

Offering a default option for defined contribution automatic enrolment pension schemes – public consultation

December 2010

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Part One – Foreword and consultation arrangements

Who this consultation is aimed at

1. This consultation is aimed at all employers, employee representatives and all pension industry professionals, including occupational pension and workplace personal pension scheme administrators, payroll administrators, accountants, payroll bureaux, Independent Financial Advisors and employee benefit consultants. Comments from workers and the general public are also welcome.

Subject of consultation

2. This consultation concerns the use of default options in:
 - workplace personal pensions¹ (WPPs) used for automatic enrolment; and
 - defined contribution occupational pensions used for automatic enrolment.

Purpose of the consultation

3. This document seeks views on the design of default options in workplace personal pensions and occupational pensions used for automatic enrolment, how they are offered, how they are reviewed, the governance arrangements and the communication of the default option, including ongoing communications.

Scope of consultation

4. This consultation applies to England, Wales and Scotland. Northern Ireland will be covered by parallel legislation which will be identical to the final regulations.

Duration of the consultation

5. The consultation period begins on 13 December 2010 and runs until 07 March 2011.

How can you respond to this consultation?

6. This document is available on the Department's website at: www.dwp.gov.uk/consultations
7. Please send your response, preferably by email to:

¹ 'Workplace personal pensions' is an umbrella term covering group personal pensions, group self invested personal pensions and stakeholder pensions.

default.guidanceconsultation@dwp.gsi.gov.uk

Or by post to:

Adam Harper
Department for Work and Pensions
Enabling Retirement Savings Programme
7th Floor
Caxton House
Tothill Street
London
SW1H 9NA

Please ensure your response reaches us by 07 March 2011.

8. When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of a larger organisation, please make it clear who the organisation represents and, where applicable, how the views of members were assembled. We will acknowledge your response.

Queries about the content of this document

9. Any queries about the subject matter of this consultation should be made to Adam Harper at the above address, or telephone 0207 449 7587.
10. We have sent this consultation document to a large number of people and organisations who have already been involved in this work or who have expressed an interest. Please do share this document with, or tell us about, anyone you think will want to be involved in this consultation.

Freedom of information

11. The information you send us may need to be passed to colleagues within the Department for Work and Pensions, published in a summary of responses received and referred to in the published consultation report.
12. All information contained in your response, including personal information, may be subject to publication or disclosure if requested under the Freedom of Information Act 2000. By providing personal information for the purpose of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information which is provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this. We cannot guarantee confidentiality of electronic responses even if your IT system claims it automatically.

13. If you want to find out more about the general principles of Freedom of Information and how it is applied within DWP, please contact:

Central Freedom of Information Team
Department for Work and Pensions,
The Adelphi
1-11 John Adam Street,
London WC2N 6HT
Email: freedom-of-information-request@dwp.gsi.gov.uk

14. More information about the Freedom of Information Act can be found on the website of the [Ministry of Justice FOI pages](#).

The consultation criteria

15. This consultation follows the Code of Practice on Consultation – www.berr.gov.uk/files/file47158.pdf. and its seven consultation criteria which are as follows:
- **When to Consult** – Formal consultation should take place at a stage when there is scope to influence the outcome.
 - **Duration of consultation exercises** – Consultations should normally last for at least 12 weeks, with consideration given to longer timescales where feasible and sensible.
 - **Clarity of scope and impact** – Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence, and the expected costs and benefits of the proposals.
 - **Accessibility of consultation exercises** – Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is designed to reach.
 - **The burden of consultation** – Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
 - **Responsiveness of consultation exercises** – Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
 - **Capacity to consult** – Officials running consultation exercises should seek guidance in how to run an effective consultation exercise, and share what they have learned from the experience.

Feedback on this consultation

16. We value your feedback on how well we consult. If you have any comments on the process of this consultation (as opposed to the issues raised) please contact our Consultation Coordinator:

Offering a default option for defined contribution automatic enrolment pension schemes

Roger Pugh
Department for Work and Pensions' Consultation Coordinator
1st Floor, Crown House
2, Ferensway
Hull
HU2 8NF

Email: roger.pugh@dwp.gsi.gov.uk

In particular, please tell us if you feel that the consultation does not satisfy these criteria. Please also make any suggestions as to how the process of consultation could be improved further.

17. If you have any requirements that we need to meet to enable you to comment, please let us know.
18. The responses to the consultation will be published in 2011 in a report on the DWP website that will summarise the responses and the action that we will take as a result of them.

