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CASS BUSINESS SCHOOL'S PENSIONS EXPERT
ON WHERE THE INDUSTRY IS GOING WRONG

november 11

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DC pensions need serious surgery says Cass Business School's pensions guru

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There has never been a more inappropriate time to introduce auto-enrolment, says Teresa Hunter

Not just an academic issue

DC pensions are bust, and it is time the industry did something about it says arguably the UK's foremost pensions academic. **John Greenwood** finds out how

The default funds that house the retirement hopes of millions are not fit for purpose and it is the duty of providers, employee benefit consultants and corporate IFAs to sort them out. That is the damning conclusion of one of the UK's foremost academics working in the field of pension and retirement.

"The current design of defaults is primitive, amateur and pathetic. And the paper I have just brought out is an attempt to correct that," says Dr David Blake, professor of pension economics at the Cass Business School, and director of the Pensions Institute.

Current default funds and their lifestyling systems achieve nowhere near the best possible outcomes for savers, and nor does the widespread practice of a single switch into annuities. And if that is not enough, we shouldn't even be saving until our mid to late thirties anyway.

Blake's claim that in a perfect world we should not start saving until age 35 has attracted most headlines, and strong criticism in some quarters, although that may be as much to do with the way his work has been reported as its actual intellectual content.

His overarching message is that we should work out what a 'rational lifecycle financial planner', or an 'econ', to borrow the language of Richard Thaler and Cass Sunstein in their book *Nudge: Improving Decisions about Health, Wealth, and Happiness* would do if they had access to all the advice and information to help them make perfect investment decisions, and then try to fashion real world structures that come as close as possible to replicating that investment strategy. His ideas were set out in two studies published in

September, one focusing on age-dependent investing and the other looking at target-driven investing.

Blake says: "We sat down and worked out what the optimum strategy was if you were a rational lifestyle financial planner. In the accumulation phase it is called 'stochastic lifestyling' and in the decumulation phase it is 'phased annuitisation'."

In this academic's academic world, lifestyling is stochastic because it responds to changes in a dynamic way as the individual proceeds through their life, rather than a mechanical switch over a set number of years.

But it also takes into account an individual's human capital, namely their earning power, as well as their financial wealth, when calculating their overall wealth.

"So someone who is young is overweight in human capital and underweight in financial capital. What does human capital look like as an asset? For most people it is like a bond because it is going to generate a regular income stream, so you should be heavily exposed to equities in the early years, and less so in the later years," he says.

This is what most people would recognise in today's lifestyle systems anyway. But for Blake, the difference is that the depletion of your human capital means you should start getting into bonds through your pension sooner.

"So that justifies the switch out of equities much earlier than the 10 years before retirement we see today. We showed it was optimal to do this from your mid forties. Little by little, but starting in your mid forties," he says.

Not only do they start switching investors out of



"I am an economist and economists start by assuming the model used is an individual who is fully rational and intelligent and smart"

equities too late, conventional lifestyling systems then go too far the other way by switching 100 per cent out of equities by a fixed retirement date, which is way too conservative an approach for Blake.

"You are still going to live a long time after you retire, so depending on your risk, you might be between 20 and 50 per cent in equities on the day you retire. On the day you retire you should also switch your bond portfolio into annuities. So your strategy is dominated by two assets, prior to retirement it's bonds and equities, after retirement it is equities and annuities," he argues.

"We then switch from stochastic lifestyling to phased annuitisation because the mortality premium on annuities goes up until your late seventies when everything is annuitised."

That is in the world of the rational financial planner; and with no costs of switching. So if we come back into the real world what comes closest to offering this?

Blake points to an earlier paper he wrote with Tom Boardman, formerly of the Prudential, called *Spend More Today: Using Behavioural Economics to Improve Retirement Expenditure Decisions*. That paper called for four key behavioural nudges to get over the problem that individuals do not like making financial decisions. First, get people to make a plan – ideally with, but if necessary without, an adviser; secondly, arrange automatic phasing of annuitisation to tackle the aversion to large irreversible transactions and losing control of assets and so allows the greatest possible degree of flexibility in managing the run-down of retirement assets; thirdly, offer capital protection in the form of 'money-back' annuities to deal with the fear of losing money if you die early; and finally use the slogan 'spend more today' which utilises hyperbolic discounting to satisfy the human trait of wanting jam



People have an aversion to making big single financial decisions which they've never had any experience of making before"

today and to reinforce the idea that 'buying an annuity is a smart thing to do'.

"People have an aversion to making big single financial decisions which they've never had any experience of making before. So where people have these behavioural biases they should pre-commit to these strategies," says Blake.

