

Governance and Structural Challenges with Individual Accounts

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What are Individual Accounts?

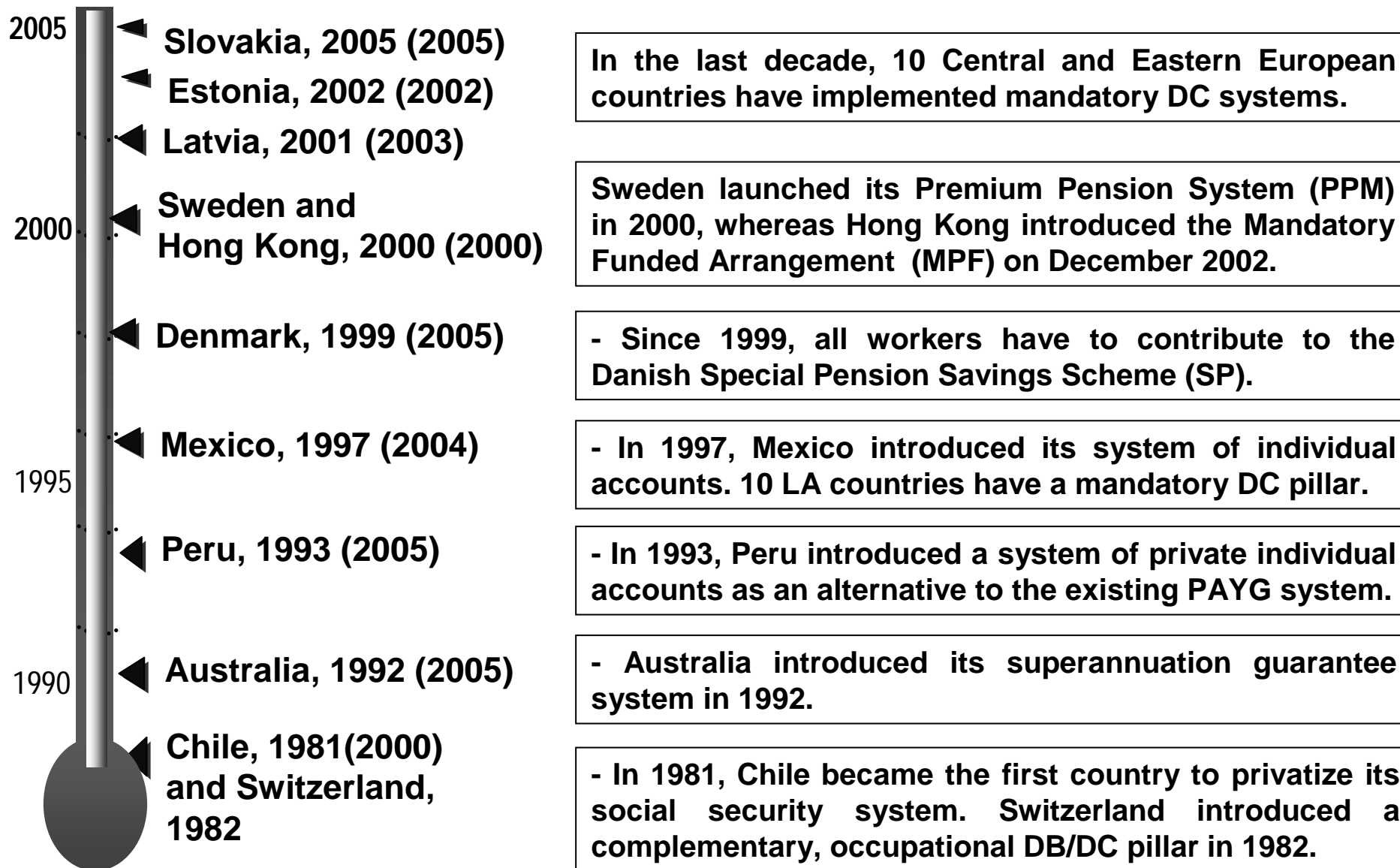
- **Individual accounts** = fully funded accounts administered either by employers, the government, or designated third parties and are owned by the individual. The level of retirement benefits depends largely on the amount of contributions made by, or on behalf of, an individual into the account during his or her working life, investment earnings, and the amount of fees individuals are required to pay.

