Pension awareness, enrolment, and auto-enrolment: checking for policy consistency in the development of pension funds in Italy

Ambrogio I. Rinaldi
Central director, **COVIP**
Chair of the Working Party on Private Pensions, **OECD**

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Outline

- Background information on the development of Italian pension funds since the 90's
- The implementation of nation-wide auto-enrolment in 2007
- The mixed results and the possible explanations
- Some evidence on the role of financial literacy and pension awareness
- Policy suggestions from the Italian experience so far
- Mentioning the relevant work of OECD in the field of pension awareness <u>and</u> connected policy issues

Background info on the development of pension funds in Italy: The start-up

- Up to the beginning of the 90's, there was no perceived need for pension funds directed to all workers, as 1st pillar was generous: pension funds were limited to high salary workers (managers of large companies, financial sector employees):

  around 700.000 members, or 3% of the work force.

- In 1992 (and then in 1995) a major reform of 1st pillar pensions was introduced (including the introduction of the NDC system), that put pension expenditure under control and significantly reduced future benefits (although with a long transition phase).

- The need for the diffusion of pension funds to all workers (and especially the young) became clear. New legislation, and a comprehensive regulatory and supervisory framework was introduced in several stages from 1993. A system of "new" pension funds was created.

The start-up

(continues)

Main features of the system:

- <u>**Pure DC**</u>
- A leading role for occupational, industry-wide pension funds
- For employers, commitment to contribute linked to labour agreements
- For workers, voluntary membership
- "Open" pension funds (set up by financial, insurance firms) directed mainly to the self-employed, with a residual role for employed workers

➢ The first new pension funds became operative in 1998. At the end of year 2000, there were already about 140 new pension funds in place - about 40 "contractual", the rest "open" – a higher number that those still in place. So-called PIPs (insurance-like personal pension plans) were introduced in 2001.

The second phase: the need for a push

- In 2004, after several years of starting, the system looks well-built in structural terms, but still with low membership rates: **around 3m workers, or 13% of work force.**

- After a wide public debate, <u>the automatic enrolment of all employed workers of the private sector was introduced</u> (with the opt-out option), directing to pension funds the annual accrual of so-called TFR (a sort of mandatory severance pay): about 7% of gross earnings.

- Several other new rules were introduced, mainly with the purpose to increase the scope for competition also in the field of occupational pensions. No specific measures were taken for the workers of the public sector and for the self-employed.

- At end-2005 the automatic enrolment was planned for the first half of 2008. Then, after the elections in May 2006, the new Government envisaged <u>to shift it earlier</u>, to the first half of 2007. The final decision was taken in late 2006. It was also decided that firms with 50 employees would be obliged to transfer to the Treasury the flows of TFR that workers did not want to be paid into the pension funds.

Nation-wide auto-enrolment: implementation in a hurry

With little time available, a "rush" phase started, implying:

- The re-drafting of all secondary regulation, to be made consistent with the new law (by COVIP, the specialized regulator/supervisor); the new regulation included specific emphasis to information to potential members

- The re-organization (by the funds) and the re-licensing (by the supervisor) of the pension funds already in place, plus the setting-up and the licensing of several others

- A campaign for increasing awareness of general public (by the Ministry of Labour):
  - all media were used, with special emphasis on TV and radio
  - dedicated web site and call center
  - monitoring of effectiveness during and after the campaign

- Many, capillary initiatives in the workplace (campaigns and meetings) organized by trade unions, often together with the industry-wide funds

- Detailed information to be supplied by employers to workers at company level

- Marketing efforts by financial firms commercializing "open" pension funds and PIPs


