

DEPARTMENT FOR WORK AND PENSIONS CALL FOR EVIDENCE

AUTOMATIC ENROLMENT: ALTERNATIVE QUALITY REQUIREMENTS FOR DEFINED BENEFIT AND HYBRID SCHEMES BEING USED AS A WORKPLACE PENSION

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1. About this call for evidence

Who is this call for evidence aimed at?

The call for evidence is aimed at employers, employee representatives and pension industry professionals, including scheme administrators, actuaries, independent financial advisers and employee benefit consultants and any other interested parties.

Purpose of the call for evidence

The Department for Work and Pensions (DWP) is required to carry out a statutory review of the operation of regulations made under Section 23A(1) of the Pensions Act 2008.

Regulations made under Section 23A(1) set out the alternative quality requirement for defined benefit pension schemes that are used for automatic enrolment. The requirements allow for simpler alternative tests to be used so that a scheme can demonstrate that it is of sufficient quality to be used by

employers to fulfil their automatic enrolment duties. This call for evidence aims to ascertain whether or not the government's policy intentions in this area are continuing to be being achieved, in particular how the simplifications and flexibilities introduced under the test work in practice, and whether any new issues have arisen since the last triennial review in 2020.

For the 2023 review, we are also including Collective Defined Contribution (CDC) schemes. CDC schemes need to satisfy the quality requirement for UK money purchase schemes under section 20 of the Pensions Act 2008 in order to be a qualifying scheme for AE purposes, or the alternative quality requirement which we prescribed in Paragraph 2 of Schedule 7 to The Occupational Pension Schemes (Collective Money Purchase Schemes) Regulations 2022 under section 28 of the Pensions Act 2008.

Scope of the call for evidence

This call for evidence applies to England, Wales and Scotland.

Duration of the call for evidence

The call for evidence begins on **15 May 2023** and runs until **19 June 2023**

How to respond to this call for evidence

Email your response to:

caxtonhouse.automaticenrolmentconsultation@dwp.gov.uk

Alternatively, you can post your response to:

Department for Work and Pensions
Automatic Enrolment Policy Team
2nd Floor, Zone A
Caxton House
6-12 Tothill Street
London SW1H 9NA

Please ensure posted responses are sent in time to arrive by **19 June 2023**.

When responding, please state whether you are doing so as an individual or as a representative of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents, and where applicable, how the views of members were canvassed.

Send any queries about the subject matter of this call for evidence to:

caxtonhouse.automaticenrolmentconsultation@dwp.gov.uk

Government response

We will aim to publish the government response to this call for evidence on the GOV.UK website. The report will also set out the conclusions of the statutory reviews into the alternative quality requirements conducted by the department.

2. How we consult

Consultation principles

This call for evidence is being conducted in line with the revised [Cabinet Office consultation principles](#) published in March 2018. These principles give clear guidance to government departments on conducting consultations.

Feedback on the consultation process

We value your feedback on how well we consult. If you have any comments about the consultation process (as opposed to comments about the issues which are the subject of the call for evidence), including if you feel that the call for evidence does not adhere to the values expressed in the consultation principles or that the process could be improved, please address them to:

DWP Consultation Coordinator
Legislative Strategy Team
4th Floor, Caxton House
Tothill Street
London
SW1H 9NA

Email: caxtonhouse.legislation@dpw.gov.uk

Data Protection and Confidentiality

For this call for evidence, we may publish responses except for those where the respondent indicates that they are an individual acting in a private capacity (e.g. a member of the public). We will remove email addresses and telephone numbers from published responses.

For more information about what we do with personal data, you can read [DWP's Personal Information Charter](#).

3. Alternative quality requirement for defined benefit and hybrid schemes

Why are we carrying out a review now?

The Secretary of State is under a statutory duty to review the regulations made under the powers in Section 23A(1) of the Pensions Act 2008, which introduced the alternative quality requirements for UK defined benefit schemes. These reviews must take place at no more than three-yearly intervals¹ and the last review took place in 2020.

The overarching aim of the review is to test to what extent the regulations are operating as intended, including whether there are any unintended consequences, and to what degree the provisions are continuing to deliver simplifications and efficiencies for employers and pension schemes.

Background

Automatic Enrolment into workplace pensions was introduced in 2012 to enable more people to save for their retirement and to make saving the norm for most people in work. The law requires employers to enrol all their eligible² workers into a qualifying workplace pension scheme and pay pension contributions.

