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| Title: Workplace Pension Reform Secondary Legislation 2015 – Alternative DB Quality Requirement IA No: DWP0049 Lead department or agency: Department for Work and Pensions Other departments or agencies: N/A | Impact Assessment (IA) | | | | | | | | |
| | Date: 30 th January 2015 | | | | | | | | |
| | Stage: Final | | | | | | | | |
| | Source of intervention: Domestic | | | | | | | | |
| | Type of measure: Secondary Legislation | | | | | | | | |
| Contact for enquiries: Lawrence Key Lawrence.key1@dwp.gsi.gov.uk | | | | | | | | | |
| Summary: Intervention and Options | | | | | RPC: Awaiting scrutiny | | | | |

| Cost of Preferred (or more likely) Option | | | | |
|---|----------------------------|-------------------------------|------------------------------|----------------------|
| Total Net Present Value | Business Net Present Value | Net cost to business per year | In scope of One-In, One-Out? | Measure qualifies as |
| N/A | N/A | Zero net cost | Yes | Out |

What is the problem under consideration? Why is government intervention necessary?

Currently where employers wish to use a defined benefit (DB) scheme to meet the quality requirements for Automatic Enrolment (AE) it must either be contracted out of the state second pension or it must meet the Test Scheme Standard (TSS). From April 2016 contracting out will come to an end so all firms wishing to use a DB scheme for AE purposes would have to use the TSS. The existing test is viewed as complex, Government intervention is needed to give employers more flexibility to satisfy the quality test. The alternative DB test is designed to be a simpler test for determining whether a DB scheme meets the quality requirements for use under AE. This change is permissive so employers may choose to use either the existing test or the new alternative DB quality test.

What are the policy objectives and the intended effects?

The policy objective is to provide an alternative for employers to determine if a DB scheme meets the quality requirements for use under automatic enrolment. This alternative should be of particular help to employers with formerly contracted out schemes who from 2016 onwards would otherwise need to ensure that their schemes met the TSS. The changes are designed to minimise the administrative burden on employers. Furthermore it is permissive so employers may choose which test to use, depending on if it is in their interest to do so.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base) Two options have been considered: Do nothing (whereby the TSS is the only test available to employers to assess DB schemes for use in AE) or legislate for an alternative DB quality test for employers (option 1). A non-legislative option is not possible as the requirements are set out in legislation.

Do nothing is not a reasonable option. Although employers will have a test by which to assess whether their DB scheme is suitable for automatic enrolment (the TSS) it is likely to impose an unnecessary administrative burden on some employers for whom an alternative test would be more suitable.

Option 1 is intended to reduce this administrative burden on employers by giving them more flexibility as to how they meet the quality requirements for (AE). Employers will be able to use the test which is best suited to their scheme and is the simplest and cheapest to administer. In designing an alternative DB quality test we have worked with interested stakeholders to develop a simpler alternative method of determining that a DB scheme is good enough for use under automatic enrolment. Our overall intention is, where possible, to keep the alternative test as simple as possible and for it to run in parallel to existing requirements in relation to scheme funding so that actuarial work required for scheme funding purposes can be relied upon for this test as well.

| | | | | | | |
|---|--|---------------------|-----------------------|---------------------|---------------------------|---------------------|
| Will the policy be reviewed? It will be reviewed If applicable, set review date: 2017 | | | | | | |
| Does implementation go beyond minimum EU requirements? | | | N/A | | | |
| Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base. | | Micro Yes | < 20 Yes | Small Yes | Medium Yes | Large Yes |
| What is the CO2 equivalent change in greenhouse gas emissions? (Million tonnes CO2 equivalent) | | | Traded: N/A | | Non-traded: N/A | |

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: _____ **Steve Webb** _____ Date: _____ **12/02/15** _____

Summary: Analysis & Evidence

Policy Option 1

Description: Introduce an alternative DB quality test for employers for employers using DB schemes to meet their automatic enrolment requirement

FULL ECONOMIC ASSESSMENT

| Price Base Year | PV Base Year | Time Period Years | Net Benefit (Present Value (PV)) (£m) | | |
|-----------------|--------------|-------------------|---------------------------------------|-----------|--------------------|
| | | | Low: N/A | High: N/A | Best Estimate: N/A |
| 2014 | 2015 | 10 | | | |

| COSTS (£m) | Total Transition (Constant Price) Years | Average Annual (excl. Transition) (Constant Price) | Total Cost (Present Value) |
|---------------|---|--|----------------------------|
| Low | N/A | N/A | N/A |
| High | N/A | N/A | N/A |
| Best Estimate | N/A | N/A | N/A |

Description and scale of key monetised costs by 'main affected groups'

N/A

Other key non-monetised costs by 'main affected groups'

Any potential familiarisation costs due to the proposed change are deemed to be marginal because:

- Employers whose schemes were previously contracted out would have to familiarise themselves with the relevant TSS literature anyway; and
- Employers approaching their staging date would have to familiarise themselves with relevant literature anyway.