Part Two – Aims of this guidance, automatic enrolment and the default option

2.1 Aims of this guidance

19. The Department for Work and Pensions is issuing this guidance to set out standards for default options in automatic enrolment defined contribution (DC) pension schemes.
20. It is aimed at providers, advisers, employers and governance committees of automatic enrolment DC pension schemes and sets out the standards which should be met when governing, designing, reviewing and communicating the default option.
21. This guidance has been developed with the support of the Financial Services Authority (FSA) and should be read in conjunction with their requirements on regulated firms; in particular the FSA Principles for Businesses which require firms to pay due regard to their customers and treat them fairly.² The Pensions Regulator (TPR) has been consulted regarding the development of the guidance, and it has been informed by their DC Risks project. This guidance builds on principle four of the Investment Governance Group's DC Principles for Investment Governance³, which states that an appropriately designed default investment strategy should be offered for members who prefer not to make a choice.
22. The guidance is split into two distinct sections; one relating to WPPs and another relating to occupational pension schemes. Although both types of scheme provide default options, the governance and underlying responsibilities differ between WPPs and occupational pension schemes.
23. Adherence with this guidance will be monitored and regulatory steps taken at a later date if necessary.

Q1. Consultation Question: Are the aims of this guidance clear?

² The FSA's Principles for Businesses can be found here
<http://fsahandbook.info/FSA/html/handbook/PRIN/2>

³ The group, established following a National Association of Pension Funds review and Government consultation into the Myners principles, will implement an industry-led framework for the application of the principles.
<http://www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx>

2.2 The Pensions Act 2008 and Automatic Enrolment

24. The Pensions Act 2008 introduces a duty on employers to automatically enrol all eligible jobholders into a qualifying workplace pension scheme from 2012.
25. In order to be used for the purposes of automatic enrolment, a scheme must be a qualifying scheme and must, in addition, satisfy the conditions laid out at section 17(2) of the Pensions Act 2008, which state that a default option must be offered to members.
26. A qualifying scheme is a scheme which meets specific criteria as laid out in the Pensions Act 2008, and could be:
 - an occupational pension scheme, including NEST; or
 - a personal pension scheme, which could be a Group Personal Pension (GPP), a Stakeholder Pension (SHP), or a Group Self-Invested Personal Pension (Group SIPP).
27. This guidance applies to occupational schemes and WPPs that are considered defined contribution (DC) schemes. To be a qualifying scheme, defined contribution pension schemes must meet the following criteria:
 - all benefits provided to the jobholder under the scheme must be money purchase benefits (or the scheme is required to meet the money purchase requirements);
 - the employer must pay contributions equal to or more than 3 per cent of the amount of the jobholder's qualifying earnings in the relevant pay reference period;
 - the jobholder must pay the shortfall between the employer's contribution and 8 per cent of the jobholder's qualifying earnings in the relevant pay reference period; and
 - there must be direct payment arrangements between the jobholder and the employer.

2.3 The default option

28. The default option is a combination of the pension funds and risk management mechanism that is selected automatically for a member joining a pension scheme, unless an alternative is specified.
29. Given that individuals cannot be required to make an active choice when being automatically enrolled, qualifying schemes used for automatic enrolment must have a default option in place.

The importance of the default option

30. It is likely that the vast majority of individuals being automatically enrolled will end up in the default option. Therefore the design, governance and communication of the default option will play an important role.
31. The default option should take account of the characteristics and needs of the employees who will be automatically enrolled into it. It is likely that employees in the default fund will not be engaged in financial decisions. Decisions will need to be taken for them about their risk profile. As such there should be an appropriate balance between risk and return for the likely membership profile and the charging structure should reflect this balance.

Q2. Consultation question: Would it be helpful to include examples illustrating how to create tailored default options to suit different employee profiles?

Q3. Consultation Question: Is the definition of the default option accessible for readers?

Part Three – Default options used for automatic enrolment in workplace personal pensions

Guidance for providers, advisors, employers and governance committees on offering a default option for defined contribution automatic enrolment schemes.

3.1 Governance of the default option

32. The ongoing responsibility for the default option may vary between provider, adviser, employer, and governance committee in different situations and for different aspects of a scheme.

33. The following list highlights stages at which responsibilities should be considered. The following list of examples is not exhaustive:
 - deciding on the suitability of the default option for the membership;
 - designing the default option;
 - monitoring the default fund performance;
 - communicating information about the default option to members;
 - reviewing and/or replacing the default option.

