INVESTMENT MANAGEMENT ASSOCIATION WORKING PAPER

INDIVIDUAL RETIREMENT ACCOUNTS: A DISCUSSION OF TECHNICAL ISSUES

AS SUBMITTED TO THE PENSIONS COMMISSION, OCTOBER 2005

Investment Management Association

ima

This is the first of two papers written by IMA. This paper looks at the technical issues involved in the creation of a low-cost, government-backed individual retirement account system. The second paper, 'Individual Retirement Accounts: International Evidence' draws a number of lessons about cost structures from the international context.

TABLE OF CONTENTS

A FUNDED ADDITION TO THE STATE PENSION

DISTRIBUTION AND ADMINISTRATION 4

WHO IS BEST PLACED TO DO WHAT? 5

FUND STRUCTURES 7

CHOICE AND COSTS 8

OPTIONS 10

CHARGES 13

ROLE OF GOVERNMENT 14

OUTLINE PLUMBING: Accumulation Phase 16

APPENDICES

APPENDIX 1: CENTRALISING CONTRIBUTIONS VIA NI OR PAYE: issues arising 17

APPENDIX 2: A DESCRIPTION OF THE RETAIL FUNDS DISTRIBUTION SYSTEM 19

A FUNDED ADDITION TO THE STATE PENSION

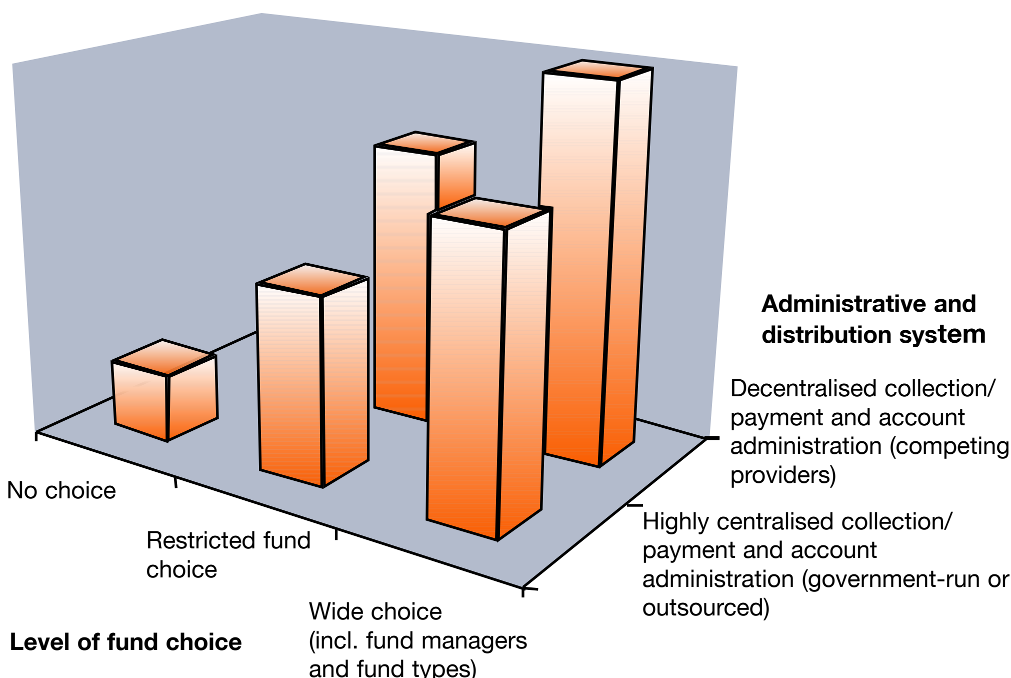
1. This paper is about how a funded addition to the state pension in the form of individual retirement accounts might be organised through partnership between the state and the asset management industry. Its focus is plumbing not policy.[1]

2. The work assumes that a funded addition to the state pension would only be acceptable to government if it could be provided within a level of overall charges at or close to those charged to institutional investors. Only options that offered the potential to achieve an annual management charge of 50bp or less are considered. 50bp is significantly less than the current charges on most retail investment products and below the costs currently levied in respect of private sector personal pensions (including those borne by individual employers).

3. The evidence from experience of other countries in South America, Scandinavia, Australasia and the USA strongly suggests:

- that the minimisation of distribution and administration costs is central to achieving this, and
- that there is a trade off between restricting individual investor investment choices and cost.

Stylised view of account costs



[1] It does not address compulsion; it does not make any assumptions about the appropriate level of the state pension; and it is not about the continuation or otherwise of SERPS or the Pensions Credit. Nor does it make any recommendations about contribution rates or the size of pension payouts.

The evidence is discussed in detail in a companion paper (Individal Retirement Accounts: International Evidence, also available from IMA).

DISTRIBUTION AND ADMINISTRATION

4. The plumbing in a system of individual retirement accounts consists of:

Accumulation phase

- Collection of cash contributions on behalf of individuals;
- Transfer of these contributions to an investment vehicle(s)/fund(s);
- Management of the investment vehicles/funds.

