PENSIONS COUNCIL

Meeting on Thursday, 23 July at 3.00pm

Virtual meeting

Attendance:	Jim Murray (Chair) Joanne Roche Kirstie Flynn Munro O'Dwyer Tim O'Hanrahan Roshin Sen
Apologies:	Brendan Kennedy Stephen Gillick Roma Burke Deirdre Cummins Eoin Dormer
Also present:	Niamh Crowley (Note taker) Brian Purcell
Quorum:	Quorum present 6 of 11 Council Members present (6 required)

Minutes

1. **Adoption of agenda**

The proposed agenda for this meeting was agreed.

2. **Conflict of interest**

No conflicts of interest were declared.

3. **Approval of draft minutes**

Comments on the draft minutes of February 2020 Council meeting to be sent by email the Chairman.

4. **Review of recent developments**

Brian Purcell and Roshin Sen provided an update on the recent developments from DEASP:

- The Programme for Government outlined the new government's pension policy plans.

- The State Pension will remain the bedrock of the Irish pension system.

- The government will establish a Commission on Pensions to examine sustainability and eligibility issues with state pensions and the Social Insurance Fund. The Commission will report by June 2021. The Government will take action having regard to the recommendations of the Commission within 6 months.

- Pending the report of the Commission on Pensions and any subsequent Government decisions on its recommendations, the State Pension age will remain at 66 years and the increase to 67 years will be deferred (i.e. until at least June 2021).

- Introduce a Total Contributions approach, aligning a person's contributory pension more closely with the contributions they make. This will include a provision for credited contributions, ensuring that people who take time off work to care for loved ones are not disadvantaged.

- 65 year olds who are required to or chose to retire early can receive an 'Early Retirement Allowance or Pension' at the same rate as jobseekers benefit.

- Introduce a system to enable people to defer receipt of their state contributory pension on an annual basis, to include actuarial increases in payment as soon as practicable.

- The Minister has been briefed by both the Pensions Policy (Alan Flynn) and AE (Roshin) sections on the plans in relation to the Programme for Government.

- No decisions have been made regarding the composition of the Commission on Pensions or the full details of the issues it will examine

5. Working Groups

A) DC Investment in the context of Automatic Enrolment

Joanne Roche presented her paper outlining the high-level issues that arise when considering the investment of auto-enrolment contributions. Overall, the Council members were in agreement with the main thrust of the paper. Joanne will edit the paper ahead of the next meeting to capture comments made by Council members as part of the wide-ranging discussion on the questions posed therein. Please find draft paper in Appendix 1.

Joanne noted that there are a number of aspects of the auto-enrolment design regime which have as yet not been decided upon which may impact on the investment strategy design, namely decumulation options and the governance structure. As regards governance structure the investment strategy for autoenrollment should be designed with members best interests in mind; hence the governance structure should have little or no effect on the investment strategy.

Question 1 - Should contributors be offered any investment choice?

While a default option would always be necessary, members should ideally have some choice as to how to invest their contributions. Members who have the necessary financial education and skills, to make informed decisions, should be facilitated in exercising choice.

There was overall agreement in favour of offering investment choice to contributors, typically in the range of 5-7 funds.

Munro O'Dwyer noted that it would be worthwhile emphasising in the paper that the Auto-enrolment system will be introduced into the prevailing pension environment in 2022/2023 which may look somewhat different to the current landscape given plans for the proliferation of master trusts. The transposition of IORP II is expected to result in the consolidation of many of our existing schemes into small number of Master Trusts. Roshin added that unless something is done, pension coverage will not increase, which is why they have introduced the AE awareness campaign.

It was also noted that the default option must be appropriate, and they are not defaulting people into pension funds they are not happy with.

Question 2 - If there is a default investment option and a number of fund options, what approximate default investment participation would be good?

Joanne explained that it is likely that the vast majority of individuals being automatically enrolled will remain in the default option, adding that the IAPF DC Scheme Survey published in April 2020, the percentage of members using the default option has risen materially since their last survey in 2017 from 70% to 80%.

