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Defined Contribution Pensions: Dealing with the Reluctant Investor

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# Defined contribution pensions: dealing with the reluctant investor

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#### Abstract

**Purpose** – The purpose of this paper is to provide an overview of key issues in the governance of defined contribution pension schemes, with a focus on investment matters, and to recommend best practices.

**Design/methodology/approach** – The paper draws on the results of an online survey of the opinions of pensions professionals and on interviews with pensions professionals.

**Findings** – The paper finds that many employers and pension scheme trustees are reluctant to take an active role in pension scheme design and to provide support and guidance to members for fear of legal liability. Scope exists for regulators and legislators to create "safe harbour" provisions that will encourage employers and trustees to become more active in supporting members.

**Practical implications** – The paper makes a number of suggestions for best practice in the design and governance of defined contribution pension schemes, for example, in terms of the fund choice that should be offered.

**Originality/value** – The paper provides the first comprehensive review of investment issues for UK defined contribution pension plans.

**Keywords** Pensions, Pension funds, Investments, Regulation, Governance, Trustees, United Kingdom **Paper type** Research paper

#### 1. Introduction

This paper examines the governance of defined contribution (DC) schemes with reference to the investment choice and, in particular, the design of the default fund. We explain where and why the current system fails to support DC scheme members and what steps can be taken to address the problems.

DC is the most common type of new pension scheme in the private sector and is likely to continue to be so for the foreseeable future. Under defined benefit (DB) schemes the employer bears the investment and longevity risk. Under DC these risks are transferred to individual members, who must make complex decisions about the types of funds in which they invest their contributions. With the exception of their senior executives, it is unusual for employers to pay for face-to-face regulated



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investment advice and this lack of member-specific *advice*, as opposed to generic information and guidance, has a marked effect on the distribution of members across the available funds. Figures vary from scheme to scheme but the latest NAPF annual survey found that, where available, the default fund, on average, attracts the contributions of 94 per cent of members. (NAPF, 2007).

Most DC members can be described as "reluctant" or "disengaged" investors. These are the individuals who, for a range of reasons, are not prepared to make an active investment choice and instead *passively accept* the default fund. We argue that the high proportion of scheme members who passively accept default arrangements raises important questions about the structure of the default fund and whether this can meet the needs of a large and diverse membership. We make recommendations, based on our research, to help the various parties involved in pension scheme design – including regulators – to do their utmost to help reluctant investors make appropriate decisions.

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 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 this report seeks to address and a subject of current interest for "The Pensions Regulator" (TPR, 2006).

The primary factors that determine the outcome of a DC pension plan during the accumulation phase are investment strategy – principally asset allocation – and the level of contributions. This paper focuses on the former – the investment strategies offered by DC schemes and, in particular, the default fund provided for members who do not want to make an active choice.

It became evident during our research that while employers and insurance companies usually were keen to do the best they could for scheme members, their good intentions stopped well short of taking a legal (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. They must not put their personal interests before the duty, and must not profit from their position as a fiduciary, unless the beneficiaries consent.

We found that advisers and consultants were prepared to take a fiduciary responsibility only where they were paid to provide regulated advice, either by the employer, who paid a fee, or through a commission paid by the scheme provider. Trustees of occupational DC schemes undertake the fiduciary role in terms of ensuring an appropriate fund choice for members but they are not authorised by the FSA to give regulated individual advice and they are often reluctant to respond to members' requests for guidance. In all cases, therefore, where a scheme offers a default,

the underlying assumption is that this does not constitute an advised "sale" in the regulatory sense and, therefore, that the member is responsible for the investment decision.

This collective reluctance to accept a fiduciary responsibility is being examined by TPR and in the coming years is likely to be challenged. For 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 FSA, it is equally evident that reluctant investors assume that the default fund has been chosen to meet their specific needs.

The remainder of the paper is organised as follows. Section 2 explains our research method, while Section 3 discusses governance in DC investment. Section 4 focuses on default funds, while Section 5 looks at issues in investment choice, and is followed by a brief conclusion. Our full report also discusses issues in communication and advice, but in the interests of spaces, these are not covered here.

#### 2. Research method

In the fourth quarter of 2006, we undertook a thorough analysis of the DC investment strategies currently available to private sector employees in the UK. This research was supplemented by an online survey, which was completed by 54 experienced professionals from the DC pensions market. Respondents included individuals who work for fund management companies, pension scheme providers and pensions consultancy firms, as well as pensions lawyers and professional trustees.

