

Tomorrow's Investor

Pensions for the people: addressing the savings and investment crisis in Britain

by David Pitt-Watson

RSA

About the RSA

The RSA's central belief is its faith in the power of civic action. At the heart of the RSA's mission is the desire to bridge the social aspiration gap: the gap between the society people say they want and the way they behave. Our principal challenge is to develop a dynamic, credible and persuasive account of what the future citizen needs to be if we are to deliver the world we want.

The RSA engages practitioners and thinkers in concrete, practical action and the development of ideas aimed at creating the kind of state, civic and commercial institutions we need to enable active citizenship.

The Tomorrow's Investor project speaks to this core purpose. It aims to be a catalyst for ideas relating to a growing issue and starts by looking at what kind of investors and owners we need in order for capital markets to deliver to our requirements and wishes.

Since the RSA first began working in this area, it has become increasingly focused on ascertaining whether the project can be used to generate a new model of investment, addressing what we see as a market failure. The primary challenge we set ourselves was to create the policy, market and business case for a new low-cost, responsible pension fund with high transparency and accountability; a pension fund that delivers long-term returns regardless of the economic climate.

RSA

The Royal Society for the encouragement of Arts, Manufactures and Commerce
8 John Adam Street
London WC2N 6EZ
T +44 (0)20 7930 5115
www.theRSA.org

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The RSA is an Enlightenment organisation devoted to finding innovative practical solutions to today's pressing social problems. Through its 27,000-strong Fellowship it pursues its mission: to help people be the people they need to be to see the change they want in the world.

The citizens of the future will need to be self-reliant, engaged and other-regarding if they are to create a principled and prosperous society. This is nowhere more true than in financial matters. The Tomorrow's Investor project, the first stage of a prolonged RSA engagement with these issues, aims to facilitate this goal, both practically and intellectually.

More information can be found at the RSA website: www.theRSA.org.uk

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About the author

David Pitt-Watson is the founder of Hermes Equity Ownership Service, the largest shareholder stewardship programme of any fund manager in the world. He was formerly head of all Hermes shareholder activist activities. He has enjoyed a varied business career, both as a prominent City investor and as a senior strategic advisor.

Pitt-Watson has advised leading policymakers on issues of industrial and financial policy for more than 20 years. He is a director of Oxford Analytica and a trustee of the Institute for Public Policy Research (IPPR). He has been a member of several policy commissions.

A graduate of Oxford and Stanford Universities, Pitt-Watson was visiting professor at Cranfield University School of Management from 1990 to 1996. He is the author of *The New Capitalists*, published by Harvard, which describes how a 'civil economy' can emerge in the economic sphere, mirroring civil society in the political sphere.

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In keeping with the ideals of the RSA, all these people and institutions gave freely of their time, expertise and resources to help design what we believe can be a fair and effective pensions future for Britain.

Tomorrow's Investor advisory board

1 Sir John Banham, advisory board chair

Sir John Banham is the chairman of Johnson Matthey Plc (ranked number two in the *Management Today* league table of Britain's Most Admired Companies 2008) and the senior independent director of Invesco Ltd. Since 1992, he has chaired five major UK plcs and has significant experience of venture capital as chairman of Westcountry Television, ECI Partners and Cyclacel Pharmaceuticals.

Banham was the first controller of the Audit Commission (1983-1987), director-general of the Confederation of British Industry (1987-1992), and the first chairman of the Local Government Commission for England (1992-1995)

2 Alistair Blair

Alistair Blair is an investment journalist. He read PPE at Oxford and completed an MBA at Manchester Business School. He has 10 years of practical City experience, having worked at Hill Samuel and Fidelity Investments. A regular contributor to the *Investors Chronicle* and other national publications, he also runs a small investment fund.

3 Robin Ellison

Robin Ellison is head of strategic development for pensions at Pinsent Masons, advising on the development of pensions and related products as well as European pensions, pensions trustee law and pensions in matrimonial matters.

In addition to being an accredited mediator, Ellison is a non-executive director for a number of companies and trustee of several pension funds. He is visiting professor in pensions law at the City University Business School (now the Cass Business School) and visiting senior lecturer at Kings College London. He founded the Association of Pensions Lawyers and is chairman of the National Association of Pension Funds. He was the first solicitor to be elected honorary fellow of the Pensions Management Institute.

4 Philip Goldenberg

Philip Goldenberg is a solicitor with extensive corporate finance experience, specialising in corporate governance and employee share ownership. From 1983 to 2004, he was a partner in S J Berwin, and since 2004, he has been a consultant to Michael Conn Goldsobel Solicitors.

Goldenberg was involved in the conception and enactment of the profit-sharing provisions of the 1978 Finance Act. He was also legal adviser to the RSA's Tomorrow's Company Inquiry (1995), and later advised the DTI on its 1998 Company Law Review.

5 David Pitt-Watson, project leader

David Pitt-Watson is the founder of Hermes Equity Ownership Service, the largest shareholder stewardship programme of any fund manager in the world. He was formerly head of all Hermes shareholder activist activities. He has enjoyed a varied business career, both as a prominent City investor and as a senior strategic advisor

6 Vicky Pryce

Vicky Pryce is chief economic adviser and director general, economics at the Department for Business, Innovation and Skills. She is on the council of the Royal Economic Society and has recently been elected a fellow of the Society of Business Economists. Pryce is also visiting professor at the Cass Business School and has been elected to the Council of the University of Kent.

7 Matthew Taylor

Matthew Taylor became chief executive of the RSA in November 2006. Prior to this appointment, he was chief adviser on political strategy to the prime minister.

Taylor was appointed to the Labour Party in 1994 to establish Labour's rebuttal operation. His activities before the Labour Party included being a county councillor, a parliamentary candidate, a university research fellow and the director of a unit monitoring policy in the health service.

Until December 1998, Taylor was assistant general secretary for the Labour Party. During the 1997 general election he was Labour's director of policy and a member of the party's central election strategy team. He was the director of the Institute for Public Policy Research, Britain's leading centre-left thinktank, between 1999 and 2003.

8 Lindsay Thomas

Lindsay Thomas was a director of the Financial Services Authority until 2006. His senior FSA roles included directorships of Retail Firms Supervision, Knowledge Management and Authorisation. As a senior supervisor he has been at the centre of almost every major issue in financial services markets stretching from the 1986 crash and Barings, to LTCM and Equitable. Thomas is now working with FD Public Affairs' specialist financial services practice, providing advice to clients. In addition, he is also CEO of Sustainable Risks Ltd, a risk, communications and regulatory advisory practice.

I Foreword

Happy retirement or pensioner poverty?

'A long, healthy and happy retirement' is what everyone wishes for themselves and their loved ones. A decade ago this was a reasonable prospect for most families: at the time, a combination of final salary pension plans and house price inflation masked inadequate levels of personal savings by millions of British households.

This is no longer the case: today, a toxic combination of the closure of private sector final salary schemes, falling house prices, poor investment returns for savers and high management costs mean that poverty in old age is a looming prospect for millions outside the public sector. One of the least generous state pension plans in Europe will not be able to bridge the savings gap. The public coffers have been drained by the need to bail out Britain's high street banks.

Small wonder that the British public is being told on all sides to save more, work longer and expect a lower quality of life in what used to be referred to as 'the third age'. It is an unattractive and, for many, a frightening prospect.

It need not be like this.

Britain's savers are not condemned by some ineluctable fate to further decades of inadequate investment returns and to continuing excessive management costs. There are many internationally competitive UK quoted companies in which to invest; and international comparisons show that management costs could be reduced by two-thirds or more, with no loss of service or quality of advice.

After a lifetime of work, a decent pension can be available for the many rather than being the privilege of the relatively few.

But there is a catch: the problems must be confronted by Whitehall and Westminster, rather than ignored in the hope that they will be blown away by future asset bubbles. This will not be easy in a political culture adept at ignoring longer-term problems unless there is obvious short-term political benefit in grappling with them. And, when in doubt, it is invariably easier to treat the symptoms of the problem. In this case that involves more means-tested benefits, which further undermines the case for individual savings, by relatively lower-paid people in particular.

The RSA's Tomorrow's Investor project has brought together leading thinkers specialising in these issues, and successful practitioners from the financial services industry who have delivered impressive returns for investors over decades. Their report proposes a way to improve investment returns through closer engagement between the owners of public companies and their management. Where were the owners of Lloyds when the bank purchased HBOS? Where were the owners of RBS when the disastrous decision to press ahead with the acquisition of ABN Amro was taken? The report also shows how the costs of managing pension funds can be reduced massively, building on experience in the US, Netherlands and Australia. This important report is timely given the imminence of the Personal Accounts

Delivery Authority (PADA) initiative and the opportunities and risks that it involves. It should be required reading for all those aspiring to form the next government or to manage pensioners' funds for them. I commend it.

Sir John Banham DL

Chair

Advisory board

Tomorrow's Investor

2 Introduction

The willingness of individuals to save and of companies to use that saving to invest in profitable projects is at the heart of a successful modern economy.

We entrust our savings to those who claim the expertise to manage them. A chain of agents takes our money and invests it in those areas of the economy that should be the most productive.

There are two reasons why the investment chain is so significant in a capitalist economy. First, because it should allow cost-effective investment in companies; agents select the best companies to receive funds in order to get the greatest returns, which can be passed on to the saver. This, of course, requires that the agents in the investment chain do not add unreasonable costs. Second, the investment in shares should mean those who raise funds can be held to account; it is the shareowner who appoints the board of directors of the company, and therefore ultimately controls its conduct.

But at present, neither of these goals are being realised. The cost of the investment chain has been rising, reducing returns to savers and/or raising the cost for investors. We discuss this in more detail in Chapter 3. And the governance of our companies is widely seen to be inadequate; we have, as the City minister would say, “ownerless companies”. As Adam Smith would have reminded us, and as the current financial crisis would attest, that is a recipe for “negligence and profusion”¹.

We believe this situation can be remedied. A combined effort from private, public and social spheres can generate new institutions that will ensure the management of our savings in a way that is cost-effective and begins to call to account those responsible for managing our companies, and our financial institutions.

This report therefore addresses three issues

- * It shows how we can develop new low-cost forms of savings.
- * It shows how these can contribute to a framework for responsible investment.
Taken together, low-cost, responsible saving can markedly increase returns to savers and benefit the economy.
- * Finally, it aims to demonstrate that the financial community is able to provide these services and would be interested in doing so, and it sets out the practical steps needed to establish these new investment vehicles.

These proposals are made possible by the planned establishment in 2012 of a system of auto-enrolment complemented by a system of personal accounts, and matched funding, for pensions contributions. This framework provides the foundation upon which a system of low-cost, transparent, accountable pensions funds could be built. Not only would this help individuals to save, it would also contribute to the emergence of a much-needed culture of long-term investment. However, the potential of the personal accounts system could be squandered without small but vital reforms to its current design. First, the infrastructure of auto-enrolment and the infrastructure of personal accounts need to be made

available to a range of approved providers conforming with basic principles of responsibility and low cost. Second, the infrastructure must be available to savers beyond the current savings limit applying to the personal accounts system. These are relatively simple measures to implement. With these changes there is a good chance we can create a culture of saving and long-term investment in the UK, to the benefit of our economy and our citizens. Without them not only will this opportunity be missed but the whole viability of the personal accounts system must be in question. With the system due to be introduced in 2012 and the Conservatives currently reviewing their policy, there is an urgent need to address these issues.

