Pension Policy Research Group Conference

Wednesday 17 June 2015

Current Pension Issues
School of Business, Trinity College

Governance Issues and Automatic Enrolment

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Introduction

- Current pension systems are widely recognized as failing in a number of ways, for example in Ireland coverage has remained around 50% of the work force, despite numerous initiatives.
- Many current pension arrangements will fail to deliver an adequate income in retirement.
- For these reasons a number of countries have introduced or are proposing to introduce, a scheme for automatic enrolment (AE).

Reasons for introducing Automatic Enrollment

- In 2010, the Government proposed an automatic enrolment (AE) pension scheme with the stated intention of ensuring increased "coverage and adequacy".
- Additional reasons given :-

- overcome "inertia";
- Increase transparency;
- Reduce inequities in pension provision
- Increase affordability by allowing breaks in contributions withdrawals for a house deposit.

- The OECD in a review of pension systems for the Irish Government stated (OECD, 2013 p. 12):-

- "To increase adequacy of pensions in Ireland, coverage in funded pensions should be increased. Increasing coverage can be achieved through: compulsion; soft-compulsion, automatic enrolment; and/or improving existing financial incentives".

- More recently An Tanaiste
- "confirmed Government's approval to proceed with work to develop a roadmap and timeline for the introduction of a new supplementary workplace retirement saving scheme" (Press release, Department of Social Protection, Feb. 3rd, 2015).

New Zealand Kiwi saver

- The OECD (2013) has in particular singled out the New Zealand automatic enrollment (KIWI scheme) in relation to an automatic enrollment scheme for Ireland. The OECD state:-
- “ New Zealand offers an interesting case study” (OECD, p. 128).
- However the OECD Report (2013) does not refer to the costs of the New Zealand automatic enrolment scheme, in terms of direct costs.
- Of $19 billion of funds under management in 2013, the state contributed $5.3 billion (27.9%), and employers $3.5 billion (18.4%) (St. John, et al. 2014, p. 18).
- Costs in terms of fees and charges are also reported as difficult to identify and hence to control (St. John, p. 20).
- There are also issues in terms of regulation where lines of responsibility are “obscure” (St. John, p. 20).
- AE by itself will not solve all pension system problems.

  The Department for Work and Pensions (2014, p. 5) in the UK comment that:-
- “By 2018, 8 to 9 million people will start saving or be saving more as a result of AE. This places a new responsibility on government, regulators,, and the financial services industry to ensure that workplace schemes are well run.”

Governance is more important for DC schemes than for DB schemes

- Governance issues have assumed a more central role in pension research and analysis and include issues that are central to funded pension systems, such as costs, returns, and regulation.
- The increased prominence of DC schemes poses additional challenges for trustees (UK Pensions Regulator 2011).
- The main difference in the role of trustees in DB and DC schemes arises from the absence of an employer guarantee.
- All of the risk (long term investment performance risk, short term cyclical risk, longevity risk, and the risk of under-funding) is thus transferred to scheme members.
- Whether due to poor investment investment decision making, or poor administrative and management decisions, employers have no liabilities for deficits in defined contribution type schemes.
- Hence pension fund governance has a greater impact on pension outcomes for defined contribution type pension schemes.

The Role of Trusts

The Pensions Authority in Ireland state :- “In previous annual reports and elsewhere the Board has drawn attention to the very important role that trustees perform” (Pensions Authority Annual Report, 2013, p. 4).

- Defined benefit schemes are always organised as a trust and some defined contribution schemes are organised as a trust, but are more generally contract based.

- These differences are important:-
- Trust based schemes are subject to trust law and regulated by the pension regulator,
- but contract based schemes are subject to the law of contract and regulated by the Financial Regulator – the Central Bank in Ireland and the Financial Conduct Authority in the UK. Although the pensions regulator in Ireland also has a role in DC based schemes.

- The financial regulator in various countries is also responsible for regulating the financial archictecture on which all private sector pension funds are dependent.

- These relationships are complex (See Figure 2.1 Law Commission, 2014).
- In addition the trust deed which will vary from one scheme to another, has assumed particular significance in law cases in Ireland involving pension fund trustees and employers.

Fiduciary Duties ?

A common assumption is that those involved in pension provision (trustees, investment managers, stock brokers, etc.) are subject to a general law in relation to fiduciary duties, that is “a legal duty to act solely in another party’s interest” (http://www.law.cornell.edu/wex/fiduciary_duty).

The question of who is subject to fiduciary duties is stated to be a “notoriously intracatable question” (Law Commission, 2014, p. 34). Yet fiduciary duties in pension provision are extensive and growing.

