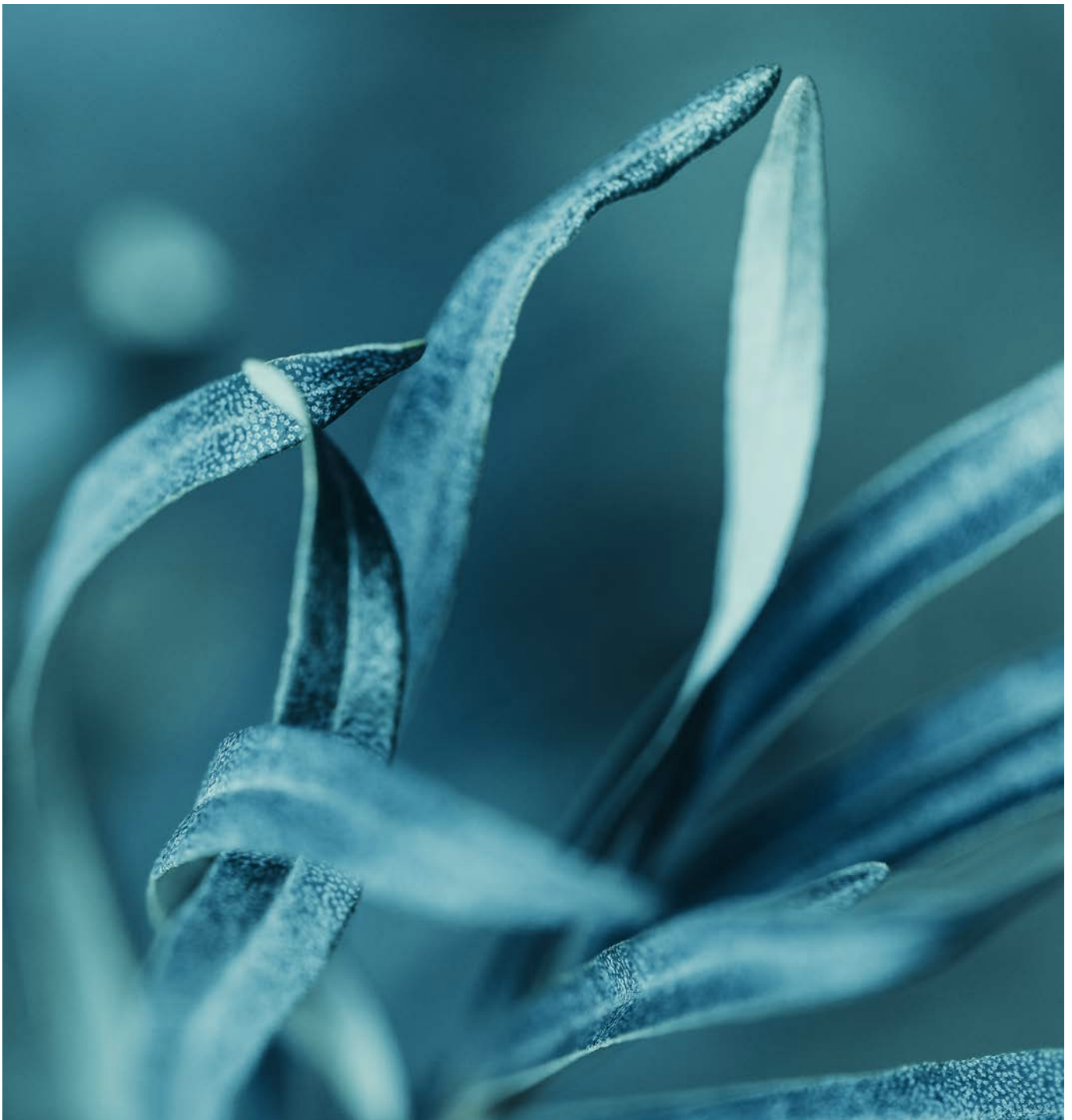


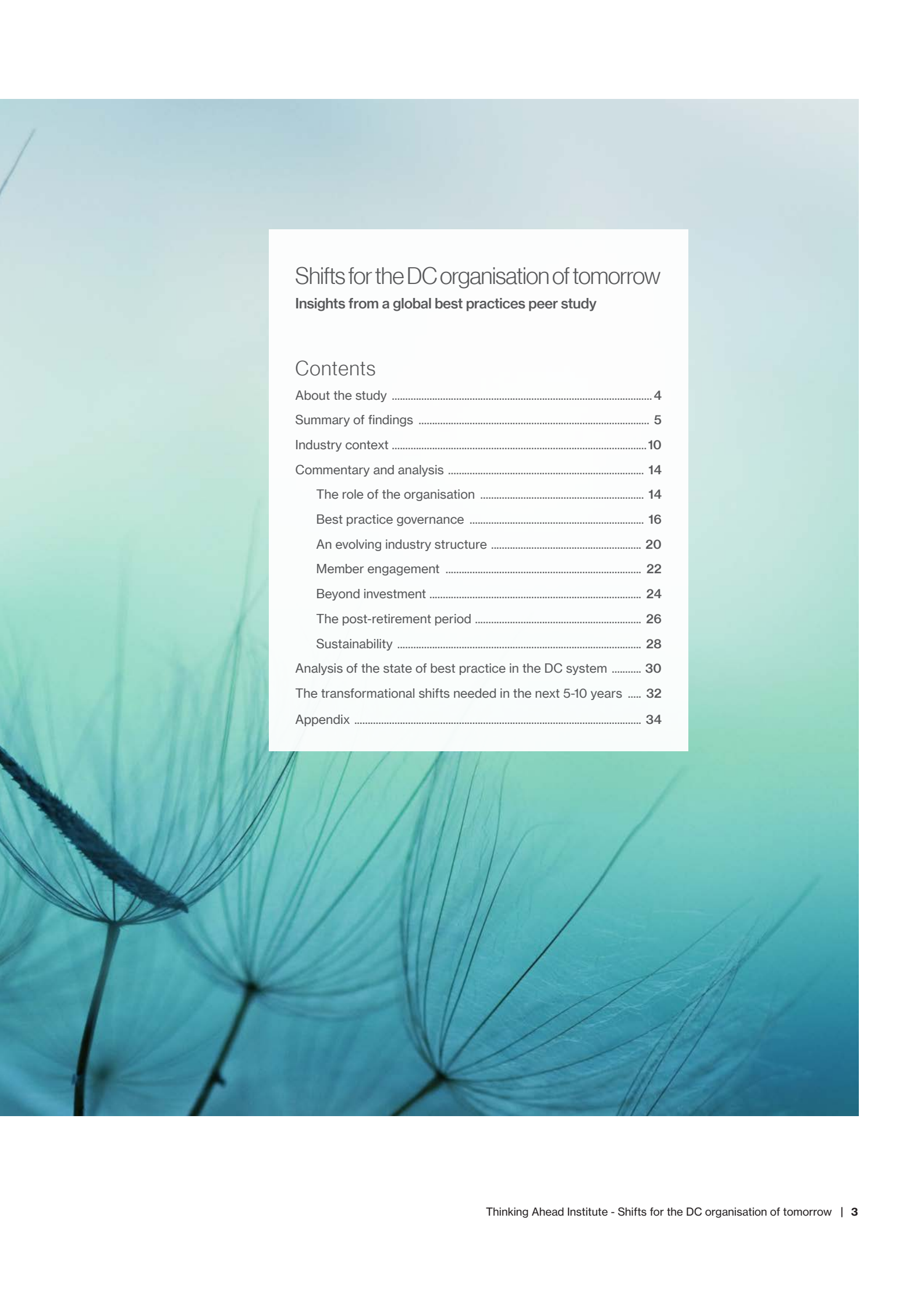
**Thinking Ahead** Institute

## Shifts for the DC organisation of tomorrow

Insights from a global best practices peer study







## Shifts for the DC organisation of tomorrow

### Insights from a global best practices peer study

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# About the study

In this study, we have set out to paint a picture of the changing face of defined contribution (DC) around the world, drawing on the insights of the organisations that are defining the next generation of best practices.

The study is based on a survey and interviews of ten leading organisations on four different continents. The median DC asset size of the ten organisations was roughly \$80 billion, and the median DC participant base was 900,000 people.

Study participants were selected in order to offer a geographic spread and to include both profit-for-owner and profit-for-member organisations. The survey and interviews were conducted between May and September, 2018.

