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Insights

The Pension Act of 2008 - Benefits and Risks for employers and employees

The Pension Act of 2008 ("the Act") established a new three-tier pension regime for the country and created a privately-managed pension sector. Building on numerous articles that have excellently described the changes introduced by the Act, this article clarifies what these changes mean for employers and employees. We discuss here the benefits provided by the introduction of the Tier 2 and Tier 3 pension schemes. We also highlight the major risks that employers and employees need to be aware of as they plan towards achieving full implementation of the Act by the end of 2010. In subsequent articles we will discuss how both employers and employees may best manage and mitigate these risks.

Under the new Act, workers in Ghana can now contribute up to 35% of their gross salary to pensions and not pay income tax on those contributions. This is a significant opportunity for workers to save for their retirement.

How pensions worked prior to the introduction of the Act

Prior to the enactment of the 2008 Act, employers and employees contributed a total of 17.5% of employees' salaries to a defined benefit scheme managed and administered by the Social Security and National Insurance Trust (SSNIT). Of the 17.5%, employers contributed 12.5% of the employee's salary while the employee contributed 5%.

Changes introduced by the Pension Act of 2008

Under the new three-tier regime, contributions by both employers and employees have been increased by 0.5% to 13% and 5.5% respectively. Of the 18.5% contributed on the employee's behalf, 13.5% continues to flow into Tier 1, a restructured defined benefit scheme managed and administered by the government through SSNIT. The remaining 5%, effectively the bulk of the employee's 5.5% contribution, now flows into Tier 2; Occupational Pension Funds. These are defined contribution schemes sponsored by each employer, administered by trustees on behalf of employees, and managed by private sector fund managers.

In addition to these two mandatory tiers, Tier 3 provides for discretionary contributions into provident funds provided by the employer, or personal pension funds offered by other private sector entities. Tier 3 funds are also defined contribution funds, administered by trustees and managed by private sector fund managers.

The sum of all contributions into the three pension tiers introduced by this Act may not exceed 35% of the employee's salary.

Benefits of Tier 2 defined contribution schemes to the employer

1. No change or implications to bottom line, tax benefits remain the same.
2. Schemes with stellar performance and that are administered efficiently are a source of competitive advantage in attracting and retaining key personnel.

Benefits of Tier 2 defined contribution schemes to the employee

1. No change or implications to tax treatment on contributions since these are not subject to income tax. However the benefits received under the scheme, namely investment income and capital gains, are also not subject to tax.
2. Better control of outcome; the size of retirement benefit is a direct result of the operational, trustee and manager selection, and asset allocation choices made. These are decisions that the employee, through the employer and the trustee, can influence.
3. Assets in a Tier 2 scheme are segregated from those of the government and the employer, and are completely under the control of trustees acting for the benefit of employees.
4. Tier 2 assets may be used as a down payment for securing a mortgage on a primary residence.
5. Accrued benefits of scheme members are protected and assets may not be seized by creditors if the employee is sued or goes bankrupt.

Risks of Tier 2 defined contribution schemes to the employer

In taking on the responsibility for establishing a defined contribution

Defined Benefit and Defined Contribution Schemes

- In a defined benefit scheme the provider is committed to paying a predetermined amount on the employee's retirement, usually based on the employee's length of contribution and average salary.
- In a defined contribution scheme the employee contributes a fixed amount, typically on a periodic basis. The payout to the employee on retirement is not a predetermined amount but depends solely on how well the investments of the scheme have performed.

Employers now have a fiduciary responsibility to employees and need to ensure that the management of the pension schemes are done in the employees' best interest.

pension scheme for employees, employers now have a fiduciary duty to their employees. As a fiduciary, employers stand in a position of trust. As stated in the Act, **a fiduciary is not permitted to profit from the fiduciary's position and owes undivided loyalty to the other party, in this case the employee or pension scheme participant. The fiduciary must avoid conflicts of interest unless otherwise authorised by the other party after full disclosure.**

Legal precedent for companies sponsoring defined contribution schemes in the UK and US outline the fiduciary responsibility as follows:

1. Acting in the best interest of scheme participants and not yourself.
2. Acting impartially and not discriminating among different classes of employees.
3. Acting prudently, responsibly and honestly; acting in a way that a prudent person would in their own affairs.
4. Avoiding conflicts of interest.

