B International experience — default funds in pension systems

In 1994, the World Bank undertook a review of pension systems in various countries. It recommended that pension systems should consist of three pillars.

1. A mandatory, publicly-managed and tax-financed pillar (like Australia’s old-age pension).
2. A mandatory, privately-managed and fully-funded pillar (like Australia’s superannuation system).
3. A voluntary pillar (individual savings) (World Bank 1994).

Many countries have since adopted a three‑pillar model for their pension system. However, there is still considerable scope for differences between countries within the World Bank’s framework, such as the default arrangements in mandatory pillars or the degree to which competition between funds is permitted. This appendix focuses on these features, examining:

* New Zealand — for its process for selecting default KiwiSaver providers
* Sweden — for the national default fund which all members are allocated to when they do not exercise a choice of fund
* Chile — for the high administration costs imposed on individuals as a result of extensive marketing expenditure by funds, and the recent reforms that have led to a single default fund
* the Netherlands — for its industrial relations system which determines pension funds for workplaces and industries
* Hong Kong — for the roles that stakeholders play in choosing funds and the presence of industry‑specific funds.

## New Zealand

In 2007, New Zealand introduced KiwiSaver, an automatic-enrolment, voluntary savings system administered by Inland Revenue. Employees are automatically enrolled in the system and can contribute a minimum of two per cent, and a maximum of eight per cent, of their gross wages to the system. Individuals can opt out of KiwiSaver if they wish, and can opt back in at any time. There are several incentives to join and contribute to KiwiSaver schemes, including government contributions, fee subsidies, employer contributions and tax incentives. In general, contributions to KiwiSaver products (schemes) are preserved until members reach superannuation age (65). However, members may make a one-off withdrawal when buying their first home (Commission for Financial Literacy and Retirement Income nd).

As in the Australian system, all individuals in New Zealand are free to choose their own KiwiSaver scheme. Where an employee has not made a choice, they are automatically enrolled in their employer’s chosen scheme (if the employer has made such a choice) or in one of six default schemes. According to section 50 of the *KiwiSaver Act 2006* (NZ), default members are allocated on a ‘sequential’ basis between the appointed default schemes. The default providers were determined by the New Zealand Government prior to the commencement of KiwiSaver, and a retendering process is expected to take place in 2014.

### Default provider selection process

The Ministry of Economic Development conducted an ‘open, competitive tender process’ (Inland Revenue 2011a) in 2006 to appoint default providers. In making their decisions, Ministers received advice from independent external experts who carried out detailed evaluations of the applicants.

Criteria used to select default providers included:

* security and organisational credibility
* organisational capability
* proposed design of the provider’s Default KiwiSaver Scheme
* administration capability
* competitive fee levels
* investment capacity/capability (Cullen 2006, 2007).

Littlewood (2012) made several criticisms of the 2006 process for selecting default providers, arguing for changes to be made to the process when the default providers are reviewed in 2014. Criticisms included that the 2006 process:

* was not transparent, with:
* poor disclosure of the Government’s reasons for decisions
* decisions seemingly made on a ‘least risk to Government’ basis, rather than in the best interests of members
* provided a competitive advantage to default providers without any compensation, through:
* the automatic enrolment of default members
* the reputational effect of being endorsed by Government, which attracts additional members
* appointed too many default providers, given the small size of the New Zealand market.

### Default KiwiSaver providers

The New Zealand Government appointed six default providers:

* ASB Group Investments Limited.
* AMP Services (NZ) Limited.
* ING (NZ) Limited.
* Mercer Human Resource Consulting Limited.
* National Mutual Corporate Superannuation Services Limited (trading as AXA New Zealand).
* TOWER Employee Benefits Limited (Cullen 2007).

Each of the default providers have aspects of their products set by Default Provider Notices. The Notices took effect from the time the providers were appointed, and are valid until 30 June 2014.

The Notices specify:

* that between 15 and 25 per cent of member assets are invested in growth assets
* that default providers must ensure that non-default investment products are available to members of the default KiwiSaver scheme
* fee types and amounts that may be charged to members
* reporting requirements for default providers.

The set of default KiwiSaver schemes applies consistently to all individuals in New Zealand. This contrasts with Australia, where default superannuation products are determined by award through the industrial relations process, or by workplace through the enterprise bargaining process. No suggestions have been made in commentaries of the KiwiSaver system that different default schemes should apply to different individuals.

However, one notable difference between the two systems is the absence of bundling of other components with KiwiSaver schemes — that may optimally vary by industry — such as insurance.[[1]](#footnote-1)

Some features of default KiwiSaver products have set benchmarks for the rest of the industry to follow. For example, the requirement for default products to have low fees is thought to have encouraged price competition amongst all providers (Ministry of Economic Development 2010). This indicates that mandated features of default products can play a role in shaping competition in the industry more broadly.