¹ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), Book V

3 The need for responsible investment

The investment chain and the credit crisis

Chains and the links that hold them together are the basic mechanism of the financial system. Each market participant is a link in many chains. An ordinary member of the public, for example, will almost certainly be a link in the lending chain by virtue of his or her savings account, which is amalgamated with many other sources of finance and loaned to companies or other borrowers. By the same token, if he has a mortgage he will be at the other end of the same chain. These chains connect him to the rest of the system, just as they connect all the other participants to him and to each other.

Ensuring these chains work efficiently is of vital economic importance for productivity and long-term growth. First, because the chains are critical mechanisms for ensuring that investment is allocated efficiently and cost-effectively. Second, because for equity investment, ownership rights and responsibilities are also transmitted along the links. Rights and responsibilities form the basis for accountability, without which any system is vulnerable to exploitation and irresponsible risk taking.

The investment chain for long-term saving is facing two significant and immediate problems, both of which have been exacerbated by the credit crisis. First is the issue of accountability: fund managers and companies are not seen to be behaving in the interests of those whose savings have been entrusted to them. In particular, while usually ensuring their own interests are protected, those who have invested on our behalf have allowed unjustified and unwise risks to be taken with our money. They have also failed to attend sufficiently to the long-term interests of the economy and society. Second is the issue of costs: our current system of private pension provision may be taking up to 40 percent or more of our money in fees and costs, compared with 10 percent for best practice by collective investment plans in other parts of the world. So only 60 percent of the money and returns that we earn ends up in our hands, rather than the 90 percent if best practices were followed. In other words we could add 50 percent to private pensions (from 60 percent to 90 percent) if we were to redesign the system.

While usually ensuring their own interests are protected, those who have invested on our behalf have allowed unjustified and unwise risks to be taken with our money

These problems need to be dealt with simultaneously: a cost-effective system that is not accountable would end up wasting our investments; an accountable system with high costs would create effective investments, but dissipate the returns with fees. This paper aims to outline how both problems can be solved.

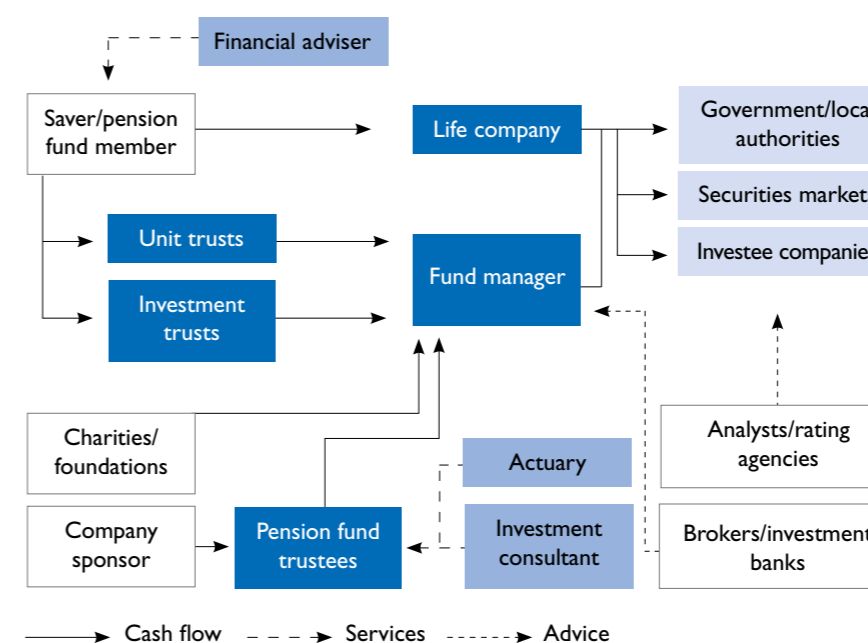
Governance

The investment chain describes what happens to the investment made by a long-term saver in a pension or a life insurance policy. This chain can be very involved and subject to many variations, but in its broadest terms it looks something like this:

- * A wage earner puts some of their salary aside.
- * That sum goes into a company pension scheme.
- * In the pension scheme it is bundled up with the savings of many other people.
- * The pension fund trustees, stewards on behalf of pension fund sponsors and members, appoint fund managers to manage the money.

- * The fund managers invest in company securities, including equities or shares.
- * This gives them the right to appoint the board of directors.
- * The directors in turn are responsible for the good management of the company. They owe their fiduciary duties to the company, and should exercise them in the best interests of shareholders. In doing so, they should also have regard for the company's key stakeholders.

To describe all the links in the investment chain would be complex; there are sometimes dozens of intermediaries. For example, we have not looked at the role played by investment consultants in advising pension fund trustees or the fact that companies' financial statements are verified by auditors, which protects shareholders – such as pension funds – who are themselves acting on behalf of millions of small investors. Yet the principle is there: that through these chains the entire market is connected. Business research and education charity Tomorrow's Company led a two-year research project into the effectiveness of the UK investment system. This diagram, taken from their report, *Restoring Trust*, gives some sense of the situation²:



The role of shareholders in the investment chain is particularly notable. Companies operate for, and are answerable to their shareholders. But the above diagram shows how quickly the owners of capital can be distanced from their holdings.

Any approach to influencing company behaviour must incorporate the role of the shareholders in whose interests the board must act. It must also deal with the principal-agent problem. This, broadly speaking, is the problem of getting your agents to work on your behalf rather than their own. It occurs wherever people delegate necessary functions to third parties: in politics, business and, most notably, economics. When agents don't act on behalf of their principals, any system is in trouble. Imagine if a doctor or a lawyer stopped acting in their patients' interests. Imagine if our fund

² Tomorrow's Company, *Restoring Trust* (2004)

managers were to do what they wanted with our money, and companies worth billions were run only in the interests of the dozen or so people on their board. The principal-agent problem goes back a long way. Adam Smith recognised it, opposing absentee ownership of companies in the strongest possible terms: “negligence and profusion must always prevail, more or less in the affairs of such a company”³.

The events of recent months demonstrate Smith’s enduring wisdom. They also affirm an obvious but often forgotten truth: if we do not have good owners, we will not have good companies.

Absentee shareholders

The immediate holders of the shares in Britain’s banks and companies are the fund managers and life companies in the diagram on page 13, known collectively as ‘institutional investors’: vehicles that invest the money of third parties. This has been the great change of the past 50 years. In 1963, UK pension funds, unit trusts and insurance companies held around 18 percent of UK shares. In 2006, they held around 40 percent of the UK stock market at a combined value of £762bn. Many foreign investors in the UK are also institutional investors. So the majority of the shares in almost every British company are held in trust for millions upon millions of people. And British institutions have themselves moved into overseas equities, which by 2005 accounted for a larger share of assets under management than UK shares. In other words, it is not just in Britain but across the entire developed world that companies are owned, and should be run for, the millions of beneficiaries of pensions and other long-term savings.

Institutional shareholders have come under heavy criticism as the postmortem on the credit crisis continues. “Shareholders did virtually nothing to prevent and manage the financial crisis”, Dutch finance minister Wouter Bos said recently at a conference in Amsterdam. “The Boards of many financial institutions felt pressured by their shareholders: yields and leverages were forced up, resulting in bubbles that could only seem healthy by neglecting financial risks.”⁴ Speaking at the National Association of Pension Funds (NAPF) investment conference in March, FSA chief executive Hector Sants called on pension funds to help avoid future financial crisis by taking a far greater role in checking on management performance and risk in companies they own. “You have a major role in addressing the issues arising from this financial crisis”, he told delegates. “I have questioned whether, if there had been more effective and collective shareholder intervention, whether the financial crisis we are witnessing today would be as severe.”⁵

Some people find these critics too harsh. Yet while institutions and pension funds are not alone in bearing the blame for the crisis, their role in addressing corporate governance issues is crucial. As Hermes Equity Ownership Services chief executive Colin Melvin put it in a recent discussion with the author of the report: “Pension funds are long-term trustee owners. It is vital they ensure their ownership duties are undertaken so that we can have accountable companies and sustainable economies.” We have seen what happens when accountability and responsibility are absent. Given the clout they wield, pension funds have an urgent duty to demand good governance.

³ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), Book V

⁴ ‘Bos attacks shareholder role in financial crisis’, www.ipe.com/news/Bos_attacks_shareholder_role_in_financial_crisis_31003.php

⁵ ‘Sant blames investors for financial crisis’, www.professionalspensions.com/846237

This duty is not merely a moral one. A long-term perspective and an interest in sustainable growth are crucial for institutional investment because these investors are universal owners; they represent the savings of thousands, sometimes millions of individuals. Through their collective investments, they have amassed portfolios so extensive and so diversified that they have an interest in the economy as a whole rather than just specific companies or industries. In short, meeting shareholders’ interests for healthy financial returns with a view also to broader stakeholder responsibilities is both privately and socially beneficial. That is what good governance, the proper use of entrusted power, is supposed to deliver.

Past and future problems

The credit crisis and its fallout have exposed the inadequacies of the institutional investors’ behaviour as shareholders. But the issue of ensuring good governance is a long-standing one. If we fail to tackle it, it will cause problems well into the future, far beyond even our current predicament.

We need companies to be run in the best long-term interests of the shareholders. Investor engagement can play an important role in making this happen. As we all now know, the costs of failing to act for the long term can be huge. But the erosion of shareholder value can also be seen in numerous small malpractices, which are symptomatic of the wider problem. We can identify a number of them in the areas of communication, finance, strategy and ethics:

- * Companies routinely try to put the best ‘spin’ on their results. Most CEOs accept that in meeting their shareholders the aim is to encourage them to buy the shares rather than to help resolve management problems with an engaged owner.
- * Despite all the evidence that most acquisitions fail to deliver value, companies continue to make them. Acquisition was, of course, at the heart of the recent problems faced by Lloyds and RBS.
- * Incentives: the credit crisis has made us only too well aware of the damaging effect of the bonus culture on company behaviour.

Perhaps the greatest crisis we will face, if we fail to solve the governance problem, is not financial but environmental. Given that companies are owned by millions of people, it makes sense for them to participate in finding solutions to our environmental problems. Climate change is a classic example of a situation where the right thing for society will also be the right thing for business. For institutional investors in particular it is a no-brainer. They might initially benefit when an investee company externalises costs but they will ultimately experience a reduction in market and portfolio returns as pollution or environmental degradation adversely affect returns from other assets. Like all universal owners, their interest is in reducing negative externalities (such as pollution and corruption) and increasing positive ones (such as sound corporate governance and effective education and training) across their investment portfolio.