This study does **not** attempt to offer a representative cross-section of the industry. Rather, it draws on the experiences of a selected sample of organisations that we felt offered a leading-edge perspective on emerging practice in some aspect of DC.

Several criteria were used for inclusion in the study, with a preference for organisations that were especially notable in some areas, even if not strong across the full range. The criteria were: scale; ability to invest in technology; commitment to member engagement; commitment to good governance; excellent investment accumulation model; excellent decumulation model.

# Summary of findings

## Systemic implications

### **Pension adequacy is a significant failure of the system**

There can be a bigger role for the state as a constructive partner in creating the conditions for future pensions adequacy.

### **There is weak commitment and low resilience from plan sponsors**

There are issues of industry structure and continuity/commitment in the face of structural change.

The role of the firm as a pension sponsor may diminish as an evolving industry structure emerges in which specialist pension delivery platform organisations play a greater role.

### **Post-retirement income arrangements are primitive**

Better design requirements include choice architecture, and the development of a market for longevity tail insurance.

### **There are wider issues to address around engagement and sustainability**

These are more than ancillary issues.

### **Regulation can play a more positive role**

The ability of industry participants to build better solutions can be hindered or enhanced by the actions of regulators.





# Summary of findings

## Implications for industry structure

### **Global themes can be discerned across different markets**

Each DC market, from the most developed to the smallest, is driven by local considerations. Regulation is a local affair, as are tax, employment norms and most financial service provision. In that sense, we cannot talk of a global DC system, only of an aggregation of local systems.

Nonetheless, it was clear from our conversations that each market faces similar challenges, and that there are many parallels in the responses to those challenges. There are several truly global DC themes.

### **Redefining the role of the employer**

Traditionally, employers played a central role in the DC system. More recently, platforms have emerged that offer an alternative to single-employer plans and re-define the role of the employer. These platforms take different forms in different markets.

### **Scale matters**

Staying competitive in the face of regulatory and administrative challenges and keeping up with technological change is expensive. The costs of doing so may squeeze out small players.

### **The accumulation phase is just the beginning**

It is now widely recognised that the focus on accumulation alone is too narrow, and that greater attention needs to be paid to the goal of providing lifetime income.

The organisations that we spoke to took differing views about the role they see themselves playing in the post-retirement phase.

# Summary of findings

## Implications for organisations

### **Organisations differ in how they see their roles**

Each of the organisations we surveyed has a mission that has been well thought-through and clearly articulated.

The nature of those missions differ: some focus on the participant's outcome, others on excellence in clearly-defined areas.

### **Investment is not the only (or even the primary) focus**

Managing scale (and, in some cases, growth), administration, operations and meeting regulatory requirements all demand significant resources and attention.

### **Governance is still key**

Governance practices at the organisations we spoke to are in general stronger than in the industry as a whole. However, there is room for improvement even here.

With regards to the effectiveness of the system as a whole, there are large gaps.

There is insufficient focus on the needs of the plan participant, and entrenched resistance to change.





# Industry context

**The background to this study is a DC system that is changing, and that faces several fundamental challenges**

These challenges begin with coverage. The coverage of the pension system varies considerably between countries. In the US, roughly half the private sector workforce does not participate in an employment-based retirement plan. Even in Australia, where retirement saving has been mandatory for many years, there are gaps.

Adequacy of contributions is also an area of concern. There is a mismatch between input to the system and the desired output: average contribution levels are unlikely to produce the amount of retirement income that is typically sought.

Given the effectiveness of the nudge approach to participation in the DC system - auto-enrolment, where it has been applied, has tended to result in significantly higher coverage - there is a view that the same principle can work with contribution levels.

Nudge-type solutions are harder to apply to contributions than to coverage, though.

The development of the DC system has paid little attention to the needs of lower earners. As coverage expands, that needs to change. Study participants also noted gender disparities in pension outcomes.

The system is also often ineffective for those who change jobs frequently, with breaks in contributions common, and the possibility, too, of leakage from the system as participants sometimes withdraw their savings.

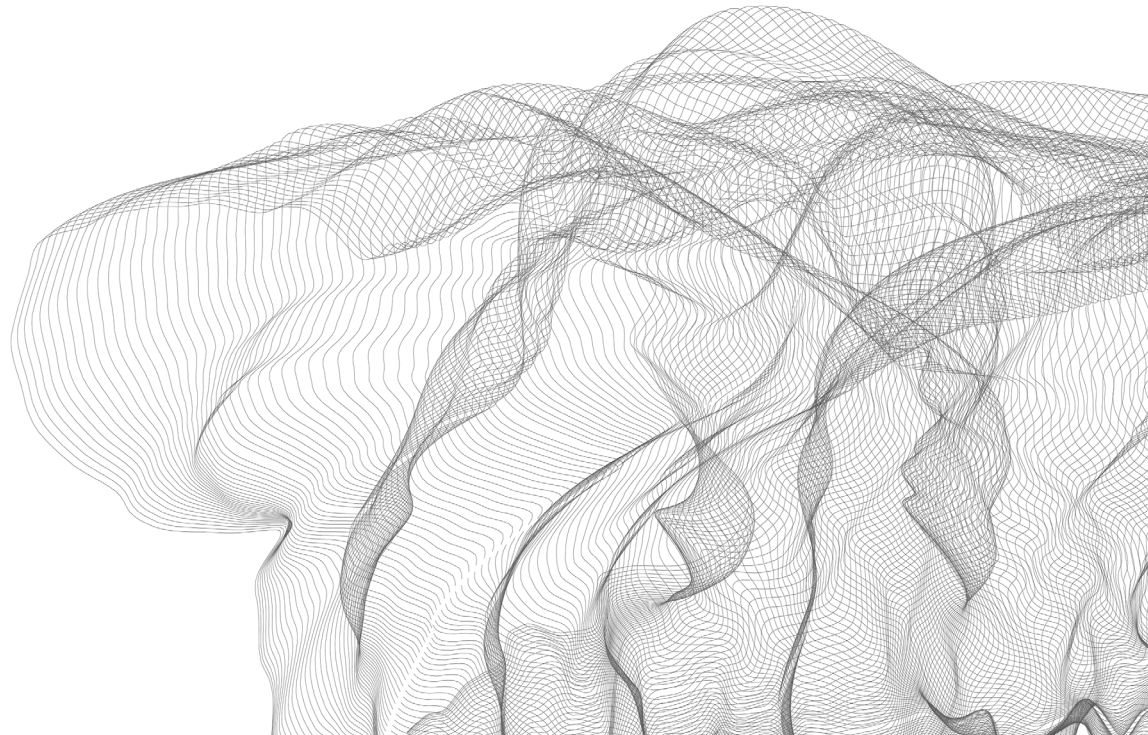
Other challenges facing the system include a lack of trust in the financial services industry and in governments. This can make solutions harder to implement.

“Auto-enrol has brought a lot of low income households into the retirement system.”

---

“75% are going to be fine. We need to focus our attention on the group that is not.”

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### DC 1.0, 2.0 and 3.0

The development of the DC system can be likened to a series of upgrades. DC plans started out as savings vehicles, often serving as a supplement to a defined benefit pension plan. But, as Ezra, Collie and Smith (2009)<sup>1</sup> note: “They outgrew their old skin. Over time, they reached a tipping point at which they stopped being merely a convenient, tax-efficient way to save, and instead became the primary vehicle for providing financial security in retirement.” Hence the need for version 2.0, a system with the purpose of providing income throughout the retirement years. Upgrading a retirement system is a slower process than upgrading a piece of software and, as we write these words in 2018, much work remains to be done.

The evolution of the system will not end with version 2.0, however. Beyond that lies a closer customisation to individual circumstances, and integration in the broader wealth management process.

<sup>1</sup> Ezra, D., B. Collie and M.X. Smith (2009) “The retirement plan solution: “The reinvention of defined contribution”. *John Wiley & Sons*.