Post-retirement phase

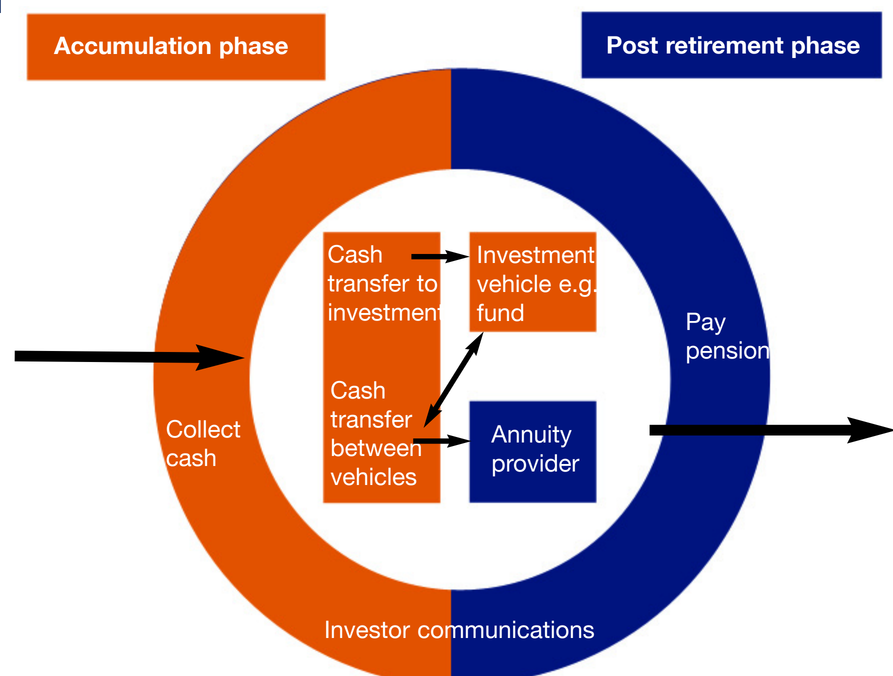
- Transfer of investment/cash to an annuity provider;
- Pension payments to individuals.

Common to both

- Associated record keeping:
  - In relation to individuals e.g. contributions; investment entitlements; personal details including names, addresses and bank account details;
  - In relation to investments, values of investments.

Figure 1 below shows how these activities might be grouped together in an overall pensions system.

Figure 1



5. At the core of the system are an investment vehicle - a fund, or funds, into which individual contributions are fed during an individua'ls working life - and an annuity provider who commits to paying out a regular sum to provide a post retirement income.

6. The system's outer rim is the interface with individual end clients - employees and pensioners. In the accumulation phase, this part of the system collects up cash from individuals, keeps a record of individual contributions - who has contributed how much and when - and provides the same information back to individuals on a regular and consistent basis: it also provides information back to individuals about the current value of their holdings in the investment vehicle. In the post retirement phase, the outer rim corresponds to the payment of pensions.

7. Between the core and the outer rim are interfaces inwards to the investment vehicle, between the investment vehicle and the annuity provider, and outwards to the administration of pension payments. These interfaces move cash in and out of the investment vehicles and to the annuity provider. They also relay information about the valuation of the investment fund so that the outer rim has the necessary information to inform individuals about the value of their holdings at any point in time.

WHO IS BEST PLACED TO DO WHAT?

8. The schema set out above segments the high level activities needed in a funded system based on individual contributions into a number of process groups which in broad terms map to similar functions undertaken in the public and private sector. The question of which elements are best (in terms of costs)[2] undertaken by the public or private sector is discussed below. It is assumed that where relevant infrastructure exists, then a system that utilises it will in general offer the lowest cost.

Collection of contributions and record keeping (public sector)

- The NI Contributions Agency collects NI contributions from employers monthly or quarterly and maintains the NI contribution records of individuals;
- In principle then it is well placed to perform the collection function and to be the record keeper of individual contributions;
- In practice, the Contributions Agency attributes the aggregate NI contributions it receives from employers to individuals at the end of a year, once it has received the information from employers in their end-year returns;
- Were pension contributions to be collected in the same way (as an additional earmarked NI contribution for example), there would be the potential for a lag between collection and investment. However this need not be the case and measures for dealing with it are discussed in appendix 1;
- The NI Contributions Agency maintains a record of names, addresses, and NI numbers.

[2] There are also other considerations. Some 55% of the workforce is located in small and medium sized enterprises (SMEs) with 250 workers or less, and a significant proportion of small firms fail each year. In these circumstances, collecting contributions as part of NI may have additional non-cost advantages.

Payment of pensions and record keeping (public sector)

- The Pensions Agency maintains individual pensioner records including name, address, NI number and bank account details in order to pay out state pensions;
- In addition it provides statements to individuals of forecasts of their future pensions based on the Contributions Agency's records of contributions;
- In principle it is well placed to provide the payment mechanism for additional pension payments arising out of a funded scheme, and to provide annual updates on the amount to date paid into any fund by an individual and the current value of the investments, the latter on the basis of fund valuation information.

The investment vehicle (private sector)

- Infrastructure to provide asset management lies outside the public sector. The UK is one of the largest centres for asset management in the world; it would seem sensible to use it to manage the investment vehicle.

Transfer interface (privately operated)

- The core activities of this interface are the aggregation of investment orders on behalf of individuals, the passing on of aggregated purchases and sales to the managers of the investment vehicle, and maintaining records of holdings, both in aggregate, and by individual holders.
- In the Swedish premium pension system these activities are undertaken by a government agency. However, they look very much akin in the UK to the services provided by fund supermarkets/transfer agencies (see Appendix 2), and suggest then, unlike in Sweden, the infrastructure to provide such services already exists in the private sector.
- There are two caveats to this conclusion: first the range of activities required will depend to some extent on the number of types of fund and the number of providers of the investment vehicle; and, second, the current capacity of individual supermarkets may be significantly below the capacity that would be needed in a state system covering 10 to 20 million people. As a consequence it is likely that additional capacity would need to be built.
- There is a risk that the addition of this level of business to any one of the existing privately run supermarkets could give it a dominant market position, quickly leading to a monopoly.
- Whilst the design, building and day to day management of an interface based on the supermarket/third party administration approach could be outsourced to the private sector through a competitive bidding process, ownership might have to reside in the public sector in order to ensure that the volume created by a pension system was not used to undermine the current competitive market structure.

