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Second pillars

Provider and product selection for funded individual accounts

There are many ways to structure mandatory private pension funds that rely on individual accounts. As in any market there are products and firms that provide them. Both are typically circumscribed by the government for public policy reasons. Relevant legislation will specify the agent responsible for making key choices as to who manages the money and where it is invested. As discussed below, the locus of decision-making in funded schemes varies widely with potentially important implications for the performance of the scheme. In the context of mandated private pensions, this note looks at what investment and withdrawal products can be offered, who can offer them and who chooses from among the alternatives available in this market.

Provider choice

Individual account schemes managed by a central authority, (typically with prescribed annual returns) are often called 'provident funds'. They exist in Bhutan, Fiji, India, Indonesia, Malaysia, Singapore, Sri Lanka, Tanzania and Uganda. By design, there is only one provider – the parastatal entity that runs the scheme.

A partial exception are the exempt funds in India and Sri Lanka. Here, large employers are allowed to manage funds and administer the schemes for their employees. Perhaps the more important deviation from this model is found in **Singapore**. Upon achieving a certain minimum account balance, a member of the Central Provident Fund is allowed to withdraw funds to be invested through one of the many licensed unit trusts operating in the country.

The inverse of this approach is applied in **Sweden** where only workers that fail to make any provider choice are placed into a centrally-administered scheme. However, most contributors exercise their right to choose from among hundreds of mutual funds eligible to manage their individual accounts. These providers do not know their clients however, since funds are transferred en bloc from a central collector who also does the record-keeping for each individual account. Swedes can contribute to more than one mutual fund simultaneously.

Individual contributors also make the choice of provider in the most of the 20 countries in **Latin America and Eastern Europe** that have introduced individual account schemes. During the accumulation stage, workers choose from among specialized providers that manage assets, keep records and in some cases are directly involved with the collection of contributions. In most cases, workers can shift between providers as they choose, although some restrictions apply in terms of annual frequency.

Each region has one interesting exception. In **Bolivia**, the Government selected two private consortia after an international bidding process and licensed them to manage individual accounts

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in the new system. Each was granted a 5-year concession and assigned half of all contributors. Provider choice would enter only after the initial concession period. In 2002, **Macedonia** passed legislation that includes a 10-year concession for a two firms. In both cases, the argument for this approach was the need for scale economies to reduce costs in light of the small markets.

These two examples illustrate how private management need not always be synonymous with choice of provider and how competition among potential providers can take place through an auction process. Yet, even when the market is open to many entrants, provider choice will be limited by the natural concentration of the market for this specialized service.

As shown in Figure 1, the number of providers varies significantly across countries. About one million El Salvadoran contributors must choose from among three of these specialized firms while Swedes can choose from scores of mutual funds. With the exception of Singapore and Sweden, the countries shown in the table have limited the universe of providers by requiring specialized pension institutions and imposing a set of licensing conditions that limit market entry. The third column shows the percentage of members that change providers annually.

Number of providers available 1

Country	*Number of providers*	*% of members changing provider*
Argentina	12	4.7%
Chile	7	3.7%
Colombia	6	3.5%
Costa Rica	9	n.a.
El Salvador	3	8.7%
Hungary	22	0.9%
Kazakstan	16	n.a.
Mexico	13	0.4%
Peru	4	0.2%
Poland	20	1.5%
Singapore	41	n.a.
Sweden	100+	n.a.
Uruguay	4	7.5%

In some countries, key choices are made not by individual workers, but rather by their employers. And, in a few cases, the choice of provider is made at an even more aggregated level through unions or the 'social partners' involved in industry-wide collective bargaining.

The systems in **Australia, Hong Kong** and **Switzerland** rely mostly on employers. In each country, coverage in an occupational scheme is mandated for employees with earnings above a certain threshold. Employers are required to remit pension contributions to the pension administrator that they have selected. The administrator maintains the individual account records, either manages the assets directly or arranges for outside asset management. In some cases, employers have the option of affiliating with a multi-employer institution. The approaches taken in these three countries differ, however, in other important respects.

In Switzerland, employees must agree with the choice of pension administrators and the pension institutions must be separate, nonprofit legal entities whose sole function is to manage the pension plan. These institutions are managed by boards composed of an equal number of representatives of employees and employers. The board determines portfolio strategies and selects asset managers. It is also worth noting that although Swiss workers do not have direct control over their funds, they are covered by a guaranteed rate of return of four percent (oddly, expressed in nominal terms).

