ASIA-PACIFIC REGULATORS' AND INDUSTRY DIALOGUE

Session 3

Preconditions for Industry Response

Mr Jeremy Duffield

Managing Director, Vanguard Investments Australia Ltd

SUMMARY PAPER

Private Pensions – Preconditions for Success

Questions:

Is there a natural evolution in the development of retirement pension funding? If so, what are the preconditions for success at each stage?

Does the model emerging in a number of developed markets -- with a focus on Defined Contribution with member investment choice, and sometimes Fund/Plan choice -- represent a natural "end-state" of private pension plan development? What are the issues related to such approaches? What are the preconditions before a nation should adopt such an approach?

The presentation will address these questions in an overview format. The Australian experience with compulsory superannuation and first member and now Fund/Plan choice will be drawn on. The author concludes that over time more countries will adopt similar approaches and, yet, because there are many challenges and preconditions to success that the model is not suitable for all countries. There are also significant lessons to learn from the successes and mistakes made in the development of the Australian model.

Introduction

What is the role of private pensions and what's required for them to emerge?

It's common in developed markets to talk of the three legged stool of retirement savings: 1) social security or government basic pension; 2) employment related funding; 3) private / personal savings. We now find that many people will add a fourth leg – working during "retirement" – either due to preference or necessity.

(Of course, this ordering represents a reversal of the way "old age" is funded in earlier stages of economic development when continuing work and private savings (as well as family support) are the only means relied on.)

But public policy discussions of retirement funding typically begin with the concept of a minimum social security payment. In some countries, this is means-tested; in others, not. In some countries, the "pension" is designed to be very generous; in others it is designed to be minimal. Many governments (not surprisingly) seek to reduce the burden on the public purse by encouraging the development of a strong second-leg of retirement savings -- employment based savings, often through programs tied to current earnings.

The private and the public workplace often elect, and sometimes are required, to offer retirement schemes as a key benefit.

Historically, Defined Benefit schemes emerged first; only later Defined Contribution (DC) plans developed. DC plans are now in the ascendancy and I expect that to continue. A further emerging trend has been the provision of investment choice. In some environments (e.g. Australia) a further element of choice is available: Fund/Plan Choice – whereby the member can elect the superannuation or pension plan.
With Fund Choice, the schemes become not only private in the sense of being workplace based, but increasingly the domain of retail financial service institutions.

The logic behind the evolution of the second leg is as follows:

DB plans are increasingly unattractive to employers: private and government – due to the risks associated with providing adequate funding.

Therefore, employers should contribute fixed amounts to Defined Contribution schemes - - or amounts that are partly determined by employers and partly voluntary savings by employees.

If only the contribution is fixed, and not the benefit, it becomes increasingly the employee's responsibility to provide for their own retirement.

∴ They should have investment choice. If they're going to be responsible…..

∴ They should be able to determine which fund they invest in; i.e. what investment options are available, what services they buy (such as advice & insurance), and how much they pay.

Australia has moved successfully to this model over a period of 15 years. The key elements are: compulsory minimum contributions of 9% of pay, with tax concessions. Members increasingly have both choice of a wide range of investment options and choice of which Fund/Plan they utilise. A number of other developed markets have similar approaches or similar elements.

Preconditions?

So, what are the preconditions for a successful second leg (employment-based savings arrangement)? A number of things to consider, some of the most interesting being:

- Affordability vs. need? Can the nation afford to set up both the first leg and the second leg of the model and how will the schemes match the retirement funding need?
- Political will? Does the political will exist to set up the policy program? How does political philosophy impact the policy settings? It is vital to get broad support for a stable enduring system
- Some of the key decision points are:
    - Should the program require compulsory contributions? Should it require universal coverage? Or should it be left up to the employer with incentives to participate? Should the participant be offered voluntary contributions?
    - Tax incentives? Are they necessary? Do they favour the well-off?

  - Should investment choice be encouraged or a trustee sponsored investment program?
  - Should members be able to select their Fund/Plan?
- Are financial markets and asset management industries set up to support the policy?
  - Are financial markets adequately developed?
  - Is there access to sensible investment options / fiduciary management skills
- What are the regulatory requirements?
  - Complex pension rules typically required
  - Appropriate oversight
- Record keeping systems
  - Should not be underestimated - - keeping track of millions of accounts over many years
  - Investment choice makes it more complex
  - Centralised or decentralised?
- In the case of Member Investment Choice, what is the readiness of the participating population?
  - Appropriate investment skills and financial literacy.
  - Importance of good default choices
  - Availability of Advice

The author will speak to the Australian experience regarding each precondition and talk to lessons learned, both successes and shortcomings.

Conclusions:

Each country should seek a solution that fits its own needs and stage of development. Over time, I think the dominant trend in developed markets will be towards individual accountability/responsibility for one’s own retirement savings -- with increasing choice available to participants as the population becomes more financially literate and experience. That is still a long time off for many countries. There are certain preconditions which should be met before proceeding down the track and I have covered some of them in my presentation and look forward to discussing them further with the panellists.