- Alternatives would be for government to accept more than one supplier, or for the industry itself to come up with a collaborative solution.

FUND STRUCTURES

Investment vehicles

9. There would be benefits if the fund or funds were based on the structure of an open ended collective investment vehicle (as per an authorised unit trust or an OEIC). Taken together these provide substantial investor protection, safety, simplicity and transparency, important attributes for both investors and for government as scheme sponsors.

First, they are unitised:

- A unit represents a fixed share in a fund. The total value of a fund is the sum of the market values of the securities held in the fund. At the point of its creation, a fund needs to decide what the initial price of a share in the fund will be (£1 is a frequent choice): the initial number of units/shares is then the initial value of the securities held in the fund divided by the initial price.

- The value of a unit is directly related to the market values of the securities held in the fund. As new money flows into a fund, new units are created using the then unit price: for example, whereas initially £50 might have bought 50 units at the creation price of £1, if the market values of the securities were to subsequently rise by 10% say, £50 would buy 45 units and if it were to go down by 10%, then £50 would buy 55 units.

- Where inflows to the fund come in differing amounts at different times and on behalf of different individual holders, accounting in units is a convenient way of attributing at any point in time shares in the fund back to individual holders on an equitable and transparent basis.

- Units are priced daily and prices published daily. Individual holders in such a fund can compute on a daily basis if they so wish the value of their investment.

- Industry wide standards for performance measurement and cost measurement aimed at ensuring fair comparisons between managers are already in place.

Second, they have an established legal structure that protects the end investor against failure or fraud in the fund management company:

- The assets of the fund are not owned by the fund management company; they are owned by a depositary or trustee who acts on behalf of the underlying investor and is independent of the fund management company;

- The depositary controls the creation and redemption of units;

- The depositary has oversight of all the actions of the fund manager in his dealings with the fund (as listed in Table xx in Apppendix yy).

Third, the management and operation of the fund are governed by detailed regulation focussed on investor protection which for example:

- Requires fund accounts to be prepared and audited to an established, publicly available and approved accounting standard;

- Determines what can and cannot be charged to the fund;

- Circumscribes the fund manager's activities.

10. The investment vehicle should be an accumulation fund or funds in which all income received is received gross of tax and re-invested rather than distributed. From a tax perspective the fund would then have the same tax treatment as other pension fund investments.

Annuity

11. It is assumed that the accumulation phase ends at the state retirement age, and at that point there would be an appropriate transfer from the investment vehicle to an annuity provider, and that this transfer would be subject to the same tax arrangements as other pension vehicles i.e. currently that an individual can take out up to 25% of his 'fund' as a tax cash free lump sum[3] with the remainder used to purchase an annuity.

12. However the obligation to buy an annuity exposes the individual to significant market risk. This has two sources: first he is an enforced seller of his investment portfolio at the market prices prevalent at that time, and second he is an enforced buyer of the annuity at the annuity rates that prevail at that time. The second is recognised in the flexibility introduced through permitting the annuity purchase to be delayed to any point between retirement age and reaching the age of 75. However this flexibility is likely on average to be of little value to those at or below median earnings who may not be able to defer receipt of the additional pension.

13. Although not a new issue in relation to annuities and pensions, the potential expansion of this type of arrangement to the wider population perhaps merits an examination of whether this risk can either be mitigated or at least made more transparent.[4]

CHOICE AND COSTS

14. As the evidence from experience in other countries indicates, the extent to which individuals are allowed to exercise investment choice is one of the two key factors in determining the charges that they face. The broad choices facing individual employees are: membership of the scheme or not; choice between fund type(s), choice of fund manager(s).

[3]One of the issues for government will also be whether or not there is access to the accumulated holdings prior to retirement age, and if so, on what terms. We assume that there will be an appropriate incentive not to withdraw early.
[4]See Golden & Keating 'Evergreens: Pensions and Tontines' Newton Institute 2005; Blake, D., and Burrows, W. (2001) 'Survivor bonds: Helping to hedge mortality risk,' Journal of Risk and Insurance 68, 339-348.

15. The first of these is not the subject of this paper. Our assumption is simply that there is sufficient flow into the system to merit its existence and to sustain its cost effectiveness. How that comes about - compulsion, auto-enrolment with opt out or opt in - does not impact on the design of the subsequent arrangements described in this paper. On the other hand, restricting the investment choices available to individuals may be more palatable if the individual can opt out of contributing, and less palatable were contributions compulsory.

16. The choices that drive costs are investment choices - choices between fund types, between different allocations and between different managers. Making these choices requires each individual to sift through a complex information set for each fund including for example, fund objectives, investment approach, asset allocation, performance, and manager track record. The more choices across fund types and fund manager the larger the set of information that an individual must process in making a decision where to invest. This creates a demand for professional intermediaries (in the retail market, IFAs) to process the information and to provide advice to individual investors. The information set provided and the advice processes are both regulated. In addition to the cost of advice, choice also means that individual fund providers are encouraged to market their products directly to individuals, thus adding a further layer of cost.

