DWP Department for Work and Pensions

The use of vesting rules and default options in occupational pension schemes

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Background

This report provides the findings from a study conducted by RS Consulting on behalf of the Department for Work and Pensions (DWP), examining the use of two aspects of trust-based defined contribution (DC) pension schemes: vesting rules and default options. Both elements of this research will help DWP understand more about how trust-based DC pension schemes operate in the run-up to the implementation of the workplace pension reforms in 2012.

Vesting rules and default options

Vesting rules for trust-based DC pension schemes specify the period of time that an active member must wait after joining, before they become entitled to benefits under the scheme. The current rules stipulate that employees that leave a trust-based pension scheme with between three months and two years of pensionable service may not receive full benefits, and so trustees may give them the choice of a short service refund or a transfer of the fund to a new scheme. While a transfer includes all employee and employer contributions, the refund includes only the employee contributions, with the employer contributions refunded back to the scheme.

A pension scheme's default options represent the fund choice and lifestyling options that are selected automatically for a member joining a pension scheme if they do not choose an alternative. At present it is not compulsory for an employer with a trust-based DC scheme to provide a default option, but after the reforms are implemented every pension scheme that an eligible job-holder could be automatically enrolled into will have to have one. This research was in part used to inform the government's draft guidance on default options in trust-based DC schemes, which was published for consultation in December 2010.[1] The guidance itself will be published in spring 2011.

Methodology

The study was qualitative in nature, and consisted of in-depth, face-to-face interviews with 41 participants, including:

- Twenty-four employers that had set up and operated a trust-based DC pension scheme, some of whom also acted as pension scheme trustees;
- Ten providers that offered trust-based DC pension schemes to employers;
- Seven intermediaries that advised employers on trust-based DC pension schemes.

Interviews were conducted in August and September 2010 with the senior individual within each company best placed to discuss trust-based DC pension scheme strategy.

Research findings

Scheme decision-making roles and responsibilities

Trust-based pension schemes are regulated under UK trust law. This means that trustees have a legal responsibility for the administration, management and investment decisions for a particular pension scheme.

[1] Department for Work and Pensions (2010). Offering a default option for defined contribution automatic enrolment pension schemes – public consultation.

Within the employers in this study, the trustees were usually a mix of senior and more junior employees. They were very rarely experts in pensions or finance. Typically the larger organisations had dedicated pensions managers who assisted the trustees with scheme administration and management, and these pensions managers often had specialist pensions knowledge. However, trustees within the smaller employers often did not possess any particular financial expertise.

In practice this meant that trustees, especially in smaller companies, were heavily reliant on their intermediaries' advice for most aspects of running the scheme, including the setup of the scheme vesting rules and the design of the default option.

Pension providers did not take part in scheme decision-making, but rather were instructed by the trustees or intermediaries as to a particular course of action. Providers occasionally attended trustee meetings if asked to report on investment performance or explain particular investment options.

Vesting rules and their application

In most cases the scheme vesting rules were incorporated into the overall scheme rules that had initially been set up by the trustee board and intermediary. These typically stated that:

- If an employee left in the first three months of pensionable service the employee was refunded only their employee contributions;
- If an employee left between three months and two years of pensionable service the employee was offered a choice between a refund of the employee contributions, or a transfer of employee and employer contributions to a different pension scheme.

A minority of participating employers allowed full vesting rights or permitted a transfer from the first day of joining the scheme.

Typically employers allowed between three and six months for the leaver to make a decision. If employees did not make a decision within the prescribed period, the default was usually to process a short service refund. Employers, providers and intermediaries generally agreed that the majority of employees tended to opt for a short service refund rather than a transfer into a different pension scheme, even though this effectively meant that they sacrificed the employer contributions.

The very large employers, typically with over 1,000 employees, and some smaller employers with high staff turnover, processed large numbers of short service refunds. In these cases the accrued refund pots were large enough to be of importance to the employer. Typically the trustees waited for the pot to reach an appropriate size before discussing in the next trustee meeting how to use the funds. Uses included:

- Paying for the general running costs of the scheme;
- Offsetting employer pension contributions;
- Intermediary advice, a review, or a communication exercise.[2]

The largest employers with high staff turnover said that the rules played an important role in allowing them to continue to offer their employees a trust-based pension scheme rather than a contract-based pension. Otherwise employers did not typically see the refund pot as being very significant, and some had not processed enough refunds to have considered what they might use the funds for.

Some employers offered pension contributions under a salary sacrifice arrangement. This meant that all contributions were treated as employer contributions, and if an employee left before the end of the vesting period no short service refund was due back to the employee. In most cases employers were careful to communicate this fact beforehand, and some avoided the situation by not targeting salary sacrifice at workforces with a high staff turnover, or not allowing employees to opt into salary sacrifice until they had been a pension scheme member for two years.[3]

Objectives and design of the default option

The objectives of the default options of the employers in the study were very similar: to provide a safe and balanced investment option that would achieve long-term growth for the member. However, there was variation in terms of how to achieve this objective. The design of the default fund depended largely upon when the trustees and intermediaries last formally reviewed the fund's objectives and design.