### Plan conception

### Governance objective

#### DC1.0

Tax efficient workplace savings vehicle

- Facilitate access to range of savings products with some risk-based guidance
- Help maximise time-weighted returns given available investment options, subject to risk constraints

#### DC2.0

Post-retirement income provision vehicle

- Integrate accumulation phase with post-retirement consumption needs
- Consistent with optimising whole-of-life money weighted return for member’s DC assets, delivery of risk-managed outcomes in retirement

#### DC3.0

Integrated whole-of-life wealth management vehicle

- Consistent with optimising whole-of-life money weighted return across all of member’s assets

Source: “Proposing a stronger DC purpose.” *Thinking Ahead Institute (2017)*

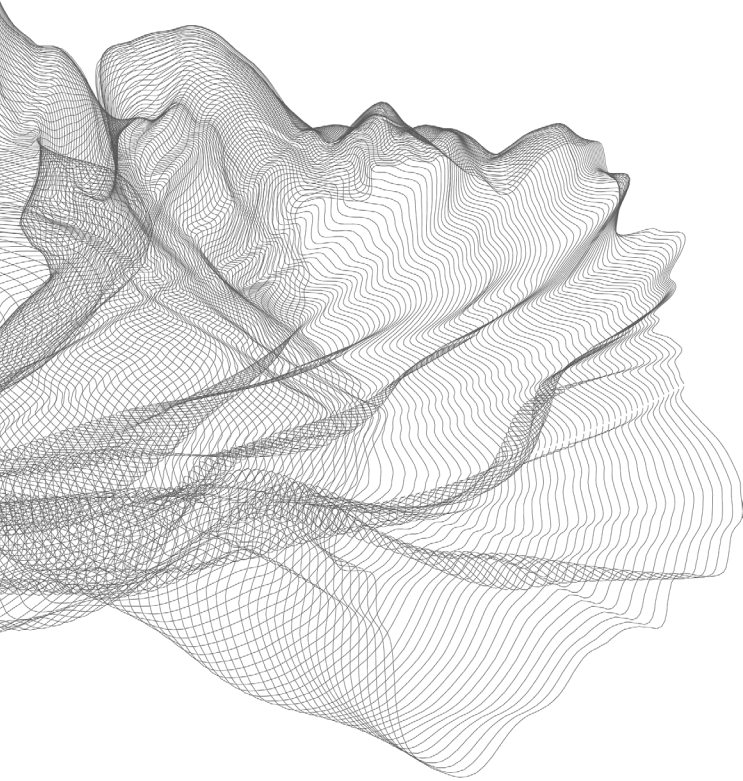
“There is huge risk if the perception becomes that 3% will generate a decent retirement.”

**Change is, however, difficult**

As Clark & Urwin (2009)<sup>1</sup> noted in the context of the global financial crisis, “most funds have felt constrained by the limits of their expertise, have struggled to make effective judgments on financial markets, and have tended to be bystanders in the passage of events”.

Asset owners, being relatively new institutions, have not fully matured and don't have the conditioning of creative destruction that the corporate sector has.

There are transformational change opportunities:



<sup>1</sup> Clark, G. & Urwin, R. "Innovative Models of Pension Fund Governance in the Context of the Global Financial Crisis" *Pensions: Int J.*

The background of the page is a close-up photograph of teal-colored feathers, likely from a parrot. The feathers are layered and have a fine, ribbed texture. A white rectangular box is overlaid on the upper half of the image, containing text.

### Observations from *the asset owner of tomorrow*

The 2017 paper *the asset owner of tomorrow* highlights a number of high-level issues to be addressed over the next 5-10 years.

#### **Greater influence through strategic leadership**

We believe that the relative influence of asset owners compared with asset managers will rise, in part through strengthening leadership

#### **Bigger impact from evolved regulations**

Asset owners will be on the receiving end of further investor protection regulations. What they invest in will also be over-regulated. This will be a very mixed picture - some good, lots of bad.

#### **Mission issues are challenging**

There is a significant governance challenge in creating a unified purpose - what a fund exists for - and defining success: what measures indicate progress and how to manage outcomes better.

#### **A more connected ecosystem**

An ecosystem model is needed to show how to deal with mega-trends such as the 'great acceleration' in technology, demography, globalization, environment and social norms. Technology is the stand-out influence on the next 5-10 years.

# The role of the organisation

## **Whether the organisations are new or long-established, missions have been given careful thought**

Survey respondents almost all expressed strong agreement with the statements “Our mission and/or vision is clearly articulated and can be repeated from memory by everyone within the organisation” and “Our mission and/or vision is embedded very strongly in our structure and decisions and actions”. These responses were borne out in the interviews: in each case, there was clear understanding of, and commitment to, the organisational mission. We would note that the organisations we spoke to are not necessarily typical of the industry as a whole, and that this clarity of mission is not universally present across the wider DC industry.

## **There is notable variation in the nature of these missions**

When asked to choose between the statements “The purpose of our organisation is to help achieve plan participants’ goals” and “The purpose of our organisation is to be excellent at specific tasks (eg, investment, administration)”, responses were widely dispersed. In other words, some organisations have an explicit focus on the plan participant’s outcome, while in other cases, the organisation has a clear but narrower scope: particular tasks in which it aims to excel.

## **The distinction is largely, but not entirely, driven by organisational circumstances**

The organisations we studied differed in several ways: type of organisation, client base, commercial structure, fiduciary and regulatory context and so on. So the differences in the breadth of focus are to a large extent a reflection of organisational circumstances. To some extent they are also, however, a reflection of choice.

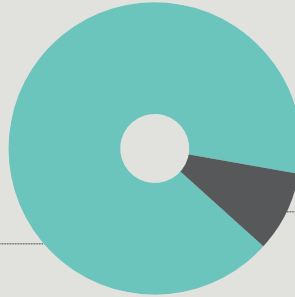
“Ask yourself what objective you are managing: a business/commercial one or one that is addressing the problems your participants face.”

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**91%**

Our mission and/or vision is clearly documented and can be repeated from memory by everyone within the organisation



**9%**

Our organisation has not given thought to a mission and/or vision

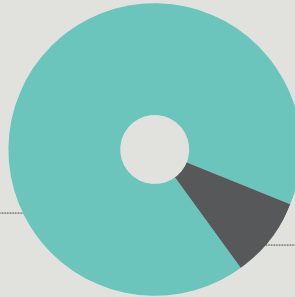
*Dispersion of results: 11%*

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**91%**

Our mission and/or vision is embedded very strongly in our structure and decisions and actions



**9%**

Our mission and/or vision is not at all embedded in our structure and decisions and actions

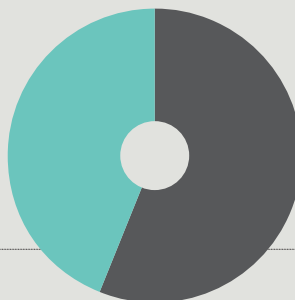
*Dispersion of results: 10%*

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**44%**

The purpose of our organisation is to be excellent at specific tasks (e.g. investment, administration)



**56%**

The purpose of our organisation is to help achieve plan participants' goals

*Dispersion of results: 34%*

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**Note on survey responses**

Responses were provided on a ten-point scale, and the aggregate result shown is the average response recalibrated as a percentage. Dispersion is the standard deviation of the responses.

# Best practice governance

## Governance standards at these organisations are seen as high, with some variation across attributes

The self-assessment of governance standards at these organisations was generally high. The survey covered twelve attributes of best practice, drawn from Clark and Urwin's *DC pension fund best-practice design and governance*<sup>1</sup>. Not every area was seen as equally strong, however. Among the areas perceived as strongest were the effective use of the manager line-up and the clarity of organisational mission.

Areas that scored relatively poorly were board competencies and the ability to attract/compensate talent.

We would observe that the areas of relative strength did vary across markets and across types of organisation. Responses to questions regarding board competency, focus and vision were more dispersed than on other topics. While many aspects of governance within the industry have become increasingly professional in recent decades, trustee board composition and structure has evolved relatively little.

We would note here that a commitment to good governance was one of the criteria used to select participants in the study. As such, the results should not be taken as representative of the industry in general. Rather, they identify the perceived strengths and weaknesses of an important (and influential) subgroup.

“The tail is wagging the dog; the people in charge of managing the money are shaping the industry”

“Fiduciaries need to step up”

“Locked into the status quo”

“Utterly dysfunctional”

“The industry is blinkered”

<sup>1</sup> Clark, G.L. and R. Urwin (2011). “DC pension fund best-practice design and governance” *Benefits quarterly* 27:4







### **But there is heavy criticism of the governance of the wider system**

When discussing the operation of the broader system, however, respondents were far less sanguine. Almost all expressed a negative opinion - highlighted in the range of quotes below - about the effectiveness of the DC system at meeting its broader goals.

So even though individual organisations are seen as acting purposefully and competently, this is not adding up to a broader system that effectively serves the end saver.