17. At the two ends of the spectrum amongst those groups of countries with centralised contributions are the US (TSP) and Sweden (Premium Pension). The former has a limited number of fund types whose managers are chosen by the TSP and not by individuals. In the latter individuals can choose between the universe of mutual funds authorised in Sweden (some 650 funds) and permits switching between them. The Swedes found it necessary to have a default option - a default fund, whose characteristics were centrally determined. Initially this was a provision for individuals who felt unable to exercise choice, but it has subsequently become the preferred option for many investors.

18. However, limiting the investment choices that individuals can make does not make these choices go away: they still have to be made by someone.

- Should the system be based on a single fund or more than one fund, if more than one how many?;
- If a single fund, who determines what is an appropriate asset allocation or investment strategy?;
- If more than one fund, on what basis are inflows allocated, by government or individuals choosing between funds?;
- If individuals, how much advice should be provided and by who?;
- And can this be achieved without undermining the objective of cost minimisation?;

- In addition government sponsorship can imply a residual responsibility if things were to go wrong operationally - contributions get mislaid or misplaced for example - and if expectations about investment performance were not met - because of cyclical downturn in markets for example;

- In resolving these issues of system design, how can sufficient competition between private sector providers be retained in order to deliver best value to investors?

OPTIONS

19. Our objective is to identify whether a system that has an end to end annual charge of 50bp or less could be achieved. Individual investment choice appears to be as significant to meeting this objective as centralisation in terms of cost. In order then to complete the syste, we need to resolve the issues above.

20. The evidence from Sweden suggests that extending choice to the universe of investment funds has disadvantages - it adds to costs, confuses investors (it offers too much choice) and it makes it difficult for firms to create critical mass (holdings are too widely spread)- and does not remove a need for government to be involved in defining a default arrangement. Indeed, a default arrangement is commonplace elsewhere.

21. How to allow the investor to make a choice if he so wishes is important. The simplest solution would be to allow him to opt out of contributing.[5] He would then be free to invest whatever he liked but bearing the additional costs, if any, of that decision. That would leave government free to limit the range of investment choices available to those that it felt were most relevant to pensions and to the average investor. For example, reflecting the focus on pensions, the options for defining alternative objectives for the investment of the fund may be rather narrow - for example, long term indexation to either wages or prices with alternative degrees of downside risk. Also, there may be several different investment strategies that could deliver the same objectives.

22. These considerations lead us to conclude that a limited number of fund types - no more than 3 or 4 - might be an appropriate point in the range between the TSP and Swedish options, but these fund types would be managed by a number of independent managers. By fund type we mean a mandate set against an appropriate benchmark/objective, a similar approach to that used by pension fund trustees. The management of each fund type would be apportioned across a number of managers. The aim would be to have the maximum number of competing managers subject to a minimum mandate size (to ensure critical mass). The number of managers could then grow through time as the size of the fund increases.

Manager choice

23. Managers would be chosen through open competition on a minimum 5 year basis. Contributions would be allocated equally between managers. An individual's investment would therefore be spread across all the managers of a particular fund type

[5]He might also wish to add to his contributions (through AVCs). This could add to the cost of collection via NI, but the amount contributed might need to be limited to avoid undermining the current retail market structure. For the same reason, if one took say a 2.5% contribution rate, this might be capped in nominal terms at the NI upper earnings limit.

with individuals holding units in the aggregate fund, which would be invested in individual manager funds. This arrangement is similar to a fund or funds or multi-manager structure except that, unlike in the fund of funds or multi-manager approach, flows into the underlying constituent funds would be allocated by a pre-determined rule (in this example, equally) and not by the fund of funds manager.

24. There are a number of advantages to such an arrangement:

- it provides diversification of fund manager risk;
- it provides competition between managers for mandates;
- government is not managing the fund of fund - flow is allocated by a pre-determined and transparent rule, not by government;
- it distances government from issues related to individual securities, for example takeovers and mergers, and individual company concerns, for example corporate governance and executive pay. These decisions would be spread over a number of fund managers, each making their own judgements solely on the basis of their individual views of the impact on future investment performance.

Fund types

25. If there are to be a limited number of fund types on offer, someone - either government or its agent - needs to define their characteristics. For the purposes of this paper, all that is required is that individual choice is limited, and what follows is by way of illustration in relation to government's involvement in fund design, rather than advocacy of a particular approach[6] in relation to fund types.

26. We assume that government would set an overall investment objective. This could be related to earnings growth[7] as measured by either average or median earnings. However, it is unlikely that this would be achievable without exposure to market risk, for example equity market risk. Government might therefore want to make achieving this objective subject to some additional risk related parameters, for example defined in terms of an average holding period (say 20 years) and the probability of not at least achieving a return in excess of price inflation over the assumed holding period.

27. Fund managers would bid on the basis of investment strategies that meet these government determined investment objectives as part of the open competition described above. In this model, government's role is setting appropriate investment objectives leaving the market to put up alternative investment strategies to meet these objectives, thus building on both parties comparative advantage.

28. However, the biggest market risk occurs at retirement when the individual employee is obliged to liquidate his investment and buy an annuity. This suggests two additional fund types, both variants of the first:

[6] Our understanding is that the portfolio management component of the overall charges would not be materially different across the range of likely outcomes so decisions made about fund types do not materially impact on the less than 50bp objective.

[7] As contributions to the fund are being made out of earned income, it would be natural to assume that both government and the individual contributor would have a common objective that whilst in the fund they would retain their real value in terms of earnings and not prices.