Hong Kong employers can decide whether to set up their own plan or to affiliate with one of a number of multi-employer plans. They are not required to consult with their employees before making their decision and the employees play no role in the management of the plan. Employers in two industries, construction and catering, participate in industry-wide plans in recognition of the high degree of labor mobility in these sectors. Most other employers have chosen to affiliate with one of some 47 master trusts that have been set up by local financial institutions.

The Australian pension industry is more complex than those in Switzerland and Hong Kong. It consists of industry-wide funds jointly managed by the social partners, funds offered to employers in general, funds tailored specifically to very small employers, funds offered only to public sector agencies, and funds set up by one or a small number of corporations. Altogether, there are some 3,000 different funds, not counting those targeted specifically on small employers. Australian pension institutions must be separate legal entities created as trusts, and in all but the smallest trusts, at least half of the trustees must represent members. The publicly-offered funds tend to be sponsored by financial institutions.

In all three systems, workers who change employers retain the rights to the accumulations in their accounts. The Hong Kong system guarantees workers the right to move their balance to the pension institution of their new employer, but does not require them to do so and does allow pension institutions to charge exit fees.

Industry funds exist in Australia and Hong Kong but they are the dominant model in **Denmark** where the requirement to participate arises from collective bargain agreements that cover some 80 percent of wage earners. Pension providers are technically nonprofit insurance companies, owned and operated by the social partners.

The Danish approach is similar to a provident fund arrangement in that neither the employer nor the employee has a direct voice in choosing the provider. However, the government or parastatal does not have any direct influence over the operation of the fund.

Investment options

Around the world, individual account schemes accumulate funds for retirement according to very different investment rules. In some countries, portfolio limits are structured in such a way as to severely restrict choice. (For details, see the Primer Note entitled "Portfolio limits".) These 'single portfolio' systems are found primarily in Latin America and Eastern Europe, but also in the Danish and Swiss employer-based systems.

Limiting investment options results in less variation in retirement income, especially within a particular age cohort. It is also a feature consistent with rate of return guarantees since without limits the potential for moral hazard would be high.

"Multiple portfolio' systems in contrast, allow for some variation in outcomes. If one **Swedish** worker chose to contribute to a low risk, money market fund while another invested in an equity fund, the difference between their annual returns will be significant. Likewise, if the same two workers were otherwise identical in terms of age and lifetime wage paths, their investment choices would result in very different pension outcomes.

In **Hong Kong** worker's have been given the right to select from among several different portfolios, even though the law does not require it. The law does require, however, that where choices are offered, one of them must mimic a savings account in which no capital losses are possible. The other choices are funds containing various mixes of bonds and equities traded on organized financial markets. At the end of 2001, about 47 percent of the total assets were equities.

In **Australia**, over half of members had some kind of investment choice by 1996-97. The degree of member choice has been expanding rapidly. Some 60 per cent of contributions in 1996-97 were paid into funds with investment choice, compared with 53 per cent the previous year and just 46 per cent in 1994-95. There has also been an expansion of the number of options offered by funds with member choice — from 5.8 in 1994-95 to 6.2 in 1996-97. Anecdotal evidence suggests that plans that offer investment choice typically allow members to alter portfolios twice a year at no cost, but charge a fee of around one per cent for more frequent changes.

Draft legislation would require employers to comply with one of three models:

- Limited choice of at least four funds, which must consist of at least one public-offer fund and at least one retirement savings account (a type of deposit), and an industry fund and an

in-house corporate fund if they exist under current arrangements;

- Unlimited choice, where employees nominate their preferred fund; or
- A negotiated agreement between employees and employers.

A more flexible environment with greater choice does have advantages. First, individuals can have very different tolerances for risk. Second, since the individual pension account is only one component of a larger portfolio of assets, the investment strategy may simply reflect appropriate diversification. Third, most younger workers with many years of work ahead of them can diversify their portfolio by investing in equities or other assets not correlated to their future wage incomes.

One strategy being adopted in several countries is to begin with a single portfolio and to gradually allow additional investment options to be added. In Singapore, the gradualist approach is achieved by allowing only a portion of the balances to be invested outside of the CPF. The Swiss are currently examining options for expanding worker choice within the mandatory occupational scheme.

Mexico and **Poland** are also single portfolio countries planning to add investment options. In the case of Poland, a second fund will be allowed from 2005.

