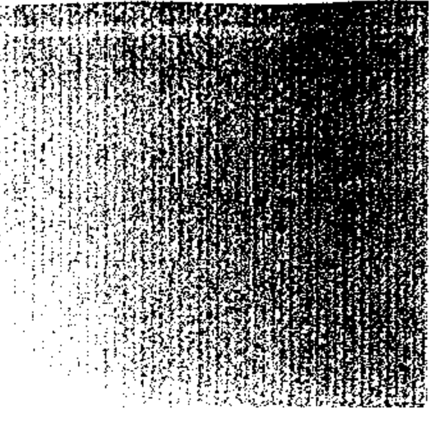
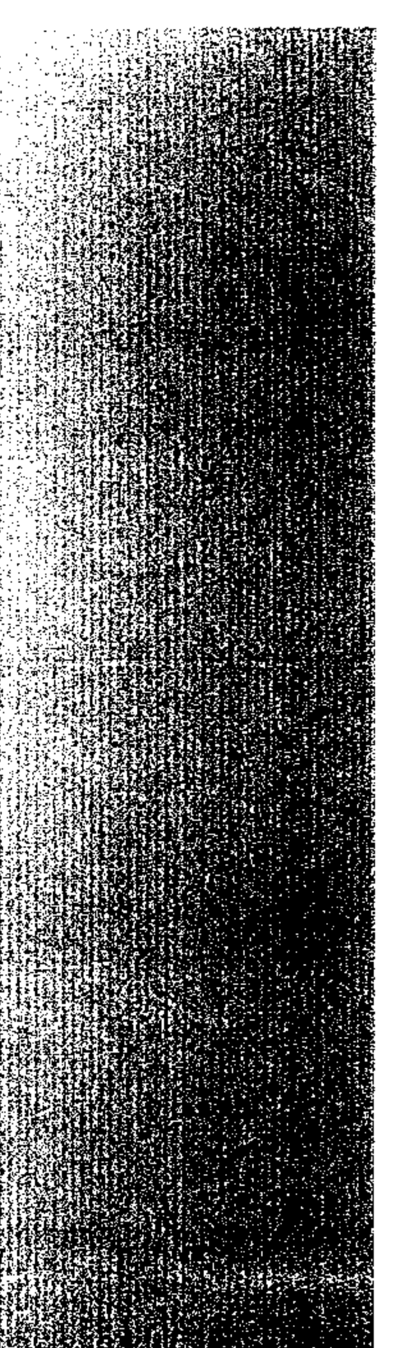
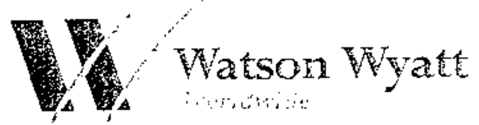


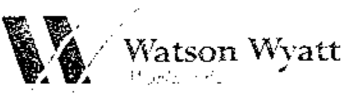
Pension Provision in Malta





Pension Provision in Malta

Watson Wyatt Limited
Actuaries & Consultants
4 August 1998



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Pension Provision in Malta

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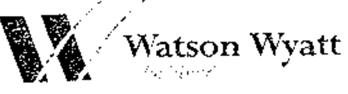

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1 Introduction

The purpose of this report

1.1 We have been asked by the Maltese Government supported by sponsoring insurance companies Middle Sea Insurance Company Limited and Mid-Med Life Assurance Company Limited to prepare a report on pension provision in Malta from an actuarial perspective. In this report we specifically comment on.

- The results of a model that was developed to assess the finances of the current state pension arrangements in Malta ("the current scheme"). In particular, this includes an assessment of the financial consequences of modifications to the current scheme and the sensitivity of the financial results to the underlying economic and demographic parameters assumed in the model.

- The implications of an alternative scheme for pensions arrangements not only in terms of its financial consequences but also in terms of the necessary regulatory framework that would be required.

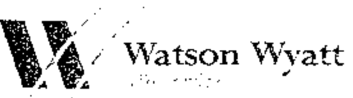
1.2 We were also asked to report on pensions provision in other countries and this is the subject of a separate report.

1.3 In carrying out our work we identified the considerable amount of research on this topic which has already been carried out in Malta by the Government and other institutions. Where this research has been made available to us we have tried to avoid, as far as possible, duplication of existing reports but rather have focused on the issues involved from an actuarial perspective. In accordance with our brief, our objective is to provide policymakers, potential pensions providers and the "social partners" with a framework within which the detailed policy options can be evaluated and implemented as is considered appropriate.

The structure of this report

1.4 Our main findings are set out in the section "Executive Summary". Subsequent sections provide in more detail a description of the financial model that has been developed, the results generated in various scenarios, the options involved in establishing an alternative approach to providing pensions in Malta, and the regulatory implications of adopting a new pension regime which involves some participation from the private sector.

1.5 In the appendix to this report we enclose additional work carried out by Watson Wyatt which we consider relevant to the issues under consideration.



1.6 We would emphasise that we feel it important that this report be read in its entirety since otherwise it is possible that misleading conclusions could be drawn. We would draw particular attention to section 6.

1.7 Our brief was to set out the main issues from an actuarial point of view and not to make definite recommendations. In this report we have at certain points expressed opinions where we feel this is helpful. Ultimately however we consider that any decisions on the future of pensions arrangements in Malta must be one for the Government of Malta recognising that any reform will need the support of the people and institutions of Malta. We see a clear next stage as being that of consultation with the interested social partners in Malta on ways forward leading subsequently to firm proposals and appropriate legislation and implementation.

1.8 Watson Wyatt Limited would welcome the opportunity to discuss, expand, or clarify any of the issues raised in this report and to assist in the practical issues arising from a change in the pensions regime if this is considered to be appropriate.

2 Executive Summary

Overview

2.1 In this section we summarise the main findings and issues described in more detail in the subsequent sections of this report.

Key findings concerning the current scheme

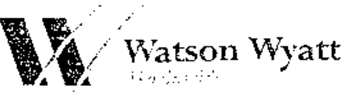
2.2 The results of projections generated by a financial model of the current scheme using a central set of economic and demographic assumptions indicate that:

- The most likely scenario is that pensions costs based on current benefits will increasingly exceed pensions contributions based on current contribution levels.
- If the projected shortfall in contribution income is expressed as a percentage of GDP it is only in about 10 years' time that the shortfall increases significantly and the current scheme's finances deteriorate. This suggests that there is time to introduce any changes in a gradual way if this is considered appropriate.
- Even if more optimistic assumptions are adopted the long term financial stability of the current scheme remains questionable.
- If the policy objective is to balance the income and outgo of the scheme then it is necessary to reduce benefit outgo and/or increase contribution income. In practice this means considering policy options involving reducing benefit levels, increasing the retirement age, or increasing contribution rates. Of the options that were examined a policy of limiting the rate of increase in pensions to the increase in prices (rather than the increase in wages) appears to be particularly effective in bringing the scheme's income and outgo into balance.

2.3 If the decision is taken that the current scheme should be reformed so that contribution income and pensions outgo will be balanced then further decisions will be necessary on the nature of the change and the pace of its introduction. The issues are:

- A change which is immediate would probably be more easily understood by the general public and more easily administered.
- A change which is gradual in nature is less likely to disrupt the pensions expectations of the public and this is particularly important for those near to retirement. A change which is gradual in its effect presents the Government with the opportunity to make modifications and adjustments in the light of the scheme's financial experience.

On balance our view is that a phased change to the current scheme is preferable particularly since the indications are that for Malta the "shortfall" problem is more of a medium term problem.



The second tier of pension provision

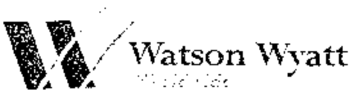
2.4 If the benefits provided by the current scheme are modified then it would be natural to consider if it would be appropriate to introduce a second tier of pension provision. If such a second tier is introduced the main issues to be considered are:

- What level of benefits should the state provide through the first tier and what benefits should the second tier arrangement provide?
- Should the second tier be funded or pay as you go?
- Should the second tier be state sponsored or private sector?
- Should the second tier be on an individual level (personal pensions) or at a collective level (employer sponsored)?
- If the second tier is on a funded basis should the benefits be on a defined contribution or a defined benefits basis?
- Should contributions to the second tier pension be compulsory?
- If the second tier pension is private sector how should it be regulated by the state? Should the state offer tax incentives to encourage the second tier?

2.5 As in Malta these questions are the subject of considerable debate in many developed countries seeking to deal with demographic trends undermining the finances of their traditional pension arrangements. In appendix A to this paper we attach work done by David O Harris of Watson Wyatt concerning developments in Australia and evidence to the US Senate. Many of the questions noted above are addressed in these papers and it may be that the Australian model is of some relevance to Malta.

2.6 We discuss the issues involved for Malta in more detail in sections 4 and 5 of this report. In summary our view is that if the state pension scheme is modified to ensure that it is financially self sufficient then there is a strong case in Malta for a second tier pension. We would suggest that the features of a reformed pensions system be:

- The state pay as you go system providing a basic "safety net" level of pension.
- A second tier providing additional pensions.
- The second tier pension should be on a funded basis.



2.7 We think that if such a system is envisaged then there would be considerable attractions in the second tier pension being on a defined contribution basis sponsored by the private sector (i.e. employers, unions and individuals) and on a personal basis. Our reasons for suggesting this approach centre around the need for a flexible system which avoids as far a possible duplication of administrative effort and which is clearly understood by the Maltese public.

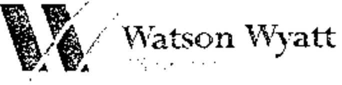
2.8 Difficult decisions will be required in relation to the extent to which contributions to the second tier should be compulsory - there is a case (see appendix A) which suggests that without compulsion some sections of society will not save sufficient amounts to provide meaningful second tier pensions. Additionally decisions would be needed on the transitional arrangements (we favour a steady transition over a period of years in order to avoid excessive disruption of the public's current pension expectations).

2.9 If such a system were to be introduced successfully then we consider that it would be essential for it to be supported by an appropriate regulatory framework and for the system to have the support of all the social partners in Malta.

The next steps

2.10 We see the next steps as being:

- Decisions on the broad structure of pensions reform.
- Projection/costing of the proposed design.
- Decision on the structure in the light of the financial projections.
- Consultation
- Final design and costing
- Legislation and implementation.



3 Financial model of the current state scheme

Overview

3.1 In this section we present the results of a financial model projecting future pensions related costs. We have taken as our starting point the current pensions arrangements and input key economic and demographic assumptions into the model in order to generate the necessary projections. Because the results are sensitive to these economic and demographic assumptions which inevitably will prove to be incorrect to a greater or lesser degree, we have produced alternative projections illustrating the sensitivity of the model results to variations in key parameters.

3.2 The second stage of our work on the financial model has been to input into the model various alternative designs of pensions benefits so that the impact of modifying current arrangements can be assessed.

The model

3.3 The main features of the model are as follows:

- A projection of the Maltese population by age and sex up to 2025.
- Assumptions concerning per capita amounts spent each year on pension benefits.
- Assumptions concerning the progression of GDP up to 2025, the percentage of that GDP represented by wages and the percentages of those wages representing contributions towards pensions costs.

3.4 In the short to medium term the numbers of retired persons and those becoming newly retired can be predicted with relative certainty since the principal factor influencing the numbers of persons drawing pensions will be mortality. Thus the parameters influencing the outgo on pensions will be those relating to the rate of increase in benefits and to any changes in the current benefit structure.

3.5 In the short to medium term the projections of income are likely to be much less robust since they will depend on assumptions about employment patterns, the progression of GDP and wages as well as any changes in the current contribution rates.

Key economic and demographic parameters

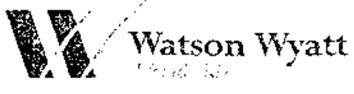
3.6 The "central" economic and demographic assumptions that have been adopted are as follows:

- A population projection as follows:

Year	Total population aged 16 to 60	Males over 61	Females over 60
1998	234,013	25,603	35,789
1999	235,942	26,107	36,481
2000	237,619	26,615	36,938
2001	239,568	26,910	37,186
2002	241,649	27,002	37,244
2003	244,055	26,995	37,956
2004	245,233	27,585	39,360
2005	244,976	28,954	40,736
2006	244,679	30,209	42,124
2007	244,165	31,520	43,647
2008	243,214	32,939	45,033
2009	242,137	34,296	46,219
2010	240,932	35,533	47,349
2011	239,669	36,770	48,327
2012	238,913	37,695	49,223
2013	238,177	38,578	50,022
2014	237,555	39,409	50,864
2015	236,822	40,267	51,684
2016	236,009	41,182	52,543
2017	235,140	42,089	53,407
2018	234,260	42,990	54,195
2019	233,613	43,719	54,998
2020	232,973	44,409	55,733
2021	232,400	45,080	56,277
2022	232,120	45,671	56,732
2023	231,978	46,122	57,014
2024	232,202	46,191	57,195
2025	232,579	46,511	57,243

- 90.9% of males and 23.9% in 1998 increasing to 28.1% by 2017 of females are eligible for pensions.

- 36.6% of eligible females receive widows pensions



- Pensions per capita pa of LM1,843 in 1998 increasing by 6.9% pa
- Bonus payment per capita pa of LM186 in 1998 increasing after each 10 years by 50%.
- GDP of LM1,202.2 million in 1998 increasing as follows:

Year	Rate of nominal increase pa in GDP (%)
1999	6.3
2000	6.6
2001	7.8
2002	7.9
2003	8.1
2004	7.2
2005	6.3
2006	6.3
2007	6.2
2008	5.9
2009	5.9
2010	5.7
2011	4.5
2012	4.9
2013	4.9
2014	4.9
2015	4.8
2016	4.7
2017	4.6
2018	4.6
2019	4.7
2020	4.7
2021	4.7
2022	4.9
2023	4.9
2024	5.2
2025	5.2

- Wage bill taken as 48% of GDP
- Inflation of 3% pa
- Employers contribution rate of 10% of wages
- Employees contribution rate of 8.3% of wages
- 11% of contributions not collected

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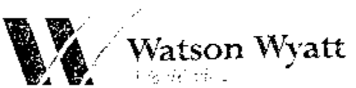
Results on the central assumptions assuming no change in the current scheme

3.7 The projected income and outgo in respect of pension benefits are as follows:

Year	Income LM million	Outgo LM million	Income minus outgo LM million	Income minus outgo as a percentage of GDP %
1998	94.2	105.3	(11.2)	(0.9)
1999	100.1	113.9	(13.8)	(1.1)
2000	106.7	122.9	(16.2)	(1.2)
2001	115.0	131.9	(16.9)	(1.2)
2002	124.1	140.7	(16.6)	(1.0)
2003	134.1	150.9	(16.7)	(1.0)
2004	143.8	169.9	(26.1)	(1.4)
2005	152.8	187.5	(34.7)	(1.8)
2006	162.5	206.6	(44.1)	(2.1)
2007	172.6	227.7	(55.1)	(2.5)
2008	182.8	250.9	(68.2)	(2.9)
2009	193.5	275.5	(82.0)	(3.3)
2010	204.5	302.0	(97.5)	(3.7)
2011	213.8	330.0	(116.2)	(4.3)
2012	224.2	358.9	(134.6)	(4.7)
2013	235.2	389.8	(154.6)	(5.1)
2014	246.8	433.6	(186.8)	(5.9)
2015	258.7	469.7	(211.1)	(6.4)
2016	270.9	509.8	(239.0)	(6.9)
2017	283.4	553.0	(269.6)	(7.4)
2018	296.5	599.4	(302.9)	(8.0)
2019	310.5	648.9	(338.3)	(8.5)
2020	325.1	701.2	(376.1)	(9.1)
2021	340.4	757.3	(416.9)	(9.6)
2022	357.0	816.1	(459.1)	(10.1)
2023	374.6	878.0	(503.4)	(10.5)
2024	393.6	939.3	(545.4)	(10.8)
2025	414.5	1007.7	(593.2)	(11.2)

3.8 As can be seen on the central assumptions the projections indicate that the deficit steadily rises but that as a proportion of GDP the most serious deterioration begins in about 10 years time. This suggests that there is time for the issues to be carefully considered and if necessary orderly arrangements be implemented. The net deficit would, we assume, need to be made up by the state either through higher taxes, or from other elements of the Governments budget or at least in the short term through increased borrowings.



Alternative key assumptions

3.9 It is important to appreciate how sensitive the central results in 3.7 are to changes in key assumptions. For this reason we examined the impact of a change in one key parameter assuming no change in the current scheme design:

- Rates of growth in GDP 0.5% pa higher than in the central basis (but with no change in the rate of increase in pensions benefits). This might in part be attributed to a higher than anticipated proportion of young women entering the workforce - these women would have the immediate effect of increasing the level of contributions but their impact on pensions outgoings would not be significant until very many years into the future.
- Pensions benefits increase by 0.5% pa more than in the central basis (but with no change in contribution income).
- The proportion of contributions not collected reduced to 5.0% (from the central assumption of 11%).

3.10 The results of these projections can be summarised in terms of the projected income minus outgo of the pension scheme as a proportion of GDP:

Income minus outgo LM million

Year	Central basis %	GDP growth higher %	Higher growth in pensions %	Higher proportion of contributions collected %
1998	(0.9)	(0.8)	(1.0)	(0.4)
1999	(1.1)	(0.9)	(1.2)	(0.6)
2000	(1.2)	(1.0)	(1.4)	(0.7)
2001	(1.2)	(0.9)	(1.4)	(0.6)
2002	(1.0)	(0.8)	(1.3)	(0.5)
2003	(1.0)	(0.7)	(1.3)	(0.4)
2004	(1.4)	(1.1)	(1.8)	(0.9)
2005	(1.8)	(1.4)	(2.2)	(1.2)
2006	(2.1)	(1.7)	(2.6)	(1.6)
2007	(2.5)	(2.1)	(3.1)	(2.0)
2008	(2.9)	(2.4)	(3.5)	(2.4)
2009	(3.3)	(2.8)	(4.0)	(2.8)
2010	(3.7)	(3.2)	(4.5)	(3.2)
2011	(4.3)	(3.6)	(5.1)	(3.7)
2012	(4.7)	(4.1)	(5.7)	(4.2)
2013	(5.1)	(4.5)	(6.2)	(4.6)
2014	(5.9)	(5.2)	(7.1)	(5.4)
2015	(6.4)	(5.6)	(7.7)	(5.9)
2016	(6.9)	(6.1)	(8.3)	(6.4)
2017	(7.4)	(6.6)	(9.0)	(6.9)
2018	(8.0)	(7.1)	(9.7)	(7.5)
2019	(8.5)	(7.6)	(10.4)	(8.0)
2020	(9.1)	(8.1)	(11.1)	(8.5)
2021	(9.6)	(8.6)	(11.7)	(9.1)
2022	(10.1)	(9.0)	(12.4)	(9.5)
2023	(10.5)	(9.4)	(13.0)	(10.0)
2024	(10.8)	(9.7)	(13.4)	(10.3)
2025	(11.2)	(10.0)	(14.0)	(10.7)

3.11 As with the central assumptions the results show a deficit which though rising is relatively stable - the major deterioration in the schemes finances begins in about 10 years' time.

