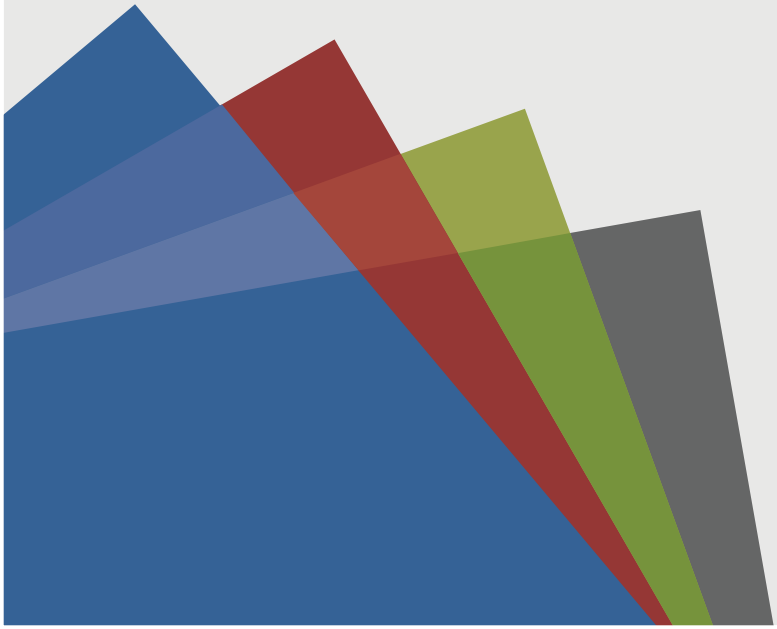
DC Investment Governance

Evaluating Value For Money



Elston Consulting

DC Investment Governance

Evaluating Value For Money

The emphasis of DC investment governance is increasing to ensure savers' interests are put first.

Trustees of DC schemes are now required to

A. Design the default investment strategy in the members' best interests
B. Ensure core financial transactions are processed promptly and accurately
C. Assess whether costs and charges represent "good value"

Each year, the chair of trustees must sign an annual governance statement confirming this.

As the annual governance statement is likely to be prepared for the first time for DC schemes, this briefing note considers how a governance statement might look to ensure these requirements can be defined and met.

When preparing the annual governance statement, some guiding principles for Trustees to consider as potential best practice could include:

1. Make sure there is a **clear and consistent process** for structuring and preparing the annual governance statement
2. Make sure **definitions and terms** are clearly defined, with reference to any legislative and regulatory guidance
3. Make sure the **evaluation process is transparent and measurable**, in addition to qualitative considerations

This paper suggests how these principles can be put into practice.

1. Creating a clear and consistent process

Make sure there is a clear and consistent process for structuring and preparing the annual governance statement.

Trustees should refer to legislation and regulatory guidance as regards a suitable structure for the annual governance statement and agree a checklist of contents for inclusion. An example checklist is included in the Appendix.

Trustees should liaise with their service providers – scheme administrators, investment consultants and investment managers – as regards their ability to provide the required information for inclusion in the governance statement.

The timescale for delivery of information and preparation of a draft governance statement should be agreed between trustees and service providers.

The draft governance statement should be reviewed against the agreed checklist of contents for inclusion and circulated for review.

The checked draft governance statement is reviewed and agreed by trustees for sign-off at a minuted trustee meeting.

2. Establishing clear definition of terms

*Make sure **definitions and terms** are clearly defined, with reference to any legislative and regulatory guidance.*

A. Design the default investment strategy in the members' best interests

What is the default investment strategy?

