towards a new pensions settlement

THE INTERNATIONAL EXPERIENCE

GREGG McCLYMONT
AND ANDY TARRANT

policy network

TOWARDS A NEW PENSIONS SETTLEMENT

This volume presents the recent experiences of pension reform in seven countries: Australia, Canada, Germany, the Netherlands, Poland, Sweden and the United Kingdom. Faced with common problems of ageing societies and constraints on taxation levels, all are increasingly passing responsibility for saving for retirement to citizens. However, there is enormous variety between countries in the degree to which the state intervenes to mitigate the risks which the individual can face in saving for a pension.

About Policy Network

Policy Network is an international thinktank and research institute. Its network spans national borders across Europe and the wider world with the aim of promoting the best progressive thinking on the major social and economic challenges of the 21st century.

Its work is driven by a network of politicians, policymakers, business leaders, public service professionals, and academic researchers who work on long-term issues relating to public policy, political economy, social attitudes, governance and international affairs. This is complemented by the expertise and research excellence of Policy Network's international team.

www.policy-network.net

TOWARDS A NEW PENSIONS SETTLEMENT

The International Experience

Edited by
Gregg McClymont
and Andy Tarrant

policy network

ROWMAN & LITTLEFIELD INTERNATIONAL

London • New York

Published by Rowman & Littlefield International Ltd
Unit A, Whitacre, 26-34 Stannary Street, London, SE11 4AB
www.rowmaninternational.com

Rowman & Littlefield International Ltd. is an affiliate of Rowman & Littlefield
4501 Forbes Boulevard, Suite 200, Lanham, Maryland 20706, USA
With additional offices in Boulder, New York, Toronto (Canada), and Plymouth (UK)
www.rowman.com

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

ISBN: PB 978-1-78348-748-6

Library of Congress Cataloging-in-Publication Data

Library of Congress Control Number: 2016930906

∞ ™ The paper used in this publication meets the minimum requirements of American National Standard for Information Sciences—Permanence of Paper for Printed Library Materials, ANSI/NISO Z39.48-1992.

Printed in the United States of America

CONTENTS

ABOUT THE CONTRIBUTORS

EDITORS

Gregg McClymont is head of retirement savings at Aberdeen Asset Management. Gregg was previously an MP and shadow pensions minister in the last parliament. Before entering the House of Commons, Gregg was a tutorial fellow of St Hugh's College, Oxford. He is also a visiting fellow at Nuffield College, Oxford.

Andy Tarrant served as researcher to Labour's shadow pension minister, Gregg McClymont, in the 2010–15 parliament. He qualified as a solicitor at Herbert Smith and worked on regulatory issues for the UK telecoms regulator, British Telecommunications PLC and the European Competitive Telecommunications Association. His academic work focuses on political economy and regulatory design.

CONTRIBUTORS

Jeremy Cooper is chair of retirement income at Challenger Limited, a full-time executive role focusing on research, public policy issues and thought leadership. Prior to joining Challenger, Jeremy chaired the 'Cooper Review' into the superannuation system, the recommendations of which have been substantially adopted. Before his review role, Jeremy was deputy chair of the Australian Securities and Investments Commission (ASIC) for five years from mid-2004.

Prior to his term at ASIC, Jeremy was a partner of an Australian law firm, now part of Ashurst.

Steffen Hagemann is a researcher at the Research Center on Inequality and Social Policy (SOCIUM) in Bremen, Germany. He currently works on a project on paid work beyond state pension age in Germany and the UK. In his PhD thesis, he investigated the collective discourses around ageing, older workers and reforms of old age provision in both countries.

W Paul McCrossan is a retired actuary who was elected three times as member of the federal parliament of Canada, where he had political oversight of pension legislation. He has served as president of both the Canadian Institute of Actuaries and the revamped International Association of Actuaries, as well as member of the New Brunswick Pension Reform Task Force and as an external adviser to the UK's Morris Review of its actuarial profession.

Marek Naczyk is a postdoctoral researcher at the Hertie School of Governance, Berlin, and a research associate at the Centre d'études européennes and the LIEPP, Sciences Po Paris. Previously he held postdoctoral appointments at the Oxford Institute of Social Policy. His research focuses on the politics of pension privatisation in OECD countries and on the links between pension reform and corporate governance reform.

Edward Palmer is professor emeritus in Social Insurance Economics at Uppsala University, fellow at the Uppsala Center for Labor Studies and senior adviser for the Swedish Social Insurance Agency.

Eduard Ponds is professor in the Economics of Pensions at Tilburg University and employed at APG (All Pensions Group) in Amsterdam, the Netherlands.

Onno Steenbeek is professor of Pension Fund Risk Management at the Erasmus School of Economics in Rotterdam, as well as managing director of ALM and Solutions at APG Asset Management in Amsterdam, the Netherlands.

ACKNOWLEDGEMENTS

We would like to thank the contributing authors. We would also like to thank all those who discussed the issues raised in the chapters with us and in particular staff at B&CE.

We thank Aberdeen Asset Management for their sponsorship of this publication.

INTRODUCTION

This volume is a study of the recent experiences in pension reform of the United Kingdom and six other nations. The six have been hailed as international trailblazers in pension reform at one time or another in recent years; all have experienced pension policy reform successes and difficulties. Australia, Canada, Germany, the Netherlands, Poland and Sweden are therefore useful reference points for UK policymakers, who, as the UK chapter makes clear, are in the midst of a far-from-complete reform of our own domestic pension system. The UK chapter illuminates serious structural defects in the current UK occupational pension system. These defects are sufficiently serious that the new UK government will continue to be pressured in the direction of further reform to ensure privately provided workplace pensions are demonstrably value for money.[1] We expect the pressure for further reform to rise with the expected uplift in employer and employee contributions to automatically enrolled workplace pensions in 2018. An increase in total contributions from two per cent to eight per cent of annual salaries will mean most UK employees will be contributing materially significant sums from their wages. If one wants to consider likely salience, it is worth noting that the average employee will be contributing significantly more to his or her pension than the average 'band D' annual council tax payment.

UK CONTEXT

The UK reform process began with the Independent Pensions Commission appointed by Tony Blair in 2005. It examined a complex system encompassing a basic state pension, means-tested pension credit, the state second pension system, as well as voluntary individual company pension schemes into which only a minority saved. The pensions commission's blueprint was an alternative system combining a foundation pillar state pension to provide a secure and easily understood income with high quality additional workplace schemes. In order to ensure this alternative system achieved mass coverage, three revolutionary steps were proposed: every employer would be obliged to offer a workplace pension; every employee was to be enrolled into it (unless they decided to opt out); and, because private pension providers often did not want to serve low and medium earners, provision should be ensured by a not-for-profit state-subsidised provider, the National Employment Savings Trust (Nest). The latter would have a universal service obligation to accept contributions from any employer or employee and provide a low cost, high quality service. The last Labour government adopted these recommendations.

One of government's motivations for appointing the pensions commission was to seek advice on designing a system that would be fit for both economy and society in the 21st century. In the globalised economy, individual firms come and go – often very rapidly. The average time an employee stays with any one firm is even shorter. The vast bulk of firms are small.

As a consequence, it no longer makes sense to have a workplace pension system primarily directed at large, enduring employers with stable workforces and the resources to manage a pension scheme themselves. The lack of fit between the original pension system and the new economic reality is the structural reason behind the decline of single company defined benefit (DB) schemes in the UK and abroad. It is also a reason behind the rise of defined contribution (DC) pension schemes, which effectively allow employers to pass responsibility for pension schemes and employee outcomes to financial institutions. In DB schemes, the employer must honour the annual level of income promised to the employee, topping up payments to employees where the financial performance of the underlying assets fall short of the amount needed. In DC, unlike DB, there is no guarantee as to income. Instead, the income in retirement is dependent solely on the performance of the funds invested. However, the view of the pensions commission was that the type of pension scheme that fitted the new environment needed to change: there would need to be mass multi-employer schemes increasingly known as 'master trusts', as well as individual employer schemes.

A changing demographic context also underpinned the commission's work. When the state pension was introduced few lived to enjoy it for very long. Now, large numbers of people can expect to spend a third of their lives in retirement. A decline in the number of workers relative to those in retirement (the 'dependency ratio') as well as a generalised reluctance to increase tax burdens means that individuals need to save more for their retirement. To encourage them to do so the retirement income provided by occupational pension schemes has to be attractive enough for most people to want to contribute into them. The focus of the UK pensions commission was only on pension saving (the 'accumulation' phase). However, a complete pension system must cover both the accumulation phase and the phase in which those savings are drawn down (the 'decumulation' phase), particularly as, post the 2015 'pension freedoms' legislation, many retirement products will have a continued investment saving element. Enhancing the attractiveness of occupational pensions in both the accumulation and decumulation phases is the challenge now faced in the UK.

INTERNATIONAL EXPERIENCE

A process of reforming occupational schemes to make them fit for current employment patterns and lives in retirement is in fact common to all developed countries, so there may be lessons we in the UK can learn from developments abroad. At different times in the last 15 years, various countries have been identified as leading in aspects of successful reform. We have asked experts from a number of these countries to contribute chapters reflecting on the successes and failures as they see them, in each of their countries. These chapters deal specifically with developments in turn in Australia, Canada, Germany, the Netherlands, Poland and Sweden. Each author highlights the challenge of designing fit-for-purpose occupational schemes (often described as 'second pillar' schemes). These are typically funded by employer and employee contributions and supported by tax relief from the state. The contributions are usually invested in private funds and retirement incomes of former employees are dependent on market returns to those funds. 'First pillar' schemes are basic state pensions typically funded from general taxation, although in Poland and Sweden these are funded out of specific taxation for pensions. 'Third pillar' schemes take the form of retail savings products provided by financial services companies, into which individuals save without any employer contribution and their returns too are entirely dependent on the market performance of the funds into which the savings are invested. Unlike the other countries, the German move to encourage mass private pension saving has placed a greater emphasis on third pillar products, although this is now being called into question.

THE ROLE OF THE STATE

The state has a key role in providing, and setting the terms of access to, the universal state pension. This responsibility includes the level of the state pension, how it is protected against inflation and the rules regarding eligibility. For example, being unemployed but looking for work usually leads to no loss of eligibility. But many of the countries in this volume are struggling to maintain the level of the state pension. This is because it is typically financed out of current tax contributions. In other words, each working generation pays for the generation in retirement – a system known as 'pay-as-you-go'. Countries where the birth rate has fallen and population replacement has not occurred through immigration have a choice between raising taxes on current workers to pay pensions to those currently in retirement, or instead to reduce pensions to those who have retired.

In most countries, the state pension provides a basic income in retirement but a comfortable retirement requires additional income drawn from savings in occupational pension schemes (second pillar pensions). Traditionally, employers provided this in DB schemes that were individual to the employer. They outsourced the administration and fund management but deployed governance systems, which meant they could, if they wished, keep a close eye on the value for money provided by the outsourced providers. In the world of contract DC, employers are at arm's length from the providers and employees have little or no ability in practice to control the quality of the service provided by financial institutions. In the UK, much of the debate in pensions in recent years has been about the type of regulation needed to ensure that financial institutions do not extract too high rents from people's pensions, compromising their ability to retire. As the UK chapter discusses, the reforms required to meet this challenge are far from complete.

