Volume III 2018

Pathways

Aon Hewitt Investment Consulting's Newsletter for Retirement Plans

In this Issue

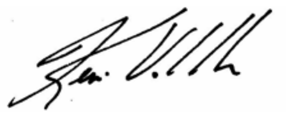
Welcome Message

In this edition of Pathways we offer tools to help improve the decision making of fiduciary committees, outline considerations to help evaluate defined contribution (DC) recordkeepers based on current trends and innovations, and highlight an idea about how to enhance defined benefit plan portfolio returns through bank capital relief strategies. We provide an analysis of how unfunded public pension obligations impact state and local credit ratings, and recommend actions public funds can take to improve their funding outlook and reduce borrower cost. Finally, we provide an overview of our new study *The Real Deal*, which answers the question "Will employees be ready for retirement?"

We wish to remind our readers that our Retirement Legal Consulting & Compliance group publishes a quarterly newsletter with articles on timely topics. On page 6 of their latest newsletter you can find a summary of the most recent litigation. Litigation remains an active reality, and we continue to encourage plan sponsors to pay attention to the latest developments. You can download the newsletter here.

If you need assistance or have questions on the topics we've covered, please contact your consultant or any of the authors or practice leaders identified at the end of the newsletter. As always, we look forward to your feedback.

Thank you,



Kevin Vandolder, CFA
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Empower Results®

Positioning Fiduciary Committees for Success: Assessing Structural Contributors to Decision Making

by Eric Friedman, FSA, EA, CFA

There is no one-size-fits-all approach to determining decision-making structures.

Fiduciaries are always trying to make the best decisions. To do this, they should also think about the structural contributors to their decisions, which include the factors that shape how decisions are made—such as the roles and responsibilities of various parties, how the investment committee/board spends time, the reports it uses, and the training it provides its members. These factors affect the decisions that investment committees and boards ultimately make, such as asset allocation and hiring and firing investment managers. Effective decision-making structures are critical for institutional investors to make the decisions that will set them up for the best chance of success.

There is no one-size-fits-all approach to determining decision-making structures, as the particular circumstances of each investor affect the preferred approach. We've found that an effective approach is for the investment committee or board to discuss and analyze the strengths and weaknesses of its investment program, which may yield useful insights on opportunities to improve.

One way we facilitate these discussions is to ask each member of the investment committee/board to complete a 10-minute online survey and discuss the results with the group. The questionnaire may be customized, but generally covers areas such as:

- Committee/board's use of time. Is the group focusing its time and attention on the most critical areas?
- Process for monitoring and selecting managers. Is the process for manager selection and termination designed in a way that is likely to result in the best decisions?
- Attitude toward innovation. How can they better align governance processes with the committee/board's openness to including more innovative investment strategies in the portfolio?
- Historical versus forward-looking market views. Should there be a different balance between the time spent analyzing historical performance and that spent on forward-looking views?
- Reporting. Are there areas in which the structure of the performance reports being used can be improved?
- Training and education. Would additional training help members be more effective in their roles on the committee/board? If so, in what areas?
- Documentation of roles. Would committee/board members benefit from a clearer documentation of roles?

The results are often enlightening, because the structure of the survey process helps mitigate "group think" and facilitates robust discussion on key topics like areas of consensus/difference, opportunities for improvement, and alternative approaches for consideration. Some common situations we've seen include respondents changing how the group allocates time in meetings (usually to focus more on higher-level decisions and less on details), finding the reporting ineffective, delegating operational decisions, or seeing room for improvement in the process for monitoring and selecting managers.

We believe having thoughtful and reflective discussions about improving decision-making structures is not especially difficult, complex, or time-consuming—yet it is critically important to do periodically. Ask your Aon consultant if you'd like to perform this type of exercise within your organization.

Merits of Customized Investment Options for DC Plans Remain as Compelling as Ever!

Discussion is ongoing in the DC marketplace about the pros and cons of customizing DC investment options. We continue to believe strongly that those DC plans with size as an advantage, generally $250 million or greater, should seriously consider customization opportunities. The merits are many, including:

1. **Customizing the target-date glide path to plan demographics.** Unique plan demographics can make a customized glide path a better fit for some populations. While this may not be an advantage for all plans, a demographic review can assess whether there are benefits to any particular plan.
2. **Adoption of nontraditional DC standalone strategies.** Customization allows the opportunity to deliver sleeves of diversifying asset strategies such as private real estate, liquid alternatives, and unconstrained bond strategies.
3. **Manager flexibility.** Using a multi-manager white-label naming approach enables changes in investment managers to be implemented more quickly and efficiently, with limited participant disruption.
4. **Fee advantages.** There is potential to achieve institutional pricing through leveraging the plan size, consolidating options, and blending active and passive strategies.

