DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
INSURANCE AND PRIVATE PENSIONS COMMITTEE

Working Party on Private Pensions

Tentative project proposals for 2015-2016: discussion note

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TENTATIVE PROJECT PROPOSALS FOR 2015-2016

1. This note presents a brief description of several projects for the period 2015-2016 the Secretariat would like to propose for the WPPP’s consideration. The OECD WPPP has been very active since the onset of the financial and economic crisis discussing and reviewing work aiming to improve the functioning of private pensions. This work includes the strengthening of the regulatory framework by updating the Core Principles of Occupational Pension Regulation to encompass a broader range of pension plans (DAF/AS/PEN(2012)3/REV5), the OECD Roadmap for the Good Design of DC Pension Plans (http://www.oecd.org/daf/fin/private-pensions/50582753.pdf), and the work included in the last two editions of the OECD Pension Outlook, 2012 and 2014. Despite this, much work remains to be done to address the challenges that population ageing and the global economic environment pose to pension systems. Important issues remain on the agenda for future work such as balancing sustainability and adequacy; diversification between public and private pensions; tackling the high costs of running funded private pensions; potential conflicts of interest of pension advisers; and improving the structure of the pay-out phase of defined contribution pensions by encouraging annuity products.

2. The project on incentives and retirement savings (DAF/AS/PEN/WD(2014)11) and the project on annuity products (DAF/AS/PEN/WD(2013)6) already started in 2014 will continue in 2015-2016.1

3. Following the Program of Work and Budget (PWB) 2015-2016 and delegates’ helpful replies to the PWB questionnaire, including the type of analysis they would like the Secretariat to pursue, the following list of projects is proposed:

   1. Diversification between public and private pensions
   2. Cost of running funded private pension
   3. Conflict of interests in pension advice
   4. Facing the challenges of a low return environment
   5. Improving the structure of the pay-out phase of pensions
   6. Continuing with the discussion about the need to adjust the classification of private pension plans
   7. Agency problems, asymmetric information and governance

4. The scope and approach to address the different undertakings are more developed for some projects than for others. The scope and approach to address the project on conflict of interests of pension advisors is fully developed thanks to the work presented by the US delegation in the June 2014 WPPP meeting.

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5. The OECD Secretariat would like to encourage different delegation to actively engage in the preparation of these projects.

6. The OECD Secretariat would appreciate if delegates could consider these proposals and provide feedback through the written procedure by Friday 16 January 2015 the above list ordered by preference.

1. Diversification between public and private pensions

7. The purpose of this project would be to show how funded pensions and PAYG-financed pensions interact and reinforce each other in order to improve the retirement situation of individuals. A multi-pillar system is essential for delivering appropriate retirement income.

8. This work stream will also look at the experiences of different OECD countries to learn about what works best, why it may work and under what conditions it seems to work.

2. Tackling the high costs of running funded private pensions

9. Pension funds and managers of assets accumulated for retirement charge different fees for managing retirement pots. These fees and charges can easily eat away a large part of the potential amount of assets that people may accumulate for financing retirement, reducing the amount of retirement income that people may have (see table below).

<table>
<thead>
<tr>
<th>Fee as % assets</th>
<th>Reduction of pension (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.05</td>
<td>1.2</td>
</tr>
<tr>
<td>0.15</td>
<td>3.6</td>
</tr>
<tr>
<td>0.25</td>
<td>5.9</td>
</tr>
<tr>
<td>0.50</td>
<td>11.4</td>
</tr>
<tr>
<td>0.75</td>
<td>16.5</td>
</tr>
<tr>
<td>1.00</td>
<td>21.3</td>
</tr>
<tr>
<td>1.50</td>
<td>28.9</td>
</tr>
</tbody>
</table>

Note: The impact of fees on pensions is calculated assuming an individual that contributes 10% of wages, wages growth at an annual rate of 3.8% (resulting from 2% inflation and 1.8% growth in productivity). The individual contributes for 40 years since age 25 until age 65 when he retires. The assumed return on portfolio investment is 7%. Lower returns decrease the impact of fees on pensions. For example, the impact of a fee of 1.5% on pensions falls by almost 3 percentage points when returns to portfolio investment fall from 7% to 5%

Source: OECD calculations.

http://dx.doi.org/10.1787/888932599310

10. The costs of running funded private pensions are one of the more damaging subjects for saving for retirement and private pension provision. There is ample discussion on whether the level of costs and fees charged for managing pension assets and also for providing retirement products (e.g. annuities, phase withdrawals) is too high and to what extend they are justified. The general perception, which the lack of transparency and standardized reporting of those charges does not help, is that the cost of running funded private pensions is too high.