Climate change is a classic example of a situation where the right thing for society will also be the right thing for business

Yet too often we find large companies behaving in ways that cannot be in shareholders’ interests. The funding of lobby groups to oppose proper

environmental regulations would be a case in point. For our environmental problems to be addressed, it will be necessary for large corporations to act. It would be the ultimate irony if, supposedly acting in the interests of their millions of beneficial shareowners, company lobbying was to destroy the planet on which those shareowners live.

Collective ownership and regulation

The passivity and alienation of large institutional investors has been a constant feature of the past 40 years. Even more prominent, however, has been the passivity and alienation of the ultimate owners, those long-term savers whose capital stakes have purchased so much of the stock market.

The history of the post-war years could be written as a heartening tale of power moving away from elites and towards ordinary people. Through their pension funds, banks, fund managers and insurers, ordinary people have come to own the corporate system. Their money, invested by institutional investors, controls large slices of the biggest companies in the world.

Yet the true nature of this ownership relationship has not been realised.

Most people are thoroughly disengaged from their investments. During the credit crisis the comparison has repeatedly been made between nationalisation and private ownership. It is rarely recognised that the two are in many ways the same. After all, when a company is owned by institutional investors, it is effectively owned by millions of people. One large British company calculated that, when it paid a dividend, over 200 million people benefited.

The classic socialist belief was that the way to control unbridled capitalism was through common ownership. Our model of capitalism actually includes a form of collective ownership: a form that might have heralded some form of investor democracy. Unfortunately, neither the socialist nor the democratic vision has become a reality. Instead, there is widespread detachment, leaving the system with a vacuum of ownership.

One solution is regulation. Sophisticated regulation is essential to the financial system, but it is not a panacea. First and most obviously, because all regulation creates in its wake a small industry dedicated to its circumvention, often with perverse outcomes for the system as a whole. The contours of each new financial crisis tend to be defined by the response to the previous crisis. Some level of trust must exist in the system, as the economist Robert Shiller argues in *The Subprime Solution*:⁶ we cannot regulate against every single eventuality. Regulation may undermine the vigilance that is necessary to safeguard economic and financial systems. Indeed, if market participants think they can do anything provided they stay within ‘the rules’, it is a licence for people to find ways around those rules. Rule-based regulation will not stop unprincipled people. And finally, of course, it is not possible to regulate for the complex intellectual and ethical judgements involved in good ownership. Good ownership, and its practice, is not readily definable by law, or easily tested in court.

⁶ Robert J Shiller *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do About It*, Princeton University Press 2009

We believe that open markets are a good thing, but that they will only work well where they are accompanied by responsibility and accountability. Sophisticated regulation that takes the whole system into account can help prevent abuse, not just by seeking to ban particular activities, but by promoting interactions between individuals in the investment chain that ensure the principles are upheld. Then, if the system works as it ought, where companies, fund managers and others serve the collective investment schemes that have entrusted them with money, we will give ordinary people a stake in the system – a kind of shareholder democracy. Indeed, without such a system of ownership, we cannot expect companies to be well run.

The aim therefore, is not to try to replace the current position with regulation. Rather it is to use regulation to ensure that ownership rights and responsibilities are properly exercised.

The citizen investor

For too long most fund managers have failed to take their role as accountable and responsible owners seriously, instead focusing almost exclusively on short-term gains. Now, if anything, their horizons have been shortened. In the meantime, long-term savers have lost whatever faith they had in financial institutions and have become less likely either to save for the future or to take action to improve shareholder value.

The institutions that might allow popular ownership are also under-developed. The economists John Kay and Aubrey Silberston have actually argued against the idea: they contend that, unlike majority owners, diverse shareholders own shares, not companies⁷. It is true that even if pension members or unit trust holders were given more ownership rights than they currently possess, it would still not be quite correct to think of them as owners in the strict sense. But this does not necessarily matter. ‘Ownership’ may not be the best way to talk about investment in the technical sense, but it can be a useful heuristic. As the *Tomorrow's Company* report *Tomorrow's Owners* put it: “It is an excellent word to convey the stewardship dimension because it carries with it layers of meaning accumulated over centuries, relating to rights and responsibilities such as the duty of care”⁸. The problem is we do not even have ownership in this sense.

But there is a still deeper problem. The old pension funds that could have provided the foundation for responsible capitalism are now being closed to new entrants. Ten years ago some of the biggest owners of UK companies were pension funds of companies such as BT and Royal Mail, the rail industry and the banks. These funds will remain very significant investors for at least a generation, but given that few of them are accepting new entrants, more savings vehicles must be found. And it is essential that they, together with the traditional pension funds, promote responsible investment practice.

However, these newer funds face a challenge; they are not receiving enough contributions to produce adequate pension returns, in part because they are not trusted. In fact, as we shall see in the next chapter, the level of pension savings

⁷ Kay John and Silberston Aubrey, ‘Corporate Governance’, *Perspectives on Company Law Vol 2* (August 1996), www.johnkay.com/business/149

⁸ *Tomorrow's Company, Tomorrow's Owners* (2008)

is well below that required to allow people to retire in the circumstances they demand. Sadly, the widespread mistrust in the financial system is not unmerited. Too many retail financial products currently on sale are enormously costly, with fees taking a huge proportion of the money saved.

So the challenge for our financial system is twofold: first, to create the architecture for responsible capitalism, and second, to allow a cost-effective way for citizen investors to access the investment opportunities it creates.

In this paper we cannot address all the challenges associated with these issues. However, we do believe it is possible for the UK to establish an investment structure that gives citizen investors powers appropriate to their collective investment. And of course, that needs to be done in a low-cost fashion. With costs reduced, returns will be substantially higher. And, with more responsible companies, profits and returns should also be significantly enhanced.

The architecture to allow this to happen has been established through the creation of the system of auto-enrolment and personal accounts. This is a once-in-a-lifetime opportunity. But without the small reforms outlined in the introduction, the system is likely to fail to meet the objectives currently set for it.

However, before we suggest solutions, we need first to look at the investment institutions that exist today, and at whether, why and how they need reform.

4 What is wrong with current pensions and investments in the UK?

The current situation

Twenty-five years ago, Britain had one of the most advanced private pensions systems in the world. Most large companies and many small ones had established 'defined benefit' (DB) pension schemes that aimed to pay a set proportion of the beneficiary's final salary as a pension, and offered appropriate benefits for other dependents.

The system was not perfect. It coped poorly with those who changed jobs and it disproportionately benefited those whose salaries increased during their period of employment. Nevertheless, those enrolled in a DB scheme would typically save 6 percent of their salary, matched by 9 percent from their employer – 15 percent in all. These monies were managed collectively, overseen by trustees, and were generally low cost.

Today, these DB schemes include the largest funds in Britain, as a result of contributions made in the past. However, a combination of unpredictable increases in longevity, volatile investment return and inappropriate promises made to beneficiaries has resulted in the closure of most of these plans to new entrants. While a defined pension is still available to new employees in the public sector, this protection is rarely available to those entering private sector employment.

Unless action is taken soon, Britain faces a pensions crisis. Public pension provision in the UK is already one of the lowest among OECD countries. Without sufficient private pension provision many people will face a retirement on much lower incomes than they have come to expect. Also, if people fail to save and the state pension is low, they may end up relying on other state-funded benefits.

According to the National Statistical Office, private sector pension participation rates have fallen from 52 percent in 1997 to 42 percent today; that is the equivalent of 800,000 people losing pension provision. The poor are worst hit. Only 21 percent of men, and 32 percent of women with weekly gross annual earnings of £300 or less are making contributions to their employers pension scheme⁹.

Even for those still enrolled in private pensions the outlook is not good. As DB schemes have closed, savers have set aside money in 'defined contribution' (DC) plans, in which the pension payment is linked to contributions and the investment return the individual has made. Three things have happened as a result. First, the contributions being made have generally reduced. Second, most DC plans do not have a collective savings element, so those who live longer do not benefit from the savings of others – hence, all else equal, the amount of savings in a DC plan need to be higher to ensure the same income in retirement.

Finally, DC plans, especially those that are not provided by employers, can be very expensive; as we shall see, up to 40 percent or more of an individual's contribution to a private DC/annuity pension may be swallowed up in fees. Further, the structure of DC schemes makes cost-effective provision particularly difficult for those on lower incomes.

⁹ National Statistical Office, *Pension Trends*, (March 2009)

This is not to say that DC plans are bad, or indeed that there are not problems with DB plans. However the closure of so many company DB schemes, and the failure to find a comprehensive replacement, has caused a problem. Put simply, under current arrangements, it is not cost-effective for pension providers to sell pensions to those on lower incomes who need them most. “It is a shocking thought”, says Simon Fraser, president of the Retirement Institute at Fidelity International, “that if this is not corrected, we could see the emergence of a generation of private pension paupers”¹⁰. The economic crisis only makes this a more likely prospect.

As research by behavioural economists shows, human beings often fail to act in ways that are in their long-term interests. Three factors dissuade people from investing: cost, confidence and complexity. These factors are interlinked: part of the rationale for investing in a pension, for example, includes an element of confidence that it is worth making a sacrifice of immediate income for income in retirement. But cost, or affordability, is the most important. First, because surveys – and the RSA’s primary research – tell us that this is what matters to consumers. The National Association of Pension Fund’s research shows that the most frequently cited reason for people not joining a pension scheme when one is available is affordability¹¹. Second, because costs and charges are the most potent symbol of the failure of good governance and the build-up of complexity.

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Payment and profit

Given the importance of cost, one would have thought that providers of savings products would have been battling strenuously to keep costs down. However, the reverse has taken place.

Much attention has been focused on the evidence that in the lead-up to the credit crunch executive pay spiralled irrationally, until it was rewarding failure and promoting excessive risk. Between 2002 and 2007 the total earnings of the FTSE 100 executives doubled, well above wage settlements for the economy as a whole. The system of bonuses, intended to link pay to performance, instead ended up incentivising risk.

But at least boardroom pay is made public. What about the pay of the financial intermediaries, who invest our money in the companies that are now the subject of scrutiny?

Over the past 50 years, the costs and charges of financial institutions have increased far beyond any reasonable expectations. This was made possible because of the disconnection between investment companies and their clients.

In a paper for the RSA, the financial journalist Alistair Blair examined charges in unit trusts. These are generally higher than those paid by pension funds, though the big picture is the same across the private provision industry.

Blair describes how, when the UK unit trust sector first got going in the 1930s, its annual fee was fixed by regulation at 0.5 percent. Had this charge stuck, he

notes, “then 70 years of advances in investment indexes would have made the unit trust industry as rich as Croesus. Instead, it ended up much, much richer”¹².

Unit trust fees were increased to around 1.25 percent, despite improvements in technology and increases in the size of funds. “It takes hardly more manpower to run a £500m fund than a £50m fund”, Blair writes. “Yet at half a percent a year, the larger fund brings in ten times the management fee”. At 1.25 percent a year, the profits are even greater.