This is a permissive change, employers will only choose the alternative test if it is more cost effective for them to do so.

| BENEFITS (£m) | Total Transition (Constant Price) Years | Average Annual (excl. Transition) (Constant Price) | Total Benefit (Present Value) |
|---------------|---|--|-------------------------------|
| Low | N/A | N/A | N/A |
| High | N/A | N/A | N/A |
| Best Estimate | N/A | N/A | N/A |

Description and scale of key monetised benefits by 'main affected groups'

N/A

Other key non-monetised benefits by 'main affected groups'

As the legislation will be permissive, schemes are only likely to use the alternative DB quality test if the costs of doing so are less than that of using the TSS. We are unable to robustly estimate the number of firms who will use the new alternative test, however for all those that do the expectation is that it will be cheaper and easier to use (otherwise they would use the TSS). Whilst we are unable to estimate the number of employers who will choose to use the alternative test, we expect it will only be a very small proportion of all employers due to the relatively small proportion of employers with open DB schemes (approximately 1% of all employers offer a DB scheme to workers)¹.

Key assumptions/sensitivities/risks

Discount rate (%) 3.5%

As the legislation will be permissive, schemes are only likely to use the alternative DB quality test if the cost of doing so is less than that of using the TSS.

We have assumed that firms will seek to minimise costs and so use the test that is cheapest (and simplest) to administer for their scheme.

We are unable to robustly estimate the number of firms who will use the new alternative test, however for all those who do it will be a net benefit compared to using the TSS.

BUSINESSASSESSMENT (Option 2)

| Direct impact on business (Equivalent Annual) £m: | | | In scope of OIOO? | Measure qualifies as |
|---|---------------|--------|-------------------|----------------------|
| Costs: 0 | Benefits: N/A | Net: 0 | Yes | OUT |

¹¹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/330512/rr881-employers-pension-provision-survey-2013.pdf - Table 2.5

Evidence Base

Background

1. A range of legislation has been introduced to support the Government's strategy to tackle the consequences of increasing longevity and widespread under-saving for retirement. This includes the Pensions Acts of 2008, 2011 and 2014 which set out the high level framework for automatic enrolment. The proposals discussed in this Impact Assessment are intended to introduce technical simplifications to ease the burden on employers, particularly having regard to the small and micro businesses that will shortly be required to enrol their eligible workers into a workplace pension scheme.
2. In March 2013 we consulted on the introduction of an alternative DB quality requirement². We have recently consulted again on the detail with a view to establishing the impact of the proposed legislation³. The response to the recent consultation will be published in early February. Where appropriate, we have referred to responses to the consultation in this impact assessment.
3. Automatic enrolment mandates employers to provide a workplace pension for their eligible workers. Automatic enrolment commenced in July 2012 beginning with the largest employers. All employers that existed in April 2012 are required to meet their duty to enrol their workers into a qualifying workplace pension scheme by April 2017, with small and micro employers starting to stage from June 2015. Around 1.3⁴ million employers will ultimately be affected and around 10 million people will be eligible for automatic enrolment⁵, with 8 to 9 million people newly saving or saving more⁶.
4. Currently a Defined Benefit (DB) Pension Scheme can meet the quality requirement for automatic enrolment by holding a certificate in relation to a member that means the member is contracted out of the state second pension. To obtain a contracted out certificate employers must meet the Reference Scheme Test (RST); to meet the reference scheme test a DB scheme must provide benefits that are broadly equivalent to or better than a "reference" scheme. DB schemes that do not hold a contracted out certificate need to satisfy the Test Scheme Standard (TSS).
5. The TSS works by comparing the benefits in the scheme with the benefits in a benchmark test scheme. Where the benefits of at least 90% of the members of the scheme are as good as or better than those in the Test Scheme, the quality requirement is met. Schemes that hold a contracting out certificate are currently 'automatically' able to know that their scheme meets the quality requirement without needing to consider the TSS at all. From April 2016 contracting out will end⁷ and employers will need to ensure that their DB schemes meet the TSS if they are to use it for automatic enrolment (as RST will no longer exist).

