

<b>Title:</b> Post Implementation Review of Alternative Quality Requirements for Defined Benefit schemes  <b>PIR No:</b> DWP2017_PIR_001  <b>Original IA/RPC No:</b> RPC14-FT-DWP-2215(2)  <b>Lead department or agency:</b> DWP  <b>Other departments or agencies:</b> N/A  Contact for enquiries: Elellta Beyene- 02073404286	<b>Post Implementation Review</b>
	<b>Date:</b> 06/11/2017
	<b>Type of regulation:</b> Domestic
	<b>Type of review:</b> Statutory
	<b>Date measure came into force:</b> 01/04/2015
	<b>Recommendation:</b> Amend
	<b>RPC Opinion:</b> not applicable

### 1. What were the policy objectives of the measure?

Automatic enrolment into workplace pensions was introduced in 2012 to enable more people to save for their retirement and to normalise saving for most people in work. The law requires employers to enrol all eligible<sup>1</sup> 'jobholders'<sup>2</sup> into a scheme of sufficient quality. Employers who choose to use a Defined Benefit (DB), or hybrid scheme to meet their automatic enrolment duties must ensure their scheme meets the minimum quality requirements set out in law.

The legislative basis for alternative quality requirement for DB pension schemes and defined benefit sections of hybrid schemes is set out in the section 23A and S24(a)(b)) of the Pensions Act 2008 respectively. Details of the alternative tests were introduced in 2015 through 'The occupational and personal pensions (automatic enrolment) (amendment) regulations 2015' which amended the Occupational and Personal Pension Schemes (Automatic Enrolment) Regulations 2010' (the Regulations).

The legislation as amended introduced two alternative tests of scheme quality available to employers offering DB schemes or certain hybrid schemes:

- a) A cost of accruals test – based on the cost to the scheme of the future accrual of active members' benefits; and
- b) A test enabling hybrid schemes which meet prescribed requirements to use the money purchase quality requirements

The objective of the alternative tests is to minimise the burden on schemes by providing the option of a substitute, simpler test when determining if a DB or hybrid scheme meets the quality requirements for automatic enrolment.

This was followed by technical change which for a transitional period<sup>3</sup> allows formerly contracted out schemes to apply the cost of accrual test at a scheme level rather than benefit scale level even where there is material difference in the cost of providing benefits to its members. This measure was introduced ahead of the ending of contracting out from April 2016, and is intended to streamline the test for formerly contracted out schemes that are typically delivering benefits that were at least equivalent to, or in excess of, the requirements for contracting-out of the second State Pension.

The regulations on alternative quality requirements are permissive. The intended effect is that schemes/employers sponsoring DB schemes will have the option of using the less onerous test, but ultimately schemes have the choice of applying the original test- the test scheme standard (TSS) or the alternative quality requirement based on their circumstances. In simple terms, a scheme satisfies the TSS if it provides broadly equivalent benefits to pensions

<sup>1</sup> Eligibility is defined as jobholders who are aged between 22 and State Pension age, earning over £10,000 in 2016/17 section 3 2008 Act

<sup>2</sup> Job holder 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

<sup>3</sup> The transitional period ends either the date of the first report signed by the actuary after 5 April 2016 that breaks down the cost of accruals to benefit scale level; or 5 April 2019, whichever comes first.

provided under the test scheme (a hypothetical DB scheme).

An impact assessment<sup>4</sup>, validated<sup>5</sup> by the Regulatory Policy Committee (RPC) was published alongside the 2015 Regulations.

#### Statutory review requirement:

The Department is required to carry out a statutory review of the Regulations during 2017, and thereafter at no more than three yearly intervals. This Post Implementation Review outlines views on the effectiveness of the relevant regulations and the Government's next steps.

## **2. What evidence has informed the PIR?**

The regulation on alternative quality requirement is permissive. As such, employers and advisors have the option of adopting the simplified tests or, continuing to use the original test – TSS if that works better for them. The impact assessment for the 2015 regulations<sup>6</sup> assessed the measure as zero net cost and deregulatory (an 'OUT'). The assumption applied was employers and their advisors would only adopt the alternative tests if the benefits outweigh the costs.

We estimate one per cent of employers use formerly contracted out DB schemes (therefore a maximum take-up of one per cent of employers assuming ALL employers make use of the simplifications). Given the direction of impact on business i.e. **permissive simplification; the level of potential impacts; and that this is a repeat review**, we considered a light-touch review concentrating mainly on a public consultation is proportionate. Further, the transitional arrangements discussed in sections above will be in place until 2019. In view of this and in recognition that the Department is required to carry out the next review in 2020, we believe that will be a more appropriate time to re-examine this policy in even more detail.

The Department's approach is consistent with the guidance provided in the Better Regulation Framework which recommends that the level of evidence collected should be consistent with: the level of impacts; the degree to which policy is contentious, novel or risky; and the overall costs of obtaining of data. In the context of this PIR we considered a review for which the main evidence base is a public call for evidence is a proportionate approach.

