FRS Invest | Pro™

a Constellation Software Inc. Company

Pensions around the World

A deep dive into Defined Contribution Pensions in Australia, the United Kingdom and Ireland

From the Financial Risk Solutions User Conference, 2019

Introduction

The 2018 Global Pension Assets Study1 conducted by Willis Towers Watson, and released in February this year, reported Defined Contribution (DC) assets in funded pensions schemes now slightly exceed Defined Benefit (DB) assets across the largest 22 pension markets. With around USD 20 trillion in DC assets, the growth rate has been steady at 8.9 percent in the last ten years compared to a much more sedate 4.6 percent for DB.

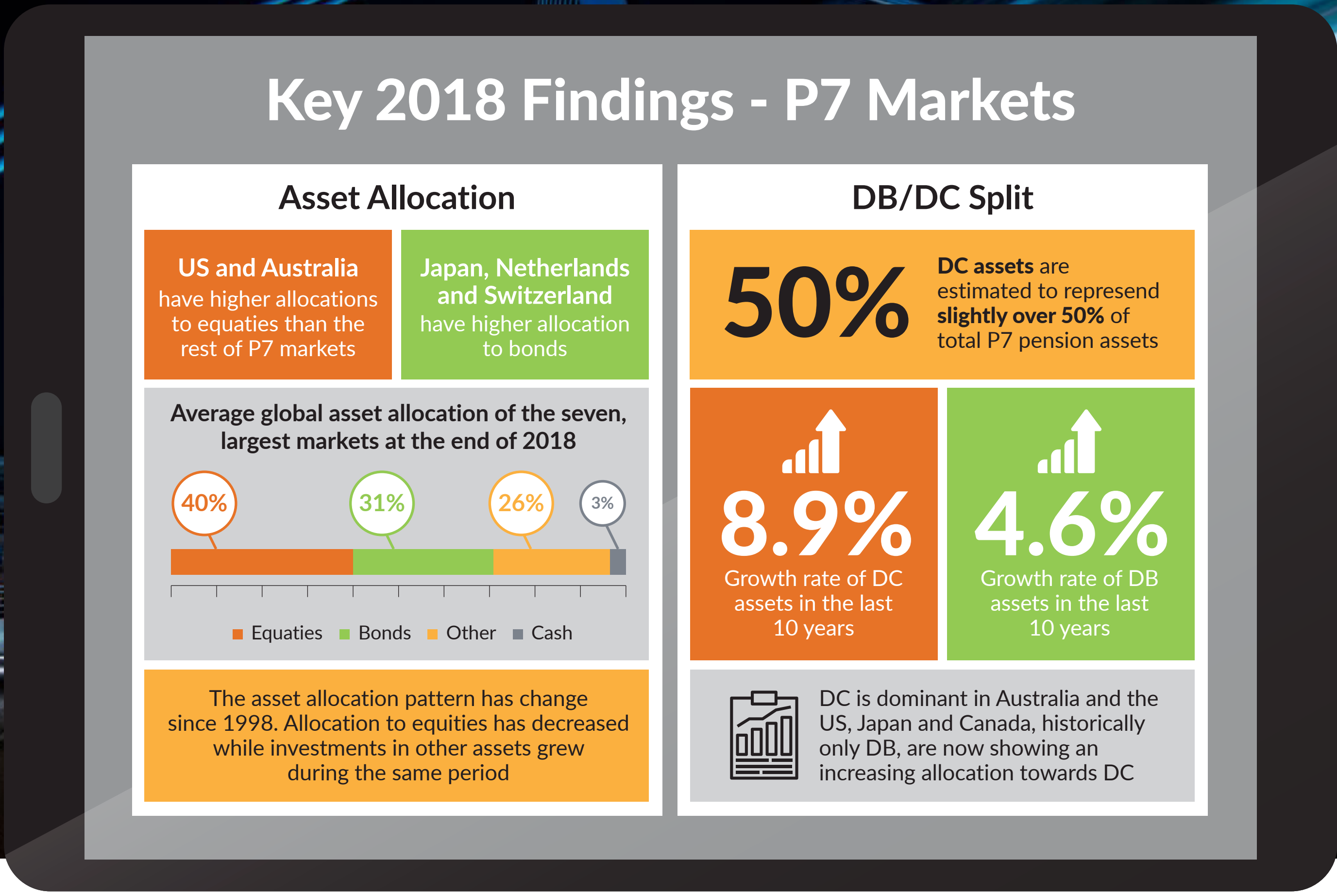
At the Financial Risk Solutions (FRS) bi-annual User Conference this year, our team provided a comprehensive review of the pensions markets in Australia, the United Kingdom and Ireland.