### **Structures continue to adapt**

Although change happens gradually, the DC system has evolved significantly across all major markets over the past 10 and 20 years. Adaptation - at both the organisational and system level - continues to occur.

### **“Culture is everything now”**

Many of the organisations we spoke to were revisiting their decisions around the insourcing/outsourcing of the investment management function. Interestingly, movement was occurring in both directions: some bringing more in-house and others outsourcing more.

Peer comparisons - which historically have been a dominant form of assessment - did not feature prominently in our conversations. Nonetheless, they have not gone

### **“The industry has been completely hijacked by agents... We forgot about the member”**

away completely, and were usually implicitly present in some form.

The organisations in the study represented a range of structures: profit-for-owner vs. profit-for-member, and different regulatory regimes, for example. Each structure comes with its own constraints and its own benefits. The continued evolution and adaptation of each organisation was, as a result, heavily influenced by the organisational circumstances and competitive environment in which it found itself.

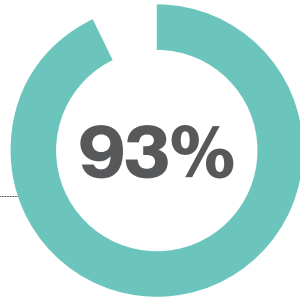
One area that is receiving growing attention is organisational culture. The importance of culture is increasingly recognised and conscious efforts to nurture an effective culture are becoming more common.

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**Manager line-up**

My organisation makes effective use of its investment managers, with clear mandates

Dispersion of results: 10%

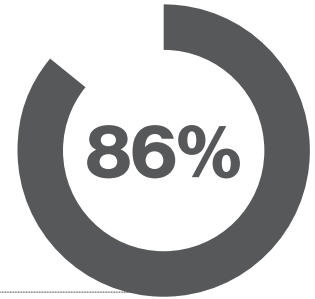


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**Competitive positioning**

My organisation has a clear investment process that is framed by reference to its comparative advantages and disadvantages and plays to its relative strengths

Dispersion of results: 10%

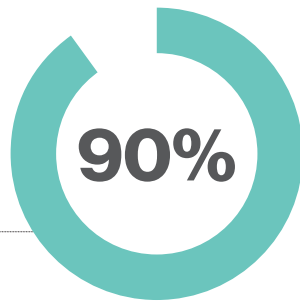


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**Mission clarity**

My organisation has a strong sense of purpose and stakeholders are committed to a clear mission statement

Dispersion of results: 6%

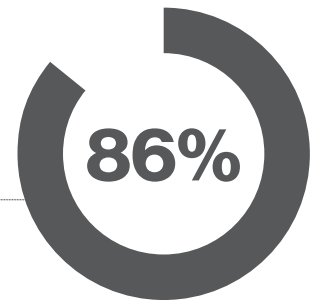


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**Real-time decisions**

My organisation makes decisions for the fund in real time rather than calendar time

Dispersion of results: 10%

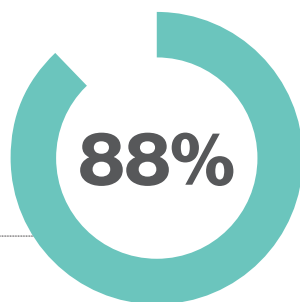


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**Investment executive**

My organisation has an expert investment executive, has all required competencies, and is appropriately resourced

Dispersion of results: 16%

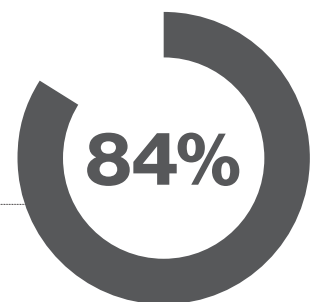


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**Risk budget**

My organisation has a clear understanding of investment risks and the uncertainty implied

Dispersion of results: 11%

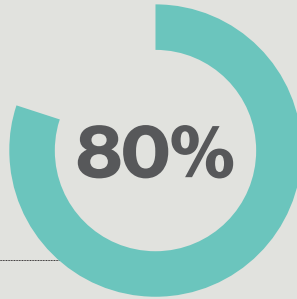


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**Beliefs**

My organisation has a strong set of investment beliefs that command organisation-wide support and align and inform all investment decision making

Dispersion of results: 14%

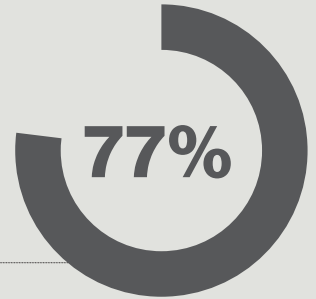


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**Effective focusing**

The organisation's board (or equivalent) spends time in highly disciplined ways applying attention to the most important/valuable issues

Dispersion of results: 20%

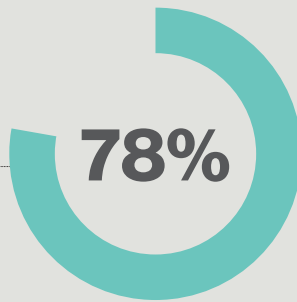


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**Leadership**

My organisation's leadership provides a clear and strong vision

Dispersion of results: 17%

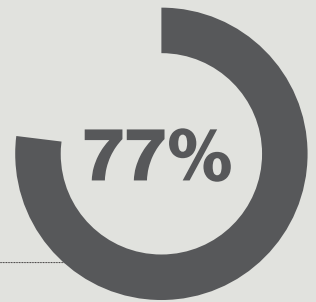


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**Compensation**

My organisation is able to attract and retain appropriate investment related talent, and aligns that talent with the fund's fundamental objectives

Dispersion of results: 14%



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**Learning/culture**

My organisation has a learning culture, within the investment related teams, which deliberately encourages change and challenges the commonplace assumptions of the industry

Dispersion of results: 15%

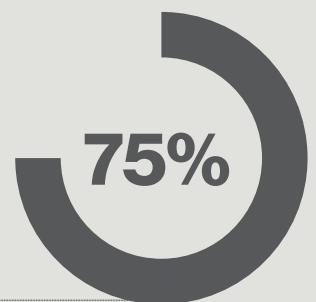


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**Board competencies**

The organisation's board (or equivalent) is expert, has all required competencies, and is appropriately resourced given its mission and context

Dispersion of results: 16%



# An evolving industry structure

## The growth of master trusts/platforms is a key industry development

Among the major DC markets, Australia's system has moved furthest away from the single-employer plan model, largely a result of legislative steps taken in the 1980s and 1990s. Other markets seem set to move in the same direction in the coming years, to some degree at least, with the emergence of multiple employer platforms.

This development will offer employers more choice in what role they'd like to play in the provision of retirement benefits to employees. It will, most likely, become easier to out-source not merely investment or administrative functions, but also the key fiduciary role of operating the plan.

The incentive for platforms to compete with each other and to innovate is greater than for single-employer plans, leading to a different industry dynamic and giving rise to different considerations for regulators.

As in Australia, the full impact of this change will emerge over a period of many years. How it unfolds will be path-dependent and is likely to vary across different jurisdictions.

## Managing scale is increasingly important

The study participants were all large organisations, some extremely large. Scale brings many benefits, but it is demanding to manage.

In some cases, these organisations were also growing fast, which creates additional challenges.

## “You need scale to be efficient”

As technology advances, expectations evolve and significant investment continues to be essential for organisations to remain competitive. Scale matters in this environment. Scale not only brings cost economies, it also enables access to broader investment opportunities, such as private projects. Where scale can be anticipated with confidence (as opposed to being dependent on uncertain variables such as short-term investment performance) it enables better planning. Against these benefits are set the loss of access to some capacity-constrained investment opportunities,

## “There is room in the market for different types of master trust”

**77%**

Large scale is an essential prerequisite for an effective DC plan

**23%**

Scale is not a key determinant of the effectiveness of DC plans

*Dispersion of results: 38%*





and certain service model diseconomies. DC is a more challenging model to scale than defined benefit. Although the majority of survey respondents strongly agreed with the statement “scale is an essential prerequisite for an effective DC plan”, some disagreed. This highlights the role played by industry structure: the benefits of scale could be accessed at a level other than the plan level. Responses to “The minimum scale necessary for a DC plan to be viable is:” varied widely, ranging from US\$300m to US\$20bn. The need for scale is expected to be a contributing factor (among several others) in continued consolidation within the industry.