34. For each stage decision makers should consider who is accountable and assign responsibilities to the designated party as appropriate (i.e. provider, intermediary or employer). The box below illustrates two possible scenarios.

35. The roles and responsibilities of the designated party in relation to the default option should be clearly defined and available to members on request; they should be updated when significant changes of governance occur.

Q4. Consultation Question: Bearing in mind the complex nature of responsibilities, is this description acceptable?

Potential scenarios

Example A:

An employer chooses to go directly to a provider to arrange a qualifying pension scheme for their employees. The provider agrees to offer their standard default option to the employees and to hold responsibility for all aspects of the default option.

Example B:

An employer engages an adviser to design a bespoke default option for their employees. The provider agrees to offer the bespoke default option on the proviso that the employer and/or adviser hold certain responsibilities such as ongoing suitability for members and appropriate investment decisions. The responsibilities of all parties should be clearly understood and documented in case there is a change of adviser, if the adviser ceases to be authorised or when an employee leaves service.

3.2 Designing the default option

36. The scheme's default option should be designed with the likely membership profile in mind and should follow the standards set out below:

Objective

- The default option should have a high-level objective, which explains in broad terms what the default option aims to do and the strategy it will use in order to achieve this aim; this should be reflected by its name.
- The overall objective should cover a simple description of the risk management strategy, including what it aims to achieve for member outcomes and how.

Suitability

- In terms of its investment strategy and asset allocation, the default option should, as far as reasonable, take account of the characteristics and needs of employees who will be automatically enrolled into it.

Affordability

- The default option should be appropriately and competitively priced and charges should not be excessive in relation to the services being provided, taking into account the characteristics of each particular scheme.
- Overall charges including scheme charges, adviser charges, consultancy charges and fund charges should be reflected in the design of the fund and should consider members' needs.
- Overall charges should be clearly disclosed and the effect that these charges will have on members' outcomes should be made clear.

Risk management

- Thought should be given to risk throughout the process of designing the default option.
- The default option should have in place a risk management strategy. By this we mean a strategy which mitigates members' investment volatility appropriately over the lifetime of the product, for example, traditional lifestyling, DC banking or target-date funds.
- The risk management strategy should take into account, on reasonable grounds, the retirement profile of members.
- Members should not be locked into the default option. Members should have the ability to opt out of any automatic switching mechanism and switch to alternative funds without incurring excessive charges.

Investment Strategy

- The allocation of assets should be determined with the likely membership profile in mind and should expect to meet the risk and return goals as set out in the default option's objective.
- Thought should be given to asset allocation so that risk is spread. For example, it would not be appropriate for the default option to invest solely in the shares of one company.

Q5: Consultation Question: Should specific examples of risk management strategies be provided?

Q6: Consultation Question: Have we sufficiently described the role of the risk management strategy in the default option and is it accessible for readers?

3.3 Reviewing the default option

37. The review of the default option should be carried out with the membership profile in mind.
38. The design, performance and continued suitability of the default option and its investment strategy should undergo a full review by the designated party at least every three years and when certain events occur. The following list of examples is not exhaustive:
 - change in the charging structure;
 - consistent overperformance or underperformance of the underlying funds used in the strategy against objectives set by the fund manager;
 - significant change of employer structure or member demographic (for example, an acquisition or a merger);
 - significant changes in the financial markets or economy; or
 - significant and relevant legislative changes occur.
39. The default option should also be monitored at regular intervals throughout the year.
40. The review of the default option should look at:
 - ongoing suitability of the default option;
 - ongoing suitability of the charge level;
 - the risk management strategy of the option;
 - the past and expected performance of individual fund components; and
 - whether the performance of individual components is consistent with the overall objective of the default option.
41. The designated party should be able, on demand, to produce proof, such as written documentation, that a review has been carried out. If any action is taken as a result of the review this information should be clearly communicated to members. Similarly if the designated party concludes that it would be inappropriate to make any changes suggested by the review, the reasons for not making those changes should be fully documented and information should be available to members.

Q7. Consultation Question: Does this section set out appropriate standards for reviewing the default option?

