Automatic Enrollment Schemes (AES): Lessons for the Russian Federation

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Outline

1. Overview
2. Country cases
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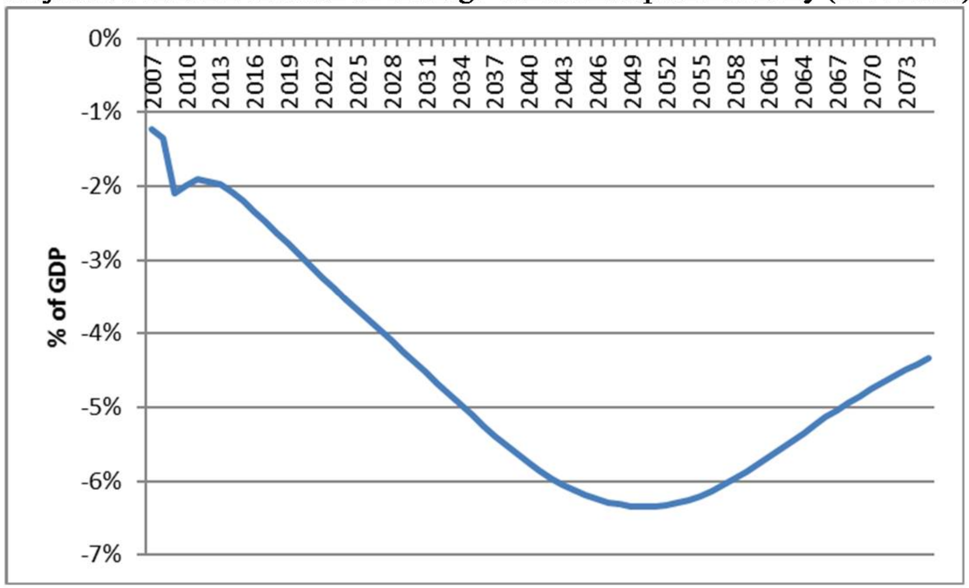
Challenges of the pension systems in CEE

- Population aging is a serious fiscal threat in most of the Central and Eastern Europe (CEE)
- The age structure has changed from a traditional pyramid toward a column, and in some it has started to resemble an inverted pyramid.
- The aging of the population will be putting significant pressure on fiscal accounts

Projected Pension Deficits in an Average Central European Economy (2007-2077)



Source: Schwarz and others (2014)

