Individuaul Accounts for Social Security Reform

Turner, John A.

Published by W.E. Upjohn Institute

Turner, John A.

Project MUSE. muse.jhu.edu/book/17397.

⇒ For additional information about this book
https://muse.jhu.edu/book/17397

⇐ For content related to this chapter
https://muse.jhu.edu/related_content?type=book&id=573320
Agency Risk and the Management of Individual Account Investments by Corporations and Mutual Funds

The three-year decline in world stock markets starting in 2000 and the dramatic plunge of technology stock prices made clear that individual account participants face substantial financial market risk. However, participants are also vulnerable to improper management of their investments, as evidenced by the corporate scandals at Enron and WorldCom.

Participants in individual accounts may face risk at three levels of investment management: 1) financial management of corporations, 2) management of investments by mutual funds and other financial intermediaries, and 3) management of investments by individual participants themselves.

Participants in individual accounts must rely on agents—the officers of corporations and the officers of mutual funds. These agents typically have conflicts of interest in that their primary concern may be their own income rather than that of the shareholders. The problems arising when agents manage investments result in agency risk for participants in individual accounts.

In considering financial management by corporations, this chapter examines whether participants in individual accounts have adequate protection. For financial management by mutual funds, the focus is on conflicts of interest in mutual funds, the level of fees participants pay, and the transparency of those fees. The chapter also considers the possible role of government as an investment manager. The following chapter takes up problems arising from financial management by individual participants.
The Swedish Premium Pension system and the Chilean mandatory individual accounts exemplify issues that arise in the institutional management of investments in individual accounts.

**The Swedish Premium Pension System**

The Swedish Premium Pension system, with its mandatory 2.5 percent contribution, provides individual accounts designed to reduce the administrative burden on employers and to limit advertising costs and administrative expenses for service providers by using centralized management through a government agency. It provides an example of how individual accounts might be managed in the United States.

As mentioned in Chapter 2, the Premium Pension is administered by a government agency established for this purpose, the Premium Pension Authority (PPM). As a clearinghouse and record keeper for the individual accounts, the PPM collects contributions, disburses them to mutual funds, and makes benefit payments. A central agency should help keep administrative costs low because of scale economies (Palmer 2001b).

When considering the administrative costs of pension systems, generally the focus is on the institutions managing the investments and the pension system, and the important issue of the costs borne by employers is ignored. The administrative burden on employers varies greatly by type of individual account. The Premium Pension places a minimal administrative burden on employers. Employers withhold contributions from employees’ pay, aggregate the tax and contribution withholdings for their employees, and make a single monthly tax and contribution payment to the National Tax Authority.

Swedish employers only report information on the individual worker’s earnings once a year to the government. Therefore, individual pension rights cannot be established until workers have filed the income data for their income taxes and these statements have been consolidated with employers’ reports. Collecting contributions and then posting them to the workers’ accounts takes the National Tax Authority and the PPM
18–24 months or longer from January of the year in which the contributions were made. When the tax authorities have determined individual pension rights, they inform the PPM as to how much each worker’s account should be credited, and the PPM transfers that amount to the workers’ accounts.

In the interim before individual workers’ pension rights have been established, pension contributions are placed in a fund at the National Debt Office. The rate of return paid on the fund is close to that paid on government debt. Because government bonds in Sweden are secure, they provide a guaranteed rate of return for the Premium Pension participants.

Workers can challenge the income and contribution statements that the tax authorities provide, and errors in record keeping inevitably occur. In December 2001, the National Tax Authority informed the PPM that it had changed income and contribution figures for 50,000 workers (out of approximately 4.5 million). The tax authority had understated the income and therefore the pension contributions for 11,000 people (Reid 2002). This problem raises the issue of whether workers should be compensated for the shortfall in investment income if the shares that should have been credited have appreciated.

When the National Tax Authority has informed the PPM of the amount credited to each worker, workers select how to invest their annual contributions. At the same time, all new labor market entrants allocate their initial contributions to mutual funds. Workers also can elect to place their contributions in their spouse’s account instead of in their own. This feature allows spouses to choose a form of earnings sharing to determine their household pension benefits, which can be used, for example, to supplement the account of a wife who is out of the labor force rearing children.

The PPM places all the workers’ contributions for a year, plus the accumulated interest, in the mutual funds over a period of four to five days. For example, in the second week of April 2001, the PPM received 20 billion Swedish crowns (SEK), the contributions from 1999 (Jarvenpaa 2001). In the first week of February 2002, the PPM placed approximately SEK20 billion from the funds into the Swedish Premium Pension system, which was the amount of the contributions plus interest for the year 2000 (PPM 2002). Thus, the system treats all workers equally with regard to the timing of the investment of their contributions in the
mutual funds. Workers can make daily interfund transfers of money already invested except during the blackout period, when the annual contributions are being placed.

The PPM keeps all records of the individual accounts and fund share values. It aggregates individual transactions concerning interfund transfers at the PPM at the end of each day and then transmits a net purchase or redemption to each fund. The PPM matches buy and sell orders internally, limiting its transactions with fund managers to the net amount of the individual transactions. This procedure greatly reduces the mutual funds’ transaction costs compared to a system in which mutual funds receive contributions for and make benefit payments to individual participants.