Changes in pension scheme design

3.12 Naturally one response to a projected worsening in the pension scheme's finances is to consider the implications of changing the scheme itself. In common with the approaches taken by other governments throughout the developed world the options fundamentally consist of one or a combination of increasing the contribution rates required or reducing the benefits provided. The reduction benefits can take a number of forms such as limiting the level of benefits increases (e.g. in line with price inflation as opposed to wage inflation), limiting the levels of pensionable salary or increasing the retirement age.

3.13 A more radical solution for Malta to reduce the financial burden on the state scheme would be to permit some degree of opting out of the state scheme in favour of a private sector funded pension arrangement.

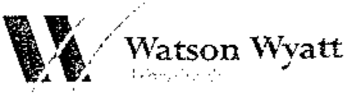
3.14 The model has in the first instance been run on the central basis assuming that the current scheme is amended as follows:

- The level of pensions are limited to increase by not more than the rate of increase in prices taken as 3.0% pa. This means that as a proportion of the average wages benefits are assumed to fall.
- The same pension age of 65 is adopted for both men and women.
- The overall rate of contribution from employers and employees is increased by 1% of the wage bill (perhaps 0.5% from employers and 0.5% from employees).

3.15 The results of these changes can be summarised in terms of the projected income minus outgo of the pension scheme as a proportion of GDP:

Income minus outgo LM million

Year	Central basis %	Benefits growth limited %	Pension age increased to 65 %	Contributions increased %
1998	(0.9)	(0.9)	0.9	(0.5)
1999	(1.1)	(0.8)	0.8	(0.7)
2000	(1.2)	(0.7)	0.7	(0.8)
2001	(1.2)	(0.4)	0.7	(0.7)
2002	(1.0)	0.0	0.6	(0.6)
2007	(2.5)	0.0	0.2	(2.1)
2012	(4.7)	(0.3)	(1.7)	(4.3)
2017	(7.4)	(0.7)	(4.2)	(7.0)



3.16 The above results are illustrated on the basis that the change being examined is implemented immediately. In practice for reasons of fairness to persons just about to retire it would probably not be practical to introduce such a "big bang" approach - it would be necessary to introduce a transitional arrangement which would have the impact of diluting the effect of the change at least over the medium term.

3.17 It is noticeable that limiting the growth in benefits appears to be one of the most effective ways of containing the deficit. Increasing the pensions age is beneficial in the medium term but in the very long term deficits reappear.

3.18 In the scenarios where the state benefits are effectively reduced (either by limiting the rate of growth in benefits or raising the retirement age) it would probably be reasonable to permit individuals to make some measure of pensions savings via a second tier pensions. Possible options are discussed in the following sections. The indications from the above model on the central assumptions are that if benefits were limited surpluses would arise enabling the state to provide some incentives to develop an additional funded provision.

4 Alternative pension scheme structures

Overview

4.1 In this section we discuss the decisions needed and the advantages and disadvantages of the alternatives if a decision is made in principle to introduce a second tier scheme for pensions provision involving an element of funding for retirement as opposed to a scheme based entirely on "pay-as-you-go" principles.

4.2 There are clearly a number of possibilities ranging from:

- Moving to virtually no state first tier pension with the population dependent on the second tier for virtually all their pensions - this system is likely to be criticised as too harsh and socially divisive.
- A system with virtually all pension being provided from the state first tier pension (operated on a pay as you go basis) with a minimal second tier for those (probably the better off members of society) wishing to make additional pension provision. The difficulty with this approach is that is does not address the increasing shortfall in funding pensions that is projected to arise in the future.

4.3 In practice we think that the most acceptable of the available frameworks is likely to be based on the concept of a basic state pension operating on the lines of the current scheme (providing a basic safety net. albeit for reduced benefits compared with the current scheme) supplemented by an additional funded second tier scheme. For this reason we have concentrated on this approach at this stage.

A funded second tier pension

4.4 The main advantages of establishing the second tier on a funded basis are:

- Funding defines quite clearly the pension entitlements and contributions of individuals. Unlike pay as you go arrangements funded schemes are not vulnerable to the same extent to demographic changes in the ratio of pensioners to workers and changing attitudes in the acceptable levels of contributions from the working population.
- The assets generated by funded schemes produce a pool of capital which some economists argue is beneficial to the operation of the economy - in the case of Malta some of this capital might be invested overseas giving the finances of the schemes an exposure to growth in other economies.

4.5 Disadvantages of the funding approach are:

- There is a need to achieve a rate of return on invested assets. If assets producing a real rate of return after allowing for inflation are not available then this may make this approach to financing pensions costs inefficient.

- It is necessary to ensure that appropriate arrangements for the proper management and administration of the pension fund assets are made. If expensive regulatory, administrative or distribution systems are necessary then the value of the benefits can be eroded.

Defined benefits or defined contributions

4.6 If the second tier approach is funded it will be necessary to decide on whether to adopt a defined benefits or defined contribution system.

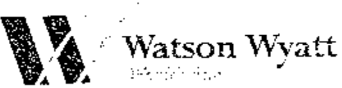
4.7 The main advantage of a defined benefit approach is:

- The potential pensioner knows that his or her pension benefits will be a proportion of (usually) final salary the proportion depending on the length of service. In many ways this is the best form of benefit since the persons retiring will be able to relate his or her income and standard of living to their standard of living immediately prior to retirement.

4.8 Potential disadvantages of defined benefits schemes are:

- The funding of the benefit promises is on an actuarial basis and the level of contributions may need to be adjusted from time to time (depending in particular on the investment performance of the fund) to ensure that benefit promises can be kept. This lack of certainty in contribution levels and the relative degree of administrative complexity means that defined benefit schemes are generally only suitable for larger pension schemes where economies of scale in relation to the expenses of operating the scheme can be achieved and schemes with a sponsoring employer or groups of employers for industry wide schemes (or in the case of Malta the state if the second tier pension is state run) to provide funding as a last resort in the event of a deficiency arising.

- When employees change jobs complicated issues can arise in relation to whether a pension should be preserved in the scheme of his old employer or whether a transfer payment should be made to the scheme of his new employer (and in this case how should the transfer payment be calculated).



- Because at the detailed level defined benefits schemes are complex they can be difficult for regulators to supervise - legislation governing the operation of defined benefit schemes can become extensive in order to prevent abuses of the system.

4.9 Defined contribution schemes offer the following advantages:

- Contribution levels are certain.
- A fund can be built up for each individual so that transfers between schemes (or preserved pensions) do not require complicated or contentious calculations.
- Compared with defined benefit schemes administration, supervision and regulation is facilitated because of the more transparent nature of the defined contribution arrangements.

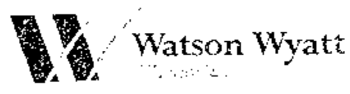
4.10 The main disadvantage of defined contribution schemes is:

- There is no certainty about the level of pension that will be paid since this will depend upon the investment performance of the individual's fund up to the date of retirement and the annuity that the fund at retirement can purchase. Clearly as an individual approaches retirement estimates can be made of the likely level of pension that will be payable (and contribution levels adjusted accordingly) but the fundamental feature of defined contribution schemes is that the investment risk is borne by the potential pensioner rather than as with defined benefit schemes the sponsoring employer.

Voluntary or compulsory

4.11 If a funded second tier pension is introduced a decision is required on whether contributions are to be entirely voluntary or compulsory and in the latter case at what level. The issues for consideration by policymakers are:

- An entirely voluntary system is likely to result in certain sectors of society not saving enough to provide meaningful pension over their first tier basic pension. This is likely to be the case even if tax incentives are given in respect of pension savings.
- A compulsory system if not properly communicated to the public could simply be viewed as another form of taxation.



4.12 Our view is that that to encourage meaningful levels of saving some tax incentives (ideally as far as possible initially financed from the revisions to the first tier system) are appropriate. However we feel that this is by itself is unlikely to be sufficient on its own to encourage the necessary savings - hence we feel that there should be some compulsory level of saving required from employees and employers, expressed as a percentage of salary. The level of such contribution that will be acceptable to the public is difficult to judge. We would favour a modest level of compulsory saving combined with a third tier pension which would be voluntary for those whose wish to make additional provisions. Clearly if this policy option were to be introduced then there would be a need for a strong public education program on why it was necessary to ensure that adequate pensions savings are made.

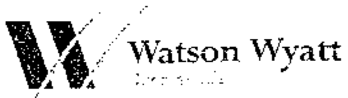
State or private sector

4.13 A key issue is whether the second tier should be operated by the state or by the private sector on a regulated basis. The advantages of the state operating the system are:

- A single system could operate on a consistent basis and to some extent economies of scale could be achieved.
- The necessary expertise in administration and investment could be obtained by subcontracting these functions to appropriate institutions.
- Some supervisory costs would be saved.

4.14 The advantages of allowing the private sector to operate the second tier pension would be:

- There would be freedom of choice for the public.
- Competition amongst providers might result in a improved service for the public.
- Although there would be some additional regulatory costs (although this might be charged to the providers themselves) the cost to the state of providing the necessary administration would be removed.



4.15 A compromise position would be to establish a state second tier scheme but give individuals the option to opt out and take out a private pension. Our view is that in the context of Malta this compromise is not particularly attractive. If it was adopted we think there is a risk of confusion in the mind of the public between the state and private second tier schemes and there would be the cost to the state of both establishing its own scheme (and presumably marketing it in competition with the private sector) and at the same time incurring the costs of regulating the private sector.

5 Regulatory considerations

Overview

5.1 In this section we consider the regulatory issues that would need to be addressed if a form of funded private pension arrangement were to be permitted.

Security

5.2 From the viewpoint of the state it is essential that any private organisations involved are subject to the highest degree of financial security and operated with the utmost probity. Also we think that it would be important to ensure that the costs to the state of supervising private pension fund providers are as far as possible contained. This would suggest that a system of licensing of private pensions providers is necessary but as far as possible this should be based on the regime operated by the MFSC in relation to financial institutions. Key points of the regulatory regime should include:

- Controls on the directorship and management of pension providers.
- Regular, audited financial statements and returns to the MFSC in a form to specified by the MFSC.
- A requirement for the provider to be financially sound - perhaps a requirement for a margin of solvency to be maintained could be required.
- Segregation of moneys held to provide pensions moneys from the shareholder fund of the providers.
- Powers of intervention for the MFSC and the power to withdraw approval as a provider (and require the transfer of pensions moneys to another provider).
- Requirement of the provider to maintain appropriate data records, to follow appropriate administrative procedures and to maintain appropriate financial records.

Other issues for consideration

5.3 There are a number of other key issues to be addressed and decisions to be taken by policymakers if a funded second tier pension is to be introduced:

- Given the importance of pensions to the economy of Malta and its citizens is there a case for restricting providers to locally based institutions at least initially.

- Should the investments of the funds be restricted in any way? For example should there be a requirement to hold a certain proportion of assets in Malta as opposed to overseas? Should there be guidance on the broad categories of assets that can be held (e.g. bonds, equities, property etc.) . We should add that our view is that if the second tier pension is on a defined benefit basis then it is important that a prudent balance investment policy is followed. However we consider that this is best enforced through the mechanism of returns to the MFSC and the supervisory powers of that body as opposed to prescriptive specific legislative limits (which may become too rigid to operate satisfactorily).

- Should providers be required to contribute to a compulsory insurance scheme to protect against default by a provider? On what basis should this insurance scheme be established?

- Should the expense charges made by pensions providers be restricted or subject to a statutory disclosure regime?

- If a defined benefit system is operated how should the annuity market (required to convert the pension fund at retirement into an annuity) be operated? Should funds be obliged to purchase annuities off approved insurers or will the state provide the annuity?

- If employers, groups of employers or trade unions wish to establish second tier pensions for their employees or members should this be permitted. In our view this should be allowed provided all the necessary regulations and safeguards are met by these institutions. In practice this might require the establishment of a vehicle to act as the provider by these institutions and it might be that these providers would find it more efficient to subcontract certain functions to suitably experience institutions (e.g. fund managers, banks, insurance companies).

6 Reliances and limitations

Reliances

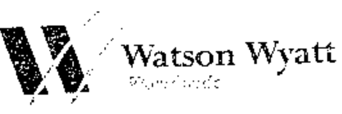
6.1 In producing this report we have relied without independent verification upon the accuracy and completeness of the data and information provided to us, both in written and oral form, by [insert full list of data providers]. Where possible, we have reviewed the information provided for reasonableness and consistency with our knowledge of the relevant demographic and financial parameters appropriate to Malta.

6.2 Reliance has been placed upon, but not limited to, the information listed in appendix B.

Limitations

6.3 The report has been prepared by Watson Wyatt Limited on an agreed basis to meet the specific purposes of [relevant department/state office/organisation], sponsored by Middle Sea Insurance Limited [and Mid-Med Life Assurance Company Limited] and must not be relied upon for any other purpose. The report has been prepared for use by persons technically competent in the areas covered. Except with the written consent of Watson Wyatt Limited, the report must not be reproduced, distributed or communicated in whole or in part to any other persons or organisations, or be relied upon by any other persons or organisations. The report must be considered in its entirety since individual sections, if considered in isolation, may be misleading. Draft versions of the report must not be relied upon by any person or organisation for any purpose. No reliance should be placed on any advice not given in writing. If reliance is placed contrary to the guidelines set out above, Watson Wyatt Limited disclaim any and all liability which may arise. Any reference to Watson Wyatt Limited in any report, accounts or other published documents is not authorised without prior written consent.

6.4 Assumptions are made about future experience, including economic and demographic experience. These assumptions have been made on the basis of reasonable estimates. However, actual future experience is likely to differ from these assumptions, due to random fluctuations, changes in the operating environment and other factors. Such variations in experience could have a significant effect on the results and conclusions of this report. No warranty is given by Watson Wyatt Limited that the assumptions made in this report will be reflected in actual future experience.



6.5 This Report was based on data available to Watson Wyatt Limited at, or prior to, 4 August 1998 and takes no account of developments after that date. Watson Wyatt Limited are under no obligation to up-date or correct inaccuracies which may become apparent in the report. Any limitation of liability in this report shall be construed to the fullest extent permitted by law. If any part of a provision of this report is held invalid, illegal or unenforceable then the remainder of such provision shall remain in full force and effect.

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[4 August 1998]

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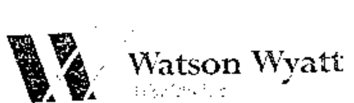
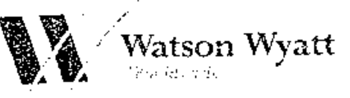


A Appendix A

In this appendix we enclose papers prepared by David O Harris of Watson Wyatt principally concerning the Australian experience - we consider that these papers may be of relevance to the position in Malta.



DAVID O. HARRIS

David O. Harris is a Research Associate with Watson Wyatt Worldwide's Research and Information Center in Bethesda, Maryland. He received a Bachelor of Business in Accounting and Graduate Certificate in Bank Management from Charles Sturt University, Australia in 1992 and 1995. Subsequently, he became a Senior Associate of the Australian Institute of Banking & Finance in 1996. Prior to joining Watson Wyatt this year, he served as the International Liaison Officer with the Australian Competition & Consumer Commission (ACCC), an Australian Government competition and consumer protection agency which is actively involved in financial services issues. Before that he had participated in a Government secondment with the Office of Fair Trading's Pensions Inquiry in London as their International Research Manager during 1996-1997. This position required him to co-ordinate research on eight different pension models and work on specific United Kingdom issues associated with regulation, women and minority groups. This report was released in July 1997 and has had a significant impact on focusing the debate on pensions reform in the United Kingdom.

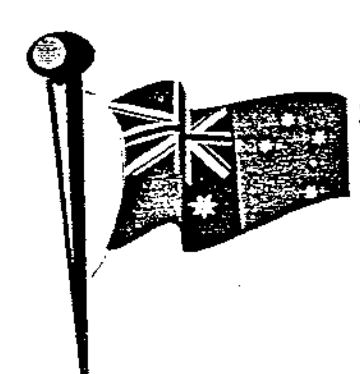
From 1994-1996 Mr Harris served as Compliance Education Officer with the Australian Competition & Consumer Commission where he conducted seminars and workshops on how competition and consumer laws impacted on life insurance and superannuation providers. He also worked on inter-governmental and industry committees examining how reforms could be implemented in the superannuation and life insurance industries concerning disclosure of information and codes of practice relating to sales advice. He began his Government Service career with the superannuation and insurance industry regulator, the Insurance & Superannuation Commission (ISC). During his time with the ISC he worked on issues relating to the implementation of new superannuation legislation and compliance issues relating to life insurance disclosure. Before entering the Government Service Mr Harris worked in the commercial banking environment between 1986 -1991 with one of Australia's leading financial services organizations, National Australia Bank, in the areas of lending and investment planning.

Mr Harris was named the 1996 AMP Churchill Fellow which allowed him to conduct research and consultations into what influences public confidence in the life insurance and pensions industries in Singapore, Malaysia, South Africa, Zimbabwe, United Kingdom, United States and Canada. His final report ***At the Intersection: An International study of Public Confidence in the Life Insurance and Superannuation (pensions) industry*** was published in April 1997 and has been widely distributed to industry, consumer and government policy makers. In addition, he is currently working on contributions to publications which look at the nexus between aging population, social security reform and consumer behavior.

B Appendix B

[insert the full list of the sources of information used in preparing this report]

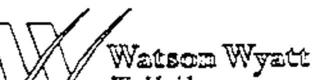
Watson Wyatt



The Australian Superannuation System: Structure and Lessons for the United States

David O. Harris
Research Associate,
Watson Wyatt Worldwide

Senate Majority Leader's Task Force on Social Security -
Wed. 22 July 1998, 9.00am
Russell Senate Office Building, Washington DC



The Australian Retirement Framework - Outline

- The First Pillar: The Age Pension
  - a PAYG model since 1909
  - associated government costs
  - eligibility and details
- The Second Pillar Mandated, Fully Funded, Defined Contribution System - Since 1992
- The Third Pillar; Associated Voluntary Arrangements
  - Annuity, Fund Managed and Life Insurance Products
  - Rebate and Concessional Arrangements for Individuals and Spouses.

