

GN28: Retirement Benefit Schemes - Adequacy of Benefits for Contracting-out

Classification

Practice Standard

MEMBERS ARE REMINDED THAT THEY MUST ALWAYS COMPLY WITH THE PROFESSIONAL CONDUCT STANDARDS (PCS) AND THAT GUIDANCE NOTES IMPOSE ADDITIONAL REQUIREMENTS UNDER SPECIFIC CIRCUMSTANCES

Purpose

The purpose of this Guidance Note is to advise actuaries of the considerations which they need to take into account in assessing the equivalence of a scheme's benefits with those of a 'reference scheme', the details of which are set out in section 12B of the Pensions Schemes Act 1993. It also advises actuaries on the considerations which they need to take into account in providing a reference scheme test certificate. A scheme must also satisfy other requirements if it is to be a salary-related contracted-out scheme; those requirements are not covered by this Guidance Note.

Application

An actuary responsible for determining whether the benefits of an occupational pension scheme, or an appropriate sub-section of such a scheme, satisfy the statutory standard required for salary-related contracted-out schemes and sections of Contracted-out Mixed Benefit Schemes (COMBS) which are contracted-out on a salary-related basis.

Legislation or Authority

Pension Schemes Act 1993 (c.48). Sections 12A and 12B (as amended).

Civil Partnership Act 2004: Section 255

The Occupational Pension Schemes (Contracting-out) Regulations 1996, as amended. ('the Contracting-out Regulations')

The Occupational Pension Schemes (Mixed Benefit Contracted-out Schemes) Regulations 1996, as amended.

Northern Ireland has its own body of law relating to pensions and, in relation to Northern Ireland, references to the Great Britain legislation contained in this Guidance Note must be read as including references to the corresponding Northern Ireland legislation. The appendix shows Northern Ireland legislation equivalent to the Great Britain legislation mentioned in this Guidance Note.

This Guidance Note has been approved by the Secretary of State for Work and Pensions and the Department for Social Development in Northern Ireland in accordance with Regulations.

Author

Pensions Board

Status

Approved under Due Process

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1 Introduction

- 1.1 Section 12A of the Pension Schemes Act 1993 and the Regulations made thereunder indicate that an employer will only be able to apply successfully for a salary-related contracting-out certificate in respect of a scheme providing benefits which are ‘broadly equivalent to or better than’ the benefits provided by a ‘reference scheme’, details of which are set out in section 12B of that Act. This equivalence can only be certified by the ‘scheme actuary’ appointed under section 47 of the Pensions Act 1995 unless no such appointment is required under that section (see Contracting-out Regulation 24). All future references in this Guidance Note to ‘certificate’ refer to the reference scheme test certificate. In their application to COMBS further references to a ‘scheme’, ‘members’ and ‘membership’ must be read also in the context of the salary-related part of a COMBS.

2 Frequency of Provision of Certificates

- 2.1 A certificate, in the specified form, must be provided to HM Revenue and Customs (specifically the Savings, Pensions, Share Schemes (SPSS)) as one of the conditions to be met by a scheme seeking to contract-out under the reference scheme test.
- 2.2 For a scheme contracting-out for the first time, a certificate must be provided with the contracting-out election package (see also 4.7).
- 2.3 The actuary must reconsider the scheme’s ability to meet the statutory standard whenever informed, in accordance with GN29 or Regulations made under section 47(9) of the Pensions Act 1995 or section 37 of the Pension Schemes Act 1993, of a change which might affect the scheme’s ability to satisfy the test and, in carrying out such reconsideration, must comply with part 5 of this Guidance Note.

3 **Instructions**

- 3.1 The actuary will receive instructions from the employer to determine whether the scheme satisfies the ‘reference scheme’ test. Since the actuary is already acting for the trustees or manager(s) of the scheme, the trustees or manager(s) must be told that these instructions have been accepted from the employer (unless the actuary has already informed the trustees or manager(s) of an ongoing appointment to provide the employer with such advice as may be required from time to time). The actuary shall provide the signed certificate to the employer.

