Department for Work and Pensions

AUTOMATIC ENROLMENT: GUIDANCE ON THE ALTERNATIVE QUALITY REQUIREMENTS FOR DEFINED BENEFITS PENSION SCHEMES AND THE DEFINED BENEFITS ELEMENT OF HYBRID PENSION SCHEMES

April 2016

Automatic enrolment:
Guidance on the alternative quality requirements for defined benefits pension schemes and the defined benefits element of hybrid pension schemes

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Part 1: Introduction

The employer duty

1) Employers have a legal duty to automatically enrol their eligible jobholders into a qualifying automatic enrolment pension scheme and to maintain active membership for those jobholders already enrolled.

2) In order to be used for automatic enrolment, a pension scheme must meet certain conditions set out in sections 16 and 17 of the Pensions Act 2008. They must also meet the relevant quality requirement. For a defined benefits pension scheme (or the defined benefits element of a hybrid pension scheme) the quality requirement is satisfied, if, in relation to the relevant members, the scheme satisfies:

   (a) the test scheme standard; or
   (b) the alternative quality requirements for UK defined benefits schemes.

3) Employers should liaise with their scheme trustees or managers and their advisers to determine whether their current scheme satisfies the relevant requirements and, if not, what changes will be needed to comply with the automatic enrolment requirements.

4) Defined benefits and hybrid pension schemes providing average salary benefits (career average schemes) must, in addition, satisfy the separate requirement that they provide for the annual revaluation of accrued benefits by at least a minimum level[1].

5) The Pensions Regulator has published detailed guidance on employers' duties. Employers and their advisers should familiarise themselves with the Regulator's guide to automatic enrolment, in conjunction with this guidance. See attached link. The Pensions Regulator's detailed guidance on automatic enrolment. The Regulator has also provided simplified guidance on employers' duties. See attached link. Your step-by-step guide to automatic enrolment

Legislation Relevant to the Guidance:

[1] The minimum level is the lesser of the increase in the RPI, CPI and 2.5% each year. See Part 5 of Automatic Enrolment: Guidance for Actuaries on certifying Defined Benefits and Hybrid Pension Schemes

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Sections 22- 23A of the Pensions Act 2008 ("the Act")

The Occupational and Personal Pension Schemes (Automatic Enrolment) Regulations 2010 (SI 2010/772) ("the Regulations") Regulations 32L, 32M, 36, 40 and 43-45

The Hybrid Schemes Quality Requirements Rules 2016

The Employers' Duties (Registration and Compliance) Regulations 2010 (SI 2010/5) Regulation 8

Northern Ireland has its own body of pension law and references to Great Britain legislation are to be taken, where necessary, as including references to the corresponding Northern Ireland legislation.

What is the legal status of the guidance?

6) This guidance is intended to assist in the practical application of the alternative quality requirements for defined benefits and certain hybrid pension schemes. The guidance is non-statutory but will by necessity reference the legislation. Employers can use the guidance in conjunction with the legislation and other guidance issued by, for example, the Pensions Regulator. The guidance is not intended to replace the legislation which takes precedence. If an employer is in any doubt regarding their responsibilities and requirements, then they should consider taking independent professional advice.

7) Although the Department for Work and Pensions (DWP) has done its best to ensure that this guidance is comprehensive, it does not cover every circumstance so consideration should be given to other guidance such as the Pensions Regulator's guidance relating to employers' automatic enrolment and related duties. See section on "the employer duty". Contact us | The Pensions Regulator. Ultimately, it is the legislation that takes precedence and this should also be considered along with any relevant legal advice.

8) The guidance reflects current legislation as of 6 April 2016. Please ensure that you have the most recent version, as the content may need to be updated over time because of changes to the law. DWP will periodically review the guidance.

For whom is the guidance intended?