THEORETICAL JUSTIFICATION FOR MARKET INTERVENTION

The American economist George Akerlof won the Nobel prize in 2001 for his paper entitled *The Market for Lemons.*[2] 'Lemons' in this case being slang for poor value used cars. His paper discussed the impact of asymmetries of information between buyers and sellers. Where these are prevalent, poor quality goods will inevitably drive out good ones. The market will become dominated by sellers of poor quality goods and the number of buyers will severely reduce in response. Institutions to act as guarantors of quality are the necessary antidote to prevent such market failure.

Information asymmetries are prevalent in pensions. Few apart from the cognoscenti understand pension statements. Even if they did, this would be to little avail as many transaction costs are not yet actually disclosed. And even if they were, employees only have the option of saving with the scheme with which their employer has signed up, so where the scheme is poor quality the only choice would be to opt out from workplace pension saving altogether.

INTERNATIONAL LESSONS

High Costs and Charges and Lack of Transparency

Charges can occur at three levels: at the administration layer, where contributions from savers are collected and income paid out; at the fund layer, where the sums collected at the administration layer are invested and fees are charged by the fund manager; and *by* the fund layer, where costs of undertaking investment with other intermediaries are deducted from the monies in the fund. There has been a lack of transparency at all levels but particularly in respect of the last category. A lack of monitoring of what occurs at the fund layer is a particular concern in respect of DC (and third pillar products) in the UK, as the administration layer and the fund manager are typically vertically integrated. In other words, the shareholders of the pension provider might maximise returns where there is poor monitoring of fund practice. High costs and charges drain public confidence in pensions saving: in Poland, contributions to private workplace schemes have been cut by politicians, partly in response to popular resentment of high costs; in Germany, the initial popular enthusiasm for third pillar, or 'Riester', products has fallen away due to poor performance, which is partly a consequence of high costs. Conversely, in Australia, Canada, the Netherlands and Sweden, mechanisms for pressure on costs and charges and for transparency are key measures for building and maintaining support for the reformed system.

The Need for Scale Provision

Pension schemes in the UK are typically organised around an individual employer. This means that most forgo economies of scale that would significantly boost the returns and thus the pensions potentially available to their members. In DC schemes, scheme administration and fund management are typically contracted out to an insurance company. The DC market in the UK is dominated by a small number of insurance companies and they have scale. By basing offers around individual employers, although contracting with individual employees, insurers are able to achieve the advantages of scale while price discriminating. This means that they offer reasonable costs and charges when they encounter employers with resources and time to engage and less reasonable ones when they do not. Mechanisms to encourage or oblige consolidation of schemes are required to ensure that all have access to true value for money. The Australian, Canadian, Dutch and Swedish chapters all discuss the importance of scale. The Australian and Swedish systems have adopted clear regulatory mechanisms for tackling the issue.

Governance

Traditional DB schemes can be more aligned with the interests of their members because they are governed by trustees who are legally required to ensure that decisions taken by the scheme prioritise the interests of the members above all others. Contract DC providers have to take the savers' interest into account but are legally obliged to prioritise their shareholders. In a market without the extreme asymmetries seen here, market pressures should normally serve to align shareholder and member interests. Insurance companies do provide trust-based schemes where employers request them. Governance is of course intimately related to costs and charges and scale. Trustees are obliged to achieve the best outcomes for members; contract providers are not. The Australian, Canadian, Dutch and Swedish systems rely on strong governance: either trustees where there is vertical integration (Australia) or a separation between pension administration and fund management (Sweden) or both trustees and separation (Canada, Netherlands). Strong consumer-focused governance is absent in German third pillar and in Polish occupational schemes. In the UK, consumer groups, the Labour party and the TUC have argued that all workplace pension schemes should have trustees. However, the 2010–15 UK coalition government opted instead for "independent governance committees" – which are appointed by the pension provider, allow for conflicts of interest and which are advisory rather than governing.

At Retirement

In traditional DB schemes, the pension scheme simply paid out the agreed proportion of salary to retired employees. In DC schemes, the individual receives the sum saved in employment (including accrued investment gains or losses) and is either obliged or encouraged (typically via tax rules) to purchase a financial product which will provide a retirement income. Traditionally in the UK, this product has been an annuity, a financial product that pays out a fixed monthly income in exchange for the accumulated savings. Annuity providers purchased assets with a steady and predictable stream of income (ie government bonds). The monthly sum they paid to retirees was based on the predicted return to the purchased bonds and the average probable longevity of the cohort for whom they were being bought, less the costs of the annuity provider including (in theory) a reasonable profit. In the UK, annuity market regulation did not respond effectively to the impact on value for money of consumer inertia. In part because of this, dislike of annuities has led the UK government to withdraw measures that required mandatory annuitisation. The products supplied in response to 'pension freedom' at retirement are not subject to the (weak) forms of regulation that apply to pension saving. To meet this regulatory gap, the UK is hoping that the availability of limited state-funded guidance will empower consumers. Interestingly, the UK appears to be heading in the opposite direction to Australia.

In Australia, perhaps because of the very recent development of the superannuation market, the retirement product is poorly developed. The consequence, as the Australian chapter discloses, has been a recommendation from Australia's financial system inquiry that Australia needs to develop products with characteristics like drawdown/annuities. The inquiry emphasised that the same kind of controls over governance that had been adopted in the saving phase need to be extended to the products supplied for the retirement phase. The problem with simple investment and saving products identified by the Australians is that a proportion of people run out of money and another proportion over-save. This is because no one can predict how long they will actually live. Annuities or annuity-style products are necessary at some stage in retirement because they allow a cohort of retirees to efficiently pool the risk of longevity, bringing down the cost to everyone of purchasing an income for the latter stages of retirement.

In Sweden, there is no risk of consumer detriment from market failure as the state is the monopoly annuity provider.

Dutch and Canadian collective DC (CDC) pension schemes internally annuitise on behalf of members. Longevity risk is dealt with on an intergenerational basis. This means that if either an earlier generation lives longer in retirement than predicted, taking a larger claim from the assets, or if assets are hit by a market shock and current pensions are maintained, then a later generation could be penalised. The risk for younger generations is mitigated in Canadian DC by a buffer fund created up-front by the employer.

CDC is now permitted under UK legislation. However, the detail of the regulations which would set the parameters in which they could operate is still being developed.

NOTES

1. ". . . the major risk that they [survey participants] associated with pensions was that institutions were untrustworthy. Common worries concerned pension schemes folding (with no savings being returned to members), pension funds being illegally or immorally raided by investors, or losing everything through irresponsible decisions by 'whizz-kids in the City'". *IPPR Defining Ambitions: Shaping Pension Reform Around Public Attitudes* (2013), p 16.

2. The Market for Lemons: Quality Uncertainty and the Market Mechanism, George A Akerlof, *The Quarterly Journal of Economics*, Vol 84, No 3. (Aug, 1970), p 488–500.

THE UNITED KINGDOM

Gregg McClymont and Andy Tarrant

The American economist George Akerlof won the Nobel prize in 2001 for his paper *The Market for Lemons.*[1] The paper analysed the consequences of information asymmetries in the secondhand car market. The greater knowledge possessed by sellers led to buyers purchasing 'lemons' – poor value used cars. Akerlof emphasised the wider applicability of his study: in markets where sellers possess much greater information than buyers, poor quality goods will inevitably drive out good ones. The market will become dominated by sellers of poor quality goods and the number of buyers will drop dramatically in response. Institutions acting as guarantors of quality are the necessary antidote to such market failure.

The UK is in the midst of major reform of pensions. The basic state pension and the earnings-related additional state pension scheme are being merged into a single flat-rate state pension. The intention is to create a foundation pension on top of which people will build workplace private pension provision. The foundation pension's value is likely to be approximately £7800 per annum. This is roughly 30 per cent of the average wage. Thus a replacement rate that provides a reasonable standard of living in retirement requires significant additional workplace private pensions saving.

Achieving value for money workplace private pensions means keeping 'lemons' at bay. This is a challenge: this is a market which features not just major information asymmetries[2] but also a new twist on the principal-agent problem – the ultimate consumers, employees, do not choose the product, employers do. The individual – even if aware of product deficiencies – is unable to switch for this reason; more widely the principal-agent problem manifests itself via smaller employers, who do not have the time or expertise to monitor pension quality. This is why the Department of Work and Pensions found in a 2012 survey of workplace pension schemes that 59 per cent of employers running smaller contract-based schemes (sized between 12 and 99 members) did not know that their employees paid any pensions charges at all.[3]

If common sense dictates 'the market where possible, the state where necessary', then workplace pensions, for the structural reasons examined above, necessitate government oversight. All British employees are being auto-enrolled into workplace private pensions. If 'lemons' flourish, Akerlof's insights tell us that mass opt-outs will eventually follow.

The UK workplace private pension market is characterised by a sharp decline in traditional defined benefit (DB) pension schemes. Most employers do not want to carry the substantial investment risk and actuarial risk onto their balance sheet. The number of workers in private sector DB schemes still open to new members is just 1 million; the total private sector workforce is 23 million. The provision of workplace pensions is now largely via defined contribution (DC) schemes. These pensions, unlike DB, offer no guaranteed income. Instead, retirement income depends on the performance of the funds invested. Before auto-enrolment, the providers of DC pensions had managed to persuade only a small and declining number of savers – about 900,000 – that it was worth investing in these products.[4] The state is now requiring employers to purchase these products on behalf of potentially 10 million people.[5]

Semi-compulsion for pension saving (auto-enrolment) was adopted because successive governments recognised the behavioural barriers to pension saving. The behavioural barriers are such that when the vast majority of pension savers are auto-enrolled, they elect to make no active choice but save into the default scheme offered by the pension provider. This has always been the case – historically, around 80–90 per cent of savers into pre-auto enrolment trust-based company DC schemes also made no active choice as to the funds in which they would be invested but were instead allocated to the default option, monitored by trustees.

WHAT MAKES A PENSION A 'LEMON'

The potential 'lemon' characteristics of British pensions are as follows:

A Lack of Transparency of Costs and Charges

Historically, pension providers have not disclosed all their costs and charges; large numbers of pensions were sold with high charges,[6] absorbing too much of the investment gains. The result for savers was smaller pension pots and reduced retirement incomes.[7] Under pressure from a coalition of consumer groups, employee representatives and the official opposition, the government introduced an annual management charge cap of 0.75 per cent for the default option in pension schemes. But the government has not applied this cap to the substantial pensions savings left behind by employees when they switched jobs prior to the price cap coming into effect – known as 'stranded pots'. The same pro-consumer coalition also campaigned for transparency of the costs incurred by the fund managers[8] with whom pension schemes invested pension contributions (often within vertically integrated companies). Again, the government conceded that these should in principle be declared. The Financial Conduct Authority (FCA) is currently consulting on which costs should be declared and it remains to be seen whether effective transparency will be achieved.

Lack of Scale

Pension schemes in the UK are typically organised around an individual employer. This means that most forgo the economies of scale that would significantly reduce administrative overheads, and increase investment and, therefore, member returns. There is however scale on the seller side. The DC market is dominated by a small number of insurance companies increasingly selling group personal pensions (GPPs), although master trusts are growing too in the auto-enrolment space. GPPs enable price discrimination between the employees of larger and smaller employers. There are currently about 140,000 DC pension schemes in the UK.

