Better Pensions, Better Lives: How investment funds can help individuals save for retirement and reduce fiscal pressures on governments

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Introduction

The Pensions Working Committee of the International Investment Funds Association (IIFA) is pleased to submit to the membership a report titled "Better Pensions, Better Lives: How investment funds can help individuals saving for retirement and reduce the fiscal pressures on governments".

The purpose of the report is to assist the advocacy efforts of IIFA members in expanding the role of investment funds in the regulated pension space.

The report provides materials that can be shared with national or supra-national policymakers, regulators and government officials. It is unique in that it combines the expertise of a global community of investment funds associations.

The paper utilized our members' experiences and expertise to explore the positive role that investment funds, and the asset management industry as a whole, can play in helping people to build significant retirement wealth to meet their retirement needs.

When governments are exploring new pension initiatives, they should consider how investment funds may be part of the solution. This report is intended to be used as a tool with supporting data to help our members get a seat at the table.

The report primarily is based on the data collected from a detailed survey conducted with responses from 22 IIFA member associations, supplemented by data from the Organization for Economic Cooperation and Development (OECD), national accounts, national regulatory authorities, and other private-sector data. These data have been compiled, analyzed and incorporated into the report through specific case studies which illustrate and support the paper's thesis.

The report is the result of a collective contribution from the 18 members of the Pensions Working Committee of the IIFA.

With a view to expediting the production of the document in an efficient manner, a smaller group composed of James Carman, Bernard Delbecque, Anna Driggs, Markus Fuchs, Sarah Holden, Claude Kremer and Sally Wong, carried out the coordination and drafting of the report, with the active support of Phil Davis, a financial journalist and writer established in London.

Thanks to the tireless commitment by each over the past two years, and invaluable contributions from the entire IIFA Pensions Working Committee, the report can now be released.

A special acknowledgement goes to the Investment Company Institute (ICI) for having prepared the detailed survey questionnaire and providing sample responses to make it easier for members to understand the type of information sought.

The current members of the Pensions Working Committee are: Claude Kremer (Chair), Arnaud Jacoulet, Jose Carlos Doherty, Ana Flavia de Angelis C. Lopes, Rosemary Lightbody, Elmar Jatzkowski, Valentin Galardi, Bernard Delbecque, Koh Hwee Ngim, Sally Wong, Anna Driggs, Sarah Holden, James Carman (who contributed considerably to this report and has since left the IIFA), Arnie Hockman, Niall Flanagan, Kentaro Namiki, Jun Sugie, Markus Fuchs and Imran Razvi.

The 22 IIFA member associations who contributed the information to this paper are:

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Australia: courtesy of the Financial Services Council (FSC), https://fsc.org.au/
Austria: courtesy of the Association of Austrian Investment Companies (Vereinigung Österreichischer Investmentgesellschaften, VOIG), https://www.voeig.at/voeig/internet_4.nsf/sysPages/en.html
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Executive Summary

State pensions are the mainstay of retirement benefits for millions of older people around the world. But they are increasingly under strain and it is widely recognized that **state pensions will not be able to provide the benefits of the past**.

The challenge is that the basic state pension in most countries is pay-as-you-go (PAYG), meaning current workers fund retiree pension benefits, typically through payroll taxes. With the aging of population in many countries—caused by both lower birth rates and increased longevity—the number of workers per retiree is declining. As a result, tax rates required to fund promised benefits will have to be increased in the future or future benefits will have to be reduced (or both).

Many governments have already reacted to the challenge, most often by reducing promised pension benefits by increasing the pensionable age. These changes have rarely been enough to bring revenue and expenditures into long-term balance, and often proved extremely unpopular.

Funded pensions are less affected by population aging as each generation pre-funds their own retirement benefits.

Studies demonstrate that **workers with a mix of funded pensions and PAYG pensions can maintain their standard of living in retirement.**

Solving the challenge of preparing for a financially-secure retirement has been taken up by private companies, individuals and governments, resulting in a vastly improved pensions landscape. As the IIFA survey data show, company-run defined contribution (DC) schemes dominate funded pensions, although some countries offer citizens nationally-run DC schemes. Other countries allow citizens to invest in personal pension plans, which are not managed by the state or by employers.

Over time, these funded DC pensions and retirement accounts have grown, and many workers—particularly those who change jobs frequently, or spend spells out of the workforce—will be better off as a result of the shift to these account-based retirement savings.

Through the growth of employer-sponsored DC schemes, national schemes and individual pension plans, funded pensions have expanded at an exponential rate in the past 20 years. **The ongoing shift from unfunded to funded pensions should, in time, ease the pressure on households and government fiscal accounts alike.** In particular, funded account-based retirement plans provide individuals with the tools to help secure income for their retirements.

Investment funds are used increasingly in pension plan management because they help solve the issues of transitioning to a funded pensions world. Investment funds provide professionally-managed, diversified, vehicles to help investors, who may know little about finance, to build retirement nest eggs. They are also widely used by insurers and pension funds.

Funds help pension savers build wealth. The IIFA survey finds that robust risk management and governance are incorporated into the investment industry across the world. Funds in most countries set out clearly what their risk-return aims are, and investors' money is well protected from theft. The fund industry is highly regulated, and funds are structured to comply with prescribed investment, operational and ethical rules. Funds also are simple and readily available for investors to buy.

Generating investment returns is a key goal of the investment industry management. By offering a range of risk and returns in diversified portfolios aiming to generate investment performance, **asset managers can help savers to build wealth** to support stronger future retirement income. Moreover, the investment industry is designed to serve an investor's changing financial goals across the entire life cycle—whether younger and focused on saving for a home or education; or in prime earning years and focused on saving for retirement; or older and managing assets to generate income in retirement. The investment industry responds to investor needs not only up until retirement, but through their entire life.

The fund industry is professionally managed. That's to say, the vast majority of investment managers and other industry professionals have recognised qualifications which facilitate expert investment management, and good operational management too.

In additional to being professionally-managed and diversified, **investment funds allow fund shareholders to access and hold a wider variety and number of investments than they could investing on their own.** Investment funds are also cost-effective, with competitive pressures and economies of scale driving fees down over time.

For all these reasons, **the investment industry has become the rock on which many modern pensions systems are now built.** The IIFA survey reveals just how deeply the investment industry is embedded in many pensions systems and how this improves the wealth of pensioners.

Critically**, saving for retirement must be promoted to succeed.** Providing citizens with a range of funded pension options is a great start. Policymakers also must ensure that **robust retirement savings incentives** are in place. Tax incentives encourage workers to contribute to retirement plans. Plan design features, such as automatic enrolment and good defaults, also play a key role. But unless these same citizens trust and understand what is being offered, saving for retirement will only increase incrementally. Education around investment basics and the importance of saving for retirement also is important to successful outcomes.

Financial education occurs through a range of channels (e.g., schools, universities, governments, regulators, financial services firms) and formats (e.g., pamphlets, seminars, webinars, websites, interactive tools). Increasingly, governments, employers, plan sponsors, and financial services firms are employing technology to engage savers and tailor education messages to individuals.

The investment industry plays an important role in efforts to inform and educate. The provision and depth of financial education vary widely across countries. Given that saving for retirement is the process of putting aside some of current earnings to have for retirement, much financial education around saving and investing occurs when workers start their careers. In a funded account-based retirement saving system, the role of the investment industry is key, not only in providing investment options, but also in explaining key financial concepts.

The industry, and policymakers, must continue to increase their efforts to educate savers if billions of people are to live comfortably in their later years. Individual account-based retirement saving is a powerful tool in the hands of savers, when incentives, plan design, and investor engagement work together.

Chapter 1. The rising burden of state pension systems

With the costs of pay-as-you-go schemes rising due to ageing populations, state pensions are increasingly under strain. If they are to be sustainable, countries must either substantially raise taxes or cut pension benefits, or both. These solutions tend to be unpalatable to citizens and governments alike, so governments are gradually increasing their focus on funded pensions.

Effective pensions systems are vitally important to economies. Why? First, and most obviously, they provide financial support to sustain citizens in their later years. Without this support, older people would suffer poverty and the consequent poor health and welfare conditions this brings.

But pensions are more than that.

They provide people of working age with the security of knowing they will be provided for in older age. This confidence encourages workers to spend their earnings, ensuring that the broader economy is boosted. The prospect of sufficient retirement income also gives them the confidence to take risks vital to the private sector, such as setting up new businesses.

For governments, efficient pensions systems which protect all or most of their citizens, reduce financial pressures, allowing them to invest in services and infrastructure which boost gross domestic product (GDP).

Not least, the prospect of security in old age is key to the welfare and happiness of all citizens.

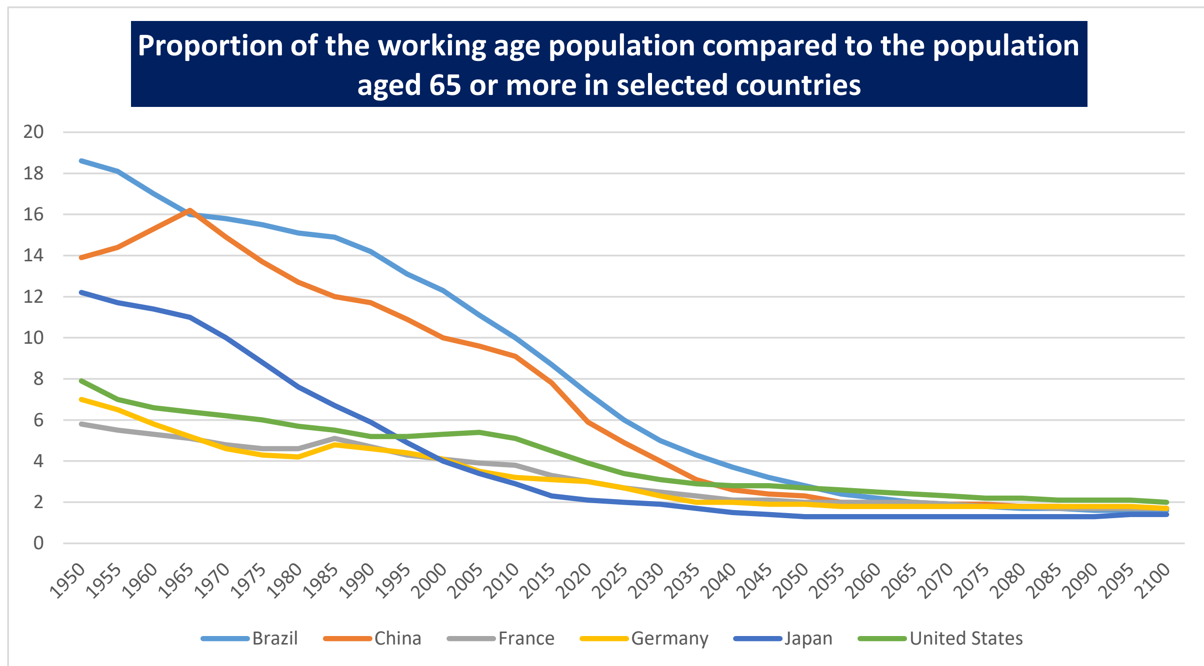
1.1 Unfunded pensions running out of road

State pensions are the mainstay of retirement benefits for millions of older people around the world. But they are increasingly under strain, and state pensions will have difficulties in the future to provide the benefits of the past.

The challenge is that the basic state pensions in most countries are pay-as-you-go (PAYG), meaning current workers fund retiree pension benefits—typically through payroll taxes. Although some PAYG pensions have built up trust funds, those assets represent only a fraction of future benefit costs. With the costs of PAYG schemes rising, many countries face the difficult choice of substantially raising taxes or drastically cutting pension benefits.

The reason the costs of PAYG schemes are rising is that the population is aging, reducing the number of workers per retiree (Figure 1.1). As a result, the amount of taxes each worker must pay to fund any given level of pension benefits has increased.

Figure 1.1
Fewer Workers for Every Retiree
Number of people in working age per person 65+

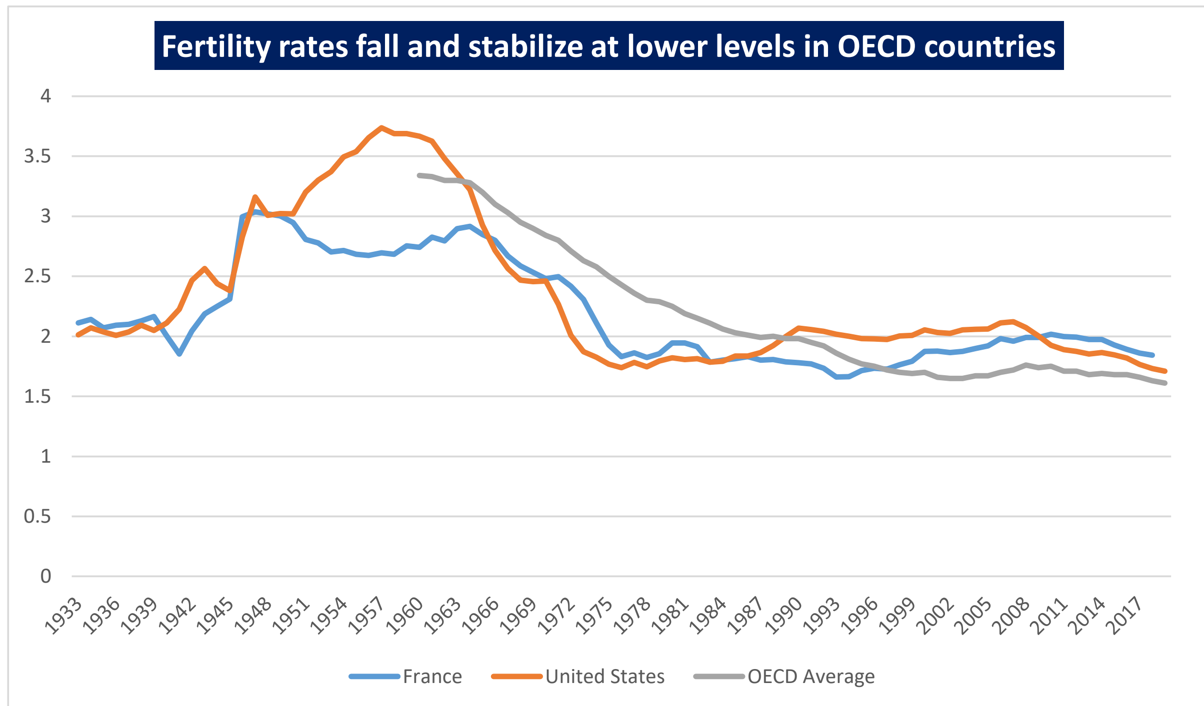


Source: OECD DAF Pension Unit

The aging of the population is largely the result of two trends.

First the total fertility rate—that is, the number of children that women have, on average, during their lifetime—has fallen substantially since the 1960s (Figure 1.2). In fact, total fertility is currently at historically low levels, below the rate experienced during the Great Depression. Even absent other changes, lower birth rates alone would have substantially reduced the ratio of workers to retirees.

