Pensions Policy Institute response to the Personal Accounts Delivery Authority's consultation, Building personal accounts: designing an investment approach

Submitted by Matthew Annable, PPI Chairman on behalf of the PPI

Introduction

The role of the Pensions Policy Institute

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

2. This document provides the PPI's response to the personal accounts delivery authority's (pada) consultation on the issues around designing the investment approach for personal accounts.

3. This response is limited to providing comment on the major policy decisions that are proposed by pada in the proposed approach for the investment strategy for personal accounts. We have outlined where we feel the available research and evidence supports the proposed approach and in some cases have also highlighted issues for further consideration. This response does not cover all of the questions outlined in pada's consultation document. Many of these questions are detailed implementation questions that are outside of the PPI's main area of expertise.

4. The response focuses on three major policy decisions:
   (1) The member characteristics that should influence the design of the personal accounts scheme. The PPI suggests in this response that the key characteristics of the target membership that should be taken into consideration in the design of personal accounts include: low levels of financial understanding and low tolerance for volatility in short-term

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investment returns, low levels of other saving and potential for eligibility for state benefits and irregular employment patterns which may influence opt-out rates and contribution levels. For individuals, a member's age and distance from retirement may be important factors, particularly if a relatively high-risk investment strategy is being pursued for some scheme members.

(2) The overarching objectives for the personal accounts default fund should be couched in terms of replacement income rather than on the basis of an index or "best efforts" approach. A target replacement income is likely to be more easily understood by the scheme member and is consistent with the Pensions Commission's objective that a median earner should aim to achieve a target replacement rate of at least 45% of pre-retirement income. The objective should not just focus on maximising retirement income but also on minimising the risk that income falls below a minimum specified level. We would therefore suggest that the overarching objective needs to comprise of a balance of three components: a target replacement income for a member with a full contribution record, a minimum acceptable retirement income for such a member, and a maximum level of short-term volatility of return.

(3) The PPI stresses the need to ensure that member communication is non-technical and easily understandable to members of the scheme. The Trustees will also need to recognise that many members of the scheme may be influenced by the media's portrayal of the scheme.

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Q2.1 Which member characteristics should influence the design of the personal accounts scheme?

1. If the personal accounts scheme is to be successful, then it is important that potential members have the confidence to remain opted-in to the scheme for as great a proportion of their working lives as possible. The relatively low level of financial understanding and the current savings behaviour of the target group as a whole are both factors, which may influence the group's behaviour in this respect. In particular, it is possible that these characteristics of the target group will make them relatively intolerant of short-term volatility in investment return. Members may well not understand that short-term volatility and higher long-term returns often go together and members are also very likely to be influenced by adverse media coverage associated with short-term dips in investment performance. The consequence of this is that members might display a greater propensity to cease contributing after a performance downturn than do the members of the typical DC pension scheme.

2. Another key characteristic relevant to the design of the scheme is the potential for members of the target group to frequently change their employment arrangements, creating frequent opportunities for them to reassess their continued membership of the scheme.

3. We would caution against placing too much reliance upon members' assertions as to their "risk tolerance". One consequence of the group's relatively low level of financial understanding is that they may well not fully understand the consequences of taking investment risk, nor be able to articulate their attitude towards risk.

4. On an individual basis, a member's age and distance from retirement may be important factors, particularly if the Trustees take the view that the default fund should have a higher risk investment strategy for younger members.

Q2.2 From the evidence presented, what conclusions should we draw about our future membership?

5. We would conclude that the members of the scheme are likely to have low levels of financial understanding, have little or no other savings or

sources of income in retirement and that many are likely to be entitled to housing or other benefits.

6. Members are also likely to move in and out of employment and from one employer to another, more frequently than the average working population of the UK.

Q3.1 The trustee corporation may have to strike a balance between what it believes members want and what it believes is the best investment solution for the majority of members. Where do you think this balance should be struck for the personal accounts default fund?

7. As illustrated by Figure 3.1 in the consultation document, the outcome in terms of retirement income for most members of the scheme is likely to depend more upon their contribution record than on investment performance. The Trustees should be very conscious of this fact in developing the design of the default fund and seek to obtain investment outcomes, which minimise the probability that large numbers of participants opt out.

8. This does not necessarily mean that members' views of what they want should be given absolute precedence over what the Trustees think is "right". The low level of financial understanding amongst potential members means that being given what they want ex ante may be no protection against members being dissatisfied with the outcome and may actually increase the chance that they ultimately opt out of the scheme. However the Trustees' view of what is "right" needs to factor in the anticipated behaviour of members in the light of experienced investment performance, whether or not they consider that behaviour to be rational.

Q3.2 How should the different contribution profiles of members affect the scheme's investment objectives?

9. Given the potential administrative burden it would be impractical to offer different default funds to members who are perceived to be likely to have different contribution profiles, and identifying members' likely contribution profiles ex ante would be fraught with difficulty. As discussed in 3.1 above, there may be some value in turning this question around and asking how the investment objectives might affect contribution profiles, though.