This effect of increasing fees and complexity is not limited to retail investment products. As Lord Turner reported in his FSA review of the financial crisis: “It seems likely that some and perhaps much of the structuring and trading activity in the complex version of securitised credit was not required to deliver credit intermediation efficiently. Instead it achieved an economic rent extraction made possible by the opacity of margins, the asymmetry of information and knowledge between end users of financial services and producers, and the structure of principal/agent relationships between investor companies and between companies and individual employees”¹³.

Institutional investors are as culpable as anyone in permitting these charges and levels of remuneration. Yet there are more fundamental reasons for the high costs and charges of pension funds.

Calculating the cost of retail investment for UK savers

Retail investors, like members of company pension funds, largely delegate the management of their savings to fund managers. The fund managers charge these investors for the portfolio and risk management services they provide, sparing investors the burdensome task of performing these services themselves.

The charge that retail suppliers make is usually quoted as an annual fee, which is taken as a proportion of the total balance of funds in each year. Typically, the charge might be 1.5 percent. This might initially seem like a small figure, but over the lifetime of a pension, all those 1.5 percents add up.

In fact, if a 1.5 percent fee is charged every year, both during the period of saving and during the period of payment of a pension, around 40 percent of the total potential savings pot will end up in fees. The example given in appendix 1 shows how the arithmetic works.

This is not new news. A study done in February 2000 for the FSA, *The Price of Retail Investing in the UK*, showed that total charges for insurance pensions might be over 1.5 percent¹⁴. And Turner’s report into the future of pensions in Britain says “Both the behavioural barrier to savings and the cost of provision have been made worse by the bewildering complexity of the UK pension system, state and private combined”¹⁵.

¹⁰ “Typical UK worker to retire on just £215 per week, less than the current minimum wage”, www.insidemoneytalk.com/news/fid/fid201.html

¹¹ National Association of Pension Funds, *NAPF Annual Survey 2008*

¹² Alistair Blair, RSA, *Costs and charges in unit trusts* (September 2008) www.theRSA.org/projects/civic-capitalism/tomorrows-investors

¹³ Adair Turner, FSA, *The Turner Review: a regulatory response to the global banking crisis* (2009)

¹⁴ P18 Kevin R James, FSA, *The Price of Retail Investing in the UK* (February 2000)

¹⁵ Adair Turner, Pensions Commission, *A New Pensions Settlement for the Twenty-First Century*, also called *The Turner Report* (2005)

So why is it that costs are so high? After all, the cost of managing an investment portfolio that is rarely traded should be pretty low, perhaps less than 0.2 percent. Why do savers pay eight times as much?

Pension fund cost structure

Pensions costs are not driven solely, or even primarily, by the cost of managing funds.

First, private pensions need to be sold. This involves relatively complex advice being given to the purchaser, much of which is mandated by law. For a private pension, this is typically done by an independent financial adviser (IFA), who until recently was paid on commission for what was sold. Therefore it was in the IFA's interests to keep selling (and reselling) new pensions.

Second, there is the set-up and ongoing administration of the fund. The former is particularly important. Modern banking systems make the administration of a pension from year to year relatively low-cost. But every time a new pension is established, considerable cost is involved.

Taking these two elements together, the length over which a pension is held, its 'persistency', becomes a key element in its cost. So someone who joins a pension plan for life, will, all else equal, enjoy lower costs and higher income than someone who switches pension, because the switcher will incur repeated marketing and set-up costs. The lower the persistency, the higher the cost.

The problem is, however, that the IFAs who sell private pensions have been motivated to encourage new investment. Hence the system of private pensions we have established puts the interests of investors and advisors in tension, with a detrimental impact on returns for the former.

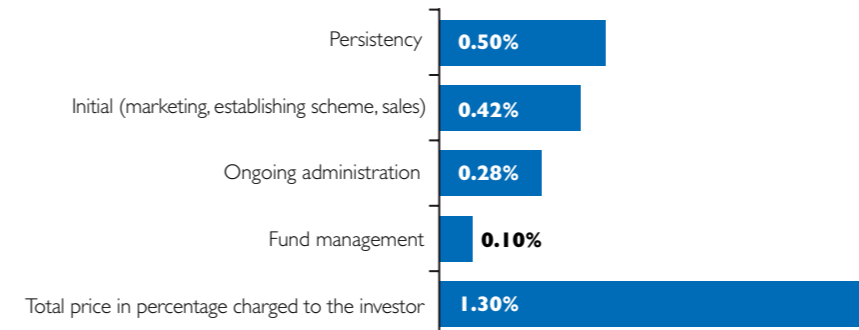
If a provider is found to be mis-selling a pension, they can be liable for the loss. One of the most likely grounds for the accusation of mis-selling is encouraging someone on a low income to save for income in retirement when those savings will potentially cause them to lose other welfare benefits in retirement and end up little or no better off. This makes low-income individuals the most costly to serve, and since their savings are small, the ones who generate the least commission. This in turn means that low-income individuals are particularly difficult to provide with private pensions; it just is not profitable to do so. Indeed with the current cost structure, it is virtually impossible for retail pension providers to offer a service for low earners, a group that, in the UK, mostly comprises young people and women.

In addition to the high costs and perverse incentives in the marketing of pensions, consumers also face the problem of deciding which provider will give them the best return. Typically, this is done by looking at the historic returns of investors. But past returns are not good predictors of future performance. Nonetheless, it is hard to persuade an investor to place their money with a fund that has lost money, when they could choose one that has had healthier returns.

Fund managers respond to this, opening many funds, each with a slightly different investment approach, each buying and selling shares in an effort to beat the 'index', or average performance of the securities in which they invest. In aggregate, these funds may have difficulty beating the index return. Indeed, because they need to pay commissions and stamp duty on their trades, and employ expensive staff to choose the companies in which they invest, it is difficult for them to do so. But of course, in any year, or even over a few years, some will. Therefore there is an incentive to trade shares in the hope of out-performance, which will encourage more people to invest in your fund, rather than someone else's. But excessive trading by all reduces overall returns. And the proliferation of many small funds increases costs still further.

We have developed a system of provision for retail investors that is costly, and does not work to their advantage. And, as we have seen, it appears to be getting ever more expensive.

In 2005, Lord Turner identified the factors that are pushing the cost for a personal pension scheme higher, even where the lowest cost investment management is used. The evidence provided in his report suggests that the increase is driven by the costs of low persistency (frequent changes of provider) and by the upfront and ongoing administration charges associated with providing pension schemes for private investors.



The average explicit cost (including initial, low persistency, upfront and ongoing administration) is estimated to be at 120 basis points, which is equal to 1.20 percent (a basis point is 1 percent of 1 percent). This accounts for almost 92 percent of the total price charged to investors. The 10 basis points (0.10 percent) of managing investment passively bring the total price to 130 basis points (1.30 percent) for individuals who wish to save for their retirement privately. Details of Turner's cost assumptions are set out in the 2005 Turner Report¹⁶.

What investors want

As part of the Tomorrow's Investor project, the RSA undertook a consultation with pension and insurance beneficiaries about what they want from their savings. The consultation took the form of a deliberative forum in which the savers were able to question investment experts openly and honestly, as well as giving an account of their own attitudes to saving and investment.

¹⁶ Adair Turner, Pensions Commission, *A New Pensions Settlement for the Twenty-First Century* also called *The Turner Report* (2005)

The day featured presentations from a number of senior figures in the investment world, including Marc Jobling of the ABI, Mark Goyder of Tomorrow's Company and Robin Ellison of Pinsent Masons. The structured discussions provided useful feedback about what investors wanted from their investments, which was detailed in an interim project report¹⁷. In summary, investors told the project team that:

- * Their primary requirement was for a strong return.
- * They were also deeply concerned with security.
- * They would want to promote corporate responsibility as a secondary issue.
- * They were aghast at the impact of fees on the returns they could expect from their investment.

This corresponds in large measure to the findings of more traditional measures of investor opinion. Surveys by Mercer and Jardine Lloyd Thompson (JLT) support the impression that long-term savers look for a secure bottom line above all else. The Mercer poll found that 78 percent indicated a preference for safe and secure savings investments, even if that meant that their assets did not grow in value as much as they could¹⁸.

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A crisis of confidence

However, the forum also revealed that there was little appetite for more active participation. Investors would like to hand over the power to manage their investment to someone whom they can trust; not to become involved in the minutiae of the debate. This was true whether the issue was promoting good management of companies (as discussed in Chapter 3), or other aspects of investment choice.

This creates an unstable situation. The participants in the deliberative forums understood that the investment system had flaws but they had little interest in addressing those flaws directly. A lack of confidence in any part of the financial system will have knock-on effects for the whole. For example, confidence in workplace pensions versus other forms of saving declined sharply as a result of the recession, according to research by the NAPF¹⁹. Although confidence is starting to be rebuilt, there is still a long way to go. This is despite the fact that, as we have seen, workplace pensions remain one of the best ways for people to save.

At the RSA forum, participants, with few exceptions, tended to display a disconnected mindset and a frustration at having to be involved. To the extent that they had any faith in the investment world, theirs was a blind faith:

“You sign up, you hand it over to someone who knows what they are doing with it and you trust them to do a good job”.

This attitude creates a fundamental challenge for the creation of a vigilant civil economy:

- * Economists agree that effective accountability is important in ensuring that companies are managed to make a proper return for their owners, or indeed

that any agent acts on behalf of their principal. However, our consultation not only revealed a concern among investors about becoming involved, but also considerable reservations about how accountability could be achieved.

- * The investors' disconnected mindset came from a sense of powerlessness and a feeling that there were no alternatives, whatever they might feel about the system.

The one fact that really resonated on the day was the revelation that a 1.5 percent per annum fee (as shown in the example in appendix 1) translates into as much as a 40 percent charge over the lifetime of a pension. This was a clear statement that the investors could engage with personally. But despite their anger, they were largely fatalistic about it because they felt that there were no other options for them.

The consultation revealed a paradox in that investors complained about lack of choice but said at the same time that they would prefer not to be involved.

Beyond the citizen investment fund

In the next chapter, we will be focusing on how it might be possible to establish long-term savings institutions that promote confidence in the system, offering low-cost accountable investment vehicles that take their role in promoting good governance seriously.

We would however reiterate that any new institution must be part of a broader debate about the nature of capital markets, the responsibilities they owe to the providers and users of capital and how best these are affected. It should be seen as part of a 'civil economy' of diverse institutions, which mirrors civil society by:

- * Focusing on governance to make companies accountable.
- * Reforming investment to make all funds responsible owners.
- * Focusing on appropriate information for savers, and on independence of providers.
- * Encouraging 'shareholder democracy'.

To aim for perfection in these areas may seem far-fetched and idealistic, but to seek incremental improvement is not that great a stretch.

These issues go beyond the scope of this project, which aims to address just one part of the investment chain. It is our belief that an alternative structure that worked actively to engage investors and improve corporate governance would make the difference in this marketplace. In the meantime, however, our research confirmed to us that in order to serve the citizen investor any fund must focus on keeping costs down. Under the current model of retail savings, costs make a huge impact on returns. In almost all cases the difference that would be made by investors paying lower charges year on year would more than match any benefit of successful performance by their fund managers.