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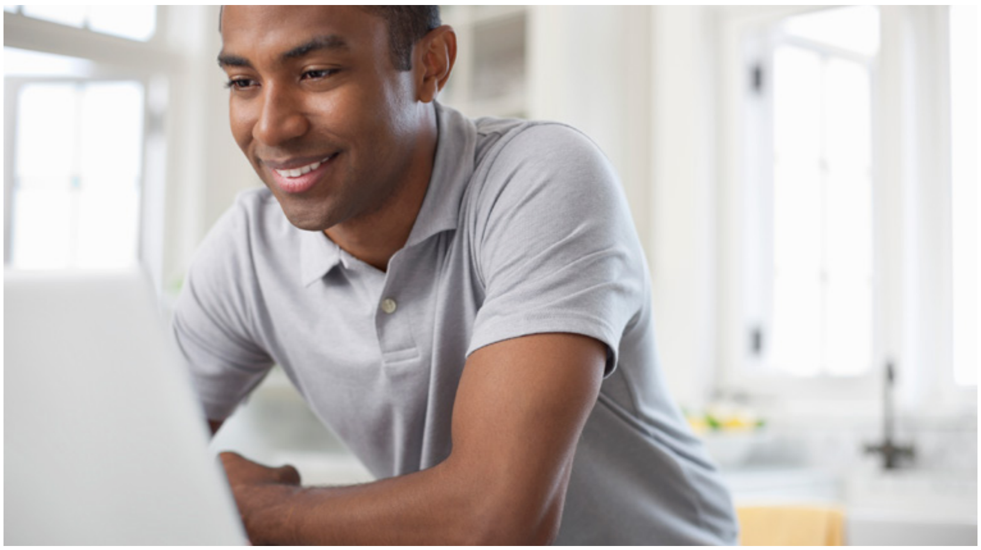
Defined Contribution Recordkeeper Evaluation: Current Trends and Innovations Benefiting Plan Participants

by Rhonda Jinks



Record keeping continues to be a competitive industry as vendors invest in technology and look for ways to differentiate themselves. Many of the product innovations we've already seen (and expect to see in the future) are being driven by the trends discussed below. When evaluating a vendor's performance or conducting a vendor search, we believe plan sponsors should look beyond fees and consider whether their participants have access to new products and services.

1. A Focus on Retirement Income

When defined contribution (DC) plans first emerged, participants were encouraged to take advantage of the tax-deferral opportunity and potential market growth. Over time, these plans increasingly became the primary retirement income source for many employees, and the message transitioned to saving "enough." Vendors began referring to a broad minimum savings rate and attempted to quantify the lump sum needed at retirement (for example, as a multiple of a participant's final pay). Participants have now been contributing to DC plans for decades, and as they approach retirement the logical question they are asking has become "How do I know if my balance will meet my retirement income needs?"

> In 2018 there has been a good deal of discussion among legislators about further supporting retirement income and annuity safe harbors.

In response, vendors began focusing on the issue of retirement income adequacy. Lump-sum balances were translated into a hypothetical monthly income, and online tools were developed that incorporate additional data (outside assets, lifestyle requirements, anticipated medical expenses) in order to help participants understand whether their income stream would meet their particular needs. We have also seen tools offering advice on when to access different sources of money, including Social Security, to maximize income and minimize taxation.

In recent years there has been a lot of discussion about the use of in-plan annuities. In-plan annuities are available in virtually all not-for-profit 403(b) plans by law, but the same cannot be said for corporate 401(k) or public 457(b) plans. In addition to plan sponsor interest, in 2018 there has been a good deal of discussion among legislators about further supporting retirement income and annuity safe harbors. As demand increases, and if more legislation is written, we expect providers to look for opportunities to incorporate these products into their service models.

At Aon we believe in the importance of retirement income and will continue to help our clients evaluate plan design for the potential role of annuities within their DC plans.