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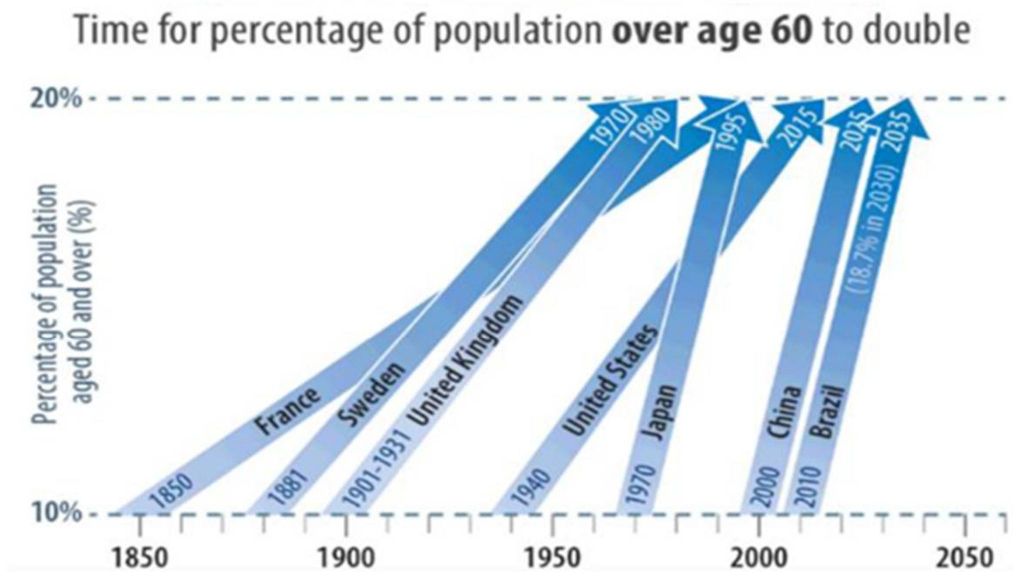
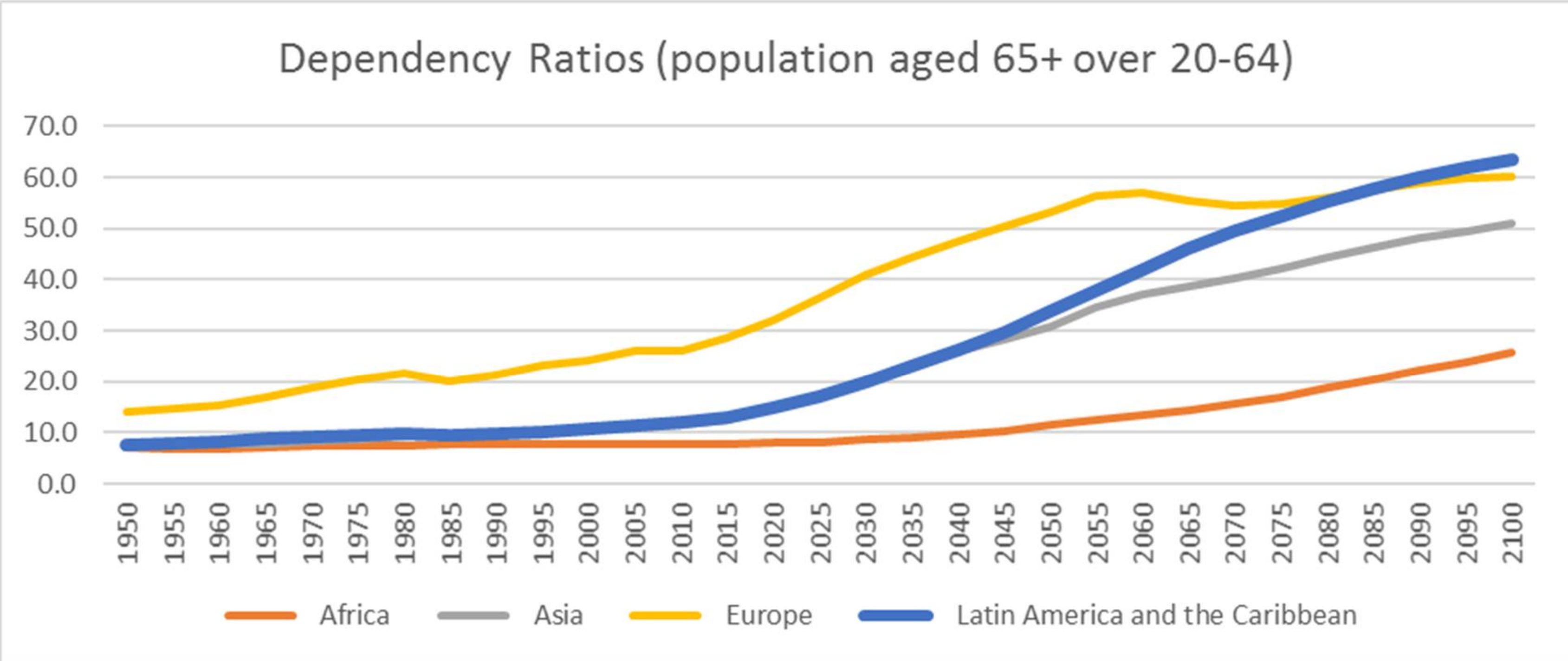
Challenges of the pension systems in Latin America

- While Latin America has a younger population, the population is aging at rates with no precedents in the history of humankind.
- Latin America will suffer an accelerated aging of the population in the coming decades.



Source: WHO (2015).

