THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

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Your ref:

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Dear Sirs

BUILDING PERSONAL ACCOUNTS: DESIGNING AN INVESTMENT APPROACH – A DISCUSSION PAPER TO SUPPORT CONSULTATION

The Institute of Chartered Accountants in England and Wales (the Institute) is pleased to respond to your request for comments on the discussion paper, *Building Personal Accounts: Designing An Investment Approach – A Discussion Paper To Support Consultation.*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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ICAEW REPRESENTATION

ICAEW REP 83/09

BUILDING PERSONAL ACCOUNTS: DESIGNING AN INVESTMENT APPROACH

Memorandum of comment submitted in August 2009 by the Institute of Chartered Accountants in England and Wales in response to PADA's Building Personal Accounts: Designing An Investment Approach – A Discussion Paper To Support Consultation published in May 2009.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the 'Institute') welcomes the opportunity to comment on the discussion paper on designing an investment approach for the personal accounts scheme published by the Personal Accounts Delivery Authority in May 2009.

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 165 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

GENERAL COMMENTS

Underlying objective of the personal accounts scheme

4. We believe that the aim of the personal accounts scheme is to provide a privately administered, funded, additional state pension. The primary objective of the scheme should be to deliver returns that keep pace with inflation at minimal cost, with maximum predictability in a simple, engaging and accessible framework.

Investment objective

5. We believe the investment engine will determine the success or failure of the scheme.

6. To achieve the underlying objective, the personal accounts scheme must be simple and cheap to administer and offer predictable returns in an easily understandable format that will win the confidence of a disengaged audience. The target market for the scheme generally has relatively low levels of financial literacy and modest income. The investment engine must be cheap to administer and members must be able to understand what they can reasonably expect to receive at normal retirement age (NRD) based on what they and their employer have paid into their fund. The investment methodology must therefore be capable of meeting the objectives as described above.

Investment funds

7. The 'psychological driver' should be to engage by restoring confidence in pensions as a reliable savings vehicle. Predictability of the amount of pension that will be payable must therefore be central to the design of the default fund of the scheme and the investment philosophy, as must simplicity, which means limiting the choice of alternative funds. In this context, we believe that the financial capability programme has a key role to play in the success of the

scheme, and we note that the ICAEW is committed to developing financial capability in both schools and deprived communities (further information on our financial literacy programme is set out in Appendix A).

Default fund

8. We believe the natural fund of choice should be an index-linked deferred annuity based fund, which should be targeted at the majority of members. Anyone who does not opt out of the index-linked deferred annuity ('the Default fund') by making an alternative investment choice should be assigned to the default fund. This fund would deliver a guaranteed element as a pension (which can be expressed as £x of income in retirement for every £y invested), plus the possibility of additional discretionary returns subject to investment performance (we have set out more information on this Non-Profits Deferred Index Linked Annuity suggestion in Appendix B).

9. Such an investment strategy would reduce the expected payments by around a third when the scheme matures. However there would be considerably greater predictability of outcome, which can be communicated to members in simple and comprehensible terms.

10. The use of an index-linked deferred annuity as the Default fund would have implications for the gilt markets and, for this to be workable, the government would need to issue sufficient amounts of index-linked gilts. There would also need to be a sufficiently deep market in mortality risk protection.

Additional fund options

11. Choice comes at a price. In practical terms, additional fund options will lead to increased administrative costs and reduce economies of scale. The need to communicate complex information to members in clear and comprehensible terms is expensive and difficult to achieve. There is a danger that excessive choice will be counter- productive as it will increase costs and introduce additional risks. Additionally, offering a wide range of investment funds is likely to generate information overload which will work to alienate an already disengaged target audience that may have particularly low levels of financial literacy.

12. Further, in principle we question whether choice is good *per se*: choice is not good for the majority of the likely members of the scheme, although we acknowledge there needs to be some choice between funds e.g. to accommodate those whose religion forbids certain kinds of investment. On the issue of choice, we believe there is plenty of anecdotal evidence where despite the number of choices under DC schemes, 90% or more of the members will chose the default fund option.