Description and Issues Associated with the First Pillar

- Demographic Considerations
  - > 65 years: 15% of the population currently, 2.9 million, to 23% by 2030, that is, 5 million people.
  - > 85 years: from around 2% to more than 5% by 2030.
- Flat Benefit equivalent to a maximum of 25% of average weekly earnings. Overall amount provided under this pillar is determined by income and assets test.
- Maximum payments per fortnight ~ $347.80 ($US218.21) for a single pensioner and $290.10 ($182.00) each for a pensioner couple. Regular assessments are conducted by an associated Government agency.

Percentage of Age Pensioners Receiving Full or Part Pension as at June each year

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Full rate %	74.4	73.5	73.0	70.5	67.2	66.4	67.3	66.2	67.0	65.4	67.4
Part rate %	25.6	26.5	27.0	29.5	32.8	33.6	32.7	33.8	32.7	34.6	32.6

Age Pension Program Expenditure (Actual)

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Outlays ($b)	6.3	7.0	7.6	8.3	9.2	9.9	10.6	11.7	11.9	12.4	13.1

Preparing for the Development of The Second Pillar

- 1983: 40% coverage. Superannuation assets of $32 billion. Employer sponsored.
- White-collar: High coverage. Defined Benefit (DB) plans were common.
- Blue-collar workers: Low coverage. Defined contribution (DC) plans were common.
- Low coverage for female workers.

The Associated Political Economy of Pensions Reform

- Election of a Federal Labor Government (social democratic) with union support in 1983. Prime Minister Hawke, former ACTU (AFL-CIO President)
- Superannuation campaigning by union groups and members of the Labor Caucus.
- Award superannuation in 1986: 3% of an individual's salary committed to individual superannuation accounts.

Preparing for Expansion of the Second Pillar

- Post-1986 industry funds (employer/employee developed strongly)
- Insurance and Superannuation Commission established in 1987 as the regulator of superannuation funds.
- Public confidence is in part generated or results from suitable regulatory interaction.
- Government support for maintaining a standard of living in retirement for workers.

Birth and Development of the Second Pillar

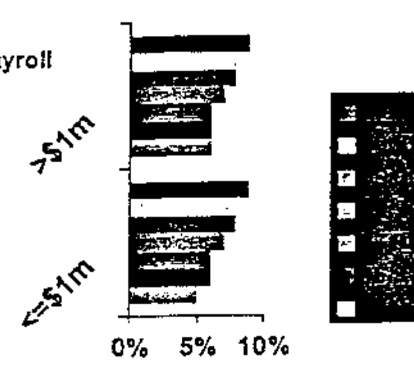
- Treasurer's announcement:
  - shortfalls of the age pension: PAYG is inadequate
  - unreliable private voluntary savings
  - community acceptance for retirement needs

Birth and Development of the Extended Second Pillar

- Push and delay in 3% award superannuation claim.
- Superannuation Guarantee Act of 1992 would facilitate:
  - extending superannuation
  - encouraging employers to meet their obligations
  - creating an orderly mechanism for future increases

Superannuation Guarantee

- Employers must contribute or a SGC will be imposed.
- 3% introductory level will increase to 9% by 2002.
- Tax deductions are provided for contributions to complying super funds.
- Initial threshold set at earnings of $450 per month.



Fund Types and Status

- Corporate or enterprise funds
  - single or group employer
- Industry funds
  - sponsored by employer and employee organizations
- Public sector funds
  - largely unfunded for federal, state and local government employees
- Retail funds
  - offered principally by large institutions
- Excluded funds
  - individual or family-based funds of one to four members
- Other funds
  - offered directly by life offices

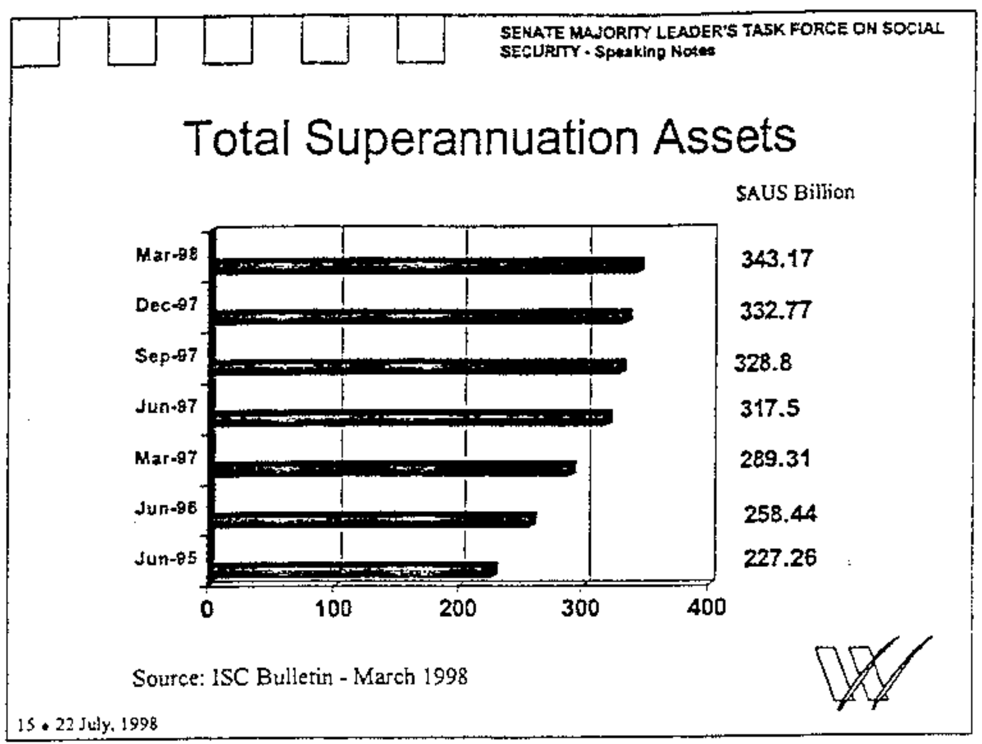
How was Mandated Superannuation Sold to the Public?

- Frank admissions by the Government that the the retirement system could not sustain itself in the long term - demographic time bomb.
- A vigorous public education campaign by government and industry making employers and employees aware of their obligations under the new system~ $11 million over two years.
- Politicians embraced the reforms and argued strongly that 'people would be better off' in the long run.
- A strong regulator who would uphold the interests of superannuation fund members.
- Self interest with 'more people being worried about living to long than dying to early'.

SENATE MAJORITY LEADER'S TASK FORCE ON SOCIAL SECURITY - Speaking Notes

Statistical Highlights

- $343.2 billion in total superannuation assets in March 1998
- Total number of Superannuation Funds ~ 160,350
- In November 1995 coverage was 80.9%. Estimated to be currently 91% in 1997.
- Strong growth in Do-It-Yourself (DIY) or Excluded Funds.



SENATE MAJORITY LEADER'S TASK FORCE ON SOCIAL SECURITY - Speaking Notes

Superannuation Assets (Dec Q 1997)

Overseas investments	17.8%
Other investments	4%
Direct property	4.6%
Units in trusts	11.1%
Cash, deposits and placements	10%
Equities	28%
Short term debt securities	9.1%
Long term debt securities	17%

ISC Bulletin Dec. 1997

16 • 22 July, 1998

Revisions of the Australian Model

- Super involved in political debates. Conservative Government elected in 1996.
- Savings rebate
  - abandonment of 3% by 3% employee and government tax cut funded contributions
- Spouse rebate on superannuation contributions on behalf of a spouse.

SENATE MAJORITY LEADER'S TASK FORCE ON SOCIAL SECURITY - Speaking Notes

Revisions of the Australian Model

- Development of 'low-risk/low-return' capital guaranteed products — RSAs
- Threshold on the SG system lifted. Opt out ability for low income earners
- Choice of Investments and Funds legislation for employees proposed.
  - Emphasis on removing the link between employment conditions (awards) and superannuation coverage.

Consumer Considerations in Pension Reform

- Generation X increasingly doubtful of retirement provisions under the first pillar.
- Appropriate product design issues linked with retirement provisions.
- Strong public education focus by government and industry.
- Ongoing political reforms to strengthen consumer protection guidelines.
- Distribution issues largely resolved by a Code of Practice relating to the conduct of Intermediaries.

SENATE MAJORITY LEADER'S TASK FORCE ON SOCIAL SECURITY - Speaking Notes

Conclusions

- A radical shift in a short period of time.
- More contributions required for retirement.
- Relatively low administrative and marketing costs compared with other mandated second pillar systems eg. Chile
- Extensive debates involving industry, consumer groups and government
- Limited consumer detriment associated with the reform process in terms of the sales process and solvency details. This contrasts with the experience that took place in the UK.

Choice: The United States Experience and Likely Lessons for Australia

by

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Sylvester J. Schieber, Ph.D., Vice President and Director,
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Colloquium of Superannuation Researchers 98
University of Melbourne
Melbourne, Australia
Thursday, 9 July 1998

All findings, interpretations, and conclusions in this paper represent the views of the authors and do not necessarily represent the position of Watson Wyatt Worldwide or any of its associated subsidiaries.

I. Introduction

The concept of choice associated with retirement plans is becoming increasingly important as workers around the world are becoming more and more dependent on defined contribution plans. Accumulating balances in these "individual account" plans over time raises workers' perceptions of ownership of their retirement wealth. The growing sense of ownership inevitably leads to mounting pressure for individual control of that wealth. With greater control of retirement wealth, the individual consumer must increasingly grapple with key concepts and issues associated with investment options. In this paper, we seek to reveal how some of the more "burning issues" associated with the debate surrounding choice in Australia have been addressed in the United States under employer-sponsored retirement plans that allow workers to direct the investment of their retirement assets.

The analysis that will be presented here is largely developed around a class of widely popular defined contribution plans in the United States known as 401(k) plans. Legislation adopted in 1978 provided the basis for these plans, but the effective start up of these products did not really occur until the early 1980s. The name itself, 401(k), is a reference to the United States Internal Revenue Code, section 401, paragraph (k). This section of the US tax code allows employers to offer these plans which permit employees to save for their retirement with the benefit of favorable income tax considerations.

By way of setting a general context, the second part of the discussion focuses on the structure of the retirement system in the United States and on the 401(k) phenomenon as part of the system. The third part discusses how the general practice of allowing workers to direct the investment of their retirement plan assets arose in

these plans. The fourth section describes the range of investment options provided in typical 401(k) plans. The fifth section analyzes general investment allocations by members of these plans, and the factors related to each. This particular analysis includes a detailed assessment of the investment choices made by the participants in 87 plans through the examination of the administrative records used in operating these plans.[1] The final section of the paper draws some conclusions from the US experience that might help to illuminate the discussions about investment choice now underway in Australia.

II. The Retirement System in the United States

It is important at the outset to look briefly at the overall retirement system of the United States for comparisons and differences with the Australian model. Unlike Australia, the United States has a pay-as-you-go first pillar (social security) which requires a contribution of 12.4 percent of payroll, divided equally between the employer and employee. Today this plan provides benefits that are roughly 40 percent of final salary for a worker with average career wages who retires at age 65. Benefits relative to final salary are somewhat higher compared to preretirement earnings for workers with lower lifetime wages and somewhat lower for those with higher lifetime wages. Today, full benefits are paid at age 65 with reduced benefits available at age 62. Starting in the year 2000, the age at which full benefits are payable is scheduled to increase gradually to age 67, with further reductions in benefits payable at age 62.

In recent years, there has been a wide ranging discussion about whether the American social security system can be sustained on a pay-as-you-go basis as the

[1] The analysis of the 87 plans that is presented here is drawn from a more detailed presentation by Robert L. Clark, Gordon P. Goodfellow, Sylvester J. Schieber, Drew A. Warwick: *Making the Most 401(k) Plans: Who's Choosing What and Why* (Philadelphia, PA: 1998 Pension Research Council Symposium, April 27 and 28, 1998). Copies are available from the current authors on request.

country's post-World War II baby boom approaches retirement age. Like so many other aging countries, the United States is confronting an unfunded liability issue with the first pillar of their retirement system. The most recent official projections predict insolvency of the program in 2032. It is interesting to note that one of the solutions discussed in Congressional and industry circles is the development of individual retirement accounts modeled in some ways on Australia superannuation accounts. Clearly the Australian superannuation model's ability to address the issues of coverage, product design, and overall efficiency has provided a source of interest to many individuals and groups in the United States who are pushing social security reform.

The second pillar of the American retirement system is comprised of employer sponsored retirement plans offered under the auspices of significant tax incentives. The third pillar is individual saving outside social security and employer-sponsored plans. The tax preferences accorded retirement savings in the second pillar of the system are generally not available in the third. The one exception is individual retirement accounts (IRAs), which permit workers to save up to $2,000 per year on a pre-tax basis. The limited pre-tax savings available in this form pale in comparison to the relative generosity of employer-sponsored vehicles. While only about half the workforce is covered by an employer-sponsored plan at any particular point in time, roughly two-thirds to three-fourths of people approaching retirement age can expect to get a benefit from a plan they participated in at some point during their working career. For the overwhelming majority of workers who save to meet their retirement needs over and above what social security provides, most of their retirement savings accrues in the second pillar of the system.

Employer-sponsored plans are offered voluntarily by employers, but as noted, there are substantial tax-incentives encouraging them to do so. Employer contributions to their plans are tax deductible in the year in which they are made. The contributions to the plan trusts and their interest income are not taxable to workers until they retire and actually receive a distribution of the benefits. The tax code does specify limits on the level of contributions and benefits that may be provided through these vehicles on a tax-preferred basis, but these would be considered extremely generous in an Australian context. Because these plans are provided significant tax preferences, they are also highly regulated under the Employee Retirement Income Security Act (ERISA) and the federal tax code.

Since the passage of the Employee Retirement Income Security Act in 1974, defined contribution plans have taken on an increasingly important role in the second tier of the American retirement security system. In 1975, there were slightly more than 103,000 private, defined benefit plans operating in the United States. The number of defined benefit plans grew steadily until 1983 when there were just over 175,000 plans in operation. Since then we have seen a fairly steady decline in the number of plans, with just under 74,000 plans in existence in 1994, the last year for which we have published disclosure data. Over this same period the number of defined contribution plans grew steadily from slightly under 208,000 plans to nearly 616,000 plans.[2]

The pattern of participation in defined benefit plans directly followed the pattern of plan growth between 1975 and the early 1980s as participation grew from 33 million workers in the prior year to about 41 million by 1984. Although there was a decline of nearly 58 percent in the number of private defined benefit plans in operation

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[2] U.S. Department of Labor, Pension and Welfare Benefits Administration, ***Private Pension Plan Bulletin, Abstract of 1991 Form 5500 Annual Reports*** (Washington D.C., Winter 1998), p. 63.

between the early 1980s and 1990s, participation in the plans only declined by about 1.6 percent from the peak and stood at 40 million workers in 1994. At the end of the 19-year period, participation was 22 percent higher in defined benefit plans than it had been at the beginning. In the case of defined contribution plans the growth in participation was nearly as steady as the growth in the number of plans. In 1975, there were 11.5 million participants in plans, growing to nearly 35 million by 1985. Beyond 1985, the growth in defined contribution plan participants slowed somewhat. By 1994, participation in defined contribution plans had grown to 44.8 million workers, representing a 289 percent growth over the level in 1975 but only a 28 percent growth over the level in 1985.[3]

Participation in defined contribution plans grew rapidly immediately after the passage of ERISA because the benefit limits under section 415 of ERISA allowed greater tax-qualified retirement contributions in cases where employers were sponsoring both types of plans than in cases where they had only one or the other. This encouraged many employers that had traditionally offered only a defined benefit plan to introduce supplemental defined contribution programs. The growth in participation further accelerated during the early 1980s because of introduction of section 401(k) plans. Under these plans workers could voluntarily defer compensation on a pretax basis. Most employers that had sponsored profit sharing or thrift-savings plans prior to the publication of section 401(k) regulations introduced 401(k) features into their defined contribution plans. Many employers that had not offered such plans in the past provided employees with a section 401(k) plan soon after the release of the regulations.

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[3] Ibid., p. 67.

During 1998, a private-sector worker can contribute on a pre-tax basis up to the lesser of $10,000 or 20 percent of earnings into a 401(k).[4] The earnings on the assets are not taxed in the year they accrue to the trust. Benefits from these plans can be taken under regular tax schedules starting at age 55 for people who retire. Distributions must start by age 70.5 for retirees. The tax incentives alone are a significant reason for workers to participate in these plans but most plans are structured to provide even greater economic incentive for workers to participate in them. Most plans provide for employer matching of employee contributions. While some employers will match employee contributions dollar for dollar, the typical plan calls for an employer match of 50 percent of employee contributions up to 6 percent of pay. Match rates of zero, 25 percent, 50 percent, and 100 percent are common, but the 50 percent match rate is most prevalent.

III. The Move Towards Employee Management of Plan Assets

Through the end of the 1970s and into the early 1980s, the assets in defined contribution plans typically were held in pooled trusts and each participant in the plan was credited with his or her vested pro rata share of the pool. The vesting periods during this era could range up to 10 years, although they tended to be somewhat shorter than that. Because of the vesting periods, however, significant amounts of the money in the plans at any point in time were not yet the property right of the individuals to whom they had been credited.

With the establishment of 401(k) plans, workers were now contributing their "own" money to the plans to a much greater extent than they had before, and there

[4] Workers in the public and nonprofit sectors have not had the same historic availability of 401(k)s. They have had similar plans available to them covered under sections 357 and 403(b) of the federal tax code.

was immediate vesting in their balances as stipulated by the tax code. The new realities of defined contribution plan structure that evolved during the 1980s changed perceptions about whose money was in the plans and how that money should be managed. With the evolution of 401(k) plans during the 1980s, sponsors of defined contribution plans increasingly offered participants the opportunity to direct the investment of their retirement accounts.

ERISA generally provides that a fiduciary of a benefit plan must discharge his or her investment responsibilities prudently, including diversifying plan investments to minimize the risk of large losses. To the extent these duties are breached, the fiduciary is liable to the plan for any losses. ERISA, however, includes an exception to this provision in section 404(c) where it provides that in cases where the participants can direct their own investments, the plan fiduciaries are not liable for any loss or breach that results from the participant's exercise of control. In the late summer of 1987, the Department of Labor released preliminary regulations under section 404(c) beginning to detail the rules under which employers could hand off some of the fiduciary obligations that they held when they controlled their defined contribution assets.