Chile provides an interesting case study of an evolving approach to portfolio choice. During its first two decades, members of the private system could invest only in a single portfolio. While the portfolio limits were gradually loosened between 1981 and 2001, all participants had essentially the same overall asset allocation at any given time. However, in January 2002, after several years of debate, the government announced the introduction of multiple portfolio options. The five options are shown in Table 2. (The new system was implemented in July 2002.) Individuals not choosing from among these options are assigned a fund type according to their age (i.e., more equities for younger workers). This important change provides an important natural experiment for researchers interested in financial literacy and worker investment choice.

Portfolio choices in Chile 2

	Maximum non-fixed income	*Minimum non-fixed income*
Fund A	80%	40%
Fund B	60%	25%
Fund C	40%	15%
Fund D	20%	5%
Fund E	Not authorized	Not authorized

Product choice at the payout stage

The preceding discussion has centered on choices that are made in a funded, individual account system during the accumulation stage. But most of these systems also restrict withdrawals upon retirement and encourage or mandate the purchase of longevity insurance. (Withdrawals in the case of death or disability prior to retirement are also regulated in this way). Once again, we observe significant cross country variation in what products are allowed, who can provide them and who actually makes the choice.

Australia, Hong Kong and Singapore allow for lump sum withdrawals upon reaching retirement age, although Singapore imposes a 'minimum sum' rule that entails a kind of minimum pension scheduled withdrawal. Annuities are available in the market but only a small fraction of members actually purchase them. Life insurance companies compete for the relatively small voluntary annuities market. In contrast, most countries with individual accounts restrict withdrawals as shown below in Table 3.

Withdrawal options 3

Lump sum	Australia, Hong Kong, Singapore
Scheduled withdrawal or annuity	Chile, Colombia, Dominican Republic El Salvador, Macedonia, Mexico, Peru
Annuity only	Argentina, Croatia, Hungary, Latvia, Poland, Switzerland, Uruguay

In Eastern Europe, Sweden, the United Kingdom and several Latin American countries, individual accounts must be converted to annuities. Normally, this requirement takes effect at retirement, although in the United Kingdom, retirement savings must be annuitized before age seventy-five. Often, the type of annuity product is also prescribed. In Chile and Hungary for example, the annuity must be indexed to inflation. In several countries, the spouse must be covered through a joint annuity.

With the exception of Sweden, where the government is the annuity provider, the worker the typically chooses from among insurance companies offering acceptable annuity products. In contrast, while annuities are required in Denmark and Switzerland, these are purchased on behalf of the group by the social partners running the scheme and the employers respectively.

Group annuity purchases may have some advantages in light of information costs and potential bargaining power with insurance companies. A paper by Robert Palacios and Rafael Rofman looks at the payout stage in four Latin American where individuals purchase annuities. The study highlights some of the problems with the retail market (see box). Their preliminary conclusions suggest that not enough attention has been paid to how well the market functions during the payout stage, especially with regard to consumer understanding of the products.

Organizing individual accounts

Individual accounts can be organized in a variety of ways. In the accumulation stage, individuals could be allowed to choose from among many providers and investment options or this choice could be severely restricted. Alternatively, other agents such as employers or unions could negotiate with providers and choose the range of products to offer to workers. Similar design issues arise in the payout stage, especially when there are restrictions on how balances can be withdrawn after retirement. The common feature in all cases will be government regulation and supervision of the private pension market.

Choosing annuities in Peru

Retiring workers in Peru must choose from eight alternative annuity types. The AFP must request quotations from every annuity provider in the market. Quotations must be presented in a standard form in a closed envelope, which can only be opened by the retiring worker. Then the AFP must prepare a simple form where it states, for each annuity type, the company name, reference number, implicit interest rate and the amount the beneficiary will receive in the first payment, net of commissions.

This system appears to be reasonable, but the plethora of annuity types is confusing for consumers. AFP personnel responsible for helping them to make an informed choice are not always well trained. While insurance company agents might be more competent, regulations prohibit them from approaching retiring workers in an attempt to limit the role of marketing in the process.

In practice, most insurance companies have small sales forces that contact retiring workers. Information on potential clients is obtained from AFP personnel, with or without the knowledge of their managers. In many cases, workers decided what product and provider they will choose before requesting quotations. Consequently, this process becomes a formality. Regulation regarding sales forces is not completely clear. Strangely, according to the current rules, annuity providers may have a sales force but may not actively solicit customers.

All administrative paperwork and claims are conducted through the AFP. This rule was established to simplify the paperwork for beneficiaries, and to reduce costs, since the insurance companies “use” the AFP branches to service their customers. As a result however, many beneficiaries are not aware that their provider is an insurance company, independent from the AFP. This reduces market transparency.