13. We appreciate, however, that even a small percentage of the scheme membership could represent a large number of people, and to offer no choice at all could discourage more financially aware people from joining the scheme. We therefore suggest one or two funds in addition to the Default fund, but we believe that the cost of providing choice should be allocated to those opting for the non-Default funds rather than spread across the scheme as a whole.

14. The ICAEW believes that only a limited number of low-cost options are required to fulfil the objectives of the scheme, which are as follows:

- Default fund (index-linked deferred annuity)
- Balanced Managed Fund
- Sustainable Balanced Managed Fund
- Sharia Compliant Fund

15. In general terms, we favour a passive investment style on the basis of consistency of return at minimum cost and that this approach is therefore more consistent with the objectives of the scheme. The Balanced Managed Fund would invest in various asset classes, and provide a slightly higher risk, higher reward option for the target market, who are unlikely to want to construct portfolios themselves. The asset allocation would be actively managed, but the underlying funds would predominantly be passively managed, for example, UK All Share Index Trackers and Global GDP Index Trackers, to keep costs low (we suggest a GDP tracker because the long term performance of the fund will tend to reflect the long term rate of return on global capital, rather than historic relative stock market valuations). Underlying investments would also include Fixed Interest Funds. The choice of underlying funds would be determined by cost and tracking error.

16. We have included a Sustainable Balanced Managed Fund, to cater for members who would like their savings invested ethically/responsibly as we consider this is important from a public interest perspective because (unless employers run their own scheme), members who wish to benefit from an employer contribution will be restricted to the funds offered by personal accounts and they should be able to invest their funds ethically if they wish to do so. Similarly, we have included a Sharia compliant fund to enable those with certain religious beliefs to participate in the scheme.

Lifestyling

17. Lifestyling would not be required for the Default fund if it is a deferred annuity contract. In respect of the Balanced Managed and Sustainable Balanced Managed funds, to protect the interests of members and manage investment risk over time, lifestyling could be achieved by members of these alternative funds simply transferring into the Default fund from the point that members are 15 years from NRD. This should be relatively easy to explain to members who opt for one of the Balanced Managed funds, who can then be informed (during this lifestyling period) how much of their fund has been switched into the Default fund, with an indication of the pension they can then expect to receive in respect of that portion of their fund that has been transferred.

18. It may not be appropriate to offer lifestyling for the other funds either. The Balanced Managed Fund and Sustainable Balanced Managed Fund could each be set up as a series of Target Date funds, by which we mean separate funds for each cohort of retirees (for example, Balanced Managed Fund members wishing to retire in 2050 would opt into the relevant '2050 Balanced Managed Fund'). As these funds mature, the entire fund would switch into the Default fund from 15 years on a percentile basis. We suggest PADA does some further research into the relative administration costs of lifestyling at individual level (for millions of members), compared with administering separate target funds for each annual retiree cohort.]

19. In respect of the Sharia fund, as the religious beliefs of the members may prohibit them from investing in the Default fund, an equivalent timeframe of lifestyling

should be built into the Sharia fund, if possible to do so within the constraints of complying with Sharia law (subject to the practicality and cost of doing so).

Responsibility for the scheme

20. We should like to take this opportunity to point out the importance of establishing the 'ownership' of the scheme, as stressed in our response to the earlier consultation on Scheme Rules. Whilst the trustee corporation will be responsible for adopting the investment strategy best suited to delivering the objectives of the scheme, the government needs to take responsibility for confirming those objectives and encouraging maximum take up of membership.

ANSWERS TO SPECIFIC QUESTIONS

2.1 Which member characteristics should influence the design of the personal accounts scheme?
2.2 From the evidence presented, what conclusions should we draw about our future membership?