In many cases modern practice is that securities held by pension funds and other investors are not owned directly but rather by intermediaries. For example a Centralised Securities Depository may hold securites on behalf of account holders.

- The Law Commission Report comments that there has been some debate on the legal relationships governing this ownership structure and comment “We now **think** that it generally operates as a series of trusts” (Law Commission, 2015, p. 229).

- Apart from legal uncertainty, other problems that arise relate to owners exercising rights such as voting, a lack of transparency, for example where secrurities are lent for trading purposes in terms of identifying the associated income flows, and potential risks (Law Commission, p. 231).
- Considerable value added may arise from ownership of equities through exercising control.

Widespread Assumptions of portfolio theory

- The principles of "moden portfolio theory" have been long established in regulations in prescribing pension scheme investment strategy.
- Portfolio theory emphasises two variables - return and risk.
- There may be considerable differences between returns to an investment manager compared with an investor such as a pension fund.
- Portfolio theory does not allow for consideration of the effects of costs in terms of management charges and trading costs.
- Costs could amount to 3.5% of assets under management (Stewart and McNally, 2013).
- There is growing evidence that costs of some investment categories are so high that ignoring these costs in selecting assets is misleading in terms of risk/return tradeoffs.

- Financial innovation can result in increased costs
- High frequency trading in conjunction with 'dark pools' has increased trading cost for users of equity markets such as pension funds with a consequent increase in profits for financial intermediaries.
- The UK regulator has estimated that failure to obtain best execution prices increases cost for asset management in the UK by £4.2 billion per annum (FCA, 2014, p. 8 and Grene, 2014).
- PWC (2012) state "Retirement plan sponsors searching for higher potential performance without comparably higher potential risk are looking more closely at alternative investments, including hedge funds and private equity funds as another investment option".
- But "Research undertaken by Railpen found that underlying fees may be 300-400 per cent of disclosed fees in particular for private equity and venture capital funds.

Information asymmetries

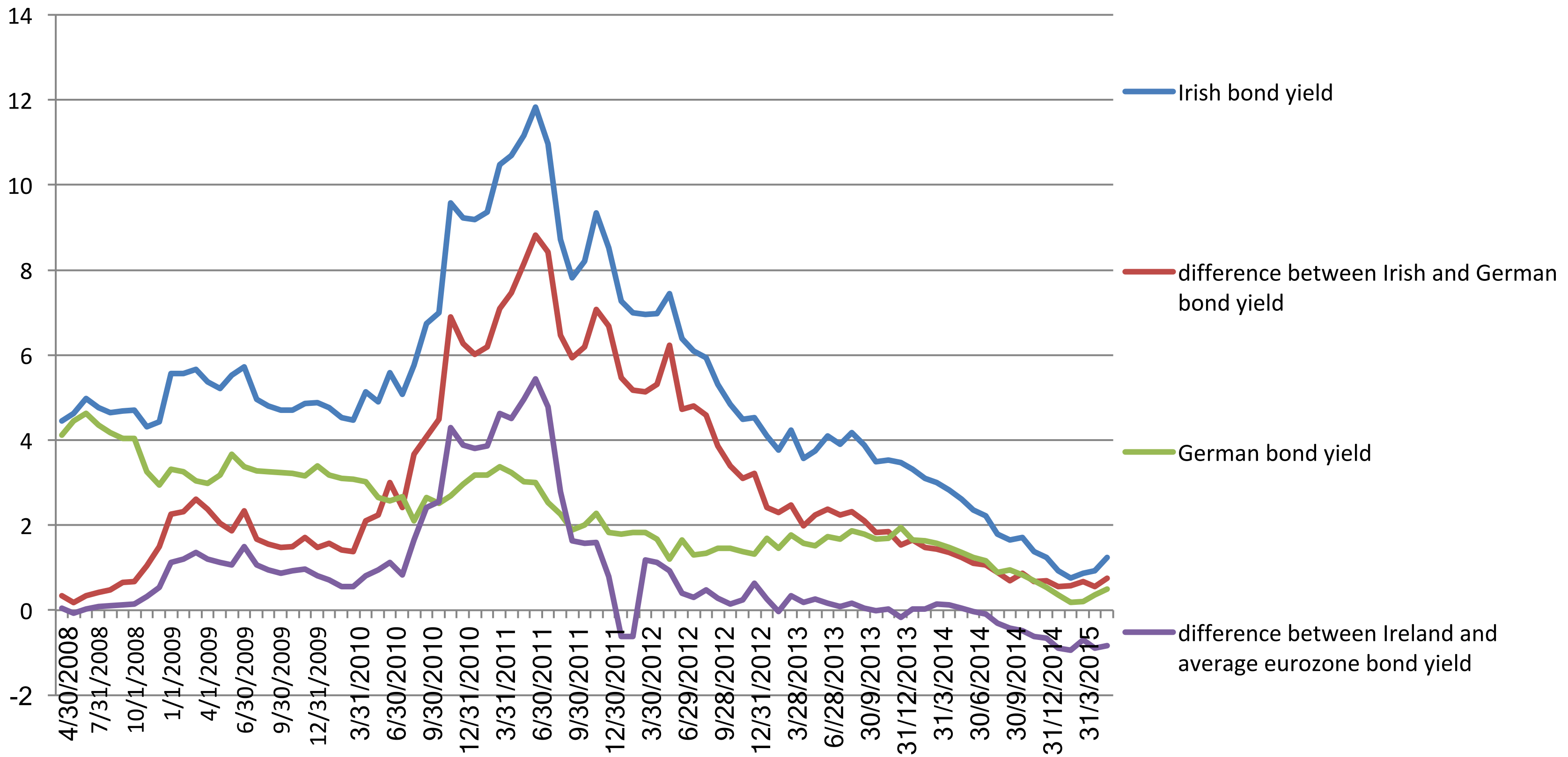
- Conjunction of financial innovation with ambiguities and uncertainty relating to the governance and management of pension funds, raises issues in relation to policies which seek to extend substantially personal pension coverage.
- Capital markets are characterized by information asymmetries and other capital market imperfections.
- Considerable empirical evidence indicates that participants in pension schemes are particularly ill informed.
- Information asymmetries may be difficult to remove. Benartzi and Thaler (2007) report from a study of participants in a large public sector pension scheme in the U.S. that "in spite of a serious effort to educate the employees about their options, they had very little understanding of the plan's features" (Benartzi and Thaler, 2007, p. 97).
- Barr and Diamond comment that many consumers do not understand basic finance concepts and "virtually nobody realizes the significance of administrative charges for pensions" (Barr and Diamond, 2010, p. 9).