We also conducted open interviews with over 60 pensions experts, either face-to-face or by phone. In many cases, these are the same individuals who participated in the survey, but the interviews allow for a more in-depth understanding of their views. Comments from individual respondents in this research are non-attributable, but we do indicate the professional role of the interviewees. From these interviews we were able to build up a clear picture of the framework in which employers introduce DC, the advice they receive, current trends and innovations, and the nature of the problems that concern all parties involved in the design and delivery of schemes for the reluctant investor.

#### 3. Governance of DC investment?

#### 3.1 Survey results

- Sixty-nine per cent of the pensions experts we surveyed say that the typical investment arrangements in UK DC pension plans do not meet most members' needs.
- Respondents, on average, think that only 10-15 per cent of DC scheme members understand the investment risks they face. Over half put the figure at 10 per cent or less.

In this section, we ask the question, what constitutes appropriate governance in the context of DC pension scheme investment.

DC schemes, and in particular the contract-based arrangements such as group personal pensions (GPPs) and stakeholder plans, are derived from a retail investment product – the personal pension – which is regulated by the FSA. This presents particular problems now that contract DC is becoming the most common arrangement for private sector workplaces.

The understanding of governance as it applies to the investment of DB schemes is not transferable to DC. Governance for DC is about providing arrangements such that scheme members can make appropriate investment decisions.

For members, understanding basic investment fundamentals and the confidence to make decisions are quite separate characteristics. Even where a member has a reasonable understanding of investment issues, putting this into action is a separate task. It is important not to underestimate the member's fear of making the wrong decision. This is a major factor that explains the concentration of members in the default fund, which further implies that additional information and communications, although very important, will not by themselves convert the reluctant investor into an active one. Our research suggests that what most members want is not more information, but rather to have an expert make the investment decision for them.

The main problem arising from this situation is that many investment "experts" do not want to make decisions on behalf of members for fear of liability. As we discuss later in this paper, this applies to various aspects of DC investment including the selection of default funds, the decision on how much investment choice to offer to members, and nature of information and advice provided to members. We have the perverse outcome that experts — who have the skill and knowledge to make investment choices on behalf of members — prefer not to make them because of fear of liability if the decision turns out to be "wrong". The consequence is that decisions are made instead by the members — that is, those who, on average, have very limited investment knowledge. We argue below for changes to law and regulation so that employers, trustees and others who are in a position to support members of DC schemes have less to fear from using their expertise provided they can show appropriate standards of care.

3.1.1 Differences in governance between trust-based and contract-based schemes. Trust-based DC is used by the larger employers and can be established with a high level of governance via the trustee board. In theory at least, therefore, a scheme with a trustee board is better placed to ensure the member makes appropriate investment decisions. The trustees are responsible for meeting relevant investment regulations, and investing funds in a manner consistent with the members' best interests. Their approach to this should be set out clearly in the Statement of Investment principles. In practice, however, the fiduciary role of the trustee board in relation to DC is mutable and open to interpretation. This means that the effectiveness of the trustee board can and does vary from scheme to scheme.

In some cases, trustees probably do not give DC the attention it deserves. Many trustees of occupational DC schemes are also trustees of a DB scheme and the latter presents the most pressing problems at present due to underfunding and the prescriptive requirements of the Pensions Act 2004. Consultants report that DB issues dominate trustee meetings and that DC frequently is sidelined almost to the point where it becomes an issue listed under "Any Other Business":

Trustees sometimes neglect DC. They have their head buried in DB problems. (Consultant)

Trustee meetings for DC are inefficient. With DB the investment decisions affect the employer. With DC they affect the employee. (Consultant)

Some schemes may benefit from having a separate group of trustees who oversee the DC scheme from those responsible for the DB scheme. This would suggest having a separate trust, which is the case in many, but not all, DC arrangements. That way, the DC scheme may get more consistent attention. A DC sub-committee is another possible option.