The wide range of structures observed across the two dozen countries that already employ individual accounts is not arbitrary. In some cases, it is the product of the history of the voluntary pensions market, as in Australia and Hong Kong. Sometimes, design reflects policy objectives. Proponents of single portfolio arrangements, for example, argue that many workers would have limited financial literacy. Limiting the universe of providers or products has also been justified on the basis of minimizing costs. This was clearly a key rationale in Bolivia and Macedonia.

Figure 4 groups countries with funded individual account systems according to the agent responsible for choosing the asset manager, investment portfolio and payout provision. This captures only a small part of the variation between countries however, since choice, while available, may be more restricted in some countries than in others. Note also, that the 'single portfolio' countries' are shown as having government determined investment portfolios (bottom center box). This classification is chosen because the main determinant of members' investment strategy in these countries is the set of portfolio limits set out by the government regulator. Nevertheless, this hides important differences between countries as to investment options even within this constrained environment (see the Primer note on this topic entitled, 'Portfolios').

The table shows that a wide range of combinations are possible within an individual account system. In fact, it is also possible for one country to utilize more than one of these choice-agency structures at the same time, as in the case of Australia where industry funds, employee and employer decisions all co-exist within the Superannuation system.

While many variations can be imagined, the most common approach is to provide individual workers with choice over who manages their assets while restricting their investment choice. The main exceptions to the first point are Bolivia and Macedonia where concessions were granted to private firms and individuals had no provider choice. Regarding investment choice, only countries with highly advanced financial sectors have allowed a wide set of alternatives. With the reform of 2002, Chile joins Hong Kong, Sweden, Singapore and the United Kingdom in this group.

Reliance on individual provider choice combined with limited product choice also applies at the payout stage. Only Sweden relies on government provision of annuities. Most countries allow individuals to choose from among providers but restrict the kind of products that can be purchased.

Who chooses what? 4

Agent	Asset manager	Investment portfolio	Payout provider
Employer	Australia Hong Kong Switzerland	Australia Switzerland	Switzerland
Employee	Argentina Chile Colombia Dominican Republic El Salvador Estonia Hungary Kazakstan Mexico Peru Poland Sweden United Kingdom* Uruguay	Chile Hong Kong Sweden Singapore United Kingdom*	Argentina Chile Colombia Dominican Republic El Salvador Hong Kong Hungary Kazakstan Mexico Peru Poland Singapore United Kingdom* Uruguay
Industry/ social partners	Australia Denmark Hong Kong**	Australia Denmark Hong Kong**	Denmark
Government regulator	Bolivia Macedonia	Bolivia Chile Colombia Croatia Dominican Republic El Salvador Estonia Hungary Kazakstan Macedonia Mexico Peru Poland Uruguay	Sweden

* United Kingdom refers to personal pensions only
** Industry-wide funds for construction/tourism only

The individual account schemes in most of the countries described in Figure 4 were created during the last decade. Little is therefore known about the relative advantages of different arrangements.

For example, while most analysts associate a greater degree of portfolio choice with higher administrative costs, the magnitude of this tradeoff is not well established. Also, the benefits of greater individual control over investments is also not well understood. It is likely to differ significantly across countries and over time according to levels of financial literacy. The shift from a single to a multiple portfolio environment in Chile and portfolio choice in Hong Kong should both provide interesting case studies for researchers.

More individual choice increases the challenge for consumers who face a retail market of pension providers and where information can be costly. Group schemes offer some economies in getting this information as well as bargaining power with providers. However, they also introduce agency issues that are difficult to quantify and which are likely to vary significantly across countries.

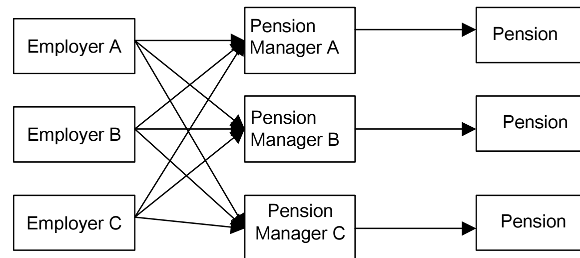
In Figure 5, there are three examples of different provider choice models. In Switzerland's employer based scheme, providers are chosen by a board with equal numbers of employer and employee representatives. This may mitigate the possible conflicts of interest that could arise if employers choose a provider.

