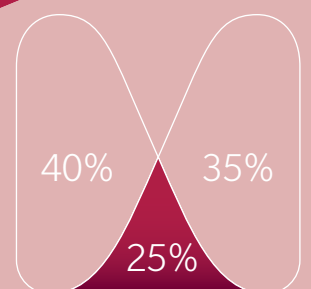


# CHAPTER 7

## THE INTEGRITY SUB-INDEX

The integrity sub-index is determined by considering three broad areas of the private sector pension system, namely: regulation and governance, protection for members and costs. As this sub-index is only concerned with the private sector pension plans (i.e. Pillars 2 and 3 of the five-pillar World Bank model), it has a more restricted scope than the previous two sub-indices. The private sector pillars are, however, critical because without them the government becomes the only provider, which is not a desirable or sustainable long-term outcome. A sound and well regulated private sector pension system, which has the confidence of the community, represents an important component of retirement income systems in the future.



# The integrity sub-index

The country with the highest value for the integrity sub-index is the Netherlands (91.4), with the lowest value being for China (50.1). As noted above, this sub-index covers three broad areas affecting private sector pension plans and the better scores were achieved by countries with well developed private pension industries.

In each of the three broad areas, several questions have been asked to ascertain the requirements that apply to private sector pension plans in each country.

Full details of the values in respect of each indicator in the integrity sub-index are shown in Attachment 3.

## Regulation and governance

### Calculation

With the exception of Question R2 dealing with the activity of the regulator, each question in this section is scored with a score of 2 for “yes” and 0 for “no”. In some cases the response is neither a clear “yes” nor “no” so that the score may be between 0 and 2 depending on the actual circumstances.

### Question R1

Do private sector pension plans need regulatory approval or supervision to operate?

Is a private pension plan required to be a separate legal entity from the employer?

Is a private pension plan required to have separate assets from the employer?

### Objective

These questions were designed to assess the extent to which a private sector pension plan is required to be a separate entity from the sponsoring employer and hold assets that are separate from the employer.

Eleven countries obtained the maximum score indicating the presence of the basic groundwork needed for a sound governance framework.

### Weighting

Each question was given a five percent weighting in the integrity sub-index, resulting in a total of 15 percent for these three questions.

## Question R2

Are private sector pension plans required to submit a written report in a prescribed format to a regulator each year?

Does the regulator make industry data available from the submitted forms on a regular basis?

How actively does the regulator (or protector) discharge its supervisory responsibilities? Please rank on a scale of 1 to 5.

The following table was provided to assist in answering the third question.

Scale	Description	Examples of Activity by the Regulator
1	Inactive	Receives reports from plans but does not follow up
2	Occasionally active	Receives annual reports, follows up with questions but has limited communication with plans on a regular basis
3	Moderately active	Receives annual reports, follows up with questions and has regular communication with plans, including on-site visits
4	Consistently active	Obtains information on a regular basis from plans and has a focus on risk-based regulation. That is, there is a focus on plans with higher risks
5	Very active	Obtains information on a regular basis from plans and has a focus on risk-based regulation. In addition, the regulator often leads the industry with ideas, discussion papers and reacts to immediate issues

### Objective

These questions were designed to assess the level of supervision and the involvement of the regulator with the industry.

### Calculation

The last question was scored on a five-point scale as shown in the table. It is important to note that this question did not assess the quality of the supervision; rather it considered the activity of the regulator.

The results highlight that the role of the pension regulator varies greatly around the world. Generally speaking, the pension regulator plays a stronger role where the pension industry has developed over many decades.

### Weighting

The first and third questions were each given a five percent weighting, with the second question being given a 2.5 percent weighting, resulting in a total weighting of 12.5 percent for these three questions.

## Question R3

Where assets exist, are the private pension plan's trustees/executives/fiduciaries required to prepare an investment policy?

Are the private pension plan's trustees/executives/fiduciaries required to prepare a risk management policy?

### Objective

These questions were designed to assess the regulatory requirements in respect of certain functions that may be required in respect of the fiduciaries who oversee private sector pension plans.

Eight countries obtained the maximum score highlighting the fundamental role of trustees or fiduciaries in pension plan governance.

### Weighting

Each question was given a 5 percent weighting in the integrity sub-index, resulting in a total of 10 percent for these two questions.