The decision to impose a conservative investment strategy on default schemes has been a point of debate in New Zealand. Although conservative strategies have meant members of default KiwiSaver schemes fared relatively well during the recent economic downturn, they may not be in the long-term best interests of members. Over a long time horizon, growth strategies will outperform conservative strategies (Basu and Drew 2009). However, the investment time horizon of some KiwiSaver members may be quite short as they can, on a one‑off basis, withdraw the balance of their account to purchase their first home.

### Role of stakeholders

The New Zealand Government, Inland Revenue, KiwiSaver providers and employers all play a role in administering the KiwiSaver system for employees and other members.

Apart from the Government providing concessions and appointing default providers, Inland Revenue handles much of the administration supporting KiwiSaver. All employee and employer contributions are received by Inland Revenue, and then forwarded on to the relevant KiwiSaver provider. Organisations seeking to register a KiwiSaver product must seek certification from Inland Revenue. To become certified, organisations must meet specific criteria (Inland Revenue 2011a).

KiwiSaver providers must complete a scheme provider agreement, which defines the relationship between the provider and Inland Revenue. The agreement details both operational and technical requirements. Providers must produce an annual report including audited accounts and membership details, and lodge an annual statistical return with the Financial Markets Authority (Inland Revenue 2011b). Providers must also send and receive information in a secure and timely manner, using automated processes and a single standard for business‑to‑business communications with all scheme providers. Providers must ensure that they are integrated with the central KiwiSaver business‑to‑business gateway (Inland Revenue 2007).

Employers are generally required to act as an intermediary between employees and Inland Revenue. They must:

* provide a KiwiSaver information pack to employees who are to be automatically enrolled, and those who choose to opt in
* where the employer has chosen a KiwiSaver scheme, provide employees with information about that scheme
* make compulsory employer contributions of two per cent of the employee’s earnings to Inland Revenue, in addition to the contributions deducted from the employee’s earnings
* provide information to Inland Revenue about employees enrolled in a scheme (Inland Revenue 2009).

Employees can choose a scheme other than their employer’s chosen provider or the default provider they have been allocated to. They may also choose between the contribution rates of two, four or eight per cent of their pre-tax earnings. If they do not wish to be enrolled in a scheme, employees can opt out between two and eight weeks of starting their job (Inland Revenue nd).

## Sweden

Sweden has a three-pillar pension system, with a second pillar known as premium pension, which is similar to Australia’s compulsory system. The premium pension system is centrally administered by the Swedish Pensions Agency (SPA), which also has responsibilities for other types of pensions. The SPA is funded by an annual fee imposed on each individual pension account of 0.3 per cent of assets.

On behalf of each employee, employers contribute 2.5 per cent of wages to the employee’s premium pension account. The contributions are paid to the National Tax Authority, together with the employer’s monthly tax obligations. The National Tax Authority then forwards the premium pension contributions to the SPA.

The SPA acts as a clearing house, forwarding contributions to pension funds chosen by each individual. The pension funds then invest the contributions. The SPA also keeps account records for members of all funds, functioning as a single access point for all individuals seeking information about their accounts. Benefit payments are also administered by the SPA.

To facilitate choice of pension funds for individuals, the SPA maintains a catalogue of premium pension funds. The catalogue lists each fund, along with a description of its total capital, fees, returns over the last five years, and a measure of risk. The catalogue is freely available to the public and funds are not charged a fee to appear in the catalogue. When it was first introduced in 2000, the catalogue listed 456 funds. It now includes more than 800 funds. Working-age adults are asked to choose a fund from the catalogue. If no choice is made, the individual’s contributions are allocated to a single national default fund (Stewart 2005; Weaver 2005).

### The national default fund

Initially, two thirds of individuals chose a fund other than the national default fund, although the default fund attracted more members than any other fund. Women and younger people were more likely to make an active choice. Since the inception of the system, the proportion of individuals choosing a fund other than the default has fallen significantly. As a result, membership of the default fund as a proportion of total members in the system has risen from 33 per cent in 2000, to 42 per cent in 2010 (Cronqvist and Thaler 2004; Johannisson 2010).

The fund has followed a strategy of minimising costs in order to reduce fees for members. It has achieved this through comparatively small marketing and investment expenditures — the majority of the fund’s assets are invested passively. The fund has also targeted a high level of growth. Until 2010, between 70 and 90 per cent of assets were invested in equities, with the majority in foreign equities (Weaver 2005). In 2010, the fund shifted to a lifecycle investment strategy. Now, 100 per cent of member assets are invested in equities until members reach 55, then a gradually increasing proportion is shifted to fixed income investments as members age (Johannisson 2010; Palmer nd).