A system design issue is the number of choices an individual account system offers to workers. One view posits that the greater the range and number of options, the better able are workers to make a selection that suits their personal situation. An alternative position is that, beyond a point, more choices raise the likelihood of errors in decision making by individuals lacking a sophisticated understanding of investments.

Swedish workers have far more investment choices than do participants in any other type of mandatory individual account. Initially in 2000, the Premium Pension offered a choice of 455 mutual funds; by 2005, that number had risen to more than 600. More than 80 mutual fund companies participate in the system; nearly half of these companies are managed outside Sweden.

Swedes have shown a strong preference for domestically managed funds, with foreign funds receiving only 4 percent of all contributions (Weaver 2002). This suggests that many participants have chosen mutual fund companies with which they are familiar, rather than trying to evaluate the choices.

One reason for allowing participants to select from among numerous funds, including international ones, is that the Swedish stock market is small; if only a few domestic funds were available, they eventually would dominate the market. Any mutual fund company licensed in Sweden may participate in the Premium Pension system. Generally, licensed funds must meet the European Union’s portfolio diversification requirements. Swedish equity funds, however, are exempt because
the Swedish equity market is dominated by one company, Ericsson (Weaver 2002).

The PPM provides participants with a booklet that lists all available funds. Further, it provides this listing without charge to the funds, which results in free advertising to those interested in the Swedish market. For this reason, it would appear desirable to charge a flat fee for companies to participate, reducing substantially the number of funds with few investors.

The booklet divides the funds into categories and subcategories, including domestic and international stock funds, mixed stock-bond funds, and bond funds. Derivatives funds are considered to be too risky an investment for social security accounts and thus are not included as an option.

Most of the funds are equity funds; of these, about 10 percent are index funds, investing passively in a broad stock market index rather than actively researching and picking securities. Index funds tend to have the lowest fees of any funds because they are passively managed: there is no fee for paying analysts to study stocks and make subsequent buy and sell decisions since those activities are not undertaken. Passively managed funds also have low portfolio turnover costs because they do relatively little trading.

Participants can invest in bonds through about 70 bond funds in addition to about 80 generation funds. The mix of stocks and bonds in these funds varies with the participants’ age; the percentage held in bonds increases with age so that older workers hold less risky portfolios. One-quarter of the funds invest primarily in Sweden.

In addition to a wide range of domestic and foreign funds, Swedish workers also can invest in one of two government-managed funds. A government organization, the Seventh Swedish National Pension Fund, is the default fund for workers who do not make their own choice. It manages the money for those workers who do not choose a fund or funds. This fund has more than three times as many participants as the fund most frequently designated by choice (PPM 2002). As of 2002, the default fund held about 30 percent of the assets invested in the Premium Pension system, and roughly 40 percent of the participants invested in it. The second government fund is an alternative for workers who want the government to manage their individual account. To participate in this fund, workers must specify it.
The Seventh Swedish National Pension Fund (Sjunde AP-fonden, or Seventh AP Fund, or AP7) manages both funds with an independent, appointed board that functions as a fund manager. The default fund is heavily invested in equity. Its equity holdings cannot exceed 90 percent of the total value in this fund or fall below 80 percent. Of the equity holdings, as much as 75 percent can be invested in foreign stocks. In 2001, the default fund invested 90 percent of its assets in Swedish and international equities. In 2002, that figure had declined to 82 percent in equities, of which 17 percent were in Swedish holdings and 65 percent were in foreign ones (Sjunde AP-fonden 2003b, p. 4).

The Swedish default fund has a much riskier portfolio than is typical of default funds in 401(k) plans with automatic enrollment of participants. Those default funds—presumably at least in part because of worries over legal liabilities if losses are incurred—typically consist of fixed-income securities. Part of the Swedish default fund is managed actively, and part is managed passively, invested in broad indexes. Part of the fund’s passive portion is invested in an indexed bond fund.

One concern with funded mandatory pensions is the risk of political interference by government in investment decisions and capital markets. The broad range of funds and few limitations on the choices of funds offered in the Swedish system greatly reduce the concern that the government may manipulate the investment process or limit the range of investment choice on political grounds.

An issue that arises with government management of pension investments is whether investment decisions should take social issues into account rather than be based solely on financial considerations of risk, liquidity, and expected return. The two Swedish government funds’ investment strategies incorporate environmental and ethical concerns. The funds invest only in companies that adhere to the international conventions Sweden has signed on human rights, child labor, the environment, and corruption. They will not invest in companies that have violated United Nations human rights standards, child labor standards, International Labor Organization standards concerning the treatment of workers, and international conventions against bribery, corruption, and environmental degradation. These restrictions on investments do not apply to nongovernment-managed funds, although some voluntarily follow them.
Because of these restrictions, the Swedish government funds do not invest in some large, well-known companies. The government funds invest in between 2,000 and 2,500 companies worldwide, and during summer 2001, the government funds screened all of these companies for adherence to the standards. The results indicated that approximately 30 companies violated the conventions, so they were excluded from the portfolio. While the funds’ policy only excludes companies that have violated international conventions, broken laws, or admitted wrongdoing, companies that have been banned on that basis include the Coca-Cola Company, Exxon Mobil Corporation, Liz Claiborne, and Sears, Roebuck and Company, according to the Seventh Swedish National Pension Fund’s (AP7) annual report (Sjunde AP-fonden 2003a, pp. 19–20). Because most new workers entering the system are in the default fund, they are not investing in Coca-Cola and these other prominent companies. This raises a question of whether participants are sacrificing rate of return for social goals.