TFR.
L'importanza
di scegliere ora.
Entro il 30 Giugno tutti i lavoratori del settore privato potranno decidere in assoluta libertà se destinare il proprio TFR futuro (cioè la liquidazione ancora da maturare) alla Previdenza Complementare o se invece mantenerlo in Azienda. Chi sceglie la Previdenza Complementare può orientarsi su forme pensionistiche collettive, Fondi Negoziali o Fondi Aperti, oppure su Piani Individuali di Previdenza. Ognuno di questi ha i suoi benefici, come una maggiore copertura previdenziale futura, agevolazioni fiscali o la facilità di ottenere anticipazioni di denaro sul capitale versato. Fare una scelta consapevole è importante. Perché stai scegliendo oggi cosa è meglio per te e per il tuo domani. Informati sul sito www.tfr.gov.it e con il Numero Verde 800 196 196.
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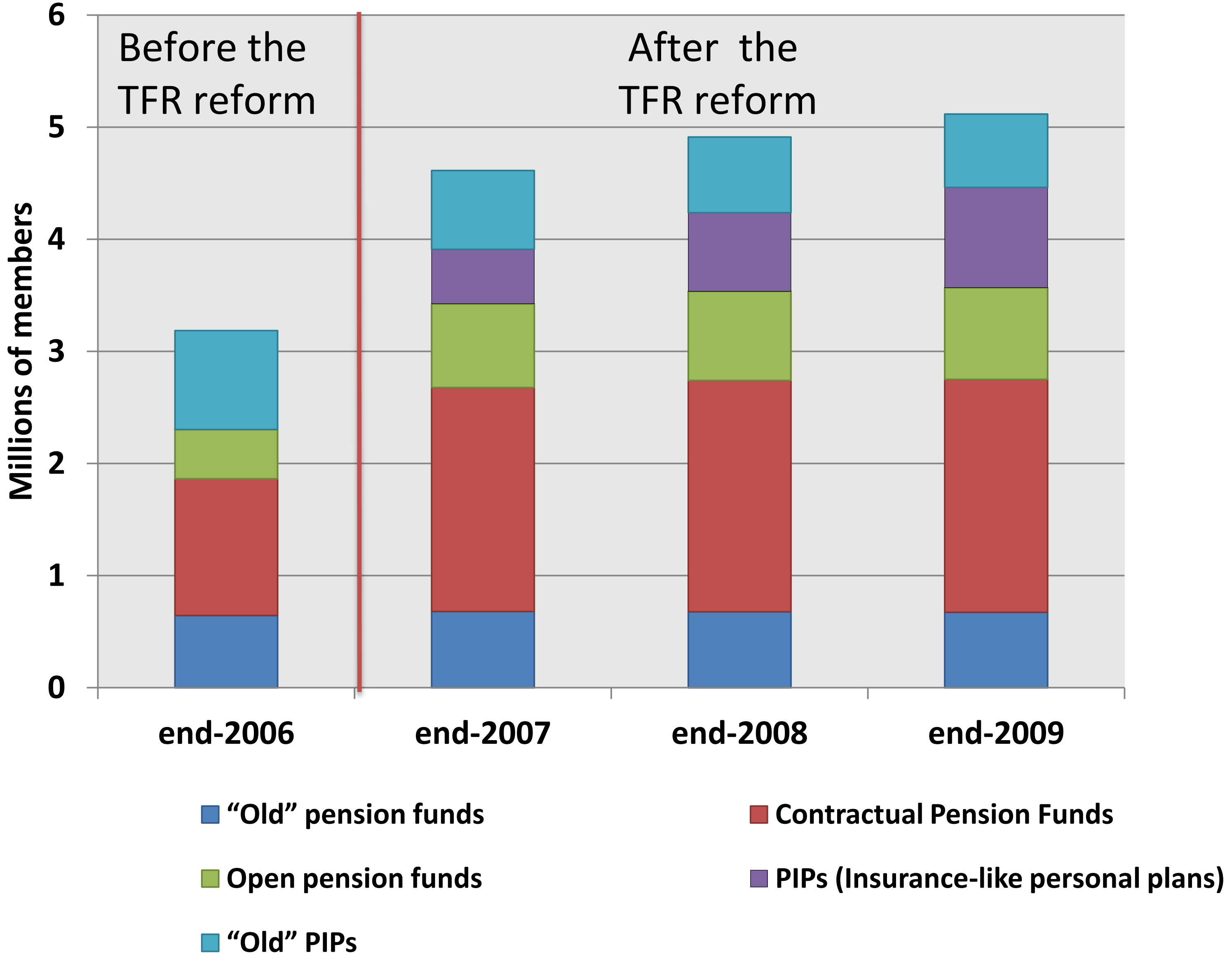
The results so far

