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Global Pension System Reforms: Common Trends

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Good afternoon and thank you for joining us for what we hope will be an enlightening and thought-provoking seminar about the long-term savings challenges facing countries around the world, the emergence of the defined contribution system to replace or supplement current pension programmes, and specifically, what all of this means for Japan.

ICI Global is thrilled to be co-sponsoring this seminar with ICI and The American Chamber of Commerce in Japan (ACCJ). The investment management committee of the ACCJ has been active in promoting retirement savings, which is an important endeavour and one that ICI Global applauds. One of the core policy missions of ICI Global is to stimulate a global dialogue about the long-term savings and retirement challenges facing jurisdictions worldwide, and to demonstrate how funds can help meet those challenges as part of defined contribution plans.

To that end, ICI Global has been reviewing defined contribution schemes around the world through our Defined Contribution Systems Survey. Thus far, our review has yielded some preliminary trends that will be the basis of my presentation today.

Before I talk about those trends though, I will give you brief overview of ICI Global.

ICI Global represents regulated investment funds that are publicly offered to investors in jurisdictions worldwide. We do not represent hedge funds, private equity vehicles, or other specialist funds; we focus on those funds that form the core holdings of long-term investors around the world, whether retail or institutional.

Our goal is simple: to advance the common interests and promote public understanding of global investment funds, their managers, and their investors.

To that end, ICI Global pursues a policy agenda with four main areas of focus: the role of funds in financial stability, transnational regulatory developments, trading and market structure issues, and the role of funds in pensions and long-term savings.

It is the last category—the role of funds in pensions and long-term savings—that prompted us to do an in-depth review of defined contribution systems around the world, which focused on Australia, Chile, Hong Kong, Japan, New Zealand, Singapore, Sweden, the United Kingdom, and the United States. The goal of our review was to gain a greater understanding of the design and operation of these defined contribution systems and the key aspects of each system.

As we have been analysing the data, we have discovered a number of global trends. It is important to remember, however, that while we can learn a great deal from these trends, we should not view them in a vacuum.

Many different factors shape and influence a country’s pension system, including demographics, cultural beliefs, the social contract

that prevails in that culture, and economic concerns.

Thus, we need to keep in mind that the ways in which governments, companies, and individuals are responding to the trends shaping pension systems do not represent universal truths. What works in Scandinavia won't necessarily apply in Australia—and a wise choice for South America may not be accepted in North America. So today I am offering some preliminary findings from our survey—not prescriptions for global policy.

That said—we have observed many common themes across these countries. One of the most striking is the intense level of policymaking activity around the globe.

Research shows that between 2007 and 2012, virtually all member countries of the Organisation for Economic Co-operation and Development, the OECD, instituted some type of pension reform. And most of those reform measures focused on coverage and adequacy.

Why are so many countries reforming their pension systems? According to the OECD, there are two primary drivers.

The first driver is that government-provided retirement schemes are becoming increasingly unsustainable. Funding issues, fueled by imbalances between contributions and payouts, have long been problems for government-provided retirement schemes. When the 2008 financial crisis hit, those problems were exacerbated and brought to the fore, which forced countries to either reform their current system or examine alternative long-term savings programmes, such as defined contribution systems.

The second driver behind the surge in pension reform is changing demographics. Two major demographic trends are happening in many developed countries around the world: people are living longer and fertility rates are declining. This combination has been described as "demographic scissors" cutting the viability of retirement systems, as fewer workers support a growing base of retirees.

In addition to driving pension reforms, these two factors—fiscal unsustainability and changing demographics—lead us to the first global trend.

As countries around the globe examine and reform their pension schemes, the first trend we see is that many of them are implementing individual account defined contribution programmes. We see these programmes being used to replace or supplement occupational systems in some cases, while other countries are using them to supplement or replace national pay-as-you-go systems.

Let us talk about a couple of countries that have implemented defined contribution schemes to replace or supplement occupational systems.

Australia replaced its occupational schemes with a defined contribution scheme called the Superannuation Programme. Under the Superannuation Programme, employers are required to pay a proportion of an employee's salary and wages into a superannuation fund.

In 2007, New Zealand introduced the KiwiSaver programme to supplement both the country's voluntary occupational pensions and the government's flat-rate pension. The KiwiSaver programme has mandatory auto-enrollment with an opt-out period. It also has required specified contribution levels for participating employees and their employers. Thus, unless an employee opts out of KiwiSaver, both the employee and employer must make specified contributions to the employee's retirement account.

