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Automatic Enrolment Programme Management
Office Pensions Policy
Department of Employment Affairs and Social Protection
Floor 1 Áras Mhic Dhiarmada
Store Street
Dublin 1
D01 WY03

4 November 2018

Dear Sir/Madam

Please find herewith a submission from CFA (Chartered Financial Analyst®) Society Ireland, the Irish chapter of the CFA Institute. Our mission is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. We represent almost 600 members in Ireland while CFA Institute represents over 150,000 members worldwide in over 140 countries.

We commend the Minister and Department of Employment Affairs and Social Protection on the proposed introduction of an auto enrolment (AE) element to the state retirement savings system. It has been proven elsewhere to help citizens save towards a better retirement. We have focused our responses on our area of expertise and would welcome the opportunity to offer our help to the Department as it further considers these complex issues. A solid foundation which breeds confidence in the underlying savers is critical to the long term success of the program.

Around the world, a lot of effort has been exerted into increasing retirement savings by choice architecture, effectively to "nudge" non-savers into saving. Some great work on this was done by Thaler and Sunstein in their book Nudge (2008) and AE is a prominent feature of choice architecture which serves to increase participation in defined contribution schemes wherever it is implemented.

People are extremely difficult to engage on the topic of pensions, even their own pension. AE is an excellent first step in nudging behaviour in the right direction However, that same indifference of individual savers towards pensions places a much greater level of responsibility on the Department to put the right system and structures in place that will bolster and drive confidence in individuals' long term savings experience.

There are four areas in particular we would like to comment on:

1. The fund choices available to members (of which the default fund will be one),
2. The fee cap proposed
3. The proposed structure
4. The need for individual investment advice.

1. Standard Choice Savings Products: low, moderate and medium risk

We would encourage the Department to reconsider how they are defining risk (or at least consider the use of the term in communications with members). The terminology above suggests the Department's definition of risk focuses on 'market risk'. We would suggest that in constructing an automatic enrolment programme, 'longevity risk[1]' should be the AE programme designer's primary focus[2]. Longevity risk and retirement savings adequacy are inextricably linked.

The primary risk faced by defined contribution pension savers today (including AE programme participants), is not having enough money to (1) firstly retire and (2) to adequately support themselves once they have retired. For most, this results from a combination of (1) not saving enough and/or (2) their retirement savings not producing a sufficient return after costs (or net return). The "how much to save" question is a multi-faceted one based on an individual's attitude to investment risk, when one starts saving, when one expects to retire and how long one expects to live in retirement. The "sufficient net return" question is equally as complex, and influenced by what assets you are invested in, how the market performs over one's saving lifetime and the costs of the investment products. What we do know is that members who are furthest from retirement have time on their side and a greater ability to take risk.

These younger members could be placed in "higher risk/higher return seeking" assets as they will have a number of investment factors working in their favour:

(1) when they have the highest allocation to risk assets they are a long way to retirement and so markets have time to recover if they do fall (and they are likely to during everyone's lifetime);

(2) during the early years members are most likely to have lower levels of capital saved and so ongoing monthly contributions will have a greater impact (i.e. if markets do fall, members will be investing their monthly contributions at lower price levels);

(3) members are more likely to benefit greater from the power of compounding – higher expected returns for a longer period;

(4) Some higher risk/higher return seeking options (e.g. passive equities) have very low costs, sometimes even cheaper than cash and;

(5) The member's retirement savings could then be migrated to a lower risk/lower return focused investment as the member approaches retirement and may want to embrace a more conservative investment approach.

This approach allows a much more personalised saving and investment journey built around each individual.

2. Target Annual Management & Investment Charges

Fund management charges are a guaranteed subtraction to any return stream. They are the only known when it comes to predicting how your investments will grow or fall into

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[1] The risk that as individuals live longer they will outlive their retirement savings.

[2] after increasing coverage which they will achieve by introducing the auto enrolment programme.

the future. This obviously makes them critically important and careful attention must be paid to minimise them but they are not the only consideration (see point 3 in the "Ten Principles for an Ideal Retirement System" developed by the CFA Institute and Mercer in the Appendix). Construction of a sound well diversified portfolio, robust against all market environments with reasonable forward looking return expectations may be challenging with a fee cap of 0.5%. What is important to members in the end is the net (after cost) return they earn. A fee cap should not hinder the ability to earn return or impact on the ability for sound portfolio optimisation/management through optimal diversification.

There are generally two very broad types of investments, passive and active. Passive investments (such as an index funds) focus on buying broad market exposure passively and can be accessed very cheaply. Active investment management is where a fund manager uses his/her investment skill to try and generate an investment return that is 'better' and 'different' than the market. Better can come in different forms; it often means 'higher' returns for similar risk (or similar returns for lower risk), but it can also mean a 'different type of return' such as the one you get from investing in assets like property, forestry, infrastructure, private debt and private equity. These investments are often referred to as 'alternatives' and you cannot typically access them passively. Diversity in a portfolio is important as the different investments behave differently in different market conditions. Active management is dearer to access than passive management. However, it can at times offer diversification from traditional asset classes such as equities and bonds which reduces drawdowns (or falls). An example of this is forestry as an asset class where trees typically grow 1-2% each year regardless of the performance of the stock market. DC investors are the last of the long term investors and as long term investors, they can take some illiquidity risk.

