Lessons from Overseas

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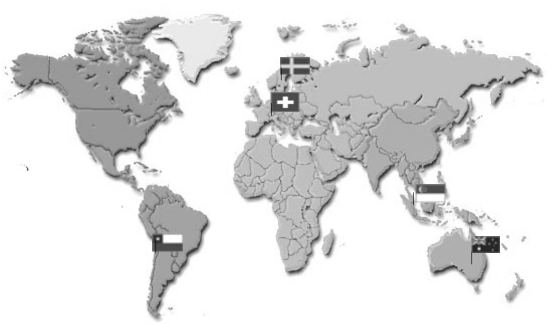

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Chile

- Population: 15.2m
- Currency: Chilean Peso
- Language: Spanish
- Area (sq km): 736,905
- GNP per capita: $11,700
- Interesting fact: has the lowest death rate per capita from motorcycle accidents

Lesson 1 - Chile

SINGLE PILLAR	OLD SYSTEM pre 1981	NEW SYSTEM from 1981
Provision	State social security	Mandatory private
Type of benefit	Defined benefit	Defined contribution
Financing mechanism	PAYG	Funded individual account
Contributions	In excess or 20%, 67% er/33% ee	Employer Nil Employee 10%

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Lesson 1 - Chile

OLD SYSTEM pre 1981:

- Administratively complex SS system:
  - circa 50 administrative agencies
  - different old age pension systems
- Benefit circa 70-100% covered earnings
- PAYG system
- Total contributions in excess of 20%*, circa 2/3rds employer financed

* For long term benefits: retirement, disability and survivors

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Lesson 1 - Chile

NEW SYSTEM from 1981:

- Reform of SS system, including pensions
- Move to private DC pension provision
- Administration by regulated authorised providers, AFPs
- Compulsory 10% employee contribution, further 10% employee voluntary contribution permitted
- All contributions tax deductible
- One-off salary increase of 17% of salary 1 March 2001
- Flexibility at retirement to:
  - Transfer funds to another provider
  - Purchase annuity, do income draw-down or a combination

Lesson 1 - Chile

Outcome:

- Simplification of former complex system
- Reduction of state and employer burden/risk:
  - Shift from state to private provision
  - Shift from PAYG to funded individual account
  - Shift from employer to employee financing
  - Shift from defined benefit to defined contribution
- Greater transparency of new system to employees
- Catalyst for growth of investment and insurance services/markets

Australia

- Population: 18.8m
- Currency: Australian Dollar
- Language: English
- Area (sq km): 7,682,300
- GNP per capita: $19,870
- Interesting fact: has the highest level of coal consumption per capita

Lesson 2 - Australia

THREE PILLARS	
1st PILLAR	State old age pension
2nd PILLAR	Mandatory Superannuation Guarantee (SG)
3rd PILLAR	Occupational and private personal supplementation

Lesson 2 - Australia

1st PILLAR – State Old Age Pension:

- Means tested
- PAYG defined benefit system
- Financed out of government general revenues
- Retirement age 65
- Full pension circa AUD 12,000
- Income/asset test for eg single homeowner:
  - Full pension if income circa < AUD 3,000 pa and assets < AUD 140,000
  - Nil pension if income circa > AUD 31,000 pa and assets > 285,000

Lesson 2 - Australia

2nd PILLAR – Mandatory Superannuation Guarantee (SG):

- Introduced 1992
- Little compulsory provision prior to that
- Funded defined contribution and defined benefit (but defined benefit in decline for some time)
- Financed through individual employer superannuation schemes or industry-wide funds
- Individual employer funds in significant decline
- Normal retirement age 65

Lesson 2 - Australia

2nd PILLAR – Mandatory Superannuation Guarantee (SG):

- Compulsory minimum employer contribution of 9% of salary
- Employers/employees can make contributions in excess of SG minimum requirements and often do
- In recent years trend to offer members choice of different investment options
- Highly regulated system