Blake is essentially taking nudge theory beyond automatic enrolment further into pensions and into the realm of lifecycle financial planning.

"I am an economist and economists start by assuming the model used is an individual who is fully rational and intelligent and smart. And we can get some powerful results from that.

"But the problem with most economists is they say 'let's stop there'. I say we know the optimal strategy, but we also know people do not behave in that way," he says.

Despite headline-grabbing ideas such as not starting pension saving until 35, he supports auto-enrolment for those younger than that, as these individuals will never follow the savings habits of the optimal saver. Blake also understands why Nest has decided to adopt its cautious investment approach thereafter, and is complimentary of its target-date approach to investment, even though it does not have stochastic lifestyling, which he sees as better than many defaults out there.

So does he think therefore Nest is ahead of what quite a lot of what the private sector is offering currently? "I think that they are, but the point is they are big enough to do it. Nest is going to become the biggest pension fund in this country for the next 30 years," he says.

ALL ABOUT DR DAVID BLAKE



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- Director of the Pensions Institute
- Chairman of Square Mile Consultants, a training and research consultancy
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- Senior Consultant, UBS Pensions Research Centre, London School of Economics
- Research Associate, Centre for Risk & Insurance Studies, University of Nottingham Business School
- Formerly Director of the Securities Industry Programme at City University Business School
- Research Fellow at both the London Business School and the London School of Economics
- Professor of Financial Economics at Birkbeck College, University of London.
- Was a student at the London School of Economics in the 1970s and early 1980s, gaining his PhD on UK pension fund investment behaviour in 1986. In 1996, he established the Pensions Institute



“Corporate wrap is for a very small percentage of the population. Not many people have these choices”

So does that leave the rest of the private sector pensions industry playing catch up with Nest when it comes to default funds?

“There is a lot in that statement. My feeling is that the private sector DC designers are way behind the curve. The design of DC is currently very primitive. I’ve said this for many years,” he says, referring to his 2008 paper *Turning Pension Plans into Pension Planes: What Investment Strategy Designers of Defined Contribution Pension Plans can Learn from Commercial Aircraft Designers*.

“We are at a very primitive stage of development. The people doing the accumulation are not talking to the people doing the decumulation,” he says.

Despite his praise for Nest’s default approach, he does not think it is the genuine article, by any means. “I was on committees advising them on their investment strategies, and they made it very clear they were not going to try anything new. They were not going to be investment innovators,” he says, showing some irritation that Nest officials had in some cases tried to give the impression they had adopted his theories. “Some of them were going into conferences and using the term stochastic lifestyling. I thought that was a bit much because it sounds like you’re trying to look like you’ve invented this term yourself. And at the same time you say saying you are not going to do anything new.”

Despite his academic critique of the wrongs of the UK pensions system, he does not have time for the arguments of those who say we should import Dutch-style collective DC models into the UK.

“The problem is you introduce moral hazard when you start sharing between generations. As long as you have got lots of new members joining you can give extra benefits to older people, but the liability for them is effectively passed on to the younger worker who hasn’t got a clue what is going on. So it becomes a bit of a Ponzi scheme.

Then when you have a low number of workers and

lots of pensioners the whole thing is up in your face,” he says.

“But risk sharing is fine - my biggest attempt at risk sharing is spending 10 years trying to get the government to share risk, having campaigned to get it to issue longevity bonds to help to improve pensions. But then the government has not taken up my idea. They don’t want that risk,” he says.

So what is the biggest risk of auto-enrolment?

“The risks are that the workers with very poor job rights are forced out of it. Their employers will say ‘if you don’t sign this bit of paper, you will lose your job’. I think that will happen a lot. Lord Turner did not think it will happen, the people at Nest do not think it will happen, but we know the squeals of everybody when costs go up by half a per cent. Costs here are going by more than half a per cent. Some people might say that these are people who should not be going in there anyway and that is a good thing, and if they can’t afford shoes for their children at school, then being forced to go into the stock market is not right, but my view is people should realise they need to save for their retirement. I would have gone for compulsion,” he says.

So will it come at the review? Unlike most commentators these days, Blake thinks this unlikely. “Governments are too afraid to talk about compulsion.”

He is also less convinced of the potential of corporate wrap. “Corporate wrap is for a very small percentage of the population. Not many people have these choices,” he says.

Describing DC as now the only game in town, Blake displays a passion for making it work better. The sheer volume of cash that is set to flow into DC plans in the coming years will drive a greater degree of product development. Those creating the retirement savings products for the workforces of the future could do well to go back to first principles and study the behaviour of the rational lifecycle financial planner. ■

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