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9) This guidance is primarily for employers' advisers, who have been asked to determine whether a defined benefits scheme or the defined benefits element of a hybrid pension scheme is a qualifying scheme for automatic enrolment. However, employers may find the guidance helpful. The law requires employers to automatically enrol their workers into a scheme of sufficient quality. From 6 April 2016, contracting-out will end. Employers will no longer be able to use the existence of a contracting-out certificate as evidence that their scheme satisfies the relevant quality requirement.

10) Scheme quality must instead be demonstrated by comparing the scheme against the test scheme standard, as set out in the legislation and guidance below or by applying one or more of the alternative quality requirements set out in the legislation and to which this guidance relates.

11) Detailed guidance for employers and actuaries on the application of the test scheme standard can be found in the following guidance. See links below -

- **employers guidance**: Automatic Enrolment: Guidance for employers on certifying defined benefit and hybrid pension schemes and

- **actuaries guidance**: Automatic Enrolment: Guidance for actuaries on certifying defined benefit and hybrid pension schemes.

12) An employer can determine whether their scheme satisfies the alternative quality requirements or ask an adviser to make that determination. This guidance includes matters and issues provided for in legislation that an employer or their adviser **must** consider when applying the alternative quality requirements and also includes guidance for advisers and employers on matters to help them in doing so. For many defined benefits schemes or the defined benefits element of hybrid schemes, the relevant alternative quality requirements are likely to be based on the cost of providing for the future accrual of active members' benefits ("cost of accruals test"). Further details are set out in Part 2 below.

13) All references to "the actuary" in this guidance should be taken as references to an actuary appointed by the employer(s) or the scheme trustees or managers. If an actuary appointed by the scheme trustees or managers is asked to determine whether the scheme satisfies the alternative quality requirement, the parties need to be clear whose duty it is to ensure the alternative quality requirements are met

(the employer's) and the capacity in which the adviser is acting. This is especially the case, if the employer is relying on an actuarial report or schedule of contributions, which may specifically exclude third parties including the employer relying on anything in the report.

What are the alternative quality requirements?

14) Since 1 April 2015, there have been two alternative tests of scheme quality available to employers, offering defined benefits schemes or certain hybrid schemes, to meet their automatic enrolment duties:

(a) the money purchase quality requirements in section 20 of the Act for a scheme of a prescribed description (see Part 3); and

(b) the cost to the scheme of the future accrual of active members' benefits **(cost of accruals test**).

Who can apply the alternative tests of scheme quality?

15) The application of both tests has been simplified for the use of employers and their advisers. When applying the tests:

(a) they can use existing actuarial reports, or alternatively commission or undertake calculations, to determine whether the scheme satisfies the cost of accruals test[2]; or

(b) they can consider the rules or provisions of the scheme to determine whether the scheme satisfies the relevant conditions that enables the money purchase quality requirements to be applied[3].

To which schemes do the alternative quality requirements apply?

16) The alternative tests can be used to determine whether the schemes set out below satisfy the quality requirement for automatic enrolment and related duties:

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[2] The test is set out in section 23A (1) (b) of the Pensions Act 2008. The associated regulations are in regulation 32M of the Occupational and Personal Pension Schemes (Automatic Enrolment) Regulations 2010 (SI 2010/772).

[3] The test is set out in section 23A (1) (a) of the Pensions Act 2008. The associated regulations are in regulation 32L of the Occupational and Personal Pension Schemes (Automatic Enrolment) Regulations 2010 (SI 2010/772).

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(a) UK defined benefits schemes and the defined benefits element of UK hybrid schemes;
(b) defined benefits schemes and the defined benefits element of hybrid schemes with their main administration in an European Economic Area (EEA) State other than the UK; and
(c) defined benefits schemes and the defined benefits element of hybrid schemes with their main administration outside of the UK and the EEA (non-EEA schemes). These schemes can be qualifying schemes in relation to existing members but workers may not be automatically enrolled into them.