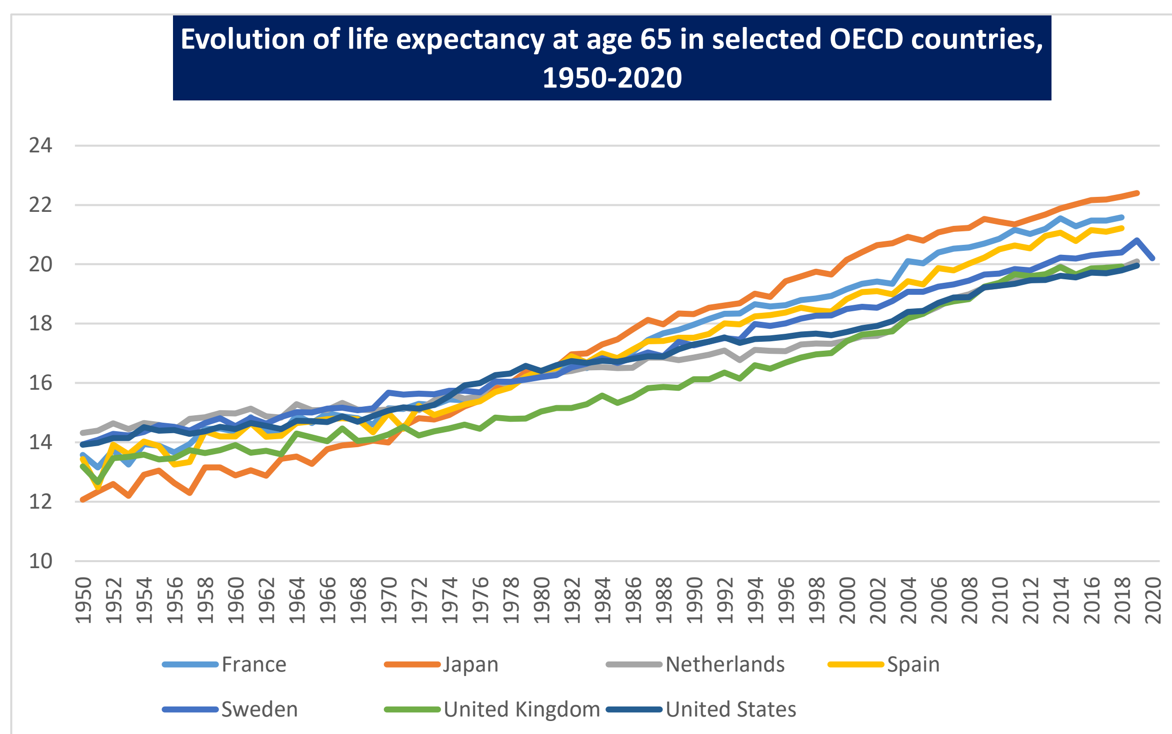
Figure 1.2
Total Fertility at Record Low Levels
Average number of children per woman during lifetime



Source: OECD DAF Pension Unit

In addition to lower birth rates, retirees are living longer (Figure 1.3). Since 1950, remaining life expectancy for individuals age 65 has risen about one year per decade, on average. Without an increase in the retirement age, increased longevity further reduces the ratio of workers to retirees.

Figure 1.3
Life Expectancy at Age 65 *Years of remaining life at age 65*



Source: OECD DAF Pension Unit

As the ratios of workers to retirees have fallen, some governments have increased tax rates and reduced promised pension benefits—often by increasing the pensionable age. These changes have rarely been enough to bring revenue and expenditures into long-term balance, and often proved extremely unpopular.

The experience with PAYG pensions has increased interest in funded pensions. Some countries have basic state pensions that are funded—having relied on funded pensions from the start or having transitioned from PAYG to funded pensions. Other countries have, or are trying to encourage, funded pensions that supplement the basic state pension. Considerable funding of pensions has taken place around the world. But the process is relatively young, and some solutions are better than others.

The rest of this paper examines: the funded systems already in place; how policymakers can encourage their citizens to actively participate in securing their financial futures; the rising role of investment funds in retirement saving; and the importance of financial education in improving outcomes.

Chapter 2. Momentum is switching to funded pensions

Most "funded" defined benefit (DB) plans are actually underfunded and face the prospect of running out of money when benefit payments exceed contributions. Most countries have legislation allowing defined contribution (DC) schemes to be established by companies, while a number–such as Canada, Australia, Sweden, Mexico and Malaysia–offer nationally-run DC schemes. Furthermore, many jurisdictions allow citizens to invest in personal pension plans, which are not managed by the state or by employers. Governments employ a range of tax and non-tax incentives to encourage investment in state, company and personal pensions. As a result, funded pensions have expanded at an exponential rate.

2.1 The importance of retirement system design

There are two key decisions to be made on retirement system design: (1) whether the plan is pay-as-you-go (PAYG) or funded; and (2) whether it is defined benefit (DB) or defined contribution (DC) in its design.

A retirement system component that is **pay-as-you-go (PAYG)** uses money coming in from current workers to pay for benefits of current retirees. PAYG structures are typically only used by national governments, since they are assumed to be permanent, and therefore able to maintain such schemes by levying taxes. As explained in Chapter 1, a faster-growing base of retirees versus workers in many jurisdictions has put strain on the sustainability of the PAYG state pensions. For a PAYG system to be sustainable, contributions must be sufficient to pay the promised benefits to retirees.

A retirement system that is **funded** has assets earmarked—that is, set aside in a separate trust—to cover pension benefits.

If the pension benefit— the income paid to retirees—is defined, the scheme is a **defined benefit (DB) plan**. In a funded system, contributions to a DB plan, whether by the employer, the employee, or both, broadly fund the pension plan so that the plan can pay the promised benefits to retirees. In a PAYG system, contributions are used to pay a defined amount of income to current retirees.

Difficulties arise with DB design—whether PAYG or funded—when contribution rates are insufficient to fund promised benefits. Most countries have experienced a decline in workers per retiree, which will require these countries to either increase contribution rates to their PAYG systems or reduce promised benefits to remain solvent. With funded systems, most countries have not set contributions high enough to pay future benefits. As a result, most "funded" DB plans are actually underfunded and face the prospect of running out of money when benefit payments exceed new contributions.

Alternatively, the amount of pension benefit paid can be directly linked to contributions. This is a **defined contribution (DC) plan**, where the contributions are specified (i.e., defined), and the benefit is the account balance accrued.

In a DC plan, there is no benefit formula, as there is in DB plans. The benefit in a DC plan is simply the balance in the account, which reflects contributions made and investment returns earned. Contributions to DC plans can be made by employers, workers, or both. Workers may be allowed to decide how investments are made in their individual accounts, or investments may be collectively invested, with each worker getting a proportional share of the entire DC plan.

Studies demonstrate that workers with a mix of PAYG and funded retirement plans will be able to generate sufficient resources to maintain their standard of living in retirement, and that many retirees—particularly those who change jobs frequently or spend spells out of the workforce—will be better off with a DC plan design rather than a DB plan design.[1]

With a DC plan, there is a direct link between how much is saved and the benefit received, which is the account balance. DC plans offer the opportunity for significant asset accumulation, but it is important that individuals have access to educational materials or advice (see Chapter 5), or defaults (see Section 4.2, below) to ensure they make appropriate contribution and know how to diversify their investments.

The fully-funded, account-based DC plan also offers an advantage over DB plan design, because workers are not dependent on the solvency of their employer and the ability of the employer to fund the promised benefits (see "Case Study: DB plans could be fully funded, but rarely have been," in Section 2.3, below).

DC accounts continue to compound and grow, even as workers change jobs or find themselves with time outside the workforce. Unlike DB plan design, where if you change jobs frequently, the benefit is lost or greatly reduced, DC accounts—whether left at the former employer, transferred from one employer to another, or moved to an individual retirement account—continue to compound and grow on a tax-advantaged basis.

With PAYG systems under severe strain, countries have tried to increase the role of funded pensions. Some countries have developed funded Pillar I pensions (e.g., **Chile, other South and Central American countries, Mexico, Australia, Sweden (a portion), Malaysia**). Others have sought to supplement their basic pensions with funded pensions (e.g., **Canada, United States, Italy, Japan, and Finland)**.

[1] See Investment Company Institute, *The Success of the US Retirement System*; available at https://www.ici.org/pdf/ppr_12_success_retirement.pdf.

Some jurisdictions now have state-run DC plans

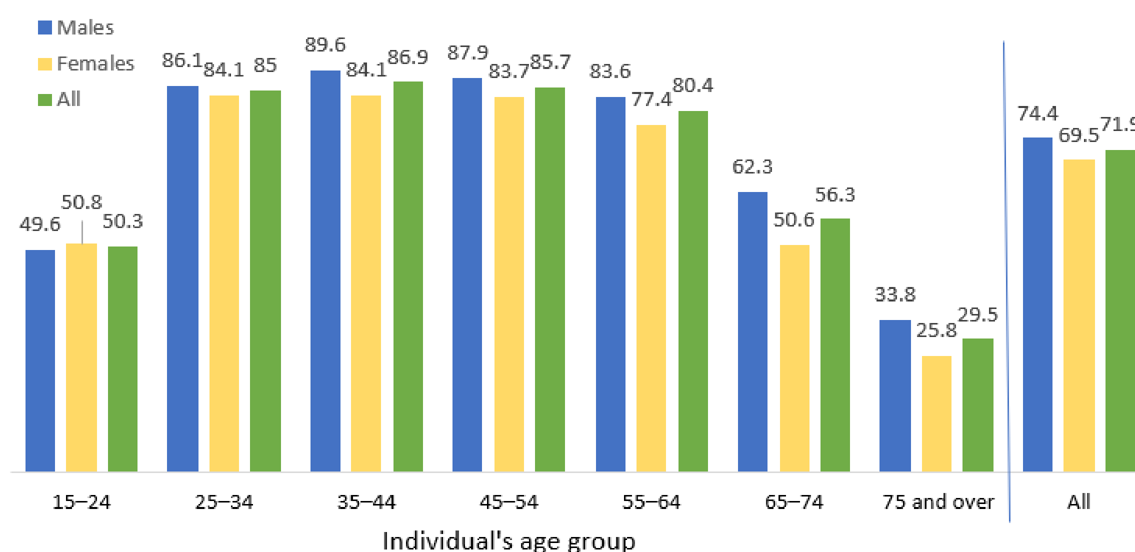
DC plans are not always provided by employers. Some countries offer all citizens the opportunity to invest in nationally-run DC schemes. For example, a compulsory scheme operates across **Canada**, where there are mandatory pension programs for all workers to which both employers and employees must contribute.

In **Australia**, the national scheme is run by superannuation funds. These funds are so well known to Australians that they are referred to colloquially as "supers" (see "Case Study: "Supers" dominate in Australia," below).

Case Study: "Supers" dominate in Australia

*In **Australia**, people of all ages have second pillar pensions, with more than half of even the youngest citizens (aged 15 to 24) enrolled in superannuation schemes (Figure 2.1). Australia has created a number of superannuation funds, each of which serve particular needs and saver types.*

Figure 2.1
Majority of Australians Covered by Superannuation
Percentage of population with superannuation, by age group and gender



Source: Australian Bureau of Statistics, Household Income and Wealth, Australia: Summary of Results, 2017–18, Table 12

The Australian superannuation system is unusual in that it is mandatory for almost all employees. For this reason, retirement assets in Australia are dominated by the "supers", which manage nearly 80% of all funds in the country.[2]

[2] See the Australian Bureau of Statistics, Managed Funds, Australia: Summary managed funds institutions, Table 2; available at https://www.abs.gov.au/statistics/economy/finance/managed-funds-australia/latest-release.

Federal law dictates that employers must place 9.5% of employees' salaries into a super.[3] *The vast majority of Australians "default" into a superannuation fund. That is, they do not opt to make a choice of fund. These defaults are called MySuper funds, which are plain, no-frills, low-cost funds.*

The size of the superannuation sector – almost A$3.1 trillion as of March 2021[4] *– is a significant part of the domestic economy. Superannuation assets also are important to Australian households, generally representing the second-largest asset for Australian retirees after the family home.*

In **Sweden**, a new national pension system was approved in 1994. Although still mainly PAYG (15% of the pensionable salary), one of its features was that a percentage – 2.5% of the pensionable salary – would go to the premium pension system (PPM). The PPM offered savers the opportunity to choose the funds to invest their money. Those who do not make a choice are defaulted into a UCITS-like fund run by the government. The first selection of PPM funds was made in 2020.

Case Study: Mexico embraces DC

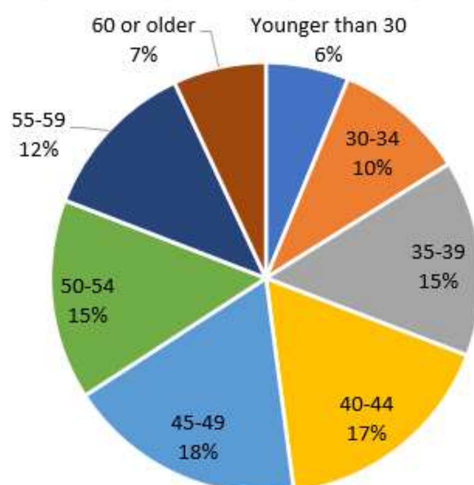
Mexico *reformed its pension system in 1997, transforming it from a pay-as-you go (PAYG), DB scheme to a fully-funded, private and mandatory DC scheme. Participants in the Mexican system choose from a variety of private pension fund managers called Administradores de Fondos para el Retiro (AFORES). Mexico's AFORES retirement system collects mandatory contributions of 6.5% from citizens through their salaries, deducted automatically. Types of AFORES include Personal Retirement Plans, Special Savings Accounts, Fixed Income Investment Funds, and Insurance Plans with a Retirement Component. All these accounts have tax benefits up to certain limit and hold assets that can only be accessed when people are 65.*

AFORES funds are divided into 10 age groups, each with a corresponding level of risk exposure. AFORES funds are held by investors covering a full range of ages: in 2019, nearly one-third (31%) of AFORES fund assets were in funds appropriate for investors younger than 40, while more than one-third (34%) were for investors age 50 or older (Figure 2.2).

[3] The Superannuation Guarantee (SG), is mandated to rise to 12% by 2025.

[4] See The Association of Superannuation Funds of Australia (ASFA), "Superannuation Statistics"; available at https://www.superannuation.asn.au/resources/superannuation-statistics.

Figure 2.2
Retirement Savers of All Ages Invest in AFORES Funds
Percentage of AFORES fund assets by funds' targeted age group, 2019



Source: IIFA Role of Investment Funds Survey

In addition, PPPs (Private Pension Plans) are schemes set up by employers in Mexico. These have tax benefits and have a limit of seven times the minimum wage.

An example of another mandatory system is **Malaysia**'s Employees Provident Fund (EPF), which was established as a federal statutory body in 1951 under the purview of the Ministry of Finance to manage the compulsory savings plan and retirement planning for private-sector workers and non-pensionable public sector employees. The EPF Act 1951 requires employees and employers to contribute towards the employees' retirement savings. The scheme is fully-funded and provides DC-type benefits to members. It is financed through monthly contributions based on the amount of an employee's salary. In the period, 1 January 2021 to December 2021, an employee and their employer are required to contribute 9% and 12% respectively of the employee's monthly salary each month. However, both the employee and employer may voluntarily contribute at a higher rate.

To expand the scope of the EPF, voluntary self-contributions by those who were not previously covered by the scheme have been allowed.

2.2 Tax and non-tax incentives used to increase retirement savings rates

Providing citizens with a range of funded pension options is a great start. But unless people trust the options presented to them and understand how they will benefit from them, saving for retirement will only increase incrementally. Tax incentives promote retirement saving, so it is important for governments to provide tax benefits to long-term retirement savings, including contribution limits that allow for accumulations large enough to fund retirement.

Incentives can definitely change the equation. While income taxes discourage savings, tax incentives can promote retirement savings.[5] The OECD has provided leadership in seeking changes to savings habits by encouraging policymakers to diversify their citizens' sources of finance for retirement and develop funded pensions to complement PAYG public pensions. The OECD notes that financial incentives may be needed to encourage saving in retirement savings arrangements, especially when these are voluntary.

Many countries have responded to the OECD's messages. Countries typically use two types of financial incentives—tax incentives and non-tax incentives—to encourage individuals to save for retirement.[6] Tax incentives for retirement savings are indirect subsidies provided through the tax code. By contrast, non-tax incentives, such as matching contributions and subsidies, are direct payments, whether by employers or the government, toward pension accounts.

Tax incentives encourage funded pensions participation

Policymakers have decisions to make regarding the timing of tax incentives.

Many countries apply an "Exempt-Exempt-Taxed" (EET) tax regime to retirement savings, whereby both contributions and returns on investments are exempt from tax while in the retirement plan or account, while benefits are treated as taxable income upon withdrawal (Figure 2.3). The majority of US and Canadian retirement assets, for example, are Exempt-Exempt-Taxed (EET).

While the EET model dominates in the **United States** and **Canada**, in both countries a Taxed-Exempt-Exempt (TEE) option also has been created—in the United States, the Roth individual retirement account (IRA) introduced in 1997,[7] and in Canada, the Canadian Tax Free Savings Account (TFSA) introduced in 2009 (see "Case Study: Canadian tax incentives promote retirement saving," below).

Other variations include the EEE tax regime, where contributions, returns on investment and pension income are all tax-exempt. From a saver's perspective, this is the most attractive of the tax incentive regimes, but it is the most expensive for government treasuries. Examples of the known variations and where they are used are shown in Figure 2.3 below.

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[5] See Peter J. Brady, How America Supports Retirement: Challenging the Conventional Wisdom on Who Benefits (2016); available at https://www.ici.org/whobenefits.

[6] See OECD, *Financial Incentives for Funded Pension Plans: OECD Country Profiles* (2019); available at https://www.oecd.org/finance/private-pensions/Financial-Incentives-for-Funded-Pension-Plans-in-OECD-Countries-2019.pdf.

[7] Roth IRAs are named after US Senator Roth, who sponsored the legislation that created them.