As regards governance of contract-based schemes, several advisers and consultants put forward the idea of establishing a board or executive, which would undertake some of the responsibilities of trustees. This could oversee the selection and monitoring of investment managers and funds, and take a role in determining the information and guidance provided to members. The employer could invite employee representatives on to the committee and invite advisers and providers to report to the committee. However, such a committee would lack formal legal responsibility for the pension arrangements – which are contracts between the employees and the provider – which might limit its effectiveness:

While employers want to help employees make sensible decisions, they don't want any legal responsibility for the outcome. The answer is to establish a pension committee for the contract scheme, which can do everything that trustees did but without actually giving advice to members and having any legal responsibility. (IFA)

Trustees are not always best placed to supervise DC arrangements, but there should be a strong governance committee. Trustees often are reluctant to do much with what is members' money. I'm a big fan of intelligent governance but I'm not convinced a board of trustees is the right way to deliver this. (Consultant)

As regards the role of investment consultants, some respondents suggested that trust-based DC gave the consultant the same commercial advantages as DB, in that they could advise but would not have to take responsibility for dealing with individual members:

Few people want to take responsibility for the end-user in DC. Who wants to "own" the compliance? The big consultants are the worst and the life companies have an advantage there. (Asset Manager)

3.1.2 The role of the employer. Many employees would like to turn to their employer for guidance on what to do with their DC pension investments. Employers, though, are often reluctant to help for fear of falling foul of financial services regulation or incurring other liabilities if the guidance they offer causes some disadvantage to members. There would seem to be merit in looking at what can be done to encourage employers to take a more active role:

I am in favour of making the law easier for employers to stick their neck out a bit in what they can say to employees without fear of being penalised by a regulator or ombudsman. (Pensions Lawyer)

The traditional way for the employer to offer support is to establish a trust-based scheme with a board of trustees. However, as noted above, trust-based schemes are in decline, as employers move to the simpler, cheaper contract-based arrangement. This is not just a question of lower employer contributions — the move to contract-based DC decouples the scheme, its liabilities and its expenses from the company and directs all risk and expense towards the member. Under trust-based DC, the employer usually pays some or all of the costs, for example, administration, whereas both administration and investment costs fall on the member in contract-based plans. Since pension tax simplification was introduced in April 2006, there has been no tax advantage in trust-based schemes. Previously, members could take a higher tax-free cash sum out of a trust-based model but simplification created

Employers are switching to contract DC to put a distance between themselves and the scheme outcome, so that all they have to do is collect and forward contributions — they don't want to be involved in the fund choice. (IFA)

We have virtually no new business enquiries for trust-based DC. We have lost trust-based clients to contract-based schemes. The life companies' pitch is that they offer a more straightforward platform. (Asset Manager)

While employers are moving from trust-based to contract-based schemes to reduce their responsibilities, there are some indications that the regulators may wish to see employers take more direct responsibility for the oversight of contract-based schemes. The Section 3.2 below highlights some important issues raised in TPR's recent consultation paper on DC regulation.

#### 3.2 The regulation of DC investment

In November 2006, The Pensions Regulator published a consultation paper (TPR, 2006) setting out how it intends to regulate DC pensions. The paper notes four issues that TPR believes could contribute to poor investment practices:

- (1) inadequate processes for the selection and ongoing review of performance of investment managers and funds;
- (2) provision of an inappropriate fund or range of funds;
- (3) inappropriate design of the default fund; and
- (4) lack of member understanding.

In terms of fund choice, the paper notes that the investment range must allow members to make choices that suit their circumstances, but that providing too wide a range increases complexity and may increase the risk of administrative errors being made.

TPR says that it intends to offer guidance on good practice in the following areas:

- effective processes for selecting and reviewing investment managers;
- effective processes for the review of investment funds;
- how to offer a well-designed fund or range of funds to suit member demographics;
- examples of different approaches to the design of default funds;
- · examples of investment options including diversification; and
- examples of clear and simple information that can be provided to members.

Perhaps, the most important part of the consultation paper is the section covering the Regulator's "expectations", which can be viewed as a description of the standards that need to be met. The stated requirements are:

 there is a robust selection process for investment managers and funds, and regular performance reviews;

- a suitable fund or range of well-managed funds is offered, especially in respect of the default fund; and
- steps are taken to help raise members' understanding of investment decisions, level or risk and potential impact on benefits.

The Regulator's guidance on DC investment issues can play a key role in helping employers and trustees to design their DC arrangements in a manner that is helpful for members. If employers and trustees can show they have followed TPR's guidance then that may have some impact on any discussion of liability for poor investment results. However, formal safe harbour provisions might be more beneficial.