Marketing costs have added greatly to the expense of mandatory individual accounts in some countries, as discussed later in this chapter. To avoid that problem, in Sweden the mutual fund management companies participating in the system know the total investment from the Premium Pension but not the identities of individual investors. Because fund managers do not know their clients, it is expected that entry costs to the Swedish market would be reduced for non-Swedish funds. Mutual funds only need to offer investment management services; they do not need to spend money acquiring distribution channels, which means they do not need to hire numerous sales agents and open retail offices (Herbertsson, Orszag, and Orszag 2000).

While the investment returns earned by individual accounts may have a large effect on their popularity, it is not reasonable to judge a well-managed system by such returns, because a pension system cannot earn better rates of return than are available in the capital markets. Because of world equity markets’ decline during the period 2000–2002, many funds earned negative rates of return over this period. The total return for the AP7 Fund, the default fund, was –7.4 percent in 2000, –10.6 percent in 2001, and –26.7 percent in 2002. This compares to a total return for the PPM index (the capital-weighted average for all PPM system funds open for active choice) of –10.6 percent in 2001 and
−33.1 percent in 2002 (Sjunde AP-fonden 2003b). (The figure for 2000 is not available.)

The Chilean System

Chile’s mandatory individual accounts provide further evidence as to issues encountered in investment management. Chile permits firms to freely enter into and exit from the pension fund administration (AFP) market, even of foreign companies, provided that minimum capital requirements are met. The AFPs compete for participants. Workers are free to select the AFP of their choice, and for a number of years they could switch their accounts among pension providers as often as they wished. Since 1997, participants have only been able to change AFPs after meeting a minimum stay requirement of six months, a restriction implemented to decrease administrative costs that resulted from frequent shifts in AFPs by some workers. This policy limits free choice but appears to eliminate excessive changing of AFPs by some participants. This activity was driven by the commissions the AFP sales force received for attracting new members and by incentives, such as small appliances, provided to participants to induce them to switch. The Swedish Premium Pension system, by contrast, has no minimum stay requirement, but it also does not have a sales force marketing to individual participants and trying to entice them to switch funds.

The AFPs have a high proportion of Chilean pension assets in government bonds. This figure generally has been around 40 percent of the assets in the system, but it reached a peak of 47 percent in 1986 (Rodriguez 1999). The large percentage of pension investments in Chilean government bonds appears to be counter to the philosophy of the Chilean free enterprise model of investing in the private sector.

TIERS OF FINANCIAL MANAGEMENT

Several issues have arisen concerning investor protections in the first two of the three tiers of pension investment management: financial management by corporations and by mutual funds.
Tier One: Corporations

Financial market scandals during the early years of the twenty-first century raised questions as to whether pension participants, along with other investors in financial markets, had adequate protections in U.S. capital markets against conflicts that arise from the separation of corporate ownership and control.

Conflicts of interest in corporations

The collapse of Enron Corporation and other corporate scandals exposed weaknesses in the safeguards that protect U.S. investors. Arthur Andersen LLP, the external accounting and auditing firm hired by Enron, did not detect and correct inaccuracies in Enron’s financial statements. Enron’s board of directors did not prevent the company from distorting its financial statements. Thus, investors relied on false financial statements. Even though the accounting firm and the board of directors are supposed to act independently to protect the interests of investors, including pension participants whose individual accounts are invested in the company, they both are employed by the company. Because of this conflict of interest, they may be reluctant to thwart top management’s wishes.

The quality of information contained in financial disclosures

Because of bad accounting, Enron was able to conceal billions of dollars of liabilities so that its financial position appeared to be much more favorable than it actually was. This raises the issue of whether the laws governing financial disclosures by corporations, and their enforcement, are adequate.

Analysts on Wall Street and the credit rating firm that evaluated Enron failed to detect problems and may have failed to adequately investigate Enron’s finances before advising investors. They have argued in their defense that they relied on the accounting information that was available. Nonetheless, financial analysts face potential conflicts of interest: gaining investment banking business for their firms, preserving good relations with the companies they cover, and supplying buy rather than sell recommendations to the mutual fund industry (Baer and Gensler 2002). These potential conflicts cast doubt on the usefulness
of information provided by some financial analysts and credit rating firms.

Compounding problems concerning the quality of financial information, two large banks were implicated in the fall of Enron Corporation for hiding billions of dollars in loans. The concealment made it appear that Enron had less debt than was actually the case. While not admitting guilt, the banks paid millions of dollars in fines to the Securities and Exchange Commission (SEC).

Even with full, accurate, and transparent disclosure of relevant financial information, corporations may not be good stewards of their shareholders’ funds. They may overpay their top executives, paying millions of dollars a year for the management of even poorly run corporations. Or they may disburse funds in ways that are counter to at least some shareholders’ interests (such as by donating to the political campaigns of particular candidates or to charities).

