

INSIGHTS FROM THE
2014 Global Retirement Savings Conference

Common Principles for a Diverse World

- Reflections on the Chilean pension system •
 - OECD's roadmap for DC plans •
 - NEST •
 - Investor engagement •
- Role of regulators and governments •
 - Default vehicles •
- Sustainable retirement outcomes •

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INSIGHTS FROM THE
2014 Global Retirement Savings Conference
Common Principles for a Diverse World

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About ICI Global

The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US\$18.6 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

ABOUT THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute (ICI) is the world's leading association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's US fund members manage total assets of US\$17.1 trillion and serve more than 90 million US shareholders. Non-US fund members manage total assets of US\$1.5 trillion.

ICI has a deep interest in the retirement system and retirement policy. In the United States, ICI's mutual fund members manage roughly half of the US\$12.6 trillion in assets in defined contribution (DC) plans and individual retirement accounts (IRAs). The Institute has a large and active research programme on retirement trends, economics, and policy issues, and is the primary source for statistical data and research on retirement plans and the role of mutual funds in helping investors save for retirement.

TO LEARN MORE

Visit www.iciglobal.org/grsc to access all the materials from the 2014 Global Retirement Savings Conference, including panellists' slides, speaker biographies, and video testimonials.

Contact Anna Driggs, Associate Counsel—Pension Regulation, at anna.driggs@iciglobal.org with questions about this report or about global long-term savings and retirement.

Go to www.ici.org/retirement to read more about ICI's retirement research.

Letter from Dan Waters ICI Global, Managing Director

Around the world, countries of every size and economic situation are grappling with how they can help their populations build resources for retirement. Coping with that challenge demands the best thinking and cooperation from all sectors.

This is why ICI Global hosted its second Global Retirement Savings Conference: Common Principles for a Diverse World on 17–18 June 2014 in Geneva, Switzerland.

Featuring thought leaders, policymakers, and senior fund executives from 17 countries and five continents, the event examined:

- » the global direction of pension reforms;
- » how that direction affects different countries and their current policies; and
- » how the asset management industry needs to respond to global and local reforms to achieve better pension outcomes.

The ideas and insights that emerged from the conference are documented in this report, with three overarching themes resounding throughout the event.

First, pension systems are complex and must be looked at holistically. Most systems include complementary programmes designed to deal with different sectors of the population and different social needs. Therefore, any assessment of a system's ability to provide adequate retirement security must take into account all of the system's components.

Second, the movement towards defined contribution (DC) options continues apace. DC

plans have become a popular alternative or supplement to government-provided retirement schemes and defined benefit plans, and it is through DC plans that regulated funds can play a vital role in helping countries meet global retirement savings challenges.

The prevalence of DC systems and the growing use of funds within them led to our third theme: DC systems face a common set of concerns, including coverage, contribution levels, default investments, costs, and payout solutions.

A common set of concerns, however, does not imply a common solution. Countries have unique cultures, economies, and needs, all of which influence how governments, businesses, and individuals respond to these concerns.

Therefore, our intent in publishing this report is not to endorse prescriptions for global policy or to enshrine ICI Global's views. Instead, we hope to help policymakers, companies, and citizens worldwide build retirement resources by sharing the knowledge we gained about how different countries are responding to global retirement savings challenges.

I hope you enjoy reading this report. Because ICI Global is committed to advancing the dialogue about how to improve retirement security worldwide, I encourage you to share this publication with others.

Addressing global savings issues is a daunting challenge, and I hope the information in this report will help foster solutions to meeting that challenge.

Reflections on the Chilean Pension System

PARTICIPANTS

SOLANGE BERSTEIN

Former Head of the Pension Supervisory Authority
Chile

PAUL SCHOTT STEVENS

President and CEO
Investment Company Institute
United States

Known as one of the pioneers of pension reform, Chile replaced its pay-as-you-go (PAYGO) system with a defined contribution (DC) system in 1981. In 2008, the system underwent substantial reforms. In a conversation about the country's pension system and those reforms, Solange Berstein, former head of Chile's Pension Supervisory Authority, and Paul Schott Stevens, president and CEO of the Investment Company Institute (ICI), explored the effects that Chile's pension system has had on the country's capital markets, and covered such topics as investment performance, regulating for risk, and the system's auction process to lower entry barriers and introduce competition in fees. Berstein and Stevens also discussed the challenges facing the system today, including meeting participants' expectations about replacement rates.

The following is an edited transcript of their discussion.

Stevens briefly talks about the history of Chile's system and Berstein's role in the reforms. He then asks her questions about different aspects of the system and opens up the session to audience questions.

Paul Schott Stevens: Chile's pension system has been—and continues to be—one of the best known and most influential in the world. You're celebrating the 33rd anniversary of having replaced your PAYGO public system with a DC system. That means there's still not anyone who has been in the new system throughout his or her entire career. But it's getting close, isn't it?

Solange Berstein: Yes, it's getting close.

Stevens: During your time as the regulator, there were many changes. For example, a 2006 report by a Presidential Commission called for reforms to expand pension

coverage and to provide adequate pensions for participants. It also called for increased competition among account and investment management administrators, commonly known as AFPs. In 2008, under your leadership, the Pension Fund Managers ushered in a wide variety of reforms to address these stated concerns. They also addressed such issues as improving financial literacy and establishing more savings opportunities.

When we last spoke, we discussed some of the successful elements of Chile's system and some of the achievements that came out of the reforms. You refer to these as the 'lights' of the Chilean system. Looking

back on your time in a policymaking position, could you describe what the lights of the Chilean system are?

Berstein: As you just mentioned, we have a long history at this point—but not long for a pension system. We're still on our way to having a person who has retired under it with a full career. In 2006, there was an in-depth analysis of how the pension system was working, and it was a good time to do that—even a little bit late, I could say. Yet we didn't have much information until then about what was going on with the system.

After a little more than 20 years of the system, we had access to labour histories to see how people were contributing to the system, and we were able to predict what was going to come out of it. That type of work was done for the 2008 reform—we looked at what was really going to happen with future pensions for people with full careers. Through this analysis, the commission you just mentioned concluded that the system worked very well in many senses. One of the main things is the positive impact it has had on the Chilean economy, particularly on the development of the capital market. Of course, that means more employment, more contributions, and better pensions.

At that same time, however, we realised that pensions were not going to be as much as people in the lower end needed, so the solidarity pillar was built. I think the solidarity pillar for the poor people is one of the system's strengths. It's playing a big role in finance and pensions for current and future generations. Thus, I would say some of the 'lights' are economic growth, capital market development, better allocation of resources to good projects in the country, and the solidarity pillar that takes care of the vulnerable people.

Also, the reform took care of competition; we have an auction process for the new members. There have been three auctions, and they were very successful in lowering fees and increasing competition. There's still a lot to do, but those are the good things that have happened in the later years.

Stevens: I want to focus on one point that you made—the effect that pension systems have on capital market development. There is a very significant interplay between how a country runs its pension system and how vibrant its capital market system is. Could you give us a sense of what the Chilean capital markets were like before 1981, and what they are like now? To what extent are changes attributable to the pension reforms during that intervening period?

About the participants

Solange Berstein became superintendent of Pension Fund Managers in 2006 and contributed to the 2008 reform of the Chilean pension system. Shortly thereafter, the supervisory agency that she led became the Pension Supervisory Authority, which oversees the whole pension system. As chair of this institution, Berstein helped develop best practices for pension supervision in Chile and at the international level. She also has been actively involved in the Organisation for Economic Co-operation and Development (OECD) and was vice president of the International Organisation of Pension Supervisors (IOPS).

Paul Schott Stevens has served as President and CEO of the Investment Company Institute (ICI), the leading association globally of investment funds, since June 2004. He directed the 2011 launch of ICI Global to respond to the globalisation of fund investing and regulation, and has consistently championed the role of investment funds and defined contribution plans in providing for retirement. Stevens was ICI's general counsel from 1993 to 1997. Earlier in his career, he served as special assistant for national security affairs to President Ronald Reagan.

Berstein: I think it's dramatically different. We had, at that point, a very small capital market. It was very illiquid and there were not many instruments or issuers. But things have changed over the years, and pension funds had a significant role in that. Investment regulation is the one thing that has changed the most. There is also a lot more diversification and many more instruments. At the beginning, there was just investing in government and banking instruments. Then equity started in the late '80s, and then foreign investments started as the funds grew.

Thus, our capital market has grown, together with pension funds—not only in the sense that there are savings available for investment, but also in that it's not *any* investment. It has to qualify; it has to meet some requirements for pension funds to invest in it. That also makes a lot of difference, because it makes your capital market more transparent and liquid. There is a lot more sophistication in our capital market today, because that's what pension funds require.

Our capital market is also more stable for certain shocks, even in the fixed-income stream or the equity market, because pension funds are there for the long term. So the impact of certain things is less in some circumstances.

On the other hand, pension funds are quite big. If they all move at the same time, that could be a concern. Yet they tend to stay and be there for the long term, so in most cases, it means more stable capital markets.

Stevens: Did you have major flows during the financial crisis?

Berstein: No, not on the side of pension funds, although people might have switched between different funds. In that sense, it's not the pension fund that's deciding to change the portfolio; it's the individual that changes the fund and makes the pension fund rearrange things in order

to meet what each individual requires, because we have different funds and portfolios with different risks. In the 2008 crisis, there were some people that switched from the riskiest fund during the worst phase of it. They went from the riskiest fund to the safer fund, and then went back in the worst moment, of course.

Stevens: They tried to time the market and it didn't work out too well.

Berstein: It didn't work out too well, and recently, there has been a little more switching.

Stevens: These investor behaviours are very interesting, because we see them in the United States as well. We have been responding to concerns about the prospect of dramatic flows out of funds in the event of some financial shock—waves of redemptions that require portfolio managers to sell securities that then batter the markets. Our research shows that during our post-World War II period, market-in and market-out, this doesn't happen because people seem to have earmarked this money as long term. Would you say that's also true in Chile?

Berstein: I think we are going the other way around, at least at this point. In the later years, people have been trying to do a lot more market timing. I think it's a process that people are starting to learn, whether they are doing a good job or not at trying to time the market. It's not a large number of people, but we are seeing a lot more market timing now than before.

Stevens: I would like to discuss investment performance. As I understand it, AFPs' investment performances have been pretty good.

Berstein: Yes, and that is one of the good things of the system at this point. The returns have been quite good for the different pension funds, from the riskiest to the safest. Since 2002, on an annual basis—with the 2008 crisis in between—returns have

been almost 7 percent for the riskiest fund and around 4 percent for the safer one in real terms.

Stevens: That's net of fees and after inflation?

Berstein: It's after inflation, but not net of fees. Fees are discounted at around 0.6 percent of assets, independent of the type of fund. So the real rates of return have been quite good during these years and during the multifund period that started in 2002.

Stevens: Could you explain how the system, in a way, helps to ensure a rate of the same investment returns for savers in the same type of fund?

Berstein: We have a minimum rate of return for each type of fund, and we have five different type of funds: a riskier one, a less risky one, a moderate one, a conservative one, and a more conservative one. Thus, we have five different funds with different amounts of equity in each [see figure D.1]. There is a minimum return, and there is also competition between plan managers.

If the AFP is doing the right thing for the risk profile of the members in those funds, then that is the good news, because you have similar funds and they are competing on a certain range. They are not dramatically different, but they are going in the right direction in terms of the risk they are providing to the members who have that risk profile. That would be the good news.

The bad news could be that this fund could 'go somewhere else,' because there is no absolute risk control on the regulation or supervisor or anywhere. There *are* investment limits in terms of the type of investment each of these funds can have. Indeed, it's 80 percent equity at the most, so you could say, 'Oh, then risk is controlled, because it's 80 percent equity at the most.' Yet when you talk about fixed-income instruments, it doesn't mean zero risk—you can have more risk or less risk. When you go to derivatives, you can have more risk or less

Chile has six AFPs, each of which offers five different funds: A, B, C, D, and E. These funds differ from each other based on a set range of equity and fixed-income allocation. In addition, AFPs are responsible for guaranteeing a minimum investment return and are required to hold a buffer reserve to meet this obligation. The minimum investment return is based on the asset-weighted average real yield of all the pension funds of the same type. For more information about Chile's system, see pages 62–64.

Sources: Jaime de la Barra (Compass Group), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland); OECD

risk. So you can't regulate by the name, by labelling things. Eighty percent equity can involve a lot of risk or less risk, depending on the type of equity, the type of fixed income, etcetera. Simply labelling the funds or giving them these kind of structural limits doesn't limit risk. Thus, the regulator has to be very careful in overseeing what's going on in the fund to control for absolute risk and ensure investments are in line with what pension members should have in their portfolios.

Stevens: Your role at the regulatory level is to try to make sure these portfolios are constructed in a way that meets the expectations of someone who's choosing this or that level of risk?

FIGURE D.1
Chile's Multifund Asset Allocation
Percent

Fund	Minimum Equity	Maximum Equity
A	40	80
B	25	60
C	15	40
D	5	20
E	0	5

Prepared by: Jaime de la Barra (Compass Group), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

Berstein: Right. In the case of Chilean regulation, it is very flexible at this point, and that is another good thing about the 2008 reform. Before the 2008 reform, a lot of the investment regulation was in the law. You had to go to Congress every time you wanted to move things. Now, most of the investment regulation is secondary regulation that's issued by the Pension Supervisory Authority. There is a committee of experts that looks at what the Pension Supervisory is doing and it gives an opinion. They can even say, 'No, you're not going to do this because it would have a negative impact.' In response, the regulator would have to do something else or convince the committee that it's a good thing. There is this dialogue, which I think is a very efficient way to change the regulation to take care of this risk-level issue.

Stevens: There has been a significant evolution in thinking about the kinds of assets to which a Chilean pension investor might be exposed over his or her lifetime. Looking beyond the Chilean market to international markets, how has thinking evolved in that regard? That's been quite dramatic, has it not?

Berstein: Yes, it has. In the early '90s, investment abroad wasn't allowed. This is very important, because as pension funds get larger, there are two things. First, you need diversification. Otherwise, you have all your eggs in the same nest and things could get bad. Second, because funds are so big for the size of the country, you can get bubbles in certain markets, where prices start going up. Therefore, it's really critical that pension funds are able to invest abroad, because there is not enough space at home for these type of funds. In Chile, pension fund assets are almost 70 percent of GDP, so the entire pool of assets is quite large. Investment abroad started in the early '90s, and the limits have been increasing over time. At this point, the limit for investment abroad is 80 percent, but funds invest less than 40 percent offshore. It's a home bias that's causing the funds to invest

in this way. It's not a restriction in terms of the law. So, investment abroad is something good that has been happening over time.

Stevens: We talked about the 'lights,' and now I want to talk about the 'darks.'

One of the things that everyone in the pension world talks about, no matter where they live, are costs and fees. That's an important part of the conversation you have had in Chile. You referred to this a little bit earlier, when you mentioned creating an auction process to influence costs. During this process, the AFPs bid to see which can offer the lowest fee. Then there's a period during which they have to fulfil that promise. It's an interesting way of creating a market dynamic—but by regulatory fiat—to try to drive fees lower. Can you describe it and what kind of success you have had?

Berstein: Yes, having competition in the pension industry, which is compulsory, is a double challenge. It's not easy. After looking at the analysis and all the research that was carried out for the 2008 reform, we realised that people didn't know how much they were being charged. There was a survey done in which 97 percent of the people said they didn't know how much they were charged, and the other 3 percent said they did. Yet when those 3 percent were asked how much they were charged, their answer was wrong. They thought they knew, but they didn't. I think less than 1 percent really knew how much they were charged.

People don't care. It's a compulsory system—the money is taken out from their salary, and they don't even realise how much in fees is taken out of it. They don't know they can decide. They don't know that it makes a difference.

So competition in fees was non-existent at that point, and what we realised is that people respond a lot more to what we call sales agents. If the sales agent went to you, then that was good news if the agent was

going to switch you to the right company, a cheaper company, or a higher-return company. It was bad news if he or she was going to switch you to the wrong company and you didn't even realise that.

Sales agents can play two roles in a market like this that has people who are uninformed: the role of providing people with information so they can make the right decision, or the role of persuading people to switch to a place they don't understand. The role of sales agents was very critical in this industry, and people didn't know anything about fees.

Barriers to enter an industry like this were very high. Indeed, no company entered this market for many years, because the market was consolidated with just five firms. There was no possibility of entering this market, because the one way to do it was to hire tons of sales agents to go into the streets and 'catch people.' Yet the people they were going to attract were 'switchers'—the ones most likely to switch again. The unloyal ones.

Stevens: People who were following the hot money.

Berstein: Yes, the hot money. So, it was very difficult for a company to have efficient economies of scale in a market where they had to hire such a high number of sales agents and had low productivity in terms of being able to keep customers, without having to hire more and more sales agents. Barriers to entry were very high.

One of the auction's purposes was to lower barriers to entry. When you hold the auction, all new members have to go into the company that wins the bid. The cheapest company wins the auction, and because it won, it gets all the new workers. In Chile, the first-time contributors total about 250,000 people a year, which is a significant number.

The company that won the first two auctions—there is an auction done every two years—already has a little more than 1 million members, most of them because of the auction, not because of voluntary switching. Thus, the auction process did its job in terms of lowering barriers to entry, and we have a new company now. It was very successful in that sense.

The auction's other purpose was to lower fees, and it has achieved that goal. The company that won the first two auctions is charging 0.77 percent. The average fee is around 1.45 percent, so that's almost half of the average fee. It's also good news for the new members—those 1 million people—they have a lower fee.

In addition, one of the companies voluntarily lowered its fees. Also, the third auction was won by what used to be the most expensive company, but now it's the cheapest company [see page 29]. We have this dynamic, where fees are getting lower. At this point, around 40 percent of the members have lower fees than they did some time ago, which is good news. Of course, there is still a lot to do.

Stevens: So I'm thinking about that and some of the reading I did before this interview. You have the same challenges that many other countries have, including consistently rising life expectancies, a political reluctance to raise retirement ages—something that exists in many jurisdictions—insufficient contribution rates, and low minimum savings. All of this translates into inadequate pensions, complicated by the inequalities that you see in Chilean society, so—as you say—there is indeed a lot to do.

You recently had a change in your leadership. The centre-left coalition returned to power in Santiago, and Michelle Bachelet, the new president, is focusing on pension reforms. If she were here with us tonight, what would you tell her is the way to solve

some of these underlying problems, building on the progress that you have made to make the Chilean pension system even stronger?

Berstein: The biggest challenge at this point is pension adequacy. We have a financially sustainable system, but socially we have a problem because people are not getting what they expect to get. There are at least two things that should be done. The first thing involves expectations. Somehow, in the system analysis, we have the 70 percent replacement rate that people have in mind. This is validated because, for instance, the disability pension is 70 percent. The requirement for early pension is 70 percent. It's kind of a number going around in the system that you should be getting a 70 percent replacement rate. That is a very large amount. It's very large in the sense that you would need a lot of savings to have a replacement rate of 70 percent.

Contribution density refers to the proportion of months that a worker makes contributions to the system, compared with the maximum number of months the worker could have contributed.

Source: US Office of Social Security Administration, Office of Retirement and Disability, www.ssa.gov/policy/docs/ssb/v71n1/v71n1p35.html

In Chile, life expectancy is 88, while 60 is the retirement age for women. Thus, you have to fund almost 30 years, and women contribute to the system for less than half of the time they are in the workforce. They're contributing 10 percent of their salary for 15 years in order to finance 28 years. You can do two things in a situation like this: increase the contribution rate to an outrageous amount, or increase the retirement age to an outrageous age.

How do you actually solve this? You have to put a lot of money in from the government, but there are other demands on the government. For example, there's education. So maybe expectations should not be 70 percent—maybe they should be 60 or 50 percent. That is a very difficult thing to address. When people are expecting 70, how do you get them to realise that 70 is a number that you might not be able to achieve, even with the reforms taking place?

In addition to lowering expectations, we must somehow increase pensions. There are different formulas to do it. Let me tell you about the type of things we're thinking of, all of which are very difficult. On one hand, you could increase the contribution rate. Yet if we increase the contribution rate in a country where there is a significant informal labour market, we might push more people into the informal market because the higher contribution rate makes it more costly to have a contract.

Stevens: Labour market dynamics are a very important consideration.

Berstein: Exactly. So we have to be careful, because we might have higher contributions and lower contribution density. You have to be very careful about how you move things around.

In terms of the retirement age in Chile, it's not compulsory to retire at the legal retirement age. You can continue working. Yet participation in the labour market at the later stage of life is very difficult. So what are you going to tell people? 'No, you can't retire at age 65; you can retire at age 67 or 70.' But they have no job. They have no money. What are they going to live off of? If you increase that age, you also have to work with the labour market to see what opportunities could be there for people of higher ages. There is no easy solution, and this

has to be dealt with very carefully to get the right result, which is adequate pensions.

Stevens: I think behavioural economics have some lessons not only for pension plan participants, but also maybe for politicians, too. It is very hard to change retirement ages or mandate increased pension contributions. Perhaps if you do it slowly over time, just very incrementally, and do it in such a way as to make it less noticeable, you get to a place that's a little bit easier.

Solange, would you be willing to take a couple of questions from the audience?

Berstein: Yes, of course.

Audience Member 1: Given Chile's brilliance in setting up a pension system that's worked extraordinarily well on a continent that didn't have much in the way of pension systems, which countries come to you and look at what's going on in Chile, to see if they can adapt it? What countries do you look at, to see if they're doing clever things that you could emulate in the long term?

Berstein: During my time at the Pension Supervisory Authority, we were always getting visits from different countries from all over the world. We received Chinese delegations and Nigerian ones, as well as ones from many African and Latin American countries. Some of them implemented reforms similar to the Chilean ones. Some of them implemented reforms similar to us and then reversed them. Yet there is a lot of interest around the world in what has been done in Chile.

What countries have we looked at? Recently, we looked a lot at the United Kingdom and what they are doing with NEST [National Employment Savings Trust]. I think that's something very interesting. We've looked a

lot at Australia from the supervisory point of view. We've learned a lot there, and we are very grateful to the Pension Supervisory Authority of Australia. There are many other countries that we can learn from about specific issues, but those two are the ones we have visited and looked at most recently.

Audience Member 2: How much do you attribute the success of the Chilean system to the luck of the economy doing exceptionally well over the last 15 years, fuelled by resources that helped drive up investment returns? I say that coming from Australia, which went through a similar situation. People say an enormous amount of Australia's success was simply luck of an economy that was doing exceptionally well.

Berstein: Yes, I think that's part of the challenge. When we looked at the returns in Chile, during the first 15 years, it was sometimes volatile. Yet the returns were especially high during the first 15 or 20 years. For instance, the multifunds started in 2002. If the multifund system had started right before the 2008 crisis, the story could be different. So yes, the context in which reforms are done has a lot to do with the success or failure, so there is some luck involved there.

It's not just luck, however. That's part of the story, but it's also that the system has worked quite well. There's still a lot to do, but it has worked quite well. The funds have been correctly managed. There has not been fraud. The money has grown.

Yet challenges remain. One of the challenges Paul mentioned is life expectancy. He also mentioned contributions, which are low. There are many things. Real rates of return in the future might not be as high as they were in the past, so that's also part of the challenge. But I do think that we have a good starting point, at least.

The OECD Roadmap for the Good Design of Defined Contribution Pension Plans

PABLO ANTOLIN-NICOLAS

Principal Economist

Head of the Private Pension Unit

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France

Across the world, countries are shifting from defined benefit (DB) plans to defined contribution (DC) plans. Despite the positive features of DC plans, the shift has come with many challenges, including smaller contributions, potential retirement income volatility, and—with people now making more of their own investment choices—low financial literacy.

In response to these challenges and to help policymakers around the world develop DC systems, the Organisation for Economic Co-operation and Development (OECD) created the Roadmap for the Good Design of Defined Contribution Pension Plans.

Pablo Antolin-Nicolas oversaw the OECD's Working Party on Private Pensions development of the roadmap. In his keynote address for the Global Retirement Savings Conference, he discusses the roadmap's three guiding principles—coherence, adequacy, and efficiency—and outlines its ten key policy recommendations.

Those recommendations include encouraging high participation rates, adequate contributions, and long contribution periods; promoting well-designed incentives; and establishing appropriate default investment strategies for the accumulation stage and partial annuitisation for the payout phase.

The following is an edited transcript of his speech.

Pablo Antolin-Nicolas: Good morning and thank you for giving me the opportunity to present the OECD Roadmap for the Good Design of Defined Contribution Pension Plans.

The roadmap is the OECD's response to the retirement savings challenges facing OECD countries and the rest of the world. During my remarks, I first will identify the challenges that prompted the OECD to create the roadmap and then I will explain it.

One of the things that has been happening in most countries has been the shift from

DB pension plans to DC pension plans. In part, this shift is the result of unsustainable DB promises either from private DB pension plans or from public pension systems. As we discuss this shift, I think it's important for us to be objective about it, as well as the positive and negative features of DC plans.

One of the positive aspects of DC plans is that the link between pension benefits and contributions is direct and straightforward. Therefore, the issue of overgenerous contributions and other things normally discussed with DB pension plans disappear. One of the

negative aspects, however, is that the risks rest completely on the individual, and he or she might not be best-prepared to bear those risks. Another problem with DC plans is income volatility. In DC plans, retirement income is not promised because it depends on many parameters, some of which are uncertain.

For some parameters, individuals, regulators, and policymakers have some degree of choice. For example, what is the contribution rate? How long are you going to contribute? When are you going to retire? There are other parameters, however, that are uncertain, specifically risk parameters. For instance, what will your returns be overall and by asset class? What will inflation be? In addition, there is labour market uncertainty: what will your wage profile be? Are you going to suffer spells of unemployment? Finally, there is demographic uncertainty: how long will you live?

These risks always have been there, but the financial crisis heightened their importance and focused people's minds on them. One way to highlight these risks is to examine theoretical replacement rates for DC pension plans. I say 'theoretical' because DC pension plans didn't exist in most countries before 1990 and in any country before 1980. So what the OECD did was assume that DC pension plans have existed since 1900. We then used historical data on returns for multiple asset classes, inflation, and life expectancy to calculate replacement rates, assuming a certain contribution rate and a contribution period of 40 years.

[Referring to figure KN.1] What we found was that one of the key challenges in DC plans is volatility. Indeed, retirement income in a pure DC plan is very volatile. One thing I sometimes like to highlight in this chart [referring to same figure] is that in the United States, the fall in retirement income was much greater during the dot-com crisis than during the 2008 financial crisis.

Another thing I like to point out, especially given the current discussion about whether we are moving into a world of low inflation, low returns, and low interest rates, is Japan's experience since 2000. Its replacement rate has changed enormously. The difference in when people retire is based on two financial market variables: inflation and life expectancy. My main point in showing this chart to you, however, is to illustrate that volatility is a key challenge in DC plans.

Having acknowledged some of the positive and negative aspects of DC plans, I want to touch on some other negative factors that coincided with the DB to DC shift. Let me be clear though, the issues I'm about to describe do not have anything to do with DC plan features, but they compounded the problems associated with the shift.

First, in many countries, the shift has been accompanied by a reduction in employer contributions or even lower employee contributions. In addition, the shift to DC systems elevated the importance of financial literacy, and thus, highlighted the fact that many individuals have low financial literacy.

About the speaker

Pablo Antolin-Nicolas is Principal Economist and Head of the Private Pension Unit of the Financial Affairs Division at the Organisation for Economic Co-operation and Development (OECD). He manages the research and policy programme of the Working Party on Private Pensions, a body that brings together policymakers, regulators, and representatives from private sectors in almost 40 countries around the world. His work covers issues related to the operation and regulation of funded retirement income systems, and he was instrumental in putting together the OECD Roadmap for the Good Design of Defined Contribution Pension Plans.

Before we moved to a DC world, financial literacy wasn't important. Yet now that individuals have to make most of the choices, it's important. People, however, are unable or unwilling to make these choices, which has led to worries about the adequacy of DC pension plans in the long term and the level of investor protection. So with DB pension plans, we have sustainability issues, while with DC pension plans, we might have adequacy concerns.

DC pension plans also are becoming a major source of retirement financing in most OECD countries. In some countries, they're the main source, and we think it's important that these plans are appropriately designed in order to improve the adequacy of retirement income generated from these plans.

That's why the OECD created the Roadmap for the Good Design of Defined Contribution Pension Plans. The roadmap was approved

and endorsed by the OECD's Working Party on Private Pensions, which comprises pension regulators from the 34 OECD countries and a few observers.

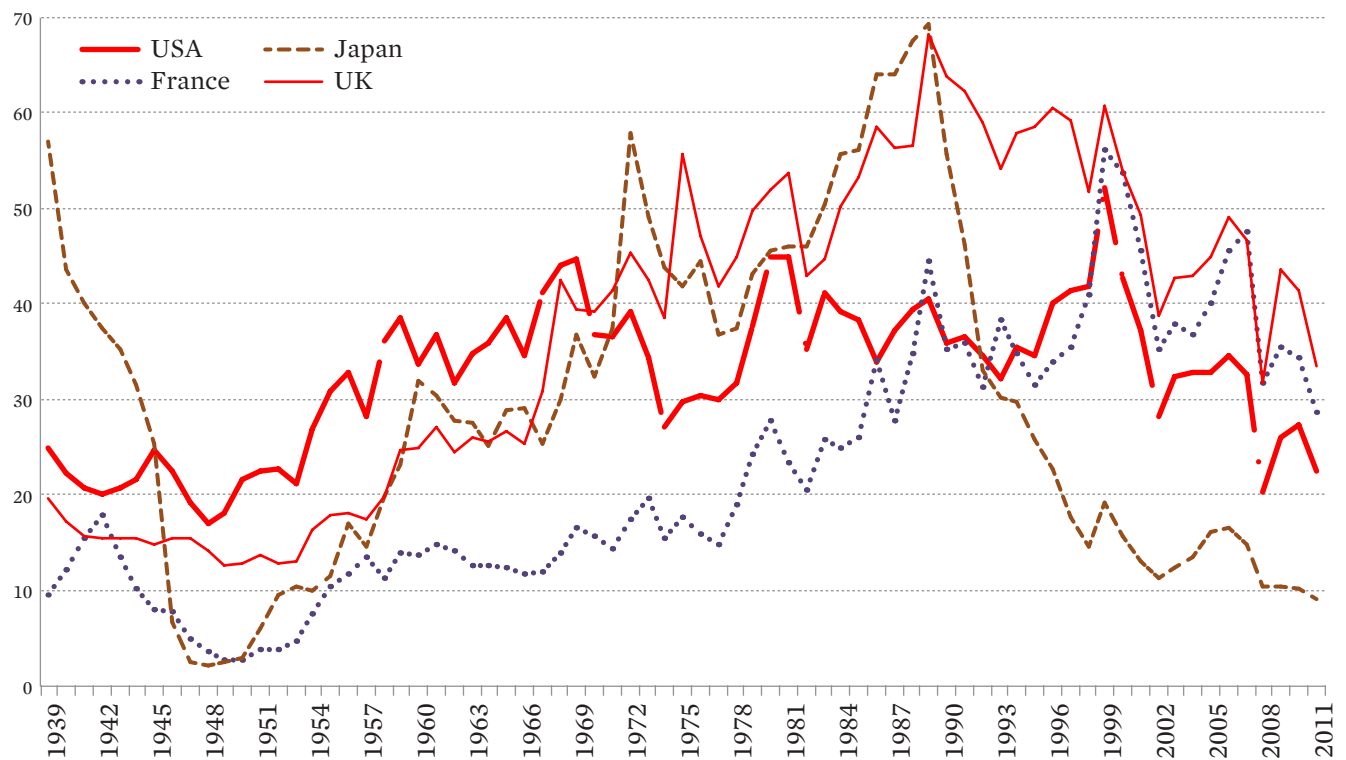
We approached the roadmap from the perspective of trying to increase people's chances of achieving a certain retirement income, rather than from the perspective of guarantees or whether a certain minimum income should be guaranteed. We used three guiding principles to decide on our main policy recommendations, and those principles are coherence, adequacy, and efficiency.