#### Low costs

The Swedish system demonstrates the benefits that can be achieved by a single national default fund with small marketing and investment expenditures. Rather than having default members allocated across various funds, concentrating them in a single fund achieves scale benefits, spreading fixed costs more thinly across the membership of the fund. The default fund engages in limited marketing activities as its purpose is simply to receive and invest the contributions of individuals who make no choice of fund. Also, the passive investment strategy employed by the fund results in minimal trading costs and fees to investment analysts.

Total fees charged to members of the Swedish default fund amounted to 0.6 per cent of assets in 2005, and this is projected to decline to less than 0.3 per cent by 2025 (Impavido, Lasagabaster and García-Huitrón 2010). This is considerably lower than fees observed in most other pension systems around the world, including the Australian system (Tapia and Yermo 2008).

The use of a passive investment strategy has not diminished returns for members. The investment performance of the default fund has exceeded that of the median pension fund in Sweden (Stewart 2005).

In addition to the Swedish premium pension system achieving low costs for members, costs experienced by employers and funds are also reduced through centralised administration. The single payment that employers make once a month covers all their employees, and is combined with their tax payment to reduce administrative costs. As payments for all employers are made to a single organisation, it standardises and simplifies employer obligations.

#### State management

One common concern around state-run funds is the degree to which investment decisions are politically motivated. This does not appear to have occurred with the Swedish default fund (Turner 2006), but the default fund has — to a greater extent than private funds — made investment choices based on social and environmental issues. It has disinvested in companies found guilty of violating international conventions to which Sweden adheres, including conventions on human rights, labour, the environment and bribery and corruption. In 2004, 38 companies were on the default fund’s investment exclusion list, including some large multinational companies. This raises the question of whether the investment returns of participants in a national fund should be diminished in order to pursue social goals (Turner 2006; Weaver 2005).

#### Marketing issues

When the system was implemented, the Swedish Government commenced an extensive advertising campaign encouraging individuals to choose their fund. The only way individuals could gain membership in the default fund was by not making an active choice, and they were prevented from rejoining the fund if they subsequently made an alternative choice. In addition, free advertising was provided for alternative funds in the form of the catalogue produced by the SPA.

Initial advertising by alternative funds focused on their past performance and level of local investment. As a result, the fund to attract the largest share of members (other than the default) was Robur Aktiefond Contura, which had increased in value by 534 per cent over the preceding five years. However, the fund lost 70 per cent of its value over the next three years, and was significantly outperformed by the default fund over this period (Cronqvist and Thaler 2004).

## Chile

Chile was one of the first countries to implement a three-pillar pension system on which the World Bank’s recommendations were based. Pension reform in 1981 introduced mandatory individual accounts. Since its introduction, the system has undergone various changes.

Chilean workers contribute 10 per cent of their earnings, plus a fee for administration and insurance of approximately 2.3 per cent of their earnings, to an authorised pension fund (*Administradoras de Fondos de Pensiones* — AFP) (Iglesias-Palau 2009). The contribution is administered by employers on behalf of their employees. Before 2010, it was the responsibility of employees to choose both an AFP and the investment option within that AFP, but this has since changed (see below).

There are currently six AFPs. The entrance of new AFPs is restricted, and subject to government approval (Business News Americas 2007).

The types of investment options each AFP may offer are defined by legislation. Each fund must offer four options — B through E — and has the option of offering a fifth option — A. Funds are not permitted to offer any other investment options. Each investment option is restricted in the amount of each asset class it may invest in. Option A is a high growth option, with funds permitted to allocate as much as 80 per cent of member assets to equities. The level of risk and growth assets declines through the investment options to option E, which may only invest in cash and fixed interest. Individuals who do not choose an investment option will be placed by default into option B, C or D depending on their age (Ferreiro Yazigi 2003).

Administrative fees for members were high in the 1980s and 1990s as a result of large marketing expenditures by AFPs. It was common practice for AFPs to recruit large sales forces that were paid commissions for attracting new members to the fund. Incentives such as small appliances were frequently offered to potential members (Turner 2006). Between 1982 and 1998, average marketing costs for AFPs ranged between 21 and 52 per cent of total expenses (James et al. 2000).

The marketing costs in the system have subsided over time as a result of three factors. First, the Government imposed restrictions on the frequency with which individuals could switch between funds, and regulated the use of sales agents. Second, consolidation within the industry has reduced the competitive forces that drove marketing expenditure (Holzman and Hinz 2005). Third, the introduction of an auction process focusing on fees to determine the default provider has helped to create price-based competition (Social Security Administration 2012).

In 2010, the requirement for employees to make a choice of AFP was removed. Instead, all employees commencing work with an employer are automatically allocated to a single default AFP. Employees may still make an alternative choice if they wish. The default AFP is determined every two years by an auction process where the AFP that offers the lowest administrative fee is authorised as the default fund for the next two years. The fund maintains its position as the default provider during those two years unless:

* another fund offers a lower fee for at least two consecutive months
* another AFP provides a higher rate of return sufficient to make up for a higher administrative fee, or
* it violates AFP regulations (Social Security Administration 2012).