Lesson 2 - Australia

2nd PILLAR – Mandatory Superannuation Guarantee (SG):

- Preservation/locking-in of benefits until retirement
- Tax concessions apply for benefits to Reasonable Benefit Limit (RBL*) – now A$619,000 as lump sum
- SG contributions not tax deductible, but fund is paid as a tax free lump sum at retirement (few members opt for an annuity) within RBL
- Above SG, members can contribute pre or post tax
- Benefits in excess of RBL taxed at member's highest marginal rate

Lesson 2 - Australia

Outcome of SG:

- Creation of 2nd Pillar compulsory system
- Minimum level of preserved retirement provision for all
- Reduction of state and employer burden/risk:
  - Shift from state to private superannuation provision
  - Shift from PAYG to funded provision
  - Shift from defined benefit to defined contribution
- Increased transparency of new system to employees
- Increased employee choice/control of retirement savings
- Has fuelled growth in domestic capital markets and financial services sector in general
- Broad acceptance of the need for, and value in, SG legislation

Lesson 2 - Australia

Outcome of SG:

- Current 9% SG contribution under scrutiny – increase widely debated
- Property boom has lead to bricks and mortar being the long-term investment of choice though
- Self-Managed funds (similar to SSAS/SIPP) likely to be the big winners from Choice of Fund legislation – direct property investment opportunities main driver
- Choice of Fund catalyst for change within the funds themselves (along with trustee licensing). The market is sensitive to fee levels and this is a key competitive driver between funds. Consolidation is inevitable and many have already merged

Singapore

- Population: 4.0m
- Currency: Singapore Dollar
- Language: Malay/English
- Area (sq km): 647
- GNP per capita: $26,910
- Interesting fact: highest oil consumption per day per 1000 people

Lesson 3 - Singapore

COMPULSORY PROVIDENT FUND (CPF):

- Set up in 1955 to provide basic welfare benefits
- Evolved into comprehensive social security/savings scheme
- Compulsory defined contribution/savings system
- Financed by employer and employee contributions (some government subsidies)
- Funded individual savings accounts
- Account savings used to provide a range of benefits including:
  - Retirement
  - Healthcare
  - Home Ownership
  - Family Protection

Lesson 3 - Singapore

COMPULSORY PROVIDENT FUND (CPF):

- Contributions based on monthly earnings up to circa SGD 6,000
- Total contribution circa 33% of earnings (under age 55): 13% employer, 20% employee
- All contributions tax deductible
- Total contributions allocated to three separate savings accounts:
  - Ordinary Account circa 20%
  - Special Account circa 6%
  - Medisave Account circa 7%

Lesson 3 - Singapore

CPF Accounts:

- Medisave Account – Savings used to meet healthcare costs (variety of medical insurance schemes including Medisave, Medishield, Medifund and other approved medical insurances)
- Ordinary Account – Savings available for property purchase, retirement, investment, education and purchase of CPF death/disability insurance
- Special Account – Savings reserved primarily for retirement

Lesson 3 - Singapore

CPF Retirement:

- Ordinary and Special Account savings can be invested cash, bonds, shares, insurance products, unit trusts and exchange traded funds
- Up to 35% can be invested in shares and corporate bonds
- Members can withdraw savings - and effectively retire - from age 55, provided they set aside a Minimum Sum in their Ordinary Account to provide old age benefits
- The Minimum Sum is currently circa SGD 80,000 and must be used to provide a monthly income from normal retirement age 62 – either by income draw-down or annuity purchase
- Benefits taxed as income

Lesson 3 - Singapore

Outcome:

- Comprehensive fully integrated state/private funded system
- Decreased retirement burden/risk for state and employer
- Transparent individual account system
- Great degree of control for employees over their savings
- Catalyst for growth of investment and insurance services/markets
- Some aspects of administration remain relatively complex
- Some investment restrictions remain
- A potential gap in coverage for employees with earnings above CPF monthly earnings limit of SGD 6,000 –government recently introduced new Supplementary Retirement Scheme (SRS) vehicle