Part 2: The cost of accruals test

Basic principles

17) The cost of accruals test:

(a) is essentially the assessed cost of the future accrual of active members' benefits over a given period of pensionable service. Under the test, a defined benefits scheme (or defined benefits element of a hybrid scheme) is a qualifying scheme, if the cost of providing benefits accruing for or in respect of the **relevant members** over a **relevant period** would require contributions to be made of a total amount equal to at least a **prescribed percentage** of the member's total **relevant earnings;** and

(b) normally applies at scheme level. However (and subject to an important transitional arrangement for certain formerly contracted-out salary-related schemes – see paragraph 34 below), it must be carried out at a benefit scale level, where there is a material difference in the cost of providing benefits between different groups of active members.

18) It may be cost-efficient for the calculations required for the test to be undertaken alongside or as part of other actuarial activities relating to the funding of the scheme or equivalent activities for unfunded schemes.

Core features of the cost of accruals test explained

19) **The relevant members** are the active members of the scheme of which the jobholder is a member. However, where there is or was a material difference in the cost of providing the benefits accruing for different groups of relevant members, over the relevant period, then (subject to the transitional arrangement) the testing is carried out separately for each sub-group (ie benefit scale). The actuary, having considered a range of factors (see box on page 10), will determine whether there is a material difference in cost.

20) **The relevant period** is the period over which the cost of providing the accruing benefits is estimated. The period is normally to be taken from the most recent written report signed by the actuary, containing information about the cost of future benefit accrual by reference to a period which begins later than the **effective date** of that report. Such a report could include, for example: *funding*

valuation reports, funding updates, other actuarial reports, agreed schedules of contributions etc (if they contain the relevant information on the cost of future benefit accrual). For unfunded schemes, the relevant information might be contained in periodic financial statements that provide the employer with information about the future cost of benefit accrual in the scheme.

21) In the absence of such a report the relevant period is any period of 12 months.

22) If there has been a change in the benefit structure since the effective date of the most recent actuarial report (or after the beginning of the 12 month period mentioned above), the relevant period is the period of 12 months commencing on the day on which the change in benefit structure took effect. However, if the actuary believes that the change does not invalidate the previous outcome of the test, s/he can provide the employer with a letter to that effect, rather than carry out a fresh test.

23) **The relevant earnings** are the earnings that the scheme uses to determine pensionable earnings, provided that they are at least equal to or more than the earnings calculated using one or more of the definitions set out in the table below, for all of the relevant members. To ensure that the cost of providing benefits, under the alternative quality requirements, is broadly equivalent to the cost of similar benefits, under the test scheme standard, the earnings definitions have a corresponding **prescribed percentage** contribution rate.

Legislative definitions	Prescribed percentage of relevant earnings	
Relevant earnings must be at least equal to or more than:	**Survivors' pension benefits provided by scheme**	**Survivors' pension benefits not provided by scheme**
qualifying earnings	10%	9%
basic pay	11%	10%
basic pay and taking all of the relevant members together, the pensionable earnings of those members constitute at least 85 per cent of the earnings of those members in the relevant period	10%	9%
earnings	9%	8%
basic pay above the single person's basic State Pension or the Lower Earnings Limit	13%	12%

24) Pensionable earnings can be earnings on a fixed date; scheme or tax year: for example the previous tax year.

Applying the cost of accruals test

25) Unless the transitional arrangement applies, employers undertaking the cost of accruals test are expected to identify whether their scheme has more than one benefit scale for the purpose of the test or to seek advice, if it is not immediately obvious. Where different benefit scales are identified for which there is a material difference in the cost of providing benefits between different groups, the cost of future accrual must be tested for each benefit scale, separately. Employers should also consider whether they need advice on the detailed application of the test.

Guidance for an actuary assessing the scheme or advising the employer.

Which methods and assumptions can the actuary use in determining whether a scheme satisfies the test?

We expect actuaries to use their professional judgement when selecting a method and assumptions in order to undertake the cost of accruals test. In practice, they may wish to use the methods and assumptions already used for other purposes such as the funding of the scheme or an equivalent activity for unfunded schemes.

