LCP's response to the call for evidence on auto-enrolment alternative quality tests

19 June 2023

This document sets out LCP's response to the Department for Work and Pensions' call for evidence on auto-enrolment alternative quality tests published on 15 May 2023.

Who we are

LCP is a firm of financial, actuarial, and business consultants, specialising in pensions, investment, insurance, energy, health and business analytics. We have around 1,000 people in the UK, including 160 partners and over 300 qualified actuaries.

The provision of actuarial, investment, covenant, governance, pensions administration, benefits advice, and directly related services, is our core business. About 90% of our work is advising trustees and employers on all aspects of their pension arrangements, including investment strategy. The remaining 10% relates to insurance consulting, energy, health and business analytics. LCP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.

Our response

We have set out overleaf our answers to your four questions.

We are happy for LCP to be named as a respondent to the Call for Evidence and for you to reference our comments when you come to set out your conclusions to this review.

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About Lane Clark & Peacock LLP

We are a limited liability partnership registered in England and Wales with registered number OC301436. LCP is a registered trademark in the UK and in the EU. All partners are members of Lane Clark & Peacock LLP. A list of members' names is available for inspection at 95 Wigmore Street, London, W1U 1DQ, the firm's principal place of business and registered office.

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LCP's response to the consultation

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?**

   Yes, in relation to your "Test one" (the test enabling schemes which meet prescribed requirements to use the money purchase quality requirements). As we stated, in our response to your 2020 Review, this test has enabled our client to use their scheme, modelled on a deferred annuity purchase structure, as a qualifying scheme for auto-enrolment purposes. We would very much like this test to continue to be available.

   A qualified yes in relation to your "Test two" (the cost of accruals test). It has certainly assisted the vast majority of our DB and hybrid clients, as their pensionable earnings definitions are able to slot into one of the five available permutations and it is normally a straightforward next step to check that the prescribed percentage test is met as part of the triennial actuarial valuation. However, we repeat our suggestions from the 2020 Review that you consider some modifications to the legislation and/ or guidance as necessary to address some concerns by those schemes who can find that it is not possible to use cost of accruals, despite providing benefits that are worth considerably more than the 8% minimum under DC provision, and so have to use the complex test scheme approach.

   We suggest that you construct a variant of the cost of accruals test that operates in one step – by simply comparing the expected contributions to support accruing benefits in the scheme against the amount generated by applying one of the prescribed percentages against their associated relevant earnings.

   Under this approach, the scheme actuary would typically report at the triennial actuarial valuation, that the future cost of accruing benefits is x% of the scheme's pensionable earnings and the total amount required is equal to at least that generated through applying the prescribed percentage to one of the permitted relevant earnings definitions.

   As we said previously, one of the drawbacks of the cost of accruals test is that it assesses scheme quality in two distinct steps – first by checking whether the scheme's pensionable earnings definition is at least as generous as any one of the permissible "relevant earnings" definitions, and only if this test is passed, going on to check whether the contribution rate required to be paid is no less than the "prescribed percentage".

   The first step can cause difficulties in particular situations – such as if a cap on pensionable earnings has been introduced or there is an unusual definition of earnings that is pensionable. As the overall quality of the scheme may be in little doubt, with expected contributions well in excess of applying the prescribed percentage to one of the permitted relevant earnings definitions, we feel it would make sense for there to be a one-step process.

   Those schemes that have to fall back on the test scheme due to their unusual pensionable earnings definitions often find that they have to undertake complex calculations in order to prove that leaving service benefits after three year's accrual are more generous than those had the scheme provided test scheme benefits, when from a "broader picture" perspective the overall quality of the scheme is not in doubt.

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?**

   In our experience it is invariably the scheme actuary for the cost of accruals test, as evidenced in their report on the triennial actuarial valuation.

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 particular regarding previously unforeseen issues when compared to the TSS?

Please see our comments in Question 1 in relation to your "Test two".

4. **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?**

Our understanding is that CDC schemes can become a qualifying scheme for auto-enrolment purposes by satisfying one of the following:

- The money purchase quality requirements (through a 8% of qualifying earnings overall contribution with the employer contributing at least 3% of the 8%);
- Any of the alternative quality requirements for money purchase schemes;
- The CDC cost of accruals test which is expressed in a very similar form to that for DB and hybrid schemes.

Which test to use will depend on the design of the CDC scheme. For the one CDC scheme currently authorised by the Pensions Regulator (Royal Mail), its design is more DB-like than DC with pension costs rising with age, and so an overall test of quality across the membership as a whole, rather than for each member, makes sense, just as it does for DB schemes.

This is less likely to be the case for the new types of CDC scheme, as there may be less willingness to accept cross-subsidies between different age groups given that each participating employer may have its own distinctive age profile. For these schemes their structure is likely to be more DC-like, with contributions directly related to the member (whether paid by the member or employer on behalf of the member) buying future retirement income on an age-related scale.

Some employers may participate in such schemes as an alternative to their current qualifying money purchase scheme, with the contributions remaining unchanged. Those employers are likely to be comfortable using one of the current money purchase tests listed above, as for them, essentially, nothing has changed.

Others may wish to adopt a pattern of contribution that targets similar retirement outcomes for a given period of service. They would be seeking to deliver a benefit outcome similar to Royal Mail, but in a different way. For them it is possible that the money purchase tests will not be appropriate and the current CDC cost of accruals test too constraining (as, for example it is built on the same two-step structure as the DB cost of accruals and so requiring a pensionable earnings test to be passed first).

We suggest that further consideration is given to the auto-enrolment tests for the new types of CDC scheme once you have settled on the constraints around how such schemes should operate. It may then be that a test can naturally follow.

Finally, in section 4 of the Call for Evidence you also invited stakeholders to provide examples of issues about active members opting for lower benefit accrual in DB and hybrid schemes and, where this happens, whether it might make the alternative quality requirement tests for DB and hybrid schemes unviable. Our experience is that there is very little opting down activity in such schemes, often for the simple reason that the scheme does not contain such an option (and where it does the lower scales would be designed to pass the cost of accruals test). As a result, it has not had an impact on our ability to use the cost of accruals test.