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Protecting individual rights in privately managed pension plans

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Why study private pensions and the inherent risks?

Over the past several years, there has been an ever-increasing trend towards incorporating funded, privately managed pension plans into the core of a country's social security system. These pension reforms are occurring worldwide, in countries at all levels of economic and social development. This trend is driven by several factors, but primarily can be attributed to a governmental realization that, due to changing demographics, changes in workforce composition and global economies, there will be unprecedented pressure on current systems to provide a secure retirement pension. This is coupled with a growing perception that the traditional public pension system may not pay out at the expected levels, or may not be sustainable at all. In order to protect future retirement incomes, a dual structure of public and privately managed plans is being created and citizens are being actively encouraged – or required, to participate.

Under the ISSA Initiative, a consortium of four firms, headed by Callund Consulting Ltd., was commissioned to investigate the specific risks involved in privately managed retirement plans and whether or not the current regulatory framework and institutional safeguards adequately minimize those risks. The scope of the study included a variety of private pension plans, irrespective of whether they were compulsory or voluntary, occupational or non-occupational.

Who was in the study?

A cross-section of different types of schemes in ten countries, geographically dispersed, was examined in much detail. The countries selected were:

Germany, Spain, Switzerland, United Kingdom;
Hungary, Poland;
Brazil, Chile, Mexico;
Australia.

In each country, the overall structure is different. Nonetheless, the analysis of different schemes that have evolved out of different cultural and historical traditions provides some valuable insights, which should be of value to policy makers. While the circumstances surrounding a particular country's move to promote a privately managed pension system are individual, the actual types of schemes and their principal characteristics fall into four categories:

Mandatory occupational schemes (employer-based)

1. Australia: employers must make mandatory contributions. There is a residence-based means tested universal state pension system.

2. Switzerland: employers and employees must make mandatory contributions. The contributions are age and sex-related and increase with age. The resultant pensions supplement a universal state pension.

Mandatory individual accounts schemes (non-employer-based)

1. Chile: only employees and the self-employed are required to pay contributions. While there is no universal state pension, there is a means tested guaranteed minimum benefit.

2. Mexico: contributions come from employers, employees and a government subvention. The publicly managed social security pension scheme is being phased out.

3. Hungary: a dual system of state and privately managed mandatory pensions was introduced in 1997. Contributions to the private scheme come from employees and self-employed persons.

4. Poland: following the 1997 reforms, persons born before 1949 continue to participate in the old state pension scheme. Those born after 31 December 1968 must participate in a reduced state scheme and a mandatory, privately managed scheme. Employers and employees each contribute one-half of total contributions while the self-employed pay the total contribution.

Voluntary collective schemes (employer-based)

Voluntary privately managed retirement schemes are widespread and predate the mandatory schemes referred to above. They have been established voluntarily by employers and may

involve the compulsory or voluntary participation of the employees. Invariably, they supplement state pension schemes.

1. Brazil: "Closed funds" (i.e. funds in which the membership is restricted to the covered employees of the sponsoring employer(s)), provide pensions for employees and are supplemental to state pensions. These are commonly based on defined contribution arrangements, but sometimes on defined benefit plan in which case the employer acts as guarantor of the promised pensions. 'Open funds' wherein membership is not restricted to the employees of certain employers are generally based on a defined contribution plan.

2. Germany: Supplementary employer-based pension schemes, in five different constitutional forms, complement the state pension system.

3. Spain: Voluntary supplementary pension schemes were introduced in 1987 and can either be sponsored by a single large employer, or, where each of the employers has less than 250 employees, by a group of employers. The terms of a scheme are subject to collective bargaining between employers and employee representatives.

4. United Kingdom: Voluntary schemes supplement a universal state pension. They may also be used as a basis of contracting out of the state second pension, a mandatory second tier of state provision. Defined benefit schemes, the most common, are now being replaced by defined contribution schemes, as employers' reluctance to be guarantor of last resort becomes more widespread.

Voluntary individual schemes (non-employer-based)

Personal pension-savings arrangements constitute a fourth type of system. These were not examined in detail as they were outside the scope of this study.

What was learned?

The study looked at several key indicators to examine the quality and extent of protection members may have in a privately managed retirement scheme. Specifically:

a) How well protected are employees in acquiring coverage, vesting, preserving, and transferring rights?

b) What risks are associated with the schemes including political, professional, financial and inflationary? Also examined in this section are the risks associated with the timing of cashing out accumulated capital and converting it to annuities.

c) Is information about the scheme easily accessible by the member?

d) What institutional safeguards, by virtue of licensing, authorisation and regulation exist? Do governance structures support members' interests?

e) What impact have regulations had in controlling risk and protecting rights?

Findings

a) Access to membership and preservation of contributions

While overall the study revealed that basic access was protected across mandatory schemes, there are still some weaknesses that need to be addressed. For example, lower-paid workers are excluded from some mandatory plans (Australia and Switzerland), thus leaving those individuals who may be least likely to be able to save for retirement reliant on the basic pension.