- ➢ **a significant, but still unsatisfactory increase in membership:**
- ➢ **at end-2009, just over 5m members, or 20% of workforce, 27% of private sector employees** (most of the result already achieved at end-2007)

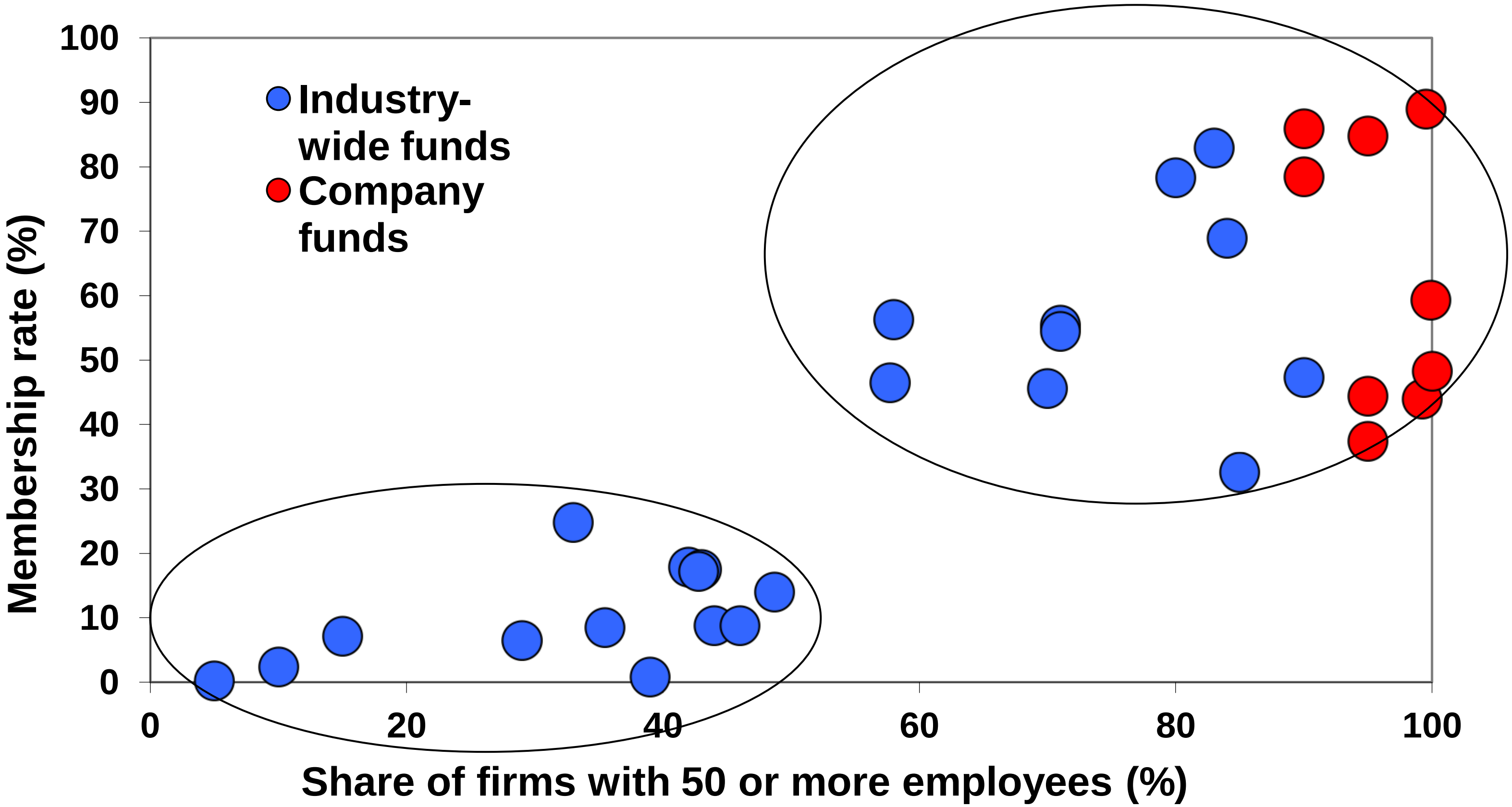
Moreover:

- <u>Very few true “auto-enrolled”</u> (or “silent”) <u>workers</u> (at odds with experience of other countries). Auto-enrolment has continued to be in place for new workers, but still with marginal results
- Membership is very diverse across sectors and funds – mainly depending on firm size and presence of trade unions
- Participation among the young is particularly low
- Competition is still weak across different kinds of pension plans. Costs are also very different, and the most expensive products sell well

Membership before and after the TFR reform

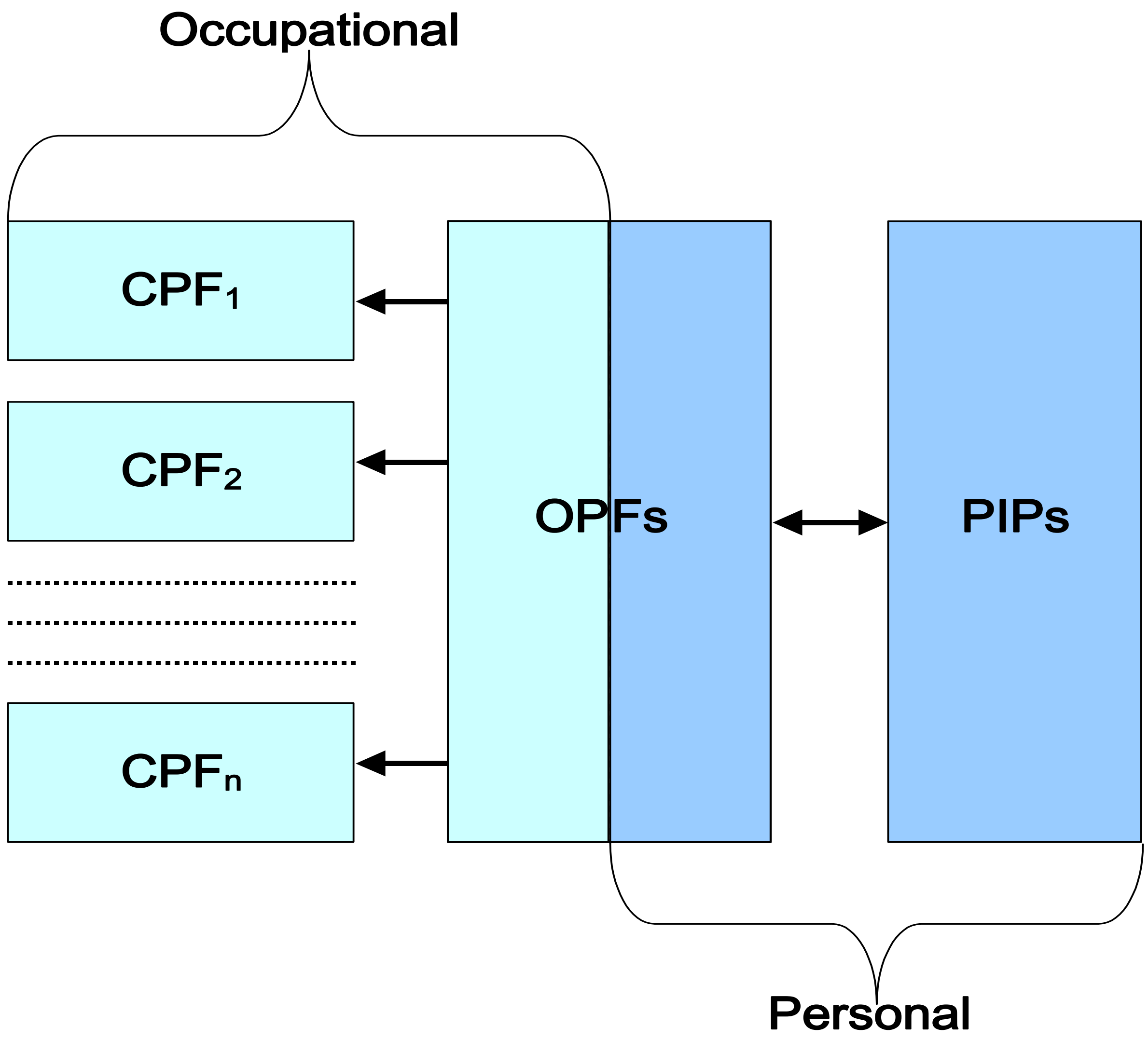


Contractual pension funds: membership rate and firm size



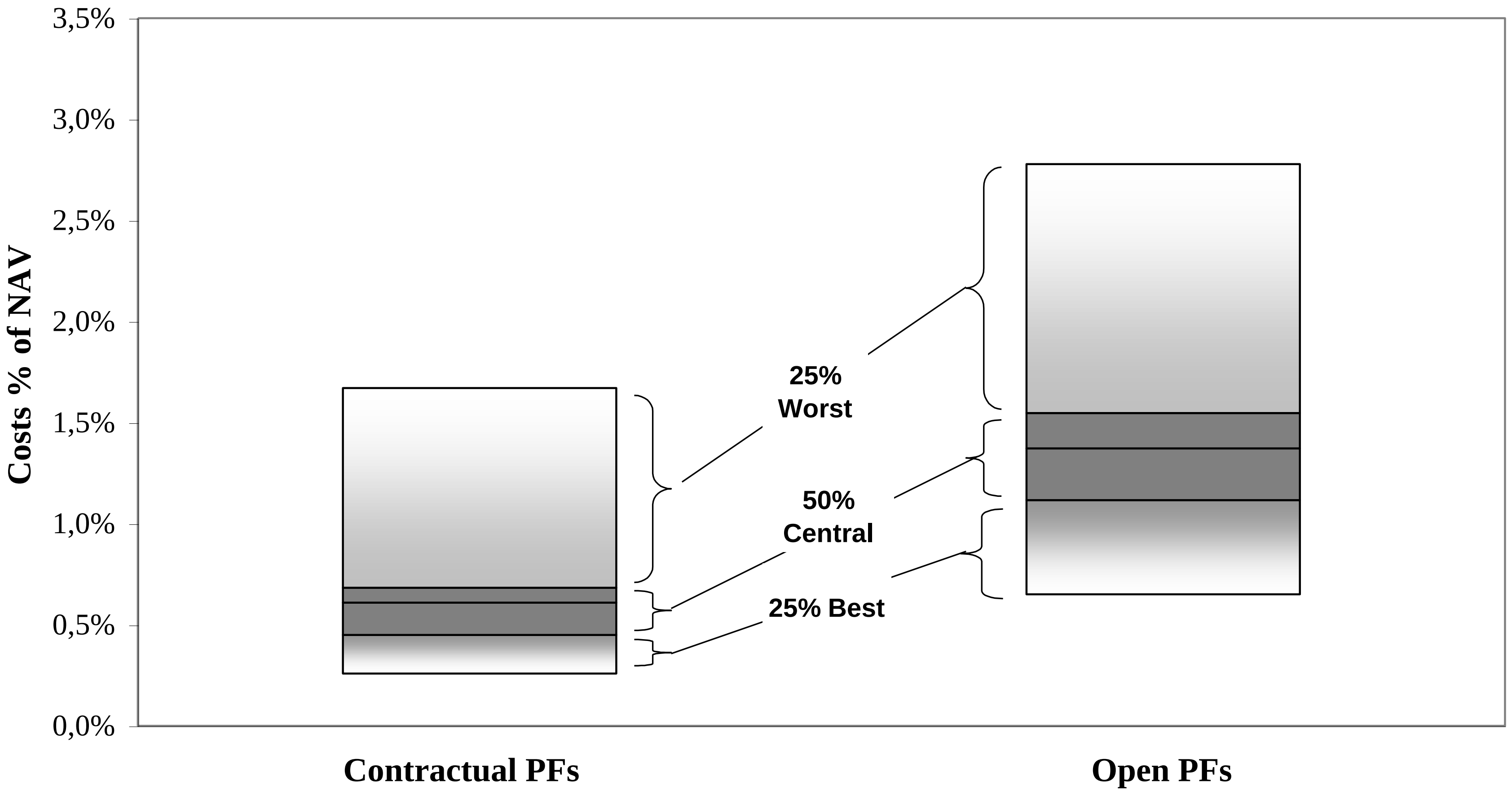
- **Two equilibria :**
  - –a good one (role of social parts, “cafeteria effect”, peer behaviour)
  - –a bad one (little and distorted information)