We selected these countries because they are the markets in which FRS is most active. The three markets are at quite different stages in their development with compulsory DC business. Also, the ratio of pensions assets to Gross Domestic Product (GDP) ranges from 130 percent for Australia through to just 45 percent for Ireland.

This report provides an overview of the history and current state of DC pensions in these three countries and highlights key areas of opportunities for fund managers to benefit and get ahead of their competition.

Market	Total Assets 2018 (USD billion)	Assets/GDP ratio (%)
Australia	1,866	130.7%
Brazil	243	12.7%
Canada	1,630	94.0%
Chile	196	65.5%
China	198	1.5%
Finland	233	84.2%
France	155	5.5%
Germany	557	13.8%
Hong Kong	156	43.2%
India	129	4.8%
Ireland	166	45.4%
Italy	187	9.0%
Japan	3,061	60.8%
Malaysia	227	65.4%
Mexico	185	15.4%
Netherlands	1,517	168.7%
South Africa	213	56.4%
South Korea	733	44.3%
Spain	41	2.8%
Switzerland	893	128.0%
UK	2,856	101.7%
US	24,711	120.5%
Total	40,173	60.4%

Australia - a proven model for co-contributed pensions



Australia's pension arrangements were originally agreed under individual industrial awards and negotiated by individual unions. In 1983 the union movement agreed directly with the government to forego a national three percent pay increase and instead channel it into a superannuation system for all employees in Australia. In 1992 the Keating government overhauled the system and created the modern version of superannuation that Australia has today.

The employer's contribution rate has increased from three percent in 1992 to 9.5 percent today. Legislation was passed in 2014 to increase the contribution rates from 2021 by 0.5 percent per year up to 2025 when it will be 12 percent. However, this has been pushed back to 2021 as the economy slows, and there is significant debate around the impact of increasing compulsory contributions levels versus rising wages.

Employees can make voluntary contributions through salary sacrifice either pre-tax or post-tax, although there are limits. These voluntary contributions can be very tax-effective and are locked up until retirement age. Retirement or preservation age is legislated and ranges from 55 to 60, depending on your year of birth.

The taxation of superannuation in Australia is different to many markets. Australian's pay 15 percent tax on contributions, income and realised capital gains when the member is in accumulation mode (i.e. pre-retirement). As soon as the member retires, tax is no longer payable.

With many Australian's returning to work after official retirement, this results in the unique situation of being able to access your savings pot free of tax while still contributing to the same pension pot. There is no requirement to purchase an annuity and no restrictions on the amount you can access as a lump sum.

Superannuation success

There is no doubt that superannuation has been a considerable success for Australia. Superannuation assets in Australia represent EUR 1.667 trillion, which equates to nearly 78 percent of all managed funds in the country. The assets accumulated in the superannuation system, along with the removal of the pension burden from the government, is arguably one of the reasons Australia has not had a recession for nearly three decades.

Every year, the flow of funds into superannuation is increasing. Australian Super, the county's largest superannuation fund has monthly inflows exceeding EUR 1 billion, presenting a significant challenge to get all of this money invested efficiently and effectively.

This strong growth is expected to continue due to rapid population growth, increased contribution rates and new legislation to bring the gig economy and part-time employees into the superannuation system.

Types of funds

Interestingly, the administration of this vast pool of money is not performed by the traditional financial services industry. Funds run by financial institutions represent only 23 percent of the industry.

- ## Self-Managed Super Funds (SMSF)

The largest segment of the industry is Self-Managed Super Funds (SMSF) - small, private trusts with a maximum of four members who also serve as trustees. SMSFs are generally administered by accounting firms who do the back-office accounting and regulatory work, with the investment decisions made by the members. These funds are also the fastest-growing segment, a trend that accelerated when the costs of administration dropped enough to justify smaller pots of money being self-managed. The growth further accelerated when the regulation allowing SMSF to take out mortgages to purchase investment properties, within the fund itself, was introduced.

- ## Industry Super Funds

Industry Super Funds were initially established to provide for the retirement of workers from a specific industry. These funds are not for profit, do not have shareholders and are run only to benefit members. They have heavily focused on having low fees and have never paid commissions to financial planners. Examples of these funds include VicSuper, the superannuation funds of the Victorian government employees and CBUS, the Construction and Building Industry Super Fund.