Now let us discuss a couple of countries that implemented defined contribution programmes to replace or supplement national pay-as-you-go schemes.

Chile replaced its pay-as-you-go system with a defined contribution scheme called the Pensions Administrator's Fund or the AFP system. Under the AFP system, employees are required to make specified contributions to accounts managed by one of six AFPs, which are private firms that handle investment management and account administration services. Unlike New Zealand, Chilean employers are not required to make specified contributions to an employee's account—but they can make voluntary contributions. Before introducing the AFP system, Chile had more than 100 different pay-as-you-go pension schemes and each scheme had different contribution rates, requirements for retirement, and benefits.

Sweden also reformed its pay-as-you-go public system, but did so in a different manner. Sweden replaced its pay-as-you-go programme with a "hybrid" scheme. The new plan allocates employees' mandatory contributions both to a state-run pay-as-you-go pension system and to an account-based system using funds selected by the employee from a list approved by the Swedish Pension Agency.

Finally, let us look at the United Kingdom, because it has taken a different approach than the other countries we have discussed.

In an effort to reform its occupational pension system, the United Kingdom implemented a new programme with mandatory auto-

enrollment and an opt-out period, as well as required specified contribution levels for both participating employees and their employers. Employers have the choice of using an existing plan; forming a new plan; or enrolling in the National Employment Savings Trust Programme, also known as NEST. NEST is a new national defined contribution programme that the United Kingdom created. All contributions are invested in the NEST Retirement Date Funds as the default option, although participants can choose from five additional funds in which to designate contributions.

As we consider this first trend, let me remind you of my earlier caution. Many countries are implementing individual account defined contribution programmes, but as you have heard, the features of each programme differ from country to country.

Take for instance, required specified contribution levels for participating employees and employers. As discussed, New Zealand and the United Kingdom require both participating employees and employers to make specified contributions. Chile, however, only requires employees to make specified contributions. And as my ICI colleague, Anna Driggs, will explain in her presentation about the U.S. system, defined contribution plans there generally do not specify contribution levels.

While each country surveyed has reformed or replaced its pension system with some sort of defined contribution system, that system has been designed to meet each country's specific needs and concerns.

The second trend uncovered by our survey is three-pronged and is a result of increases in life expectancy, which is one of the factors contributing to pension reform. Data show that because people are living longer, countries are raising contribution rates, increasing retirement age, and changing forms of disbursement.

Several countries have or are in the midst of raising their contribution rates.

For example, Australia passed a law that will go into effect in July, which will gradually raise the required contribution rate from 9 percent of an employee's compensation to 12 percent.

And in Hong Kong, where the employer and employee are each required to contribute 5 percent of the employee's monthly income to the Mandatory Provident Fund, the government recently increased the maximum level of monthly income for such contributions from $20,000 Hong Kong dollars to $25,000 Hong Kong dollars.

The second result stemming from increased life expectancy is that countries are raising the retirement age, the age at which people can stop working and draw benefits without being penalised.

For example, Australia will gradually increase the minimum retirement age for superannuation benefits from 55 years old to 60.

And here in Japan, Parliament passed a bill last year that raised the retirement age from 60 to 61, which will go into effect this April. The retirement age will then increase to 65 by the year 2025. But I defer to my fellow speaker, Mr. Koji Sugita, on this, as he knows the details of Japan's retirement schemes better than I do.

And in my adopted home, the United Kingdom, the state pension retirement age will gradually increase from 65 years old to 68 by 2050. The state pension is the United Kingdom's general government pension system and is similar to Social Security in the United States.

The third result stemming from increased life expectancy is that some countries are reforming how they disburse benefits.

Different countries have different views on which form or mixture of disbursements will help ensure people have resources throughout their retirement. Some countries and long-term savings systems encourage graduated payouts, while other countries offer participants a choice between lump-sum and graduated payouts.

For example, Singapore recently made annuities mandatory for some retirement accounts. And in Hong Kong, which currently only allows participants to withdraw their benefits in one lump sum, the Mandatory Provident Schemes Authority is proposing that members have a choice between lump-sum or graduated payouts.

In the United States, participants in defined contribution plans already have the option of either withdrawing their money in one lump sum or withdrawing smaller amounts over a longer period. A survey of U.S. households shows that participants who take lump-sum distributions are generally good stewards of their money, choosing either to reinvest it or to spend it prudently on essential needs, such as buying a primary residence, repaying debt, or paying for healthcare.