By 'coherence,' we mean that DC pension plans need to be designed in concert with the overall pension system. DC plans are not in a vacuum; there are public pay-as-you-go, or PAYGO, pensions and other types of pension arrangements in every country. So when you design a DC pension plan, you have to take into account the

FIGURE KN.1

Challenges: Large Volatility of Retirement Income in DC Plans

Percent, replacement rates



Prepared by: Pablo Antolin-Nicolas (OECD), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

whole thing. Of course, the design recommendations are going to vary across countries, depending on the overall structure of each country's pension system.

DC pension plans also need to be internally coherent. This means that the accumulation and payout phases need to be properly aligned, because how you design the accumulation phase will have an impact on the payout phase and vice versa. In many countries that we surveyed, we found that while the accumulation phase was properly designed, there wasn't even legislation in place for the payout phase.

When talking about coherence, we also need to take into account that we live in a world of uncertainty and there are many risks, including financial market, demographic, and labour market risks. Therefore, coherence also involves monitoring the risks that affect retirement income in DC pension plans. You cannot just design a plan and say, 'We're done and we'll see what happens forty years from now.' No, you have to continually monitor it, and let people know that what they're going to get is not written in stone, that things might change, and that appropriate measures need to be taken to address whatever problems come along.

When it comes to our second guiding principle, which is adequacy, the most important thing is that DC pension plans complement other sources of retirement income. This, of course, is linked with coherence. So when you establish the contribution rates, contribution periods, and how the payout phase is designed, you need to remember that retirement income will be coming from other sources and the DC plan income needs to complement them. For example, some people might argue, 'Why are you going to have a rigid payout phase with rigid annuities, in a country where the social security programme already provides a highly annuitised retirement income?' However, if the main source for retirement income comes from DC pension plans, you might want to have stricter recommendations.

With respect to our third principle, which is efficiency, the main goal is to choose investment strategies that reduce the effect of negative outcomes on retirement income. Of course, there are many investment strategies that one can choose from in the risk/return spectrum, and the choice will depend on the policymaker's goal. If a policymaker's main concern is to avoid sharp declines in retirement incomes as a result of big shocks, like the most recent financial crisis, then we believe default investment strategies that avoid extreme drops might be good ones—particularly for people close to retirement.

Efficiency also plays a role in the structure of the payout phase because as assets accumulate, they need to be allocated to protect retirees from longevity risk. One of a pension system's main goals is to provide protection from longevity risk so people have an income until they die. But there also are arguments for flexibility and liquidity during the payout phase. So you need to strike a balance between protecting against longevity risk but also having flexibility and liquidity during the payout phase, and that's where efficiency comes into play.

Let me turn now to the main policy recommendations.

As you might imagine, the OECD's first recommendation is that the design of DC pension plans needs to be coherent, which of course stems from our first guiding principle. DC pension plans must have internal coherence, coherence with the overall system, and a robust governance framework that addresses and monitors all the key risks—including labour, financial, and demographic risks—because there is an inherent uncertainty with saving for retirement.

The second recommendation is to encourage high participation rates, adequate contributions, and long contribution periods. All OECD countries have various types of pension systems and arrangements, and there is a big difference between compulsion, semi-compulsion, and auto-enrolment.

In addition, it's important to note that each country's policy goal dictates which arrangement is best. For example, when policymakers in Ireland were designing the country's system, they told us that their policy goal was twofold: to increase coverage as much as possible for the entire population and to have the lowest cost possible.

With that policy goal, compulsion is probably better than auto-enrolment because countries with compulsion have higher coverage rates. Moreover, auto-enrolment is more complicated to implement than compulsion and can be more costly, particularly for firms. Auto-enrolment does work very well, though. It has increased coverage levels in many countries and it also provides choice. Indeed, when choice is important—and it is an important policy option—auto-enrolment is an approach that works.

There are other measures that countries can implement to increase contributions and participation. One of them is matching contributions, which can happen either through an employer or the state. Many studies in the United States have shown that matching contributions by employers work. Other countries are doing it at the state level, such as the United Kingdom, New Zealand, and to some degree, Australia and Chile. Auto-escalation schemes are another proven

measure. And it's also essential to have an appropriate incentive structure.

Now, some people might wonder what can be done in a situation where all the replacement rates are going down. Of course, if we are moving into a world of low return, low inflation, low growth, and low interest rates, the only way to maintain the replacement rate is to contribute more for a longer period of time.

Some people argue, 'Well, that's obvious.' Yet during the financial crisis, every country's first reaction was to reduce contribution rates in DC pension systems, even in public systems. So it may be obvious, but it's not something that everyone does. If you reduce contributions today, tomorrow you are going to have less.

The OECD's analysis and calculations show that the best way to reduce uncertainty about achieving a target retirement income—whatever that target might be—is to contribute a larger amount for a longer time period. This of course is due to compound interest. Postponing retirement is the more efficient approach, because you have a shorter period to finance and a longer period of accumulating assets. In addition, the impact is greater if you postpone retirement than if you start working earlier.

FIGURE KN.2

Encourage People to Contribute and Contribute for Long Periods

Changes to contributions or to the contribution period changes the probability of reaching the target retirement income (RR)

Contribution rate / Time frame	Prob (RR≥30%)	Prob (RR≥70%)
5% / 40 years	61.6	13.9
10% / 40 years	91.7	52.8
5% / 20 years	2.8	0.1
10% / 20 years	33.0	1.3

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So let me give you some data. [Referring to figure KN.2] If you have a target replacement rate of 30 percent and you contribute 10 percent over 40 years, you have about a 92 percent probability of reaching that target. If you contribute only 5 percent, the probability drops by one-third to about 62 percent. And if you contribute 10 percent over only 20 years, the probability of reaching that 30 percent replacement rate is less than 33 percent.

UK policymakers asked us what an adequate contribution rate would be for the country's auto-enrolment system. This of course depends on your objective, among other things. Many people's objective is 60 percent of their final salary, which means they would need to contribute more than 8 percent to achieve that in the United Kingdom. You have to design everything taking into account your target, the risks, and the probability of reaching your target. This is in the best-case scenario, because when you look

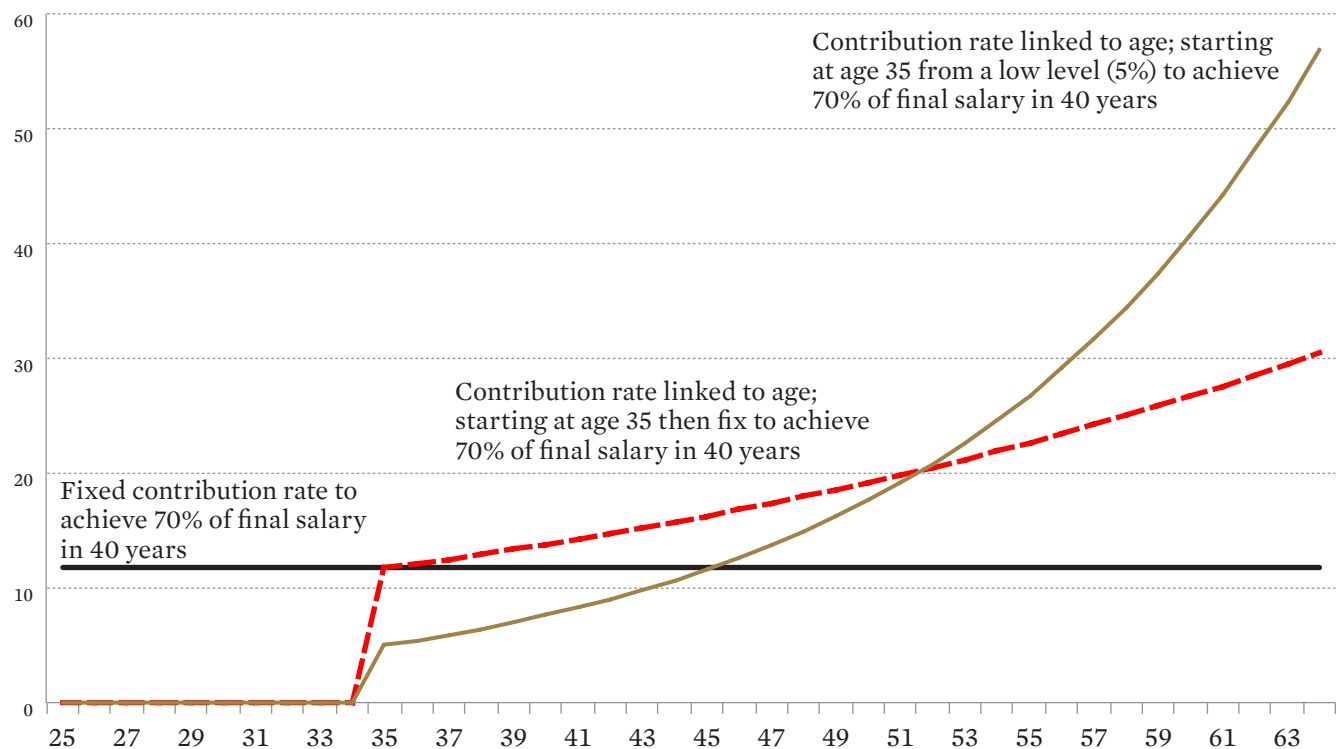
at the actual numbers, people don't stay 40 years—not even in public systems. Yesterday's discussion about postponing retirement is valid, but you need to not only look at the supply side of the labour market, but also the demand side, where there are very serious problems [see page 8]. Sweden and Iceland are the only countries I know that have addressed those problems to a certain degree, with high participation rates for people older than 65.

Some people suggest linking contribution rates to age. [Referring to figure KN.3] The argument for this is when people are young, they need money for other things, such as housing and raising children, so they can't start saving much until later. This is a good idea, and it works. The problem though, is that contribution rates have to increase to high levels at the end of people's careers. In addition, there is a problem of time inconsistency: once you reach 50 or 60 years old, you have to contribute 40 or 50 percent

FIGURE KN.3

Contribution Rates Linked to Age

Percent



Prepared by: Pablo Antolin-Nicolas (OECD), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

of your income because you didn't save in your twenties and thirties, and you are probably not going to do it. Therefore, the OECD always cautions about taking this approach. We don't say it's a bad idea. Yet as I've said, you need to assess the long-term implications when you design something.

Our third recommendation is to promote well-designed incentives, especially in voluntary systems. As part of this recommendation, we suggest strengthening the value of tax incentives for low-income people. All DC pension systems in OECD countries have tax incentives, and they're basically all designed the same way. Contributions and returns are tax-exempt, or partly tax-exempt, and benefits are taxed. This design favors high-income individuals because it's based on marginal tax rates. If your policy objective, however, is to favor low-income individuals, you might consider changing to tax credits. Now, if your objective is to be neutral in terms of the incentives, then matching contributions work quite well. If you already have tax incentives, then consider adding matching contributions in the form of subsidies—as in Germany's Riester system. At the OECD, we will be working on a project for the next two years that looks at the tax rules and incentives in different countries.

The fourth recommendation is to promote low-cost retirement savings instruments. How? By having disclosure-based initiatives. Yet it's not only about disclosing and providing information. Information has to be provided in a standardised format that people can compare. This is essential. A few countries, such as the United Kingdom, are talking about establishing caps on fees. Many people argue that caps might not work. At the end of the day, the key issue is to have market competition, where the markets are working properly. You could also consider complementing the disclosure-based initiatives with structured solutions. Solange spoke yesterday about one that seems to be working quite well in Chile,

with tender mechanisms of default allocations to low-cost providers [see page 7].

Before I present our next recommendation, let me explain what problem we were trying to address with this recommendation and what options we considered. At the beginning of my presentation, I explained that DC plans experience volatility in retirement income, which concerns policymakers and regulators. There are two possible solutions to this issue. One is to introduce minimum return or minimum income guarantees, and the other is to adopt default lifecycle investment strategies. The OECD assessed both approaches, using modelling and historical data, and we decided not to include guarantees in our roadmap. We're not saying guarantees are bad; they just have pros and cons that need to be assessed.

One of the positive aspects of guarantees is that they ensure the amount of accumulated savings does not fall below a certain value. Such guarantees are extremely useful, because people understand them. Yet, one needs to take into account that guarantees are costly. If a country decides to go through guarantees, that's fine—but it should put the cost on the table. And to some extent, guarantees are not too costly. That is only in the strongest conditions though, which include fixed- and long-contribution periods, a constant investment strategy, and no switching providers. Guarantees in DC pension plans also are less necessary in countries with PAYGO pension systems, because the PAYGO system normally provides a guarantee.

After weighing these pros and cons, our next recommendation stems from the OECD's decision not to go down the road of guarantees, but rather the road of default investment strategies. Indeed, our fifth recommendation is to establish appropriate default investment strategies while also providing individuals with a choice of funds that have different risk profiles and investment horizons.

DC plans are about giving choice to individuals. Yet behavioural, economic, and financial literacy data show that some people are either unwilling or unable to choose among investment strategies. In fact, in most countries where people have investment strategy choice, the percentage of people that don't make the choice is quite enormous.

Thus, we believe that default investment strategies should concentrate on reducing the risk of extreme negative outcomes on retirement income. It's important to note that defaults do not eliminate choice; those who want to choose can still pick their risk profile and investment horizon. This is important, especially in countries where choice is an important political consideration. Defaults are for protecting people who either do not want to choose or who are unable to choose. In addition, there should only be one default option, not 3,000, because that defeats the purpose of a default.

How do we provide protection? At the OECD, we balance the tradeoff between higher potential retirement income and risks. Yet, we don't measure risk by volatility; we measure risk by what an individual's retirement income will be in a worst-case scenario. The OECD has stochastic models that give us a sense of what an individual's retirement income will be in worst-case scenarios. That's how we assess different investment strategies—the potential retirement income you can earn versus the retirement income in an extreme negative outcome. To be able to choose an investment strategy, you need to establish a probability threshold to assess the risk. Of course, different regulators and countries have different thresholds, and that's a political choice. The higher the threshold, the fewer investment strategies available. The lower the threshold, the more investment strategies available.

Our sixth recommendation is to use lifecycle strategies, which reduce the exposure to risky assets, as defaults, to protect people close to retirement from negative outcomes.

Solange mentioned yesterday that equities have multiple degrees of risk, and that fixed income has risk as well [see page 5]. The key thing is to reduce people's risk profile as they age. An important aspect of this recommendation is that lifecycle strategies are easy to explain to people. They provide protection for those close to retirement, in case of negative shocks.

Of course, there are many investment strategies, and some might perform slightly better than lifecycle strategies. Yet, our policy objective—to reduce the risk of extreme negative outcomes on retirement income for people close to retirement—determined the choice of our recommended investment strategy: lifecycle strategies. These strategies also are very useful in short contribution periods.

Let me explain. The longer the contribution period—so let's use 40 years with a 10 percent contribution rate—the more likely a portfolio consisting of 100 percent equities will produce a higher amount of retirement income than a balanced portfolio. During the last ten years, equities might not have been great, but over the last 40 years, most countries had returns of 7 to 8 percent in nominal terms, including dividends. The shorter the period, things change, and of course the glide path is very important.

Further, lifecycle strategies do not perform better than balanced portfolios, with the same risk exposure over a 40-year period. Results are dramatically different, however, when you introduce certain criteria, such as a negative shock three, four, or five years before retirement. Under that scenario, the probability is much higher that pension benefits based on the lifecycle portfolio will perform better than those based on the balanced portfolio with the same risk profile. Our recommendation is based on this. Of course, the design of the glide path is very important. Our preference is for glide paths that sharply decrease equities in the last decade before retirement.

Lifecycle strategies can be structured as a single fund, such as a target date fund in the United States or they can be organised around several funds, such as multifunds in Chile.

So, lifecycle strategies work, but they are not a panacea, even though they've been introduced as such in some countries. They only provide protection from extreme negative shocks for those close to retirement. They do not eliminate volatility, and they do not address adequacy of income. All of this is very important, because you cannot just set the default investment strategies based on the life cycle, and that's it, everything will work.

Ensuring effective member communication and addressing financial literacy issues are essential.

—Pablo Antolin-Nicolas

The OECD's seventh recommendation is to encourage annuitisation as protection against longevity risks. More specifically, we believe that combining programmed withdrawals and deferred life annuities could be an appropriate default for the payout phase. We think that's the way to balance flexibility and liquidity with protection from longevity risk. You don't need to use all your assets to provide protection from longevity risk. In addition, whether you need this protection—and how much—depends on other parts of the pension system, and of course that varies across countries.

Our eighth recommendation is to promote the supply of annuities as well as foster innovation and cost-efficient competition in annuity markets. I should mention the OECD is currently working on a study that analyses annuity products, the different guarantees they involve, and applicable regulatory frameworks in OECD countries. Obviously, if we are talking about promoting annuitisation, we need functioning

annuity markets. There are many things we can do about it, including removing tax disincentives and supporting innovative products. There are variable annuities with different types of guarantees, products that combine accumulation with the pay-out phase, reverse mortgages, and products that combine pension and healthcare. For these products, it's important to be careful with the design.

Next, there's the issue of changing the framing. We believe it's extremely important to keep repeating the message: 'Annuities are not investment products; they are insurance products.' As investment products, they're a bad investment—but they are not about investment. Providers need to have instruments to hedge risk.

The OECD's ninth recommendation involves developing risk-hedging instruments to facilitate dealing with longevity risk. In this regard, OECD is finishing a project now on how to design instruments to hedge longevity risk, and also how to assess the different levels of longevity risk. Our key message is that we should be focusing on hedging or mitigating risk, instead of transferring it entirely. Otherwise, markets will never develop—because the side of the market that will have to absorb the risk is not there. Capital market solutions are important, but to develop them, we should focus on standardised hedges, instead of bespoke hedges. Of course, there is the whole debate about whether the state has a part to play, and we believe there is a role for the state to induce transparency, liquidity, and standardisation in the market. Whether there is a role to issue longevity index bonds is something more delicate and something that needs to be discussed further.

Our final recommendation is that ensuring effective member communication and addressing financial literacy issues are essential. We have discussions about what pension statements should include. We talk about national programmes and about

communicating reforms as well as potential reforms. The studies that we have done in many countries normally suggest that communications should be very focused. If you try to address too many issues, the only thing you're doing is confusing the citizen, and as a result, you're not achieving your goal.

We also have analysed, particularly through focus groups, how to better design pension statements—including if we want to communicate risk in the pension statement and how to better communicate it. In fact, we did that in Chile with Solange's team. Our objective is to make people proactive through effective communications, but of course it's difficult to come up with effective communication.

Last night's discussion highlighted the need for people to retire later and to contribute more to increase their chances of achieving their target retirement income. Yet how do you communicate that? With tables, graphs, and figures? Some ideas seem so clear to us, but they're not so obvious to retirement savers. For example, we tested one picture that looked like a speedometer, and everybody thought it meant something completely different than what we thought it meant.

On financial education and financial advisers, there are very interesting approaches in several countries. The United Kingdom is now discussing the issue of providing financial advisers for everyone. Yet it's not that easy to have financial advisers for every individual. Also, the incentive structure for financial advisers needs to be addressed. There are conflicts of interest. The United States, for example, is discussing financial advisers' conflicts of interest at the moment. And many countries want to discuss them in the context of the OECD. Some countries now require a certification of financial advisers. In addition, standardised certification seems to be working. In fact, Australia is an example of

it working. There are many approaches to this, and the issue is becoming increasingly important. Thank you very much.

Audience Member 1: I just wanted to ask you a question about incentives, particularly about the need to focus them in a different way. The question really hinges on what seems to be an international consensus on the principle of deferred taxation for pension savings. You referred to the exempt-exempt-tax principle, which is not really incentivisation; it's actually the avoidance of double taxation. Therefore, it's not that people are provided with a specific incentive, in the form of a match, to save. It's actually an agreement to help people smooth out their tax over a lifetime. Do you have any thoughts about how you might move away from that? You talk about matching, but if we were to dismantle that system, we would be dismantling something that has taken many decades to build up. We're certainly interested in the United Kingdom in starting to think about how you could move beyond that, but not in a way that creates incoherence in the broader tax framework.

Antolin-Nicolas: I completely agree with you. We are not talking about dismantling this. We recognise that there are two sides to the tax deferral incentive issue, which is completely valid. Our position is that systems are designed so high-income people get the biggest bang for their buck. If a policymaker comes to us and says, 'We want to increase incentives through the tax system,' what we say is, 'Well, you have this tax system at the moment, where people below a certain threshold—and that threshold could be quite high in OECD countries—do not file for income tax.' For these people, tax incentives are not provided. And the lower your income, the lower your tax incentives.

So what we say is don't dismantle the system, but instead, add matching contributions. That balances the incentive structure.

Audience Member 2: I was intrigued by your principles, and I have one question with two elements. One thing that I often find globally is that the political discipline to make changes doesn't always exist. Lots of good ideas don't get implemented because there is a lack of political discipline on the government's part. The second element is, I think we are one of the most complicated industries in the world. So is there a principle for simplicity and political discipline? Was that part of the OECD's consideration?

Antolin-Nicolas: Well, one of the reasons we support default lifecycle strategies is because they are simple to explain to people. So, simplicity did take. Simplicity is essential, because communicating to members or individuals is essential. And you need to do it in a way that is easy for them to understand and in a language they understand.

Political discipline is a more serious problem. As contributions evolve over time, there are political, policy, and timing inconsistencies. These are very problematic. For example, when you discuss public systems, many countries want to go to a PAYGO system. Their rationale is 'Well, at least our pensions are protected.' Ask the French, Spanish, or the Italians whether the pensions they had ten years ago are the same today. Even in a PAYGO system, political discipline of the promises does not exist. When we talk with officials in some countries—including Ireland, Spain, and Italy—about how to make reforms when things are going so bad and there's no money to implement them, I always think of what the Swedish and English did with the Turner Report. You sit down and have all the stakeholders discuss it. Then you reach an agreement and obtain approval from all the political parties in Parliament. The reform doesn't need to be implemented today, but the key thing is the political agreement.

There are many reasons why reforms haven't worked in some countries. In Hungary, for example, the government always used cost as an excuse. Yes, costs were very high. Yet there is never just one factor. I discovered later that only one political party in Parliament approved the reforms; there was no consensus in the country. So yes, I agree that political discipline is much more difficult.

Audience Member 3: When you were talking about one of your recommendations, you said that the ideal post-retirement phase is going to be made up of deferred annuities and a phased drawdown. What do you think of the United Kingdom's recent move to give people complete freedom to do whatever they like when it comes to retirement, including perhaps buying a Lamborghini?

Antolin-Nicolas: I personally think they made that move for the wrong reason. I'm not in favour or against the move. Yet I think the reason why they did it—at least what they have said in the press and in speeches—is wrong. As I understand it, there has been a long discussion in the United Kingdom that annuity markets don't work. By the way, this is the country where annuity markets work best. They don't work perfectly, but they work better in the United Kingdom than in any other country. Yet the reason why the government decided that no one has to buy an annuity is because some people were arguing that someone who retired 20 years ago with the same pot would get far more in pension than someone who retired today—thus, something is wrong. Yet the only thing wrong with annuities is that we are in a world of low growth and low interest rates. That doesn't have anything to do with pensions. It *affects* pensions, and we obviously need to assess how it does so, but it doesn't *come* from pensions.

You can try to address this problem by telling people, ‘Okay, you’re free to do whatever you want, because you will do better,’ but how are people going to do better? Growth is lower. Interest rates are lower. So the reasons to do it were not the right ones, and we believe that partial annuitisation should be a default, at least.

Audience Member 4: As a follow-up to that question, I’m just wondering the extent to which you see longevity as a risk to the validity of default options. People will be living longer, so their point of retirement may be less certain. Because they’ll be living longer, their needs, in terms of income and the absolute amount that they’ll need, may be more. For example, if a 65-year-old man is in an exclusive short-duration or bond portfolio, he may not have enough to keep him going for 30 years. So it’s just that question of the risk of the default option as regards to longevity.

Antolin-Nicolas: So you raised one side of the problem—the length of the accumulation phase. At the end of the day, the problem of life expectancy is the ratio of the years you’re saving for retirement to the years you’re retired. That ratio should take into account the contribution level and the contribution period, as well as other things. That will give you a target retirement income. And that ratio should change in a way that changes in life expectancy do not affect, or the different parts of the ratio should change so the ratio remains constant.

For the accumulation phase, if people live longer, we’ll have to work longer to keep that constant. The OECD’s recommendation—regardless of whether the system is public or private—is that the retirement age should be later or linked to life expectancy. We are starting to give this recommendation a little more nuance, because

according to different socioeconomic variables, life expectancy for low-income, blue-collar individuals is not the same as life expectancy for high-income, white-collar individuals.

One thing from the discussion yesterday that I thought was interesting is that maybe we should not have a fixed retirement age—maybe people should retire when they think they should [see page 8]. Well, first, regulators or the government should set up a threshold for retirement income, and from the moment you reach it, you can retire. Otherwise, you can retire whenever you want. That’s okay for DC pension plans but it’s a problem when you’re talking about public systems, or when basic pensions or minimum pensions kick in. It’s also a problem when you factor in that people have different professions.

For the payout phase, our recommendations are very simple. First, pensions and annuity providers—whatever way they go, the system or the combination—should be required to use up-to-date mortality tables that include future improvements in mortality and life expectancy. They should be updated every year—not every ten years—because at the end of the day, longevity risk is just one part of the future changes that you are not accounting or reserving for. The better your tables are, the more accurate the inclusion of future improvements will be. The more you reserve, the less longevity risk you are going to have. Obviously, there is always going to be some fluctuations. Yet that is the capital market solution, which is a small part. At the end of the day, what is left is what they call the aggregate or the cohort longevity risk, which is everybody is going to live longer. But that’s a risk that cannot be insured and that will fall completely on the individual—through the state or through the individual having lower retirement income.

PANEL 1

Building Retirement Resources: How Do Governments and Regulators View Their Role and What Should Their Role Be?

PANELLISTS

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During the past several decades, many countries have created second pillars and some have reformed them. In this panel, speakers discussed the successes and challenges they have encountered with second pillars, as well as the role of the government and regulators in meeting those challenges. Panellists explored issues surrounding coverage, fees, contribution rates, default funds, and more.

In addition, they spoke about the challenges regulators and governments face in meeting changing expectations towards pensions, the feasibility of imposing global or regional standards on different countries' systems, and the challenges of working within the confines of an existing system.

The following is an edited transcript of their discussion.

Brian Reid, the moderator, starts by introducing Roberto Rocha from the World Bank, who discusses the organisation's work on pensions. Reid then asks the panellists a series of questions based on some of the issues Rocha addresses.

Brian Reid: I'm pleased to be moderating this panel of distinguished regulators and policymakers who will talk about the role of governments and regulators in building retirement resources.

We'll begin with Roberto Rocha, senior advisor for the financial services practice—financial architecture and regulation at the World Bank, who will reflect on his work in global pensions over the last 20 years. He also will outline some of the lessons learned about pillar two and, to some extent, pillar three pensions.

Roberto Rocha: Thank you for the opportunity to share some of the World Bank's experience in building pension systems over the past several decades. During my presentation, I'll focus on emerging countries, but I'll also reference developed countries.

Let's start with an overview of what we're going to cover. First, we're going to talk about the definitions of all the pillars. In my experience, it creates a lot of confusion when you talk about pillars one, two, and three, because they might mean different

things to different people. Second, we'll review trends in pension reforms during the past three decades, especially regarding what has happened in the emerging world. Third, we'll discuss the outcomes of new pension systems that have been put in place since the famous Chilean reform in 1981.

In addition, we're going to examine pension reform reversals. We're going to discuss the types of reversals, the countries, the challenges, and the causes. Finally, we'll talk about the policy agenda for the future, during which we will focus on the second and third pillars. For the mandatory second pillar, we're going to discuss what policymakers can do to strengthen them, since their mixed outcomes are the reason for some of the reversals. We'll also examine what countries should do to expand or strengthen their voluntary third pillars.

Now let's talk about definitions. The zero pillar is the basic pension in most countries, and it's usually tax-financed. The first pillar is the workhorse of most pension systems; it is pay-as-you-go, or PAYGO, and contribution based, with varying degrees

About the panellists

Brian Reid is Chief Economist at the Investment Company Institute (ICI). He joined ICI in 1996 and was appointed chief economist in 2004. Reid leads the Institute's research department while overseeing all ICI statistical collections and analysis of the mutual fund industry.

Dirk Broeders is a Senior Strategy Advisor for the Supervisory Policy Division within De Nederlandsche Bank and he specialises in pension fund regulation. He is also Treasurer of the International Organisation of Pension Supervisors (IOPS) and was head of research and strategy at a Dutch asset manager.

Darren McShane is the Chief Regulation and Policy Officer of the Hong Kong Mandatory Provident Fund Schemes Authority (MPFA). He heads the Regulation and Policy Division, which is responsible for investment regulation, policy development, and legal services as well as research and statistics.

Roberto Rocha is Senior Advisor, Financial Systems Practice—Financial Architecture and Regulation in the Financial and Private Sector Development Department at the World Bank. He has been extensively involved in research and operational work supporting the development of financial and pension systems and has numerous publications in these areas.

Justin Wray is Head of the Policy Unit for the European Insurance and Occupational Pensions Authority (EIOPA). He is responsible for pensions, insurance, external relations, and impact assessment. Before EIOPA, Wray worked at the UK Pensions Regulator as head of pension administration and governance.

of links between contributions and benefits in different designs. Then we have the second pillar, which is private and fully funded. The second pillar's most important characteristic is it is either mandatory or quasi-mandatory. In some countries, the second pillar is defined benefit, or DB, but it's predominantly defined contribution, or DC, in the world today. Then we have the third pillar. It's also fully funded and privately managed. The only difference between the second and third pillars is that the second is mandatory and the third is voluntary. Finally, for completeness only, we always talk about the fourth pillar, which includes general savings for retirement, wage income, and housing income.

Now let's take a look at what has happened in the world during the past three decades. Several countries have developed, created, or strengthened their zero pillars. Many countries in Latin America see having a pillar against poverty—a basic pension to ensure almost universal coverage at the retirement phase—as an important issue. Coverage, however, is a challenge. Even when systems are mandatory, that doesn't mean you have universal coverage. In most emerging countries, coverage remains a real issue because of informal labour markets. Countries have decided to provide universal coverage in the payout phase, through programs that ensure a basic, minimum pension for all citizens, regardless of contributions.

The PAYGO or first pillar has been difficult to reform. The politics of reforming pension systems are extremely complicated. Imbalances go on forever, and they are usually addressed when the country is in a crisis. For example, we have seen several

cases of dramatic change in Europe during the last few years, which only took place because of an extreme crisis.

In terms of second pillars, the main event of the past three decades was the creation of second pillars in almost 30 countries, mostly in Latin America and Central Europe. Yet in my opinion, the second pillar phase has ended. Very few countries, by comparison, still entertain the creation of second pillars. Now the focus is on strengthening existing second pillars.

There also is an ongoing effort to develop and expand third pillars. The World Bank has received an increasing number of requests from countries asking us to help them develop voluntary third pillars, even from countries that have reversed their second pillars.

Now, where are these pillars in the world? There are several zero pillars across different regions and groups of countries. Yet the funded second and third pillars are mainly concentrated in three groups: high-income OECD countries, Latin America, and Central Europe.

The new second pillars, however, have experienced mixed outcomes.

[Referring to figure 1.1] Coverage remains a challenge in many countries, even in mandatory systems. Changing a system from PAYGO to multi-pillar or from PAYGO to a funded system did not necessarily improve coverage during the accumulation phase, because coverage reflects more fundamental factors in an economy, such as the degree of informality and the level of economic development.