The Regulations - regulation 32M(4)

How does an actuary distinguish between different benefit scales?

Where members accrue benefits based on different criteria (such as career average or final salary) and other criteria including -

(a) the rate at which benefits accrue or accrued;
(b) the provision of survivors' benefits;
(c) the scheme's normal pension age;
(d) the scheme's definition of pensionable earnings;
(e) the method of statutory revaluation (provided for by Schedule 3 to the Pension Schemes Act 1993);
(f) the method of statutory indexation (provided for under section 51 of the Pensions Act 1995) or under the scheme rules;
(g) the scheme's maximum pensionable service period;
(h) the scheme's calculation of pensionable service; and
(i) the scheme's rule on retirement before normal pension age,

the actuary will need to determine whether there is a material difference in the cost of providing different benefits to different members. We expect that actuaries will use their professional judgement in making this determination.

However, the cost of accrual should be considered in the round – so that if one group has a similar cost to another, but the sub-division of the benefits and hence the sub-division of the cost of accrual differs, that is not a valid reason for treating them as separate groups –

- for example, if one group of active members' benefits are based on 1/60th accrual and no pension increases and another 1/80th, but with pension increases and the cost is very similar, then there is no need to consider them as separate groups.

- other examples of differences in costs that may not be material are: different children's benefits and different guarantee periods (ie benefits on death in retirement linked to the length of time the pension has been in payment)

Guidance

In making the determination about material difference in cost, the actuary can ignore:

(a) differences in cost that relate solely to the age or gender profile of the relevant members;
(b) benefit scales that relate to members who are not jobholders; and
(c) benefit scales that relate to jobholders who have asked to be enrolled into benefit scales lower than those that would satisfy the test.[4]

[4] Employers have a duty to automatically re-enrol periodically eligible jobholders in benefits scales that do not satisfy the cost of accruals test into benefit scales that do satisfy the test.

What is not included in the test?

(a) administrative costs such as the Pension Protection Fund levy;
(b) insurance costs and expenses;
(c) back service contributions in the recovery plan; or
(d) lump sum payments on death.

Some of the other benefits that can be included in the test:

(a) Pre-funded discretionary benefits; and
(b) extra pension payable on ill-health etc

Satisfying the test

26) A scheme qualifies in respect of a jobholder, if the scheme satisfies, or where there is more than one benefit scale the relevant benefit scales satisfy, the cost of the accruals test.

27) Employers will want to retain for a period the advice from a relevant signed actuarial report as evidence that their scheme meets the quality requirement. Separately, employers are required to retain a copy of the contracting-out certificate for six years. Other automatic enrolment record keeping requirements also prescribe a period of six years. So it would therefore seem sensible for employers to adopt this period as good practice for record keeping here.

28) Although there is no formal requirement for the cost of accruals test to be re-examined on a regular basis, the employer is likely to wish to obtain confirmation that the scheme continues to meet the test. It may be cost-effective for this to be done as part of the scheme's valuation cycle.

29) Employers have a duty to ensure that their eligible workers are enrolled into a scheme that satisfies the relevant quality requirements. Evidence that the scheme satisfies the cost of accruals test should be based on the most recent report either provided specifically for that purpose or as part of other reporting. Where that report shows that the scheme or a benefit scale(s) within it do(es) not satisfy the test, the employer will have the option of:

- improving the scheme or benefit scale;
- applying the test scheme standard to that scheme or benefit scale; or
- designating a different qualifying automatic enrolment scheme for that group of jobholders.

Schemes with more than one participating employer

30) The intention is that the test is applied at scheme level for all the relevant active members of a multi-employer defined benefits scheme (subject to there not being a material difference in the cost of providing the benefits accruing for different groups of members). Therefore, individual employers do not have to apply the test or commission the actuary to test the benefit scale(s) of the relevant members or groups of relevant members that they employ. However, where schemes already break the assessment down to employer level or where participating employers wish to do so, the test may be applied to the benefit scales sponsored by individual employers.