Once again, we are seeing this theme of countries responding to a trend in a way that suits each country's social contract and economic needs.

Our third trend shows us that there is an increase in employee choice. Whether it is a choice in investment providers or a choice in

investments, scheme providers are giving employees more options when it comes to where and how employees invest their money.

For example, in both Australia and Chile, employees are allowed to switch investment providers once a year, within their national scheme. And last November, Hong Kong started allowing employees to make an annual transfer of accrued benefits generated from their own mandatory contributions to another investment provider of their choosing.

In the United States, an employer chooses the selection of investments, which may include options from multiple investment providers. Employees then choose from those investment options how they want to allocate their contributions.

Fees—particularly the amount of fees that participants or employers are paying—is a topic that many participants, providers, and governments are monitoring closely. And our fourth trend shows that some countries are addressing the criticism of high fees by implementing programmemes with fee controls, fee restrictions, or mandatory fee disclosure. This is yet another trend that shows different countries taking different approaches to fit their own needs.

For example, Sweden controls fees—specifically administrative fees—through a rebate. In Sweden, a central agency, the Premium Pension Authority, or PPM, administers Sweden's pension system. To control administrative fees, the PPM requires fund providers to give the PPM a rebate of a percentage of the investment management fees, which the PPM then passes on to participants.

Like Sweden, the United Kingdom is working on controlling administrative fees. The new NEST programme, which I described before, is operated online to hold down costs.

Chile has implemented a unique system to reduce administrative fees. Every two years the government conducts a competitive bidding process among pension providers, and then automatically enrolls all new scheme entrants in the provider with the lowest fee. That provider is then required to maintain its fee structure for two years, and it also must charge existing participants the same fee as new entrants.

Another country that is concentrating on fees is Australia. Australia implemented fee restrictions by introducing a new default programme with low fee requirements, which will go into effect this summer.

And the United States has addressed fees by implementing mandatory fee disclosure. Mutual funds always have disclosed their fees to plan sponsors, and in turn, plan sponsors have disclosed those fees to plan participants. Last summer though, the Department of Labor enacted new regulations that require providers of all investment products to send enhanced fee disclosure to plan sponsors. Plan sponsors are then required to disclose fee information to plan participants, so that both sponsors and participants have a more comprehensive picture and better understanding of their retirement plan fees.

The fifth trend from our survey is that more countries are implementing lifecycle or target date funds as default investment options. Lifecycle funds, also known as target date funds, are professionally managed funds that are tailored to meet a participant's investment objectives based on the number of years a participant plans on working. Target date funds consist of a mix of assets, which the provider adjusts over time to become less focused on growth and more focused on income. These funds provide participants with diversification and automatic rebalancing, and are becoming increasingly popular, particularly as default investment options.

For example, in Hong Kong, at least one scheme provider has introduced lifecycle funds as default funds instead of using the Mandatory Provident Fund conservative fund, which is a capital preservation fund that invests in bank deposits and high-quality money market instruments. The Mandatory Provident Fund conservative fund serves as a low-risk investment option to scheme members who are approaching retirement or who are unwilling to expose themselves to shorter-term market movements, but it is limited because it does not allow investment in equities. In addition, several other scheme providers have introduced target date funds as investment options.

In 2010, Sweden changed the investment strategy of its state-managed default fund. The fund used to invest in a mix of 70 to 90 percent equities. Now it uses more of a target date strategy, and invests in an increasing number of fixed-income investments as members age.

And in the United Kingdom, all of the default funds in the United Kingdom's NEST Programme are target date funds.

Our sixth trend is that automatic enrollment features and programmes are on the rise. Various countries have started implementing them to encourage retirement savings.

For example, last October, the United Kingdom implemented a mandatory automatic enrollment programme, which will be phased in through 2016. And New Zealand's KiwiSaver programme also includes an auto-enrollment feature, which I mentioned earlier. Both of these automatic enrollment programmes allow for participants to opt-out shortly after they start working. Some defined contribution

plans in the United States also have an automatic enrollment feature, which Anna will discuss in greater detail in her presentation.

The seventh and final trend comes as no surprise and is a logical extension of the other trends: as more countries implement defined contribution systems with individual investment choices, there is a greater focus on the need for participant education.