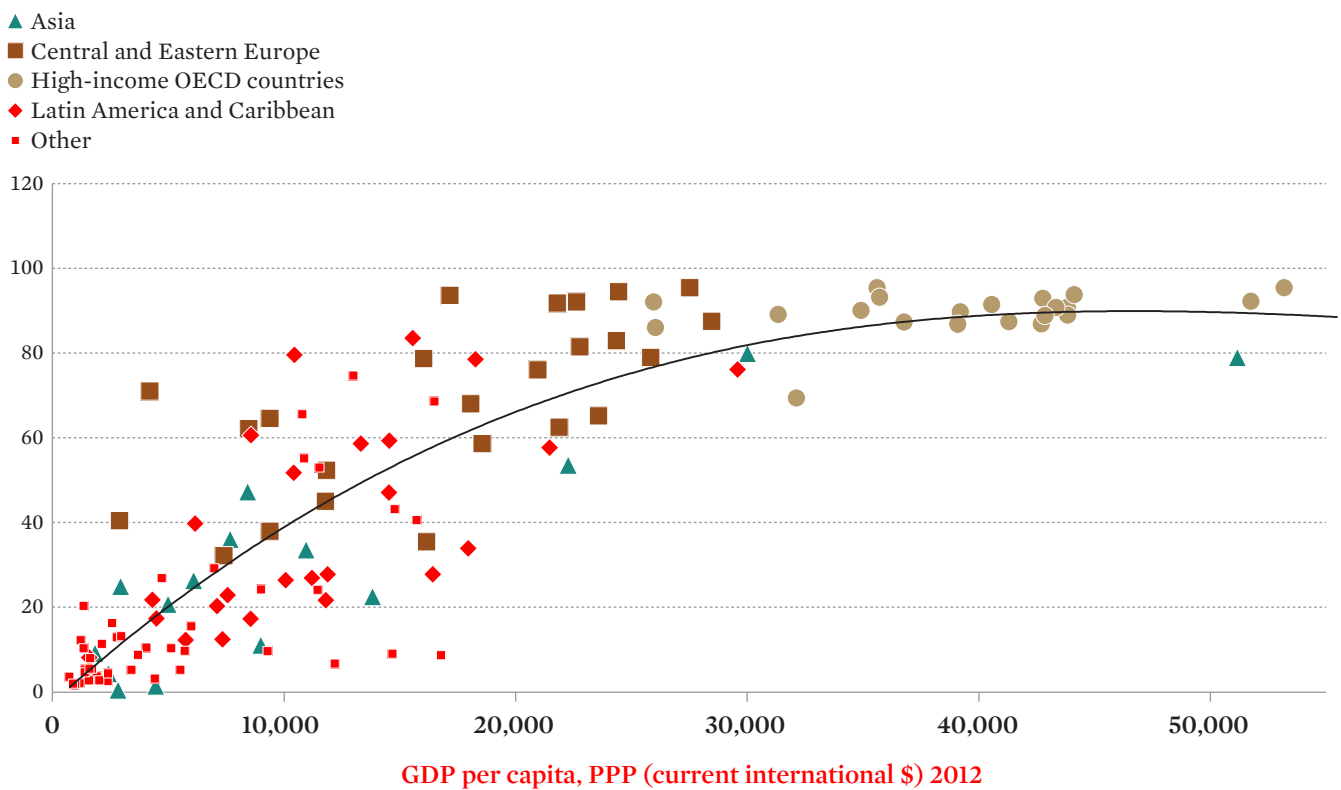
Increasing coverage—even in mandatory pillars—is not easy. Let’s take Central Europe and Latin America. There are countries in those regions that have implemented mandatory second pillars, but even with the mandate to contribute, those countries are still struggling to improve coverage. For instance, Mexico has a mandatory second pillar, but the coverage ratio is 30 percent of the labour force.

Another mixed outcome is the growth of pension assets. Assets have grown faster in mandatory systems, which was expected. Yet, they should have grown at an even faster rate had some of the problems in these systems, such as high fees and inefficient portfolios, been addressed in the early stages.

FIGURE 1.1

Coverage of Mandatory Pillars (1 and 2)*

Coverage of mandatory systems and per capita income
Active members as a percentage of labour force



*Driven by fundamental factors such as level of development and informality; Central European coverage has been higher for historical reasons

Source: World Bank pensions database

Prepared by: Roberto Rocha, presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

Fees also illustrate a mixed outcome. Once again, I have some data. [Referring to figure 1.2] Fees have declined, as they should, with an increase in assets. However, they have not declined fast enough; fees are still high. In some countries, this was one of the irritants that led politicians to attack these systems and contributed to policy reversals.

Another disappointing outcome is that portfolios in the second pillar systems have remained inefficient, as they were invested heavily in government bonds with short durations and bank deposits. This has been happening in too many countries for too long because of several causes, some of which are macroeconomic.

Let me give you some data. [Referring to figure 1.3] The sum of bank deposits and government bonds—most of them with very

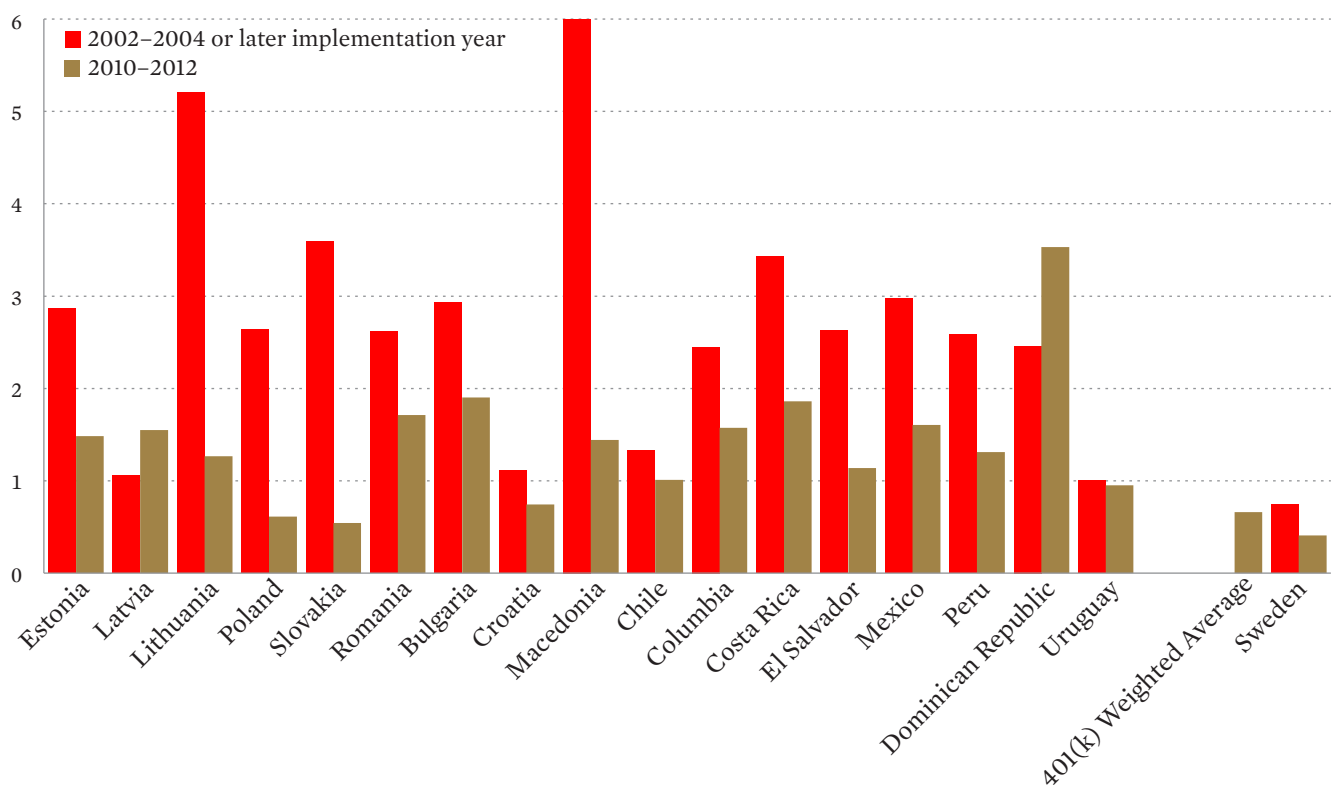
short durations—account for a large share of the portfolios in many countries. After ten years, people started asking themselves, ‘Did we do a pension reform for this? Why do you have a new second pillar that buys government bonds and bank deposits?’ What is the risk diversification of this system? What’s the difference between a second and first pillar? There is no diversification, no contribution to capital market development, no contribution to the economy, no returns—and it took so long for regulators to address this problem.

The short-term view of industry regulators is another reason why portfolios have remained inefficient. A third reason is a lack of capital market reforms. Having pension funds and an institutional investor base is good, but we saw a lot of passivity on the

FIGURE 1.2

Fees Have Declined but Remain High in Many Cases*

Pension fund fees as a percentage of total assets



*Due to price-inelasticity and consumer inertia in individual-based systems; many countries imposed caps and other policy measures to handle high fees

Sources: World Bank pensions database, OECD global pensions database, IOPS, National sources

Prepared by: Roberto Rocha, presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

side of policymakers in developing instruments. For instance, in countries that implemented these second pillar reforms 20 years ago, we're still being asked to help develop corporate bond markets. For so many years, there was policy inertia in creating investments that pension funds could purchase. There was a base to buy them, but the supply did not exist, partly because of that inertia.

Performance also is a mixed outcome of the second pillar system. This is partly because of conservative portfolios and partly because of bad luck. Some of these reforms were implemented in periods of crisis. As Solange Bernstein, former head of Chile's Pension Supervisory Authority, indicated during her question-and-answer session, there was an element of luck [see page 9]. Chile got high

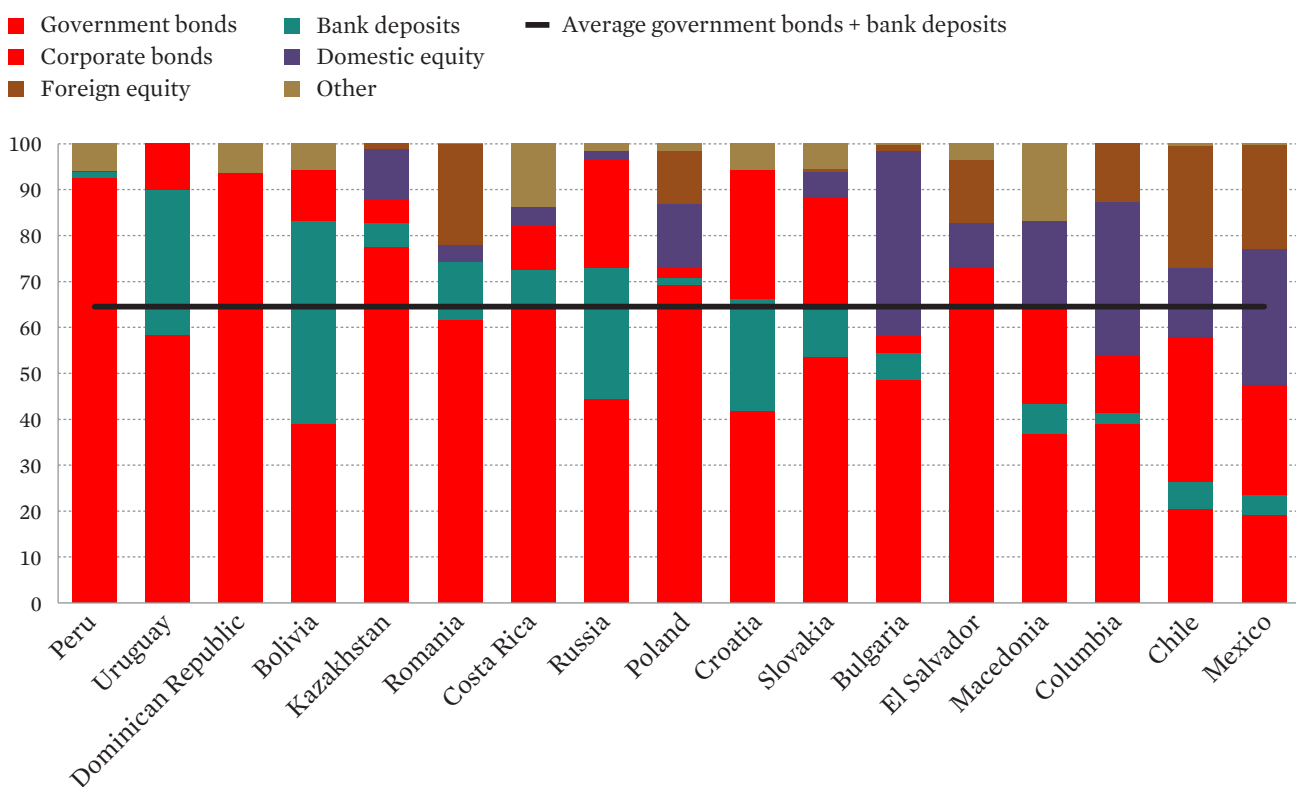
returns from the beginning. It benefited from a decade of very good returns during the 1990s. Some of the other second pillar reforms that were implemented in the 2000s suffered through one economic crisis after another, especially in Central Europe where the crisis was more prolonged.

In addition, for a private pension system to make sense, there has to be a positive differential between the real return of the pension systems and real wage growth. This difference is key. Real returns have to be higher than real wage growth, because this will define your replacement ratio to begin with. If real wage growth is higher than real returns, it means you will have a better pension in a PAYGO system than in a funded system.

FIGURE 1.3

Portfolios Remain Disappointing in Many Cases*

Portfolio composition as a percentage of total assets



*Share of government bonds with short durations and bank deposits is 70 percent of assets or higher in many countries

Sources: World Bank from national sources, OECD global pensions database

Prepared by: Roberto Rocha, presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

All these mixed outcomes led to some policy reversals in various countries around the world. Argentina, Hungary, and Bolivia completely reversed their second pillars; they just killed them. They shifted the assets to the government, to the PAYGO system, and they eliminated the second pillar.

Another set of countries—Poland, Russia, and Slovakia—made substantial reversals. When I say substantial reversals, I mean a partial transfer of assets to the PAYGO system. Substantial reversals also include a substantial and permanent reduction in contributions, combined with a shift from mandatory status to opt-in status so people can move back.

There is a third class of countries that did a moderate reversal. Estonia, Latvia, Lithuania, and Romania didn't shift any assets, but they reduced contributions.

Finally, there is another larger group of 14 countries that have not done any meaningful reversals, which means there is still hope that the multi-pillar system will be preserved—provided that policymakers truly address the problems that have accumulated for so long.

Now, there were three main drivers of reform reversals. The first was fiscal pressure. Countries became scared by rising deficits and said, 'Let's move the assets and contributions back to the public system because we want to solve the fiscal problem.' There was a debate about this in Europe and Latin America, and it was completely misguided. Some countries were facing fiscal problems, both in flows and stocks, but the second pillar was a minor part of this problem. The revenue losses from the first pillar to second pillar—the conversion of contributions—was 10 or 15 percent of the increase in the deficit. The deficit was due to other causes, such as lack of fiscal control, a reduction in contributions, and increasing public sector wages.

The other two drivers of reform reversals were high fees and poor contributions by these new systems to capital market development. One of the things that legitimises a private system is people's belief that it's contributing to the economy. As people see pension funds financing investments, the private sector, and infrastructure, it gives the industry a legitimacy that builds on itself. And that was not the case in many of the countries with reversal reforms.

Now let's look at the policy agenda for the future. First, we need to have a comprehensive agenda that includes supportive fiscal policies, adequate contributions in some countries, lower costs and fees, longer investment horizons, capital market development, and a payout phase.

First, we'll discuss policy agendas for increasing contributions. It's incredible to see some countries that have killed their PAYGO systems and that only have the second pillar, and the contribution to that pillar is 6 percent. So then, you start to think about what this means for projected replacement ratios. Let's use Mexico as an example. In the last generation before the reform to the first generation of the reform, the ratio dropped from 60–70 percent to 15–20 percent. How can you possibly manage the politics and social aspects of such an abrupt change in the system? In many countries, they either will have to reintroduce a real multi-pillar system or dramatically increase contributions to the second pillar, which is a debate taking place in Mexico and other countries today.

Next, let's talk about policy agendas for reducing costs and fees. Various countries already are working on this. Some countries are centralising functions such as collection and recordkeeping, either through a centralised arrangement or by inducing pension funds to outsource more of these functions to external providers. There also is a whole discussion about caps and fees. Some countries capped fees in a very smart and reasonable way, linked to the size of

assets across functions, and over time, it worked. Some countries tried too much too soon. They put fees at such a low level that it induced people to forget about any asset allocation strategy, as investments in common bonds and bank deposits were cheaper. So it backfired, and those low fees contributed to inefficient portfolios. Thus, if you're going to put caps on fees, you really have to know how to do it.

Mexico introduced innovative switching rules. People can only switch to a fund that provides higher net returns, which are defined as gross returns minus fees. [Referring to figure 1.4] In addition, Chile implemented another innovative measure for reducing fees: an auction on new entrants. Solange talked about this yesterday [see page 7], and it's a very creative strategy, which Peru is already copying. Finally, we always ask, do countries need more ambitious reforms? One of the references that the World Bank likes is the Swedish system. It's a genuine multi-pillar system. Every pillar is well designed—the zero, the

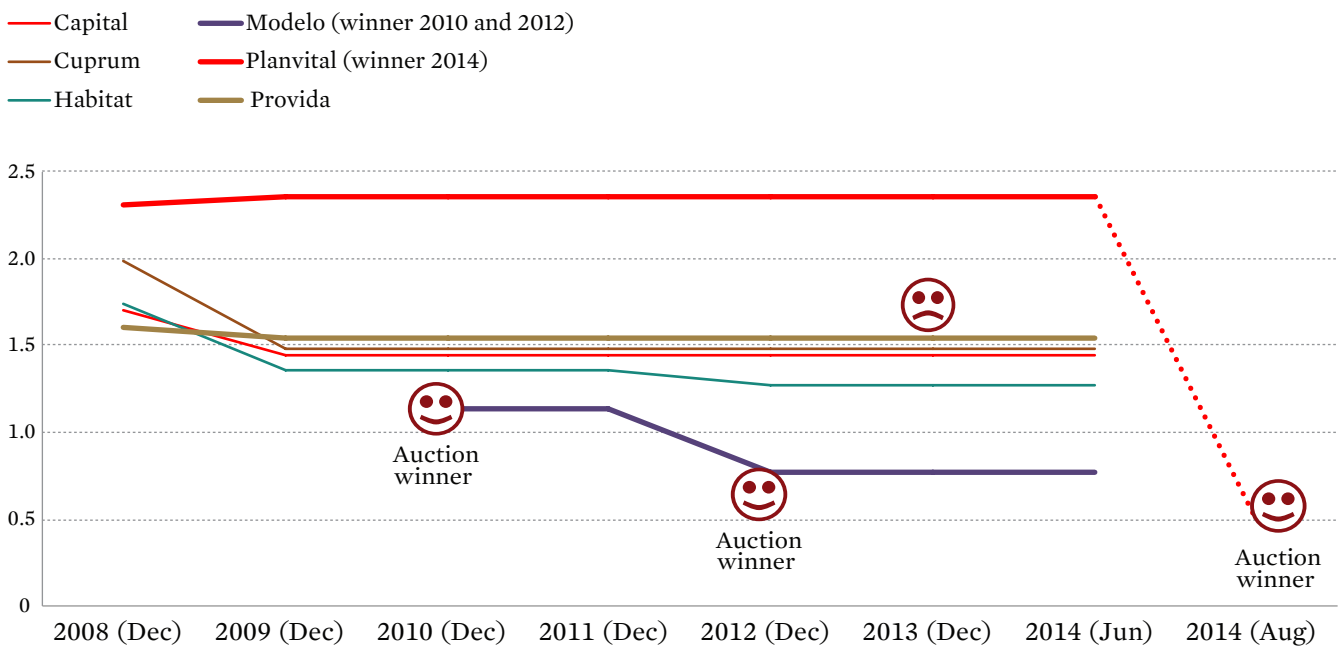
first, and their two second pillars. It's designed to be low cost and to diversify risks in a creative and intelligent way, including in the payout phase through risk-sharing annuities.

Now, let's discuss the policy agenda related to longer investment horizons of pension portfolios. The World Bank is very involved in trying to help several countries design efficient lifecycle strategies. 'Lifecycle' is too general a name though; you can design a lifecycle in 1,000 different ways. The devil is in the details. The results can vary depending on how you design it. Lifecycles are not independent of the payout phase. When you design a lifecycle, your final destination is important. Is your final destination a lump sum or a life annuity? So, the tail end of the life cycle will depend fundamentally on what the objective is. If it's a lump sum, you're going need the portfolio invested in liquid, short-duration securities. If the payout is a life annuity, the portfolio should be invested as long as possible.

FIGURE 1.4

Illustration of Possible Policy Measure to Reduce Fees: Auctions of New Entrants in Chile

Fees charged by Chilean AFPs, 2008–2014; percentage of salary



Sources: IOPS, Chilean Pension Supervisory Agency

Prepared by: Roberto Rocha, presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

Next, let's talk about the policy agenda for capital market development, which is extremely important. The Chileans were very proactive in creating and developing instruments such as infrastructure and government bonds. Securitisation was important, because the supply was emerging as the institutional investor base was increasing. Thus, the two sides of the equation were being developed at the same time. Some countries created pension funds, but did not put any regulation in place to allow for the creation of instruments.

For our policy agenda for the payout phase, I advise you to go to the World Bank's website. We have done a lot of research on annuities in emerging countries, and we have participated in attempts to develop longevity bonds—failed attempts in some countries. It's difficult to price a longevity bond when pension funds have different mortality pools, because somebody is going to pay a high price and somebody else is going to pay a low price. How do you establish a single price in a market like that?

In terms of a feasible solution, the World Bank has converged on a risk-sharing arrangement, as you have in TIAA-CREF, the largest pension fund in the United States with 100 years of experience in designing risk-sharing annuities. Risk-sharing arrangements also have worked in Sweden and Denmark. That type of arrangement addresses longevity risk and the solvency problem, which is what we are facing today.

Finally, let's discuss the policy agenda for the third pillar. We think the debate in the developed world applies to the developing world. The ideas and propositions that we have to deal with are essentially the same. Yet, what is different about emerging countries? Why do we have to adapt these ideas to an emerging country context? Because the incomes are lower and the variance over the average is higher. In addition, there is more inequality and informality. All of these features make it more challenging to develop a third pillar. Therefore, the usual techniques and incentives do not

work as well in an emerging country as they do in a developed country.

So what is the policy agenda for promoting third pillars in emerging countries? The first element is availability. You have to make entering the system as simple and hassle-free as possible. Countries like Brazil and China have traditional occupation schemes that are stagnant. They just don't grow. It's impossible for a small enterprise to enter the system. The regulatory burden is simply too much. Thus, it's important to introduce simple structures that are hassle-free and low cost to expand coverage.

The second element is financial incentives. Yet, the usual financial incentives that we have seen, the EET regime, which consists of exempt contributions, exempt accumulations, and taxable distributions, does not work well because only a small share of people can benefit from it. So you have to introduce different tax regimes, such as TEE, which includes taxable contributions, exempt accumulations, and exempt distributions, to reduce taxation over time to improve incentives and permanence. An example of this would be a Roth IRA [individual retirement account] in the United States. In addition, you have to think about government matching contributions, if there is fiscal space in the budget.

Third is automatic enrolment, which is a very good idea if you can do it. I say, 'if you can do it,' because in some emerging countries, automatic enrolment can become a political liability for the pension fund. For example, if a participant feels that his balance suffered because of a crisis, then there could be a lawsuit. Thus, the asset manager may think twice before introducing an automatic enrolment and a default rule, because the courts are not trained enough to understand that a decrease in a balance is temporary, and that you should not sacrifice the whole system because of a couple of cases.

The fourth element of the World Bank's policy agenda for promoting third pillars

in emerging countries is automatic investment default portfolios. It's interesting how little progress has been done in this area, and there is an enormous role for the investment industry. In my country, which is Brazil, the institutions have made more progress in this area. Yet in a country that has a reasonable level of capital market development, we still have work to do. A combination of insurance products has been debated. For example, to increase coverage, should we combine retirement protection with health protection in the retirement phase? It's an intriguing idea, but we have to be careful because regulating health insurance is complicated.

The fifth element is financial education. Financial education is important, but we know from experience that it doesn't always help or work the way it is intended. The World Bank thinks it's important to educate regulators, policymakers, and above all, the courts. It is very important to educate the courts in an emerging country, so that a bad judicial decision at the end of the process does not backfire and destroy a lot of the work done at the beginning of the process.

Thank you very much, and I hope this was useful background for the discussion.

Reid: Thank you, Roberto. You provided us with an excellent overview of the various second and third pillar initiatives globally, including the successes and challenges. I think one of the striking aspects of the presentation is that while we have a diversity of approaches globally, we not only have some of the same challenges, but also some of the same features in many of these plans. They have been drawn from a common set of principles, and now in terms of a second wave of reforms we're drawing on a similar set of initiatives that both Pablo and Roberto have discussed.

Each of my panellists has been involved in efforts to improve retirement security in their jurisdictions. Darren and Dirk,

your work focuses on single jurisdictions, whereas Justin, yours looks at efforts to create pension rules across the European Union. I'm going to ask each of you to outline some areas of regulatory reform that your organisations are pursuing and some of the reasons for those reforms. Darren, I'm going to start with you. I know you're a little limited on what you can speak about because you have a proposal coming out shortly, but could you discuss some of those reform initiatives, please?

Darren McShane: Of course. As background, I'm a representative of the Hong Kong system, which is a small, classic World Bank second pillar system—so DC, employment-based, and all that. It's 14 years old, so it's a relatively young system. I've worked for the Hong Kong Mandatory Provident Fund Authority (MPFA) for a while, and in the time I've been there one can see the phases of change.

The appetite for change, in itself, changes over time. In the early days of any system, the changes regulators put in place are very much focused on embedding it. You've got a set of rules, and the first thing people need to understand is their rights. Second, they need to be comfortable that their rights are being honoured—employers and employees' obligations to make contributions, providers' obligations to keep the contributions and do the right thing with them, etcetera. It's all important. It's about dealing with those sort of confidence issues early on.

Then, I think you move into a phase of refining and better protecting members' interests. This ranges from getting more member engagement to improving disclosure about important issues. It also includes regulating sales processes and those interaction issues—a lot of the nitty-gritty about how to deal with design efficiencies, scheme structure, number of providers, and investment options. Some of the work that the Hong Kong MPFA is doing at the moment touches on that, but also goes to

what I think is the third phase. You get to a point where, even with all that, people become impatient. Public expectation and political expectation is not necessarily aligned with what was delivered 15 or 16 years ago. There's an appetite for moving beyond refinement and changing some of the parameters.

So it's not just about, as I say, dealing with how one best provides within the framework that's given. One of the great pitfalls with pension systems is you only ever have a blank page once. You have to live with what you're given as a regulator and a policymaker for the rest of existence—with the page that was written at some point in time. You can't just keep rewriting it. But you do need to deal with the appetite for how to move those things forward.

I think one of the issues that it eventually comes down to is renegotiating the social contract on which the page was written in the first place. I know in Dirk's area, there's a lot of renegotiation of that in the Netherlands. People's expectations change.

Fees do drive a lot of other outcomes. In my own jurisdiction, I often think—in a perverse sense—that one of the mistakes we made was improving disclosure on fees too well. People were actually much happier when they didn't know how much they were paying; there was far less controversy about the fee debate. Yet, having given them that right and telling them their rights, they improved the disclosure. That leads to a much more difficult debate about how you solve the problem. Thus, one moves on to issues about fee controls, which are part of a whole series of reforms we look at.

One of the things we're currently looking at pulls many of these threads together. It looks at it a little bit through the fee prism, but it is very much focused on defaults. We're inclined to do something I don't think has been done anywhere else—to move from a diversified approach for defaults to a singular approach for defaults.

There are many systems that have standardised defaults, but I can't find too many examples of others who have moved from everyone having their own to producing a single outcome. So we're looking at that. Yet everything is looked at through the fee prism once it becomes an issue, so there will be some elements of fee control around that and we're hoping to move that forward soon.

That will deal with some of the expectation. As I said, however, I think the profound issue is that over time, all the stakeholders want to renegotiate that social contract. Therefore, people's expectations about what the government does within a system changes over time, which drives some of the thinking about how to integrate the second and other pillars.

Reid: Dirk, you have a very different system. In many ways, it is a second pillar system in the Netherlands. Even though it's voluntary, you have very high participation rates. There are, however, reform proposals that you're working on. Could you share some of those and your thinking around them?

Dirk Broeders: Let me start by explaining a little bit about the Dutch culture. I've come to the conclusion that pension regulation is actually the same as football. Every Dutch man and woman considers him or herself an expert at football, giving an opinion on how we should play the match. It's also striking that many people have an opinion on pension regulation. If you look at any newspaper, you will regularly find articles by people who have an opinion on what the appropriate discount rate should be for a DB contract.

If you look at the age of an author of a specific article, you will find that the older the author is, the higher the discount rate he proposes. This is really striking. We have a huge debate with the government and all the stakeholders—representatives of employers, employees, the Dutch Central Bank, academia, retirees, young

people—and we negotiate. We don't call it 'negotiation,' but we sit together in a room and explain to each other what we think is appropriate. That is key. The government is responsible for pension regulation, but it listens to everybody in society and then reaches a decision.

Our government is really involved in hearing all stakeholders and then making a decision on regulation. This has developed over time. If you went back 50 years ago, the entire regulation for pension funds consisted of one rule: pension funds should act in a prudent manner. Now we are moving towards rule-based supervision. During the last four years, we've been discussing how to adapt our current regulatory framework going forward because of many underlying trends that have to be taken into account: low interest rates, longevity risk, inflation risk, and aging populations. Actually, we're on the verge of proposing new legislation, which will go to Parliament in the next few weeks. Parliament will discuss it for the rest of the year, and then hopefully it will be implemented next year.

That's not where we're going to end though. If you look at society and changes in society, it's no longer just about low interest rates and longevity. It's also about very different developments in society. The average consumer is much more critical and much more individualised. If you look at our current system, it's a one-size-fits-all system; everybody pays the same contribution rates, accrues the same benefits, and gets the same benefits. We are talking about moving towards a system that offers more tailor-made pensions to individuals. It also should offer more flexibility, because there's no flexibility in our current pension system and some people want to have some flexibility regarding the contribution rate or payout phase.

We just started these discussions and, again, all stakeholders are involved. These are difficult discussions because we have encountered differences in beliefs. If you

look at our current pension system and the old pension system, we would consider that to be a social system. One view is that the pension contract is a social contract, meaning that we take care of the elderly in society; we take care of spouses. Going forward, I see it developing more into a financial contract, where solidarity is not the key issue. This latter view is mainly from the regulator, younger people, and academics. That said, a pension fund's key function is to intermediate between a participant in financial markets by offering a very effective and cheap way of getting retirement income. This is a very good debate, and I wonder where we will end up.

If you look at society and changes in society, it's no longer just about low interest rates and longevity. It's also about very different developments in society. The average consumer is much more critical and much more individualised.

—Dirk Broeders

Reid: That poses a particular challenge then for sort of a pan-European regulator. Justin, you just put out a set of proposals trying to create a more unified framework in Europe. Could you explain some of these initiatives, particularly given the range of approaches across Europe?