The Council were in agreement that the majority of members will probably opt for the default option (or not opt for any other option) and the design, governance and communication of the default option will play an important role in securing good outcomes for members.

Question 3 - How wide an investment choice should participants be offered? How should the fund options differ from each other?

This question was not discussed.

Question 4 - In either the default or the optional funds, should there be investment return guarantees?

It was noted that guarantees come with a high price in terms of forsaken return, and potential state liability. A fund with a full guarantee would have difficulty in meeting the adequacy requirements in terms of future income. While not favouring a guarantee as such it was suggested that there could be merit in looking at a scheme to protect members' contributions or savings.

The current situation of the Covid 19 pandemic and its effect on markets was discussed in the context of guarantees. It was suggested that contributors must be reminded that pensions are long term investments and should avoid making decisions based on sudden market downturns.)

Question 5 - In the default investment, should the level of investment risk reduce as the participant gets older? If so, when and how quickly?

Joanne discussed the lifestyle structure which de-risks as a member approaches retirement, allowing for growth of risky assets in early and mid-career and de-risk as individuals approach retirement. Joanne added that an alternative approach that could be considered would be a “smoothed” fund which could continue into the decumulation phase.

There was broad agreement that the lifestyle structure is the most appropriate for the default investment. Tim Hanrahan mentioned Target date funds which are a subset of the range of lifestyle and Joanne agreed to amend the paper to include additional detail on some of the lifestyle variants including target date funds. In the ensuing discussion, members agreed that the ‘when’ and ‘how quickly’ investment risk is reduced could be left to the providers to decide.

Question 6 - The UK NEST auto-enrolment default fund aims to minimise risk in the first year of membership. Should an Irish AE adopt a similar approach? Are there any other approaches to risk targets that should be considered?

Members broadly concurred with the points made in the draft paper produced by the AE working group.

Question 7 - What should be the risk/return objective(s) for any default fund(s)?

Members broadly concurred with the points made in the draft paper produced by the AE working group.

Question 8 - How can investment risk be communicated to participants?

Joanne acknowledged the challenges of communicating investment risk even for experienced investors. However, the target for AE is those who have no existing pension provision and may have little prior investment experience.

It was suggested that risk indicators, for example, low risk through medium and high risk must accurately describes the fund and its inherent riskiness, as some people make their decision purely on this indicator.

A simple scenario analysis was also suggested i.e. favourable scenario and unfavourable, exploring three scenarios max.

B) Pension Scheme Consolidation

Munro O’Dwyer presented an introductory paper on pension scheme consolidation which explores the rationale for consolidation, the challenges to consolidation, the current consolidation process and a summary of the UK position in relation to DC consolidation.

Munro explored the two main objectives for scheme consolidation

1) Scheme members should benefit from the economies of scale available to larger schemes.
2) It is very difficult to regulate the large number of schemes.

Pension scheme consolidation will be driven by the requirements of the IORP II Directive and the resultant shift towards large schemes and master trusts (including AE). Increased IORP II governance standards and plans to introduce new powers for the Pensions Authority will assist the consolidation process.

Munro provided a summary of the main challenges to consolidation:

1) It is likely that the efficiency gains will be overestimated - in the short term there will be complications around the move to a single client to a “multi-client” model
2) Governance will take a period of time to settle down - the role of the Trustee (and their independence from the administration / investment providers); the balance between internal and external expertise; the regulatory approach (versus single employer schemes)

Munro informed the Council of the view taken in the UK that by enabling smaller schemes to exit the market or consolidate and improving bulk transfer arrangements should help scale to develop.
In his view, the statutory rules for making bulk transfers without consent were both difficult to apply and serve no useful purpose in the DC context. The UK Government therefore proposed to simplify the process for transfers between “pure” occupational DC schemes with a view to reducing complexity and removing a key obstacle to DC scheme consolidation.