The default strategy is the investment strategy

- into which contributions are allocated where member has not exercised a choice
- into which contributions of 80% or more contributing members of scheme were allocated on the later of 6th April 2015 or the employer's staging date
- into which contributions of 80% or more of contributing members are allocated after the later of 6th April 2015 or the employer's staging date

Disclosing the default investment strategy

The default investment strategy should be clearly articulated and disclosed using standard asset class terms. This means that:

- members can understand how the default investment strategy is managed over time
- members can make an informed choice as to whether they wish to remain in the default investment strategy or select a different investment option based on their individual preference for risk and return
- decision-makers are clear as to the current and expected investment exposure of different cohorts of the membership and its suitability to the aims and objectives of the Statement of Investment Principles and the best interests of the members

Whether a default investment strategy uses a lifestyling approach or a target date funds approach, there is always a 'glidepath' towards a retirement or 'target' date, which is the turning point between an accumulation emphasis and a decumulation emphasis. This is typically the Normal Retirement Date of a scheme.

What are the member's best interests?

Members best interests is a suitably broad term that is at the core of any trust-based scheme.

> *The trustees have full responsibility for the management, administration and investment of the plan. The trustees' fiduciary duty is to run the scheme according to the trust deed and rules which may have been setup by, for example, the employer – and to act in the interests of members and while they can delegate tasks to various specialists, such as investment managers, the responsibility remains with the trustee.*

Source: DWP[i]

More specifically, it is the responsibility to consider with due consideration of investment and administrative risks, how best to maximise at or around their expected retirement date the future retirement income, however taken, whilst minimising the risk to that income, in a way that is suitable for the characteristics of different cohorts of the membership of the scheme.

Future retirement income may include any or all of cash, annuity or drawdown depending on the characteristics and best interests of the membership.

Characteristics of the membership might include the level, consistency and growth potential of income, combined contribution rates, demographics (life expectancy), preferences and behaviours, for different cohorts grouped by expected retirement date.

Future retirement date is not a point in time but more likely to be defined by a year (e.g. 2025) or a range of years (e.g. 2021-25). Before the retirement date, the emphasis is predominantly accumulation. At and after the retirement date, the emphasis is predominantly decumulation. It is likely to be the Normal Retirement Date of the scheme or the State Pension Age, or the age at which the membership are likely to require or expect a shift towards a decumulation emphasis.

Again, whether a lifestyling approach or a target date funds approach, there is always an expected retirement or 'target date' by which each cohort of the membership can be grouped. This retirement date can be defined as the turning point between an accumulation emphasis and a decumulation emphasis.

Measuring a good outcome

A good outcome has been defined by DWP as a replacement ratio that compares post-retirement income (from all likely sources) to pre-retirement income. In addition to looking at the (median) likely level of income, decision-makers should consider the expected range of likely returns, to evaluate the risk, to differing levels of likelihood, of a post-retirement income falling short of the required level of income to meet that replacement ratio.

Qualitative considerations

Whereas the member outcome can be clearly defined in economic terms above, qualitative considerations could include the range of investment choices offered to members, both in the accumulation stage and the decumulation stage, and the availability of engaging educational support with broader generic information to support member decision-making and financial capability.

B. Ensure core financial transactions are processed promptly and accurately

What are core financial transactions?

Core financial transactions include the:

- investment of contributions to scheme
- transfers of assets relating to members in and out of scheme
- transfers of assets between different investments
- payments from scheme to, or in respect of, members

What is promptly and accurately?

Promptly can be defined as ensuring the time frames for transactions are sufficiently prompt that the member's exposure to the market returns on their chosen investment strategy (or the default strategy in the absence of choice) is not materially different to their exposure had the transaction not taken place.

Accurately can be defined as ensuring that the quantum of investment is exact and reflects full value of the contribution, transfer or payment net of any disclosed and compliant member deductions.

Accurately can also be defined as ensuring that the allocation of a transaction is appropriate for the purpose of the transaction. In respect of contributions and transfers in this means the accurate allocation of assets across the funds within the chosen or default investment strategy.

Measuring promptness and accuracy

Trustees can establish or review service level standards with their scheme administrator to review and agree expected timeframes for administrative and data processes. These processes should be clearly defined and auditable.

Measuring promptness and accuracy

Trustees can establish or review service level standards with their scheme administrator to review and agree expected timeframes for administrative and data processes. These processes should be clearly defined and auditable. Trustees can measure the number of processes and the percentage of those processes completed within agreed timeframes of the service level standards.