3.2.1 Implicit and explicit advice. Many of the problems in DC investment could probably be solved by providing members with individual investment advice. However, this is quite rare due to the cost. Generic guidance obviously has a role to play, but some of the professionals we interviewed noted that it was typically not sufficient to enable members to make confident investment decisions:

I believe that most people actually need far more than generic financial advice at points in their lifetime, for example, on joining, transferring, or retiring. (Consultant)

Employers and trustees are wary of giving advice, but members would like guidance from an expert. Furthermore, what the FSA defines as advice is a long way from the definition most employees would use. Many members will regard aspects of the design of their scheme as implicit advice. This is particularly true of the default fund, which members can easily regard as being chosen as being suitable for them:

The selection and monitoring of the default fund or funds is absolutely critical to the success of the scheme and to good governance. It doesn't matter that the regulations do not regard this process as "advice" in the technical sense. Effectively it is advice, since most members take the default option on the assumption that it has been selected specifically for those who do not want to make investment decisions. (Trustee)

3.2.2 Safe harbour. One prospect for improving governance of DC schemes is that each party to the scheme – and this could include any combination of the employer, trustee, adviser, consultant, life office and asset manager – should be set clear regulatory responsibilities. In exchange for taking a greater fiduciary role, they should be protected through the introduction of safe harbour rules.

By safe harbour, we mean provisions that relieve the employer, trustees or other party from liability for the investment outcome provided the decisions they take conform to the standards set out in the regulations. Details of safe harbour provisions used in the USA are set out in Section 3.3. It is not compulsory for employers and others to follow the safe harbour guidelines, but doing so provides important protections which many will be reluctant to forgo.

Our argument is that provision of a safe harbour could encourage employers, trustees and advisers – the relative experts on investment – to provide more support to members in investment decision making. Key areas of application include specifying and selecting default funds, choosing appropriate ranges of investment choice, and providing members with appropriate information and guidance.

Obviously, care needs to be taken in developing and specifying the safe harbour provisions. They are likely to drive behaviour and if they are poorly thought out, that behaviour may be no better than the situation we have today. Nevertheless, we recommend

3.3 US Safe Harbour provisions for DC default funds ("qualified default investment alternative")

The US Employee Retirement Income Security Act (ERISA) provides relief from liability for investment outcomes for sponsors ("fiduciaries") of DC pension plans, typically 401(k) plans, where members make their own investment choices from an appropriate range of funds on offer. This relief is known as a "safe harbour". Some plan sponsors have worried about potential liabilities arising from the performance of default funds on the basis of an interpretation that default funds are not "chosen" by members. Many have responded by either refusing to have a default fund or choosing a low risk fund, such as cash, as the default to minimise the chances of short-term losses. These decisions can create a number of adverse consequences such as discouraging employees from joining (because they must make a fund choice), preventing use of automatic enrolment (which requires a default fund), and encouraging recklessly conservative investment strategies.

The Pensions Protection Act of 2006 contains several measures designed to support the use of automatic enrolment, one of which is an amendment to the ERISA safe harbour provisions. The new provisions create a safe harbour where:

- assets are invested in a qualified default investment alternative (QDIA);
- members have been given an opportunity to provide investment direction but have failed to do so:
- members have been given notice 30 days before the initial investment and again 30 days before the start of each plan year about how their assets will be invested in the QDIA;
- the plan offers a broad range of investment alternatives; and
- members are able to switch out of the QDIA into the other funds.

The regulations also provide requirements for the QDIA:

- it must not impose any transfer penalties on switching to other funds;
- it must be managed by a registered investment manager or investment company;
- it must be diversified so as to minimise the risk of large losses;
- it may not invest employee contributions directly in employer-issued securities; and
- it may be a lifecycle fund, a target-date fund, a balanced fund, or a professionally managed account.

A key point about safe harbour provisions is that they are not compulsory for sponsors to follow. The sponsor is free to choose an alternative course of action. The provisions do, though, give sponsors a firm steer as to what approach the government regards as appropriate. If the provisions are well-designed, they provide a powerful indication of best practice.

