London South Bank University considerations for new defined contribution benefit structure

This note has been prepared by Lane Clark & Peacock LLP ("LCP") for London South Bank University ("LSBU"). It sets out the various options and issues LSBU should consider when agreeing the contribution structure and associated benefits linked to the new Defined Contribution ("DC") pension arrangement to be establish effective September 2012.

Executive summary

Some of the main points set out in this note are as follows.

- the selected contribution structure for the new DC arrangement should be consistent with the requirements of auto-enrolment and TUPE regulations;
- we suggest LSBU implement a matched contribution structure which would regard employees who value pension provision, whilst potentially achieving a lower average cost per employee; and
- LSBU should consider the provision of life and ill health benefits for members of the new DC arrangement.

These and other points are considered in more detail below.

1. Background

LSBU has asked LCP for advice on establishing a new contract-based DC pension plan (the "Plan") for new employees together with advice regarding the design of the new arrangement.

We have outlined below the areas LSBU will need to consider with regard to competitiveness against other higher education employers; compliance with auto-enrolment legislation.

2. Contribution structure

LSBU will need to decide on the level of contributions to provide to members for future service and the structure to be used. This should be considered in light of the introduction of auto-enrolment which comes into effect in 2012, taking into account the impact this might have on expected member participation rates. However, full compliance with auto-enrolment is not expected until 2018. Further information on auto-enrolment is shown in Appendix 1. There are a number of different types of contribution structures used in UK pension schemes; matching, flat and age related. A brief summary of each is given below.

We would be happy to model potential employer contribution costs and benefit outcomes under different contribution structures if required.

2.1. Matching

Matched pension contributions are increasingly popular with employers who want to offer a generous pension benefit to those employees who value such a benefit, whilst potentially maintaining a lower average cost per employee. A matched contribution structure would allow LSBU to provide higher employer contributions to employees who regard saving into a pension as a priority and are therefore prepared to invest in it themselves to secure the higher employer contribution. Employees that do not place a high value on pension benefits can contribute at a lower level and receive a corresponding lower employer contribution.

- A matching contribution encourages employees to maximise their personal contribution and take advantage of a maximum matching employer contribution.
- The contribution scale usually requires a minimum employee contribution to qualify for the employer contribution.

The table below shows an example of a three tier employer matching contribution structure Employees would have the option of contributing 3%, 4% or 5% of basic salary in return for a 5%, 6% or 7% contribution from LSBU.

Employee Contribution	University Contribution
3%	5%
4%	6%
5%	7%

The above is just an example, other examples are shown in Appendix 2; the actual scale used will depend on your requirements eg competiveness, and any budget restraints. We would suggest that the total minimum contribution is sufficient to meet the minimum required under the auto enrolment legislation.

In our experience, the majority of new contract based DC pension schemes are set up on a matching contribution basis. The main disadvantage to this type of structure is that it is difficult to budget costs accurately due to unknown level of contribution employees elect to pay. This can be mitigated to some extent by having two levels of contributions and restricting the ability to change contributions to say, once a year.

2.2. Flat contributions

- A flat contribution scale is simple to calculate and apply for internal remuneration budgets.

- The contribution scale is easy to understand and, simplistically, may be perceived as fair between employees.
- A flat contribution may be overly generous for younger employees, who may not value pension, and uncompetitive for older employees (if they compare to defined benefit provision or age related DC).

2.3. Age-related contributions

- An age-related contribution structure is intended to reflect that a pension of £1 pa costs more for an older member than for a younger member, so provides more equal benefits when measured as pension amount on retirement.
- Age-related contributions may also, effectively, go some way toward rewarding long servers.
- A disadvantage of age-related contributions is that two people in similar jobs may get different employer contributions just because of age.
- It is more difficult to budget for the overall costs of an age-related scheme as contributions will vary with the age-profile of the membership.
- New employees are generally younger employees for whom an age-related scale is less generous than a flat scale, so moving to an age-related scale might be expected to be less expensive in the short-term than a comparable fixed contribution.
- New age discrimination legislation came into force in December 2006. Although our understanding is that sensible age-related DC contribution structures are permissible under the legislation, we would strongly recommend that you take legal and actuarial advice on this point should you wish to consider this type of structure.

We would be happy to provide illustrations and analysis of the implications of adopting an age related structure, if required.

3. Level of contribution

The level of contribution should be considered with reference to your budget, auto enrolment requirements and market trends.