Figure 2.3
Overview of the Tax Treatment of Retirement Savings in OECD Countries

E = exempt from tax; T = taxed
Note: Main pension plan in each country; data as of 2019. Countries offering tax credits on contributions are considered as taxing contributions, as the tax credit may not cover the full amount of tax paid on those contributions.

Source: Organization for Economic Cooperation and Development, *Financial incentives for funded private pension plans: OECD country profiles* https://www.oecd.org/finance/private-pensions/Financial-Incentives-for-Funded-Pension-Plans-in-OECD-Countries-2019.pdf

Most countries exempt returns on investment from taxation in pension plans and accounts. The majority of countries do not tax the funds accumulated and do not impose a lifetime limit on the total amount that plan members can accumulate in their pension plans or accounts.

The way pension funds are taxed, and the incentives offered by governments are constantly evolving to encourage more and better ways of savings for retirement.

Case Study: Canadian tax incentives promote retirement saving

*In 1957, **Canada** introduced the Registered Retirement Savings Plan (RRSP) and Canadians could contribute up to 10% of their pre-tax earnings into a RRSP, up to a maximum of C$2,500. By 2020, Canadians could contribute up to 18% of their pre-tax earnings up to a maximum of C$27,830. Unused contribution amounts from previous years may be carried forward.*

RRSPs are an EET tax regime and have several tax advantages:

- *Contributions are made with pre-tax income and reduce the contributor's current year tax liability;*

- *Any gains and investment returns earned in the plan are not taxed until the money is withdrawn;*
- *When the money is withdrawn during retirement, the investor's highest marginal tax rate will usually be significantly lower than it was when they made the contribution – leading to a real net tax reduction;*
- *The untaxed investment returns in the RRSP between the contribution and withdrawal date compound to further increase the assets of the plan.*

New Canadian Savings Product Introduced

In 2009, the Canadian government introduced the Tax Free Savings Account (TFSA) to offer a choice in the timing of taxation. The TFSA is an example of a Taxed-Exempt-Exempt (TEE) regime. Contributions are not tax deductible, but the income and investment returns generated in the plan are exempt from tax, and retirees may withdraw their money without paying tax on the withdrawal. Younger workers who are early in their careers, and therefore in lower tax brackets, may find this option attractive.

Currently, Canadians are allowed to contribute up to C$6,000 annually to their TFSA. Unused contribution amounts from previous years may be carried forward.

In **France**, the recent law, "PACTE", will encourage pension saving by establishing a new DC savings product (the Plan d'Epargne pour la Retraite, or PER). This new pension product can be designed as an asset management or insurance product. PER offered by asset managers will be invested in lifecycle funds, with some rules fixed by law. They will be allowed to invest broadly in stocks, the proportion of stocks decreasing as the retirement date approaches.

Policymakers aim to increase contribution amounts

Contribution limits must also be considered by policymakers to make retirement plans attractive to employers and employees, and encourage sufficient savings. Some systems have automatic increases set to keep pace with inflation, others implement specific changes to expand access or increase contribution limits over time.

In January 2019, **Norway** increased the tax-deductibility limit for contributions by self-employed workers into voluntary DC occupational plans from 6% to 7%.

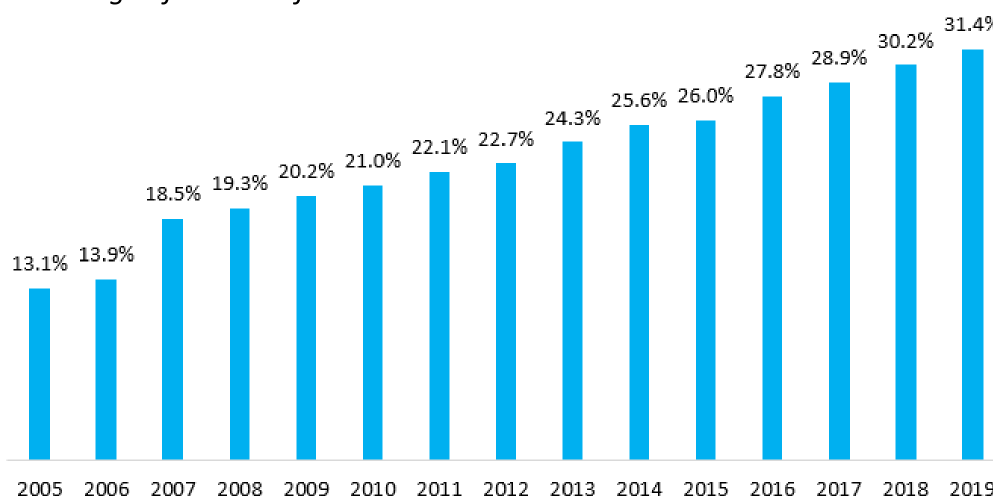
In **Germany**, if employers contribute at least €240 a year to an occupational pension scheme on behalf of a low-income earner (those earning less than €2,575 monthly), the employer receives a tax allowance of 30% of the contribution, up to a maximum contribution of €960.

In order to increase contribution levels, the **Czech Republic** in 2017 increased the tax relief on members' contributions from Kc12,000 ($566) to Kc24,000 ($1,132) annually, and the level of employer contributions not considered as taxable income from Kc30,000 to Kc50,000.

In **Denmark**, an extra tax exemption of 22% was introduced in 2018 for the last 15 years before retirement, while for pension savers with more than 15 years to retirement, the extra exemption was 8%. The extra exemption for the last 15 years before retirement was further increased in 2020 to 32%.

In **Italy**, since 2017, performance bonuses granted to employees up to €3,000 a year are exempt from income tax if they are used for expenses, including contributions into occupational pension plans. This and other measures explain why participation rates in private pensions plans in Italy have more than doubled over the past 15 years (Figure 2.4).

Figure 2.4
Participation Rates in Private Pension Plans Have More Than Doubled in Italy
Percentage of the workforce



Source: COVIP Annual Reports

In 2020, **Korea** increased the maximum tax-free contribution limit to personal pension plans from Won7 million ($6,350) a year to Won9 million ($8,200) a year and reduced the tax on pension payments.

In **Malaysia**, contributions into the Private Retirement Scheme (PRS), a voluntary saving and investment scheme, allow individuals to claim a tax relief of up to M$3,000 ($744) a year. The tax relief has significantly contributed to the annual asset growth rate of 71.3% into PRS schemes from 2012 to 2020.

Auto-enrolment: when the path to savings is automated

In a voluntary retirement plan offering, in addition to tax incentives, plan design with regard to the participation and investing decisions is important.

In the **United States**, automatic enrolment in private-sector DC plans has increased participation rates, particularly among younger and lower-income workers. Additionally, automatic increases in default contribution rates typically increase contribution rates by one

percentage point annually, as workers age and experience salary increases. Default investments that offer diversification, often in the form of target date or lifecycle funds, place retirement savers on a path that has an opportunity for growth in their investments.

Since January 2019, the second pillar in **Lithuania**, a voluntary DC account system, has also become an automatic enrolment scheme. For individuals contributing at least 3% of gross income, the government contributes 1.5% of the previous year's gross salary.

Poland introduced an automatic enrolment scheme in 2019, in which the individual benefits from an employer matching contribution and from government subsidies.

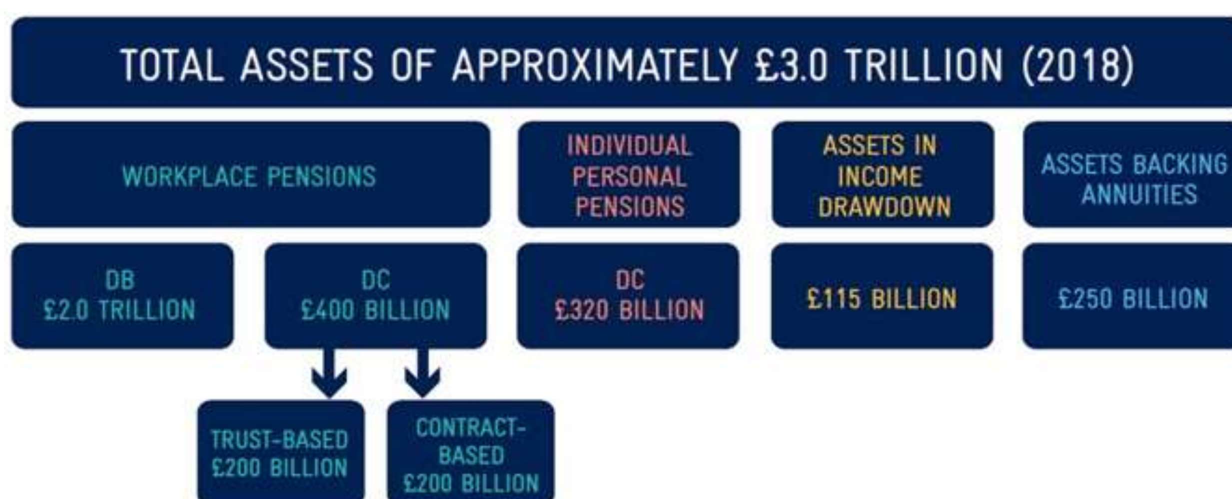
Turkey also introduced automatic enrolment to its DC scheme in 2017. In addition, the government matches 25% of individual pension contributions up to 25% of the annual minimum wage.

Case Study: Auto-enrolment changes the face of UK retirement

*In the **United Kingdom**, DB (funded) assets continue to make up the majority of the UK pension market (Figure 2.5). However, the policy of automatic enrolment introduced in 2012 has had a major impact on pension saving in the UK, with most employers choosing to use DC schemes under automatic enrolment. Over 10 million people have been automatically enrolled since the introduction of the policy and the number of savers in DC schemes now comfortably exceeds those actively saving into DB schemes.*

Auto-enrolment has also improved saving persistency and increased the total amount contributed to a pension.

Figure 2.5
Overview of the UK's Pension Landscape



Sources: ONS, FCA, PPI, IA, DCLG. Due to changes in regulatory reporting, some data have not been updated since 2015. Estimates are provided on a best-efforts basis until alternative sources are found.

2.3 Employer-sponsored pension plans and individual retirement accounts co-exist

In many jurisdictions, retirement saving is facilitated not only through employer-sponsored plans, but also through personal individual pension accounts. Employer-sponsored plans can be DB or DC in design (see discussion in section 2.1, above). However, DB plans have historically had difficulties in funding promised benefits. Increasingly, funded pensions are company-run DC plans, which define the liability of employers (contributions) and provide a benefit (the account balance) that is well-suited to mobile workforces. Personal pension accounts also have been rising in availability and popularity in many places around the globe.

Case Study: DB plans can be fully-funded, but rarely are

With a funded DB plan, employers are expected to invest in assets to meet projected liabilities—that is the value of the benefits promised. Actuarial rules determine the valuation of current assets and the discounting of future liabilities to the present for comparison, and any shortfall is a claim of the pension fund on the plan sponsor (the employer).

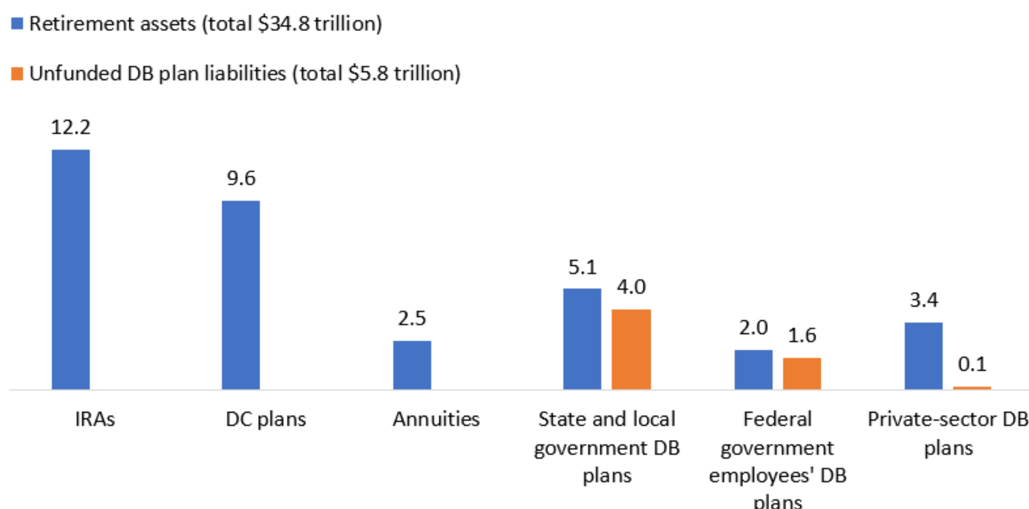
*The **United States** provides a case study of the difficulties inherent in such a funding exercise—where decisions made in the present do not come home to roost until many years in the future.*

Prior to the Employee Retirement Income Security Act of 1974 (ERISA), pension plans in the United States were not funded. As policymakers strengthened funding requirements over time for private-sector employers offering pensions, actuarial assumptions and changing funding rules resulted in funding difficulties for these DB plans.

The underfunding of US DB pension plans is clear to see. Federal, state and local government DB plans, which are not subject to ERISA, are severely underfunded, while private-sector DB plans are also underfunded, though to a lesser degree.

In the United States, at year-end 2020, the total unfunded liabilities of DB plans were $5.8 trillion (Figure 2.6). State and local government DB plans had $5.1 trillion in assets and $4.0 trillion in unfunded liabilities and federal DB plans had $2.0 trillion in assets and $1.6 trillion in unfunded liabilities. By comparison, private-sector DB plans had $3.4 trillion in assets and just $147 billion in unfunded liabilities.

Figure 2.6
Underfunding of Government DB Pensions Is Pronounced in the United States
Trillions of US dollars, year-end 2020



Sources: Investment Company Institute and US Federal Reserve Board; see ICI Quarterly Retirement Market Data at https://www.ici.org/research/stats/retirement

Proliferation of company-run DC plans

Company-run DC schemes dominate the DC plan space globally. Most countries have legislation allowing DC schemes to be established by companies.

In the **United States**, the 401(k) plan is one type of DC plan.[8] Workers who participate in a 401(k) plan have the option to contribute a portion of their earnings into a retirement account. In addition, employers may contribute to the employee's retirement account, either through automatic or matching contributions. When the worker reaches retirement age, their retirement benefit is the balance in the 401(k) account, and the worker may begin to withdraw money.

In **Canada**, employer-sponsored workplace pension plans have some C$1,660 billion of assets.

The retirement system in **Brazil** is composed of Social Security, a public pension system, and the Supplementary Pension, which is a private pension system. Employees in the private sector and public servants are automatically affiliated to Social Security, which is financed by employers (private companies or government agencies), workers (employees of the private

[8] These private-sector DC plans are named after their section of the Internal Revenue Code (§401(k)). Workers at universities, public schools, and non-profit organizations typically are offered 403(b) plans (again, referring to their section of the Internal Revenue Code).

sector and public servants) and the federal government, which is obliged to cover cases of financial insufficiency in the system.

The Supplementary Pension is a private retirement plan which supplements Social Security. Closed private pension plans are offered by companies to their employees and by professional associations to associated professionals. The sponsor may make contributions on participants' behalf.

In **Sweden**, meanwhile, occupational pension assets totalled SKr3,192 trillion in 2019, of which SKr1,079 trillion, or 34%, were invested in funds and the rest in traditional life insurance. **Austria's** so-called "second pillar" scheme administered by employers and known as *Pensionskasse*, manages €21.4 billion in assets.[9]

In **Italy**, Contractual Pension Funds (CPFs) support occupational pension plans (not individual plans) and are non-profit organisations. CPFs are not allowed to invest contributions directly and are obliged to appoint financial managers from recognised asset management companies, investment firms, insurance companies or managers of alternative investment funds. At the end of 2018, CPFs managed €50.4 billion of workers' assets.

In **Japan**, the Defined Contribution Pension (DC) system includes plans that are corporate-type or individual-type. For corporate-type plans, the selection of financial advisors is carried out and paid for by the company. Companies pay a predetermined amount of contributions each month and contributions can be flexibly designed, such as fixed amount or salary proportion. Japan is one of the few countries which have investments backing its state pension. The Government Pension Investment Fund (GPIF) manages some $1.45 trillion of assets. However, corporate pensions are also sizeable at $870 billion.

Personal pension accounts managed by individuals are allowed in some countries

Many countries allow citizens to invest in personal pension plans, which are not managed by the state or by employers. These personal plans usually deliver a tax break to the saver and allow savers to choose their own investments. But they usually restrict savers from investing in certain asset types, which are deemed too complex for individuals.