2. New Ways to Engage Participants

There was once a time when every plan participant received the same communications. When that proved ineffective, vendors eventually began using demographic data to target distinct audiences. As an example, employees who were 100 percent invested in a single fund (particularly a money market fund or company stock) would receive communications emphasizing diversification. Now vendors are able to generate communications that are personalized to each individual, such as an illustration of how one's monthly retirement income would increase if the current deferral rate were increased.

> Account transactions and messaging need to be conducted via the participant's preferred method.

Behavioral finance continues to be a contributing factor. To begin with, positive messaging has been demonstrated to be more

Defined Contribution Recordkeeper Evaluation: Current Trends and Innovations Benefiting Plan Participants (cont'd.)

effective than dire warnings about never being able to retire. Even more dramatically, the success of automatic enrollment and escalation has proven that participants will make better decisions if they are "nudged" in the right direction. Vendors now present participants with a specific actionable suggestion—"If you increase your deferral rate to 6 percent you'll receive the maximum match"—along with a quick and easy way to implement that suggestion, often with just one click. Many participant websites now prominently feature this type of messaging right on the welcome page.

We hear a lot these days about how baby boomers, Generation X and millennials behave differently, and vendors are actively considering how best to engage with these various demographic groups. Account transactions and messaging need to be conducted via the participant's preferred method, whether that be the website, mobile applications, text, Snapchat, or whatever technological innovations are yet to come. The requirement to send some legal disclosures via traditional methods has presented a real challenge, not just from a cost perspective but because valuable information may be going unnoticed or ignored.

At Aon we believe that DC plan participants respond best to messages that resonate with their own individual experience, behavior, and

motivations. Plan sponsors should use technology to segment their populations and "nudge" them to make good decisions.

3. Financial Wellness

"Financial wellness" has been a buzzword in the industry for several years now, but what this means from a practical standpoint hasn't necessarily been clear to plan sponsors. The concept, of course, is that saving for retirement competes with other financial needs like paying off student loans, putting children through college, or even just paying the monthly bills. Therefore, if we really want participants to retire successfully, we may need to help them manage other financial demands at the same time.

A smart financial wellbeing program should work alongside the DC plan and other employer-provided benefits.

Many vendors have posted articles on their websites and offered employee education sessions on topics such as budgeting, but access to actual tools and services is not yet the norm. We expect that online resources will explore a broader range of topics, such as writing a will or determining insurance needs, while services that prioritize the payment of financial obligations will be offered more and more frequently. In-person financial planning resources may become more prevalent as well. However, plan sponsors still need to consider their fiduciary responsibilities when offering these services.

We believe a smart financial wellbeing program should work alongside the DC plan and other employer-provided benefits—offering a range of tools, services, communications, and interventions at each stage of an employee's financial life, both before and through their retirement years.

Bank Capital Relief: Evolving Banking Regulation Creates Investment Opportunity

by Chris Walvoord

Bank capital relief transactions enable banks to use the capital markets to shed some of their risk by buying credit protection on a portfolio of loans. The transaction "insures" a portion of the risk associated with the loans, thereby reducing the amount of regulatory capital the banks are required to hold against the loans. This opportunity is driven by regulatory changes in the banking industry, particularly in Europe, where banks have lagged their U.S. counterparts in selling non-core assets and reducing their loan portfolios.

In the typical bank capital relief transaction, the investor agrees to provide protection for the second loss tranche on a pool of loans. The bank usually retains the first loss tranche and the senior risk. The loan pool can include short-term trade finance loans and longer-term corporate loans, usually to small or medium enterprises (SMEs) in Europe.

The bank pays a fixed premium annually in advance for the term of the agreement, typically five years, and the investor posts collateral to a trust account equal to the notional size of the tranche. At the end of the term, the investor receives its collateral back, less any losses on the reference portfolio. The net result for the investor is the premium minus the realized default losses.

> The expected returns of bank capital relief strategies are generally higher than those of a direct lending program.

Bank capital relief is similar to other forms of bank disintermediation such as securitization or direct lending; however, there are very clear distinctions. The key difference is that in bank capital relief, the loans are not sold by the bank, but instead remain on its balance sheet. The bank typically wants to "own the relationship" with the borrower and usually sells the borrower a range of other services in addition to the loan. This strategy enables institutional investors to obtain exposure to corporate borrowers who typically don't borrow in the public markets.