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[2] Further details on reviews and scheme communications can be found in Chapter 5 of the main report.

[3] Further details on salary sacrifice options can be found in Section 3.4 of the main report.

Less knowledgeable trustee boards within smaller employers had often not formally reviewed the default option in recent years, and so the fund make-up was frequently out of line with current practices, and may not have taken into account the current membership profile. Employers in this group were typically invested 100 per cent in equities, and many of these were invested in the UK only, a practice that had generally been avoided in recent years, according to intermediaries.

Where the fund had been set up or reviewed in the past three years or so, there was more variation between employers, investing in differing proportions of equities versus safer investments such as bonds. In these cases, the equities usually had wider geographical diversity. Intermediaries typically considered the profile of the workforce in designing the default, taking into account factors such as:

- Trustees' views as to their workforce's attitude to risk;
- Employee turnover;
- Contribution levels and salary;
- Job role and industry sector;
- The age profile of the employees.

Most of the employers in the study used a lifestyle fund within the default option, which automatically switches a member's investments from riskier to safer assets as retirement approaches. Among the employers in this study:

- Default funds that had not been reviewed in the past three years typically began the transition in the last five years before the expected retirement date;
- Default funds that had been reviewed in the past three years typically began the transition somewhere between five and ten years before the retirement date.

Intermediaries commonly reported that transition periods of ten to 15 years were becoming increasingly popular, with a more gradual transition into safer investments happening over a longer period.

Default option charges

This research explored two of the charges associated with the default option: intermediary charges and provider and fund management charges.

Intermediary charges were typically a flat fee, and were paid directly by the employer. Two models of charging were common, the annual retainer and the per-hour charge. The intermediary fees were related to all aspects of advice associated with the scheme, and so it was not possible to isolate costs relating specifically to the default option.

Provider and fund management fees were charged to the member, and were bundled together as a single annual management charge (AMC), calculated as a percentage of the value of the fund. The AMC applied to the default options of most of the employers in this study was between 0.4 per cent and 0.6 per cent, with the larger employers typically offering lower AMCs than smaller employers due to economies of scale. The very largest employers were often able to negotiate AMCs of below 0.4 per cent.

Intermediaries pointed out that it is good practice for employers to consider the AMC when choosing the most appropriate default option for their members. While all the employers who reviewed the default option stated that they did take the AMC into consideration, the majority also pointed out that the AMC was of relatively low importance in comparison to fund performance when deciding upon a provider.

Default option governance and reviews

Employers and intermediaries generally agreed that, within the schemes' trustee bodies, there were no formalised processes for setting out who was responsible, and when, in designing, operating, and winding up the default option. In practice this meant that where it was necessary to assign a specific task in relation to the default fund – for example, monitoring fund performance or leading a review of the fund's continued suitability for their membership profile, the responsibilities were allocated on an ad-hoc basis.

In most cases the nature and the frequency of the default fund reviews depended on the size of the employer. Typically, employers with more than around 100 employees took a structured approach to the default option reviews. They typically had regular, formal processes in place to ensure that the default fund was appropriate to their members' needs. These reviews included looking at both the investment strategy itself and the lifestyling options.

Employers with fewer than 100 employees tended not to conduct regular, formal default option reviews. Some had never formally reviewed their default option, while a minority was reviewing them for the first or second time when this study took place, largely in response to poor recent investment performance.

Possible future developments in default funds

Many providers and intermediaries noted that default options in trust-based DC pension schemes have changed significantly over the past ten years. The typical asset allocation has developed from funds that were invested entirely in equities and often in just one country, to a wider range of asset classes with wider geographical diversity. The typical lifestyling period also appears to have been increasing from five years to ten years or longer.

Providers and intermediaries typically felt that the changes seen in default fund design over the last ten years would be likely to continue. Further changes were expected to happen in several areas, including:

- A more flexible lifestyling process that reflects the current trend towards flexible retirement;
- Increased protection against stock market falls;
- Changes likely to be brought about by NEST (National Employment Savings Trust), including the possible use of target date funds.

Areas to be included in the draft guidance

Smaller employers, particularly those with less knowledgeable trustee boards that had not reviewed their default fund recently, were often unable to assess the areas where they felt they would need guidance on the default fund. Once again, they assumed that their intermediary would keep them up to date on any relevant information.

Providers and intermediaries stressed that the guidance should outline what areas trustees should look at in designing and maintaining a default option, but not prescribe the features of the fund or just become a box-ticking exercise. Providers, intermediaries and medium and large employers generally agreed that the guidance should cover the following areas:

- The fact that schemes should always have a default option;
- The default option should take into consideration the risk profile of employees;
- The default option should review its objectives and asset allocation on a regular basis;
- The roles of the trustees, provider and adviser should be made clear;
- Communications to members should take place on a regular basis.

The full report of these research findings is published by the Department for Work and Pensions (ISBN 978 1 84712 923 9. Research Report 725. March 2011).

You can download the full report free from: http://research.dwp.gov.uk/asd/asd5/rrs-index.asp

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