Employers with more than one scheme

31) Employers using more than one defined benefits scheme or relevant hybrid pension scheme to meet their automatic enrolment duties must ensure that each scheme separately meets the relevant quality requirements.

Newly established schemes

32) Employers using a newly established scheme to discharge their automatic enrolment duties will have to undertake the determination or commission the actuary to determine whether the scheme or benefit scales satisfy the cost of accruals test.

Materially amended schemes

33) Employers sponsoring schemes that have been materially amended since the last actuarial advice on the cost of accrual (for example, as a consequence of contracting out ending on 5 April 2016) will have to undertake or commission the actuary to estimate the cost of future benefit accrual in order to determine whether the scheme meets the cost of accruals test.

Transitional arrangements for certain formerly contracted-out salary-related schemes

34) For a transitional period, a scheme-level cost of accruals test is available to the employers of formerly contracted out schemes, even if there is a material difference in the cost of the benefits accruing for different groups of members. This is available only:

(a) in respect of jobholders who were in contracted-out employment on 5 April 2016; and
(b) where the scheme rules have not been amended after that date in a way that would mean that the contracting out requirements would not continue to be satisfied but for the abolition of contracting out.

35) Under the easement, for the purpose of the test, the relevant members are the members of the scheme who were active members and in contracted-out employment on the effective date of the most recent written report from an actuary. Although, the test is not carried out separately for different groups of members, it is for members who were not in contracted out employment on 5 April 2016. For further details, see below.

36) The transitional period in relation to the scheme ends on the earlier of two dates: (i) the date that the first written report determining whether there is, or was, a material difference in the cost of providing the benefits accruing for different groups of relevant members is signed by an actuary after 5 April 2016 and (ii) 5 April 2019.

Schemes with relevant members in contracted-out employment and non-contracted out employment

37) Under the easement, a scheme can only satisfy the quality requirement in respect of jobholders who were in contracted-out employment on 5 April 2016. The employer may wish to use the scheme as a qualifying scheme for other jobholders. For these no immediate action is required, as these members will be covered by the simplified test scheme standard [5](or the full test scheme

[5] **employers guidance**: Automatic Enrolment: Guidance for employers on certifying defined benefit and hybrid pension schemes

standard) until that falls due for review. However, if the employer wishes to review the test for these members prior to 6 April 2016 the employer can:

(a) use the simplified test scheme standard, or ask the scheme actuary to undertake the full test scheme standard; or

(b) use the standard cost of accruals test, which may require an actuary to determine whether there is a material difference in the cost of providing benefits in respect of different groups of members. If there is such a difference, the test is to be carried out separately for those groups.

Career average schemes

38) In addition to meeting the requirements of the cost of accruals test in relation to all the relevant jobholders, career average schemes must provide for each year's accrual to be revalued, whilst the member remains in service, at least at the minimum rate[6]. The minimum rate is the lesser of the increase in the RPI, CPI and 2.5% each year. For further details refer to part 5 of the Automatic Enrolment: Guidance for Actuaries on certifying Defined Benefits and Hybrid Pension Schemes or the equivalent guidance for employers.

Hybrid schemes

39) The intention is that employers using hybrid schemes for their automatic enrolment and related duties can use the test scheme standard or the alternative quality requirements to demonstrate that the defined benefits element of their scheme satisfies the appropriate quality requirements. Rules made under section 24 of the Act have the effect that the test scheme standard or the alternative quality requirements are to be applied either on their own or in association with the money purchase quality requirements. Actuaries should refer to the ***Guidance for actuaries on certifying defined benefits and hybrid pension schemes*** and employers to the ***Guidance for employers on certifying defined benefits and hybrid pension schemes. See also the hybrid scheme quality requirements rules***

[6] See regulation 36 of the Occupational and Personal Pension Schemes (Automatic Enrolment) Regulations 2010

Part 3: The prescribed requirements for schemes to be assessed against the money purchase quality requirements

Is your scheme of a prescribed description?