The structure of the pension funds market in Italy



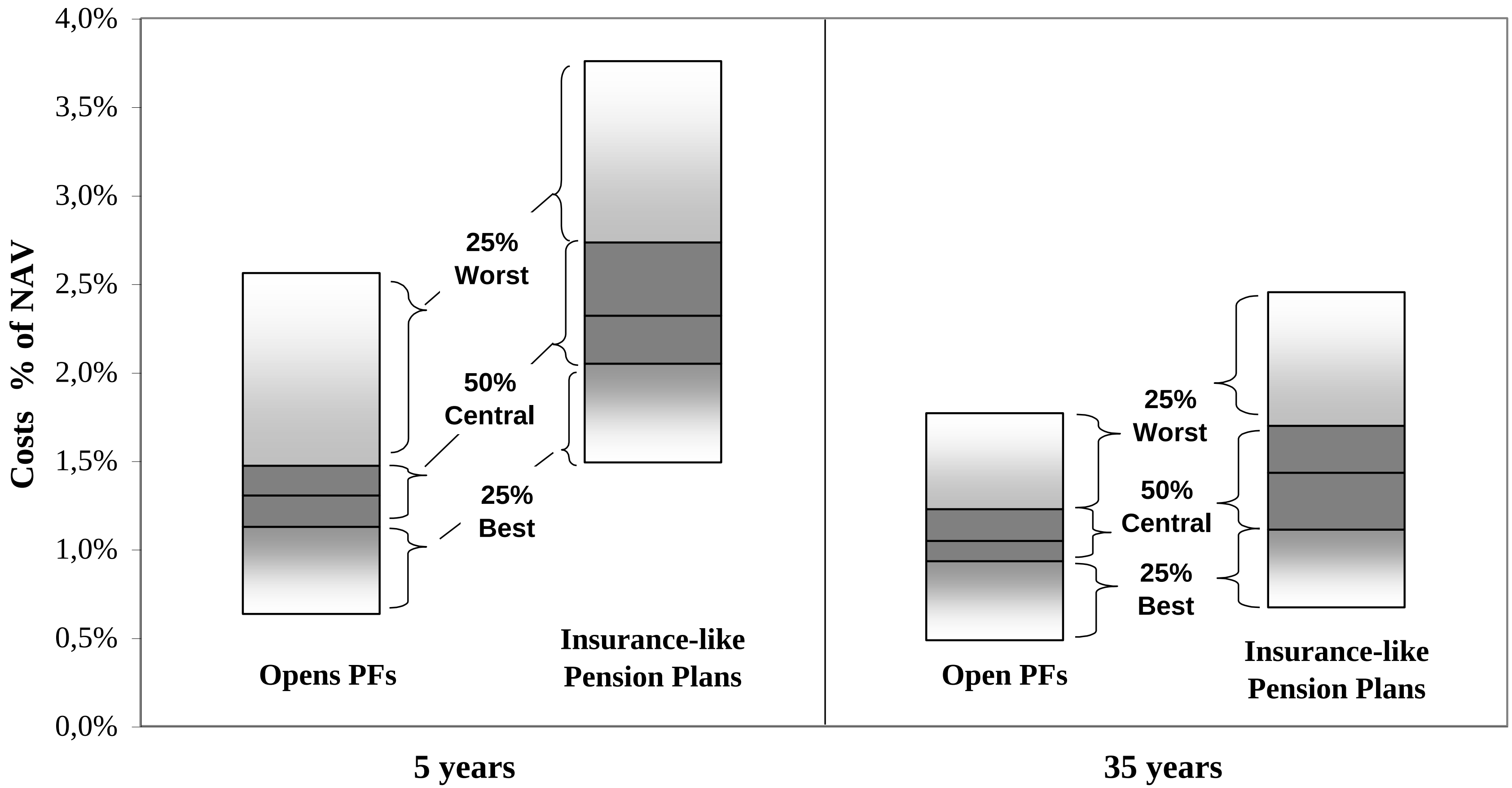
Cost competition in the market for occupational plans

