

# Research report

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

by Andrew Wood, Peggy Young and  
Dominika Wintersgill

Department for Work and Pensions

Research Report No 725

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

Andrew Wood, Peggy Young and Dominika Wintersgill

A report of research carried out by RS Consulting Ltd on behalf of the Department for Work and Pensions

© Crown copyright 2011.

You may re-use this information (not including logos) free of charge in any format or medium, under the terms of the Open Government Licence.

To view this licence, visit <http://www.nationalarchives.gov.uk/doc/open-government-licence/> or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: [psi@nationalarchives.gsi.gov.uk](mailto:psi@nationalarchives.gsi.gov.uk).

This document/publication is also available on our website at:  
<http://research.dwp.gov.uk/asd/asd5/rrs-index.asp>

Any enquiries regarding this document/publication should be sent to us at:  
Department for Work and Pensions, Commercial Support and Knowledge Management Team,  
Work and Welfare Central Analysis Division, 3rd Floor, Caxton House, Tothill Street, London SW1H 9NA

First published 2011.

ISBN        978 1 84712 923 9

Views expressed in this report are not necessarily those of the Department for Work and Pensions or any other Government Department.

# Contents

Acknowledgements.....	vi
The Authors .....	vii
Abbreviations .....	viii
Glossary .....	ix
Summary .....	1
1 Introduction .....	6
1.1 Policy background.....	6
1.1.1 <i>The workplace pension reforms</i> .....	6
1.1.2 <i>Vesting rules</i> .....	6
1.1.3 <i>Default options</i> .....	7
1.2 Research aims and objectives .....	8
1.3 Methodology.....	8
1.3.1 <i>The recruitment process</i> .....	9
1.3.2 <i>Fieldwork</i> .....	10
2 Scheme design, operation and decision-making: roles and responsibilities.....	11
2.1 The trust-based DC pension schemes featured in this study .....	11
2.1.1 <i>Employers</i> .....	11
2.1.2 <i>Providers</i> .....	12
2.1.3 <i>Intermediaries</i> .....	13
2.2 Scheme roles and responsibilities.....	13
2.2.1 <i>Role of the trustees</i> .....	13
2.2.2 <i>Role of the intermediary</i> .....	14
2.2.3 <i>Role of the provider</i> .....	14
3 Vesting rules and their application.....	15
3.1 Scheme vesting rules.....	15
3.2 The procedure used when an employee leaves .....	16
3.2.1 <i>Communicating with scheme leavers</i> .....	16
3.2.2 <i>Approach when a leaver does not make a choice between refund and transfer</i> .....	17
3.2.3 <i>The decisions typically taken by leavers</i> .....	17

3.3	Employers' use of short service refunds.....	18
3.3.1	<i>Very large employers and employers with high staff turnover .....</i>	18
3.3.2	<i>Small and medium-sized employers that did not have a high staff turnover.....</i>	19
3.4	Vesting rules in the context of salary sacrifice arrangements .....	19
3.5	Views on the current vesting rules .....	20
3.5.1	<i>Views of very large employers and employers with high staff turnover....</i>	20
3.5.2	<i>Views of smaller and medium-sized employers that did not have a high staff turnover.....</i>	21
3.5.3	<i>Views of providers and intermediaries .....</i>	22
3.6	Possible future developments and the impact of automatic enrolment.....	22
4	Objectives and design of the default option .....	23
4.1	Options given to an employee on joining a scheme.....	23
4.1.1	<i>Employers that offer a default option alongside other options .....</i>	24
4.1.2	<i>Employers that offer a default option and no other options.....</i>	25
4.1.3	<i>Employers that offer no default option .....</i>	25
4.2	Objectives of the default option.....	26
4.3	Default option design: recent trends.....	26
4.3.1	<i>Default option design prior to 2002 .....</i>	27
4.3.2	<i>Default option design between 2002 and 2007.....</i>	28
4.3.3	<i>Default option design since 2008 .....</i>	28
4.4	Factors taken into account by intermediaries in designing the default option .....	29
4.5	Default fund design.....	31
4.5.1	<i>Design where the scheme has been set up or reviewed in the past three years.....</i>	31
4.5.2	<i>Design where the scheme has not been set up or reviewed in the past three years .....</i>	31
4.6	Lifestyling within the default option .....	32
4.7	Default option charges.....	33
4.7.1	<i>Intermediary and administrator charges .....</i>	33
4.7.2	<i>Provider and fund management charges .....</i>	33

5	Default option governance communication .....	35
5.1	Default option governance and responsibilities .....	35
5.2	Default option reviews .....	36
5.2.1	<i>The approach of larger employers</i> .....	36
5.2.2	<i>The approach of smaller employers</i> .....	38
5.3	Default option communications .....	38
5.3.1	<i>Approaches taken to communication</i> .....	38
5.3.2	<i>Perceived adequacy of current communications</i> .....	39
5.3.3	<i>Possible future developments in communications</i> .....	40
6	Default funds: future developments and need for guidance .....	41
6.1	Current and future developments in the design of the default option .....	41
6.1.1	<i>Flexible retirement</i> .....	42
6.1.2	<i>Downside protection</i> .....	43
6.1.3	<i>The possible impact of NEST</i> .....	44
6.2	Awareness of existing guidance on default options.....	45
6.3	Initial reactions to the government's proposed guidance .....	46
6.4	Views on areas to be included in the government's proposed guidance .....	46
6.4.1	<i>Schemes should always have a default option</i> .....	47
6.4.2	<i>The default option should take into consideration the risk profile of employees</i> .....	47
6.4.3	<i>The default option should review its objectives and asset allocation on a regular basis</i> .....	48
6.4.4	<i>The roles of the trustees, provider and adviser should be made clear</i> .....	48
6.4.5	<i>Communications to members should take place on a regular basis</i> .....	48
6.4.6	<i>Other minority views</i> .....	48
6.5	Views on areas to be avoided in the government's proposed guidance.....	49
7	Conclusions and policy developments .....	50
7.1	Vesting rules .....	51
7.2	Default options.....	51
	Appendix A Methodological appendix.....	53
	Appendix B Materials used in conducting the research.....	54
	References .....	74

# Acknowledgements

We would like to thank the Department for Work and Pensions (DWP) for supporting this piece of research.

Laura Andrews has been responsible for liaison between DWP and RS Consulting, has provided valuable support and guidance throughout this study and has ultimately ensured a successful project. We would also like to thank John Stafford and Jane Francis for their valuable contributions to this study, as well as their colleagues in the Industry and Scheme Policy Team.

Finally, we would like to thank the 41 employers, providers and intermediaries who generously gave their time to participate in this research. While all of the participants in the study must remain anonymous, we hope they will recognise in the findings a reflection of their own circumstances as they see them today, and of their expectations for the future.

# The Authors

**Andrew Wood, Research Director**, specialises in public policy and financial sector research, for both public and private sector clients. He has run many high-profile studies for the Department for Work and Pensions (DWP), covering different aspects of the international pensions landscape, the UK pension reforms, retirement saving and decision-making. He read Modern and Medieval Languages at the University of Cambridge.

**Peggy Young, Associate Director**, has been undertaking research in the financial sector, for both public and private sector clients, for more than 25 years. Specialising in qualitative techniques she has played a major role in other pensions-related studies for clients including DWP and the Association of British Insurers (ABI).

**Dominika Wintersgill, Project Manager**, has five years' experience of public policy research, including projects for DWP, HM Revenue & Customs, the Office for National Statistics, the Home Office and the Department for Culture, Media and Sport. She read Culture and Society at the London School of Economics and Cultural Studies with German at the University of East London.

# Abbreviations

ABI	Association of British Insurers
AMC	Annual Management Charge
DB	Defined Benefit
DC	Defined Contribution
DWP	Department for Work and Pensions
EBC	Employee Benefits Consultants
FSA	Financial Services Authority
GPP	Group Personal Pension
HR	Human Resources
IGG	Investment Governance Group
NEST	National Employment Savings Trust
SPA	State Pension Age
SSAS	Small Self Administered Scheme
TCF	Treating Customers Fairly
TPR	The Pensions Regulator
WPP	Workplace Personal Pension

# Glossary

Active investment strategy	An attempt to out-perform the market by selecting and trading specifically chosen investments. There are a number of strategies that an active investor may use, and the fund management charges are usually higher than a <b>passive investment strategy</b> .
Active member	A <b>member</b> who is currently accruing benefits in a pension scheme, usually because employer and/or employee pension contributions are being paid on a regular basis.
Annual management charge	A charge levied annually by a pension provider on a <b>member's pension fund</b> to cover the costs associated with providing that pension. The charge is usually levied as a percentage of the total fund value.
Automatic enrolment	Pension scheme enrolment technique whereby an employer automatically enrolls <b>eligible workers</b> in the <b>workplace pension scheme</b> without the employees having to make a separate application for membership. Employees are able to opt out of the scheme if they prefer.
Closed scheme	A pension scheme that does not admit new <b>active members</b> , but contributions may still be made by existing members and/or the employer.
Contract-based pension scheme	A <b>defined contribution (DC)</b> pension scheme purchased by an individual, either through their employer or individually, from a pension provider. It is owned entirely by the individual with the contract existing between the individual and the pension provider.
Default option	The <b>pension funds</b> and <b>lifestyling</b> options that are selected automatically for a <b>member</b> joining a pension scheme, unless an alternative is specified.
Default fund	The assets that form the <b>default option</b> .
Deferred member	A person who is no longer an <b>active member</b> but who still has benefits in the scheme, usually because they have left their employer after they have achieved full <b>vesting</b> rights.
Defined benefit scheme	An <b>occupational pension</b> scheme that provides benefits based on a formula involving how much a person is paid at retirement (or how much a person has been paid on average during their membership of the scheme) and the length of time they have been in the pension scheme.

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 <b>pension fund</b> is annuitised.
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.
Diversified growth fund	An actively managed fund, designed by the fund provider to provide similar returns to equities, but with reduced volatility. The fund can invest in a very broad array of asset classes and countries to achieve this aim.
Eligible worker	In the context of the <b>workplace pension reforms</b> this refers to those workers that will be <b>automatically enrolled</b> into a <b>qualifying workplace pension scheme</b> .
Employee Benefit Consultant	An organisation that provides regulated financial advice to its clients on the use of pensions and other financial products. In the context of this report, they are a type of <b>intermediary</b> .
Group personal pension	An arrangement made for the employees of a particular employer, or for a group of self-employed individuals, to participate in a <b>personal pension</b> scheme on a grouped basis.
Group stakeholder pension	A <b>personal pension</b> that must meet certain legislative conditions including <b>annual management charges</b> of no more than 1.5 per cent. Employers with five or more employees who do not already offer a pension scheme must currently offer a group stakeholder pension scheme. These employers do not have to contribute to a group stakeholder pension but they must allow employees access to the scheme. Stakeholder pensions will cease to be mandatory after the <b>workplace pension reforms</b> are introduced.
Independent Financial Adviser	An adviser, or firm of advisers, that is in a position to review all the available products and companies in the market as the basis for recommendations to clients. All IFAs are regulated directly by the Financial Services Authority (FSA).
Intermediary	An <b>IFA</b> or <b>employee benefit consultant</b> that provides regulated financial advice to its clients on the use of pensions and other financial products. All intermediaries as defined in this report are regulated directly by the FSA.

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.
Mandatory retirement age	An age, which may be set out in a contract of employment, at which an employer can require an employee to retire. Employees can retire at an earlier age if they choose. At the time of fieldwork, employers could set this no lower than 65.
Master trust	A multi-employer <b>trust-based pension</b> scheme, which enables investors to combine their assets for greater leverage.
National Employment Savings Trust (NEST)	An occupational pension scheme, formerly known as Personal Accounts, established by legislation. NEST will be aimed at <b>eligible workers</b> on moderate to low incomes, who do not have access to a good-quality <b>workplace pension</b> .
Occupational pension	In this report, an occupational pension is synonymous with <b>trust-based pension</b> .
Passive investment strategy	An approach to investment that requires limited maintenance by the investment manager. It is designed with the intention of long-term appreciation, and does not attempt to out-perform the market. They usually invest in <b>tracker funds</b> , and fund management charges are usually lower than an <b>active investment strategy</b> .
Pension Schemes Act 1993	An act which consolidated certain enactments relating to pension schemes. In the context of this study, the act set out the current <b>vesting</b> rules for trust-based pension schemes.
Pensions Act 2008	The Act introduced to Parliament in December 2007 to take forward measures aimed at encouraging greater private saving for retirement from 2012. A system of <b>automatic enrolment</b> into a qualifying pension scheme meeting the quality requirement will provide eligible workers who are not currently enrolled in a <b>workplace pension</b> with an opportunity to save for retirement.
Provider	An organisation, usually a bank, life assurance company or building society, that sets up and administers a pension scheme on behalf of an individual or trust.

Qualifying earnings	In the context of the <b>workplace pension reforms</b> this refers to the part of an individuals' <b>earnings</b> on which contributions into a <b>qualifying workplace pension</b> will be made.
Qualifying employer	In the context of the <b>workplace pension reforms</b> this refers to employers that employ any <b>eligible workers</b> .
Qualifying workplace pension	In the context of the <b>workplace pension reforms</b> all <b>qualifying employers</b> must offer their <b>eligible workers</b> a qualifying workplace pension. This is a scheme that must fulfil the core requirements of <b>automatic enrolment</b> and the quality criteria set out in the <b>Pensions Act 2008</b> .
Salary sacrifice	Under salary sacrifice, an employee agrees to give up the right to receive part of their salary, usually in return for the employer's agreement to provide the employee with some form of non-cash benefit. In the case of pensions, the employer pays additional contributions into the employee's pension of a value equivalent to the amount of salary sacrificed.
Short service refund	If an individual ceases to be an <b>active member</b> of a <b>trust-based</b> scheme, or deed poll structure, before the end of the <b>vesting period</b> , the employer may in certain circumstances process a short service refund, whereby the employee contributions are refunded back to the employee, less tax, and the employer contributions are refunded back to the scheme.
Small Self-Administered Scheme	A company scheme where the <b>members</b> are usually all company directors or key staff, and all of the members are <b>trustees</b> of the scheme.
State Pension Age	The state retirement pension is currently paid to people who reach the SPA of 65 for men and 60 for women and who fulfil the conditions of the National Insurance contributions. At the time of fieldwork, legislation was in place to increase the SPA for women to 65 by 2020, and to 66 for both men and women by 2026.
Target-date fund	A <b>pension fund</b> 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.
Treating Customers Fairly (TCF)	All firms regulated by the FSA have to support the FSA Handbook's principle that a firm 'must pay due regard to the interests of its customers and treat them fairly'. The TCF principle aims to raise standards in the way firms carry on their business by introducing changes that will benefit consumers and increase their confidence in the financial services industry.

---

Tracker fund	An investment fund designed to follow the performance of a particular index. How successfully it does this can be quantified by its tracking error.
Trust-based pension	A pension scheme taking the form of a trust arrangement, which means that a board of trustees is set up to govern the scheme. Benefits can be either DC or defined benefit.
Trustee	An individual or company appointed to govern a <b>trust-based</b> 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, for the benefit of scheme members.
Vesting period	The period of time that a member must wait after joining a <b>trust-based</b> scheme, before they become entitled to benefits under the scheme. If they cease to be an <b>active member</b> before the end of the vesting period, their contributions may be refunded or transferred to a new scheme.
Workplace pension	Any pension scheme provided as part of an arrangement made for the employees of a particular employer.
Workplace pension reforms	The reforms introduced as part of the Pensions Act 2008: the measures in the Act include a duty on employers to automatically enrol all <b>eligible workers</b> into qualifying <b>workplace pension</b> provision from 2012 to improve pension saving for those who participate. DB and some hybrid schemes must meet a test of overall scheme quality; and DC schemes and some hybrid schemes require a minimum contribution equivalent to eight per cent of qualifying earnings.

# Summary

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.

## Background

While it is known that the workplace pension reforms will have a significant impact upon the UK pensions landscape from 2012, DWP has identified two particular areas relating to the operation of trust-based DC schemes that necessitate further understanding: 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.<sup>1</sup> The guidance itself will be published in spring 2011.

## Scope of the research

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.

---

<sup>1</sup> Department for Work and Pensions (2010). Offering a default option for defined contribution automatic enrolment pension schemes – public consultation. Available at: <http://www.dwp.gov.uk/consultations/2010/dc-default-option-consult.shtml>

## Key findings

### **Background: 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.

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 set up 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;
- 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<sup>2</sup>.

---

<sup>2</sup> Further details on reviews and scheme communications can be found in Chapter 5.

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.<sup>3</sup>

## **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.

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;
- 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.

---

<sup>3</sup> Further details on salary sacrifice options can be found in Section 3.4.

## **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.

# 1 Introduction

This report provides the findings from a study conducted by RS Consulting on behalf of the Department for Work and Pensions (DWP). This report examines two elements of trust-based defined contribution (DC) pension schemes: the use of 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.

This chapter outlines the policy background to the study, the aims and objectives of the research, and finally the methodological approach taken.

## 1.1 Policy background

While it is known that the workplace pension reforms will have a significant impact upon the UK pensions landscape from 2012, DWP has identified two particular areas relating to the operation of trust-based DC schemes that necessitate further understanding: vesting rules and default options. In this section we summarise the workplace pension reforms, as well as the two policy areas.

### 1.1.1 The workplace pension reforms

The Pensions Act 2008 sets out a series of measures aimed at encouraging wider participation in private pension saving. The aims of these reforms are to overcome the decision-making inertia that currently characterises many individuals' attitudes to pension saving and to make it easier for people to save for their retirement.<sup>4</sup>

The measures in the Act include a duty on employers to automatically enrol all eligible workers into qualifying workplace pension provision from 2012 and to provide a minimum contribution towards the pension saving of those individuals who participate.

Employees will be able to choose whether to remain in the pension scheme or opt out of it. For all those that remain, the reforms will require DC schemes to provide a minimum contribution equivalent to eight per cent of qualifying earnings. At least three per cent of this contribution must come from the employer, and unless the employer chooses to contribute more than three per cent, employees will be required to contribute a further four per cent on the same band of earnings, while the government will contribute around one per cent in the form of normal tax relief.