## Question R4

Do the private pension plan's trustees/executives/fiduciaries have to satisfy any personal requirements set by the regulator?

Are the financial accounts of private pension plans (or equivalent) required to be audited annually by a recognised professional?

### Objective

These questions were designed to assess the regulatory requirements in respect of these two aspects of the governance of private sector pension plans.

Interestingly only Brazil, China, France and the Netherlands received the maximum score indicating that several countries could improve their requirements, particularly in respect of the first question.

### Weighting

Each question was given a five percent weighting in the integrity sub-index, resulting in a total of 10 percent for these two questions.

## Commentary on the regulation and governance results

The scores ranged from 27.0 for the USA to a near maximum score of 46.5 for the Netherlands.

The low score for the USA highlights the lack of a single pension regulator and the absence of several requirements that are common in other countries.

## Protection and communication for members

### Calculation

With the exception of question P1 dealing with funding, each question in this section is scored with a score of 2 for “yes” and 0 for “no”. In some cases the response is neither a clear “yes” nor “no” so that the score may be between 0 and 2 depending on the actual circumstances.

## Question P1

Describe the required minimum level of funding for defined benefit and defined contribution schemes and the requirements to reach full funding when this does not occur.

### Objective

These questions were designed to assess the level of funding required in respect of both defined benefit (DB) and defined contribution (DC) plans. Funding levels are critical in securing members’ future retirement benefits.

### Calculation

The calculation considered the requirements for both DB and DC plans (where relevant). For the DB funding assessment, we considered both the extent of the funding requirement and the period over which any deficit must be rectified.

### Commentary

Most countries require full funding of DC plans; in fact, many respondents noted that this feature is the essence of such a plan. However the requirements for funding DB plans vary considerably. There are, in effect, no requirements in some countries whereas in other countries, such as in the Netherlands and the USA, any deficit requires rectification within a specified period.

### Weighting

The funding of a member’s retirement benefit in a private sector pension plan represents a basic protection of the member’s accrued benefits and this indicator is therefore given a 12.5 percent weighting in the integrity sub-index.

## Question P2

What are the limits, if any, on the level of in-house assets (that is, equity or debt investments in the sponsoring employer) held by a private sector pension plan?

### Objective

An essential characteristic of a sound retirement income system is that a member's accrued retirement benefit is not subject to the financial state of the member's employer.

### Commentary

Most countries have a restriction on the level of in-house assets held by a pension plan. These restrictions are often set at five percent of the plan's assets. The exceptions are France, Germany, Japan, Poland, Singapore and some defined contribution plans in the USA.

### Weighting

This requirement represents a key method of protecting the member's accrued benefits and is therefore given a five percent weighting in the integrity sub-index.

## Question P3

Are the members' accrued benefits provided with any protection or reimbursement from an act of fraud or mismanagement?

In the case of employer insolvency (or bankruptcy), describe how the members' accrued benefits are protected, if at all.

### Objective

There are many risks faced by members of pension plans. These two questions considered what protection, if any, the members receive in the case of fraud, mismanagement or employer insolvency. In the latter case, the employer may not be able to pay any contributions that are owed.

### Commentary

The answers to these questions vary considerably by country. In some cases, there are some restricted arrangements in place to support the member whereas in the UK a fraud compensation scheme exists.

### Weighting

Whilst these issues are very important where such incidents occur, experience in most countries suggests that it is not a common event or that its financial effect is relatively minor. Hence each question is given the weighting of 2.5 percent in the integrity sub-index, resulting in a total of five percent for these two questions.

## Question P4

When joining the pension plan, are new members required to receive information about the pension plan?

### Objective

It is important that members receive information when joining a pension plan, including a description of the benefits and the risks they may face, particularly with the global growth of DC plans.

### Commentary

All countries, except China and India, require information to be provided when members join the plan.

### Weighting

The weighting for this question is five percent in the integrity sub-index.

## Question P5

Are plan members required to receive an annual report about the pension plan?

### Objective

Annual reports present the opportunity for pension plans to communicate with their members, highlighting plan information and contemporary issues that may need to be considered by the members.

### Commentary

There is considerable variety in the responses, with China, France, Germany, India and Poland having no requirements in respect of annual reports.