Life style fund(s)

In this fund type, the transition from less to more capital certain assets is managed over a number of years (ten or more) prior to retirement in order to smooth out market fluctuations. Typically firms offering this approach manage this process through a number of funds each representing a different cohort of retirees.

Deferred annuity fund

The transfer from the investment vehicle into an annuity involves selling equities and bonds for cash, and using the cash to buy an income stream which is itself the return from a fund largely invested in cash and bonds. Annuity rates depend upon a number of factors including mortality estimates and long term bond rates and these are uncertain so that actual annuity rates vary from year to year. An individual purchasing an annuity is locked in at the rate at the time of purchase.

Just as lifestyling smoothes the asset risk, there ought in principle to be an opportunity to buy annuities forward, thus building up the final annuity purchase over a number of years and smoothing across annuity rates (a bit like buying units forward in an annuity that commences paying out at the retirement date).

A refinement would be to link lifestyling and the forward annuity purchase, as both are the same transfer of assets into cash and bonds.

29. The decisions between these three approaches that an individual faces are about how and when he wants to take the additional pension. If immediately at retirement, then the choice is between the lifestyle and deferred annuity options; if, however, an individual employee does not need the addition immediately at his retirement date then he might choose to stay invested in the base fund for as long as possible (to aged 75 under current pension arrangements with the benefit that if he died before then his accumulated investment would be part of his estate).

30. In practice, although an employee might choose between these three options at the start of his working life, the impact on the investment strategy is not felt until the 10 to 15 years before retirement. It would be possible therefore to permit individuals to revise their initial choice at that point in their life, recognising that their personal circumstances might have changed. For example, someone originally opting for lifecycle on the basis that they might need to take the pension immediately on retirement might choose differently if they had received an unexpected bequest.

31. These are not the only ways in which fund types could be determined - government goes further than fund objectives and defines fund types which represent different asset allocations, and different risk profiles.[8] Equally they could appoint portfolio managers to manage mandates determined by asset class rather than by fund objective.

[8] In so doing they would be taking on more responsibility for achieving the objectives, for example by determining a target asset allocation, and hence face more moral hazard.

CHARGES

32. We set ourselves an objective of designing arrangements that would deliver an annual charge of 50bp or less. Clearly, whether this is actually deliverable or not is a commercial decision for firms and platform operators to make in response to government. The IMA cannot commit industry participants to the IMA's estimates. All we can do is to set out the basis of our estimates and test for reasonableness.

33. We have tested this in two ways: bottom up and top down. Bottom up, our estimate is built up as follows:

i. Collection of contributions is via an additional percentage on to the employee NI rate, and collected in the same way as NI. Our assumption is that the impact of this on the NI contributions agency costs would be small. The collection arrangements are unchanged, and personal records systems are largely already present (names, addresses, annual NI contributions (cash) etc.))

ii. Transfer agency component 10 to 15bps. This compares with 20 to 30bps charged currently by supermarkets to retail funds. The lower estimate is a consequence of much bigger scale, less record keeping (personal details remain with the NI agency), and little switching.

iii. Asset management - between 20 and 30bps depending on the investment strategy pursued by the individual manager. This is based on current institutional charges.

iv. This puts the overall charge in a range from 30 to 45bps, with some comfort zone below the 50bps objective which could accommodate as yet unforeseen running costs, for example at the NI Contributions agency, of between £12mn and £35mn a year.[9]

Taking a top down view:

i. The median charges in the UK retail funds market are a 5% initial charge and 1.5% annual management charge. Some 3% of the initial charge and some 0.5% of the annual management charge (AMC) represent the cost of distribution (for example, payments to IFAs).

ii. Without distribution costs the AMC is 1% (100bps). Of this, the administration component is about 40bps. Of the remaining 60bps, about half is a charge for portfolio management and the remainder represents operating margin to cover overheads e.g. product design, marketing, advertising, trustee oversight etc. and profit.

iii. A large part of the administration costs represents customer record keeping associated with ownership and fund income distribution. A significant part of the overheads are expenses e.g. marketing and advertising that would not be incurred in the proposed system.

[9] 10 million participants with on average earnings of £20,000 a year and a 2.5% contribution rate implies inflows totalling £5billion per year and an average fund size of £25 billion over the first 10 years.

iv. The impact of the removal of these expenses is evident by looking at the annual management charges faced by institutional investors in the same funds. These range from 20 to 60bps, substantially less than retail. Also there is usually no initial charge.

v. Duration of holdings also matters. The average duration of a holding by an individual retail customer is about 7 years. For new products we are advised that profitability is usually assessed over a slightly longer period. In the proposed scheme, the average holding period will be two to three times longer.

vi. Taking 4 & 5 together suggests an objective of 50bps is not unreasonable.

ROLE OF GOVERNMENT

33. The potential role of government in a nationwide investment scheme raises a number of concerns both for the private sector - undue influence, monopoly power - and for government itself - moral hazard. In the schema outlined above, government's roles are:

- To set the contribution rate;
- To operate the system that collects contributions and does the appropriate record keeping;
- To set fund objectives;
- To establish procedures for the appointment of portfolio managers.

34. In being the operator of the contributions collection part (and the pensions payment part), the government is faced with operational risk - of mislaying contributions or of getting the amounts collected wrong for example. The question for it is whether these risks (i) more than already exist within the current NI system and (ii) more than might exist[10] in alternative arrangements, for example, an employer collection system alone (as in private sector DC or money purchase).