The risks rising out of this new fiduciary role are as follows:

Legal risk
An employer may be sued by a disgruntled employee or ex-employee, or by a retiring employee who believes the employer's actions in establishing and overseeing the pension fund were not done in their best interest

Reputational risk
Improperly established funds, with inadequate controls, processes and governance structures could lead to fraud or disastrous investment results. These could negatively impact the employer's reputation.

Regulatory risk
Not meeting or keeping up with regulatory requirements could lead to fines and legal action from the regulatory authority.

Strategic risk
Implementing and managing the intricate requirements of the pension act may consume an inordinate amount of senior management time and can distract from strategic goals and performance of the company.

Risks of Tier 2 defined contribution schemes to the employee

The employee's exposure under Tier 2 of the pension act is dependent on the decisions of the trustees and the performance of the chosen fund managers selected by the trustees. There is no promised amount when you retire. Should the scheme not be properly set up, suffer from fraudulent activities, or the investments underperform, you as an employee would lose all or some of your contributions.

In Tier 2 the employee is therefore exposed to:

Market risk
Tier 2 investment decisions are made at two levels; first by trustees in deciding the investment policy and which assets, such as equity and bonds, to allocate the funds to, and secondly by fund managers when picking specific stocks. Bad decisions or errors by either of these entities could result in investment losses leading to poor investment returns and possibly loss of employee contributions.

Operational risk
Defined contribution schemes are complex, especially if the number of participants is large and the assets being managed are diverse. Whether the trustees of the scheme administer it themselves or outsource it to independent fund administrators, operational risks remain. There is always the risk that administrators of the scheme may fail to exercise adequate operational controls, resulting in loss of information about the individual's accumulated contributions.

Governance and control risk
Poor governance structures by either the company or the trustees could exacerbate the two previously mentioned risks. Poorly selected trustees who are not properly equipped to select and effectively monitor fund administrators, fund managers and custodians expose the Tier 2 assets to

a higher probability of loss associated with conflicts of interest, incompetence and fraud.*

Tier 3 schemes provide additional benefits to both the employer and the employee

In addition to all the benefits and risks identified for Tier 2 schemes, there are other unique risks and benefits for both employees and employers associated with Tier 3 Schemes.

Additional benefits to the employer under Tier 3

1. Employer contributions to Tier 3 are not subject to further Tier 1 contributions by the employer, effectively reducing the cost of this compensation by 13%.**

2. Vesting rules allow employer contributions to be delayed until certain conditions are met. For example, letting contributions vest over a few years encourages employees who might be considering a move to another firm to remain until the monies vest.

Additional benefits to employees under Tier 3

1. Tier 3 contributions are not subject to payroll deductions and the growth is not subject to taxes.

2. Employees may elect to put Tier 3 funds into any approved personal pension scheme. Thus if the employee decides that an external fund is better managed they may elect to have the employer make a pre-tax deduction from their salary and pay it into the Tier 3 fund of the employee's choice.

Additional risks to the employer under Tier 3

1. The employer is obliged to facilitate the employee's contribution to any personal pension scheme of their choice, increasing the operational complexity associated with providing this pension option.

Additional risks to the employee under Tier 3

1. As an alternative to a regular private investment, the employee is unable to utilize these funds for 5 years in the case of the informal sector, and 10 years in the case of the formal sector.

Summary

The Pension Act of 2008 introduces new benefits and risks to both employers and employees. The main benefit to the employer is reputational - a stellar-performing, efficiently administered pension scheme can be a competitive advantage in attracting and retaining key personnel. In addition, employers may gain some savings by paying part of employees' contributions into a Tier 3 scheme as opposed to paying it as salary.

The key risks to employers are legal, reputation and regulatory risks arising from them assuming the new role of fiduciary to their employees.

The main benefit to the employee is more control of the outcome of their pension contributions. The value of their Tier 2 and Tier 3 pensions is entirely based on how well the investments in the pension scheme perform, which is a direct result of the quality of scheme governance, operational processes and investment choices. These are all decisions that the employee, through the trustee can and should influence.

The key risks assumed by the employee are market risk, operational risk and governance risk, which arise when the scheme is not properly administered or is inappropriately invested.

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*According to the Pension Act fund administration is one of the trustee's responsibilities and should be independent of the fund manager. This is because the fund administrator typically monitors the fund manager; ensuring that investments are compliant with investment and regulatory guidelines, and calculating and verifying the investment returns produced by the fund manager. Letting the fund manager perform the fund administration function shatters this independence requirement and introduces a conflict of interest in the pension scheme.
**The same amount, paid directly to the employee, attracts an additional 13% contribution by the employer into the Tier 1 pension scheme.