Inadequate Governance

Traditional DB schemes can be aligned with the interests of their members because they have trustees who are legally required to make all of the decisions about the scheme and to do so prioritising the interests of the members above all others. Contract DC providers have to take the savers' interest into account but are legally obliged to prioritise their shareholders. In a market absent of extensive information asymmetries, buy-side pressure would normally serve to align shareholder and member interests. Insurance companies do provide trust-based DC schemes where employers request them. However, such provision needs to be universal. Faced with consumer groups and Labour party complaint as to the inadequate nature of DC governance, the last government opted instead to require contract-based providers to install 'independent governance committees'. Conflicts of interest are permitted on these bodies, which are appointed by the pension provider and which are advisory rather than governing.[9]

Inadequate Regulation

Trust-based pension schemes are regulated by the Pensions Regulator (TPR). Contract-based schemes are regulated by the FCA. In short, their respective approaches could be summarised as follows. TPR prioritises the savers' interest but has inadequate powers, the FCA has adequate powers but is relying on heretofore absent buy-side pressure to drive product improvement.[10]

Retirement Income Free-for-All

The market for annuities provides a good example of the FCA approach. Until last year, retirees had to purchase an annuity with the savings pot they had built in a DC pension scheme. (An annuity is a regular income stream purchased with a lump sum formed from the pension savings accumulated prior to retirement.) However, inertia characterised the behaviour of a large proportion of savers and they were channelled into buying annuities directly from the pension provider with whom they saved, without first considering all the offers on the market. The consequence of this was an income in retirement which was often 20 per cent below what could have been achieved.[11] The FCA approach was to increase the prompts given to savers rather than ensure that savers were offered the best product available.

The unpopularity of annuities generated a political reaction. The government legislated to lift the requirement to purchase them. However, this does not remove the existence of longevity risk (ie the risk that you may live longer than you expect and therefore run out of savings) and therefore the need for an annuity or annuity-type product at some point in retirement. So annuities still require effective regulation.

The majority of purchases will now be of income drawdown products where the savers pension pot stays invested and a mixture of profit and capital is withdrawn to provide income. All of the 'lemon' characteristics described above will now apply to the retirement income phase, but neither the government nor the FCA have any plans to regulate. The FCA is consulting on its regulatory approach to retirement income products in 2016, but, consistent with its standard approach, the direction it gives respondees is to answer questions relating to consumer prompts.[12] There is now a logical disconnect between the semi-effectively regulated default saving phase and the unregulated retirement income phase. With respect to the latter, the government's approach is to rely on offering savers a non-mandatory short 'guidance' interview to help them with a complex one-off purchase with potentially life-changing implications. The worry must be that many savers will simply buy drawdown products in the same way they purchased annuities. This outcome is hardly what savers say they want from a pension system, which is "pension provision that supports members' best interests without requiring active customer choice".[13]

No System to Direct Employers to Schemes with High Quality Default Products

There is no licensing system for workplace pension schemes in the UK. Such a licensing system would be ideal for dealing with asymmetry of information and ensuring a reasonable number of scale, well-governed, low-cost providers, such as Nest,[14] could compete in the market. Employees could be secure in the knowledge that their employer had selected only from pension schemes that meet quality criteria with respect to delivering value for money, including governance criteria. Furthermore, the absence of a licensing scheme is one of the factors which facilitates the pension scammers engaging in fraudulent activity.[15]

NOTES

1. The Market for Lemons: Quality Uncertainty and the Market Mechanism, George A Akerlof, *The Quarterly Journal of Economics*, Vol 84, No 3. (Aug, 1970), p 488–500.
2. Not least the one-off nature of consumption, which removes learning by doing until it is too late.
3. DWP, Pension landscape and charging: Quantitative and qualitative research with employers and pension providers, 2012.
4. http://www.ons.gov.uk/ons/dcp171766_313466.pdf, p9.
5. https://www.gov.uk/government/news/standing-ovation-as-auto-enrolment-hits-5-million-and-auto-transfer-launch-plans-are-unveiled.
6. A third of pension savings are in schemes charging above one per cent: https://www.fca.org.uk/news/defined-contribution-workplace-pensions-ipb. Logically, the audit should actually have covered all savings being charged more than 0.75 per cent.
7. The OFT estimated that a one per cent annual management charge would reduce retirement savings for someone on an average salary by 21 per cent: http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/shared_oft/market-studies/oft1505, p71.
8. These are separate from the annual management charges of the pension scheme.
9. The Labour party's shadow pensions team in the 2010–15 parliament provided detailed comments on governance design to the OFT and the FCA. Please contact andy_tarrant@yahoo.com if you would like to obtain copies.
10. For a longer discussion, see http://henrytapper.com/2015/07/07/the-future-of-pension-regulation-andrew-tarrant/.
11. http://www.napf.co.uk/PressCentre/Press_releases/0176_Savers_left_short_changed_and_bewildered_by_unfair_annuities_system.aspx.
12. http://www.fca.org.uk/static/documents/consultation-papers/cp15-30.pdf.
13. See principle eight on page 30 of the research into consumer demand in IPPR "Defining ambitions: shaping reform around public attitudes" (2013) p33.

14. Government has sought to directly provide a quality alternative for the low and medium income employees which the insurance companies had historically been less keen on serving. Nest is a not-for-profit government-backed pension scheme. It has scale, low costs and is run by trustees. However, it also labours under restrictions which prevent it from serving its target market. For example, a company cannot engage in bulk switching all its employees to Nest where a private provider is under-performing or over-charging. The last government originally claimed that European rules prevented it from lifting the restrictions. Labour argued this was false and this position was eventually endorsed by the European commission. The last government stated that it would lift all the restrictions by 2017, but it remains to be seen whether this commitment will be met.

15. http://www.theguardian.com/uk-news/2015/mar/10/protect-pensioners-scammers-who-want-savings-say-mps.

AUSTRALIA

Jeremy Cooper

The Australian retirement system is a three pillar system. Two key pillars are a government safety net, the age pension, and the private workplace pension market, superannuation.

The age pension is available to all retirees over the age of eligibility, but is subject to means testing via an asset and income test. About 50 per cent of retirees receive a full age pension and another 20 per cent of retirees are eligible for a part payment of the age pension. Age pension increases are linked to wages and the cost of living. Payments continue for the life of the retiree, however, the level of the age pension is inadequate for most retirees, given that it is intended as a safety net only. Age pension payments are benchmarked to 25 per cent of average male weekly earnings. Importantly, the age pension is not a contributory pension, but is funded purely by current day taxpayers.

Superannuation is a compulsory, employment-related defined contribution (DC) system introduced to supplement the age pension and reduce the burden of retirement social security on taxpayers. 'Super' in Australia is mandatory for all employers whose employees meet certain working conditions. A percentage of wages[1] are paid by the employer into a DC savings scheme of either the employee's choice or a default fund if no choice is made. Superannuation is a retirement savings system, rather than a retirement income system. Employer obligations effectively cease on retirement, and there are no requirements for retirees to stay in the system. The implications of this are only just being appreciated in Australia.

THE CURRENT SUPERANNUATION SYSTEM

Australia has very few regulations around how retirement savings (benefits) should be taken once preservation (access) age has been met, currently 56, but increasing incrementally to 60 by 2024. Retirees have a number of choices on reaching preservation age, the two predominant choices being a lump-sum withdrawal or an income stream. Roughly half the population still take a lump sum, and income streams or annuitisation are not, and have never been, mandatory in Australia.

If a retiree chooses to take an income stream in retirement, the predominant product is an account-based pension (ABP) which is really just a retirement managed fund product. With an ABP, retirees can invest in a wide range of investment options, but must withdraw a certain minimum amount each year.[2] All benefits paid from super are tax-free once a person reaches 60 and permanently retires.

ISSUE IN THE RETIREMENT SYSTEM

The Australian compulsory superannuation system was set up in 1992 and since then it has evolved, but not fully matured. Because of its DC nature and the fact that it has been principally about accumulating savings and not the provision of secure retirement income, accumulation-style thinking and strategies permeate into the retirement phase, despite the fact that retirement demands a different approach. This is perhaps the biggest current failing of the Australian super system.

DC Is a Lump-Sum Approach to Retirement

DC savings schemes, and lump-sum approaches, fail to deal with the key risks facing retirees, these being: inflation risk, longevity risk and market risk (including sequencing risk). These risks mean that DC retirees are often exposed to too much volatility and uncertainty about the durability of their savings in retirement and how much sustainable cash flow they can expect.

Pure DC schemes do not deal adequately with any of these risks.

Measuring Success and Failure

One of the biggest challenges for funds in providing appropriate retirement solutions for their members is the lack of a clear success measure.

In accumulating assets, there is really only one goal: accumulate as many assets as possible, via the highest investment returns, with minimal outgoings and an optimal level of volatility to create the largest possible pool of savings. This provides a clear measure of success. In retirement, typically, there are four forms of expenditure to plan for and success will often involve meeting all of these objectives.

- Everyday living costs which require predictable and regular cash flows;
- Discretionary or lumpy expenditures, including emergencies;
- Expenditure beyond average life expectancy; and
- Bequests for the next generation.

REFORMS: RECENT PAST, PRESENT AND FUTURE

Super System Review 2009–10

In 2009, Australia began a major review of its superannuation system. The major reforms that flowed from the Australian government's response to the review are labelled 'stronger super'. These included a modernisation of the administration of super schemes, the introduction of a new style of simpler, more cost-efficient default fund called 'MySuper' and a range of changes to governance, transparency of outcomes, and disclosure of risk and return objectives and a focus on scale and efficiency.[3]

MySuper

A key reform has been the creation of a new default accumulation product (not unlike the UK's National Employment Savings Trust, but having a bigger footprint across the system) called MySuper. The key features of MySuper include: a single, diversified investment strategy with no requirement for investment choices to be made by members; standardised reporting requirements written in plain English; and a limited range of fees that can be charged, with performance fees having to meet certain criteria to be acceptable. By law, a default member must be allocated to a MySuper product.

Governance

The reforms also delivered new duties for fund trustees. The Australia Prudential Regulatory Authority (APRA) has introduced a range of prudential standards and two specifically address duty of trustees and board governance. One requires funds to have a policy that sets out the standards that trustees must adhere to, and the competencies required of a trustee. Trustees must be assessed against these on a yearly basis. The standards and competencies set by the fund will be reviewed by the regulator as part of the licensing requirement.

Another prudential standard requires the trustee board to have a formal charter that sets out the roles, responsibilities and objectives of the board. This governance framework must include a specific duty to deliver value for money as measured by long-term net returns; to consider annually whether the fund has sufficient scale; and, how the board will assess its performance against these objectives. The care, skill and diligence expected of a trustee have also been raised as a matter of law to that of 'prudent superannuation trustee'. This effectively raises the standard to that of a professional trustee, rather than just a reasonable person. This is a very significant change.

SuperStream

SuperStream is a reform of the 'back office' of superannuation. It is designed to enhance the administration of superannuation, streamline processing and produce cost efficiencies. This will be achieved by implementing new data standards for transactions between employers and funds and between funds; automatic account consolidation of low balance accounts and the automation of data processing. There are about 100m transactions in super each year and these will all become processed without human intervention. It has been estimated that this will save up to A$1bn a year.