5 years time horizon



Cost competition in the market for personal plans

5 and 35 years time horizon



Explaining the results

Structural and objective factors:

- Low financial literacy and pension awareness among workers to start with
- “Saving” (in terms of contribution rates) for pensions is already high – not clear how much room for further contributions
- For the workers, TFR is a strong competitor vis-à-vis pension funds
- TFR is good as a source of financing for smaller firms (below 50 employees) – incentives for these employers do not work in the right direction
- Many workers (particularly among the young) are liquidity constrained. Little room for additional savings
- Financial and economic crisis:
  - increases liquidity constraints on potential members
  - increases need for financing for smaller firms
  - increases risk aversion, diminishes confidence in pension plans investing in financial markets

Explaining the results (cont.)

Implementation factors:

- Hurried introduction of auto-enrolment: insufficient time to create awareness
- Insufficient effort to improve awareness on the decrease of 1st pillar pensions in the long run, with some uncertainty about the further measures that may be introduced
- regarding pension funds, some aspects of legislation (e.g. taxation) are complex and difficult to communicate
- Unclear public support for the TFR into the pension funds: “appetite” by the Treasury for the TFR of larger firms

Explaining the results (cont.)

Implementation factors: (cont.)

- ”Conscious” adhesion, or “a*desione consapevole*” – the importance to choose - was the main theme of the awareness campaign by the Government and trade unions – more consistent with voluntary enrolment than with the “paternalism” that should be implicit in auto-enrolment - some evidence that the campaign did favour the opting out
- No “true” auto-enrolment: filling a form has been made compulsory to certify “non-action”.
- In terms of contribution rate, the default is sub-optimal for the employee (as it does not provide for the employer’s contribution, but only for the TFR)
- In terms of investment option, the default is also sub-optimal for most members: a very conservative, guaranteed investment line

Explaining the results (cont.)