For more details see: www.dol.gov/ebsa/newsroom/fsdefaultoptionproposalrevision. html

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#### 4. Default funds

4.1 Survey results

- eighty-nine per cent of the pensions experts we surveyed think that a DC scheme should have a default fund:
- respondents, on average, say that, where a scheme has a default fund, typically 82 per cent of members invest in it; and
- fifty-seven per cent of respondents think DC schemes should offer a lifestyle fund
  as the default, while 39 per cent think lifestyle should be available as an option
  members can choose.

In this section, we examine what constitutes good governance in the context of default fund design. We also discuss lifestyle funds, given that lifestyle is a common approach for the default fund.

The results of our survey, together with other surveys such as the NAPF 2006 Annual Survey (NAPF, 2007), show that typically more than 80 per cent of scheme members accept the default fund, many of them passively. Default funds, therefore, are essential for the reluctant investor, who is deterred from joining if membership involves making complex, often incomprehensible, investment choices. Default funds are obviously also required where automatic enrolment is being used:

It is tempting to suggest that a default should not be offered in order to force people to make a decision. However, thinking realistically, it is unlikely that we will, in the foreseeable future, get many people to engage with this decision so I think a default is necessary and may produce better/less volatile results than would be true for people forced to make a choice. (Insurance Company)

The NAPF 2006 survey reports that 83 per cent of DC schemes have a default fund. Despite this widespread use, our research revealed growing concern amongst some advisers about the potential liability of employers, trustees and advisers for any problems arising in the default fund.

The real purpose of the default is to encourage people to join. Without it, people will see that they have to make complicated choices and will not join. But, there is a trend away from defaults in occupational DC because the trustees are afraid they will be held accountable for the outcome. (Asset Manager)

I am increasingly of the view that providers and employers can't escape liability for the outcome where there is a very large number of people in a default fund. Members who accepted the default will claim that they didn't actively choose it. (Insurance Company)

4.1.1 Choosing the default fund. Many of the professionals we interviewed believe that members generally see the default fund as implicit advice. We investigated the selection process for the default fund and found that employers using contract-DC usually delegate the choice to their adviser. The adviser in turn tends to recommend the default fund put forward by the selected provider. Historically, this has been either a balanced managed or index-tracking fund, depending on the provider's areas of specialisation. This means that the default fund is not driven by buy-side needs, but by sell-side expediency:

With stakeholders the main driver is cost – so the default fund will be the life office's cheapest option. So, if you have an L&G stakeholder the default will be passive; Scottish Whatever's will be the active balanced managed fund. The [members'] 'choice' therefore, is illusory.

The TPR consultation on DC governance notes the intention for the regulator to provide guidance on the process for selecting a default fund. This would seem likely to include issues such as considering the risk tolerance of members, the appropriate means of managing risk as members approach retirement, and the effective management of costs. As we argued above, it may make sense to go further and establish safe harbour provisions that protect the employer from liability for the outcome of investment in the default fund provided that appropriate care has been taken in the selection decision.

4.1.2 Lifestyle funds as the default. Lifestyle (or lifecycle) funds switch members' pension fund assets from equities to bonds and cash as the planned retirement date approaches. A lifestyle overlay is a common component of default options and it serves two important purposes. First, it ensures that members are invested predominantly in equities, or other growth assets, for most of the accumulation years. Secondly, it ensures that members gradually switch from risky to safer assets in the few years before retirement to avoid the potentially disastrous impact of a market crash at a time when earned income is expected to cease shortly.

The lifestyle approach is common in practice, with the NAPF (2007) survey reporting that it is used as the default in 63 per cent of DC schemes. However, there are disputes over:

- · the length of the lifestyle switching period;
- · the exchange of assets involved in the switch; and
- if lifestyling is even an effective strategy at all.

There is also a concern that where there is only one lifestyled default fund this gives rise to an over-concentration of members in a single fund. As mentioned earlier, this poses potential problems for employers in particular if members are dissatisfied with the outcome and complain that they were "directed" into an inappropriate fund.