In the ensuing discussion, a suggestion was made to include a section on small self-directed schemes and whether there is a place in market for people who wish to make unusual investment choices. Although it was noted that self-directed schemes could be subject to IORP II, this has yet to be transposed.

Munro O’Dwyer gave an overview of the main reasons outlined on page 4 of why the current consolidation process is not fit for purpose.

Rather than argue over this or that element of the current regulation, the Chairman suggested the paper should start with an empty page, so to speak, and outline the regulations that would be needed to facilitate and regulate consolidation.

Munro and Kirstie will edit the paper ahead of the next meeting to capture comments made by Council members.

C) Future of Funded DB schemes
This item was not discussed.

D) Recent Market movements
This item was not discussed.

6. Next Meeting

Chairman, Jim Murray to circulate a proposed meeting date for August and September.

Appendix 1

Auto-enrolment and investment 22 July 2020

Introduction

In this note we have set out at a high level the issues that arise in considering the investment of auto-enrolment contributions.

We have framed our responses cognisant of the existing pension landscape in Ireland and referring to existing investment requirements and guidelines for occupational pension schemes and to relevant aspects from the debate around the design of the new 'PEPP' Pan European personal pension product. We have referred to the 2015 publication from the Pensions Authority entitled 'investment guidelines for trustees of defined contribution schemes', many aspects of which will also be relevant to the debate on what choices should be made available to an AE investor.

The key difference between AE investors and those investing in the existing regime is that the employer of the AE investor has not yet had an opportunity to make a pension saving vehicle available either through affordability considerations, inertia, or some other reason and will now be required to 'auto-enrol' employees in a pension arrangement. The Government is playing an an increased role in auto-enrolment requirements and design and for that reason it could be perceived that it has a greater level of responsibility for the permissible range of investment choices as compared with traditional occupational schemes such that these are in members' best interests.

There are a number of aspects of the AE design regime which have as yet not been decided upon which may impact on the investment strategy design:

(i) **Decumulation options** – whether options would be as per the existing regime which allow a combination of (a) tax free lump sum and annuity or (b) tax free lump sum and ARF or (c) where the pot is below certain thresholds which are service/salary related a tax free lump sum only.

There are also other decumulation options which may be relevant to AE either at outset or in the future such as drawdown vehicles similar to the current ARF option but which allow for pooling of the mortality risk (which would deliver a certain level of pension on a 'best endeavours' basis), or state backed annuities (which would guarantee a given level of pension) albeit with the state acting as guarantor rather than an insurance company. The former option whereby mortality risk is pooled such that a given amount of pension income is provided on a 'best endeavours' basis (but not guaranteed per se) looks to be the more viable of these two options. We discuss the impact that decumulation options would have on any life-styling strategy 'landing point' in this paper.

(ii) **The governance structure** - which as per the Strawman document could take the form of a master trust structure or a contract-based structure. In the master trust structure (as with any occupational pension scheme trust structure), it is the trustees who have responsibility for managing and overseeing the proper investment of the scheme assets. With the contract-based structure, potentially an independent oversight governance committee would have responsibility for performing that same role.

We believe the optimal investment strategy should be designed to be in the best interest of members and therefore decided independent of whichever governance structure is adopted. However, where the Auto-enrolment system takes the form of a master trust structure than it could be deemed to fall within the definition of an 'IORP' which would mean it would be subject to the investment provisions in that area. For any master trust and even more pertinently the AE system the level of governance expected of the trustees will be higher than a typical occupational scheme given the larger membership and higher risks involved.

Diverse range of views

We are conscious from that responses to the AE consultation that there is a wide divergence of views as to the default investment option in particular. There is intense debate as to whether the default fund should be a low return option such as a cash / bond fund or even provide some level of 'guarantee' or a fund which allows a greater level of return over the long term but with the investor experiencing volatility risk over the investment time horizon.