A development with these industry funds is the in-sourcing of the investment management process. This began around 15 to 20 years ago when the industry funds realised that it was more cost-effective to hire a team of asset managers rather than pay the fees their asset managers were charging, particularly for simpler mandates such as domestic equities. Another unique feature of the industry funds is that the boards are dominated by the union movement and have openly stated political ambitions and focus.

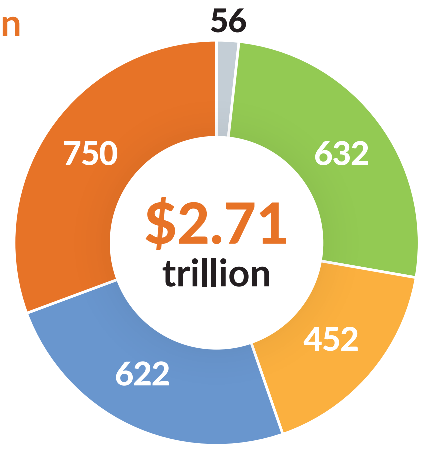
- ## Retail Master Trusts & Wrap Platforms

Funds run by financial institutions for individuals are a growing part of the market.

- ## Corporate Pension Funds

A small sector is Corporate Pension Funds, employer-sponsored trusts run for the benefit of the employees. Each fund has its own trust structure that is not necessarily shared by other employers.

Superannuation Mix $bn



Administration of Funds

Most non-SMSF super funds operate a small fund of fund structure with approximately nine investment choices available to the member. The structures have two internal layers, sector and asset class. In total, a corporate or industry fund would have around 30 daily unit prices, some with more than $50 billion in Assets Under Management (AUM).

Mirror funds are not used and external collectives are rarely used. The external investment level is dominated by segregated mandates rather than external collectives.

All of the funds FRS have spoken to do not use Box Management because they hold the view that their members are also shareholders. Many perform cash allocation in spreadsheets, which has resulted in some unusual operational processes such as the use of a 'banker fund concept' where the daily cashflows are absorbed into the largest investment option before being allocated later in the month. In markets such as the UK and Ireland, this would be considered as not treating all customers fairly.

Room for improvement

Despite the positive picture of the Australian pension market, there are several industry-wide issues, including:

- A large number of unintended multiple accounts
- Entrenched underperforming funds
- Some ineffective boards
- Some inappropriate interpretation of best interests
- Exclusion of people who earn less than AUD 450 a month

An extensive Royal Commission review into banking and finance exposed some issues, including charging deceased people for life insurance and selling people products they didn't need. With the regulators drafting new laws, we can expect some changes in this industry.

Regulators driving change

A recent article in the Australian Financial Review, 'We will litigate': ASIC warns super funds'2 stated that poor-performing funds would be taken to court because they are failing to act efficiently, honestly and fairly. The regulator indicated that it would force around one hundred persistently underperforming funds out of the system.

A second Financial Review article, 'APRA to turn the screws on super'3 from March 2019, quoted the Australian Prudential Regulation Authority (APRA) announcement that industry funds may be failing the sole purpose test as they diversify into additional products (mortgages and banking).

While regulators are driving much change in the industry, so too are the politicians with elections likely to throw up a series of changes to superannuation, including lowering the contribution cap and increasing the tax on higher earners contributions. All in all, the changes seem to be aimed at making supers less of a tax strategy for those who can already afford a comfortable retirement.

The opportunity for Australian funds

With 9.5 percent of salaries contributing to private pension pots in Australia and steadily increasing to 12 percent in June 2026, such enormous annual flows of new monies into funds is an excellent opportunity for the funds' industry. It also creates a challenge to find a home for such vast sums of new monies seeking solid returns.

The United Kingdom - fast pensions growth through Auto Enrolment

While the UK came to co-contributed pensions much later than Australia, the uptake has been very impressive. Auto Enrolment (AE) for co-contributed pensions commenced in October 2012 in a staged approach. The four stages were as follows:

Employer Size	From	To
250 or more members	01-Oct-12	01-Feb-14
50 to 249 members	01-Apr-14	01-Apr-15
Test tranche for less than 30 members	01-Jun-15	30-Jun-15
30 to 49 members	01-Aug-15	01-Oct-15
Less than 30 members	01-Jan-16	01-Apr-17

1. UK Automatic Enrolment Duty Source: www.gov.uk

The scheme applies to employees from age 22 to state pension age with earnings above £10,000 per annum. Tax is applied at source or via net pay arrangement and employees can opt-out. The largest employers started first, followed quickly by SME employers. Today, all employers, including new employers, are part of automatic enrolment by default.