For instance, so-called "open private pension plans" in **Brazil** are offered by banks and insurance companies, and can be purchased by any individual (or legal entity). The most common are Plan Generating Free Benefits and the Life Generating Free Benefits.

In **Canada**, the third pillar or individual tax-assisted retirement savings, consists of Registered Pension Plans (RPPs) and Registered Retirement Savings Plans (RRSPs). RPPs are

[9] Source: Austrian Financial Markets Authority (FMA), 2018

traditional workplace pensions, including DB and DC plans. RRSPs, by contrast, are an employee’s private retirement savings, kept in a tax-advantaged account. Some employers also contribute to employee RRSPs, in the form of group RRSPs (GRRSPs).

In the **United States**, the third pillar or individual retirement account (IRA) allows for contributions as well as rollovers of tax-qualified assets from employer-sponsored retirement plans (whether lump-sums from DB plans or account balances from DC plans, and whether offered by private-sector or government-sector employers). Traditional IRAs are offered as EET (Figure 2.3), while Roth IRAs are TEE. The United States also has employer-sponsored IRAs, mainly designed to promote retirement savings at small employers.

In **Austria**, second pillar products are offered by special private institutions (called *Pensionskassen*), which predominately invest their savings in investment funds. The third pillar product is offered by insurance companies and investment funds companies.

Italy has insurance-based personal pensions (PIPs), which are life insurance contracts offered by insurance companies. Italy also has open-ended pension funds (OPFs). OPFs are promoted by asset management companies, banks, investment firms, insurance companies and support both occupational and individual plans.

In 2018, the Chinese Ministry of Finance and the State Administration of Taxation introduced the Pilot Program of Personal Tax-Deferred Commercial Pension Insurance for individuals in **China**. The implementation of the pilot projects in Shanghai, Fujian Province (including Xiamen City) and Suzhou Industrial Park was the first exploration in China into the third pillar of pensions. During the pilot, only commercial insurance products were included. In the future, more financial products such as publicly-offered funds will be included.

Investors in **Japan** can access an individual-type DC known as “iDeCo”. This is a retirement account in which a certain amount of contributions is accumulated every month until the age of 60, and a fixed amount is used to invest periodically in investment funds or insurance. The benefits are received in bulk or in instalments after the age of 60. Investors can make voluntary additions to their iDeCo retirement funds.

Also in Japan, a tax exemption measure to promote investment by individuals was introduced in 2014. This tax-free investment system is modelled on the Individual Savings Account (ISA) in the United Kingdom and is called NISA (Nippon Individual Savings Accounts). Strictly speaking, the NISA is not a pension, but it is generally used for very long-term savings, including those earmarked for retirement.

In **Malaysia**, PRS is a voluntary long-term savings and investment scheme designed for additional savings for retirement. PRS seeks to enhance the choices available to all Malaysians—whether working for an employer or self-employed—to supplement their retirement savings in a structured and regulated environment. Each PRS offers a choice of

retirement funds in which individuals may choose to invest, based on their own retirement needs, goals and risk appetite.

2.4 Growth of funded pensions has been dramatic

Largely through the growth of employer-sponsored DC schemes, national schemes and individual pension plans, funded pensions have expanded at an exponential rate in the past 20 years. (Nevertheless, in some jurisdictions, DB pension assets still represent a significant share.)

Global institutional pension fund assets in the 22 largest pensions markets totalled $46.7 trillion at the end of 2019,[10] representing a 10-year compound annual growth rate of 6.5%. Total DC assets represent over 50% of the total pension assets of the seven largest pensions markets (**Australia, Canada, Japan, Netherlands, Switzerland, United Kingdom** and the **United States**). DC pension assets have grown from 31% of total pension assets in 1999 to 50% in 2019.

In 2019, DC plan assets exceeded DB plan assets for the first time, a culmination of 10 years of faster DC assets growth than DB (8.4% versus 4.8% annually), reflecting increases in the number of DC members and higher contributions on average by each member.

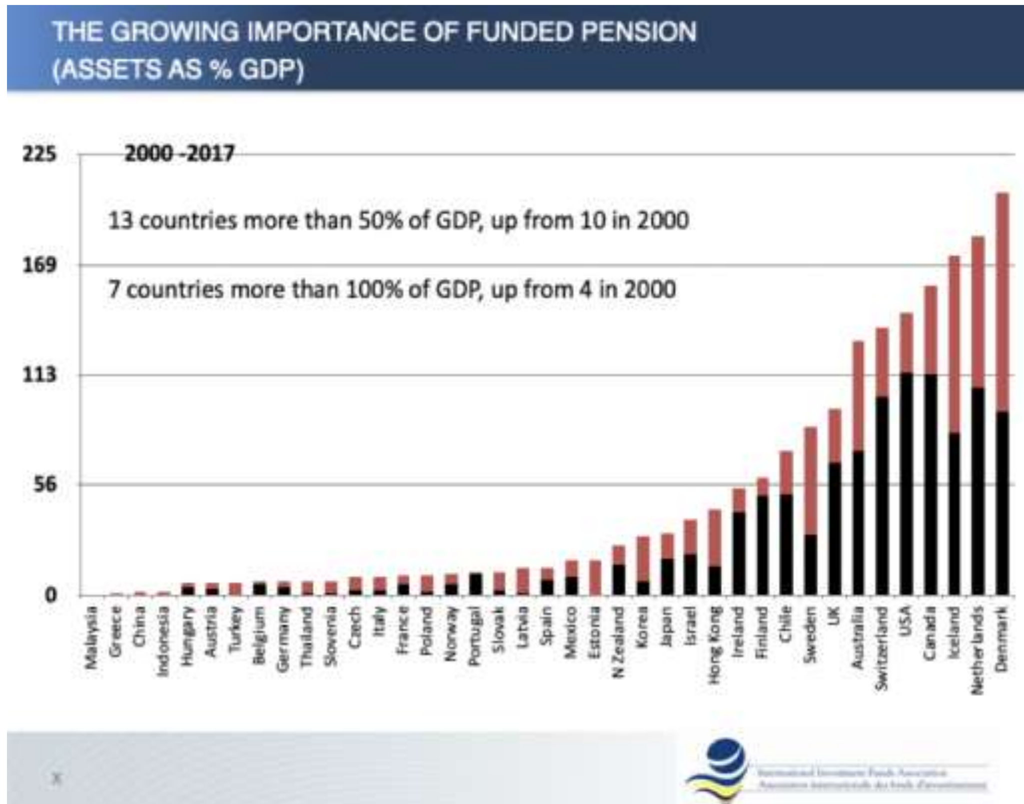
Total pensions assets to GDP ratio was 68.8% at the end of 2019 and some countries now have private pension wealth which is far higher than their GDP (Gross Domestic Product, a measure of the size of a country's economy). The countries with most funded pension assets as a proportion of GDP are **Denmark**, the **Netherlands**, **Iceland** and **Canada** (Figure 2.7).

[10] See Willis Towers Watson, "Global pension assets on the rise," *Press Release* (February 10, 2020); available at https://www.willistowerswatson.com/en-CA/News/2020/02/global-pension-assets-on-the-rise.

Figure 2.7

Funded Pensions Play a Rising Role in Retirement Systems Worldwide

Funded pension assets as a percentage of GDP, 2000 and 2017



Source: OECD

Chapter 3. How the investment industry serves the needs of savers

Investment funds offer individual investors professional investment management to help them achieve their financial goals. Funds have low minimum investment thresholds and their costs are constantly falling thanks to competition between fund managers and the sheer scale of the investment industry. Funds provide asset allocation and diversification, which ensures better investment returns for the risk taken, and can also provide access to alternative and ESG-focused strategies. Funds are simple for investors to buy, have strong protections from theft and fraud, and are highly transparent – giving investors regular updates on where their money is invested and how it is performing.

By investing and growing the money people entrusted to them, the investment industry helps people provide for their future and achieve their financial goals.

Investing can mean taking risk with the aim of obtaining a return that is higher than that available from "risk-free assets" such as bank deposits or government bonds.

Professional investment is carried out by investment managers, also known as asset managers. These asset managers invest and manage risks on behalf of pension funds in a professional and cost-efficient way. They conduct research on economic developments, financial markets, industries and companies to find attractive investment opportunities. They select financial securities such as stocks and bonds that are listed on international exchanges, and they may invest in unlisted assets such as private companies or real estate.

Asset managers sometimes make investments on behalf of a single large investor, such as a pension fund or an insurance company. Or investments can be made available to hundreds, thousands, or even millions of investors through collective funds.

The International Investment Funds Association (IIFA) describes regulated funds as collective investment pools that are substantively regulated, open-end investment funds. Open-end funds issue new fund shares (or units) and redeem existing shares (or units) on demand, providing important flexibility to investors.

These funds are professionally-managed, diversified, and cost-effective, typically regulated with respect to disclosure, the form of organization (for example, as corporations or trusts), safe custody of fund assets, minimum capital, valuation of fund assets, and restrictions on fund investments—such as limits on leverage, types of eligible investments, and diversification of portfolio investments.

In the **United States**, regulated open-end funds include mutual funds and exchange-traded funds (ETFs). In **Europe**, regulated funds include Undertakings for Collective Investment in Transferable Securities (UCITS)**,** and alternative investment funds, commonly known as AIFs.

In many countries, regulated funds also may include institutional funds, which are prohibited for sale to retail investors.

Investments also play an important economic financing role by channelling savings into the real economy. By doing this, they create jobs and strengthen the economy.

3.1 Investment funds offer diversification and asset allocation

Investment funds offer investors, who may know little of the world of finance, cost-effective professional investment management of a diversified portfolio to help them achieve their financial goals, whether saving for a home, education, or retirement. Investment funds set out clearly what their risk-return and investment aims are, and the availability of funds through a wide array of financial institutions makes it simple for investors to buy funds. Funds are highly-regulated, protecting investors' money from theft, and they are structured so that investment managers work according to prescribed investment, operational and ethical rules.

The key role of an investment manager is to find good investments and buy a number of assets which, combined, aim to provide return commensurate with the level of risk undertaken. Many individuals do not have the time or resources to analyse, select and purchase the best assets for their long-term financial goals.

Put simply, funds offer asset allocation and diversification, which is about giving investors access to many different types of assets and many different issuers of assets. Asset types available through regulated funds are broadly equities (stocks), bonds, and money market instruments. A typical equity fund will diversify across many different issuing companies, in some cases investing to represent a broad market index. Funds also may invest across different sectors of the economy (e.g., technology or healthcare) and across different regions of the world to provide diversification. Funds may also invest in alternative investment strategies (see Section 3.2, below). A growing number of funds seek to invest according to environmental, social, or governance (ESG) criteria (see Section 3.2, below). Whatever the investment strategy, fund managers analyze assets and select those they believe will perform the best and meet investors' expectations.

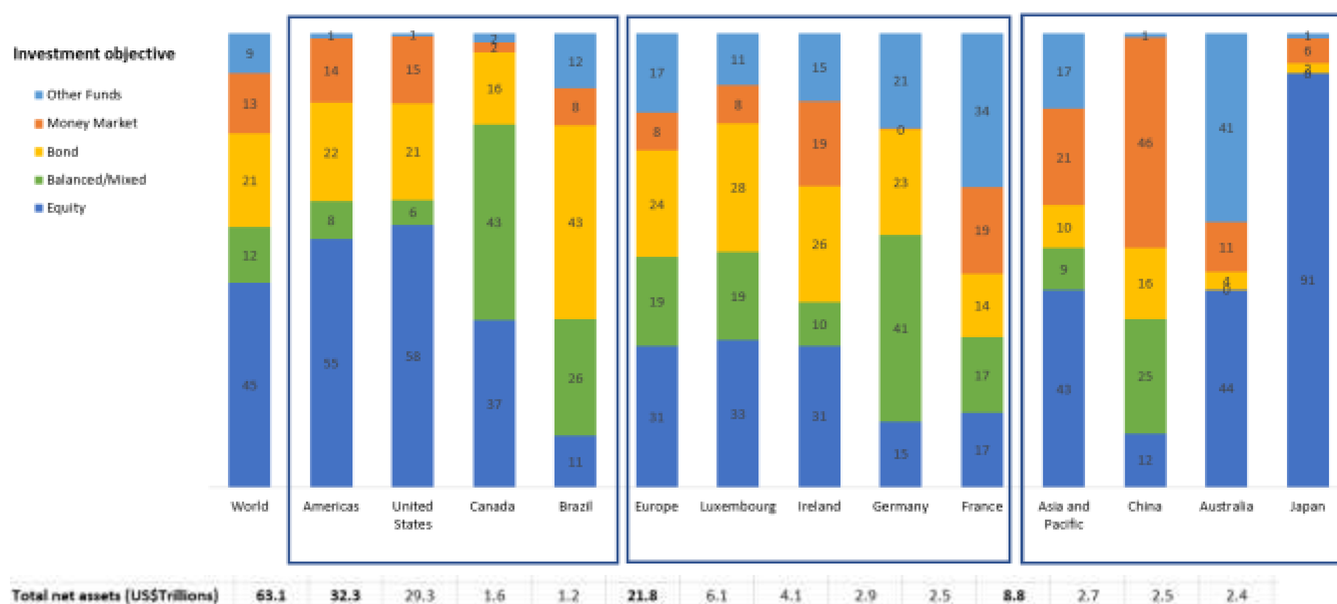
Asset allocation refers to the composition of a portfolio. Managers may change this composition regularly based on their ongoing analysis of markets and securities. A fund typically discloses its investment objective, and the fund manager selects securities in alignment with that disclosure.

Investment fund assets are characterized by a wide range of investment objectives, with different risk-reward profiles. Worldwide, 45% of investment fund assets are equity funds, 12% are balanced/mixed funds, and another 21% are bond funds (Figure 3.1). Money

market fund assets are 13% of the worldwide total, and other funds account for the remaining 9%.

Preferred asset allocation varies substantially from country to country. In the **Americas**, a higher allocation to equity funds (55% of total assets in the region) is driven in large part by the US (where 58% of total fund assets are equity funds), while in **Canada** balanced/mixed fund assets (43% of the total) are the largest component (Figure 3.1). In contrast, bond funds (43% of total assets) are more common in **Brazil**.

Figure 3.1
Funds Offer Access to Equity Investing and Diversified Portfolios
Percentage of total net assets, year-end 2020

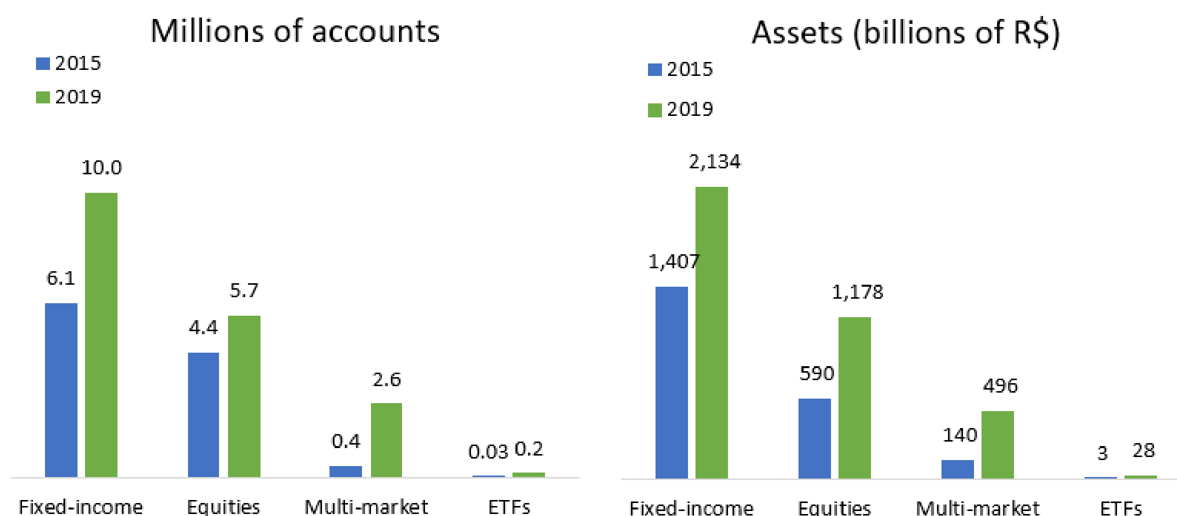


Source: International Investment Funds Association, Worldwide Data Exchange (https://www.ici.org/research/stats/worldwide)

Case Study: Account and fund asset growth in Brazil drives diversification

*In **Brazil**, the number of fund investment accounts and assets is rising. Brazilian investors are allocating to a wide range of asset classes, including fixed-income, equities, multi-market and ETFs (Figure 3.2). For example, the number of fixed-income investment fund accounts has risen from 6.1 million accounts in 2015 to 10.0 million accounts in 2019, an increase of 63%, while assets in fixed-income funds rose 52%. The most dramatic growth has occurred in multi-market investment funds (accounts up 525%, assets up 255%) and ETFs (accounts up 438% from a low base, and assets up 936%).*

Figure 3.2
Growth in Number Investment Accounts and Investment Fund Assets in Brazil
Millions of accounts; assets in billions of Brazilian real (R$)



Source: ANBIMA

The use of investment funds by investors in **Germany** is representative of many continental European markets, with investors allocating to a wide range of assets, each with different risk-reward profiles (Figure 3.1). Nevertheless, funds with balanced/mixed fund assets have grown in recent years to be a higher share of total net fund assets in Germany (41%) than across Europe in general (19%).