Appendix 3 shows employer DC contribution rates comparing the education sector against the private sector.

The Association of Consulting Actuaries “2011 Pension Trends Survey”, found that the average employer contribution to group personal pension (GPP) arrangements is 5.5% of total earnings and the average employee contribution is 4.1%.

The 2010 Pensions DCsions Sponsor Survey which covers larger group DC Schemes found that the median employer contribution was 8.5% of salary and the median employee contribution was 5.0%.

Our own experience with regard to contributions offered by employers (rather than actually paid as described above) show that the lower quartile contribution is 5.75% of basic salary, the median is 8.5% of basic salary, and the upper quartile is 14.25% of basic salary. These figures are an average across the range of all client types and all employees.

We have recently worked with two other universities to establish DC provision for non-academic staff. Both opted to implement a tiered contribution structure with higher employer contributions for those employees who are prepared to contribute more themselves. The lower tier contribution level has been designed to comply with auto-enrolment legislation due to be introduced from 2012.

Please note that we are not suggesting the above contribution rates are sufficient to produce adequate retirement income. If required, we can produce projections of the likely levels of pension based on the entry age of the employee and the contribution structures you wish to consider.

4. Definition of salary

LSBU currently has considerable flexibility in defining pensionable salary, this will be restricted when auto-enrolment is fully implemented. In light of this, we would suggest LSBU considers adopting a pensionable salary that meets the requirements as they currently stand.

The majority of pension arrangements base the contribution levels on basic salaries. If this approach is adopted for a workforce with a large disparity between basic salary and total earnings the headline percentage level of contribution will be lower when expressed in terms of total earnings.

Unless there is a large disparity between basic salary and total earnings, we would suggest using basic salary as the salary definition (subject to any auto enrolment requirements). This avoids volatility in the total level of contribution fluctuations and therefore aids budgeting

5. Transfer of Undertakings (Protection of Employment) Regulations

You have indicated that the new Plan may be used to provide future pension benefits for employees transferring employment under the Transfer of Undertakings (Protection of Employment), ("TUPE"), Regulations. As such the Plan's contribution structure should be designed to meet the minimum TUPE requirements for a contract based pension arrangement.

As a minimum, employees transferred under TUPE, who were previously eligible to participate in an occupational pension scheme with their old employer, must be able to join a DC pension scheme in which the employer matches employee contributions of up to 6% of basic pay.

We have considered this requirement in the suggested contribution structures throughout this document.

6. Salary Sacrifice options

A salary sacrifice arrangement would effectively direct the employee contribution into the pension arrangement as an employer contribution. Employees would agree to give up a proportion of pay equal to their pension contribution and LSBU would then pay the same amount into the pension plan. The benefit of giving up pay is that the employer and the employee pay lower National Insurance ("NI") contributions.

A salary sacrifice arrangement works because the NI liability is calculated on the pay employees actually receive. A reduction in pay means that employer and employee will both pay lower Class 1 NI contributions resulting in an immediate cash saving for both parties.

Implementation of salary sacrifice requires a change to employees' contracts of employment, and care is needed to ensure that the arrangement is acceptable to HM Revenue & Customs ("HMRC"). Clear communications are needed to help members understand what they are agreeing to. Finally, a notional salary will need to be introduced to ensure that employees' other salary-linked benefits are not worsened.

LSBU may be familiar with the benefits and drawbacks of salary sacrifice when linked to a trust-based pension arrangement, however an additional feature exists in relation to contract-based arrangements. Whereas a trust-based arrangement grants full tax relief at source, individuals who contribute to a contract-based pension receive only basic rate tax relief automatically on their contributions. Higher-rate tax relief is reclaimed from the local tax office as a lump sum or through amendment of the PAYE coding. A salary sacrifice arrangement effectively grants full immediate tax relief at source.

7. Risk benefits

It is common for employers to offer risk benefits as part of an overall benefits package.

Typically these consist of death benefits in the form of a lump sum but can also be paid as a pension payable to a beneficiary.

It may also include ill health provision although this more common in defined benefit arrangements. Ill health benefit designs range from long-term financial protection arrangements that replace the members' income and pension contribution to pension age to short term arrangements that provide a few year's protection with or without additional lump sum payments on completion of the period.

I hope this note is useful. Please contact me if you have any questions or would like to discuss any of the points raised in more detail.