The precipitous decline in stock prices during October 1987 raised a number of fiduciary issues for plan sponsors still managing their defined contribution plan portfolios. For example, many plans at that time calculated the value of distributions on the basis of the last valuation date of assets in the plan prior to a worker's termination. Many valuations were done on a quarterly basis. Plans whose valuation dates coincided with the end of a calendar quarter were in the position of paying individuals who terminated prior to the end of 1987 considerably more than the value of their account at the date of termination. Paying someone terminating on October

31, 1987 the value of his or her account on the basis of a September 30, 1987 valuation would further drain the value of the remaining portfolio for those workers who remained in the plan. Thus, in addition to the restructuring of retirement plans and the changing perception about ownership of plan assets, there were practical developments that encouraged plan sponsors to allow participants to direct their own investments.

During September 1992 the Department of Labor finalized the section 404(c) regulations which were somewhat less onerous than the initial proposed regulations had been. In order for a plan to meet the 404(c) requirements a plan must allow participants to "exercise independent control" over the assets in his or her individual account. This means that the participant must be able to give investment instructions to a plan fiduciary who must generally comply with such instructions. In addition, the regulations require that sufficient information to make informed investment decisions must be made available to participants in these plans. The regulations allow plans to restrict the frequency with which investment changes may be made, but require that participants be able to give investment instructions with a frequency which is appropriate for the expected market volatility of the investment. The regulations state general rules requiring that the available investment alternatives must be sufficient to give the participant a reasonable opportunity to materially affect both the potential return on assets in his or her account and the degree of risk to which the assets are subject. The regulations require that the participants be able to choose from at least three alternative investment alternatives each of which is diversified. This diversification requirement means that an employer's securities cannot be one of the three investment options required to meet the minimum requirement of investment

choices provided, but once a plan sponsor has provided three diversified options, the plan sponsor's own securities can be offered as an added option. Of the three required choices to meet the standard, each has to have materially different risk and return characteristics; which allow the participant to achieve a diversified portfolio with desired risk and return characteristics. Overall, the participant must be able to minimize risk through diversification across the investment choices offered. In return for setting up the 404(c) plan, the sponsor is not liable to participants for any loss or breach of fiduciary responsibility that result from the participant's exercise of control.

The combination of factors that have evolved over the last 10 to 15 years means that most defined contribution plans today offer participants control over at least some part of their retirement accumulations. As the United States has made the transition from professionally managed pension portfolios to an increasing dependence on individual investment decisions, the relative level of assets in defined contribution plans has been increasing in comparison to defined benefit plans. In 1980, private defined benefit plans held slightly more than $400 billion in assets. The balances had grown to $1.2 trillion by 1994 reflecting an annual compound growth rate of 8.2 percent. By comparison, defined contribution assets grew from $162 billion in 1980 to $1,088 billion in 1991, with an underlying growth rate of 14.6 percent per year.[5]

IV. Investment Options Offered in Self-Directed Accounts

In Australia, the debate over whether to provide workers multiple investment options for their superannuation funds has two elements. The first focuses on the need to provide employees with choice of a provider of investment management

[5] Ibid., p. 73. The asset amounts exclude funds held by life insurance companies under allocated group insurance contracts. These funds make up roughly 10 to 15 percent of total private pensions plan assets.

services. The second deals with the choice of fund or investment options to match the desired risk tolerance profiles of fund members. Although employers in the United States have provided members of certain kinds of pension (superannuation) plans with a degree of choice for some time now, the emphasis over choice of service provider was not a significant consideration in most cases during the early evolution of the choice phenomenon. At least initially, the concept of choice in these plans related to the offer of multiple investment options with a range of risk characteristics that complied with the section 404 (c) diversification requirements. Typically, the multiple investment options were provided by a single investment manager.

During 1996, Watson Wyatt Worldwide undertook a survey of nearly 600 defined contribution plans in the United States.[6] Of these, nearly 80 percent allowed for participant direction of the investment of all the assets in the plans. The typical investment restrictions in those plans that did not allow the participants full control of their funds related to the employer matching contributions. It is not uncommon among plans that offer company stock as an investment option for the employer to restrict some portion of the investment of the employer's own contributions to investment in company stock. In other words, the employee is allowed to put his or her contributions into any of the various funds offered in the plan, but the employer contributions will be at least partially restricted to the company stock option.

The Watson Wyatt survey found that typical workers participating in these plans had six investment options available to them. There was a range of funds available under the plans. Retail funds commonly available to individual investors were

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[6] Watson Wyatt Worldwide, *1996 Survey of Defined Contribution Plans* (Washington, D.C.: 1996).

offered by 52 percent of the plans; 49 percent offered institutional funds that are not available to individual investors but are offered by vendors specifically for these kinds of plans; 32 percent offered diversified funds offered only through their own plans; 36 percent offered an index fund; and 37 percent offered a fund comprised of the sponsor's stock.

The various kinds of investment funds can be classified into a relatively small set of generic options. Fixed or stable value funds would include investment options composed individually of money market instruments, corporate or government bonds, or fixed return insurance products. In the Watson Wyatt survey we found that 83 percent of the plans offered this investment option for employee contributions and 66 percent offered it for the employer matching contributions. Domestic equity funds would hold a diversified portfolio of stocks, although many of these funds would be concentrated in specific segments—e.g., high technology—sectors of the market. Some of the equity funds would be broad-based index funds. In the 1996 survey we found that 82 percent of the plans offered some domestic equity investment option for employee contributions and 64 percent offered it for employer matching contributions. International equity funds would typically be a portfolio of publicly traded stocks from various countries outside the United States. The survey results here indicated 47 percent of the plans offered an international equity option for employee contributions and 38 percent offered it for matching contributions. Sixty percent of the plans offered a blended fund that would have some combination of equity and fixed income assets for employee contributions and 38 percent offered such a 'balanced" fund for employer matching contributions. The company stock funds would be comprised strictly of the stocks of the plan sponsor. The survey found that 30 percent of the plans offered

company stock for employee contributions and 32 percent offered company stock for employer contributions. A small number of plans offered a real estate fund, about 4 percent, or some other specialized fund targeted toward "socially responsible" investments or some other particular market niche.

Indirectly, Table 1 gives a sense of the growing importance of employee choice in the management of retirement assets in the United States. It shows that contributions to 401(k) plans and total assets in them were taking on increasing importance in the private employer-sponsored retirement system from the mid-1980s through the mid-1990s. The required plan disclosure filings to the Department of Labor indicated that the asset balances in 401(k) plans had reached $675 billion by the end of 1994.[7] These plans have continued to grow rapidly since 1994. In 1998, research conducted by Spectrem Group in San Francisco estimated that the amounts invested in 401(k)s by American workers reached $1.075 trillion at the end of March 1998. In addition, they estimated that another $420 billion was invested in section 403(b) and section 457 plans, which are retirement plans for employees of public schools, hospitals and other nonprofit organizations, and of municipal and state agencies.[8] In other words, it appears that roughly $1.5 trillion in retirement assets in the United States is now in plans where employees are directing the investment of the assets for them.

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[7] U.S. Department of Labor, Pension and Welfare Benefits Administration, ***Private Pension Plan Bulletin, Abstract of 1991 Form 5500 Annual Reports*** (Washington D.C., Winter 1998), p. 85.

[8] Humberto Cruz: '401(k)s Surpass $1 trillion milestone; Lack of Education Concerns Experts' (Fort Lauderdale, FL: Sun Sentinel, April 11, 1998.

When the phenomenon of self-directed retirement accounts first became popular, many plan sponsors were administering their own 401(k) plans. At that time, they would allow their employees to make investment allocation choices at the end of discreet periods such as the end of the month, quarter, and so forth. With the growing sensitivity to variations in the market and the need to allow workers to tailor their portfolios to meet their own risk preferences, greater flexibility has been introduced into plan operations. This move to greater flexibility has been accomplished by the outsourcing of plan administration to vendors who allow plan participants to move their money on a daily basis between the investment options available to them.

As 401(k) contributions and asset balances grow rapidly, increasing demand is being placed on the service vendors to the plans to provide more investment options. Our survey data cited earlier indicated that as recently as 1996, it was common for 401(k) plans to only offer a selection of three or four mutual funds. Today, plan participants are being provided ever more choices. A recent article in the trade magazine *Pensions & Investments* noted that by early 1998, "the average number of investment options offered to participants rose to 8.5 from 7.9 in 1997. The number of defined contribution plans offering seven or more options more than doubled between 1995 and 1998."[9]

The next stage of the evolution of choice in 401(k) plans is now underway. Many of the vendors who aggressively pursued the "daily valuation" market as it developed offered a relatively small set of investment options, typically from within a single family of funds. For example, Fidelity Investments was one of the most

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[9] Christine Williamson, "401(k) Participation Rising," *Pensions & Investments* (May 1998), p. 128.

aggressive vendors that moved into this marketplace during the initial move to plans that allowed workers to move their assets on a daily basis. Early on, Fidelity offered plans several fund choices from within its own total "family" of investment funds. But other administration vendors who did not provide investment management services, as Fidelity does, began to build alliances with multiple investment managers. The administration vendor, in these cases, facilitated one-stop access to multiple providers of investment services for participants in self-directed plans.

Today, many employers tout the number and diversity of fund providers and associated options as an effective human resources tool in attracting new staff in an increasingly tight labor market. The next stage of the evolution of choice in these plans is now underway. Over the past couple of years, self-directed brokerage investment accounts have only been installed in about 9 percent of defined contribution plans. The brokerage option usually makes individual stocks and bonds available to plan participants. While this phenomenon started in professional firms with some relatively sophisticated plan participants, "more and more sponsors are insisting that vendors offer the option, which resembles a personal brokerage account."[10] Some companies have even gone one step further by offering a brokerage component to their plan menus.

With the growing trend of offering more and more choice of vendor and fund options, some in the 401(k) industry now argue that plan sponsors are facing a new set of legal and fiduciary issues when considering the option of providing more investment options for their employees. Questions are increasingly being asked of how

[10] HA Jackson: 'Why they don't do windows', Institutional Investor, Institutional Investor Inc., United States, April 1998, p.129.

quality control will be maintained while giving access to a myriad of funds for investors who may not be sufficiently sophisticated to handle the range of options. This warning is summarized by the Department of Labor's pensions arm, "The selection of funds offered through a window or a broker is a fiduciary decision, and there has to be some oversight of the broker to ensure he is a good service provider."[11] Clearly employers will find it difficult to scrutinize the enormous numbers of mutual funds in the United States. Although no complaints have been lodged with the Department of Labor or lawsuits filed charging that an employee lost money because an employer was lax in monitoring its multiple offerings, some legal opinion suggests that with the litigious nature of American society, such a development is very likely.

While fiduciary and legal issues may loom large as 401(k) participants are given more and more investment options, cost considerations may ultimately limit the spread of retirement plan participants' access to the American investment marketplace. Offering more investment vendors complicates the administration of plans driving up costs. More options also reduce the concentration of funds with any one vendor and concentrates the application of fixed costs associated with giving a set of workers access to that particular fund. Finally, brokered accounts will typically experience a great deal more turnover of individual assets in a worker's portfolio than would typically be the case in an index or other diversified fund. Such turnover, of course, has affiliated costs associated with it.

V. Investment Allocation in Plans Offering Choice

There is a growing concern among some retirement policy analysts and employer-sponsors of retirement programs in the United States that the shift toward

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[11] Ibid., p.129

participant-directed investment of defined contribution plan assets in recent years is resulting in overly conservative investment of these assets. The real concern is that workers are not realizing the economic horsepower from their defined contribution assets that they could realize and that in the long term, the retirement security of many workers participating in self-directed plans will suffer because they are not. One recent survey suggests that nearly two-thirds of plan sponsors are concerned about the asset allocation decisions that their employees are making with their employer-sponsored retirement plan assets.[12]

Recently there have been a number of articles in newspapers, magazines, and trade publications raising the consciousness of the general public about the concerns related to participant-directed investment of retirement plan assets. In some of the articles the focus is on the relative capabilities of professional asset managers who are generally involved in the asset placement decisions of defined benefit assets and those of individual plan participants in typical defined contribution plans. In other cases the focus is on the relative risk that large sponsoring organizations can assume in investing retirement assets in comparison to individual investors.

Most of the assessments of asset allocation in retirement plans allowing workers to direct the investment of their assets in the plans focus on the aggregate allocation of assets. These assessments tend to compare the aggregate allocation of assets in self-directed plans with those of defined benefit plans that are managed by professional asset managers in almost all cases. Typically, these analyses find that the

[12] Institute of Management and Administration, *Defined Contribution Plan Investing* (April 25, 1995), p. 1.

assets in self-directed funds are somewhat more conservatively invested than in cases where the assets are under professional management. This latter conclusion is important because it implies that workers participating in self-directed plans will get lower rates of return over the long term than would be generated in pooled funds.

While these results are instructive, they tend to ignore the underlying age and earnings structure of the participants in the plans that allow participant choice. This is an important point. An employer funding a pooled fund will typically have a different time-horizon over which asset allocation choices might be made than an individual worker. Individuals with the shortest time horizon over which to make retirement investment decisions, those closest to retirement, will typically have the largest accounts. People with shorter time horizons will naturally invest somewhat more conservatively than those with longer time perspectives. It is important, then, to understand how individual workers invest their assets, because a portfolio structure that might make little sense for a plan sponsor with a long time perspective might make a great deal of sense for a collection of individuals with very different time horizons.

Concerns about the shift to retirement plans that allow participants to manage the investment of their own retirement savings sometimes focus on specific groups of individuals that might be disadvantaged by their own characteristics. For example, it is often hypothesized that low-waged workers might be overly risk averse and thus invest inappropriately. One area that is of particular interest to many analysts of 401(k)-type plans is the relative behavior of men and women who are eligible to participate in them. Prior research has found that women demonstrate greater risk aversion in allocating assets within their self-directed defined contribution plans than men.[13] To understand

[13] For example, see Vickie A. Bajtelsmit and Jack A. Vanderhei, "Risk Aversion and Pension Investment Choices," and Richard P. Hinz, David D. McCarthy, and John A. Turner, "Are Women

how workers invest in an environment of choice, it is imperative to look at individual investment behavior.

In this section of the paper, we present the results of an analysis of how the participants in 87 401(k) plans invested their assets in an environment with multiple investment options. The data reflect the status of workers in these plans as of December 31, 1995.[14] The analyses of participation in these plans, the contributions to them, and the investment behavior that are reported here cover the 1995 calendar year. Forty-one of these plans were administrative record keeping clients of Watson Wyatt Worldwide; 46 were not. The smallest plan in the group had just under 25 participants, the largest had just short of 15,000. The plans included in the analysis were not chosen on any random probability basis, but there is no reason to believe that the variation in characteristics of these plans is not similar to that of plans generally.

A total of 234,573 workers were employed by the sponsors of these plans at some time during 1995. Some of the workers were not included in analysis for a variety of reasons. Workers who did not have at least one year of service were not included because some plans had a one-year of service participation standard. Workers who did not work the full year were eliminated because the administrative records did not provide annualized earnings in some cases. Workers earning less than $10,000 per year were excluded because the goal of the original analysis was to examine the behavior of workers who were working relatively significant hours and the

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Conservative Investors?: Gender Differences in Participant-Directed Pension Investments," in Michael S. Gordon, Olivia S. Mitchell, and Marc M. Twinney, eds., *Positioning Pensions for the Twenty-First Century* (Philadelphia: University of Pennsylvania Press, 1997).

[14] This analysis is drawn from Robert L. Clark, Gordon P. Goodfellow, Sylvester J. Schieber, Drew A. Warwick: *Making the Most 401(k) Plans: Who's Choosing What and Why* (Philadelphia, PA: 1998 Pension Research Council Symposium, April 27 and 28, 1998).

administrative records did not include an hours measure which we could use for such screening. After these deletions, a base file 156,367 workers who were eligible to participate in the plans was analyzed. The analysis was conducted at two levels. The first looked at general behavior under the 401(k) plans being analyzed. The second analyzed the differential behavior of men and women. In this latter analysis, the working file was further reduced to 142,543 records for an analysis of gender differences in investment behavior.[15] The resulting distribution of workers by age, earnings level, and sex are shown in Table 2. Of these, 46 percent are classified as female. The women included in the analysis are disproportionately distributed in earnings categories falling below $35,000 per year. Women in their 20s are also disproportionately represented.

Table 3 presents average cumulative balances of employee money and total funds held by workers who have participated in the 401(k) plans that were analyzed. The tabulations include not only people who contributed to the plans during 1995, but also those who had contributed previously although they might not have contributed that particular year. Not surprisingly, there is a strong relationship between both earnings levels and age on average plan balances. In the bottom three earnings classes including pay levels up to $35,000 per year, the average cumulative total balances in the plans are roughly equal to one-half year's earnings level. Above that the average

[15] The working files used in this analysis did not include an indicator of workers' gender. Gender determination was based on the first name of the worker using a file that had both name and gender of persons. If a particular name was associated with a person of one gender in at least 80 percent of the cases, that name was classified as being associated with that gender. Mary, for example, was found to be a woman's name because it was virtually always associated with someone who was female. Thus everyone in the working file with the name of Mary was classified as being female. Some names are common for both men and women. People with these names were not assigned a name in the working file. Thus, the gender analysis covered fewer workers than the combined analysis that did not take gender into consideration.

balances grow steadily until they approach current pay for workers earning between $75,000 and $100,000. The range of accumulated funds across the different age groups varies significantly when considering the variation in pay levels. For example, at the earnings levels up to $25,000 the accumulated balances of workers in their 60s are roughly six times those of workers in their 20s. For those at pay levels from $35,000 to $75,000 the differential for these age groups drops to nearly four times. At earnings levels above $75,000, the differential ranges from eight to ten times.

Table 4 shows the 1995 account balances for age and earnings categories of men and women. For all workers, men had balances of $24,880 or over twice the size of the average women's balance of $11,360. The gender differences are larger with age as the average female balance declines from 59 percent of the male balance for workers 20 to 29 years of age to 38 percent for workers aged 60 to 64. Specific age/earnings combinations where men's balances are larger than women's are show in bold type in the table. Men's balances are consistently larger than women's for workers in their 20s. Beyond that though, men's balances exceed women's only at the bottom and top end of the earnings distributions.