**Tier Two: Mutual Funds**

Because individual account participants generally invest in mutual funds rather than in individual stocks, the second tier of management affecting investment value for individual account participants concerns mutual funds and pension fund management companies. Conflicts of interest arise in the management of mutual funds just as they do in the management of corporations (Mahoney 2004).

**Preferential treatment**

In 2003, the New York State Attorney General charged that at least one U.S. mutual fund provided preferential treatment to some investors. These individuals were allowed to trade after the market had closed, based on the market closing price. Thus, these investors could benefit from information that became available after market closing that would affect the price of the mutual fund. This illegal practice allowed some investors to benefit at the expense of others.

**Does competition reduce costs?**

The designers of the Chilean system thought that market competition would ensure the lowest possible administrative costs as pension
fund providers competed for participants on the basis of fees. To encourage competition by permitting free movement of workers between funds, the Chilean pension fund management companies, or AFPs, are not permitted to charge exit fees when workers change AFPs.

Commissions charged by the AFPs in Chile are set competitively, meaning that their level is not regulated by the government. However, there is little price competition in commissions, because no AFP advertises that it offers low fees. Instead, advertising focuses on the service provided or on building a brand image, such as for financial stability. In addition, AFPs have offered financial incentives to workers to switch companies. This type of competition has not led to the free market result expected, that of reduced fees. Instead, high expenses relating to advertising and marketing have increased costs. The sales force in the system rose from 3,500 in 1990 to 15,000 in 1995 (OECD 1998).

In the United Kingdom, competitive forces alone were also not sufficient to drive down charges on retail financial products. As a result of this apparent market failure, the government introduced individual account Stakeholder plans in 2001, subject to a statutory maximum annual charge of 1 percent of asset values, with no entry or exit charges. Because of this regulatory limit, providers of Stakeholder pensions have greatly reduced the amount of “free” advice they provide to workers trying to decide whether to choose these accounts (Bolger 2001). Some insurance companies have argued that a cap on fees of 1 percent for an individually marketed financial product is too low and have decided not to offer it. The fee cap has since been raised to 1.5 percent for the first 10 years of an account, after which it can be no more than 1.0 percent. One of the reasons for the high level of fees is that providers of these pensions must determine whether they are an appropriate investment for the individuals who participate.

The costs of maintaining a financial account are largely fixed, not varying by the size of the balance. Consequently, financial institutions often charge flat fees for maintaining accounts, which fall especially heavily on low-income workers because of their relatively small account balances. In part because of the fixed charges, Australia has exempted low-income workers from mandatory individual accounts. This exemption is similar to the practice in Denmark, which excludes those who work less than 10 hours a week from the mandatory individual accounts.
Comparative administrative costs

The operation of the Swedish Premium Pension system differs from that of most other mandatory individual accounts. Sweden has tried to reduce costs by implementing a central agency to manage the accounts. This approach raises the question of whether the Swedish system has lower administrative costs than the system in Chile or the one in the United Kingdom.

The administrative costs in the Chilean system in 1998 averaged 1.36 percent of account balances. Chile currently has the lowest administrative costs, as a percentage of assets, of any Latin American mandatory pension system, according to one study, because of its large base of assets and longer experience (James, Smalhout, and Vittas 2002). Administration costs tend to fall as assets grow; this is due to economies of scale and learning by doing.

In Sweden, even when the 0.30 percent fee paid to the PPM (the government management agency) is included, a substantial portion of the money contributed to this new system has been invested in funds where the administrative expenses are about half that in Chile.

Participants in Sweden generally have picked low-fee funds: in 2000, 48 percent of the money invested in the system was put in funds with fees ranging from 0.25 to 0.49 percent (Palmer 2001b). Thus, with the addition of the 0.30 percent fee paid to the PPM, nearly half of the money in the system was invested in funds with total fees ranging from 0.55 percent to 0.79 percent, compared to average fees in Chile of 1.36 percent. The total fee in Sweden averaged 0.95 percent of assets in 2000 (Palmer 2001b) and was 0.85 percent in 2001 for nongovernment funds (Engström and Westerberg 2003). The fee paid by participants in the default fund, which was the option in which the most money was invested, was only 0.17 percent in 2002, resulting in a total fee of 0.47 percent (Engström and Westerberg 2003).

The total fees (including the PPM fee) in Sweden are similar to those for large, actively managed mutual funds in the United States but higher than those for passively managed U.S. funds. For example, the Vanguard Group offers passively managed equity funds with annual fees about half those paid in Sweden—less than 0.20 percent of account balances. Fees may tend to be lower in large countries than in small ones, however, because of economies of scale in administrative costs.
The PPM employs a little more than 200 people to run the system. That number does not include the employees of the mutual funds. Because the United States is roughly 30 times larger than Sweden in population, the experience of the PPM implies that a government bureaucracy of more than 6,000 people would be needed to run a similar system in the United States.