- **Why were they introduced?**
 - Reform of regressive pension systems
 - Economic transition (Eastern Europe)
 - Rebalancing the roles of the public and private sectors
 - To introduce a second pension (Australia)
 - Neighbourhood effects and policy transfer (Latin America, Eastern Europe)
 - Encourage investment and market development



Rise of Mandatory Private DC systems

Individual Choice Introduced (year)





Recent initiatives

New Zealand / UK

- 2007, auto enrol new employees KiwiSaver, with 3 weeks opt out
- Employer will contribute with 4% of salary / Savers can chose provider and from limited range of funds
- UK Pensions Commission proposed National Pensions Saving Scheme (NPSS) /Automatic enrolment with 1 month opt out
- Contributions 5% employee (1% tax relief) / 3% employer /limited investment choice + capped fees / possible central administration

Ireland/ South Africa

- Proposals 'Special Savings for Retirement' in Ireland and 'National Retirement Fund' in South Africa – introducing mandatory, supplementary DC accounts for all workers

India

- New Pension System – individual DC for civil service/ voluntary all workforce

USA

- Bush Administration Social security reform proposals



Advantages of Individual Accounts

- **Transparency / Clarity**
- **Actuarial Fairness**
- **Portability / Flexibility**
- **Individual Choice**
- **Potentially Higher Returns**
- **Administrative Reform**

Challenges Experienced by Countries with Individual Accounts Systems

- **Coverage**
- **Suboptimal Investment Decisions**
- **Costs**
- **Annuitization**

1. Coverage

Problems

- Contributions earnings linked therefore systematic under-coverage for some parts of population (unemployed, women)
- Difficulties with including self-employed /informal sector (e.g. *Chile estimates for self-employed participation as low as 6%*)

Potential Solutions

- Incentives for informal sector (match contributions, flexible rate – by age/ wage – allow withdrawals/ loans)
- Better collection for self-employed
- Financial education and awareness campaigns
(e.g. *Chile self-employed with above average knowledge of pension system 14% more likely to make contributions*)



2. Suboptimal Investment Decisions

'Survey of Investment Choice by Pension Fund Members'
16 countries mandatory + voluntary DC plans

Choice of pension fund manager

- **Generally individuals choose manager**
- **Normally no fees for shifting between managers**
- **Default option for no choice in some countries**
- **Licensing conditions limit entry of providers**
- **Choice of provider may be limited by market**

Choice of portfolio

- **Most countries members choose portfolios**
- **Some countries set investment limits for each fund – others managers set investment rules**
- **Most countries allow fees + charges to discourage switching – sometimes regulators impose limits**
- **Most countries specify a default portfolio – e.g. life-cycle**
- **Managers usually charge for switching between portfolios**



Choice Pros + Cons

Positive

- Allows members to reflect different needs, preference, risk tolerance
- Shown to raise contribution and participation rates

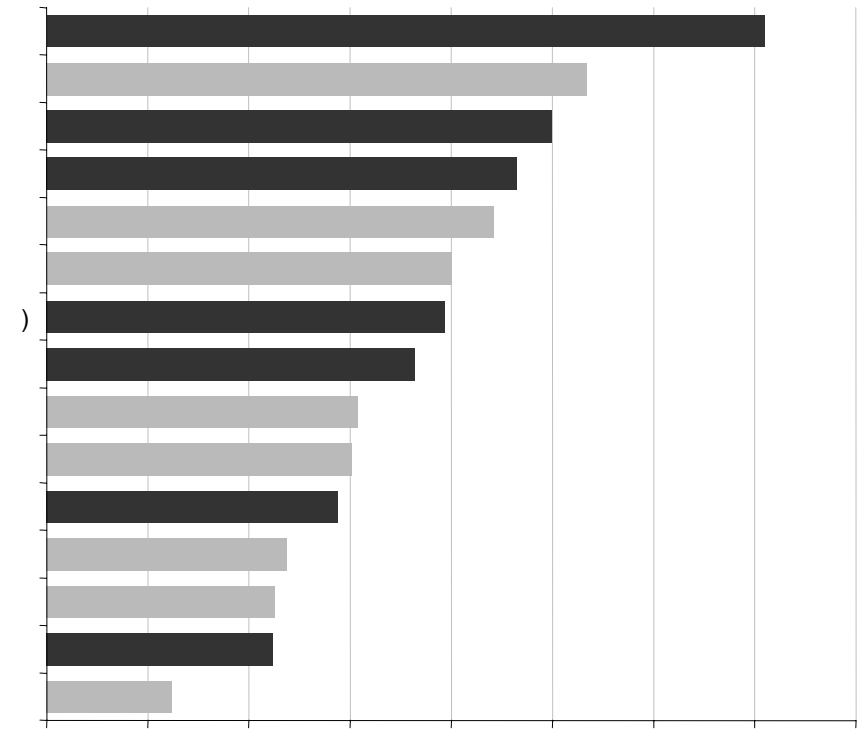
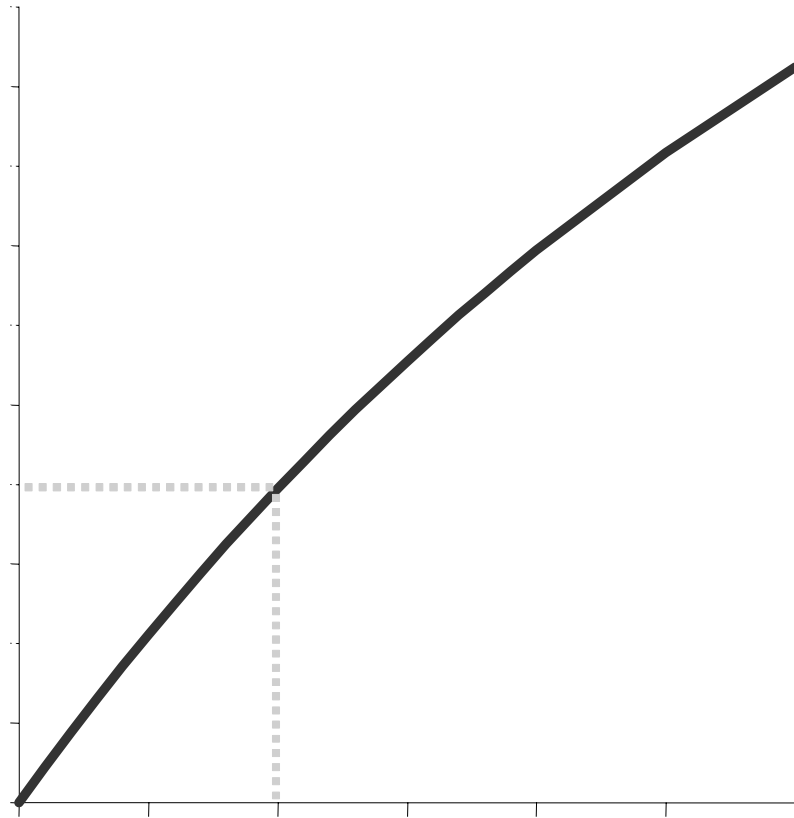
Negative