“We are going to see massive consolidation”

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“Keeping it simple is an unwritten core value”

# Member engagement

## There is no clear winner in the battle between paternalism and libertarianism

Cass Sunstein and Richard Thaler's highly influential *Nudge*<sup>1</sup> drew heavily on ideas that were first set out in an earlier paper with the less-catchy title *Libertarian paternalism is not an oxymoron*<sup>2</sup>. Both works seek ways to allow individuals control over their own money (libertarianism) while at the same time recognising that most people are not experts in financial matters (paternalism). It is this concept that lies behind the widespread adoption of auto-enrolment for DC plans in the early 2000s. The tension between the two perspectives was evident in attitudes to member engagement. The organisations we spoke to adopted widely differing attitudes to the nature of their roles and, in particular, to how far their remits extend. This is evident in the contrasting sentiments expressed by the quotes and survey responses shown opposite.

There was significant variation in the responses to survey questions about the reliance on defaults as

compared to engaging with members to create better outcomes. For example, one question offered the choice of "We actively engage with participants in order to ensure appropriate participation levels, contribution rates, investment strategy and so on" or "The way in which we provide guidance to participants is through the decision architecture and default options". Responses to this question were highly dispersed.

These differences extended to attitudes around communication and reporting, and to the role of generic education vs. online tools vs. one-to-one advice. They relate to the previously-noted differences in organisational missions.

A number of study participants are among those leading the move towards incorporating estimated lifetime income into member reporting. Some are also actively engaging with members on spending policy - with generic education and online tools common, and roughly half providing one-on-one advice. More care is being taken in the language and framing of communications.

"People don't know enough to make informed decisions"

"I would prefer to focus on outcome than engagement"

"It's almost impossible to tell if an individual is ready for retirement just by looking at their employer pension account"

"The most important thing is to know your customer: that's your competitive advantage"

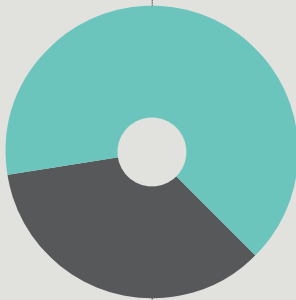
"Right now, we speak as one voice to many and that does not resonate with all our participants"

<sup>1</sup>Thaler, R.H. and C.R. Sunstein (2008). "Nudge: Improving decisions about health, wealth and happiness" *Yale University Press*.

<sup>2</sup>Sunstein, C.R. and R.H. Thaler (2003). "Libertarian paternalism is not an oxymoron" *University of Chicago Law Review* 70:4.

**65%**

We are focused on building the best possible default option and do not provide help on asset allocation strategy to participants who opt out of the default



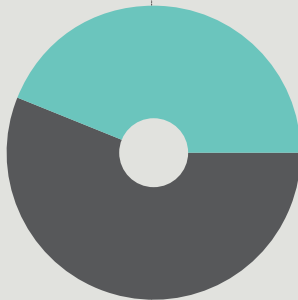
**35%**

To help all participants achieve the best outcome, we offer extensive educational materials

*Dispersion of results: 26%*

**44%**

We actively engage with participants in order to ensure appropriate participation levels, contribution rates, investment strategy and so on



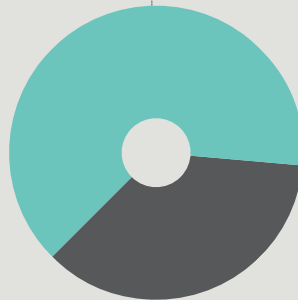
**56%**

The way in which we provide guidance to participants is through the decision architecture and default options

*Dispersion of results: 32%*

**64%**

Our reporting to participants is based primarily on progress toward the objective of lifetime income provision



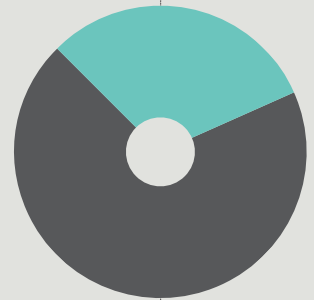
**36%**

Our reporting to participants shows only account balances and investment returns

*Dispersion of results: 23%*

**31%**

We actively engage with retirees to help them set a spending policy



**69%**

No help is given to retirees in setting a spending policy

*Dispersion of results: 28%*

# Beyond investment

## Investment

Investment is a core element of a DC program, but is not the sole focus of these organisations. Survey responses overall agreed more with the statement “Investment is just one of several factors that determine our effectiveness in meeting participant goals” than “We are an investment organisation: the primary value we provide is in the investment returns”. Responses were almost equally split between “We generate investment returns through finding good asset strategies and through the skilful selection of investments” and “Investment returns are generated by markets, which we do not control”.

Most of the organisations in our study did not use an off-the-shelf asset allocation glide path. While all glide paths vary with age, several other factors feature in some cases: gender; account balance; salary; market conditions; estimated social security benefits; deferral rates and expected timing of withdrawal/target retirement age.

## But much more than just investment

In discussing the primary areas of current focus for these organisations, operational and administrative matters were dominant. Operational challenges are especially notable at organisations that are particularly large, particularly fast-growing or facing a changing environment (which is most of those in our study).

The details of the challenges varied across the organisations, largely because of differences in areas such as political backdrops, fiduciary expectations, agility, commercial circumstances, number of payrolls to interact with, the scope of administrative role and so on. Some, but not all, choose to actively engage with the legislative process.

Overall, administration/operations at these organisations is largely effective, reflecting their leading industry position. Nonetheless, nearly all continue to devote substantial resources to this area. Technology infrastructure is particularly expensive, and rapid change is difficult due to scale, regulation and complexity.

In some cases, security has become a particularly pressing issue.

“Pensions, unlike banks, have never really had to think about fraud issues, but the industry is becoming more liquid and transactional, so that is changing”

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**30%**

We are an investment organisation: the primary value we provide is in the investment returns

**70%**

Investment is just one of several factors that determine our effectiveness in meeting participant goals

*Dispersion of results: 18%*

**47%**

We generate investment returns through finding good asset strategies and through the skilful selection of investments

**53%**

Investment returns are generated by markets, which we do not control

*Dispersion of results: 29%*

**27%**

Our default asset allocation for participants is an off-the-shelf glide path

**73%**

We customised our default asset allocation glide path for our participant base

*Dispersion of results: 29%*

“The drivers ... are really IT security and getting out of the technology business, enhancing the participant experience and using data to get them to better retirement solutions.”

**79%**

Our organisation is highly effective in its administration/operations

**21%**

Our organisation is ineffective in its administration/operations

*Dispersion of results: 14%*

**90%**

Our organisation is currently devoting significant resources to improving its administration/operations

**10%**

Our organisation is not currently devoting resources to improving its administration/operations

*Dispersion of results: 12%*

# The post-retirement period

## Attention is turning to the payout phase

The great majority of organisations raised the provision of post-retirement lifetime income as a key topic for the industry. Not all, however, regarded it as falling within their remit: for example, corporate sponsors may see their role as being to take employees up to retirement and to hand over accumulated savings at that point, leaving others to manage the post-retirement period.

The topic of post-retirement income is growing in prominence as the system matures and as account balances at retirement become larger.

## Several potential objectives may apply in the post-retirement period

Although most respondents saw the DC system as primarily a retirement system, there is a recognition that lifetime income is not the only goal for every participant. In many cases, some part of the DC account is intended to be used as short terms funds, or for bequests. When forced to choose between the goals of maximising savings at the point of retirement or maximising lifetime income, survey responses varied with a slight - but not overwhelming - skew to the latter. This preference is reflected to some extent within the investment portfolio itself.

Different objectives, or combinations of objectives, create a more difficult situation.

Member engagement is needed if a truly appropriate balance between these goals is to be achieved.

## Longevity tail insurance is not well developed

Of the various possible goals of a DC account in the post-retirement period, the one for which the system is currently least effective is the provision of lifetime income, and specifically the provision of late-life income: ie, ensuring that retirees do not run out of money in the event of unexpectedly long lives<sup>1</sup>.

Unlike the DB system, DC does not easily pool longevity risk. These organisations are only beginning to engage with that challenge.

