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Employee Benefits, Pensions and Allowances

Key concepts and terms

- Defined benefit pension scheme (final salary)
- Employee benefits
- Pension scheme
- Stakeholder pension
- Defined contribution pension scheme (money purchase)
- Flexible benefits
- Segmentation
- Total reward statement

Learning outcomes

On completing this chapter you should be able to define these key concepts. You should also know about:

- Objectives of employee benefits
- Flexible benefits
- Types of pension scheme
- Total reward statement
- Main types of employee benefits
- What pension schemes provide
- Communicating pensions policies
- Types of allowances

Employee benefits

Employee benefits are elements of remuneration given in addition to the various forms of cash pay. They also include items that are not strictly remuneration such as annual holidays.

Objectives

The objectives of the employee benefits policies and practices of an organization are to:

- provide a competitive total remuneration package that both attracts and retains high-quality employees;
- provide for the personal needs of employees;
- increase the commitment of employees to the organization;
- provide for some people a tax-efficient method of remuneration.

Note that these objectives do not include 'motivate employees'. This is because the normal benefits provided by a business seldom make a direct and immediate impact on performance. They can, however, create more favourable attitudes towards the business, which can improve commitment and organizational performance in the longer term.

Main types of employee benefits

Benefits can be divided into the following categories:

- Pension schemes: these are generally regarded as the most important employee benefit and are described in the next part of this chapter.
- Personal security: these are benefits that enhance the individual's personal and family security with regard to illness, health, accident or life insurance.
- Financial assistance: loans, house purchase schemes, relocation assistance and discounts on company goods or services.
- Personal needs: entitlements that recognize the interface between work and domestic needs or responsibilities, eg holidays and other forms of leave, child care, career breaks, retirement counselling, financial counselling and personal counselling in times of crisis; fitness and recreational facilities.
- Company cars and petrol: still a much appreciated benefit in spite of the fact that cars are now more heavily taxed.
- Other benefits that improve the standard of living of employees such as subsidized meals, clothing allowances, refund of telephone costs, mobile phones (as a 'perk' rather than a necessity) and credit card facilities.

- Intangible benefits: characteristics of the organization that contribute to the quality of working life and make it an attractive and worthwhile place in which to be employed.

Benefits provision

The CIPD 2008b reward survey established that some of the most popular benefits for all sectors were:

- Pensions – 97 per cent.
- 25 days or more paid leave – 84 per cent.
- Childcare vouchers – 62 per cent.
- Life assurance – 59 per cent.
- Car allowance – 57 per cent.
- Health and well-being benefits – 57 per cent.
- Mobile phones – 54 per cent.
- Enhanced maternity/paternity leave – 54 per cent.

Company cars were popular in manufacturing and production (75 per cent of respondents) but did not appear in the top 10 benefits in other sectors.

Flexible benefits

Flexible benefit schemes (sometimes called ‘cafeteria systems’) allow employees to decide, within certain limits, on the make-up of their benefits package. Schemes can provide for a choice within benefits or a choice between benefits. Employees are allocated an individual allowance to spend on benefits. This allowance can be used to switch between benefits, to choose new ones or to alter the rate of cover within existing benefits. Some core benefits such as sick pay may lie outside the scheme and cannot be ‘flexed’. Employees can shift the balance of their total reward package between pay and benefits, either adding to their benefits allowance by sacrificing salary or taking any unspent benefit allowance as cash.

Segmentation

Segmentation involves the identification of the special individuals or groups of employees who create the most value and providing them with an individualized (and better) reward package. It allows employers to tailor their reward programmes to the needs and wants of their employees of choice. However, segmentation can damage morale. It creates an elite group and may be perceived as a form of favouritism.

Taxation

It should be remembered that most benefits are taxable as ‘benefits in kind’, the notable exceptions being approved pension schemes, meals where these are generally available to employees,

car parking spaces, professional subscriptions and accommodation where this is used solely for performing the duties of the job.

Pensions

Pensions provide an income to employees when they retire and to their surviving dependant on the death of the employee, and deferred benefits to employees who leave. Schemes offered by organizations (occupational pensions), as distinct from state pensions, are funded by contributions from the organization and usually, but not always, the employee. Pensions are the most significant benefit and are a valuable part of the total reward package, but they are perhaps the most complex part.