The expected returns of bank capital relief strategies are generally higher than those of a direct lending program, and are at the upper end of the range for securitized products such as collateralized loan obligations. The expected volatility of bank capital relief structures is at the lower end of the range for these three types of credit strategies. Interest rate sensitivity is likewise low, since the loans tend to be floating rate.

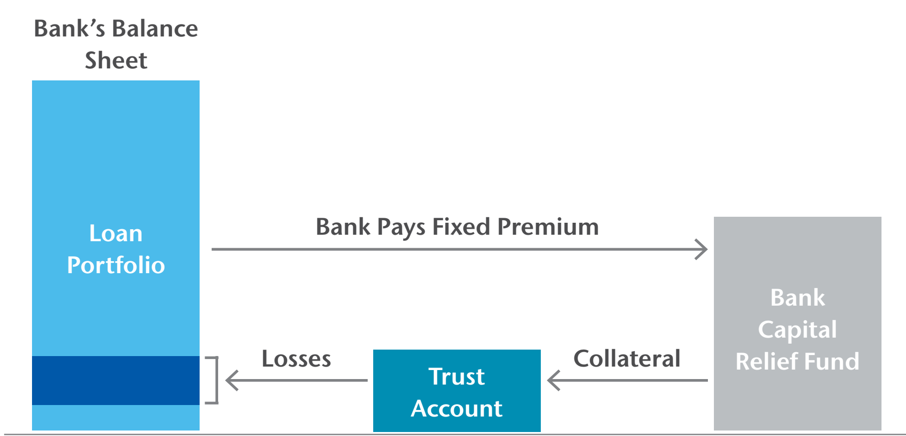
We think there is a strong case for this strategy for investors that can give up medium-term liquidity, since the term of the transaction is typically five years. The primary risk of the strategy is losses in the reference loan portfolio that are significantly greater than expected. There is also the potential for adverse selection in the choice of the loan portfolio. The fund sponsor must actively manage both of these risks.

We believe bank capital relief strategies can aid diversification within a portfolio and allow investors to access an attractive level of income that has a low correlation with traditional equities and fixed income. An allocation to bank capital relief is especially appealing for investors that do not currently have an allocation to private debt.

As with all actively managed strategies, care must be taken when evaluating and selecting a bank capital relief manager. The strategy remains niche and requires a specialist skill set with considerable experience in implementing and structuring these transactions. Manager selection is therefore critical to successful investing in this area.

Read more [here](#).

Example of a Bank Capital Relief Transaction



For illustrative purposes only

Understanding How Unfunded Public Pension Obligations Impact State and Local Credit Ratings: A Call to Action

by John Sullivan

For many public sector entities, unfunded pension obligations are a meaningful component of total long-term liabilities. Due to the magnitude of these obligations and the level of discretion in contributions and assumption-setting, unfunded pension obligations are receiving increased scrutiny from plan participants, taxpayers, public policy groups, and credit rating agencies. The question becomes "How do pension plans influence credit ratings—and consequently, borrowing costs—for public entities?"

In 2017, Aon interviewed the "Big Three" rating agencies (Fitch Ratings [Fitch], Moody's Investor Services [Moody's], and Standard & Poor's Financial Services [S&P]) to better understand the impact pension obligations have on their state and local bond ratings.

While each agency has a unique rating methodology, all three agencies focus on both the current and future state of pension liabilities and plan management.

Each agency organizes its rating framework into four or five broad factors. Public pension liabilities are generally compartmentalized within a "debt and liability" component, which is assigned a 20 percent weight by both Moody's and S&P. Fitch does not assign specific weightings in an effort to tailor its ratings to issuer-specific circumstances. While each agency has a unique rating methodology, all three agencies focus on both the current and future state of pension liabilities and plan management.

When looking at the current state, although much discussion goes into setting expected return assumptions, it is important to know that rating agencies are not necessarily relying on the liability figures reported in the Comprehensive Annual Financial Report (CAFR). Instead, some make adjustments to allow for easier and more uniform comparisons across entities. At one end of the spectrum, Moody's recalculates liability using a market-based discount rate (currently, 3-4 percent). On the opposite end, S&P does not make any direct adjustments to the liability figures reported in the CAFR, which use much higher discount rates (7.5 percent was the median rate in FYE 2017 for public plan sponsors, according to PublicPlansData.org). Fitch falls in the middle by recalculating the liability using a 6 percent discount rate.