The PEPP consultation which reflected debate on this point between insurers (who were in favour of investment guarantees) and assets managers (who were not) finally allowed for the concept of a 'basic PEPP' and 'alternative PEPP'.

Although under the PEPP regulations, it will be for providers to ultimately choose whether the 'Basic PEPP' they offer will provide a 'guarantee' per se or a fund which has a 'risk mitigation technique in place consistent with the objective of allowing the PEPP saver to recoup the capital investment. One of the risk mitigation techniques likely to be adopted will be a life-cycling approach which gradually reallocates monies from equities/other growth assets into bonds/cash in the last few years before retirement (up to 10 years prior) such that by retirement age virtually 100% of the fund will be bond/cash invested.

Investors have the option to make a choice between providers and then between each provider's 'basic PEPP' and 'alternative investment options'. PEPP providers may offer up to 6 investment options. The investment options shall include the basic PEPP and may include alternative investment options.

Respective role of the Government / Trustees/ Providers when it comes to investment strategy and choice?

Under the existing pension landscape and the envisaged auto-enrolment regime there will be a number of different stakeholders involved in the provision of investment fund choices:

- The role played by the Government / policymakers in setting the high-level investment objectives;
- the role played by trustees / investment oversight governance committee of the Auto-enrolment system in making specific fund choices available;
- the role played by individual providers in designing, packaging, labelling and communicating their investment options.

It may that there are clear guideposts set out for plan trustees and fiduciaries in light of the objectives[1] of AE of providing for the retirement security and adequacy for Irish workers. These guideposts may potentially make reference to how the funds and default funds may be structured at a high level in order best meet the AE objectives. They may also refer to recent trends such as those involving environmental, social and governance (ESG) investing. The PEPP for example refers to xxx

While many of the scheme's activities, such as administration and investment management, may be outsourced to the providers, the trustees / oversight governance committee as appropriate depending on the structure remain responsible for those activities and their governance systems must ensure proper oversight.

1 Should contributors be offered any investment choice?

We are conscious of the fact that auto-enrolment will sit within the existing pension framework and landscape. For some individuals there will be choice between setting up a pension under the existing

[1] Per the strawman the objective of the auto-enrolment system is that the level of contributions made by members should be sufficient to yield a reasonable income replacement rate in retirement (when taken together with the state pension

occupational pension scheme or personal pension framework and the associated choices and options or being auto-enrolled into the new AE framework.

Where choices and options in the auto-enrolment system are restricted or constrained as compared with the existing pension options our view is that would need to be a strong rationale to do so.

The Pensions Authority's Investment guidelines for trustees of defined contribution schemes sets out arguments for why contributors should be offered investment choice. In our view these same arguments could apply to contributors under the AE system:

1. Members are investing their own money and are bearing the associated investment risk and, as such, should ideally have some choice as to how to invest their contributions.
2. Some members may have the necessary financial education and skills, tools and time to make informed decisions and should be facilitated in exercising choice.
3. As the trustees / investment oversight committee will generally not be familiar with the financial resources and circumstances of their members, or of their preferences or risk tolerance generally, they may not be positioned to make a well-informed or appropriate choice on members' behalf.

Notwithstanding the above, where DC members are entitled to choose their investments, the evidence from Ireland and elsewhere is that most plan members invest through a default investment strategy. The design and selection of the default strategy is therefore a key issue.

We consider further what range of choice should be made available at question 3. In broad terms we believe a choice of c5 – 7 funds would be optimal. Two few choices and members will not be in a position to mitigate some of the investment risks which they will be exposed to in trying to achieve an adequate pension income whereas too many choices may confuse members and make it more difficult to make a choice.

2 If there is a default investment option and a number of fund options, what approximate default investment participation would be good?

Overall it is likely that the vast majority of individuals being automatically enrolled will remain in the default option. Therefore, the design, governance and communication of the default option will play an important role in securing good outcomes for members.In practice as has been seen with current occupational defined contribution schemes both here and abroad the majority of contributors will 'select' / remain in the default option. Per the IAPF DC Scheme Survey published in April 2020[2] the percentage of members using the default option has risen materially since their last survey in 2017 from 70% to 80%.