In addition, the Act set up NEST (National Employment Savings Trust), which will serve as a new national new low-cost workplace pension scheme. This scheme will be one of the qualifying schemes available to any employer who wants to use it to meet their new duties.

### 1.1.2 Vesting rules

The current vesting rules for trust-based DC pension schemes were set out in the Pensions Schemes Act 1993.<sup>5</sup> A scheme's vesting rules specify the period of time that an active scheme member must wait after joining, before they become entitled to benefits under the scheme. If they cease to be an active member before the end of the vesting period, they may not be entitled to full benefits.

---

<sup>4</sup> Department for Work and Pensions (2009). Workplace Pension Reform – Completing the Picture: Executive Summary – Policy Narrative.

<sup>5</sup> The full wording of the act can be found at:  
<http://www.legislation.gov.uk/ukpga/1993/48/contents>

The Act stipulates the following minimum requirements:

- If an individual ceases to be an active member within three months of joining a scheme, the trustees are not obliged to offer the individual any benefits under the scheme. The trustees may process a short service refund, whereby the employee contributions are refunded back to the employee, less tax, and the employer contributions are refunded back to the scheme. The individual then ceases to be a member of the scheme.
- If the individual ceases to be an active member with at least three months but less than two years of pensionable service, the employer must also offer the option of a transfer of the pension fund to a new scheme. A transfer into a new scheme would include both the employee contributions and the employer contributions. The individual may still choose a short service refund if they wish, which would include only the employee contributions. Schemes are able to give a short service refund as a default if an employee does not make a decision within a reasonable time.
- If the individual reaches two years of pensionable service, they must be given full vesting rights, meaning the benefits of the plan cannot be revoked. If the individual ceases to be an active member they become a deferred member.

The Pension Schemes Act 1993 stipulates the minimum requirements that the scheme must offer. They may allow employees more generous terms if they wish, i.e., they may allow a transfer to a new scheme after less than three months, or may allow full vesting rights after less than two years.

### 1.1.3 Default options

A pension scheme's default options represent the fund choice and lifestyling options that are selected automatically for a member joining a pension scheme, unless an alternative is specified. At present, it is not compulsory for an employer with a trust-based DC scheme to provide a default option. An employer may, for example, require all joiners to actively select a pension fund before they can join.

After the workplace pension reforms are implemented, the terms of automatic enrolment will mean that individuals can be enrolled into a pension scheme without making any active choices, including any active choice with regard to investment options. This will mean that, under the new rules, every pension scheme that an eligible job-holder could be automatically enrolled into will have to have a default fund option in place. All eligible employees will be enrolled into the default option unless they have made an active choice of investment.

In 2009, DWP consulted on guidance on the use of default options in workplace personal pensions (WPPs).<sup>6</sup> This draft guidance set out minimum standards surrounding the use of default options in contract-based workplace pensions that were to be used for automatic enrolment.

The principles set out in the draft DWP guidance cover the following areas:

- Objectives of the default option, explaining its aims and strategy.
- Suitability: ensuring the default option is suitable for the majority of scheme members, in terms of its investment strategy and asset allocation.
- Affordability: ensuring the default option is appropriately and competitively priced.

---

<sup>6</sup> Department for Work and Pensions (2009). *The use of Default Options in Workplace Personal Pensions and the use of Group Self Invested Personal Pensions for Automatic Enrolment*.

- De-risking mechanism: ensuring that the default option has a way of transferring assets into safer investments as retirement approaches.
- Asset allocation: ensuring that the default option is invested in a diversified portfolio of assets.
- Governance: holding regular reviews and communicating effectively with scheme members.

In occupational schemes, the trustees are responsible for determining the overall investment strategy and for the choice of funds offered to scheme members. At the time this study was conducted the equivalent guidance on default options in trust-based DC pension schemes was being developed.

## **1.2      Research aims and objectives**

This research study was designed to gather the views of employers, providers and intermediaries about current practices within trust-based DC pension schemes.

With regard to the scheme vesting rules, this research aimed to:

- assess how the vesting rules are interpreted and put into practice;
- understand the factors determining employers' behaviour in relation to short service refunds;
- explore the attitudes of employers, providers and intermediaries to the vesting rules;
- gauge the likelihood of changes in behaviour after the pension reforms have been implemented.

The research was also designed to inform the consultation documents on the use of default fund options in trust-based DC pension schemes.<sup>7</sup> Specifically its aims in this regard were to:

- gather the views of employers, providers and intermediaries on the current use of default options, to inform the content of DWP guidance;
- gain an understanding of emerging and future practices;
- gather information regarding existing guidance and rules on default options in trust-based DC pension schemes;
- draw together the views of employers, providers and intermediaries on future default option guidance.

## **1.3      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;
- ten providers that offered trust-based DC pension schemes to employers;
- seven intermediaries that advised employers on trust-based DC pension schemes.

---

<sup>7</sup> The consultation was published after the completion of fieldwork for this study, in December 2010: Department for Work and Pensions (2010). Offering a default option for defined contribution automatic enrolment pension schemes – public consultation. Available at: <http://www.dwp.gov.uk/consultations/2010/dc-default-option-consult.shtml>

A qualitative research approach was considered to be the most effective way to achieve the study objectives and explore opinions and practices in detail. Because the research was qualitative, rather than quantitative, its purpose was not to report on the number or percentage of individuals or organisations holding a particular view or having a particular set of experiences, nor to provide statistical data relating to the frequency of views across the UK. Instead, it explored a range of opinions in depth.

Fieldwork took place in August and September 2010. Participants' views may have changed since the fieldwork took place, and may change in the future.

This section summarises the methodology; further detail is available in Appendix A.

### **1.3.1 The recruitment process**

Employers were selected at random from a sample of trust-based DC pension schemes that was provided by The Pensions Regulator (TPR). In the case of providers and intermediaries, the research aimed to interview as many of the top 20 UK trust-based pension providers and the top 20 employee benefits consultants (EBCs) as possible, to ensure that the greatest market coverage could be gained through the interviews conducted. The sample frames were constructed based on information from a variety of sources.<sup>8</sup>

A specially designed set of screening questions ensured that the participating employers' trust-based DC schemes were open to new members, because discussions about default options and vesting rules were only relevant to those schemes that new employees were able to join.<sup>9</sup>

The screening questions also ensured that we recruited a spread of different scheme sizes (see Appendix A.1 for the full breakdown). Schemes with fewer than 12 members were excluded from the study, because trust-based DC schemes under this size are extremely rare, except for small, self-administered schemes (SSAs). These fall outside of the scope of this study, because the members are usually all company directors or key staff, and all of the members are trustees of the scheme, which means no investment decisions are made by trustees on behalf of other members.

Where employers, providers or intermediaries matched the recruitment criteria and were willing and able to give up the time to commit to a face-to-face interview, the recruitment team sent them an introductory letter from DWP and a summary of the topics that would be discussed.<sup>10</sup>

All participants were assured that all of the information discussed in the interview would remain confidential to the RS Consulting research team and would only be reported in aggregate form; it would not be attributed to specific individuals or organisations, either in presentations to DWP or in this final report.

### **1.3.2 Fieldwork**

Interviews were conducted in late August and September 2010 by the RS Consulting management team.

In case of employers, the interviews were conducted with the most senior person responsible for the pension scheme. These typically included Pensions Managers, HR Managers and Financial Directors.

---

<sup>8</sup> Sources included the Association of British Insurers (ABI), Presswatch, information held by the DWP policy team and listings of leading providers and intermediaries from published research reports.

<sup>9</sup> This screener is available as Appendix B of this report.

<sup>10</sup> The materials sent to participants are available in Appendix B of this report.

## **10      Introduction**

---

Many of the participants were also scheme trustees or secretary to the scheme trustees.

Interviews with providers and intermediaries were conducted with senior decision-makers responsible for trust-based DC pension strategy. The interviewees' job roles included Pensions Policy Manager, Head of DC Pensions and Head of Technical Marketing and Research.

A common discussion guide was used for all of the individual depth interviews: the full guide can be found in Appendix B.

# 2 Scheme design, operation and decision-making: roles and responsibilities

Before examining vesting rules and default options in detail, it is important to understand the nature of the trust-based defined contribution (DC) pensions included in this study. If an employer chooses to set up a trust-based scheme, a board of trustees is responsible for providing members with a safe and secure investment framework. Consequently the employers featured in this study typically saw themselves as far more ‘paternalistic’ than the average UK employer, in that they felt more responsibility for ensuring that all of their employees had access to high-quality pension provision.

Section 2.1 provides background on the schemes used by the employers in this study, as well as the schemes offered by the providers and intermediaries interviewed. Section 2.2 will then examine where the roles and responsibilities lie in terms of setting the rules and running a trust-based DC pension scheme.

## 2.1 The trust-based DC pension schemes featured in this study

This section introduces the types of pension scheme offered by the employers, providers and intermediaries participating in this study.

### 2.1.1 Employers

The employers participating in this study typically used their trust-based DC scheme as their primary pension scheme open to new joiners to the company. This did not mean that it was necessarily the only pension scheme in operation, or even that the majority of current employees were members of the DC scheme. Most of the employers in this study also had a defined benefit (DB) pension scheme, which had been closed to new joiners at some point between five and 15 years ago. These employers reported that it had become unfeasible for them to sustain the liabilities of the DB scheme, and so they had decided to switch new joiners to a trust-based DC scheme instead.

*‘We have got several DB schemes which are open to accrual but closed to new members. When I say new members I mean all members. It doesn’t matter whether they are top level execs, nobody gets into the DB scheme. It’s completely closed.’*

(Employer, 1,000 members or more)

In a minority of cases employers had also frozen the DB scheme, preventing new DB accruals for existing members and making new contributions into the DC scheme instead.

A minority of participating employers had never operated a DB scheme; instead they had operated a trust-based DC scheme since the start of the company’s existence. A minority of employers also operated contract-based schemes alongside the trust-based DC scheme. The different schemes were designed for different groups of employees, such as:

- contract-based DC pensions that were used for a specific element of the workforce. This included, for example, an industry-wide contract-based stakeholder pension designed for workers in the construction industry;

- self-invested personal pensions, designed for senior staff only, or high earners with some level of financial confidence and knowledge.

The desire of these employers to provide a good trust-based pension for their employees came across strongly in the interviews. Most of the participating employers said that although they had been ‘forced’ by financial necessity to close their DB scheme, they still wanted to maintain control over the running of the scheme and keep the decision-making in-house. Most employers felt that a trust-based scheme offered this greater level of control thanks to the trustee board, which was made up of company directors and other employees: they were therefore seen to be better equipped to look after their members’ interests.

*‘It basically arose out a feeling that they wanted a trustee body with a bit more involvement and oversight. The shift from DB to DC was already shifting quite a responsibility onto the shoulders of the membership.’*

(Employer, 1,000+ members)

### 2.1.2 Providers

A pension provider is an organisation, typically an insurance company, a bank, or a building society, that devises, sets up and administers a pension scheme. In the context of trust-based schemes, the provider performs these services on behalf of the board of trustees set up by the employer. Typically the provider offers the trustee board a wide range of investment options, each of which is managed by a fund manager (either in-house or external to the provider), from which the trustees can select a number of funds to offer their members.

This study included some of UK’s largest pension providers. Most of the participating organisations offered a very wide variety of pension options, although we focused only on trust-based DC schemes. In the context of this study, there were two broad types of trust-based DC scheme offered by the providers in this study:

- **single-employer solutions**, offered by most of the providers and used by all of the employers in this study. Under this arrangement each employer is responsible for setting up and maintaining their own trustee board;
- **multi-employer solutions**, also referred to as master trusts, offered by a minority of providers in this study. These are multi-employer occupational pension schemes, which the provider manages under a single account. The trustees are professionals that are usually employed by the provider. This means that employers under this arrangement are not required to set up their own trustee boards, and investment decision-making does not need to take place at employer level.<sup>11</sup>

Providers often reported that trust-based solutions in fact accounted for a small proportion of their new pension business in comparison to the work-based personal pension market, and in rare cases they reported that they did not actively sell new schemes, and merely maintained their existing business.

*‘At the moment trust-based schemes we don’t actively sell. We used to be active in the market, but have broadly withdrawn from all occupational pension provision. At the moment there doesn’t seem to be a compelling business case for re-entering.’*

(Provider)

---

<sup>11</sup> Because investment decision-making does not need to take place at employer level, we did not include employers with master trusts as participants in this study.

### 2.1.3 Intermediaries

The intermediaries in this study were the organisations that provided regulated financial advice to the scheme trustee boards on the use of their DC pensions. This included advice as to the scheme vesting rules and default options, and in some cases the intermediaries also offered wider administration and member communications services to employers.

Most of the participating intermediaries advised on a range of pension solutions, including trust-based DC pension schemes. When prompted about master trusts, most said that these were not a significant area of focus, typically considering them to be a niche product. As a result most were not frequently recommending master trusts to their clients at the moment. While they insisted that they closely followed developments in the master trust market, they were unsure as to whether such schemes would increase in popularity. Many felt that the wider trust-based pension market would continue to decline as more employers switched to contract-based solutions, and master trusts would be no exception. Nevertheless, some saw a possibility that the master trust market could slowly grow if employers with trust-based schemes saw value in outsourcing their trustee board to specialists.

## 2.2 Scheme roles and responsibilities

This section explores the roles and responsibilities involved in the decision-making and operation of trust-based DC pension schemes. While the main decision-making responsibilities rested with the scheme trustees, intermediaries played a key advisory role, upon which the trustees were usually heavily dependent; whereas the providers were not directly involved in scheme decision-making, and essentially acted upon instructions given by the trustees or intermediary.

### 2.2.1 Role of the trustees

All trust-based pension schemes are regulated under UK trust law. This means that trustees of a pension scheme have a legal responsibility for the administration, management and investment decisions within a particular pension scheme. In short, they have a duty in law to act in the best interests of scheme members. They often delegate responsibilities such as communication or administration and usually use professional advice; however the overall responsibility remains with the trustees.

The trustees were usually a mix of senior and more junior employees of the companies interviewed, and so 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 pension managers often had specialist pensions knowledge. However, the smaller employers said that their trustees did not possess any particular financial expertise, and often they were daunted by the responsibilities of being a trustee.

*'The employee nominated trustee went through all the things we are now responsible for – "If you don't do this you can go to jail" – and she was actually horrified. You have to be doing something fairly fundamentally wrong to go to jail, but it's quite a lot of responsibility to put on people who aren't legally trained or perhaps not financially trained. You've probably done this because you're seen as a good spokesperson for the business, or people trust you, but that doesn't necessarily mean you've got the right qualifications.'*

(Employer, 12 to 99 members)

In practice this meant that trustees, especially in smaller companies, were heavily reliant on their intermediaries' advice for most aspects of running the scheme.

### 2.2.2 Role of the intermediary

Employers and intermediaries agreed that intermediaries were critical to the running of most trust-based schemes, even though they were not ultimately responsible for them. They were central to the set up of the scheme rules and the design of the default option. They would regularly take part in trustee meetings, where they would be responsible for providing specialist advice, and they led the analysis of the scheme's investment performance.

Some intermediaries, depending on the arrangements made with an employer, would also be responsible for scheme administration or for communicating with scheme members.

### 2.2.3 Role of the provider

Pension providers did not take part in scheme decision-making, but rather were instructed by the trustees or intermediaries on a course of action.

*'[Scheme decision-making] is not our role per se. We give the trustee the choice. Within our policy document there is that choice so it is literally down to the individual trustees, possibly with the consultation of the intermediary, because they have quite a big influence.'*

(Provider)

Providers occasionally attended trustee meetings if asked to report on investment performance or explain particular investment options, where their main role was to provide information rather than advice to employers and intermediaries.

The situation was different in the case of master trust providers, because the investment decisions were made by professional trustees that were attached to the provider rather than the employer. As the provider offered an integrated service including trustees, scheme provision and fund provision, the key decisions were taken by the provider rather than the employer: this removed the need for the employer to use an intermediary for these functions.

# 3 Vesting rules and their application

This chapter examines the use of vesting rules in trust-based defined contribution (DC) pension schemes. The Pensions Schemes Act 1993 specifies the minimum vesting rules that schemes can use. Employees that leave a trust-based pension scheme within the first three months of pensionable service have the right to a short service refund of their employee contributions only. If they leave employment between three months but before two years of pensionable service, they must also be given the option of a transfer of the full fund value to a new scheme, which will include employee and employer contributions; however, schemes are able to give a short service refund as a default if an employee does not make a decision in a reasonable time. After two years of pensionable service, members have full vesting rights. Section 1.1.2 explains these rules in more detail.

This chapter examines how these vesting rules were interpreted and put into practice by the participating employers. It also investigates provider and intermediary views as to the current vesting rules and their experiences of how employers interpret these rules.

## 3.1 Scheme vesting rules

Most of the employers interviewed were aware of their scheme's vesting rules. These were incorporated into the overall scheme rules that were initially set up by the trustee board and intermediary. In most cases the schemes' vesting rules were in line with those prescribed in the 1993 Act:

- 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 short service refund of the employee contributions, or a transfer of employee and employer contributions to a different pension scheme.

*'If they leave within three months then they have a refund of their own contributions and not the company's. If they leave after three months but less than two years then they have the right to transfer their value or receive a refund of their own contributions. [...] After two years they can leave their money where it is in the scheme.'*

(Employer, 100 to 999 members)

A minority of participating employers used alternatives to the above rules:

- Some employers gave full vesting rights from the first day of joining the scheme. This approach was occasionally used by employers that had a majority of unionised staff, or in cases where existing defined benefit (DB) schemes were being frozen to new accruals and existing members' new accruals were moved to a new trust-based DC scheme.
- Some employers permitted a transfer of funds to a different pension scheme from the first day of joining the scheme, instead of after three months of pensionable service.

A minority of the participating employers were unsure of their scheme's vesting rules. This was particularly the case among employers operating fairly small schemes of fewer than around 100

members, as well as among some larger organisations with a low staff turnover. This was because they reported having little experience of dealing with early leavers. Not needing to apply the vesting rules meant employers were often unable to recall details of the short service refund rules set out in their scheme.

