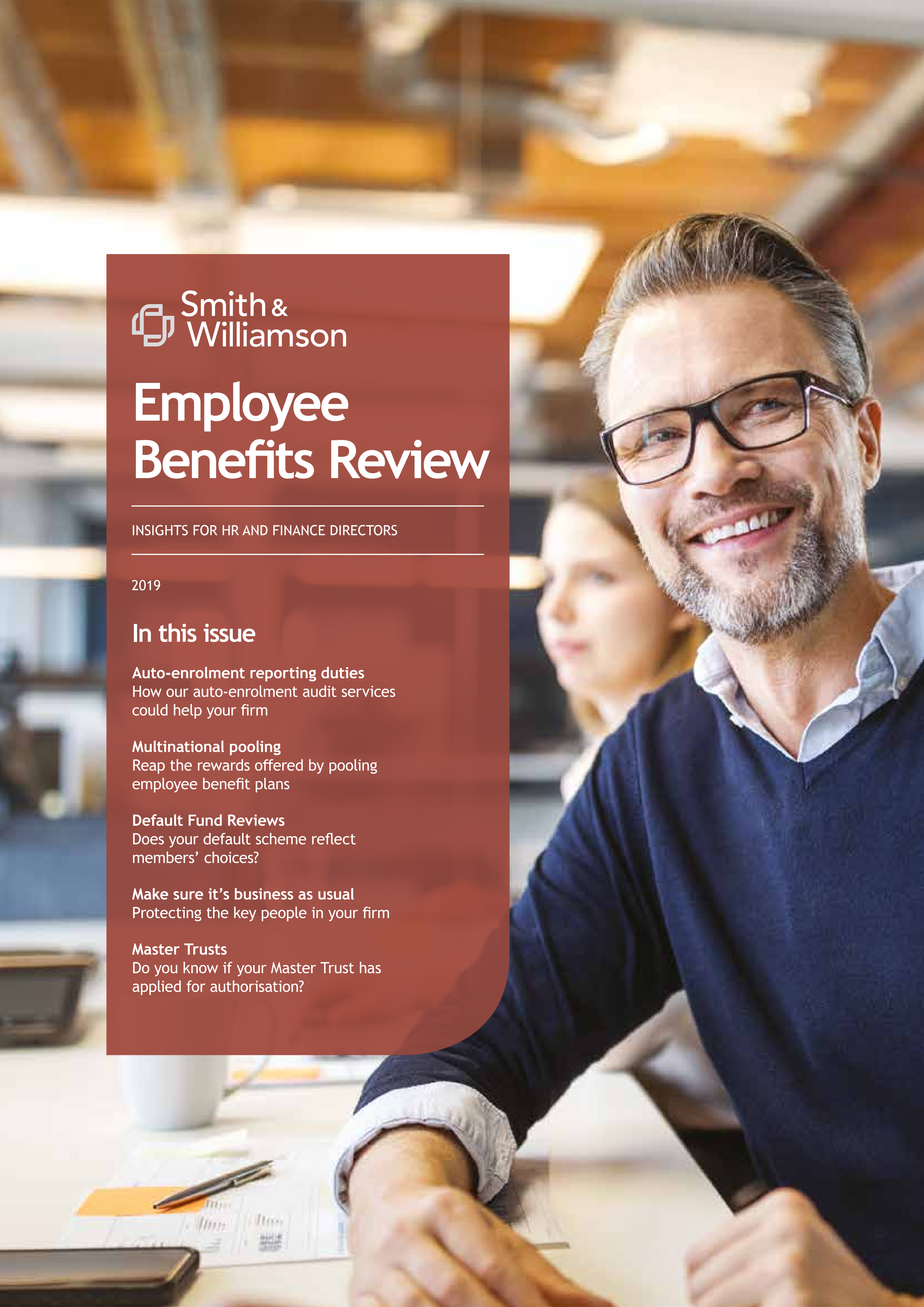


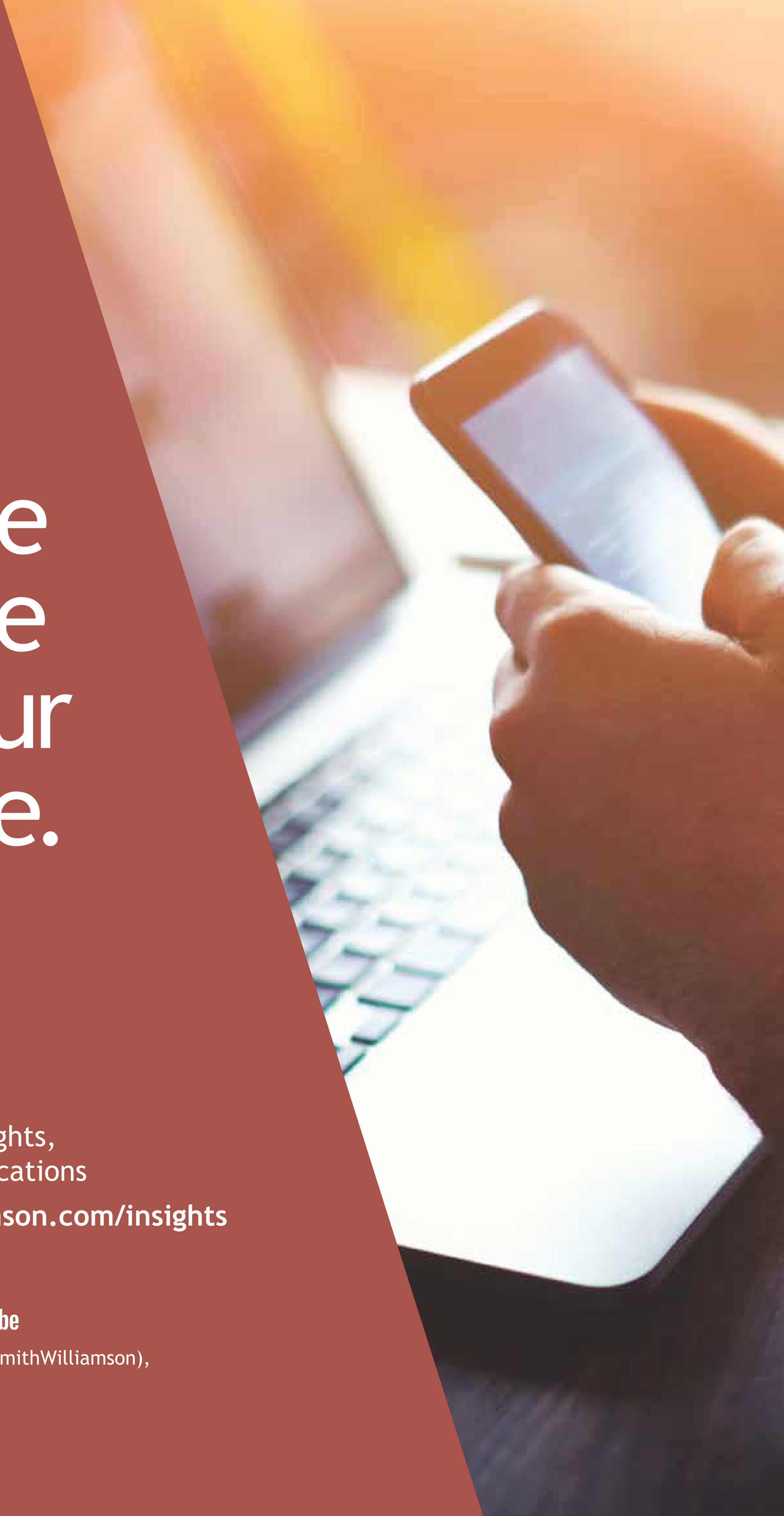
Smith & Williamson

Employee Benefits Review

INSIGHTS FOR HR AND FINANCE DIRECTORS

2019

In this issue



Foreword

Welcome to the Autumn edition of the Employee Benefits Review. This month's issue looks at the problem of auto enrolment reporting duties, where we have seen a 144% rise in the number of businesses fined for auto enrolment errors. We also tackle multinational pooling, where businesses can benefit from the economies of scale by pooling their employee benefits. Default fund reviews are also in the spotlight; these have largely gone under the radar, but leave an employer open to challenge if the appropriate due diligence is not conducted.

These are also pressing topics, but it would be remiss of me to neglect the political and economic landscape over the short to medium term given the complications surrounding the UK's exit from the European Union.

Since entering No.10, Boris Johnson's strategy on Brexit has been to take a hard line stance with the EU. At the very least, the Prime Minister appears to be hoping that by threatening "no deal" and circumventing Parliament the EU will renegotiate the backstop on the Irish border. The events over the last few days may well have derailed this approach.