There are several factors accounting for the differences in balances held by men and women in these plans. Looking back to Table 2, the women in the plans being analyzed were disproportionately skewed toward the lower earnings levels in all age classes. When comparing balances between men and women in summary age groupings, even if women contributed at the same rate as men, their balances would be lower because of their lower earnings levels. In addition, the analysis found that men at lower-earning levels and those in their 20s consistently contributed at higher rates relative to their earnings level than women. Finally, an analysis of the time workers

had spent with the current employer found that other than for women in their 20s, men consistently had been with the employer longer than women. This was especially true for men in their 50s and 60s. Many of these plans do not allow workers to transfer 401(k) assets from prior employers into their plans. The analysis reported here did not include such monies where they were permitted. Thus time covered under the plan is extremely important in explaining the relative balances held by men and women.

In the full analysis presented in the larger paper, plans were separated into two groups based on whether the plan offered the plan sponsor's company stock as an investment option. Such stock is offered under essentially three distinct conditions in these types of plans. Some plan sponsors simply make company stock an investment option that workers may freely choose to invest in or not. Another group of plan sponsors will allow workers free choice on the assets in the plan that are the result of the employees' direct contribution to the plan, but will require that all funds accumulated through employer matching contributions go into company stock. Yet a third group of plan sponsors actually condition employer matching contributions on the employee investing in company stock with his or her own personal contributions to the plan. The analysis of plans that included company stock found significant differences between men's and women's investment behavior. While these results are interesting, we do not report them in detail here because they do not seem to have particular relevance to the current discussion.

For purposes of analyzing investment behavior for those workers who did not have company stock as an investment option in their plans, the investment options were classified into two broad groups: equities and fixed-income assets. While there may be some variations in the risk profiles of specific equity funds that are offered in

plans where multiple equity funds are offered, grouping them together simply groups a set of assets that consistently will have a higher risk profile than fixed income assets. Similarly, grouping money market funds with fixed-return insurance contracts might combine investment options with somewhat different risk characteristics, but those differences are far less than the differences between a broad generic class of fixed-income assets and any of the equity funds.

Table 5 examines the account balances for men and women in the 58 plans that do not have a company stock investment choice. Looking at the column on the far right side of the table, we see that younger workers consistently hold a greater portion of their assets in equities than those who are older. This pattern is generally consistent across the earning distribution with the exception of those workers at the very highest earnings levels. Looking at the "Total" rows in the table, there is generally a consistent pattern of workers at higher earnings levels being willing to take on greater investment risk than those at the lower earnings levels. It might be possible to argue that workers in general should be willing to take on more equity risk than the results in the table imply. However, the pattern of risk taking certainly seems to comport with the reasonable ability of younger and higher-paid workers to take on financial market risk when compared to their older and lower-paid counterparts.

The bold entries in Table 5 indicate the age/income groups where males hold a higher percentage of account balances in equities. Of course, this means that men in all other age groups have a greater reliance on fixed-income assets than women. With the exception of young men at the low and high tails of the earnings distribution, women generally hold a higher proportion of their 401(k) assets in equities than men. These results suggest that previous findings that women tend to devote a higher percentage

of their retirement savings to low-risk/low-return assets are wrong. The remaining analysis in the longer paper supported this conclusion. Indeed the authors concluded that it was wrong to classify women's investment behavior inferior to men's and that in cases where companies offered company stock in their plans, women's behavior appeared to be more rational.

VI. Public Education and Investor Choice of Provider and Fund

Like in Australia, public education in the United States is increasingly being examined as a method for both increasing participation in retirement plans and also assisting employees 'craft out' a suitable and sustainable investment strategy for their future retirement needs. Unlike Australia, no large scale use of Federal funds or proposed use has occurred in United States for public education. The main emphasis for education of plan participants has fallen on the individual industry entities, industry associations and specialized consultants or organizations who deal solely with the education needs of small and large sized 401(k) plans, for example.

A further distinction with regard to the United States and Australia concerning public education provision is how the provision of such support for the plan participant is legislated in the United States. Plan sponsors are required to provide some form of education process for plan participants in terms of retirement and how they should most appropriately invest for their future retirement needs. The Department of Labor (DOL) has mandated that companies provide education programs for plan participants. The DOL is clear about stressing 'education' rather than 'advice', which is prohibited under ERISA.[16] The problem that employers face is the distinction between the two.

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[16] Robert A. Benish: 'The Ongoing Challenge of Providing Investment Education', Compensation & Benefits Management, Aspen Publishers, United States Inc., Winter 1998, Vol. 14 No. 1, p.43.

"Litigation-shy employers nationwide are steering clear of giving investment advice, instead relying largely on brochures and quarterly account statements to educate their employees about retirement."[17] The net effect of this 'minimalist' approach to public education for plan participants regarding fund choice is that many workers often adopt investment strategies which may either see them take too much or too little risk, thus eliminating the likelihood of a comfortable retirement.

Going against this litigation-based trend, some companies in the United States have adopted a more assertive role with regard to their public education responsibilities. These companies are bringing in outside consultants to conduct group seminars or talk directly with participants about their individual risk profiles and appropriate investment strategies to fit them. Consequently, many employees feel more comfortable about investing in the stock market and thus adopting a more diversified position regarding their retirement investment portfolio. Other employers are using advancing technologies such as the internet and an evolving set of retirement planners which allow workers to "model" the implications of alternative investment patterns for their own situations.

While there is a growing awareness that educational communications programs are vitally important, the assessment of these thus far has not concentrated on their effects on participants' investment behavior. For example, Robert Clark and Sylvester Schieber found that employee communications programs are as effective in motivating employees to participate in 401(k) plans and in raising their contribution rates to them

[17] Liz Pulliam: 'Employees are Confused because Companies are Reluctant to Offer Direction on a Wider Array of Investment Options; 401(k)s: so many choices, so little advice', Orange County Register, Chicago Tribune Company, United States, April 13,1998, p.3; Zone:C.

as significant employer matching of employee contributions.[18] A similar study found that the provision of retirement planning services increase participation rates in plans on average by 12 percent and raised contribution rates by 2.2 percent of pay.[19] The work of Douglas Bernheim at Stanford University in California with several associates suggests that communications is actually more effective at stimulating participation and contribution rates in 401(k) plans for lower-wage workers than for their higher-wage counterparts.[20] Part of the reason for this conclusion might relate to the tax incentives provided these plans. The incentives alone are much larger for high-wage workers than for those earning less, and thus the tax value alone may be sufficient to stimulate high-wage workers participation in the plans. For lower-wage workers, on the other hand, additional stimulus is helpful.

With choice of funds legislation planning to commence on July 1, 1999 in Australia, it is clear from the United States experience that fund managers and plan sponsors will have to dedicate more financial resources towards providing more effective and efficient financial education programs for superannuation fund members. One company who has embraced the need for providing financial education services of excellence to its clients is Scudder Investment Services Inc. It has created Scudder University, which is responsible for developing and creating the company's defined

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[18] Robert L. Clark and Sylvester J. Schieber, "Factors Affecting Participation Rates and Contribution Levels in 401(k) Plans," in Olivia S. Mitchell and Sylvester J. Schieber, *Living with Defined Contribution Plans* (Philadelphia: University of Pennsylvania Press, 1998).

[19] Sue Burzawa: 'Interplay of Design and Communications Provide Opportunities to Boost 401(k) Plan Participation', Employee Benefit Plan Review, United States, p.34.

[20] B. Douglas Bernheim, Daniel M. Garrett, Dean M. Maki "Working Education and Saving: The Long Term Effects of High School Financial Curricula Mandates", Paper 6085, National Bureau of Economic Research, Boston MA., (1997).

contribution plan education program. 'The goal is to empower 401(k) plan participants to make appropriate investment decisions.'[21]

Scudder's educational programs are designed to extend over one-two or three-year time periods. Implementation of such programs is accomplished by six basic components that include:

- basing programs on sound educational concepts, that is, taking into account how adults learn
- reaching the least sophisticated as well as the most sophisticated retirement plan investors
- recognizing that each employee's financial background and experience with money is different
- providing foreign language educational materials and speakers, when necessary
- anticipating employees' needs (for example, the three-year bull market prompted Scudder to prepare materials about a potential market correction)
- focusing on education for the long term[22]

Financial education and its recognition as a powerful support and maintenance mechanism for 401(k) plans have been noted by many studies. The challenges remain though to lift quickly the level of understanding of financial service products for participants in such schemes. With an apparent view by more and more employers that it is the individual employee who should be playing a more active role in the investment decisions regarding their retirement, there is a growing awareness that public education is becoming increasingly vital. Unfortunately, many workers still have limited

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[21] Robert A. Benish: 'The Ongoing Challenge of Providing Investment Education', Compensation & Benefits Management, Aspen Publishers, United States Inc., Winter 1998, Vol. 14 No. 1, p.44.

[22] Ibid., p.44.

investment know how. Shlomo Benartzi and Richard Thaler have found that "some people spread their contributions evenly across the investment options regardless of what the options are" that are provided them.[23] In another study of highly educated professionals, "only 5 percent had sought education or help from financial services professionals. Most relied on family members and friends, who vary considerably in their capacity to provide high-quality information and counsel."[24]

For the United States ongoing growth in choice of providers and investment options will mean that inevitably the demand for financial education will grow. An additional factor which also may shape the direction of choice in the United States and associated public education required will be if the first pillar (social security) moves towards a more fully funded basis for its continued operation. Such a likely retreat from the PAYGO (pay-as-you-go) method of retirement funding will put further pressure on the individual to become more conscious of their retirement needs. The likely domino effect will see the further expansion of investment options and public education aspects associated with 401(k) plans. Possible controls on this continued implementation of increased choice for plan participants may be through associated litigation in terms of fiduciary responsibilities of employers and the associated costs that are likely to be generated from such a retirement plan expansion.

VII. Lessons and Conclusions for Australia

Even though Australia and the United States have significantly different approaches to an overall retirement framework, lessons from the United States

[23] Shlomo Benartzi and Richard H. Thaler, "Naïve Diversification Strategies in Defined Contribution Plans," a paper prepared for the Teacher Insurance Annuity Association and College Retirement Equity Fund, the US Department of Labor, and the Center for International Business and Economic Research at the University of California at Los Angeles (1998).

[24] Robert C Atchley PhD: 'Financial Gerontology', Journal of the American Society of CLU and ChFC, United States, July 1997, p.43

experience concerning choice of provider and investment options are relevant for Australian consideration. Indeed the cultures, saving and investment behavior of the two countries are quite similar, as has been noted by several American lobby groups and politicians pushing for social security reform and the adoption of an individual retirement account, styled in part on an Australian superannuation account.

Specific lessons can be derived from the United States concerning choice and the associated public education experience for Australia:

- With retirement plans being the largest financial asset for most workers and pension balances growing steadily, many participants are keen to have the ability to diversify their associated investment portfolios, thus minimizing potential loss and hopefully generating higher overall returns.
- Technological innovation and individual participant demand has prompted many plan sponsors to seek greater and greater flexibility and choice from their 401(k) plan. Yet such demands have translated into increased costs being borne by both the plan participant and sponsor. For Australia who lacks some of the technological efficiencies which the United States market has in the operation of its retirement plans, higher administrative and marketing costs are likely in certain areas of the market.
- A strong difference exists between the plan participant having the ability to utilize scores of different choice options, with regard to providers and investment options and actually using them optimally. Although many firms have provided individual participants with a variety of options, industry surveys suggest that many plan members are conservative about their investment strategies and generally invest their funds in a limited number of corresponding conservative investment options.

- Watson Wyatt Worldwide's analysis of plan administration data suggests that actual investment selections are generally correlated with the age and earnings level of the worker making the choice. Further, there does not appear to be significant differences between men and women in their use of investment options, at least to the extent that employer stock is not a separate element of the plan.
- Increasingly plan providers in the United States are developing 'operating platforms' which allows multiple access to various forms of fund management products for individual participants. In Australia, with associated technological innovation and increased competition occurring, through choice of funds legislation, a similar pattern to that of the United States is likely to occur. This is likely to mean greater development of co-branding and strategic alliance arrangements between providers.
- While the provision of larger investment options are being demanded increasingly by plan participants in the United States, the need for different providers being offered by plan sponsors has not reached the same level of interest and debate as has occurred in Australia. In Australia there seems to be perceived merit in the generation of greater investment options from the diversification of investment providers, as individual balances increase in superannuation accounts. Yet the United States experience regarding multiple providers and the benefits generated for the plan participant are less clear. It is not clear that adding investment providers in many cases gives workers any greater opportunity to diversify the risk of their retirement portfolios or to do so more efficiently. This last point is especially important with the higher associated administrative costs associated with the diminished concentration of funds that results when more providers are offered.

- Greater demands on public education facilities and resources offered by individual industry participants or associations are likely to occur in Australia as a result of choice legislation. United States experience has demonstrated that with increased investment responsibility for guiding his or her retirement assets, plan participants will increasing demand and seek educational resources to make more informed investment decisions.
- As choice options become more important effective educational tools must be employed in Australia to educate plan participants about their individual retirement positions. More integrated VRU technology and eventually the Internet will allow plan participants to allocate their retirement savings among available investment options more effectively. These public education requirements will create higher fixed and variable costs that will have to be met by the superfund and indirectly all members.
- Plan sponsors will increasingly play a more active role in the nurturing and understanding of choice of provider and fund by the plan participant. It is uncertain to what extent financial entities will have to increase or modify their educational resources to meet the associated demands of possibly confused or uncertain fund members possibly after the introduction of choice of funds legislation.
- Appropriate development and implementation of financial education will be a way for superannuation funds and financial participants more generally to maintain and increase their customer base. Such education tools and practices will be seen to be a way of differentiating associated products and services. This trend has certainly occurred in the United States.

The Australian Superannuation System: Meeting the Challenges of Social Security Reform

by

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Testimony before the
House Commerce Committee
Subcommittee on Finance and Hazardous Materials

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The views in this statement are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide or any of its other associates.

Mr Chairman, I am pleased to appear before the Subcommittee on Finance and Hazardous Materials to discuss enhancing retirement security through individual investment choices in the United States. In particular I am keen today to share with you the experiences of the retirement reforms which implemented in Australia during the late 1980s and 1990s and which have received praise from international pension experts in both Europe and North America.

As requested, I have prepared a detailed analysis of the Australian superannuation (pensions) model in terms of how private pension provision has enhanced the ability of many Australian employees to provide satisfactorily for their retirement. In this analysis I have included aspects which provide an outline of the Australian retirement system, details of the funds management industry, associated consumer protection strategies employed by the Australian Federal Government, public education and wider acceptance of associated superannuation reforms by the Australian community and how they were generated, associated contrasts between the Australian and British pensions models and finally the associated conclusions which various groups and individuals in the United States may develop from the Australian superannuation model.

An Outline of the Australian Retirement Model

The First Pillar

The Old Age Pension in Australia is seen by many as providing both a foundation and an important source of income for those retirees who have limited resources to sustain themselves in retirement. Many older Australians who are or have retired in the past often have not build up sufficient retirement savings. A common perception in the past by many workers was that they were entitled to an old age pension after paying taxes all their working life. Largely this view was encouraged by many governments but in the 1980s increasingly, the Commonwealth Treasury and the Federal Government expressed concerns over the direction of expenditure for providing the first pillar of Australia's retirement framework.

Increasingly expenditures in providing the first pillar were also linked to a concern over the demographic position of Australia in the next century.

"For Australia the percentage of the population aged over 65 is expected to rise from 15% of the population, 2.9 million, to 23% by 2030, that is, 5 million people. The percentage aged over 85 is expected to more than double from around 2% to more than 5% amounting to 650,000 Australians over 85."[1]

The full pension payment under this pillar represents approximately 25% of average weekly earnings. Maximum payments per fortnight are calculated on a flat basis and are reduced accordingly, based on income and asset tests. These income and asset tests are detailed below.

Table 1: Summary of the Income Test Provisions of the First Pillar

Income Test	Maximum Payment if Your Fortnightly Income is Equal to or Less Than	No Payment if Your Fortnightly Income is Equal to or More Than
Single	$100.00	$806.40
Couple (combined)	$176.00	$1,347.20
For each child	$24.00	add $24.00

Table 2: Summary of the Asset Test Provisions of the First Pillar

Assets Test	Maximum Payment if Your Assets are Equal to or Less Than	No Payment if Your Assets are Equal to or More Than
Single, homeowner	$125,750	$243,500
Single, non-homeowner	$215,750	$333,500
Couple, homeowner	$178,500	$374,000
Couple, non-homeowner	$268,500	$464,000

Maximum payments per fortnight are $347.80 ($US218.21) for a single pensioner and $290.10 ($182.00) each for a pensioner couple. These payments are affected by a regular assessment submitted to Centrelink. These payments may be reduced in three ways:

1. Assets which are over the maximum payment settings will cause payments to be reduced by $3 per fortnight for every $1,000 (single or coupled combined);

[1] Susan Ryan, "Quality of Life as It Relates to Australia's Aging Population or Living to 100 in a Civilized Society", Association of Superannuation Funds of Australia, Speech, 1997

2. Hardship provisions apply; and
3. Income over the amounts for maximum payment reduces the payment by 50 cents on the dollar (single pensioner) or 25 cents on the dollar (each member of a couple).

Although these pension values seem low compared with other OECD countries for example, high levels of home ownership exist in Australia. Some estimates suggest that 60% of Australian retirees own their own dwelling outright.

The overall trends for this retirement pillar in the long term are that increasingly greater superannuation accumulations in individual accounts will see a progressive decline in the need for social security. Although the Federal Government past and present is committed to this development, it is likely that financial planning by intermediaries will still adopt a strategy of maximizing social security payments and associated social allowances. Such an approach will continue to have fiscal implications for Australia into the next century.

Recent Government Initiatives

Deferred Pension Bonus Scheme (1997-98)

- This offers a positive incentive for people of Age or Service Pension age to defer retirement.
- People who defer Age or Service Pension take-up and continue in gainful employment for at least 25 hours per week will accrue a bonus of 9.4 percent of basic Age or Service Pension entitlement for each year of pension deferral, up to a maximum of 5 years.
- The bonus will be paid as a tax-exempt lump sum on pension take-up. At current rates, the maximum bonus would be $21,250 for a single person, and $35,450 for a couple, in receipt of the maximum rate of pension.

Improving the Social Security means test and reasonable benefits limit treatment of Retirement Products (1997-1998)

- These measures will make the Social Security means test treatment of income streams fairer, and will provide more simple and consistent treatment of similar income stream products.
- From 20 September 1998, income streams will be classified and means tested on the basis of their characteristics. Those products where ownership of the asset is signed away in

return for an income stream for life or life expectancy (or 15 years where life expectancy is greater) will be exempt under the assets test. All other income streams will be assets tested using a simpler and fairer test that accurately reflects the actual asset value.