Switzerland

- Population: 7.4m
- Currency: Swiss Franc
- Language: French/German/Italian
- Area (sq km): 41,284
- GNP per capita: $26,340
- Interesting fact: lowest number of 20 year old women who gave birth to a child whilst in their teens

Lesson 4 - Switzerland

THREE PILLARS	
1st PILLAR	Federal old age pension (AHV)
2nd PILLAR	Mandatory minimum private pension (BVG) from 1985
3rd PILLAR	Occupational and private personal supplementation

Lesson 4 - Switzerland

1st PILLAR – Federal Old Age Pension:

- Per AHV SS legislation 1948
- Many revisions since, most recent to align retirement ages males and females and widow/widower pensions
- PAYG defined benefit system
- Employer and employee contributions circa 5% of total earnings
- Benefit based on covered earnings circa CHF 13,000-76,000
- Minimum pension circa CHF 13,000, maximum pension CHF 25,000
- Inadequate income replacement on earnings CHF 25,000-76,000

Lesson 4 - Switzerland

2nd PILLAR – Mandatory minimum private pension:

- Per BVG legislation 1985
- Intended to address gap in replacement income on earnings in excess of CHF 25,000
- Funded "quasi defined contribution" system
- In reality a defined benefit arrangement – a "cash balance" style plan with annual guaranteed minimum investment return and fixed annuity conversion rates
- Financed through individual employer pension foundation or collective/multi-employer foundations provided by insurance companies/other financial institutions
- Contribution salary is AHV covered earnings between CHF 25,000-76,000

Lesson 4 - Switzerland

2nd PILLAR – Mandatory minimum private pension:

- Age related mandatory minimum total pension contributions range from 7% (age 25-34) to 18% (age 55-65) of earnings
- At least 50% of total contribution must be met by employer
- Accumulated member's account at retirement converted to pension at rate of 7.2% (fixed 1985-2004), lump sum payments also possible
- Annual guaranteed minimum investment return prescribed by Federal Council:
  - 1985-2002 (inclusive) = 4%
  - 2003 = 3.25%
  - 2004 = 2.25%
  - 2005 = 2.25%

Lesson 4 - Switzerland

Outcome:

- Risks associated with investment return and annuity conversion guarantees poorly understood by stakeholders
- Market conditions 1985-2002 ensured apparent success of BVG system:
  - Positive investment performance, easy to meet 4% return guarantee
  - Surpluses developed, foundations crediting returns in excess of 4%
  - Interest rates/bond yields reasonably supported annuity conversion rates

Lesson 4 - Switzerland

Outcome:

- By 2002 apparent many foundations in trouble:
  - Market crash had turned historic surpluses into deficits
  - Asset strategies misaligned to deliver minimum return guarantees in current market conditions
  - Low bond yields unable to support annuity conversion/insurance rates
  - No processes/strategies in place to address deficits
  - Many Swiss employers provided similar plans for earnings in excess of CHF 76,000, compounding the effect

Lesson 4 - Switzerland

Outcome:

- Reactions 2002-2005:
  - Material reduction to historic investment return guarantee
  - Awakening to need for risk management strategies
  - Alignment and tightening of investment strategies
  - Revision of annuity conversion/insurance rates to reflect market conditions and increased longevity
  - Implementation of processes/strategies to address deficits
  - Many employers, for first time in history, did not provide minimum investment return on plan above BVG minimum
- Related valuation and accounting issues under IAS 19/FRS 17

Sweden

- Population: 8.9m
- Currency: Krona
- Language: Swedish
- Area (sq km): 449,964
- GNP per capita: $18,770
- Interesting fact: highest number of seats in parliament held by women (as % of total).