Marginally more individuals may select an alternative option where communications are well designed and engaging and where contributors perceive that an option other than the default is more appropriate to their circumstances.

Per scheme return data compiled by the Pensions Regulator in the UK[3] 95% of members of DC schemes with 12 or more members are invested in the scheme's default strategy.

Similar statistics prevail in other countries.

In terms of what 'good' looks like, a high proportion remaining in a well-designed default fund would be a positive feature of the AE system. Such a default fund would be a best in class fund and offer excellent value for money. The fund should be designed to achieve the AE objectives (also cognisant of the level of anticipated contributions as investment returns on their own will not generate an adequate retirement income), whilst helping individuals mitigate the key risks they would otherwise be

[2] The IAPF Survey covered 64,848 active members and 27,594 deferred members
3 https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-presentation-of-scheme-return-data-2018-2019

exposed to over a long time horizon. These investment risks are described in detail in section 3 of the Pensions Authority's 'Investment Guidelines for trustees of defined contribution schemes'.

Given that under the strawman there are expected to be four different providers under the AE system with four different default funds varying across a number of dimensions, it may be however that performance does vary significantly across the four. To mitigate the risks associated with this and to encourage competition amongst the four, we suggest that employers have a role in 'recommending' its preferred provider to those of its employees unable or unwilling to make a choice.

3 How wide an investment choice should participants be offered? How should the fund options differ from each other? Possible options include

- Ethical/Sharia funds
- Investment manager choice
- Sector specific (such as equities, bonds, property, etc.; geographical choices could also be offered
- Different levels of risk/return trade-off

Text on this topic from the Pensions Authority investment guidelines for DC schemes is below which we believe should equally apply to AE investors.

'In deciding how many other investment options to make available to scheme members, trustees should aim to ensure that the suite of funds offered enables members to protect themselves from the various investment risks identified in section 3. This means that the funds offered should cover a range of risks including the main asset classes (equities, bonds, property and cash) or the offering could be a suite of managed funds from lower to higher risk. This would suggest a choice of between 5 to 7 funds (although the optimum number will differ from scheme to scheme). If too few funds are offered, there is a danger that some investment risks are not "covered off"; on the other hand offering more funds may simply serve to confuse members and make it more difficult for them to make a choice. There is no "right answer" as to the optimum choice.'

Providers should also be required to offer a lower return fund which could be 100% cash, or might have some exposure to bonds, including inflation linked bonds. This fund should be labelled 'Low Return' (as opposed to low risk) to avoid members opting into this without understanding the potential consequences.

In addition, providers should offer a higher risk fund, which might have 100% equity exposure, and should be labelled 'High Risk'.

Sustainability / ESG considerations

We believe it is worth considering integration of a sustainable investment approach for all funds in the AE System.

The general consensus is that over time the world will need to transition to a more sustainable, efficient, socially focused, low carbon economy. In this scenario, both sustainable assets, as well as companies considering sustainability, may possibly outperform other alternative investment options in the long term, and so may better serve investors and individuals with longer time horizons.

We suggest that the registration process and criteria to approve Registered Providers to the AE System may be the most efficient mechanism to implementing any proposed sustainable investment approach.

4. In either the default or the optional funds, should there be investment return guarantees?

Guarantees typically come with a high price in terms of forsaken return. Given the objective that the AE system will provide an adequate retirement income we believe that a return without a guarantee would provide the greatest likelihood of allowing contributors to, coupled with the contribution requirements, satisfy the adequacy objective.

An obligation to provide a financial guarantee would lead to investment into traditional assets, such as government bonds and bank deposits, leading to relatively low returns, especially in a low interest rate environment. A financial guarantee could also create a significant barrier to entry as only some providers (non-insurance companies) would be able to offer such guarantees.