Retirement Phase

The big disappointment in the reform process was that the 2010 recommendations about retirement were not adopted by the government. Those recommendations were that the trustees of a fund offering a default retirement product should be obliged to devise an investment strategy dealing with existing factors such as risk, diversification, liquidity and the ability to discharge liabilities (existing requirements), as well as two additional factors:

- inflation risk; and
- longevity risk.

The intention was that the mechanics of the solution be left to the market, but, in one way or another, the trustees would be required to deal with the ‘silent killer’ in retirement plans – inflation – and the risk of members running out of money: longevity risk. This would have called for some level of annuitisation or for the use of a product that had annuity-like features (ie risk pooling) rather than just an allocation of different asset classes. In simple terms, a pure-DC product that leaves all the risks with the member would not have cut the mustard.

It seems that super funds were not ready or the changes looked too dramatic. Whatever the reason, Australia was left with an incomplete retirement income system.

Financial System Inquiry – 2013–14

Superannuation has been reviewed (again) as part of Australia’s financial system inquiry, which released its final report in December 2014. The report dedicated its second chapter to superannuation and retirement incomes, which gave weight to their importance to Australia’s financial system.

Recommendations

The inquiry made three recommendations aimed at better outcomes for superannuation members. The recommendations were:

- To set clear objectives for the superannuation system to ensure that the system provides income in retirement, as a substitute for, or to supplement, the age pension. Setting such an objective would ensure system stability and consistent alignment of policy settings, community expectations and industry initiatives. It would also ensure that the superannuation framework provided the same level of support to members when they face complex financial decisions at and after retirement, rather than only during the accumulation stage.
- Improve operational efficiency during the accumulation of retirement savings by using a formal competitive process for the allocation of default funds. This is not dissimilar to some of the proposals relating to the UK's stakeholder pensions.
- Improving efficiency in retirement, by providing alternative products for risk pooling and allocating retirees' consumption. Such products would be difficult to bring to market without also removing barriers to new product development, such as tax policy settings.

Comprehensive Income Product for Retirement

One of the key items of the final report was recommendation 11, which suggested requiring superannuation trustees to pre-select a comprehensive product for retirement (CIPR) for retiring members. The aim of the CIPR would be to ensure that, at a minimum, retirees would have access to a flexible, stable and regular income stream that manages longevity risk and other risks, possibly inflation and the risk of cognitive decline.

The inquiry recognised that such a product might need to be a combination of other products that provide the required features. However, it also pointed to the fact that there needs to be a greater range of retirement income products in the market. It was noted that further innovation was required in order to meet varied retiree needs, beyond the limited range of account-based pensions or traditional annuities currently available.

Government Response to Inquiry

In October 2015, the government responded to the inquiry, and agreed in principle to nearly all of the recommendations to which it had not already responded.[4] Relevantly it agreed to:

- Develop legislation to enshrine the objective of superannuation, and improve its governance and transparency;
- Consult on legislation to improve member engagement, and to facilitate trustees of superannuation funds providing CIPRs; and
- Remove impediments to the development of more competitive and appropriate retirement income products, and progress the still-incomplete review of the review of retirement income stream regulation.[5]

The government pointed out that some of the inquiry's recommendations were already in progress, such as the reforms relating to the governance of superannuation trustee boards.

It is interesting to note that the government is not proposing to require trustees to preselect CIPRs, as recommended by the inquiry, but is only going to facilitate this for trustees. This is a much softer approach than advocated by some. As things currently stand, a retiree will never end up in a CIPR by default. Investing in a CIPR will be strictly a matter of choice. Also, funds will not be required to offer them. That too will be a matter of choice. These settings will, arguably, create room for a wider range of potential outcomes for retiring members. Some funds might choose to do little in this area, whereas other might create much more effective retirement solutions for their members. How this will play out in practice remains to be seen.

NOTES

1. This is currently 9.25 per cent and is set to increase to 12 per cent by 2022.

2. The Australian government is keen to ensure that tax-subsidised savings are consumed and not artificially kept in a zero tax environment.

3. See the 'Stronger Super' website at: http://strongersuper.treasury.gov.au/content/Content.aspx?doc = home.htm.

4. See government response to the financial system inquiry, available at http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/Govt%20response%20to%20the%20FSI.

5. http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2014/Review-of-retirement-income-stream-regulation.

CANADA

W Paul McCrossan

In response to concerns about the sustainability of defined benefit (DB) pension schemes in the Canadian province of New Brunswick, the provincial government and unions have agreed on a form of collective defined contribution (CDC) scheme designed to replace the traditional DB schemes. The New Brunswick schemes are called ‘shared risk pension plans’ and are currently largely being deployed in the public sector, although they are also available for private sector employers.

CAUSES OF UNSUSTAINABILITY

By 2007, the danger to the stability and sustainability of the Canadian pension system was apparent to the International Monetary Fund (IMF). In its financial sector assessment programme evaluation of the Canadian financial system, the IMF issued a stark warning to Canada:

> [Canadian pension regulators] should ensure that the regulatory framework for pension funds focuses increasingly on the adequacy of risk management practices and resources, in addition to the traditional solvency approach. . . . These developments require continued reinforcement of risk management skills in pension funds and their

> supervisors. Poor risk management and large losses by pension funds could lead to political pressure for bailouts. The large number of medium and small defined benefit pension funds may find it costly to operate in this environment.

The warning was scarcely noticed. The federal government does not appear to have drawn the provincial pension regulators' (who regulate over 90 per cent of Canadian employee pension plan assets) attention to the stark IMF warning.

There was another serious threat to the Canadian pension system, also first identified in 2007, when the first comprehensive credible mortality study of one of Canada's largest pension plans, covering high income, highly educated workers, found that its mortality was improving faster than had ever been imagined.

Equity prices fell sharply in the member countries of the Organisation for Economic Cooperation and Development (OECD) in 2008–09, while sovereign interest rates fell in the stronger OECD countries as a 'flight to safety' occurred followed by systematic 'financial repression' (of sovereign interest rates) by the stronger countries' central banks in a determined attempt by central banks to stimulate economic activity.

Finally, economic contraction caused the size of the workforce in most large pension plans (outside the 'buoyant' healthcare sector) to decline, causing pension plans to 'mature' much faster than had been anticipated. Suddenly, many pension plans found that their pension payments rapidly grew to exceed contribution inflow, leaving little free cash flow to invest in the recovering equity markets.

With perfect hindsight, it could be seen that if risk management had been applied before the Great Recession hit, pension plans could have offset most of the effect of falling interest rates and market volatility by increasing their exposure to long bond interest rates. (One Canadian pension plan, the Hospitals of Ontario Pension Plan had voluntarily embarked on just such a risk management commitment before the Great Recession hit and had remained fully funded during and after the Great Recession; but it was the exception.)

THE IMPACT OF DEMOGRAPHICS ON REGIONAL ECONOMIES ACROSS CANADA

There was one additional factor destabilising pension plans with different speeds across Canada: relative regional ageing. While Canada had taken action to stabilise the cost of the Canada Pension Plan after 1986 by increasing the rate of immigration to about two to three per cent of the total population each year, immigration was concentrated into the energy-rich western provinces of Canada: Toronto and (to a certain extent) Montreal. Immigration was very low into Canada's maritime provinces as well as into rural Quebec and Ontario. Further, there was substantial emigration out of maritime Canada as many young adults left for better economic opportunity in booming western Canada. The result was that Canada was aging at different speeds – fastest in the maritimes, somewhat slower in Quebec, slower again in Ontario and slowest in western Canada.

Not surprisingly, the Standard & Poor's ratings of Canada's provinces were lowest in the east and progressively higher as one looked westward across the country. New Brunswick is a maritime province.

PENSION REFORM IN NEW BRUNSWICK

In late 2010, a new government was elected in New Brunswick. The premier quickly established a three-person pension reform taskforce to recommend regulatory changes in the province based on three objectives (stability, sustainability and affordability) and two principles (transparency and inter-generational equity). It was left to the taskforce to determine what the five criteria meant.

Transparency

Transparency was settled first. All investigations would take place in open view of key worker representatives (unions). Any suggestion tested would be shared with the unions and all suggestions from the unions would be investigated.

Inter-Generational Equity

Inter-generational equity was considered next. Expected mortality improvements must be reflected so that older plan members and younger plan members each had a prospective 'fair deal'. In practice, this meant both that the age of unreduced future service pension benefits had to increase relative to the age of unreduced pension for accrued benefits and early retirement discounts had to increase to reflect the expected improved longevity. In other words, pensions would have to be accessed later and early retirement would be less generously covered.

Stability and Sustainability

Stability and sustainability were quickly determined to require risk management of pension assets and liabilities with both 'marked to market'. But, what discount rate would be appropriate for marking liabilities to market? The taskforce came to the conclusion that the AA corporate rate used in international financial reporting standards (IFRS) was a suitable high quality yield rate basically unsullied by the 'financial repression' being practiced by central bankers. But rigorously managed assets alone would not provide the conservatism required to stabilise the pension promise. For that, a form of implicit and explicit risk-based capital was needed. Through trial and error, the taskforce found that making certain accrued and future benefits contingent produced a workable form of implicit risk-based capital, while developing a funding policy that withheld surplus distributions until sufficient internal capital had been built up to produce a workable form of explicit capital. The risk of generating this explicit capital does not, however, fall solely on the first cohorts of savers. This risk is also shared with employers.

All benefits were divided into 'base benefits' (which had to have at least a 97.5 per cent probability of being paid, eg a career average income) and 'ancillary benefits' (which had to have at least a 75 per cent probability of being paid, eg cost of living protection). Pension contributions had to be on an almost fixed basis with no contribution holidays permitted unless the plan was so overfunded as to violate the income tax limits on tax assisted retirement savings and only very small, finite contribution increases permitted depending on the risk-funded status of the plan.

Affordability

Affordability was determined with reference to the long-term cost of the plan compared to the level of tax-assisted retirement savings available to plan members in a registered defined contribution pension plan or in the equivalent individual registered retirement savings plan.

Benefit Adequacy Was Not Considered

The pension taskforce tested the shared risk pension plan framework for plans that had target benefits of final average indexed pensions, updated career average pension plans and flat benefit multi-employer pension plans. They found that target benefits (defined ambition benefits) could be soundly managed within the constraints of the New Brunswick model.

The taskforce decided that it would be agnostic as to the level of the pension promise in any pension plan regardless of the form of the promise. The only thing that counted was the expected level of security of the pension promise. Risk must be managed within the plan to expect to deliver the 'base benefits' with a 97.5 per cent probability and the ancillary (target) benefits with a 75 per cent probability over 20 years.

MORTALITY AND INVESTMENT POOLING EFFECTS

Experience with both individual tax assisted retirement savings accounts and DC pension plans in Canada had shown that individual plan members were not effective asset managers. One of the key aspects of the collective schemes is that they share the benefits of scale and expertise; both are key. They are also governed by trustees ensuring that schemes prioritise and are seen to prioritise the best interests of savers.

Experience also showed both that individuals were poorly positioned to make the critical decisions about how to spread their retirement savings over their future lifetimes and that a pension plan could appropriately have a much more balanced asset portfolio that met the needs of retirees and actives than any retiree could prudently select. In addition, many pension experts stressed the advantages of sharing mortality risk as desirable for pension plan members as can be accomplished under both DB plans and shared risk (target benefit) pension plans.

By encouraging the conversion and maintenance of existing pension plans into shared risk pension plans the benefits of pooling could be preserved. The government hopes to expand the coverage with new shared risk pension plans to improve security to those not now covered by employment pension plans in the not too distant future.