Regardless of how the politics shape up in the autumn, we expect the new Government to crack on with policies to mitigate the economic risk of a no deal Brexit. We see four key areas where so-called "Borisnomics" could ease some of the problems associated with leaving the EU without a withdrawal agreement.

At the heart of the Johnson administration policies will be a rolling back of austerity to lift economic growth over the medium term. Based on data from the Institute of Fiscal Studies and the Prime Minister's announcements, we think that the government's fiscal stimulus plans – income tax and national insurance contributions cuts, plus more spending on education, NHS and the Police – could increase spending by over 30 billion pounds cumulatively by 2023/24.

We expect a loosening in monetary policy as well. While the Bank of England sets UK policy interest rates independently, the Johnson Administration will have a say on who will replace the Bank of England Governor, Mark Carney, when his term ends in January 2020. It is possible that a more dovish Bank of England Governor is selected to fit in with the Borisnomics agenda and this appointment could steer the monetary policy committee to lower interest rates and a new quantitative easing programme.

The Government could adopt deregulation as part of its economic policy. In the past, Boris Johnson has talked about a divergence in UK rules from the EU in particular sectors to raise productivity and exploit new technologies. As a template, President Trump's supply side reforms - including deregulation and limiting red tape, plus tax cuts - lead to a surge in small businesses confidence and accelerating productivity growth.

Simplifying or reducing stamp duty could boost the housing market, an issue highlighted by Mr Johnson during his Tory leadership campaign. Considering the fairly strong relationship between house prices and private consumption growth, reducing property transaction costs could lead to a pick up in the housing market and provide a significant lift to real economic growth.

Having provided the foreword to our Employee Benefits Review for some 10 years now, I have been wrong more times than right so it is worth taking the aforementioned with a pinch of salt. Please enjoy this edition of the EBR. ■

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Auto-enrolment reporting duties

144% rise in number of businesses fined for auto-enrolment errors

In January 2019 EMW Law published an analysis that identified that the number of businesses fined by the Pensions Regulator for auto-enrolment errors has climbed 144 per cent to 35,810 in 2017-18 from 14,650 in 2016-17.

Having reviewed the data from the regulator, it shows that there has been a threefold increase in fines; from £12.6m in 2016-17 to £42m in 2017-18.

The review conducted by EMW Law, identified that smaller companies without in-house HR functions are at risk of making errors when attempting to auto-enrol employees, due to the complexity of auto-enrolment.

Indeed our experience would certainly concur with the research; however, I would go further and say that errors are not limited to smaller employers.

While larger businesses will often use specialist payroll software to calculate what pension payments to make on behalf of staff, we have come across many instances where large employers have very poor record-keeping.

We have found that many large employers have approached auto-enrolment as a ‘tick box’ exercise, with the only fully understood ongoing duty being tri-annual re-enrolment. Duties such as scheme certification (which need to be done every 12-18months) have largely been overlooked, and default fund reviews have been assumed to be the responsibility of a third party.

Another typical finding has been a lack of ongoing training or complete lack of a governance structure. There are many instances where those members of staff who initially dealt with auto-enrolment have subsequently left the business, taking the knowledge with them. Those then taking on the duties are not fully versed in the legislation.

This is leaving employers exposed to large fines as the regulator is conducting spot checks around the country. The watchdog warns that “employers should make sure they’re staying on top of their legal duties as we may pay them a visit”.

With smaller business we have seen a trend where they have tried to deal with auto-enrolment ‘on the cheap’ with an increasing number now revisiting their approach and seeking help from a professional advisor as they realise that they do not have the resources to accurately maintain on-going compliance.

In recognition of the struggles many employers are experiencing we have created an auto-enrolment audit service so as to ensure there are no ’blind spots’, and that employers can adopt a best practice approach. ■

To discuss using this service, contact:

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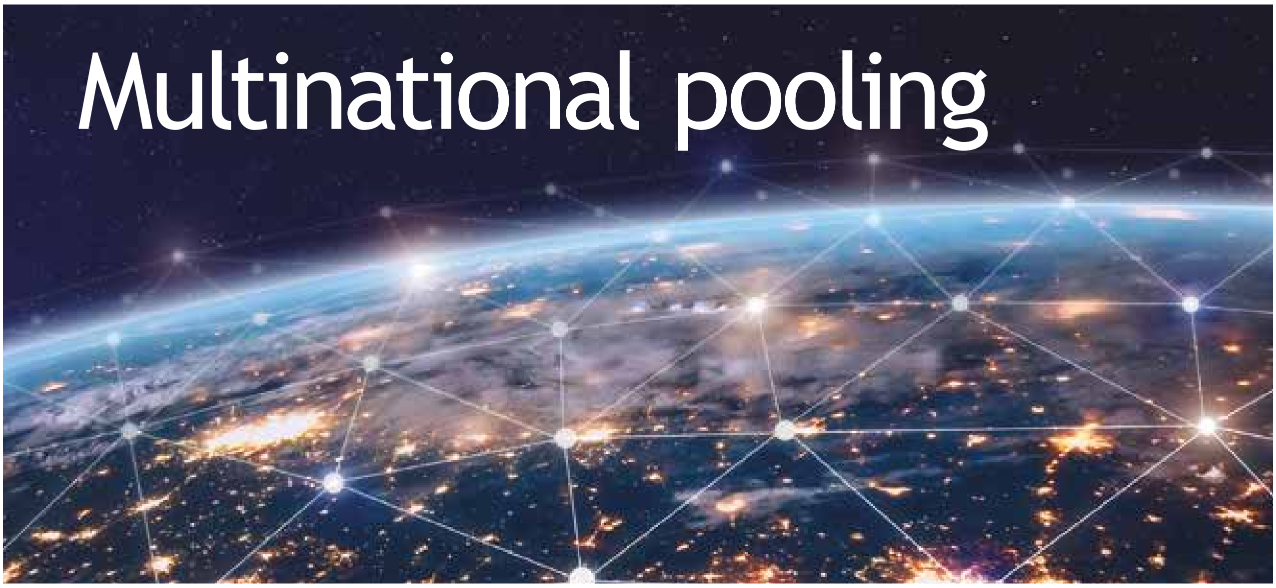
source: https://www.pensions-expert.com/Law-Regulation/144-rise-in-number-of-businesses-fined-for-auto-enrolment-errors?ct=true

Multinational pooling



Multinational businesses of all sizes can reap the rewards offered by pooling employee benefit plans

Multinational pooling is a mechanism that allows multinational companies to combine the insured employee benefit plans of their subsidiaries in different countries with a multinational pooling network. These insured benefits can then be ‘experience rated’ to take overall claims performance into account and an overall surplus or loss can then be determined.

Where a surplus arises, rather than being retained by insurers on a plan-by-plan basis, it is returned (less expenses) to the multinational as a dividend. If claims performance is such that a deficit arises, this can be carried forward or covered by stop loss insurance. Over the medium-to-long term, 8% to 15% of premiums can typically be returned as dividends. Importantly, plans remain insured in each country with local insurers benefiting from normal terms, conditions, administration and local claims settlement. Premium rates are set locally by insurers who compete on price and service quality in each country. Pooling can also offer improved visibility of local plans, and in certain circumstances can result in improved terms at a local level.

A growth sector

There are eight major pooling networks operating in various forms. They are either owned by insurers with a regional or global presence or are independent. Independent networks generally have a wider geographical coverage and have the ability to select leading insurers in each country as local members. Pooling offers firms the potential to realise economies of scale and to reduce the cost of their employee benefits provision through the payment of multinational dividends, while in each country, maintaining contracts with leading local insurers ensures that the best terms are achieved for the firm. Given the trend towards higher premium rates in some countries and the increasing globalisation of business, the use of multinational pooling can only be expected to grow.

Pooling is not only the preserve of large companies: several networks offer small groups pooling, which is designed to allow smaller multinational businesses to take advantage of pooling with other similar-sized companies while being protected from variations in their own claims performance. There are usually no minimum employee or premiums criteria to join, provided there are insured contracts in at least two countries. Any losses are generally not carried forward. One of the leading small group pools has generated a dividend of an average of 13.94% over the period from 2011 to 2015.

Although it’s often overlooked, pooling has the potential to add significant value to the employee benefit programmes of multinational companies. ■

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Default Fund Reviews

Many defined contribution ("DC") pension plans were established before April 2015, when "Pension Freedoms" came into effect. Until then, most people bought an annuity at retirement and even those who had initially adopted "income drawdown" were obliged to purchase an annuity with their residual funds by age 75. The advent of "Pension Freedoms" changed all this ...