Yours sincerely

Prepared as an attachment to an email at 17:55 on 17 January 2012

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Auto-enrolment

Appendix 1

From October 2012 employers will have to automatically enrol their employees into a compliant pension arrangement.

Employers need to consider the best approach to adopt, taking into account costs and their own individual circumstances and then implement their preferred solution.

The date that employers need to comply with the new requirements will depend on the number of employees on their PAYE reference code. This will then determine an employer's "staging date". The Government recently announced that staging dates for employers with less than 3,000 employees was being delayed. We are currently waiting for further clarification from the Government.

The minimum contributions under the new regime are 5% for the employee and 3% for the Company of "Qualifying Earnings" (this is Gross Earnings, which includes variable earning such as overtime and bonuses, between £5,715 and £38,185). However, these contributions are being phased in gradually until we understand October 2018 (eg the minimum employer contribution in 2013/14 is 1%).

The Government recognised that the majority of pension arrangements use basic salary as the definition of pensionable salary and therefore ensuring that pension arrangements meet the core contribution requirement would be burdensome. They have therefore proposed three alternative structures in addition to core requirement that employers could introduce to comply with the requirements.

Structure	Minimum requirements
Core	Contributions linked to qualifying earnings (between £5,564 and £39,853 per annum for 2012/13). This definition includes all elements of variable taxable earnings (within the above band) in each pay period. The minimum contribution, linked to the above pensionable salary definition, would be 8% with at least 3% from the company.
Tier 1	Contributions linked to basic pay. Basic pay includes all elements of pay that do not vary. For Zero Hours Team Members we understand this would include their basic hourly wage. This option could exclude variable pay items such as commission, overtime and bonuses. The minimum contribution linked to the above pensionable salary definition would 9% of with at least 4% from the company.

	This option is not compatible with an offset.
Tier 2	Contributions linked to pensionable pay, subject to pensionable pay being at least 85% of the employer's total pay bill. The minimum contribution, linked to the above pensionable salary definition, would be 8% with at least 3% from the company. This option is not compatible with an offset.
Tier 3	Contributions linked to 100% of earnings. The minimum contribution linked to the above pensionable salary definition would 7% of with at least 3% from the company. This option is not compatible with an offset.

Matched contribution structures

Appendix 2

For ease of review the alternative structures are shown with brief comments on each. The comments may be considered from different perspectives (eg finance vs. trade union).

Option 1

Employee Contribution	LSBU Contribution
2%	6%
4%	8%
6%	10%

Option 1 is potentially the most generous of the contribution structures depicted. It is likely to result in the highest level of employee participation due to the 2% entry level and the "matched plus 4" design may encourage more employees to contribute at the highest band.

Option 2

Employee Contribution	LSBU Contribution
3%	5%
4%	6%
5%	7%
6%	8%
7%	9%

Option 2 illustrates a "matched plus 2" contribution structure. The contribution bands are narrow with a 1% step between each tier.

Option 3

Employee Contribution	LSBU Contribution
4%	5%
5%	7%
6%	8%
7%	10%

Due to the higher entry level employee contribution, Option 3 is likely to attract fewer participants than the other options illustrated. The design provides a proportionately greater reward for those that contribute at the highest level ie “matched plus 3” verses “matched” at the lowest band. This design may encourage a greater proportion of members to select the highest contribution level.