Lesson 5 - Sweden

THREE PILLARS	
1st PILLAR	State old age pension (Old AFP/ATP and New System)
2nd PILLAR	Mandatory private sector pensions – ITP and SAF/LO
3rd PILLAR	Occupational and private personal supplementation

Lesson 5 - Sweden

1st PILLAR – Old Age Pension under AFP/ATP:

- Prior to 1999
- Applies to all born pre 1937, transition arrangements for those born 1937-53
- PAYG defined benefit system
- Benefits determined by reference to annual Base Amount (BA), circa SEK 40,000
- AFP flat rate pension based on earnings up to 1 x BA
- ATP earnings related pension based on earnings between 1 and 7.5 x BA
- After a full career aggregate AFP+ATP pension circa 60-65% of covered earnings (to 7.5 x BA)

Lesson 5 - Sweden

1st PILLAR – Old Age Pension under New System:

- Introduced 1999
- Applies to all born 1954 or later
- Mixed system:
  - Mainly centrally managed PAYG “defined contribution” system
  - Small externally funded defined contribution component
- Total contribution of 18.5% of total salary, shared between employer and employee
- Of this, 18.5% of salary up to 7.5 x BA directed to retirement benefits as follows:
  - 16% registered in notional individual national account (but actually used to finance current pensions in payment, PAYG)
  - 2.5% paid into private personal savings plan with a provider of the employee’s choice

Lesson 5 - Sweden

1st PILLAR – Old Age Pension under New System:

- Notional individual account annually increased with an index linked to economic growth
- Private personal savings plan increases with investment returns
- At retirement both accounts used to provide an annuity
- After a full career new system expected to deliver a pension of circa 50-55% of covered earnings (to 7.5 x BA)

Lesson 5 - Sweden

2nd PILLAR – ITP plan:

- Since 1960
- Covers most private sector salaried employees
- Defined benefit system
- Primarily insured with central provider Alecta
- Larger employers may chose to use book reserving method (FPG/PRI)
- Covered earnings up to 30 x BA
- Alecta determines individual participating company contribution rates, which are fully paid by employer
- Replacement ratios from ITP approx:
  - Salary up to 7.5 x BA 10%
  - Salary band 7.5 to 20 x BA 65%
  - Salary band 20 to 30 BA 32.5%

Lesson 5 - Sweden

2nd PILLAR – SAF/LO plan:

- Covers most private sector wage earners
- Funded defined contribution system
- Replaced former DB plan for wage earners (STP) in 1996
- Covered earnings are total gross salary
- Employer pays 3.5% of employees wages to an insurance contract of the employee's choice
- Main insurer is AMF but there are a number of other authorised insurer offering both with-profits and unit linked products

Lesson 5 - Sweden

Outcome 1st Pillar New System:

- Recent redesign
- Some reduction of state burden/risk:
  - Shift from defined benefit to "defined contribution"
  - Partial shift from state to private
  - Partial shift from PAYG to funded provision
- True employee understanding of new "defined contribution" system will be judged in time

Lesson 5 - Sweden

Outcome of 2nd Pillar ITP and SAF/LO:

- In recent years pressure from employers to move from defined benefit to defined contribution to better control costs
- SAF/LO defined contribution system has reduced burden/risk on employer replacing former defined benefit commitments
- Employee perception of ITP as old fashioned and inflexible
- Employer perception of ITP as difficult to manage/understand costs
- Ongoing discussions on redesign of ITP, likely switch to defined contribution
- Related ITP valuation and accounting issues under IAS 19/FRS 17

The Lessons

Trends:

- Shift from state SS to compulsory private provision
- Shift from state PAYG to private funded arrangements
- Shift from defined benefit to defined contribution designs

Not one magic solution:

- Chile – Big bang, simple and transparent compulsory private solution
- Australia – Minimum level of compulsion to start with
- Singapore – Is it a savings or pension scheme
- Switzerland – Danger in mixing defined contribution with defined benefit guarantees without understanding/managing risks
- Sweden –Employers increasingly uncomfortable with lack of control/understanding of cost of insured ITP. Too early to tell on social security plan.

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