Chapter 5:
Investment and accessing savings
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Investment is one of the key considerations for any pension scheme.

Personal accounts will offer a default fund to which members will be enrolled if they do not exercise choice.

The executive delivery authority will design the investment strategy within a general framework set by the Government.

Our research shows that people find pension decisions difficult and many want a simple choice, but a significant minority want extra fund choice. Personal accounts will offer a wider choice of funds and we expect this will include a choice of social, environmental and ethical funds and branded funds. It will be for the executive delivery authority and the personal accounts board to decide when and how these additional funds should be introduced.

Accessing pension saving is also critical to the scheme. Personal accounts will work within the current tax framework for pensions: most will annuitise. Individuals can find decisions about retirement income difficult, so the personal accounts board will be asked to look at how best to support individuals in making good decisions for them. One possibility is through a more structured choice process.

“Participants certainly should have a choice, but that should be achieved by offering a range of investment products for those that wish to make their own investment decisions and a default fund for those (almost certainly an overwhelming majority) who are unable or unwilling to do so.”

(JP Morgan)
What level of choice will be offered in personal accounts?

5.1 A simple scheme requires that fund choice is limited. Whilst accepting that some individuals would want choice, many respondents in focus group discussions felt that having a choice of funds in personal accounts would make the scheme more complicated and confusing than it needs to be, and they suggested that this is likely to increase opt-out rates.¹

5.2 Many people are poorly equipped to make financial choices, particularly those who are younger or have lower incomes. A recent nationally representative UK survey found that many people do not shop around for financial products and one in five make choices without seeking any information or advice first. The majority (79 per cent) use only marketing information and non-independent advice when choosing financial products, and almost half do not consider either price or product features when making a decision. The survey showed that some people end up buying inappropriate or unnecessary products as a result, or do not understand the nature of the products they have.²

5.3 Evidence from Sweden and the USA suggests that people are particularly poorly equipped to make choices about investment asset allocation. Many adopt a naïve diversification strategy³; some heavily base their decisions on funds’ previous returns; and others concentrate their assets in their own employer’s shares, mistakenly viewing them as safer.⁴⁵

³ In which money is divided equally among a number of funds, irrespective of the underlying asset composition of the funds.
5.4 Evidence from the US 401(k) schemes shows that participation rates fell as the number of fund options increased; participation rates were particularly low when fund options exceeded 30.6 (Figure 5.1).

Figure 5.1: The relation between the number of funds offered and participation in 401(k) pension schemes

Source: Figure taken from How much choice is too much?: Contributions to 401(k) retirement plans, by Iyengar, Jiang & Huberman, 2003. PRC paper in 2003. Reproduced by permission of the authors.

Note: The graph was plotted using a two-stage parametric estimation method and so is by no means certain. The dotted lines show 95 per cent confidence intervals.

6 For example, participation rates are 75 per cent for schemes with two funds, falling to just under 70 per cent in schemes with 12 funds. Participation rates drop to just over 60 per cent in schemes with over 50 funds.
5.5 However, some choice is important to meet the needs of the target group. Research findings indicate that some consumers in the target group for personal accounts do want choice, particularly those with higher incomes. Some younger respondents also mentioned a desire to have the choice to invest ethically. An appropriate level of choice helps individuals to take personal responsibility for saving for their retirement and may encourage some people to save more. A study of US 401(k) schemes showed that people with a choice of investments contributed 8.5 per cent more into the scheme than those with no choice at all.

5.6 **Personal accounts will offer a structured choice of investments for members.** The board of the personal accounts scheme will have a duty to members to provide fund choices that are appropriate and serve the needs of members.

5.7 There will be a three-tiered approach to fund choice:

- a default fund for members who do not wish to exercise a choice;
- a small number of bulk-bought funds at low charges; and
- a wider range of funds, which we expect to include social, environmental and ethical investments, and branded funds.

**Box 5a: Social, Environmental and Ethical Investment (SEE) in personal accounts**

SEE represents a small but growing proportion of total UK investment, current UK ethical funds constitute 1.8 per cent of total UK retail funds.