Qualitative considerations

Trustees can consider qualitative aspects of promptness and accuracy such as the administrators willingness and ability to commit to service level standards and the process for correction if those standards are not met.

C. Assess whether costs and charges represent "good value"

What is good value?

While "good value" principle has become embedded in legislation, there is no definition of terms or guidance on it as yet.

Trustees should consider creating a "Good Value" policy document that covers the four key member-related services of **governance, communication**, **administration** and **investment** and formalises the quantitative and qualitative approach for defining and measuring these aspects.

Good value can and should be distinct from a focus on cost alone and should be reviewed both qualitatively and quantitatively.

Governance: is the primary consideration and ensures there is proper oversight, control and review of all the other three member-related services. This can be delivered by the trustee board of a trust-based scheme or the Independent Governance Committee of a contract-based scheme.

Communication: Communications provided to members within the cost of the scheme should be engaging, informative and accessible. Additionally, for consistency with other regulatory standards, communications should be fair, clear and not misleading, and should not disguise, obscure or diminish the significance of any important statement or warning as regards relevant risks[ii]. Schemes should consider *the DWP Automatic enrolment and pensions language guide* when preparing scheme literature[iii].

Measuring good value (member communications)

A survey-based approach with statistically significant sample size of current or likely users could help inform trustees as regards the effectiveness, quality and good value of communications. There should be a formal review every three years, in line with the broader review of scheme arrangements.

Qualitative considerations

Schemes should make provision for member feedback and suggestions as regards communications. Standards around language use could be considered such as the Crystal mark as well as the *DWP Automatic Enrolment and Pensions Language Guide* and any guidance from TPR on language simplification.

Administration: administration services provided to members within the cost of the scheme should be prompt and accurate. In addition to the core financial transactions outlined above, other administrator controlled functions could include process relating to: automatic enrolment, death, divorce, joining/leaving the scheme, record updates, retirement.

Measuring good value (scheme administration)

Trustees should prepare and agree a schedule of controlled functions (including core financial transactions) with respect to the fees charged, or allocated to, scheme administration. These processes should be clearly defined and auditable, and any cross-subsidy should be disclosed.

Qualitative considerations

Trustees can consider qualitative aspects of administration such as member feedback such as the administrators' willingness and ability to commit to service level standards and the process for correction if those standards are not met.

Investment: investment service provided to members within the cost of the scheme should have the potential to deliver a good outcome (see above) for members

within the scope of the scheme's investment policy. This review should be conducted at least every three years and without delay after any significant change in investment policy, and without delay after any significant changes in the demographics of scheme membership.

To support this review, trustees should assess the extent to which the net (risk-adjusted) return on investments relating to the default arrangement as experienced by different cohorts of the membership is consistent with the aims and objectives the trustees have in respect of the default arrangement.

In the context of the investment strategy, the starting point for the evaluation process will be the new requirement to prepare a statement of investment principles for default strategy for inclusion within the scheme's broader SIP.

This statement should cover the trustees' aims and objectives for default fund; investment policies; and an explanation of how aims and objectives and policies are in members' best interests. This statement should be revised after every review unless trustees decide that no action is needed.

When assessing the members' best interests as part of this regular review, trustees should consider the membership profile of the scheme, their needs (in terms of required retirement income), their risk capacity (size of pot, earnings, contributions rate and investment term), member behaviour as regards pre-retirement and post-retirement choices.

Measuring past and expected performance. As part of the formal governance review cycle, and could therefore be both backward and forward looking in character. Adopting a cohort-based approach means that there is focus on the different retirement profile of the membership[iv] as well as due regards for the differing demographics within the scheme membership.

Measuring good value (investments)

An ex-post measure of good value in an investment context could be defined as the risk-adjusted returns, net of fees, of the default investment strategy over time relative to the policy benchmark that reflects the stated strategy ('glidepath'), as experienced by different cohorts of the membership. An ex-ante measure of good value in an investment context could be defined as the likely level and variability of replacement rates for a given default investment strategy, net of fees.