3.4 Communicating the default option

42. The Occupational and Personal Pension Schemes (Automatic Enrolment) Regulations 2010 specify that when an individual is automatically enrolled into a WPP they must be given information on the default option as part of the terms and conditions of the personal pension contract.⁴
43. Initial communications to members regarding the default option should include the following:
- a statement setting out the roles and responsibilities of decision makers in relation to the default option;
 - a description of the default option;
 - a statement of the overall objective of the default option with an indication of the risk profile;
 - an explanation of how the objective is going to be achieved, including an explanation of what funds have been chosen and for what reason;
 - an explanation of the management strategy and the aims of that strategy; and
 - an explanation of the risk management strategy and what it aims to achieve. This is especially important given that as the member nears retirement they may realise that de-risking may not be suitable for them if, for example, they are retiring early or late or are taking income drawdown.
44. All of these aspects of the default option should be communicated in a **clear manner** which the membership can understand and via form(s) of media easily accessible for members.
45. After implementation of the default option, certain communications should continue to be available on an ongoing basis, the following list is not exhaustive:
- information about reviews of the default option; and
 - information on de-risking as the member nears retirement.

Q8. Consultation Question: Does this section set out appropriate standards for communicating the default option?

⁴ The FSA's Conduct of Business Rules also prescribes what information must be disclosed at the point of sale for workplace personal pension schemes.

Part Four – Default options used for automatic enrolment in occupational pensions

Guidance for providers, advisors, employers, trustees and governance committees on offering a default option for defined contribution automatic enrolment schemes.

4.1 Governance of the default option

46. The trustees of a pension scheme have the overall and ongoing responsibility for the administration, management and investment decisions within that pension scheme.
47. Where trustees delegate certain functions of the investment governance process, there should be clearly documented terms of reference and reporting processes.
48. The following list highlights stages at which responsibilities should be considered. The following list of examples is not exhaustive:
 - deciding on the suitability of the default option for the membership;
 - designing the default option;
 - monitoring the default fund performance;
 - communicating information about the default option to members; and
 - reviewing and/or replacing the default option.
49. For each stage decision makers should consider who is accountable and assign responsibilities to the designated party as appropriate (i.e. provider, intermediary or employer). The roles and responsibilities of the trustees in relation to the default option should be clearly defined and available to members on request. They should be updated when significant changes of governance occur.

Q9. Consultation Question: Is this an accurate reflection of the roles and responsibilities for trustees regarding the default option?

4.2. Designing the default option

50. The scheme's default option should be designed with the likely membership profile in mind and should follow the standards set out below:

Objective

- The default option should have a high-level objective, which explains in broad terms what the default option aims to do and the strategy it will use in order to achieve this aim; this should be reflected by its name.
- The overall objective should cover a simple description of the risk management strategy, including what it aims to achieve for member outcomes and how.

Suitability

- In terms of its investment strategy and asset allocation, the default option should, as far as reasonable, take account of the characteristics and needs of employees who will be automatically enrolled into it.

Affordability

- The default option should be appropriately and competitively priced and charges should not be excessive in relation to the services being provided, taking into account the characteristics of each particular scheme.
- Overall charges including scheme charges, adviser charges and fund charges should be reflected in the design of the fund and should consider members' needs.
- Overall charges should be clearly disclosed and the effect that these charges will have on members' outcomes should be made clear.

Risk management

- Thought should be given to risk throughout the process of designing the default option.
- The default option should have in place a risk management strategy. By this we mean a strategy which mitigates members' investment volatility appropriately over the lifetime of the product, for example, traditional lifestyling, DC banking or target-date funds.
- The risk management strategy should take into account, on reasonable grounds, the retirement profile of members.
- Members should not be locked into the default option. Members should have the ability to opt out of any automatic switching mechanism and switch to alternative funds without incurring excessive charges.

Investment Strategy

- The allocation of assets should be determined with the likely membership profile in mind and should expect to meet the risk and return goals as set out in the default option's objective.
- Thought should be given to asset allocation so that risk is spread.
- Trustees must comply with the law relating to investment in the sponsoring employer(s) business(es).

Q10: Consultation Question: Have we sufficiently described the role of the risk management strategy in the default option and is it accessible to readers?