Justin Wray: Yes, but let me start by saying a little bit about the European Insurance and Occupational Pensions Authority, or EIOPA, and what it is. We are a European supervisory authority, and we have a set of objectives, tasks, and powers. While EIOPA is an authority in its own right, our governing board consists of representatives from each of the 28 EU member states. So we are governed by our members. We also have stakeholder involvement hard-wired into our government structure. In addition, we are required to create a body comprising academics, people from the pensions industry, and members of pension schemes who have certain rights, including to influence us with respect to legislation we propose.

So, we are a supervisor whose governance is carefully constructed to take account of the different views in Europe.

What are we here to do? Fundamentally, we're here to take an ambitious, European approach to pensions. We believe there can be a better internal market for pensions in Europe. I don't think anyone is crazy to say, 'Well, pensions is actually a purely national activity.' That is a perfectly reasonable point of view. Yet, in the European Union, in general, there is a move towards more internal market, more harmonisation and convergence in financial products. The question is, are pensions so different from every other financial product? We do not believe so.

We think there are considerable benefits to a more European approach. Think about labour mobility. This is one response to the crisis that has affected many European countries. Already about 3 percent of people in the European Union live and work in a different country from where they were born. This is a trend that will likely increase as different European economies diverge in terms of performance. Now, when there is such movement, is the ability to transfer pension rights or the ability to remain in an existing pension scheme even though you're in another country top of your priorities? Probably not. Yet over time, is it a factor in order to make these transfers of people sustainable? Yes, it is.

In terms of capital, banks are currently retreating in terms of lending—in terms of traditional finance activities. Is this potentially an opportunity for pension funds? Yes, it is. To do so, however, you need a degree of expertise and you require a degree of scale. These are activities that are much more likely to be easier on a European basis than on a purely national basis. If you want to create more of an internal market in the European Union, then you need certain common standards for member protection. You need to be sure that the people running the pension schemes have at least a minimum level of competence and a high

standard of integrity. Contributing to a pension fund involves entrusting your retirement money to an institution, possibly for decades at a time. If you're doing that on a transnational basis, the requirements for those who run such pension schemes need to be real; they need to be something in which individuals can trust.

In the DB world, it is important that the promises made are believed and kept. That requires at least a common degree of measurement of the promises. If you look at the current European experience, the way in which assets and liabilities are measured on a national basis varies greatly between the different member states. We did some work to measure assets and liabilities on a common basis and we found huge diversity. In some member states, the national position—on the face of it—would be fine in terms of solvency. If you actually measured it on a common basis—and I would argue perhaps a more realistic basis—you'd find that a number of member states face significant challenges. EIOPA's challenge is not only to recognise all the diversity that is in the member states, but also to capture the benefits of an improved European approach.

Reid: One of the things that all of you have pointed to is this tension between trying to design pension systems where there's a combination of laws, regulations, incentives, and voluntary or market-based choices. With that in mind, what is the role of regulators and what should that role be? Are there some guideposts for where regulation works and where we need to leave it to the private sector? What are your views on this? Where do these two intersect?

Broeders: In the Netherlands, the Dutch Central Bank is the supervisor, and our formal task is to advise our government on pension regulation. That being said, the government also listens to every other stakeholder in the pension system, and in the end, it decides what the regulation should be. Given that we have a lot of detailed information on pension funds, including their

investments, fee structure, costs, and pension contracts, I think we have an edge. We have an advantage of knowing things and being able to provide input to the government about the effects of new regulations and changes in regulation.

In the end, however, we are only an adviser. We are not in the position to draw regulation. As I said earlier, 20 years ago, there was only one rule in the pension act about regulation: a pension fund should act in a prudent manner. There was a lot of policy regulation within the supervisor itself, but that was akin to best practices—what is going on, what do we see, and what is considered appropriate. For instance, the discount rate, which was fixed at 4 percent back then, was not in the pension act. It was more or less policy guidance from the regulator. Now that has completely changed. Today, it's really rule-based regulation, specifically prescribing the discount rates, having solvency requirements, having what we call a continuity analysis of making long-term projections of the pension plan's funding position. Now we are adding to that through new regulation by giving the beneficiaries detailed information about what they can expect from their pension once they retire, what risks are involved, and what the outcome will be if they retire in a bad or worse economic scenario.

All these rules are very detailed. For example, once you make a projection in the continuity analysis, all the parameters are prescribed by law. For that, the government has a committee of finance professors that advises the government on what the equity risk premium should be, what the inflation rate should be, and so on. As I said, all these things are very detailed, and every detail could potentially be discussed in Parliament. This is an issue, because you might end up having a discussion in Parliament, for instance, on what the equity risk premium should be, and I don't think that's the way to go forward.

Reid: Darren, you're dealing with this right now. You're rethinking where more rules

or regulations should be considered for a more uniform outcome. Is there a philosophy or a way of thinking about this framework?

McShane: It's an interesting issue. I was a securities regulator before I moved to the pension world, and regulation does go in cycles. It suggests to me that regulation is largely reactive. There are some minimum standards, and banking is a good example of this. The Basel Committee has lots of things converted to standards, laws, and regulations around the world. The pension world is much less developed than that, but good work is coming out of the OECD Working Party on Private Pensions. In addition, the International Organisation of Pension Supervisors (IOPS) put in place a basic framework for what the starting point should be. Beyond that, I think philosophically, regulation is reactive. Regulators are happy to leave the decisionmaking to the professionals in the market. We're talking about the investment world and pensions, where that person can be trusted to do the right thing. That's what drives the cycles and why I think regulation is reactive to a large extent. When I was working in the securities environment, the guiding philosophy at the Australian securities regulator at the time was 'business facilitation.' Now I haven't heard that phrase in the regulatory environment for a few years.

I think the philosophy of the regulatory cycles is when does that trust break down? At what point, either through the political or regulatory processes, do we get to a place where the regulator or policymaker doesn't have faith that those decisions can be left to others? I think policymakers will be more comfortable where there's a strong alignment of interest. I think in the pension space, there's a natural alignment of interest around investment returns. Thus, I tend to think the regulatory rules about investment restrictions globally tend to decline rather than grow over time because an investment managers' job is to get better outcomes. That's in common with the members' outputs. This also

comes into play with efficiencies. Providers want a more efficient system because more efficiency reduces costs, which produces lower fees.

Of course, there are misalignments though. I'll go back to that four-letter word starting with 'F'—fees. In systems where there are commercial providers and entities in operation, there's a natural misalignment about pricing your product. Philosophically, I think it falls neatly into those. Of course, it is always bumped along by crises. When I say regulation is reactive, the public necessity of being seen as doing something on a particular issue is very strong when there's a particular crisis. We've seen lots of examples of that post-2008.

Reid: Roberto, in some of your discussion points, there was this tension between where the market and individual choice land. In your mind, do you have a philosophy about where the rules and regulations land? Is it more along the lines of Darren, where they are reactive, or should they work towards a common good?

Rocha: I think there was an enormous regulatory failure. There was blindness to the problems in emerging countries and problems were left unattended for too long. The market gets stuck sometimes in a bad equilibrium. This is not a market that competes in prices, so you have to make it compete in prices. Sometimes it gets stuck in high fees or inefficient portfolios. Or sometimes it gets stuck in bad macroeconomic policies or in an environment where there are no instruments to invest, and they have to solve the problem. So all of this combined to form a perfect storm in many countries.

Reid: Justin, how do you view this setup from a pan-European perspective? You have a particular challenge, because this generally has been a local jurisdiction topic. Yet with the pan-European regulator, you're trying to bring some greater uniformity.

Wray: As Darren and Roberto said, I think ultimately, the issues are philosophical. You can be trained as an economist, as I was, and believe in markets, price mechanisms, and that the law of regulation should be limited. Yet, I think pensions are special in this respect, whether it's at the European level or any other level. They are so complex to the individual. They are so important that the balance between intervention and just saying, 'Let's have a process of price discovery and lack of intervention,' has to be struck in a different place.

A lot of the discussion this morning has been about limits to the market. For example, with respect to fees, are transparency and disclosure sufficient? The answer appears to be 'no,' because price caps either are in place or are being contemplated in a number of EU member states. The standard of governance for those who run pension funds is not something that can just be left entirely to the individual pension funds. You need to set certain minimum standards, particularly on a pan-European basis. The challenge in Europe, of course, is the diversity that exists. I think, however, this is an area where regulators need make no apology for the need to intervene.

Reid: My final question is, do you see some converging trends globally? We have a variety of systems with first, second, and third pillar combinations. Some of the second and third pillars are more DB; others are DC. If you look out ten or 15 years from now, do you see convergence or divergence? What is your forecast in terms of where jurisdictions and regulation are going?

Rocha: I see an incredible, increasing awareness of the problem. The reversals that took place are now well understood. I see regulators in many emerging countries concerned about preserving their systems, and they are beginning to act on it. I think there is an agenda that in general,

everybody agrees with. You can disagree on the specific agenda, but I think the agenda is well understood. The willingness to implement it, however, is something else. Yet, I think they understand the problems and the possible solutions.

McShane: I find convergence a difficult concept in pensions because they are so country-specific and idiosyncratic. At the supervisory level, we're seeing the emergence of standards through the work of IOPS and things, and at the multilateral level, we're seeing the emergence of solutions, design issues. There are, however, so many country-specific limitations that make it difficult to move to common solutions. Using IOPS as an example, the sheer diversity of language, issues, structures, and things that we have in conversations with our membership is just boggling. In Europe, that may be less of an issue, because there is common heritage around many of these issues. Yet, it's hard to see such diversity converging in a genuine sense. I think there is a common understanding of the issues and the direction towards solutions, but the starting points are so far apart that it's hard to see convergence in a meaningful sense globally on pension structures.

Wray: I think there are some common factors. As Roberto said, there is a greater awareness of demographics. For example, in many countries around the world, retirement ages are increasing because of this increasing awareness of demographic issues. I also think there is an increasing awareness of the limits to pillar one, or state-funded systems. This may be a particular issue in Europe, but in about 11 European countries, private pension income is less than 5 percent of retirees' incomes. Given the fiscal challenges that many European countries face, such a low proportion of private pension income is not sustainable.

Within private pensions, one can see a shift from DB to DC. This is certainly not uniform. There are many countries that firmly

remain defined benefit countries. Yet, you see a shift from DB to DC in other places. In some countries, employers are retreating from being the principal person responsible for pension provision. So, perhaps you see current growth and some future growth in pillar three arrangements, directly between an individual and a pension provider. But as Darren just said, there is also huge diversity. One can recognise patterns, but one should be cautious about saying there are uniform trends all over the world.

There is a greater awareness of demographics....there [also] is an increasing awareness of the limits to pillar one, or state-funded systems.

—Justin Wray

Broeders: I think that legacy is an issue. You can't quickly transfer existing benefits to a new system. I'm actually quite optimistic about convergence, however, because I think we all face the same uncertainties and the same trends. I always use the example of a recent study in the Netherlands, that girls born today are expected to reach 100 years old. Thus, there will be continuous pressure to adapt our pension system, including the first, second, and third pillars.

We have low interest rates, volatile markets, and longevity issues all around the world. Obviously, you would like to have a clean sheet approach, and sometimes we try to do that—to just forget the legacy and go back to the drawing table. So what do you want to draw? You want to draw four things. You want to have a savings function for wealth accumulation and an investment function for wealth creation. Once you retire, it will go to the payout phase. The important thing in that is risk sharing—sharing of longevity, investment, and inflation risk. I think these are common principles around the globe, and in the end, we all have to deal with the same issues.

PANEL 2

Global Differences in Investor Attitudes Towards Saving and Investing and the Strategic Challenges in Delivering Financial Advice and Education

PANELLISTS

S. KATHERINE ROY, Moderator
Chief Retirement Strategist
J.P. Morgan Asset Management
United States

JOSEF PILGER
Executive Director Asia Pacific Pension Practice Lead
Ernst & Young
Australia

YUTA SEKI
Managing Director, Research
Nomura Institute of Capital Markets Research
Japan

MASSIMO TOSATO
Chief Executive, Schroder Investment Management, Ltd.
Executive Vice President, Schroders plc
United Kingdom

There are many elements that influence successful investing. In this panel, speakers from Japan, Australia, the United Kingdom, and the United States discussed those elements and the challenges of creating a successful retirement investor, particularly in the context of rapidly aging populations. The common challenges range from lack of financial literacy and irrational investor behavior to the difficulty in creating engagement with defined contribution (DC) stakeholders—both employers and employees. Panellists also examined results from a global survey of investor attitudes and talked about their respective countries' retirement systems

'While retirement is our primary goal, we still have work to do globally in terms of our time horizon and our investing behaviours,' one panellist said. 'We have to think about things through the mindset of the end-investor, no matter what we're doing.'

The following is an edited transcript of the discussion.

Katherine Roy, the moderator, starts with a presentation and then asks the panellists questions about their research and experiences.

Katherine Roy: During this session we're going to discuss the minds of investors and some of the headwinds we face in relation to their perceptions and thinking.

We have several expert panellists with us, including Josef Pilger, who will give us some perspectives from around the landscape; Massimo Tosato, who has some interesting research from Schrodgers; and Yuta Seki, who will talk about the Japanese experience.

The trends I'm about to discuss we all know well, and they really do affect investors' mindsets. The first trend is that of aging populations around the world. The next 20 years will see tremendous demographic shifts. By 2050, one-third or more of the populations in such countries as Germany, Italy, and Japan will be older than 65, and this will affect the mindset of investors both young and old. One of the byproducts of aging populations is increased pressure on pay-as-you-go, or PAYGO, pension systems. We're seeing this in the United States with our Social Security system. The world is expected to move from one retired person for every ten people today to one in four by 2060. There are further implications for investment management strategies as investors seek to decumulate wealth to support their lifestyles for which there is no

clear investment methodology to help them actually accomplish that.

So what are we concerned about? [Referring to figure 2.1] I think what surprises me most is how common investors' concerns are across different regions as well as overall. As investors age, they consistently indicate that long-term care is a key issue, especially in the United States. They also indicate that governments' financial situations and insufficient government pension funds equal the greatest threat, when you combine them.

What we are doing about these concerns also is somewhat consistent. Few of us are doing much of anything, unfortunately. For DC plans in the United States, we've been focusing on goals-based investing or 'financial planning' for more than 20 years. Yet 30 percent of investors still indicate they have little or no knowledge of how much they need to comfortably retire. In addition, less than half of investors in the United States—and even fewer globally—have any plan for how they're going to reach their financial goals.

What about the global retirement markets? There will be a significant shift from defined benefit (DB) to DC plans and individual savings in order to finance retirement. As the

About the panellists

S. Katherine Roy is an Executive Director as well as Chief Retirement Strategist and Head of Individual Retirement for J.P. Morgan Funds. She specialises in identifying themes, strategies, and solutions that can help advisors successfully partner with individuals in the transition and distribution life stages.

Josef Pilger leads Ernst & Young's (EY) pension and retirement practice across Asia-Pacific as well as EY's global pension and retirement practice expansion. He works with many leading pension and retirement providers along the value chain, including pension funds, life insurers, and asset managers across Asia-Pacific to protect and grow their businesses.

Yuta Seki is a Managing Director at Nomura Institute of Capital Markets Research (NICMR) and also head of the research department. NICMR is a think tank whose research focuses on policy issues in global capital markets and financial services. Seki sits on numerous committees and works closely with the Financial Services Agency of Japan.

Massimo Tosato is Chief Executive of Schroder Investment Management Limited and is Executive Vice Chairman of Schrodgers plc. Since joining in 1995, Tosato has held numerous international roles within the company. He was previously vice president of the European Fund and Asset Management Association from 2011 to June 2013.

shift starts to take place globally, and investors have greater choice and flexibility, there will be even greater pressure on individuals to save and invest for retirement.

With that background, we want to think about how individuals are influenced by many things and how it takes a lot to develop an ecosystem that can ensure successful investing. Josef, based on this picture, what are the factors that affect investors' success? What is the long-term opportunity for the retirement industry overall if we do things right?

Josef Pilger: [Referring to figure 2.2] There are numerous dimensions that influence successful investing. This morning, we heard a lot about the analytical perspective. Yet behavioural economics play a very big role in successful investing, probably the role.

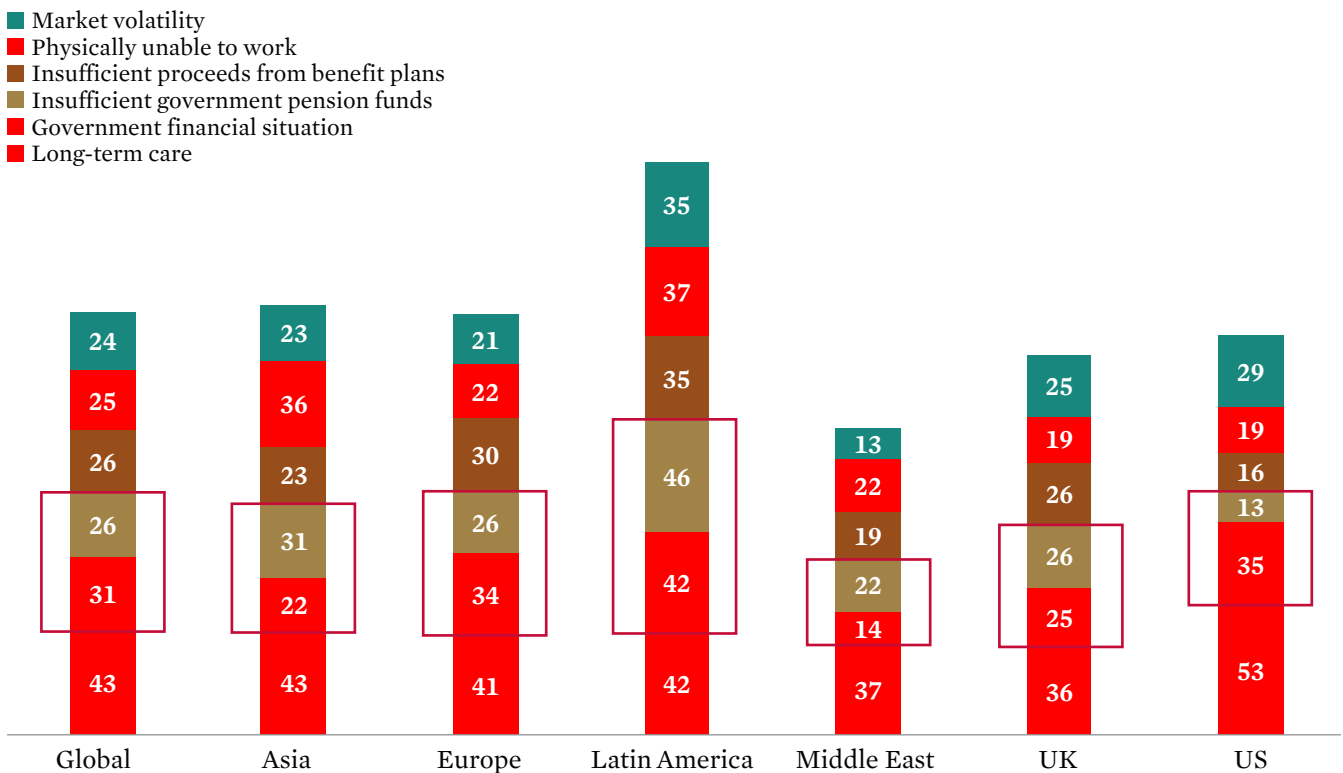
I'd like to touch on the four main dimensions that influence successful investing. The first is education. The second is financial advice, and I don't just mean financial advice delivered by financial advisers. I mean receiving advice that helps people make informed decisions. The third is investing, and the fourth is governance.

Now, let's talk about education. I find that in most countries, financial education or literacy is a problem left to academics and representatives of foundations who go into schools and teach financial literacy. This leads to the question: Is that still appropriate in the 21st century? We have much more choice than we used to. With the move to DC, one thing we're focusing heavily on is the outsourcing of outcome responsibility. This is a very big thing. Yet what we fundamentally forget in the shift to DC is that we're also outsourcing the

FIGURE 2.1

Perceived Threats to Financial Security in Retirement

Percentage of investors



Note: Multiple selections allowed

Source: Natixis 2014 Global Survey of Individual Investors

Prepared by: Katherine Roy, presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

decision responsibility, and I think we're spending far too little on empowering customers—both employers and plan members—to make informed decisions. If I want to book a train to Zurich tomorrow morning, I can do it using my mobile phone. I can even book my breakfast on that train via my mobile. Why can't I do that with pensions? I think that's an area that hasn't received enough attention globally.

Now let's turn to our second element: financial advice. I think we get sidetracked in the framing and delivery of it. As an industry, we are awfully complicated. For comparison, please recall when you last bought a car. A car is much more complicated than a pension ever will be, but you can buy one in about three-and-a-half seconds. So why can't we be more intelligent in how we deliver financial advice? It's easy

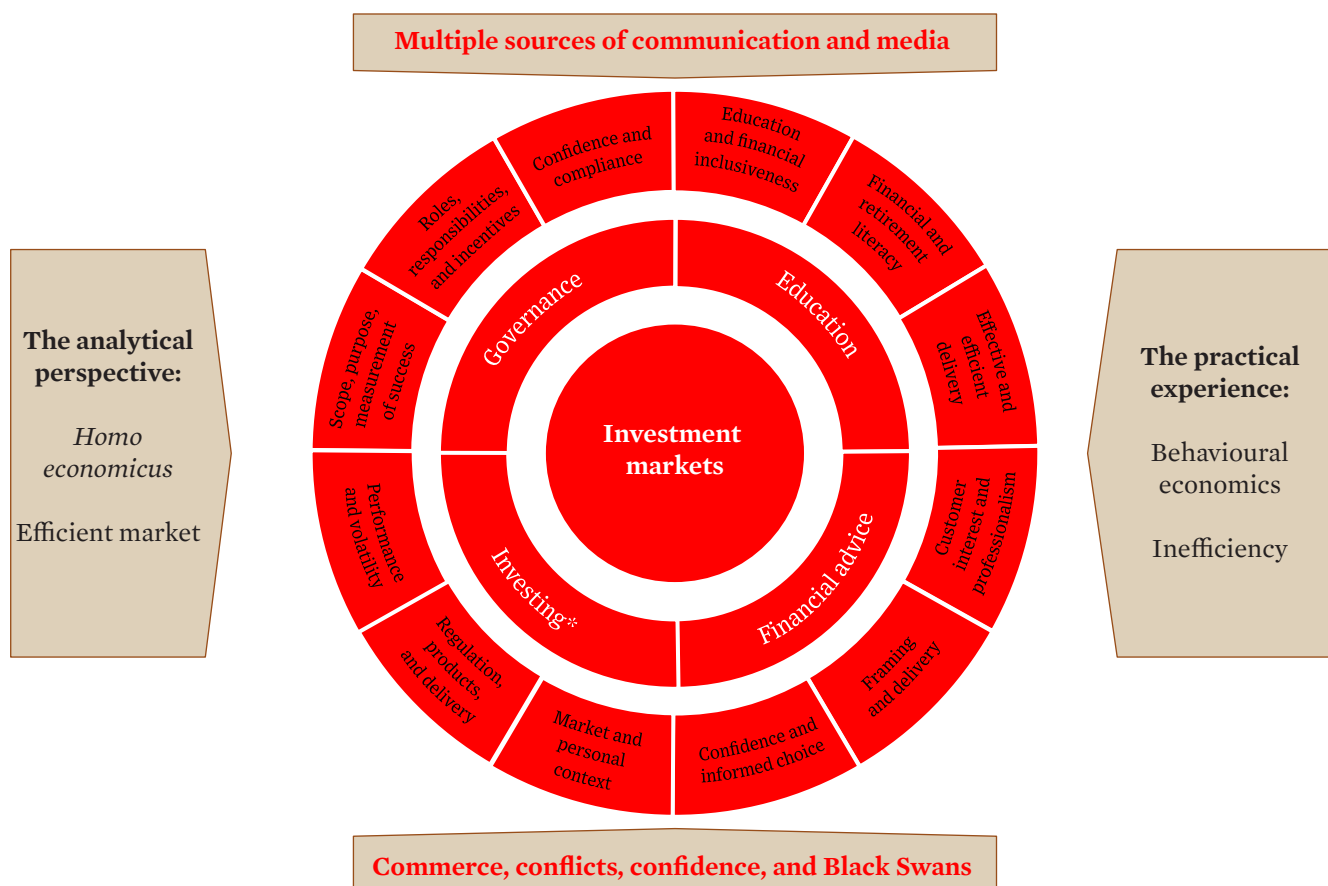
to point to the uniformed or complacent customer, but to me that's far too simplistic. Mobile technology is changing the industry, and we need to keep in mind how customers are accessing information.

In fact, we probably need to reinvent the way we look at financial advice. Certified financial advisers play a vital role in that, but so does technology, such as mobile phones. We need to think about how we can deliver financial advice in the pension space—not only to high-net-worth individuals and their families, but also to the mass market.

Let me move to investing. One thing we've seen is a big focus on volatility and performance. Surprisingly, in some markets, people didn't run away from equity investments in their DC plans during the financial

FIGURE 2.2

Many Dimensions Influence Successful Investing



*Customer perspective

Prepared by: Josef Pilger (Ernst & Young), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

crisis—at least not as much as we anticipated. So maybe market resilience and people’s understanding of performance and volatility is greater than we thought.

Another thing is that regulation needs to be less complicated, because the regulation of most pension systems around the world is very difficult to understand. When I moved to Australia again seven years ago, I read my product disclosure statement. After page 17, I gave up. Yet I was keen and interested, so we need to think about more simplicity.

Also, we need to think much more about ‘me.’ We talk about customers without differentiating among them. Twenty years ago in Australia, you could make generalisations about the population by saying, ‘Australians are usually that kind of category of people and this is how they think. This is their value system.’ Now, in some parts of the population, it’s much more diverse—there are people from all over the world. So making these generic assessments is quite difficult and dangerous. With modern technology, I think we can do much better.

Let me touch on the last point: governance. I think if we use the private sector to deliver pensions, then we need to appreciate that doing so comes with a fiduciary obligation. We need to have some level of clarity around the roles, responsibilities, and incentives—and with that comes the understanding that pensions have two components. One is the asset management side, which is a function of assets under management. The more assets I have in a system, the more I will pay, but the overall ratio can go down. Yet there’s a fixed component that is often forgotten. Administration of pension systems, DB or DC, is not always correlated to the amount of assets under management. We saw some statistics earlier this morning for some eastern European countries. If you actually convert the percentages into abstract dollar fees, you will find that many of those countries were not expensive. It’s just they have a very small asset pool, and therefore the administration component is quite important.

The overarching aspect to me is people’s confidence, particularly with the move towards DC and choices. That is why we need to reflect a little more on our objective for pension systems. I see it as a bull with two horns, both of which can hurt you. Horn number one is the academic solution, the ideal designed pension system. Yet as the CEO of the Indian pension system told me two years ago, ‘We have that, but nobody buys it and nobody sells it. So we have an ideal system but nothing happens.’ Horn number two involves taking a slightly more pragmatic approach by understanding that maybe some fees are necessary to drive take-up, but under a framework of transparency.

Now, there are two final points I want to make. Number one is communication. We all need to do much better with it, because the language we are using is very difficult for lay people to understand. Number two is a question. Before the introduction or discovery of black swans, everybody thought swans were white. Given that we had the financial crisis in 2008—the black swan—how should we think about investing and pension structures with the existence of black swans?

Roy Taking some key parts of this discussion and thinking about them from an individual investor’s perspective, for whom there continues to be a hangover from the black swan events, we want to highlight four key areas. The first comes from the financial and retirement literacy point—where do we stand today? The second is from a cultural perspective—how important is it that the ecosystem and solutions are tailored to local markets? The third is from a regulation, products, and delivery perspective—what are the implications of regulation? And the fourth is from a product opportunity or product innovation perspective—is it better to be a building-block builder or should we be embedding more behaviourally engineered components into the products themselves?

Massimo, your group recently did some interesting global research on investor attitudes. What have you discovered? What is driving these attitudes?

Massimo Tosato: To offer some context, let me explain how we organise our activities. We have two main client channels on the asset management side. The first one is the institutional channel, where we manage long-term assets held by pension funds, pension plan sponsors, or insurance companies. Then we have what we call the intermediary channel, where we operate in personal savings—or the fourth pillar—and sell our own products through an intermediary.

In recent years, we conducted a global survey across 23 countries, polling about 15,000 people. The participants were mainly in the most affluent segments of the population—people that have 10,000 euros to invest during the course of a year.

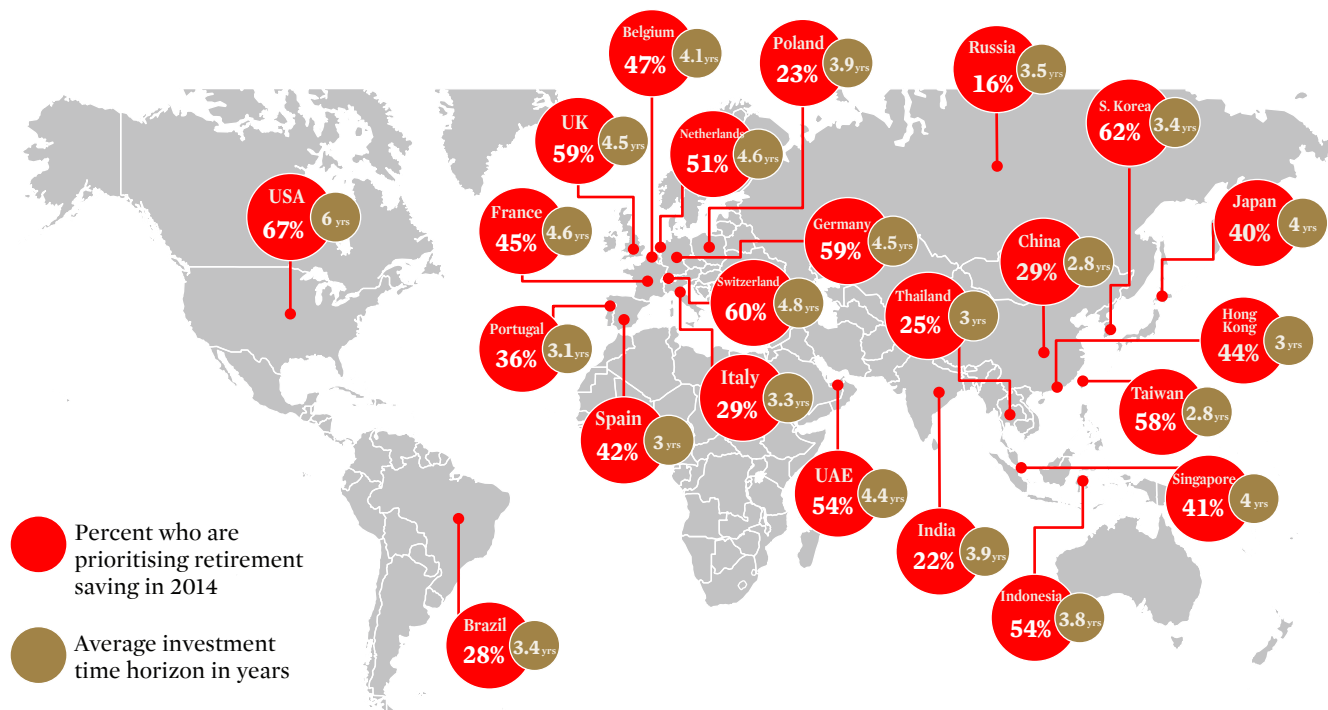
Now most interestingly, in the last two years, respondents have indicated that boosting their retirement savings is their single most important financial goal. This is quite a new outcome, post-crisis, and is because of the increasing realisation that the fourth pillar is becoming absolutely necessary to complement declining payout from corporate or national pension funds. The result is a bit varied across regions. [Referring to figure 2.3] The United States has much more in personal savings than other areas of the world. In Asia, where you have a younger population and higher growth in income, there is less in personal savings. And in Europe, personal savings have risen a lot because of the crisis and all the talk in the media about changes to the pension system.