21. Age, low income, relatively low levels of literacy, numeracy and financial capability, risk averse, disengaged, irregular working pattern and likely to be dependent on state benefits at some stage in their lifetime. Scheme design must be consistent with these characteristics; hence our comments on investment design in general comments above.

3.1 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?
3.2 How should the different contribution profiles of members affect the scheme's investment objectives?
3.3 What should be the overarching objective of the personal accounts default fund and why?
3.4 What particular measures should the trustee corporation undertake to ensure that members can have confidence in the scheme?

22. The trustee corporation must act in what it believes is in the best interests of members as a whole, rather than trying to take account of what it believes members want. For the reasons given above we believe most members will be unable to make an informed decision. We also believe that individual contribution profiles of members should not affect investment objectives at scheme level.

23. A key objective is to have a simple, low-risk scheme and if members wish to opt for an alternative fund (rather than the default fund) then costs should be born by those individuals, not shared across the membership. The Scheme needs to be highly transparent and illustrate the risks associated with opting-out of the default fund, to include the costs of so doing and associated impact on potential performance and predictability (as the Balanced Managed funds would not provide a 'predictable' income in retirement).

24. One of the key characteristics of members of the default scheme is likely to be risk aversion, hence the personal accounts default fund must offer predictable returns. We believe the default fund should deliver returns that will keep pace with inflation at minimal administration costs and with maximum predictability in a

simple and engaging and accessible framework. To achieve this underlying objective, the scheme must be simple, cheap to administer, and offer predictable returns that can be understood and win the confidence of disengaged audience that will generally tend to have relatively low levels of financial literacy and modest income. We believe this should be in the form of an index-linked deferred annuity fund (see above).

25. It is important to note that it is not solely the trustee corporation's duty to ensure confidence in the scheme; we believe the government (as quasi-sponsor of the scheme) should also retain some responsibility for the success of the scheme. From an investment perspective, this should take the form of government backing or, at the very least, commitment to issue sufficient index-linked gilts.

26. Membership, and especially retention (given the evidence regarding the impact of contribution breaks on pension levels), needs to be encouraged, possibly via some sort of incentive to join, and/or reward for staying in the scheme. For example, state payments made on behalf of those between jobs and seeking employment and government sponsored bonuses for continued contributions. It should be remembered that personal accounts should form part of a unified system aiding people to provide for their retirement, and should supplement / dovetail with state pensions and other forms of state aid.

3.5 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?

27. Establishing an index-linked deferred annuity fund as the default fund will assist the trustee corporation in helping members understand what returns they can expect from their investment (see also our general comments above). It will also be important to use simple diagrams and language in a concise non-legalistic style.

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

28. No, this is far too complicated.

4.1 In what situations should personal accounts use tactical asset allocation and why?

29. In general terms, this question is irrelevant in light of our suggestion to use a deferred annuity contract, with strategic lifestyling approach for the Balanced Managed funds switching into the default fund as from 15 years of NRD on a percentile basis, and it will be up to the provider/s of the deferred annuity contract to manage their own assets to deliver the guarantees offered to the trustees. For the Balanced Managed funds (prior to lifestyling), see general comments above as to the type of funds/assets we believe should be included.

4.2 What are your views on how the personal accounts scheme can use alternative asset classes to benefit from potentially improved diversification and investment performance, while still meeting its needs for liquidity and accurate pricing?

30. Not appropriate – see above comments.

4.3 Across which asset classes should diversification of the default fund extend?
4.4 What should be the balance between active and passive managers in the default fund, and is this consistent with a low-charge scheme ?
4.5 Do certain asset classes favour a particular management style? Please provide evidence to support your response.
4.6 What approach should the trustee corporation use to identify active managers who are likely to outperform?

31. See general comments above and Q8 below.

4.7 Should the personal accounts scheme participate in securities lending?
4.8 If so, what controls and limits should it impose, if any?

32. Securities lending comes at a price – counterparty risk and potential loss of voting rights, but can generate additional returns. Securities lending should not be excluded as an option but needs to be treated with caution and be at the discretion of the trustees.