*'I can't think that I've been in that situation. People join here and stay here.'*

(Employer, 12 to 99 members)

The participating providers and intermediaries interviewed agreed with the majority of the employers, that it was rare for employers to deviate from the standard vesting rules set down in law. Intermediaries generally reported that it was also rare for them ever to suggest adopting an alternative approach.

*'That would come under the scheme rules. We wouldn't say to them "You must follow a certain course." Because it is written in their own trust it would be the scheme rules that dictate that.'*

(Provider)

Providers reported that they had no involvement in setting the scheme vesting rules.

### 3.2 The procedure used when an employee leaves

In this section we describe how options around vesting rules are communicated to employees departing with between three months' and two years' service, who therefore need to decide between a short service refund and a transfer to a new scheme.

#### 3.2.1 Communicating with scheme leavers

Employers broadly followed the same procedure when dealing with leavers that had not yet accrued full vesting rights. Employers informed the leaver in writing as to the fact that they could choose between a short service refund and a transfer to another scheme. This included information on the value of the refund they could receive, excluding employer contributions, and the value of the transfer, including employer contributions. Additionally, the letter set out a period of time during which the leaver had to inform the employer about their decision, either by returning a form within a prescribed period, or in some cases by contacting a particular person in writing.

*'We communicate it in the leaving letter. When somebody leaves it says "You will be paid until X and this is what your holiday is, and this is what happens with your pension, and this is what your choices are."*

(Employer, 100 to 999 members)

The period of time allowed for an employee to make a decision appeared to vary somewhat, and many employers were unsure of the period of time allowed. Typically, employers allowed between three and six months for the leaver to make a decision, although there was some variation from this. Some suggested that they might wait indefinitely for a reply from the employee before transferring or processing a refund, although they could not generally recall a scenario where an employee had taken a very long time to respond. Additionally, some employers sent out reminders to leavers after a set period if they had not made a decision.

#### 3.2.2 Approach when a leaver does not make a choice between refund and transfer

In most cases employers had a default approach in place if employees did not make a decision

within the prescribed period, and this was to process a short service refund.

*'They give them an open option first and then if they don't do anything they give them the cash back.'*

(Employer, 1,000 members or more)

Intermediaries pointed out that this was the only possible default option under this scenario, since an employer could not by default process a transfer to another scheme if the employee did not tell them which scheme they wished to transfer to.

The only exception to this approach was in the minority of cases where the company allowed full vesting rights as soon as a member joined the scheme. In this scenario, the default position was usually to treat the ex-employee as a deferred member, until the employer or the administrator was informed by the leaver of their request to transfer or receive a short service refund.

*'Our default is that you haven't told us you want to transfer, so therefore your default is you are deferred.'*

(Employer, 100 to 999 members)

### 3.2.3 The decisions typically taken by leavers

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 approach effectively meant that they sacrificed the employer contributions.

*'The vast majority take a refund. If there is a refund option they take it.'*

(Employer, 1,000+ members)

Although most employers were reluctant to suggest reasons for this, some intermediaries pointed out that short term views tended to dominate, with the immediate need (or desire) for money outweighing the potential increase in their pension pot. Others pointed out that it might simply be a result of the fact that employees do not get around to transferring, or that some may not be a member of another scheme in time to ask for a transfer.

Some reported that it was more common for older employees, who were closer to retirement age, to choose to transfer the fund to another pension scheme, both because the need to build up a good pension pot was more urgent and because they were more likely to have alternative arrangements in place already. In addition, employers that currently offered pensions under a salary sacrifice arrangement also reported that their employees tended to opt for a transfer, because under this system all contributions would be classed as employer contributions, and so no short service refund would be due.

*'I would say very few take the refund option. There are two reasons for that. One very good reason is they lose the value of the employee benefit so it is usually only done if somebody is really hard up for money, but also we have a flexible benefits scheme where people can pay their pension contributions via salary sacrifice. If they do that they have not actually made any employee contributions at all so there would be nothing to refund.'*

(Employer, 1,000 members or more)

Section 3.4 further examines how short service refunds operate within schemes offering salary sacrifice.

### 3.3 Employers' use of short service refunds

If an employee leaves their employer with less than two years' pensionable service and chooses a short service refund, they receive only their employee pension contributions back. The employer contributions are refunded back to the scheme itself. The trustees of the scheme are able to decide how to use the refund. Although the funds themselves cannot be transferred back to the employer without paying a punitive rate of tax, they can be used to offset future employer contributions, or to pay for intermediary advice that the employer would otherwise have paid, for example.

The perceived importance to employers of the short service refund pot depended primarily on how much money it accrued over a year. This in turn depended on company size and the number of employees leaving the company during the first two years of service:

- the very large employers, typically 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;
- most other employers did not see the refund pot as being very significant, and some had not processed enough refunds to have even considered what they might use the funds for.

The uses to which both of these groups put the refund pots are examined below.

#### 3.3.1 Very large employers and employers with high staff turnover

Employers that employed a large number of staff, typically over 1,000 employees, and some smaller employers with a high staff turnover, reported that their schemes regularly accrued fairly substantial refund pots.

Even in these cases, it was rarely specified in the scheme rules how the refunded employer contributions would be used. Typically, the trustees waited for the pot to reach an appropriate size before discussing in the next trustee meeting how to use the funds. Most employers were able to give two to three examples of areas where the refunded contributions were typically used. These included:

- paying for the general running costs of the scheme, in particular on-going advice and third-party administration;
- to offset employer pension contributions;
- paying for a specific piece of advice regarding the pension scheme, or a review by the intermediary;
- paying for communication exercises, which were usually undertaken by the intermediary;
- paying bank charges associated with the running the pension scheme.

*'That fund is partly used for some expenses like bank charges, but that only uses up a small bit of it, and then it is effectively offset from the contributions that the employer would otherwise pay.'*

(Employer, 1,000 members or more)

Intermediaries agreed with the employers as to the uses to which short service refunds could be put. Occasionally, the following were also mentioned by intermediaries:

- to pay any one-off investment transaction costs that the scheme may incur when choosing to switch between one fund provider and another;
- to pay for annuity broking advice for members that were about to retire.

### 3.3.2 Small and medium-sized employers that did not have a high staff turnover

Small and medium-sized employers that did not have high levels of staff turnover typically reported that they did not usually accumulate a significant short service refund pot. Some of the smaller employers reported that they had no experience of dealing with any potential short service refund pots at all.

As a consequence most had rarely or never considered what they might have used the funds for. A minority of the larger employers in this group said that they had in the past used the accumulated refunds to assist with overall scheme running costs, and the decision to do this was taken as part of the trustee board meeting, but overall this was a rare occurrence.

## 3.4 Vesting rules in the context of salary sacrifice arrangements

Under salary sacrifice, an employee agrees to give up the right to receive part of their salary, usually in return for the employer's agreement to provide the employee with some form of non-cash benefit. In the case of pensions, the employer pays additional contributions into the employee's pension of a value equivalent to the amount of salary sacrificed. Because National Insurance rules treat employer contributions differently to employee contributions, both the employee and the employer currently pay less National Insurance under salary sacrifice than they would if the employee had paid the equivalent sum as an employee contribution.

Under salary sacrifice, all pension contributions are treated as employer contributions. This means that if an employee leaves before the end of the vesting period, no short service refund is due back to the employee. In other words, if the departing employee does not arrange a transfer to a new scheme, they may lose all the contributions paid to the scheme.

Only a minority of the employers in this study offered a salary sacrifice option. Among these employers, there were greatly different experiences of employee take-up of the option, ranging from 'very low' to almost 100 per cent. The participating intermediaries reported that growing numbers of employers did offer the salary sacrifice option, as they were increasingly starting to recognise the savings associated with it.

Intermediaries and the employers offering salary sacrifice felt that it could be mutually beneficial for the employer and the employees, and typically said that salary sacrifice was potentially suitable for most groups of employees. Only two groups of employees were identified as unsuited to salary sacrifice:

- **very low earners**, specifically those that were paid close to the minimum wage. Salary sacrifice would not be permitted to lower their basic salary below the minimum wage, and so intermediaries did not recommend salary sacrifice for these groups;
- **employees likely to leave their employer within two years**. Some intermediaries reported that they would not recommend salary sacrifice to employers where staff turnover in the first two years of employment was known to be high, because of the risk that departing employees could lose all their pension contributions. Intermediaries and employers stressed that it was vital that the rules around the potential loss of contributions were clearly communicated, before members chose salary sacrifice.

*'You then obviously need to be able to communicate the choices correctly: if you knew that you had joined a company and perhaps you had made a mistake and you were going to leave, you wouldn't be doing salary sacrifice.'*

(Intermediary)

Concern about this particular scenario had encouraged some of the employers to amend the rules around salary sacrifice, to ensure that no employee was at risk of losing contributions. Approaches included:

- refunding the leaver the equivalent of what would have been the total employee contributions. This was paid by the employer via payroll, rather than via the pension scheme, and so was fully taxable, which meant that in practice the employee received slightly less back than they would have, had salary sacrifice not been in place:

*'If someone leaves and would have been entitled to a refund of contributions we get the administrator to work out what the refund would have been...They get the money back as if they have paid it in themselves but it becomes a payment from the company as opposed to from the pension scheme.'*

(Employer: 1,000 members or more)

- not allowing employees to opt into salary sacrifice until they had been a member of the pension scheme for two years.

A minority of employers, who did not offer salary sacrifice, said they were considering introducing this option in near future. They considered salary sacrifice to be an attractive option potentially, but were postponing offering it to employees in anticipation of possible changes to tax rules for high earners.

*'We were planning to introduce it this autumn, but with the uncertainty about what is happening next April we have decided not to at the moment, because it would be silly to introduce something for our high earners that they can only do for three or four months.'*

(Employer, 100 to 999 members)

### 3.5 Views on the current vesting rules

The largest employers in the study, who were most likely to accrue a substantial refund pot, attached greatest importance to the current vesting rules. Most other employers had given the issue less consideration. The views of both groups, as well as those of providers and intermediaries, are examined in this section.

#### 3.5.1 Views of very large employers and employers with high staff turnover

The largest employers interviewed tended to regard the vesting rules, and specifically the fact that short service refund pots could be accrued, as a significant benefit to the running of the scheme. In particular, large 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.

The very large employers were able to accrue substantial refund pots as, due to their size, they processed large numbers of short service refunds. The pots helped them to offset some of what they perceived to be the high costs of running a high-quality pension scheme to all members' benefit.

*'We have quite a high turnover particularly in our call centres and retail outlets. If they leave, the company's contributions go back into a sum of money within the trust, which we use then to pay all our expenses...One of the big things [in deciding to keep a trust-based scheme] was that vesting allowed us to take the money back into the pension fund.'*

(Employer, 1,000 members or more)

In addition, the fact that there was a two-year delay before members received full vesting rights was seen to minimise the administrative burden of dealing with very large numbers of deferred members with small pension pots. Some employers were also of the view that the rules could in fact be an encouragement for employees to join the scheme, because they knew that if they left after a short amount of time, they would at least get their contributions back.

A minority of the very largest employers suggested that if the vesting rules were to change, barring short service refunds and allowing full vesting rights immediately, they might well need to consider whether to switch to a contract-based scheme: although none said that they had any concrete plans to do so.

### **3.5.2 Views of smaller and medium-sized employers that did not have a high staff turnover**

The smaller employers and those with a low staff turnover considered the vesting rules to be of little overall importance, relative to other elements of a trust-based DC pension scheme. Indeed, many had never considered them to be a benefit at all, some pointing out that the administration involved in processing occasional short service refunds was in fact a disadvantage.

*'They don't really offer much of a benefit. There is administration involved. It is not enormous but it is a bit of a nuisance really. I don't really see any benefit at all.'*

(Employer, 100 to 999 members)

Some of these employers could identify possible advantages to the rules, noting that the ability to refund or transfer the pension fund could lessen the administrative burden of having to be responsible for a large number of small pension pots.

*'Certainly for the scheme and the management of the scheme you don't really want to have masses of people who've only had six months in your scheme, because you've got a very small pot of money that you are then responsible for managing right the way through.'*

(Employer, 100 to 999 members)

Others did however express more negative attitudes when considering short service refunds from the employee's viewpoint: suggesting that they might encourage people not to save for retirement by allowing them to seek refunds and thus not accumulate a pension pot.

*'Thinking about an ideal world, I would say [refunds] really shouldn't happen. If they do short service, well they should have it, both their contributions and the employer's contributions, and take it with them and continue to invest in the scheme provider or take it somewhere else.'*

(Employer, 100 to 999 members)

### **3.5.3 Views of providers and intermediaries**

The views of providers and intermediaries on the vesting rules were largely similar to those of the participating employers, believing that they were likely to be of importance to the largest schemes, while being relatively inconsequential to the remainder. For the largest schemes, or those with high turnover, they were seen as helping employers to cover the considerable running costs associated with large trust-based pensions.

*'I think it's a big benefit...If you are in an employment sector where there's quite a high turnover of staff, that's a big advantage for them in terms of cost, to have a refund of contributions if the member wants a refund of contributions, because, again, that offsets your costs against that particular pension scheme.'*

(Provider)

Intermediaries that were responsible for advising employers as to their scheme choice typically reported that the vesting rules were very rarely a major issue for most employers, and they did not believe that most trustees would take the decision as to what scheme to offer on the basis of these rules. They did typically point out however that they would tell employers about the possible cost savings and administrative advantages of the rules if they were relevant to them, even if they did not drive pension scheme choice.

*'Most trust-based plans have been set up for a whole number of reasons and vesting profits is not something that really sits on the radar until you have had a plan in place for four or five years and you see those coming through...When they are setting up a plan I don't think they would be consequential.'*

(Intermediary)

### 3.6 Possible future developments and the impact of automatic enrolment

Most participating employers said they had no plans to introduce any changes to the vesting rules they had set out in their trust-based pension schemes. Only small minority suggested that they would like the rules to change: some suggested that the period required for an employee to receive full vesting rights could be extended to cut down the administrative burden associated with having many deferred members. Others suggested that employees that are made redundant during the vesting period should be allowed to stay as deferred members should they wish, because the decision to cease being an active member was not their own, and as such they should not be penalised.

Providers and intermediaries did not anticipate any change to the vesting rules in the near future, and most did not feel that the workplace pension reforms would have a significant impact on practices in this area from 2012. A minority did however predict that some changes might occur:

- A minority predicted that employers might choose trust-based schemes over contract-based arrangements for groups of employees where staff turnover was high, if the rules regarding vesting continue to differ between the two types of pension:

*'I suppose the only difference will be once we are in a state of auto-enrolment I think we will be duty bound in looking at the clients' best interests to say, if there is a class of employee where they do have a very high level of short service, they should seriously consider some kind of low-cost bundled DC trust arrangement.'*

(Intermediary)

- A minority suggested that the introduction of NEST (National Employment Savings Trust) might popularise the use of multi-employer arrangements such as master trusts.
- Some suggested that the introduction of NEST might in fact level out the offering between existing schemes and NEST, resulting in more employers allowing their members full vesting rights immediately.

# 4 Objectives and design of the default option

Chapters 4 to 6 of this report will explore the default options that are used within trust-based defined contribution (DC) pension schemes. This chapter will examine how default options operate, focussing on the options that are given to employees when they join a trust-based DC scheme, and what happens if they make no choice.

The chapter will also look at the overall objectives of the default options offered by employers now and over the past ten years. This will then lead onto an examination of the typical investment make-up of the default fund itself, including approaches taken to lifestyling – reducing the investment risk that an individual faces as they approach retirement.

Finally, this chapter will examine the administration, management and adviser charges associated with the default option, and who bears these charges.

## 4.1 Options given to an employee on joining a scheme

Automatic enrolment was not operated by any of the employers included in this study, and so once employees became eligible to join the pension scheme, they were required to opt in. Different employers had different waiting periods in place before employees were eligible to join: most allowed employees to join either from their first day of employment or after three months, although longer waiting periods were sometimes in operation.

Irrespective of the waiting period, it was normal for employees to receive a paper-based joining form from the employer as soon as they were eligible. This came with their employee induction pack if they were eligible from day one. Alongside the form, they were typically given a pension scheme membership pack, which may have been designed by the provider or the intermediary, and in the case of larger employers this pack was often employer-branded. Although the pack as a whole provided full details of the scheme, the possible investments and other options, providers, intermediaries and some employers were keen to stress that the joining form itself was kept as straightforward as possible.

To join the scheme and authorise the deduction of the specified employee contributions from their salary, employees were always required to provide a signature at least. In some cases, employees were also given the option of increasing their employee contributions if they wished to as part of the form.

The other decision that employees were asked to make was their choice of investments. There was some variation between employers in terms of how they presented the investment options to employees, and specifically what happened if employees did not make a choice, with three broad approaches taken:

- the most common approach was for a number of different investment options to be offered, of which one was clearly marked as the default. If employees did not choose an option, the default would be selected for them (see Section 4.1.1);
- in rare cases only one investment option was given on the form: essentially there was no investment choice for the employee to make (see Section 4.1.2);

- In rare cases a number of investment options was offered, and there was no default: the employee had to make a decision between the investment options to join the scheme (see Section 4.1.3).

### 4.1.1 Employers that offer a default option alongside other options

Most employers offered several investment options to employees, and one of these was the designated default option. Although the term ‘default option’ was not generally used on the form, it was made clear to employees that this set of investments, alongside any associated lifestyling programme, was the option that would be chosen for them if they did not make any choice.

The number of funds offered alongside the default differed widely, from as little as two to three to as many as ten to 15 different funds. Intermediaries often noted that an increasing emphasis has been placed in recent years on simplifying the employee’s decision: and one consequence of this had been the fact that fewer investment options were presented to employees alongside the default. Although in almost all cases it was possible to invest in the full range of investment funds offered by the provider, these were not necessarily all presented to employees on the joining form, to avoid overwhelming them.