The third case, where government chooses the provider introduces another possible conflict of interest. The process of granting a concession and the insulation from political influence of the institution chosen becomes of paramount importance. The terms of the concession are then of paramount importance given the lack of competition to discipline performance. Bolivia and Macedonia are examples of countries that have granted temporary concessions to providers. Another related case is Sweden where the government itself annuitizes individual account balances after an accumulation period characterized by provider and portfolio choice.

Individual account structures 5

(a) Employer-based plans

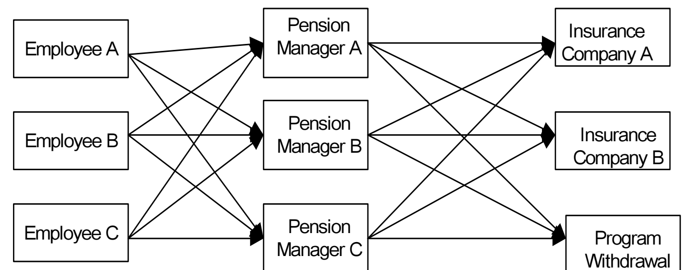
Switzerland



Asset manager choice: joint employer/employee
Annuity provider: joint employer/employee

(b) Individual plans

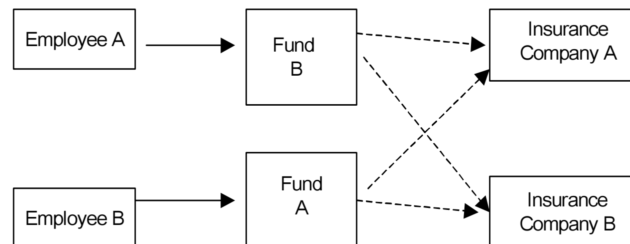
Peru



Asset manager choice: individual employee
Annuity (or SW) provider: individual employee

(b) Regulated monopoly

Bolivia

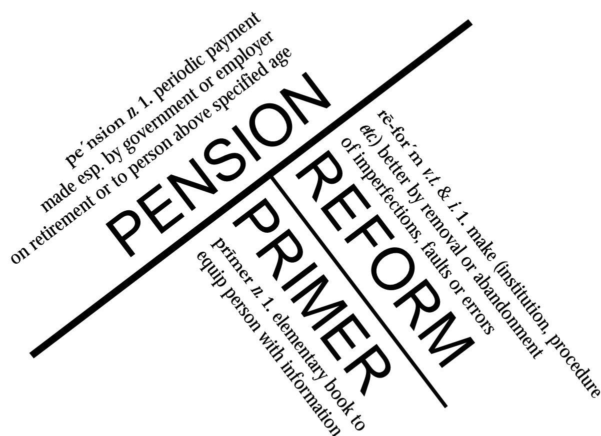


Asset manager choice: Government
Annuity provider: individual employee

A hybrid model: default fund plus

Any mandatory pension scheme with individual accounts must strike a balance between individual choice and public policy objectives. More provider choice may increase competition but could also increase the chances that a government guarantee will be triggered when a weak firm fails. More portfolio choice may allow for investment outcomes that undermine key public policy objectives such as target replacement rates. Yet, most of the reforms are too recent to yield substantial evidence regarding the performance of different individual account arrangements. More research is needed in order to better understand these and other tradeoffs.

One approach that seems worth studying further is a hybrid model that aims to reap the advantages of the different structures. Consider for example, a 'default fund', with private providers selected by employers, industry or government with a limited set of portfolio choices. This would presumably be a low cost option with limited services and choice for those unable or unwilling to contend with the retail market for individual pension providers and products. Meanwhile, individuals with strong preferences and a willingness to pay for them with time and higher fees could do so by using licensed providers along with a wider array of portfolio options. It would be essential in such an arrangement however, that the 'default fund' provider operated on a level playing field with the rest of the industry and was sufficiently insulated from government intervention.



Conclusions and recommendations

- There are many possible structures for individual accounts in terms of provider and investment choices and how those choices are made
- The most popular model – dominant in Latin America and Eastern Europe – is to allow individuals to choose the provider but to restrict their investment options as well as the type of payout at retirement
- Only a few countries – mainly those with relatively advanced financial markets – allow significant portfolio choice
- Group-level choices may be useful in order to reduce information costs to the individual and take advantage of bargaining power
- But individual choice allows most flexibility for preferences and avoids agency problems
- More research is needed in order to establish the tradeoffs between different arrangements and the conditions under which one functions better than another
- One promising approach is a hybrid model that includes a default fund with predetermined providers and limited portfolio options along side a competitive decentralized scheme for those willing and able to exercise their preferences

Further reading

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