

Offering a default option for defined contribution automatic enrolment pension schemes

Government response to the consultation

24 May 2011

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Section 1: introduction

1. The Pensions Act 2008 introduces a duty on employers to automatically enrol all eligible jobholders into qualifying workplace pension provision from 2012. 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. It is likely that the vast majority of individuals being automatically enrolled will end up in the default option.
2. It is therefore essential that the default option is a sound and suitable investment savings vehicle for individuals. The decisions taken by providers and trustees, and where appropriate employers and advisors, will determine the success of the default option.
3. We feel that setting out good practice in guidance is the best method to promote successful default options and achieve good member outcomes. We need to allow pension products to evolve and therefore do not seek to be overly prescriptive; but we also want to make clear the behaviours we expect to see concerning default options which will protect individuals and support the pension reforms.
4. We have worked closely with the pensions community and have conducted extensive research to understand what existing good practice there is and reflect this in the guidance. We have also worked closely with the Financial Services Authority (FSA) and the Pensions Regulator (TPR) in drafting the guidance and their consultations on the changing nature of the DC landscape.
5. This guidance forms part of the Government's wider work programme to make sure the regulatory environment after 2012 supports the aims of automatic enrolment and maximises individuals' retirement savings. This work includes looking closely at how early leavers are treated in pension schemes, such as through the short service rules, and making transfers of small pension pots easier. The Government issued a Call for Evidence on these issues recently, and we intend to release a response in the Summer outlining next steps.

Section 2: consultation

6. On 13 December 2010 we published draft guidance on 'Offering a default option for defined contribution automatic enrolment pension schemes'. The consultation closed on 7 March 2011.
7. We received 40 formal written responses to this consultation and we are grateful to everyone who replied. We also met with pension providers, industry professionals and consumer groups before, during and after the consultation. We are grateful to all those who gave so generously of their time to discuss the issues and share ideas and suggestions. A list of organisations that responded to the consultation is at Annex A.
8. All stakeholders stressed the importance of the default option and the overwhelming majority of stakeholders supported the need for the guidance; for both workplace personal pension schemes and trust-based occupational schemes. It was acknowledged that the document had to find a balance between protecting members' interests and promoting good practice, while also reflecting how the pension market operates and allowing industry the freedom to innovate. We have tried to meet this balance within the revised guidance.
9. This document is available on the DWP website at:

<http://www.dwp.gov.uk/consultations/2010/dc-default-option-consult.shtml>

A paper copy of this document can be obtained from:

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Section 3: responses to the consultation

10. There were a number of key concerns raised in several responses which, due to their broad focus, did not fit easily within any set consultation question. We have addressed these topics at the outset as they inform later sections of the government response.

Governance of the default option in workplace personal pensions

The guidance states that, for workplace personal pensions, ‘decision makers should consider who is accountable and assign responsibilities to the designated party as appropriate’.

Stakeholder response to the consultation

11. Several stakeholder responses requested clarity around the allocation of responsibilities and raised hypothetical scenarios for which the guidance does not make clear with whom final responsibility will lie. There were concerns that the guidance places too much responsibility on employers, which isn’t reflected in contract law.

Government response

12. The guidance does not intend to prescribe responsibilities that are above or beyond what is expressed in existing law, where the workplace personal pension exists as a contract between the provider and the individual members of the pension scheme.

13. However, in practice, decisions about the design and running of the default option may be taken not just by providers, but also by advisers engaged in the process as well as employers who wish to be engaged in the setting up of a default fund. Our research and engagement with stakeholders on default options in WPPs tells us that the nature of these relationships can vary from situation to situation¹. Allocating responsibility for each and every scenario is beyond the remit of the guidance and would contradict the principles-based nature of the guidance.

14. We believe that robust and clear governance in workplace personal pension schemes is critical to securing good outcomes for members. Therefore we would expect that, in all instances, responsibilities for designing, monitoring, communicating and reviewing the default option are clearly articulated and agreed on by all parties. So the guidance makes

¹ Dobson, C. et al., (2010) Default Options in Workplace Personal Pensions: Report of a Qualitative Study. DWP Research Report 628.

clear that, from the outset, decision makers should decide among themselves who has responsibility for what and that this is documented.

15. We will be working with stakeholders to monitor the effectiveness of the guidance and how it is being followed in practice. If there is a case for expanding the guidance to make it more detailed in this area we will examine this closely and consider incorporating suggestions into later reviews of the document.

Monitoring adherence with the guidance

The guidance states that 'adherence with this guidance will be monitored and regulatory steps taken at a later date if necessary'.

Stakeholder response to the consultation

16. Several stakeholders expressed concerns as to how the guidance will be monitored and what criteria would have to be met for regulatory steps to be taken at a later date and what those steps may be.

Government response

17. We have expanded the guidance to state that DWP will be monitoring adherence with the guidance using tools such as the DWP's charging survey. TPR also regularly reviews standards of governance and their findings will feed into DWP's review of the guidance.
18. We have set out more clearly our approach to evaluating the success of the guidance. This will include a regular review of the guidance to allow it to evolve as the pensions landscape changes and make sure it remains useful and achieves its objectives. Any change to the guidance will take place following such a review, and stakeholder engagement. If there is sufficient evidence that the guidance is not promoting good practice (widespread excessive charges for example), we will consult with stakeholders on how best to achieve good practice via regulation.
19. Adherence with the guidance will also be covered by the Department's plans to fully evaluate the success of the reforms and how they are delivered.