Balanced funds in **Germany** have seen asset growth of more than 6.3% a year in the three years to June 2020, while real estate funds (included in “other funds” in Figure 3.1) have experienced particularly high growth rates of around 9% a year. Balanced funds allocate to a mix of equities, bonds and other assets to reduce overall risk and increase the return potential. The inflows to these two types of funds indicate that German retail investors are actively diversifying their portfolios.

In **Italy,** flexible funds are the most popular fund type, representing 37% of households’ fund assets. Flexible funds are similar to balanced funds, but can invest in and divest from asset classes more rapidly, in response to changes in market conditions.

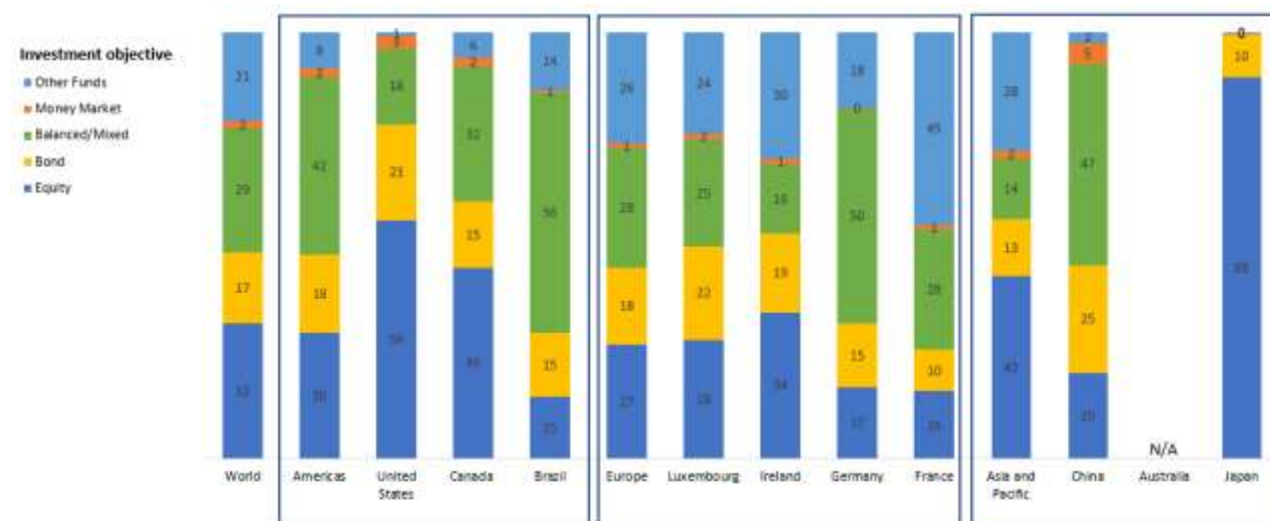
Equity fund assets are the largest reported category in the **Asia-Pacific** region, but it should be noted that **Japan** reports balanced/mixed fund assets in that category (Figure 3.1). In **Australia**, superannuation investors can choose from different investment options such as balanced, high-growth and other options. These portfolios contain a wide mix of assets which are designed to match the risk profile of a different types of investors at different stages of their life and career.

3.2 Investors have access to large numbers of funds

Worldwide, more than 140,000 investment funds offered to investors (Figure 3.3). The largest category of funds offered worldwide are equity funds, which include actively-managed and indexed funds, and funds that invest in domestic, international, or global stock markets. Meanwhile, 29% of investment funds are balanced/mixed funds, which invest in a mix of stocks and bonds, or a combination of stock, bond, and money market funds. Bond funds account for 17% of funds worldwide.

Europe leads in the number of funds by region, having launched 42% of investment funds worldwide (Figure 3.3). The **Americas** account for 30% of funds worldwide, and the **Asia and Pacific** region for 26% (the remaining 1% of investment funds are in South Africa, not shown in the figure).

Figure 3.3
Significant Number of Funds Offered in Every Jurisdiction
Percentage of number of investment funds, year-end 2020



	World	Americas	United States	Canada	Brazil	Europe	Luxembourg	Ireland	Germany	France	Asia and Pacific	China	Australia	Japan
Number of funds	**142,250**	**42,787**	11,231	5,050	22,433	**59,834**	14,590	7,948	7,006	10,802	**37,497**	6,770	N/A	13,429

N/A = not available

Note: Other funds include real estate, guaranteed/protected, and other funds. Japanese equity fund category includes balanced/mixed funds. For additional notes, see International Investment Funds Association, Worldwide Data Exchange, available at https://www.ici.org/research/stats/worldwide.

Source: International Investment Funds Association

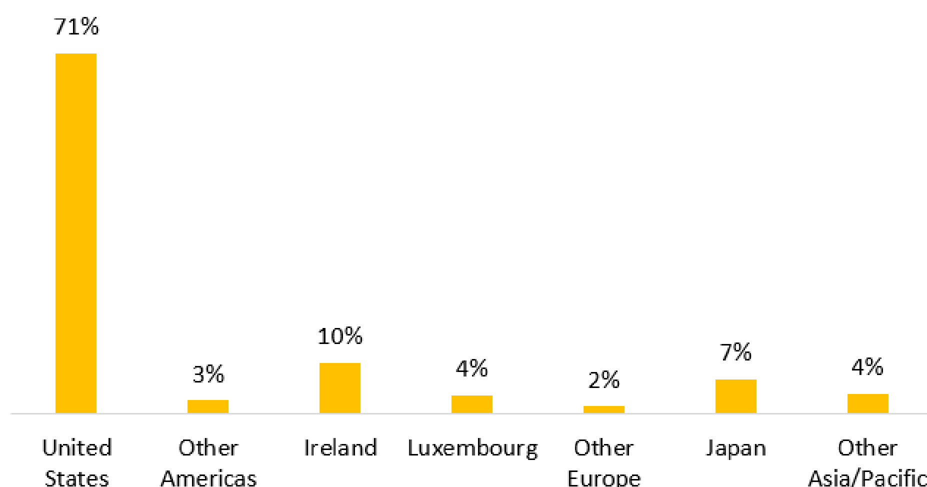
Exchange-traded funds (ETFs) are playing an increasingly large role

ETFs have grown in popularity across the world, representing nearly one-fifth of investment fund assets, because they are a cost-effective, represent a diversified way to invest, and

offer trading throughout the day. ETFs are similar to investment funds in that they provide access to many types of investment strategy and invest in a great number of securities, thus providing high diversification. The key difference is that ETFs are bought and sold as shares on a stock exchange, in the same way that, say, Microsoft or Siemens shares are purchased by investors.

The largest ETF market is in the **United States**, where ETFs have experienced great growth. At year-end 2020, ETF assets worldwide stood at $5.4 trillion, compared with $23.9 trillion in mutual fund assets.[11] ETF assets in the United States represented 71% of ETF assets worldwide (Figure 3.4). The second-largest ETF market is **Ireland**, with $0.8 trillion in ETF assets, compared with $3.3 trillion in mutual funds. The third-largest is **Japan**, with $0.5 trillion in ETF assets, compared with $1.9 trillion in mutual fund assets.

Figure 3.4
Exchange-Traded Fund (ETF) Assets Have Grown in Jurisdictions Worldwide
Percentage of ETF total net assets, year-end 2020



Source: International Investment Funds Association (https://www.ici.org/research/stats/worldwide)

Funds also offer investors access to "alternatives"

The inclusion of asset classes that go beyond traditional categories in order to boost returns for retirement investment portfolios is becoming central to the optimisation of portfolios, in particular in the light of low yields. Alternative investments refer to investment in non-traditional strategies, where traditional strategies are usually taken to mean funds of listed equities and bonds.

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[11] See International Investment Funds Association, "Worldwide Regulated Open-End Fund Assets and Flows, Fourth Quarter 2020," available at https://www.ici.org/research/stats/worldwide.

Asset managers are best positioned to allow investors to gain access, in a cost-effective way, to a range of alternative investments, such as real estate, infrastructure and private equity, that would not otherwise be available to investors.

Mutual fund regulation in **Canada** was substantially reformed when amendments implementing alternative mutual funds came into force in January 2019. Alternative mutual funds are a new category of publicly-offered mutual funds that are permitted to invest in physical commodities or specified derivatives, or borrow cash or engage in short selling in a manner not typically permitted for other mutual funds.

In the **United States**, alternative strategy mutual funds have experienced significant growth, rising from assets of about $41 billion at year-end 2007 to nearly $240 billion at year-end 2014. In May 2021, alternative strategy mutual fund assets stood near $200 billion.

Many structures exist to facilitate investment in alternatives. For example, the Alternative Investment Fund (AIF) operates across the **European Union**. Individual countries also have their own designation for alternative funds. **Austria, Germany**, and **Switzerland** authorise *Spezialfonds* which are essentially UCITS funds but with more liberal thresholds, and allow access to niche and illiquid assets such as real estate, non-UCITS funds, precious metals and non-securitized loans.

In **Luxembourg**, a *société d'investissement en capital à risque* (SICAR) is an investment company designed for investments in private equity and venture capital. It usually qualifies as an alternative investment fund (AIF) and can be sold to "well-informed" investors. A Specialised Investment Fund (SIF) is an investment fund that can invest in all types of assets. It usually qualifies as alternative investment fund (AIF) and can be sold to well-informed investors.

In **China**, Listed Open Ended Funds (LOF), the Qualified Domestic Institutional Investor (QDII) scheme, hedged strategy funds, target date funds and commodity futures funds are all types of structures offering non-traditional investments.

In **Korea**, there are designated collective investment schemes for alternative assets such as real estate funds, hedge funds and special asset funds which invest in agriculture, fisheries, livestock, minerals and energy, among others.

In **Malaysia,** in addition to traditional equity and bond funds, a range of other investment options is available to retail investors, including funds that invest in assets or business activities in accordance with Shariah (Islamic) principles. In addition, since 2020 PRS funds are allowed to invest in ETFs that are backed by physical gold, and wholesale funds are allowed to invest in foreign real estate via a special purpose vehicle structure.

Investment funds are increasingly ESG-friendly

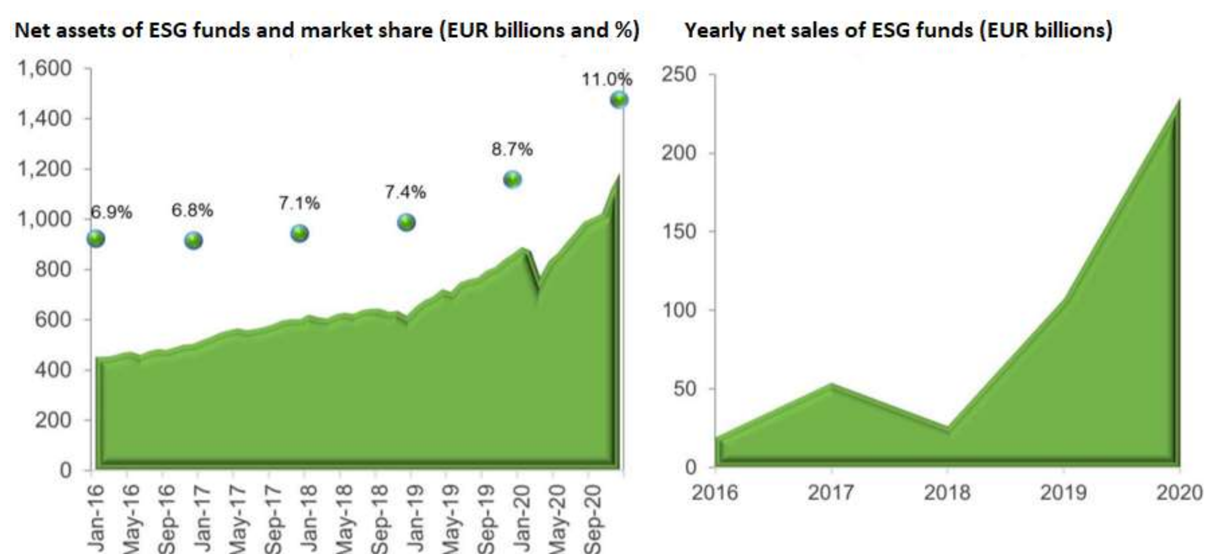
Environmental, social, or governance (ESG) criteria are becoming important to many investors. The desire to act responsibly through their investments, to tackle issues as disparate as climate change and unfairness in the workplace, is growing fast.

For this reason, many investment firms have focused on creating versions of their existing funds which are ESG-compliant. Some have created entirely new types of funds which target solutions for climate change, poverty and other ESG-related issues. There has even been a number of start-up investment firms that have ESG as their guiding investment philosophy.

Individuals acting alone can make some impact on ESG issues, but thousands of investors acting in concert can make a decisive change. This is another way in which the purchasing and influencing power of the investment industry can be brought to bear on issues of importance to investors and society.

In **Europe**, net assets of ESG funds have increased significantly over the past five years, and especially in 2019 and 2020. In December 2020, net assets of ESG funds amounted to €1.2 trillion (Figure 3.5). While non-ESG funds saw a growth in net assets of only 4.8% in 2020, ESG funds recorded a growth rate of 37.1%. The stronger growth of ESG funds reflects in part the higher proportion of equity funds in the ESG universe and the strong performance of equity markets in 2019 and, to a lesser extent, in 2020. This resulted in the share of ESG funds growing from almost 7% of total net assets in 2015 to 11% in 2020 (Figure 3.5).

Figure 3.5
Expansion of ESG Funds in Europe



Source: Morningstar Direct platform and EFAMA's calculations; see EFAMA, *Market Insights*, "ESG in the UCITS Market – a powerful and inexorable trend" (March 2021); available at https://www.efama.org/sites/default/files/files/Market%20Insights%20Issue4%20ESG%20funds_1.pdf

In many jurisdictions, governments and agencies drive the ESG agenda. Nevertheless, industries such as the investment industry have the power to drive ESG considerations one step further, finding new and better solutions for ESG issues. These solutions not only satisfy investors, but can be useful in helping nations move to more sustainable economies.

As well as developing strategies that are ESG-friendly, fund managers are in a strong position to police companies in their portfolios. As a result of the duration and size of their investments, fund managers play an important role as stewards of companies with a view to maintaining and enhancing the long-term value of companies for investors. This responsibility is often described as active ownership or engagement, also called shareholder engagement or shareholder advocacy.

Through shareholder engagement and stewardship, fund managers talk to companies about ESG issues and encourage them to improve where necessary. Where encouragement is not enough, some large investment houses simply refuse to hold the shares or bonds of non-compliant companies.

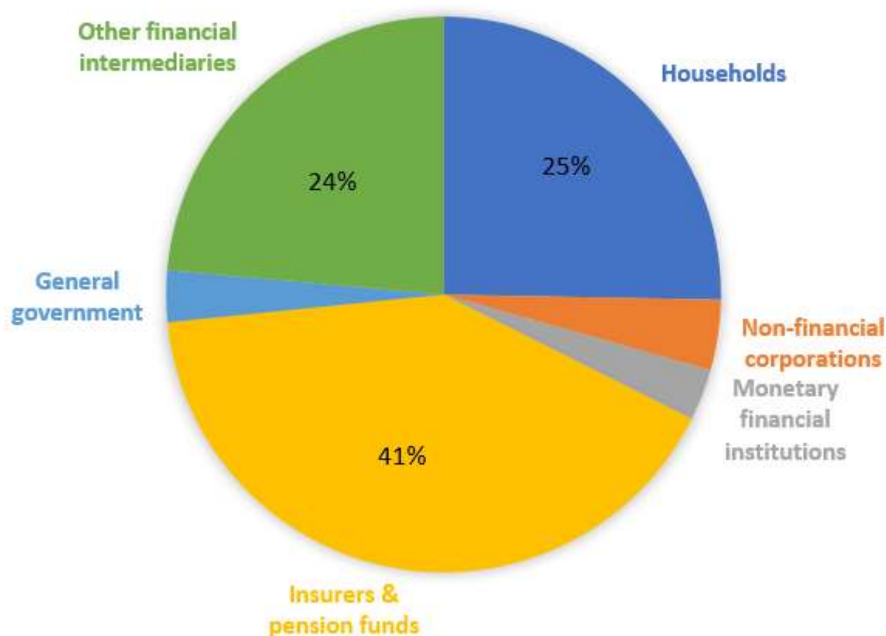
In some jurisdictions, asset managers have acted strongly on ESG in recent years amid their fiduciary duty to integrate financially relevant considerations into their investment processes. Screening processes, best-in-class responsible investment, impact investing, stewardship, and thematic investing are all examples of approaches used by asset managers to meet the diverse ESG goals of investors.