RECENT DEVELOPMENTS IN CANADA

The Canadian federal government began a consultation process seeking input as to whether the target benefit pension plan approach should be adopted nationally.[1] To date, over 25 responses have been received from organisations that can be viewed online.

In June 2015, the Canadian Institute of Actuaries (CIA) published an extensive (50 page) analysis of the Canadian actuarial profession's views on target benefit (CDC) plans.[2]

As can be seen, the Canadian actuarial profession views the establishment of a new target benefit plan (as might be the case with a collective defined contribution plan in the UK) somewhat differently than the conversion of an existing DB pension plan to a shared risk pension plan (as was the case for all plans in New Brunswick).

While generally supporting the risk management structure developed in New Brunswick, the CIA paper suggests that less stringent risk management criteria might be appropriate for a newly established plan, such as is contemplated for CDCs in the UK.

NOTES

1. http://www.fin.gc.ca/activty/consult/pic-impicc-eng.asp.
2. http://www.cia-ica.ca/docs/default-source/2015/215043e.pdf.

GERMANY

Steffen Hagemann

In Germany, the state pension (first pillar) provides earnings replacement. It is supplemented by non-mandatory occupational (second pillar) and private pension schemes (third pillar).[1] The state pension works as social insurance and rests on a wage-based contribution principle. In this pay-as-you-go scheme, the fixed rate of contribution (18.7 per cent of gross income in 2015) is equally shared between employers and employees and covers the majority of German employees. Following the 'equivalence principle', higher contributions and longer contribution times lead to a higher pension receipt (limited upwards through a cap). Limited periods of unemployment or raising children also accrue entitlements. In the second pillar, occupational pensions are either defined benefit (DB) or hybrid, and are most prevalent in certain sectors – typically in the large manufacturing industry where they are part of collective agreements, other large companies, and in the public sector. They are unequally distributed amongst the working population, both by sector and by gender. However, scheme coverage has grown and pension reforms in 2001 now give every employee the right to an occupational pension through salary conversion.[2] Private pensions (third pillar) play an increasing role since 'Riester' products are subsidised by the state. The 2001 reforms boosted the market for private pension products, which are offered by banks, investment companies and insurers. Up to 16 million people have so far purchased a 'Riester' product. These contract-based schemes need to comply with regulations in order to qualify for tax rebates. This includes observance of specific annuitisation principles (such as guarantee of return at least equal to contributions) and gender neutrality.[3] In order to receive full state subsidies in the form of direct allowances from the general tax revenue (up to €154 per year plus €300 child allowance), 'Riester' savers have to invest a minimum of four per cent of their previous years' income.

PENSION REFORMS AND CONTROVERSY

In reaction to growing financial pressures on its pay-as-you-go system through population ageing and persistently low birth rates, pension reforms in Germany have reduced the traditionally dominant role of the first pillar. The wage replacement level of the state pension will gradually decrease; while it formerly delivered a net earnings replacement rate of up to 70 per cent after 45 years of contribution, this will decrease to around 50 per cent in the coming decades. A 'sustainability factor' in the state pension formula reflects the higher share of pensioners in relation to a decreasing number of (working) contributors. Additionally, a cap of 22 per cent is set on the contribution rate until 2030. Interconnected with such input-oriented reforms to sustain the state system, the state pension age is also increasing from 65 to 67 (stepwise from 2012 on to 2029).[4] In consequence, future pensioners will to a greater extent have to rely on the second and third pillar if they seek sufficient wage replacement. The working population is therefore encouraged to develop more individual responsibility for provision in old age. This shift of the German system in a more liberal direction with regard to public-private share has fuelled much political debate. Concerns have been raised with regard to product quality that may lead to low returns and disappoint savers' expectations, also due to low interest rates in the wake of the contemporary economic climate. 'Riester' schemes are generally more expensive than, for instance, UK products.[5] Concerns also relate to their rather low take-up rates, especially among low and medium earners. Although the first group is targeted through subsidies of 'Riester' schemes, barriers to individual provision can be explained by low financial resources and financial literacy. Criticism is also directed at professional standards for sales forces and advisory processes which remain extremely varied – raising prospects of consumer detriment. Altogether, the introduction of 'Riester' schemes to the German system triggers the question to what extent private pensions can actually contribute to reasonable retirement incomes as state provision subsides? Critics predict that the shift towards more privatisation in combination with a lower state pension will increase old-age poverty in Germany.

DEMANDS FOR FURTHER REGULATION OF PRIVATE SCHEMES

'Riester' schemes and other investment products are supervised by the state. These products have to comply with legal disclosure obligations and cost transparency regulations, which is the precondition for being subsidised. However, whether the required disclosure actually constitutes full disclosure remains unclear. This was criticised by consumer interest groups, who also complained about the relatively minor penalties scheme providers faced if they breached the obligations.[6] In reaction, a new law was introduced which now obliges providers to guarantee more transparency through a standardised information leaflet for customers. Furthermore, once the product is purchased, the provider has to deliver further information to the customer on costs and returns. However, another problematic aspect is that no legally binding calculation methods exist for state-funded products like 'Riester' schemes with regard to mortality tables and, with that, profit participation.[7] Beyond such demands for further regulation, the main challenge is to find solutions for people on low and medium incomes who will be strongly affected by the lower provision level of the state pension.

NEW EFFORTS IN OCCUPATIONAL PENSIONS

Simply shifting more responsibility for old-age income to individuals and the market via the third pillar appears more and more as a flawed solution. The Federal Ministry of Labour and Social Affairs recently proposed to increase the take-up rate of occupational schemes in the second pillar. This may be achieved by pension plans which are organised as part of collective agreements by social partners and cover whole sectors. Such arrangements already exist in certain sectors. In Germany, collective agreements can, under certain conditions, be extended to companies who are actually not committed to the bargaining agreement. This may eventually increase coverage of occupational pensions, especially among the numerous small- and medium-sized enterprises. The proposal endorses the set-up of specific pension plans, which offer minimum guarantees as *Pensionskassen* or *Pensionsfonds*, and are secured by the German pension protection fund (PSV). These potentially operate more cost-effectively and could give rise to a much wider coverage of the workforce. However, the social partners are critical of the proposals. The German Confederation of Trade Unions expresses scepticism that higher coverage can be achieved because employers often veto the extension of the benefits of collective agreements to companies outside of general collective agreements. It further expresses a fear that if such plans were actually extended to companies which are not party to collective agreements, the employers which are outside of the general collective agreements might only make minimal contributions to the organisational effort behind the relevant pension plan and may free-ride on the benefits. The Confederation of German Employers' Associations, which as an umbrella organisation represents employer organisations from different sectors, fears that competition on the market for employees may be distorted by the new arrangements.

NOTES

1. The following brief description of the German pension system draws on: Scherger, S., Hagemann, S., Hokema, A., & Lux, T. (2012). Between Privilege and Burden. Work Past Retirement Age in Germany and the UK, ZeS-Working Paper No. 04/2012 (p 23–24). For a more in-depth description of the system see: Schulze, I., & Jochem, S. (2007). Germany: beyond policy gridlock. In E. Immergut, K. M. Anderson & I. Schulze (Eds.), The Handbook Of West European Pension Politics (p 660–710). Oxford: Oxford University Press.
2. Contributions to specific schemes are free of tax and of social insurance contributions up to four per cent of social security ceiling (€2904 per annum in 2015), plus an additional €1800 free of tax.
3. Berner, F. (2011). New Private Pensions in Germany: A Pension Market or a Branch of the Welfare State? Contested Regulatory Issues. In L. Leisering (Ed.), The New Regulatory State. Regulating Pensions in Germany and the UK. (p 127–149). Basingstoke: Palgrave Macmillan.
4. As a transition measure, the new coalition government between Conservatives and Social Democrats has decided to lower state pension age to 63 for people who have contributed for 45 years to the state pension insurance. Once phased out along with the general rise to 67, the earliest receipt of the state pension after 45 contribution years will only be possible at the age of 65 (for those born from 1964 on).
5. For a comparison of schemes and regulation see: Willert, M. (2011). Can Personal Pensions Bridge the Savings Gap? Regulation and performance of personal pensions in Great Britain and Germany. In J. Clasen (ed.), Converging Worlds of Welfare? British and German Social Policy in the 21st Century. (p 218–242). Oxford: Oxford University Press.
6. Hagen, K., Kleinlein, A. (2012). *Ten Years of the Riester Pension Scheme: No Reason to Celebrate.* DIW Economic Bulletin 2, p 1–14.
7. Hagen/Kleinlein 2012: 13.

THE NETHERLANDS

Eduard Ponds and Onno Steenbeek

Like most developed economies, the Netherlands is struggling with its retirement system. The retirement of the baby-boom generation, in combination with significant upward shocks in life expectancy, put pressure on so-called pay-as-you-go systems, in which the current labour force pays the benefits of current pensioners. Apart from a pay-as-you-go first pillar, the Dutch have a well-developed second pillar of fully funded pension funds. Despite its size and strength, this part of the system has experienced important reforms over the last decade and more changes are likely to be implemented in the near future. This contribution will focus on second pillar pension funds.

INSTITUTIONAL STRUCTURE: THREE PILLARS

As in most developed countries, the pension system in the Netherlands is organised as a three pillar system.

The first pillar comprises the public pension plan, offering a flat-rate pension to all retirees based on the number of years they have lived in the Netherlands. Financing is on a pay-as-you-go basis and benefits keep pace with the legal minimum wage. At retirement, a couple will receive an income of approximately €1400 a month, and a single person €1000. Since the 1950s, the formal retirement age has been 65, but recently a stepwise increase to 67 in 2023 has been agreed upon. After 2023, the retirement age will be linked to improvements in life expectancy, such that the period over which state pension is received is equal for each generation.

The second pillar provides retired workers an additional income from supplementary plans. Most second pillar plans are mandatory funded defined benefit (DB) plans. Most of the 400 pension funds in the Netherlands aim to provide wage indexation or price indexation to accrued rights and benefits. More than 90 per cent of the Dutch labour force is covered by these funds, with the remaining self-employed or employed in companies smaller than 10 people. Finally, the third pillar comprises voluntary personal savings.

SECOND PILLAR PENSION FUNDS

There are three types of pension funds in the Netherlands. The dominant type in size is the industry-wide pension fund, organised for a specific industry (eg construction, health care, or transport). Participation in an industry-wide pension fund is mandatory for all firms operating in the sector. A company can opt out only if it establishes a corporate pension fund that offers a better pension plan to its employees than the industry-wide fund. Where a supplementary pension plan exists, either as a corporate pension fund or as an industry-wide pension fund, participation by workers is mandatory and governed by collective labour agreements. The third type of pension fund is the professional group pension fund, organised for a specific group of independent professionals such as physicians or notaries.[1] The number of pension funds has shrunk significantly over the past years, from around 1000 in the year 2000 to less than 400 in 2015. Most smaller funds have been absorbed by their bigger counterparts, while some were liquidated. For corporate funds, the mandatory consolidation with their sponsor's balance sheet was a key motivation to change the setup. Another important cause was the introduction of much stricter requirements for trustees which made it more difficult to find the right people. A final cause was the increased administration and service costs. Due to stricter rules regarding transparency, corporate funds are not able to hide costs from the fund's profit and loss statement. The consolidation trend is accommodated and even promoted by the regulator which has always voiced the wish to bring the number of funds down significantly.