4 **Methodology**

- 4.1 If a scheme has a benefit structure which provides pensions equal to or better than the reference scheme in every respect, including the earnings definition and widows’, widowers’ and surviving civil partners’ pensions, the actuary can provide a certificate without further investigation, but cannot provide a certificate where there are no active members in the scheme (or in the case of a COMBS there are no active members in the salary-related part) and the actuary is aware of an intention not to admit active members into the scheme (or the salary-related part of a COMBS).
- 4.2 A scheme does not have to match the structure of the reference scheme to be contracted-out provided that the actuary is able to certify that the benefits are broadly equivalent to or better than the pensions under the reference scheme, tested separately for members’ own benefits and pensions for their widows, widowers or surviving civil partners.
- 4.3 The tests of equivalence must be satisfied on an overall basis for the membership collectively. This means that the average amount, or value, of benefit to be provided by the scheme must not be less than the average amount, or value as appropriate, of the benefits under the reference scheme for the relevant group of employees. Provided that the overall tests are satisfied, the actuary must also be satisfied that not more than 10% of the individual members or their widows, widowers or surviving civil partners would fail the tests of equivalence. The actuary need not automatically look at the benefits for each individual member in order to be satisfied that each of these tests of equivalence is satisfied; it is a matter of professional judgement for each actuary as to the amount of investigation which is necessary.
- 4.3.1 If the scheme has more than one benefit scale available to members, whether these scales are available on an open choice to members or whether they are defined for certain categories of employment, then the equivalence tests must be carried out separately for each scale. Only if a particular scale satisfies the equivalence tests in its own right can those members to whom it applies be in contracted-out employment. In this context, ‘benefit scale’ encompasses both the accrual rate and the definition of pensionable pay.

- 4.3.2 Where there is more than one employer linked to a scheme, each or any of them may wish to have their own individual contracting-out certificate covering their own employees. The tests of broad equivalence described in 4.3 must then be carried out separately in respect of the employees covered by each separate contracting-out certificate. Where a holding company contracting-out certificate is to be used, separate tests will not be required for the different employers covered by it, unless 4.3.1 applies.
- 4.3.3 Where an employer has two schemes, neither of which can be treated as contracted-out in its own right because, for example, one provides death-in-service benefits and the other provides pension benefits the actuary may consider the aggregate of the benefits when providing the certificate.
- 4.4 The tests of equivalence are to be based on the active membership of the scheme as at the effective date of the certificate. Members of the scheme who are not contracted-out under the salary-related test must be disregarded.
- 4.5 The tests of equivalence must also be based on the latest available remuneration data.
- 4.5.1 If the latest available remuneration data relates to a period ending before the effective date, the actuary must consider obtaining confirmation from the employer that no significant changes in remuneration patterns had occurred before the effective date.
- 4.5.2 The chosen period for which the latest available remuneration data is obtained will normally be one year. Where the actuary has reason to believe that remuneration patterns for that period are significantly abnormal and the employer has confirmed in writing that this is the case, then the actuary can test whether the scheme satisfies the broadly equivalent requirement based on remuneration data over the three years ending on the effective date and provide a certificate on that basis.
- 4.5.3 As the sole area of uncertainty will in many cases be differences between earnings definitions as required by the scheme and as required by the reference scheme, the actuary may be able to draft a statement on this issue for the employer to sign which will permit the actuary to carry out the certification without individual analysis.
- 4.6 Normally in an actuarial investigation the actuary would comment briefly on the quality of the data which had been provided, along with any reservations regarding the data. In view of the nature of the certification which has to be provided, the actuary must be satisfied that the quality of the data is sufficient before completing the certification.
- 4.7 If a certificate is to be provided in respect of a scheme which is being established, the scheme must be tested on the basis of its anticipated membership. The actuary must review the scheme's ability to pass the test upon receipt of data on the actual membership. This review must be carried

out no later than the completion of the scheme's first formal actuarial valuation after its establishment.

