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Irish Pensions Roadmap
Smart Defaults

- A successful automatic enrolment system requires a well-designed default investment strategy.
- High take-up of the default typically leads to better outcomes.
- Defaults need to be suitable for members, based on analysis of membership profiles.
- Lifecycle investment approach, via lifestyle or Target Date Funds, is the best approach to managing defaults.
- Focus should be on value for money rather than lowest cost. Value can be added through diversification and risk management.
- ESG integration is increasingly important in managing long-term risks in defaults.
- Strong governance is critical to achieving good member outcomes.

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Pensions coverage of Irish private sector workers is low

The most recent census estimated that less than half of workers between the ages of 20 and 69 in Ireland has a pension.[1]

We welcome the proposed introduction of automatic enrolment which has been used successfully in the US and the UK. In the UK, automatic enrolment has raised private sector pensions participation from 42% to 73% over the period 2012 to 2016.[2]

The success of any automatic enrolment pension system hinges on the design features — who is eligible for enrolment, how they are enrolled, the mandated contribution rates, and the default investment strategy.

This note focuses on best practices in designing the default investment strategy.

[1] https://www.cso.ie/en/census/

[2] Source: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/668971/automatic-enrolment-review-2017-maintaining-the-momentum.

A successful automatic enrolment system requires a well-designed default investment strategy

By definition and design, automatic enrolment requires no engagement from the enrolled employee. Therefore, there needs to be a default investment strategy to which the member's contributions are allocated. The pension scheme may well provide the option for the member to engage and make an alternative investment choice, but the default is key.

High take-up of the default is not a bad thing and typically leads to better outcomes. In our experience default fund use is typically high with, for example, 99% of members in the UK's National Employer Savings Trust in the default fund.[3] There is growing acceptance that high levels of adoption of a well-designed default is positive rather than a failure of engagement. There is little evidence that the wider population can be engaged and educated to make effective investment decisions and maintain them under review. As seen in Sweden's Premium Pension system, which offers over 600 different fund choices, having too much choice can result in people making sub-optimal decisions, choosing funds which are unsuitable.[4]

99%

Of members in the UK's National Employer Savings Trust in the default fund.

600

Different fund choices in Sweden's Premium Pension system

[3] Source: https://www.fca.org.uk/publication/market-studies/retirement-outcomes-review-interim-report.pdf
[4] Source: https://www.ssa.gov/policy/docs/ssb/v65n4/v65n4p38.html

Are members better off in the default?

Whilst default strategies cannot be tailored to meet the needs of every single member, the ongoing governance should mean better outcomes than where individuals make their own choices. Below is a simple illustration.[5]

Journey A

Mary, aged 25, joins her DC scheme this year and decides to self-select a global equity fund for her pension savings.

Throughout her career, Mary becomes less engaged with her pension, she changes jobs and her personal circumstances change. In addition, the market environment is constantly evolving and may even experience a market crash.

On average, in the event of a 1-in-20 adverse market outcome when Mary is 65, her pension pot would be worth:

€329,477

at the age of 65.

Journey B

Mary, aged 25 joins her DC scheme this year and does not make an investment choice.

Mary's employer has selected a Target Date Fund which moves into less risky assets as she approaches retirement.

On average, in the event of a 1-in-20 adverse market outcome when Mary is 65, her pension pot would be worth:

€416,436

at the age of 65.

[5] Source: State Street Global Advisors as at 31 December 2017. The methodology used is a Monte Carlo simulation to project outcomes based on subjective judgments and assumptions by ISG, SSGA. Mary is assumed to have joined the scheme in 2017 at the age of 25 and retires at age 65. Annual contributions and salary growth are assumed to be 6% and 2% respectively.

Defaults need to be suitable for members, based on analysis of membership profiles

The default must be suitable for the employees being enrolled in it. Good practice calls for the pension scheme provider to analyse the characteristics of their membership and use that information in the design of the default. Key characteristics include age, sex, wage profile, retirement date, life expectancy, risk tolerance and likely use of assets at retirement.

Defaults should use a lifecycle investment approach that varies the level of investment risk taken by members according to their life stage. The further the member is from retirement the greater their human capital relative to the invested portfolio and hence the greater their ability to take risk. When a member is in this early stage of their lifecycle, they have a long time horizon to recover any losses to their portfolio and can therefore afford to take on more risk. The closer to retirement, the less ability to recover and hence the need to take less risk.

The lifecycle approach can be delivered by an administration-led lifestyle approach (switching between funds in the member's account) or via a single Target Date Fund where the allocation is switched as the target date approaches. In our view, Target Date Funds provide a number of advantages over lifestyle strategies.

How do Target Date Funds work?

A member will hold a single Target Date Fund which corresponds to their expected retirement date. For example, a member who is 30 now and expects to retire when they are around 67 will hold a 2055 Target Date Fund. The fund will automatically switch between different asset classes to reduce risk as the target date approaches.

How can they help members?

Target Date Funds are:

1. Carefully designed, managed and governed by investment professionals.
2. Quick to adapt to changes in regulation, consumer behaviour and market conditions.
3. Simple to communicate to members.
4. More flexible around when a member will retire.

How do Target Date Funds differ to the administration-led lifestyle approach?