But low costs alone will not produce investment returns. The latter ultimately depend on the performance of underlying investments. So, as well as being low-cost, any new fund must demand that its investee companies search for long-term value for their investors (or citizen-savers).

¹⁷ Rowland Manthorpe and Seb Martin, *Tomorrow's Investor Interim Report* (2008) www.theRSA.org/projects/civic-capitalism/tomorrows-investors

¹⁸ Mercer Human Resource Consulting, *Work and Savings Survey: the shift from defined benefit to defined contribution* (2007)

¹⁹ National Association of Pension Funds, *Pension Provision and The Economic Crisis* (January 2009)

5 The citizen investor fund

Aim of the project

The RSA's Tomorrow's Investor project has three principal objectives:

- * To explore how the development of new low-cost forms of savings can help individual savers.
- * To create a framework for responsible investment that will benefit the economy and the investor.
- * To explore the steps that would need to be taken to establish these new investment vehicles.

There is a longstanding belief both inside and outside the financial industry that responsibility comes at a high price. We do not agree.

We believe it is possible to create a fund that is lower cost and therefore higher return than most that are currently available on the market, and still set aside funds to demonstrate proper attention to its responsibilities as an owner, and its accountability to its savers.

We would underline that the second objective stems both from our values and from a business rationale. In time, we expect that it will not only help to restore some trust in the system, but also to improve returns. These are difficult tasks. Trust, once lost, is slow to return. And while we believe that shareholder engagement can improve returns, we accept that this cannot always be captured as a private return. Our fund will work to ensure companies are well-run in the interest of long-term owners.

In the rest of this chapter, we describe the likely characteristics of the fund, and how they can be achieved. In summary we believe there are four overriding features that the fund must have:

- * It must be low-cost: efficiently and economically channelling people's savings to the best investment opportunities.
- * It must be a trustworthy institution: those who invest in it should be able to place their faith in the integrity of those managing the fund to deliver on the goals it has set.
- * It must be accountable: while individuals may wish to delegate to others, those to whom the powers are delegated should be able to give an account of themselves and to respond to those whom they are employed to serve.
- * It must have a delegated structure. It is very clear that most savers want the question of how their money is invested to be decided by others.

We would note that the features laid out here should be totally unremarkable, or to put it another way, they should be common to all pension investment vehicles. Our contention is that currently these features are too often lacking in the pension system in Britain, but that it is possible to create them.

This chapter will also touch on how these affect the investment philosophy and other aspects of the fund. In the last chapter we will discuss how, practically, an institution or institutions that can deliver on these goals might be established.

A trustworthy institution

Confidence in financial institutions, never high, has been further damaged by the recent financial crisis. This is an important cause of low levels of long-term savings, as we saw in Chapter 4.

The ideal fund would work to improve trust in the investment chain; as well as being trustworthy in itself. Here are some of the characteristics that should be built into the DNA of any such fund:

- * **Status as a social enterprise with appropriate and engaged trustees**
The fund should have as its primary goal the maximisation of returns to savers, in the fullest sense. Its constitution should reflect that aim. Like most pension funds, it should be governed by a trustee board. Only institutions with a demonstrable track record of meeting the long-term needs and wishes of their savers should make appointments to that board. Representative bodies of employers, employees and pensioners might also be given nomination rights. All would subscribe to a constitution that ensured their decisions were governed by the overriding goal of providing long-term returns to savers.
- * **An expert board beyond reproach**
The board of trustees is not just a representative body. While some nominations should reflect the constituency the fund is seeking to serve, the board should also contain senior figures from finance, business and the wider community, combining both expertise and an unimpeachable commitment. The board members would have no conflicts of interest and nothing to lose but their reputations.

Would it be possible to find people willing to serve on such a board? We think it would. The scale and importance of the issue we are addressing is of recognised significance and the possibility of its resolution will, we believe, attract people of the highest calibre.
- * **Transparency and payment to executives**
There is no issue more likely to undermine trust than inappropriate payments to executives. All payments made to those managing this fund, whether they are contractors or executives, should be simple and transparent. Any payments made for performance should be strictly controlled and only paid when it is apparent that long term performance, which has been in the interest of savers, has truly been achieved.
- * **Simplicity and clarity**
If the fund is to be trusted, it must be able to address people's savings needs as simply as possible; it should be easy for them to invest. Savers should be absolutely clear about the investment philosophy that the fund intends to

pursue, and the link between that philosophy and the results of the fund should be transparent. This does not necessarily mean that the fund would be able to guarantee the outcome of its investment approach, particularly when investment returns are volatile. But it would be able to explain why it took the decisions it did, and why these were in the interests of its savers. Such accountability would be greatly enhanced if the fund had a very simple investment approach.

An accountable institution

For a financial institution to be trustworthy it has to be accountable. The ideal fund would be accountable in the following ways:

- * Accurate and comprehensive reporting, using clear, comprehensible metrics across the lifetime of the pension.

We have already seen how investors are often confused about the characteristics of the fund in which they have invested. An accountable institution would present them with the full, relevant information.

In *Nudge: Improving Decisions about Health, Wealth and Happiness*, Richard Thaler and Cass Sunstein describe how the presentation of information drastically alters the way people see it: if people are told that a sausage is ‘90 percent fat-free’, then they are far more likely to buy it than if they are told it is ‘10 percent fat’²⁰. This is exactly what is happening with the costs and charges of long-term savings, as the RSA’s consultation showed all too clearly.

Pension funds currently express costs and charges as an annual percentage of the funds under management. They present a small number somewhere around 1 to 2 percent. This is the equivalent of claiming to be 90 percent fat-free. The reality of charges is only really visible when they are expressed as a total cost over the lifetime of the investment. As we have seen, this can be a large number. This is the fat. Consumers should know about it.

- * Thorough and far-reaching systems of enquiry

Members would be able to obtain information quickly and easily – the amount they have saved, the expected payout and the responsibility in ownership. They would also be able to find out the location of their investments. So, for example, the value of everyone’s account should be available to them; it is perfectly possible to allow savers to know, under different assumptions, the likely pension that will be provided from their investment. Such simple user-friendly systems are available from current leading suppliers.

But more than just knowing the value of investments, users should know where their assets have been employed. In our consultation, participants were asked to inquire of their pension funds which companies they were invested in. Most funds were unable or unwilling to provide this information, despite the fact that their computer systems must hold such data. If we are to overcome the principal-agent problem, then at least the principal should be aware of how their money has been invested.

²⁰ Richard H Thaler and Cass R Sunstein
*Nudge: Improving Decisions about Health,
Wealth and Happiness*, Penguin (2009)

- * Investor power

Once investors know how their funds are invested, they can, should they wish to do so, make their individual and collective opinions known.

Internet communication makes this possible today in a way that would have been unimaginable only 10 years ago.

For example, the responsible investment organisation FairPensions has developed a system that allows people not only to understand where their money is invested, but also to work together to influence the behaviour of the companies they own. FairPensions have indicated that they would be happy to help build systems that would allow investors to communicate their opinions to the managers of a fund of the type we are proposing.

- * Expertise and accountability

These simple structures and systems for creating trust and accountability do not require day-to-day attention by fund participants. Investors do not need to make decisions about their funds, but it is critical that they have the possibility of inquiry and of making their opinions felt. There must also be processes for providing adequate responses to those opinions.

So, for example, the BBC is generally recognised as a responsive ‘public service’ broadcaster. This does not mean that viewers decide on programming decisions. But it does mean that when there is a negative reaction to what is broadcast, the BBC is expected to respond appropriately. The same should be the case for a well-governed investment fund.

A delegated institution

This high degree of accountability should make it possible to offer the delegated investment service that citizens demand. The majority of the fund’s investment functions need not be carried out in-house.

Indeed costs would be kept down by outsourcing many of the fund’s basic functions. After informal enquiries, we believe that it would be possible to delegate the following aspects of the fund to third parties:

- * Default investment philosophy
- * Fund management
- * Fund administration
- * Basic ownership responsibilities

Such delegation is common practice in big pension schemes. Indeed we have had informal conversations with some of Europe’s largest pension funds and fund suppliers and are confident that they would be able, at a very minimum, to execute a mandate along the following lines.

- * To establish a defined contribution (DC), or hybrid defined contribution/defined benefit (DC/DB), closed pension fund, where individuals could deposit pension savings.
- * To invest that money in appropriately diversified 'asset classes' (cash, bonds, shares and property) befitting the age and likely retirement date of the investor. (For example, a younger investor would have their money placed in higher risk and return securities, but, as they neared retirement, the investment would switch to securities offering a more secure return.) This would happen automatically.
- * To appoint one or more managers – this is likely to be done on a low-cost basis. The saver would retain ownership rights, so that shares could be voted and rights and responsibilities discharged.
- * To provide annual statements, and all other reporting and systems of inquiry mentioned in the paragraphs above.
- * To provide a 'governance service', which would ensure that the votes attached to shareholdings were exercised, and that where companies in the portfolio failed to deliver for their shareowners, they were contacted and, where appropriate, a process of engagement was begun.
- * To campaign more generally for responsible management and investment practice.

We are confident that, with adequate scale, all these services could be provided for a fraction of the cost of a traditional retail pension. In chapter 6 we will describe how this could be done.

With these services delegated, the responsibility of the fund itself would be to ensure that suppliers delivered their services.

This is the central and most important role. However, we believe the fund should be in the vanguard of improving governance and investment practice more generally.

A responsible institution

The ideal fund will do more than simply look after its own functions. As discussed in Chapter 3, the value on investments will be protected and enhanced best if there is a general rise in the accountability and responsibility of the financial system. Therefore, promoting those values and voicing wider concerns about the financial system must also be within the fund's remit, because it is on the functioning of that system that returns ultimately depend.

As we have seen, fund managers currently devote little time or resources to financial stewardship. They have neither the interest in nor the aptitude for it.

However, over the past few years, voting and stewardship services have been established that can offer pension investors a much higher degree of scrutiny of their ownership functions. For example, some services will provide recommendations on the voting of shares (Risk Metrics, PIRC or others would undertake such a task). Others will engage with companies whose management practice is out of line. (Hermes and Governance for Owners would be two such suppliers). It would

therefore be possible for a diversified fund to delegate basic stewardship functions. (Note: the author of this report is a senior adviser to Hermes.)

This is of some importance. In the past there has been an assumption that, in order to take ownership duties seriously, either a fund manager needed to be of great scale, or to have a very small number of investments, and hence be poorly diversified. By the use of third-party services, it is possible to overcome these difficulties. A high level of stewardship can be obtained for a relatively small but well-diversified fund.

However, the fund we propose would go further. In chapter 3 we looked at the need to improve the strength of the investment chain from investor to company. This type of fund would seek to raise concerns about weaknesses in that chain, whether they relate to the responsibility of fund managers or of companies themselves. As we have said, it is not possible for this fund to address all the issues necessary to create a responsible, civil economy. However, it does make sense, subject to resources, for it to campaign for improvement on behalf of all investors.