The 0.30 percent fee participants pay to the PPM in Sweden is intended to permit the organization to become self-financed over the long run. However, the PPM had to borrow from the government because of high start-up costs, so the reported PPM fee understated the actual initial expenses. Two offsetting effects are expected on future fees. Authorities anticipate that the end of the start-up period, coupled with growth in the accounts, will reduce expenses relative to the asset base. Conversely, the increase in expenses for annuitizing benefits and providing benefit payments will cause fees to rise. On net, the PPM expects its fee to fall.

The fees for the Chilean system do not include the cost of annuitizing benefits or making other forms of benefit payments. The fees in Sweden also basically do not cover this cost because the system is new and few people are claiming benefits. A potentially major difference in administrative expenses between Sweden and Chile is the cost of annuitization. In Sweden, there is no separate fee for annuitizing an account, which is mandatory and is done through the PPM. The average fee for annuitizing in Chile as of 1999, for those workers choosing that option, was 5.25 percent of the account balance (SAFP 2001). An earlier study calculated the fee based on the difference between the rate of return from buying a Chilean 20-year Consumer Price Index–linked bond and the average internal rate of return paid to annuitants; it found that benefits were reduced by 10.20 percent (Valdés-Prieto 1994). The percentage taken by the fee may decrease over time as the size of the account balance being annuitized increases.

The United Kingdom’s decentralized individual accounts are particularly expensive; the high cost led the British government to develop Stakeholder pensions. A U.K. study found that the costs of switching funds decreased account balances by about 15 percent on average. The costs of annuitizing benefits trimmed the value of benefits received by about 10 percent. Taking into consideration all costs borne by workers, the value of benefits was cut by 40 to 45 percent (Murthi, Orszag, and
These figures do not include the costs of the government agency supervising the system, which are not charged to workers but are borne out of general government revenue.

Thus, the British approach is more costly than that of Chile. The Swedish system is the least expensive in terms of administration, while the costs of large, passively managed U.S. equity funds are even less. A Swedish-type model operated in the United States could result in lower fees than in Sweden because the large size of the U.S. labor market would allow for greater economies of scale in mutual fund management. Including the cost of providing annuitized benefits, fees of about 0.5–0.6 percent of assets might be feasible.

TRANSPARENCY IN INDIVIDUAL ACCOUNTS AND THE DISCLOSURE OF FEES

“Transparency” refers to participants receiving clear information that is adequate to allow them to make informed choices. Transparency is desired in financial transactions, including those in retirement income systems. The transparency of competing methods of providing social security benefits is an issue in the reform debate. Proponents of individual accounts have argued that those accounts are transparent while defined benefit plans are not (World Bank 1994). They view individual accounts as being transparent because the cost to workers, measured as the amount that participants contribute, is clearly identified, as is the amount accumulated in their individual accounts. Furthermore, benefits received are based on the returns on the individual accounts, and those accounts do not involve the transfer of resources across persons. With defined benefit social security systems, workers may have difficulty understanding who is helped from the resource transfers across different groups of participants.

Individual account participants need transparency so that they can compare the fees of different mutual funds or pension funds. Competition concerning fees will not occur if participants do not know how much they are being charged. Transparency may lead to competitive pressures on service providers to reduce fees, and individual participants would be better able to judge the performance of their pension service.
provider and to understand the effect of fees on their accumulation of assets. Inadequate disclosure may be a factor in the large variance in charges and expenses of 401(k) plans (Economic Systems Inc. 1998). What appears to be a small difference in fees can mean thousands of dollars to a worker over the life of an individual account.

Ensuring that greater information is provided to consumers, when balanced against the costs of providing that data, generally is considered to be a legitimate activity of government, rather than an intrusive extension of regulatory powers. The issues concerning social security’s transparency have three components: expenditures, benefits, and the relationship between expenditures and benefits (Table 4.1). Expenditures have two components: mandatory contributions and fees. This section, based on the research of Korczyk and Turner (2003), examines the transparency of the fees charged participants in individual accounts. It addresses the question: Do participants know how much they are paying in fees and expenses on their individual accounts? The focus is on fees incurred during the accumulation phase before retirement.

**Types of Individual Account Fees**

Individual account fees include those charged by plan administrators and fund managers and transaction costs for security purchases and sales. Fees reflect administration costs: collecting contributions, keeping records, communicating with participants, educating participants about financial matters, preparing reports for the government, complying with ongoing government requirements, updating plans to maintain

<table>
<thead>
<tr>
<th>Components</th>
<th>Defined contribution</th>
<th>Defined benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs</td>
<td>Disclosure of fees</td>
<td>Uncertain future costs</td>
</tr>
<tr>
<td>Benefits</td>
<td>Depends on financial markets</td>
<td>May be affected by politics</td>
</tr>
<tr>
<td>Relationship between costs and benefits</td>
<td>Unclear effect of fees on level of future benefits</td>
<td>Benefit formulas may make relationship complex</td>
</tr>
</tbody>
</table>

SOURCE: Author’s compilation.
compliance with changing legal requirements, and disbursing benefits (Table 4.2). Charges also arise from the cost of managing investments: the bid-ask spread in the buying and selling of financial assets, as well as transaction costs and fees for researching alternative investments. Some fees can be allocated to different participants based on their cost-generating activities, or the fees can be spread over all participants. Charges can be front-loaded, meaning that they are paid at the same time as contributions, or they can be back-loaded and charged on exit. They can be imposed as a flat annual rate, annually as a percentage of assets or contributions, or itemized based on fee-generating activities. Some of the largest fees are completely hidden. Brokerage commissions are included in the cost of shares (raising their cost) and are not broken out as separate fees in shareholder reports (Norris 2003). The essential issue, however, is the need for funds to disclose in a readily understandable manner the aggregate amount of fees charged against the assets or contributions to an individual’s account. In that way, the participant can make an informed decision when choosing among funds.