The Dutch pension fund system is one of the largest in the world, covering over 90 per cent of the active labour force, ranking fourth in total assets under management. The value of assets under management in November 2014 amounted to €1150bn, or approximately 175 per cent of Dutch gross domestic product for that year.[2] Funds are generally organised as foundations, owned by plan members, so as not to be at risk of being bought by fund managers.

Originating in the 1950s, pension funds in the Netherlands were initially set up as traditional DB plans, similar to those in the United States and United Kingdom. Over the past quarter century, DB plans in those countries have largely been displaced by individual defined contribution (DC) plans, while most pension plans in the Netherlands have maintained their DB structure. Within this structure, however, the Dutch funds have undergone significant change. In 2003, in the wake of the collapse in funding levels from the dotcom bust, the Dutch government imposed strict funding requirements and new accounting rules. Most importantly, pension liabilities were to be valued using a risk-free market interest rate (in practice the euro swap curve was prescribed), instead of a fixed rate of four per cent. In response, in order to improve risk management, most pension funds switched to what may be called 'hybrid' DB plans with conditional indexation, while others shifted even further to collective DC plans.

In the hybrid DB plans with conditional indexation, benefits are calculated as in traditional DB plans except that indexation of pensions in payment and accrued benefits is conditional on the plan's funding status. Collective DC plans are equal to hybrid DB plans with one main exception: contribution rates are fixed for at least five years. As all risks are borne by plan members and the employer no longer assumes risk, a collective DC plan qualifies as a DC plan and it is treated as such under the International Financial Reporting Standards (IFRS), which is perceived as attractive for the sponsoring companies of corporate funds. Table 1 provides more information on specific features of Dutch plans.

A key variable in pension supervision is the nominal funding ratio, defined as the market value of assets over the market value of nominal liabilities. Liabilities are valued using the risk-free nominal market interest rate curve with some adjustment.[3] The relationship between the funding position and the indexation often is organised via a so-called 'policy ladder', which links indexation to the funding level (compare Figure 1). The rules for providing indexation will be changed with the introduction of the new supervisory framework as from 2015 onwards. The key principle to link the indexation to the funding ratio remains (see the next section).

CURRENT DEBATE ON PENSION SYSTEM REDESIGN

Following the restructuring of most Dutch pension plans in the early 2000s, the average funding ratio slowly recovered. However the average funding ratio fell dramatically since the start of the economic crisis, from a high of 150 per cent in mid-2007 to less than 90 per cent in the first quarter of 2009 (see Figure 1). Although stock markets recovered after their initial fall, the strong decline in interest rates drove up the (market) value of nominal liabilities. Since then, the conditional indexation rule prevented most pension funds from providing any indexation, but many funds even had to reduce benefits as it proved impossible to recover to the required 105 per cent threshold within the maximum recovery period.

Table 1: Key Characteristics of Dutch Pension Funds
The following are key features of pension plans in the Netherlands (as of the end of 2014).

- Uniform accrual rate:
  Employees build up for each year of service 1.875 per cent of their (pensionable) wage as new pension rights. For example, a career of 42 years may give a pension income of 80 per cent of the average wage over the individual's career – on average, this implies benefits of around 70 per cent of final pay.

- Uniform contribution rate:
  All employees pay the same contribution rate, which is set yearly such that the annual contributions match the present value of new accrued liabilities by employees, based on each additional year of service, plus buffer requirements and indexation goals.

- Uniform indexation rate:
  The accrued benefits of all plan participants are indexed yearly in a uniform way. Usually the aim is to index with the wage growth rate of the industry or that of the company offering the pension fund. A number of pension funds differentiate between their indexation policy for employees (indexation linked to wages) and retirees (indexation linked to price inflation). The actual indexation rate is conditional on the financial position of the pension fund.

- Uniform asset mix:
  Pension fund wealth is invested in one asset mix.

In the aftermath of the sharp decline in the funding position in 2008, representatives of labour unions, employers and the government started up negotiations on a plan redesign in order to make the system more shock-resilient. Two types of shocks in particular were considered: first, shocks in life expectancy, and second, shocks in financial markets. The reform makes the pension plans less prone to sudden and severe pension cuts to solve underfunding. Moreover, the plan reset is applied with a check on generational fairness. The new practice as of 2015 is structured as follows. Two funding ratios play a central role in the new setup. First, is the current nominal funding ratio, which will be smoothed over the previous 12 months in order to limit excess volatility. And the second is the required

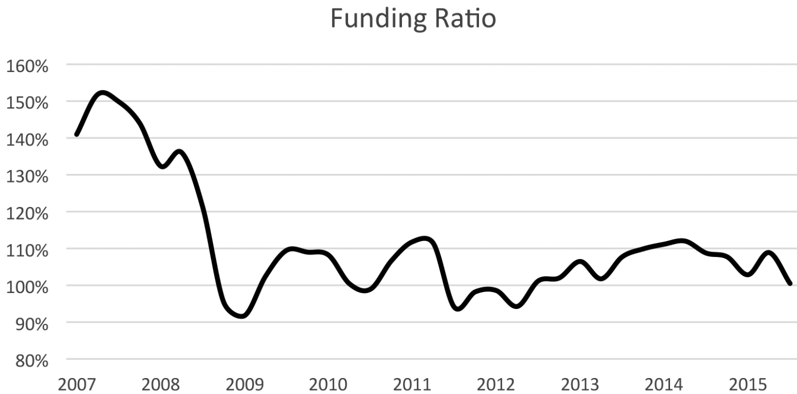

Figure 1. Nominal funding ratio of a typical Dutch pension plan, March 2007–June 2015 (Estimate based on data from DNB [www.dnb.nl])

funding ratio defined by rules set by the supervisor. This required funding ratio has a direct link with the investment risk taken in the fund's financial strategy. A typical pension fund will have a required funding ratio between 125 per cent and 130 per cent. Should the funding ratio fall below this level, funds have to indicate how they expect to recover within the following 10 years. Only in the case of strong underfunding will this lead to cuts in nominal benefits. This is a major relaxation compared to the previous regulations, and it is especially beneficial to the older participants. To maintain generational balance, however, the reform simultaneously defines a less generous policy regarding indexation. Full indexation is still possible but only at much higher funding ratios. Indexation might be given as far as this is allowed within the frame of restoring the financial position in 10 years' time. When, based on the prescribed set of rules and return assumptions, the required funding ratio will recover in a shorter period of time, the pension fund may provide some indexation. The bottom line is that cutting pensions is less likely, but providing full indexation has also become more difficult.

Figure 2 sketches the main relationship between the nominal funding ratio (along the horizontal axis) and the indexation rate (along the vertical axis). Full indexation can be provided when the nominal funding ratio is higher than a specified threshold, typically around 135 per cent when wage indexation is the objective. When the funding ratio is above this threshold, this overfunding can be used to provide catch-up indexation to restore missed indexation and negative indexation (cuts) in previous years. Funds with funding ratios deep below 100 per cent, say 95 per cent and lower, cannot escape from falling back on pension cuts to meet the supervisory requirements.

Figure 2 depicts how the new indexation policy is non-symmetrical in nature, as the cumulative provided indexation never can surpass the level of full indexation, whereas cuts can be given without any limit. The counterpart is that the new rules preclude more prudency and higher funding ratio levels in the longer run.

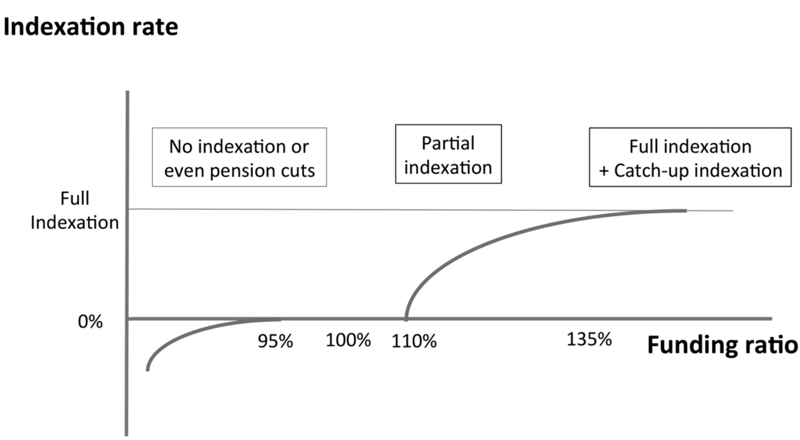

Figure 2. Indexation rules summarised by the policy ladder

More radical reforms are currently under discussion. Part of the debate focuses on the use of the uniform contribution rate in combination with a uniform accrual rate (see Table 1), which leads to undesirable value transfers among certain cohorts within the fund to others. This aspect of the current system prevents moves to cater to individual wishes of participants who display heterogeneity in career, income level, life expectancy. The uniformity in accrual and contributions leads to value redistribution from low to high income workers, from short-living (male) to long-living (female) participants, and from early careers to late careers. While in the past this was hardly known and understood, these transfers have become more transparent and considered undesirable. Reducing redistribution to acceptable levels is a tough and expensive challenge and it will probably play a major role in the reform agenda in the coming years.

CONCLUSION

Over the last decade the Dutch pension system has shown a large capacity to adapt the settings of the three pillars to changing circumstances. Final pay is replaced by average wage schemes and the introduction of market valuation of pension liabilities has provided a major incentive to the creation of a more robust pension system in absorbing shocks in financial markets, while maintaining the benefits of risk sharing within and across generations. The next challenge is to reshape the second pillar to take into account changing lifecycle patterns. Pension funds are likely to remain collective in nature, but more room will be provided to accommodate diversity in lifecycle and career patterns.

NOTES

1. More than 80 per cent of all pension funds are of the corporate pension fund type. Of the remaining 18 per cent, most are industry-wide funds, besides a small number of professional group funds. The industry-wide pension funds are the dominant players, both in terms of their relative share of total active participants (>85 per cent) and assets under management (>70 per cent). Around 300 corporate pension funds encompass

about a quarter of the remaining assets. The 12 professional group pension funds have on average almost €2bn under management.

2. OECD, 2013, Pensions at a Glance 2013, Paris: OECD.

3. Currently, the discount curve is based on the Euroswapmarket, adjusted for maturities above 20 years using an ultimate forward rate methodology.

POLAND

Marek Naczyk

As Poland has been experimenting with pension privatisation together with several other central and eastern European countries, it has received considerable attention from pension policymakers in recent years. In 1999, the country transformed its purely public, pay-as-you-go and defined benefit (DB) pension system into a 'multi-pillar' and defined contribution (DC) one. Younger generations – ie all those workers who were aged less than 30 in 1999 – saw their statutory benefits dramatically cut and turned into 'first pillar' pensions based on a non-financial defined contribution of 12.22 per cent of their gross wages (I refer to this as the NDC subsequently). Simultaneously, they were now obliged to pay 7.3 per cent of their salaries into a 'second pillar' managed by commercial 'open pension funds'. Those who were aged between 30 and 50 at the time of the reform also had their statutory benefits transformed into NDC first pillar pensions, but were given the right to choose whether or not to join the funded second pillar. By contrast, all those workers who were aged 50 years or more had to remain in the old public DB system. Finally, regardless of their age, all Polish workers were offered limited tax incentives to save in 'third pillar' DC occupational or personal pension plans.