The call for evidence<sup>7</sup> was targeted at employers, employee representatives and pension industry professionals, to provide a broad spectrum of opinion on which to base our assessment. The Department sought feedback on the implementation of specific elements of the regulations as well as the overall operation of the policy.

We considered:

- Whether the alternative quality requirements for DB schemes broadly deliver the intended simplifications and flexibility in contrast to the Test Scheme Standard (TSS)
- The degree to which the simplifications were being utilised
- Whether employers and advisors were making use of the further transitional arrangements intended to provide further simplifications for a limited period (introduced through the 2016 regulations) were being utilised
- Any unintended consequences
- How the regulations could be further simplified to reduce the burden on employers

We received detailed feedback from eight organisations, whose members have a direct interest in this legislation. Respondents represent a cross section of interested parties, including actuarial organisations, trade associations and representative body of providers of advice and services to work-based pension schemes.

## **3. To what extent have the policy objectives been achieved?**

The evidence gathered for the review suggests the objectives of the alternative quality requirement: to provide a simplified quality test which caters for the bulk of DB schemes, is broadly being met. Respondents largely agreed the alternative tests deliver the intended simplifications for the majority of DB schemes, but the structure of the cost of accrual test is not suitable for certain schemes in select circumstances.

Following the review the Secretary of State's decision is to maintain the vast majority of the regulations without changes. The only change the Department will further explore will be in relation to active members of DB schemes

<sup>4</sup> [http://www.legislation.gov.uk/ukia/2015/133/pdfs/ukia\\_20150133\\_en.pdf](http://www.legislation.gov.uk/ukia/2015/133/pdfs/ukia_20150133_en.pdf)

<sup>5</sup> [http://www.legislation.gov.uk/uksi/2015/501/pdfs/uksirpc\\_20150501\\_en\\_002.pdf](http://www.legislation.gov.uk/uksi/2015/501/pdfs/uksirpc_20150501_en_002.pdf)

<sup>6</sup> [http://www.legislation.gov.uk/ukia/2015/133/pdfs/ukia\\_20150133\\_en.pdf](http://www.legislation.gov.uk/ukia/2015/133/pdfs/ukia_20150133_en.pdf)

<sup>7</sup> <https://www.gov.uk/government/consultations/automatic-enrolment-defined-benefit-alternative-quality-requirements-and-provisions-for-seafarers-and-offshore-workers/automatic-enrolment-defined-benefit-alternative-quality-requirement-and-provisions-for-seafarers-and-offshore-workers>

who voluntarily choose to make contributions at a level below qualifying levels. We propose to explore making legislative changes which would allow schemes to disregard any such members' benefits from the cost of accruals test. Proposed changes will be subject to consultation.

Sign-off for Post Implementation Review: Chief economist/Head of Analysis and Minister

***I have read the PIR and I am satisfied that it represents a fair and proportionate assessment of the impact of the measure.***

A handwritten signature in blue ink, appearing to read 'G. Norman', with a horizontal line underneath.

Signed:

Date: 11/12/2017

## Further information sheet

Please provide additional evidence in subsequent sheets, as required.

### 4. What were the original assumptions?(Maximum 5 lines)

For the purposes of the 2015 impact assessment (IA)<sup>8</sup>, costs and benefits of the regulatory change was assessed to be deregulatory with a net benefit of zero. As the change is permissive it was not possible to make any robust conclusions or assumptions on what proportion of employers will use the alternative DB quality tests. We could have tried to identify those who had applied the tests through a survey but it was felt that the level of burden this would place on businesses would be disproportionate.

#### Assumptions on employers affected :

The **original IA identified** the employers potentially affected by this change would be:

- Those who have existing open DB schemes and have yet to stage<sup>9</sup> (and who intend to use them for automatic enrolment); and
- Those whose DB scheme were contracted out at the time and will have to show that their scheme meets the quality requirements for AE from April 2016 (if they intend to use the scheme for automatic enrolment).

The IA assumed the regulations would in reality affect a very small proportion of all employers in the private sector due to the relatively small proportion of employers with open DB schemes –in 2013 approximately one per cent of all employers offered a DB scheme to workers<sup>10</sup>.

The IA also identified these were likely to be predominantly large employers. Of the one per cent of private sector employers offering DB pension schemes 57 per cent have more than 1,000 employees and 44 per cent with 500-999 employees as opposed to 1 per cent of organisations with 1-49 employees<sup>11</sup>.

At the time the impact assessment was drafted, there were 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). Of those yet to stage, the original assumptions were that a relatively small proportion would use a DB or hybrid scheme to meet the requirements of auto enrolment.

How does this compare with recent data?

There is a downward trend in the number of DB schemes being used for auto enrolment. Latest data from the Pensions Regulator (tPR) indicates only three per cent of schemes reported in declaration of compliance are DB schemes<sup>12</sup>; the remaining 97% use defined contribution schemes. As the figure on DB schemes include private and public sector schemes, and as a large proportion of DB schemes are likely to be in public sector employers, the number of (private sector) employers which this measure can impact is likely to be a lot less than three per cent.