Specific issues for personal plans:

•Despite efforts made through information requirements, strong information asymmetries between selling agents and potential members are still there

•Application of “rules of conduct“ regulation taken from MIFID is not very helpful: clustering of clients through questionnaires and the resulting characterization of products as suitabile/ appropriate do not address costs, and do not deal with excessive risk aversion

A few examples:

Cost of the product	Age of potential member	Exposure to equity risk	Usual MIFID characterization
high	young	low or nil	appropriate
high	old	nil	appropriate
low	old	low	inappropriate

➢**Specific information mechanisms may be needed for pension products in order to make competition work (e.g. comparative information, etc.)**

Some evidence on financial literacy, pension awareness, and the decision to adhere

In June 2008 COVIP commissioned a survey in order to better understand the factors influencing workers' choices regarding pension fund membership
(telephone interviews of about 1000 employed private sector workers)

The classic "Lusardi-style" questions were included:

Questions on financial literacy	% of correct replies		
	Entire sample	PF members	not PF members
Compound interest rate	53,5%	59%	52%
Inflation perception	48,5%	53%	47%
Difference btw. stocks and bonds	49%	55%	47%
Risk diversification	53%	61%	51%
Relationship btw. price/yield of bonds	11,4%	12,9%	11%
Sample size	*981*	*224*	*757*

➢ **Replies are in line with those of other countries and show a positive (though small) effect of financial literacy of the decision to adhere**

Some evidence on financial literacy, pension awareness, and the decision to adhere (cont.)

A few other questions were also asked:

Questions on awareness on pension reform (NDC vs. earning-based system, etc.)	% of correct replies		
	Entire sample	PF members	not PF members
Your benefits will depend: only on the contributions you pay / only on your salary as an active worker / on both / DNK	28,5%	32,6%	27,2%
How large you expect your benefits to be in terms of your last salary: <50% / btw. 50-60% / btw. 60-80% / >80% / DNK	63,3%	70,1%	61,2%
The PAYG system (*sistema a ripartizione*) is a system where contributions paid today are used for: Paying current retirees / paying future benefits to current active workers / both / DNK	37,2%	44,6%	35%
Sample size	*981*	*224*	*757*

- Replies show a positive effect of "pension awareness" on the decision to adhere
- Preliminary results of econometric analysis through probit models show a stronger effect of pension awareness vs. financial literacy on the decision to adhere

Policy suggestions from the Italian experience so far

➢ Ensure consistency between education efforts and other policy tools

- clear communication on effects of 1^{st} pillar reforms is essential ("orange envelope", etc.): cfr. *OECD Recommendation, par.2:* "*promote understanding of the changing retirement environment*"
- default options are a strong way to convey education/advice; avoid sub-optimal default options that may contradict education efforts
- policy design should create a incentive-compatible environment (e.g. making pension fund membership of workers at least neutral for employers / Treasury)
- competition across pension products may be greatly helped by financial education, but also needs specific devices (e.g. comparative information, etc.)

➢ Mitigate the high risk aversion induced by the financial crisis

- Risk appetite is highly procyclical, make use appropriate investment default options (e.g. life-cycle, target funds) that help educating members to have stable, long term orientation and an appropriate exposure to equity risk

Policy suggestions from the Italian experience so far (cont.)

- **Find <u>the right balance of responsibilities</u> between the State (legislation), social partners and individuals. Soft paternalism, nudging, is useful to complement information and education efforts directed to individuals**

- **<u>"One size does not fit all",</u> but do not escape the responsibility to advice (trough appropriate default options) <u>"what is likely to be the best"</u> for the average worker**

OECD, etc. work on pension awareness and connected issues

- Pioneering work on pension-related financial education and awareness initiated in 2003
- OECD recommandation on Good practices for financial education related to private pensions; developed in 2006 by the WPPP, formally approved by the OECD Council in 2008
- Work with IOPS on information to be delivered to members of DC pension plans (IOPS Working Paper n.5 by Rinaldi-Giacomel, 2008)
- Current work on DC pension plans, investment and default options, pension projections and ways to inform members on the uncertainty surrounding estimates (P.Antolìn and others, 2009 and 2010)

- **from OECD work, a major message emerges on the complementarity between the different policy tools available for managing risks in the context of DC pensions (financial education, information to members, supervision, regulation, appropriate design of default options, etc.)**

- **a consistent policy framework across all the available tools is needed in order to exploit this complementarity**

Thank you for the attention!

for comments or questions,

rinaldi@covip.it