35. Government is not directly interfering in how contributions are invested - it is not setting a target asset allocation, it is not determining investment style - active or passive for example, it is not setting any parameters about choice of individual securities nor involving itself in corporate governance matters. It is acting through setting fund objectives.

36. It could however use this to influence investment decisions through frequent changes to the objectives, for example the risk tolerance or the link to wage growth. Fund manager choice and the allocation of inflows to individual managers are also areas where there would be concerns were these open to political influence. On the other hand, direct interference in such areas would also expose government to additional risks.

[10] One particular risk that government might wish to consider is what happens if an employer ceases trading (a risk already highlighted in relation to the large part of the labour force employed in SMEs.

37. Pensions are a long term investment with accrual and payment periods several times the life of a single parliament. Both potential contributors and potential suppliers of investment services need to have confidence in government's long term commitment to an agreed set of arrangements. Decision making in relation to delivery of investment services needs to be consistent through time, transparent and, as far as possible independent of government if it is to be credible.

38. The evaluation of fund manager investment strategies to meet the fund management objectives, the ensuing appointment of fund managers and the subsequent evaluation of fund managers' performance are all areas where government would in any event need the help of experts. Bringing externally recognised expertise to bear in these areas would add to credibility, and more so if this expertise was seen to be being applied independent of government.

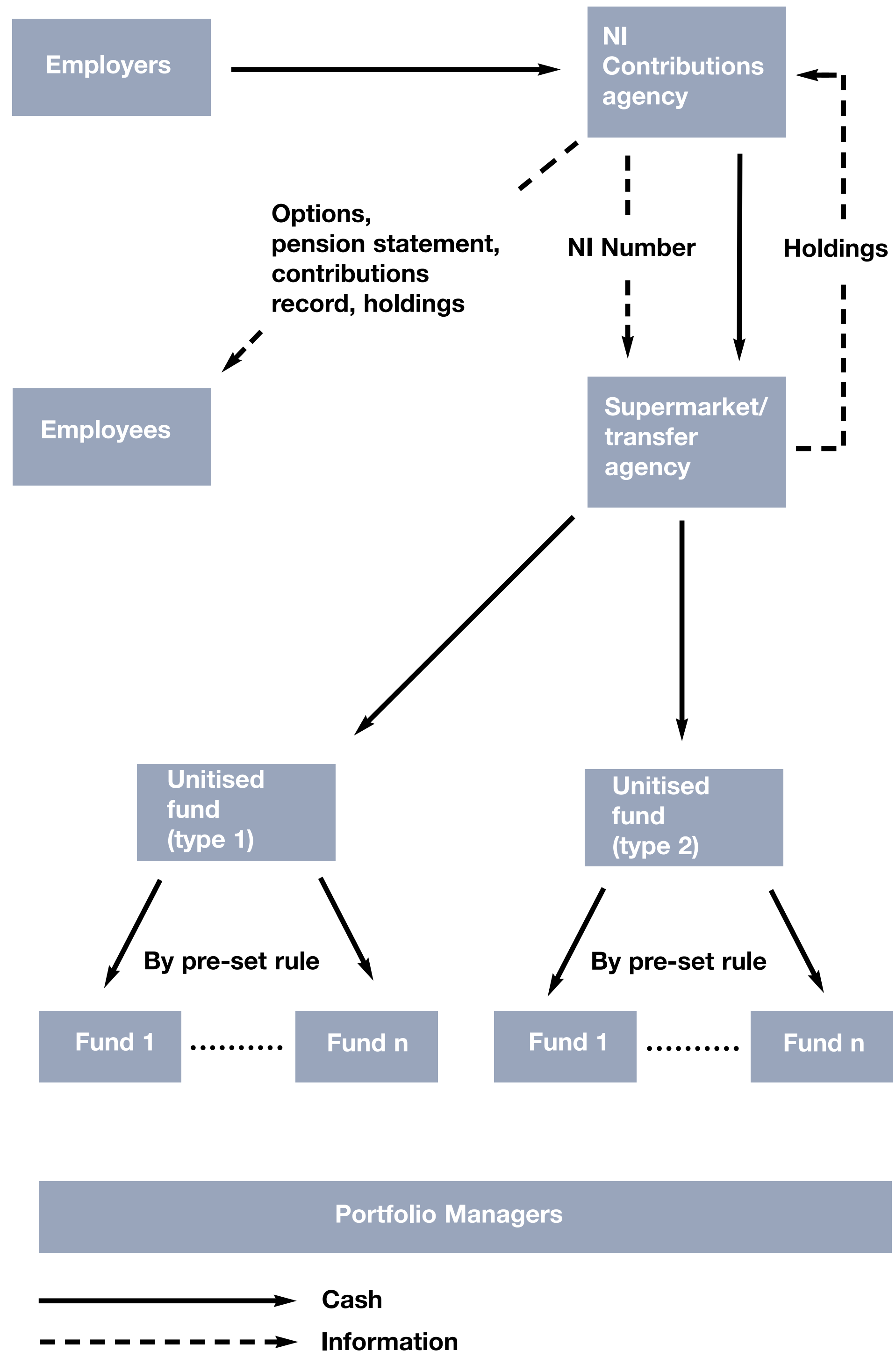
39. One option might be a committee of recognised experts, appointed through a similar process to that used for the Monetary Policy Committee, with a remit to appoint fund managers, selected on the basis of the fund managers' proposed investment strategies, and to review their performance relative to the funding objectives set by government (and the Government would periodically confirm in writing to the Committee). The Committee would report, say on an annual basis, on the performance to date of the funds, the prospects for meeting the funding objectives on a two and five year horizon (say), and any remedial actions it was proposing to take (for example, in the case of an underperforming fund manager).