The forward-looking view of pension obligations has a direct influence on an entity's overall credit rating.

These subtleties have large dollar impacts. For a pension plan with a 12-year liability duration, a 1 percent decrease in the discount rate results in a 12 percent increase in the plan liability.

The forward-looking view of pension obligations has received increased attention and also has a direct influence on an entity's overall credit rating. In assessing pension obligations, the Big Three consider factors such as:

- Are policies in place to adequately fund future obligations?
- Have entities historically made their full actuarially determined contributions?
- How will unfunded pension liabilities impact future budgets?
- Are methods and assumptions realistic?

The key takeaway is that forward-looking pension plan management—and not solely the current level of an entity's unfunded pension liability—has meaningful impact on credit ratings. We anticipate that the attention and impact of pension plan management on credit ratings will not soon fade, especially if pension debt continues to contribute a meaningful portion of an entity's total debt.

Credit Ratings and Borrowing Costs

So what does this mean for the cost of debt for public entities? Pension plans have a direct

Understanding How Unfunded Public Pension Obligations Impact State and Local Credit Ratings: A Call to Action (cont'd.)

impact on an entity's ultimate credit rating. It is no surprise then that there is a relationship between credit ratings and bond yields—lower-rated bonds tend to require a higher yield to investors, providing less capital to public entities. This leads us to a simple but powerful conclusion: Taxpayers in these jurisdictions are paying higher borrowing costs and could save money through healthier pension plan management.

Selecting appropriate actuarial assumptions, avoiding excessive risk taking, and developing an adequate funding policy are actions that indicate plan sponsors are taking a proactive and realistic approach.

A Call to Action: Proactive Plan Management Has Real Impact

While there are certain pension factors (such as capital market returns and beneficiary demographics) that cannot be controlled, there are aspects that entities can control and clear actions that can be taken to directly improve a public pension's impact on its locality's credit rating. We recommend that plan sponsors consider the following:

1. Conduct an actuarial assumption audit to review the reasonability of key assumptions.
2. Consider adjustments to the expected return assumption that are in line with forward-looking expectations for asset returns.
3. Review the plan's funding policy, looking far enough into the future to identify potential pain points.

Selecting appropriate actuarial assumptions, avoiding excessive risk taking, and developing an adequate funding policy are actions that indicate to the Big Three that a plan sponsor is taking a proactive and realistic approach toward fully funding pensions and properly managing an entity's total debt profile. While an entity's debt priorities and revenue framework to service such debt will vary on a case-by-case basis, every jurisdiction has the ability to thoughtfully develop a funding policy and set appropriate assumptions.

These initial steps will help pension stakeholders better understand their true economic costs, improve the funding outlook for public pensions, and potentially reduce borrowing costs and taxpayer burden.

For more details on this topic, see our full report, "How Do Public Pension Plans Impact Credit Ratings?"

Will Your Employees Be Retirement-Ready? *The Real Deal*

by Grace Lattyak, Melissa Hollister, Saif Choudhury, and Rob Reiskytl

Only 1 in 3 workers today will have saved enough to retire comfortably by age 67. Do you know how your employees stack up? When will they be able to retire with adequate retirement resources?

The Real Deal: 2018 Retirement Income Adequacy at U.S. Plan Sponsors study provides powerful insights into retirement savings behavior and the investment experience of U.S. private-sector plan sponsors. The 2018 study offers insight into the overall retirement readiness of U.S. workers, and is a benchmark for employers across 28 different industries as they measure the effectiveness and sufficiency of their programs.

According to this study, in order to maintain their preretirement standard of living over an average life expectancy, workers who participate in their employers' benefit plans for their entire career typically need to accumulate retirement assets (in addition to Social Security) worth about 11.1 times their final pay for an age 67 retirement. (This varies by participant and could be different for your workforce.)

When the study compares projected resources to projected needs, roughly 1 out of 5 workers (19 percent) is expected to have a surplus at retirement. Another 15 percent may have resources that are close to, but do not exceed, their needs. These employees will likely fall close enough to their targeted needs to allow them adequate retirement income with minor adjustments to their postretirement spending or with supplemental income from assets outside their employers' plans. However, that leaves a majority of workers who are projected to fall short and will need to save more, delay their retirement, significantly adjust their standard of living in retirement, or some combination. What percentage of your workers are on track to save enough for retirement?