In Ireland consumers typically do not opt for guarantees and guarantees have not been a prominent feature of the pension landscape for many years.

Where a guarantee is to be provided some additional details would need to be worked through:

For example, if a guarantee is provided and the benefit of the guarantee is applied to the saver at the point of switching (rather than one that was only available at a known retirement date) this would be expected to increase the complexity and expense of providing the guarantee. The requirement to provide capital protection at each potential future switching date which cannot be known in advance (effectively daily capital protection on the option of the saver) would limit the investment options open to the saver and lead to a short-term focus. This constraint on the ability to take a long-term approach to investing could lead to sub-optimal investment returns while providing limited additional protection to the saver (as the guarantee would need to be available on a daily basis for all savers but for the majority of savers would only be required at retirement).

If the guarantee is available on switching this could lead to savers selecting against the provider by switching out of the provider immediately following a fall in investment markets. To mitigate this lapse risk, the provider would need to adopt a conservative short-term investment strategy, which may unnecessarily constraint the investment return available to the saver.

Alternatively, where a product includes capital protection, but only on retirement, and the current market value of the saver's assets is lower than the capital protection value, the saver would be unable to switch, as they would lose the protection of the guarantee and only receive the current market value.

5. In the default investment, should the level of investment risk reduce as the participant gets older? If so, when and how quickly?

The answer to this question depends in part in what decumulation options are available to AE investors in retirement. For now, we have assumed that the decumulation options will be the same as those prevailing for defined contribution schemes ie tax free lump sum (of up to 1.5 times final remuneration) and annuity or tax free sum (up to 25% of the fund) and ARF.

We consider that an appropriate structure would be a lifestyle structure which de-risks as a member approaches retirement. In this case, careful consideration must be given to

- the period over which the funds de-risk and
- the landing point i.e. the target asset allocation at retirement date should be appropriate for the drawdown approach that the member is likely to choose for the payment of benefits in the decumulation phase.

An alternative approach that could be considered would be a "smoothed" fund which could continue into the decumulation phase.

Lifestyle funds seem to work well as a strategy. At a high level allow for growth risky assets in early and mid career and de-risk as individuals approach retirement.

Some facts about life-cycle strategies

- The glide path along with the asset allocation becomes less risky over time, is a key risk-mitigation technique
- The very essence of life-cycle strategies is to generate superiors returns at comparatively low risk over a long investment horizon, compared to strategies featuring guarantees
- Taking investment risk is usually rewarded in the long term and retirement saving typically has a long-term investment horizon
- Younger investors generally have much greater flexibility (time) to recover from negative market outcomes than those nearer retirement
- Regular rebalancing of the portfolio is also a key mechanism to manage investment risk

No 'one-size-fits-all' glide path: The optimal glide path depends on different factors specific to each saver, including the form of out-payments available.

In this context, the customer should be able to place reliance on the effectiveness of the life-cycling techniques underpinning the default option for each provider to minimise downside risk, which in turn places responsibility on Government / the Pensions Authority as appropriate ensure that these life-cycling techniques are robust.

It is logical to reduce the risk as members get older in order to consolidate gains made over a long investment time horizon and to minimise further volatility risk but then 'when' and 'how quickly' should ultimately be left to providers to decide as these may be unique features of their life-cycling strategies.

Stochastic modelling could be used by the overseeing body e.g. the Pensions Authority or the Government as appropriate to assess whether the proposed investment strategy is risk mitigating.

6. The UK NEST auto-enrolment default fund aims to minimise risk in the first year of membership. Should an Irish AE adopt a similar approach? Are there any other approaches to risk targets that should be considered?

The approach taken seems to work well in the UK in terms of encouraging behaviour. The low return represents only 1 year of many years' for investment returns (e.g. an individual becoming auto-enrolled at 23 has 45 years worth of contributions and investment years to enjoy before anticipated state pension age of 68).We suggest going even further and that consideration be given to using a cash fund, or other low return fund, for the investment of contributions paid in the first two or three years of AE to minimise the risk that members see a significant fall in the value soon after enrolling.