- The Superannuation Industry (Supervision) Regulations will be amended to provide superannuants greater choice as to which income stream products qualify as 'complying' pensions or annuities for the purpose of accessing the higher pension RBLs.

Table 3: Age Pension Program Expenditure (Actual) as at end June each Year

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Outlays ($b)	6.3	7.0	7.6	8.3	9.2	9.9	10.6	11.7	11.9	12.4	13.1

Source: DSS Annual Reports

Table 4: Percentage of age pensioners receiving full or part rate pension as at end June each year

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Full rate %	74.4	73.5	73.0	70.5	67.2	66.4	67.3	66.2	67.0	65.4	67.4
Part rate %	25.6	26.5	27.0	29.5	32.8	33.6	32.7	33.8	32.7	34.6	32.6

Source: Pensions Quarterly Survey, DSS

The Political Economy of Superannuation Reform in Australia

Australia constitutionally is a federation of six states and two territories. Tax raising and revenue powers are largely in the control of the Commonwealth Government. This fact is important for the way a unified savings and retirement incomes policy has been adopted in Australia.

In 1983 a Labor Party (social democratic) led by Mr Bob Hawke MHR came to power with the later Prime Minister, Paul Keating as his Treasurer. After eight years in Opposition the newly elected Labor Party government was keen to exploit its sizable majority with wide sweeping reforms of labor relations, financial services and microeconomic reform. Both men were determined to deregulate the economy and create an Australian economy once more able

1996. Possible reasons associated with this statistical pattern center on the development of collective bargaining and the growth in information industries and corresponding decline in heavy/manufacturing industry.

Background to the Mandated Superannuation System

With this as a backdrop, the need for change in the retirement policy of Australia was sharply defined by a Labor Government in 1983. The then newly elected Government had strong links with the trade union movement, whose peak body, the Australian Council of Trade Unions (ACTU) urged greater superannuation coverage for workers.

By 1986 circumstances were ideal for the introduction of a widespread employment-based retirement incomes policy. Continuing wages pressure and demands by the union movement on the government for a comprehensive superannuation policy to be initiated saw the introduction of award superannuation, set at up to 3% of an individual's yearly income. This amount was paid by the employer in the form of a wage increase granted by the Conciliation and Arbitration Commission.

Industry funds were effectively given a tremendous boost with this industrial and political decision. They are sponsored by employer and employee organizations in one or more industries and were established initially to receive the 3% award contributions. As at June 1996 there were 159 industry funds with 5.8 million accounts (35%) and $17.6 billion in assets (6%). A heavy concentration exists within this type of superannuation fund. Ten of the largest funds account for some 66% of assets in this sector.

Ongoing debate about the aging population and growth in superannuation funds continued into the late 1980s. Partly to ensure appropriate prudential safeguards were implemented and developed towards superannuation, the Insurance & Superannuation Commission (ISC) [now the Australian Prudential Regulatory Authority (APRA)] was established as the agency responsible for the regulation of superannuation on a Federal level. As indicated in my Churchill fellowship report, public confidence in the pensions industries of many countries, including the United States is partly a product of how efficiently the retirement incomes industry (life insurance and pensions) is regulated. Responsible Australian Government ministers along with bureaucrats in the late 1980s and today remain determined to avoid any breaches of legislation which will erode public confidence in the retirement

incomes model. In contrast the United Kingdom is seeing the Government eager to reform the regulation of pensions so restoring public confidence in the pensions industry after widespread mis-selling of personal pensions.

In 1989, there was a further major government initiative in the development of a retirement incomes policy to address the medium and long term needs of an aging population. The *Better Incomes: Retirement into the Next Century* Statement was released.

> "The *Better Incomes Statement* expressed a commitment to 'maintain the age pension as an adequate base level of income for older people' but went on to state that persons retiring in the future would require a standard of living consistent with that experienced whilst in the workforce."[2]

The Birth and Development of the Australian Superannuation Model

With a delay to the 1990-1991 wage case occurring, where the ACTU and the Government supported a further 3% round of award superannuation the then government saw its opportunity to act in a decisive manner towards retirement saving.

In August 1991 the then Treasurer foreshadowed the Government's intention of introducing a Superannuation Guarantee Levy which commenced on July 1 1992. In issuing a paper on the levy the Treasurer indicated that such a scheme would facilitate:

- a major extension of superannuation coverage to employees not currently covered by award superannuation;
- an efficient method of encouraging employers to comply with their obligation to provide superannuation to employees; and
- an orderly mechanism by which the level of employer superannuation support can be increased over time, consistent with retirement income policy objectives and the economy's capacity to pay.[3]

Additionally in a statement *Security in Retirement, Planning for Tomorrow Today* given on 30 June 1992, the then Treasurer, the Hon John Dawkins MP, reaffirmed the government's position and direction on the aging of Australia's population and the need for compulsory savings for retirement:

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[2] Senate Select Committee on Superannuation: 'Safeguarding Super', June 1992, p.7, Canberra, Australia

"Australia-unlike most other developed countries meets its age pension from current revenues. Taxation paid by today's workers is thus not contributing to workers' future retirement security; the revenue is fully used to meet the annual cost borne by governments.

And, like most other people, Australians generally undervalue savings for their own future retirement. Private voluntary savings cannot be relied upon to provide an adequate retirement security for most Australians. This is so even with the very generous taxation concessions which are available for private superannuation savings.

....In the face of these factors, changes are required to the current reliance on the pay-as-you-go approach to funding widely available retirement incomes. This means that we need now to start saving more for our future retirement. It also means that saving for retirement will have to be compulsory. It means that these savings will increasingly have to be 'preserved' for retirement purposes. Lastly, the rate of saving will have to ensure retirement incomes which are higher than that provided today through the age pension system.

There seems to be a general awareness in the community that something has to be done now to meet our future retirement needs."[4]

The Second Pillar

The Superannuation Guarantee Charge Act 1992 requires all employees to contribute to a complying superannuation fund at a level which increased from 3% p.a. in 1992 to 9%p.a. It should be noted that some discrimination was made for small business in how the levy was introduced and increases, based on the size of the annual payroll. If the employer chooses not to pay the levy he or she will have a superannuation guarantee charge (SGC) imposed on their business operations by the Australian Taxation Office (ATO). By deciding to neglect their obligations under Act the employer will not receive favorable taxation treatment in regard to contributions made by them on their employees' behalf.

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[3] Senate Select Committee on Superannuation: 'Safeguarding Super', June 1992, p.13, Canberra, Australia

[4] The Hon John Dawkins, MP, Treasurer: 'Security in Retirement, Planning for Tomorrow Today, 30 June 1992, pp1-2, Canberra, Australia

to compete on world terms. A vital ingredient in achieving this goal was significant reductions in wages growth.

Underlying political pressures were building for change in the Australian superannuation system:

- Significant dissatisfaction amongst the labor movement over the extent and coverage amongst blue collar workers. For instance the commission paid to life agents meant that the withdrawal benefits paid to short serving employees was often negligible.
- A strong belief amongst senior union officials that the future of the unions must lie in being able to deliver more than wage increases to their members (especially given their recognition of the need to modify wage demands if Australia was to stay competitive) and recognition that financial services was one service that for a variety reasons would be attractive to deliver.
- The need for the government to satisfy pay demands especially amongst militant unions such as the building unions without creating inflationary pressures.
- The competitiveness of the financial services sector which meant that some major institutions were prepared to support the initiative.

Increasing involvement by the union movement in superannuation matters challenged the traditional ideological biases against union involvement by existing industry participants. Yet some companies adopted a more lateral approach with the establishment of institutionally owned but independent non traditional providers of superannuation services. Larger Australian life insurers such as AMP, National Mutual and Colonial Mutual all embarked on establishing such a structure, with the support of the then Government and union movement.

In Australia a centralized wage fixing system has existed whereby wages are determined for some or all workers via a conciliation and arbitration process. Although this centralized approach is changing through enterprise bargaining, unions remain solidly in support of award based superannuation.

Although the union movement has played a pivotal role in the development of the Australian superannuation model trade union membership, like in many developed nations has continued to steadily decline. Between August 1986 and August 1996, the level of trade union membership reported by employees declined by around one-third from 46% in 1986 to 31% in

Table 1

Total Private Employer-Sponsored Retirement Plan and 401(k) Contributions and Assets in the United States for Selected Years

	Total Contributions to All Plans	401(k) Contributions	401(k) as Percent of Total	Total Assets in All Plans	401(k) Assets	401(k) as Percent of Total
1984	$ 90,625 M	$ 16,291	18.0	$ 1,044,592	$ 91,754	8.8
1985	95,188	24,322	25.6	1,252,739	143,939	11.5
1986	91,503	29,226	31.9	1,382,910	182,784	13.2
1987	92,070	33,185	36.0	1,402,488	215,477	15.4
1988	91,248	39,412	43.2	1,503,635	276,995	18.4
1989	97,920	46,081	47.1	1,675,597	357,015	21.3
1990	98,792	48,998	49.6	1,674,139	384,854	23.0
1991	111,124	51,533	46.4	1,936,271	440,259	22.7
1992	128,795	64,345	50.0	2,094,087	552,959	26.4
1993	153,642	69,322	45.1	2,316,272	616,316	26.6
1994	144,353	75,878	52.6	2,298,556	674,681	29.4

Source: U.S. Department of Labor, Pension and Welfare Benefits Administration, *Private Pension Plan Bulletin, Abstract of 1991 Form 5500 Annual Reports* (Washington D.C., Winter 1998).

Table 2

Total Workers for Whom Gender Was Determined and Percent Women by Age and Wage Level in 1995

Age group	Wage level of workers eligible to participate in 401(k) plans stated in thousands of dollars								Tota worke
	10.0-14.9	15.0-24.9	25.0-34.9	35.0-44.9	45.0-59.9	60.0-74.9	75.0-99.9	100.0 +	
				Total number of workers					
20-29	2,772	8,409	7,110	2,749	1,110	181	77	43	22,4
30-39	3,007	10,783	13,498	9,400	7,032	2,878	1,724	1,363	49,6
40-49	2,742	8,688	9,640	6,958	6,247	3,287	2,433	2,506	42,5
50-59	1,954	5,351	5,242	3,267	3,230	1,618	1,361	1,544	23,5
60-65	451	1,210	935	548	486	260	196	253	4,3
Total	10,926	34,441	36,425	22,922	18,105	8,224	5,791	5,709	142,5
				Percent of total workers who were women					
20-29	68.7	62.4	51.3	31.8	25.8	27.6	39.0	39.5	53
30-39	70.4	65.1	48.3	32.2	26.5	23.6	22.6	20.2	44
40-49	72.9	71.9	54.9	35.4	24.9	19.0	15.7	13.7	44
50-59	75.9	72.2	56.5	35.2	19.9	12.7	9.4	5.3	44
60-65	71.2	68.1	56.8	35.2	18.5	9.2	8.2	5.5	46
Total	71.6	67.4	52.0	33.6	24.5	19.2	16.3	12.8	45

Source: Sample of 87 plans collected by Watson Wyatt Worldwide.

Table 3

Average Account Balances Accumulated from Employee Contributions and Total
Contributions for Workers in 401(k) Plans by Age and Wage Levels in 1995

Age group	Wage levels stated in thousands of dollars for workers with 401(k) balances								
	10.0-14.9	15.0-24.9	25.0-34.9	35.0-44.9	45.0-59.9	60.0-74.9	75.0-99.9	100.0 +	Total
	Average cumulative balances of employee money								
20-29	1,258	2,128	3,646	6,811	10,862	15,000	13,444	14,799	4,026
30-39	2,802	4,238	7,003	11,423	17,813	26,875	34,106	43,745	12,411
40-49	4,661	6,234	9,804	16,726	25,755	39,919	52,644	73,109	21,884
50-59	6,811	9,759	15,677	26,221	38,689	55,534	71,594	117,054	32,145
60-65	8,290	14,442	20,908	30,732	46,830	64,523	80,600	145,358	36,082
Total	4,184	5,711	8,920	15,276	24,673	38,700	51,945	81,367	18,562
	Average cumulative balances of all money								
20-29	2,200	3,907	6,781	11,881	18,783	23,834	19,810	21,928	7,169
30-39	5,328	7,539	12,762	20,454	30,905	44,944	55,993	68,937	21,409
40-49	8,226	10,974	17,461	29,131	44,731	65,955	89,316	121,279	37,359
50-59	11,304	16,506	26,430	42,934	63,941	88,733	119,121	202,854	53,770
60-65	13,081	23,318	34,391	50,655	78,417	103,810	123,932	239,431	58,797
Total	7,250	9,908	15,731	26,342	42,168	63,413	86,537	136,447	31,511

Source: Sample of 87 plans collected by Watson Wyatt Worldwide.

Table 4

Average Account Balances Accumulated from Total Contributions for Workers in 401(k) Plans by Gender, Age, and Earnings Levels in 1995

Age group	Wage levels stated in thousands of dollars for workers with 401(k) balances								
	10.0-14.9	15.0-24.9	25.0-34.9	35.0-44.9	45.0-59.9	60.0-74.9	75.0-99.9	100.0 +	Total
	Average cumulative balances of all money held by women								
20-29	1,246	2,025	3,259	6,377	9,012	13,893	10,087	8,153	3,074
30-39	2,608	4,122	7,038	11,832	18,002	25,736	30,527	36,294	9,146
40-49	3,893	5,890	10,041	17,910	27,521	40,444	48,644	58,644	13,786
50-59	4,937	9,219	16,336	28,287	39,795	53,001	62,161	99,353	17,377
60-65	6,374	12,564	21,289	34,374	53,487	64,274	78,379	72,657	19,853
Total	3,430	5,493	9,173	16,301	24,672	35,422	42,473	53,983	11,360
	Average cumulative balances of all money held by men								
20-29	1,351	2,334	4,150	6,996	11,420	14,286	13,966	19,787	5,201
30-39	3,426	4,511	6,981	11,249	17,787	27,158	34,797	45,575	15,100
40-49	7,345	7,317	9,628	15,989	25,038	39,495	52,574	74,426	28,426
50-59	13,164	11,306	15,060	25,193	38,261	56,531	71,672	117,724	44,637
60-65	14,604	19,641	20,883	30,227	46,250	63,429	82,559	152,961	52,520
Total	6,622	6,224	8,640	14,689	24,639	39,491	53,326	84,638	24,880

Source: Sample of 87 plans collected by Watson Wyatt Worldwide.

Table 5

Percentage of Total Balances Allocated to Equities by Participants in 401(k) Plans by Gender, Age, and Wage Level in 1995 (Employer Plans without Company Stock as an Investment Option)

Age group	Wage levels of 401(k) account holders stated in thousands of dollars (allocation rates are stated in percents)								
	10.0-14.9	15.0-24.9	25.0-34.9	35.0-44.9	45.0-59.9	60.0-74.9	75.0-99.9	100.0 +	Tota
	Percentage of women's balances held equities								
20-29	55	57	60	67	67	75	72	30	58
30-39	48	52	56	63	66	67	74	77	55
40-49	49	51	51	60	59	60	68	70	52
50-59	42	46	48	56	58	61	60	69	46
60-65	40	37	43	48	61	49	50	87	39
Total	47	51	53	61	62	63	69	72	52
	Percentage of men's balances held in equities								
20-29	58	46	57	64	70	72	83	84	57
30-39	50	45	51	59	63	68	72	78	59
40-49	47	39	39	53	57	60	63	71	54
50-59	39	31	32	44	49	54	57	64	46
60-65	32	23	28	41	40	56	50	61	40
Total	48	40	46	55	59	62	64	71	54

Source: Sample of 58 plans collected by Watson Wyatt Worldwide.

At the present time the levy is currently at 7% which will increase progressively by to 9% by 2002. The threshold for paying this levy was based initially on the individual earning a minimum of $450 per month.

Table 5: Details of the Prescribed Superannuation Requirements Linked with the Mandated Second Pillar

	Employer's Prescribed Rate of Employee Support (%)
1997-98	6
1998-99	7
1999-00	7
2000-01	8
2001-02	8
2002-03 and subsequent years	9

Tax

The taxation of superannuation is based on a three tiered arrangement. Such a taxation approach also applies to the less significant, somewhat unplanned voluntary third pillar of the Australian superannuation system. Both domestically and internationally, the Australian approach to taxing contributions, investment income and overall returns is severely questioned.

Contributions: employer and tax deductible member superannuation contributions are included in the assessable income of a superannuation fund and taxed at a rate of 15 percent.

Contributions made by the member to a superannuation fund where no deductions has been allowed in respect of those contributions, ie undeducted member contributions, are not subject to taxation when contributed.

Where members earn over the surcharge threshold, currently $73,220, a surcharge of up to 15 percent will apply on all employer and tax deductible member superannuation contributions.

Investment: Income is included in the assessable income of a superannuation fund and is taxed at a rate of 15 percent.

Benefits: Lump sum superannuation benefits from a taxed fund after age 55 are not subject to tax unless the benefits exceed $90,474 for 1997-98. (This threshold is indexed annually to the rise in full time adult Average Weekly Ordinary Time Earnings, ie AWOTE).

Amounts in excess of this threshold are taxed at 15 percent plus the Medicare levy. Lump sums benefits from an untaxed fund taken after age 55 are taxed at 15 percent plus the Medicare levy for the first $90,474 and at 30 percent plus the Medicare levy for amounts in excess of this threshold.

Superannuation pensions are taxed so as to retain the concessional taxation of superannuation:

- the component of pensions that represents the return of member contributions that were not deductible when they were made is not subject to tax;
- the pension provider does not pay tax on income derived from the assets which support the pension payments; and
- a 15 percent rebate is available in respect of pensions paid from a taxed source.

Undeducted member contributions are not subject to tax on withdrawal.

Despite superannuation being taxed at three stages - ie, when contributed, accumulating in the fund and at the end benefit stage - savings accumulated in the superannuation system are subject to a lower level of tax than, for example, salary and wages income that is saved in a bank account or similar investment product.

Reasonable Benefit Limits (RBLs). The amount of concessionally taxed superannuation benefits received by a person over his or her lifetime is limited by RBLs (indexed to AWOTE). The pension RBL is available provided at least 50 percent of the total benefits received by a person are taken in the form of a pension or annuity that satisfies pension and annuity standards. Table 7 shows the lump sum and pension RBLs for 1997-98.

