



**EMBARGOED UNTIL 00:01 TUESDAY 24 APRIL 2007**

## New private sector pension schemes must innovate and take more responsibility for investment strategy to avoid jeopardising the retirement prospects of over 90% of members

Private sector employers that offer an investment-based 'defined contribution' (DC) pension scheme will put their employees' retirement prospects at risk unless they introduce a more innovative 'default' fund, warns the Pensions Institute at Cass Business School. Employers, scheme providers and advisers must also take greater responsibility for the design and communication of the default fund, as this is where typically over 90% of members invest their contributions.

DC schemes transfer investment risk on to individual members and therefore the success of such schemes, in terms of producing adequate pensions, depends very heavily on the success of the investment strategy. At present, typically over 90% of DC scheme members accept the default fund option because they do not feel sufficiently knowledgeable or confident to make active investment choices. (Source: National Association of Pension Funds 'Annual Survey 2006') *'Dealing with the reluctant investor: Innovation and governance in DC pension investment'*, the Pensions Institute's fourth report, analysed the DC investment options currently available and found that most traditional default funds do not match members' needs adequately in terms of asset allocation and risk profile.

Moreover, the very people best equipped to help reluctant investors to make suitable investment decisions, namely employers and pensions professionals, do not do so because they are afraid of legal liability if the outcome is unsatisfactory. This governance or 'responsibility' gap on the part of employers and pensions professionals is particularly acute in contract-based schemes, where the member has a direct contract with the provider (typically a life office) and there is no board of trustees to look after members' interests.

Alistair Byrne, an academic at the University of Strathclyde and a co-author of the report, says, "While employers and insurance companies usually are keen to do the best they can for scheme members, their good intentions stop well short of taking a fiduciary responsibility for the outcome." A fiduciary duty is an important concept in law and implies the highest standard of care. Such individuals or entities are expected to look after the best interests of the individuals to whom they owe their allegiance.

Byrne continues, "We recommend that regulators encourage employers, trustees and advisers to take a greater fiduciary role and protect them through 'safe harbour' rules that restrict liability, provided due diligence has been done. Clearly 'due diligence' in this context would need to be defined carefully but clearly. Key areas of application include selection of the default fund, the extent of investment choice offered to members, and in determining the nature of the information and advice that is provided to members.'

Debbie Harrison, a Senior Visiting Fellow of the Pensions Institute and co-author of the report, says, 'The collective reluctance on the part of employers, providers and advisers to accept a fiduciary responsibility is currently being examined by The Pensions Regulator and rightly so. While it is true that the action of offering a default does not constitute individual advice under the very precise regulatory meaning set out by the Financial Services

Authority, it is equally evident that ‘reluctant investors’ in DC schemes assume that the default fund has been chosen to meet their specific needs. Employers and pensions professionals must be encouraged to take a clearer role in selecting the default fund investment strategy and the range of investment funds on offer in the scheme. For the sake of the reluctant investor’s welfare in retirement, common sense, we feel, should not be thwarted by regulatory semantics.’

This report has a clear message for the government, which plans to introduce a national DC scheme – Personal Accounts – in 2012, into which all employees not currently in a scheme will be automatically enrolled. According to government sources, this will bring a further eight million employees into the DC investment environment. “These people will be particularly vulnerable to investment risk as they will be largely lower- to median-earners and will have little or no investment experience”, Harrison comments.

David Blake, Director of the Pensions Institute, says, ‘This is the first thorough review of DC investment strategies in the private sector. We analysed traditional default fund structures and found them often wanting. However, we also identified important investment initiatives, such as the ‘target date’ fund, the ‘diversified growth’ fund, and ‘risk-graded’ funds, which, if adopted, could provide a much better deal for the reluctant investor.’

A brief description of these funds is provided below.

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The report is available on the Pensions Institute website: [www.pensions-institute.org](http://www.pensions-institute.org).