Yet while boosting retirement savings is people’s primary financial goal, when you ask about investment horizons, their responses contradict that goal. Sixty-one

FIGURE 2.3

Investor Confidence Varies

Divergence between focus on retirement saving and investment time horizons



Source: Schroders Global Investment Trends Report, February 2014

Prepared by: Massimo Tosato, presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

percent of people interviewed said they're looking at time horizons of one to five years. Only 5 percent indicated that they're looking at ten years or more. So you have this huge dichotomy that drives asset allocation decisions, and consequently, portfolio returns become totally insufficient to provide enough income in the long term.

Let me give you some data. On average, our survey indicated that only 20 percent of portfolios are in high-risk assets, such as equities, high yields, or emerging markets; 35 percent are in medium-risk assets, such as fixed income; and unfortunately, 44 percent are in cash. Now, this did not change in 2011 and 2012, even though that was probably the ideal moment to reinvest in equities. But that's the individual citizen who has a much less professional attitude towards investing. So there is this significant dichotomy between people's goals, their time horizons, and how are they investing.

That also is a consequence of the lack of advice or a reluctance to look for advice. Only 40 percent of investors in our survey said they are looking for advice in 2014. That figure is higher in the United States, around 53 percent, and lower in Europe and Asia, approximately 38 percent and 36 percent, respectively. This lack of advice is due to availability, cost, ignorance, and probably trust.

Roy: Yuta, from a Japanese perspective, do those numbers surprise you?

Yuta Seki: [Referring to figure 2.3] I was a little surprised to see that the average investment time for Japanese was so long—around four years. I sense it's shorter than that. Yet if you analyse Japanese savings, you have to be careful about the generational gap between older and younger people. About 60 percent of our domestic household savings are held by people 60 and older, and 70 percent of mutual fund holdings and securities investments are held by older people. So maybe older people are still enjoying the social security support from the PAYGO DB system and are investing to accumulate

additional resources for retirement. Most older people are allowed to invest in order to generate additional income to maintain their lives or pay for medical costs. That's why the Japanese numbers are a little better than those for the other Asian countries.

Tosato: I was in Japan a couple of weeks ago, and as you probably know, Japan has introduced a fourth pillar called the Nippon Individual Savings Account, or NISA, which follows the British ISA, or Individual Savings Account, or system. One of the interesting outcomes of NISA has been the success in converting the existing customer brokerage houses, which tend to be on the older side. But up to now, NISA has had very little take-up from the younger generations, which are the ones that need to build up the fourth pillar over the next 20 or 30 years. So far the asset allocation in NISAs has been more in cash and bond sectors.

I think everybody at this conference also knows about the reform taking place in the United Kingdom. Starting next year, individuals will no longer have to invest at least half their pot in annuities. Now as fund managers, we like the opportunities that could arise from eliminating an oligopolian structure. Yet when you think about the possible pot—£16 to £20 billion maturing pensions and another £4 billion from maturing ISAs in the insurance sector—you expect that people will take out a lump sum for possible needs such as housing or children, and that roughly 15 or 20 percent will continue to buy annuities because they find comfort in that.

For annuities, the worldwide standard goes from a minimum of 1 or 2 percent in some countries to about a maximum of 20 percent. That leaves you with an addressable market of around £12 billion, and we think about one-third could go to the asset management industry through specifically designed products. Two-thirds will remain with the insurance companies, because insurers are going to wake up and design products either through their own fund management companies or in partnership

with asset managers. Yet in absence of annuities, what type of product, what level of risk, and how it's going to be implemented become absolutely crucial looking forward.

Roy: How are you thinking about that as an asset manager?

Tosato: A key issue we see in most of the public discourse is that you have a debate about the investment allocation of pension funds and a debate about the payout ratio afterwards. Yet we see much more of a continuum today between one and the other, because when people retire between ages 60 and 67, they now have a 25-year time horizon in front of them. You can't really say, 'I want to cash out. I'm 65 years old, and I'm completely in cash.' Otherwise you have to reinvest from scratch for the next 20 years. So we've been trying to work with investment ideas that manage the risk continuum.

Candidly, one interesting 'failure' I had involved designing, in our view, probably one of the best products ever in this area. It's a product that would give you growth from age 55 to 65 with declining lower volatility, followed by a protected payout, guaranteed at 7.5 percent per year, from age 65 to 75. Then at age 75 or older, you could go out and buy an annuity. It's rather complex, but the message could have been very simple: We'll keep you in growth assets to maintain and grow your capital without ratcheting up the high water mark. Then we'll guarantee you a return of 7.5 percent a year for the next ten years until you buy an annuity.

Unfortunately, we couldn't find an insurance partner to work with because the insurers were concerned about relying on capital market outcomes instead of their own traditional balance-sheet methodology and third-party manager. We also couldn't find any banks that would distribute the product because they felt uncomfortable selling something that had a time horizon of 20 to 30 years. So we said, 'We'll do a fund ourselves. We'll launch it with our name and go out in the UK market.' And

interestingly, we raised zero over the last two years until we withdrew the product.

Now, there were some technical reasons why it was difficult to make this product work. One of the main problems was that most of the mutual funds in the United Kingdom grew through platforms designed to pay dividends out of income, rather than out of capital gains. Our product, however, was designed to work with capital gains so you would have a lower tax rate.

We conducted a focus group to understand the reasons why the product didn't work. One key issue had to do with psychology and behaviour. People trusted an asset manager much more than an insurance company to give them their annual savings, but people only trusted an insurance company to give them a regular income over 20 to 30 years.

Roy: It's interesting that you have the product captive for ten years and then do the payout. When we launched payout funds about eight years ago in the United States, they were not successful because of what happened with market timing, though the engineered product is still a good idea. What continues to surprise me about your product design is that in the United States, we spend so much time trying to educate people about how long they're going to live and trying to get them to think about deferred annuities—hedging the tail risk in terms of living past age 85. Behaviourally, however, we're incredibly pessimistic about how long we're going to live, so no one actually purchases them. Most of our immediate annuities are purchased at age 55 for income at age 65.

Tosato: One of the product's positive aspects was its flexibility. You could put in money anytime during the first ten years until the distribution phase, and you also could withdraw it anytime. You could change your mind and say, 'You know what? I want to buy a flat for my married daughter.' 'Fine.'

Roy: Right. So we mentioned the NISA experience. Yuta, could you talk a little bit about how that came about in Japan and what you're seeing in terms of adoption?

Seki: Sure. The NISA started this year and it's a tax-exempt account for individual investors. Unlike ISAs in the United Kingdom, cash, deposits, or fixed-income products are not allowed in NISAs. Only individual equities and equity funds are allowed. It's a time-limited programme—it lasts only ten years—and the tax-exempt time period is only about five years. The industry hopes to make this system permanent, based on the results thus far.

NISA is a huge government experiment to encourage ordinary people to invest because the Japanese have kept much of their household financial assets in bank deposits. Around 53 or 55 percent of household financial assets are in bank deposits, and only 10 or 12 percent are in equities or mutual funds. Thus, the objective of government policymakers is to get people to shift some of their assets from bank deposits to investments. Another objective of Japanese policymakers is to invite younger people to invest. Younger people will be facing very serious problems with retirement income and medical costs when they get old. Policymakers want younger people to start investing as early as possible and to get used to investing—get used to risky investments.

It has been only three or four months since NISA was introduced, and as Massimo mentioned, 60 or 70 percent of account holders are older than 60. Only experienced investors are getting excited about NISA's tax-free feature. Yet for people in their twenties and thirties, the ratio of inexperienced to experienced investors looks better than it does for older generations. NISA is still in its early stages though, and we hope that younger people take it up.

Also, macroeconomically, the timing is good because the current administration has implemented very aggressive economic policies to stimulate Japan's economy. The Japanese government and the Bank of

Japan are trying to move from a deflationary economic environment to a mild inflationary environment. If the inflationary environment gets settled, it is likely that more young people will invest.

Roy: Great. I'd like to pause here. Are there any questions related to Massimo's research or investment innovation?

Audience Member 1: There seems to be a real conflict of interest between the manufacturer or service provider and the end client. All the end clients want more transparent information, more pricing information, and more clarity—and we want it on our smartphone or on the Internet.

Yet from the asset manager's point of view, more transparency, clarity, and more sophisticated investors inevitably force the market down to the Amazon model of higher and higher margins. What do you think about the conflict between clients wanting more transparency and price information and asset managers not liking to give out too much information?

Tosato: First, I think you have to distinguish markets with bundled overall charges from markets with unbundled charges. There are markets where there is a clear breakdown of how much is being paid for administration services, fund management, and distribution. That's actually the case in the United States and now in the United Kingdom, although it's less transparent in some European countries. Holland recently changed, as have parts of Switzerland and Italy. Hong Kong also is working on the issue. So I see increased transparency year after year, which is positive, because with bundling, the customer doesn't know who is paying for what.

A second point is that in Europe, the Key Information Documents (KIDs) foster a good amount of transparency, because you're obliged to report a single number that pulls together all the customer's costs, except for brokerage costs. Thus, there is a huge level of transparency now. You have one price.

It's called an 'ongoing charge,' and you have to declare the ongoing charge on your KID.

This trend towards transparency is driving prices down. There is a huge price competition, but not among fund managers. It's more between the challenges that passively managed funds and ETFs pose towards the active manager, and the distributors that are trying to recapture some of the margins at the expense of fund managers.

Roy: I now want to discuss what drives success in DC plans and whether having culturally specific solutions—those that are tailored to the market in which they're delivered—are more successful than standard approaches. Let's start with DC plans in Japan, with a quick view from Yuta in terms of history and in terms of NISA targeting more affluent and experienced investors. Are DC plans more oriented to the less-educated or less-experienced investors, and have DC plans been a successful endeavor in Japan?

Seki: Before I talk about investor attitudes towards DC plans in Japan, I need to describe the regulatory hurdles and legal framework restrictions. First of all, contribution size is pretty limited. You can only contribute ¥50,000 a month. That becomes about ¥600,000 annually, which means \$6,000 a year. Many people believe that is not enough for retirement savings. Also, eligibility and coverage are quite limited. For example, public sector workers are excluded from DC plans. I think this limitation keeps the Japanese government from getting onboard with supporting DC savings.

Even with such limitations, Japanese DC plans are gaining in popularity. It has been only 12 years since DC plans were introduced in Japan, but there has been amazing growth—almost 5 million people are participating in them, and 18,000 corporations are plan sponsors. Big financial institutions, including Nomura, Mizuho, and Nippon Life, are working hard to provide educational materials to plan participants because generally speaking, employees of

big Japanese corporations are very educated, but they still lack financial literacy.

In addition, private sector institutions are working very hard to provide education and literacy materials to participants, but it is not enough. Asset allocation is still very conservative. About 38 or 40 percent of assets are in deposits and about 20 percent are with insurers. It's rather reasonable if you compare it to the overall household financial asset allocation in Japan, but we still have to find better ways of getting people to think about the long-term view and providing financial literacy to DC plan participants.

Roy: I'm wondering, Josef, in terms of experience you've had with other pension plans within Asia, do you think investment solutions that are tailored to particular cultural preferences are more successful than standard approaches?

Pilger: Yes, but my answer is from a different angle. I think the key is thinking more about what employers and employees want and how to engage them. I am a big fan of the AIDA concept in marketing. 'A' is for attention, 'I' is for interest, 'D' is for desire, and the last 'A' stands for action. The application of this concept will differ in mandatory systems versus voluntary systems. So, regardless of the country, how do we deliver the solutions that employers and employees want in a way that engages them? I'll give you an example. I was presenting at a pension forum in China about a year ago and was introducing one of the solutions that we use in the Australian market, a kind of contribution clearinghouse. Afterward, the human resources manager of one of the largest state-owned enterprises said, 'Josef, if you ensure that I get this solution, I will advocate for enterprising annuities in my company. At the moment though, it's just a pain.' Thus, I think we need to not only think more about pension policy, but also about pension delivery—about the poor person who is going to do it, the employer and the employee who have to make the decisions.

Tosato: Josef, I have a question for you about the recent developments in Australia with respect to contribution rates. When our own company moved from DB to DC about five or six years ago, we did a study to determine what the contribution rates should be to generate a reasonable pension. Making certain assumptions, we came out with 21–22 percent. Now supposedly, 1 percent comes from the first pillar, which means we would have to pay in about 20 percent every year.

In Schroders' plan, which is still probably one of the best in Britain, the company pays 16 percent and if employees volunteer 2 percent, the company will match with another 2 percent for a total of 20 percent. Australia probably has one of the best DC systems worldwide, but the contribution rate is still 9.25 percent. It's on the way to 12 percent, but the new government recently postponed the increase. Don't you see that as a major long-term risk, and aren't low contribution rates probably one of the biggest risks worldwide?

Pilger: Yes, it is a risk. Yet one thing we often forget is that takes about 40 years, or a working generation of people, for a DC system to succeed. On that front, postponing the increase one or two years was a political and economic decision.

Would I personally have done it differently? Probably, because to me pensions are all about discipline, and you need to have the discipline during good times and tough times. Yet given that Australia already made the decision and postponed the increase by only a few years—and that we have 3 percent voluntary contributions on top of the 9 percent—I'm not overly concerned.

One big achievement in Australia over the past ten years or so is increasing engagement on pension issues. I used to talk to my colleagues in Germany about pensions. After about three-and-a-half seconds, people would start yawning. In Australia, you

can have dinner party conversations about pensions, or rather, investments. Everybody is engaged.

So from a purist perspective, I would not have postponed the increase. Yet from an overall perspective, it's the right direction, and in the political context, I think it makes a lot of sense.

Roy: It's definitely the envy of the United States, given our low savings rates. Twelve percent sounds lovely. Is one of the risks though, with Australia and others, the decumulation phase? While there are very good savings policies going in, how are people doing and where do you think the direction is going once people receive their lump sums out of the programme?

Pilger: Yes, in Australia, decumulation is a risk at the moment because we don't have a very sophisticated decumulation product or system. It's very cultural.

Australians hate any kind of annuities and not being able to control their assets. It goes back probably into the 80s, when the Australian government privatised government assets, telecommunications in particular. And we're the country with the world's highest percentage of people owning equity. Based on that, it's clear that Australians have developed a love for controlling their own destiny, and I think getting back to an annuity-style solution will take time. It's hard to say whether that will be a life insurance-driven product or more an investment-driven product; at the moment, people don't like either, and I think it's very much cultural.

Audience Member 2: Regarding the Australian model, you hear that the mandatory nature of the programme actually generates disengagement among participants and that there has been a backlash because of that disengagement. Any comment on that?

Pilger: I have a couple of points I'd like to make. First, I don't think it's necessarily the

structure of the mandatory system that's causing disengagement. In Australia, about 60 percent of the contributions are going into union-based decided default solutions set by award union contracts. Thus, the overarching element is not the mandatory nature of the retirement system, but the mandatory nature of the union award systems. So on that front, I agree with you. On the surface, a mandatory system encourages disengagement. Yet that may not necessarily be the worst thing for some.

At the same time, all plans are seeing that people in the 50-and-above age group start to want more control of their destinies. And because some pension funds have been slow to respond to people's desire for more control, people moved into 'self-managed funds.' These funds, which had enormous growth over the past three years, are very similar to individual retirement accounts, or IRAs, in the United States, and people are loving them. Yet lots of providers are now essentially going as far as putting wealth-management and fund-supermarket platforms onto their administration platforms. So you have that control again, and you still can stay in the collective of the fund.

Tosato: Let me reverse the question. We heard this morning that from a political point of view, aiming at long-term social stability in countries that are experimenting with change from PAYGO to DC, compulsory may be the only solution that gives you long-term social stability. Is implicit in your question a negative answer and that you don't like compulsory systems?

Audience Member 2: No, I think they certainly have their place. In the United States, it's probably a non-starter at this point, given what we've handled on the healthcare side. Yet I think it's probably a panacea for some countries in the sense that it does drive enrolment rates up. The mandates, however, may have consequences. For

example, Hong Kong's mandatory system is perceived rather negatively by the population, because it's viewed as being forced upon them. From a personal perspective, I think it could be a viable solution for some. I just wanted to understand the cultural repercussions.

Pilger: I had the pleasure of working with somebody who was involved with setting up Australia's system 20 years ago, and he told me that during the first few years, people hated the system. They thought it was an imposter—they thought, 'how dare you?' Yet six years later the government conducted some polls, and people were starting to love it. If you ask people now, they make noise about what can be improved, but the fundamental acceptance and appreciation is there. I think Margaret Thatcher said that sometimes you don't know what's good for you and you need to be told. Now, I can't see this ever happening in the United States, at least based on my conversations, but you never know. Even for 401(k) plans, it took about 30 years—depending on which statistics you want to follow—to get about 80 percent of the eligible people to join and reap billions of dollars in tax incentives.

We have to think about things through the mindset of the end-investor, no matter what we're doing, and we need to make sure that what we do meets its intended goals with the intended group.

—Katherine Roy

Roy: I believe with that we're at time. I think what we learned during this panel is that while retirement is our primary goal, we still have work to do globally in terms of our time horizon and our investing behaviours. We have to think about things through the mindset of the end-investor, no matter what we're doing, and we need to make sure that what we do meets its intended goals with the intended group.

Tomorrow Is Worth Saving For: NEST and Investor Engagement

TIM JONES

CEO of the National Employment Savings Trust (NEST)
United Kingdom

In a candid and humourous speech, Tim Jones, CEO of the United Kingdom's National Employment Savings Trust (NEST), discussed the need for less-complex products and better customer value propositions. He also talked about NEST's challenges, successes, and his vision for how people will ultimately engage with it.

The following is an edited transcripts of his remarks.

Good afternoon and thank you for having me. When giving speeches, I've decided it's always a good idea to be rude to nobody, to a few people, or to everybody. I've chosen everybody, so you can all hit me later [audience laughs]. I've also completely changed what I was planning to say as a result of what I heard during this morning's panels and speeches. I'm going to start by telling you about a doll. This doll is called 'Girls' World,' and it was a toy our children had when they were growing up. It's the head and shoulders of a lady, and the hair grows. So you can make Girls' World have long or short hair, and hours of fun can be had with it.

Now you might say, 'How on earth do people describe this thing to their target market?' Do they describe it as 'a head and shoulders doll with hair of different sizes?' No, they don't. This is what it says on the side of the box: 'The world of hair and beauty secrets.'

There are two things being sold by the marketing professional who built that customer value proposition: entry to a club—a world which you're currently not a member of—and the inside track to knowledge about

'secrets' that you will use as an adult to attract a mate. Because it's the 'world of hair and beauty secrets?' No! It's a plastic doll with hair that's different lengths! [audience laughs] Now *that* is the difference between a product and a customer value proposition.

The problem with pensions is that you lot haven't got there yet. You haven't understood that you need a customer value proposition. You're all talking about the product. The reason you're talking about the product is because there is a massive information asymmetry between you posh gits and the punters out there who need to have a better later life. And the reason there's this information asymmetry is because you have contrived to make pensions incredibly dull.

So let me give you the three defences that people bring to pension savings. This is the defence of people under the age of 35: 'I am invincible! I'm young! I want to buy that dress! I want to go on holiday! I want to get drunk! I want to watch football! Pensions are for old people—get out of my way.'

This is the defence of middle-aged people: 'Do you know how much it *costs* to raise a family? Do you know how much school fees

are?’ It’s called the ‘price of beef defence,’ and the defence is, ‘I don’t have any room in my stretched budget to put money away for later life.’

Finally, this is the line of defence for post-family people: ‘*I know* I should have done something. *I know* I’m going towards a terrible place in later life—but it’s too late now, so let’s go down to the bar.’

These three defences are all emotional defences, which are much more difficult to overcome than rational ones. So we’re in a product area where you have this massive propensity *not* to buy.

I’m going to switch analogies now. You lot have done another cardinal sin—you haven’t actually worked out what the product is.

We are called the National Employment Savings Trust. We’re not called the National Employment *Investments* Trust. When we go out to hard-working people in the United Kingdom and say, ‘We’re investing your money,’ they say, ‘That’s outrageous! How dare you invest our money? We’re *saving*! We’re trying to be conservative here. We’re trying to be sensible! We’re trying to protect our lady! You’re investing it? Investment is risky. And risk means only one thing: negative, catastrophic failure.’

All the behavioral research [says that people feel] failure is 50 times more likely than success. So if you tell people you’re investing their money, they think you’re mad,

because they’re trying to save for their later life. If you then say:

‘Well, I’ve got a flippity-floppity eastern-Asian opportunities emerging-market smart beta fund. Or I could give you an ETF with added leverage—a bit of long-short.’ [audience laughs]

They say:

‘Well, they’re insane. But they can’t be insane, because they all drive Porsches and BMWs. So they’re not insane and they’re talking gibberish and they’re stealing my money. Because I don’t drive a Porsche or a BMW, they all do, so they’re clearly not insane.

But they’ve created this language, this nonsense of ‘long-short, smart beta, flippity-floppity ETFs,’ which means they’re stealing my money. And they go to beautiful hotels in Swiss lakesides to talk about it. So they’re *definitely* stealing my money. That’s another good reason not to play. I’ll go and do something else.’

It’s a bit like if you go to buy a Volkswagen, and the guy brings you in and says, ‘Right, and I’d like to educate you. You need financial education.’ But this time, of course, it’s engine education.

‘Sit down here, please. I’m going to talk to you about the flow through a fuel injection system and the differences of the torque curve parameters between

About the speaker

Tim Jones is CEO of the National Employment Savings Trust (NEST) Corporation. Jones has substantial experience in the financial sector, having previously held a variety of senior positions including non-executive director of Capital One Bank (Europe), chief executive of retail banking at NatWest Bank, and chief executive at Mondex, Purseus, and Simpay.

adding a compressor or a turbocharger, with or without afterburn. [audience laughs]

Now it's really important. Now don't laugh, don't laugh. I'm sorry, this is a very serious subject. This is your later life we're talking about. How dare you laugh? I've defined this as being serious. How dare you laugh at me?

No. When you go to a Volkswagen garage, they say, 'Here's a Polo or a Golf. It works. It's got a very good engine.' They don't ask you to design the engine.

So, I'm going to break my rule and be individually rude to one of this morning's panellists, Massimo Tosato, because he is such a nice man. This morning, during the second panel, Massimo said he's so perplexed that there is this predominance of low-volatility assets [see page 44]. We shouldn't be perplexed. People are trying to save. They're not trying to invest. Their assessment of the risk profile is such that when we show them a jagged NEST growth line and compare it to a just-about-at-inflation-managing-flat-growth line, they prefer the flat one. They are not in an investing headspace here. You think they should be, because a lot of the history here is tied up in the paternalism of fiduciary duty and all of that stuff.

What I'm trying to do at NEST is say, 'How could we make this product simpler?'

—Tim Jones

At NEST, we have an investment strategy that is very sophisticated. It has lots of flipity-floppities. In our growth phase, we're trying to do consumer price index plus 3 percent after all charges, with a very narrow range of outcomes. But we're not asking any of our members to do that. That's our job. We're the engine designers. They just want to buy a car. So I think there's

a huge reevaluation to be done here about what the product is.

What we're trying to do at NEST is engage about this stuff with people who earn up to US\$50,000—or roughly the equivalent in the United Kingdom. They're not stupid. They are really very clever people, but they don't get this stuff because it's been made so complicated.

I loved the slides about the design of the NISA [Nippon Individual Savings Account] this morning [see page 46]. I mean, guys—could you make it any more complicated? 'Oh, and it only lasts five years, yet there's another five years, but only another five years.' [audience laughs] Who designed that product? Not a product designer. There's no product designer on the planet who would design that product. That's not a product, it's a joke. [more audience laughter] So you've got to sort of step through now and think, 'How are we going to do this?'

My second big point today is *the product is too complicated*. There's no point in trying to financially educate somebody about a product that's too complicated. The product has to get simpler. What I'm trying to do at NEST is say, 'How could we make this product simpler?' I'm trying to have a conversation with my imaginary member of NEST and talk to them about what I'm trying to do here.

So, what is my 'world of hair and beauty secrets?'

We have done serious work on this. We started with four people called Brian who were made to be ten years older than each other. There was Brian 1, Brian 2, Brian 3, and Brian 4. They all went to a bar, in a video, and started chatting to each other. The hunch was, if we get people to think about themselves in their later lives that would work. Well, it doesn't work—so we rejected that. What we've come to so far is an advertising slogan that says, 'Tomorrow is worth saving for.' The subtlety of this

is what we're saying to people is, 'Look, you like to do things today—go to the pub, go out with your mates, go to the cinema. You'll want to do those same things tomorrow.'

The sleight of hand is this: we're not asking you to think about being decrepit and beyond work. We're asking you to think about tomorrow being like today. Only you're not going to be working—so where is the money coming from? The hook into that is, 'Tomorrow is worth saving for.' It's an aspirational sell, because we quickly then go to:

'Well, if tomorrow is worth saving for, how are you going to pay for it when you stop working?'

'Oh, that's interesting. You've got my attention there. Tomorrow *is* worth saving for...How much am I going to get from the state? *How much?* Is that all? Oh, my goodness. Okay—let's engage.'

So in terms of product design, this is where I am. The first part of it is pure defined contribution, or DC. Let's just grow wealth. What's the message? 'You need to park some of the money you're making now, otherwise you'll have a rubbish later life.' Everybody can understand that. So, that's the first message. 'You need to park some wealth now, because tomorrow is worth saving for. Where else is it going to come from?'

Then, when you get there, there will be a range of choices about what to do with that money, and those choices will be driven by your personal circumstances. You can take some of it as cash, a drawdown, or as a type of annuity.

My challenge then is going to be, can I really communicate those choices and get into a conversation? Because I *do not* believe in financial education in the kind of middle-class sense: there are posh people—male, pale, and stale, typically—who are very clever, because we do drive BMWs and Porsches, and we are going to patronise you.

'You're going to sit in front of us, and we're going to tell you stuff that you frankly should know. But you're a bit stupid, so you don't. So we're going to patronise you quite a lot, and you'll probably pay hundreds of pounds, thousands if we can fix it. You'll certainly pay a lot of money for us to patronise you—and that's called financial education.'

No! What I want is for the lovely members of NEST to understand it so they chat to each other about it on social media. I want there to be wikiNEST experts who are talking to each other about it, because it *isn't* rocket science. We're parking a bunch of money over here and we're growing it carefully. Then we're going to turn it into a lump of cash if there's not very much and there's some debt to pay down or a draw-down thing.

This 'annuity' thing—it's such a weird word. It's *retirement income*. So why don't you call it that then? [*audience laughs*] We don't use the word 'annuity' at NEST. We call it a 'retirement income,' because that's what it is. Then a conversation ensues:

'Oh, retirement income, that's cool. Why is it such a bad deal?'

'Oh, because the guy on the other side has to guarantee it forever. He doesn't know how long you're going to live.'

'Okay.'

So we can begin to have a language that is rooted in common sense and everyday reality, not rooted in 'flippy-floppy ETF smart betas,' which is a language that *only* belongs in engine design conferences and has *no* place anywhere near a customer.

There will be the occasional 2 or 3 percent who fancy themselves at the 19th hole of the golf course saying, 'Have you seen my flippy-floppy ETF smart beta with a bit of long-short?' There will always be a small number of people who like that stuff. It's a tiny market, and you've got to indulge

them. At the moment, however, this industry is a bit like having a global car industry of enormous scale where everybody is still building coach-built vehicles and then they go and build the next coach-built vehicle.

Let me give you one more flavor of this. We at NEST have a very sophisticated flip-psy-floppy investment strategy. We will have about a million employers using NEST by the time we're through. We've got 7,000 now, but we'll have a large number of the small and micro businesses in the United Kingdom using NEST. How many times have we developed that investment strategy? Once. Do we think it applies to all the employers and their staff? Yes. Do we have evidence behind that? Yes.

So why do you have employee benefits consultants going into major corporation number one and saying, 'Do this,' and then the same firm going into major corporation number two and saying, 'Do that.' What is going on here? But that's the industry we've got.

My challenge to you, ladies and gentlemen, is to understand what your value proposition is. Design and defend a product against that value proposition and then persuade people that it's a great product to buy.

—Tim Jones

And this information asymmetry has stopped the industry from developing a proper consumer relationship that takes you away from coach-built cars and towards Volkswagen Golfs that work—where the customer simply demands that the engine works. They don't want to design it. It's your job to design the car and engine. It's their job to be a happy consumer of a product that works.

So my challenge to you, ladies and gentlemen, is to understand what your value proposition is. Design and defend a product

against that value proposition and then persuade people that it's a great product to buy. Recognise that it's your responsibility to do all of that—not theirs—and then we can quadruple or quintuple the size of this industry.

Thank you very much. Questions?

Audience member 1: In a lot of countries and systems, we have many private-sector products, and to some degree they need to differentiate. What would be your advice to really be successful? How does it work? How can we apply them to just products?

Jones: My core point is, the way the products are presented is so far away from the optimum presentation. There's loads of blue-ocean room to go at a better presentation of the product. The value proposition that's presented—to the extent there is one—is dewy-eyed, gray-haired people with incredibly good skin and slim profiles looking at each other on lakes in India. [*audience laughs*] That is so far away from the reality of any of our retirees, give or take the top 0.5 percent, that it's a joke. That's not the tomorrow my members think is worth saving for. The tomorrow they want is to be able to go out for a meal every now and again, to take their grandkids to the zoo, or to go to the cinema. That's the reality of the tomorrow that's worth saving for. So there's a huge distance to travel to get rooted in the reality of what people want and need in their later lives. Strip away all the jargon, and begin to build trust that you understand what they want.

Audience Member 2: How much of NEST's success do you attribute to developing a beautiful customer value proposition for the doll, versus the founders' decision to default people to auto-enrolment?

Jones: I'd say about 95 percent to the founders. NEST came about as part of a reform programme. It's one part of a

reform programme because the reform programme covers pillars one and two. It doesn't really deal with three. That reform programme was created by Adair Turner, Jeannie Drake, and John Hills, and their work was a piece of genius in terms of public policy. They should have the majority of the praise, if praise is due, for what is going on in the United Kingdom. I could puff my chest out and say we have 1.25 million members after 20 months or whatever, which is technically true. If we hadn't, however, then we would have kind of failed, because we're supposed to have 3 to 4 million members at the end.

The reason they got it right was because they consulted very widely. They found Richard Thaler, Shlomo Benartzi, and Cass Sunstein and got the behaviour economics. My caricature of why people don't join means there's no point in exhorting them to join. They'll never join. So if you can't do compulsion—which politically we can't do in the United Kingdom—then opt-out automatic enrolments is your only choice left to shift the dial. It was supposed to shift the dial from 30 to 70 percent enrolment. It has actually shifted it from 30 to 92 so far. Of the more than 3 million workers who have been enrolled, we have only 8 percent opt-out in the United Kingdom so far. So, that was a piece of genius.

A couple more tiny things about that. They did two reports. The first report has no hint of a solution. It draws you into a shared understanding of the problem. As an exercise in how to develop public policy, it's awesome. They realised you shouldn't 'solutionise' in your first report, but instead draw stakeholders into a shared understanding of the problem. Then the second report beautifully derives the solution from that shared problem set.

The second thing that Adair and crew did was consult over and over and over again.

When I joined, I joined to lead something called PADA, the Personal Accounts Delivery Authority, not NEST. PADA was there to design NEST in a very consultative way, so we did. We had formal consultative groups—a consumer group, an employer group, and an industry group. We did that seriously, and those groups informed the design of NEST. We then morphed PADA to become NEST. This concept of consulting and drawing stakeholders from across political, industry, and interest groups was a key feature of how they did it. That's another reason that it's going okay so far.

Audience Member 3: If I can ask about engine design—I understand the investment strategy starts at a more conservative place?