A fee cap sends a message to prospective managers but it could inadvertently exclude a significant number of underlying asset classes. If a fee cap is to be implemented, it should be done at the scheme level (rather than individual funds / products in the wrapper) to allow sufficient flexibility and product access. Many assets such as property, infrastructure and other illiquid assets can marry nicely with the needs of retirement savers and the consequences of parameters should be carefully considered before they are set.

Defined contribution funds are beginning to mature in Ireland today and are now using their experience to venture into non-standard/alternative assets (i.e. investing outside of equities and bonds). As noted above, these new assets bring diversification benefits to members, producing a likely smoother sequence of returns by not needing an over-reliance on equities to meet long term return requirements. A lack of diversification results in more volatile returns. An unintended consequence of this may be disengagement by members with the risk of a reduction or at extremis, cessation of contributions.

3. AE structure

The rationale for creating a "pot-follows-member" approach which minimises the involvement of members and employers makes sense to us. In order to work properly and to ensure confidence amongst members, senior experienced management and investment personnel should be hired within the Central Processing Authority (CPA) in conjunction with an experienced administration team as soon as possible given the workload required. It is essential that there is a strong governance culture created initially with strong conflict of interests and code of ethics policies in place for the process of selecting managers or other providers in order to build and maintain the

confidence of the Irish public in the CPA. Independence across the various functions (e.g. fund manager differs from investment adviser) which are outsourced will help breed innovation and competition across providers.

The question also arises as to what happens once the member chooses to retire. Consideration should be given to the prospect of the member effectively investing in an ARF or AMRF within the same pension arrangement – i.e. rather than taking monthly contributions from members, it now pays members monthly payments (pensions) while the member's remaining pot remains invested. Derisking (towards the end of the accumulation phase) could be slowed down as the money will be invested for a lot longer, post retirement. The state could also look at issuing annuities directly (effectively by issuing smaller amortising bonds).

4. Investment Advice and Communication.

In order to be successful, the AE programme must build the trust of the community it serves. This will require the Government, the Department and the Registered Providers to provide a range of related features including good personalised communication, together with access to education and advice. An emphasis on advice and education in notably absent from the AE strawman. In addition the provision of personal financial advice is unlikely to be covered by the level of fees currently proposed. An individual's retirement savings typically represents their most important financial asset after their house. A valuable improvement to the AE strawman would be an increased emphasis on communication, education and advice. Communication should be in clear, simple language with a heavy use of visuals to aid understanding (the ESRI have quite a body of work on this). A good website/portal should also be established and in this digital age we as an industry should be more creative in how we communicate and the means of communication we use to provide members with information and assistance about their personal situation. This can be through a range of approaches including web-based calculators with live data feeds, a call centre for advice, seminars and the provision of personal financial advice online and in person.

In summary, careful attention must be given to the various fund options and the setting fee caps. We firmly believe the range of options needs to include a higher risk option and that fees should be kept low but not to the detriment of members being unable to invest in long term asset classes or assets which offer diversification benefits. Member communications, individual advice and helping members with figuring out how best to draw down their savings need further consideration. Any limits or parameters imposed by the Department need to be set consciously with the consequences fully considered.

Again, CFA Society Ireland is happy to help the Department further in any of the above points or indeed any other areas that the Department wishes to analyse. We are fully supportive of the goal of introducing an AE retirement saving scheme for Ireland and would be delighted to assist in any way we can.

Yours sincerely,

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Noel Friel CFA
President, CFA Society Ireland

Appendix

In 2015, CFA Institute teamed up with Mercer on a paper titled "An Ideal Retirement System"[3] to come up with ten principles for an ideal retirement system.

TEN PRINCIPLES FOR AN IDEAL RETIREMENT SYSTEM

1. The government must establish clear objectives for the whole retirement system, including the complementary roles of each pillar, and incorporate the provision of a minimum income to alleviate poverty amongst the aged population.
2. A minimum level of funding should be made into a pension system for all workers with contributions by employers, employees and the self-employed, as well as for those of working age who are receiving certain forms of income replacement. In effect, this means every worker will have a retirement account with an entitlement to future benefits.
3. There should be cost-effective and attractive default arrangements, both before and after retirement, for individuals who do not wish to make decisions.
4. The overall administration and investment costs of each pension arrangement should be disclosed with some competition present within the system to encourage fair pricing.
5. The retirement system must have some flexibility as individuals live in a range of personal and financial circumstances. This flexibility includes recognizing that retirement will occur at different ages and in different ways across the population.
6. The benefits provided from the system during retirement should have an income focus but permit some capital payments or withdrawals during retirement, but without adversely affecting overall adequacy.
7. Contributions (or accrued benefits) at the required minimum level must have immediate vesting and portability. These accrued benefits should only be accessible under certain conditions, such as retirement, death or permanent disability.
8. The government should provide taxation support to the funded pension system in an equitable and sustainable way, thereby providing incentives for voluntary savings and compensating individuals for the lack of access to their pension savings.
9. The governance of pension plans should be independent from the government and any employer control.
10. The pension system should be subject to appropriate regulation including prudential regulation of pension plans, communication requirements and some protection for pension scheme members.

[3] https://www.cfainstitute.org/en/research/future-finance/retirement-system