Dependency Ratios (population aged 65+ over 20-64)



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Automatic Enrollment Schemes (AES)

- Increasing employers' contributions is not only politically challenging, but also from the economic perspective (effects on countries' competitiveness)
- Most of the CEE countries have a limited space for increasing mandatory contributions
- Automatic enrollment schemes provide an alternative for increasing future pensions and reaching high coverage.
  - By default employers are registered in a pension system, but they can opt-out
- While initially tested in countries with common law tradition (UK, USA, New Zeeland), several countries with civil code tradition have implemented such schemes more recently

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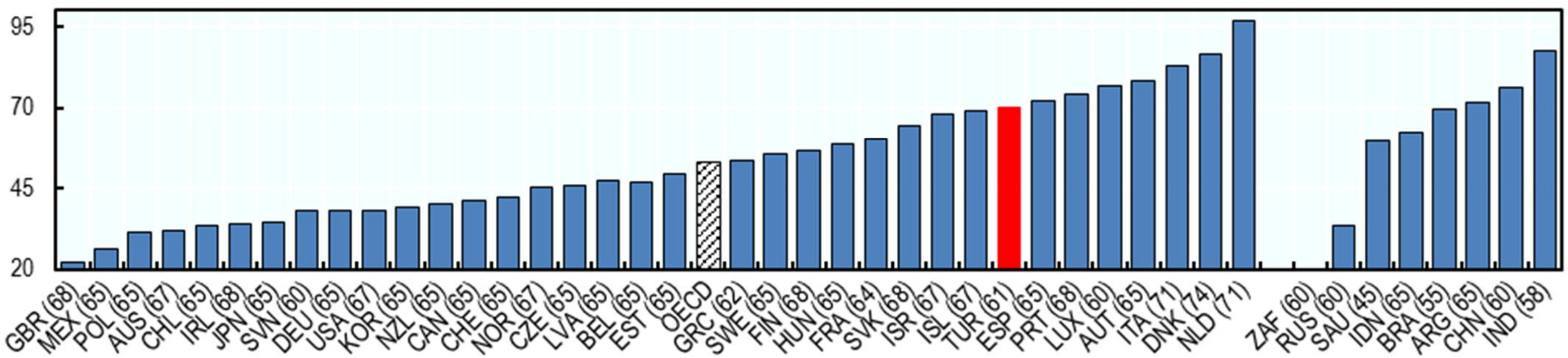
The Case of Turkey (2016)

- Turkey has one of the most generous social security systems among OECD countries.
- Despite having a relatively young population, in 2013-2015, pension expenditures reached 7.2% of GDP, with more than half of the financing coming from the state budget.

Gross Pension Replacement Rates in OECD countries



Source: Pensions at a Glance 2017

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Turkey: AES implementation calendar

Calendar of implementation of the automatic enrollment scheme (AES)

Number of Employees by company	Date of implementation
1000+	January-2017
250-999	April-2017
100-249	July-2017
50-99	January-2018
10-49	July-2018
5-9	January-2019

Source: Ministry of Treasury and Finance of Turkey

Turkey: AES Main Features

Contribution rate employer	0%
Contribution rate employee	3% (default)
Contribution rate government	25% of rate of employee + TL 1000 welcome bonus
Opt-out period	60 days
Time for implementation	5 months
Cap on fees	0.85% AUM
Investment options	5 funds
Industrial organization	Existing pension fund management industry
Special features	Allows early withdrawal after 10 years of contribution