Between their own savings and the amount their employer provides in retirement benefits, the average employee needs to save 16 percent of pay for retirement each year (assuming the employee starts at age 25 and retires at age 67). Your employees look to you for guidance on how much to save. Is your plan design structured to encourage higher savings rates? Do you offer contribution escalation and set the escalation target rate at an appropriate level for retirement income adequacy? Do you allow savings in Roth accounts and health savings accounts so your employees can maximize tax efficiency?

The Real Deal study found that age 70 is the median age at which full–career contributors are projected to have resources that meet their needs.

The study outcomes are based on middle-of-the-road market performance and rational, efficient investor behavior from plan participants. However, any number of factors can adversely impact a participant's long-term investment performance, from excessive fees to unwise decisions. Just a 1 percent lower rate of return over a participant's career reduces average projected retirement resources by 1.1 times pay, representing a 15 percent reduction in private resources. Are your investment

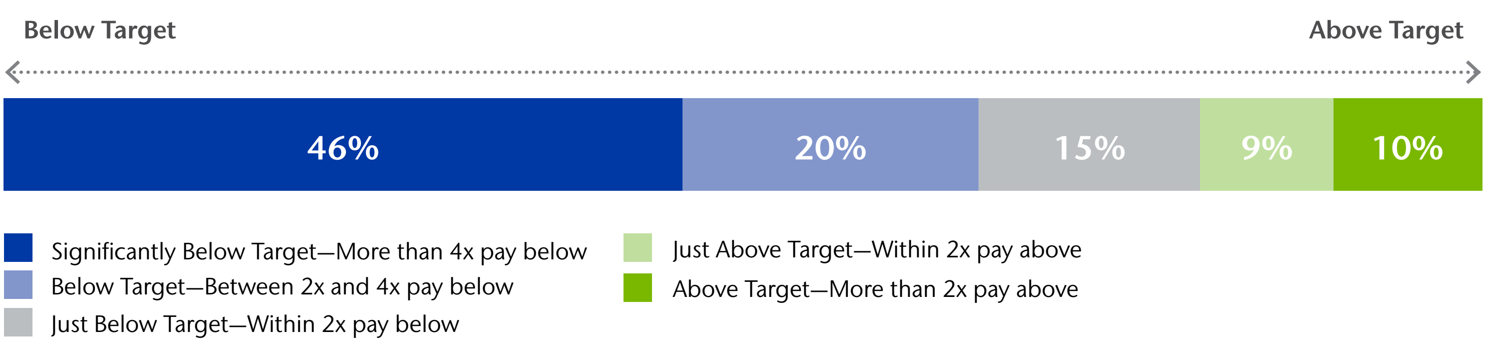
Will Your Employees Be Retirement-Ready? *The Real Deal* (cont'd.)

defaults, alternatives, and fees appropriate? Do your employees have access to investment help (e.g., guidance, advice, managed accounts)?

The age at which an employee retires also significantly impacts their expected retirement adequacy. *The Real Deal* study found that age 70 is the median age at which full-career contributors are projected to have resources that meet their needs. However, the industry in which an employee works can significantly affect their retirement readiness. The median age of retirement adequacy among *The Real Deal* respondents varies by industry from age 67 to over age 75. The market dynamics driving these industry differences come down to employee pay, benefits, and savings rates.

Missing the Mark

Projected accumulation of resources to age 67 shows the majority of workers are not on track for a secure retirement. Here's how the surplus or shortfall of projected resources compared with target needs is distributed:



Source for all details and graphic in this document: Aon's The Real Deal: 2018 Retirement Income Adequacy at U.S. Plan Sponsors, published by Aon October 9, 2018.

Read more about the 2018 study findings—download the report at www.aon.com/TheRealDeal.

Through a company-specific *Real Deal* analysis, Aon can help you and your employees understand how to achieve their retirement goals, based on your specific population and the benefits you offer. To take a look at your employees' retirement adequacy or the efficiency of the investments in your retirement plans, reach out to Grace Lattyak (grace.lattyak@aon.com; 415.486.6931), Rob Reiskytl (rob.reiskytl@aon.com; 925.807.0843), Saif Choudhury (saif.choudhury@aon.com; 312.381.1327), or your regular Aon investment or retirement consultant.

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