Table 4.2 The Structure of Fees in a Mixed (Equity Bond) Mutual Fund

<table>
<thead>
<tr>
<th>Fees and expensesa</th>
<th>Amount ($ 000s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment advisory services</td>
<td>20,725</td>
</tr>
<tr>
<td>Distribution services</td>
<td>20,028</td>
</tr>
<tr>
<td>Transfer agent services</td>
<td>5,676</td>
</tr>
<tr>
<td>Administrative services</td>
<td>999</td>
</tr>
<tr>
<td>Custodian</td>
<td>708</td>
</tr>
<tr>
<td>Registration statement and prospectus</td>
<td>675</td>
</tr>
<tr>
<td>Postage, stationery, and supplies</td>
<td>643</td>
</tr>
<tr>
<td>Reports to shareholders</td>
<td>235</td>
</tr>
<tr>
<td>State and local taxes</td>
<td>116</td>
</tr>
<tr>
<td>Directors’ compensation</td>
<td>106</td>
</tr>
<tr>
<td>Auditing and legal</td>
<td>69</td>
</tr>
<tr>
<td>Other</td>
<td>97</td>
</tr>
<tr>
<td>Total</td>
<td>50,104</td>
</tr>
<tr>
<td>Total assets</td>
<td>15,914,561</td>
</tr>
</tbody>
</table>

NOTE: Figures in the source are unaudited.

a For the six months ending April 30, 2003.

Survey of Transparency in Individual Account Fees

Transparency in individual accounts depends on how and to what extent participants receive information about the fees they pay. The following discussion explains how this issue is addressed in the United States, Australia, Chile, Sweden, and the United Kingdom.

The United States’ Thrift Savings Plan

The Thrift Savings Plan provides individual accounts for U.S. federal government workers that are similar to 401(k) plans for private sector workers. It is one of the largest pension plans in the world. Participants receive statements, which provide information as to beginning assets, contributions, withdrawals, investment earnings, change in market value, and ending assets. While the statements appear to give a complete accounting of inflows and outflows determining the difference between beginning and ending assets, they provide no information about the amount by which participants’ accounts have been reduced by fees. Information about the calculation of fees is contained in descriptions of the plan, but nowhere can the participant find the total amount that he or she paid. In addition, fees arising from transactions costs in the purchase and sale of securities are not disclosed. These fees are hidden in the net investment returns. It would be more transparent to separate gross investment returns from fees (Box 4.1).

401(k) plans

Like the Thrift Savings Plan, 401(k) plans do not disclose to participants the total amount in fees charged to them. Under Department of Labor (USDOL) regulations, a Summary Plan Description must include any provision that may result in the imposition of a fee on a participant (Huss 2003). However, information on the schedule determining the actual amount of fees charged generally is not contained in such documents because the information may differ if service providers are changed. The data may be in the documents of the service providers to the plans. For investments involving mutual funds, the fees on a percentage basis relative to assets are available in the mutual fund prospectuses.
The Thrift Savings Plan is an individual account plan that the federal government provides for its employees. It is a possible model for individual accounts as part of Social Security.

**How the Thrift Savings Plan Works**

The Thrift Savings Plan is similar to 401(k) plans in the private sector. Federal government employees are not required to contribute, but can contribute up to 14 percent of their pay. The federal government automatically contributes 1 percent of pay for all eligible employees hired since 1983, whether or not they contribute. If workers choose to contribute, it also makes matching contributions. Workers have a choice of five broad-based investment funds, plus a lifecycle fund that automatically shifts its portfolio more into bonds as workers approach their expected retirement date. Workers can withdraw benefits at age 59½ and continue working for the federal government. They can receive loans from their accounts while working. Workers are not required to annuitize their account balances or to provide survivor’s benefits. Workers participating in the Thrift Savings Plan also contribute fully to Social Security and in addition have an employer-provided defined benefit plan. Thus, their investments in the Thrift Savings Plan are on top of a solid base of Social Security and a defined benefit pension plan.

**The Thrift Savings Plan as a Model for Social Security Reform**

Add-on accounts, such as the Thrift Savings Plan, do not reduce traditional Social Security benefits, and they do not worsen the financing of Social Security because they do not affect the contributions paid into it. In these respects, the Thrift Savings Plan may be a good model for Social Security reform.
A Department of Labor ruling permits certain fees to be charged to individual accounts based on participants’ activities that generate costs, such as requesting a benefit payment (Huss 2003). Thus, fees for some services may be clearly disclosed to participants. However, even plan sponsors may not know how much in fees their participants are being charged for other services, such as those supplied by record keepers, investment managers, and other service providers. This situation arises because plan sponsors have consistently favored the imbedded and invisible mutual fund pricing model, rather than explicitly accounting for and paying for custodial, record keeping, and other services (Rosenblatt 2001).