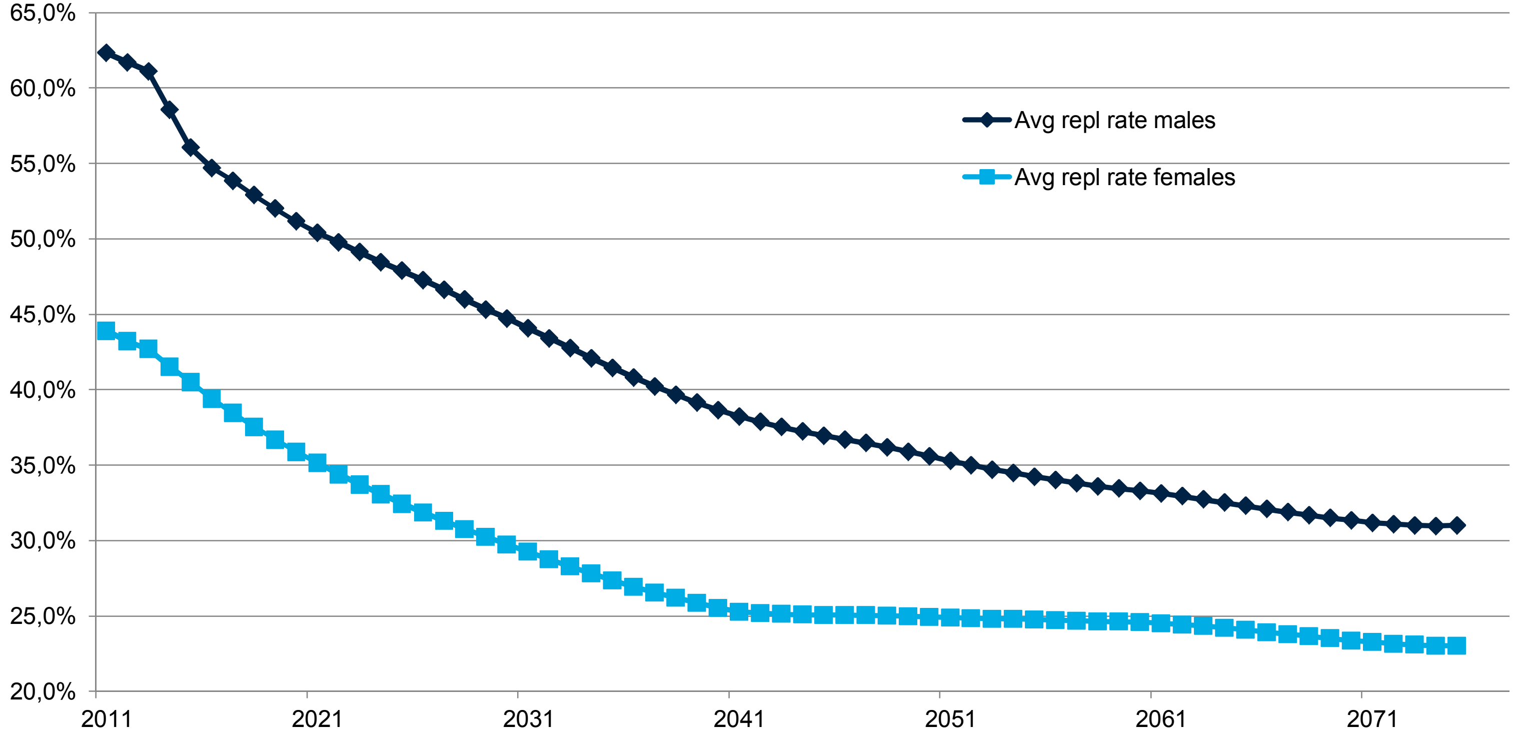
Turkey: preliminary results

- The implementation of the system resulted in high opt out rates.
  - As of February 2018 approximately 60 percent of the employees exercised their right to opt out.
  - As of August 2017, opt out rates for private and public-sector employees have been 60 and 45 percent respectively.
- While most of the local discussion for the high opt out rates has been about the lack of contribution from employers, other explanations include
  - Lack of time for enacting regulations;
  - Motivation for additional savings in the presence of high replacement rates offered by the social security scheme; and
  - Lack of time to prepare well targeted educational and communication campaigns.