The variety of different lifestyle mechanisms that are in use across the DC market suggests that opinions vary about what is most effective. Different providers operate lifestyle mechanisms that start the switch into safer assets at any time from three to ten years (and in a few cases more) prior to the expected retirement date. Equally, the growth vehicle in use for the early years of membership varies across providers and can be a UK equity fund, a global equity fund or some form of balanced fund, with additional variations in terms of active or passive management. (Byrne *et al.*, 2007):

Lifestyle hasn't changed or developed for a decade. The thinking varies. Some argue that a three-year switch is optimal to allow for maximum growth but in practice it does not work. This is largely because people don't know when they are going to retire and three years doesn't give enough flexibility — nor does five in many cases. The current trend is towards an earlier start for switching. One of our clients decided to err on the cautious side and recently changed from five to ten years because of the uncertainty over actual retirement dates. (Consultant)

The decision on the switching period is driven by two main considerations. The first relates to managing market risk: obviously a longer switching period provides greater protection from losses, but on the other hand imposes a cost in terms of reduced expected return, given the longer period in low-risk/low return assets.

The other consideration relates to uncertainty in relation to the member's retirement date. A short switching period may mean that a member who is forced to retire a few years early is still heavily invested in equities – and hostage to market conditions – at that point.

Traditional lifestyle funds switch the member's balance from risky assets, such as equities, to safer assets such as bonds, as the planned retirement date approaches. Typically, this is achieved by switching the units of the funds the member is holding from, say, the equity fund to units in the bond and cash fund. An alternative method that simplifies unit holdings is the target-date fund.

Target-date funds work on a similar principle to conventional lifestyling, but the switching occurs within each dated fund. So, for example, a member expecting to retire in 2040 would buy the "2040 Fund". This would have an internal lifestyling mechanism and would start to switch into safer assets in, say, 2030 so that by 2040 the fund is 75 per cent in fixed income and 25 per cent in cash. Target-date funds may be easier for members to understand: they simply choose the fund that coincides with their planned retirement date and the manager does everything else. In this way they focus the member on the final outcome rather than on shorter-term performance.

Target-date funds may be appropriate for use as the default in a DC scheme. As with many forms of funds, providers may take different views on what is an appropriate asset allocation to support the target-date. This diversity is not bad in itself, but given diversity in the underlying asset allocations, employers, trustees and advisers need to make their selections very carefully with the member profile in mind.

4.1.3 Changing the default fund. In trust-based schemes, trustees select the default fund and the investment range. An important issue arises when they decide the existing arrangements are no longer appropriate, for example, due to sustained poor performance by the investment manager.

Where trustees decide to make a change, they need to think about how to deal with member's existing holdings in the fund that has been removed. Often the approach taken is to inform members of the change and invite them to switch. Trustees often seem reluctant to close fund options entirely and force members to switch. The result can be large numbers of members invested in legacy funds, with complications in administration, communication and ongoing monitoring:

Trustees are not bold enough. Where they do change an under-performing manager, many fail to ensure members automatically transfer. Instead they send a letter saying that there is now a new manager – and they leave it up to the member whether or not to switch. The result is that most members stay put and end up with under-performing legacy funds. (Consultant)

An alternative is to create a range of funds in the employer's name –, e.g. the XYZ UK equity fund. This is sometimes known as a "white-labelled" fund, where the asset manager provides the manufacturing on an unbranded basis. The trustees and/or their adviser can then appoint one or more managers per fund and monitor them, replacing managers where necessary. This avoids the above problem because members don't have to make any decisions – they are automatically moved to the new managers.

This approach would appear to have benefits from a governance point of view and from an administrative perspective. It should be possible in contract- as well as trust-based arrangements. However, employers and trustees may be reluctant to adopt this approach for fear of liability should their investment decisions turn our poorly. Again, there may be a need for safe harbour provisions that reassure the decision

#### 5. Investment choice

#### 5.1 Survey results

Most of the pensions experts we surveyed think that DC schemes should offer a relatively narrow range of funds for members to choose from (Table I). The respondents' views on the appropriate number of funds to offer can be contrasted with data from the NAPF 2006 Survey (NAPF, 2007) on the choice actually provided by DC schemes.

5.1.1 Too much choice? Beyond the default, most DC schemes offer a range of funds for the active investor. The NAPF 2006 survey reports that 94 per cent of DC schemes provide members with investment choice. Twenty-three percent of schemes offer members 20 or more funds to choose from and 10 per cent of schemes offer 40 fund choices or more.