Lifestyle Strategy	Target Date Funds	Advantages
Member holds several funds	Member holds a single fund	Simple for members to understand and simple for employers to oversee
Targets a specific retirement date	Groups members into age cohorts	More flexibility around when a member will retire
Administrator switches from fund to fund	Manager switches assets in fund	Quicker, more reliable, lower cost and easier to implement
Asset allocation usually preset	Asset allocation can be dynamic	Asset allocation managed through market, behavioural and regulatory changes
Blackout period may be required if the glide path changes	No administration impact from a glide path change	No administration impact

Members want to keep their retirement options open

42%

Didn't know or wouldn't know until at least two years before retirement.[6]

The investment strategy will take account of how members will access benefits at retirement. Irish legislation allows for members to purchase an annuity, use income drawdown, withdraw a cash lump sum, or a combination of the three.

One option would be to tailor the strategy to the member's preferred or anticipated retirement benefits. In practice, members have relatively little visibility of the choice they will make. In our New Choice, Big Decisions research carried out in the UK over 2015 and 2016, we found that members were uncertain about their retirement options and changed their decisions several times as they approached retirement. Also increasingly, the retirement date will be uncertain; for example, if the mandatory retirement age is abolished and the State pension age is increased. Hence, it is better to have a default design which keeps members' options open and is robust to the uncertainty that we have observed.

[6] Source: SSGA 2016 Retirement Confidence Monitor

Focus should be on value for money rather than lowest cost

Value can be added through diversification and risk management, which may add to costs.

Over time, as scale in DC schemes increases, we would expect fees to come down significantly. In the US, the Target Date Fund market is estimated at $880bn and fees in the region of 0.08% for passive asset management are common.[7]

The UK has less scale than the US and fees for large schemes usually fall far below the cost cap of 0.75%. For example, the average annual management charge for the default funds in schemes within FTSE 100 firms was 0.36% in 2017.[8] The fee level in Ireland will be reflective of the scale in the market and this will change over time as asset sizes grow. It is important for policy-makers to ensure that members are receiving value for money and a cost cap, similar to the one that exists in the UK, is one way of achieving this.

A better measure for defaults is value for money. The default strategy needs to be value for money to deliver good outcomes for members. This need not equate to lowest cost. In many markets, defaults are built using low-cost index-tracking funds as the core. However, the risk/return profile can be improved by broader diversification (e.g. alternative assets — high yield, emerging market debt, real estate and infrastructure securities).

Diversification can include allocations to relatively illiquid real assets, e.g. property, infrastructure, private equity — where members may benefit from an illiquidity premium in returns. While many DC systems have been built on daily fund trading and valuation, there is no need for this and members typically have an horizon long enough to use these illiquid assets. Australian superannuation schemes have used their significant DC scale to pool the units of members' DC funds, providing the capability for illiquid investments. While illiquid investments may not be possible in the early years of the new pension system, we would hope to see product innovation and believe this is something the industry should aspire towards.[9]

There is relatively little active management of defaults, although some markets are seeing greater use of factor-based ‘smart beta’ strategies that move beyond traditional market cap weighted indices to structure portfolios based on factors (value, quality, size) found to improve the risk/return profile of the portfolios.

Some schemes choose to use a more dynamic approach to asset allocation to manage risk for members — the right assets at the right time. This again has potential to raise cost, but with the aim of improving risk-adjusted returns for members.

[7] Source: https://corporate1.morningstar.com/ResearchLibrary/article/803362/2017-target-date-fund-landscape/

[8] Willis Towers Watson FTSE 350 defined contribution pension scheme survey 2017.

[9] Source: https://australiancentre.com.au/publication/australian-superannuation-sector-success-story/

ESG integration is increasingly important in managing long-term risks in defaults

The World Economic Forum predicts that seven of the ten greatest risks facing people, institutions and economies over the next decade will come from threats outside of purely financial categories, such as extreme weather events, water and food crises, and the impact of climate change.[10]

Across the world, many pension scheme providers and sponsors are now giving more attention to Environment, Social and Governance issues in their portfolios.

At the simplest level, this involves asset stewardship - engaging with companies and proxy voting with the aim of improving corporate governance and mitigating environmental and social issues arising in the investee companies' businesses. At a wider level, it involves full integration of ESG issues into analysis of the portfolio investments, excluding or underweighting companies with poor ESG credentials and emphasising companies with better profiles.

Such moves have been encouraged by regulators noting the long-term financial risks created by ESG issues and the fiduciary obligation of scheme sponsors to consider those risks. This is distinct from ethical or values based investing, where exclusions are made on personal ethical preferences rather than risk grounds.

While a key focus of ESG integration is risk management, there are arguments that a good ESG approach in the portfolio can help member engagement, with many members preferring that their investments are used to 'do good' rather than contribute to environmental or social harm.

ESG integration helps manage long-term risks and is usually supported by members. As such, consideration should be given to ESG in default design.

[10] The Global Risks Report 2017, World Economic Forum.

Governance is critical to achieving good member outcomes

Whilst setting a good default is important in achieving good member outcomes, we should expect that things will change over time. For example:

Regulation

- Auto-enrolment will change the pensions landscape in Ireland significantly, which could lead to markedly increased participation and changes in savings rates, pot sizes, product innovation and more.

Member profiles

- Member needs may change over time as people increasingly look to DC as a source of retirement income and focus shifts away from DB.

- Our population is ageing and living longer and therefore we can expect that people will be working longer.

Investment environment

- The investment and economic backdrop will change over time.

In order to cope with these changes and more, it is crucial the default has good ongoing governance. The default needs to evolve to do this. Hence there should be a requirement for regular evidence based reviews of the default, certainly no less than every three years.

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