- Pay regular contributions to the pension scheme on behalf of existing members of the scheme.
- Monitor the ages and earnings of new staff and existing staff who are not already members of the scheme. All staff who meet the criteria must be enrolled in the pension scheme.
- Manage requests to join or leave their pension scheme.
- Keep records of how they have met their legal duties, including a register of members, records of contributions and any requests to join or leave the pension scheme.
- Re-enrolment – every three years, employers need to put staff back into their pension scheme if they have left it, and if they meet the criteria to be put into a pension scheme.

Rapid growth

Today 84 percent of UK staff are in a workplace pension scheme, up from 77 percent last year. The growth of enrolment is impressive with the total number of staff automatically enrolled by March 2018 at 9.5 million, up from 5.2 million in 2015. The proportion of private sector eligible staff participating in a workplace pension increased from 42 percent in 2012 to 81 percent in 2017. Additionally, the total amount saved by eligible savers in 2017 was 90.3 billion up from 86 the previous year.[1]

Types of funds

• The National Employment Savings Trust

National Employment Savings Trust (NEST), is a defined contribution workplace pension scheme launched in 2011 to facilitate automatic enrolment as part of the government's workplace pension reforms (Pensions Act 2008). It is available to any UK employer and, as of July 2018, had £3 billion AUM, 6.8 million members and 656,000 employers.

A charge of 1.8 percent on each new contribution and a 0.3% annual management charge (AMC) on the total value of a fund each year. Charges were initially higher (linked to the set up of the Trust) but following criticism in 2010 they were brought down. In addition to, auto enrolment providers include People's Pension, NOW Pensions and SmartPensions.

• Retirement Date Funds

Also known as target date funds are offered, these investment funds are tailored to the member's date of retirement and gradually de-risk, reaching their most conservative point at the target date. The mix of assets in these funds changes as the retirement date gets nearer. Auto enrolment providers offer a diverse range of funds for different palettes including ethical funds, Sharia law funds and higher risk funds.

Maximum Contributions to Auto Enrolment

Contributions can be in the form of regular payments, a one-off lump sum or a combination of both. The limit includes the contributions paid into all of the individual's pensions (if there is more than one) and includes personal contributions, tax relief and any contributions that are paid by the employer. The lifetime allowance is a total amount of all pension savings that can be built up over the individual's entire working life without triggering a tax charge. The annual allowance is GBP 40,000, and the lifetime allowance for the 2019/2020 tax year is GBP 1,055 million. High earners can consider saving into international portfolio bonds.

The Future looks bright

The Pensions Schemes Act aims to make greater risk-sharing between employers, individual members and third parties more manageable. The Pensions Regulator has welcomed the new powers that were granted to them in 2017 to authorise and supervise master trusts. The number of providers has grown significantly over the last few years as more staff are put into schemes thanks to auto-enrolment. These savings need to be secure. The regulations under the Act are still being developed but will give the Pensions Regulator powers to ensure that master trusts are financially secure and stable and managed by individuals who are fit and proper.

Changes in the way we work, such as the gig economy, will impact auto-enrolment and the number of staff who may need to be auto-enrolled. Extending the scheme to include people on short-term contracts or doing freelance work, as opposed to permanent jobs still poses a challenge.

With increasingly large annual inflows to the industry, robust controls must be in place to administer the tremendous amount of activity in numerous funds efficiently while mitigating investment operations risk.

Ireland - a world of possibility

Currently, auto-enrolment pensions do not exist in Ireland. Irish employers are obliged to make a pension plan available to employees, but neither employers nor employees are required to contribute to it.

In its 2014 'Review of the Irish Pensions System', the Organisation for Economic Co-operation and Development (OECD) concluded that the single highest goal in Irish pension policy should be to increase coverage through the introduction of a mandatory or quasi-mandatory earnings-related pensions system.

The Irish Government now intends to develop and introduce, by 2022, an 'Automatic Enrolment' (AE) supplementary retirement savings system. AE will be an earnings-related workplace savings system where enrolled employees will retain the freedom to opt-out if they so choose.