Regardless of the number of options offered alongside the default, it was normal for 80 per cent to 100 per cent of employees to take the default option. Intermediaries and providers typically reported that this was normal regardless of the employer size or type, and the employers in this study appeared to confirm this. Intermediaries and providers often said that there would be a minority of exceptions: employees working in the finance industry and those with some personal experience of investments were often cited as examples of employees likely to select an alternative option. Some trustees also commented that people that were closer to retirement when they joined, or that had transferred in a pension from a different employer and so had larger accumulated funds, were more likely to choose a different option to the default, because they attached greater importance to the need to consider and select the appropriate investment options.

Employers typically believed that the low proportion of employees selecting their own fund was a combination of two factors: employees’ trust in the scheme trustees to select an appropriate investment choice for them, as well as a general lack of interest and financial knowledge among employees, which meant that most had little desire to investigate whether an alternative option might be more appropriate for them.

*‘The default fund is for somebody who doesn’t make that choice, or makes the choice but actually wants to go for the easy option – and there is a level of trust there.’*

(Employer: 1,000 members or more)

None of the participants in this study were able to distinguish between employees that had actively chosen the default option, versus those that had ticked no box at all. In this context, some intermediaries were careful to point out that an employee choosing the default option was not necessarily showing a lack of interest, but could equally be taking a conscious choice, and the correct one for them.

*‘You have to be very careful not to generalise and assume that people are in the default because they can’t be bothered to make a choice or are lazy. Nowadays, we put a lot of effort into designing a really good default option. It’s a fund designed to be appropriate for 80 per cent plus of the membership.’*

(Intermediary)

Members had the option of switching their investments to an alternative option after joining, whether or not they started in the default option. Usually, this could be done as often as they wished, particularly where the provider offered online pension fund management, but in some cases the option of switching funds was limited to once per quarter.

#### **4.1.2 Employers that offer a default option and no other options**

In rare cases, schemes offered members one default investment option as the only choice on the scheme joining form. Some intermediaries reported that this was becoming an increasingly common practice, albeit still rare. Their reasoning was based on the view that the focus of the trustees and the intermediary should be on the default option, because it is likely – some believed inevitable – that the majority of employees would invest in the default. Offering additional investment options, it was believed, risked confusing employees and perhaps even risked them putting off joining, if they were reluctant to have to make an investment decision.

*'It's better to get people into the scheme than to bewilder them with choice. I don't think you will ever get more than a handful of members actively making decisions, taking tactical decisions, classifying their own attitude to risk properly and acting accordingly.'*

(Intermediary)

Where this approach was taken, it was seen as vital for the trustees, in close consultation with the intermediary, to select the most appropriate investment choice for employees. This tended to be a lifestyle arrangement, comprising a selection of equities and bonds: the nature of these is examined further in Section 4.5.1.

In some cases, there were in fact some limited options available to employees: for example the length of the lifestyling period. But critically, the investment choice was fixed at this stage. The employers and intermediaries concerned did point out that if an employee were to approach them with a request to switch the investments to an alternative fund offered by the provider, this would be granted: but in the case of the employers in this study, this had reportedly never happened.

#### **4.1.3 Employers that offer no default option**

Offering no default option at all – effectively making employees choose an investment option to be able to join the scheme – was also rare among the employers in this study, and no intermediary reported that this was a growing trend.

It was, however, seen by the employers concerned as a good tool to encourage joining. An additional objective of these trustees was to encourage their employees to 'buy into' the scheme and actively engage with the process of investment decision-making. Ensuring that all employees selected their own fund was seen as part of this.

*'We don't have a default option. We felt that it was important as far as possible to make the member engage with the investment decision and that providing a default option would give them a very easy way of not engaging.'*

(Employer, 1,000 members or more)

Under this approach, a selection of five to ten funds was available to employees, each with varying degrees of risk. Some of these options were lifestyle arrangements with similar characteristics to other schemes' default funds. In most cases the majority of employees tended to opt for these lifestyle arrangements – in one specific case, almost 90 per cent did – suggesting that the outcomes of this approach may not in fact have been greatly different to those of schemes where a default was offered.

### 4.2 Objectives of the default option

Before considering the fund make-up of the default option, it is important to understand its objectives. In other words, what do the pension scheme trustees want to achieve for the members that end up in the default option? The pension scheme trustees are responsible for this decision, although they are heavily guided through the process by their intermediary.

In fact, the overall default fund objectives reported by trustees in this study were essentially straightforward, and varied very little: they were to provide a safe and balanced investment option that would give long-term growth for the individual. Although there was a great deal of variation in terms of how to achieve this objective, as the remainder of this section will explore, the overall objectives of the default option did not vary.

This approach taken by the employers in the study was therefore a cautious one. No employers we spoke to said, for example, that their default fund objective was to achieve a very high level of long-term growth that out-performs the market average. Trustees and intermediaries often reported that employers were very wary of ‘gambling’ with employee pension contributions, and typically avoided any approaches that were seen by their advisers as risky.

### 4.3 Default option design: recent trends

Based on the default option objectives set by the trustees, the intermediary typically recommends a number of approaches to default fund design, from which the trustees are ultimately responsible for selecting the most appropriate one for their membership profile.

All of the employers in this study had set relatively cautious investment objectives for their default fund. This does not necessarily mean that the default option design was the same for all funds. There was in fact a great deal of variation, and this variation was only partly explained by differences in the profiles of different workforces.

The design of the default fund appeared to depend more than anything else on when the trustees and intermediaries last formally reviewed the fund’s objectives and design. It is good practice for trustees and intermediaries to conduct such a review every three to five years: but in practice the frequency of review was often less than this, and some schemes had never reviewed the objectives since the scheme was set up. Section 5.2 will examine the review process further.

As a result, even though we conducted research with employers in September 2010, we were essentially studying schemes whose objectives and fund make-up had been set at any point between the late 1990s and September 2010. And as many intermediaries and some providers and employers pointed out to us, best practice in default option design has changed considerably since the turn of the century.

To appreciate what drives the fund make-up of the default options in existence now, it is therefore important to appreciate how accepted practice has changed over the past ten years or so. This section explains intermediaries’ and providers’ views on this subject.

#### 4.3.1 Default option design prior to 2002

In the late 1990s the DC pension scheme was a relatively new product. Defined benefit (DB) schemes had been the usual approach among the employers that wanted to offer their employees a high-quality pension scheme that guaranteed a certain level of income in retirement. Trustees were responsible for looking after employees’ funds, but with the knowledge that the employer had ultimate responsibility for funding the scheme.

As employers increasingly chose to close DB schemes to new members, the trust-based DC scheme grew in popularity. Intermediaries in this study often reported that at that stage, trustees and intermediaries did not spend significant time discussing the default option. This was for several reasons:

- In most cases the vast majority of members were still in the DB scheme, and so this scheme received a disproportionate amount of attention in trustee board meetings, particularly at a time when the scheme was closing to new members.
- Little work had been done to predict the proportion of employees likely to go into the DC scheme's default fund, and moreover there was less appreciation that the vast majority of employees were likely to do so.
- The range of funds to invest in was more limited than today, and few intermediaries had experience of designing bespoke default fund options:

*'If you go back a few years, the employers were still focusing their spend, budget, time and attention on DB plans. Some of the default plan designs that were put in place were very basic and didn't take much of the employer's time and thinking.'*

(Intermediary)

This essentially meant that there was little difference between most of the default funds in the market: passive tracker funds tended to be the normal approach. Such funds are designed with the intention of long-term appreciation, and do not attempt to out-perform the market in any way. Intermediaries and providers reported that such funds tended to invest 100 per cent in equities, which may have been invested in the UK only, or in a mix of UK and overseas funds. The employers in this study that had not reviewed the default fund since 2000 typically had one of these models as the default option.

Because the UK and overseas stock markets had seen several years of continued growth in the late 1990s, these investment strategies widely seen as appropriate for the default option, offering individuals what was seen as secure, long-term growth prospects.

In most cases, ten to 15 alternative fund options were offered by the employers in this study to members alongside the default, and lifestyling was common in the final five years before retirement, with investments gradually being transferred to cash over that period.

#### 4.3.2 Default option design between 2002 and 2007

The second period that intermediaries often recognised as important in the development of trust-based DC default option design was the period from 2002 to 2007, during which stock markets recovered from the downturn of the early 2000s.

After the severe fall in equity values, there was a recognition that equity tracker funds were not necessarily appropriate to all pension savers given their potential volatility, and the associated bad press they had received. Some of the intermediaries and providers we spoke to referred to the trust-based DC market as 'maturing' from 2002 to 2008, which led to an increasing move towards more carefully selected default options, that took the individual membership profile into account.

*'Then of course we had a number of stock market setbacks which got people thinking. In the early part of the century really people realised that pure equities don't necessarily offer the guaranteed growth that we thought they did in the late 90s.'*

(Intermediary)

This has often led to increased diversity in asset allocation, with inclusion of a proportion of safer investments such as bonds in the default fund throughout an individual's lifetime, even before the lifestyling period begins. As well as this, the need for geographical diversity was also recognised, with investments in more than one country increasingly preferred, to spread the risk of one country's stock market falling disproportionately.

This broad industry picture appeared to be supported by the employers in this study. The more recently the default option had been reviewed, the more likely it was to incorporate a more diverse range of investments: and indeed, employers that had reviewed their funds more than once over this period often reported this type of shift in investment strategy.

*"So after [poor stock market returns from a 100 per cent UK equity fund], we switched to a fund that's got equity and elements of other things in it as well: [adviser] said we were very exposed to the UK stock market. This new fund has more of a spread of investments across the world, and an element of bonds too."*

(Employer 100 to 999 members)

Over this period there was relatively little change to the accepted lifestyling period: the final five years before retirement was still seen as the norm, with investments gradually being transferred to cash over that period.

### 4.3.3 Default option design since 2008

The most recent period in default option design was seen by many providers and intermediaries as being the years since the financial crisis and subsequent stock market downturn in 2008 to 2009. Because equity values around the world were affected, geographical diversity did not prevent short-term loss in equity values, and although pension funds were expected to recover in the long-term, those approaching retirement were hit especially hard.

Some intermediaries and providers pointed out that the traditional five-year lifestyling period did not give the funds of imminent retirees enough time to recover from such a severe downturn. As a result, since the 2008 recession an increased focus has been placed on the period of lifestyling, which has typically increased from five years before retirement to seven to 15 years beforehand. This was said to mitigate the risk of someone very close to the point of retirement suffering disproportionately if there is a large fall in the stock market.

*'As a reaction of 2008 I think people have realised that if you have a really severe correction like that, you want to be coming out of equities a lot sooner to at least give the individual a fighting chance with further contributions and a more structured approach to investing to make up some of those losses. So we are now seeing the norm as more around about the ten-year mark leading into bonds and cash over that sort of period of time.'*

(Intermediary)

This development was evident to some extent within the employers featured in this study: some, although not all, of the default options that had been reviewed over the past three years had transition periods of over five years. This is examined further in Section 4.6.

Intermediaries and providers expected that the extension to the lifestyling period would be the first of a number of developments and innovations in default fund design that would occur in late 2010 and subsequent years. Other possible future developments are explored in Section 6.1.

## 4.4 Factors taken into account by intermediaries in designing the default option

Section 4.3 has shown us that the design of a default option – whether it contains a passive UK equity tracker, or a more diverse range of investments, and whether the lifestyling period is five years, or longer than this – depends as much on when the scheme was last reviewed as it does upon the intermediary's and trustees' strategies. Many intermediaries were explicit in pointing out that they believed this meant that trust-based DC schemes should be considering the nature of their default options if they had not done so recently.

*'If you look at some of the default plan designs around now, if you were designing them from scratch today you wouldn't start there. There is plenty of opportunity in the market for modest sized plans to enhance their defaults.'*

(Intermediary)

Many of the employers in this study had in recent years taken the opportunity to formally review the default option. Chapter 5 will explore the review process itself in more detail; here we consider the factors that the intermediaries reportedly take in to consideration when assessing the design of the default option.

Intermediaries typically described the process of selecting the default fund in quite broad terms. Although they saw the process as too complex to describe in detail, all were able to describe the factors that they took into account in designing the default. Five broad areas were mentioned:

- **Trustees' views as to their workforce's attitude to risk** was consistently reported to be an important driver of intermediaries' strategies. Although in this study the trustees tended to have a similarly cautious outlook, there were some variations between employers, as Section 4.5 will explore.
- **Employee turnover.** In companies where staff turnover was high, a high proportion of employees were likely to be active members for only a short period, and so never build up a substantial retirement pot. In these cases, a more cautious approach might be taken, as the impact of a short-term fall in the value of the funds would be likely to have a disproportionate impact.
- **Contribution levels and salary.** Many intermediaries reported that those whose pension contributions were highest, and these generally increased with salary, were likely to be willing to take on a higher degree of risk: more highly paid employees might be willing to take on more risk for increased returns, although some intermediaries reported that those in the default fund were still likely to prefer a more cautious approach.
- **Job role and industry sector.** These were seen as predictors of salary and contribution levels.
- **The age profile of the employees.** A minority of intermediaries also suggested that an older workforce might require a more cautious investment strategy.

Intermediaries often pointed out that the relationships between these areas were complex, and there was no simple formula that governed the design of the default fund.

*'It really comes down to knowing the workforce. We do a lot of member analysis, a lot of member segmentation into different categories. It is generally by age, salary, type of work that they do. There is a lot of behavioural science behind that work that kind of governs how we might then approach the default. So a lot of research, a lot of analysis and a lot of psychology behind some of the work that we do.'*

(Intermediary)

In fact, many providers and intermediaries suggested that there are several factors that limit the variation between different employers' default funds. In part, this is because the same default option needs to be selected for all of the employees joining a scheme, even if there is variation between them in terms of age, salary and job role. Consequently there must be a degree of compromise in the design of the default, if it is to meet the needs of the majority.

*'It will never meet the needs of everybody, but then that is the point of a default so we shouldn't pretend they do. At least it is some kind of understanding of the customers that we serve, the workforce that we serve.'*

(Intermediary)

Intermediaries reported that they generally made several assumptions about all of the employees that were likely to go into the default fund, regardless of other factors:

- Most employees will go into the default fund:

*'Eighty per cent of employees are in the default fund, which means spending time on making the other options really good is wasted effort.'*

(Intermediary)

- The employees that do go into the default fund will be those that are harder to engage with.
- Decisions will therefore need to be taken for them about their risk profile.
- They are likely to be relatively risk-averse, and so they are unlikely to want to pay a premium for an actively managed fund, for example.

Intermediaries also pointed out that trustees were in many cases unsure or unwilling to guide their adviser about the risk profile of their members for fear of making a mistake, and in these cases the adviser tended to opt for a more cautious approach. This belief appeared to be supported by many of the trustees themselves.

*'I hate to think that I really have to sit in judgment on what funds should be available.'*

(Employer: 12 to 99 members)

### 4.5 Default fund design

Intermediaries and employers typically reported that the majority of members were invested in the default option. This meant that decisions taken by trustees about its design were likely to have an impact on the fund performance of most of the scheme membership.

The design of the default option was driven in the first instance by when it was last formally reviewed by trustees. Where the fund had been set up or reviewed in the past three years or so, there was a wide degree of variation between employers, from more cautious to more adventurous funds. Where they had not, there was far less variation, with most invested in passive tracker funds. Both of these are examined in this section.

#### 4.5.1 Design where the scheme has been set up or reviewed in the past three years

In examining the asset allocation of the default options that were set up or formally reviewed in the past three years, we were able to identify three broad categories. The following examples were the typical approaches that we found:

- **Cautious:** Fifty per cent to 75 per cent UK and worldwide equities, with the remainder in safer investments such as bonds. This approach to asset allocation was usual where staff turnover was high, or trustees wanted a low risk default for their employees. In some cases this was a result of a review of the previous asset allocation, where the existing default had been deemed too risky for members:

*'Five years ago our default option was a simple tracker. Since then we have reviewed it to get the nature of the default fund just right...because our staff turnover is very high, it is still quite a conservative, passive fund.'*

(Employer: 1,000 members or more)

- **Balanced.** Eighty per cent to 90 per cent UK and worldwide equities, with the remainder in safer investments such as bonds. This higher proportion of equities was very common among employers during the growth stages of the investments
- **Adventurous.** One hundred per cent UK and worldwide equities, often with a small proportion invested in emerging economies or investments traditionally associated with some element of risk. Many employers did choose to invest entirely in equities, particularly those whose trustees appeared not to be as risk-averse as some.

*'Their membership profile is 20s or early 30s and so equities are a good strategy for long-term growth.'*

(Employer: 100 to 999 members)

Although there was some variation in the asset allocation, one feature of the employers in this group was that they invested in a geographically diverse set of investments: we did not speak to any employers in this group that invested entirely in UK equities.

#### **4.5.2 Design where the scheme has not been set up or reviewed in the past three years**

Where the default option had not been formally reviewed in the past three years, the fund make-up was often out of line with current practices, and may not have taken into account the membership profile. The following approaches were typical among the employers in this group:

- **Passive UK tracker.** Such funds were invested 100 per cent in UK equities, typically in passive investments.
- **Passive UK/worldwide tracker.** Invested 100 per cent in passive equity funds as above, but not exclusively in the UK.
- **Balanced (very rare).** Eighty per cent to 90 per cent UK and worldwide equities, with the remainder in safer investments such as bonds.

Most of the employers in this group were invested 100 per cent in equities, and if we were to use the classification we used for those who have reviewed their scheme recently, they would therefore be classified as 'adventurous'. Furthermore, many of these were invested in the UK only, a practice that had generally been avoided in recent years, according to intermediaries.

Employers in this group tended to be smaller on average, particularly those that had fewer than 100 scheme members. The employers were often those whose trustees reported some unease with the decision-making responsibilities of being a trustee, and so were often reliant on the intermediary to tell them that the default fund was in need of review. It appeared that this did not necessarily happen in all cases.

*'It's 75 per cent UK equities, 25 per cent foreign equities...As trustees we don't feel qualified to give advice or to take decisions on behalf of our members. We rely on the advice of [intermediary]. I assume they would tell us if they didn't think the current fund was best for our members.'*

(Employer: 12 to 99 members)

### 4.6 Lifestyling within the default option

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.