Why occupational pensions are provided

Pensions are provided because they demonstrate that the organization is a good employer concerned about the long-term interests of its employees who want the security provided by a reasonable pension when they retire. Good pension schemes help to attract and retain high-quality people by maintaining competitive levels of total remuneration. But they can be expensive and funding problems can arise, especially in defined benefit (final salary schemes).

What pension schemes provide

The range and level of benefits from pension schemes depend on the type of scheme and the level of contributions. In general, schemes provide the following benefits.

Pension scheme benefits

- Benefits on retirement – these are related to the final salary of individuals when they retire or the amount that has been paid into a defined contribution scheme while the individuals were members.
- Benefits on death – the pensions of widows or widowers and children are normally related to the member's anticipated pension; the most common fraction is half.
- Benefits on leaving an employer – individuals leaving an employer can elect to take one of the following options: a deferred pension from the occupational scheme they are leaving, the transfer of the pension entitlement from the present employer to the new employer (but this is not always possible), or refund of their contributions, but only if they have completed less than two years' membership of the pension scheme.

The main types of schemes are described below.

Defined benefit (final salary) schemes

The main features of a defined benefit scheme are as follows.

Pension entitlement on retirement

- On retiring, the employee is entitled to a pension that is calculated as a fraction of final salary (on retirement or an average of the last two or three years) multiplied by the length of pensionable service.
- The maximum proportion of salary allowed by HMRC is two-thirds of final salary after 40 years service.
- The amount of the pension depends on the final salary, the value of the annuity that provides the pension and the accrual rate. The accrual rate refers to the fraction of final salary that can be earned per year of service. When a pension is described as 1/60th it means that 40 years service would produce a two-thirds of final salary pension, and 30 years would produce a pension of half the final salary. This is a fairly typical fraction in private sector firms.

Employer and employee contributions

Employer contributions can be a fixed percentage of salary. Alternatively, the percentage increases with service or is a multiple of the employee's contribution (eg the employer contributes 15 per cent if the employee contributes 5 per cent). Employee contribution rates vary considerably, ranging from 3 to 15 per cent with a median of around 8 per cent.

Pension fund

Employee and employer contributions are paid into a combined fund, and there is no direct link between fund size and the pensions paid. The money remaining in the fund after any lump sums have been taken out is invested in an annuity to provide a regular income, the amount of which may be revised upwards periodically to compensate for inflation.

Dependants

Dependants are entitled to a percentage of the employee's pension entitlement if he or she dies during retirement or in service with the company.

Lump sum

Part of the pension may be exchanged for a tax-free lump sum up to a maximum under HMRC rules of 1/80th per year for up to 40 years service.

Defined contribution (money purchase) schemes

The main features of defined contribution schemes are as follows.

Pension entitlement

The employee receives a pension on retirement that is related to the size of the fund accumulated by the combined contributions of the employee and employer. The amount of the pension depends on the size of contributions, the rate of return on the investment of the accumulated fund, and the rate of return on an annuity purchased by the employer. It is not related to the employee's final salary.

Contributions

The employer contributes a defined percentage of earnings, which may be fixed, age-related or linked to what the employee pays. The 2003 survey by the National Association of Pension Funds found that the level of employer contribution averages 6 per cent. The employee also contributes a fixed percentage of salary.

Pension fund

The contributions are invested and the money is used at retirement to purchase a regular income, usually via an annuity contract from an insurance company. The retirement pension is therefore whatever annual payment can be purchased with the money accumulated in the fund for a member.

Members have individual shares of the fund, which represent their personal entitlements and which will directly determine the pensions they receive.

Dependants

Dependants receive death in service and death in retirement pensions.

Lump sum

One-quarter of the pension can be taken as a tax-free lump sum on retirement.

Comparison of defined benefits and defined contribution schemes

Defined benefit

- A guaranteed pension is provided to employees.
- Benefits are defined as a fraction of final salary.

- Employer costs are not fixed or predictable.
- Employer takes financial risk.
- Benefits are designed for long-serving employees.
- Early leavers lose.

Defined contribution

- The pension provided for the employee is uncertain.
- Benefits are purchased using an accumulation of contributions invested.
- Employer costs are fixed and predictable.
- Employee takes financial risk.
- Benefits are not designed for long-serving employees.
- Early leavers do not lose.

Many companies are dubious about the financial wisdom of final salary provision. Defined benefit schemes provide much more value to older and longer-serving employees but the costs involved and greater labour mobility have led some employers to question this emphasis, particularly in newer industries with young, high-turnover workforces.