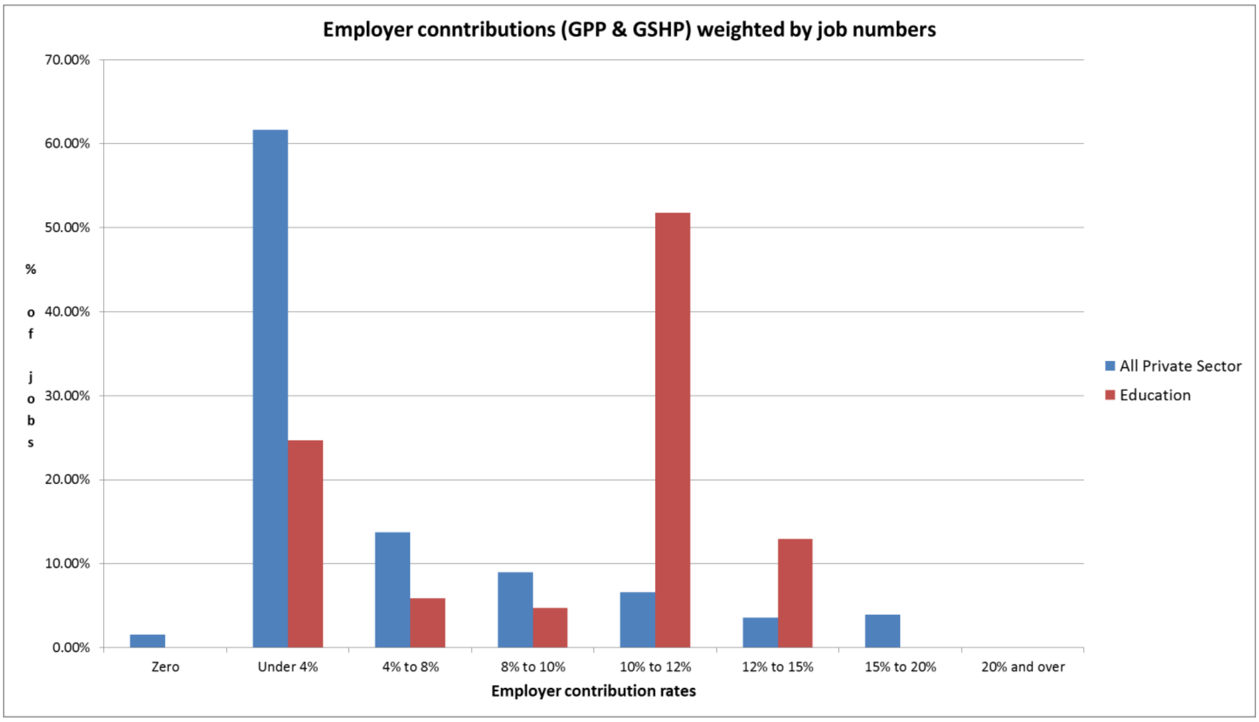
Option 4

Employee Contribution	LSBU Contribution
3%	6%
6%	8%

Option 4 provides only two contribution levels with a substantial step between the bands. Members would have to double their contribution to move to the next tier which may discourage members from taking advantage of the higher employer contribution available. A two tier structure of this sort may also be administratively simpler for payroll to operate. *This style was favoured by our other university client and will be available to relevant employees when their new DC arrangement is launched.*

Under Option 1 and 2 pensionable pay has to be at least 85% of the employer’s total pay bill

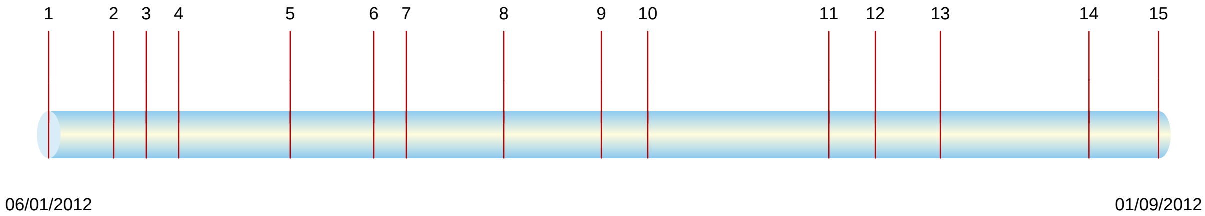
Comparison of Employer DC contribution rates in the private sector versus the education sector



Source: ONS

Timeline

The table below provides a high level timescale for the design and implementation of the proposed new DC pension arrangement.



Milestone	Date Completed	Description
1	06/01/12	LCP to submit paper on benefit structure including contribution structure and salary sacrifice
2	20/01/12	Meet to discuss benefit structure paper
3	27/01/12	LSBU to agree contribution structure for contract based arrangement
4	03/02/12	LSBU to provide employee data to LCP
5	27/02/12	LCP submit provider recommendation report
6	16/03/12	Beauty parade (and provider site visits if required)
7	23/03/12	University to confirm provider selection
8	13/04/12	LCP to recommend fund range and default investment strategy
9	0405/12	Implementation meeting with new provider
10	14/05/12	LSBU to consult legal advisers regarding any amendments to employment contracts to accommodate salary sacrifice and/or automatic enrolment as appropriate
11	22/06/12	Review and agree provider communications
12	02/07/12	Member communications issued with joiner forms (or opt-out forms as appropriate) for contract based arrangement
13	16/07/12	Presentations by provider to introduce the new arrangement
14	17/08/12	Deadline for return of employee applications/opt-out forms
15	01/09/12	Scheme commences