40) An occupational pension scheme of a prescribed description is permitted to use the quality requirements for money purchase schemes in Section 20 of the Act to qualify to be used for an employer's automatic enrolment duties. To determine whether the scheme is of a prescribed description, there are a number of conditions that must be satisfied:

(a) members' benefits are calculated by reference to factors which include the contributions made to the scheme by, or on behalf of, the member;
(b) the contributions in sub-paragraph (a) are converted, in accordance with scheme rules, as soon as reasonably practicable and no later than a month after receipt, into a right to an income for life;
(c) the benefits payable to the member under the scheme become payable no later than the member's State Pension age;
(d) following the conversion of the benefits in sub-paragraph (a), the amount of the members' benefits cannot be reduced unless this is at the member's request;
(e) following any actuarial valuation, the trustees or managers have absolute discretion to use any excess funds to increase members' benefits; and
(f) where benefits have been increased using the excess assets referred to in (e), they cannot be reduced except at the member's request.

41) Employers may wish to take advice from the relevant scheme professional(s) in determining whether their scheme satisfies all of these requirements.

Part 4: Frequently Asked Questions

My scheme uses a definition of pensionable earnings that will always be more generous than the definitions in the regulations. Can it use the cost of accruals test?

Yes. Schemes that use definitions of pensionable earnings that are equal to or more than one of the definitions in regulation 32M (9) of the Regulations can use the cost of accruals test.

If there is a material difference in the cost of accrual solely because one group is significantly older than the other, do I have to test them separately?

No, in making the determination as to whether there is a difference in the material cost of providing the benefits by comparing the benefits in one scale against another, the actuary can ignore differences in cost that relate solely to the age or gender profile of the relevant members. Please see the box on page 10 of this guidance.

When assessing the cost of accrual do I have to use the basis that was finally settled at the most recent scheme funding valuation?

The intention is that actuaries should use their professional judgment. It would be acceptable for them to use the methods and assumptions on which the most recent funding valuation is based.

Is a certificate required and if so what should it contain?

No, there is no requirement to give a certificate. However, employers will want to retain written evidence that the scheme they are using to comply with their automatic enrolment duty meets the quality requirement. It would therefore be helpful for actuaries to provide the employer with clear advice confirming whether the cost of accruals test is met or not.

My scheme is ceasing to contract out from 6 April 2016. When do I need to give the confirmation that the cost of accruals test is met?

Ideally, you should give confirmation on or before 5 April 2016. This is because employers are required to ensure that their eligible jobholders are automatically enrolled into a qualifying scheme and to maintain active scheme membership for those already enrolled in the scheme. On or after 6 April 2016 a defined benefits scheme can no longer qualify by virtue of a contracting out certificate. However, so long as you are certain that the scheme remains of sufficient quality that confirmation can be given, it can follow shortly after 5 April 2016.

If an actuarial report shows a contribution rate based on a control period of 36 months, but doesn't actually state that period in the report, can you still use 36 months as the relevant period.

Yes, you can use 36 months as the relevant period.

My scheme rules cross refer to the reference test scheme benefits in section 12B of the Pension Schemes Act 1993 which will be repealed. Can I still use the transitional easement for formerly contracted out schemes?

Yes, so long as you meet the conditions for this easement to apply. See paragraph 34 above.

The latest actuarial report is for the 31 December 2012 valuation. Can the cost of accruals test use the figures in that report?

Yes, provided that there have been no changes in the benefit structure that invalidate that report – see paragraph 22 above.

My scheme has two sections. Section A pensions all pay and the contribution rate is 20%. In Section B, pensionable pay is basic pay less 1.5 x Lower Earnings Limit so this section does not satisfy any of the definitions under the cost of accruals approach. Can we use the test scheme standard for Section B and the cost of accruals test for Section A?

Yes. If the cost of accruals test is not met for a particular section it is possible to apply the test scheme standard to see if the section meets the quality requirements through this route.