For example, in 2010, the United Kingdom implemented the Money Advice Service, an independent programme set up by the government to give free advice to everyone across the country—online, over the phone, or in person. This includes advice on pensions and retirement. The online programme also includes several tools and suggested action plans to help UK residents plan for retirement.

Hong Kong provides another example. In November 2012, the Hong Kong Securities and Futures Commission launched the Investor Education Centre, or IEC. According to its new CEO, the IEC is going to develop a wide range of public investor education programmes and will play a key role in improving financial literacy.

New Zealand also is taking steps toward increasing participant education, through its Commission for Financial Literacy and Retirement Income. The Commission is helping New Zealanders financially prepare for retirement in three ways: by offering online tools to help citizens manage their personal finances; by publishing research papers about retirement issues; and by working to make sure personal financial education is part of the New Zealand school curriculum.

In the United States, the Department of Labor is complementing its new fee disclosure regulations by developing webcasts, videos, and publications to help participants better understand the fees associated with their retirement accounts. In addition, the Department of Labor offers myriad educational tools to help Americans plan for retirement, including a brochure about the top 10 ways to save for retirement, answers to the most common questions about pension plans, and videos to help small businesses understand their retirement plan options.

The private sector also can play a key role in investor education. Once again, I'll use the United States as example, because plan sponsors and financial service providers have led the way in educating participants by offering online planning tools and calculators, seminars on investing, and more.

What can we conclude from these results—preliminary as they are—of ICI Global's Defined Contribution Systems Survey?

At the highest level, it is clear that demographic changes and funding issues will continue to challenge government-provided retirement schemes around the world.

The good news is that there is a viable alternative or supplement to government-provided retirement schemes—one that is flexible and that can be adapted to fit the different needs of different countries around the world. That is the defined contribution system.

More countries are implementing defined contribution plans to either supplement or replace their current system. Why is that though? What makes defined contribution plans so attractive?

I argue there are three main factors that make these schemes an increasingly popular option: portability, ownership, and innovation.

Today's employees are mobile. It is not unusual for them to move from job to job, career to career, or—in places like Europe—country to country. That puts a premium on retirement benefits that are portable, in the sense that they are dynamic—assets in a defined contribution plan grow with a worker throughout his or her lifetime, whether in one centralized scheme or multiple schemes from several jobs.

This dynamic nature rests upon the second key characteristic—ownership. Participants in defined contribution plans own actual assets—not a promise of future benefits. Increasingly, individuals have an expanding choice of investments in their accounts, which helps them to comprehensively manage their household's total balance sheet.

The third factor that makes defined contribution plans particularly well suited to today's workplace is innovation, which means that the schemes offering these individual accounts can be tailored to the range of individual circumstances in the workplace. Some people are self-starters and eager investors; others prefer to follow suggested paths or rules of thumb. Take for example New Zealand, the United Kingdom, and the United States—each country has some sort of defined contribution scheme that offers a form of automatic enrollment to get more workers into plans. This is a key innovation that uses workers' inertia to put them on the path to saving.

Or look at Hong Kong and Sweden. As our fifth trend shows, these countries are increasing their use of target date funds, which, as we discussed, are innovative funds that are diversified and that automatically rebalance savings as markets move and participants age.

As more countries either supplement or replace their current schemes with a defined contribution system, there is a growing need to understand how defined contribution systems work and how they can be made to work better for each distinct population they serve, because as I hope is clear, there is no universal formula for every country.

The relative roles of employment-based and national systems; the degrees of freedom in contribution levels, investment choices, and individual control; and the arrangements for asset management will all vary from country to country. And, of course, they should.

Lastly—if you will permit me a bit of self-interest here—we at ICI Global feel that investment funds have a vital role to play in building the future of retirement, a future in which defined contribution plans most likely will play a bigger role. The products that our members have developed contain key features that serve retirement savers well.

For example, in the United States, funds are already indispensable components of defined contribution plans and are helping participants successfully save for retirement.

In fact, of the $5 trillion in defined contribution plan assets in the United States, 57 percent are invested in mutual funds.

In addition, fund companies have a long history of interacting with investors and can provide valuable insights into how to reach, educate, and serve retirement savers. Moreover, our member funds are professionally managed, well regulated, transparent, diversified, and cost-effective. They are offered in many jurisdictions around the world, giving our industry a global perspective that can inform policymakers as they consider needed reforms to their pension systems.

I hope I have brought some of that global perspective to our discussions here today. Thank you for your time and attention.

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