However, defined benefit schemes are still the most popular, especially in the public sector. The CIPD (2008b) Reward Survey found that 53 per cent of employers had such schemes while 22 per cent had defined contribution schemes.

Stakeholder pension

A stakeholder pension is a government sponsored scheme, primarily designed for lower paid employees. Employers who do not provide a suitable pension scheme for their employees are required by law to offer access to a stakeholder scheme. A stakeholder pension is a defined contribution arrangement that satisfies certain conditions, designed to ensure that it provides good value for money and that members' interests are protected. The most important provision is that contributions from members should be flexible – they must be free to pay whatever contributions they wish, when they wish.

Communicating pensions policies

The pension benefits provided by employers should be developed as an important part of a coherent total reward package. Good schemes demonstrate that employers care about the

future security and well-being of their employees, and pensions are a valuable means of gaining and keeping employee commitment to the organization. Younger and more mobile employees are often indifferent to pensions but the older they get the more they are concerned, and these mature employees contribute largely to organizational success.

Careful consideration needs to be given to telling employees about the scheme. They need to know how it works and how it benefits them – it is too easy for employees to take pensions for granted. It is particularly important to communicate the reasons for any changes, and staff should be involved in discussing the reasons for the proposed arrangements and given the opportunity to comment on them.

Total reward statements

Employees tend not to appreciate the value of the benefits provided for them by their employers. To overcome this problem many companies are now issuing total reward statements that spell how much more the company provides for its employees than their pay.

Allowances

Allowances are paid in addition to basic pay for special circumstances (such as living in London) or features of employment (overtime, shifts or working unsocial hours). They may be determined unilaterally by the organization but they are often the subject of negotiation. The main types of allowances are:

- Location allowances – London and large town allowances to compensate for higher costs of living.
- Overtime payments – most manual workers are eligible for paid overtime as well as many staff employees up to management level. Higher-paid staff may receive time off in lieu if they work longer hours. Typically, organizations that make overtime payments give time and a half as an overtime premium from Monday to Saturday, with double time paid on Sundays and statutory holidays. Some firms also pay double time from around noon on Saturday. Work on major statutory holidays such as Christmas Day and Good Friday often attracts higher overtime premiums.
- Shift payments are made at rates that usually vary according to the shift arrangement. A premium of, say, one-third of basic pay may be given to people working nights, while those on an early or late day shift may receive less – say, one-fifth of basic pay.
- Working conditions allowances may be paid where the work is unpleasant.
- Subsistence allowances may be paid for accommodation and meals when working away from home.

- Stand-by and call-out allowances may be made to those who have to be available to come in to work when required.

Employee benefits, pensions and allowances – key learning points

Objectives of employee benefits

- Provide a competitive total remuneration package.
- Provide for the personal needs of employees.
- Increase the commitment of employees to the organization.
- Provide for some people a tax-efficient method of remuneration.

Main types of employee benefits

Pensions, financial assistance, personal needs, company cars.

Flexible benefits

Flexible benefit schemes (sometimes called ‘cafeteria systems’) allow employees to decide, within certain limits, on the make-up of their benefits package. Schemes can allow for a choice within benefits or a choice between benefits. Employees are allocated an individual allowance to spend on benefits. This allowance can be used to switch between benefits, to choose new ones, or to alter the rate of cover within existing benefits.

What pension schemes provide

Pensions provide an income to employees when they retire and to their surviving

dependant/s on the death of the employee, and deferred benefits to employees who leave.

Types of pension scheme

The main types of pensions are defined benefit pension schemes (final salary), defined contribution pension schemes (money purchase) and stakeholder pensions.

Communicating pensions policies

Careful consideration needs to be given to telling employees about the scheme. They need to know how it works and how it benefits them – it is too easy for employees to take pensions for granted.

Total reward statement

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Types of allowances

Location, overtime, shift, working conditions, subsistence, stand-by.

Questions

1. From your chief executive: 'How does a flexible benefits scheme work and how would we benefit from introducing one?'
2. From the local paper: 'We are running a section on employee benefits and pensions. Could you write a short piece on the differences between defined benefit and defined contribution pension schemes and why many of the former are being abandoned?'
3. From the finance director: 'I am sure most of our employees do not appreciate the value of the benefits they receive. What can we do to remedy this situation?'

Reference

CIPD (2008b) *Reward Survey*, CIPD, London