The case of Poland

- Poland was one of the early adopters of mandatory funded schemes.
- In 1999, Poland was one of the first countries in Europe in adopting a mandatory funded pension scheme.
- The transitional deficit of the mandatory funded scheme was largely debt financed
- In 2013, the government debt levels reached self imposed limits and triggered the beginning of the unwinding of the mandatory funded scheme.
- The expectation of decreasing replacement rates has helped to create consensus about the need of building savings for retirement

Poland: projected replacement rates[1]
(as a percentage of average salary)



1 Projections after the 2011 adjustments in contribution rates.
Source: World Bank (2012)

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Poland (2018): AES Implementation Calendar

Number of employees	Date of Implementation
250+	July 2019
50-249	January 2020
20-49	July 2020
Other (including Public Sector)	January 2021

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Poland (2018): AES Main Features

Contribution rate employer	1.5% → 2.5%
Contribution rate employee	2% → 4%
Contribution rate government	PLN 250 welcome bonus (2019-2020)
Time for implementation	7 months
Cap on fees	0.5% AUM + 0.1% success fee AUM
Investment options	Target date funds (default)
Industrial organization	Existing pension fund management industry plus life insurance companies Collection of contributions through a parallel mechanism
Payout phase	25% lump sum + phased withdrawal (age 60)
Special features	PFR is a default provider

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Poland: Preliminary lessons

- The timing of the AES reform is essential.
  - It addresses the future demand for better pensions that is likely to come in the next decades..
  - From the economic cycle perspective, as the Polish economy is close to full employment, characterized by strong wage growth and consequently willingness from employers to make additional contributions.
- Lifecycle portfolios are a good investment default option in an open market system with a relatively developed capital market, especially if it is decided to use a common portfolio benchmark.
- The idea of involving a government institution in the asset management needs to be properly crafted.
- It is important to be mindful about the time for implementing the reform.
- While fees will be capped in the case of Poland, wasteful completion is expected in attracting employers

Québec (2014): AES Implementation Calendar

Number of employees	Date of Implementation
20+	January 2016
10-19	June 2017
5+	January 2018

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Québec (2014): AES Contribution rates

Contribution rate (% gross salary)	Period
2%	July 2014-December 2017
3%	January 2018-December 2018
4%	After January 2019

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Québec (2014): AES Main Features

Contribution rate employer	0%
Contribution rate employee	2% (2017); 3% (2018); 4% (2019)
Contribution rate government	0%
Time for implementation	--
Cap on fees	1.25% AUM (default); 1.5 (rest)
Investment options	Lifecycle portfolios (default) + 3 to5 other options
Industrial organization	Existing pension fund management industry
Special features	Allows early withdrawal after 10 years of contribution
Payout phase	No lump sums (locked part)

The case of Québec: Preliminary lessons

- Several important features: lifecycle investment portfolios (default option); the employer selecting the pension fund managers; gradual increases in contribution rates that create incentives for staying in the system.
- Well placed payout phase, but insufficient given the possibility of withdrawing employees' contributions during the accumulation phase.
- Caps on fees seem to be high for an economy with a sophisticated financial market.
- The low rate of participation in the plan, explained by the presence of other pension plan products, and probably inadequate enforcement capacity.

Chile (2008): AES for self-employed

The focus of Chile's AES is the self-employed, as a transition for turning their contributions to the pension system mandatory.

Chile: Calendar of Payments of Contributions (% net income)

Year	% of net income to contribute	Process
2012	40%	Opt-out
2013	70%	Opt-out
2014	70%	Opt-out
2015	100%	Mandatory

Source: Internal Revenue Service

Chile: Preliminary lessons

- Coverage of the self-employed increased from an historical average of 4% to approximately 25% percent.
- While the outcomes in terms of coverage were modest compared with other countries, it is still significant since it is only related to the self-employed
- The high opt out rates can also be explained by factors such as the high contribution rates as a starting point; and easy process for opting out

Brazil (2015): AES for employees of the federal government

- Brazil’s Funpresp is that it was born as an opt-in scheme and then it turned into an opt-out institution.
- While as an opt-in institution, it struggled to get sufficient contributors; as an opt-out it has received massive participation of civil servants.
- In November 2015, the change in status of Funpresp to an opt-out scheme reduced the opt out rates from 71% to 14% from Nov-2015 to Nov-2017.