A low-cost fund

We have described above the characteristics of a trustworthy, accountable, delegated and responsible fund. The remaining issue is how this can be done at a low cost.

We have established that the annual cost of a private pension is usually around 1.5 percent. This means that, over the lifetime of the average pension, as much as 40 percent of an individual's savings are frittered away on costs and charges.

It may therefore come as a surprise to learn that initial costings for delivering the services outlined in Chapter 5 suggest that it is possible to provide all the main elements of a fund, subject to scale, for around 0.5 percent – that is fifty basis points. Over the lifetime of their pension, individual savers would pay not 40 percent, but 12 percent. Instead of receiving 60p for every pound invested, they would receive 88p.

These figures have been confirmed by suppliers of these services. In particular, APG, arguably Europe's largest pension fund, has reviewed this report, and confirmed in a letter to us that these costs are realistic. Hermes has written a similar letter indicating its ability to ensure that any shares owned by the fund would be responsibly managed. These letters are included as appendices 2 and 3.

Over the course of its lifetime, the fund would be working not just to achieve returns but also to improve overall company performance. This in itself is likely to improve investment returns for the long term, contributing towards a possible 50 percent increase in returns on pension savings (the 88p in the pound as detailed above). This should ultimately have a wider impact by encouraging savings, providing finance to companies and thereby helping to create an investment system that is beneficial to all and contributes to a healthy economy.

This is a huge prize. But is it possible?

In the past there has been an assumption that, in order to take ownership duties seriously, either a fund manager needed to be of great scale, or to have a very small number of investments, and hence be poorly diversified

0.5 percent is a figure most big pension providers will recognise; they run their funds for a similar cost. It is also consistent with the cost of pension provision in countries like Sweden and Holland, and with the cost of many of the larger, DB schemes in the UK, which are closing. Yet the cost of private pension provision is still prohibitively high. Why is this the case?

The two components that drive up the cost of pensions are, as we saw in chapter 4, marketing and persistency. Of the total amount charged, some 33 percent is taken on marketing, while a further 38 percent is the result of low persistency. Less than 30 percent of the total charge is as the result of necessary fund management and administration.

The Pensions Commission, which established the principle of personal accounts, recognised this problem, and the 2008 Pensions Act, which followed their recommendations, took some important steps to resolving it. The solution was an inspired but imperfect one, and, without crucial adjustments touched on earlier in the report, the goal of low-cost provision for all may not be reached. In Chapter 6, we will set out in more detail how it may be possible to build on the personal accounts system to create pension provision that is not only trustworthy, accountable and responsible, but also low cost.

However, we should first review two important issues: the likely investment philosophy of the fund, and how we can encourage appropriate citizen involvement in the investment chain.

A simple investment philosophy

The ideal fund would demonstrate its commitment to low costs, accountability and responsibility by pursuing a simple investment philosophy.

The first question that will need to be addressed is the old saw of active versus passive management.

There is now a broad consensus that while some exceptional managers may be able to beat the market, most find this difficult. It is therefore likely that, given the need to avoid costs, the fund will be attracted to either a very low-cost active, or a passive (index) strategy. The fund should be appropriately diversified to include global as well as UK companies, and other assets classes such as property. However, at all times it will focus on long-term returns for its investors, which implies low costs.

Central to keeping investment charges low is the need to limit administrative costs, trading costs, taxes and sales charges. As the fund manager Paul Lee showed in his RSA paper *Long-term low friction: An investment framework which works for the beneficiaries rather than their agents*, these can be significant²¹.

Lee examined the various frictional costs – the implicit and explicit costs associated with market transactions – that erode returns for institutional investors and hence for their ultimate clients. Over time, these costs become very significant.

Investment consultant Watson Wyatt calculated in 2008 that even an average company pension fund pays 1.1 percent of their assets in fees when frictional costs are taken into account. Assuming a standard 7 percent return, someone who saves £5,000 a year should generate a pension pot of £472,000 over a 30-year period. Instead, based on the Watson Wyatt figure, they will get £383,000 – due to frictional costs²². That is before the administrative costs of the fund manager are included, reducing the pot yet again. Nor does it calculate other direct costs, or the cost associated with poor accountability of companies, discussed elsewhere in this report.

So in choosing a fund management strategy the trustees are likely to be strongly guided by the need to keep frictional costs low.

They will also have to address the question of how much risk should be taken with investments. This is likely to focus on asset allocation decisions, which we discuss in more detail in chapter 6.

Citizen involvement and the wisdom of crowds

The ideal fund we are proposing would delegate most of its functions to experts, without abandoning its commitment to popular participation and innovation. This would be achieved by adding simple structures of engagement to its core functions. These would be available to those who wished to use them, but would not be demanded of all.

In his book *Infotopia: How Many Minds Produce Knowledge*, legal philosopher Cass Sunstein talks about a series of methods currently being used to aggregate widely dispersed knowledge²³. None of them are new, but they are all being used in new ways. Sunstein is particularly excited by prediction markets, such as those used for gambling. These are astonishingly accurate. The Hollywood Stock Exchange, for example, predicts Oscar winners nine times out of 10. Google use prediction markets to help forecast its own development, predicting dates for products, new office openings and a range of other outcomes of importance to the economy. Using virtual money, Google employees invest in particular options, creating a price that reflects a probability. Their predictions have proved extremely helpful for company strategy.

The ideal fund could take a similar approach, looking to find ways of capturing the dispersed knowledge of its investors; not in order to trade shares, but to understand which companies are perceived to be performing well and badly. Such information is not only vital for the purposes of representing investors; it would also be helpful to the companies in which the fund will invest. It could be an opportunity to engage people in a fun, active way in finding discrepancies between the perception of a company's behaviour between the public at large and by its own managers.

The involvement of owners is not only helpful in overcoming the principal-agent problem. By engaging citizens, companies and financial institutions would have many minds at their disposal. By heeding their collective advice they could improve their results even while involving and engaging their owners.

21 Paul Lee, *Long-term low friction: An investment framework which works for beneficiaries rather than their agents* (September 2008), www.theRSA.org/projects/civic-capitalism/tomorrows-investors

22 Watson Wyatt, 'Funds paying over 50% more in fees than five years ago' (February 2008)

23 Cass R Sunstein, *Infotopia: How Many Minds Produce Knowledge*, OUP (2006)

6 Issues and Solutions

The problem of costs

The creation of a low-cost, high-responsibility fund is a realistic aim – but only if the selling, set-up and persistency issues can be addressed.

At present, as we saw in chapters 4 and 5, costs are fixed at unreasonably high levels through a systemic flaw in the pensions system: the way in which they are sold. Products have to be marketed, which costs money. They also have to be accompanied by advice, to avoid the sale of an inappropriate product

Historically, funds' ability to provide long-term saving at a low cost is further stymied by agents' commission structure. Agents were paid to sell, and thus to encourage switching, even though doing so incurs repeated set-up fees. Persistency is the best way to keep charges down. Yet the selling structure of pensions militates against persistency. Recent initiatives by the FSA aim to address the worst abuses, though it is difficult to see how the motivations of financial advisors to sell and re-sell can be eliminated. Part of the problem arises from the need to give individuals advice, for fear of mis-selling. Regulation originally created in response to mis-selling scandals has made the system sclerotic; intended to protect the consumer, it ends up increasing costs even further.

The government response

The problem of costs is a well-recognised one.

Our analysis here echoes that of the Pensions Commission, which reported in 2005. Following Lord Turner's report, the government made a large-scale intervention to resolve the problem of costs. It committed to setting up, by 2012, a national pension scheme with automatic enrolment: personal accounts.

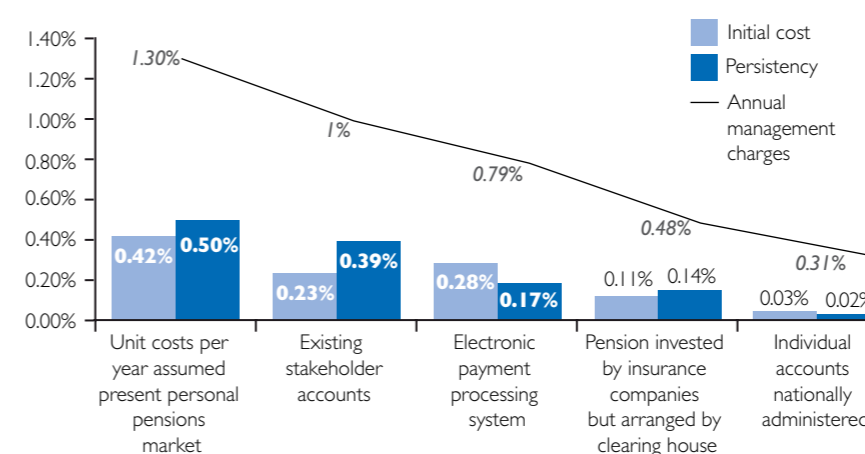
Under auto-enrolment, employers who do not otherwise provide pensions will be required to register their qualified employees by 2012. Qualified employees are aged between 22 and state pension age and will automatically be enrolled in a pension scheme. They can withdraw from this should they wish to, however, observers believe that, as a result of auto-enrolment, rates of participation can increase up to 90 percent as evident in Denmark²⁴. Furthermore, there is an extra incentive to enrol in personal accounts. If participants make an initial contribution of 4 percent of their income on savings from earnings of between £5,000 and £33,000 annually, it will be matched by a 3 percent contribution from their employer and a 1 percent contribution from the government.

By creating a system of auto-enrolment, the government has sidestepped the problem of the costs associated with marketing and product set-up. The government top-up then provides a further incentive to save. The graph opposite shows a comparison of auto-enrolment costs with the cost of the current system, taken from the Pensions Commission report²⁵.

²⁴ OECD Global Pension Statistics project

²⁵ Adair Turner, Pensions Commission, *A New Pensions Settlement for the Twenty-First Century*, also called *The Turner Report* (2005)

The total savings of auto-enrolment can be summarised thus:



PADA has been established to bring the personal accounts scheme into being. This is an advisory body that will be wound up in 2012, when it will be replaced by what is referred to in policy documents as the 'trustee corporation'. PADA will construct the scheme and ensure the transition to the corporation, which will run personal accounts from its launch.

But there are some issues with the design of personal accounts that will prevent it from functioning as the fund we describe in chapter 5.

Personal account issues

The personal accounts scheme is a bold and ambitious one. As one of the participants in our consultation said, it is "a last chance to preserve comprehensive provision of private pensions in Britain". We strongly support that goal.

However, we should not be naive about the considerable difficulties facing the scheme.

Writing in the *RSA Journal*, Liam Halligan raised the issue of means-tested benefits: because of these, he contended, many people will be tacitly advised to opt out of the system²⁶. To put it another way: won't the poorer person whom the personal accounts system is set up to serve, be better off not saving? After all, they are likely to be entitled to welfare benefits in retirement, which could be reduced if they have a pension income.