SEE varies both by the ethical basis, for example religious or environmental, and the investment technique, for example screening-out companies or encouraging companies to change their behaviour. This investment choice comes at an additional cost because investors have to pay for active investment managers who are required to spend time ensuring investments are, and remain, ethical. It would, therefore, not be appropriate to enforce those extra charges on personal accounts members who had not actively chosen to incur them.

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9 Ethical Investment Research Services and Investment Management Association data.
Evidence shows that, on average, SEE has performed slightly less well than standard investment over the last ten years, though there is a great deal of variation across all types of investment.

The Government is clear that politicians should not interfere with the investment decisions or priorities in personal accounts. Instead, the Government will task the personal accounts delivery authority with choosing investments in line with members’ interests. Research\(^\text{10}\) suggests that some people, particularly younger people, want access to SEE. Given the apparent consumer demand, the Government envisages that personal accounts will include appropriate SEE choices. It will be for the delivery authority to decide how these should be delivered and, in particular, whether they should be bulk-bought or part of the branded choice.

Since it is anticipated that 6–10 million people will pay around £8 billion a year into personal accounts, the inclusion of SEE could represent a large boost to the relatively small but growing SEE market. The UK SEE market has total assets under management of £20.6 billion on a narrow definition: the broader definition expands this to £530 billion worth of total assets under management.\(^\text{11}\)

As well as researching global best practice related to SEE, the Government intends to conduct research into the personal account target group’s attitudes to SEE, and into best practice in SEE investment around the world.

In addition, the Department for Work and Pensions (DWP) will be involved in a working group to be created by the Department for Environment, Food and Rural Affairs to develop recommendations on how to remove barriers to SEE.

5.8 As with all defined contribution occupational pension schemes, the personal accounts governing body will have a duty to exercise prudent choice and supervision of funds offered. In order to achieve this requirement, the number of funds offered will be limited. This is in line with current trust-based occupational pension schemes.


\(^\text{11}\) Eurosif SRI Study 2006, market size as at December 2005. The narrow definition covers funds which use positive screening, investing in companies with a commitment to responsible business practices, and ethical exclusion, where a large number of negative criteria and/or filters are applied. The broader definition covers use of engagement policies to encourage more responsible business practices, and more general ethical approaches to investment.
The default fund

5.9 A default fund is common practice in existing pension schemes. The idea of a default fund was well received by participants in recent DWP research for its simplicity and straightforwardness. The 2004 Pension Plan Design Survey found that 64 per cent of defined contribution schemes offered a default investment fund.

5.10 The personal accounts default fund is essential for those individuals who do not wish to exercise choice or feel that choice is not necessary. A 2005 survey of UK defined contribution occupational schemes by Aon Consulting found that less than a quarter of participants select funds other than the default.

5.11 The Government anticipates that the personal accounts default fund will have the following characteristics to ensure that individuals who do not make an active investment choice are defaulted into an appropriate investment:

- the default fund will be structured to deliver an appropriate trade-off between risk and return for the target group;
- the default fund will be invested across many different asset classes to reduce specific investment risk; and
- the default fund will be life-styled so that, for example, an individual's investments will be moved out of equities into bonds as they approach retirement age to ensure the timing risk related to accessing an annuity is reduced.

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Who should be responsible for different aspects of investment in personal accounts?

5.12 Developing investment strategies is not an area of Government expertise – in both the creation and running of personal accounts it is vital to have independence from both politicians and pressure groups. This will be members’ money and their pension in retirement and it is vital that their savings are protected from external pressures. The Government proposes to take primary powers in the second pensions Bill to require the executive delivery authority, advised by an investment committee, to develop an appropriate investment strategy within a framework prescribed by legislation.

5.13 The high-level framework for investment is likely to include the following:

- facilitating the best possible risk-adjusted net rate of return through low fund-management charges;
- specifying the provision of a default fund; and
- regularly reviewing the suitability of the investment funds and fund managers chosen for personal accounts.