Jones: It absolutely does. Again, we did really fantastic research because we are a very evidence-based. I've approached this just as if I were working for Unilever and asked to design a new product. What's the first thing you do? Go and talk to the consumers of the product. That's what we did—we went and talked to them. And they didn't understand a word we were talking about because we were using the jargon of the industry, so we had to create a language. There's a NEST vocabulary. You can see it on the website. You can download it—it's called *English*. [audience laughs]

We then said, 'Okay, so the conventional wisdom is this is a DC plan and young employees can take lots of risks because they've got time to recover. But remember, there's both the chance to opt out and the chance to cease, so these young people can always cease.'

Then we talked to these young people about their risk appetite. 'Do you want to take a bit of risk?' 'Oh, yes, I'll take a bit of risk.' Then we exposed them to a bit of risk in two calls a week apart where we said,

‘You had 100 units last week. You’ve come back this week to 90. Sorry.’

They were so cross. They were angry beyond, ‘Who’s stolen my money?’ They had no concept of markets, and they knew their money had been stolen because they’ve been to St. James’s and seen people from hedge funds. They know that the people in the hedge funds have stolen the money. They’re not stupid. So they were saying, ‘This is ridiculous. I’m supposed to be saving. You told me it was 100. Now it’s 90. I’m out of here.’

And the emotion of that reaction took us to a lower-volatility start for people in their twenties—still matching inflation, but no more—because their risk tolerance was way below their risk appetite. Their expressed risk appetite was far higher than their actual risk tolerance. And because they’re young and not earning very much, there’s very little money in their pots. What’s the benefit of shooting the lights out? There’s trivial long-run financial benefit in shooting the lights out. If you teach people to stop saving at an early age, my goodness, you’re guaranteeing they won’t have a decent retirement in later life. That’s why the foundation phase is lower volatility in NEST.

Audience Member 4: It’s been pointed out you didn’t quite have to sell NEST in the same way that commercial providers do. But in the future, you may be in the business of selling postretirement products. Do you see yourself going further down that road?

Jones: Okay, let me just challenge the first part of what you said one. We *did* have to sell NEST. Pensions is a really conservative industry. So imagine you’re the new provider from the government, and a number of media people who cover your industry are just itching to write ‘empty NEST’ as a story. One of them wrote it—Julian Knight—in the *Independent*, you may remember. So we needed to have some household names.

Otherwise, we would have seen ‘*the empty NEST government IT project disaster continues on page 94*,’ which is a reference to a satirical magazine called *Private Eye*. That story would have just run wild, and we would have been in real trouble. So we did, as a new government-sponsored player in a private market, have to assert ourselves quite strongly.

Now your question about where we will go, in light of the budget changes, is a great one. The formal answer is, we’re going to consult in the autumn. You’ve heard some of the informal stuff in my earlier remarks. For a variety of lifestyle and financial reasons, many of our members don’t stop working at state pension age. So, when at that age somebody gives you money for the first time, it feels like a really good thing—and a really bad time to start taking the pension you’ve built in your DC pot. Why do that? It’s in their interest to actually continue to save while they continue to work so that the impact they can have on their later lives—when they’ve started to dial back from work—is maximised.

The issue is, there’s a massive journey to go on to get people to understand that. At the moment, they’ve been so disconnected from this world. My hunch about how to do this—and I completely agree with all the stuff that’s been said about it taking a generation—is that we won’t get through to people in their twenties and thirties. They know they should be doing this, which is why only 2 to 3 percent of them are opting out. So they’re not opting out. They’re quite canny. There’s something deep down that says, ‘Actually, this makes sense. I think I’m going to stay in here.’ Yet they’re not engaging with it.

But what I know from my retail banking background is that something happens from age 38 to 44. People stop being ambitious for their careers. They start being grandparents. They stop moving house. They start to contemplate their mortality.

And I think that's the point when somebody will say to them:

'I've bet you got money at NEST.'

'NEST? What's that?'

'It's something you've got money in.'

'What do you mean, I've got money in it?'

'Yeah, it's this pension. You must have been in it.'

'Yeah, maybe I was.'

Then they'll come to us, and that will be the first time. They may have been a NEST member for 20 years, but in their early forties, they'll come to us and find out what they've got. And we will be ready for them in a very warm, welcoming, 'Come on, it's great, all your mates are already here,' kind of way. We'll say, 'Let's start talking about building up a big amount of money through these different things we can do.' And we'll do it in a language that makes sense so we get to this place that Australia's got to, where you can go to a bar in Sydney and hear people talking about their Supers. That's exactly where we want to get to in the United Kingdom. Not as a sophisticated, complicated conversation, but as a very practical, rooted conversation of, 'How am I going to get the later life standard of living that I want?'

Audience Member 5: You were hard on all the people in the room about the product design.

Jones: Yes.

Audience Member 5: I was thinking that our friends from Nomura did not design this thing that was explained today. It was no doubt something that the Japanese diet put together.

Jones: Sure.

Audience Member 5: We have complicated systems in the United States that are dreamed up by our Congress, and it's

intended to satisfy tax policies, concerns, and all the rest of it. You're not exempt from this in the United Kingdom either.

Jones: No, we're not.

Audience Member 5: In fact, there are proposals abroad, potentially in London, which would make your own retirement system even more difficult to explain. So how do we get the policymakers, the legislators—the ones who actually sit and design pension regimes—to understand that you need to design them in such a way that they can be sold? Because, that's essentially your message.

Jones: It is. I think the thing to do is to persuade people that the role of the state in many of our countries will be to alleviate poverty. So pillar one will be about poverty alleviation. Poverty alleviation will not meet the aspirations of the citizen and, therefore, you need to facilitate that more happens. Yet that 'more' needs to come with a consensus, because it often won't be mandatory. Sometimes it will, and if you can get away with that culturally—great. But often it won't be. So isn't it good, then, that we actually tap into what people really need and want and treat it like a product, the same way that other really important products are treated? It's only when you get into this marketing mindset—where you need to have customer value propositions underpinned by sound product design that's communicable—that you actually get to the right kind of road and the right kind of direction. The state second pension in the United Kingdom was so complicated that hardly any of the officials knew it all, and it's going now with our pillar one reform. So, complexity is a feature of many of these things, because they go through political processes that involve balancing interest groups. But the real process should be to focus—certainly in pillar two and beyond—on a notion that customers need to be treated as *customers* for this really important product, just as they are for other important products in their lives.

PANEL 3

Use of Default Vehicles: Different Countries, Different Takes

PANELLISTS

STEPHEN P. UTKUS, Moderator
Principal
Vanguard Center for Retirement Research
United States

NICK CALLIL
Head of Retirement Income Solutions
Towers Watson
Australia

JAIME DE LA BARRA
Partner
Senior Investment Strategist
Regional Head of Business Development
Compass Group
Chile

RICHARD GRÖTTHEIM
CEO
Seventh Swedish National Pension Fund (AP7)
Sweden

Default vehicles play various roles in pension plans around the world. During this session, panellists from four different countries presented an overview of their pension systems and explained how default vehicles work within those systems. They also focused on the different types of lifecycle funds, the challenges of designing and reforming glide paths based on age or asset allocation, and the role of alternative investments in funds.

The following is an edited transcript of the discussion.

Stephen P. Utkus, the moderator, invites the panellists to present an overview of their country's pension system and then asks them a series of questions.

Stephen P. Utkus: During this panel, we're going to talk about default fund investing, as well as the array of investment choices offered in individual account-based defined contribution, or DC, plans. We have four perspectives to offer from Australia, Chile, Sweden, and the United States. Nick Callil will go first, followed by Jaime de la Barra, Richard Gröttheim, and then myself.

Nick Callil: I'll talk about the default system in Australia, but first I'd like to give you a snapshot of the country's overall system and where it is at the moment: We have AUD\$1.6 trillion assets in the system—that's about US\$1.5 trillion. That's grown from 53 percent of GDP ten years ago to more than 100 percent now. The system is a major factor in the Australian economy

and is underpinned by the mandatory employee contributions, which are currently 9.25 percent of employee income. They will increase to 9.5 percent starting 1 July 2014 and then ultimately rise to 12 percent by 2023.

Australia is very much a DC system, so while defined benefit, or DB, funds do exist, we estimate the proportion of DC assets in the entire system to be about 84 percent. While I think the mandated employee contributions are basically seen as a success, the postretirement phase needs more work. We don't have a mandated income stream or, really, any incentive to take income streams in retirement. We don't have a clear-cut design for default investments as one approaches retirement. It's not really possible to know whether you're investing for an investor who is going to invest for another 30 years postretirement, or someone who's going to cash out. So that is a difficult problem that funds need to grapple with.

When we talk about defaults and about choice, it's important to understand that in Australia there are two layers of choice which apply—and, hence, two defaults. An individual employee has a 'fund choice'—a

choice of vehicle to which their employer contributes. Then, within that fund, there is an 'investment choice'—a choice of investment options or strategies. Both of those have defaults. The default fund is typically selected by the employer—or, if it's a unionised arrangement, it's selected through a negotiation between the employer and the relevant union. Within the fund there are a wide array of options, ranging from diversified options to single individual security options, but the default investment option is the choice of the fund operator.

A significant change in the Australian system commenced 1 July last year after many years of planning and discussion. We call it MySuper, and it is intended for disengaged—or 'true default'—members, who represent about 80 percent of the workforce. For those members, we have a simple, low-cost, easy-to-compare vehicle in which their contributions are invested, and there is a level of prescription on what a MySuper product can look like.

For instance, for investment defaults, you must have either a diversified or a life cycle default. It's not prescribed in terms of what level of risk or what asset allocation it must take—that's why I say there's a

About the panellists

Stephen P. Utkus is Principal and Director of the Vanguard Center for Retirement Research, which assists employers, consultants, policymakers, and the media in understanding developments in the US retirement system. Utkus also is a member of the senior leadership team of Vanguard's institutional retirement business in the United States.

Nick Callil is Head of Retirement Income Solutions for Towers Watson Australia and a senior member of the firm's Australian benefits practice. With more than 26 years of consulting experience, Callil manages key relationships and provides strategic advice to major funds, corporations, and employers in the public and private sectors.

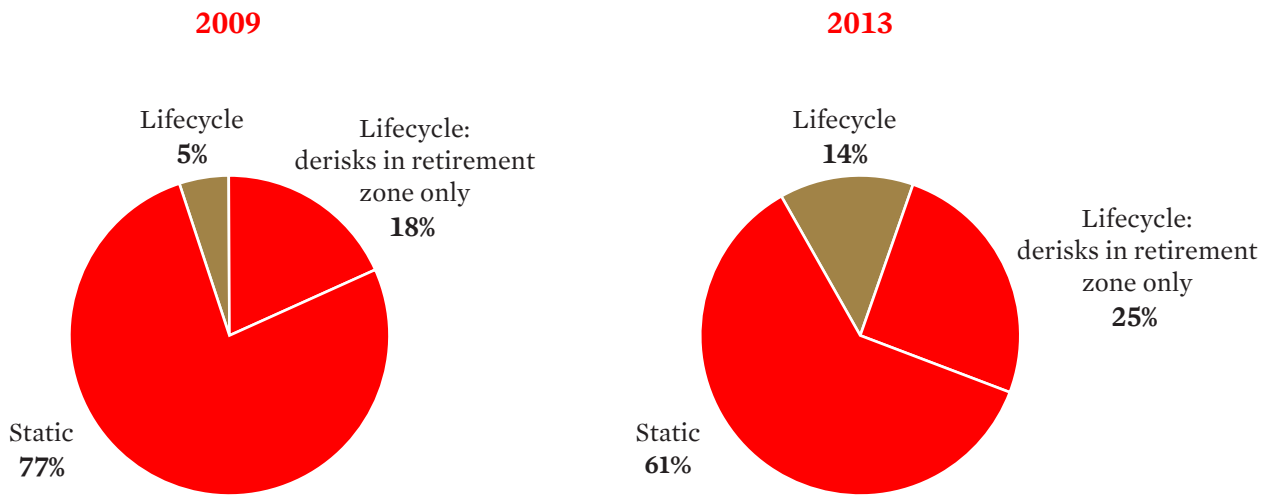
Jaime de la Barra is a founding partner of Compass Group in Chile, and is currently Head of Business Development and the Senior Investment Strategist. Between 1992 and 1996, he created and was the head of investment research for Grupo Santander in Chile. Previously, he was a vice president in investment banking at Citicorp Chile.

Richard Gröttheim is CEO of the Seventh Swedish National Pension Fund (AP7). Before this position, he was executive vice president at AP7. Gröttheim also was head of the monetary and foreign exchange policy department at the Swedish central bank and chief economist at the Swedish brokerage firm Aragon Securities.

FIGURE 3.1

Default Design: Static vs. Lifecycle

Not-for-profit funds only



Prepared by: Nick Callil (Towers Watson), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

level of prescription. It doesn't go too far in prescribing how it should look, but it must be diversified.

Likewise on fees, there's not a prescribed level of fees. Yet there is a limit on the types of fees, and there's a requirement that all members must incur the same fees. The system is trying to strike a balance between uniformity while not being too prescriptive and letting the market work. The aim is to have as many features in common as possible, and to drive down the headline fees that apply.

[Referring to figure 3.1] This figure looks at what the default investment option looks like, and this is just within a subset of the market—the large fund sector of the market, not the retail individual sectors.

What we see is that the market is very much still geared towards what I call a static default. By static, I mean it is not lifecycle—it doesn't vary with age. Obviously, there's a strategic asset allocation, and the actual allocation may vary from that over time, but it's not a glide path governed by age or any other factor.

If you talk about true lifecycle, that's 14 percent of the market. If we add funds that vary the asset allocation in the retirement zone only, that's another 25 percent. The remainder—61 percent—is what we call static. When we compare that to 2009, when the static funds represented 77 percent, we see there has been a shift towards lifecycle. Thus, while we're not a market where lifecycle is the norm, it is growing in importance—and there's a lot of discussion about whether it's the right solution or not.

Now let's discuss what the asset allocation is for the large fund sector of the market. Talking about just funds with a static allocation, the vast majority—between 70 and 80 percent—allocated their assets to high growth. Some funds are outside of that, but it's the norm to have what I think is a high-growth allocation within our default funds.

Within the growth assets component of the defaults, Australian equities and international equities dominate—37 and 35 percent, respectively. Funds also have been quite good at involving themselves in the unlisted markets—getting first access to infrastructure, such as airports and

electricity companies, many of which have been privatised in the last 20 years.

If we look at the funds that embrace the lifecycle approach, we can see that it is just some of the major funds. [Referring to figure 3.2] This figure shows the lifecycle glide paths that apply, expressed in percentage of growth assets. What you see is that there's a wide range of points at which de-risking commences, particularly for funds that initially have a very high growth allocation. What we see is that they can start de-risking as early as age 45. At the other end of the spectrum, we see funds that go to age 75 and then de-risk. As I mentioned before, there are some funds you perhaps wouldn't call lifecycle in the conventional sense, because they are static all the way up to retirement. Yet, if you remain in that fund and in the default option, then they drop down perhaps one step at age 75 or something like that. So you may

call these lifecycle funds, depending on your preference, but there is a separate approach to the glide path design.

The other thing you might notice in the figure is that some of the lines actually stop at age 65. These funds adopt an approach that says we do not need a default all the way. We need a default for our members joining at age 20 and 30, but once they get to retirement, they should be engaged, so we don't want to have any defaults. We want them to make a choice, so these funds take an approach where people who stay in the fund will actually be forced to make a choice. No default will apply for those particular funds.

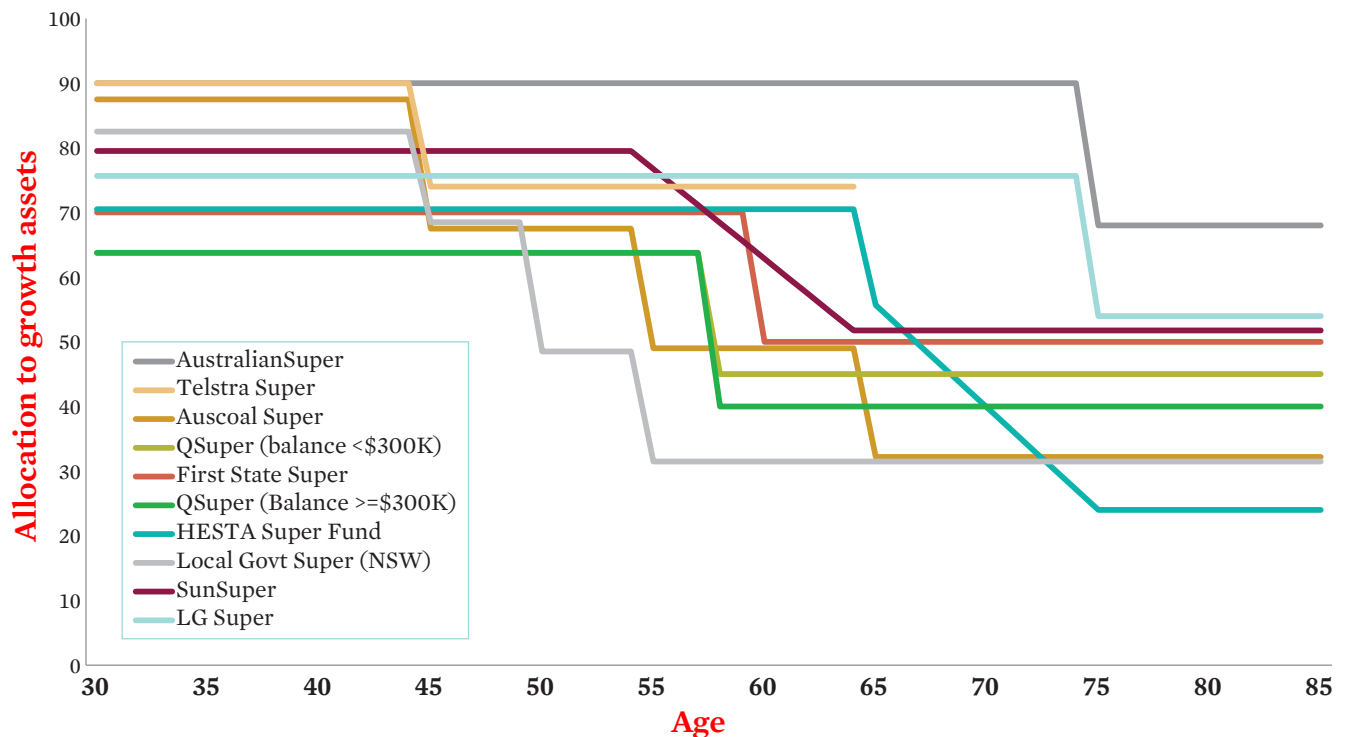
If we think about the topical issues that are being applied in default funds in Australia, they have been dominated in the last few years by the implementation of the MySuper system. The dust is settling on that, and now we're able to step back from some

FIGURE 3.2

Lifecycle Glide Path Design

Australian not-for-profit funds with lifecycle design, December 2013

Percent



Prepared by: Nick Callil (Towers Watson), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

of the implementation issues and look at some more strategic issues that apply in the industry. One of the topical issues is a focus on fees and, in particular, a focus on more expensive asset classes, such as alternative assets. The question being asked is, ‘Do they have a place in a MySuper default?’ Given that the MySuper default is intended to force down fees via market forces, some of those more expensive asset classes could find themselves under pressure to maintain their place in the portfolio.

Another topical issue is providing an annual estimate of retirement income. In Australia, we traditionally have a lump sum system, and there is no income focus in retirement. The idea, however, of actually putting in front of people an estimate of their annual retirement income is very much on the agenda, and some funds are doing that now. In addition, there’s regulation to promote this approach.

The third topical issue is a question I alluded to earlier today—how do we actually illustrate the risk of outcomes? Not just the risk of investment returns, but the risk of not achieving a retirement income of \$35,000 or \$40,000 per annum—the risk that if you retire at a bad time, it might only be \$20,000 or \$25,000 per annum. In addition, there is the related question of how we actually mitigate the retirement risk zone and sequencing risk. What should the policy be for moderating the exposure that members have—particularly default members—to a drawdown at the critical ages, plus or minus ten years from retirement?

Another topic that has gotten some airplay, and that some funds are looking at, is the concept of a dynamic or adaptive lifecycle. For example, rather than a glide path that just looks at age as the trigger for de-risking, other factors are considered, such as account balance or level of income. Then, those are used to trigger a de-risking of the account balance.

Jaime de la Barra: My involvement in these issues is mostly from the investment

management and capital markets side. I’m a partner at an investment management firm, which we set up about 18 years ago. Since the start of my professional life, I’ve been involved in capital markets, teaching, and in policymaking relating to capital markets. I don’t work in pensions; I work in capital markets.

The Chilean Pension Fund System was created in 1981. It currently consists of three pillars. The first is a mini government-guarantee pension. The biggest, and the most important, piece is the second one—a compulsory DC system that is now almost 60 percent of GDP, with around \$166 billion accumulated in DC compulsory funds.

Then there’s the third pillar, which is the voluntary, DC individual accounts-based system, where the multifunds or the pension funds that are used for the compulsory system also can be used as a voluntary savings vehicle. This is, in my view, a very important feature of the Chilean pension market. These compulsory funds are managed by private-sector single-purpose pension fund management companies called AFPs that act as a fiduciary third-party manager. During the past months, we have seen a lot of activity in terms of the ownership in this industry. Two of the three largest providers changed hands—one from a Spanish group, BBVA, was sold to Met Life, and a Chilean group was sold to Principal Financial Group. Therefore, the landscape of ownership of these companies has changed significantly in the last six months.

AFPs manage mandatory or compulsory accounts and voluntary savings accounts. The same building blocks are used as savings products for the compulsory and voluntary parts. The worker, as in Australia, has a choice. This is also a very important feature of the Chilean system—that the worker can choose between the manager of the funds and the accounts. They also can choose, within a framework, between funds—between five asset allocation funds whose structures are prescribed in the law.

In addition, the worker has a choice in terms of what to do when they retire; it's basically a choice between two schemes. One is a programmed withdrawal of the monies that are left in the individual account with the pension fund management company. The second is they can bring the money accumulated in their accounts to an insurance company and buy a single premium fixed-rate annuity. I believe around 70 percent of workers choose the single premium fixed-rate annuity.

The system is based on universal rules. All workers in Chile—except the military and some other very special workers—are subject to the same rules. The asset allocation funds serve as savings vehicles, and the funds differ among each other based on the range of equity and fixed-income allocation allowed by the law. There are six AFPs and five asset allocation funds. Worker contribution is 10 percent of gross salary. There is no employer contribution. The employer involvement is only in the collection, and they have legal duties about collection. The fees that these pension providers charge are 1.45 percent of salary. In some of the presentations, you might see 1.45 percent of the contribution. It's 1.45 percent of the salary, which means 14.5 percent of the contribution. You are charged, in a way, an entry fee of 14.5 percent of every

contribution, but that money buys management of your account for the rest of your life. If you translate that into an asset-under-management type of fee, most calculations arrive at a 0.6 percent fee, which I think is very reasonable for retirement schemes.

There are 9.5 million accounts, with contributing accounts accounting for a little bit more than half of that. The average return since the system's inception has been extremely high, and that, in my view, has a lot to do with the microeconomic performance of the country and also the competitive nature of the industry. The multifund asset allocation structure is the most basic and, in a way, the biggest driver of the asset allocation of these funds. It is what is written in the law. Fund A, which is the most aggressive, has to keep equity allocation between 40 and 80 percent. If you go down to Fund E, the least aggressive, equities account for up to 5 percent [see page 5].

The current allocation of the five funds reflects the reality that real interest rates in Chile are extremely high compared to global real rates. In Fund E, more than 90 percent of the assets are allocated to domestic fixed income. In Fund A, which is 80 percent equities, most of the assets are allocated to international equities, given

FIGURE 3.3

Default Path and Fund Options

	Men	35 or younger	Between 36 and 55	Older than 56	Retirees
	Women	35 or younger	Between 36 and 55	Older than 56	Retirees
A		👍	👍	✗	✗
B		Default	👍	👍	✗
C		👍	Default	👍	👍
D		👍	👍	Default	Default
E		👍	👍	👍	👍

Prepared by: Jaime de la Barra (Compass Group), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

that the size of the Chilean equity market—even though it has grown significantly in the last 30-something years of the system’s existence—is too small for the \$166 billion accumulated in those funds.

[Referring to figure 3.3] There is a path—or a path combination and a path prohibition—in the law that is basically gender- and age-based. If you’re a woman, you cannot choose the most aggressive fund if you are older than 51 or if you are retired. In the case of men, you cannot choose Fund A or B if you are a retiree, which for men, means you’re older than 65. There is a default path that glides you from Fund B to Fund D. The most conservative fund is not in the default path, which actually results in quite decent replacement rates in different Monte Carlo simulations on market returns and volatility.

The challenges and current issues in the system basically arise from the fact that the system, in a way, has two dimensions. One is that the multifunds are basically risk-based and not replacement-rate focused. The second dimension is that the default path and the default options given to participants help mitigate risk-based savings by focusing more on replacement rates. There is a big controversy now, because the president has gathered a commission to review changes in the system between choice and implied guarantees. Some providers believe that the product has to be something that the client understands and that drives some providers to request more power to offer advice in terms of the glide path. Others believe that has a lot of risk. Some industry players are very worried about implied guarantees—as Roberto Rocha said during the first panel [see page 30], in Brazil some providers have been sued by participants who believe that the providers have not met their promises in terms of implied guarantee.

Once you choose, you are on your own. That’s another feature of the system that might require a difference in terms of

opting out every one, two, or three years, because today, if you opt out of the default path, you are out forever.

Another aspect that we are focusing on is how investment guidelines based on asset class initial limits can be improved. Today, the only two asset classes that the law considers are fixed income and equities. There is no mention of infrastructure, real estate, or private investments.

Pricing, which has been a big topic in this discussion today, is really not a relevant issue for informed or high-income participants. Thus, in a way, there is no pressure for price competition from well-off people who participate in the system and who also contribute on a voluntary savings capacity, because all participants are charged at the beginning for their contribution. After that, the well-off people are being served for ‘free,’ which means there is no market for pressure in terms of pricing.

Richard Gröttheim: The Swedish pension system consists of three or four pillars, depending upon how you describe it. I’m going to talk about the first pillar today, which is the government pension plan. It consists of two parts: pay-as-you-go, or PAYGO, and DC. Eighteen and a half percent of a participant’s income goes to that system—16 percent to PAYGO, and 2.5 percent to mandatory individual accounts within the first pillar. These individual accounts are where AP7—the Seventh Swedish National Pension Fund—fits in. So AP7 is within the DC part of the government pension plan.

We act within that system as the default fund. You can choose among 800 private funds, not providers. There are 100-plus providers but 800 funds. That’s one of the disadvantages of the Swedish system—it’s too liberal. Yet there is a default option, and that’s AP7; we’ve been invested since 2000, which is when the reform of the Swedish pension system took place. We had

a new set-up in May 2010, when we moved to a lifecycle product.

We have the same investment rules as private mutual funds. We can invest in equities, bonds, and in private equity. We have 3 percent in private equity, and we can invest up to 10 percent. We believe there is an equity risk premium. Equities will, over longer periods, give better returns than bonds. You can argue about how much, but if you look at the last 100 years, the premium is between 3 and 5 percent. To get that, however, you need to take financial risk over the longer term, and you have to accept volatility in the assets.

Our mission is to ensure that those who don't want to choose—or who can't choose—should have just as good a pension as others. Helping to create a good pension is our contribution to creating security. It's not to get low volatility; it's to create a good pension. We work to minimise the likelihood that a retired person talks to a neighbour and discovers that he or she has a lower state pension than the neighbour. To get a good pension, you need to take financial risks to get that equity risk premium. Equities move up and down quite a bit, but over longer periods you get return. Bonds have lower volatility in the short term and the fees are better, but in the long term, you're a loser.

When we started, we had limits on how much risk we could take. We had to have lower risk than our competitors—the 800 other funds—but we still had to work to get as good a return as the others. New guidelines were delivered in 2009. The default fund should work in concert with the income pension. Because the income pension is a low-risk, PAYGO system, you need to take the equity risk where you can—in the premium pension.

[Referring to figure 3.4] The income pension—the PAYGO part of the system—accounts for 86 percent of participants' total pension. The premium pension—the DC part—is 14 percent. If we move on

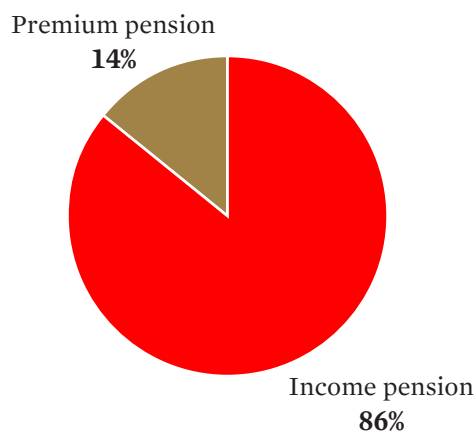
a path where the return in the premium pension is better than the return in the income pension, the premium pension will increase up to maybe 20–25 percent when you retire.

There is a new product called *såfa*. In Swedish, *såfa* is coach, so we wanted to give people the impression that they can comfortably sit down in the coach for life. We have two building block funds: an equity fund and a bond fund. We also have some choice alternatives, but I will not go into that. Basically, we have the theme of dividing up to get large economies of scale in two funds and putting them together in the product *såfa*.

Now the scary part. [Referring to figure 3.5] In financial theory, you should move up along the efficient frontier to the most diversified portfolio, which is the global equity fund. Then you should leverage that instead of moving up the efficient frontier into modern markets or country funds, such as China or Turkey, which have a higher expected return but high volatility. It's better to get the leverage, and we do that. We have a global equity fund and, on top of that, 50 percent in a normal case leverage. It is hard to explain sometimes,

FIGURE 3.4

Payments to Government Pension



Prepared by: Richard Gröttheim (AP7), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

when markets move up and down, but then you need to stick to the long-term horizon. It's 45, 50, 60 years for a young man or woman that we're talking about, and if you have an equity risk premium, you should have that high risk in the premium pension—as the income pension is a real interest investment.

Now to the lifecycle arrangement. Starting at age 55, we gradually scale down the risk. We do this every year to avoid the sequencing risk you get if you scale it down more substantially on fewer occasions. Every year, we increase the proportion of the bond fund in your portfolio until you're 75. That is a 3 or 4 percent yearly decrease in equities.