Qualitative considerations

Qualitative considerations could include quality and consistency of investment reporting, and clarity of investment policy and objectives.

3. Evaluation process

*Make sure the evaluation process is **transparent and measurable**, in addition to qualitative considerations*

For all key aspects of member service – communication, administration and investment there should be a clearly documented and transparent evaluation process.

Policy

The first step should be to articulate a good value policy for each of these aspects.

Process

The second step should be to establish a process for gathering evidence to form a quantitative and qualitative assessment of how good value can be measured for each of these aspects.

Evidence

The third step should to review and summarise the evidence in a consistent format to create a discussion document for trustee boards to consider.

Option

The fourth step is to discuss with stakeholders and service providers what options, if any, are available to trustees to enhance and ensure good value, based on the evidence.

Conclusion

The final step is for the trustees to review the evidence and options outlined to make a decision as regards next steps, if any.

Appendix

Proposed checklist of contents for the investment governance[v]

INVESTMENT GOVERNANCE

1. Consider number of funds offered within the scheme
2. Offer an adequate range of investment options, including a default
3. Consider classifications, names, objectives and benchmarks for investment options, including for the default option.
4. Consider cost and fees (member borne deductions) and ensure they are reasonable
5. Review the management of service providers (external investment managers, consultants and administrators) and their contracts.
6. Consider potential for risk and return (net of fees) in the default strategy design for different cohorts of the membership.
7. Consider member needs and circumstances, including term to retirement and risk capacity.
8. Consider any legislative changes and their impact on the appropriateness of the default strategy.
9. Assess the risk-adjusted performance, net of fees, of each investment option, including the default strategy, for different cohorts of the membership.
10. Consider removing underperforming options if appropriate
11. Monitor the suitability of the investment wrapper and act if not suitable
12. Report performance, risks and remedial action to members.

GOOD VALUE REVIEW

1. Describe the review process of the default investment option and changes made or date of last review
2. Describe how requirement to process transactions promptly and accurately has been met
3. State level of charges and transaction costs applicable to default arrangement during scheme year
4. State range of levels of charges and transaction costs in non-default investment funds during scheme year
5. Indicate any information about transaction costs that trustees have been unable to obtain and what is being done to obtain this in future
6. Explain trustees' assessment of extent to which member-borne charges and transaction costs represent "good value" for members

Notes

[i] DWP, Annex B Glossary, Government response to the consultation on Better workplace pensions: Putting savers' interests first

[ii] FCA Financial Promotions, Frequently Asked Questions
http://www.fca.org.uk/firms/being-regulated/financial-promotions/financial-promotion-faq

[iii] https://www.gov.uk/government/publications/automatic-enrolment-and-pensions-language-guide

[iv] DWP, Guidance for offering a default option for defined contribution automatic enrolment pension schemes
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/185056/def-opt-guid.pdf

[v] Based on TPR Template For Governance
http://www.thepensionsregulator.gov.uk/docs/igg-template-for-governance-plan.pdf

FIVE Questions to ask your consultant

1. What is the current asset mix over time of the default strategy and is this still appropriate to the memberships' demographics, needs, and risk capacity?
2. Which benchmarks best represent each asset class, and the strategy as a whole?
3. What is the policy[1] and actual[2] performance for each of the components of the strategy, and for the strategy as a whole for each cohort of the membership?
4. Does the difference between the actual performance and the policy performance of the strategy evidence value added to, or subtracted from, risk-adjusted returns for each cohort of the membership?
5. Is that difference explained by tactical allocation changes, component fund performance, fees, or other implementation decisions recommended by the consultant/manager?

1. Performance before fees of the benchmarks that represent the strategic asset allocation over time, excluding any tactical changes.

2. Performance after fees of the funds within the strategy over time, including any tactical changes to the allocations to those funds.

For latest information on the FTSE UK DC benchmarks please visit:

www.ftse.com/dc

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