Traditionally, most providers transitioned funds gradually into these safer investments in the last five years before retirement. As Section 4.3.3 explained, many intermediaries have increased this period when reviewing default options in recent years, particularly in response to the financial crisis of 2008, when the five-year lifestyling period was not seen as having provided sufficient protection against the fall in equity values.

The employers in this study reflected this trend:

- Funds that had not been reviewed in the past three years typically transitioned investments in the last five years before the expected retirement date.
- 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, however we did not interview any employers with such long transition periods.

*'In funds nowadays, they start transitioning 15 years before retirement into bonds, and then in the last five years into government bonds and cash.'*

(Intermediary)

The makeup of the final safer funds did vary to a small extent between employers, but most providers and intermediaries offered one of the following approaches, or a close variant thereof:

- 100 per cent cash;
- 50 per cent cash; 50 per cent fixed interest bonds, e.g. Government bonds.

Only in one extremely unusual case did an employer interviewed have no lifestyling within the default option. This was a small employer, offering a pension scheme whose trustees had not reviewed the default option since the scheme was set up in the early 2000s. As a consequence, the default option invested in 75 per cent UK equities and 25 per cent foreign equities through to an individual's retirement date.

### 4.7 Default option charges

This research explored two of the charges that are associated with the default option. Intermediary and scheme administrator charges were typically a flat fee, and were paid directly by the employer.

Provider and fund management fees were charged to the member, and were levied together as a single annual management charge (AMC) as a percentage of the value of the fund.

#### **4.7.1 Intermediary and administrator charges**

Intermediary and administrator charges for trust-based DC schemes were typically paid by the employer, rather than by the members themselves. Two models of charging were common:

- **Annual retainer:** The employer paid the intermediary and administrator an annual fee, which would include attendance at a specific number of trustee meetings a year (typically four). Further meetings, such as any in-person presentations or meetings with staff that the trustees request, are charged on an hourly basis.
- **Hourly charge:** The intermediary charges a fixed hourly fee for all activities.

The intermediary and administrator fees were related to all aspects of advice and administration associated with the scheme, and so it was not possible to isolate costs relating specifically to the default option.

Occasionally, these fees could be paid by the pension fund itself. This happened in cases where a sufficient number of employees had left the scheme within the vesting period and taken a short service refund, which had led to the generation of a short service refund pot that could be used to fund a specific piece of advice or communication. This is explored further in Section 3.3.

#### **4.7.2 Provider and fund management charges**

Provider administration and fund management charges were typically bundled together as a single AMC, which was set by the provider and calculated as a proportion of the individual member's pension fund. It was shown on the member's statement as a deduction of units from the member's total fund value. The same AMC was typically set for all members of the default fund, covering the following costs associated with providing that pension scheme:

- **The provider's setup costs for the scheme.** This typically involved investigating the employer, attending a face-to-face beauty parade to pitch for the employer's business, producing a tender document and enrolling members.
- **The provider's ongoing scheme administration costs.** This typically involved processing leavers and joiners and changes to contributions and fund choices.
- **Fund management costs.** These were charged by the fund provider and then bundled as part of the pension provider's AMC.

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. Some employers had charges outside of this range: the lowest in the study was 0.15 per cent and the highest was 0.9 per cent. In the cases where the AMC was particularly high or low, the size of the employer appeared to determine this, 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.

Some providers pointed out that other factors such as salary, contribution levels, the staff joining rate and staff turnover also influenced the AMC, with providers offering better rates to employers whose members were likely to accumulate larger pension pots.

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 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.

*'The charges are important to a degree, although our charges are very low anyway so you are looking at margins of a margin really. In our current default fund we have got a charge of 17 basis points [1.7 per cent] so it is quite a low charge. When they were looking at options there were options that could be 20 basis points and they were looking at options that would be 15 basis points, but actually in the scheme of things it was not significant enough to make a deciding factor.'*

(Employer: 1,000 members or more)

# 5 Default option governance and communication

Chapter 4 demonstrated that the design of the default fund in trust-based defined contribution (DC) schemes appeared to depend to a large extent on when the trustees and intermediaries last formally reviewed the fund's objectives and design. Where the fund had been set up or reviewed in the past three years or so, there was a wide degree of variation between employers, from more cautious to more adventurous funds. Where they had not, there was far less variation, with most default funds invested in passive tracker funds.

This chapter will examine the review process itself in more detail, as well as how the outcome of the review and other key decisions around the default fund are communicated to members, the perceived adequacy of these communications, and possible future developments in this area.

## 5.1 Default option governance and responsibilities

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. While scheme rules addressed these processes for the scheme as a whole, the rules did not generally assign roles specifically focusing on the default option. Nevertheless employers and intermediaries stressed that the trustees had a duty of care to take responsibility for these functions as part of their wider duties.

*'There is nothing written in the scheme rules that says, "We will consult this. We will consult upon this person. We will look at the default option in X years" – general trust law would cover it in any guidance. The responsibility could only be with the trustees couldn't it?'*

(Intermediary)

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.

As Section 2.2 explained, employers were heavily dependent on the intermediary for professional advice on all aspects of the default fund. In practice this meant that many tasks were delegated to the intermediary, such as conducting the necessary research required to ensure that the default fund met the needs of the members, conducting a provider beauty parade, or flagging up any legislation, issues or problems to the trustees that they would need to be aware of.

This approach was common among employers of all sizes. A minority of the larger employers said that their trustee boards were large enough to justify the existence of a dedicated investment sub-committee, for whom the design of the default fund was a key responsibility. In these cases, tasks would be delegated to them, although all decisions needed to pass through the main board.

*'We have an investment subcommittee and they will put a proposal to the full trustee board. The subcommittee don't have a mandate to make the decisions. They do a detailed analysis and they put forward a proposal.'*

(Employer, 1,000 members or more)

The identity of the board of trustees was generally made known to scheme members on a regular basis. Some of the smaller employers in particular mentioned that the identity of the trustees was well known to employees, and employees would occasionally discuss pension issues with them informally. In most cases, however, the trustees operated at arm's length from the members, and employers had mixed views as to whether employees were interested in this information.

*'When there is a new trustee being nominated then we highlight that in the communication. Whether people actually read it or not is a difficult thing. Certainly trustee communications highlight the board of trustees. Letters have the names of the trustees underneath. Whether everybody cares or not, I don't know but certainly the trustees try to make it obvious.'*

(Employer, 1,000 members or more)

Employers typically reported that it was unusual for individual trustees' roles and responsibilities to be communicated to scheme members. The employers did not consider this information to be as important to scheme members, although some highlighted that this information would always be available on member request if required.

## 5.2 Default option reviews

In most cases the nature and the frequency of the default fund reviews depended on the size of the employer, as did the approach itself and the understanding of what a formal review entailed: larger employers tended to have a more structured and formal approach to reviewing the default option, while smaller employers conducted fewer reviews, and many had never conducted one at all.

### 5.2.1 The approach of larger employers

Typically, the larger employers with more than around 100 employees took a structured approach to the default option reviews. They typically had regular, formal processes 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 typically reported that the trustees met on a quarterly basis to review the investment performance of the default option at a high level, while a more comprehensive review of performance took place annually. Some employers noted that whereas in the past defined benefit (DB) schemes tended to get the majority of the time in trustee meetings dedicated to them, DC schemes now had far more time dedicated to reviewing their performance.

Default funds were typically subject to a full review every three to five years, which followed the guidance given by the majority of intermediaries that this is 'good practice'. The frequency of the review was not, however, written into the scheme rules. In the largest employers the dedicated trustee investment sub-committee would be responsible for conducting the default fund review.

*'Typically, we would review every five years the DC offerings. That said, at every quarterly trustee meeting we reviewed the investment performance and we would get reports from the investment consultant on not only what is generally happening in the marketplace but if there are any fund manager's specific issues. So we are constantly monitoring.'*

(Employer, 1,000 members or more)

Typically, the intermediary played a key role in the review process, assisting with reviews of the investment strategy within the fund, the performance against the fund benchmark, the default option charges, the fund's continued suitability for members, market trends and the suitability of the provider or fund manager.

*'In terms of a full scale review of everything, that is every two or three years: normally what you are doing is reviewing the de-risking strategy, the lifestyle structure. You are normally reviewing the strategic objectives i.e. the risk return objectives that you have set yourselves. You are reviewing the make-up of the growth funds. In between that, often we will ask questions like "Is 75 per cent equities and 25 per cent diversified growth right?" We might do that on a much more frequent basis.'*

(Intermediary)

The intermediaries, following the review, would also prepare a report for the trustees whose responsibility it then was to consider the recommendations and decide whether to act upon them. It was then the responsibility of the trustees to communicate any changes that resulted from the review process to scheme members. Changes to the fund make-up of the default option itself were seen as important and would be communicated straight away. In some cases the provider or intermediary could be instructed to carry out these communications. Other, less significant, changes were often relayed via the annual report.

*'We will send a formal letter out if there are any proposed changes to the fund. At that point we will highlight the options to them and what the default is likely to change from and to and remind them that they have got the option of not being in the default if they don't want to be.'*

(Employer, 100 to 999 members)

As providers had no direct involvement in the decision-making processes involved in reviewing the default option, most providers pointed out to us that they would only become aware of reviews at the end, if these had resulted in changes being made to the default option.

*'There would be a trustee announcement to members in advance because we would then probably be asked to switch members from one fund to another on a given date, so that would have to be communicated to members in advance, say on this particular date – this will happen.'*

(Provider)

### 5.2.2 The approach of smaller employers

The smaller employers with fewer than 100 employees tended to behave differently to larger employers. Most did not 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.

*'It is subject to review but it is not so regular. Since [provider] started working with us in the mid-90s, this is probably our second review. It is not a regular thing.'*

(Employer, 12 to 99 members)

Many of the employers in this group said that they relied upon their intermediaries to initiate any review that was necessary, and the intermediary had simply never told them that this might be the case. Others said that they were broadly happy with the performance of the fund, and simply did not wish to conduct a review; some even reported reluctance among employees for change as a reason for not conducting a review.

*'No we haven't – in an ideal world we would review this and other funds in terms of performance. The trustees meet annually with our advisers to go over duties and responsibilities etc. But not performance...Our employees don't like change.'*

(Employer, 12 to 99 members)

As Section 4.5.2 reported, where the default option had not been reviewed, they tended to invest 100 per cent in equities, sometimes 100 per cent in UK equities, a practice generally avoided by intermediaries in recent years. Many intermediaries commented that, while scheme reviews were now taking place more frequently than they had been in the past, these were still not frequent enough.

## 5.3 Default option communications

Employers reported that their trustees took responsibility for communicating information on the default option to scheme members: all new staff would receive a pack which detailed the pension options available to them, including information on the default option and any other investment options available to them. Additionally, employers reported that they communicated with all scheme members about the pension scheme on an annual basis.

### 5.3.1 Approaches taken to communication

The majority of employers used written, standardised communications to keep employees informed – supplemented by other media as appropriate.

Paper was by far the most common form of communication used by the employers. When new employees joined the company they would typically receive a joining pack or an introductory letter which informed them of their options with regard to their pension. This would include information regarding the default option. Additionally, a majority of employers said that their scheme members would receive personalised annual member statements, sent out by the pension provider, in paper format.

Many larger employers produced a trustee newsletter for members, which discussed the fund performance and other items that were believed to be of interest and relevance to the scheme members, such as changes to the trustee board or regulatory changes. In some cases, these were prepared and sent by the intermediary, although trustees usually retained some level of control over the content.

A majority of employers reported that their pension scheme provider had developed online access tools for members. There it was possible to see full details of the default option, view its performance and make changes to their investment online. A minority of the larger employers said that they communicated with active scheme members via six-monthly or annual email newsletters.

In terms of face-to-face communications, a minority of employers paid for one-to-one meetings between employees and a financial adviser if they required this. Additionally, some providers gave road shows or annual presentations to active scheme members on the performance of the fund. Finally, in some of the smaller organisations the scheme trustees also served as informal points of contact for the members. Where a company had a member-nominated trustee, these tended to be well known among employees and could be approached informally with questions regarding pensions.

### 5.3.2 Perceived adequacy of current communications

While the majority of the employers, intermediaries and providers interviewed considered the communications that members were sent to be adequate, there were a number of suggested improvements that were made by all three groups.

Overall, employers considered their scheme communications with members to be adequate. However, many also suggested that communications could be more engaging and tailored towards

lay audiences. The employers said that the language used in communications could be difficult to understand and the information difficult to absorb. In particular, there was recognition that communications needed to be shorter and simpler, more focused on audience comprehension and engagement. Nevertheless, employers recognised that it was often the need to meet regulatory requirements that led to providers producing lengthy documents that were written using complex language.

Employers had concerns about the extent to which their use of technical terminology could inhibit member engagement. They felt that while pensions could be a difficult subject, it was important that the associated risks were presented in a clear manner in order to ensure members had all the facts.

*'I think it is barely adequate...One of the first things I noticed when I joined the company, not even in a pensions role, I looked at the communication I was given as part of my contract and I thought "My God, I am not going to read that" and I am a pensions manager. It was bland and technical jargon. There was no, "What is in it for me?" sort of thing.'*

(Employer, 1,000 members or more)

Some of the employers said that the move from a DB scheme to a DC scheme was a particular challenge, in terms of ensuring employees were fully informed and able to make appropriate choices.

Many of the providers themselves acknowledged that it was difficult to strike the right balance between providing scheme members with sufficient information to help with understanding and decision-making, while not overloading the audience to the extent that they were confused.

*'I guess it comes back to what you want it to achieve. We can give people lots of information which would bamboozle them and confuse them, so there is always an issue between trying to have clear concise material and material which gives them sufficient information...Does it go into exactly where the default is invested and how that might change? It gives an overview. I am not sure people necessarily get to that. Getting them to read material when they are not necessarily engaged is not straightforward.'*

(Provider)

Many of the participating intermediaries also felt that provider communications could be improved, some suggesting that providers were not prepared to invest enough resource in improving communications, as this impacted on their profits and had no direct benefit to the providers. This criticism was sometimes also levelled at employer communications.

*'With a few exceptions, [communications are] relatively poor I would say. I think it is one of those things that with money being squeezed and budgets being squeezed it's just not something that employers put a lot of resource towards. Running a pension scheme is not cheap. Spending a lot of money on admin and consultant fees, your actuary and everything else that goes with it, communicating is quite often then forgotten about or not necessarily seen as the important part of it.'*

(Intermediary)

### 5.3.3 Possible future developments in communications

Employers, providers and intermediaries often agreed that the recent increase in electronic communications had improved communications overall over the last five years, making it easier to interact with scheme members across the board, not just those that were invested in the default option.

*'I would think because we do communicate through email now we probably communicate more because a) it is less expensive and it is more environmentally-friendly and b) it is just easier than stuffing envelopes and then getting them all back and they are not there and it just works much better. It is much quicker and it is easier.'*

(Employer, 100 to 999 members)

This move was expected to continue in near future, with many employers agreeing that employees tended to prefer electronic sources as they allowed more frequent and straightforward access to information about their pension funds. Providers and intermediaries often pointed out that legislation currently dictated what information could be provided online, but there was a desire to exploit it further, where possible, by all parties. This included improvements to the navigation on provider websites, using company intranets to inform employees of their options, and greater use of email.

Many also hoped for – and expected – improvements to the quality of the communications themselves. Apart from the use of more ‘plain English’ there was a suggestion from some providers and larger employers that communications could be tailored to different life stages. For example, it could be possible to create specific messaging for younger members in the early stages of their career that re-enforces the need to save money in a pension; while those members approaching retirement could be informed what would be happening in the next few years with regard to their fund and what their options are, with particular focus on the beginning of the lifestyle de-risking process.

*'I think the biggest change [in communications] is a trend like segmentation. There is all this talk about it. Not much action at the moment but I think companies are gearing up to it. Trustees are starting to look more at it. I think we are going to see more and more use of it in time, because a lot of companies segment communications for other parts... But in terms of actual pension scheme messages they don't really do it.'*

(Employer, 100 to 999 members)

# 6 Default funds: future developments and need for guidance

Chapters 4 and 5 have shown us that default options in trust-based defined contribution (DC) pension schemes have developed 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 appears to be increasing from five to ten years or longer, and electronic communications are becoming more popular, with potential for more targeted communications in the future.

Many of these developments have been in part a reaction to wider events, most recently the stock market downturn of 2008 to 2009. Because this research was conducted in 2010, relatively soon after these events, many of the developments reported by providers and intermediaries were still emerging. In this chapter we explore some possible future developments in the design of the default option that providers and intermediaries expected to emerge.

At the time of interviewing, in August and September 2010, the government's draft consultation on the use of default fund options in trust-based DC pension schemes had not yet been published.<sup>12</sup> Although no details of the guidance were revealed to participants as part of this study, all were asked their views on possible areas they would like to be included or excluded from the guidance. This chapter also examines providers', intermediaries' and employers' views on this area.

## 6.1 Current and future developments in the design of the default option

Providers and intermediaries typically felt that the changes seen in default fund design over the last ten years would be likely to continue. There was a belief that there would be a greater focus on getting the default fund right, with less focus on presenting a wide, tailored range of alternative investment options to potential members.

The changes that were expected could be divided into three broad categories:

- Those that reflect the current trends towards **flexible retirement**.
- Those focused on providing increased protection against stock market falls, or **downside protection**.
- Changes likely to be brought about or accelerated by the workplace pension reforms and by NEST (National Employment Savings Trust).

---

<sup>12</sup> The consultation was published after the completion of fieldwork for this study, in December 2010:  
Department for Work and Pensions (2010). Offering a default option for defined contribution automatic enrolment pension schemes – public consultation. Available at: <http://www.dwp.gov.uk/consultations/2010/dc-default-option-consult.shtml>

### 6.1.1 Flexible retirement

As many of the providers and intermediaries in this study acknowledged, the need to account for more flexible retirement practices will be a key challenge for the pensions industry in the future. As people live longer and stay fit and healthy for longer, working later in life is becoming not merely more of an option, but a necessity both for individuals and society as a whole. The increase in the State Pension Age (SPA), the planned abolition of mandatory retirement and the end of compulsory annuitisation were often cited as examples of recent policies that have supported this shift.