The Auto Enrolment, Defined Contribution model

The government produced a set of 'Strawman' proposals for how the AE system might work and invited feedback in 2018. In the Auto Enrolment, Defined Contribution model, members will have the option to choose from a small range of retirement savings products made up of four investment strategies at most.

Employees, employers and the state will each contribute to the member's account. AE will not be a substitute for existing pension provision and will instead supplement the existing State Pension and complement, rather than replace existing private pension provision.

The existing state pension is targeted to provide approximately one-third of average wages.

An estimated 35 percent of Irish private-sector employees have a supplementary pension compared with 84 percent in the UK following the introduction of AE.

All employees earning over EUR 20,000 and between the ages of 23 and 60 who do not already have pension arrangements would be auto-enrolled into a defined contribution (DC) retirement savings scheme. The self-employed and those outside the above criteria would not be required to auto-enrol but could opt-in to the scheme.

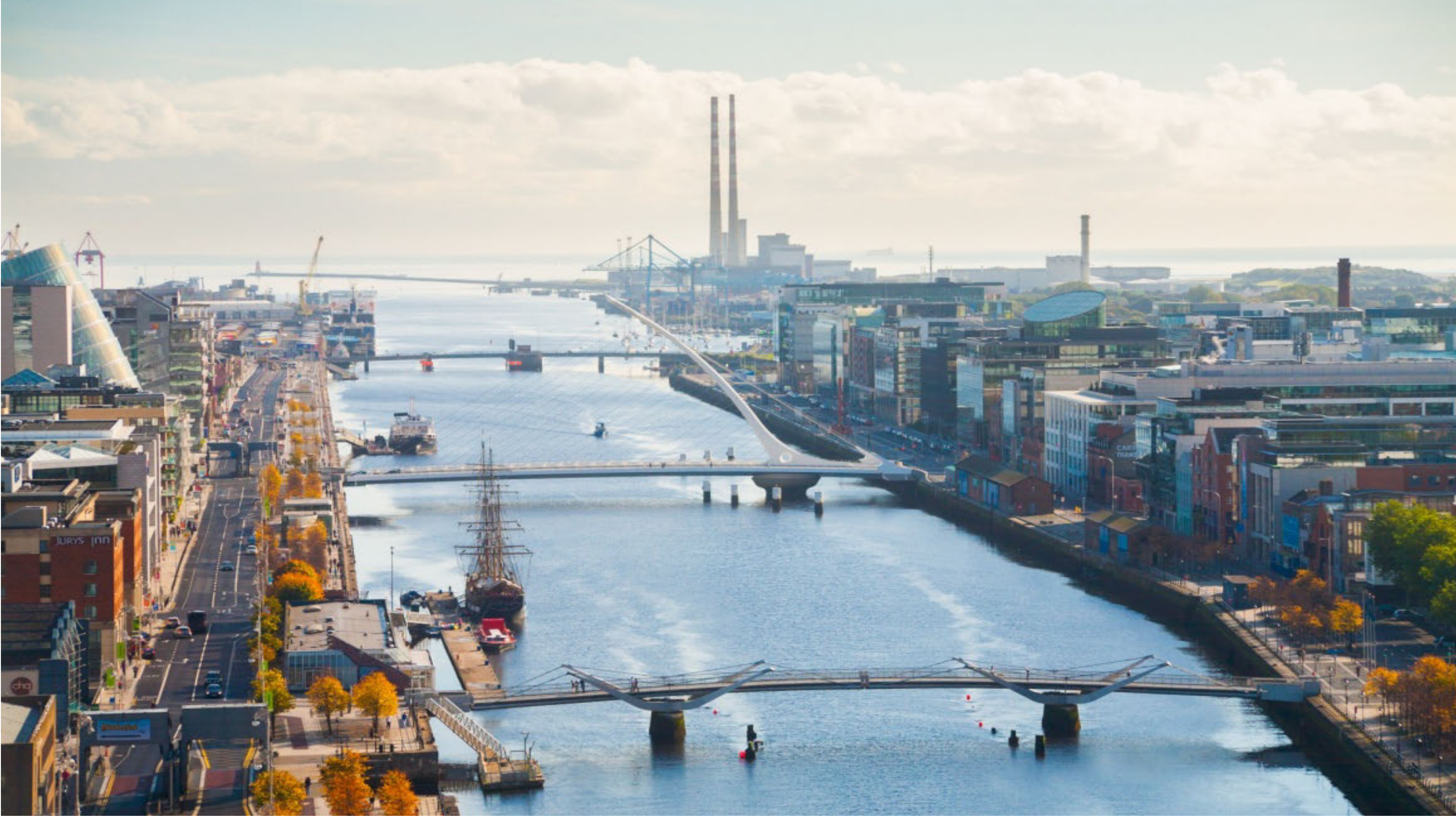
Initially, employees will make contributions of one percent of earnings, increasing by one percentage point each year until year six when the contribution rate will be fixed at six percent.