Today most advisers and consultants recognise that wide choice can confuse members and that a small range of funds is preferable, but they do not always feel confident, from the liability perspective, in narrowing down the choice. Our interviews revealed that the selection of an appropriate range of fund choices in relation to membership profiles is hampered by the fear that the selection and elimination process could create a liability if it goes wrong, i.e. members could later claim that they suffered because better funds were denied to them:

There have been a lot of articles recently on the inadvisability of providing choice. I have to say, having just joined my own firm's GPP, which had over 200 funds to choose from, I agree with this. (Pensions Lawyer)

It is difficult for employers to pare down fund choice. Typically they will want their consultant to do it. Consultants are wary of cutting funds out of predetermined ranges – there is "regret risk" that the ones they exclude will do well. (Asset Manager)

We appear to have the unfortunate situation whereby, experts believe that a small range of funds is appropriate but what is offered frequently is a much wider choice, even though this is confusing and unhelpful for the member.

Beyond the reluctant investor there may be members who want and need a wider fund choice. If schemes want to provide choice for this group, it is important they do so in a manner that does not impose costs and complexity on the vast majority of members with simpler requirements. One option would be to establish an appropriate filter system for the investment range. This would involve creating two or three layers of fund choices, so that members with basic requirements need only consider the simple choice offered in the first tier and the wider range is only displayed to those who request it.

Number of funds	Survey: per cent of respondents	NAPF data: per cent of schemes
1	0	6
2-5	17	14
6-10	57	35
11-20	9	21
20 +	15	23
Do not know	2	N/A

Table I.

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5.1.2 Risk-graded multi-asset funds. As we have discussed above, it is unlikely that a single default fund will meet the risk/return preferences of 80 per cent + members of the scheme. The issue may be that the default fund is the only "packaged" option and moving from that to "Do It Yourself" asset allocation using individual funds is too intimidating for most members. One alternative to this, which is growing in use, is to offer a small number of packaged options that members may choose from. For example, the scheme could offer either three or five multi-asset strategies differentiated by the balance between risky and safer assets, with some form of lifestyle overlay to manage risk through time. Members can choose amongst them based on their perceived attitude to investment risk, and the funds can be described or categorised on that basis.

One way to characterise the funds is to give them names such as: Adventurous, Balanced, Cautious (the "ABC" approach). These names attempt to differentiate the funds for the reluctant investor. Underlying the classification can be a more objective measure of risk, for example, where each fund has a target range for its value-at-risk or volatility parameters. An example is provided below in Table II.

Members can be provided with a risk profiling questionnaire to help them consider their attitude to risk. Some providers suggest that this type of approach has been helpful in reducing the percentage of members who end up in the default fund. The key is in making the fund choice more manageable for the non-expert, although it is fair to say that inertia remains strong and many members will, in any case, end up in the default fund:

Risk profiling of members can be advantageous. You're more likely to offer a suitable fund range and to get positive member feedback. But it's labour intensive and there are regulatory risks. (IFA)

While the "ABC" approach appears to have merits, employers, trustees and advisers need to make sure the provider's interpretation of risk profile matches their own view. It is unlikely that many members will be able to do so for themselves.

One issue raised by a number of our contacts was whether these types of funds should have descriptive names, such as "Cautious" or names based on factual aspects, such as the equity content ("The 75 Fund", which has a 75 per cent equity allocation). The argument for the latter is there is less risk of members being misled, for example, where they interpret "Cautious" in a way that is different from the provider's view. However, elsewhere we make the argument that members will be better served by communicating funds based on *what they are expected to achieve* rather than on the asset allocation and investment style.

Finally, it is worth noting that the ABC approach does not remove the need for a default fund: some members will not complete the risk profiling questionnaire and

Cautious	Cautious (per cent)	Balanced (per cent)	Adventurous (per cent)
UK equities Overseas equities Fixed income	30 30 40	40 40 20	50 50

**Table II.** Example of risk-graded managed strategies

**Source:** Hypothetical example developed based on a review of fund options available in the UK pensions market

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#### 6. Conclusion

Most of the pensions professionals we interviewed regarded the majority of DC scheme members as reluctant investors. Various things, such as limiting fund choice, can be done to make DC schemes more usable for such investors. However, our research suggests many employers and trustees are reluctant to take these steps for fear of incurring liabilities for any adverse outcomes. We believe there is scope for regulators and legislators to provide guidance and safe harbour provisions that will give these parties greater confidence to take an active role in supporting their members.

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#### Further reading

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