Deferred members in workplace personal pensions

Consumer groups suggested that changes be made to the affordability and design sections of the guidance to ensure that both active and deferred members of workplace personal pensions are treated fairly.

Stakeholder response to the consultation

20. Consumer organisations stressed that workplace personal pension schemes ought to be able to prove that the default option is serving all members of a workplace personal pension fairly, specifically around the issue of charges.

Government response

21. The Government appreciates the impact that high charges have on an individual's pension and we do not want to see either active or deferred members exposed to excessive charging levels.

22. That is why in the guidance we have stressed that the default option should be appropriately and competitively priced, and that charges should not be excessive in relation to the services being provided. We have expanded this part of the guidance to highlight that this principle should be applied to both active and deferred members of workplace personal pensions.

23. This is an area that we will monitor closely in our evaluation of the guidance.

Q.1 – We asked whether the aims of the guidance are clear.

Stakeholder response to the consultation

24. The majority of stakeholders agreed that the aims of the guidance were clear, but that the status and scope of the guidance could be developed further.

25. Some stakeholders asked for clarification on certain issues including:

- whether the guidance set additional or higher standards for pension schemes than already established.
- the target audience.
- whether the guidance could better compliment the *Principles for Investment Governance of Defined Contribution Work-based Pension Schemes*, developed by the Investment Governance Group (IGG).

Government response

26. We previously stated that the guidance had been issued to set out standards for default options in automatic enrolment defined contribution (DC) pension schemes.

27. This remains true, but we agree that it would be helpful for the scope and status of the guidance to be better presented. We also feel that, in setting

out these clarifications, reading of the governance and design principles will be placed in a better context.

28. To improve understanding of the aims, scope and intentions of the guidance, and in line with stakeholder responses, we have:
- made it explicitly clear in the guidance that the document is a principles-based document concerned with promoting 'good practice'.
 - briefly described what a default option should aim to achieve.
 - clarified that DWP will review the guidance document periodically, to ensure that the guidance evolves with experience and consistently reflects good practice.
 - provided more detail on the target audience.
29. The IGG sets out best practice principles for investment governance, including detailed advice about the design and management of the default option. The DWP guidance builds on this platform, setting out standards we, as Government, expect providers and decision makers to follow to ensure the default option is sound and suitable for members.
30. We have amended the guidance to cross-refer to the IGG's *Principles for Investment Governance of Defined Contribution Work-based Pension Schemes* explicitly and therefore compliment existing the good foundations laid by the IGG in this space.

Q.2 – We asked if it would be useful to include examples illustrating how to create tailored default options to suit different employee profiles.

Stakeholder response to the consultation

31. Stakeholder opinion was split on the issue of examples. Some expressed the view that examples would be helpful; to aid employers' understanding of what is meant by 'membership profile' for instance.
32. Others identified the risks associated with setting out examples; they might be mistakenly perceived as an 'industry standard' or could stifle innovation. There was also a question of whether sufficient analysis was available to provide credible examples.

Government response

33. The draft guidance contained no examples of tailored default options for different employee profiles. We have continued with this approach for the guidance.

Q.3 – We asked whether the definition of the default option is accessible for readers.

Stakeholder response to the consultation

34. Stakeholder responses to this question were mixed. Some were content with the draft description. The majority felt that it would be satisfactory with minor amendments, such as if ‘investment vehicles’ were to replace ‘pension funds’. A small number of stakeholders requested a more in depth description; one which mentioned both ‘risk’ and ‘return’, as well as having a greater focus on how risk is managed.

Government response

35. We have decided to amend the description of the default option to take into account improvements suggested by stakeholders.

36. This section now simplifies the definition of the default option, in line with stakeholder comments.

Q.4 – We asked whether, bearing in mind the complex nature of workplace personal pensions, our description of how governance arrangements should be carried out is acceptable.

Stakeholder response to the consultation

37. The governance section of the guidance attracted a wide range of comments, reflecting the importance of this issue. While many stakeholders felt that the description of the responsibilities was adequate, many posed several ‘what if’ scenarios which questioned where final responsibilities would lie in contract based situations.

Government response

38. Principles-based guidance, by its nature, has only a limited capacity to resolve detailed hypothetical questions. In order to answer many of the questions posed in the stakeholder responses it is likely that regulatory steps would need to be taken. At this stage we do not believe that regulatory steps are necessary in this area, as we do not want to restrict the flexibility for providers, employers and advisers to design a default option that suits the specific needs of scheme members. Rather, we want to see good practice encouraged and reinforced, which is why we have taken a principles-based approach in the guidance. We believe the key standard to follow here is that accountabilities are clearly agreed on – for all aspects of the default option – and that this is well documented. This is in line with the approach taken by the Investment Governance Group.