## Notes for editors

For economic and demographic reasons that have been well documented, in the 21<sup>st</sup> century many finance directors no longer consider Defined Benefit (DB) pension schemes a rational investment. As a result, defined contribution (DC) is now the most common arrangement for employees in the private sector who have changed jobs recently. According to the NAPF, whose members are the medium and large UK pension schemes, 2000 DB schemes closed between 1995 and 2005.<sup>1</sup>

DC can be trust-based (‘occupational DC’), in which case the employer establishes the scheme under UK trust law and there is a board of trustees whose job it is to act in the members’ best interests and negotiate on their behalf with service providers, including asset managers. The alternative is contract-based DC and here the contractual arrangement is directly between the individual member and the provider, typically an insurance company. The key difference between these two structures, therefore, is that in contract-based DC, there is no entity recognised in law or regulation that acts solely on the members’ behalf. Contract-based schemes do, however, fall under financial services regulation and Financial Services Authority (FSA) requirements for providers to ‘treat customers fairly’. Our research reveals that the current trend in the private sector is not only from DB to DC, but also from occupational DC to contract-based schemes. The governance gap on investment matters associated with contract-based arrangements is one of the issues the Pensions Institute

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<sup>1</sup> *The National Association of Pension Funds (2007) ‘2006 Annual Survey’* ([www.napf.co.uk](http://www.napf.co.uk)).

report seeks to address and a subject of current interest for the Pensions Regulator (TPR), which has issued a consultation paper on DC governance issues.<sup>2</sup>

In the Pensions Institute's online survey of 54 senior pensions professionals with experience of the DC market:

69% of the pensions professionals surveyed said that the typical investment arrangements in UK DC pension schemes don't meet most members' needs.

On average, the professionals think that only 10-15% of DC scheme members understand the investment risks they face. Over half of survey respondents put the figure at 10% or less.

**Target date funds** appear to be attractive for the reluctant investor. Importantly, the model helps to focus the member on the outcome rather than on annual growth. Members do not have to make complex fund choices and therefore do not require detailed knowledge of asset class characteristics. Instead the member simply selects the fund nearest to the planned retirement date – for example the 2030 fund. If the expected retirement date changes the member can switch to a longer dated fund or phase retirement by dividing contributions between, say, the 2030 and 2035 funds.

The asset manager adjusts the asset allocation of the fund with the target date in mind (either on a mechanistic or discretionary basis), so that the lifestyling takes place within the fund itself, requiring no switching of the member's unit holdings. While extremely simple from the member perspective, target dating is merely a form of packaging and delivery. The underlying funds used to create the asset mix can be as sophisticated as the provider wishes, although cost will be an important consideration.

**Diversified growth funds** are a more sophisticated version of the traditional balanced managed fund, incorporating a wider range of asset classes, including those that have a low correlation with equities and bonds – for example, commodities, hedge funds, private equity and high yield bonds. The diversified growth fund should produce a better trade-off between risk and return and could be suitable for target date funds. The main downside at present is the high charges associated with the alternative asset classes used to mitigate volatility in the fund but it is likely in future that synthetic structures could be used to replicate these asset classes at a lower cost.

Some schemes provide a narrow range of **Risk-graded funds** – typically three or five funds, each of which contains multiple asset classes. Members can choose the fund that fits their attitude to risk, for example, adventurous, balanced or cautious (the 'ABC' structure). This approach may mean fewer members end up in a single default fund because the investment choice is simpler. Risk profiling tools can be provided to help members with this choice, although if members do not engage with the tools they may misunderstand what is meant by the fund description.

### **About the Pensions Institute**

The Pensions Institute at Cass Business School was founded by Professor David Blake in 1996. As the first and only UK academic research centre focused entirely on pensions, the Institute brings together a broad range of disciplines from economics, finance, insurance, and actuarial science through to accounting, corporate governance, law, and regulation. The objectives of the Pensions Institute are to undertake high quality research in all fields related to pensions, to communicate the results of that research to the academic and practitioner community, and to employers and trustees.

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<sup>2</sup> TPR (2006) 'How The Pensions Regulator will regulate defined contribution pension schemes in relation to the risks to members'. ([www.thepensionsregulator.gov.uk](http://www.thepensionsregulator.gov.uk))

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