About one-third of 401(k) assets are invested in mutual funds (Jossi 2003). The SEC regulates mutual funds and prescribes what fees and expenses borne by investors must be disclosed and in what format. By law, mutual funds disclose some fees and expenses in a standardized

---

**Box 4.1 (continued)**

In some other respects, however, the Thrift Savings Plan has features that may not be a good model for Social Security reform. Workers are allowed to take loans from their accounts while working. They can begin withdrawing from their accounts at age 59½ while working. They can retire at age 57 and begin collecting benefits. These features may reduce the amount that would be available in the accounts for retirement needs at older ages. Also, workers can make interfund transfers daily. That allows some workers to try to time the market, which generally is inappropriate for long-term investing. Workers are not required to annuitize their account balances. Though that feature may be satisfactory for an add-on account because adequate annuitization for federal workers is provided through Social Security and the defined benefit plan, the feature would not be desirable for a carve-out account that reduced Social Security benefits. The benefits provided by the Thrift Savings Plan are not price-indexed, and there is no requirement that survivor’s benefits or disability benefits be provided through the plan.
table near the front of the prospectus. They disclose them as an expense ratio, which is the annual ratio of expenses divided by assets. An individual participant’s fee as determined by the expense ratio is debited from the shareholder’s assets every month. Pension participants may be charged the expense ratio for retail clients or a lower institutional rate.

Mutual funds are not required to disclose, however, and consequently do not disclose all of the fees and expenses charged to participants’ individual accounts. For example, they do not disclose expenses incurred in buying and selling securities. These costs appear to be about 0.5 to 1.0 percent of assets annually for actively managed mutual funds (Baer and Gensler 2002). Under what are called soft dollar arrangements, mutual fund investment advisers use part of the brokerage commissions they pay to broker-dealers for executing trades to obtain research and other services. Because these expenses are not disclosed and the soft dollar costs are combined with transaction charges, this arrangement adds further to the lack of transparency in fees that 401(k) participants bear (USGAO 2003).

The remaining two-thirds of 401(k) funds in the United States not invested in mutual funds are invested in guaranteed investment contracts (GICs), separate insurance company accounts, bank collective funds, and employer stock. Many of these vehicles disclose even less information about fees than do mutual funds. The problem is especially acute in plans operated by insurance companies (Jossi 2003). Typically, fees and expenses on GICs, offered by insurance companies, and on bank deposit accounts are not disclosed to the purchaser; only the net rate of return is provided.

In sum, 401(k) plan participants rarely, if ever, know how much they have paid in fees. Even if they were to try to obtain that information, under current business practices in the financial services sector it would generally not be possible for them to receive a complete accounting of the fees they had been charged (Box 4.2).

**Australia**

International experience offers useful models for providing transparency in the fees charged to individual account participants. Australia requires mutual funds and pension plans to disclose fees that workers pay. The rule applies both to establishing an account and to providing the periodic statements. Thus, when a pension plan or mutual fund provides a
report of account activity, which typically includes the opening balance, contributions, withdrawals, investment earnings, gains or losses, and end-of-period balance, it also shows in Australian dollars the amount in fees charged the account holder. Consequently, the system in Australia provides a possible model for the transparent disclosure of fees.

**Chile**

Pension funds in Chile levy a fixed administrative fee and a charge on contributions (Whitehouse 2001). Because the charge on contributions is in addition to the mandatory payment of 10 percent of earnings, participants are presumably well aware of the fees they are assessed, although they may have little understanding of the impact on their retirement income. This approach is also used by Colombia, El Salvador, and Peru (Bateman 2001). Participants, however, do not know how much they pay in fees arising from the buying and selling of assets by the pension fund providers.

**Sweden**

The mandatory Premium Pension system in Sweden has a complex fee structure. It charges a fixed annual fee of 0.3 percent of the account

---

**Box 4.2 The Effect of Fees**

Given the large variation in the level of fees charged on individual accounts, the effect of fees on benefits at retirement can be substantial. Consider two different situations, both of which involve a worker contributing $1,000 a year to an individual account over a career of 30 years. In the low-fee situation, where fees are 0.2 percent a year, the worker receives a real rate of return of 3 percent. In the high-fee situation, where fees are 1.2 percent a year, the worker receives a real rate of return of 2 percent. After 30 years, the low-fee worker has an account balance of $47,575, while the high-fee worker has an account balance of $40,568. The difference between the account balance of the high-fee worker and that of the low-fee worker is roughly equal to seven years of contributions.
balance and a money management fee. The 0.3 percent fee is collected by each mutual fund from the assets that it manages and is transmitted to the PPM, which administers the system, for its expenses.

The money management fee is complex. Each mutual fund charges a management fee. Funds must charge the same money management fees in the Premium Pension system as they charge in retail markets. The fund companies’ contracts with the PPM stipulate, however, that some of the fee must be returned to the PPM. The rebate is possible because the PPM performs most of the administrative functions for the accounts, so the fund managers’ administrative costs are lower in the Premium Pension system than in retail financial markets.