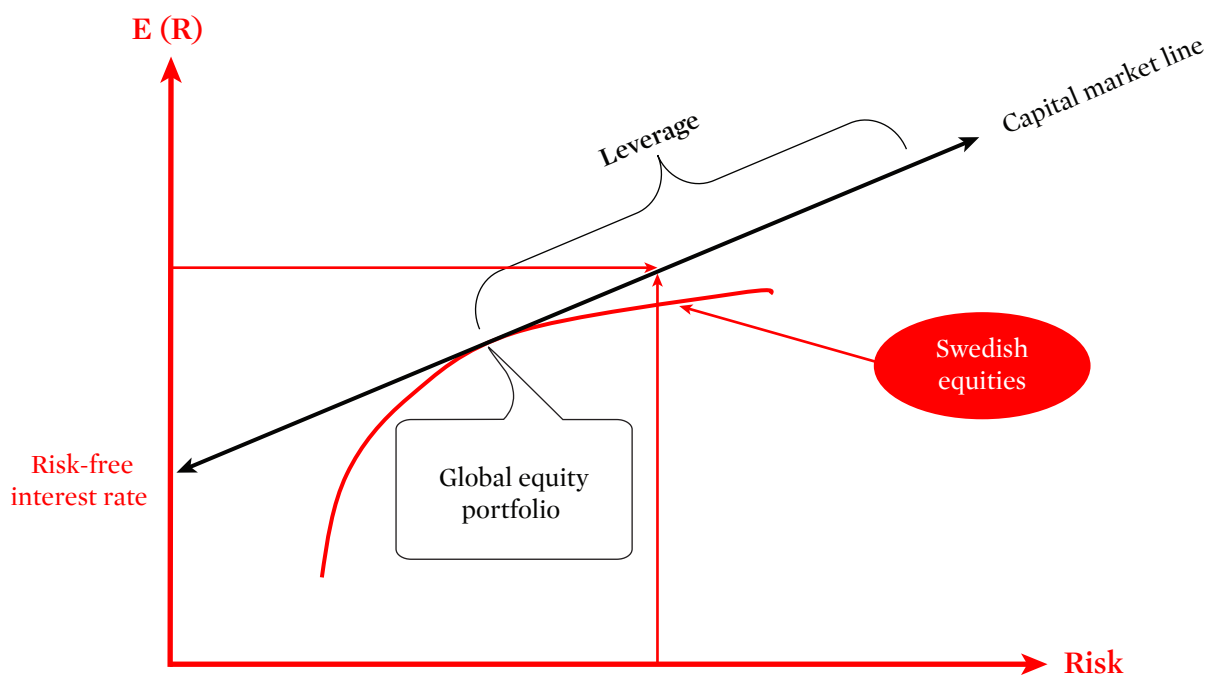
The results have shown that AP7 has returned double what you get if you had been choosing, on average, between the 800 different funds. We are up 6.2 percent since the year 2000, while the private funds, on average, have been half that. Taking that risk is, in my mind, what you should do with the default option. We have 27 percent of the capital, 42 percent of it individual,

and we have a responsibility to give a good pension, not to decrease the volatility.

Utkus: Let me describe briefly what's happening in the United States with respect to default fund policy. In the United States, private-sector workers receive a baseline inflation-adjusted annuity from the government's pillar one system, called Social Security, with a median replacement ratio of around 40 percent. The replacement ratio is higher for low-wage workers; it's lower for high-wage workers. I'm going to focus my attention on defaults today within the DC sector, which is voluntary in the United States. About seven in ten private-sector workers are eligible, according to the latest coverage numbers. Approximately five in ten actually participate today.

Sometimes, you'll hear US representatives speak about individual retirement accounts, or IRAs. These are simply pension accounts that are controlled by the individual rather than led by the employer. Employees, when they leave an employer, can take their money and roll it over to an IRA. Thus, it's

FIGURE 3.5
The Thinking Behind the AP7 Såfa



Prepared by: Richard Gröttheim (AP7), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

good to think of the DC system in a comprehensive sense of 401(k)s and IRAs.

The 401(k) plan system was founded on the idea that everyone needs freedom of choice—what Shlomo Benartzi and Richard Thaler have called ‘investor autonomy.’ The United States, however, has actually retreated from that notion as a matter of policy, in a significant way. In fact, during the past decade, the reliance on default options has increased with respect to savings policy, with the introduction of automatic enrolment. Today, six out of ten new entrants entering 401(k) plans in the United States are automatically enrolled, meaning that the majority of new participants are really enrolled at default rates and are not making active savings choices.

In addition, the government authorised new default investments for these default contributions. There are three types of these default investments, which go by the name QDIA: a target date lifecycle product, a traditional balanced strategy (like the Australian static allocation funds or the multifunds), and a managed account, which is a personalised technology-based advice service.

Let me just give you a sense today of the rapidity of the change within the United States. Ten years ago, any default, when it was used, was cash. Today, 85 percent—and now approaching 90 percent—of DC plans in the United States offer target date fund strategies as an available investment option. When they have to choose a default, virtually all employers choose the default. This is quite a dramatic sea change in less than a decade. McKinsey and Cerulli estimate that one-half of all private DC assets in the United States within another five years or so will be in target date strategies. This is explosive growth. There’s this massive allocation away from individual investment options chosen by individual workers. If you are an asset manager in the room, and you manage those individual options, you are seeing your money being redeemed to the leading target date providers in this marketplace. It’s fair to say that by 2020,

half of all retirement assets in the United States will be invested according to these strategies.

There are five leading providers—Vanguard, Fidelity, T. Rowe Price, BlackRock, and J.P. Morgan—which account for more than 80 percent of assets. When you look at their glide paths by age, you do see a relative convergence of designs across providers. That’s because most are modelling outcomes using similar assumptions. There are some subtle debates about the transition around age 55 to 60, between the providers who have more conservative glide paths versus more aggressive. Yet one analyst in the United States, Morningstar, examined these for outcomes through retirement and said they produced very similar results. Some other providers have very conservative or more aggressive options but 80 to 85 percent of allocations are with these five providers.

There is a debate over the design. Are we investing to retirement or through retirement? By and large, more of the assets are going through retirement. Yet there is a debate at the employer level and among managers about how assets are used in retirement and, therefore, how the glide path should be designed.

There’s also an extensive discussion about asset diversification strategies. Today, it’s mostly liquid market asset allocation strategies. There are very few illiquid strategies, and that’s because these accounts in the US system are quite fungible and liquid. You can move them any time you change your job, so alternatives—particularly illiquid strategies—have not made their way into these designs. Maybe in the future.

There’s a big active versus passive debate. In the retail world, there’s a shift in the adviser community towards passive through exchange-traded funds, or ETFs. In the 401(k) world, we estimate that nearly one-half of all assets in target date strategies are now passive. That includes active managers who have strategies that require them to use active, so it’s quite interesting.

The existing 401(k) system is 20 percent passive and we estimate the target date strategy is around 50 percent passive, so an active-passive shift is underway. Finally, there is the whole question of guaranteed income. Should the approaches be integrated, or is the inflation-adjusted annuity provided by the state government pension enough?

Okay, we have a number of questions for the panellists, and the first has to do with this growing interest around the world in age and age-based default funds. We saw different degrees of variation by country. Richard, I would like to start with you—do you think this is inevitable? Are all DC systems moving to age-based allocation paths, or will the remaining systems stay dedicated to more traditional approaches?

Gröttheim: I'm more convinced after listening to the presentations this morning that this is definitely a trend—and it is a good and realistic trend. As I explained, the government instructed us to move in this direction four years ago, and I think that was wise. It was a pretty new system, so it didn't matter in the first ten years because there were very few people who retired from the system. Yet as the system grows and matures in Sweden and in other countries, I think a lifecycle product is good. In Sweden, you can choose whether you want to stay in the fund or if you want the life insurance and annuity, and most people stay. Of course, if you have an equity risk premium, you will gain from that if you live 20 years after retirement.

Callil: There's a range of investment arguments for and against the lifecycle approach, which I think we're all familiar with. One of the barriers in Australia to it taking off is that a lot of funds simply aren't equipped to actually implement the lifecycle approach. As simple as it sounds to implement an age-based glide path, most funds in Australia have been geared up to change investment allocation when requested by members. It is an

implementation barrier that needs to be overcome before these can become widespread.

Utkus: Jaime, I was thinking that, in some ways, Chile was the original lifecycle model, right?

De la Barra: Right.

Utkus: Do you think there will be a movement away from the policy that says, 'Now, once I opt out of the lifecycle fund, I'm out of the lifecycle fund?' Do you think that would come as a change?

De la Barra: Yes. What we have gathered from the group of people who have been thinking about this from a private-sector perspective is that there are two issues. One is the ability of some of the providers to think more along the lines of NEST [National Employment Savings Trust], in terms of asking, 'What does my client want to know from me or want to have from me?' Some of them say, 'My client might want advice that is a bit more dependent on replacement rates than just a gender- and age-based glide path.' So, some industry participants are advocating to offer their clients more freedom—to offer their customers a value proposition that involves holding their hands throughout their life and, in some cases, saying, 'You have accumulated a certain amount of growth, so you don't need to be in the most aggressive fund. You can now be in a more conservative fund.' But there's a debate, because some other players believe that this approach might backfire, because it might carry with it some implied guarantees. This is one of the most relevant discussions that will happen, but I don't see any reversal in the gender and age glide path.

There is also the issue that you mentioned—if you opt out once, you are out of the default forever. That's something that definitely needs to be reviewed, and there is consensus among the industry players that a change will be good for the system—so, for example, you might have to renew, in a way, your opt-out decision.

Utkus: Nick, I also was interested in your comment about this notion of multifactor asset class models. Age is where we're starting. The OECD obviously has said age is a great factor to consider with these multi-asset factor models. What do you think? What's happening in Australia in that way?

Callil: It's certainly something that we and others in the industry have been discussing for a while. The best answer to that is there is a major government fund in Australia for government employees—a DC plan with a generous contribution rate of 7.5 percent. That gives them room to move and really model some cohorts. Essentially what they've said is, we want to have a model where de-risking is affected by more than just age. Ultimately, they would base the de-risking on things like income, account balances, and whether you have money in another fund. In other words, if you're a member of a legacy DB fund with a generous benefit attached to that, then you perhaps should be taking more risk with your DC plan than someone who doesn't have a DB plan. These are the sorts of factors that ultimately they wish to take into account.

They've done this in a very systematic way, so it's been going on for a number of years. Most recently, they launched an arrangement where just one extra factor—account size—is now a de-risking factor. For example, if you get to age 55 and you've got more than \$300,000 in your account, then your account gets de-risked more than someone who has less than \$300,000. The reasoning is, because you've reached an adequate level, you can take some risk off the table. So, though that fund makes a point of saying, 'We don't want to be the role model for the Australian system,' and that this might not be for everyone, it's an interesting development, and there's a lot of interest in how the fund is doing that. It's not without its implementation issues, though, so not every fund could do that.

Utkus: Yet everyone is different. Someone might say, 'Well, you think I've reached the right threshold, but maybe I have to have some personalisation that may be difficult to accommodate.' Maybe people would need to call a special phone number or go online and answer five questions before they do that?

Callil: Yes, they might—but that would be a great outcome. If we can use this model to draw people in and engage those who wouldn't otherwise be engaged, great. Yet the reality is, after you've done as much as you can on that, you're still left with the question of what to do with a truly disengaged member. The fund will still move the money of a disengaged customer, but the fund is very much sending the message, 'If you think this isn't right for you, then please contact us. If we're missing some information or you just don't agree, then by all means, make your own choice.' The aim is to engage as many members as possible—but like funds all around the world, they have a high level of disengaged membership.

Utkus: In our pre-discussion, one of the things we talked about was asset allocation policies around the world. One of the interesting discussions we had was about this intersection between asset allocation policies and regulatory development, and the need for the regulators to keep up to speed on investment policies, separate from the law. Jaime, you mentioned that in Chile, the mix between equity and fixed income is sort of hard-coded. What do you see happening with that debate?

De la Barra: One of the implications of the way the system works is that it greatly restricts what people can do out of the bond shares. The fact that members or customers can move from one fund to the other and from one provider to the other means that these are giant daily liquidity mutual funds. Another feature of the system has, in a way, a herd behaviour by the providers attached to it. That is the minimum guarantee, which is based on peer group performance.

Utkus: Could you say more about that?

De la Barra: There is a penalty for underperforming. If one of the providers falls short of a certain band of peers, the owner or the shareholder of that pension fund management company has to pay the difference—and that goes directly to the members' accounts. Some people say that even if that feature didn't exist, the providers would behave like sheep anyway, because they compete for the customer. The competition for the customer needs some kind of homogeneity in terms of product. The fact that the providers behave very similarly and that these are giant daily liquidity mutual funds has meant there is extremely little investment in alternatives or in assets that are not very liquid equities or mainstream bonds. That means two things. One is you're supposedly giving up the 'illiquidity premium.' Two, you're losing the opportunity to validate the system because you are funding important things, such as roads, private equity, and entrepreneurship.

It's a different equation to sort out. In a system basically made up of giant daily liquidity mutual funds, how do you invest in alternatives that are very illiquid, in the case of private equity, ten-year commitments? There is one Chilean AFP that firmly believes you can get that premium by investing in small-cap value. They have, in a way, bought 100 percent into the Fama-French model, so that there is no illiquidity premium and you can capture it through these other premiums. Two Chilean AFPs have come to believe in an illiquidity premium, and they have invested basically in global private-equity buyout funds mostly because there is less headline risk. If they invest with Blackstone or with KKR, the regulator cannot say, 'Why did you invest in a small Chilean venture capital fund managed by a guy who nobody knew?' It's a difficult square to round.

Utkus: Let's come back to alternatives for a second, but I do want to get to the leverage discussion. A target date fund doesn't have private equity and leverage. Is that

because, Richard, the guaranteed portion of the state pension is so substantial that it makes sense that the complementary portion should be levered? Is that the thinking?

Gröttheim: The thinking is that it's a smarter risk to take than moving into emerging markets or country funds. Only Sweden would be a high risk compared to a leverage of 50 percent. The rationale is it's a smarter risk for the saver to take in the long run—but, of course, we can package this in a more efficient way, as we are a large government fund.

Utkus: Thinking of Chile, I would have thought the compulsory nature of it would have made it more like Australia and Sweden, where people can then allocate portions of the portfolio. Yet because of the switching rights, it's similar to the United States. In the United States, it's less about switching, but it's switching to your own personal account when you change jobs. It's the same sort of problem. Any broader thoughts from the group about the future of alternatives? What we see now is divergence between asset allocation policies—between DB plans and some funds dabbling in alternatives. Do you see them converging or maintaining their difference?

Callil: Australian funds have meaningful allocations to alternatives—in particular, to illiquid property and infrastructure. Yet we have daily choice, both within the fund and if someone wants to take the money out and invest it all in their own cash account. So we face the same issues in terms of being able to hold illiquid assets. Yet funds have gotten around that by judicious modelling and management of what's realistic. Theoretically, everyone could lift up and go out tomorrow, and the funds' illiquid holdings would be stranded. Of course, that's not going to happen. By and large, the system is managed around that because funds believe in the illiquidity premium and want to maintain their exposures to that.

Utkus: How about in Sweden?

Gröttheim: We are limited to what we can invest in, as we are regarded as mutual funds. Private equity is actually squeezed in a little bit, and the set-up is a little bit more liquid than normal. I think the reason for moving into any asset class is diversification. In some of these new alternatives, if you round the figures, you can show that it's a good diversificator. Of course, then you should use it if you can get enough liquidity. In some of the asset classes, you have to realise that it's an alpha component—in private equity, for example. If you look at the average, you don't get much more than in public equities. If you move up to the first quartile, then you get it. But then you need to pick these funds.

Utkus: We've been talking about efficient portfolio allocation in DC systems. Do you find in your own countries a confusion between portfolio allocation decisions and adequacy discussions? In the United States, the assumption is that better portfolios lead to better prepared participants. At the margin, I suppose, that's true, but it's as if sometimes people are hoping for the capital markets to bail out, or make up for, a poor contributions policy. Do you have any of that experience in your own conversations domestically, or do people keep the portfolio question separate from the adequacy question?

De la Barra: In Chile, given the low levels of financial literacy, everything gets mixed up, starting with the politicians. For example, the evaluation of the system by some politicians and by the public in general is not very good. It didn't happen like it did in Australia, where after seven years everybody loved it. In Chile, the evaluation by the people is not good. Trying to explain to them what these private pension fund managers do and separating that from the contribution density question and from the labour market aspects of poor pensions is almost impossible. The regulator tried to do it for eight years. Everybody made

some strides, but still everybody mixes everything up. In an environment where real wages grew like they did in Chile for the 30-plus years that the system has been in place, it's very hard to explain to someone that they will not get 'X' percent of their last salary when their starting salary was 2.8 times lower. This is because if real wages grew by around 3.5 percent in 30 years, you would have a salary that is 2.8 times higher than your starting salary, which is a very difficult target to meet.

Callil: The adequacy question is a big topic in Australia. The industry body of pension funds in Australia, ASFA, has established income benchmarks. Thus, we talk about income objectives as 'ASFA comfortable' and 'ASFA modest.' 'ASFA comfortable' is about \$40,000 per year. It's almost an alternative to replacement rates, and it's becoming the language. These funds have a goal of reaching 'ASFA comfortable' for someone who's been on average wages for their whole career. That sort of thing is creeping into the language.

To your question, Steve, I think there's a pretty good understanding of the different roles that an asset allocation strategy and contributions strategy have to play. In the discussions around the lifecycle approach, there's a pretty good understanding that it's not a panacea, it doesn't address longevity risks, and it certainly doesn't address adequacy risk.

Gröttheim: In Sweden, we have a very liberal system when it comes to the DC part of the government pension plan. Most of the people who made an active choice in the beginning picked one fund, stayed with that fund for 14 years, and may not have gotten good performance. They didn't understand asset allocation at all, and nobody explained it to them. That opens up the debate of whether you should have that or not, because people can't take care of themselves. That's why I think it's so important to tell people that there is a good default option.

PANEL 4

Routes to Delivering Sustainable Retirement Outcomes— Different Concepts for Differing Risk Appetites

PANELLISTS

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An ideal retirement product—one that would provide a sustainable income stream—would strike a perfect balance between two qualities: certainty of income and adequacy of income. These qualities require certain trade-offs, which both the audience and panellists examined during this session. ‘If we want to have a sustainable pension solution,’ one speaker noted, ‘we first need to make clear what choices people have in nominal terms and also the risks they incur in real terms.’

In addition to the trade-offs, panellists discussed the types of guarantees offered by the insurance industry and innovative solutions advocated by the European asset management industry. Speakers also talked about Swiss pension schemes, which provide a minimum guaranteed rate of return, as well as the effects of coverage and fees on outcomes.

The following is an edited transcript of the discussion.

Robert Higginbotham, the moderator, starts with some opening remarks. Then each of the panellists gives a presentation, followed by a question-and-answer session with the audience.

Robert Higginbotham: Good afternoon. I'm delighted that we have such a distinguished panel to end the day. In a couple of minutes, I'm going to ask a question, and I'd like you in the audience to think about that question while our four panellists are speaking. I'll then come back to you for some answers. Yet before I get to my question, I'm going to start with some brief opening remarks.

As Tim Jones said during his luncheon remarks, a big part of setting up the United Kingdom's National Employment Savings Trust, or NEST, was to go out and ask customers what they want [see page 55]. For those of us running businesses, asking our customers to tell us what they want is a starting point. So, I thought about what our customers want when it comes to retirement provision, and I think I've designed the ideal product profile.

First, we find a product that allows you to start saving as late as possible. Next, we find a product that allows you to save as little as possible. Then, we design that product to allow you to take as little risk as possible. After that, it's really important

that you're allowed to finish saving as early as possible. Then of course, you need to have as much money as possible available at the end. That is the ideal customer product when it comes to retirement, and I'm sure that's what Tim's customer focus groups would have told him.

Yet, there is an alternative to asking customers what they want and doing market research. The late Steve Jobs, one of the greatest entrepreneurs and product developers of our lifetime, said 'You can't just ask customers what they want and then give it to them.' To me, he's saying there may be an alternative customer insight that you can't always access simply by asking customers what they want.

Let's compare two issues: one of social policy when it comes to physical health, and one of social policy when it comes to financial health.

From a physical health point of view, one of society's challenges, certainly in the West, is obesity. If you were to ask customers how to solve obesity, they might not say to eat more carrots and exercise more, but

About the panellists

Robert Higginbotham is the Head of Global Investment Services for T. Rowe Price. He is responsible for institutional distribution globally, as well as distribution via financial intermediaries in Latin America; Europe, the Middle East, and Africa; and the Asia-Pacific region.

Bernard Delbecque is Director of Economics and Research at the European Fund and Asset Management Association (EFAMA). This involves analysing data on the European fund industry, and he also is responsible for EFAMA's activities in the area of long-term savings and pension issues.

Gérard Fischer has been CEO and Chairman of the Executive Board of Swisscanto Group since March 2003. He also is the Vice President of the Swiss Funds & Asset Management Association (SFAMA), after having been its president from 2005 to 2009.

François Jacquemin is Head of Products and Solutions for Allianz Global Benefits. Before this he managed the project team that developed the unit's strategy, which focused on employee benefits globally. Jacquemin also helped build an international life insurance start-up, which became part of the Allianz Group in 2001.

Matti Leppälä is CEO and Secretary General of PensionsEurope, which is the leading voice for occupational pensions in Europe. It represents 23 European national associations of pension funds and other institutions for occupational retirement provisions (IORP). Before PensionsEurope, Leppälä worked for the Finnish Pension Alliance.

rather eat smaller doughnuts and buy a pair of training shoes, which then live in the cupboard.

When it comes to designing financial products, this is my response to Tim. As you may know, the minimum initial compulsory contribution into NEST is 2 percent, and that will rise to an enormous 8 percent by 2018. The default investment vehicle for that is a product that has 50 percent invested in real assets and 50 percent in fixed income and cash. So, in a world of allowing people to create what they think is the ideal retirement outcome, I suspect that a contribution rate of between 2 and 8 percent, invested in 50 percent equities and 50 percent fixed income and cash, is unlikely to deliver the kind of retirement outcome that our customers expect. It's easy to simplify, and I think it's easy to ask customers what they want. Yet the challenge we've taken on in our careers and industry is a lot more complex than we heard at lunch, and it's up to us to try to solve that.

In the spirit of getting insight from people who are far more knowledgeable than me, I'd like you, the audience, to think about the trade-off that we and our customers have to make between certainty—both in accumulation and in income or drawdown—and adequacy, as in the ability to make sure you have enough in both accumulation and decumulation. The question I'd like you think about is, how do we as an industry strike the right balance between giving the customer the certainty they want and giving them what we're pretty sure they need in terms of adequacy? This relates to both contributions and investment risks. I will ask your views on that in a little bit. Now I'll pass this on to François.

François Jacquemin: Thank you. I'm going to talk about the guarantee element of investment and then expand that to a broader scope. In some countries, you have elements of guarantees, where the insurance company has to provide a guaranteed return. This element can be a hard guarantee—a return guarantee plus a capital guarantee over the

lifetime of the accumulation phase and, possibly, an annuity guarantee afterwards.

This guaranteed return can be fixed for past or future savings, or it can be managed on an annual basis. In some countries, the government sets the guaranteed interest rates. In other countries, the providers set the rates. Yet there has been a trend in the industry. It's gone from very high interest guarantees to very low interest guarantees—or to no interest guarantee at all. For example, this year, we stopped providing an interest guarantee for the pension plans we have in Italy. Instead, we only provide a capital guarantee. In addition to the capital guarantee or return guarantee, we look at the insurance companies' profit. If the profit is sufficient, part of it goes to the investors or policyholders.

Now, I'd like to make a couple of points during the rest of remarks. The first one is that more people are getting older. The age pyramid is no longer a pyramid—it's more of a monolith. Let me give you some examples. At 109 years old, Robert Meier was the oldest German when he died. He had been retired for 46 years after having worked a bit less than that in the railway industry. When he retired, he never worked again and enjoyed life.

Another man, Irving Kahn, is 108. He's still alive and working as the chairman of the Kahn Brothers company. He doesn't need a retirement plan, because he's still working. My point in telling you about these two men is that it's not all about choosing for people; people should be able to have some choice in what they want. Increasingly, we see that retirees and savers want to take ownership of what they are saving, what's happening with their savings, and how they will use their income during retirement.

Yet there are important questions to consider: do they want to take ownership of everything? Do they want to choose their investments? When do they want to choose?

Another important thing to think about when looking at guarantees is that they usually are based on studies. Studies on longevity are always wrong. If we were to look at the evolution of life expectancy in several OECD [Organisation for Economic Co-operation and Development] countries during the last 150 years, you would see that we're getting older. In addition, over the last 50 or 60 years, there have been studies about how old we're going to become—and every time there was a study like that or about the evolution of life expectancy, it was wrong in a way.

Therefore, it seems pretty difficult to plan for your retirement period. During your savings period, there is a target at the end. If you take that into consideration, plus the fact that you will want to spend money during your retirement, then basing your spending on the studies we have read will not necessarily leave you with money for your later years, unless you have some form of guarantee for the longevity point. If you based your retirement planning on those

studies, it's possible that your funds did not leave you enough money to last until death. Now, let me be clear, I'm not talking about the first pillar; I'm talking about the others, either combined or separate.

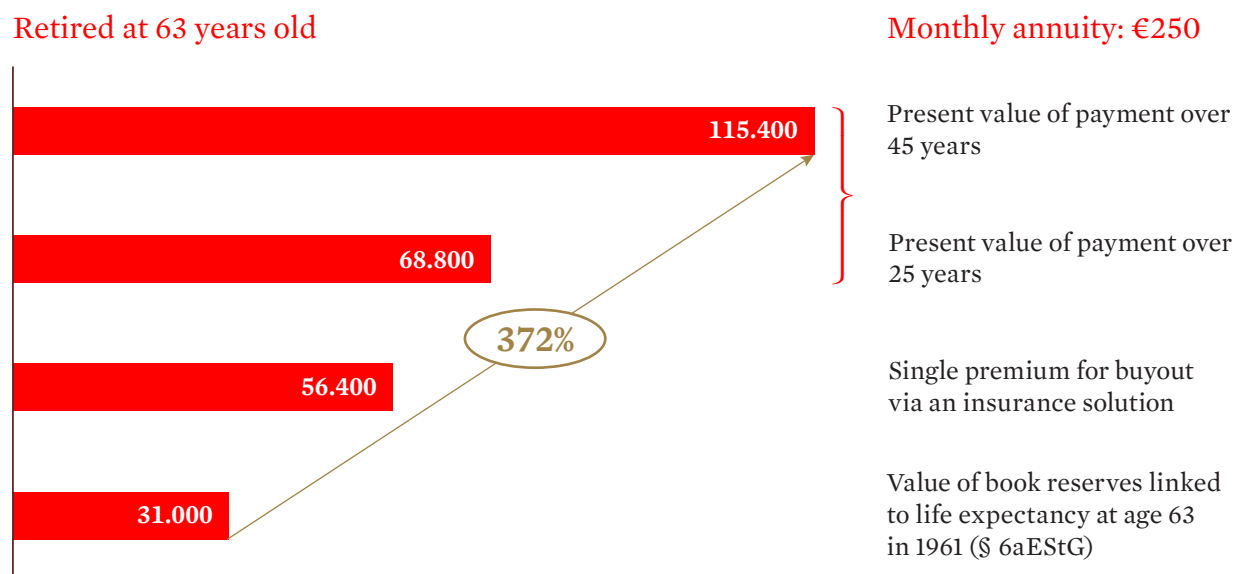
Let's return to Robert Meier with another simple example relating to cost and risk in long-term retirement. [Referring to figure 4.1] When Robert retired at 63 in 1961, the company agreed to pay him €250, flat, per month. That amount was based on the value of book reserves (€31,000) linked to his life expectancy and didn't account for inflation. To purchase an annuity for the same amount for the life term, the company would have spent €54,600.

Now, if that €31,000 was invested at the time, then after 25 years the present value of payments would have been €68,800 in 1961. Once again, that's not including inflation. And the present value of payments for 45 years, which is more or less when he died, would have been €115,400.

FIGURE 4.1

Costs and Risks in Long-Term Retirement

Value of Robert Meier's fictitious pension in euros



Prepared by: François Jacquemin (Allianz), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

Now, let me give you an example of retirement income duration sensitivity. [Referring to figure 4.2] A couple retires at age 65 with €1 million in assets. Our assumptions are that they have a life expectancy of 86 and real equity/fixed-income returns of 3.9 percent. If you look at this scenario and include the three bear market years, 2008 to 2011, then they run out of money at age 78. If they encounter a three-year period of 7 percent inflation, or an event such as the husband being admitted to a nursing home at age 75 with a cost of €3,000 a month, then they run out of money at age 83. If the husband and wife live to 95, then they run out of money at 88.

So on one hand, we can have a financial guarantee. Yet on the other hand, there are other risks that workers or retirees want protection against. For example, someone could have a family problem. Or a person could become disabled for a little while. During that time, who's going to save money? There isn't a salary anymore, so

there isn't any investment. Then what happens when that person goes back to work after five years? He or she still probably retires at age 65 or 67, but then there is a gap in saving. Therefore, there is a gap in future income.

This is what I wanted to get this panel and the audience thinking about—broadening the scope of guarantees and adding side products and ideas that could really make a difference to clients. For some investors, it's important to not only have protection against investment risk, but also additional security against other risks, such as taxation, legislative changes, death, disability, or even career breaks.

So there are many risks that need to be taken into consideration. Investment is a very important one, but it's just one. And from my perspective, it's clear that retirement and investment risks are being pushed from the employers and state to the workers and savers.

FIGURE 4.2

What is the new normal: €1M ?

Retirement income duration sensitivity (German example)

Baseline	Event	Run out of money at
Couple retiring at age 65 with €1 million in assets Real equity/fixed income returns of 3.9 percent Life expectancy of 86 years	3 years of a bear market (e.g., 2008–2011)	78 years old
	3 years of 7 percent inflation	83 years old
	Husband admitted to a nursing home at 75	83 years old
	Husband and wife live to 95	88 years old

Further assumptions: equity allocation 30 percent with 6 percent p.a. return; fixed-income allocation 70 percent with 3 percent p.a. return; monthly redemption €5,000; monthly nursing home costs €3,000; inflation rate 1.5 percent

Prepared by: François Jacquemin (Allianz), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

On one hand, the employers and the state are pretty happy because they don't have as much risk. In addition, the investment managers are happy because they get more money and can define new strategies as well as tap a bigger market. On the other hand, the employees are probably less happy because they are taking on more risk. Although some of them are pretty happy because they can take ownership of their investment choices. Yet as we've seen, lots of them stay in cash anyway. The 44 percent figure from earlier was a good indication of that [see page 44].

Thus, I think a guarantee could play an important role in supporting the industry and being a buffer between the employer and employee in a situation where the employee has to take on all the risks. Indeed, this could be a solution where both the employer and employee are happy.

Gérard Fischer: Before I start, I would like to explain the Swiss pension fund system. The information I'm going to cite is partly based on a survey we are doing at Swisscanto, which is where I work. Swisscanto is not just an asset management company; we also offer pension liability valuation services.

In Switzerland, we have a funded pension fund system that has been mandatory since 1985. The majority of the pension funds are defined contribution, or DC. Assets total about CHF730 billion; 4.9 million people are members of pension funds; and 19 percent of those members already are retired. When you retire—men at 65, women at 64—your capital typically is switched into retirement income. On average, this retirement income guarantees a 3 percent implicit return after costs—and this is for all the pension schemes in Switzerland.

So is this a good or bad deal? It's obviously a good deal if you compare it to interest

rates on state bonds in Switzerland, where ten years yield 86 basis points and 20 years yield 1.43 percent. The challenge we have as a pension system is how do we reduce the implicit cost of the system? The average cost of the system, in terms of percentage of assets with interest, is 60 to 70 basis points for asset management. The average performance of pension funds in Switzerland over the last ten years, taking into account the financial crisis, was about 3.5 percent before costs.

Now, how about sustainable retirement? We have four solutions that we propose to our clients who are thinking about both increasing retirement income and resolving the financial transfer from being an active insured person to a pensioner. It's estimated that about 1 percent of the assets in the pension system, or about CHF7 billion, is how much is transferred from active insured people to pensioners per year. This will increase with the number of pensioners and reduce the number of active insured.

The first solution, or model, is based on gains and losses every three years, so we do an average, split the pension into the fixed and variable parts, and adapt accordingly. This is a slow mechanism, however, and it leaves gaps between what should be paid and what is effectively paid.

In the second model, we examine the pension in relation to the funding ratio and adjust it according to the financial situation at the time of the individual's retirement. This model is not well liked because the pension income depends on the state of the market when the individual retires. In the third model, pensioners contribute to the recovery when there is under-coverage of liabilities—so they participate, in a way, in the risk. In the fourth model, we define the new level of retirement income on an annual basis, depending on the performance of the assets in the fund.