There will, for the first time, be a mandatory employer contribution to the employee's account. Employers will be required to make contributions matching those of their employees subject to a maximum of EUR 75,000 of annual earnings (approximately twice the average earnings).

The State incentive (in the form of tax relief of 25 percent) is presented as a contribution worth EUR 1 for every EUR 3 the employee contributes towards their retirement savings account. Therefore, when the employee contribution ultimately rises to six percent, the State contribution will increase to two percent.

Note the tax relief rate of 25 percent compares to the current highest marginal income tax rate of 40 percent.

By 2027 the total contribution would be 14 percent of eligible earnings. This is comprised of 6% from employer and the same from the employee with the state adding the last 2%. The intended Irish employer contribution rate at 6 percent would be double the 3 percent in the UK and half the proposed 12 percent in Australia.



Overseen by a Central Processing Agency

An independent Central Processing Agency would oversee the system. Employers will be required to register their employees with this Central Processing Agency and deduct their contribution through payroll and then pass these to the Central Processing Agency.

The Strawman proposed the Central Processing Agency tender to select a maximum of four 'Registered Providers.' Each of these will be required to provide four different retirement saving fund options based on risk profiles, for example low, medium and high, and a default fund. The default fund is for those who don't choose any of the other three risk profiles.

The Central Processing Agency would act as the interface between employers and employees on the one hand and the providers on the other.

Its primary functions would be to facilitate automatic enrolment, the selection by employees of their investment option and the collection and remittance of contributions (including Government contributions) to the providers.

The idea behind the Registered Providers was that they should support the achievement of economies of scale and the reduction in management fees resulting in higher pensions.

The Strawman proposal was for a maximum annual management charge of 50 basis points per annum, compared with 75 basis points in the UK and no maximum in Australia.

At retirement, the customer will have a choice of the standard drawdown options such as lump sums, annuities and Approved Retirement Funds, and providers will be required to facilitate all of these.

The response from unions, employers and industry bodies

Overall the proposal to introduce the AE system was welcomed by unions, employers and industry bodies. However, there were wide ranging views on the government proposals.

The employer bodies thought the employer and employee contribution rates were too high and pointed to the UK level of contributions which started at one percent for both and are now three percent for employers and five percent for employees after six years.

The unions, however, felt employers should contribute seven percent after six years and employees five percent.

Both union and employer bodies felt that the Revenue commissioners should act as the Central Processing Agency given they collect social insurance contributions and taxes from employers already.

Industry and employer bodies argued against lowering the tax relief for higher earners from 40 percent to 25 percent while the unions argued that all contributors should get relief at 40 percent. Non-taxpayers, they argued, should get a government contribution equivalent to 40 percent tax relief.

The industry argued that a low-risk default strategy fund would be counter-productive as there would be no exposure to real assets. The unions argued that the 50 basis points maximum charge was too high and industry responses said it was too low.

Unions also argued that all AE contributions be managed in a state-run fund, possibly led by the National Treasury Management Agency (NTMA), with no commercial providers allowed. Industry feedback was that more than four commercial providers be permitted.

The opportunity for Irish funds

Several providers are currently positioning their firms as the potential provider for the default fund in Ireland, like the other markets technology and risk mitigation plays an enormous part in the successful delivery of Irish auto-enrolment.

Summary

FRS is proud to have the Invest|Pro™ platform running in the back office of many life and pensions firms in each of these three markets. We stand committed to creating robust, risk-mitigating and scalable technology solutions that support our clients in building and maintaining trust with pension scheme members making provision for their later years through DC pension schemes.

FRS agree that mandating workers with appropriate tax and employer support is the correct way to incentivise people to contribute to their retirement. It is correct to remove most of the liability of funding old age support from the balance sheet of the state, which is funded by taxpayers and compelling workers to save for a personal pension pot which enables them to enjoy a well-funded fruitful retirement.

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