11. As the WPPP Roadmap for the Good Design of DC Pension Plans argued in its forth recommendation, there is a need to promote low-cost retirement saving instruments. Policymakers need to
ensure that there are incentives in place to improve efficiency and reduce costs in the pensions industry. Disclosure-based initiatives should be promoted, but may need to be complemented with more effective solutions such as appropriate tender mechanisms or default allocation to low-cost providers, especially in compulsory or auto enrolment systems. In certain pension's structures, cost issues can be addressed by establishing large pension schemes, run on a non-profit base.

12. This work will examine the different approaches implemented by different countries over the years to reduce costs and fees. It will assess pros and cons of these approaches, and will try to distil some best practices. It will use the work previously prepared by the IOPS on the costs and fees in different countries. It will discuss the different types of changes and fees, for example administrative, public, financial, administrative etc. and in which type of pensions arrangements are more or less important.

13. The different approaches include transparency and disclosure, introducing caps or ceilings, introducing a state or centralizer provider (e.g. Sweden, UK), tender (e.g. Chile), allow individuals to switch among providers.

14. The ultimate goal will be to provide best practices and in which context and under which conditions they may work.

3. Conflicts of interest in pension advice

Background

15. In June 2014, the Working Party on Private Pensions (WPPP) held a discussion on how to address conflicts of interest encountered by institutions providing financial advice related to retirement savings and products. Delegates expressed a strong interest in continuing work on this subject.

16. The need to take financial decisions related to retirement savings is increasing as a result of the changing role and characteristics of private pensions. Most OECD countries have introduced private pensions to complement state administered PAYG schemes. There is also a clear shift in the design of private pensions from defined-benefit plans to defined-contribution plans where individuals bear greater financial risk. While plans offering or requiring active choices are becoming more common, behavioural economics shows that individuals are generally averse to making complex financial decisions. Furthermore, many often lack financial know-how and education. This is especially true for low income earners and other vulnerable groups.

17. With a greater responsibility being placed on individuals to make decisions regarding their retirement savings, the demand for professionals providing financial advice in this field can be expected to grow. The increasing complexity of many private pension products also gives rise to asymmetrical information between pension providers or financial intermediaries and consumers. In this sense, financial advisors can play an important role in helping consumers have a better understanding of investment and payout options. In a presentation to the WPPP in June 2014, representatives from the RAND Labor and Populations Center presented results from various surveys showing that 50% of respondents in the US would seek advice from retirement plan managers (Lusardi 2008). Another more recent survey showed, however, that 48% of US respondents don’t know which sources of financial advice to trust (TIAA-CREF, 2013).

18. This type of distrust is an indication of potential conflicts of interests that can arise amongst commercial providers of financial advice, if the interests of the consumer are not necessarily prioritised. The extent to which conflicts of interest arise in financial advice is largely driven by the compensation structure to which advisors are subject. For example, commission-based structures make financial advice more prone
to be biased towards pushing investment products offering higher commissions, which could result in the financial advisor taking on more of the role of a sales agent.

19. Regulation can help to ensure that compensation structures do not create distorted incentives amongst advisors that lead to ill-advised decisions by consumers. Restrictions on commissions have been implemented in some countries to limit biased advice. Several countries, such as Australia, the Netherlands and the United Kingdom, have moved to ban commissions for financial advisors altogether. Nevertheless, there is some pushback on such bans, largely based on concerns that financial advisors will exit the market and that the ability for individuals, especially low-income and economically vulnerable groups, to seek financial advice under a flat fee-based system will be reduced. In this sense, it is important to transparently disclose the costs and benefits of financial advice, especially in relation to performance.

20. Many policies aimed at mitigating conflicts of interest in financial advice focus on requiring the disclosure of any potential conflicts of interest in an effort to create transparency and improve understanding. The effectiveness of disclosure can depend on many factors however, including how the information is disclosed. Some evidence shows that disclosure alone may not be effective. Effective oversight of the operation of financial advisors and regulation of their prudential responsibility could reduce the existence of biased advice.

21. So-called robot-advisors are also emerging in some OECD countries, including the United States and Sweden. These platforms automatically invest and rebalance funds given a specified objective or risk tolerance using algorithms. Their automatic nature may allow them to offer very low fees, making this an especially attractive solution. At the same time, more information is needed to better evaluate their investment strategy and performance and the transparency with which these products are sold.