The effects of low long term interest rates

- Deflation, falling/stagnant wages, negative interest rates, and low returns on government bonds (yield on 5 year German Government bunds is 0.14%, yield on 30 year bunds is 1.46%), and historically low annuity rates, all make funded pensions systems less sustainable.
- Pensions in payment increase in real terms.
- All annuity providers and firms providing long term guaranteed and annuitized payments are potentially at risk, for example German Life Insurance companies.
- Low or negative interest rates have considerable adverse implications for all funded pension schemes;

- Figure 1 shows the yield on Irish and German 10 year bonds from 2008 – May 2015.

Figure 1
10 Year Bond Yields 2008 – May 2015



Low yields and future pensions

- Table (1) shows the effect of assuming a 1% rate of return rather than the assumed rate of return of 7% (real return net of costs) in the AE example in the National Pensions Framework (2010, Table 4.1).
- Table (1) shows :-
- (1) Assuming a 1% return rather that 7 % means the annuitised pension payment has fallen by 75%;
- (2) Assuming a 1% net return and 20 years contributions gives a replacement rate of just 6%.

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Hypothetical returns from Automatic Enrolment Scheme (Adapted from Table 4.1, National Pensions Framework)

Assumed net of cost real returns 7% [1]	
Annual Pay	30000
Total Annual contribution (50% by employee)	1872
Contribution Rate	6.24%
40 payments of 1040 with returns of 7% per annum	373,716.93
*Annuity rate 22:1 gives an annual pension of:-	16,987.13
Replacement rate	56%
Plus Assumed social welfare pension €12,000 per annum	
Assumed net of cost real returns 1% (current German 30 bond yield is 1.46%)	
Annual Pay	30000
Annual contribution (50% by employee)	1872
40 payments of 1040	91,515.29
*Annuity rate 22:1 gives an annual pension of:-	4,159.79
Replacement rate	13.6%
Plus assumed social welfare pension €12,000 per annum	
Same assumptions as above but 20 years contribution	41,219.58
Annual pension	1,873.62
Replacement rate	6%
Plus assumed social welfare pension €12,000 per annum	