Employers who choose to use a defined benefit or hybrid pension scheme to meet their automatic enrolment duties must ensure their scheme meets the minimum quality requirements³ set out in the Pensions Act 2008 and the accompanying secondary⁴ legislation.

Up until 6th April 2016 a defined benefit scheme with its main administration in the UK could meet the quality requirements for a workplace pension scheme by:

- being contracted out of the State Second Pension (also known as the Additional State Pension);
- or meeting the test scheme standards (TSS) provided for in legislation and statutory guidance⁵ which allow defined benefit schemes to demonstrate they meet the minimum necessary standard.

The 'test scheme' is a hypothetical defined benefit scheme and, in simple terms, a scheme satisfies the TSS if it provides pension benefits broadly equivalent to those of the 'test scheme'. Following the abolition of contracting-out, on 6 April 2016, only those defined benefit schemes that satisfy the TSS

¹ Section 23A(7) Pensions Act 2008

² aged between 22 and State Pension age, earning over £10,000: Section 3(1) Pensions Act 2008.

³ In Sections 21 to 23 of the Pensions Act 2008.

⁴ www.legislation.gov.uk/ukxi/2010/772/contents/made

⁵ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/307074/auto-enrol-guid-emp.pdf

in relation to all relevant jobholders⁶ could be used as a qualifying workplace pension scheme. The TSS remains an option for employers.

In straightforward cases, DWP guidance sets out how employers can certify that their scheme meets the TSS. In more complex cases, the scheme actuary will need to certify the scheme.

In a public consultation in 2013⁷ (followed by a further consultation in 2014⁸), DWP invited views on whether there was a less onerous way for defined benefit schemes to demonstrate the quality requirement for the purposes of automatic enrolment. The majority of respondents expressed the view that the TSS was unnecessarily complex and employers would benefit from the flexibility of an alternative, simpler test.

Consequently, the framework for alternative quality requirement tests for defined benefit or hybrid schemes was introduced through the Pensions Act 2014 Act (which inserted section 23A into the 2008 Pensions Act). Details of the operation of the alternative quality requirement tests are set out in regulations (made under section 23A(1)).

The policy objective behind both of the alternative quality requirement tests is to provide a simpler mechanism for employers and their advisers to determine if defined benefit or hybrid schemes meet the quality requirements for automatic enrolment. The tests are of particular help to employers with formerly contracted-out schemes (which from April 2016 onwards would otherwise have needed to ensure that their schemes met the TSS).

The 2020 Review

The 2020 Review investigated if the alternative tests were continuing to deliver, in broad terms, a simplified mechanism for demonstrating a pension scheme met the quality requirements. The responses from the call for evidence showed that, the respondents' views were that, broadly, the alternative quality requirements are still providing a simplified route to comply with the automatic enrolment scheme quality requirements.

Some respondents did highlight concerns with the definition of pensionable pay used by some of their clients' schemes. These schemes may potentially face difficulties in applying one of the five available definitions of pay within the alternative tests to their circumstances. DWP acknowledges this concern, however our position remains that making further bespoke arrangements for

⁶ Jobholder is defined as is a worker: (a) who is working or ordinarily works in Great Britain under the

worker's contract; (b) who is aged at least 16 and under 75; and (c) to whom qualifying earnings are

payable by the employer: Section 1 of Pensions Act 2008.

⁷ <https://www.gov.uk/government/consultations/workplace-pensions-proposed-technical-changes-to-automatic-enrolment>

⁸ <https://www.gov.uk/government/consultations/workplace-pensions-automatic-enrolment-simplifying-the-process-and-reducing-burdens-on-employers>

particular schemes risks obscuring what is meant to be a broad simplified test. In these cases, the TSS is likely to be the more appropriate test.

Overall, respondents said that alternative tests continue to provide a more straightforward option for large numbers of schemes (which would otherwise have to use the TSS in the Pensions Act 2008), instead allowing them a less burdensome process to demonstrate suitability to be used as an automatic enrolment scheme.

Inclusion of CDC

CDC schemes were introduced by the Pension Schemes Act 2021 and the legislative framework for single and connected employer CDC schemes came into effect on 1st August 2022. Under that framework employers who choose to use a CDC scheme to meet their AE duties are required, as with other schemes, to ensure that the scheme meets the minimum quality requirements for qualifying schemes under the Pensions Act 2008.