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Lesson 1: The importance of a “fair deal”

- Nudging needs to be conducive to welfare improving outcome
    - AES are largely based on inertia and behavioral aspects of individuals,
    - The paternalistic approach of AES builds on the lessons learned from second pillars
- The responsibility in the design of default options is not only related to the decision of enrolling contributors and investment decisions, but also in the overall design of the system (low cost).

Lesson 2. Default investment portfolios

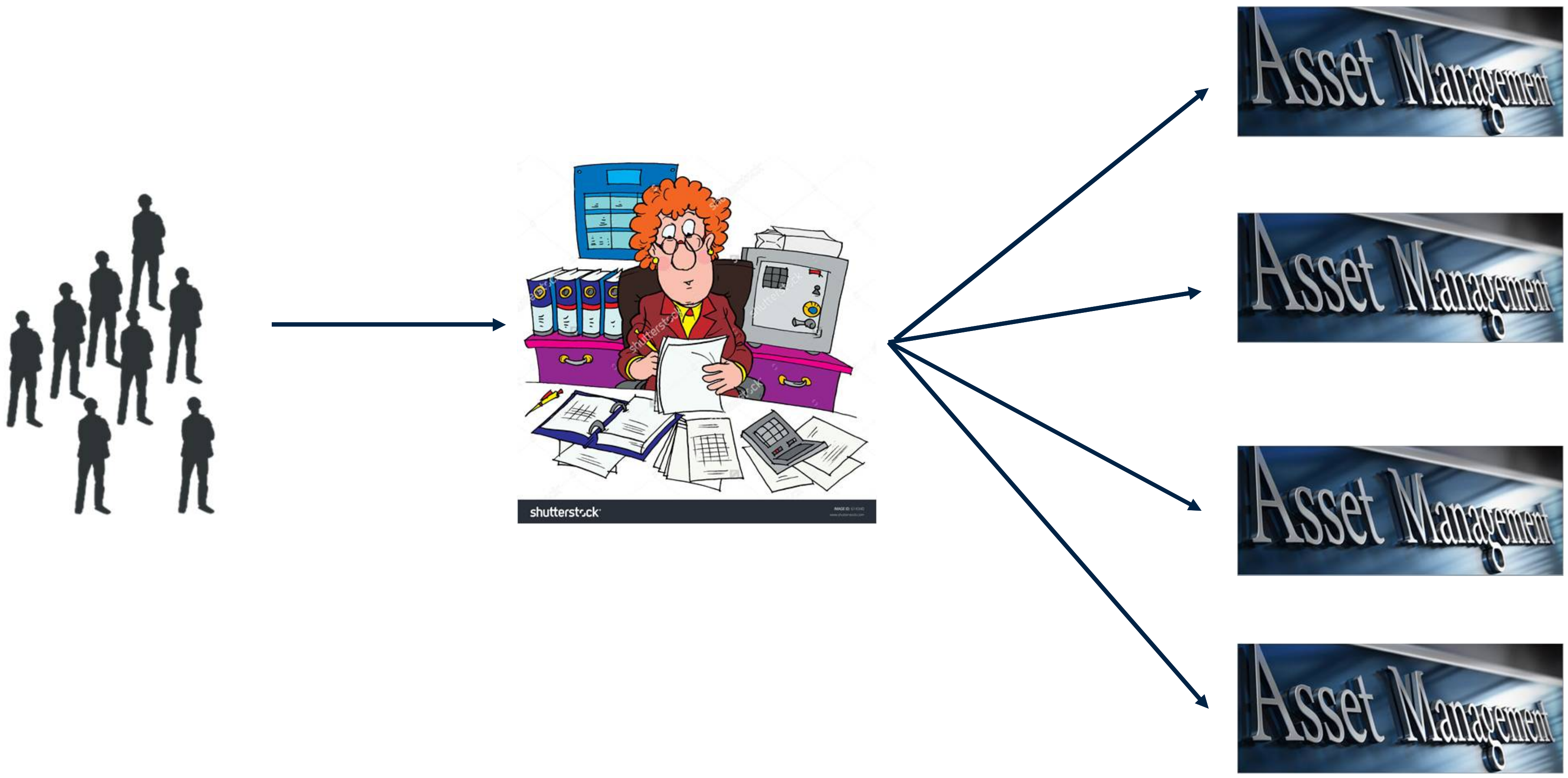
- Median individual (or employer) is unable to make adequate portfolio decisions
- In the presence of open pension funds, lifecycle portfolios are a reasonable investment benchmark
  - Investments in less liquid instruments and private deals face some significant challenges in emerging economies (creative valuation)
- In the Russian Federation, the lack of capacity to identify ultimate beneficial owners may open opportunities for self-dealing and for transactions with related parties at transfer prices that do not reflect the real value of the assets.
  - While life-cycling is a powerful concept, it may need to be modified in order to be meaningful to the objectives of AES.
- Common portfolio benchmarks facilitate competition among asset managers.