40. This of course could not guarantee that nothing could ever go awry. But from a government perspective, the best advice is being brought to bear within an arrangement that is independent, accountable and transparent.

APPENDICES

1. The NI contribution agency problem
2. Description of structure of retail funds distribution system

OUTLINE PLUMBING: ACCUMULATION PHASE



APPENDIX 1

CENTRALISING CONTRIBUTIONS VIA NI OR PAYE: ISSUES ARISING

1. The NI contributions agency collects NI contributions on a weekly or monthly basis. For people in employment, it collects via the amounts due from the employer on the basis of the employer's calculation of the amount due on behalf of his total workforce. However, these within year payments are totals on behalf of the workforce as a whole, and it is only at the end of the tax year that the employer is required to report how much of the annual total relates to each individual employee. Only then is the Agency able to confirm that the amounts collected on behalf of individual employees are correct and consistent with their earnings. For the self-employed and voluntary contributors, payments are received directly from each individual.

2. An earnings related (as per NI) pension contribution collected as an additional, but separately identified, NI payment (say a 2.5% addition between the lower and upper earnings limit for example) should be able to be accommodated within the existing collection arrangements without requiring significant changes to the collection systems either at the employer end or at the NI Contributions Agency. However, such a solution would have the same properties as the current NI collection system in that pension contributions from individual employees would only be known centrally after the end of the tax year in which they accrued.

3. This is essentially the collection method used in the Swedish Premium pension system. As in the UK, the attribution of the total paid in during a tax year is not attributed to individual employees until after the end of the tax year. In the Swedish system where employees choose the funds into which their contributions are invested, investment decisions cannot be made until after contributions on an individual basis have been reconciled i.e. after the end of the tax year. Between the time that contributions are received and the time at which they are attributed to individual employees, the money is invested in government debt.

4. This has the advantage that no final investments are made until after individual contributions have been verified, and therefore under/over payments that may have been made have been held in cash or near cash. The Swedish agency then faces no investment risk - for example which it could incur if the reconciliation process identified overpayments to be repaid out of contributions that had been invested. But it also has disadvantages: employees incur opportunity costs from the delay before investment; they face more investment risk as their annual contribution is invested at a single point in time rather than spread throughout the year; and it gives rise to an operational peak in investment processes.

Alternatives

5. The degree of choice between funds available to investors under the Swedish approach may limit the extent to which the disadvantages of delay and concentration identified above could be alleviated. One obvious alternative would be to track individual contributions as they arise i.e. for employers to submit the information they currently report at the end of the year within the year as contributions are deducted from earnings ie weekly or monthly. This would represent a major change for both employers - particularly big perhaps for small and medium sized firms with paper

based records - and for the central collections agency, both of whom might be faced with substantial up front costs of such a change.

6. An alternative approach could be to invest all receipts of contributions as they are received by the central collection agency with the central agency acting as nominee (all the investments would be held in its name and not to the account of individual employees at this stage). Attribution of investments back to individuals would then take place after the end of the tax year once individual contributions have been reconciled.[11] Under these arrangements investment takes place smoothly through the year limiting market risk, and reconciliation and investment are decoupled so delays in reconciliation don't impact on the timing of the investment on behalf of an individual. The disadvantage is that if there is systematic over collection at the aggregate level, then in aggregate the central collections agency may be paying back cash out of contributions that have already been invested i.e. it bears market risk.

[11] Allocating the total investment already made to an individual's contribution is straightforward if the fund is unitised. At the end of the tax year, the central collection agency knows how much cash it has invested during the year and how many units this amount of cash purchased. It then uses the average cash cost of a unit (total cash divided by number of units) to convert individual agreed contribution back to units of holdings. The transfer agency then re-registers the nominee holding for that year into individual accounts

APPENDIX 2

A DESCRIPTION OF THE RETAIL FUNDS DISTRIBUTION SYSTEM

1. The purpose of this section is:

- to set out the main roles and responsibilities of the various agents in the provision of open ended collective investment schemes in the UK (unit trusts and OEICS);
- to set out how fund supermarkets fit into the distribution chain;

2. The responsibilities for the management and oversight of unit trusts and OEICS are split between two entities:

- a Fund Operator (Unit Trust manager in the case of unit trusts and an ACD in the case of OEICS) who is responsible for the management/operation and promotion of the fund scheme;
- and a Trustee/Depositary who is responsible for the oversight of the fund operators management of the scheme and ensures safe keeping of the scheme property (i.e. custody of the assets) and for the income earned on those assets.

In addition, the activities of the scheme are subject to detailed regulation and the accounts of the scheme are drawn up using recognised accounting standards and are independently audited.

3. The roles and responsibilities of these two entities are set out in more detail in the first column of the attached table. Each can delegate delivery (but not the responsibility) of some of its functions: for example, the fund operator may delegate the actual management of the investments to a third party; the Depositary/Trustee often delegates the **physical** safekeeping of the assets to a custodian bank, and it can delegate the operation of the register of unit holders to the fund operator.

4. Beyond this, who does what also may depend upon distribution. The table considers 4 possible cases: the first where an individual buys units in a fund directly from the fund operator, cases two and three where he acts through a single intermediary, an independent financial adviser or a fund supermarket, and the last where he acts via a chain of intermediaries, for example through an IFA who then deals through a fund supermarket. The key finding in the table is that the introduction of an intermediary in the sales process, also moves investor facing communications and investor facing administration from the fund operator to the intermediary.