PADA research suggests that only 5 percent of their target group would fail to benefit from a national pensions savings scheme. It will be critical for the success of personal accounts that they do indeed benefit savers. This raises questions about the welfare system that go beyond the scope of this paper. However, we would observe that it would be tragic if the opportunity to encourage saving, and the chance to provide pensions for all were jeopardised by anomalies in the structure of the welfare system. In effect, it would amount to the welfare state encouraging people to become dependent, rather than to save for their own retirement.

²⁶ Liam Halligan, 'End of the line', *RSA Journal* (Summer 2008)

Personal accounts also face huge operational challenges. They need, by 2012, to have set up a system that will follow each member throughout their working lives, providing proper administration and information. No wonder PADA is already employing 200 people to establish the system.

But perhaps the greatest difficulty faced by the new system is the restrictions placed upon it by the Pensions Act.

When personal accounts were conceived, they naturally raised concerns amongst those already involved in the pensions industry. In particular, would the establishment of personal accounts lead to a switch away from current employer provision, accelerating the decline in current employer-provided schemes?

At the time, the NAPF suggested the establishment of 'super-trusts'; these would be not-for-profit entities with many of the characteristics described in chapter 5. They cited the experience of Australia and Holland. Both are regarded as having among the best private sector pension provision in the world, based on structures similar, though not identical, to those we have outlined²⁷.

However, the personal accounts system initially took a somewhat different approach, with the government responsible for establishing a new system not only for auto-enrolment, but also for other aspects of the management of personal accounts. In effect, it provided a comprehensive universal service. In order to protect current pension providers and prevent the establishment of a single monolithic supplier, the new personal accounts system was restricted in the services it could provide. First, and perhaps naturally given possible costs, the employer and government matching subsidy (of 3 percent and 1 percent) was restricted to income between £5,000 and £33,000. Second, and of greater concern, was a decision to restrict the maximum amount that anyone could save in the scheme in any year to £3,600.

£3,600 is certainly better than nothing, especially for those on lower incomes. However, most pensions experts would consider it to be very inadequate to meet the retirement income expectations of those with above average incomes; in other words those who are the most profitable to serve.

The effect can perhaps best be understood by using an analogy. Consider a town that does not have adequate grocery shops. This is a problem for everyone, but particularly for poorer people. So the local council decides it will open a new shop, which sells high-quality, low-cost produce. But, it also restricts the amount anyone can spend in the shop. So if you have a big demand for groceries, you need to go shopping twice: once to the new store, once to another. Further, as the grocery manager doubtless points out to the council officials, it is those who spend the most who help cover the costs of the grocery store. By restricting the amount people can spend, the costs and effectiveness of the new store will be undermined; its revenues will be lower, and hence its profitability reduced. We believe that is precisely the effect that the £3,600 limit will have on personal

In order to protect current pension providers and prevent the establishment of a single monolithic supplier, the new personal accounts system was restricted in the services it could provide

27 UBS Global Asset Management, Pension Fund Indicators 2008

accounts. The restrictions leave the new system only serving people on lower incomes – people, in other words, that are the least profitable.

In short, the personal accounts system is barred by its own remit from being the sort of collective investment vehicle that could profitably resolve the issues we need to see addressed. One of the successes of Britain's old company pension systems was that everyone was involved, from shop floor worker to manager, which not only created low costs, but also widespread support.

Finally, by restricting profitability in this way, personal accounts also fail to allow for competition and innovation. We would not support unmanaged competition, but pension providers who can offer the low-cost, responsible features we have laid out in Chapter 5 should be able to make their services available to those enrolling in the system. This would not mean offering a choice of hundreds of funds, which has proved to be a waste of resources. But there would certainly be room for several providers operating within the kind of remit we have outlined in this report.

The social business solution

The new pensions framework will establish both a system of auto-enrolment and the 'pipework' that will link payments by individuals to their personal accounts, throughout their employment. These are both huge steps forward in the creation of a national pension system.

One solution to the problem created by the £3,600 per annum limit would be to lift the restriction altogether. There is no indication that the government intends to do this in the short term. Further, there is the possible danger of the personal accounts system becoming an enormous monopolistic bureaucracy.

However, it would be possible for the system to be made open to others, who could accept contributions above £3,600. Provided that these suppliers could meet the low-cost/high-responsibility criteria outlined in Chapter 5, it would be a public service to allow them to offer their services. These new funds could cater for the sections of the population that personal accounts are currently, as a result of their remit, unable to service. Alternatively they could be asked to offer a comprehensive service to any auto-enrolled employee.

Unlike the Personal Accounts Authority, other providers would not be restricted in their actions. They would be able to begin as soon as auto-enrolment was established. And they would be able to offer their services to everyone, turning what is at present an uncertain proposition into a profitable business that provides a useful service to employers. Although they could be required to pay a charge to PADA for using the personal accounts infrastructure, this could be substantially lower than the cost of establishing and maintaining a freestanding system.

With access to all the employees nationally auto-enrolled it would be quite possible to establish a number of credible funds in terms of scale. Indeed, before

the establishment of PADA, this was exactly the sort of model suggested by the NAPF in their ‘super trusts’ proposal.

The final result would combine the best features of the ideal fund(s) that we have laid out here with the cost-effectiveness that only a national scheme can guarantee.

An expert legal opinion on the details of the Pensions Act suggests that there are no legal barriers to the establishment of such a fund or funds. There is no specific guidance given to service providers in the relevant sections of the Pension Act. Therefore, there is nothing preventing the Personal Accounts Authority contracting out fund management functions to third parties, or giving access to auto-enrolment for sums greater than £3,600.

7 Next steps

Advancing the proposal

The proposals we have made have been laid out in more detail than would be typical for most public policy thinktanks. However, for the RSA they are only a start. We are not just suggesting that there is a public policy response. If the main parties indicate a willingness to explore a private or social sector partnership, we are confident that a response from those sectors would be forthcoming (see appendices 2 and 3).

For that reason, we have identified three questions on which the feasibility of our proposal depends:

- * First, could third party suppliers be found, at appropriate cost, to deliver on the fund we outlined in chapter 5?
- * Second, will policymakers agree to a framework that will create the foundations for such a fund?
- * Third, would it be welcomed by PADA, and could it be integrated into the systems they are currently building?

We have had considerable discussions with suppliers of pension services over whether they would, in principle, be able to provide the services we require. We would like in particular to thank APG, the giant Dutch pension provider, and JLT the UK-based pension administrator for their help and support. We would also like to thank Hermes for its help in understanding how stewardship services can be provided (David Pitt-Watson, a senior adviser to Hermes, has led the Tomorrow’s Investor project and is the author of this report).

The discussions suggest that providers would be available to offer the services the fund would require, and to do so at an appropriate cost. Their response to this report, and the cost estimates they have made are shown in appendices 2 and 3. The RSA would be happy to provide a forum where these proposals could be developed further, should responses to this report from other sectors suggest an appetite for it.

Political consensus

The establishment of a national system of pensions saving is necessary to secure the future of long-term saving in the United Kingdom. And policy on this issue needs to last longer than the lifespan of one government or orthodoxy. Political consensus building is essential if the switchback of policy change is to be minimised. We support the system of auto-enrolment, but believe the success of the current proposals for personal accounts relies on two things:

First, policymakers should accept that the auto-enrolment and personal accounts remit needs to be extended to cover pension payments above £3,600. This does not involve requiring employers to match this higher level of saving; merely that higher savings can be placed in, and invested through, the same pension pot.

Second, the infrastructure of the personal accounts system should be opened up for use by qualifying funds offering services across the income range. The pensions system would then begin to look like the energy industry, where a natural monopoly is accessed by a variety of different suppliers who act primarily as sellers. That reform has achieved impressive savings for consumers. By cutting out marketing and persistency costs, this change would achieve much the same.

We have spoken to policymakers from the three main political parties about this proposal. We are encouraged by the interest shown and that our ideas are seen to address many of the existing concerns about the current personal accounts framework. We and they now need to take the work to the next stage, developing a business plan for a low-cost, accountable fund sitting on the personal accounts infrastructure.

Concluding statement

The fallout of the credit crunch, rising life expectancy, the continued inadequacy of retirement savings rates; all these factors create the need for a new framework for pension savings and investment.

In this report we have argued that new investment vehicles can make saving more attractive and affordable as well as creating major new market players committed to good long-term corporate governance. Our research shows that this is a practical possibility, drawing in large part from successful practice abroad. The creation of auto-enrolment and personal accounts offer us a unique opportunity, but we believe the implementation of reforms set out in this report is essential if that opportunity is to be seized. The RSA is committed to helping catalyse further development in this area. We now await the response of key policymakers to this report.

Appendix I

Work example of annual management cost (AMC)

It can often be difficult for savers to calculate how annual fees translate into total costs paid over the lifetime of a pension. So here is a simplified example of how significant those fees can be.

A wise young person decides, at the age of 25, that they will save for their pension, so that they can retire at 65, and enjoy a pension for the next 20 years. They plan to set aside a certain amount of money each year and to increase their payment annually to cover inflation at 3 percent. Their savings give them a 6 percent return each year. If they begin by setting aside £1000 a year, the build-up of their savings will look like this:

Age	Savings at beginning of year	Savings added	Return on savings	Savings at end of year
25	0	1,000	60	1,060
26	1,060	1,030	125	2,215
27	2,222	1,061	197	3,473

And by the time they have reached the age of 65, it will look like this:

Age	Savings at beginning of year	Savings added	Return on savings	Savings at end of year
64	230,096	3,167	14047	248,170

So, by their 65th birthday, they have created a pensions pot of £248,170.

The individual now takes this pot of money and converts it into a pension in order to create an income for the next 20 years, which will rise with inflation. Again, inflation is 3 percent, and returns on the pension will be 6 percent. This creates an annual pension of £16,080, which will rise with inflation, as shown below:

Age	Savings at beginning of year	Pension paid	Return on savings	Savings at end of year
65	248,170	-16,080	13,925	246,017
66	246,017	-16,560	13,767	243,224
67	243,224	-17,057	13,570	239,737
.				
.				
84	28,196	-28,196	-	0

Appendix 2

Now, let's look at what will happen if the same saver has to pay 1.5 percent per annum on fees. All other assumptions are the same as they were in the example above. The build-up of savings will look like this:

Age	Savings at beginning of year	Savings added	Fee	Return on savings	Savings at end of year
25	0	1,000	-15	59	1,044
26	1,044	1,030	-31	123	2,166
27	2,166	1,061	-48	191	3,369

And by the time they have reached the age of 65, it will look like this:

Age	Savings at beginning of year	Savings added	Fee	Return on savings	Savings at end of year
64	164,016	3,167	-2,508	9,881	174,556

And they will have created a pensions pot of £174,560.