Similarly, it was found that vested rights were relatively easily acquired in both the mandatory and voluntary schemes. For example, in mandatory employer-based schemes, contributions vest immediately, similarly in mandatory non-employer-based schemes (Chile, Hungary, Mexico and Poland), the assets of the pension account are undisputed property of the member. Likewise, in voluntary schemes the benefits, including those provided by employer contributions, generally vest in the member as they accrue. They are regarded as a form of deferred compensation. Exceptions were in Brazil and Germany – although, in Germany, the vesting provisions are, progressively, being improved. Thus, in many countries, privately managed retirement schemes give members legal title to benefits as they accrue.

However, the preservation of the real value of vested benefits is at risk. If, on changing employment, an employee retains a deferred benefit in his previous employer’s scheme, its value may erode over time, as it may not have been indexed to keep pace with inflation.

Portability of accrued rights across borders is still impeded by fiscal and other regulations although, within the European Union, steps have been taken to facilitate cross-border consolidation of accrued rights. The analysis shows that individuals will remain vulnerable to losing pension value, or not receiving the full benefits due, based on contributions made, until such time as the transferability or portability of pensions – both within a country and across borders is made possible.

b) Risks

Each type of scheme has its own inherent set of risks and clearly the study could not undertake a detailed look at each discrete type. However, there are overarching management risks that are common to all pension systems. The primary risk involves maintaining a viable scheme that not only can meet the current demands for benefits but also is flexible enough to grow to meet future demands.

All privately managed retirement schemes are heavily invested in the securities markets. Savvy and responsible management must anticipate and militate against declines in the market place. While the ultimate bearer of the risk differs between defined contribution plans (employee) and defined benefit plans (employer/sponsor), the outcome of ineffective management is a potential decreased value in the pension fund. Portfolio diversification can mitigate this risk. In emerging and transitional markets, however, as was seen in the study, pension fund investment may be limited to national markets where the ability for diversification is not great.

The problem of inflation needs to be addressed. With the exception of Chile, and to a lesser extent, Mexico there is no guarantee against the consequences of inflation on the real value of pensions. Traditionally, because they were deemed to reflect the real value of a growing economy share, equity investment has been the common practice to guard against this. Use of index-linked bonds, linked to the consumer price index has been used successfully to address this in Chile, Mexico and the United Kingdom. However, such index-linked bonds are not available in most countries. This may be one tool that policy makers may wish to

explore when developing strategies for combating inflation and associated erosion of benefit values.

As in the case of the fund manager, there are strategies available to potential retirees to lessen the effects of financial downturns. For example, timing the conversion of the pension account's capital into an annuity is one. However, such precision may not be feasible in a real world scenario. The lesson here is that individual pensioners should not be placed in a situation where they bear the entire timing risk exposure. Being able to rely on a state pay-as-you-go pension and/or a minimum guaranteed benefit, as well as the private plan might bring some balance to pension security. A flexible pension age, not tied directly to retirement would also permit flexibility in managing the reserves for both the annuitant and the fund.

c) Access to information

In all countries, there are requirements for extensive information to be provided to members and to regulators. While the level of detail that each group needs may differ, relevant information concerning the management and performance of the funds, as well as the individual entitlements of members is essential. For example, members should receive simple and transparent information on contributions, investment returns, portability options, etc., whereas the supervisory institution should receive detailed audited accounts, actuarial examination details, solvency information, etc. Communication and information sharing demand a delicate balance so that critical issues are not obfuscated and sufficient details are provided to users for sound decision-making.

If members are to make informed decisions, adequate information must be provided to them. Generally speaking, such information, including an annual benefits statement, which is clear and concise, is provided to members. In Hungary and Spain, however, no explicit requirements are stated. Sound practice would be to require the provision of adequate and appropriate information to members.

It is, of course, necessary for the staff of the regulator to be able to analyze the information effectively and detect any weaknesses. Training of staff is an essential requirement for good regulation - particularly where many schemes make up the system.

d) Institutional safeguards

In all countries, there is an umbrella of public regulation and control of privately managed schemes. Mandatory schemes are essentially compulsory savings arrangements and as such are regulated more tightly than voluntary schemes. In 1981, Chile introduced an institutional model wherein non-State, private, for-profit firms manage mandatory funds under the supervision of a state supervisory body. This model, requiring the establishment of a specific pension fund institution designed for mandatory pensions has been adopted and applied in Hungary, Poland and Mexico.

A set of institutional safeguards revolves around the analytical tools used to oversee the management of the funds. Pension professionals in Anglo-Saxon countries prefer qualitative investment controls, based on the prudent-person principle. For mandatory schemes, however, as the study showed, it is now common practice for quantitative limits to be applied to the investment instruments of a pension scheme portfolio. These limits are put in place to prevent an over concentration of a pension fund's assets in a limited range of higher-risk investments. But, quantitative regulations can require such assets to be invested in a single domestic market and in government bonds in that country. Not only does this inhibit diversification, it exposes a pension fund to the risk of default on government obligations – which is not unknown.