4.3 Reviewing the default option

51. The review of the default option should be carried out with the membership profile in mind.
52. The design, performance and continued suitability of the default option and its investment strategy should undergo a full review, instigated by the trustees, at least every three years and when certain events occur. The following list of examples is not exhaustive:
 - change in the charging structure;
 - a majority change of trustees;
 - consistent overperformance or underperformance of the underlying funds used in the strategy against objectives set by the fund manager;
 - significant change of employer structure or member demographic (for example, an acquisition or a merger);
 - significant changes in the financial markets or economy; or
 - significant and relevant legislative changes occur.
53. The default option should also be monitored at regular intervals throughout the year.
54. The review of the default option should look at the:
 - ongoing suitability of the default option;
 - ongoing suitability of the charge level;
 - the risk management strategy of the option;
 - past and expected performance of individual fund components; and
 - whether the performance of individual components is consistent with the overall objective of the default option.
55. The designated party should be able, on demand, to produce proof, such as written documentation, that a review has been carried out. If any action is taken as a result of the review this information should be clearly communicated to members. Similarly if the trustees conclude that it would be inappropriate to make any changes suggested by the review, the reasons for not making those changes should be fully documented and information should be available to members.

Q11. Consultation Question: Does this section set out appropriate standards for reviewing the default option?

4.4 Communicating the default option

56. While it is not a legal requirement for occupational pension schemes to provide information on the default option, we would expect that trustees would ensure that members are given information on the default option in a clear manner.
57. Initial communications to members regarding the default option should include the following:
- a statement setting out the roles and responsibilities of decision makers in relation to the default option;
 - a description of the default option;
 - a statement of the overall objective of the default option with an indication of the risk profile;
 - an explanation of how the objective is going to be achieved, including an explanation of what funds have been chosen and for what reason;
 - an explanation of the management strategy and the aims of that strategy; and
 - an explanation of the risk management strategy and what it aims to achieve. This is especially important given that as the member nears retirement they may realise that de-risking may not be suitable for them if, for example, they are retiring early or late or are taking income drawdown.
58. All of these aspects of the default option should be communicated in a **clear manner** which the membership can understand and via form(s) of media easily accessible for members.
59. After implementation of the default option, certain communications should continue on an ongoing basis. The following list of examples is not exhaustive:
- information about reviews of the default option; and
 - information on de-risking as the member nears retirement.

Q12. Consultation Question: Does this section set out appropriate standards for communicating the default option?

Part Five – Glossary of terms

Default option	The pension funds and risk management strategy options that are selected automatically for a member joining a pension scheme, unless an alternative is specified
Default fund	The assets that form the default option.
Defined contribution scheme	A pension scheme that provides pension scheme benefits based on the contributions invested, the returns received on that investment (minus any charges incurred) and the rate at which the final pension fund is. Sometimes referred to as a money purchase scheme.
Diversification	The spreading of assets within a fund among different asset classes (e.g. Equities, bonds, property) and/or markets (e.g. UK, Europe, Japan) to reduce risk.
Eligible Jobholder	A worker who is working or ordinarily works in Great Britain under a contract of employment, who is aged at least 16 and under 75 and has qualifying earnings.
Group personal pension	An arrangement made by employer for workers to participate in a personal pension arrangement. Each worker has an individual contract with the pension provider. Currently, the employer may or may not make a contribution on behalf of the worker. The employer may also pay the worker's contribution direct from his salary through direct payment arrangement.
Group Self-Invested Personal Pensions	A group personal pension where the contracts are SIPPs rather than personal pensions (see SIPP definition)
Lifestyling	Lifestyling is an approach to investing that automatically switches a member's investments from riskier to safer assets as retirement approaches. Lifestyle funds begin to transition investments a number of years before retirement from 'growth' assets such as equities, which should provide long-term growth but an element of short-term risk, to safer investments such as government bonds and cash, which offer more short-term security.

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Occupational pension scheme	A personal scheme set up in trust by an employer for their staff. Can be either defined benefit, hybrid or defined contribution.
Self-Invested Personal Pension	An arrangement which forms all or part of a personal pension scheme, which gives the member the power to direct specifically how some or all of the member's contributions are invested (as opposed to simply choosing a fund or funds).
Stakeholder Pension	Stakeholder pensions are a type of personal pension. They have to meet certain government standards to ensure they are flexible and have a limit on annual management charges.
Workplace Personal pension	An umbrella term covering Group Personal Pensions, Group Self-Invested Personal Pensions and Stakeholder Pensions.
Target-date fund	A pension fund that switches its underlying investments from more volatile to less volatile assets as a particular target date approaches. For example, a 2040 target date fund will transition its investments from growth assets to safe assets over a specified period leading up to 2040.
Trustee	An individual or company appointed to hold assets for the beneficiaries of a trust-based pension scheme, in accordance with the provisions of the trust instrument, the legal document that sets up, governs or amends the scheme, and general provisions of trust law.