Table 6: Outline of the Reasonable Benefit Limits Prescribed by the Second Pillar

Lump Sum	$454,718
Pension	$909,435

Employers: Employers can claim a deduction on contributions to superannuation funds up to the member's age, based on the Maximum Deductible Contribution (MDC) limit.

Table 7: Employer Deductability Associated with the Second Pillar of the Australian Superannuation System

Member's Age at Financial Year End	Deduction Limit*
Under 35 years	$10,232
35 years to 49 years	$28,420
50 years and over	$70,482
Note: * Indexed annually to Adult Weekly Ordinary Time Earnings	

The SG requires all employees to contribute to a complying superannuation fund at a level which increased from 3 percent in 1992, currently at 6 percent to 9 percent in 2002. If the employer chooses not to pay the levy, he or she will have a superannuation guarantee charge (SGC) imposed on their business operations by the Australian Taxation Office (ATO). By deciding to neglect their obligations under the Act, employers will not receive favorable taxation treatment in regard to contributions made by them on their employees' behalf.

The threshold for paying this levy was based initially on the individual earning a minimum of $450 gross per month. Under provisions introduced by the Federal Coalition any body earning between $450 and $900 can opt out of the Superannuation Guarantee arrangements.

Table 8: Profile of the Second Pillar of the Australian Superannuation System

Type of Fund	Total $billion	Assets Dec 1997	Number June 1997	of Funds	Number of Accounts	(millions) Dec 1997
Corporate	64.7	(20.5%)	4277	(3.38%)	1.4	(8%)
Industry	21.5	(6.7%)	116	(0.08%)	5.5	(30.9%)
Public Sector	74.6	(23.6%)	122	(0.09%)	2.8	(16%)
Retail	79.9	(24.4%)	319	(0.31%)	7.8	(43.4%)
Excluded	38.4	(11.7%)	157,084	(96.14%)	0.25	(1.7%)
Balance of Statutory Funds	46.6	(13.1%)	NA		NA	
Total	325.7	(100%)	161,918	(100%)	17.7	(100%)

The Third Pillar

In Australia the third pillar of Australia's retirement incomes system is characterized by individual retirement accounts being generated on a voluntary basis through the private annuity, retail funds management and life insurance markets. Some taxation and concessional rebates offered for spouses and more generally savings income aimed at retirement have seen this sector grow. These details are identified below:

- Spouse Rebate (1996-1997)[5]

A contributing spouse may receive an 18 percent income tax rebate for contributions up to $3,000 per annum to the superannuation fund or RSA of a non-income earning spouse or working spouse with an income equal or below $10,800 per annum.

- The maximum rebateable limit will be shaded out at the rate of one dollar for each dollar of spouse income exceeding $10,800, fully shading out where the spouse's income reaches $13,800. The rebate will be payable on assessment from 1 July 1998.

- Taxation Rebate for Savings (1997-98)[6]

The savings rebate aims to provide universal encouragement for private savings through the tax system and to enhance the retirement income system.

- It will apply to undeducted member superannuation contributions, and/or net personal income from other savings and investments up to an annual cap of $3,000. The rebate will be phased in at a rate of 7.5 percent from 1 July 1998 (a maximum rebate of $225), rising to 15 percent (a maximum $450 per annum) from 1 July 1999.
- It provides assistance at the contribution and end benefit stages of superannuation savings. In retirement, pensions and annuities flowing from an individual's superannuation savings, or net income receipts from savings and investments, will qualify for the savings rebate.
- It will assist existing savers and will also be a significant incentive for potential savers.

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[5] Extensive details and the descriptions of the Spouse Rebate is provided by a Commonwealth Treasury briefing paper

[6] Extensive details and descriptions of the Taxation Rebate for Savings is provided by a Commonwealth Treasury briefing p

Development and Impact of Superannuation on the Australian Investment Markets[7]

In 1983 the Australian superannuation industry had some $32 billion and 40% coverage of the workforce. Today these statistics have dramatically changed with $343 billion held in superannuation assets and an estimated coverage of the work force being 91% (Refer to Exhibit 1) depicts more recent strong growth in superannuation assets. It is anticipated that these asset levels will surpass the $1 trillion mark early in the next century.

With the introduction of mandated superannuation there was a shift away from defined benefit to defined contribution, fully funded schemes. It is estimated that around 55% of superannuation assets are held in defined contribution funds. This process along with the injection of mandated superannuation contributions saw the investment markets in Australia both deepen and broaden, in terms of product range, services offered and the overall number of participants.

Through greater consumer awareness and the need for individual financial planning for retirement, superannuation fund members are increasingly demanding greater investment choices. The net effect of such consumer behavior has been that investment managers and financial intermediaries (agents, brokers and planners) have had to be both responsive and consumer focused in providing investment vehicles which are appropriately priced and well understood by consumers. Australia, like other OECD countries is witnessing consumers who are increasingly intolerant of poorly designed and priced long term investment vehicles.

The current level of foreign investments associated with superannuation assets is around 18%. This level is expected to increase through investment managers' efforts to seek diversification of associated investments and also because of the limitations of the size of the Australian share market. Many large investment houses in the United States have associated operations in Australia.

Continued growth and development in the Australian investment market is expected to take place in the short and long term. Fierce competition in the market place has seen

[7] The author wishes to acknowledge materials provided by Ms Jill Green and Mr Peter Bennett, Head of Investment Practice, Australia: Watson Wyatt Worldwide - Sydney Office concerning this section of the testimony.

associated fees and overall returns narrow over recent years as superannuation assets progressively grow. This growth has seen superannuation trustees being able to extract more efficient fee settings for their members as volumes and account balances have increased. The following tables depict the associated investment market positions linked strongly with superannuation in Australia.

Table 9: Major Managers of Wholesale Superannuation Investments as 30 September 1997

Manager	Wholesale Superannuation Funds under management A$billion	Percentage of Total %
BT Funds Management	20.2	12.2
AMP	15.3	9.3
Westpac	11.1	6.7
Macquarie	10.0	6.1
Lend Lease/MLC	9.1	5.5
County	8.7	5.3
Industry	165.0	100.0

Table 10: Major Managers of Retail Superannuation Investments as 30 September 1997

Manager	Retail Superannuation Funds under management A$billion	Percentage of Total %
Commonwealth Financial Services	6.2	12.7
Lend lease/MLC	5.4	11.1
BT Funds Management	4.2	8.6
AMP	3.8	7.8
Westpac Banking Corporation	2.9	6.1
Industry	48.3	100.0

Table 11: Major Managers of Retail Non-Superannuation Investment Funds as 30 September 1997

Manager	Retail Non-Superannuation Funds under management A$billion	Percentage of Total %
BT Funds Management	8.8	18.3
Macquarie Investment Management (mostly cash management trust)	4.8	9.9
ANZ Bank	4.0	6.8
Westpac Banking Corporation	3.3	6.8
Lend Lease/MLC	2.7	5.5
Industry Total	48.4	100.0

Consumer Considerations Associated Social Security Reform

I now would like to turn to the obvious key stakeholder in any reform of a pensions model, that being the member or more broadly the recipient of a nation's pension system. In the last ten years businesses throughout the world, both big and small have been increasingly listening to consumers. Today consumers are on average more educated and more willing to express dissatisfaction over the goods and services they receive.

My research internationally has revealed several important patterns developing in both the developing and developed world, in Asia and in Europe towards pensions and retirement planning. Younger consumers, members of Generation X are actively expressing doubts over whether their governments can provide for them in retirement. Unlike the belief that is nurtured by their parents or grandparents, there is a very real tangible sense that Government will not effectively provide for them in retirement.

For a consumer the real danger can be a sense of myopia (the ability to do nothing) regarding their retirement. Through a cultural or generational link many believe that the State sponsored scheme will somehow be able to sustain their existing lifestyles in retirement. In a recent report on pensions by the Office of Fair Trading, in the United Kingdom a consumer

survey of 4000 people revealed some disturbing statistics about consumer attitudes towards pensions.

"More than 45% of both pensioners and non-pensioners either had no pension arrangements, other than the basic state pension, or did not know what they were."

"Women who were in full-time employment or self-employed were significantly more likely to have no pension arrangements than men in similar types of employment."

"A third of full-time employees expected to receive, in retirement, between half and two-thirds of their pre-retirement income. This compared with a quarter of those who were self employed and a fifth of part-time employees."[8]

Thus myopia can lull consumers into a very real false sense of security. Yet the major stumbling block for several pension systems who have had or are considering full or part privatization of their pension system has been the mechanism of distribution, most commonly in the form of an agent. Australia and the United Kingdom have all experienced some forms of negativity associated with the conduct of agents.

Although the United Kingdom has fully confronted the challenges of privatizing pensions, it now suffers from the associated problems of mis-selling associated with their distribution. Through mis-selling and transfers into newly created personal pensions in the late 1980s from the government's State Earnings Related Pensions Scheme (SERPS) and company schemes, the current compensation bill faced by pension providers in the United Kingdom is estimated at £11 billion.

Industry regulators including the Personal Investment Authority (PIA) and Office of Fair Trading (OFT) have clearly urged companies to resolve this matter which has dragged on effectively since 1994. Clearly the United Kingdom has proven that you cannot look at expenditure measures alone when reforming or privatizing a pension system. Issues of adequacy, compulsion and possible consumer detriment need to be considered in any reform process.

[8] Office of Fair Trading: 'Report of the Director General's Inquiry into Pensions', 1997, HMSO, London, United Kingdom

Additionally disclosure of fees, charges and commissions has been crucial in maintaining and implementing a high level of consumer protection associated with the Australian superannuation system.

Regulation and the Need for Investor Education

In researching my Churchill Fellowship report, *At the Intersection* in 1996 I noted two polarized comments being repeated frequently by industry and regulatory groups or government officials. Industry's attitude towards regulation was that it increased the costs of distribution and thus impeded the smooth functioning of the market. Many insisted that self regulation by industry associations was a more satisfactory alternative.

To contrast this stance government officials insisted that regulation of pensions was necessary to avoid the potential of uninformed or ignorant consumers purchasing products that were inappropriate for their needs, thus leading to financial detriment.

One of the conclusions in my research is that a more accurate assessment of the value of regulation is located between these two extremes.

Consensus regulation, advocated in my 1996 study identifies a need for a regulatory model which allows industry, consumer bodies and government regulators to co-operate in a helpful and effective manner. Regular formal and informal meetings between all three groups allows a more co-operative approach to be executed in the regulation of industry participants. Such a model or parts of it could useful for a planned regulator in the United States.

I am aware that state versus federal rights is a contentious issue in the United States and as I am not a lawyer I would not like to entertain or discuss the intricacies of American constitutional law. Yet I think it is important to note that federally regulated pension systems seem to operate more efficiently overall than their state counterparts on an international level. If I was to personally speculate what may happen in terms of regulation in the United States it would be the establishment of a new regulatory entity who would help in the transition and implementation of these accounts. The organization would I suspect be federally funded and federally based and would have two separate arms of operation; solvency or maintenance of proper authorities by providers of the product and a consumer protection and public education role to investigate complaints or concerns expressed by existing account holders. The

challenges would be maintaining and attracting highly competent staff and working in unison with other government agencies

The general philosophy on financial regulation in any particular country is to a considerable extent guided by the accepted norms and conventions of the broader financial community as well as the general philosophies and ideologies that are encouraged by those in political power.

In looking at financial services regulation throughout the world three major regulatory objectives are able to be identified. These included:

1. Ensuring a high level of efficiency in the provision of financial services in the best interest of the entire economy.
2. The securing and maintenance of stability in the financial system.
3. Establishment and recognition of protecting the interests of all parties affected by financial services.

This last objective is summarized quiet accurately by DT Llewellyn:

"The ultimate rationale of regulation designed to protect the consumer is to correct for market imperfections or market failure which would compromise consumer welfare in a regulation-free environment."[9]

Many regulators in major pension markets have used neo-classical theory as a starting point for the development of a regulatory framework. This theory demonstrates logically that a system of competitive markets for goods and services will achieve the basis of an 'efficient' allocation of resources.

Many assumptions underlie the neo-classical theory. They include:

- each individual participating in the market is assumed to be the best judge of his or her own interests, and to act consistently;
- maximizing his or her own utility (or personal satisfaction) within the constraints of the resources available to him or her;
- consumer demand is autonomous; and
- firms are assumed to attempt to maximize their profits.

[9] Llewellyn DT: 'Regulation of Retail Investment Services', Economic Affiars, Vol. 15, No. 2, p.13

Although neo-classical theory has dominated the thinking of many regulatory bodies in the United Kingdom and Australia, certain deficiencies exist in this approach. Firstly by observing the normal rules of efficiency in other markets these characteristics may not necessarily be desirable. A second limitation of the neo-classical theory approach which regulators have encountered is that it is a static approach. It overlooks, for example, the harmful effects to consumers of inhibiting product and process innovation.

On a related issue. A crucial element of consumer protection theory is the basis that consumers need sufficient and detailed information, through disclosure to make a well informed decision in the purchase of pension products. The economic argument associated with the transaction is that it should be transparent for the consumer ie the consumer can see the benefits derived through the transaction and the associated costs.

As indicated, my research established a correlation in some countries with the level of disclosure related to pension products and inappropriate sales being generated by, often dubious intermediaries and the level of public confidence in each country's pensions model. Regulators would have to be prepared for such problems. For example the United Kingdom's then self regulatory organizations were for example unable to prevent or successfully resolve large scale mis-selling which has tarnished what can otherwise be described as bold pensions reform.

Why have long term investment contracts such as pensions received so much regulatory attention from specific industry regulators and consumer protection agencies? Some of the reasons for this regulatory interest include that:

- It is impossible for the consumer to understand at the time of purchase the future investment returns;
- The duration of the pension contract prohibits the consumer from gaining experience through frequent purchasing decisions;
- It includes an obligation for a continuing financial commitment;
- The purchase of a pension product involves the largest commitment of a consumer's resources over a life time. Related to this feature is that the determination of an inappropriate pension sale will usually not be determined for some years; and

- Consumer uncertainty and the difficulty associated with understanding pension products can often see the consumer relying more heavily on the intermediary or agent than other purchases.

Consumer protection and the associated theories that surround it are increasingly being noted by many pension regulators and associated government agencies in both developing and developed nations. Clearly in the last twenty years consumer rights and their associated implications for financial services have been well documented. Another encouraging trend is that pension industry associations are adopting a stronger role in encouraging their members to comply with existing regulations. This process is more cost effective for the overall system as a whole but also avoids the further need for prescriptive regulation.

Public Education and Greater Acceptance of Superannuation Reforms

Australia's public education campaign was essentially funded and delivered by the Australian government between 1994-1996. Government agencies that participated included the Insurance & Superannuation Commission (ISC), Australian Taxation Office (ATO), Department of Social Security (DSS) and Treasury. Industry bodies such as the Association of Superannuation Funds of Australia (ASFA), Life Investment & Superannuation Association (LISA) [now the Investment & Financial Services Association] also played a role, along with consumer groups like the Australian Consumers' Association. The main delivery of such campaigns was provided via the ATO and to a lesser extent the ISC.

Between 1995-1996 an intense print and electronic media campaign was initiated by the ATO. This campaign was also supplemented by leaflets distributed to every Australian household explaining the principles and features behind the new mandated superannuation guarantee (SG) system. These leaflets included references to the regulator (ISC) and the importance of saving for retirement. The ISC, if you like the immediate regulator of industry, also worked closely with ASFA to assist in the formation of public education material, specifically targeting trustees and members of various superannuation fund types. The estimated cost of this campaign was estimated to be $AUS11million in 1995. (Exhibit 2 and 3)

During 1997 the ATO principally pursued public education strategies through a Communications Working Group. The Group represents organizations with an interest in

superannuation and provides valuable feedback to the ATO on proposed communication initiatives. Specific campaigns have been initiated in 1996-97 which focus on women and minority groups as these groups traditionally have a low level of voluntary contribution today to individual superannuation accounts.

Subsequently public education is now being more vigorously pursued by industry associations such as ASFA, with various publications directed at trustees and members alike. Both qualitative and quantitative research was carried out by the ATO to evaluate the effectiveness of the public education campaign held between 1995-1996.

The Federal Government's approach with regard to promoting the associated superannuation reforms, through public education seems to have been effective. It is estimated by the Insurance and Superannuation Commission (ISC) that nearly half of all inflows into the current superannuation model are being generated from voluntary contributions. Thus essentially there has been change in mind set among Australians, in terms of how they view retirement provisions. It seems that more 'people today in Australia are worried about living to long rather than dying to early.'

This attitude, along with a growing notion of self interest, in terms of being 'better off' under the current retirement system has seen wide acceptance by the general community develop over superannuation reforms. Other elements which have also led to this acceptance being generated include frank admissions by industry and political leaders that the previous retirement system was unsustainable and moreover that the country was better off economically from higher levels of savings through superannuation accounts. Continued industry education, improved distribution and bolstered financial adviser standards and effective disputes resolution schemes have all contributed to the 'brand visibility' of superannuation in the community. A further additional element that is also worth noting is that the stronger media comment and coverage of superannuation issues has aided in the overall level of public education being generated in the Australian community. The approach towards social security reform and its wider acceptance through the use of public education can best be summarized by comments made Jones and Harris (1998):

"International experience suggests that government, industry and consumer groups have mutually supportive roles to play in public education. One-off campaigns

designed to convince people that they need to take responsibility for their retirement income have limited value and without sufficient requirements for disclosure and redress may well lead to consumer detriment. The provision of information and education should not depend on an arbitrary allocation of responsibility. A government has future economic stability to gain from persuading people to plan their own retirement incomes, equipping them with the means to choose the most productive product, ensuring effective regulation to deliver what is promised and establishing accessible redress mechanisms.."[10]

An International Contrast between Australia and the United Kingdom

The following outlines some of the major elements and structures of the British pensions model. This section of the testimony serves to contrast the approach adopted by Australia towards social security reform and the associated ingredients which make such a process both effective and successful. It should be noted that the current British Government is evaluating various policy options for future social security reform.

The United Kingdom's Second Tier - SERPS and Occupational Pension Schemes

SERPS

In 1948 the Beveridge Report had developed a compulsory pension system which consisted only of the first tier. In effect this was the basic state pension and means tested National Assistance.

Yet increasingly, pressure on the Government to provide a more substantial second tier approach for all workers developed, partly as a result of the strong growth in occupational schemes. Between 1953 and its peak in 1967, occupational pension coverage expanded from 28 to 53% of employees. This coverage in recent years has declined which partly can be attributed to an overall trend in changing employment patterns.