Rationale for intervention

6. Employers with contracted out schemes can currently use the RST and their contracting out certificate to meet the quality requirement for automatic enrolment. The abolition of contracting out from April 2016 removes this option and means that the only way that a DB scheme can be shown to be good enough to be an automatic enrolment scheme will be the TSS. Firms that have already staged and used the RST to meet the quality requirements of automatic enrolment will no longer be able to do this and will have to use the TSS.

²https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221419/ae-technical-changes-consultation.pdf

³https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/381566/technical-changes-to-automatic-enrolment.pdf

⁴<http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-employer-staging-forecast.pdf>

⁵https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/266348/review-of-ae-earnings-trigger.pdf

⁶https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/323953/dwp-annual-report-accounts-2013-2014.PDF

⁷ The new State Pension is due to be introduced from this date.

7. Following a public consultation in 2013, the majority of respondents felt that the existing quality test was unnecessarily complex and employers would benefit from the flexibility to use an alternative, simpler test. Respondents helpfully suggested initial thoughts on the different ways in which an alternative test might operate. The Government has continued informal dialogue with interested stakeholders throughout the development of the alternative test.

Policy objectives

8. The policy objective of the proposed changes is to provide an alternative, simpler test for employers when determining if a DB scheme meets the quality requirements for use under automatic enrolment. This alternative test should be of particular help to employers with formerly contracted out schemes who from 2016 onwards would otherwise need to ensure that their schemes met the TSS.
9. The policy intention has been, where possible, to keep the alternative test as simple as possible and for it to run in parallel to existing requirements in relation to scheme funding so that actuarial work required for scheme funding purposes can be relied upon for this test as well.
10. The framework for the alternative test is set out in Pensions Act 2008, as amended by Pensions Act 2014 and is based on the cost of future accrual of active members' benefits. The details of the alternative test needs to be specified in regulation. The prescribed level of this alternative test cannot be below the minimum 8% total contribution required for a defined contribution (DC) scheme. This floor ensures that the existing minimum quality requirement must be broadly maintained and cannot be significantly weakened.
11. As this change is permissive, employers have the choice. They could use the existing TSS or the new alternative DB quality test. Furthermore, following feedback from the consultation, in some specific cases a scheme will be able to use the existing quality test for DC schemes. Employers who currently use the TSS may continue to do so, whilst employers who have yet to stage or who were previously contracted out may choose whichever test is cheapest and simplest for them to administer, and is most suitable to their scheme. The permissive nature of this change was welcomed by stakeholders in the recent consultation, in particular they commented on the benefit to employers of being able to choose the test that best suited them.

Description of options

Do nothing

12. Maintaining the status quo and doing nothing would mean that employers would continue to only have the option of using the TSS to meet the DB quality requirements for automatic enrolment. Employers who previously were able to meet the quality requirements for automatic enrolment through being contracted out will no longer be able to do so and will have to meet the TSS.
13. Consultation with stakeholders indicates that the TSS can be an overly-complicated administrative process depending on an employer's scheme. Therefore doing nothing may impose an unnecessary administrative burden on employers who would have previously relied on the RST, and where a simpler test may be more appropriate.

Option 1: Give employers choice, to use a new "alternative DB quality test" or in specific cases another existing test (preferred option)

14. The preferred option is to give employers flexibility as to how they meet the quality requirements for automatic enrolment, for example by introducing an alternative DB quality

test. Under the alternative test a DB scheme would meet 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”⁸. The alternative test in the proposed regulations features a cost to the scheme that would require contributions equal to at least 10% of qualifying earnings⁹ or 9% of qualifying earnings if the scheme does not provide dependant pension benefits.

15. The alternative test has been set at a level that is broadly equivalent to the quality of the TSS and so it should not be more difficult for a scheme to pass this test than the TSS. There is also no requirement for an actuary to certify that the scheme passes the alternative test. With regards to the TSS, the circumstances in which employers could self-certify were limited. Consultation responses indicate that stakeholders welcomed the removal of the need for actuarial certification, commenting that, depending on scheme administration, it could be unnecessarily onerous.
16. The overall intention has been to keep the alternative test as simple as possible and for it to run in parallel to existing requirements in relation to scheme funding so that actuarial work required for scheme funding purposes can be relied upon for this test as well. Consultation responses confirm that employers consider this change is likely to be both a benefit and a simplification.
17. Following feedback from the consultation, in some specific circumstances, a DB scheme will be able to refer to the money purchase quality requirement for DC schemes set out in section 20 of Pensions Act 2008. The requirement is that, under the scheme, the total contributions paid by the jobholder and the employer must be at least 8 per cent of qualifying earnings; including an employer contribution of at least 3 per cent.