5.14 The Government intends to task the executive delivery authority with establishing an investment management committee that will:

- consist of people with appropriate knowledge and skills;
- be independent of, and operate at arm’s length, from Government;
- be responsible for development of a clear investment strategy; and
- provide advice for the recruitment of investment managers.

5.15 Whilst it is appropriate for the Government to set out the principles of investment, it is essential for the executive delivery authority to have the scope to implement the investment principles in a manner that it considers most suitable, and to have the flexibility to make adjustments and decisions which take into account future changes in the pensions environment.
5.16 The executive delivery authority will have a duty to provide a range of choice but they will also have responsibility for deciding how and when. In particular, the delivery authority will need to balance the demand for extra choice from the minority with the demand for simplicity from the majority, in the way the choice is structured, and ensure charges are fair between groups.

Accessing pension savings (decumulation)

5.17 The private pension reforms proposed in the May 2006 White Paper will add millions more pension savers to the market, who will be required to secure an income at some point for their retirement. As the White Paper emphasised, personal accounts will be subject to the same decumulation rules as other pension schemes:

- pension income cannot be accessed before the age of 55 and income must be secured by the age of 75;
- up to 25 per cent of a pension fund can be taken as a tax-free lump sum;
- individuals who have accumulated small pension funds are not required to secure a pension income and can take their pension as a taxable lump sum; and
- if an individual dies before reaching age 75 without accessing their savings, a further pension or lump sum will be payable to their dependants.

5.18 While personal accounts will be subject to these same tax rules, it is necessary to examine the process by which individuals will access their savings in retirement. The delivery authority will be responsible for developing these detailed processes.

5.19 This work will be based on by the review of the “open-market option” (OMO), whereby individuals can shop around for their annuity to get the best deal rather than purchase from the provider they made their savings with. The review was announced by HM Treasury in its paper on annuities published at pre-budget report 2006, and will involve HM Treasury and DWP working together with a range of stakeholders to improve the operation of the OMO for consumers. The review will explore whether measures of success, such as an increase in the percentage of consumers exercising the OMO, should be set and look at the ways in which individuals are currently informed about the options of particular annuities, and whether changes should be made. In addition, it will look at the role of joint life annuities following the abolition of contracting out for defined contribution schemes.

5.20  It will also examine the potential for a more structured approach to annuity purchase that could be applied to the personal accounts scheme. This process could involve a two-staged approach. At the first stage, the individual would decide the type of annuity most suited to their circumstances, supported by suitable information and guidance. This could include information which highlights the consequences of choosing a single life annuity if the individual has a partner. At the second stage, the individual would select a provider offering the best deal on this product, perhaps with the aid of, for example, the Financial Services Authority's comparative tables or an annuity purchase platform.

5.21  For those who do not make an annuity decision by the age of 75, it will be necessary for annuities to be purchased on behalf of individuals. The decision on the default annuity at age 75 for personal accounts is an area the executive delivery authority is better placed to consider.

5.22  The Government has considered the option of bulk purchasing annuities for personal accounts participants. This would involve the negotiation of a batch of annuities to cover either everyone, or a specific sub-group wanting to annuitise during a given time period. Individuals who may benefit from this might include those with small pots where the administration costs are equivalent to a significant proportion of the pot.

5.23  However, after considering the main drivers of cost – namely life expectancy, administration costs, the annuity providers’ attitude to risk and their profit margin – the Government has found no evidence that bulk purchasing of annuities could lead to a significant increase in value for members. Additionally, requiring the delivery authority or clearing house to bulk purchase annuities could increase its costs, by adding a requirement to negotiate regularly and find suitable deals.

Conclusion

5.24  Personal accounts will offer a default fund, into which members will be enrolled if they do not exercise choice, and a wider choice of funds. Investment design will be undertaken by the delivery authority through exercise of its expertise in the investment field.

5.25  The decumulation rules for personal accounts will be the same as for other pension provision. The detailed design of the process will be a matter for the delivery authority. The design of the process will be based on the conclusions of the review of the OMO's operation.