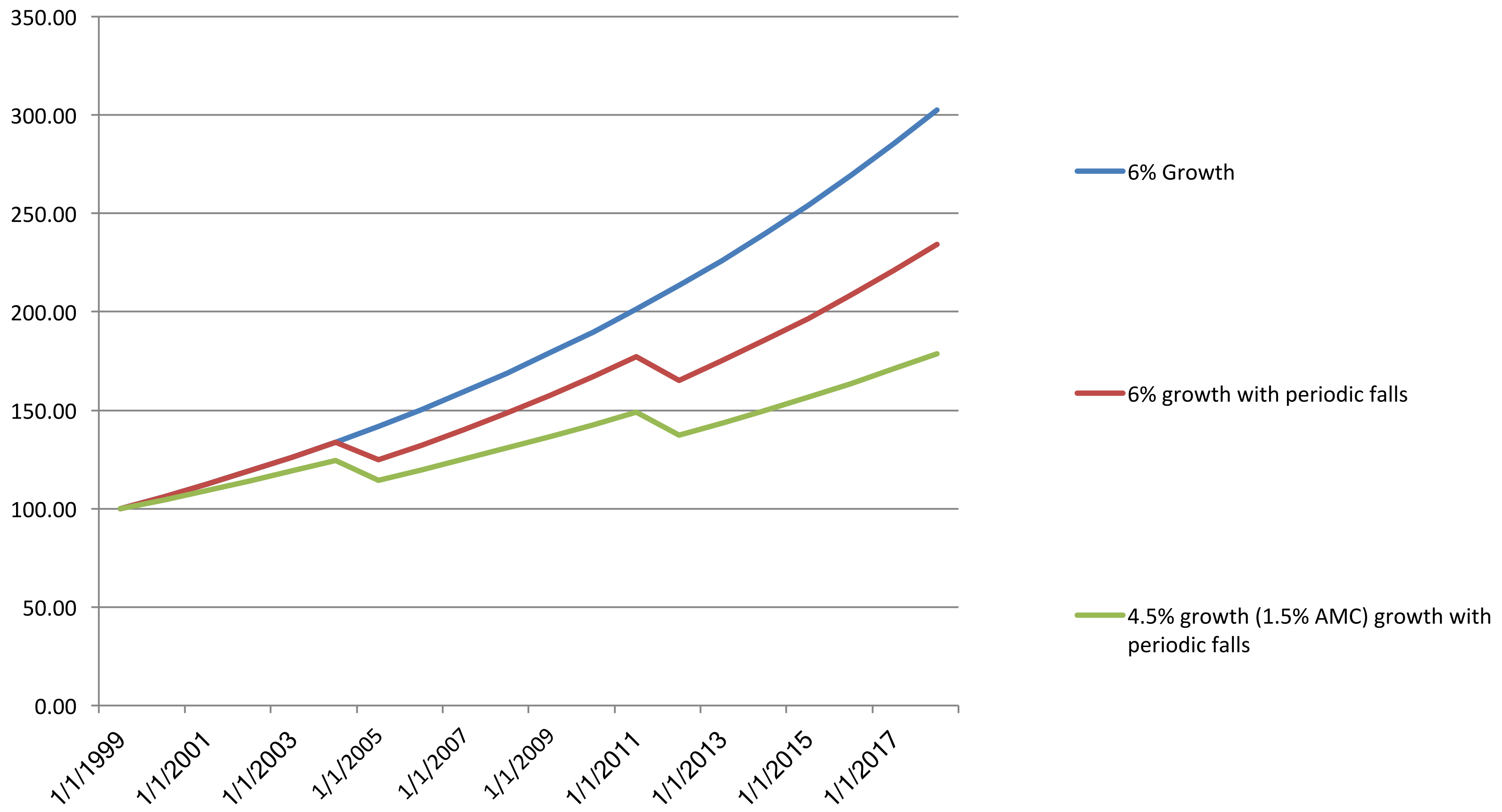
*annuity rates are currently higher

Some implications

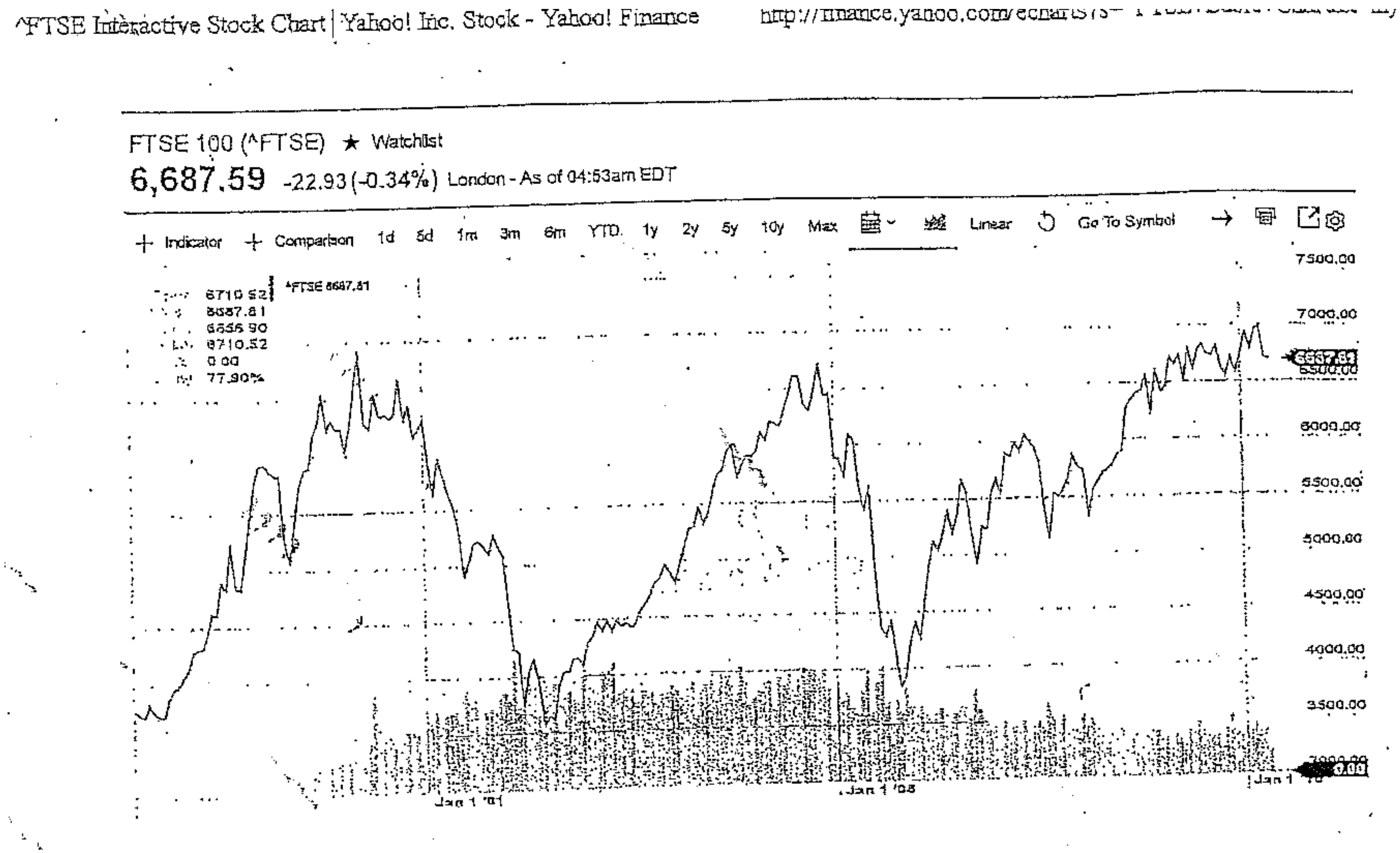
- One implication from Table (1) is that given low rates of return it is very difficult if not impossible to accumulate sufficient funds to provide for an adequate pension income in retirement.
- A pension system becomes more similar to a long run savings scheme (in particular if draw downs are allowed and annuitisation is abandoned as in the UK).
- The main benefits of joining a pension system as proposed, would consist of a possible employer contribution and tax relief, assuming tax concessions could be claimed.

- But in contrast to other long run savings schemes, costs are higher and there could be far greater risk.
- In contrast to what is often assumed (National Pensions Framework, Table 4.1; Green Paper, 2007, Table 9.2) returns do not follow a linear path.

Figure (2)
Size of accumulated lump sum under various assumptions (assumed 12% fall every seven years)



FTSE Index from Jan 1st 1996- June 16th 2015



Conclusion

- Automatic Enrolment (AE) is not a solution for many of those without pension coverage because:-
- (a) Returns are low compared with initial projected returns of 7% per annum (National Pensions Framework, 2010, Table 4.1)
- (b) Low pay, variable work history with periods of unemployment, and frequent employers, for those currently without pension coverage.
- (c) Costs for the UK AE scheme are low at a minimum charge of 0.75% , but "investment management transactions costs will not be included in minimum charges (Audit of charges, Dec. 2014, p. 12).
- Hence overall costs (minimum charge plus investment charges) could exceed returns.
- (d) Governance is important for DB schemes and even more important for DC schemes, but successful governance is difficult given the nature of long term pension provision.
- In addition
- Displacement may occur – replacing existing schemes with lower employer contribution AE schemes.
- Finally there needs to be a comprehensive assessment of costs in terms of tax expenditures of any proposed AE scheme.