## Netherlands

It is not mandatory in the Netherlands for all employees to maintain individual pension accounts. However, industrial relations processes have led to a requirement for most employers to contribute to individual pension accounts for their employees. Where employer and employee representatives in a particular industry agree on pension arrangements for employees in that industry, the Government will usually make such arrangements mandatory for all workplaces in the industry. Where such industrywide arrangements are not present, many employers voluntarily contribute to individual pension accounts on behalf of employees. As a result, 90 per cent of employees in the Netherlands are covered by such arrangements (VB and OPF 2012).

Most pension funds in the Netherlands serve only one industry or workplace and it is typical that only one fund will cover the workforce of any particular industry. There are 95 industrywide funds and 543 single-employer funds. Most employees are members of industrywide funds (Kakes 2006).

Almost all funds in the Netherlands are defined benefit funds, with pension benefits determined by the average wage of the employee over their working life. Most have some unique features not commonly found in defined benefit systems in other parts of the world. For example, where funds are in financial difficulty, employers, employees and members in retirement may be required to contribute to the fund’s recovery (VB and OPF 2012).

The governance and operation of Dutch pension funds are highly regulated. Funds must:

* be run on a not-for-profit basis
* have a board of trustees made up of equal numbers of employer and employee representatives
* serve the interests of all stakeholders, including members and employers
* not vary the contribution rate between members
* not require medical examinations for members joining the fund (VB and OPF 2012).

## Hong Kong

The Hong Kong pension system’s second pillar is known as the Mandatory Provident Fund (MPF) system. The system was introduced in 2000 and replaces the voluntary Occupational Retirement Schemes Ordinance system.

Employers and employees are each required to contribute an amount equal to five per cent of the employee’s income to the employee’s individual MPF account, up to a cap of HK$1250 per month. Employees earning less than HK$6500 per month are not required to make contributions. However, employers in Hong Kong must contribute to an MPF fund for employees, regardless of how much the employee earns (this contrasts with Australia — see chapter 2).

There are 40 authorised MPF funds offering an aggregate of 445 products. All are run by for-profit companies in the financial services sector. In order for a fund to become an authorised MPF fund, it must:

* comply with Hong Kong law and regulations
* be controlled by trustees that maintain professional indemnity insurance and meet criteria on capital adequacy, financial soundness and fitness and propriety
* comply with prescribed standards relating to internal controls and investment of assets
* be subject to ongoing monitoring by the MPF Schemes Authority (MPFA 2012).

The funds and their products are listed on the regulator’s website.

### Employer and employee choice

Under the MPF system, employers are required to choose one or more MPF funds and enrol each employee in a fund. Employees may choose any product within the fund chosen by their employer. If an employee does not make a product choice, they default into the fund’s conservative product. Each fund is required to offer a conservative product, which may only invest in bank deposits and money market instruments.

Employees may set up personal accounts with MPF funds of their choice and make voluntary contributions to those funds. They may also transfer benefits between any of their accounts, including the account into which their employer contributes. However, employees do not currently have the right to choose the fund that their employer contributes to.

Legislation will come into effect on 1 November 2012 that will allow employees to choose their own fund. The change is intended to increase price competition among funds, which was found to be lacking in a 2007 report by the Hong Kong Consumer Council, when compared with other countries such as Australia. The introduction of employee choice has been delayed several times due to concerns over aggressive marketing strategies that might be employed by funds and their salespeople after the legislation is introduced. Legislation will require salespeople (who may be bankers, fund managers or insurance agents) to be registered with the MPF Schemes Authority. Salespeople will also continue to be regulated by the three different regulators in their respective industries. Penalties will apply to salespeople who mislead customers (MPFA 2012; Yiu 2011).

### Industry funds

There are two non-public offer ‘industry funds’ in Hong Kong, both of which may be chosen by employers in the catering and construction industries. The funds are run by for-profit trustees that also administer some public‑offer products. These industry funds were set up to deal with the high labour mobility and the practice of paying wages on a daily basis within those industries. Employers in the catering and construction industries are not required to enrol employees in these funds. However, there are benefits that can accrue to employees and employers using the industry funds. Costs associated with frequently changing funds are minimised for employees to the extent that their new employer uses the same fund as their previous employer. Employers can also benefit, as they are exempted from having to provide casual employees with monthly pay records if they pay contributions for those employees into an industry fund (MPFA 2012).

1. Life insurance in New Zealand is voluntary. There are no requirements for insurance to be bundled with other products or for individuals to hold any insurance cover. [↑](#footnote-ref-1)