3.3 Investment funds are open to all, and open for life

Investment funds offer cost-effective professional investment management in diversified portfolios and are attractive to both retail and institutional investors.

In **Europe**, insurers and pension funds are by far the largest investors in investment funds, holding around 41% of investment fund assets domiciled in Europe at the end of 2020 (Figure 3.6). In the euro area, this percentage is lower (36.5%) with 22.9% held by insurers and 13.6% by pension funds.

Figure 3.6
Investment Funds in Europe Are Attractive to Retail and Institutional Investors
Percentage of total investment fund assets, year-end 2020



Source: European Fund and Asset Management Association (EFAMA); *EFAMA Fact Book 2021*

In **Europe**, investment funds are playing an increasingly important role in the asset allocation of insurance companies for two reasons. First, as interest rates dropped in recent years, it became more and more difficult for insurers to find fixed-income securities offering a sufficiently high return. Investment funds can provide insurers with an easy way to expand their sectoral or geographical exposure and to diversify risk. Second, the cost of investment funds, especially in the institutional segment, has dropped significantly in recent years, making funds more attractive to clients.

Unsurprisingly given insurers' liability profiles, bond funds accounted for the largest share (33.3%) of insurance companies' investment fund holdings at year-end 2020.[12] Multi-asset funds and equity funds followed with a share of 26.7% and 24.4%, respectively. These percentages indicate that the preferred approach of insurers to invest in the equity markets is by acquiring investment funds rather than directly buying stocks.

In **Italy**, 45% of investment fund assets were held directly by retail investors (households). Retail investors held another 20% of total mutual fund assets through retirement and insurance products. A variety of financial institutions and other investors held the remaining 35% of the Italian mutual fund market's assets.

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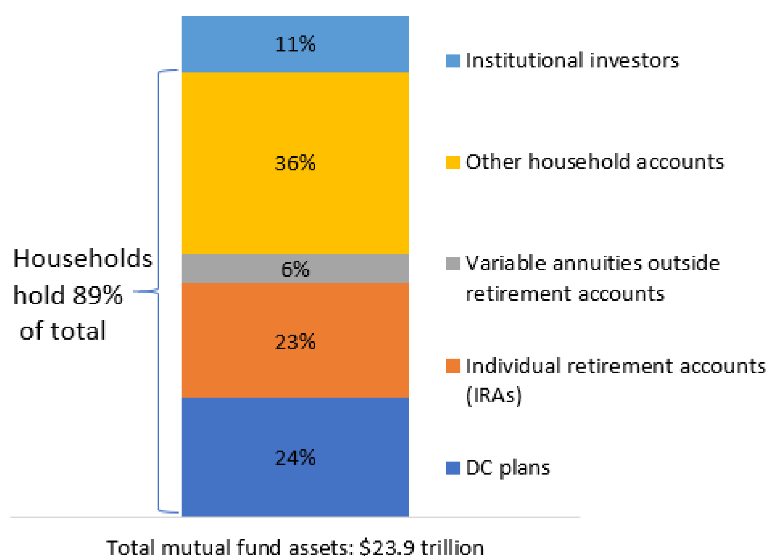
[12] Source: EFAMA Fact Book 2021.

In the **United States**, households are the main shareholder in mutual funds. At year-end 2020, 89% of total mutual fund assets were held by millions of US households, often through their DC retirement plan accounts or IRAs (Figure 3.7). Estimates suggest that institutional investors play a large role in the US ETF market: it is estimated that about half of ETF assets in the United States are held by households, while half is held by institutional investors.

Figure 3.7
US Households Hold 89% of Total Mutual Fund Assets
Percentage of total net assets of mutual funds, year-end 2020



Source: Investment Company Institute; see *2021 Investment Company Fact Book* (https://www.icifactbook.org/)

In Japan, investment funds are primarily owned via large companies rather than directly by individuals. Securities companies are responsible for 72.4% of distribution by investment funds, financial institutions for 26.7%, and direct marketing to retail investors is just 0.9% of the total.

Minimum investment thresholds in funds are low

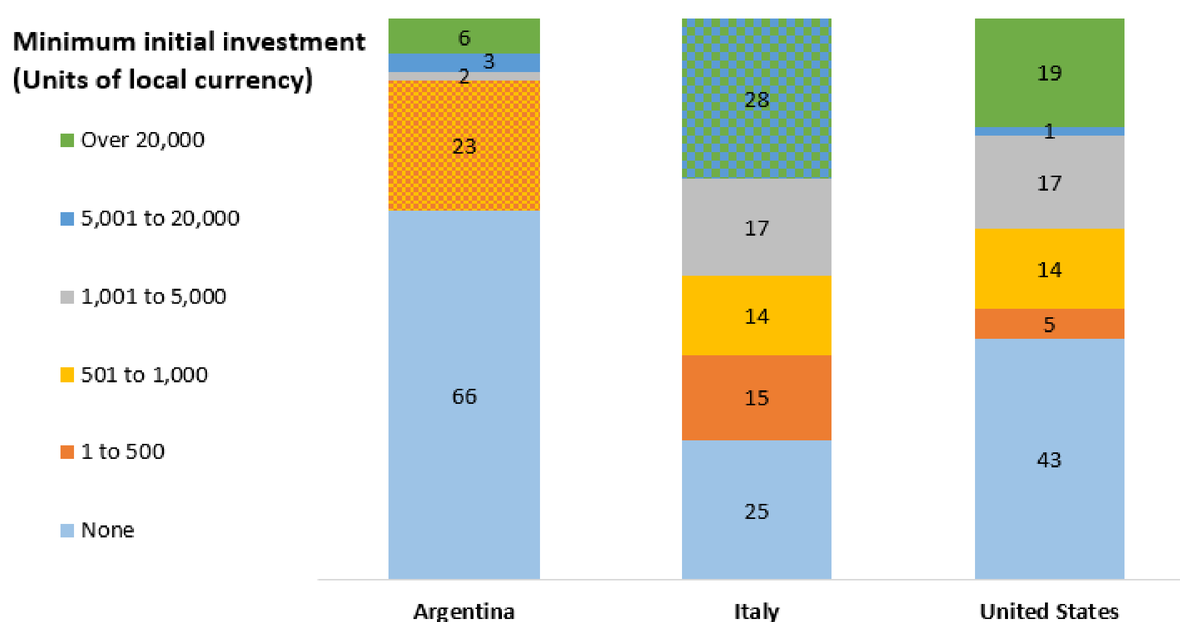
Investment funds help to democratise investing. Fund investors hail from all age and income groups, and those saving for retirement may make recurring incremental purchases over time (e.g., as they receive their monthly pay checks). Importantly, most investment funds today are available to all savers, including individual savers with modest savings. Investment funds, particularly mutual funds, generally do not have minimum investment thresholds and where they do, these thresholds tend to be low.

In the **United States**, 43% of mutual fund share classes have no minimum initial investment thresholds, while 19% have reported minimum initial investment thresholds of less than $1,000 (Figure 3.8). When an investment is made through a 401(k) plan or another

workplace contribution plan, however, any minimum is waived entirely. Similarly, IRA investors setting up ongoing contributions into an IRA investing in mutual funds may find the minimum investment amount waived.

Most mutual funds in **Canada** require a minimum initial investment of C$500, although the minimum can be as low as C$100 for some funds. For additional investments in pensions, the minimum is often C$50, although it can be as low as C$25.

Figure 3.8
Low Minimum Investment Requirements Make Mutual Funds Accessible to Investors
Percentage of mutual fund share classes by minimum initial investment



Note: Thresholds for Italy are based on € cut-offs; data are based on Morningstar data for 2018. Data for the United States are for 2020.

Sources: Camara Argentina de Fondos Comunes de Inversion; ASSOGESTIONI tabulation of Morningstar data; and Investment Company Institute

Nearly two-thirds of mutual funds sold in **Argentina** have zero minimum investment thresholds, another nearly one-quarter have minimum investment thresholds of 1,000 pesos or less (Figure 3.8). In **Italy**, one-quarter of funds have no minimums, and a further 29% of funds have minimums of less than €1,000 (Figure 3.8). Several jurisdictions report that there are generally no minimums (e.g., **Chile, Mexico, Switzerland, United Kingdom, Australia, China** and **Korea**) or low minimums (e.g., **Germany, Norway, Sweden** and **Malaysia**).

For many investment funds in **Japan**, the minimum amount is set at around ¥10,000 (about $100). It is also possible to buy funds in Japan through monthly investments, with amounts

of ¥5,000, ¥1,000 or even ¥100 (about $1) allowable. In this way, even young people with very low incomes and cash savings can start investing for retirement.

Many channels for buying investment funds

There are many channels for buying investment funds, and these channels vary by country. Today, it is usually a simple process to buy and sell investment funds, with a rising trend toward direct market or online distribution.

In some countries, investments funds are mainly bought directly from investment firms. In others they are mainly bought via a customer's high street bank—for example, in Continental **European** countries (Figure 3.9). Banks tend to leverage their customers' current accounts to offer them additional services, such as investment funds and pension products.

Other distribution channels are expanding in many jurisdictions. In a growing number of countries, a range of intermediaries, such as financial consultants and retail brokers, are the main conduit from individuals to investment funds—for example, in **Korea** and the **United States** (Figure 3.9). Financial advisors merit mention as distribution channels in **Canada**, the **United States**, **Italy**, and increasingly in **Germany**. In some countries, retirement plans are an important distribution channel—for example, in the **United Kingdom** and the **United States**.

Figure 3.9

Mutual Fund Investors Purchase Mutual Funds Through a Variety of Channels

	Brazil	Canada	Mexico	United States
		Percentage of mutual fund assets		Percentage of mutual fund-owning households*
Securities Firms			Some	
Banks	Mainly	37	Some	17
Financial Institutions			Some	47
Financial Advisors		25		22
Full-service Brokerage		23	Some	26
Private Wealth Management		9		
Insurance Companies			Some	9
Direct Market	Some	6		31
Retirement Plan/Pension Scheme				83
Other				7

	Austria	Germany	Greece	Italy	Norway	Sweden	Switzerland	United Kingdom
	Percentage of investment funds			Percentage of investment funds				
Securities Firms					Small		Some	
Banks	90	Mainly	Some	70	Mainly	Mainly	Mainly	
Financial Institutions								Some
Financial Advisors		Some		30				
Full-service Brokerage								
Private Wealth Management								
Insurance Companies		Small	Some			Some		Some
Direct Market		Small	Some		Some	Some		
Retirement Plan/Pension Scheme						Some		Mainly
Other	10							

	Australia	China	Japan	Korea	Malaysia
			Percentage of assets	Percentage of assets	
Securities Firms		Some	73	55	Some
Banks		Some		40	Some
Financial Institutions			27		
Financial Advisors	Some	Some			Some
Full-service Brokerage					
Private Wealth Management					
Insurance Companies		Some		2	
Direct Market	Some	Some	1		
Retirement Plan/Pension Scheme	Mainly				
Other				4	

* Multiple responses are included.

Source: IIFA Role of Investment Funds Survey

Household survey data from the **United States** highlight the great number of channels to purchase funds, ranging from full-service brokers or financial advisers to online platforms directly through mutual fund companies or discount brokers. It is common to see the use of multiple channels by the same household. In 2020, 83% of mutual fund–owning households had mutual funds in their employer-sponsored retirement plans, 63% owned mutual funds outside retirement plans at work, and 46% owned both inside and outside of work-based plans. Indeed, 47% of US mutual fund–owning households held funds through financial institutions, such as full-service brokers and financial advisers, and 31% held funds directly at mutual fund companies or discount brokers (Figure 3.9).

Many investors own multiple investment funds

Investment funds offer diversification within an individual fund as well as across funds. Some funds, for example lifecycle or target date funds, are designed so that the investor only need to invest in one fund, providing a mixed portfolio diversified both across stocks

and fixed-income investing. Across investment funds, investors can build their own combinations of separate stock or fixed-income funds to diversify their asset allocations.

Many investment fund investors hold multiple funds. In **Italy**, 42% of fund investors hold two or more funds (Figure 3.10). In the **United States**, 82% of mutual fund–owning households hold two or more mutual funds, with 52% holding four or more mutual funds (Figure 3.10).

Figure 3.10
Many Investment Fund Investors Hold Multiple Funds
Percentage of investment fund investors or mutual fund–owning households

Number of Mutual Funds	Italy	United States
1	58%	18%
2	20%	17%
3	9%	13%
4 to 6	10%	26%
7 to 10	3%	11%
11 or more	1%	15%
Median # funds	1	4
Mean # funds		7
Unit	Investors	Households
Year	2019	2020

Source: IIFA Role of Investment Funds Survey

3.4 The investment fund industry is robustly regulated

One of the key ways that investment industry risk is managed is through regulation.

Disclosure and transparency

All financial markets have regulators which control market behaviour and protect consumers. Some regulators are independent from governments; some are under governmental control via the central bank.

Some countries have a number of financial regulators, each assigned to a different part of the financial system, while other countries have a single regulator overseeing all financial activities. Some regulators are regional, as is the case with the European Union, but all countries also have their own domestic regulator.

Some regulators are very prescriptive and put every aspect of the fund industry under the microscope, while others are largely principles-based, putting the onus for fair behaviour on market participants.

Regulators' role is to prevent poor outcomes for investors by monitoring market structure and behaviours. They also increasingly encourage new investment structures and strategies

so that investment firms they regulate can compete successfully with those from other countries.

In some countries, regulators are mainly there to guide firms, but in others, regulators have sizeable powers and are able to warn, fine and prosecute firms and individuals for behaviour which is to the detriment of investors. Regulators with substantial powers can stop a business, restrain practices, and even remove employees from certified industry lists.

Case Study: Korean fund regulation reflects a mature investment industry

*In **Korea**, funds are a mature industry and highly professionalised. Publicly-offered funds are subject to comprehensive regulations, similar to those seen in many countries with well-developed funds industries.*

- ***Professional management.*** *Only registered professionals qualified by the Korea Financial Investment Association (KOFIA) are allowed to manage funds.*
- ***Diversification****. In mutual funds, investment should not exceed 10% in a single asset class and 20% in a single company.*
- ***Transparency and disclosure****. Sales reports, the settlement of accounts of funds and audit reports must be submitted to the Financial Supervisory Service and KOFIA.*
- ***Valuation and liquidity****. Valuation of fund assets should be done based on fair value and investment managers must operate a committee for the assessment of fund assets.*
- ***Safekeeping of fund assets****. Third parties such as banks are responsible for the safekeeping and custody of fund assets.*
- ***Fund governance****. An investment company must have one corporate director and two or more supervisory directors. A corporate director should oversee payment management remuneration, custody of assets, distribution of stocks and other matters important to the operations of an investment company. A supervisory director must oversee the business affairs executed by a corporate director.*
- ***Compliance and regulatory oversight****. A compliance officer is responsible for monitoring the internal control system. The compliance officer establishes and enforces basic procedures and standards (internal control standards) that employees should observe.*
- ***Internal control****. A comprehensive system is required for the control of an organization including internal audit, compliance monitoring, constructing a controlled environment, risk assessment systems, control activities, and systems for communication and information. Fines of up to Won50 million can be imposed on firms that have not established adequate internal controls.*
- ***Audit****. Auditors should be appointed at a general meeting of shareholders. Auditors can request to audit the performance of duties by directors, survey business affairs and the status of the company and ask directors to report on sales. A company should establish an audit committee that replaces a full-time auditor when its assets under management exceed Won5 trillion. An audit committee must be composed of three or more directors.*

Funds offer easy-to-understand disclosure

One of the ways regulators act is to ensure that investors do not put their money into investments which they do not understand. Like many countries, **Chile** distinguishes between investments that are designed for professional investors and investments for ordinary investors. It demands that a mutual fund for retail investors must not invest more than 50% of its assets in securities with low liquidity, must not own more than 30% of the shares or bonds of a single issuer, and cannot own more than 25% of the debt of Chile or of a foreign state. In addition, they are not allowed to control an issuer of securities, or borrow more than 20% of the value of the assets in a fund.