- 4.8 In order to certify broad equivalence it will be necessary to compare the scheme benefits with those under the reference scheme. In certain circumstances it will be necessary to make a comparison between the values of the respective benefits.
- 4.9 The benefits to be compared will (with the exception of those under 4.12.3) be those that are expected to accrue to the membership of the scheme in the three years following the effective date of certification.
- 4.10 The members' benefits must be those to which the members would be entitled in relation to the period of three years mentioned in 4.9 if they were to leave service at the end of that period or on earlier attainment of normal pension age. The scheme's normal pension age is defined as the earliest age at which an unreduced pension would be payable as of right.
- 4.11 The actuary must consider not only the quantities of benefit but also who is entitled to receive the benefit. The Secretary of State has advised that:
- 4.11.1 widows', widowers' and surviving civil partners' pensions must be payable to all widows, widowers and surviving civil partners respectively, except in the circumstances set out in Contracting-out Regulation 26;
- 4.11.2 the widow or widower in this context is the legal spouse and the surviving civil partner is the registered civil partner as defined in the Civil Partnership Act 2004; and
- 4.11.3 it is acceptable for a scheme to provide additional benefits for (other) survivors through the scheme rules.
- 4.12 The pensions for widows, widowers and surviving civil partners must be compared with those payable from the reference scheme separately in respect of death in service during the three year period, death in deferment and death in retirement and the tests must be passed in respect of each contingency.
- 4.12.1 For the purpose of the comparison of widows', widowers' and surviving civil partners' pensions, some reduction in respect of a large age difference between member and partner (be it widow, widower or surviving civil partner) may be ignored, provided that such reduction does not exceed 2.5% for each complete year of age difference in excess of ten.
- 4.12.2 For widows', widowers' and surviving civil partners' pensions on death in deferment and death in retirement, the comparison with the reference scheme must be made on the same basis as described in s 4.9 and 4.10 above. The widows', widowers' and surviving civil partners' pensions on death in deferment under the reference scheme includes statutory revaluation to date of death.

- 4.12.3 For widows', widowers' and surviving civil partners' pensions on death in service, the comparison with the reference scheme must be made on the basis described in 4.9 above, except that investigations will be required where the widows', widowers' and surviving civil partners' pensions are:
- (a) non-service-related (eg a fixed percentage of pay of less than 25% of the appropriate earnings as defined under the reference scheme) or
 - (b) a prospective service benefit where the accrual rate is lower than 1/160ths of appropriate earnings as defined under the reference scheme.

In such cases, the widow's, widower's and surviving civil partner's pensions payable from the scheme if the member were to die on the third anniversary of the effective date of the certificate, or on the day before normal pension age if earlier, must be compared, respectively, with the accrued widow's, widower's or surviving civil partner's pension under the reference scheme based on the member's pensionable service to that date excluding any pensionable service before the scheme first contracted-out in relation to the State Earnings Related Pension Scheme, or 6 April 1988 if later in the case of female members and surviving civil partners.

- 4.13 For the purpose of comparing the scheme benefits with those under the reference scheme, the following points must be noted:
- 4.13.1 Where a member is not accruing benefits over part or all of the three year period because the member's length of service is such that the member has accrued the maximum pension under the provisions of the scheme then, provided that the member satisfies the relevant conditions laid down in Contracting-out Regulation 28, the member shall be included in the tests of equivalence on the basis that the maximum scheme pension accrues uniformly over the member's potential pensionable service in the scheme, subject to a maximum of 40 years.
 - 4.13.2 If the benefit structure of the scheme is such that an explicit lump sum benefit at retirement is provided (other than by commutation of pension), then the value of this lump sum benefit can be taken into consideration as a member's benefit in determining whether the equivalence test is satisfied.
 - 4.13.3 No account may be taken of death benefits payable in lump sum form.
 - 4.13.4 No account may be taken of any discretionary benefits.
 - 4.13.5 No account may be taken of any benefits which are money purchase benefits.
- 4.14 If it is necessary for the actuary to compare the values of the scheme's benefits and those under the reference scheme, the actuarial assumptions set out in the scheme's Statement of Funding Principles (as defined in the Pensions Act 2004) must be employed, together with such further

assumptions as are necessary to enable the comparison to be made. If, for a particular matter, no assumption is set out in the Statement of Funding Principles, the actuary is free to make any suitable assumption, provided that, overall, the assumptions are reasonable and consistent. In the circumstances where a scheme does not have, or is not required to have, a Statement of Funding Principles, then the actuary must use actuarial assumptions which he or she thinks are reasonable and consistent. The actuary must use the same assumptions to place a value on the scheme's benefits as he or she uses to place a value on the benefits under the reference scheme.