5.1 Is a traditional lifestyling mechanism appropriate for the personal accounts default fund, and if so why?
5.2 Would a target-date approach be appropriate for the default fund, and if so why?
5.3 Are alternative lifestyling approaches suitable for personal accounts, and if so why and how should they be implemented?

33. See general comments section above.

6.1 To what extent can the personal accounts scheme deliver high-quality corporate governance at a low cost?
6.2 How will this evolve over time as the scheme's assets under management grow?
6.3 How do we achieve high-quality corporate governance where assets are managed passively?
6.4 What approach should the trustee corporation take to the voting of shares, both overseas and in the UK?

34. We are supportive of trustees (as shareholders) actively engaging with companies they invest in to promote the highest standards of corporate governance (CG). As the scheme grows, we think that an in house CG department could be established to influence the scheme's investments. As the scheme will eventually become substantial, the additional cost of introducing a CG function in due course should be small relative to the assets of the scheme.

7.1 How can the personal accounts scheme engage in responsible investment in a cost-effective way?
7.2 Should responsible investment be a matter for the default fund alone, or for all fund choices, as far as it is practical and relevant?
7.3 How should the trustee corporation interpret its fiduciary duty in relation to responsible investment while maintaining a commitment to low charges?
7.4 If responsible investment is pursued, will the members be best served by building in-house capability or outsourcing?

35. We have suggested that a sustainable/ethical fund is included as one of the optional funds. In respect of the other funds, personal accounts should be treated the same as other pension funds. i.e. the trustees should be able to act in the best interests of members and should be permitted to follow investment trends in the market. We note that there are increasingly good arguments, including economic ones, for supporting responsible investment which include sustainability, but the process/procedures would need to develop over time, in line with the market.

8.1 To what extent should the trustee corporation offer fund choice, and what should those choices be?
8.2 To what extent should those funds be lifestyled?
8.3 Should the trustee corporation offer branded funds as part of the fund choice offered to members, and if so why?
8.4 Should costs associated with wider fund choice be spread, where possible, across all members, or only apply to those members who choose alternatives to the default fund?
8.5 Should there be a limit on the number of fund switches, or charges imposed after a certain number of switches, or neither for the personal accounts scheme?

36. As mentioned in our general comments above, we believe the number of options should be as small as possible in order to keep costs to a minimum, and therefore there should be a limited number of funds, as follows:
    - Default fund (index-linked deferred annuity)
    - Balanced Managed Fund
    - Sustainable Balanced Managed Fund
    - Sharia Compliant Fund

37. We believe the cost of providing choice should not be spread across the whole scheme, but should be allocated just to those opting for the non default funds.

38. We would not support the inclusion of branded funds, as this would increase choice/complexity. We believe that each of the funds should simply be syndicated among providers

39. We also believe the scheme should be structured in such as way as to discourage / restrict switching, as this adds to costs, for example, by only allowing one switch per quarter, which must take place on a fixed specified date at the end of the quarter.

Appendix A
ICAEW Financial literacy initiatives

The ICAEW is committed to developing financial capability in both schools and deprived communities.

The ICAEW believes that improving individuals’ financial capability is important, not just in terms of their ability to manage money, but also in terms of raising their confidence as consumers of financial information and products. We aim to establish sustainable, cost-effective programmes that are responsive to the specific needs of individuals and communities.

Throughout 2009, the ICAEW has collaborated with Grant Thornton LLP to develop a financial capability programme with The Poplar Housing and Regeneration Community Association (Poplar HARCA) and the Poplar community. Poplar is one of the most deprived areas of Tower Hamlets in Central London. Its community is characterised by a high level of disengagement from education and low levels of financial literacy and capability. Our longer term objective is to roll out a financial capability in the community initiative, based on the experience with Poplar HARCA, throughout other disadvantaged communities in the UK.