A key role of regulators is to create transparency and disclosure in investment funds so that investors can see how their investments are being managed, the value of their investments, the risks that are being taken, and so on. Transparency and disclosure are essential in maintaining the trust of investors.

Concise, accessible summaries of investment fund information are found in many, but not all, countries.

In the **United States**, the regulator recognized that the full legal disclosures might be overwhelming for investors and allowed summary documents to present key information to fund shareholders. The summary prospectus in the United States provides key information in a short document for fund shareholders.

In **Europe**, the information contained in a fund prospectus is comprehensive and is a key disclosure document. But this document can also be very technical to read for retail investors. To help investors, investment firms in Europe must supply a condensed version of the prospectus called a Key Investor Information Document (KIID), which is a summary of the most important aspects of the fund. The KIID, a key form of disclosure in the European Union, must be updated monthly.

In **Japan**, continuous disclosure in publicly-offered investment funds is stipulated in the Financial Instruments and Exchange Act (FIEA). When launching an investment, investment firms must submit a securities registration statement to the authorities and a prospectus must be delivered directly to investors. If there is an important change to the prospectus at any time, a correction statement must be submitted.

In addition to disclosure under the FIEA, a report must be prepared for each calculation period and delivered to beneficiaries. The report must describe the performance and progress of operations during the calculation period, and the holding status and trading status of securities. Assets and liabilities, principal and net asset value, and profit and loss during the period must all be published too.

Keeping assets safe

The physical safety of paper and electronic securities certificates must be assured. The safekeeping of investors' assets is often referred to as "custody" in the investment industry.

A custodian is a bank that holds financial assets for safekeeping to minimize the risk of theft or loss. Investment advisors in most parts of the world are required to hire a custodian to safeguard the assets they manage for their clients. These assets may be stored in physical form, but today most are held electronically, allowing for easy and rapid transfer of cash and securities.

Custody is so important to the integrity of the investment industry, that rules for custodial banks tend to be highly prescriptive. In **China**, for instance, commercial banks wishing to be a fund custodian must be approved by the securities regulatory agency of the State Council together with the banking regulatory agency of the State Council. If approvals are granted, the bank has to meet stringent requirements, including:

- The net assets and risk control indicators must meet relevant regulations
- The bank has a discrete fund custodian department
- The number of staff who have obtained the qualifications for fund practice should meet minimum requirements
- There are safe and efficient liquidation and delivery systems
- Business premises, security facilities and other facilities related to fund custody business must meet requirements
- The bank must have an internal audit monitoring system and risk control system

Financial regulators look for any potential breaches of security or conflicts of interest in custody arrangements. The stringent demands made of custody banks in **Germany** typify this approach. The German regulator demands that custody of fund assets is strictly separated from the assets of investment management companies and the custodian. Neither creditors of the investment management company nor creditors of the custodian may have access to the fund assets. The custodian itself does not make decisions about disposition of fund assets, but acts on instructions from the investment management company. In addition, the investment management company may not take out loans or invest assets in their bank accounts without the consent of the custodian.

3.5 Investment industry is highly professional

The fund industry is professionally managed. That's to say, the vast majority of investment managers and other industry professionals have recognised qualifications which facilitate expert investment management, and good operational management too. In other words, they are skilled in asset selection and allocation, and also in providing efficient and fair service.

Duty owed to funds

Fund advisers act as "stewards" of their clients' assets: their value proposition is to offer the opportunity to invest in a pooled investment vehicle, which is managed consistent with its stated investment objectives.

Fund advisers have a fiduciary duty to the fund. In the **United States**, in addition to the system of oversight applicable directly to funds, investors enjoy protections through regulation of the investment advisers who manage fund portfolios. All investment advisers to registered funds are required to register with the US Securities and Exchange Commission (SEC) and are subject to SEC oversight and disclosure requirements. Investment advisers also owe a fiduciary duty to each fund they advise, meaning that they have a fundamental legal obligation to act in the best interests of the fund. Similarly in **Europe**, UCITS' managers owe a fiduciary duty to fund shareholders.

Case Study: Japanese investment managers have duties of "sincerity" and "loyalty"

*Under the securities regulations in **Japan**, investment funds have a "Duty of Sincerity to Customers," which means that an investment trust management company, its officers and employees must conduct their business activities in a sincere and fair manner to customers.*

Additionally, investment trust managers also owe a "Duty of Loyalty and Duty to Exercise Reasonable Care," which means that when conducting business activities, an investment trust management company must be loyal to beneficiaries and must exercise reasonable care.

Prudent investing standards

The "Prudent Person" rule is widely adopted across the investment industry and helps to ensure that clients obtain the best possible returns at an acceptable level of risk. The prudent-person rule is a principle which ensures that asset managers are "prudent" and seek the same ambitions for the enhancement and preservation of their clients' capital as they would for their own portfolio.

Many countries prescribe how managers should act for their clients, and how investment firms are set up and governed. In **China**, for example, the capital of an investment firm must not be less than Rmb100 million. The firm must have named senior management personnel and as well as staff engaged in research, investment, valuation, marketing, and so on, as stipulated by the administrative regulations and the China Securities Regulation Commission (CSRC). There must be no less than 15 members of senior management, and all workers must have a qualification to practice in the fund industry.

Furthermore, the firm must have internal control systems such as supervision, audit, and risk management that meet the requirements of the CSRC.

In addition, publicly-offered investment funds must follow strict and professional operating standards. The Administrative Measures for the Operation of Publicly-offered Securities Investment Funds, issued by the CSRC, make requirements on the raising of funds, the purchase, redemption and trading of fund shares, the investment of fund assets, the distribution of returns, the convening of fund shareholders' meetings and other fund operation activities.

Case Study: Luxembourg an early adopter of fund professionalization

***Luxembourg** is one of several jurisdictions viewed as an international fund hub. A fund hub is a country which has the investment infrastructure to serve both domestic investors and foreign ones too. Many fund management companies set up in Luxembourg and distribute their products across Europe and all over the world, using fund structures developed in Luxembourg. Other fund hubs include **Ireland, , Singapore** and **Hong Kong**.*

Since the international funds industry is important to the economy of Luxembourg, the Grand Duchy has been enthusiastic in its efforts to professionalise the industry through helping to develop EU-wide fund structures such as UCITS and the AIF. All UCITS based in Luxembourg (and throughout the EU) must have a depositary, an administrator and an independent auditor. The assets in a UCITS fund must be separated from the assets of the depositary, which means there is no counterparty risk to the depositary. The UCITS Directive sets out precise requirements for how the funds are sold to the public:

- ***Documentation and transparency**: A fund prospectus sets out the operation of the fund, investment objectives and policies, risk factors, parties involved, valuation rules, and how to buy and sell shares. Financial statements must be published semi-annually and annually. The fund must publish a Key Investor Information Document (KIID) which provides the investor on two pages the essential elements of the fund.*
- ***Eligible assets**: A UCITS fund must invest in transferable securities and other liquid assets. Uncovered short sales and borrowings are not permitted, nor are precious metals.*
- ***Valuation and liquidity**: UCITS funds and their management companies are subject to liquidity risk management requirements under which a UCITS must repurchase its units at the request of any unit-holder. Net Asset Value (NAV) must be calculated on each day there are subscriptions and redemptions.*
- ***Risk management**: There must be an adequate liquidity and operational risk management policy. A so-called risk management process statement (RMP) must be submitted to the regulator.*
- ***Oversight and safekeeping:** UCITS rules include oversight over delegates, subscriptions and redemptions, valuation of units, carrying out the UCITS' instructions, timely settlement of transactions, UCITS income distributions, cash monitoring, due diligence and the segregation of assets.*

Auditors help to ensure that investment firms' accounts are fair and accurate. Most countries demand that accounts are audited by third parties. In **Mexico**, for instance, an external independent auditor has to pronounce a legal opinion on financial reports.

In **Malaysia**, a registered scheme trustee must appoint an external auditor registered with the Audit Oversight Board. A scheme trustee must maintain an internal audit function independent from its operations to report directly to its board of directors on the adequacy, effectiveness and efficiency of the management, operations, risk management and internal controls.

In some cases, auditing is put in place to check that investment strategies are operating according to their mandates. In Malaysia, Shariah advisers of a Shariah/Islamic fund ensure that all aspects of the fund management business including the fund structure, investment and deed and disclosure documents are compliant with Shariah principles. A panel of advisers must be appointed for a fund that is expressed to be managed in accordance with specific principles.

In the **United States**, a fund's financial statements are subject to several internal and external checks. For example, annual shareholder reports must include financial statements audited by an independent certified public accounting firm subject to oversight by the Public Company Accounting Oversight Board (PCAOB). This ensures that the financial statements are prepared in conformity with generally accepted accounting principles (GAAP) and fairly present the fund's financial position and results of operations.

3.6 Competition and economies of scale drive down fund costs

Intense competition benefits investors

The investment industry is hugely competitive. This is a good thing: competition drives innovation, enhances choice, and reduces costs, to the benefit to investors, whether saving for retirement or other financial goals. Investment firms compete worldwide to manage savings, creating intense competition, which drives up standards and holds down costs.

As the world becomes increasingly global, competition intensifies. Regional and national authorities are opening up their markets to new competition, acknowledging that competition encourages innovation and creates better investment outcomes.

Take **Asia**, where the cross-selling of funds from one country to others is being encouraged through the creation of the Asian passport, which allows countries across Asia to buy and sell each other's funds.

The Asia Region Funds Passport (ARFP) is an initiative of the Asia Pacific Economic Cooperation (APEC). The purpose of the ARFP is to support the development of an Asia-wide funds management industry through improved market access and regulatory harmonisation. The following countries have already signed up to the ARFP: **Australia**, **New Zealand**, **Japan**, **Korea**, and **Thailand**.

To an extent, the ARFP is modelled on **Europe**'s UCITS (Undertakings for Collective Investment in Transferable Securities) model, which has been operating successfully for more than 30 years. UCITS is the main European framework for collective investment schemes and accounts for around 75% of all fund investments by small investors in Europe.

In creating a set of common rules and regulations, UCITS allows funds to be authorised in one state and sold freely in all other EU states. Because of their long-established and well-honed rules, UCITS funds are also in demand outside the EU and thereby provide a scalable and flexible distribution structure for global investment managers.

Similar to UCITS is the Alternative Investment Fund Managers Directive (AIFMD), an EU framework for the regulation and oversight of alternative investment fund managers (AIFMs). Like the UCITS Directive for retail funds, the AIFMD enables alternative investment funds (AIFs) authorised in one member state to be sold to professional clients across the whole of the EU using a marketing "passport".

Scale allows greater access to investments and lowers fees

Investing via funds pools the money of many investors in one portfolio and is usually a lot more cost-effective than investing as an individual. Because of its size, the investment industry can pool the combined assets of individual investors and invest these assets as if they belonged to one, large financial institution. In this way, asset managers allow investors to gain access to a wider range of investments than would be available to investors on their own.

As an example, investors with smaller amounts of capital cannot directly access the **Malaysian** Government Securities market, where the amount of each transaction can be in millions of Ringgit. Fund management companies have ready access to this market because of the large amount that they can invest in a single transaction.

The pooled arrangement also means that investments can be sourced in bulk, so they are often much cheaper than individuals could achieve by investing on their own. A recent study by **Australia**'s Productivity Commission found that economies of scale were a major contributor to cost reductions in the retirement system. Its analysis revealed that significant economies of scale have been realised in the superannuation system over the past 13 years, particularly for administration expenses. Holding constant other cost drivers, increases in scale are estimated to have generated cost savings of about A$340 million each year (on average), amounting to A$4.5 billion ($3.5 billion) in incremental gains since 2004. As a percentage of assets, the reported fees **Australia** superannuation members pay have fallen since the global financial crisis — from 1.3% in 2008 to 1.1% in 2017.

Fees can be compared across the world by looking at expense ratios. Expense ratios are the annual fee that all funds charge their shareholders. They express the percentage of assets

deducted each fiscal year for fund expenses such as management fees, administrative fees, and operating costs.

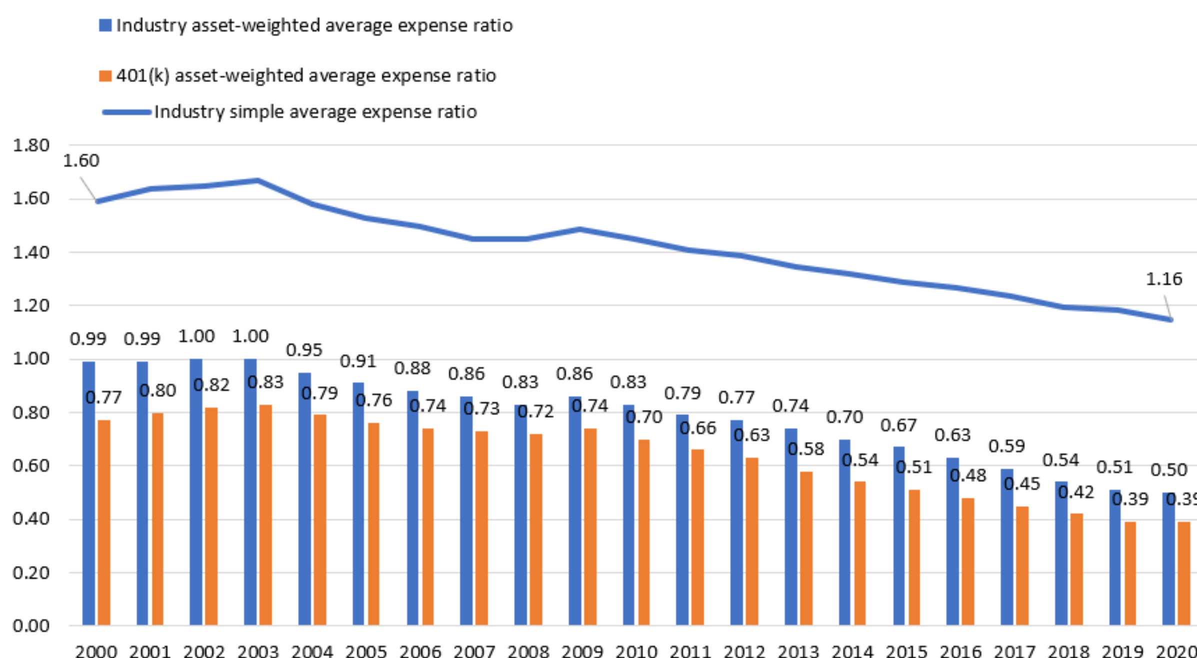
Case Study: Market pressures drive down US mutual fund fees

*The **United States** is one of the most competitive investment markets in the world. US mutual funds not only compete among themselves, but with other products. Outside of employer-sponsored retirement plans, mutual funds compete directly with ETFs. Within employer-sponsored retirement plans, although mutual funds represent the majority of DC plan assets, other pooled investments compete with mutual funds, most notably, collective investment trusts and separately-managed accounts. These competitive pressures, as well as economies of scale and cost-conscious investors, drive mutual fund fees and expenses down.*

Additionally, US mutual fund investors have increasingly chosen to pay for distribution and advice externally (out of pocket) rather than through the fees and expenses charged by the fund. Seventy-two percent of US mutual funds' total net assets at year-end 2020 were in "no-load" share classes, where any payments for the services of a financial professional largely occur outside of the fund. Some of these no-load share classes may include a 12b-1 fee—part of which may pay for the cost of distribution—but the vast majority of net assets in no-load share classes in the United States have no 12b-1 fee.

Reflecting all of these forces combined, asset-weighted average expense ratios incurred by equity mutual fund investors in the US have fallen from 0.99% in 2000 to 0.50% in 2020 (Figure 3.11).

Figure 3.11
Mutual Fund Fees and Expenses Have Fallen over Time in the United States
Fund expense ratio for equity mutual funds; percent of assets



Note: The equity funds analyzed in this figure encompass: diverse investment management styles (e.g., active and index); a range of general investment types (e.g., growth, sector, alternative strategies, value, blend, and world); and a variety of arrangements for shareholder services, recordkeeping, or distribution charges (known as 12b-1 fees).