A new solution we are working on shows the choice you could have between a guaranteed level of retirement income or a higher retirement income that includes some risk, depending on the market. Based on that, you can, within boundaries, select which part of your retirement income is guaranteed and which part is variable. We think this could be a good thing because it offers choice and could make retirees take part of the investment risk.

Now, the topic we've been discussing is sustainable pensions, and this morning we heard about guarantees. One question is, 'What can we guarantee as asset managers or as pensions funds?' Now we are talking about guaranteeing a nominal retirement income; we all know we cannot guarantee a real retirement income. So if we want to have a sustainable pension solution, I think we first need to make clear the choices people have in nominal terms and then the risks they incur in real terms, because we don't know exactly what inflation will be for the remainder of our lives. If you retire with a good retirement income, and 20 years later, you find out it's worth only half of what it was, then you have a completely different picture. For me, 'sustainable' means that as an organisation, we have to make sure that we are still in the market, we keep our promises, and we do not compromise too much.

Bernard Delbecque: Good afternoon, everyone. I'm here in place of Professor Raimond Maurer today. I worked with him on a report titled, 'Rethinking Retirement Income Strategies—How Can We Secure Better Outcomes for Future Retirees?' We asked him to write this report because we felt that the asset management industry in Europe needed to spend more time thinking about the payout phase and not just the savings phase. The report was published five years ago, and it took Raimond more than a year to prepare it. We're pleased that, in a sense, the report is still relevant today, and it's available on the European Fund and Asset Management Association's website.

The report begins by asking, what is an annuity? One key advantage of an annuity is the so-called survivor credit. The survivor credit is the return you can expect from investing in an annuity in excess of what you can expect from investing in a bond, provided that you don't die.

The underlying force behind this excess return is the fact that if you don't die, there is still a probability that 20 percent of the cohort will die. Given that the assets pooled in the annuity don't belong to the annuitant, the surviving population then benefits from the return on those assets. Of course, this is a simplified example, but it shows the importance of pooling longevity risk and the great advantage of annuities. Now there are other advantages, including the fact that an annuity is supposed to offer a guaranteed lifelong income.

Yet, annuities also have disadvantages. Annuities are illiquid assets, so you have low flexibility and liquidity. In addition, you cannot recover the money that you used to purchase the annuity. Moreover, you cannot give the assets to your surviving relatives when you die because you don't control the assets; the insurance company owns them.

Now, what are the pros and cons of a drawdown plan, which is the basic alternative to an annuity? A drawdown plan allows an individual to own their retirement assets and invest in mutual funds—or more generally in stocks, bonds, and other types of assets—with a view towards getting a regular income to finance consumption in retirement. So with a drawdown, you get the advantages of liquidity and flexibility, the possibility of bequeathing assets to your family, and the possibility of greater benefits. Those greater benefits are linked to the investment opportunities and the equity risk premium that you're going to get from staying in the stock market during the first five, ten, or 15 years of your retirement. Thus, you could have a higher income than with an annuity, and as a result, a higher level of consumption. Of course, the drawbacks

are there is no survivor credit, no pooling of risk with other retirees and, often, no coverage of longevity and investment risks.

Professor Maurer’s report proposes a combination of life annuities and drawdown plans as the best solution. Now, there are different types of annuitisation policies and strategies. There is a partial annuitisation, in which you decide at retirement to buy an annuity with a portion of your savings. In addition, there is a switching strategy, in which you can decide to keep your assets for a number of years and then switch to a full annuitisation—let’s say at age 75, for instance. Finally, there is the deferred annuitisation, which I think the OECD highly recommends and which the World Bank also has good things to say about.

We asked Professor Maurer to compare the merits of this integrated solution and tell us why a deferred annuity is better than

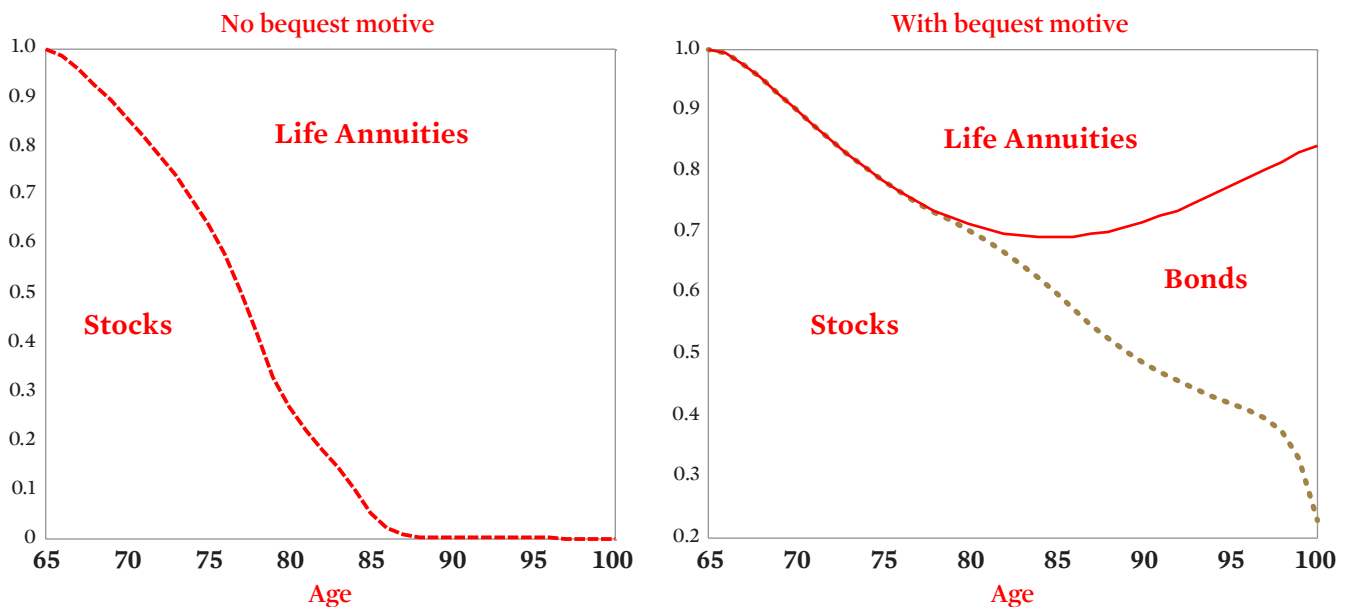
full annuitisation and whether you actually need to have an annuity. In his report, Professor Maurer developed a model to calculate the optimal investment strategies and consumption patterns in retirement. The model assumes that each individual needs to decide for each period of time how much to consume and where to invest his or assets. There also are some assumptions regarding the person’s wealth, the person’s aversion to risk, the level of guaranteed income coming in from other sources—such as a first pillar pension—and whether there is a bequest motive.

[Referring to figure 4.3] So he did a Monte Carlo simulation, which compared the optimal asset allocation for an individual with no bequest motive versus an individual with a bequest motive. Both individuals had moderate risk aversion and had accumulated some moderate wealth by the time they retired.

FIGURE 4.3

Results: Optimal Dynamic Expected Asset Allocation

Fraction



Moderate wealth/pension ratio (=5), moderate risk aversion; 10,000 life cycle, optimal feedback controls

- » First ten years of retirement predominantly invested in well-diversified stock portfolio
- » Without bequest motive, almost complete switch to annuities at age 87
- » With bequest motive, maximum investment in annuities is 30 percent

Prepared by: Raimond Maurer (Goethe University), presentation given by Bernard Delbecque at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

The simulation showed that for the individual with no bequest motive, a deferred annuity is better than moving to full annuitisation at 65 years old. At 65, the portfolio is invested entirely in stocks, and at 75, the majority of the portfolio still is in stocks. Of course, this is only one example—there are numerous examples with variation around the different characteristics of the individual—but it is not until age 87 that the individual would have switched totally to an annuity and sold the stocks.

If you assume that the individual has a level of initial wealth that is lower than in this case, you would find that the individual would be in stocks for a longer period of time. That may be counterintuitive, but in a sense, if you're poorer than the individual in our example, you would still try to get a higher income coming from the equity risk premium by staying in the stock market for a longer period of time.

For the other individual in the simulation—the person with the bequest motive—life annuities play a much smaller role. The allocation to life annuities is a maximum of 30 percent, and bonds take the role of life annuities to reduce the risk of staying in the stock market for too long. This type of result validates the OECD's and other institution's recommendations to stay in the stock markets with a diversified portfolio for a number of years into retirement. We believe it makes sense for policymakers to account for individual characteristics, particularly aversion to risk and the presence of a bequest motive, rather than forcing people to move into an annuity at 65.

Matti Leppälä: Good afternoon. For sustainable retirement outcomes, coverage and costs are important. Let's discuss coverage first. The majority of private pension schemes in Europe are still defined benefit (DB) or a hybrid of DB and DC. Yet the new pension schemes are increasingly DC, and

in some countries, they are the only option. DB plans still play a very important role, however, which is important to remember in the debate on sustainable pensions.

Now let me give some data on coverage rates in different countries. I think Australia is a successful example of auto-enrolment, because 85.7 percent of its working age population is covered. In Germany, its coverage in funded pensions used to be 2.5 percent. Now it is close to 50 percent, thanks to the country's introduction of so-called Riester pensions in 2001. The Netherlands system is quasi-mandatory and has been based on collective agreements for a long time, so it also has very high coverage—almost 89 percent.

During his speech this morning, Pablo Antolin-Nicolas advocated for mandatory systems, but mandatory is not a policy option in all countries. Anglo-Saxon countries haven't really gone for mandatory schemes; instead, they've opted for voluntary schemes. The United Kingdom's auto-enrolment scheme, which was introduced a year and a half ago, seems to be very successful. It remains to be seen what the outcome will be in a couple of years, but as Tim Jones said during his luncheon remarks, only 8 percent have opted out so far, which is very encouraging.

All in all, mandatory is mandatory, and coverage is high, except in countries with new systems. As we heard this morning, if a country has a large informal sector, you're dealing with different types of questions when thinking about ways to increase coverage. And of course, good coverage is essential for good pension outcomes.

I'd now like to discuss some of the societal reasons for different types of coverage. Coverage is better in big companies than in small- or medium-sized companies, and in the United States, the public sector has higher coverage. The unionised labour in the United States has had 67 percent

coverage and the non-unionised private sector has had 13 percent coverage. Thus, if you go for non-unionised labour markets, you will have low coverage—and in some countries, less formal work.

In addition, the nature of employment affects if you have atypical work. If you have part-time, seasonal, or temporary work, you have lower coverage. Therefore, the nature of work—and the nature of the society—has a huge impact on coverage, which is crucial for the sustainability and adequacy of the pension system. Nicholas Barr from the London School of Economics has said many things, most of which I don't agree with, but I do agree with this one. He said that the

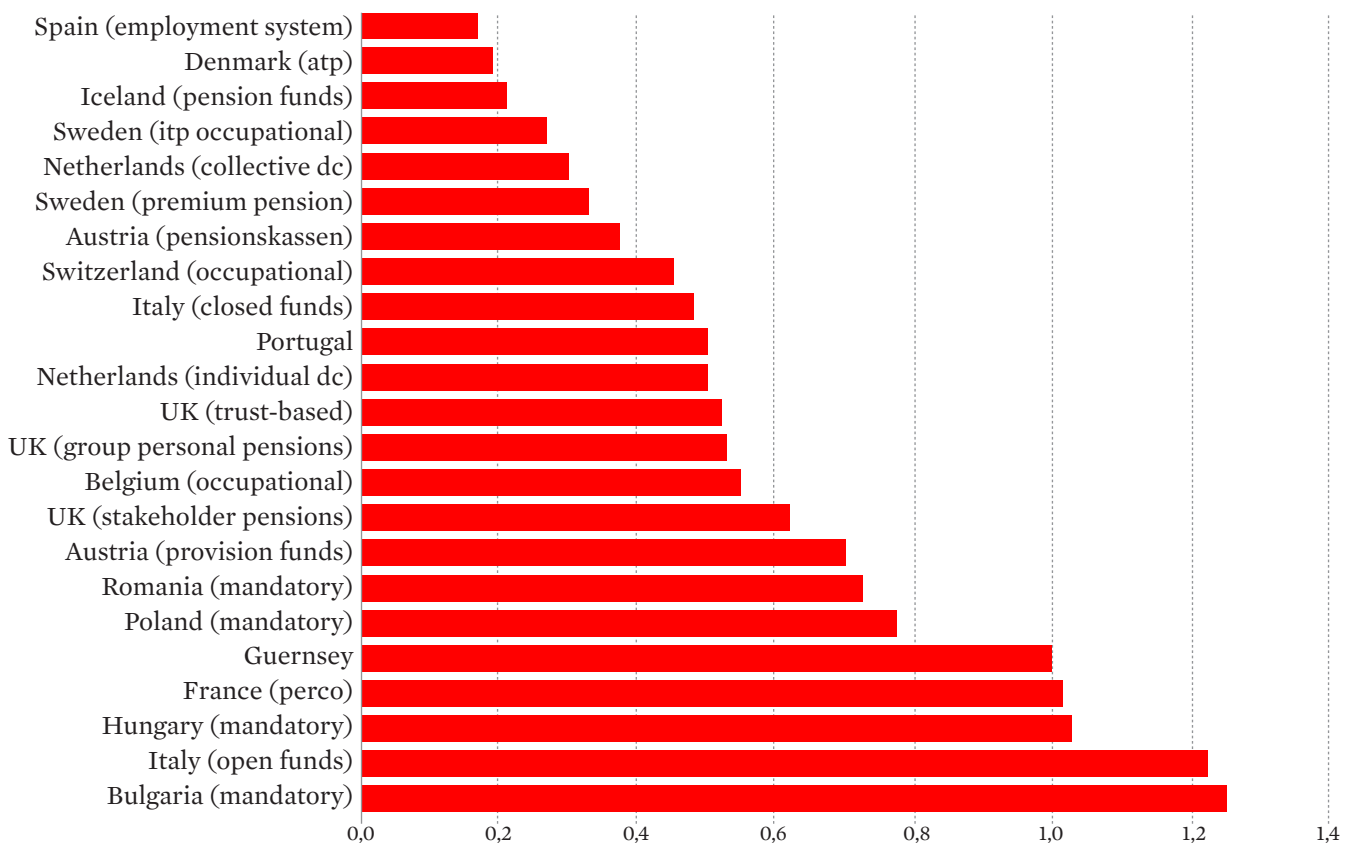
prerequisites for all pension systems are an efficient central government, fiscal stability, economic growth, and well-established financial markets that are trusted and understood by the public. So this is not about products; it's about society, the companies, and the workers. Of course, the products then make all the difference for the outcome, but these are the big issues and this is what we have to deal with.

[Referring to figure 4.4] Turning now to costs, a 2010 study shows big differences in costs, measured in expense ratios. Since then there has been pressure to lower fees in many countries, and I'm sure that will continue. In the study, the average cost was

FIGURE 4.4

Administration and Investment Costs

Percentage of assets



Source: EFRP Survey 2010

Prepared by: Matti Leppälä (PensionsEurope), presentation at the 2014 Global Retirement Savings Conference (Geneva, Switzerland)

75 basis points. The study found that 1 percent in costs means 20 percent less in benefits, and if you take the decumulation phase into consideration, 35 percent less. Thus, costs make all the difference. Of course, there are different costs, such as administrative costs and investment costs, but we believe that the important thing is that you pay for the right things and that the costs and benefits are in the right proportions. Investment costs could be high if you get value for money.

I'd now like to discuss some European developments that are relevant. Article 49 of the Institutions for Occupational Retirement Provision directive, or IORP directive, has a lot of provisions about providing information to scheme members and also about costs, especially related to disclosing information on costs. The European Commission tabled the article earlier this spring, and next it will be debated, then legislated. The European pension fund industry looked at the article, and we don't really agree with it. Many of our members don't think it fits the existing pension funds in Europe. For example, in Germany, the employer or the sponsoring company covers a lot of the costs, and it's very difficult to disseminate this type of information. Also, the Dutch have gone for a three-layered approach in providing information to scheme members, and they don't see the value added by this type of provision. Basically, I think disclosing costs is important, but a harmonised framework at the European level, such as the one proposed by the IOPR directive, doesn't make much sense. Provisions for disclosing costs need to be more diverse because the pension systems are diverse.

There are examples in many member states about how to deal with costs and disclose information. For example, in the United Kingdom, the Pensions Regulator's website has a picture that shows the different layers of costs and charges, along with a few key

points. It is very complicated, and it can be difficult to get a clear overview of the costs and then to compare. Yet, it also provides tools for pension funds to find out what the costs are, which is important.

At the European level, we also have the European White Paper on Pensions, which was published two years ago and covers several policy options. One of them is to develop a code of good practice for occupational pensions. There's a special working group focusing on that, and it's looking at elements of good practice, such as cost-effectiveness and transparency. This spring, there were a couple questions about cost-effectiveness, which were, 'What is a reasonable upper limit for costs or fees in a high-quality pension scheme? If such a limit is agreed upon, how do we prevent conversions towards it and encourage schemes to offer lower costs?' Again, we don't really believe this is something that should be done. We believe collective occupational pension schemes lead to broader coverage and cost-efficiency, but it's difficult to set these types of things at the European level. We think national diversity makes a lot of sense in this. Our British member, the National Association of Pension Funds, has adopted many codes, and one of them is on costs. Done the right way, this can lead to better practices and outcomes.

Robert, you asked about optimal pensions. I think they should be adequate, sustainable, and secure. I still think, however, that DB is alive, and I hope it remains so in the future.

Higginbotham: Thank you, Matti, and to our panellists. If you, the audience, will recall, I asked you to think about the trade-off between certainty and adequacy. Over lunch, Tim Jones highlighted some numbers showing that savers typically are four times more sensitive to negative risks than they are to opportunity for return. So we know there's a built-in demand for risk aversion.

On the adequacy side, as I said in my opening comments about NEST, we have initial contribution rates starting at 2 percent, which then rise to 8 percent. With Aussie Super, we have minimum contribution rates of 9 percent. Yet, I believe in this morning's presentation from the OECD and then from Massimo, we heard that rates need to be more towards 20 percent, so there is an adequacy gap.

I think the average DC pension pot at retirement in the United States, Australia, and the United Kingdom is around \$50,000. Yet, we've heard numerous times today that an adequate pot is more likely to be around half a million. That's an underfunding rate of about 90 percent. So we have inadequate contribution rates and pension pots, but customer demand for certainty and customer aversion to risk. As an industry, what are your thoughts on that? What are your questions for us as a panel and how do we go about navigating that?

Audience Member 1: When you think about retirement income, I think we can separate retirement into two stages. One is regular retirement; the other is advanced-age retirement—people in their mid-80s and 90s. So when we think about how to finance retirement, maybe we need to think about how to finance the two stages. The regular retirement age is 65, so perhaps the right way of financing the regular retirement phase is through savings, and then a deferred annuity could be used for advanced-age retirement. But why is there no market for the deferred annuities?

Higginbotham: I think that's a very helpful concept. In my home country, the United Kingdom, there wasn't a market for deferred annuities until very recently because we didn't have the ability to defer. So I think it'll be very interesting to see what the UK market does when that changes next year. Would the panel like to talk about why

there hasn't been a bigger market for deferred annuities?

Jacquemin: We have such products that we offer banks for their clients, but we found that the terms are not very attractive, partly because of the very low interest rates. Also, when you are 65, how do you know about what will happen in 20 years? Nobody really makes concrete plans for 85 when they get to 65.

Higginbotham: So the issues are low interest rates and then uncertainty about how long to defer.

Jacquemin: Right. Then you look at the proposal for deferred annuities and say, 'Okay, I'll have to spend the money to buy an annuity.'

Delbecque: It's about mutualising the costs and risk for people who are going to live past 85. If you consider the fact that many people are saying they won't get there, the market for insurers is very small. Therefore, the volatility will be very high for that. We can't use a large population to hedge the risk, so it becomes very expensive for a client to step into such a plan. This creates a real challenge for the insurance industry. As a solution, we want people to start receiving their annuities a bit earlier so that we have a larger population, better terms, and therefore, something more appealing to customers.

Or perhaps another way forward is an integrated solution starting at age 60 or 65. That probably would mean greater cooperation between the asset management and insurance industries. Earlier we heard that it was difficult for Schroders, but they're going to start again [see page 45]. I think using both Schroders' approach and teaming up to address people's needs for short-term and long-term solutions is the best way forward.

Higginbotham: Anything you want to say, Matti?

Matti Leppälä: I think a lot of it has been covered, but I know the OECD has recommendations and policy options for the decumulation phase and annuities. Pablo, I see you're still there in the audience, maybe you would like to share something about the thinking behind deferred annuities? We're looking into these issues at EIO-PA [European Insurance and Occupational Pensions Authority], but may I ask you to reflect on them?

[From the audience] Pablo Antolin-Nicolas: The product has to be comprehensive. The idea is that when somebody reaches retirement age, whatever age that may be, the product combines a drawdown programme with a deferred annuity—and you buy it at that time. You don't wait until you're 80 or 85 years old. The question is, why isn't the industry interested in producing it? Because for the individual, it would be cheap. Yes, the argument of low interest rates applies now, but ten years ago, there wasn't a market either.

Second, I think you have to look at the issue holistically. We've been making this point quite a bit in the United States—you can't look at our 401(k) system in isolation from our Social Security system; from the other traditional DB pension schemes, both public and private; from housing wealth, which is a form of annuity; and from individual savings outside of retirement plans. Instead, you have to look at everything together. When you do that, you begin thinking that Americans have a substantial portion of their retirement income—first, with Social Security provided on an inflation-adjusted basis. Then you add DC and DB, both private sector and public sector, on top of Social Security, along with these other forms of savings. Once you do that and combine everything, the retirement picture looks a lot better. I don't think the number referenced earlier, \$50,000, is accurate. It looks a lot better than that for American retirees. You've got to think of the whole pie.

Higginbotham: I don't know what the number is. Is it half a million? Steve, could you shed some light on the number?

So taking a holistic approach towards people's wealth and the type of pension system their country has is very important.

— Bernard Delbecque

Higginbotham: I'd like to come back to the high-level issue of the trade-off between certainty and adequacy.

[From the audience] Paul Schott Stevens: Just two quick observations. First, I don't think this issue applies only to DC pension provision. There are many participants in traditional DB pensions who have discovered there is a trade-off between certainty and adequacy, because their expectations have not been met and their pension promises have not been kept.

[From the audience] Stephen Utkus: For people with pension accounts, household accumulations are \$100,000. That's only the pension account. That's for people aged 60 to 64, but people aged 65 to 69 are roughly the same picture as well. Now, within eight to ten years, household pension accumulations for those age groups will double, as they have in the past decade or 15 years. Yet in the United States, it's not about the adequacy of DC accumulation. It's a different question: for people who aren't in DC accumulation, what's their private number?

Higginbotham: Nick, what's the number for Australia?

[From the audience] Nick Callil: The number across the whole system would be in the neighborhood of \$50,000. If you just look at people reaching retirement it's somewhere in the neighborhood of \$200,000.

Higginbotham: So in the United States it's \$100,000 going to \$200,000 and in Australia it's \$200,000. Earlier I heard that the target ought to be somewhere around half a million, so there's still some degree of shortfall.

Audience Member 2: In some ways, I think the situation is not as straightforward as a trade-off between certainty and adequacy. In fact, I think the numbers we just heard point to a certainty: if your contribution levels are inadequate, you have no chance of a decent outcome. To me, that's the point Massimo was making this morning—that we need to think about a paradigm shift in contribution levels [see page 48]. The problem then becomes inconsistency in outcomes. So I slightly disagree about the distinction between the accumulation and decumulation phases, because when we look at the modeling for the accumulation phase, we look at order of returns. You could be contributing 15 or 20 percent and have an extraordinary degree of dispersion in return, which is unacceptable to many people saving for retirement.

To some extent, this goes back to the point that François and Bernard made—we're in a world where we need to think about solutions that bridge pure asset management and insurance. Those solutions could include mutualisation, iCPPI [individualised constant proportion portfolio insurance], and a number of other approaches. Yet to persuade people to go for adequacy—to go for that 15 or 20 percent, you're going to have to make returns more consistent, both through the accumulation phase and into decumulation.

Fischer: I completely agree with Paul's statement that you need to look at the whole picture. I could be wrong, but I think most Europeans think the United States is basically about private pensions. Yet, when you look at data for the United States—with the exception of the 10th percentile—most people get their retirement income from its Social Security programme, and this is very important. When you look at data for Australia, 80 percent of people who retire do so with a public pension, and 75 percent of that 80 percent do so with a full public pension. Thus, programmes like superannuation and the 401(k) will be important issues in the future, which is why we need to talk about them. Yet currently, it's essential to look at the overall picture. But it's also important to recognise that picture is going to change.

A reduction in costs shouldn't be linked to a reduction in quality....[and] costs have to be adapted.

—*Françoise Jacquemin*

Delbecque: I fully agree with Paul and Pablo, and this also is one of the conclusions in Professor Maurer's report. When looking at individual characteristics, you need to take into account the level of an individual's first pillar pension. Some countries may be close to bankruptcy, but others still will be able to offer a reasonable state pension. Then you have to see what else either the states or countries want to offer in terms of income. Professor Maurer would say that if people reach the basic standard of living, then maybe you should just give individuals more freedom to decide about such things as risk coverage, bequest motives, and investment risk. So taking a holistic approach towards people's wealth and the type of pension system their country has is very important.

Fischer: Massimo, I'd like to comment on your proposal [see page 45]. In Switzerland, a woman took all the money out of her pension fund and spent it. Then she asked for subsidies and got them. So a question arose, was it right or not? She decided to spend all her pension fund money but then insisted she was entitled to the subsidies because she did not have anything left. So you have some moral aspects to that situation. In addition, the new level of income you need, depending on real costs, can change quite quickly. We don't know for certain what the future cost of living will be.

Massimo Tosato: The UK experience is interesting, because I think historically, UK public pensions have not been very high. Yet now the government is saying they have improved to the extent that mandatory annuitisation can be abolished starting next April. So people will be free to use the money as they please, but what will be the outcome? It will be interesting to see how society reacts if people run out of money.

Jacquemin: I want to point out that when I was speaking about guarantees earlier, I didn't mean a guarantee for everything. That depends on the person. It's very important that there's a minimum that everybody could or should have. Then there's the element of security. Do you get a minimum pension that allows you to eat and pay your bills for the rest of your life and that's it? You would not be able to travel or anything, it's just the absolute minimum? Thus, I think there is a dilemma about the level of security that everyone should be entitled to receive.

Then there's another element—the 'fun' part. When you retire, there are changes in life. There will be times that you want to spend a bit more money, and you don't want to have just the minimum. This is the idea of 'save today for tomorrow'—but

maybe it's a bit more than just that. Maybe it's 'have a little bit less fun today so you can have a bit more fun tomorrow,' that way you can actually do something during retirement and you don't have to wait for the next day to happen.

Finally, there's a third element for people around age 75 or older—when there's a little bit less ability to have fun. For these people, there could be another piece of income in the form of assistance or support. Some of these people may need help at home, but we don't know when they'll need it, so maybe there should be a minimum income that they should receive.

Higginbotham: Ladies and gentleman, one of the privileges of presenting last is that we can touch on the themes that have run through earlier presentations. One of the issues we talked about when preparing our comments was costs. I'd now like each panellist to give me some quick thoughts on cost, price, and value for money in the context of adequate retirement provision.

Leppälä: I think you should be able to invest as you please. If you want to be active, you can be. You shouldn't be pushed to just low costs. There are many costs, which leads to consolidation, and I think that will continue. There also are a lot of regulatory costs, be it investment or disclosure. These regulations can have a huge impact on costs, so I think we need to ensure that we don't pay for something that is not useful or unnecessary.

Delbecque: I think we are fully in favor of cost transparency. We support regulators' efforts, and at the European Union level, they are pushing for more cost transparency so people can have the information they need. Yet, we also believe that the European pensions market is very fragmented. There's one market per country, and you

have 28 countries. In addition, there's a lot of inefficiency because you don't have economies of scale. Thus, we also believe that policymakers should make an effort to move closer to a single market for pensions. EIOPA is working in the area of personal pension products, and we heard this morning that it has ambitions to create a single market [see pages 33–34]. I think the cost issue is policymakers' responsibility, and we hope the next European Commission will take initiative in this area.

Fischer: If you believe in a market economy, then you are looking for an efficient, cost-effective system. Simply looking at some types of costs is not enough, because in addition to regulations costs, you have a lot of opportunity costs—the things that can't be done because of regulation. That part is due to politics, which is less fiscal, but it's probably the higher part of the cost.

In Switzerland, you have the pension system and then you have additional political objectives, such as financing housing, which makes the system more complex. The additional objectives add more costs

and thus weaken the pension system's primary goal. The more goals you add to the pension system, the more you hinder its primary goal. I wish that when politicians looked at costs, they also would think about the costs of working and the hidden costs of lost opportunities, because as we've seen by looking at the funding gap, simply reducing costs by 50 percent won't solve the problem.

Jacquemin: I have two points on costs. First, a reduction in costs shouldn't be linked to a reduction in quality, and sometimes that can happen. If you simply compete on cost, then quality declines, and I'm not in favor of that. Second, costs have to be adapted. If the service is simple, the cost should be low. Yet the more sophisticated the solution, or the more freedom the individual has, the more complex services become. In that case, the costs should be higher. Thus, there should be a link between the level of service and the level of costs.

Higginbotham: Perfect. Thank you very much. We've come to the end of our panel.

Programme

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DINNER PROGRAMME

Welcoming Remarks

Dan Waters
Managing Director
ICI Global
United Kingdom

REFLECTIONS ON THE CHILEAN PENSION SYSTEM

Paul Schott Stevens
President and CEO
Investment Company Institute
United States

and

Solange Berstein
Former Head of the Pension Supervisory
Authority
Chile

18 JUNE 2014

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Welcoming Remarks

Dan Waters
Managing Director
ICI Global
United Kingdom

OPENING KEYNOTE

Pablo Antolin-Nicolas
Principal Economist
Head of the Private Pension Unit
Financial Affairs Division
Organisation for Economic Co-operation
and Development (OECD)
France

PANEL 1

Building Retirement Resources: How Do Governments and Regulators View Their Role and What Should Their Role Be?

Brian Reid, Moderator
Chief Economist
Investment Company Institute
United States

Dirk Broeders
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De Nederlandsche Bank (DNB)
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Darren McShane
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Authority
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Pensions Authority (EIOPA)
European Union

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PANEL 2

Global Differences in Investor Attitudes Towards Saving and Investing and the Strategic Challenges in Delivering Financial Advice and Education

S. Katherine Roy, Moderator
Chief Retirement Strategist
J.P. Morgan Asset Management
United States

Josef Pilger
Asia-Pacific Pension Practice Leader
Executive Director, Financial Services
Ernst & Young
Australia

Yuta Seki
Managing Director
Head of Research
Nomura Institute of Capital Markets
Research
Japan

Massimo Tosato
Executive Vice Chairman
Schroders
United Kingdom

LUNCHEON PROGRAMME

Tim Jones
CEO
NEST Corporation
United Kingdom

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PANEL 3

Use of Default Vehicles: Different Countries, Different Takes

Stephen P. Utkus, Moderator
Principal
Vanguard Center for Retirement Research
United States

Jaime de la Barra
Partner
Senior Investment Strategist
Regional Head of Business Development
Compass Group
Chile

Nick Callil
Head of Retirement Income Solutions
Towers Watson
Australia

Richard Gröttheim
CEO
AP7
Sweden

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PANEL 4

Routes to Delivering Sustainable Retirement Outcomes—Different Concepts for Differing Risk Appetites

Robert Higginbotham, Moderator
Head of Global Investment Services
T. Rowe Price
United Kingdom

Gérard Fischer
CEO
Swisscanto Group
Switzerland

François Jacquemin
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Matti Leppälä
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Concluding Remarks

Dan Waters
Managing Director
ICI Global
United Kingdom

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