There is no longer a requirement to purchase an annuity by age 75, so interest in income drawdown has greatly increased. 100% cash is another option but can attract a significant tax charge.

Annuities have also fallen out of favour because they appear expensive (a £100,000 fund today would produce an income of around £4,500 per annum at age 65) and because income drawdown funds can be passed through successive generations (and to others) on death.

The solution

Sponsors of all types of DC pension plans need to review the default investment strategy of their plans to establish if they reflect current retirement choices. If the default investment strategy no longer reflects members' choices, it needs to be changed.

How?

There are usually two phases of pension plan investment; the "growth" phase and the "de-risking" ("lifestyle") phase. The latter typically runs for five years although some schemes have lifestyle phases as long as 15 years. Analysis carried out last year by one of the leading UK pension providers identified a shorter period as being more appropriate, on the basis that to "de-risk" too soon would severely limit potential growth.

This leaves us with two investment phases to consider, with the growth phase running until say five years before a member's selected retirement date, and a lifestyle phase then running up to retirement (the "end-game"). Bearing in mind that this is to be a default fund, we should not be taking too much (or too little) risk in either phase.

Growth phase

Diverse views exist on what might be an acceptable level of risk during the growth phase of investment. Those with younger staff who are financially aware are likely to favour a higher proportion of equities than companies with a more balanced age range. In companies with a workforce that is a more representative cross-section of society, we might expect to see 60% 75% equities in the default investment portfolio.

Passive ("index") funds are widely used for default investment strategies, as these tend to attract low charges and funds can be found in most markets of the world (both equities and bonds).

A further consideration is what proportion of equities should be sourced from the UK stock market and what should be sourced from overseas markets. Although the FTSE 100 Index has performed better in early 2019 than might have been expected (possibly because many FTSE 100 companies do much of their business outside the UK) considerable uncertainty remains.

Lower-paid workers (end-game)

Lower-paid employees rarely enjoy contributions much above auto-enrolment levels so their funds tend to be smaller. Such employees are more likely to take their entire retirement fund as cash (25% of which would be tax-free). A default investment strategy targeting cash might therefore be more appropriate for this cohort than one targeting income drawdown. This could be achieved by selling growth assets in equal tranches over the five year period leading up to retirement, replacing them with investments in a cash fund.

Nearly everyone else (end-game)

Income drawdown is becoming the most popular retirement choice so the objective is to create a portfolio that represents a lower degree of investment risk than might be considered appropriate during the growth phase. Few would be prepared to accept a level of investment volatility in retirement that seems acceptable whilst working.

Holding around 40%-45% equities (suitably diversified) at the point of retirement could provide a reasonable balance between risk and growth potential for those with a "middle-of-the-road attitude to investment risk, who adopt income drawdown.

Individual investors are recommended to seek advice periodically whilst in drawdown because their objectives may change and asset allocation can go awry if disinvestments are made from the "wrong" funds or one asset class performs substantially better (or worse) than another. It is therefore prudent to seek to rebalance the residual portfolio periodically.

Action for employers

A good course of action for employers is to commission a consultancy to review their plan's default investment strategy. Bearing in mind that many schemes which target annuity purchase are likely to have been established before 2015, it is almost certainly time for a full review, which would also include the default investment strategy. ■

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Make sure it's business as usual

Protecting your firm against the financial implications of the death or illness of a key employee, partner, shareholder or in fact anyone whose death could lead to financial losses for the business.

Failure to protect your company, partnership and key staff could have disastrous implications in the event that one of you dies prematurely or becomes ill and couldn't work. You can't stop the unexpected from happening but, with planning, you can reduce the impact it has on you and your business and your profits.

Serious illnesses, such as a heart attack, stroke and cancer, no longer result in death but require lengthy periods of convalescence. The insurance contracts can be written that would provide money for this eventuality as well as death.

Protection for key employees

All businesses have key people such as those whose particular skill, knowledge, leadership or experience contribute to the company's continued financial success.

Such individuals may be a partner, your Chairman, Managing Director, IT specialist or a sales director with irreplaceable contacts and relationships. The death or disability of any of them could threaten your company's profitability. Indeed, its very survival could be at stake.

The solution

A key person insurance contract would provide funds on the death or disability or a key person in order to repay debt, replace lost business income or pay for recruitment costs/ temporary staff.

Protection for Shareholding directors

The death or illness of a shareholding director could have a serious impact, both on the future of your business, its profitability and on your family.