In 1975 the Social Security Act introduced the State Earnings Related Pensions Scheme (SERPS). Its design allowed occupational schemes to contract out of SERPS to avoid

[10] Susan P. Jones and David O. Harris: 'Consumer Protection in Financial Services: International Comparisons', University of Wales, March 1998, (Draft: Expected full publication - August 1998)

the scheme substituting for private sector provision. Effectively the design of the second tier pension was for those people not in occupational schemes.

During the initial period of this second tier pension scheme benefits, were comparatively generous with today's levels. SERPS guaranteed contributors to the scheme an additional pension of 25% of their earnings between lower and upper earnings limits. The scheme was compulsory. As indicated, employers and contributors could contract out of SERPS only into a salary-related occupational scheme if it offered benefits at least equal to those provided by SERPS.

Earnings in the best 20 years counted towards the pension at a rate of 1.25% of earnings between lower and upper limits. These limits were revalued in line with average earnings. Once payments commenced, the additional pension was uprated annually in line with consumer prices. The cost of uprating the basic pension (first tier) and SERPS was met by the National Insurance Fund.

Pensions under SERPS matured in 20 years and, as a result of the 20 best earning years formula, were especially advantageous to some groups. Employees earning more than the Lower Earnings Limit (LEL) for National Insurance Contributions (NICs) £57 per week for 1994-95 pay Class 1 NICs earn entitlement to SERPS as well as the basic pension unless they are contracted out. The Upper Earnings Limit (UEL) must by law lie between 6.5 and 7.5 times the basic state pension, and stood at £430 per week in 1994-95-around 120% of average male earnings.

An associated development which influenced the calculation of SERPS was that in 1980 the newly elected Conservative Government broke the earnings link for the annual uprating of the basic state pension and linked it instead to the Consumer Price Index. This factor is important as the LEL is itself tied to the flat-rate pension and the UEL is in turn increased in line with the LEL.

In June 1985 the Conservative Government published a Green Paper, Reform of Social Security. This document highlighted the implications of the basic state pension and SERPS over the following 50 years. The concerns raised by this paper in regard these two forms of pensions provisions can be summarized by Budd and Campbell:

"The Green Paper pointed out that the increased cost of the basic pension would benefit all pensioners equally. However the case was different for recipients of SERPS. Its earnings-related nature meant that the newly-retired would benefit more than older pensioners. Also half the extra cost would result from payments to members of contracted-out schemes (to provide indexation top-up to the Guaranteed Minimum Pension). The cost of SERPS (in 1985 prices) was expected to be about £24 billion in 2035, compared with a basic pension cost in 1985 of about £15 billion."[11]

A significant change to SERPS took place in the second half of the 1980s when the Social Security Act 1986 provided that from 1999 onwards, SERPS additions to the basic state pension would be calculated not on the basis of the best 20 years rule but instead on lifetime average earnings. Now SERPS would provide 20% of average earnings over the whole working life of the individual.

The current cost of SERPS is only around two billion pounds per annum, due to relatively few retired people having significant entitlements. By 2030 in contrast, these entitlements will have grown to its maturity point.

In summary SERPS payments in the future will progressively diminish as a percentage of a person's final retirement income through changes in the 1980s which saw these payments linked to prices rather than earnings.

The UEL has fallen from 140% of average earnings to 120% and will continue to fall. With price indexation, and 2% real earnings growth per annum, the UEL will be less than 60% of average male earnings by 2030, implying a maximum SERPS pension of only 10% of average male earnings. Conversely, the same rate of indexation of the LEL will increase the SERPS entitlement of those with earnings below the UEL, since they will accrue SERPS on a larger part of their earnings.

Contracting Out of SERPS

As indicated previously, when SERPS was introduced members and employers of occupational schemes had the ability to generate a contracting-out rebate if the scheme agreed to provide a guaranteed minimum pension, related to individual average lifetime earnings. This

[11] Budd A & Campbell N: 'The Roles of the Public and Private Sectors in the UK Pension System' - 1996, HMSO London, United Kingdom, p.7

rebate was initially set at 7% of earnings (between LEL and UEL for National Insurance contributions). The current rate, applying from 1993-94 onwards, is 4.8%.

In 1988, the contracting out option was extended to a further range of products, principally personal pension products. The reason for this decision is subject to some conjecture. Some elements say it had an ideological basis spawned by the then Prime Minister, Margaret Thatcher who felt that Government should not be involved in pensions provisions for the second tier. More likely was that advice provided by the Treasury and Government Actuary's Department indicated that through the affects of an aging population, the United Kingdom's economy would be crippled by overly generous welfare payments.

The condition for leaving SERPS is not, that a guaranteed minimum pension should be paid, but that a guaranteed minimum contribution should be made. This minimum level is the contracted-out rebate. Levels of rebate offered to people newly contracted out into personal pensions (or group defined contribution schemes) was set above the rebate for those in occupational pensions. Initially, an extra 2% 'incentive' rebate was offered with the aim of 'kick-starting' the personal pensions sector. In 1993-94, this declined to an incentive rebate of 1% restricted to the over 30s. The rationale for this policy was that a large number have already taken out personal pensions, and so a kick-start is no longer required.

The United Kingdom's Third Tier - Private Pensions

Through allowing people to contract out of their SERPS entitlements and transfer from occupational schemes personal pensions in 1988 received a significant boost in sales growth and long term product development. The popularity of these products was quickly established and thus by 1992 % 23% of male and 19% of female employees had contracted out and were in personal pensions.

Concern in Treasury and other areas of Government was that these new retirement vehicles were only being used to receive the rebate provided through transferring out of SERPS. In 1991, 24% of employees had contracted-out into personal pensions yet about three-fifths of these personal pensions had been established simply to receive the associated rebate and incentives provided by the Government. Such a situation led or induced the mis-selling of pensions which has continued to erode a recovery in the public confidence, within the industry.

Overall personal pensions today are 'manufactured' by a number of providers. These companies are mainly life insurance companies although building societies, unit trusts and other financial organizations are permitted to administer pensions (at least up to retirement). Restrictions on investments are relatively few and it is important to note that even supermarkets in the United Kingdom are offering such financial services products on an execution basis.

In general, the deposits from personal pension funds must be used to purchase annuity. . Recent legislative amendments have increased the individual's freedom of choice between annuity suppliers. The Government has ensured that the same tax privileges extend to personal pensions, as which exist for occupational schemes.

A concise summary or assessment of personal pensions and the future role that they are likely to play in the British market is provided by Mr CD Daykin, the United Kingdom's Government Actuary in his report to the European Commission.

> " Personal pensions at the minimum level for contracting-out are unlikely to provide a very inadequate income in retirement. A major challenge for education (and marketing) is, therefore, to persuade people that they must make additional voluntary contributions and that the responsibility for ensuring an adequate retirement is theirs. The State will not provide more than the basic flat-rate pension. Of course, there will still be the possibility of means-tested income support, but the whole thrust of encouraging private provision for pensions is to lessen the dependence on State Benefits.
> Views differ as to the likely success of these objectives. Trade unions and staff associations in general remain very suspicious of personal pensions, which they see as putting too much of the risk (particularly of investment performance relative to inflation) on the individual and too much money (commission, profit, etc) into the hands of financial intermediaries, insurance companies and other financial institutions. The preferred option of organized labour is the final salary occupational pension scheme, if possible with full price indexation of pensions, both in payment and in deferment."[12]

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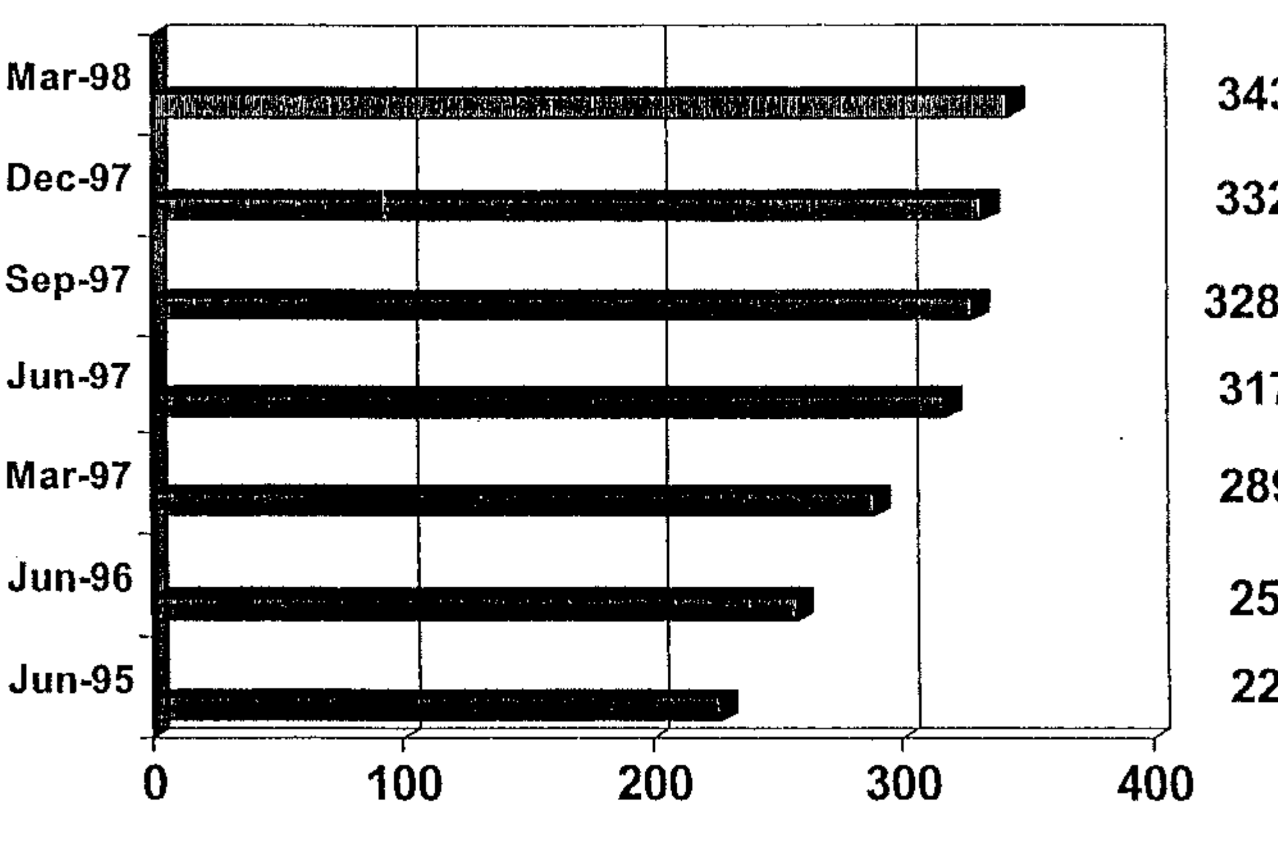
[12] Daykin CD: 'Pension Provision in Britain - Report on Supplementary Pension Provision in the United Kingdom', 1994, HMSO, London, United Kingdom

Conclusions

For the United States, the realities of social security reform are apparent when you consider models like Australia. Today as in tomorrow a fully funded, defined contribution system is essentially operated and maintained in Australia. (Refer Exhibit 4). The move towards this system involved a fundamental change in the way politicians and effectively all Australians approached the issues associated with retirement. Like the United States, Australia shares the same demands by consumers who insist that they, not the government are best placed to dictate their long term retirement provisions. This fundamental maxim should be strongly considered when evaluating social security reform and the associated social security models, like that of Australia.

Exhibit 1

Total Superannuation Assets



Source: ISC Bulletin - March 1998

Exhibit 2

Starting work for the first time

If you are starting your first job, you have the perfect opportunity to get in on the ground level of super, and watch it grow throughout your working life.

Starting your first job is an exciting new adventure. As well as the wonderful things you will learn, you will start earning your own money – giving you the independence to do what you want.

Once you get a taste for financial independence, it's very hard to let it go. You can buy what you need, build your own budget, lash out on that fabulous new car.

That's why thinking about super now is so important. The more you put into super while you're working, the more you'll benefit in the future.

IT ALL ADDS UP Think of super as the savings plan that looks after itself. Your super savings are put into a broad range of investments such as shares, property and Government bonds.

The more you put into super while you're working, the more you'll benefit in the future

TAX TIME You can also save money by taking out super because of some very special tax benefits.

Interest that is earned on investments held by all super funds that meet the Government's rules is taxed at the rate of only 15%.

This helps your super savings grow faster than other investments, which are taxed at your highest income tax rate, which could be up to 47%, depending on how much you earn.

In the future, when you are ready to retire and collect your super, the rate of tax will depend on, among other things, your age, how much you are receiving and how much you take as a lump sum or as a super pension. However, for the majority of women, this tax will be no more than 15% of your benefits.

It's about your future

What is Superannuation? Whether you work full-time, part-time or casually, super is a simple way of saving for retirement.

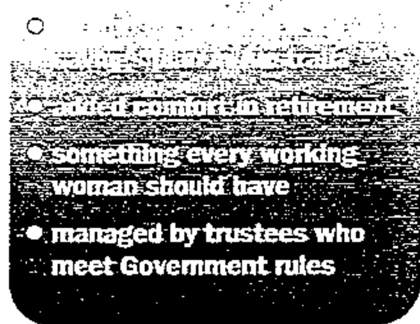
Super is paid by your employer either under awards or through the Superannuation Guarantee. Of course, you may also pay your own super contributions.

With super, you will have extra comfort in retirement. But not everyone will have enough super savings when they retire, which is why the age pension will always be available for those who need it.

How does it work? It's easy! If you are already in the workforce, your employer should have been contributing to a super fund in your name for a while – they are required to do so by law. In the future, it is planned that you'll make your own super contributions. The Government also plans to match your contributions dollar-for-dollar, up to certain limits. This way, you'll be building greater retirement savings. These savings are invested for you, give you tax breaks and are kept for your retirement.

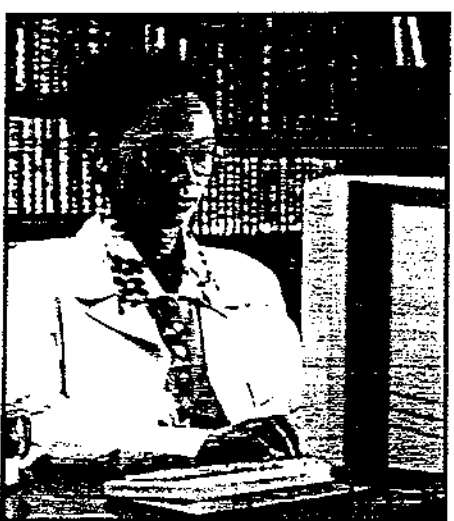
SUPER HELPLINE 13 10 20

SUPER IS...



Going back after a break

You may have taken time off to start your family, spent time at home while your children grew up, or simply had a break from work. Whatever your reason for deciding to get back to work, there's no better time to have a good look at your super.



If you have been away from the workforce for a while, no doubt you will be nervous about how you will go, and if your skills are what they used to be. And probably the last thing on your mind will be your retirement. But there is no better time than the present to spare a thought about your future.

You see, some things in your workplace will have changed while you were away. Checking your super arrangements now will give you peace of mind in the future.

The amount of super your employer pays for you can depend on how much you earn and the size of your employer's business. They may also have an award obligation to make super contributions for you. And the award will often specify which fund these contributions must go into.

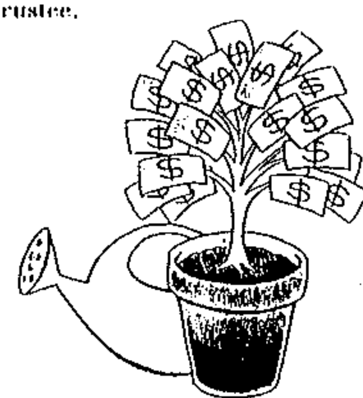
To find out what the super story is in your workplace, either ask the pay office or your boss.

The best time to do it is when you are getting back into the workforce. You can call the Super Helpline on 13 10 20 for an information booklet.

About this Brochure

The Treasurer has announced measures to prevent small superannuation balances being eroded by administrative fees and charges. This will apply to funds with five or more members.

The measures are outlined here to help you understand your obligations as a fund trustee.



More Information

For more information on protecting small superannuation amounts, contact the Insurance and Superannuation Commission's Helpline on

13 10 60
(for the cost of a local call)

For more information on the SHAR, contact the Tax Office Helpline on

13 10 20
(for the cost of a local call)

This number is linked to the Translating and Interpreting Service (TIS) which provides a translation service for non-English speakers.

This information is current as at 17 March 1995.

ISC 0004.04.95

Exhibit 3

New rules for protecting small super amounts

Super
It grows on you
A COMMONWEALTH GOVERNMENT INITIATIVE

Protecting small superannuation amounts

Member protection will prevent small amounts from being eroded where interest earned on the account is less than administration fees and charges. The rules to protect small superannuation amounts are expected to be in place by 1 July 1995 and will apply to all funds with five or more members.

Funds are required to protect balances of less than $1000 which contain some compulsory employer contributions. Administrative fees and charges must be limited, to ensure they do not exceed investment earnings on a member's balance. Funds which retain and protect small balances in this way will be able to continue to accept Superannuation Guarantee (SG) and award contributions.

Funds will be unable to retain superannuation amounts under $1000 without protecting them. Funds which decide not to retain and protect small balances will be required to transfer existing small balances to a fund which does 'member protect' or to an Eligible Rollover Fund (ERF). All ERFs will protect members' small superannuation amounts.

Note: Small superannuation amounts will still be subject to deductions for tax, insurance premiums and where the fund makes a loss or where the fund's total investment earnings are insufficient to pay its total administration costs.

Collection System

Employers will be encouraged to pay contributions into a superannuation fund which will protect their employees' small superannuation amounts from administration fees and charges. There will, as a last resort, be a collection system administered by the Tax Office known as the Superannuation Holding Accounts Reserve (SHAR) for employers who cannot find a fund which member protects.

Subject to Parliamentary approval, the SHAR collection system will be in place from 1 July 1995.

Administering Member Protection

The main aim of the small amounts measures is to ensure benefits are protected in respect of fees and charges. It does not restrict the way in which benefits are administered. For example, funds may continue charging administration fees to accounts, and as necessary apply sufficient credits at the end of the year if fees have exceeded interest earned during that year. As an alternative, funds could limit administrative charges to interest credited to the account during the year.

Upcoming Employer Mailout

Advice will soon be mailed to over 600 000 employers advising them to choose a fund which protects small superannuation amounts in this way. Employers who contribute to your fund may contact the fund to see if it will protect small superannuation amounts.

Exhibit 4

International Positions of Social Security Reform Options