It therefore makes sense to include a review of the AE quality test which applies to CDC schemes as part of the Triennial Review of alternative AE tests thus syncing all the review timings (AE and CDC) together on the same cycle.

The current alternative quality requirements

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

Test one: A test⁹ enabling schemes, which meet prescribed requirements, to use the money purchase quality requirements – based on meeting the existing quality requirements for defined contribution schemes, i.e. a minimum contribution equivalent to 8% of qualifying earnings (Section 20 of the Pensions Act 2008).

Test two: A ‘cost of accruals’ test¹⁰ – based on the cost to the scheme of the future accrual of active member benefits.

Test one

This is a test enabling schemes which meet prescribed requirements to use the money purchase quality requirements.

In response to feedback from a public consultation in 2014, a test was introduced whereby a defined benefit scheme will be able to use the money purchase quality requirement for defined contribution schemes (Section 20, Pensions Act 2008).

⁹ <https://www.legislation.gov.uk/uksi/2010/772/regulation/32L>

¹⁰ <https://www.legislation.gov.uk/uksi/2010/772/regulation/32M>

To determine whether the scheme may apply this test, 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.

Test two

This is the cost of accruals test. The cost of accruals test is based on the cost to the scheme of the future accrual of active member benefits. The test is normally applied at scheme-level and, broadly speaking, a defined benefit scheme (or defined benefit elements of a hybrid scheme) meets the quality requirement for automatic enrolment if "the cost of providing the 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 members' total relevant earnings over that period". In other words, the cost of providing benefits would at least require the minimum levels of contribution rates prescribed in legislation.

Prescribed percentages in relation to members' earnings are set at a level that broadly represents the cost of providing the benefits under the TSS. To maintain the existing quality standards for schemes, section 23A of the Act provides that the percentage prescribed in regulations cannot be below the 8% total contribution rate required for a qualifying defined contribution scheme.

The cost of accruals test generally applies at a scheme-level. However, where there is material difference in the cost of providing benefits for different groups, the test is applied at a benefit scale level.

The CDC Test

The Occupational Pension Schemes (Collective Money Purchase Schemes) Regulations 2022 introduced an alternative AE quality test for single or connected employer CDC schemes. The test, taking all relevant jobholders together, looks at monetary contributions by, or on behalf of, or in respect of those jobholders over the certification period, and these are assessed against prescribed percentages of their total relevant earnings over that period. DWP intends that the test will be applied to all relevant jobholders together, unless there is a material difference in the cost of providing rights to benefits to different groups (as set out in the CDC regulations).

This alternative quality requirement for CDC schemes will operate alongside the valuation requirements in the CDC regulations. We consider whether this test is appropriate for schemes covered by our consultation on a framework to accommodate whole-life multi-employer CDC schemes.¹¹

4. Active members who have voluntarily chosen to lower their contribution rates

In 2017, the first triennial review included a call for evidence which received several responses in relation to cases where a scheme member had voluntarily opted for a lower benefit scale. The legislative definition of ‘relevant members’¹² does not allow employers to exclude members who have ‘opted-down’, to make contributions below the qualifying rate, from their cost of accruals assessment and this creates a possible risk that a scheme fails to meet the cost of accruals test.

The department does not hold data on levels of opt-down but at the time we anticipated opting down would be less likely in defined benefit schemes as planned increases in phased contributions for automatic enrolment (completed in April 2019) that might have caused individuals to reduce their contributions in defined contribution schemes would not apply.

In 2017, the departments aim was to ensure that the tests remain relatively simple and straightforward and minimising complexity. In addition, we expected that relative to defined contribution schemes this would be a diminishing issue in the future given the increasing trend for defined contribution pension provision. It should also be pointed out that the TSS was intended for those circumstances where definitions of earnings and calculations of contribution rates remain complex, for example, because they are formed of multiple definitions. We acknowledge, however, that this might continue to be a residual issue for some schemes and sponsoring employers and we therefore invite stakeholders to provide any examples of issues they still face at the current time in this area.

¹¹ [Extending Opportunities for Collective Defined Contribution Pension Schemes - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/collective-defined-contribution-pension-schemes)

¹² Used for the ‘cost of accruals’ test. (<https://www.legislation.gov.uk/uksi/2010/772> (regulation 32M))

5. Questions

We are seeking evidence and views on the operation of the alternative quality requirements for defined benefit and hybrid schemes.