The concept of ‘flexible retirement’ was seen as increasingly important: rather than switching suddenly from full-time work to retirement, employees will instead retire gradually over a number of years, for example by transitioning from full-time to part-time work, and later into full retirement.

Providers and intermediaries often pointed out that the lifestyling process was not necessarily well set up to cope with this type of flexible retirement. Currently, the lifestyling process is based around a predicted retirement date: the member states the age they wish to retire when they join the scheme, and the lifestyling process begins a fixed number of years before this predicted date. By the time the predicted retirement date is reached, if the member in the default fund does not indicate to the contrary, their funds might be entirely invested in assets that no longer provide growth. This might even be the case if they subsequently decide to continue working and postpone drawing down their pension.

*‘The problem is of course that those people end up in the default because they can’t be bothered to make a choice. So if the default doesn’t change, they will end up in funds that have taken them out of equities far too soon.’*

(Intermediary)

Many providers and intermediaries therefore expect that the lifestyling process will need to adapt in the near future, to take into account changes to the expected retirement age, and so avoid individuals’ funds being transitioned out of growth investments too early.

*‘We are all going to be working much, much longer than we ever thought. Therefore, perhaps lifestyling will have to take in the fact that actually you won’t be retiring at 60 or 65. I believe that a lot of us will phase ourselves into retirement. I do think that the way in which employer schemes will be designed will have to change with the way the economy changes and the way we retire.’*

(Provider)

The possibility that investments could transition more gradually over an individual’s lifetime into safer investments was mentioned by some as a possible solution to this, and it is an approach that was already evident in some of the diversified growth funds described in Section 6.1.2.

### 6.1.2 Downside protection

Providers and intermediaries often predicted a number of innovations that would lessen the impact of stock market highs and lows in the future. One recent innovation – the diversified growth fund – was seen as being a manifestation of this that is already evident in the market. A minority of the employers in this study invested part of their default option in diversified growth funds.

These are actively managed funds, designed by the fund provider to provide similar returns to equities, but with reduced volatility. The fund can invest in a very broad array of asset classes and countries to achieve this aim, and may slowly transition into safer investments as the individual nears retirement. Because the fund manager invests in a diverse range of investments, it is sometimes seen as removing the need for trustees to select a wide range of different funds to invest in.

*'What people don't like overall and get nervous is stocks and shares. They don't understand it and they hate losing money. The diversified growth actually takes away from that a little bit. The idea is a smoother ride.'*

(Employer, 1,000 members or more)

*'Seven is the most risky – 100 per cent equities, spread across the globe – and One is the least, with 80 per cent safe investments. In the default option we transition people from Seven to One throughout their working life – so at age 30 they will switch from Seven to Six etc. etc.'*

(Provider)

Some intermediaries felt however that diversified growth funds would be relatively unpopular among most trustees, primarily because the product is seen as complex, and it could be hard for trustees to evaluate whether it will achieve higher returns than traditional funds. This may be exacerbated by the fact that, because it is an actively managed fund, the fund management charges are higher than traditional funds.

Several providers and some intermediaries tentatively predicted more sophisticated investment strategies within the default fund, in particular ways of providing insurance against a fall in value. This was seen as being a reaction to the recent turbulent periods in the world's stock markets, which saw many pension funds lose some of their value: there was a belief that the market now increasingly demanded such insurance-type products.

Although the exact nature of these investments could not be predicted precisely, structured products that incorporate derivatives or swaps were sometimes mentioned. However, none was sure whether such approaches would gain widespread acceptance.

*'They are very complicated for the individual to understand but basically there is a small premium to pay because they will pay a little bit extra in the management of those funds for an insurance that their fund won't lose more than X. But I think at the end of the day if you are saying to a trustee "Look, you have got to really understand how this works because you are responsible for it" I am not sure that the uptake will be quite as great.'*

(Intermediary)

### 6.1.3 The possible impact of NEST

While all of the providers and intermediaries interviewed agreed that the workplace pension reforms will have a significant effect on the pensions market as a whole, the impact of automatic enrolment on the design of the default option itself was expected to be limited. While most recognised that many people will be automatically enrolled into a trust-based DC scheme in the future, and many of these will end up in the default option, few expected automatic enrolment to necessitate a change in the approach to designing the default.

The element of the reforms expected to have the greatest impact on the default option was generally seen as being the introduction of NEST. After the implementation of the reforms, many employers were expected to use NEST as their qualifying workplace pension, and so a very high proportion of employees nationally were expected to be automatically enrolled into NEST. This was expected to generate a great deal of national and media interest. Consequently, many providers and intermediaries, and some larger employers, predicted that NEST would effectively become the industry norm, or benchmark, that other funds would judge themselves against after 2012.

Many therefore felt that default funds in occupational DC schemes would seek to emulate NEST, and potentially start to mirror the asset allocation and its other features, in part because providers, intermediaries and employers will not wish to be seen to underperform NEST to any significant degree.

*'Most defaults are balanced managed with lifestyling. That will change. It will change almost certainly to a target date fund because we have got to be comparable to NEST, because otherwise questions get asked.'*

(Provider)

NEST is likely to use target date funds within its default. A target date fund is a 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. Many providers and intermediaries believed that other pension schemes could start to mirror this approach.

Some providers and intermediaries also expected NEST's default funds to incorporate a higher proportion of more secure investments in the early years of an individual's pension saving, to allow them to establish a meaningful pot initially. Consequently, they suggested that they, and others in the market, might also consider this approach.

*'NEST potentially will have an influence as well in terms of the style of default. Obviously, we were looking at the likelihood of the target date funds. Equally there is this issue about whether or not within that target dating you also have this idea of starting with low risk to get people comfortable with the idea, and then taking it up, and then taking it back down again at the end of the working life.'*

(Intermediary)

### 6.2 Awareness of existing guidance on default options

Before discussing the government's proposed guidance, participants were asked about their awareness of existing guidance on default funds. There was very limited awareness of any existing guidance among employers. Once again the majority re-iterated the fact that they would be reliant upon their intermediaries to inform them and keep them up to date about any relevant issues.

*'I am not particularly aware. We rely on [intermediary] for that and he hasn't told us of anything that should make us wary.'*

(Employer, 12 to 99 members)

Some employers across all size bands were aware of the Myners Principles for trustees,<sup>13</sup> and a minority was aware of the Investment Governance Group's (IGG) plans, led by The Pensions Regulator (TPR), to issue a set of investment governance principles for DC schemes in quarter four of 2010.<sup>14</sup>

Providers and intermediaries were aware of the Myners Principles and the IGG's proposed revisions to it, and many also mentioned sources of guidance that were published by the Financial Services

---

<sup>13</sup> HM Treasury and the Department for Work and Pensions (DWP) (2001) *Myners Review: Institutional Investment in the United Kingdom – The Government's response*.

<sup>14</sup> A final set of DC principles was published in November 2010. Detail can be found at: <http://www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx>

Authority (FSA). These included:

- FSA Treating Customers Fairly in the context of bundled schemes;<sup>15</sup>
- FSA insurance prudential rules;<sup>16</sup>
- FSA Conduct of Business Sourcebook.<sup>17</sup>

## 6.3 Initial reactions to the government's proposed guidance

The final subject discussed in the interviews with participants was their views on possible areas that they would like to be included or excluded from the government's draft guidance on the use of default fund options in trust-based DC pension schemes. No details of the guidance were revealed to participants as part of this study. Before examining this in detail, it is worth examining participants' first reactions to the possible guidance, because this did vary depending on the group spoken to.

Larger employers with schemes of more than around 100 members and those with more knowledgeable trustee boards initially insisted that their trust-based DC scheme was already better than most contract-based schemes in existence. Some therefore questioned the necessity for any guidance on minimum standards for their default option. In their view, the sheer fact that employers with trust-based schemes had made the effort to put in place a trustee board meant that they were well-equipped to look after members' best interests, and initially considered additional guidance to be unnecessary.

*'You set up a scheme to service your employees and you are looking after your members' interests because you appoint a trustee board and you have governance around that: so how would any guidelines on this actually help?'*

(Employer, 1,000 members or more)

In most cases however, most larger employers were in fact able to propose areas that the guidance could helpfully cover.

Smaller employers and those with less knowledgeable trustee boards did not react negatively to the prospect of new guidance, although they were typically unable to assess the areas where they felt they would need guidance. Once again, they assumed that their intermediary would keep them up to date on any relevant information.

Providers and intermediaries were generally very clear on what they wanted the guidance to cover: while they would welcome clear guidance as to the broad areas that trustees should consider when designing and maintaining a default option, they also said that the guidance should avoid being prescriptive regarding the features of the fund. They agreed that the guidance should not become a box-ticking exercise that would make it difficult for the default option to remain tailored to different members' needs and profiles.

---

<sup>15</sup> All firms regulated by the FSA have to support the FSA Handbook's principle that a firm 'must pay due regard to the interests of its customers and treat them fairly'. Detail can be found at: <http://www.fsa.gov.uk/pages/doing/regulated/tcf>

<sup>16</sup> Financial Services Authority (2001) *Interim Prudential Sourcebook: Friendly Societies & Insurance Companies*.

<sup>17</sup> Financial Services Authority (2007) *Conduct of Business Sourcebook*.

*'My fear is that the DWP can't possibly know what every employer in the land is like and what every employee in the land is like. It is not an exact science but what I wouldn't want is to see something that said "Your default should look like this" because really that's far too broad brush.'*

(Intermediary)

### 6.4 Views on areas to be included in the government's proposed guidance

This section will explore the key areas that participants felt should be covered by the guidance. Providers and intermediaries as well as most medium-sized and large employers had relatively clear ideas as to what should be included in the guidance. These generally fell into five areas:

- 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.

Each of these areas is examined below.

#### 6.4.1 Schemes should always have a default option

Employers, providers and intermediaries generally agreed that the guidance should set out the fact that schemes will need to have a default option. This would primarily be a result of that fact that after 2012 employers will have to automatically enrol eligible employees into a qualifying pension scheme, whether or not they make an active decision to join, which in turn means that a default investment option has to be offered.

*'The DWP are going to have to stick their neck out and say there should be a default, because if you go down auto-enrolment you can't not have a default.'*

(Employer, 100 to 999 members)

Some employers suggested that, more than simply stating this fact, the guidance should also give further explanation as to exactly why there needs to be a default option, and what its purpose will be.

*'I think you need to explain why there is a default option, what the default option is trying to do and what the default option profile is.'*

(Employer, 100 to 999 members)

#### 6.4.2 The default option should take into consideration the risk profile of employees

Many employers felt that the guidance should set out key checks that trustees could make, which would ensure that the default option correctly takes into account the profile of members. Members' ages, salary, industry sector and risk profile were all mentioned by employers as factors that might be considered in designing the default option.

Providers and intermediaries agreed with the broad principle that the default option should be tailored to fit members' demographics, risk profile and life stage. They also typically highlighted that it was important for the guidance to allow a flexible approach to doing this, because the risk factors are likely to vary depending on the employer, and a checklist approach is unlikely to be suited to everybody.

*'I think it's important for the guidance to always recognise what the default is trying to achieve – all default is a compromise. You can never build the right fund for 90 per cent of the workforce. You can't do it. There should be a piece around appropriateness based on the demographics of the membership and that it's really about trying to put in place an appropriate risk-graded investment path for employees.'*

(Intermediary)

Some providers and intermediaries said the guidance should also ensure that the default option and its objectives include a 'working life strategy': in other words, an approach that focuses on achieving overall growth over a member's entire working life, rather than chasing performance in the short-term.

#### **6.4.3 The default option should review its objectives and asset allocation on a regular basis**

Providers, intermediaries and employers agreed that the guidance should ensure that the default option is regularly reviewed, and that monitoring of performance should always be judged in relation to the objectives of the default option.

Intermediaries in particular believed the guidance should address how often a formal review should take place and what is required from that review. A minority added that the importance of making appropriate choices within the trust-based DC scheme should not be dwarfed in trustee meetings by issues around defined benefit (DB) schemes, which had often occurred in the past.

#### **6.4.4 The roles of the trustees, provider and adviser should be made clear**

Many providers and intermediaries stressed that it was important for the guidance to make clear what the different roles and responsibilities were in relation to the default fund. Providers in particular occasionally mentioned anecdotal examples of members in schemes having 'blamed' the provider for poor fund performance, when in their view poor fund selection by the trustees might have been the cause. Clearer guidance as to the roles and responsibilities might, in their view, have avoided such situations.

Many employers in fact felt that setting out roles and responsibilities within the guidance was unnecessary, believing that the trustee board was essentially responsible for all issues around the default fund, and so they should be left with enough flexibility to manage this process themselves.

#### **6.4.5 Communications to members should take place on a regular basis**

Employers in particular mentioned communication as an area that should be covered by the guidance. Many employers said that the guidance should ensure that communication with scheme members should happen on regular basis. Some added that the guidance should promote a clear, simple and easy to understand way of communicating with members. Some employers felt that the guidance should also ensure that scheme members are adequately informed about investment risk levels, in order to achieve a better understanding of what results could be expected from different investment options.

*'For any default fund, make it very clear what the risk profile is and the importance of an individual understanding what his own risk profile would be, or his own attitude to risk would be, so he can understand what is being achieved on his behalf.'*

(Employer, 1,000 members or more)

### 6.4.6 Other minority views

There were a number of other views expressed by a minority of employers with regard to what should be addressed in the guidance. These included:

- Ensuring that provider charges are clear and appropriate.
- Disallowing short service refunds to prevent people from moving around from employer to employer without accruing any pension pot.
- Setting out a maximum level of investment permitted in more risky asset classes.
- Specifying the need for a lifestyle element within the default.

A small minority of providers and intermediaries made reference to US pension legislation which allows a 'Safe Harbour' environment. The rules associated with this allow the employer to carry out due diligence in the choice and on-going monitoring of service providers, investment alternatives and default options, as well as determining the nature and scope of the information and advice that is provided to members, while limiting liabilities. Something similar in the UK was proposed by some providers and intermediaries, so that members might receive protection, while allowing providers and intermediaries the freedom to make more decisions without fear of repercussions.

*'There is this point about fear of litigation and liability from trustees. There are two conflicting factors: the trustees being more proactive in members' interests, versus holding that back for fear of, "What potential litigation would I get in terms of doing this?" If there was potential to create some kind of safe harbour environment that said, "If you follow the guidelines that we set out then there is some kind of safe harbour structure that actually protects you", similar to the safe harbour type concept that they have got in the United States for example, I think that would be a huge step forward.'*

(Intermediary)

## 6.5 Views on areas to be avoided in the government's proposed guidance

Most employers, providers and intermediaries sought broad standards from the guidance, rather than strict requirements, pointing out that a set of specific rules could never meet everyone's needs in a diverse marketplace. They stressed in particular that it should not become a checklist or 'box-ticking exercise', which would take away the flexibility to look after specific member needs. Such areas to be avoided in the guidance included:

- What countries the default fund may invest in.
- How de-risking should operate, or over what period.
- What benchmarks should be used to judge the performance of the fund.
- What asset classes may be used in the default option; in particular the guidance should not rule out the use of particular asset classes as this may prevent the development of, for example, products that offer downside protection.

*'I wouldn't, for example, want the guidance to say "you should do passive" unless there is a good reason otherwise or something like that. That would be going too far. I think it needs to be as open as possible.'*

(Intermediary)

Many employers added that they did not wish to see the guidance take away any of the responsibilities of the trustee. They felt that trustees were best-placed to ensure the scheme was well run and appropriate for its members. They felt that excessive and overtly prescriptive guidance might take away some of the flexibility and decision-making power from scheme trustees. For example, some employers, while accepting that the default fund should be subject to a regular review, did not feel it was the place of the guidance to prescribe the actual frequency of the reviews.

*'That is why you have trustee bodies. That is their decision-making. There is no point in setting up a trustee body that has all sorts of responsibilities on it to operate in a certain way and then not allow them to operate in that way.'*

(Employer, 100 to 999 members)

Some providers felt that it was important that the guidance should not look to place a cap on the annual management charges that they apply to pension funds, as this could have a very distortive effect on the trust-based products that are available on the market.

*'No capping. The fund manager could develop the most suitable fund and it would be expensive in the early years but as the fund is under management then you would find the cost coming down. They have got to acquire economy of scale to make things happen. Again, capping could prevent the very people you are trying to help ever getting funds available to them that probably would do them good.'*

(Provider)

Finally, many providers and intermediaries stressed that they did not wish to see the guidance contradict any of the existing sources of guidance (see Section 6.2). Some providers saw the government's existing contract-based guidance<sup>18</sup> as a good basis on which to base the new guidance. Occasionally, some providers mentioned that this might also ensure more of a level playing field between contract-based and trust-based DC schemes.

*'If at all possible it should be identical or it should certainly be as close to identical as humanly possible because I don't see any need to create more differences between contract-based schemes and trust-based schemes.'*

(Intermediary)

---

<sup>18</sup> Department for Work and Pensions (2009). *The use of Default Options in Workplace Personal Pensions and the use of Group Self Invested Personal Pensions for Automatic Enrolment*.

# 7 Conclusions and policy developments

The introduction of automatic enrolment and NEST (National Employment Savings Trust) will have a significant impact on the UK pensions landscape from 2012. The government has set requirements that all schemes qualifying for automatic enrolment must meet. These will ensure that, no matter which scheme an employee is automatically enrolled into, they can be sure it meets certain standards. Improving understanding of the policy areas explored in this research – the current use of vesting rules and default options in trust-based pension schemes – should aid the government in future policy development.

Since September 2010, when the fieldwork for this study was completed, the government has continued to develop its pensions reform policy agenda along these lines. This chapter summarises the key conclusions of this study, and some of the subsequent policy developments that have taken place.