“There are not enough people asking the retirement income question: what do customers need? ... There is no reason to suppose consumers will be good advocates on their own behalf”

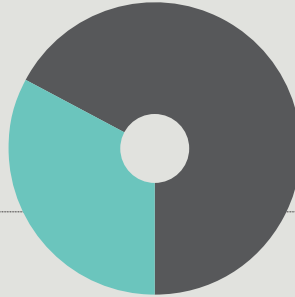
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<sup>1</sup>See “Lifetime income - the DC system's missing design feature” Thinking Ahead Institute (2018)

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**33%**

We aim to maximise the value of participants' savings at the point of retirement



**67%**

We aim to maximise the amount of lifetime income provided to participants

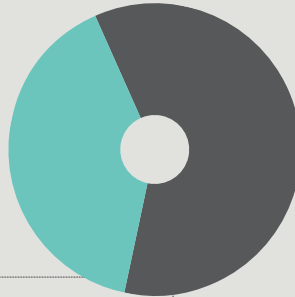
*Dispersion of results: 26%*

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**40%**

A significant element of our investment portfolio is made up of assets that are held for post-retirement lifetime income purposes



**60%**

Our portfolio is chosen entirely on the basis of expected investment returns and risks: the goal of providing retirement income is not a direct consideration in our investment decisions

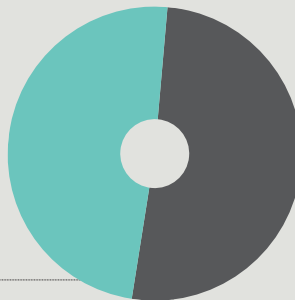
*Dispersion of results: 26%*

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**49%**

We have taken steps to protect participants against the risk of financial hardship in the event that they outlive average life expectancy



**51%**

We have not taken steps to protect participants against the risk of financial hardship in the event that they outlive average life expectancy

*Dispersion of results: 27%*

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“We got a DC system that is good at the accumulation phase but hopeless at the payout phase”

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“Accumulation is a collective decision, whereas retirement is an individual one”

# Sustainability

## Sustainability is an area of growing interest

There was very high dispersion in the responses to the survey questions about sustainability; the area is attracting no attention at some organisations and considerable attention at others. In one case, there was explicit acknowledgement of the UN sustainable development goals. Within the wider area of sustainability, climate change is a particular focus for some.

Although attitudes to the question of sustainability varied, just about all study participants agreed the subject is becoming more important. The general trend is toward greater attention being paid to this area. Most commonly, the use of a sustainability or responsible investing option was the principal way that organisations have acted so far, although the take-up of such options has been very limited thus far.

There is some evidence of a move toward incorporating sustainability considerations into the default option, rather than only into self-select options. This move is evidence of increased weight being given to the perceived financial impact of this area.

“If you are managing other people’s money, you should know who they are and what they look like.”

**60%**

Our investment approach incorporates sustainability considerations to a very material extent



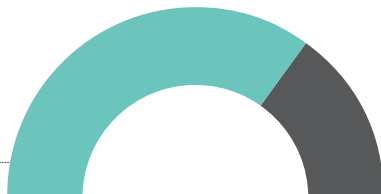
**40%**

Our investment approach is based on financial considerations only

*Dispersion of results: 33%*

**70%**

Our investment approach in five years is likely to incorporate sustainability considerations to a very material extent



**30%**

Our investment approach in five years is likely to be based on financial considerations only

*Dispersion of results: 38%*

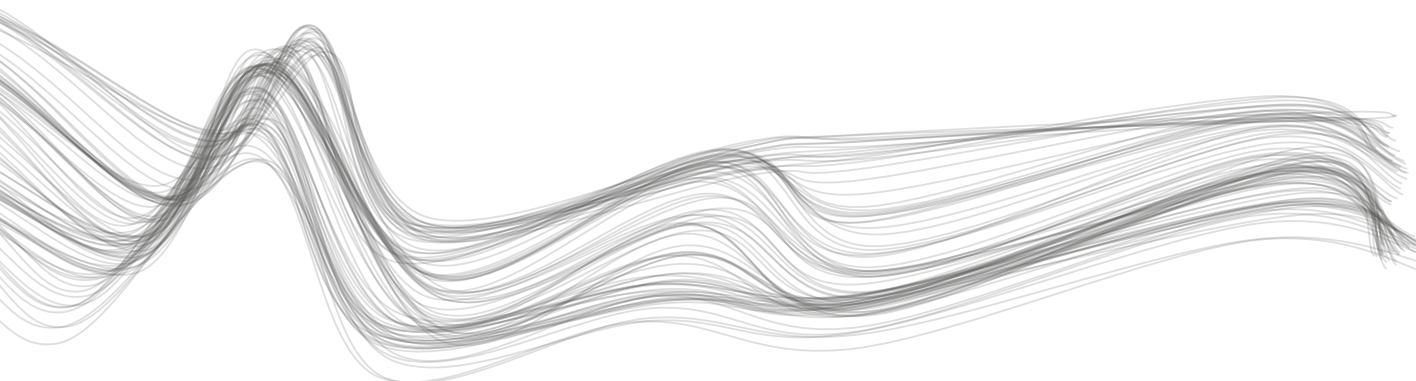
### Where next? DC 3.0

We have described the growing focus on post-retirement income as marking the emergence of version 2.0 of the DC system. But the development of the system will not stop there. Beyond version 2.0 lies version 3.0. Although some way off, there are signs of what the direction of development will be.

We believe that DC 3.0 will be characterised by hyper-customisation as technology allows more effective member engagement and better fit to individual circumstances. From our conversations with study participants, it is clear that some organisations will be more ready to adopt this model than others. Some may prefer to focus more on version 3.0 than on 2.0. Importantly, not every organisation will need to (or is trying to) own the interface with the member, which will be a central defining feature of the new system. A fuller analysis of DC best practices would explore this customisation. Other important questions for further study include: pension adequacy; continuity/commitment in the face of structural change; better risk management through time; post-retirement choice architecture; and developing a market for longevity tail insurance

“The next stage will be predominantly digital, to build customer proximity”

# Analysis of the state of best practice in the DC system



Although the organisations we spoke to vary greatly from one another, and play different roles within the broader system, they each illustrate some aspect of the changing face of DC and global best practice.

Clark and Urwin (2011)<sup>1</sup> list 12 areas of institutional best practice, calling out the coherence of the mission and its delivery as being of particular importance for DC organisations. In this study, we have highlighted that leading organisations in this field have devoted considerable thought to the articulation and application of their missions. That observation does not universally apply, we believe, to the broader DC industry. Employer commitment is too often weak; too many asset managers have struggled to pursue a consistent direction.

Indeed, even though study participants reported generally high standards of governance at their own organisations, their comments pointed to notable shortcomings in the workings of the wider system. Incentives are insufficiently aligned to the needs of the plan participant; as one interviewee put it, the industry “forgot about the member”.

How best to engage with the member is not a straightforward question. The lesson of auto-enrolment - that

default pathways are critical to outcomes - has been learned, but its application to other areas of DC may be less straightforward. Getting a worker into the retirement plan is one thing, but designing every aspect of an appropriate default pathway to last a lifetime - contribution levels; investment strategy; retirement planning; drawdown strategy; longevity insurance - requires more information about the individual, their circumstances and their goals. Members need to be engaged.

The importance of scale should not be overlooked. Cost-effective delivery of a high-quality DC offering is not possible without economies of scale. Entities that lack the required scale on a stand-alone basis can achieve it through outsourcing, or through consolidation with others. The industry structure is, however, evolving: notably with the emergence of master trusts/platforms. Further evolution seems inevitable.

While strengthening institutional best practice is a necessary part of building a better DC system, it is not the whole story. Many of the systemic challenges - coverage; adequacy of contribution levels; meeting the needs of lower earners - are outside the influence of these organisations.

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<sup>1</sup>Op. cit.



# The state and culture of regulation across the world

Our discussions on best practice coalesce in the merit of the DC system having clear objectives aligned with a functional purpose around financial security. The goals of the system are seen as: managing lifetime wealth, securing retirement income, and insuring longevity tail-risk, in the context of integrated member engagement. If the system delivers this package it is fit for purpose.

But in most countries, the DC arrangements are not fit for purpose with respect to retirement income or longevity risk management. This gap requires a transformational shift to fix and one should look to the regulatory environment to support such a transition. As outlined earlier, DC is regulated in country-specific frameworks. There are quite wide differences in practice across different countries.

There are countries that rely upon regulatory frameworks underpinned by principles rather than detailed rules applied to specific problems. Here, the related DC legislative culture is deliberately *accommodating* by being silent on the meaning and/or application of principles to specific instances, leaving those issues to ancillary statements of best practice and the evolution of case law.