Main objective

22. The objective of this project is to examine the existing market practices for the provision of financial advice and regulatory framework addressing conflicts of interest for financial advisors and to identify effective approaches to limit biased financial advice and its negative effects. This work will also draw from the OECD work on consumer protection.

Structure for project

1) Literature review

An extensive literature review will be carried out to focus on three main areas:

1. **Existing financial advice service models.** The review will describe and evaluate the existing advice service models. It will look at extent to which conflicts of interest are present in the financial advice given for retirement planning given these different models for providing financial advice and the compensation structure employed, as these structures may influence the extent to which financial advisors provide biased advice (Finke, 2012).

2. **The negative effects of biased financial advice.** The review will also focus on the negative effects of advice provided by financial advisors facing conflicts of interest, also considering different socio-economic groups. Several studies show that financial outcomes with financial advisors are not better than outcomes from receiving no advice at all (Collins, 2010; Karabulut, 2010). However the take-up of financial advice is not the same across socio-economic groups. Studies show that those with higher financial literacy are more likely to take financial advice and the advice for these groups is more likely to be relevant (Collins, 2010; Debbich, 2014). This implies that the financial
education of an individual seemingly affects the quality of the advice and individual receives. The potential trade-offs between access to advice and optimising returns will be carefully considered.

3. **Strategies to mitigate conflicts of interest for financial advisors.** The effectiveness of different strategies to mitigate conflicts of interest and biased advice will be evaluated. Disclosure requirements, which are often implemented to limit biased advice, are not necessarily effective. For example, one study indicates that an advisor who is open about his conflicts of interest may feel less inhibited about providing biased advice (Cain et al, 2005). Another more recent study shows that individuals may feel pressure to comply with the advice even if they are aware of the conflict because of a perceived obligation to help the advisor to be compensated (Sah et al, 2012). Regulating compensation structures can also be used to limit conflicts of interest for financial advice, for example moving away from commission-based compensation towards fee-based advice. While there are some concerns that consumers may not be willing to pay enough for fee-based advice, some studies have shown that adding a voluntary component to such a fee may be helpful in increasing the quality of the financial advice given (Angelova & Regner, 2013). The effects of existing alternatives to financial advisors on the prevalence of biased advice will also be studied, such as robo-advisors and investment default strategies.

2) **Stocktaking of financial advice services, compensation structures and existing regulation**

23. A stocktaking of financial advice services, compensation structures and existing regulation in OECD countries will be carried out in order to better understand national practices. A questionnaire will be sent to the regulators of participating countries. This questionnaire will focus on existing practices in providing financial advice for retirement planning, the relevant market information, the regulatory framework affecting financial advisors and finally their supervision and oversight.

- **Existing practices for providing financial advice services.** Various channels for providing advice may exist, such as independent brokers, tied agents or another financial intermediary, or even government provided services. Alternative options for individuals who do not seek advice from a financial advisor also need to be considered, for example the existence of robo-advisors. Information on the compensation and fee structures used for the different business models will also be collected.

- **Relevant market information.** A deeper understanding of the market for financial advisors is necessary to understand the synergies between the advisors, the customers and regulation. The questionnaire will collect information on the market share of participants, the take-up rates of financial advice, the level of fees and commissions and the performance of investments.

- **The regulatory framework.** This will include information with respect to the allowable compensation structures for financial advisors, any requirements around fiduciary duty, qualification requirements and any other requirements the financial advisor must adhere to in order to allowed to provide financial advice. Any recent changes to regulation in this area would also be identified.

- **The supervisory structure.** The Questionnaire will also collect information regarding the oversight of financial advisors. The focus will be on the extent of the supervision and if there are legal restrictions curbing the supervision of financial advisors. The questionnaire will attempt to collect information on whether the supervision focuses on the potential conflicts of interest, on
ensuring that financial advisors are acting in the best interests of their customers, and/or that the quality of advice given meets certain standards.

24. The questionnaire may advantageously be followed up with a round-table discussion.

3) Discussion of policy options

25. Based on the assessment contained in the first two parts of the project, policy options to address the negative outcomes from the conflicts of interest in financial advice could be put forward in a final report.

26. Discussion

- Do delegates agree with the project and its scope?
- Which countries would be interested in participating in this study?