7 What should be the risk/return objective(s) for any default fund(s)?

A useful start point for this discussion might be EIOPA's suggestion of a number of possible retirement objectives for the PEPP

- To recoup the capital invested (less costs and charges)
- To protect against inflation i.e. to recoup the capital invested plus inflationary growth
- "*to reach a high probability of recouping the inflation-protected capital and to have a good chance to earning additional investment returns and stable future retirement income*"

We would expect that an objective which promised (even if this "promise" fell short of a guarantee) downside protection plus adequate and stable retirement income would be well received. In order to provide an adequate retirement income, it is necessary to pay an appropriate level of contributions; the investment strategy alone cannot deliver this. A consumer testing exercise could help to identify what retirement objective is favoured by consumers / future AE enrolees.

What risk is being mitigated and what can impact it?

There are various potential options as to the risk that is to be mitigated, e.g

i) Return of capital in nominal terms
ii) Return of capital in real terms
iii) Return such that the fund can purchase a minimal level of income
iv) Return such that the fund can meet a minimal level of income through phased withdrawal/drawdown

In turn each of the above can be impacted by market risk (volatility), credit risk (risk of default) and liquidity risk (which can impact ability to pay out).

However, we believe that mitigation any of the above risks has merit and it should be permitted for providers to design solutions that mitigate any of these risks. Referring to the communications section below (question 8) the important element is that the auto-enrolled member is effectively informed of which of these risks is being mitigated and how effective the risk mitigation technique (of which life-styling is one) is in doing so.

Given the likelihood that the vast majority of members will be invested in the default investment strategy, we believe that this strategy should be designed to do the following:

- Provide exposure to asset classes that can be expected to generate a reasonable level of return over the long term to provide adequacy in retirement
- Reduce risk by diversifying investment across asset classes
- Be transparent and simple for the members to understand
- Build confidence in the system initially, given that most people will not have been in a pension scheme before
- Be liquid, equitable and flexible i.e. if an individual consumer, or the Government, wants to switch to another fund, this should be possible.

8. How can investment risk be communicated to participants

We note that the communication of investment risk is a challenging even for experienced investors. We are conscious that the target for AE is those who have no existing pension provision and may have little prior investment experience.

Having identified the main risk as 'retirement shortfall' (however defined), we support the need to inform the consumer of the merits (and potential downsides) of investing in real assets. We do not think that the AE investor would or should need to understand the concept of stochastic modelling to be able to understand the illustrated dispersion of returns. As pension savings including the AE system are for the long-term, it is important to ensure that the approach adopted to the presentation of information recognises that long term investment strategy, outcomes and risks are more important than the short term.

Illustrative scenarios – central / favourable / unfavourable

It would be useful for example to illustrate to AE investors potential variability by illustrating say 3 sample scenarios be shown i.e. including a 'favourable' scenario as well as the 'central / median' and 'unfavourable' scenario.

A method of presentation will need to be found which illustrates the trade-off between risk and reward, whilst making it clear to the consumer that unless there is a guarantee of a return of capital at retirement (and we are not recommending same – see question 4), it is possible (with a small probability, although AE investors may not have a proper understanding of this concept) that he or she will lose money.

Whitelabelling and risk indicators

It will be important to label the funds and give them a label which as accurately as possible describes the fund and its inherent riskiness.

Funds are generally presented on the basis of a risk categorisation with funds labelled on a continuum ranging from, for example, low risk through medium and high risk.

Another commonly used approach is a numerical risk/reward rating schema where, for example, funds regarded as low risk are rated 1, medium risk funds as 3 and high risk funds as 5.