## 7.1 Vesting rules

Contract-based pension schemes and NEST both allow the member immediate vesting rights: in other words, members are entitled to retirement benefits as soon as they join the scheme. Currently, trust-based schemes do not necessarily have to offer this. Pensions law allows the trustees of a trust-based scheme to process a short service refund if a member leaves the scheme within three months of joining, and to offer the employee a choice between a short service refund and a transfer if leaving between three months and two years of service.

The results of this study appeared to suggest that the rules around short service refunds alone were, in fact, unlikely to be a driver of scheme choice in most cases. For the majority of employers, the ‘pot’ generated through short service refunds was unlikely to generate sufficient funds for them to be of major importance. In fact, many smaller employers were not even aware that the rules existed because short service refunds were processed so rarely.

Only in the case of the very largest employers, and those with a very high turnover of staff, was the short service refund pot seen as a substantial benefit. The employers in this group were, however, already offering high-quality schemes, and in these cases the short service refunds were often used to fund activities that benefited members, such as advice and communications. In many cases the short service refund rules were a key part of the employer’s decision to offer a high-quality trust-based scheme.

The findings of this study cannot predict how employers will approach scheme decision-making after automatic enrolment is introduced. It is however reasonable to assume that, for smaller employers at least, the benefits of the vesting rules are likely to be marginal. A minority of providers and intermediaries did suggest that under the reforms, short service refunds could become more relevant, and some intermediaries pointed out that they would tell employers about the possible cost savings and administrative advantages of the rules, if they were relevant to them.

## 7.2 Default options

This research, along with many other studies, has shown that within most employers, over 80 per cent of employees are likely to end up in the default option. This means that decisions about the design of default options will impact upon a very high proportion of UK employees after automatic enrolment is introduced. The decisions that trustees need to take about employees' risk profile and the most appropriate fund choices for them are therefore critical.

In 2009, the Department for Work and Pensions (DWP) consulted on guidance on the use of default options in workplace personal pensions (WPPs).<sup>19</sup> The draft guidance set out minimum standards surrounding the use of default options in contract-based workplace pensions that were to be used for automatic enrolment. At the time this study was conducted the equivalent guidance on default options in trust-based defined contribution (DC) pension schemes was being developed, in order to ensure that trust-based schemes also followed the same principles of good practice. This research was designed to understand current practices in this area to inform the consultation.<sup>20</sup>

It has shown that there is in fact some variation in the way that default funds are designed and governed, largely depending on the size of the employer. Intermediaries typically reported to us that best practice states that the default fund should be reviewed formally by trustees every three to five years. And while typically, employers with more than around 100 employees did take this structured approach to default option reviews, not all did: the smaller employers in particular had often not reviewed the default fund since the scheme had been set up. Where smaller employers did not review the fund, this was often because they assumed their adviser would tell them to do this: but it was clear that in some cases this did not happen.

This had an impact on the design of the default option itself. Where the default option had been reviewed in the last three years there were a range of strategies chosen: cautious, balanced and adventurous, all incorporating lifestyling. But where the default option had not been reviewed, it was often 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.

The providers and intermediaries interviewed were consistent in their message that the guidance should tell trustees what areas to look at, but should not prescribe the features of the default option itself. Key areas for guidance appear to be:

- 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.

<sup>19</sup> Department for Work and Pensions (2009). *The use of Default Options in Workplace Personal Pensions and the use of Group Self Invested Personal Pensions for Automatic Enrolment*.

<sup>20</sup> The consultation was published after the completion of fieldwork for this study, in December 2010:  
Department for Work and Pensions (2010). *Offering a default option for defined contribution automatic enrolment pension schemes – public consultation*. Available at: <http://www.dwp.gov.uk/consultations/2010/dc-default-option-consult.shtml>

## 52 Conclusions and policy developments

---

Providers and intermediaries also felt strongly that the guidance should not exclude or inhibit the development of possible future products.

In December 2010, the guidance was published for consultation, taking these research findings into account. Independently of this process, the Investment Governance Group (IGG), led by The Pensions Regulator (TPR), also issued a set of investment governance principles for DC schemes in November 2010.<sup>21</sup> This included several recommendations for trustees aimed at ensuring an appropriately designed default option, including:

- Allowing appropriate time for design, review and monitoring of the default option.
- Ensuring there are clearly defined strategic objectives for the default option in terms of the levels of risk and returns inherent in achieving the desired outcomes for members.
- Ensuring the membership data on which the default strategy is based is as robust and detailed as is practical.
- Ensuring the design of an appropriate default strategy considers, as far as is possible, the needs of the broad membership.
- Ensuring that investment fees and costs are reasonable and competitive given the performance expectations of the strategy.

---

<sup>21</sup> Detail can be found at:  
<http://www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx>

# Appendix A

## Methodological appendix

### A.1 Respondent profile

The sampling and recruitment plan was specifically designed to ensure that the participating employers reflected a range of different sizes of scheme. Table A.1 gives the number of interviews achieved in each group.

**Table A.1 Number of interviews by participant type**

Category	Number of interviews
Total	41
Employers by scheme size	
12 to 99 members	6
100 to 999 members	10
1,000 members or more	8
Providers	10
Intermediaries	7

### A.2 Analysis and reporting

Digital audio recordings were made of all of the individual depth interviews for analysis purposes, with the explicit permission of all of the participants. No participants declined permission. We used each recording to transcribe the interviews. The recordings were destroyed at the end of the project.

Working closely together, the team analysed the results of the individual depth interviews at an individual respondent level to produce an internal summary document identifying key emerging themes and provisional findings.

In addition, a custom-made spreadsheet was produced, which allowed the team to collate and analyse the large quantities of data we collected. This allowed specific groups of participants' answers to be analysed together and compared. It also helped the team to identify useful verbatim comments, illustrative examples and attributions, all of which were used to add depth to this written report.

Working together, the team produced an initial document identifying key emerging themes, which formed the basis of an initial report of findings delivered internally to the Department for Work and Pensions (DWP); and subsequently this written report of findings.

# Appendix B

# Materials used in conducting the research

## B.1 Introductory letter to employers

[Respondent full name]

[Employer name]

[Date]

Dear [Respondent first name]

### **The Workplace Pension Reforms: a study of UK occupational pension schemes**

I am writing to you to ask for your help in a research study that has been commissioned by the Department for Work and Pensions. The aim of this research is to find out about the current use of default options and vesting rules in defined contribution schemes. The findings will help to inform best practice guidance that it is planning to issue later this year.

Your name has been selected from a list of occupational pension schemes held by The Pensions Regulator and we are contacting you for research purposes only.

The research is being conducted on DWP's behalf by RS Consulting, an independent research organisation. A researcher from RS Consulting will have contacted you to ask if you are willing to participate in a face-to-face interview. If you choose to take part, it will last for approximately one hour and the interviewer will agree a location that is most convenient to you, such as your office.

Any information you provide will be held in the strictest of confidence and will be handled securely throughout the study. The research findings will not identify you and no personal information will be shared with any third parties.

If you do not want to take part please let RS Consulting know at any time, either in response to the email you received from us or by phone. If you have any questions about the research please contact [DWP and RS Consulting project managers].

Your contribution will provide us with valuable information that will help to inform policy and improve the services we provide. We do hope that you decide to take part.

Yours sincerely

[DWP and RS Consulting project managers]

## **The Workplace Pension Reforms: a study of UK occupational pension schemes**

In our interview, we would like to discuss with you the following broad topics, in relation to your **occupational defined contribution pension scheme**:

- Options available to members if they leave the scheme with less than two years' membership.
- Any information you hold on which of these options members actually choose.
- Your views on how these arrangements work at the moment, and the kinds of benefits they offer you and the scheme members.
- The investment objectives and charges of the default fund you use within the pension scheme.
- The types of investments the default fund uses, and how often you review this.
- Who is responsible for each of the roles involved in operating the default fund.
- Your opinions on what type of government best practice guidance on default funds might be helpful to your organisation.

Please rest assured that we will not be requesting any detailed, numeric data and you should not need to refer to a professional adviser to answer any of the questions we discuss. The list above is a broad outline of discussion areas, and so not all topic areas might be relevant to your organisation.

Any information you provide will be held in the strictest of confidence and will be handled securely throughout the study. The research findings will not identify you and no personal information will be shared with any third parties.

Thank you again in advance for your help in this important research.

## B.2 Introductory letter to providers and intermediaries

[Respondent full name]

[Provider/Intermediary name]

[Date]

Dear [Respondent first name]

### **The Workplace Pension Reforms: a study of UK occupational pension schemes**

I am writing to you to ask for your help in a research study that has been commissioned by the Department for Work and Pensions. The aim of this research is to find out about the current use of default options and vesting rules in defined contribution schemes, as well as to get your views on what information you would like to see in draft guidance that the government is planning to issue later this year.

We are hoping to speak to the major UK pensions providers and employee benefits consultants as part of this study, and we are also interviewing a number of employers that operate occupational DC pension schemes.

The research is being conducted on DWP's behalf by RS Consulting, an independent research organisation. A researcher from RS Consulting will have contacted you to ask if you are willing to participate in a face-to-face interview. If you choose to take part, it will last no longer than one and a half hours, and the interviewer will agree a location that is most convenient to you, such as your office.

Any information you provide will be held in the strictest of confidence and will be handled securely throughout the study. The research findings will not identify you and no personal information will be shared with any third parties.

If you do not want to take part please let RS Consulting know at any time, either in response to the email you received from us or by phone. If you have any questions about the research please contact [DWP and RS Consulting project managers].

Your contribution will provide us with valuable information that will help to inform policy and improve the services we provide. We do hope that you decide to take part.

Yours sincerely

[DWP and RS Consulting project managers]

**The Workplace Pension Reforms: a study of UK occupational pension schemes**

In our interview, we would like to discuss with you the following broad topics, in relation to the **occupational defined contribution pension schemes** that you offer, whether these are single-employer schemes or multi-employer master trusts:

- Options available to members if they leave the scheme with less than two years' membership.
- Your views on how these arrangements work at the moment.
- Typical fund made-up and charging structures of funds that schemes use as default funds.
- Typical default fund objectives and asset allocation, including any de-risking mechanisms used.
- Default fund governance.
- Overall trends in the market with regard to default funds, and how the reforms might impact these.
- What you feel that the government's guidance on default funds in occupational pension schemes should cover, and why.

Any information you provide will be held in the strictest of confidence and will be handled securely throughout the study. The research findings will not identify you and no personal information will be shared with any third parties.

Thank you again in advance for your help in this important research.

### B.3 Screener for employers

#### **Introduction for Switchboard/ Gatekeeper**

Good morning/ afternoon. Please could I speak to ..... [scheme contact from database].

If named contact no longer works there and person with same job title cannot be located:

In that case, could I speak to the most senior person responsible for employee salaries and benefits?

If asked: My name is .....and I am calling you from RS Consulting, an independent market research company, on behalf of the Department for Work and Pensions.

I'm calling because the DWP is conducting research into occupational pension schemes across the UK, and this research is directly relevant to the [scheme name] pension scheme.

If necessary, offer to send letter from DWP, either by post or email. Confirm contact details and send. Continue discussion now if possible.

#### **Introduction for potential respondent**

My name is .....and I am calling you from RS Consulting, an independent market research company, on behalf of the Department for Work and Pensions.

Later this year, the DWP is planning to issue guidance that will set out minimum standards on default options in trust-based DC pension schemes.

We are contacting you because the guidance is directly relevant to the [scheme name] pension scheme. Your scheme was selected from a list of occupational pension schemes held by The Pensions Regulator and we are contacting you for research purposes only.

This research is designed to help the government understand how default funds and vesting rules operate at the moment, as well as to get your views on what information you would like to see in the guidance. The results will be published at the beginning of next year.

The research consists of confidential, face-to-face interviews with a range of employers across the UK. Can I just confirm that you are the main contact for your trust-based DC pension scheme?

If so: So I can confirm the details that I hold, do you mind if I ask some brief questions now about your organisation and your DC pension scheme?

**Read reassurance on confidentiality:** Any information you provide will be held in the strictest of confidence and will be handled securely throughout the study. The research findings will not identify you and no personal information will be shared with any third parties.

If necessary, offer to send letter from DWP, either by post or email. Continue discussion now if possible.

## Screening

Q1 How many employees does your company have in total in the UK?

SINGLE CODE

1 employee	1	Thank and close
2 to 11 employees	2	Continue
12 to 99 employees	3	
100 to 999 employees	4	
1,000 to 4,999	5	
5,000 employees or more	6	
Cannot say/don't know	99	Seek alternative contact or thank and close

Q2 Can I confirm which types of pension you offer to your staff?

READ OUT, MULTIPLE RESPONSES POSSIBLE

A trust-based DC scheme	1	Must code 1 to continue
A defined benefit pension scheme	2	If only code thank and close
A group personal pension or stakeholder pension	3	If only code thank and close
Cannot say/don't know	99	Seek alternative contact or thank and close

Q3 Approximately how many members does your trust-based DC scheme have?

SINGLE CODE

1 member	1	Thank and close
2 to 11 members	2	Ask Q3b if less than 15 members, otherwise skip to Q4
12 to 99 members	3	
100 to 999 members	4	Skip to Q4
1,000 to 4,999 members	5	
5,000 members or more	6	
Cannot say/don't know	99	Seek alternative contact or thank and close

ASK ONLY TO SCHEMES WITH 15 MEMBERS OR FEWER:

Q3b Is the DC scheme a small, self-administered scheme (SSAS)? This is a scheme usually set up for a group of directors, all of whom are trustees of the scheme.

## 60 Appendices – Materials used in conducting the research

---

If in doubt: If your scheme has any members who are not trustees, it is not a SASS.

Yes – SSAS	1	Thank and close
No	2	Continue
Cannot say/don't know	99	Seek alternative contact or thank and close

Q4 Can I just confirm, is the scheme still open to new members?

SINGLE CODE

Yes	1	Continue
No	2	Thank and close
Cannot say/don't know	99	Seek alternative contact or thank and close

Q5 And finally, can I confirm that your organisation pays an employer contribution to employees who are active members?

Yes	1	Continue
No	2	Thank and close
Cannot say/don't know	99	Seek alternative contact or thank and close

Q6 What is the maximum level of contribution that you pay most of your staff?

READ OUT BANDS IF NECESSARY, SINGLE CODE

Less than 5%	1	Continue
6%-10%	2	
11%-15%	3	
More than 15%	4	
Cannot say/don't know	99	

### Recruitment

If not recruiting: I am sorry to say that you actually fall outside of the range of companies that we need to recruit as part of this study. Apologise for taking up respondent's time. If asked, explain that report is likely to be available early next year from the research publications section of the DWP website. Thank and close.

If recruiting: We would very much like to interview [company] as part of this study. The interview would take no longer than an hour, at your workplace or somewhere else if you prefer.

Reiterate reassurance on confidentiality: Any information you provide will be held in the strictest of confidence and will be handled securely throughout the study. The research findings will not identify you and no personal information will be shared with any third parties.

I will confirm to you soon which of my colleagues at RS Consulting will conduct the interview.

**Confirm that you will send them:**

Confirmation of the name of the interviewer and the appointment details.

An introductory letter from DWP and RS Consulting describing the interview topics.

**Confirm appointment with interviewing team then send email to respondent. Remind them that if they do not want to take part they may let RS Consulting know at any time.**

## B.4 Screener for providers and intermediaries

### **Introduction for Switchboard/Gatekeeper**

Good morning/afternoon. Please could I speak to ..... (named contact).

**Where named contact fails:** My name is.....and I am calling you from RS Consulting, an independent market research agency, on behalf of the Department for Work and Pensions.

The DWP is currently consulting the major pensions [providers/intermediaries], including [company], in a study to inform the government's guidance on the use of default options in DC occupational schemes, and to understand how vesting rules are used at the moment.

I wonder whether I might speak to the head of the occupational pensions business?

If letter requested, offer to send letter from DWP, either by post or email. Confirm contact details and send. Continue discussion now if possible.

### **Introduction for potential respondent**

My name is.....and I am calling you from RS Consulting on behalf of the Department for Work and Pensions.

You may well know that DWP is planning to issue guidance that will set out minimum standards on default options in trust-based DC pension schemes. As part of this, they would like to consult the major pensions [providers/intermediaries], including [company].

The DWP would like to understand more about current practices in this area, as well as to get your views on what information you would like to see in the guidance. The research will also look at current vesting rules in trust-based DC schemes. The results will be published at the beginning of next year.

We would like to conduct a confidential, face-to-face interview with you, which would take no longer than an hour and a half, at your workplace or somewhere else if you prefer.

Offer to email introductory letter from DWP. Confirm contact details and send. Continue discussion now if possible.

**Read reassurance on confidentiality:** Any information you provide will be held in the strictest of confidence and will be handled securely throughout the study. The research findings will not identify you and no personal information will be shared with any third parties. **Ensure that respondent is clear on this, and allow them to ask any questions.**

I will confirm to you soon which of my colleagues at RS Consulting will conduct the interview.

Respondent name:

Respondent job title:

Interview address including company name:

Re-confirm email address:

Re-confirm telephone number:

Interview date:

Interview time:

Any other details for interviewers:

**Confirm that you will send them:**

Confirmation of the name of the interviewer and the appointment details.

An introductory letter from DWP and RS Consulting describing the interview topics.

Confirm appointment with interviewing team then send email to respondent. Remind them that if they do not want to take part they may let RS Consulting know at any time.

## B.5 Discussion guide for all participants

### **INTRODUCTION**

My name is ..... From RS Consulting. Thank you very much for agreeing to take part in this research.

As you know, we are conducting this study on behalf of DWP. We are exploring the use of short service refunds and default options in trust-based DC schemes across the UK.

DWP is planning to issue guidance that will set out minimum standards on default options in trust-based DC schemes later this year, and this research is designed to help the government understand more about current practices. We are talking to a range of employers that operate trust-based DC schemes, as well as pension providers and intermediaries. The results will be published at the beginning of next year.

**Confirm timings:** The discussion will take approximately 1 hour (employers)/1.5 hours (providers and intermediaries).

**Confidentiality:** I can assure you that anything you tell me will be treated in confidence by the RS Consulting project team. It will not be attributed to you, or your organisation, either in our presentations or in the final project report which will be published by DWP.