5. However, any one investor might have dealt through one or all of these routes with a number of different fund operators. This has produced a multiplicity of record keeping and investor communications systems - IFA, Fund Operator and supermarket have each a record keeping and investor communication system - and for multiple records of individual investors across these multiple systems.

6. Supermarkets aggregate purchases and sales and deal therefore net with individual funds. But they also offer the potential to concentrate record keeping and investor communications in a smaller number of places and therefore reduce duplication but

only if all the business flowed via supermarkets. A supermarket deals on behalf of IFAs or individual investors with a broad spectrum of fund operators - in each fund operator's records there is a single nominee account of holdings by the supermarket. Records of individual holdings and personal information of each investor remain at the supermarket.

ALTERNATIVE WAYS OF PURCHASING UNITS
Role of the intermediary: Who does what when

ROLES AND RESPONSIBILITIES

1 FUND OPERATOR (Unit Trust manager or ACD)

Role	1 No intermediary	2 IFA sole intermediary	3 Supermarket sole intermediary	4 Intermediary chain: IFA to Supermarket
Marketing				
(i) market research	Operator	Operator	Supermarket	Supermarket
(ii) creation [product development] of funds	Operator	Operator	Operator	Operator
(iii) promotion to potential investors	Operator	Operator/IFA	Supermarket	Supermarket/IFA
(iv) general information provision [factual info, lead fulfilment]	Operator	IFA	Supermarket	IFA
(v) sales of funds to investors [dealing on behalf of the investor]	Investor	IFA	Investor	IFA
(vi) communications with investors [periodic statements, reports..]	Operator	Operator (may send via IFA)	Supermarket	Supermarket (may send via IFA)
Administration (investor facing)				
(vii) administering the flow of cash in and out of the fund/account [processing deals placed by/for end-investor]	Operator	Operator	Supermarket	Supermarket
(viii) creating and maintaining individual accounts for fund investors [ISAs, savings schemes, supermarket…]	Operator (as account manager)	Operator (as account manager)	Supermarket	Supermarket
(ix) creating and maintaining fund registers [legal title to units]	Operator or third party registrar (as delegated by trustee/oeic)	Operator or third party registrar (as delegated by trustee/oeic)	Operator or third party registrar (as delegated by trustee/oeic)	Operator or third party registrar (as delegated by trustee/oeic)
recording all payments to and from end investors [including dividends]	Operator	Operator	Supermarket	Supermarket

** Note: the trustee of a unit trust or the oeic itself is responsible for maintaining the unit/share register, but will usually delegate to the operator or, occasionally, a third party registrar. In the former case, the operator will often outsource the function.*

Role	1 No intermediary	2 IFA sole intermediary	3 Supermarket sole intermediary	4 Intermediary chain: IFA to Supermarket
Administration (fund facing)				
(x) fund valuation and pricing	Operator	Operator	Operator	Operator
(xi) dealing with reinvestment or redistribution of dividends to investors [excluding payment/communication to end-investors]	Operator/registrar	Operator/registrar	Operator/registrar	Operator/registrar
(xii) advising asset managers of money available (or not) for investment	Operator	Operator	Operator	Operator
(xiii) recording fund portfolio transactions	Operator	Operator	Operator	Operator
(xiv) operating accounts of the fund including income received and gains and losses realised	Operator	Operator	Operator	Operator
(xv) liaison with the Trustee/Depositary and auditor	Operator	Operator	Operator	Operator
Investment management				
(xvi) research	Inv. manager*	Inv. manager*	Inv. manager*	Inv. manager*
(xvii) defining investment objectives	Operator	Operator	Operator	Operator
(xviii) investment analysis	Inv. manager*	Inv. manager*	Inv. manager*	Inv. manager*
(xix) portfolio selection and portfolio management	Inv. manager*	Inv. manager*	Inv. manager*	Inv. manager*

** Note: the investment manager is appointed by the operator, who retains overall responsibility for investment of the assets. In some cases the operator and investment manager are the same legal entity.*

2 DEPOSITARY/TRUSTEE)

Safekeeping of the assets

Supervision of conduct of the fund/fund operator

Maintenance of the Register[see note above re investor-facing administration]

3. INDEPENDENT AUDITOR

Notes

(i) The ACD is the oeic equivalent of the unit trust manager and essentially is responsible for the management (operation) and promotion of the scheme
(ii) The Trustee (unit trust) or Depositary (oeic) are responsible for:
(a) oversight of the operator's management (but not promotion) of the scheme in accordance with the relevant regulations and scheme constitution
(b) safekeeping of the scheme property (ie. custody of the underlying assets) and the collection of income generated by the portfolio
(iii) The Trustee/Depositary will often appoint a third party custodian for the purposes of (i)(b), but will retain overall responsibility for that function

Note re supermarkets

Technically, supermarkets contract with the investor essentially to provide a dealing and custody service, under which fund purchases and sales are aggregated and the units registered in an omnibus nominee account. They contract with the fund operator to provide "shelf space" for their funds on the platform in exchange for preferential dealing terms (ie. discount of initial charge), which are passed on to the end-investor, and reimbursement of annual management charges from which they pay trail commission to IFAs. The regulatory position regarding these fee arrangements, particularly whether the reimbursement of the AMC is a rebate, a service fee or indeed a commission is unclear (the rules were not written with supermarkets in mind) and a matter of some debate.

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October 2005