The PPM passes on to the participants all of the savings from the rebate. An individual participant’s rebate consists of two parts: an individual share and a general share. The individual share depends on the fees charged by the funds in which the person has invested and is given for funds whose usual fee exceeds 0.4 percent. Once the individual rebates have been distributed, the remaining rebate is apportioned among all participants based on account size. Because the remaining rebate is tied to the participants’ account balances and not to fees paid, it returns a higher percentage of fees to workers choosing low-fee funds.

The mutual fund fee covers all of the fund’s expenses except transaction costs arising from its purchase and sale of securities. Those fees are incorporated in the net rate of return the workers receive on their account balances.

Individuals participating in the system receive an annual statement indicating the amount in their accounts in the Premium Pension, and that provides no information on fees paid. Also, individual fund charges are not listed on the annual statements and are only available in percentage terms in the annual catalog of funds provided to participants.

**United Kingdom**

The United Kingdom requires individual account providers to publish figures showing the impact of their administrative costs on plan account balances. Providers apply a mandated set of assumptions on rates of return and publish what the projected payouts would be after all charges have been imposed. Consequently, this system not only provides information on fees but also indicates the expected effect of these costs on account balances.
GOVERNMENT AS FUND MANAGER

In mandatory individual accounts in some countries, the government acts as a financial manager. For example, the governments in Argentina and Uruguay manage one of the mutual funds. In Sweden, the government manages the default fund and another mutual fund.

The main issue of agency risk that arises is whether the government can be trusted to manage financial assets without basing investment decisions on political criteria. Another issue is that the government may be a high-cost investment manager. The evidence on these issues is mixed. While many of the provident funds in Africa appear to have been poorly managed (World Bank 1994), that finding does not necessarily indicate that government would perform inadequately in other countries.

The Petroleum Fund in Norway, the Quebec Pension Fund in Canada, funds for the Canada Pension Plan, and funds for the social security system in New Zealand appear to be successful examples of government management (Gillion et al. 2000). The two funds managed by government agencies in Sweden have not been criticized for making investment decisions based on political considerations (Turner 2004). Those funds are actively managed by a government board that operates independently.

Examples of good pension fund management by the federal government in the United States include the Pension Benefit Guaranty Corporation (PBGC) and the Thrift Savings Plan. The PBGC is the government corporation that guarantees benefits for U.S. defined benefit plans and actively manages investments. The Thrift Savings Plan, which is like a 401(k) plan for federal government workers, passively manages investments (Gillion et al. 2000).

State government pension plans in the United States are other examples of government management of funds. A survey of investment practices of state government pension funds has noted four possible ways that these funds could try to exert political influence (Munnell, Sundén, and Taylor 2000). First, pension funds could engage in economically targeted investments (ETIs), which are designed to meet some special need within the state. Second, the funds could try to influence the behavior of corporations through shareholder activism. Third, the funds could avoid investments in certain stocks for political reasons.
Fourth, the funds could be used by the state governments as a source of financing, from which they could borrow. This survey concludes that, while in the 1980s some state government pension funds sacrificed returns by making politically motivated investments, in recent years these funds have performed as well as those in the private sector.

CONCLUSIONS

Scandals at Enron and WorldCom have highlighted the risks that U.S. pension participants bear from corporate mismanagement. These scandals exposed major weaknesses in the elaborate system of protection for U.S. investors. Other issues concern compensation of the leadership of U.S. corporations and the use of corporate funds for political purposes.

The Swedish system offers a broad range of investment choices, a feature that increases costs. It has been able to keep expenses relatively low by using centralized administration. It has also attempted to reduce the scope for advertising and has regulated fees. The fee structure is complex but creates incentives for workers to participate in lower-cost funds. The net result of various design elements is that individual accounts in Sweden provide considerably more choice of investment options than those in Chile, while being managed at lower cost.

Individual accounts are generally not transparent in their disclosure of fees, and it would be difficult for participants to obtain that information if they attempted to do so. For example, in the Premium Pension system in Sweden, there is no statement of the total costs paid by individuals. In the Thrift Savings and 401(k) plans in the United States, total fees paid by individual participants are not indicated. In all these cases, participants are charged fees, but they do not know how much they are paying. The Chilean and Australian pension systems, however, have a clear identification and disclosure of fees, although even those systems do not list expenses that arise from the purchase and sale of securities. The United Kingdom has also taken steps to improve the disclosure of fees.

Fee information is usually provided in plan documents or in the prospectus for a financial market instrument. That, however, is not in
the most accessible or useful format; it does not disclose transaction expenses and soft dollar costs, and it does not disclose the total dollar amount in fees paid by an individual. Greater transparency in individual accounts would allow participants and plan sponsors to make better-informed decisions. It would facilitate participants’ choosing among mutual funds based on the level of fees and would thus result in pressure to lower such charges.

Notes

1. These figures are based on the author’s calculations from the Premium Pension Authority (2002).
2. The effect on returns was very small. Simulations done by the fund indicate that the portfolio excluding the 30 companies had a rate of return that was 15 basis points (0.15 percent) lower than the full portfolio.
3. The rebate is 25 percent of the difference between the gross fee and 0.4 percent of assets.