**Ask for permission to record for our analysis purposes.** The recording will not be passed onto any third party and will be destroyed after the project finishes.

Before we start our discussion, do you have any questions?

Could I first of all re-confirm your job title? And could you summarise your role within your organization?

## VESTING RULES

### SECTION 1: TRUST-BASED DC SCHEMES AND VESTING RULES

#### PROVIDERS AND INTERMEDIARIES ONLY:

First of all I'd like to look at the schemes you offer, and how they operate in terms of short service refunds. Just to re-iterate, in this study we are only looking at trust-based DC schemes – not other types of pension such as final salary schemes, group personal pensions or stakeholders.

1.1 To begin with, could you please tell me what type of trust-based DC schemes you offer? Do you offer single-employer schemes only or do you offer multi-employer master trusts as well?

**If single and multi-employer schemes offered:** We are interested in the way that both your single employer and multi-employer schemes operate, and so when we look at the next topics I would ask you to highlight any differences that may exist between the two different types of schemes.

#### EMPLOYERS ONLY:

1.2 Do you offer any other pension schemes to any employees? Obtain brief details of other schemes (trust or contract-based). If DB scheme exists, establish whether this is open/ closed/ frozen, and how this operates alongside the DC scheme.

I'd like to look at the scheme you offer your employees, and how it operates in terms of short service refunds. Just to re-iterate, in this study we are only looking at your trust-based DC schemes – not other types of pension such as final salary schemes, group personal pensions or stakeholders.

Summarise and re-confirm main features of scheme from screener.

1.3 Thinking back to when this particular scheme was chosen for your employees, what drove your choice of scheme? What factors did you consider? (**if unable to recall:**) What would you say are the main benefits this particular scheme offers your members?

#### ALL:

We'll now move onto the rules around short service refunds – in other words, what happens if an employee leaves the company after they have been in the scheme for less than two years.

1.4 E: Does your scheme have a minimum period that the member has to be in the scheme, before they are entitled to receive pension benefits (the vesting period)? How long is this? (**Legally, must be two years or less**)

**P&I:** Which of the schemes you offer have a minimum period that the member has to be in the scheme, before they are entitled to receive pension benefits (the vesting period)? How long is this typically? (**Legally, must be two years or less**)

1.5 If a member leaves the company with less than three months of pensionable service, what options are available to them in terms of the pension contributions that have been made? **Be clear on whether each of the following is an option:**

- Short service refund (i.e. The member receives their contributions back, subject to a tax deduction).
- A cash equivalent transfer (to another pension fund).

## **66 Appendices – Materials used in conducting the research**

---

- Retaining preserved rights (they continue as a member and keep the right to a pension under the terms of the pension scheme).

1.6 If a member leaves the company with less than (insert vesting period from 1.3) pensionable service, what options are available to them in terms of the pension contributions that have been made? Be clear on whether each of the following is an option:

- Short service refund.
- A cash equivalent transfer.
- Retaining preserved rights.

1.7 Re-iterate circumstances under which a member can receive a short service refund based on answers to 1.4 and 1.5. Are there any other circumstances where a member can receive a short service refund?

1.8 Could you tell me how these options are typically presented to the employee when they leave the employment of the company? How long does the employee have to decide? Will they receive any further communications over this period?

1.9 What typically happens if the employee does not make any choice at this point? Be clear on which of the three possibilities is the default option.

1.10 Focusing on each of the options available to employees leaving the company:

- Short service refund.
- A cash equivalent transfer.
- Retaining preserved rights.

What proportion of staff tend to take up each of these options, when they leave? What factors does this depend on? Be clear on timeframe, and whether information is from records or an estimate.

1.11 When an employee leaves the scheme and takes a short service refund what, in general, happens to the employer contributions? If funds are kept in the scheme: How are the funds then used?

Is this typically written into the scheme rules? If not: Who decides how the funds are used?

### **EMPLOYERS AND INTERMEDIARIES**

1.12 E: Do your employees have the option to pay pension contributions through salary sacrifice? If so, obtain brief details, and ask: What proportion would you say are taking advantage of this?

I: Do any of your employers allow pension contributions to be paid through salary sacrifice? If so, obtain brief details, and ask: What types of employer would say you offer this? On average what proportion of scheme members would you say are using this?

#### **If salary sacrifice offered:**

1.13 Which employees do you think salary sacrifice is most suitable for? What are the advantages of this option to employees? Are there any disadvantages or risks? (probe in detail if loss of short service refund mentioned)

**If loss of short service refund not mentioned spontaneously:** If a member leaves the scheme and wants a refund of contributions, what happens to the salary sacrifice contributions? If lost by member: Is this seen as a disadvantage at all? Probe in detail.

**EMPLOYERS ONLY:**

1.14 Thinking now about all the aspects of your pension scheme, what benefits would you say this particular scheme gives your employees? (if necessary: focus on benefits of this particular scheme, rather than overall benefits of having a pension)

1.15 And what benefits would you say it offers for you as the person responsible for its administration?

If vesting rules are mentioned spontaneously, probe in detail. If not:

1.16 To what extent do the current rules around short service refunds offer a benefit to you? In what ways? **Probe in detail, especially around administration and cost.**

1.17 What would you say are the less attractive or beneficial aspects of the current rules around short service refunds? If you could make any changes to the rules we have just discussed, what would they be? **Probe in detail, especially around administration and cost.**

1.18 Have you made any changes to your rules around short service refunds since you set up the DC scheme? **Probe in detail if so.**

1.19 Do you expect to maintain your current rules around short service refunds in the future? Probe in detail if so. **If not, ask:** Are there any circumstances where you might consider changing these rules?

**PROVIDERS AND INTERMEDIARIES ONLY:**

1.20 To what extent would you say the current vesting rules offer a benefit to employers? In what way? **Probe in detail, especially around administration and cost.**

1.21 What would you say are the less attractive or less beneficial aspects of the current vesting rules? **Probe in detail, especially around administration and cost.**

1.22 Are you aware of trustees having made changes to vesting rules since setting up their DC scheme? Under what circumstances is this likely to happen?

1.23 Are there any circumstances where you feel trustees might consider changing vesting rules in the future? Are the workplace pension reforms likely to have an impact on vesting rules? **Probe in detail.**

## **68 Appendices – Materials used in conducting the research**

---

### **SECTION 2: SCHEME ADMINISTRATION COSTS**

#### **EMPLOYERS ONLY:**

I'd like to look now at some of the costs associated with administering your pension scheme.

2.1 Have you ever transferred your pension scheme from one provider to another? If not: Have you ever looked into doing this?

#### **If scheme was transferred in the past:**

2.2 Are you able to tell me what the costs were of switching from one scheme to another?

Establish as much detail as known about how these costs broke down. Be clear on whether it is cost per member or total cost.

2.3 Who were these costs charged to? Be clear on where each element of the cost was charged to: the scheme or the employer.

2.4 How long did it take to make the arrangements of switching from one scheme to another? What was the degree of effort or man hours involved?

2.5 Could you provide an indication of what the cost associated with setting up a trust-based DC scheme from scratch would be for you?

#### **If scheme not transferred, but they have looked into it:**

2.6 Are you able to tell me what the costs would be of switching from one scheme to another?

Establish as much detail as known about how these costs break down. Be clear on whether it is cost per member or total cost.

2.7 Who would these costs be charged to? Be clear on where each element of the cost would be charged to: the scheme or the employer.

2.8 How long do you think it would take to make the arrangements of switching from one scheme to another? What would be the degree of effort or man hours involved?

2.9 Could you provide an indication of what the cost associated with setting up a trust-based DC scheme from scratch would be for you?

#### **INTERMEDIARIES ONLY:**

I'd like to look now at the costs that would be incurred if an employer chose to switch their pension from one provider to another.

2.10 Are you able to tell me what the costs would typically be if an employer switches from one scheme to another? Establish as much detail as known about how these costs break down. Be clear on whether it is cost per member or total cost.

2.11 Who would these costs be charged to? Be clear on where each element of the cost would be charged to: the scheme or the employer.

2.12 How long do you think it would take an employer to make the arrangements of switching from one scheme to another? What would be the degree of effort or man hours involved?

2.13 Could you provide an indication of what the cost associated with setting up a trust-based DC scheme from scratch would be for an employer?

### **SECTION 3: DEFAULT OPTION SELECTION AND MAKE-UP**

For the remainder of this interview I'd like to focus on the default option used in your trust-based DC pension scheme(s). Just to be clear, by default option, I mean the overall package of fund(s), product and advice that members' are enrolled into if they don't themselves make an active choice.

#### **INTERMEDIARIES ONLY**

3.1 How do you decide what is the best and most suitable default option for a member? What criteria do you take into consideration? Obtain full details.

#### **PROVIDERS AND INTERMEDIARIES ONLY**

3.2 What, in general, are the objectives of the default options that you offer? Why?

3.3 Does the default fund always include a de-risking mechanism? If yes, What de-risking mechanism is used? Is it/are they lifestyled?

3.4 How do you generally allocate investments within a default option? Can you give me an example of a standard investment strategy for a default fund? What is the typical make-up of the default fund? (For example, 40 per cent property, 40 per cent bonds, 20 per cent Far East)

3.5 How many other options are typically offered alongside the default fund? What does this depend on?

3.6 What proportion of members is typically invested in the default fund? What type of employee is likely to invest in the default option vs. An alternative?

3.7 How frequently are default funds typically reviewed within DC pension schemes? Who undertakes the reviews? Who else is involved in the process? Which aspects of the default fund are reviewed?

3.8 Do you make additional charges for reviewing a default option? How are these structured and what is the level of charge?

3.9 Thinking still of the default option review, do the scheme members themselves receive any information about this? If yes, What do they receive and from whom? If the review means a material change to the fund that they are invested in, would they have to agree to this? How?

#### **EMPLOYERS ONLY**

3.10 When you chose a default option for your pension scheme what factors did you take into consideration?

- 3.11 How do you decide if the default option that you use is the best and most suitable for your scheme members? What criteria do you take into consideration? Obtain full details.
- 3.12 What are the objectives of the default option? Why?
- 3.13 Does your scheme have a de-risking mechanism? **If necessary:** in other words, a strategy that mitigates members' investment volatility over the lifetime of the product? If yes – Does it take into account the retirement profile of your members?
- 3.14 How are investments allocated within your default fund? Can you tell me a little about the investment strategy? What is the make-up of the default fund? (**For example, 40 per cent property, 40 per cent bonds, 20 per cent Far East).**
- 3.15 How many other options do you offer alongside the default fund? Why?
- 3.16 What proportion of members is typically invested in the default fund? What type of employee is likely to choose to invest in the default option vs. An alternative?
- 3.17 Is the default option subject to a regular review? How often is it reviewed? Who else is involved in the process? Which aspects of the default fund are reviewed?
- 3.18 Are you involved in the review? **If yes** – What part do you play?
- 3.19 Are there additional charges for a default option review? Who makes these? How are they structured and what is the level of charge?
- 3.20 Following the review is a post-review report produced? If yes, By whom? What information does it include?
- 3.21 Thinking still of the default option review, do the scheme members themselves receive any information about this? **If yes**, What do they receive and from whom? If the review means a material change to the fund that they are invested in, would they have to agree to this? How?

#### **SECTION 4: CURRENT DEFAULT FUND CHARGES**

##### **PROVIDERS ONLY**

4.1 I'd like to look at the charges for the current default options you offer. Could you tell me how these charges are structured? **If necessary:** For example is it a fixed annual fee per member, or is it levied as a percentage of the fund value?

4.2 Do these charges vary? What are the factors that determine the level of charges levied where a member is invested in the default option? **If necessary:** for example, the size of the employer, or the extent to which the fund is actively managed? Obtain full range of factors, and which are most important, and the range of charges made.

##### **INTERMEDIARIES ONLY**

4.3 I'd like to look at the charges you make to employers for the advice offered on default options. What types of charges do you make? **If necessary:** are these up-front charges, one-off or ongoing charges?

4.4 How much do you generally charge an employer for this advice on default options? If unclear, establish what drives whether an intermediary will charge more or less.

4.5 And what are the factors that determine the level of charges levied by a provider where a member is invested in the default option? If necessary: for example, the size of the employer, or the extent to which the fund is actively managed? Obtain full range of factors, and which are most important.

#### EMPLOYERS ONLY

4.6 What role did the charges levied by the provider on the default option play in deciding upon a default option?

4.7 What type of charge is made by your scheme provider on your scheme's default option? What is the level of charge? How is that charge made up? If necessary: For example is it a fixed annual fee per member, or is it levied as a percentage of the fund value?

4.8 Are there any additional charges made by your adviser or intermediary? (e.g. Administration charges) If yes, who pays these, and what do these charges cover?

### SECTION 5: DEFAULT OPTIONS GOVERNANCE AND RESPONSIBILITIES

#### ASK ALL

Thinking now about scheme governance...

5.1 What is the general process for setting out who is responsible and when in designing, operating, and winding up the default option? If necessary: for example, is there a set procedure which decides who is responsible for the investment objectives, the asset allocation, reviewing the performance of the default option, its suitability for members etc.

5.2 How are responsibilities allocated? e.g. Written in a contract, written in member communication, not communicated...

5.3 Are scheme members typically made aware of these responsibilities and who is responsible for what?

5.4 Are there any key points at which responsibilities have to be allocated? (e.g. In designing a fund) If yes – What are those points? Who is likely to have responsibility for each? Why is that? Is it likely that they will always have that responsibility? If not: why not?

5.5 Whose role is it to communicate information about the default option to members? (The provider? The employer? The intermediary?) Why?

5.6 What information about the default option do members currently get: with what regularity, and on which occasions?

5.7 How adequate would you describe communications to scheme members on the default fund?

### SECTION 6: CHANGING AND EMERGING MARKET TRENDS

Finally, I'd like us to talk about wider emerging market trends regarding the default option, and how possible future guidance from the government might fit into this.

#### ASK ALL

6.1 Could you describe the changes you feel have taken place over the past 5 years with regard to default options in the trust-based DC pension market? Allow general answer, then probe if necessary on:

- fund design and implementation;
- governance;
- communications to members.

6.2 Do you expect this to change in the future? In what ways?

6.3 How do you feel this will change after the workplace pension reforms are implemented? Do you anticipate any issues or problems? Could you anticipate any factors that could affect the potential development of default options in the trust-based DC pension marketplace? **Obtain full details.**

6.4 As I mentioned earlier, the government is planning to issue guidance that will set out minimum standards on default options in trust-based DC pension schemes later this year. Are you aware of any current guidance or rules that already exist in this area? **Obtain full details, references, etc.**

6.5 Thinking forward to the government's guidance, what would you say are the key areas the guidance should cover? **Obtain full details and reasoning.**

6.6 How do you feel that the guidance can help to ensure that the default option is a safe and secure investment for members? **Obtain full details and reasoning.**

6.7 Would providing more clarity on the roles and responsibilities of the different scheme players be useful to you? Why?

#### PROVIDERS AND INTERMEDIARIES ONLY:

6.8 You are probably aware that the government has already issued similar guidance as to the use of default options in contract-based schemes. Do you feel that the new guidance for trust-based DC pension schemes should cover similar or different areas? **Obtain full details and reasoning.**

#### ASK ALL

6.9 What is the absolute minimum you feel is needed from the guidance that will be issued? How would receiving this guidance impact your organization?

6.10 Are there any areas that you feel it would be excessive or unnecessary to issue specific guidance? How would such guidance impact your organization?

Thank you very much for your help.

**IMPORTANT: OBTAIN PERMISSION TO RE-CONTACT:** Occasionally, it is very helpful for us to be able to re-contact people we have spoken to, either to clarify certain issues, or to get a bit more detail where the information we are given is particularly interesting. Would you be happy for us to call you back if necessary?

Yes \_\_\_\_\_ No \_\_\_\_\_

DWP will be publishing the full report of findings to this study in the new year, and we would be happy to send you an electronic copy of the report if you would like us to?

Yes \_\_\_\_\_ No \_\_\_\_\_

**THANK AGAIN AND CLOSE**

# References

Department for Work and Pensions (2009). *The use of Default Options in Workplace Personal Pensions and the use of Group Self Invested Personal Pensions for Automatic Enrolment*; <http://www.dwp.gov.uk/docs/workplace-personal-pensions-default-options-consultation240909.pdf>

Department for Work and Pensions (2009). *Workplace Pension Reform – Completing the Picture: Executive Summary – Policy Narrative*; <http://www.dwp.gov.uk/docs/workplace-pension-reforms-exec-summary-240909.pdf>

Department for Work and Pensions (2010). *Offering a default option for defined contribution automatic enrolment pension schemes – public consultation*; <http://www.dwp.gov.uk/consultations/2010/dc-default-option-consult.shtml>

Financial Services Authority (2001). *Interim Prudential Sourcebook: Friendly Societies & Insurance Companies* <http://www.fsa.gov.uk/pubs/policy/ps84.pdf>

Financial Services Authority (2007). *Conduct of Business Sourcebook* <http://fsahandbook.info/FSA/html/handbook/COBS>

HM Treasury and the Department for Work and Pensions (2001). *Myners Review: Institutional Investment in the United Kingdom – The Government's response'* [http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/mediastore/otherfiles/myners\\_response.pdf](http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/mediastore/otherfiles/myners_response.pdf)

This report presents findings of a qualitative study carried out in August and September 2010 to explore the use of vesting rules and default options in Defined Contribution (DC) occupational pension schemes. It involved 41 face-to-face depth interviews with:

- intermediaries;
- pension providers, and
- employers with DC occupational pension schemes.

The research was carried out on behalf of the Department for Work and Pensions by RS Consulting.

If you would like to know more about DWP research, please contact:  
Paul Noakes, Commercial Support and Knowledge Management Team,  
Work and Welfare Central Analysis Division, 3rd Floor, Caxton House,  
Tothill Street, London SW1H 9NA.  
<http://research.dwp.gov.uk/asd/asd5/rrs-index.asp>



---

Published by the  
Department for Work and Pensions  
March 2011  
[www.dwp.gov.uk](http://www.dwp.gov.uk)  
Research report no. 725  
ISBN 978-1-84712-923-9