

Guidance for offering a default option for defined contribution automatic enrolment pension schemes

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

1.1 Aims of this guidance

1. 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.
2. This default options guidance is principles-based and is a statement of good practice intended to support existing legislation. By this we mean it sets out high-level, non-regulatory principles to help establish good decision making when developing default options.
3. It is aimed at providers, advisers, employers, trustees of DC schemes, fund managers 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. This guidance is not aimed at default option members themselves, but seeks to promote good practice on their behalf.
4. 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.¹ The Pensions Regulator (TPR) has been consulted regarding the development of the guidance, and it has been informed by their ongoing review of how they regulate DC provision. This guidance builds on principle four of the Investment Governance Group's DC Principles for Investment Governance², which states that an appropriately designed default investment strategy should be offered for members who prefer not to make a choice.
5. The guidance is split into two distinct sections; one relating to Workplace Personal Pensions (WPPs) and another relating to trust-based occupational pension schemes. Although both types of scheme provide default options, the governance and underlying responsibilities differ between WPPs and occupational pension schemes.
6. DWP will be monitoring adherence with this guidance via tools such as the DWP charges survey. The guidance will be reviewed periodically by DWP to ensure that it evolves with experience and consistently reflects good practice. TPR also regularly reviews standards of governance and their findings will feed into DWP's review of the guidance.

¹ The FSA's Principles for Businesses can be found here
<http://fsahandbook.info/FSA/html/handbook/PRIN/2>

² The group, established following a National Association of Pension Funds review and Government consultation into the Myers principles, will implement an industry-led framework for the application of the principles.
<http://www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx>

7. Following a review, if there is strong evidence to suggest that the guidance is being wilfully ignored or that it is not having the desired effect of promoting good practice, DWP may consider issuing statutory instruments to uphold the guidance and protect members' interests.

1.2 The Pensions Act 2008 and Automatic Enrolment

8. The Pensions Act 2008 introduces a duty on employers to automatically enrol all eligible jobholders into a qualifying workplace pension scheme from 2012.
9. 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 members need not express an investment choice. This requires a default option to be available.
10. 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 the National Employment Savings Trust; or
 - a Workplace Personal Pension scheme, which could be a Group Personal Pension (GPP), a Stakeholder Pension (SHP), or a Group Self-Invested Personal Pension (Group SIPP).
11. 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
 - for WPPs, there must be direct payment arrangements between the jobholder and the employer.

1.3 The default option

12. By default option, we mean the investment vehicles that will be selected automatically for a member joining a pension scheme, unless the member specifies an alternative.
13. Given that individuals cannot be required to make an active choice when being automatically enrolled into a pension scheme, qualifying schemes used for automatic enrolment must have a default option in place.

The importance of the default option

14. 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 in securing good outcomes for members.
15. The default option should take account of the likely 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.

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

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

2.1 Governance of the default option

16. The ongoing responsibility for the default option may vary between provider, adviser, fund manager, employer and governance committee in different situations and for different aspects of a scheme.
17. 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 performance of funds within the default option;
 - communicating information about the default option to members; and
 - reviewing and/or changing the default option.
18. 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.
19. The roles and responsibilities of the designated party (or parties) 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.
20. Decision makers may wish to refer to the Investment Governance Group's 'Template for Governance Plan'³ as a possible framework to help establish key investment governance responsibilities and how they may be allocated.

³ <http://www.thepensionsregulator.gov.uk/docs/igg-template-for-governance-plan.pdf>

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. A provider agrees to offer the bespoke default option on the proviso that the employer and/or adviser hold certain responsibilities such as determining 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.

2.2 Designing the default option

21. 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 how the investment strategy will manage risk, including what it aims to achieve for member outcomes.

Suitability

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

Affordability

- The default option should be appropriately and competitively priced for active and deferred members and charges should not be excessive in relation to the services being provided, taking into account the characteristics of each particular scheme.
- A breakdown of the overall charges, including scheme charges, fund charges, expected or actual adviser charges and/or consultancy charges, should be clearly disclosed and should consider members' needs.
- The effect that these charges will have on members' outcomes should be made clear.

Managing Risk – Asset allocation and investment strategy

- As with any DC pension scheme, individuals in the default option will be exposed to investment and other risks. Thought should be given to managing risk to achieve the best outcome for members.
- The default option's investment strategy should manage these risks through the appropriate and diversified allocation of assets. Risk should not be considered in isolation.
- The investment strategy should reflect the overall objective of the default option and the balance between risk and the potential for growth.
- The investment strategy should take into account, on reasonable grounds, the retirement profile of members (i.e. number of years from retirement age).
- Members should not be locked into the default option.

2.3 Reviewing the default option

22. The review of the default option should be carried out with the membership profile in mind.
23. 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.
24. A review may also be appropriate when certain events occur that could be reasonably expected to have an adverse impact on the appropriateness of the default option. The following list of examples is not exhaustive:
 - change in the charging structure;
 - consistent overperformance or underperformance of the underlying funds used in the investment strategy;
 - 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.
25. The performance of the funds within the default option should also be checked informally at regular intervals throughout the year.
26. The review of the default option should look at:
 - ongoing suitability of the default option, including governance arrangements and objective;
 - ongoing suitability of the charge level;
 - the investment strategy of the option;
 - the performance of individual fund components; and
 - whether the performance of individual components is consistent with the overall objective of the default option.
27. The designated party should be able to demonstrate 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.