The individual now takes this pot of money and converts it into a pension in order to create an income for the next 20 years, which will rise with inflation. Again, inflation is 3 percent, and returns on the pension will be 6 percent. This creates an annual pension of £9,901, which will rise with inflation, as shown below

Age	Savings at beginning of year	Pension Paid	Fee	Return on savings	Savings at end of year
65	174,556	-9,901	-2,470	9,732	171,917
66	171,917	-10,198	-2,426	9,558	168,851
67	168,851	-10,504	-2,375	9,358	165,330
.					
.					
84	17,361	-17,361	0	0	0

So, as a result of the 1.5 percent fee, the pension payment has reduced from £16,080 to £9,900, a fall of 38.4 percent, which has gone to pay the fees. Thought of the other way around, the pension that was £9,900 could rise to £16,080, an increase of 62 percent, if fees were eliminated.

Total elimination of fees is, of course, impossible. However, as we have shown, fees could be kept to below 0.5 percent, and perhaps even brought down to 0.3 percent. The 0.5 percent fee would give a pension of £13,657. The 0.3 percent would give a pension of £14,576. In other words, by creating a system of low charges, pensions payments could be increased by around 40 percent, for the same input by the saver.

Letter from Professor Dr Olaf C H M Sleijpen, managing director
institutional clients, APG Group

Attention of Mr D Pitt-Watson
RSA
8 John Adam Street
London
WC2N 6EZ
UK

August 25 2009, Amsterdam

Dear Mr Pitt Watson,

Providing long-term income security for the growing number of elderly in our societies is one of the great challenges of our times. In recent years we have seen a gradual shift in the risk of retirement income provision from the government and sponsoring companies to workers. This shift was the result of increased transparency in the true cost of good pensions but also due to changing demographics, distress in financial markets and, unfortunately, changes in the regulatory environment. This has contributed to much lower expected pensions for the current working population. Furthermore, important risks that are hard to insure on an individual level like investment, interest rate, inflation and longevity risks have been shifted to individuals. By improving pension plan design and working on cost-efficient pension execution mechanisms, this development can be improved considerably. To act now offers a solution before a part of the current working population will retire in relative poverty.

Against this background, the RSA Tomorrow's Investor report gives a good analysis of some of the unfortunate developments in UK pensions and provides, in our view, an excellent basis for improving the UK pension system.

APG Group has a long history of nearly 90 years in collective pension provision in the Netherlands. Risk sharing between individuals and cost-effective execution are two of the cornerstones of this success. APG Group provides pension accumulation and (implicit) annuities to workers and pensioners from a broad variety of sectors ranging from government, education, construction sector, housing and other sectors. APG is, in terms of assets under management (approximately EUR 200bn), one of the largest pension providers in Europe and worldwide, serving more than four million pension fund participants.

Following our conversations and on the basis of the report, we have further explored the possibilities of setting up an effective pension solution for the UK along the lines described within the RSA's project. In this context, we assume that the design will comprise a defined contribution (DC) scheme, run at low costs and with full transparency, potentially open to a broad group of UK citizens. In order to increase the effectiveness of the scheme, automatic enrolment is strongly advised, as shown by the experience in many other countries. As regards the financial design of the scheme, we have explored two alternatives: a simple 'life cycle' approach, in which

the asset mix of each individual is automatically balanced towards less risky assets, and a 'smart DC', which also comprises a 'secure' part with respect to the pension accumulation. In both cases we would advise setting up a default fund, with perhaps an alternative fund for certain religious groups. The latter has not been explored yet. A scheme that would allow a full range of asset class choices would be costly and would most likely lead to suboptimal results, as the experience in, for example, the US with the 401(k) plan has shown.

The smart DC approach aims to overcome well-documented disadvantages to traditional defined contribution, which are related to too-low contributions, behavioural biases given investment choices, high asset-management costs, poor diversification, low returns and insufficient focus on the eventual retirement income objective. The smart DC approach aims to create individual accounts for participants, which consist of two parts: a 'secure' part, which provides basic security at the retirement date based on an inflation-linked performance objective and an 'income' part, which aims to provide additional returns based on a diversified portfolio of risky investments. The objective is to provide security at the retirement date. As with a life cycle investment approach, towards retirement a larger part of the contributions is put in the secure part. Young participants on the other hand can benefit from the long investment horizon and invest more in the income part. The system is default-driven, in order to avoid behavioural biases and to ensure lower costs. Institutional pricing is used for setting the prices for the investments. These costs will amount to approximately 30 to 35 basis points of assets under management, depending on the demographics and assuming using liquid and rather straightforward asset classes (e.g. fixed income and equities). In this default driven system, contributions can be set according to the required pension income outcome. The alternative – a plain life cycle fund – would provide less security (this would only be provided by gradually switching into, for instance, fixed income), but could be executed at somewhat lower costs, e.g. tentatively around 25 basis points of assets under management.

A smart DC approach can also be complemented with an annuity phase. This has several benefits: it increases the investment horizon, allowing for higher risk budget and consequently higher return perspective; offers efficient pricing of annuities and provides income security after retirement. Towards the retirement date the risks concerning annuitisation, i.e. conversion risk, can be decreased by, for example, management of the interest rate and inflation risk of the investments in the investment portfolio. By including solutions for the payout phase, risks can be taken away from the participant and risk sharing is increased. The impact of this add-on on the asset management costs is most likely negligible; it may have some minor consequences for the administration costs, though.

Obviously, smart DC can be complemented in a modular way with insurance solutions covering, for example, early death or disability-related risks.

Investment returns are crucial for providing good pensions. APG Group provides a complete array of asset classes. The assets of our pension fund clients are managed

in asset pools. Through these pools, pension funds can benefit from benefits of scale. Such pools are also available for a smart DC solution. This will allow for institutional pricing for smart DC participants. An additional benefit is that it is possible to construct a well-diversified portfolio at low cost.

The system in which the participant contributions and savings are administered should be basic in nature and thus cost-efficient. APG Group runs several platforms for the large group of clients we currently serve. We have, for instance, positive experiences with the Lifetime system provided by Inotime/Inovita, which allows for a scalable and efficient pension administration solution. In order to secure this technology, we are a majority shareholder in this company. The lifetime system allows for a smart DC administration and is multilingual by nature. It is also well equipped to allow for extension with personalised insurance solutions. The administration system is the core of a larger set of tasks ranging from the payment of contributions and pensions communication through to retirement payments to pensioners. Especially, web applications to allow for efficient participant communication are part of the solution. These applications look like personal pension planning tools. For our current clients and for us as a pension provider, web communication is the most cost-efficient way to communicate. We allow also for call centre support and specialist help. Call centre support can be set up either from our facilities or from a specialist company in the UK or elsewhere. The cost of pension administration very much depends on the scale of the scheme, notably the number of plan participants. Assuming 30,000 plan members, the costs (i.e. annual administration fee) would probably amount to EUR 30 per participant, assuming a full electronic-based solution plus a (hard copy) annual statement. Depending on the design of the scheme, it might, however, be possible to increase the number of participants over time, thereby lowering the administration fee substantially. Assuming, for instance, 100,000 plan members, the administration costs might decrease to EUR 15 to 20 per participant.

In summary, we believe it possible and practical to create the fund described in the report. Further, with a system of personal accounts, the UK could enjoy the best features of the Dutch system, which your report singles out as best practice in Europe.

Yours sincerely,

APG
Prof Dr Olaf C H M Sleijpen
Managing Director Institutional Clients

Appendix 3

Letter from Colin Melvin, chief executive officer, Hermes Equity Ownership Service

Mr D Pitt-Watson
RSA
8 John Adam Street
London
WC2N 6EZ

9 September 2009

Dear David,

Thank you for sending us an early copy of the Tomorrow's Investor report. We fully support its aim of providing a national scheme to enable low-cost, responsible investment. We at Hermes also strongly share RSA's desire to ensure that the fund employs the highest standards of governance and stewardship of its investments. By doing this, we believe it will not only achieve its goal of minimising investment and administrative costs but also maximise the long-term sustainable value of the fund's investments for all its beneficiaries.

The intention is for the RSA Tomorrow's Investor fund to outsource many of its basic functions including that of stewardship. You have asked us to describe what a stewardship service could provide, based on Section 5 of your report, in particular the paragraphs headed 'A responsible institution'. Our stewardship service can cover equities, which is the focus of your report, or all asset classes. Either way, for each asset class, the objectives of a responsible ownership service would include working to ensure that (1) there was a strong governance structure focused on delivering value for investors (2) incentives were clearly aligned to beneficiaries' interests (3) capital was allocated to create value (4) environmental, social and ethical considerations were promoted and (5) communication was effective between all links in the investment chain. The stewardship service would seek to achieve these objectives both at the fund manager and asset (e.g. company investment) level.

In particular, as regards equities, we would propose the following service:

Voting: Hermes Equity Ownership Services (EOS) would recommend votes at all general meetings of companies where the fund had a shareholding, wherever practicable to do so. We take a graduated approach to voting decisions and base our recommendations on public disclosures, discussions with the company and independent analyses of performance. We inform companies before we vote against or abstain on any resolution, usually following up such a vote with a letter. We maintain a database of voting and contact with each company and, if we believe further intervention is merited, we include the company in the main engagement programme.

Engagement: on the fund's behalf we would engage with companies to add value or prevent its destruction and to address material environmental, social and governance risks. Some engagements would be short, others more complex,

involving multiple meetings with board members over several years. All engagements would be subject to rigorous assessment and ongoing review. You would be welcome to suggest candidates for engagement and in all cases you would be fully informed of the engagement process.

Promoting best practice: EOS works, on its clients' behalf to promote best practice with other asset owners around the world. This takes place both on a day-to-day basis, and in developing broader initiatives. So, for example, EOS chaired, and was one of the founders of the United Nations Principles for Responsible Investment.

Public policy: we are actively engaged, on our clients' behalf, in helping policymakers to create financial markets that are accountable and responsible.

Hermes Equity Ownership Service (EOS) is well placed to deliver such a service. With over £40bn of assets under advice and close to 25 professionals, we currently have the largest resource of its kind in the world. Our staff is truly global, representing 13 nationalities and 17 languages. This allows us to engage effectively in different regions of the world. On behalf of our clients, we currently vote at over 8000 company meetings and engage more intensively with well over 400 companies on more than 1000 issues in any one year. We strongly believe in and advocate collaborative action. We participate in a number of industry bodies and initiatives around the world and have been the founders of many.

EOS is owned by BTPS, which is the UK's largest pension fund and a recognised leader in responsible investment. Through EOS, BTPS works collaboratively with like-minded investors. EOS' client base includes 14 prominent pension funds and asset managers from around the world. By supporting this international group of investors, EOS is seeking to maximise the effectiveness of the change it can achieve through responsible ownership offered at a fraction of the total cost of delivery.

Pension funds that are committed to responsible ownership typically spend the equivalent of one basis point of the asset covered by their activities, which relate to environmental, social and governance issues. Since it will take some time before the RSA's Tomorrow Investor fund is up and running, it is difficult to be precise, however, from what we know today, we believe we could provide our stewardship service for less than one basis point of the funds under advice.

Whilst not without its challenges, the RSA's project should provide an investment vehicle that will not only benefit the individuals who invest in it but also play its part in transforming our financial system for the better. We would be delighted to assist the RSA in achieving these ambitions.



Colin Melvin
Chief Executive Officer