Q3.3 What should be the overarching objective of the personal accounts default fund and why?

10. The overarching objective of the personal accounts default fund should be couched in terms of replacement income. This would be consistent with the fundamental purpose of any pension scheme and also with the Pension Commission's observation that it is a reasonable public policy objective for a median earner to aim to achieve an income replacement rate of at least forty five percent in retirement.

11. Ultimately it will be retirement income levels, which determine the economic well being of members and not whether or not the return on their fund happens to have beaten a particular index or other benchmark. The third alternative proposed, "best efforts", is not really a basis for setting an objective at all, as it begs the question "best efforts to achieve what?" It would also leave the Trustees exposed to unfair criticism from those who would fill the vacuum left by the lack of an explicit objective by providing their own, probably after the event and possibly ill informed. Objectives relating to benchmarks or "best efforts" may have their place in terms of the way in which the Trustees instruct and incentivise investment managers whom they appoint to run particular aspects of the default fund, but the Trustees themselves should focus on the provision of retirement income.

12. If the Trustees focus on replacement income as the overarching objective, thought will need to be given as to what measure of target replacement income is to be used. The Pensions Commission specified replacement income in relation to pre-retirement income, which is equivalent to a percentage of final salary. An alternative approach would be to specify the target in relation to a proportion of lifetime average earnings.

13. The objective should not just focus on maximizing retirement income but also on minimizing the risk that income falls below a specified minimum level. This latter risk is important for the target group, as on average they will be on low incomes and have little or no other savings for retirement, so the pension from their personal account will form a significant component of their overall retirement income, alongside the State pension and welfare benefits.

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14. Ideally the objective should also reflect the fact that retirement income will depend not just on investment return and interest rate at retirement, but also upon contribution record. As noted above investment performance may well have a significant impact on whether members decide to opt-out or not. The Trustees should not be satisfied if they have generated a return, which enables members with a full contribution record to obtain a satisfactory retirement income if the path that has been travelled has been so volatile as to cause large numbers of members to opt-out.

15. We would therefore suggest that the overarching objective needs to comprise of a balance of three components: a target replacement income for a member with a full contribution record, a minimum acceptable retirement income for such a member, and a maximum level of short-term volatility of return. Given the principal purpose of the personal accounts scheme - to provide a basic level of retirement income for people who have little or no other long-term savings - and the importance of a consistent contribution record in achieving that purpose, we suggest that to the extent that these three components conflict, the emphasis should be placed on the last two and that risk management should dominate return-seeking in the Trustees' thinking.

Q3.4 What particular measures should the trustee corporation undertake to ensure that members can have confidence in the scheme?

16. The biggest factor in building investor confidence will be minimizing unpleasant surprises in investment returns. Even if they have minimal impact upon long-term retirement income expectations, short periods of negative absolute returns - particularly in the early years of the scheme - may have a disproportionately harmful effect on members' confidence.

17. A thoughtful and active approach to communication is also required, reflecting both the limited knowledge and expertise that members are likely to have and the media through which they are likely to acquire information about the scheme. What is said about the scheme and its achievements by the non-specialist press and by radio and TV may well be more influential than direct communication from the Trustees in relation to establishing and retaining member confidence and so, without advocating an aggressive strategy of generating media "spin",

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we would suggest that positive public relations will play an important part in establishing confidence.

Q3.5 How can the trustee corporation communicate to members in language that is readily understood, particularly around topics such as the investment objective for the default fund?

18. As far as possible, the language used in member communications must be non-technical. An objective expressed in terms of retirement income should help in this respect, as that is far more likely to be meaningful to the average member than references to benchmarks or nebulous "best efforts". If the objective is not meaningful to members, or capable of expression in terms that members readily understand, then it probably isn't the right objective.

Q3.6 Are different approaches to sharing risk worth pursuing for the personal accounts default fund, or an alternative fund choice, and why? Please discuss implementation choices and challenges.

19. Substantial differences in the pension outcome achieved by different cohorts of scheme members would be undesirable and could potentially lead to a loss of confidence amongst members and consequently to a high level of opt-outs. It would certainly be appropriate to consider means by which the dispersion of outcomes can be controlled. However, whilst we have no objections to the principles of risk-sharing in general or of collective defined contribution schemes in principle, we can foresee a number of issues that such an arrangement might give rise to in the context of personal accounts over and above implementation challenges. In particular:

- The complexities of such a scheme are potentially difficult to explain to the layman and this could feed through to undesirably high opt-out rates.

- The notion of accounts being "personal" would potentially be lost, which could lead to a reduced interest and sense of "ownership" amongst members. Again this might have an adverse impact on participation levels.

- The need to reduce one person's benefit to pay for someone else's creates a significant communication challenge.

20. We welcome the decision to review how such schemes might operate in the UK. However, in the context of personal accounts, unless ways of addressing the implementation and communication challenges are identified, the best way of controlling dispersion of outcomes is likely to be through careful design of a default fund "lifestyle" strategy and through an acceptance that risk control should have a somewhat greater weight than return ambitions in the setting of objectives for such a fund.

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