2.4 Communicating the default option

28. 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
29. This guidance suggests that initial communications to members regarding the default option should include the following:
 - a description of the default option;
 - a statement of the overall objective of the default option with an indication of the risk profile;
 - a disclosure of the charging structure; and
 - clear signposting on how to request further information.
30. Additional information should be available to members on request. The following list is not exhaustive:
 - 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 investment strategy, what it aims to achieve and how it manages risk, particularly as a member nears retirement; and
 - a statement setting out the roles and responsibilities of decision makers in relation to the default option.
31. All of these aspects of the default option should be communicated in a **clear manner** which facilitates member understanding via form(s) of media easily accessible for members.
32. After implementation of the default option, certain communications should continue to be available on an ongoing basis. The following list of examples is not exhaustive:
 - information about reviews of the default option; and
 - information on managing risk as the member nears retirement.

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

Part Three – 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.

3.1 Governance of the default option

33. The trustees of a pension scheme have the overall and ongoing legal responsibility for the administration, management and investment decisions within that pension scheme.
34. Trustees should consider what functions may be delegated. Where trustees delegate certain functions of the investment governance process, there should be clearly documented terms of reference and reporting processes. Under trust law and the trust deed, trustees will still retain overall legal responsibility even when a function has been delegated to a designated party.
35. 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 performance of funds within the default option;
 - communicating information about the default option to members; and
 - reviewing and/or changing the default option.
36. The roles and responsibilities of the trustees in relation to the default option should be available to members on request. They should be updated when significant changes of governance occur.
37. Trustees may wish to cross refer to the Investment Governance Group's 'Template for Governance Plan'⁵ as a possible framework to help establish key responsibilities and how they may be allocated.

⁵ <http://www.thepensionsregulator.gov.uk/docs/igg-template-for-governance-plan.pdf>

3.2. Designing the default option

38. 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 how the investment strategy will manage risk, including what it aims to achieve for member outcomes.

Suitability

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

Affordability

- The default option should be appropriately and competitively priced for active and deferred members and charges should not be excessive in relation to the services being provided, taking into account the characteristics of each particular scheme.
- A breakdown of the overall charges, including scheme charges, fund charges, expected or actual adviser charges and/or consultancy charges, should be clearly disclosed and should consider members' needs.
- The effect that these charges will have on members' outcomes should be made clear.

Managing Risk – Asset allocation and investment strategy

- As with any DC pension scheme, individuals in the default option will be exposed to investment and other risks. Thought should be given to managing risk to achieve the best outcome for members.
- The default option's investment strategy should manage these risks through the appropriate and diversified allocation of assets. Risk should not be considered in isolation.
- The investment strategy should reflect the overall objective of the default option and the balance between risk and the potential for growth.
- The investment strategy should take into account, on reasonable grounds, the retirement profile of members (i.e. number of years from retirement age).
- Members should not be locked into the default option.

3.3 Reviewing the default option

39. The review of the default option should be carried out with the membership profile in mind.
40. 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.
41. A review may also be appropriate when certain events occur that could be reasonably expected to have an adverse impact on the appropriateness of the default option. 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 investment strategy;
 - 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.
42. The performance of the funds within the default option should also be checked informally at regular intervals throughout the year.
43. The review of the default option should look at the:
 - ongoing suitability of the default option, including governance arrangements and objective;
 - ongoing suitability of the charge level;
 - the investment strategy of the option;
 - the performance of individual fund components; and
 - whether the performance of individual components is consistent with the overall objective of the default option.
44. The designated party should be able to demonstrate 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.

3.4 Communicating the default option

45. 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.
46. This guidance suggests that initial communications to members regarding the default option should include the following:
 - a description of the default option;
 - a statement of the overall objective of the default option with an indication of the risk profile;
 - a disclosure of the charging structure; and
 - clear signposting on how to request further information.
47. Additional information should be available to members on request. The following list is not exhaustive:
 - 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 investment strategy, what it aims to achieve and how it manages risk, particularly as a member nears retirement; and
 - a statement setting out the roles and responsibilities of decision makers in relation to the default option.
48. All of these aspects of the default option should be communicated in a **clear manner** which facilitates member understanding via form(s) of media easily accessible for members.
49. 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 managing risk as the member nears retirement.

Part Four – Glossary of terms

Default option	The investment vehicles that are selected automatically for a member joining a pension scheme, unless the member specifies an alternative.
Defined contribution scheme	Occupational or personal pension schemes where contributions made into the scheme are invested into one or more investment funds. Sometimes referred to as a money purchase scheme.
Diversification	The reducing of risk by spreading investment across a range of different asset classes (e.g. Equities, bonds, property) and/or markets (e.g. UK, Europe, Japan).
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 SIPP's rather than personal pensions (see SIPP definition)
Occupational pension scheme	A pension 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.

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.

Workplace Personal pension

An umbrella term covering Group Personal Pensions, Group Self-Invested Personal Pensions and Stakeholder Pensions.

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