- We recommend that funds that invest 100% in cash should be referred to as 'Low Return'
- For funds that do not invest 100% in cash, we recommend that the AE system should adopt an approach consistent with the wider retirement savings market, e.g. ESMA ratings, where volatility is used as a measure of risk levels. Under this:
    - The fund described as 'moderate' risk in the Strawman would typically be 'Medium to High' risk.
    - The equity fund described in the Strawman as 'medium' risk would typically be 'High' risk.

We consider that any risk indicator attached to a given investment option should focus on the long-term investment risk, and the illustration of the dispersion of the expected outcomes will illustrate the likelihood of a shortfall relative to the expected/desired retirement income.

Layering

One of the challenges within communication are the range of stakeholders that will be recipients of the information, e.g. AE investors, advisers, regulators. Each different type of stakeholder might be expected to have different levels of understanding of pensions and financial products and also have different purposes for the information.

EIOPA has recently been advocating a layering approach to communications, and this type of layering approach being adopted for the communication of investment risk to investors on the one hand and to the regulatory authorities on the other is likely to be required.

For example, in describing the level of risk attached to a particular lifecycling strategy the Pensions Authority / Government and advisors may be interested in seeing the detailed methodology and assumptions used to assess the risk and in being provided with some statistical output (e.g. means, variances, distribution functions) that measure the risk. In contrast it may be more appropriate to provide AE investors with some simpler form of presentation which help a consumer better understand the risk.

Investment guidelines for DC investors

Section 8 of the investment guidelines for DC investors covers the topic of communication of detail with some of the key points being:

- The provision of independent financial advice is subject to legal regulation and can only be provided by individuals approved by the Central Bank of Ireland
- However trustees (or governance committee as appropriate for the AE system) can provide members of schemes with useful information including explaining the different characteristics and level of risks of the investment choices available
- They can provide general investment information to members of the scheme and can explain to members about risk tolerance and what investment choices might suit different situations. Trustees need to avoid however making specific recommendations to members.

In practice we see the providers taking responsibility for the types of communications and marketing material on investment risk (and indeed wider matters) which we observe being rolled out for larger occupational schemes reflecting expertise from a number of areas including hard sciences and softer sciences:

- Deep pension product, taxation, inheritance and actuarial expertise;
- Behavioural science;
- Learning styles;
- Video learning, traditional written, and design work;
- Web design, email design;
- Engagement tools and games

From what we observe three engagement overlays tend to work really well:

- **More channels – e.g. watch, play, read**
  Because everyone learns differently, whether it is through watching videos, playing with tools or reading documents, providing communications in a variety of formats to cater for all needs.
- **Behavioural economics**
  By understanding how we, as humans, make decisions and what the hurdles are to prevent decision making, communications can be designed to increase member engagement.
- **Consumer grade communication –** which involves making a difference with document sizes, colour coding, fonts and envelopes.
  Using retail and direct marketing research and techniques, communications can increase engagement, from pack size to envelope colour, it all makes a difference

Independent financial advice?

Some employers in occupational pension schemes arrange for financial advice to be provided to employees and where this is not available trustees are expected to point out to members that such advice would be useful particularly in the years approaching retirement.

There will be a number of key life-stages when AE investors could benefit from solid independent advice e.g. at point of retirement (to distinguish between the different drawdown options and providers and decide which best suits their needs). In the few years leading up to retirement AE investors may wish to take a more active role in deciding investment strategy (having taken some form of independent advice) or at a minimum indicating which drawdown option they are likely to take and inform their provider of same so that the correct de-risking mechanism in the lifestyling strategy can be triggered to target the correct 'landing point'.

Given the relative immaturity of the ARF market and associated advice propositions to date and given the scarcity of available truly independent financial advice on investment risk / return, there is an opportunity to develop and roll out high quality, low cost advice to the mass market. This could be done through an independent state sponsored body such as the Citizens Information Board. There may also be a case for the incorporation of robotic process automation ('RPA') in any advice solution capturing processes currently undertaken by qualified financial advisors ('QFAs') and 'best in class' pension advice.