The 1999 reform enjoyed strong support both from Polish political elites and the public. It was adopted with cross-party consensus and with the backing of the Solidarity trade union. Many Polish policymakers saw the new system as a beacon of modernity and believed that it would provide western European governments with inspiration.[1] Not only was the reform believed to solve the challenges posed by population ageing, but some even thought that benefits would be higher than in the old system inherited from the communist regime, since the 'open pension funds' would invest their monies on the stock exchange and would be managed by western European or American insurance companies. Pension privatisation was also believed to spur domestic economic growth. Because the creation of a stable base of domestic institutional investors increased the credibility of the Warsaw stock exchange with foreign portfolio investors and went hand in hand with the gradual privatisation and listing of many state-owned enterprises, the 1999 reform undoubtedly helped Warsaw emerge as central and eastern Europe's leading financial centre.

Yet, over the past few years, the 1999 reform has been called into question. In 2011, Donald Tusk's right-of-centre coalition government decided to cut the second pillar contribution rate from 7.3 per cent to 2.3 per cent of gross wages and simultaneously to increase first pillar contributions by the same percentage. In 2014, the same government went even further in reversing pension privatisation by making coverage of the second pillar entirely voluntary and by transferring all state bonds owned by open pension funds into the social security system. If the introduction of a multi-pillar system was such a miracle cure for the pension problem, why are Polish politicians now retreating from pension privatisation? The reasons lie in fundamental flaws in the design of the 1999 reform that have become evident following the global financial crisis.

A FLAWED DESIGN

While Poland's decision to privatise its pension system and to base it entirely on the DC principle clearly meant that it would be primarily up to individuals to bear the risks associated with stock market volatility, the crisis has helped highlight two other serious issues that are inherent in the multi-pillar blueprint promoted for a long time by the World Bank,[2] namely the problem of the fees charged by open pension funds and that of the enormous funding gap created by the diversion of social security contributions towards mandatory private pension funds.

As the investment performance of open pension funds strongly deteriorated in 2007 and 2008, the media and the public started paying greater attention to the returns they generated. Even though pension providers eventually recouped much of their losses, it turned out by early 2009 – ie when stock markets reached a record low – that, if one took into account the fees paid by the insured, the funds had generated real rates of return that were approaching zero since their inception. While the Tusk government's reaction was to cap the 'distribution' fee charged on second pillar contributions at 3.5 per cent instead of the seven per cent charged by most open pension funds,[3] the problem of pension fund fees in Poland – and more generally in the World Bank model of pension privatisation – is arguably more deeply rooted in the second pillar's institutionalisation as a market for 'personal pensions'. In these type of plans, it is individuals – not an employer or a trade union as in occupational plans – that have to choose their asset manager. But a decade of experience with the Polish multi-pillar system and numerous studies in behavioural economics[4] have shown that individuals typically behave passively and tend to stick to the pension provider they initially chose when joining the second pillar. Since the Polish second pillar has been simultaneously dominated by four big players, the demand side of the market – ie millions of passive and unorganised individuals – structurally lacks the market power that could force pension fund managers to bring down their fees.

The other major issue that has been at the centre of attention following the global financial crisis is the transition costs that result from pension privatisation. In the World Bank's multi-pillar blueprint, the second pillar is created through the diversion of part of social security contributions towards mandatory private pension funds. This creates a significant "funding gap"[5] for the public pay-as-you-go system, since much of the revenue that is needed to finance current public pension expenditure is simply diverted towards private pension funds. While proponents of the 1999 reform argued that it would insulate pension policy from 'political risk', they did not devise a credible mechanism to finance transition costs. Because Polish politicians have refused since 1999 to increase taxes or to decrease public expenditure in order to plug the funding gap, most of it has been financed by running substantial budget deficits and by increasing public debt, thereby shifting the burden of the financing of growing pension expenditure on future generations. As the economic slowdown further reduced the revenues of the public pension system, Polish policymakers have found it increasingly absurd that open pension funds should invest the majority of their assets in government bonds that have been issued in order to finance a debt that they have largely caused to increase.

In retreating from pension privatisation, Poland has been careful not to follow as radical a path as Hungary, which almost entirely nationalised its second pillar in 2010.[6] The country did not seize the equities that are held by the open pension funds for fear it could send a negative signal to the international financial community and to foreign investors involved in Poland. The NDC system was also kept intact. Since the introduction of NDC has already resulted in a significant cut in benefits for younger generations, the main future challenge for Polish policymakers will be to improve the adequacy of pensions.

A key to ensuring adequacy will be bringing down charges and this requires changes in governance. The lack of market power of individuals is a structural problem in any type of personal pension plan – be it mandatory or voluntary. If the expansion of private pensions is to be encouraged, Polish policymakers would be advised to start encouraging more centralised collective bargaining between employers' associations and trade unions so as to create the conditions for the creation of Dutch- or Danish-style industry-wide occupational pension schemes. With their natural economies of scale and their greater capacity to negotiate lower fees from external asset managers, these are the type of funds that are most able to deliver cost-effective, socially responsible and relatively safe retirement savings.

NOTES

1. See for example: The Wall Street Journal Europe, "Poland Sees Big Payoff from Pension Overhaul", 28 December, 1998.
2. World Bank (1994) Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth. New York: Oxford University Press.
3. Pension fund managers have also been allowed to charge a monthly management fee of max 0.05 per cent of a fund's total assets.
4. Eg James J. Choi, David Laibson and Brigitte C. Madrian (2005) "Are Empowerment and Education Enough? Underdiversification in 401(k) Plans", Brookings Papers on Economic Activity, 2005/2, p 151–213.
5. Jan Drahokoupil and Stefan Domonkos (2012) "Averting the Funding-Gap Crisis: East European Pension Reforms after 2008", Global Social Policy, 12(3), p 283–299.
6. Marek Naczyk and Stefan Domonkos (forthcoming) "The Financial Crisis and Varieties of Pension Privatization Reversals in Eastern Europe", Governance: An International Journal of Policy, Administration, and Institutions.

SWEDEN

Edward Palmer

The Swedish public pension system was originally a standard defined benefit pay-as-you-go system. In the 1990s, it was reformed with new cohorts of employees contributing to a system of individual accounts where their retirement income depends on the contributions made during their working careers. This led to the introduction of a pre-funded financial defined contribution (FDC) account scheme. At the same time, existing pay-as-you-go contribution records from 1960 were converted into accounts based on the underlying contributions,[1] to create a non-financial (notional) defined contribution (NDC)[2] scheme.

These were supplemented by a minimum income guarantee, which is means-tested against the NDC and FDC benefits. In its own right, this payment is too low to deliver an acceptable minimum income standard. The latter is accomplished with a ‘housing’ allowance that is means-tested against all income sources and wealth. This approach has meant that only about five per cent of old-age pensioners are in relative poverty – measured as 50 per cent of the median income for all households in Sweden.[3]

Both NDC and FDC are individual account schemes. However, NDC is a pay-as-you-go scheme with notional accounts and a rate of return based on the growth of contribution-based wages. The practical difference between this and the UK pay-as-you-go scheme is: first, that risk-sharing is within a population cohort and not across generations;[4] second, that the income received is proportionate to the level of contributions; and third, that indexation of contribution-based individual accounts is based on both real income growth and inflation, ie nominal income growth. In the FDC scheme, individual accounts are pre-funded and individual accounts earn a financial rate of return, determined by the individual's portfolio choice (or by the default fund's performance). In the FDC scheme, the individual can choose to invest in up to five separate funds. In both NDC and FDC schemes accounts are converted at retirement into an individual annuity product based on projected cohort life expectancy at retirement. Individuals can partially annuitise and can continue to work and contribute, consequently raising the value of their annuities.

NDC offers only a single life annuity. FDC retirement products are specified in law and in addition to single life annuities also include a survivor and joint annuity option. The NDC[5] and FDC schemes are autonomous from the public budget, whereas the guarantee is financed with general tax revenues.

Contributions for the mandated public pillar are in total 18.5 per cent of earnings up to a ceiling for earnings – in 2013 about £43,500.[6] The NDC and FDC contribution rates are 16 and 2.5 percent, respectively. Contributions, amounting to roughly one per cent of GDP per annum, have been paid into the public FDC scheme since 1995. The total value of all FDC accounts was about 17.5 per cent of GDP in mid-2013.

Sweden also has an extensive network of occupational pension schemes, which have all converted from financial DB to FDC,[7] beginning with the scheme for blue-collar workers (about 40 per cent of all workers) in 1995, albeit with various transition rules. These schemes are sector-based and cover together almost 90 per cent of all employees. The sector divisions are: private sector white-collar workers, private sector blue-collar workers, municipal and county council employees (professional employees within health care, old age care, education, social services etc) and employees of the Swedish state (civil servants, university professional personnel etc).

Retirement product options in the occupational schemes include generally, a choice of two single-life annuity alternatives, survivor and joint annuities. With a *fixed* life annuity, participants turn over their fund balances at retirement to the pension administration, which includes pooled investments of participant accounts. With a *variable-rate annuity,* the account balance remains in the individual's chosen unit-link funds, with an annual recalculation of the annuity based on the remaining account balance and cohort life expectancy, determined at the time the contract is drawn up. The public FDC scheme also provides these two options. Finally, note that in recent years it has also been possible for plan participants to re-contract providers.

Returning to the public mandatory NDC and FDC schemes, it is important to note that they are supplemented with redistributive components: nominal contributions are added for periods insured by other public insurances – unemployment, sickness, disability and compensated parental leave. Also, non-contributory credits are given for military service, higher education and to parents (one at a time) for up to four years after the birth of a child. All supplementary rights are financed with general tax revenues (and in the case of sickness, for example, an employee component). Together with the guarantee, these constitute the distributional components of the new Swedish public pension system.[8]

THE "SWEDISH" CLEARINGHOUSE MODEL

The administration of the public FDC scheme is set up as a 'clearinghouse', and as the private, sector-based FDC schemes emerged they emulated many of these cost-saving functionalities. The clearinghouse performs several functions: it acts as a collective broker between individuals and funds; it maintains individual accounts and records for all participants, collects and makes available (daily) information on fund values of participating funds, provides other information services to participants and is the monopoly annuity provider. In the public FDC scheme, all contributions are collected by the tax authority. Similarly, in the private schemes contributions for all participants – and hence participating companies – are collected by a single collection company.

To participate in the public FDC scheme, fund managers must agree to accept a system of maximum fee charges that decrease with an increasing volume of the company's managed funds. Despite the large number of companies and funds, around 70 per cent of individual accounts are managed by a handful of (Sweden's largest) private financial companies and the default fund. As a result, in 2013, total costs were 0.41 per cent (0.31 per cent for fund management and 0.1 per cent points for the public clearinghouse functions). This cost can be expected to decline further during the coming 10 years to around 0.25 per cent.

The sector-based occupational schemes have four separate clearinghouses – one for each sector. These are responsible for collecting contributions via employers, paying benefits, keeping individual accounts, providing customer information regarding the general rules and customer options, and managing transfers between providers at the request of participants. The options are precontracted companies that provide various alternatives for retirement products and fund management, with options providing individual fund choices. The employee chooses one of a number of listed providers of which there are approximately 10.