Lesson 3. The role of the employer

- The accountability of employers in civil code countries is limited compared to those with Anglo Saxon traditions.
- Salesforce from pension fund managers is likely to be directed toward larger companies
- In the presence of defined contribution (DC) pension schemes with default investment strategies, the role of employers is optimized when it is limited to registration and paying the contributions on behalf of the employees.
- In the presence of civil code countries with common benchmark portfolios, it is possible to separate the employers’ responsibility of registering employees from the one of selecting the pension fund manager.
- The governance of common portfolios is helps in aligning the objectives of the contributors with the ones of the pension fund managers.

Lesson 4. Industrial organization of the pension fund industry

- 2nd pillars tend to operate through hybrid structures that conduct account management and investment management functions together.
  - Traditional models of second pillars are characterized by wasteful competition.
  - The usual industrial organization of second pillars thus not only results in higher costs, but also in inefficient portfolio allocations.
- The business model should move toward specialized **asset managers** that compete on prices.
  - Competition on asset management would therefore take place ex-ante..
- The **account manager** is a key figure in the proposed industrial organization, and it fulfills all the functions that are not related to investment management.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Asset Management
Asset Management
Asset Management
Asset Management

Account Manager

Maintenance of individual accounts

Customer service

Issuance of documents

Financial Education

The account manager is a regulated monopoly

Collection of contribution and Payment of benefits

Lesson 5. Communication and educational campaigns

- While the automatic enrollment is the most powerful tool for bringing pension funds into the pension fund scheme, good communication is essential
- Communication strategies should have clear messages on performance, and consequently focus on expected pensions, rather than rates of return.
- Performance of portfolios should be communicated in simpler terms

It is important to pay attention to social media

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Lesson 6. Financing of economic development

- One of the common questions on pension fund schemes in emerging economies
- In the absence of other reforms, the volume of pension fund assets may outgrow the size of the available assets in the financial market
- Important to develop proactive public policies aimed at bringing ne financial instruments to the market.
    - The case of the infrastructure sector through Private Public Partnerships (PPP).
- In the presence of market failures, **state financial institutions** may play a role in supporting the participation of pension funds in the financing of projects

Lesson 7. The payout phase

- A funded pension system without a well-developed strategy for paying out eventual benefits might not be called a pension system.
- Recent experiences of liberalization of the payment of pension benefits has resulted in a high proportion of individuals taking cash lump sums
  - Important to link the AES to the overall pension system of the country
- Annuities provide a solution that protects individuals against longevity risk, and at the same time may offer relatively stable source of retirement income.

Lesson 8. Liquidity options

- Liquidity options do not have an objective
- They help to mitigate the fear of locking money until retirement age.
- Standardization of such instruments is essential for maintaining costs low

Lesson 9. Automatic escalation

- Most of the countries in the region need significant increases in contribution rates to achieve adequate replacement rates.
    - Important to move gradually
    - Automatic escalation is the right tool for such design
- Since AES are designed for future generations, automatic escalation helps to maintain employees in the system.

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Thank you!

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