Please note that we are not seeking views on the transitional provisions for the cost of accruals test in respect of scheme members who had previously contracted out as these ceased to apply in April 2019¹³.

Public Sector Equality Duty

The Public Sector Equality Duty contained in Section 149 of the Equality Act 2010 states that a public authority must, in the exercise of its functions, have due regard to the need to –

- a. eliminate discrimination, harassment, victimisation and any other conduct that is prohibited by or under the Act;
- b. advance equality of opportunity between persons who share a relevant protected characteristic and persons who do not share it;
- c. foster good relations between persons who share a relevant protected characteristic.

An equality analysis will be considered as part of the review and respondents should note that evidence on the operation of the tests in respect of scheme members with different protected characteristics can be submitted in response to Question 3.

Question 1

Are the alternative quality requirements for defined benefit and hybrid schemes continuing to deliver the intended simplifications and flexibility for sponsoring employers and pension schemes that are unable to use the TSS?

Question 2

The legislation is not prescriptive about who should apply the alternative quality requirements. In practice, who is carrying out the tests: the employer (i.e. self-certification) or its professional advisers?

Question 3

Is there anything sponsoring employers or pension schemes want to bring to DWP's attention about the operation of the alternative quality requirements, in

¹³ <https://www.legislation.gov.uk/ukxi/2010/772> (regulations 5A, 5B, 5C & 32M)

particular regarding previously unforeseen issues when compared to the TSS?

Question 4 (applicable only to CDC schemes)

Does the alternative quality requirements for CDC schemes remain appropriate for single and connected employers, and does it remain appropriate for the new types of CDC schemes?

6. Glossary

Hybrid schemes

Hybrid schemes are defined, for the purposes of automatic enrolment only, as schemes that are neither money purchase nor defined benefits¹⁴. They generally have elements of both types of benefits, and depending on the type of scheme involved (see table on page 10), they may need to satisfy a combination of the defined benefits quality requirement (including the alternative quality requirements prescribed under Pensions Act 2008 section 23A) and the money purchase quality requirement, or they may only need to satisfy either of the requirements¹⁵.

Contracting out

Under the old State Pension legislation, up to 5 April 2016, individuals were able to 'contract out' of the Additional State Pension¹⁶. This meant that workers and employer could pay less NI contributions into the state system. It was not possible to contract out of the basic State Pension. Individuals could only opt out ('contract out') of the Additional State Pension if they were part of a private pension – such as a workplace or personal pension scheme – that could build up to replace the State Pension.

The new State Pension has replaced the existing basic and Additional State Pension, ending contracting out from 6 April 2016¹⁷.

Defined benefit contracting out

Many workplace pension schemes where the pension is linked to the individual's earnings contracted out all of their scheme members as part of their scheme rules. The new State Pension has replaced the existing basic and Additional State Pension and ended contracting out for defined benefit pension schemes.

¹⁴ Section 99, Pensions Act 2008

¹⁵ Section 24, Pensions Act 2008

¹⁶ Schedule 4B. 3, Social Security (Contributions and Benefits) Act 1992

¹⁷ Pensions Act 2014

Terms in the ‘cost of accruals’ test¹⁸

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.

Relevant members

Relevant members for the purposes of the cost of accrual test 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 (i.e. benefit scale). The actuary, having considered a range of factors, will determine whether there is a material difference in cost.¹⁹

Relevant period

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 date report takes effect.²⁰

Relevant earnings

The relevant earnings are the earnings which 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 (see table below) contribution rate²¹.

¹⁸ <https://www.legislation.gov.uk/uksi/2010/772> (regulation 32M)

¹⁹ <https://www.legislation.gov.uk/uksi/2010/772> (regulation 32M)

²⁰ Section 23A(2) Pensions Act 2008

²¹ Section 23A(2) Pensions Act 2008

Earnings definition and corresponding minimum contribution rate²²

| Legislative definitions | Prescribed percentage of relevant earnings | |
|---|--|--|
| | Survivors' pension benefits provided by scheme | Survivors' pension benefits not provided by scheme |
| Relevant earnings must be at least equal to or more than | | |
| 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% |

²² Section 23A(1)(b) Pensions Act 2008; <https://www.legislation.gov.uk/ukxi/2010/772> (regulation 32M)