Investment fund charges have been a steady source of discussion in the mass media and as a result there has been a focus on explicit and 'hidden' administrative costs, which has also led to low management fees. Occupational schemes are also managed inexpensively. The best example, Alecta, the default fund for practically all (850,000) private-sector white-collar workers has a management and investment fee of 0.13 per cent with an average annual rate of return of 10.6 per cent for DC schemes for the period 2010–14.[9]

THE DEFAULT OPTION IN THE PUBLIC FDC SCHEME

Prior to May 2010 there was a single default fund (called AP 7) in the public FDC scheme for non-choosers, which one could 'choose' to become a participant in by not choosing among the approximate 800 private funds registered with the public FDC scheme. Until May 2010, however, once one had opted to place capital in one or more of the private funds, it was not possible to switch to the default fund.

In May 2010 the default fund was reconstructed. Assets were divided into two funds, a global equity fund and a fixed income fund. Total assets in this new non-chooser fund, called AP 7 Såfa, are divided between these two funds in accordance with participant age. All the assets of non-choosers below the age of 55 are now automatically placed in the global equity fund. From age 55 until age 75 three per cent of an individual's assets are automatically transferred to the fixed-income fund. Another new rule since May 2010 is that choosers who previously chose privately managed funds are allowed to switch to one of three combinations of the global equity fund and the fixed-income fund – conservative, balanced or aggressive.[10]

New entrants especially have shown increasingly little interest in choosing among the private fund alternatives. In 2013, 99 per cent of all new entrants, largely synonymous with new entrants into the labour force, chose to be non-choosers and, in total, 45 per cent of all participants in the FDC scheme have defaulted into the non-chooser fund AP 7 Såfa, but they are young and their percentage of total capital was only 28 per cent in 2013. Generally speaking it has not been a disadvantage to be in the default fund, in fact just the opposite. The capital-weighted average yearly return of the default fund (Såfa from 2010) has outperformed the capital-weighted average of all individual active choices from 2000,[11] with an 87 per cent equity content today, compared with about 80 for the capital-weighted average of investments in all privately managed funds in the overall FDC scheme. AP 7 Såfa has also outperformed the MSCI World Index since its reorganisation in 2010.[12] The management fee for AP 7 Såfa has been under 0.1 per cent in recent years.

PUBLIC FUND GOVERNANCE

Both the NDC buffer funds and the default fund in the FDC scheme are autonomous entities. They fall under the technical supervision of the Ministry of Finance and are governed by a professional board of governors. These funds' business activities are audited by the National Auditing Board.

The approximately 800 funds and around 100 fund managers providing the privately managed fund choices in the FDC scheme are under the supervision of the Financial Supervisory Authority, which is also governed by a professional auditing board, and are audited as private companies. Investments during the annuity phase are managed by independent money managers on the capital market. The annuities themselves are calculated, issued and administered through the clearinghouse function of the Public Pensions Agency.

OUTCOMES OF THE SWEDISH SYSTEM FOR FULL-CAREER WORKERS

For the worker with average earnings, entering the labour force at 20 and retiring at 65, the public NDC and FDC (Premium Pension) schemes replace 47 per cent of earnings and the sector-occupational scheme replaces an additional 15 per cent, for a total replacement rate of 62 per cent.

RECENT PUBLIC DEBATE

The public debate has focused on five issues: the first is automatic balancing of liabilities to estimated assets in the NDC scheme. This discussion arose initially and became an issue in connection with the 2008–09 recession. It has been difficult to explain why pensions needed to be decreased somewhat, at least temporarily, in conjunction with the decline in value of the buffer fund and the estimate of future contribution assets based on the current (and temporary) recessionary decline in covered wages. The response was technical in nature: to align the adjustment process, based on the estimate of future covered wages, more closely with actual current development of covered wages and resultant contributions.

Second, the construction of the buffer fund is itself an issue. A recent government report has concluded that, after 10 years, the returns of the five-fund construction have not significantly outweighed the additional costs of administration of five rather than fewer funds. This raises the question of whether funds should be merged to cut the costs of administration. It is difficult at the time of this writing to anticipate whether the discussion will lead to a change.

Third, the fall in NDC solvency with the 2008 recession and the risk of future balancing has resulted in a radical proposal from pensioner organisations to discontinue the public FDC scheme and use the 'freed' 2.5 per cent contribution rate to increase the NDC buffer fund. This increases liabilities commensurately with assets, which has a neutral effect on the solvency ratio, but in practice would provide more an increase in funded financial NDC assets. This is not likely to happen, however, since at least 70 per cent of the political representation of the new parliament (elected in 2014) has openly opposed this idea.

A fourth issue revolves around the pension ages in the mandatory pension system. A commission proposal presented in 2013 was to raise, first, the minimum age to claim an NDC and or FDC benefit from 61 to 62 from 2015 and then from 62 to 63 from 2019. Second, the age at which disability pensions are converted to old-age pensions and at which the guarantee can be claimed – age 65 – was proposed to be increased to 66 from 2019. Third, the age at which employers are obliged to keep employees is proposed to be raised from 67 to 69 in 2016. It is still too early to predict whether the government that took office in the autumn of 2014 will present the necessary legislation. The earliest date for a change was theoretically January 2016, but there is presently no indication that legislation is in the making.

The fifth issue of discussion both in Sweden and among foreign observers is the large number of funds in the Swedish mandatory public FDC scheme. A commission has recently proposed two alternative courses for the future: to reduce the number of options to a small number of equity, generation and interest funds; or increase the public promotion of the default fund, which to date has performed better than the average of all the private independent funds in the system, as a desirable choice option. At the time of this writing, there has not been a political consensus on this issue, and consequently no government proposal.

NOTES

1. Accounts for NDC, which were created from 1960, were completed in December 1998 and the first account statements were sent out in January 1999. FDC fund choices were possible first from 2000.

2. There are now many references to the Swedish NDC scheme. See eg Edward Palmer 2006. "What is NDC?" In Pension Reform Issues and Prospects for Non-financial Defined Contribution (NDC) Schemes eds. Holzmann R and Palmer E. The World Bank. Edward Palmer 2012. "Generic NDC: Equilibrium, Valuation, and Risk Sharing with and without NDC Bonds" in *Nonfinancial Defined Contribution Pension Schemes in a Changing Pension World*, eds. Holzmann R Palmer E and Robalino D. World Bank.

3. Poverty among individuals 65+ is reported to be 6.2 per cent in *Pensions at a Glance 2011*. OECD.

4. Although a buffer fund comprising assets accumulated under the historic pension system is available to finance deficits arising from the retirement of the large 1940s and 1950s cohorts.

5. Financial autonomy in the NDC scheme is maintained by calculating a solvency ratio, where liabilities at any given date are based on individual accounts during both the accumulation and decumulation phases and where assets are the fund and an estimate of contributions, called contribution assets. There is an automatic adjustment of the internal rate of return when liabilities exceed assets, based on a solvency ratio. This is explained in detail in the Orange Report—Annual Report of the Swedish Pension System 2012, Swedish Pensions Agency, 2013.

6. The ceiling is 8.07 times what is called an income base amount. The value of this amount is the preceding year's indexed with nominal wage growth to get the current year's amount. The ceiling is 451 920 SEK.

7. Note that civil servants still have a DB occupational component.

8. Contributions have an employee and an employer component. The employee component of sickness, parental leave and unemployment compensation is paid by the individual.

9. (Alecta – Annual Report 2014).

10. The assets in the global equity fund were distributed as follows: about 55 per cent in North America, a little over 20 per cent in Europe, including Sweden, 10 per cent in Japan and another 10 per cent in other Asian countries. The largest holding in the global equity fund in 2014 (Apple Inc) is 1.3 per cent of total assets.

11. http://secure.pensionsmyndigheten.se/Premiepensionen2013.html, Diagram 2.1.

12. http://www.Morningstar.se/Funds/Quicktake/Overview.aspx?perfid=0P00000CX.

CONCLUSION

All of the national pension systems reviewed in this volume are grappling with the development of a new pension system. It is one characterised by individual saving into a pension scheme where the returns are primarily dependent on the amount saved by the individual, either directly or indirectly via the employer as foregone wages, and on investment returns to those savings. While such pensions have always been available, their deployment as a mass pension savings vehicle is a qualitatively new development.

However, in order for this system to work, the state has a critical role to play as regulator of the new system and as provider itself of basic pay-as-you-go state pensions.

THE STATE AS REGULATOR

Massive information asymmetries between the pension provider and the individual require the state to ensure that savers can trust the quality of the product being provided. 'Quality' in this context is dictated by a set of features that mean the savings are applied to fulfil their purpose of generating a retirement income for the saver as efficiently as possible. If the state is unable or unwilling to play that role, there is a high probability that individuals will eventually refuse to save into pension products.

'Exit' or mass withdrawal from saving into pension products is not an efficient option for society as a whole. Disappearance of the longevity insurance element of insurance will mean that large numbers of people will under-save into high levels of poverty and another large group will save far more than they ever needed to. The lessons we can draw from the country chapters are that excessive rent extracted by providers will likely lead to either a political reaction (Poland, UK) or exit (UK prior to automatic enrolment, Germany, in the sense that there has been a low level of investment into 'Riester' products). Other countries, Australia (for accumulation only so far), Canada, the Netherlands and Sweden, have opted to take a more strategic route: proactively reforming their systems to ensure individual saving will work rather than responding to failure.

The reform experiences of these six national pensions systems suggest the necessity of mechanisms to ensure low costs, good investment practice and effective administration. On the provider side, these mechanisms are good governance and scale and, on the government side, effective regulation, including the promotion of those features. The Canadian, Dutch and Swedish experiences suggest that separation between pension scheme and fund manager may also assist the process of minimising rents. The Australians permit vertical integration but are relying on a requirement for schemes to have trustees (with a high standard of expertise placed on them) and a duty on those trustees to demonstrate value for money.

THE STATE AS PROVIDER

The state also has an important role to play by continuing to provide a basic state pension. There are three reasons for this. First, it ensures that distributional outcomes in old age are not unacceptably wide – each society chooses where it sets that limit. Second, a basic state pension is a form of diversification for individuals with additional occupational pension savings and this reduces risk to the individual. (It also potentially permits the individual to defer accessing their occupational pension when asset prices are low.) Third, in many countries, it will be some time before occupational pension amounts for most people will be sizeable.

IN INTERNATIONAL TERMS, WHERE IS THE UK?

The necessity of quality requirements underpinning a defined-contribution (DC) pension system is understood in the Department of Work and Pensions and the Pensions Regulator – and undoubtedly by the new pensions minister too. But it is unclear whether government actually has a strategic vision of the regulatory system that is necessary to embed quality. Regulatory change in the last parliament appeared to be a piecemeal reaction to short-term political pressure and much of the detailed content of the regulation to which that defensive strategy gave rise is either yet to be published (cost transparency) or is inadequate to meet its expressed aims (design of independent governance committees). Policy-setting around 'at retirement' products so far indicates that the government and the Financial Conduct Authority's preference is to hope that 'market forces' will satisfactorily resolve any issues of market failure. This may be very wishful thinking when the UK competition authority has already found that "competition alone cannot be relied upon to drive value for money for all savers in the DC workplace pension market".[1]

NOTE

1. http://webarchive.nationalarchives.gov.uk/20131101164215/http:/www.oft.gov.uk/shared_oft/market-studies/oft1505, p14.