### Weighting

The weighting for this question is five percent in the integrity sub-index.

## Questions P6

Are plan members required to receive an annual statement of their current personal benefits from the plan?

Is this annual statement required to show any projection of the individual member's possible retirement benefits?

### Objective

Whilst an annual report about the plan is valuable, most members are more interested in their personal entitlement. The first question therefore ascertained whether the provision of such information was a requirement whilst the second question considered whether this requirement required any projections about the member's future retirement benefit.

### Commentary

A majority of countries have a requirement concerning annual personal statements, but only a few require some form of projection. As account balances increase and individuals take on greater responsibility for their retirement benefits, the provision of this type of information will become increasingly important to members.

### Weighting

The first question was given a five percent weighting in the integrity sub-index whilst the second question was given a 2.5 percent weighting in the integrity sub-index, resulting in a total of 7.5 percent for these two questions.

## Question P7

Do plan members have access to a complaints tribunal which is independent from the pension plan?

### Objective

A common way to provide some protection to individuals who receive benefits from a contract with a financial services organisation (such as a bank or insurance company) is to provide them with access to an independent complaints tribunal or ombudsman. As the provision of retirement benefits can represent an individual's most important financial asset, there is good reason for such a provision to exist in respect of private sector pension plans.

### Commentary

Only four countries (Australia, the Netherlands, Switzerland and the UK) have a complaints system focused on pension plans, although Canada, Chile, Poland and the USA have a process that could be used for this purpose.

### Weighting

Whilst this indicator is not as important as funding or communication to members, it represents a desirable feature of the better pension systems as it provides all members with access to an independent body, should an adverse event occur. It is given a 2.5 percent weighting in the integrity sub-index.

### Commentary on the protection and communication results

The scores ranged from 11.9 in China and 16.3 in India to 37.5 in the Netherlands and 38.8 in Switzerland.

The low scores in China and India are caused by very limited requirements in these countries to provide information to members.

## Costs

### Questions

What percentage of total pension assets is held in various types of pension funds?

What percentage of total pension assets is held by the largest ten pension funds/providers?

### Objective

As noted by Luis Viceira in Hinz et al (2010), costs are one of the most important determinants of the long run efficiency of a pension system. He goes on to comment that:

“Unfortunately, there is very little transparency about the overall costs of running most pension systems or the total direct and indirect fees that they charge to participants and sponsors.”<sup>22</sup>

This is absolutely correct. The huge variety of pension systems around the world, with a great diversity of retail, wholesale and employer sponsor arrangements means that some administrative or investment costs are clearly identified whereas others are borne indirectly or directly by providers, sponsors or third parties.

Yet, in the final analysis many costs will be borne by members and thereby affect the provision of their retirement income. We have therefore used two proxies for this indicator.

The first question represents an attempt to ascertain the proportion of each country's pension industry that is employer-sponsored plans, not-for-profit plans and retail funds, which may be employer based or individual contracts. Each type of plan is likely to have a different cost structure which, in turn, influences the overall cost structure of the industry.

The second question highlights the fact that economies of scale matter. That is, it is likely that as funds increase in size, their costs as a proportion of assets will reduce and some (or all) of these benefits will be passed onto members.

<sup>22</sup>Hinz R, Rudolph H P, Antolin P and Yermo J (2010), *Evaluating the Financial Performance of Pension Funds*, The World Bank, Washington, p259.

## Calculation

For the first question, each type of plan was given a weight ranging from 1 for individual retail or insurance contracts to 10 for a central fund. These scores were then weighted by the pension industry characteristics for each country.

For the second question, we considered the size of the assets held by the ten largest providers or funds. A score of 1 was given when these assets were less than 10 percent of all assets rising to a maximum score of 5 when these assets represented more than 75 percent of all assets.

## Weighting

Each question was given a five percent weighting in the integrity sub-index, resulting in a total of 10 percent for these two questions.

## Commentary on the costs results

The scores for these two indicators ranged from 4.1 for France to 10.0 for India and Singapore. The maximum scores for these two countries are not surprising as each country has a central fund which should provide administrative savings with the potential to add value through investment opportunities.

## Sources of data for integrity sub-index

As the integrity sub-index is based on the operations of the private sector pension industry in each country, all the answers were sourced from Mercer consultants in the relevant countries, except where noted.