MOODY'S ANALYTICS

Embedding a "Best Practice" investment governance process into DC pensions

The growth of defined contribution (DC) as the core retirement savings vehicle has created new governance challenges for employers, advisors and product providers. Fundamental to this is the need for DC savers to achieve required retirement outcomes in the face of increasing exposure to the risks of longevity, inflation, and volatile markets.

With auto-enrolment and the introduction of default investment options, this governance challenge takes on a new dimension. Clearer regulatory guidance on DC governance[1] (TPR) and investment suitability[2] (FCA) means that strong governance and member engagement have become "must haves" in any provider selection process.

Meeting the Pension Regulator's design and governance requirements

The Pension Regulator's **Investment Governance Group** (IGG) have laid out principles for the design and governance for default funds. Compliance with these principles requires "clearly defined strategic objectives for the default strategy in terms of the levels of risk and returns inherent in *achieving the desired outcomes for members*".

The IGG's principles list factors to be accounted for in the design of the default:

- risk and return
- position in relation to all other investment options
- members' expected term to retirement
- expected format and structure of retirement benefits

The B&H Retirement Risk Dashboard

A stochastic projection of potential retirement outcomes provides a concrete framework to align default options with defined risk and return targets, set according to member profiles and target retirement income levels. Trustees and Scheme Sponsors can use this information to assist their understanding and compare default asset class options. Relying on asset volatility alone as a basis for setting the risk profile of a default option is unlikely to be valid for pension scheme default options—particularly for members approaching retirement.

Modelling assumptions are updated quarterly, based on economic research and market data, allowing clients to monitor the suitability of their default investment.

Retirement Risk Dashboard:

	Target Date Fund (1)	Target Date Fund (2)	Lifestyle Option	Cautious Fund	Balanced Managed
Growth Phase (> 10 Years to Retirement)					
- Potential Loss (1 Year)	-20%	-12%	-18%	-10%	-16%
- Potential Loss (Real Fund Value, 10 Years)	-31%	-17%	-24%	-10%	-22%
- Expected Growth (Real Terms, 10 Years)	35%	12%	21%	6%	24%
Transition Phase (< 10 Years to Retirement)					
- Potential Loss in Projected Income (10 Years to Retirement)	-25%	-14%	-20%	-7%	-18%
- Potential Loss in Projected Income (5 Years to Retirement)	-20%	-9%	-15%	-10%	-18%
- Potential Loss in Projected Income (1 Year to Retirement)	-18%	-5%	-11%	-13%	-18%
Retirement Income Phase					
- Longevity Risk: Sustainable Retirement Income Term (Years)	15.5	13.7	14.2	13.8	16.7
- Market Risk: Potential Loss in Sustainable Income (£ pa)	-17%	-5%	-9%	-13%	-18%

1. "Principles for investment governance of work-based DC pension schemes", Investment Governance Group, 2010
2. FSA Finalised Guidance 11/05, "Assessing Suitability", March 2011

Monitoring fund panels and bespoke default options

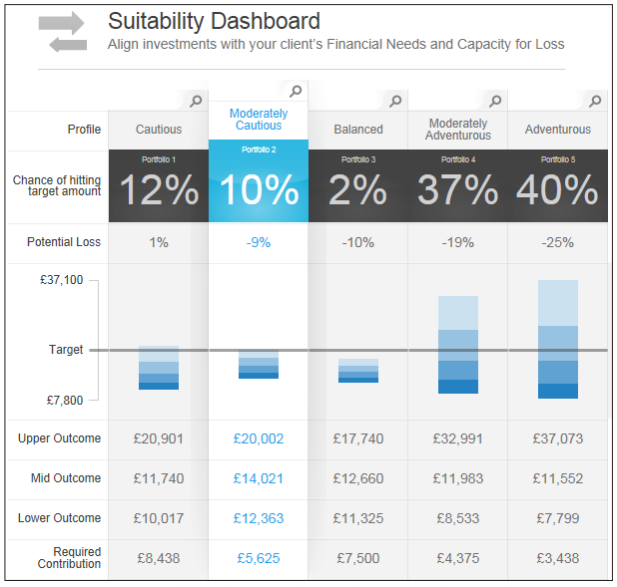
Members can usually choose from a range of investment funds aligned with their attitude to risk, term to retirement, etc. Pension providers and advisors use the Risk Dashboard to quantify and compare risk and return across a range of asset classes which can include target date funds, or products with some form of guarantee. This quantitative assessment can be used alongside an investor risk profiling tool, to assist members to choose funds matching their risk profile.

Similarly, where an advisor has implemented a 'bespoke' default, distinct funds or glide-path profile, the scheme provider the Risk Dashboard can assist to quantify the level of risk in this bespoke default, to align this with their own risk-graded funds. This is particularly important in contract-based DC where no on-going relationship may exist between the employer and the advisor.

Member engagement and communication

Most leading providers offer a range of web-based member engagement tools: risk profiling, stochastic outcome projection, retirement budgeting, etc. While these tools act as important points of differentiation, they are also fundamental to good governance for a DC scheme. It is through this engagement that individual DC savers can choose the default in relation to their own financial needs, and understand how this fund might achieve their desired retirement outcomes.

B&H stochastic modelling solutions assist a wide range of member engagement and financial planning tools



Modelling by Moody's Analytics, Visualization by SAMmedia

Risk management: good governance for DC pensions

There remains wide variation in the quality of governance underpinning defined contribution pension schemes. The focus on defined benefit funding levels means DC scheme governance has been low priority. DC savers remain exposed to risks mismatched with their expectations, or invested in assets unlikely to deliver reasonable retirement outcomes.

Understanding the relationship between risk and retirement outcomes is fundamental to good governance for DC schemes. Scenario-based stochastic modelling captures the key risks facing DC savers and provides a rigorous framework to align asset class options with risk-return targets and likely retirement outcomes. This outcome-based risk management framework has become a key element of governance and member communications for leading UK DC pension providers and advisors.

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