39. We therefore feel that the guidance as it currently stands goes as far as is practicable in describing the complex nature of responsibilities surrounding the default option in workplace personal pension schemes. Whether further steps can be taken on this issue will be examined when the guidance is reviewed, with stakeholder input.

Q.5 – We asked whether specific examples of risk management strategies should be provided.

Stakeholder response to the consultation

40. Again there was a mixed response on the topic of examples. Some stakeholders stated that examples would improve the guidance; others that there are risks involved in doing so. The key danger highlighted was that outmoded strategies for managing risk could be chosen because they are in the guidance, which could result in poor member outcomes.

Government response

41. We have therefore continued to avoid using examples in this section and have emphasised a principles-based approach to managing risk in the design sections

Q.6 & Q.10 – We asked whether we have sufficiently described the role of the risk management strategy in the default option and if it was accessible for readers.

Stakeholder response to the consultation

42. The consultation responses on this topic focussed on several key concerns:

- that our interpretation of risk management was too narrow.
- that it was overly concerned with limiting investment volatility, rather than volatility in retirement income.
- that the guidance should stress that risk should be balanced and not considered in isolation.
- that the risk management strategies mentioned in the guidance are not the only ones that are valid and that this should be reflected in the text.
- that the phrase 'risk management' is a potentially inaccurate term.

Government response

43. The draft guidance stated that the default option should have a risk management strategy, by which we mean a strategy which mitigates members' investment volatility over the lifetime of the product.

44. In line with stakeholder responses, we propose to broaden and simplify the section on managing risk to reflect a more principles-based approach which provides better protection for members' interests. This section now focuses on the investment strategy and allocation of assets to manage risk and achieve the best outcomes for members.

45. The phrase 'risk management' was considered to encompass a wide range of areas, including operational and technical, which are not the focus of the guidance. The revised wording focuses on managing investment and other risks via investment strategies and asset allocation.

Q.7 & Q.11 – We asked whether we had set out appropriate standards for reviewing the default option.

Stakeholder response to the consultation

46. The majority of stakeholders felt that our approach for reviewing the default option was appropriate and proportionate. There were several comments suggesting we make it clear that reviewing the default option may be appropriate, rather than automatic, when certain events occur.

47. A large number of stakeholders asked for more clarity around what 'monitored at regular intervals' would mean in practice.

Government response

48. The guidance lays out good practice for when a review may be appropriate and what it should look at.

49. We have amended the guidance to emphasise that reviews may be appropriate when listed events occur, but are not mandatory.

50. By 'monitoring' we mean an informal check of the performance of the funds by the designated party between full reviews. We have amended the guidance to reflect this.

51. This point now focuses on checking the performance of the funds rather than the entire default option to avoid short-term thinking on the whole default option.

Q.8 & Q.12 – We asked whether we had set out appropriate standards for communicating the default option.

Stakeholder response to the consultation

52. Several stakeholders felt that the communications requirements in the guidance were excessive for members of the default option. There was also a sense that existing legislation covered much of the member disclosure requirements.

Government response

53. We have amended the guidance to streamline the amount of information initially relayed to members. However, we have stressed that this information should be available on request to allow members to engage should they wish to do so.

54. The Government is also reviewing the existing legislative requirements which require pension schemes to disclose information to members and others (recognised Trade Unions, for example). We are intending to consult on this later in 2011.

Q.9 – We asked whether we had accurately reflected the roles and responsibilities of trustees regarding the default option.

Stakeholder response to the consultation

55. Stakeholders were broadly supportive of the description of trustees' roles and responsibilities as laid out in the guidance. Minor points were raised on the use of the word 'trustee' rather than 'designated party'

Government response

56. We have amended the guidance to state that the trustee retains overall responsibility for the scheme, even after delegating responsibilities.

57. In line with stakeholder responses, we have also stressed that trustees will have final responsibility for the default option, even in cases where the action has been delegated to a designated party.

Section 4: conclusion and next steps

58. The pensions landscape is changing. It is likely that post-2012, automatic enrolment into DC schemes, and default options, will be the norm. This guidance seeks to encourage good practice on behalf of those individuals who will be affected by such change.

59. We will be monitoring adherence to the guidance via our own internal research and our evaluation of the overarching reforms. We will continue to engage with stakeholders on how the guidance is being used and the extent to which it is being followed. This will be in preparation for a review of the guidance as part of the evaluation of the reforms during which we will again engage with stakeholders.

60. We have published the guidance in conjunction with this government response.

Annex A: list of respondents

ABI
ACA
Aegon
Alliance Bernstein
APL
Aviva
BBS Consultants
Capita Hartshead
CFEB
CIPP
Dimensional Fund Advisors
EEF
Fidelity
Friends Provident
Heath Lambert
HSBC Bank Pension Trust
HSBC Insurance
ICAEW
IMA
Jaguar Land Rover
JLT Benefit Solutions
Law Society of Scotland
Legal and General
Mercer
NAPF
PMI
Randstad UK
Mr Richard Fleet
Sacker & Partners
Scottish Life and Royal London Group
Scottish Widows
SPC
Standard Life
Supertrust UK
Tesco
TISA
TPAS
TUC
Which?
Zurich