- Vast majority choose default option
- Those who do chose do not necessarily do so wisely
- Demotivation and choice overload
- Moral hazard if social security safety net
- Can increase costs

Solutions

- Limit and structure number of choices
- Choose default option carefully
- Information disclosure + presentation
- Financial Education

3. Costs



Differences in Charges

- **Costs can be born by government / employer**
 - set up costs
 - administration
 - Information
- **Differences in charge structures / tax treatments**
- **Importance of scale**
- **Impact of marketing costs**

How to control Costs

- **Disclosure:** standard format / league tables / public information
- **Incentives:** bearer chooses provider/levy on contributions
- **Transparency:** a single 'price' for pensions
- **Restrict switching providers:** might reduce marketing costs
- **Ceilings on charges:** El Salvador, Kazakhstan, Sweden, UK
- **Subsidies to low-income workers:** Mexico
- **Force switchers to choose lower cost funds:** Mexico
- **Subsidise charges:** New Zealand (*KiwiSaver*)
- **Cross-subsidise charges:** Sweden
- **Centralized administration:** collection/ records / investment
- **Limit investment choices:** economies of scale within portfolios
- GOVERNANCE



Governance Problems DC Schemes

Governance

- **Involves:** managerial control and organization, including the regulation, supervision and accountability of management boards
- **Goal:** minimize potential agency problems or conflicts of interest between fund members and the fund administrator which can adversely affect the security of pension savings and promises
- **Benefits:** may improve the performance of the fund and creates trust amongst stakeholders – vital element for efficient functioning pension systems

Problems with DC schemes

- *Effectively contract between individual + provider*
- *Who appoints service provider?*
- *Who monitors their on-going service quality?*
- *Who ensures optimal range of investment choices?*
- *Who ensures external fiduciaries fulfilling their duty (i.e. guards against conflict of interest)?*

DC Scheme Governance Solutions

OECD Principles

I. Governance Structure

“ The governance structure should ensure an appropriate division of operation and oversight responsibilities, and the accountability and suitability of those with such responsibilities.”

- Identification of responsibilities
- Governing body
- Expert Advice
- Auditor / Actuary / Custodian
- Accountability
- Suitability

II. Governance Mechanisms

“Pension funds should have appropriate control, communication and incentive mechanisms that encourage good decision making, proper and timely execution, transparency and regular review and assessment.”

- Internal Controls
- Reporting
- Disclosure
- Redress



Other DC Governance Solutions

- Ensure a transparent process for the appointment of external trustees, with employee and beneficiaries approval of the appointment required
- Clarify the plan sponsor's on-going fiduciary responsibility for oversight of external trustees
- Establish a body to undertake this role (such as the pension commissions in Spain and Portugal)
- Make sure trustee boards understand their responsibilities towards DC as well as DB schemes
- Improve quality of trustee boards (training / proper representation / independent members)
- Encourage pension funds to manage their governance collectively in order to share governance burden amongst plan sponsors