References


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4. Facing the challenges of a low return environment

27. The current economic environment characterised by low returns, low interest rates, and low growth in advanced economies is compounding these problems. These factors may lead to lower resources than expected to finance retirement promises or simply lead to lower retirement income. Low returns reduce the expected future value of contributions as assets accumulated will grow at a lower rate than expected. Low interest rates may reduce the amount of pension income that a given amount of accumulated assets may be able to deliver, especially in defined contribution (DC) pensions. Additionally, low economic growth may reduce the overall resources available to finance pension promises.

28. The goal of the project would be to assess the impact and provide potential approaches to address its impact.

5. Improving the structure of the pay-out phase of pensions

29. This project could cover several different angles.

- First, focusing on annuities and extending the project on annuity project, this extension could focus on pricing annuity products taking into account the different guarantees they provide.

- Secondly, it could focus on designing innovative products or instruments to allocate assets accumulated at retirement that include different degrees of sharing the main risk affecting the pay-out phase (e.g. longevity, investment, inflation, agency risks).

- Thirdly, it could focus on issues around the pay-out phase that require better financial education, consumer protections to help individuals to make empowered choices. The document to be discussed at the December 2014 WPPP (DAF/AS/PEN/WD(2014)16) is an initial attempt to develop this line of work.

6. Revising the classification of funded pension plans

30. The TFPS have encouraged the Secretariat to continue with the planned discussion on the proposed changes to the classification of funded pension plans discussed at the WPPP in December 2013 (DAF/AS/PEN/WD(2013)15).

31. The idea is to assess how the different proposal may affect the collection of relevant pension statistics, the impact that it may have on current classifications.

32. There have been important changes in the landscape of retirement income provision across OECD countries. Pension plans in which benefits are determined to some extent by the amount of assets accumulated, whether mandatory or voluntary, linked to employment relationship or not, and some including guarantees and others not, have grown in importance in many OECD countries. In order to reflect this wider variety of pension plans currently available to individuals in different OECD and non-OECD countries, the Secretariat would like to open the discussion on the need to revise the OECD classification of funded pension plans. Moreover, during the joint meeting of the Working Party on Private Pensions (WPPP) and the Task Force on Pension Statistics held on 3 December 2012, delegates encouraged the OECD Secretariat to assess...
further whether and how the classification of pension plans could be revised, looking in particular at definitions of defined benefit (DB) and defined contribution (DC) pension plans already used by other international organisations. The current revision of the Core Principles of Private Pension Regulation have also brought to the fore of the WPPP discussions the potential limitations of the current OECD definitions of occupational and personal pension plans to accurately reflect this variety of pension arrangements across countries.

33. It is however important to assess the extent to which the benefits of adjusting the current OECD classification to reflect new realities exceed the related inconveniences. The current taxonomy was indeed approved by the OECD Working Party on Private Pensions after a lengthy process and many discussions between 2001 and 2004. The idea is not to go through this process again, but just to potentially agree on small adjustments to the classification. In addition, it is also important to bear in mind the fact that it is nearly impossible to any classification used in an international context to match precisely the situation in all countries. There is a balance to find between precision and simplicity to allow users to understand the different categories.

34. The purpose of this work is therefore to open and steer the discussion on the need to adjust the OECD classification of private pensions gathering different ideas and proposals from delegates. In this context, there are different perspectives to distinguish between occupational and personal pension plans, as well as between DB and DC pension plans. The OECD work provides an overview of the potential limitations of the definitions related to occupational and personal pension plans under the current OECD taxonomy and proposes small adjustments to it that would allow overcoming these limitations. It does the same for the distinction between DB and DC pension plans. The work also illustrates the potential limitations of the current OECD definitions by giving examples of pension plans for which the current OECD taxonomy may fail to provide an adequate classification. It also reviews definitions used by other international organisations and some countries.

35. The WPPP in its meeting of December 2013 when the OECD classification of funded private pension plans was discussed requested the Secretariat to assess the impact of changing the current taxonomy through a pilot exercise with selected countries.

7. Agency problems, asymmetric information and governance

36. Pension fund governance is an essential element to strengthen the regulatory framework of funded pension plan and improve the private pension system’s credibility in the eyes of the public.

37. Improving the governance of pension funds needs to take into account that the approach involves agency problems and the different agents involve have asymmetric information.

38. The purpose of the project would be to discuss these issues, assess different approaches (e.g. including contractual theory) and provide evidence on how different countries go about it.