From September 2009, the ICAEW, Grant Thornton LLP and Poplar HARCA plan to establish a working group with selected 15-18 year olds in the Poplar community and ICAEW volunteers. Young people and professionals in the working group will collaborate over an extended period of time to create a financial learning tool for the benefit of the wider community, to develop confidence and awareness about finance and business-related issues, and to relate the information to members of their community.

Since August 2007 the ICAEW has worked in partnership the Personal Finance Education Group (pfeg), an HM Treasury backed charity, to deliver our ‘financial literacy in schools campaign’. ICAEW members help teachers to incorporate personal finance education into their lesson plans, and provide in-class support to improve students’ personal financial awareness and capability.

Appendix B
Non-Profits Deferred Index Linked Annuity

Introduction

Deferred annuities are some of the oldest financial products in the market. Until the 1980's there were a limited range of products available to investors, and consequently investors only demanded simple products.

Annuity products, including deferred annuities, were widely used by all members of society as a part of their financial planning. They were simple, effective and delivered known returns to investors. The returns were guaranteed. After the events of the last 2 years, these characteristics have become more attractive.

History

Until the early 1970's Non-Profits Deferred Annuities were the contracts of choice amongst the professional classes, such as Barristers, Solicitors, Doctors and Accountants looking to save for their retirement. The main benefits of these annuities were as follows:-

1) Certainty of income
2) Guaranteed income for the life of the annuitant throughout retirement
3) No risk to the capital
4) Simplicity

In essence these annuities were replicating the pension benefit structure provided by the Government to their civil servants at the time. Until 1971, the Civil Service pension scheme paid only level benefits to the members. The index linking of benefits did not start until 1971.

In the aftermath of oil crisis in 1973, the fixed income provided by these annuities was destroyed by inflation. Thereafter non-profits deferred annuities disappeared from the financial landscape, as insurance companies were not able to offer inflation protected deferred annuities. Insurance companies did not have the scope to match these liabilities until 1981, when the Government starting issuing index linked gilts.

Deferred Annuity

A deferred annuity allows an individual to give capital to an institution and secure an income for the rest of their lives after a set date.

The rate of conversion is dependent upon the following factors: -

1) Mortality expectations for the individual
2) The profile of income, level or escalating benefits, either by fixed amounts or the retail prices indeed.
3) Bond yields
4) Credit rating of the institution
5) Expenses
6) Frequency of payments
7) Inclusion of any benefits for any dependents

The proposal is to only offer an index linked deferred annuity, where the benefits will rise by inflation. The inflation factor should be Retail Prices Index, because it includes the cost of housing.

The proposal is to allow individuals to buy a fixed pension for every £100 invested for year. Every year the rate is recalculated. Effectively it is similar to an "added years" scheme within a final salary pension scheme. The difference being that the contributions fund a specific income.

The assumption is that the administrators would buy index linked gilts to match the liabilities.

Technical Complications

Over the years, the Personal Account will become substantial. Therefore there will have to be sufficient number of index linked gilts in issuance of sufficient size to absorb the contributions. The Debt Management office will have to increase the duration of the bonds in issue to allow the administrators to match the liabilities for the younger members of the scheme.

Once the gilts have been purchased, they would be held until redemption. The ongoing management charges for passive management of the index linked gilts should be minimal.

The administrators will have to be able to insure the mortality risk with insurance companies, investment banks or the Government. At present there is no longevity insurance market outside the insurance companies. The Scheme would have a counter party risk through outsourcing the mortality risk to any 3rd party outside the UK Government.

Advantages

The advantages are as follows: -

- Guaranteed Benefits
- Low investment risk
- Simple
- Transparent
- Cheap to administer
- Protection against inflation

Disadvantages

The disadvantages are as follows:-

- Modest real returns for investors
- Potential Counterparty risk when outsourcing the mortality risks

Conclusion

A Non-Profits Deferred Index Linked Annuity has the right investment characteristics to achieve the objectives set out by the Government. However this type of annuity will effectively create a funded additional State Pension scheme.

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