Majority shareholders may have important voting rights that directly affect the running of the company. In the event of a majority shareholder's death, these rights would normally pass to the deceased's dependants.

The dependants now have the right to a say in the running of the company. But do they have the necessary experience? They may not share the objectives that the surviving shareholders have for the business and may even want to take the business in a different direction.

If they prefer to receive the value of the shares in cash who will buy them? Unless the remaining shareholders have sufficient liquid capital, they may be sold to a, possibly hostile, third party, perhaps even a competitor.

The solution

The provision of funds through an insurance contract on death or disability of a business owner or partner in order to enable the co-owners to purchase their interest in the business or compensate the business owner or their family.staff.

Protection for Partners

The partnership may have debts that are repayable on the death or critical illness of a partner, which may include a proportion or all of; bank overdrafts, hire purchase agreements, bank loans and a partners capital account.

The solution

A suitably structured Partnership protection strategy would ensure that the business remains in control of the active Partners, whilst at the same time greatly assisting the dependants of the deceased Partner.

This basis of this strategy is for each Partner to effect a life assurance policy on their own life, and for the policy to be placed into a specially designed Partnership Trust arrangement in favour of the remaining Partners. In the event of the Partner's death the policy proceeds would be made immediately available to the trust beneficiaries.

Smith & Williamson has many years of experience in arranging cover to protect businesses against such eventualities. Care must be taken in selecting a suitable product and a suitable provider in order that:

- Competitive premiums are secured
- Cover is arranged with the minimum of underwriting
- Tax efficiency is maintained
- The policy is written on the correct basis with suitable trust documentation ■

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Master Trusts

Have you chosen a Master Trust as your pension scheme to meet your ongoing auto-enrolment duties? If so have you asked whether it has applied for Master Trust authorisation?

Why ask this question?

Master Trusts had until 31 March 2019 to apply for authorisation from the Pensions Regulator (TPR). To date 23 have obtained authorisation as listed on TPR's website, just over 35 Master Trusts have applied for authorisation.

Those Master Trusts who don't apply for authorisation will be withdrawing from the Master Trust arena and will be triggering the wind up of the arrangement. Prudential is just one example of a provider that has decided to wind up its Master Trust. Employers' who have been using the arrangement will be given the option of a new group personal pension (contract based arrangement) with Prudential for auto-enrolment purposes. Current members of its Master Trust will move to an individual policy with Prudential which will have a default investment strategy.

TPR has said that its decision-making process on authorisation could take up to six months. Some of the current Master Trust providers may withdraw their application during this time, whilst some may actually fail to get through the application process. In the end there may be a Master Trust population as low as 25.

One challenging aspect of authorisation is that the Master Trust provider has to demonstrate financial stability in that it holds sufficient financial reserves to meet the cost if the Master Trust has a triggering event and has to wind up. It is not allowed to dip into member pots.

Some larger Master Trusts, and those whose business plan is to purely develop and compete in the Master Trust arena, are already acquiring a number of the Master Trusts schemes which have not applied for authorisation. These market participants have the appetite, skills and experience to help the exiting schemes wind up and transfer across in an orderly fashion.

From a member perspective the risk around Master Trusts will be reducing for those where a Mater Trust gets authorised, but increasing for those members where the Master Trust fails to get authorisation.

As previously mentioned where a Master Trust fails to get authorisation it will need to wind up. For members this will mean that they will either be moved to another group arrangement or an individual policy. Although the Trustees of the Master Trust winding up will ensure that the members will be no worse off under the new arrangement, there may be investment risk upon transfer to the new arrangement (as the members funds may be out of the investment market for a number of days upon transfer). If the Trustees decide to secure members benefits on wind up in individual plans, the members will then have sole ownership of their policy and there will be no support for them going forward around the monitoring and performance of their investment funds apart from that provided through the provider.

The "secondary market"

We believe that we will see a secondary market emerging for employers, where they consider a review of the workplace pension scheme.

Some employers are already looking to switch pension providers. This may be due to poor investment performance, administrative problems or poor member engagement. One impact of the authorisation process is that employers have had to potentially delay making structural changes to their workplace pension scheme, as the marketplace is waiting to see who comes out the other end of the authorisation process.

Employers should never forget that there is the potential to move from a Master Trust to a contract based group personal pension plan and this may actually be the most appropriate arrangement for the employer going forward. ■

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**According to the latest survey of the market by Accountancy Age magazine, 2018.*

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