Feedback from consultation

18. As previously discussed (paragraph 2) the Government recently consulted on the proposed technical changes to automatic enrolment. The consultation period was from 1st December 2014 to 9th January 2015 and a wide range of stakeholders responded (employers, pension professionals, payroll providers and organisations representing employers and employees). The consultation was on the detail of the policy and draft regulations and the general view from respondents was overwhelmingly in favour of the changes.
19. Stakeholders continue to be very supportive of the introduction of the alternative test. In particular respondents were pleased with the simplicity of the proposed test which will allow employers to continue to enrol workers into DB schemes when contracting out ends and indicated that it was likely to offer potential savings to employers. Furthermore they commented that these technical changes were a benefit to employers particularly the permissive nature which would allow employers to select the test which best fitted their scheme administration.
20. The consultation highlighted a difficulty for a small minority of schemes that are DB schemes under the definitions in Pensions Act 2008, yet have characteristics that are much more akin to a DC scheme. This presents a problem for these schemes as neither the TSS nor the new cost of accruals test are appropriate. As these schemes are more DC like, the intention is to allow them to meet the existing test for DC schemes. For employers using these schemes this will mean that they will be able to use them to meet their automatic enrolment duties. Doing

⁸S.23A(1)(b) of the Pensions Act 2008, which was inserted by s.39(2) of the Pensions Act 2014. - <http://www.legislation.gov.uk/ukpga/2008/30/section/23>; <http://www.legislation.gov.uk/ukpga/2014/19/section/39>

⁹Qualifying earnings are defined as the jobholder’s earnings between £5,772 and £41,865.

nothing would mean that these employers would have the added burden of enrolling existing members into a different scheme. This change is therefore deregulatory, it is not possible to quantify the benefit as there is no data available on how many employers and individuals will be affected.

Employers potentially affected

21. The employers potentially affected by this change will be:

- Those who have existing open DB schemes and have yet to stage¹⁰ (and who intend to use them for automatic enrolment); and
- Those whose DB scheme is currently contracted out and will have to show that their scheme meets the quality requirements for AE from April 2016 (if they intend to use it for automatic enrolment);

22. Employers offering a DB pension scheme are predominantly large. 57% of private sector organisations with more than 1,000 employees and 44% of those with 500-999 employees offer DB schemes as opposed to 1% of organisations with 1-49 employees¹¹. There are approximately 1.3 million employers left to stage¹², of these approximately 770,000 are small and micro employers with the rest consisting of new employers (who will overwhelmingly be small and micro employers). We expect a relatively small proportion to use a DB or hybrid scheme to meet the requirements of AE going forward.

23. As of March 2014, 2,001 employers have staged using a DB or hybrid scheme to meet the requirements of AE – using 408 schemes¹³. In total there are approximately 4,000 DB schemes that are open to future accrual¹⁴ and could potentially be used for an employer to meet their automatic enrolment duty. Of these schemes, around 2,500 are formerly contracted-out private sector DB schemes and will have to use either the TSS or alternative DB quality test from 2016 when contracting out ends (if they intend to use their existing scheme for automatic enrolment).¹⁵

24. As this is a permissive change we are unable to make any robust conclusions or assumptions on what proportion of employers will use an alternative DB quality test. We are therefore not able to estimate the precise number of employers that will be affected. Employers may choose whichever of the tests is better suited to them. Our consultation was not able to determine what proportion of employers this would be. In response to the consultation, however, stakeholders commented that they “*would expect the new variations to be used by the majority of employers with open DB schemes*”.

25. To obtain more evidence on the number of employers who would take advantage of the alternative DB quality test would require a large scale survey of employers. Given that these changes are permissive and deregulatory and that completing the survey would impose a burden on employers the cost would be disproportionate. Furthermore it may provide

¹⁰ Automatic enrolment is being rolled out gradually through a process known as ‘staging’. Each employer has been allocated a staging date from which they must comply with the automatic enrolment duties.

¹¹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/330512/rr881-employers-pension-provision-survey-2013.pdf - Table 2.5

¹² <http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-employer-staging-forecast.pdf>

¹³ <http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-commentary-analysis-2014.pdf> - Table 2

¹⁴ http://www.pensionprotectionfund.org.uk/Documents/purple_book_2014_chapter3.pdf - Schemes that are open to future accrual are classified as either schemes that are open or that are closed to new members but open to future accrual.