- 4.14.1 For the purpose of assessing the value of the member's benefits from the scheme, the benefit must be assumed payable from the scheme's normal pension age, as defined in 4.10.
- 4.14.2 For the purpose of valuing widows', widowers' and surviving civil partners' death-in-service pensions, the benefits to be valued are those under s 4.9 or 4.12.3 assuming that each member died on the third anniversary of the effective date of certification or the day before normal pension age if earlier.
- 4.14.3 For the purpose of valuing widows', widowers' and surviving civil partners' death-in-deferment pensions, the benefits to be valued are those which would be payable if each member had died at any time after the member was assumed to leave service under 4.10.
- 4.14.4 For the purpose of valuing widows', widowers' and surviving civil partners' death-in-retirement pensions, the benefits to be valued are those which would be payable if each member had died after the scheme normal pension age having left service in accordance with the assumptions made under 4.10. Where the scheme's normal pension age is earlier than age 65, this will mean a comparison between the value of a scheme widow's, widower's or surviving civil partner's death-in-retirement pension and the value of a reference scheme widow's, widower's or surviving civil partner's death-in-deferment (or death-in-service) pension respectively. Where the scheme provides that the widow's, widower's or surviving civil partner's pension on death in retirement is reduced if the member elects to commute part of his or her pension for a lump sum at retirement, then an appropriate reduction in the scheme widow's, widower's or surviving civil partner's pension must be made, broadly consistent with the average experience for the scheme.

5 Ongoing Supervision

- 5.1 For ongoing schemes, the actuary must consider at regular intervals, with effective dates not being more than three years apart, or such longer period as may be specified by Government, whether there are any changes in the membership profile of the scheme which might prevent the scheme from continuing to satisfy the tests of equivalence. If more detailed investigations are considered necessary to form a definitive opinion, the actuary must carry out a full review. SPSS and the trustees or managers must be informed if the

actuary would be unable to provide a fresh certificate based on the latest data, unless the situation is rectified.

- 5.2 Whenever the actuary is informed of any significant changes to the membership, including remuneration patterns, or to the terms of the scheme, consideration must be given as to whether such changes would adversely affect the ability of the scheme to pass the tests of equivalence. In such circumstances the actuary must be satisfied that it would have been possible to certify that the scheme satisfied the tests of equivalence or otherwise pass the test as set out in legislation and in this guidance note immediately following the change and, if not SPSS, the employer and the trustees must be notified, unless the situation has been rectified before notification takes place.
- 5.3 Before a proposed change in the rules of the scheme can be made, Contracting-out Regulation 42 requires the actuary to notify the trustees in writing that the scheme will continue to satisfy the statutory standard after the alteration is made.

Appendix: Northern Ireland Legislation

GB Provision

Sections 12A and 12B of the Pension Schemes Act 1993

Section 37 of the Pension Schemes Act 1993

Section 47 of the Pensions Act 1995

Section 136(5) of the Pensions Act 1995

Section 255 of the Civil Partnership Act 2005

The Occupational Pension Schemes (Contracting-out) Regulations 1996

The Occupational Pension Schemes (Mixed Benefit Contracted-out Schemes) Regulations 1996

NI Provision

Sections 8A and 8B of the Pension Schemes (Northern Ireland) Act 1993

Section 33 of the Pension Schemes (Northern Ireland) Act 1993

Article 47 of the Pensions (Northern Ireland) Order 1995

Article 133(5) of the Pensions (Northern Ireland) Order 1995

Section 255 of the Civil Partnership Act 2005

The Occupational Pension Schemes (Contracting-out) Regulations (Northern Ireland) 1996

The Occupational Pension Schemes (Mixed Benefit Contracted-out Schemes) Regulations (Northern Ireland) 1997