In Chile and Poland, privately managed schemes must provide a rate of return within narrow margins of the mean rate of return of all schemes in the system. This has a conservative influence on the investment-management practices of all such schemes.

In all countries, formal constitutional structures are required. The qualifications for managers varied widely among the countries. For example, Hungary, Mexico, Poland and Spain apply rigorous criteria. In Chile, however, no special conditions govern the quality and professionalism of managers. The close regulation and supervision of the pension funds is deemed to be sufficient in itself. A similar practice applies in Switzerland. In Australia and the United Kingdom, pension fund trustees must meet defined standards and observe the provisions of Trust Law.

This is one aspect of attention to governance. Another is the degree of representation of members within the managing bodies of schemes. In the employer-based schemes in Australia, Brazil, Spain, Switzerland and the United Kingdom, the governing bodies include representative of the employers and the employee-members.

e) Regulations

In most countries, regulators have extensive powers to enforce their provisions. The available tools include on-the-spot inspections, seizure of documents and summons to provide information. In each case, sanctions can be applied where breaches occur. The scale of sanction should, however, be proportionate to the severity and impact of the breach. For example a technical breach may not endanger benefits for any of the members.

Monitoring of schemes takes different forms, driven largely by the number of schemes that are to be monitored. In Chile, Hungary, Mexico and Poland, for example, the number of schemes is small, thus easier to oversee. Regulators in Chile and Hungary have on-line access to the pension funds' records. In Australia, Germany, Spain, Switzerland and the United Kingdom, where many approved pension schemes exist, such hands-on oversight is not practical. In countries where there are a large number of pension schemes, it is difficult for the regulatory body to address all issues at all times. Whistle-blower laws can effectively provide an additional means of "oversight".

However, it must be noted that there is the risk of over regulation. There is a delicate balance that must be maintained between effective oversight and accountability and suffocating rules that are detrimental to the sustainability of pension funds. For example, the study suggests that if the regulation of voluntary defined benefit schemes becomes intrusive and administratively expensive, a sponsor may reassess and potentially alter the provisions of the scheme, perhaps to the detriment of the membership.

Given the complex nature of pension financing and the importance of the benefits to each member, misunderstandings arise. In some jurisdictions, seemingly intractable problems are resolved by an approach to an "ombudsman". This enables an impartial judgement to be made on the underlying merits of each side's understanding in a dispute. In many countries, however, there are inadequate means of redress for individuals. In some cases, it is necessary for individuals to institute proceedings in courts. This can be expensive, complicated and, possibly, intimidating. Dispute resolution is an area that requires further consideration by regulators.

Conclusions

Over the past 20 years, many governments have endeavoured to reduce their prospective liabilities for social security pensions. At the same time, they have tried to ensure that privately managed schemes are introduced or encouraged, so that adequate financial security in old age might be built up. The development of mandatory, funded defined contribution schemes has been part of this movement.

As the study has shown, preserving the rights and financial security of the members is of primary concern. There is, however, no single 'best-practice' approach to the constitution of these schemes. Good governance must be practiced in order to assure that the retirement plan fulfils its obligations. Thus, it is incumbent upon both the management team and the individual investors to actively engage in planning for and maintaining financial security. Portfolio diversification, mitigating the effects of inflation and flexible planning for retirement can ease the financial transition into retirement.

The greatest threat to retirement pension security comes from price inflation, which is outside the control of individual pensioners or those who are responsible for the operations of privately managed retirement schemes.

Overall, the study found that basic access to mandatory schemes was protected throughout the countries that were studied. Vesting and preservation of benefits were core features of schemes. However, much work still needs to be done to preserve benefit values for retirement and when workers change jobs and schemes. This is especially important as we face an increasingly mobile labour force.

The critical role that access to information and disclosure plays is recognized in the rules and regulations of the schemes. While the level and breadth of information that regulators and members need differs, relevant information pertaining to management, performance, as well as individual investment status is essential. There is a balance that must be maintained in order to ensure that issues are not hidden and that sound decisions can be made.

In all of the countries there is an umbrella of public oversight and control of the privately managed schemes. This is especially important for the mandatory schemes, which are essentially compulsory savings arrangements. Regulators have extensive authority to ensure compliance and the extent of oversight varies, but this is primarily due to the number of schemes that need to be monitored.

Effective tools that can assist with oversight, compliance and problem resolution are the institutionalisation of "whistle-blowers" (and protection thereof) and the establishment of an ombudsman. The introduction of whistle-blower laws has resulted in bringing detrimental practices to light. Similarly, the role of the ombudsman can have a positive impact on fund practices and assuring that the rights of members are protected.