By contrast, there are countries that have a *constraining* culture by relying upon comprehensive legislation aimed at translating commitments into specific rules by spec-

ifying requirements and obligations. Here, the latitude to apply wider context to solving customer needs by reference to best practice is limited.

For regulatory regimes that are more accommodating through best practice guidance (we think more of Australia and UK here) DC providers have more opportunity to make big shifts and transformational changes. It appears that such countries should have the conditions to fix the existing gaps through the innovations of industry participants.

For regulatory regimes that are constraining in terms of the permissible actions of DC providers (we think first of the US here), the opportunity for big shifts will be limited and innovation will progress more incrementally. Such countries may not have the conditions to fix the existing gaps through innovation.

The history of successful regulation and innovation in DC is clearly a chequered one. We believe the industry itself must step up to challenge the regulators to be a more positive force in this regard. Several our study participants were hopeful that the Australian royal commission had provided a model by creating conditions for a more successful partnership of industry participants and regulators.

# The transformational shifts needed in DC regulation in the next 5 - 10 years

The key suggestions are that for a fit for purpose system we need to have four well-functioning elements:

- Manage lifetime wealth
- Secure retirement income
- Insure longevity tail-risk
- Integrated member engagement

For such a shift to be achieved in the next 5-10 years, the regulatory environment must support the move into DC2.0 and DC3.0.

But regulation is, in practice, part of the wider problems of DC on a number of counts: the framing of investment risk; the management of conduct risks; the creation of scale; and the management of cost. Each of these points needs some elaboration.

## Risk

There are situations where fiduciaries feel unable to take the action they consider likely to be in plan participants' best interest in the absence of fiduciary protection. For example, using member information to improve investment design introduces an outcome risk that inhibits taking such a step. (Before the US Policyholders Protection Act of 2006, default US DC options were often in cash for this reason).

Ideally regulation should support - for example through more active use of safe harbour provisions - a fiduciary focus on participants' interest rather than on the avoidance of blame.

## Conduct

If conduct risk is too closely associated with performance outcomes, the goal of outperforming peers is awarded the primary place, even though it is not necessarily aligned to achieving member goals.

Ideally regulation should be far better implemented in its interpretation of good practice relative to bad practice.

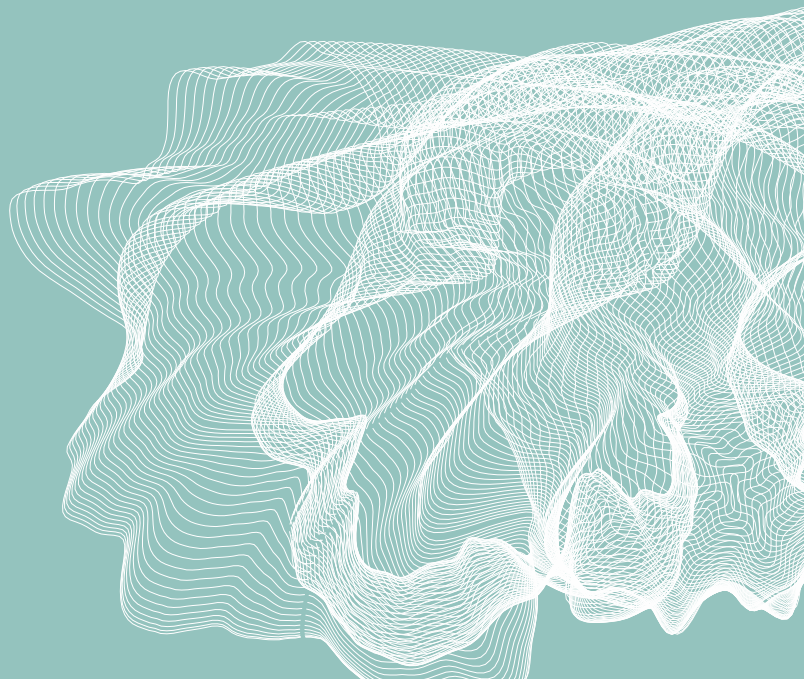
## Scale

The industry structure has been extremely inefficient in its long tail of very small DC arrangements and in dealing with participants who have accrued multiple small accounts.

Ideally regulation should generate a transformation to appropriate scale arrangements, with such scale then enabling investment in innovation.

## Cost

Asymmetries of power and knowledge (described in the Australian royal commission's work, see appendix) have been responsible for an industry that has been extremely costly to individuals and remained so even with technology driving down aggregate costs in many areas. Ideally regulation should be stronger in fostering lower costs.



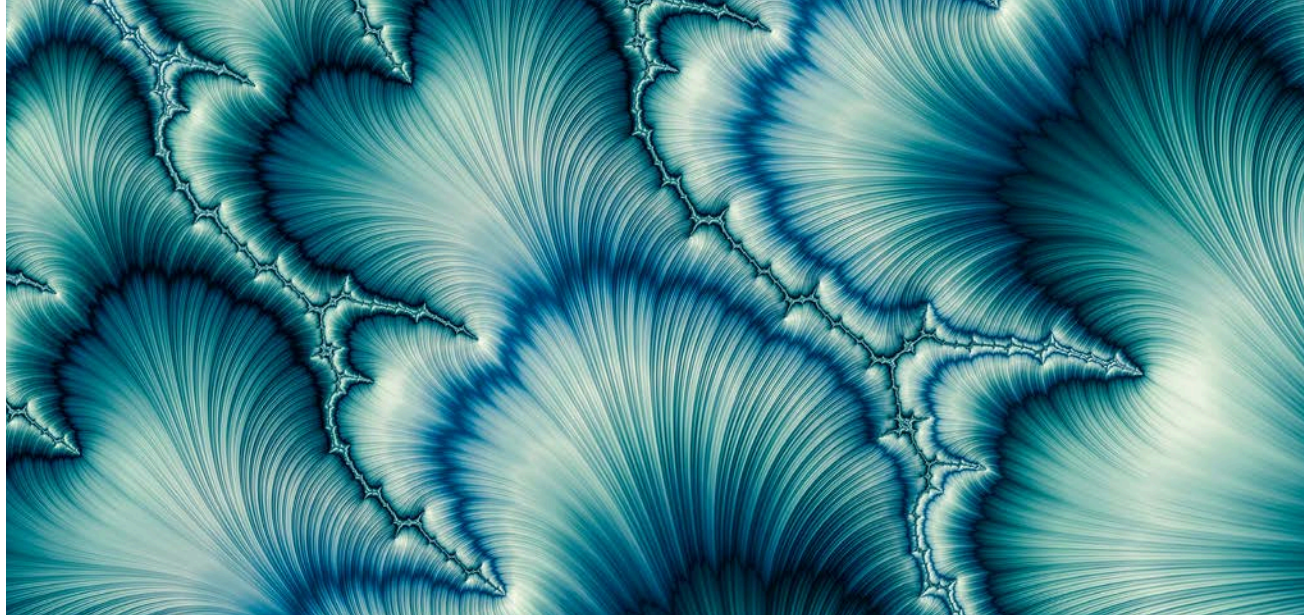


# The transformational shifts needed in DC practice in the next 5 - 10 years

For DC funds to move to DC2.0 and DC3.0 practices and standards, several shifts are required. These shifts span all facets of the organisation: the business model, operating model, investment model and engagement model. While the 2.0 model is the initial target, the longer-term aim is for institutions to take on whole-of-life whole-of-balance-sheet wealth management through

hyper-customisation as technology enables better member engagement in the 3.0 model. The successful organisation needs these elements to move in synch, as each area of change interacts with and supports the others. This is a package which makes the transformation harder but more differentiated and sticky if accomplished.