#### Assumptions on number of schemes affected:

<sup>8</sup> [http://www.legislation.gov.uk/ukia/2015/133/pdfs/ukia\\_20150133\\_en.pdf](http://www.legislation.gov.uk/ukia/2015/133/pdfs/ukia_20150133_en.pdf)

<sup>9</sup> 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. The staging of auto enrolment has an estimated completion date of February 2018.

<sup>10</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/330512/rr881-employers-pension-provision-survey-2013.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/330512/rr881-employers-pension-provision-survey-2013.pdf)  
Table 2.5

<sup>11</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/330512/rr881-employers-pension-provision-survey-2013.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/330512/rr881-employers-pension-provision-survey-2013.pdf)  
Table 2.5

<sup>12</sup> The pensions regulator – data 2017 (table 7) <http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-commentary-analysis-2017.pdf>

The original IA stated that in total there were approximately 4,000 DB schemes open to future accrual<sup>13</sup> and therefore, potentially in-scope for the 2015 regulations. Of those, around 2,500 were formerly contracted out **private sector** DB schemes and would have had to meet the TSS or the alternative DB quality tests from April 2016 (the ending of contracting out) depending on whether employers chose to use their existing scheme for automatic enrolment<sup>14</sup>.

By comparison, the number of DB schemes open to future accrual in 2016 is 3,600<sup>15</sup>-a slight reduction from the 2015 figure above. Assuming public sector DB schemes continue to form a significant proportion of the total number of DB schemes, potentially there are a reduced number of private sector DB schemes which continue to be in-scope for this measure.

As the proposed change was permissive the impact assessment made clear we did not know how many of the total number of employers using DB schemes under automatic enrolment might opt for the alternative test. However, as the introduction of an alternative test was designed to offer schemes a simplified approach to the overall scheme quality test, the impact assessment concluded schemes would only chose the alternative test if they did not incur costs greater than the costs of having to meet the TSS.

#### **Costs and benefits:**

This measure was intended to introduce simplifications to schemes/employers sponsoring DB schemes. Due to the regulations being permissive the impact assessment was unable to make any robust conclusions on the proportion of employers/schemes likely to use the alternative quality tests, and therefore an estimate as the precise number of businesses that will be positively affected. The consultation accompanying the document prior to the introduction of the measure did not provide sufficient information to inform the proportion of schemes/employers that are likely choose to use the simplified alternative tests.

In respect of familiarisation costs, any potential familiarisation costs due to the proposed change were assessed to be marginal because schemes/employers sponsoring DB schemes would have to familiarise themselves with the relevant TSS literature anyway.

The Department's position is to maintain the permissive nature of these regulations. As such, the expectation is that employers will carry on to use alternative tests in preference of the TSS, only where the benefits outweigh the costs. 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.

#### **5. Were there any unintended consequences?**

We received several responses in relation to cases where a scheme member has voluntarily opted for a lower benefit scale. The legislative definition of 'relevant members' does not allow employers to exclude members who have opted-down to below the qualifying rate from their cost of accruals assessment. This creates a possible risk that the scheme fails to meet the cost of accruals test

We anticipate opting down will be less prevalent in DB schemes as future increases in phased contributions do not apply. We expect also, that this will be a diminishing issue over the years if the increasing trend of more and more employers using DC schemes continues. Nevertheless, we acknowledge this may be a residual concern for some schemes/employers. We have considered this issue and believe there could be merit in realigning the legislation to allow schemes to disregard members who have voluntarily opted down to below qualifying levels from the cost of accruals test. We propose to explore making legislative changes which would allow schemes to disregard any such members' benefits from the cost of accruals test. Proposed changes will be subject to consultation.

#### **6. Has the evidence identified any opportunities for reducing the burden on business**

For schemes where the rules enable members to voluntarily opt-down, the legislative change above, if implemented could reduce their burden. This is because such schemes will no longer need to default to the more onerous test: test scheme standard (TSS) in order to demonstrate minimum scheme quality is met.

<sup>13</sup> [http://www.pensionprotectionfund.org.uk/Documents/purple\\_book\\_2014\\_chapter3.pdf](http://www.pensionprotectionfund.org.uk/Documents/purple_book_2014_chapter3.pdf)

<sup>14</sup> [http://webarchive.nationalarchives.gov.uk/20160109101912/http://www.ons.gov.uk/ons/dcp171766\\_352604.pdf](http://webarchive.nationalarchives.gov.uk/20160109101912/http://www.ons.gov.uk/ons/dcp171766_352604.pdf)

<sup>15</sup> [http://www.pensionprotectionfund.org.uk/Documents/Purple\\_Book\\_2016.pdf](http://www.pensionprotectionfund.org.uk/Documents/Purple_Book_2016.pdf) (see figure 3.1- scheme status)

**7. For EU measures, how does the UK's implementation compare with that in other EU member states in terms of costs to business?**

Not applicable.