¹⁵ http://www.ons.gov.uk/ons/dcp171766_352604.pdf

potentially un-robust information as employers may change their decision as to which test they will use.

Monetised and non-monetised costs and benefits

26. This change gives employers greater choice and is permissive – there are no requirements placed on employers to use the alternatives. Employers will be able to choose an appropriate test to use to ensure their scheme meets the quality requirements of automatic enrolment. If they choose not to take advantage of an alternative test, this will maintain the status quo. In this case employers would need to use the TSS to confirm their workplace pension met the quality requirements for automatic enrolment. It is reasonable to assume employers would choose to use an alternative test if the cost of doing so is less than the cost of using the TSS. For employers with schemes which are more DC-like, it is reasonable to assume they would choose to meet the alternative test if the cost of doing so is less than enrolling their jobholders into another scheme.

Familiarisation costs

27. Any additional familiarisation costs due to the proposed technical changes are deemed to be marginal because:

- Employers whose schemes were previously contracted out would have to familiarise with relevant TSS literature anyway;
- Employers approaching their staging date would have to familiarise with relevant literature anyway.

Employers who are due to stage

28. There are approximately 1.3 million employers left to stage, of these approximately 770,000 are small and micro employers with the rest consisting of new employers (who will overwhelmingly be small and micro employers). As the proposed change is permissive we do not know how many of the employers using DB schemes under automatic enrolment will opt for the alternative test. Evidence from the consultation suggested that the majority of employers with open DB schemes were likely to choose to take advantage of the alternative DB quality test.

29. The alternative DB quality test has been designed in consultation with stakeholders and is likely to be simpler and cheaper to administer for some DB schemes. In our most recent consultation stakeholders' commented the changes would allow "*employers' advisers to more easily and quickly (and therefore at a lower cost) determine whether their schemes meet the quality test*". As the change is permissive, employers can choose to use the alternative DB quality test if there is a net benefit and the cost is lower than the status quo. However they do not have to use the alternative DB quality test if the TSS is better suited to their scheme. It is therefore estimated that there will be a **benefit to employers** however we are unable to monetise this benefit.

Employers who had previously contracted out

30. Up to 2,500 formerly contracted-out private sector DB schemes will have to use either the TSS or alternative DB quality test from 2016 when contracting out ends (if they intend to use their scheme for automatic enrolment). As the proposed change is permissive we do not

know how many of the total number of employers using DB schemes under automatic enrolment might opt for the alternative test.

31. The introduction of an alternative test is designed to offer schemes a simpler way to meet the automatic enrolment quality test. As the measure is permissive, it is reasonable to assume schemes would only chose the alternative test if they did not incur costs greater than the costs of having to meet the TSS. This simplification is therefore a **benefit to employers**.

Small and Micro Business Assessment

32. The change applies to all employers regardless of size. Employers offering a DB pension scheme are predominantly large. 57% of organisations with more than 1,000 employees and 44% of those with 500-999 employees offer DB schemes as opposed to less than 4% of organisations with 1-49 employees¹⁶. As the measure is permissive, small and micro businesses will not be adversely affected. This change is likely to result in a benefit for small and micro businesses.
33. The costs and benefits outlined for employers apply to small and micro businesses, who are due to stage from June 2015.

Rationale and evidence that justify the level of analysis

34. As the measure is permissive it does not impose any additional burdens on business, it is therefore not proportionate to gather further evidence by surveying employers. For this assessment we have made use of available data and informal engagement with stakeholders to verify our assumptions.
35. Where appropriate we have used responses to the recent consultation to strengthen our evidence. Whilst stakeholders were generally positive about the proposed changes they provided little evidence to help quantify any benefits.

Direct costs and benefits to Business (OITO)

36. This change **does not impose any additional burdens on business as it is purely permissive** and schemes will only choose to use the alternative DB quality test if they feel it will be in their interests to do so.
37. From all the evidence we have gathered, we consider that there will be a benefit to business as a result of the proposed changes. Employers will benefit from the choice of test and may find the alternative DB quality test cheaper and simpler to administer. Furthermore there is likely to be a reduction in actuarial work for schemes using the alternative test due to an alignment with the work needed for scheme funding processes and the change to the circumstances in which employers can self certify (as discussed in paragraphs 9, 15 and 16).

¹⁶https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/330512/rr881-employers-pension-provision-survey-2013.pdf - Table 2. 5

38. The proposals are deregulatory and within the scope for One-In, Two-Out. As stated above we are unable to quantify or monetise the benefit for this measure, therefore it is to be considered **an OUT with a zero net cost to business.**