Shift	From...	To...
<b>Business model</b>	<ul style="list-style-type: none"> <li>▪ Mission and goals unclear and focused on asset accumulation</li> <li>▪ Focus on costs and investment performance (short and long-term)</li> <li>▪ Regulation narrows focus and constrains innovation</li> <li>▪ Most plans sponsored by single employers</li> <li>▪ Long tail of small plans</li> </ul>	<ul style="list-style-type: none"> <li>▪ Mission and goals settled and focused on lifetime retirement income</li> <li>▪ Focus on accomplishments and key performance indicators (long and short-term)</li> <li>▪ Regulation supports outcomes-focus and greater innovation</li> <li>▪ Multiple employer platforms</li> <li>▪ Increased coverage of large plans</li> </ul>
<b>People model</b>	<ul style="list-style-type: none"> <li>▪ Mixed quality workforce with significant external dependency</li> <li>▪ DC seen as an ancillary function</li> </ul>	<ul style="list-style-type: none"> <li>▪ High quality workforce with limited external dependency in selective areas</li> <li>▪ Specialist DC organisations</li> </ul>
<b>Operating model</b>	<ul style="list-style-type: none"> <li>▪ Governance weak, reactive and resistant to change</li> <li>▪ Data and technology on legacy systems and disconnected</li> </ul>	<ul style="list-style-type: none"> <li>▪ Governance strong, pro-active and innovative, particularly in Board and IC</li> <li>▪ Data and technology on contemporary systems and well-connected</li> </ul>
<b>Investment model</b>	<ul style="list-style-type: none"> <li>▪ Small-scale sustainability model</li> <li>▪ Narrower, finance-only objectives</li> <li>▪ Accumulation of assets</li> <li>▪ Avoid market-relative underperformance</li> <li>▪ Time-weighted returns</li> <li>▪ Post-retirement investment focus</li> </ul>	<ul style="list-style-type: none"> <li>▪ Stronger incorporation of sustainability</li> <li>▪ Wider focus including stakeholder responsibility</li> <li>▪ Support lifetime retirement income</li> <li>▪ Maximise lifetime income</li> <li>▪ Money weighted returns</li> <li>▪ Integrated investment and spending solutions, including longevity tail insurance</li> </ul>
<b>Distribution model</b>	<ul style="list-style-type: none"> <li>▪ Weak member knowledge and limited engagement</li> <li>▪ One-size-fits-all solutions</li> <li>▪ Auto-enrol and default options</li> </ul>	<ul style="list-style-type: none"> <li>▪ Member data and engagement and interface owned</li> <li>▪ Customised and segmented solutions</li> <li>▪ Choice architecture plus technology-enabled stronger engagement</li> </ul>



## Appendix: comment on the findings of Australian Banking Royal Commission

In December, 2017, a royal commission into misconduct in the banking, superannuation and financial services industry was established by the Australian government. This commission was taking place while our study was conducted, and the final report was published in February, 2019.

The Commission found serious shortcomings in the industry on conduct. While the superannuation (pension) system suffered less direct criticism than some other sectors of the financial services industry, the findings of the Commission are likely to exert considerable influence on the development of the DC system for years to come. The final report describes “four observations about what has been shown by the Commission’s work: the connection between conduct and reward; the asymmetry of power and information between financial services entities and their customers; the effect of conflicts between duty and interest; and holding entities to account.”

Below we provide a high-level summary of how those observations apply to the DC system, and the expected impact of the shifts described in this paper.

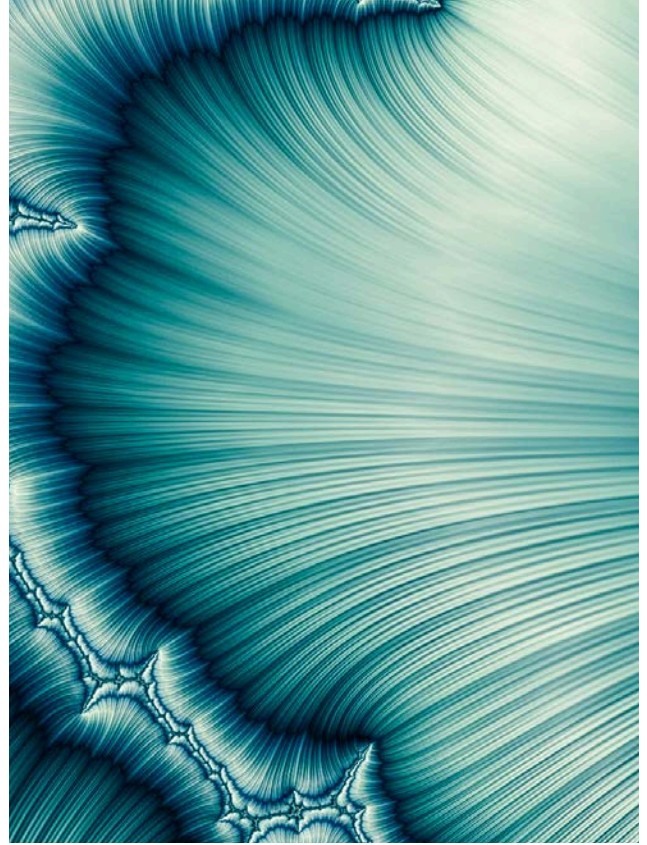
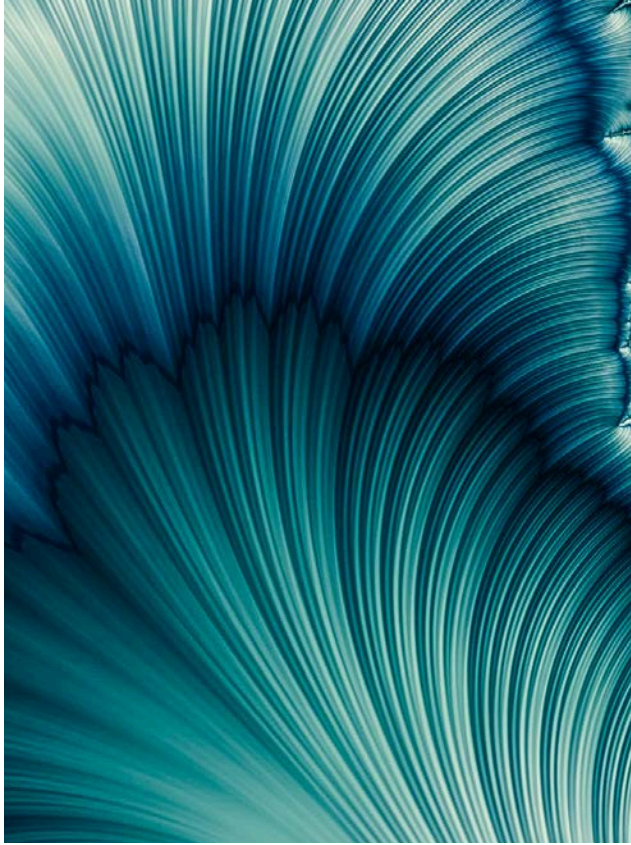
### **DC conduct and conflict**

The Commission described substantial issues on conduct and conflict.

First, *‘the conduct in issue was driven not only by the relevant entity’s pursuit of profit but also by individuals’ pursuit of gain, whether in the form of remuneration for the individual or profit for the individual’s business. Providing a service to customers was relegated to second place’.*

Second, *‘consumers often dealt with a financial services entity through an intermediary ...acting in the interests of the provider or the intermediary’.*

The issues described were exacerbated in retail / profit for owner situations, although they certainly can be present in industry funds/ profit for member situations. The issues can potentially be addressed through increased regulation, but the challenge seems more about the effectiveness of regulation, which should combine cultural change with enhanced regulatory scrutiny.



#### **DC alignment and accountability**

The Commission also described substantial issues on alignment and accountability.

*First, 'entities and individuals acted in the ways they did because they could. There was a marked imbalance of power and knowledge between those providing the product or service and those acquiring it'.*

*Second, 'too often, financial services entities that broke the law were not properly held to account.'*

These issues were not considered as uniformly distributed across the Australian superannuation industry, but the over-riding conclusion suggested the problems were quite deeply embedded.

The issues can be addressed through better aligned incentives. Again, a combination of governance and culture with increased regulatory traction or tougher application of regulation are called for.

#### **DC design and engagement**

Very limited attention was given in the Commission's terms of reference to the issues around the DC system design and engagement: particularly as regards benefit design, engagement through informed default, guidance and advice; and streamlined administration reducing cost slippages. The issues we see here are numerous, but principally: streamlining the multiple accounts issue; fulfilling the post-retirement income design challenge (targeting appropriate drawdown at appropriate risk levels; also incorporating longevity protection); and delivering engagement integrity (ensuring value adding and cost-effective inputs are embedded in the system; improving the clarity of communications and expectations).

These were issues flagged as important to be considered in further reviews with as yet unspecified time-tabling.

*We are grateful to the individuals and organisations who participated in the study, for their time and the thoughts that they shared. The following organisations have given permission to be identified as having participated in the study:*

*AMP Capital  
QSuper*

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