Sources: Investment Company Institute, Lipper, and Morningstar; see “Trends in the Expenses and Fees of Funds, 2020,” *ICI Research Perspective* (https://www.ici.org/pdf/per27-03.pdf) and "The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2020," *ICI Research Perspective* (https://www.ici.org/system/files/2021-06/per27-06.pdf)

Average equity mutual fund expense ratios incurred by 401(k) investors also have declined, falling to 0.39% in 2020 (Figure 3.11). Several factors contribute to the lower average expense ratios incurred by 401(k) plans investing in mutual funds. Among them are: (1) competition among mutual funds and other investment products; (2) plan sponsor decisions to cover a portion of 401(k) plan costs, which allow them to select lower-cost investments; (3) economies of scale, which large investors such as 401(k) plans can achieve; (4) cost- and performance-conscious decision-making by plan sponsors and plan participants; and (5) the limited role of professional financial advisers (who charge fees) in these plans.

Fund fees have tended to fall across multiple jurisdictions over time, reflecting competition, innovation, and regulatory changes.

For example, in **Malaysia**, the advent of online investment platforms has lowered fees. Investments in approved schemes which are made via the EPF i-Invest online platform have a sales charge capped to 0.50% of the value of the transaction.

By asset class, **Australia**'s asset-weighted median expense ratios are 0.90% for allocation funds (or multi-sector funds), 1.23% for equity funds, and 0.60% for fixed-income funds.

In **Chile**, fees have fallen across most fund investment types in the last decade. For example, the simple average fund fees for balanced funds in Chile fell from 1.83% in 2009 to 1.43% in 2019 (Figure 3.12).

The Securities and Exchange Commission of Brazil (CVM) in 2017 initiated the Strategic Project for Cost Reduction of Regulatory Compliance. The initiative aims to progressively reduce the cost of compliance among capital market participants in **Brazil**. With the costs of regulatory compliance lower, service providers can offer products with more attractive fees to investors.

In **Mexico’s** AFORE products, the average commission rate was 1.68% a decade ago, dropping to 1.18% five years ago and today averages 0.98%, a significant improvement (Figure 3.12).

The downward pressure on mutual fund fees in **Canada** has intensified since the beginning of 2015. A total of at least 30 firms have reduced their fund pricing. And it is not just investment management fees and administration fees which are falling, as some firms have moved to lower trailer fees. Overall, firms reducing fees account for nearly 90% of total mutual fund assets.

In Canada, fees vary by investment objective and by series (e.g., commissioned-based, high net worth, fee-based, DIY). For example, the fee-based series, long-term funds' management expense ratios have fallen from 1.13% in 2010 to 0.91% in 2019 (Figure 3.12).

Also in Canada, the CSA undertook a multi-year research project to assess what investors think and know about fees. The survey found many improvements in the investment industry. Almost all investors (91%) reported receiving a statement of either performance or cost of their investments. A large majority of the investors reported that they have an “excellent” or “good” understanding of the information included in their costs or performance statements, including market value, overall rate of return, records of transactions, and the direct and indirect fees they pay.

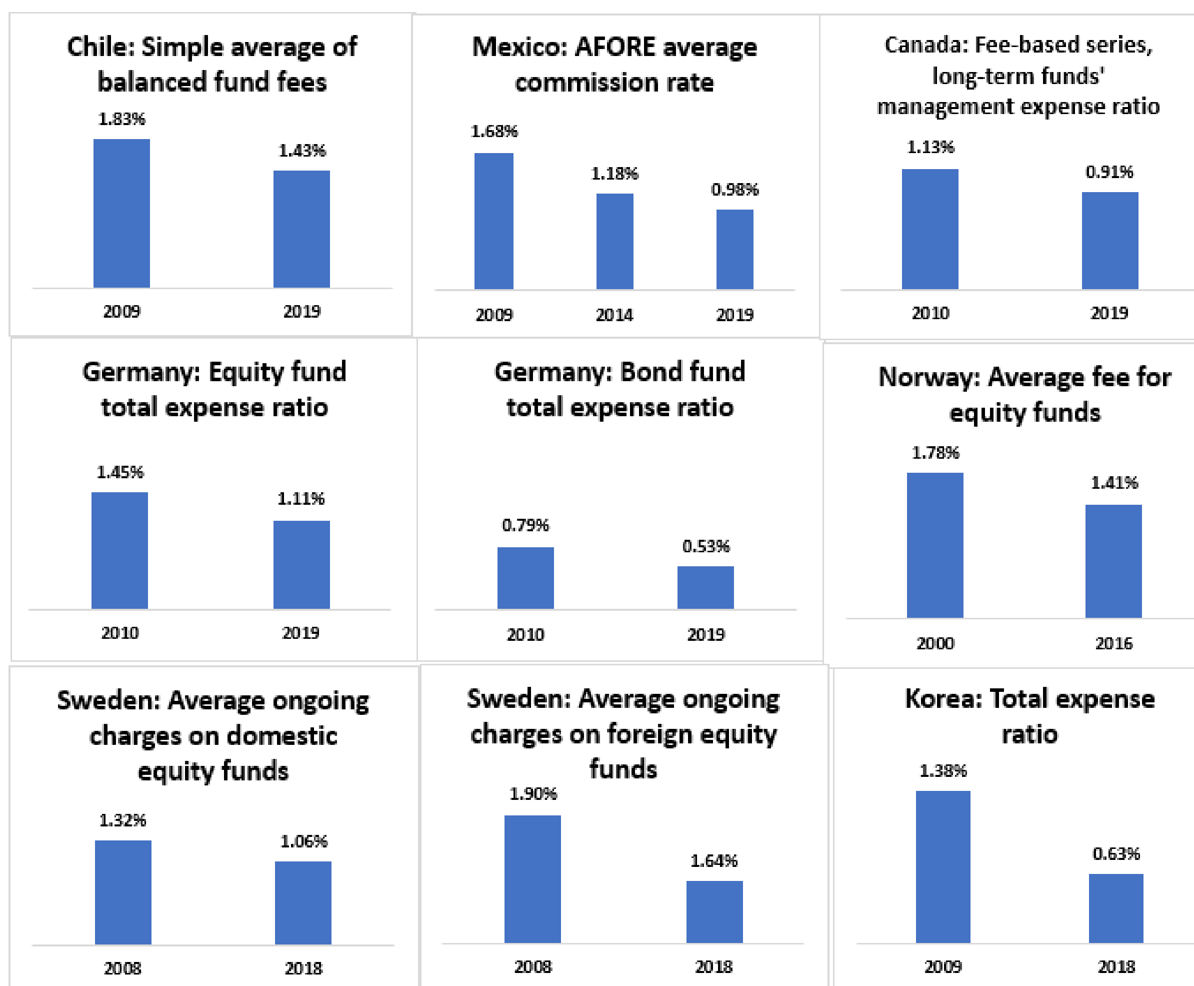
In **Germany**, equity fund charges decreased to 1.11% in September 2019, down from 1.45% in 2010 (Figure 3.12). Meanwhile, bond funds only charged 0.53% (versus 0.79% in 2010). Economies of scale have had an impact, but other drivers are the strong take-up of ETFs (which have relatively low management expense ratios), as well as the low interest rate environment, which reduces the attractiveness of bond funds.

The average fee for equity funds in **Norway** has fallen by 21% from 1.78% in 2000 to 1.41% in 2016 (Figure 3.12). And, in **Sweden**, average ongoing charges have fallen for both Swedish equity funds and foreign equity funds sold to Swedish investors (Figure 3.12).

All DC workplace schemes in the **United Kingdom** are required to offer a default investment strategy as part of automatic enrolment and this strategy is subject to a maximum charge of 0.75%. The vast majority of UK pension scheme members opt for the default strategy (rates of 90%+ are common). As a result, investment managers are focused on selling funds intended to be part of the default strategy, and keep fees correspondingly low as a result.

In **Korea**, the total expense ratio (TER), a measure of costs incurred by investors, has fallen steadily in the last 10 years—average industry-wide fees in Korea are substantially less than a half the level of a decade ago (Figure 3.12).

Figure 3.12
Investment Fund Fees Have Tended to Fall over Time



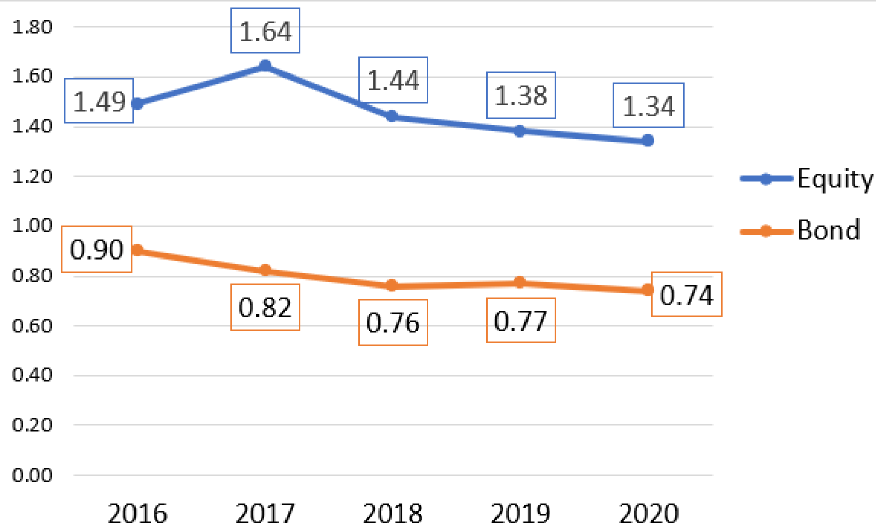
Source: IIFA Role of Investment Funds Survey

Note: Fund charges across countries are not directly comparable because not all countries include the cost of investment advice in their data.

In **Europe**, UCITS also have seen declining fees. The costs of equity funds decreased by 11% between 2016 and 2020 (from 1.49% to 1.34%), while the costs of bond funds declined by 18% (from 0.90% to 0.74%) (Figure 3.13).

Figure 3.13
UCITS Fees Have Fallen

Ongoing charges; percent of assets



Source: European Fund and Asset Management Association (EFAMA); *EFAMA Fact Book 2021*

Lower fees are not necessarily an indication that an investor is getting better value for money. As in every other sphere of economic life, value for money lies somewhere at the intersection of quality and cost. However, fees are important, and competition has ensured they have fallen considerably over recent decades and are still decreasing now.

3.7 Investment funds help investors across all age and income groups achieve their financial goals

There is huge evidence showing that the sooner people start saving for retirement the less they have to contribute over their lifetimes and the more retirement income they can expect to receive. However, the focus of saving changes over an individual's life and saving is often not a priority for younger people. In 2019, only 11% of **US** households in their twenties reported that retirement was their primary savings goal, compared with 44% of households aged 55 to 64.[13] Younger households typically are focused on other goals: education, homes, or other large purchases.

Given this lifecycle of saving, it is not surprising that fund investors tend to be in their prime earnings and savings years, with older investors having accumulated considerably higher assets.

[13] Tabulations of Federal Reserve Board, Survey of Consumer Finances data; see Figure 8.2 in *2021 Investment Company Fact Book*; available at https://www.icifactbook.org.

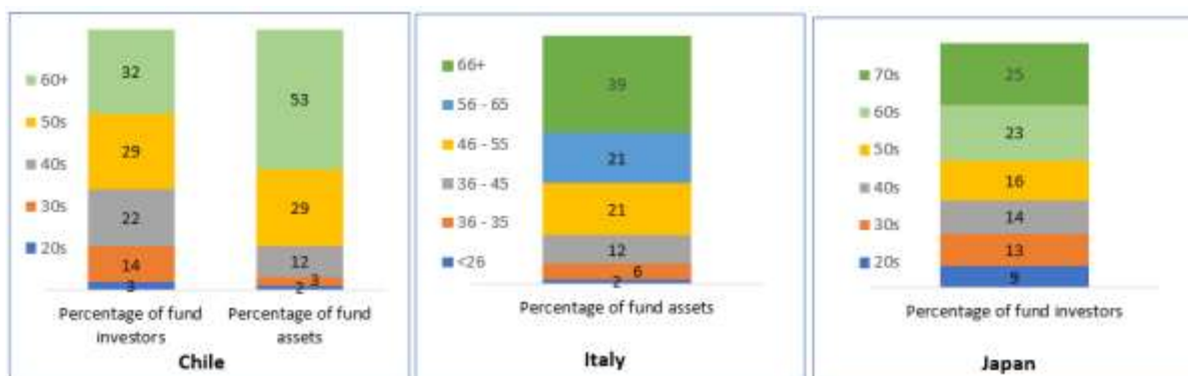
In **Chile**, reflecting the maturity of the pension system, which has been funded since the 1980s, Chileans display a similar lifecycle of saving for retirement—with workers in their prime earning and saving years representing the largest share of Voluntary Pension Savings (Ahorro Previsional Voluntario, or APV) investors. According to research by the regulator, most investors in APV funds, the voluntary retirement plan, are between 40 and 60 years old. This group accounts for 51% of all APV investors and 41% of the assets under management in APV funds (Figure 3.14).

Reflecting the power of compounding and the length of time older retirement savers have been accumulating assets in the system, older APV investors hold the lion's share of the assets. Investors under the age of 40 own just 5% of APV fund assets, compared with the over-60 age group, which owns 53% of all APV fund assets (Figure 3.14).

In **Italy**, investors also come from all age groups and the impact of compounding accumulations can be seen. In 2018, 2% of investments in Italy were held by individuals younger than 26, while 39% were held by people aged 66 and older (Figure 3.14).

In **Japan**, fund investors are spread more evenly across the entire age distribution. More than one-fifth of fund investors are young—in their twenties or thirties—and one-quarter are in their seventies (Figure 3.14). Another 30% are in their prime earnings years—their forties and fifties—and the remaining 23% are in their sixties.

Figure 3.14
Fund Investors By Age Group



Source: IIFA Role of Investment Funds Survey

In the **United States**, while early-career investors are as likely to own mutual funds as late-career investors, late-career investors have accumulated a larger share of fund assets, as might be expected. In 2020, 47% of US households younger than 40 owned mutual funds, compared with 54% of US households aged 40 to 55, 44% of US households aged 56 to 74, and 30% of US households aged 75 or older.

Similarly, **Germany** has age democratisation in its fund ownership, with younger people nearly as likely as older people to own investment funds.

Likewise, in **Mexico**, retirement savings programs have introduced workers of all ages to fund investing. The savings into AFORES represent all age groups (see Figure 2.2 in “Case Study: Mexico embraces DC”, in Section 2.1, above).

Fund investors from all income groups use funds to reach important financial goals. Whereas in order to have the ability to save, a household needs enough income to more than cover day-to-day living expenses, investing tends to become more prevalent as households’ incomes rise.

Additionally, when saving for retirement, it is important to understand the role of the government pension in each jurisdiction to understand the extent to which lower-income individuals need to save and invest to supplement the payments they will receive from government programs.

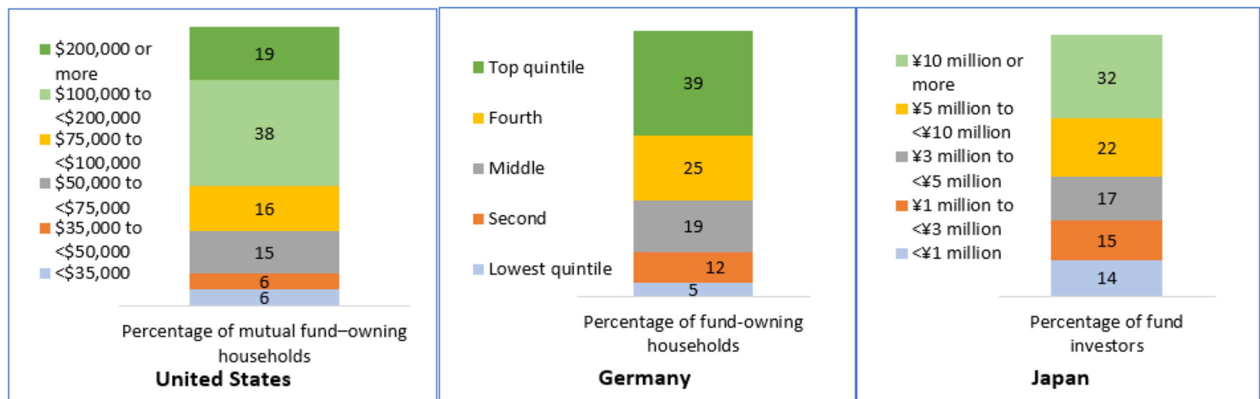
In the **United States**, households of all income levels invest in mutual funds, but mutual fund ownership rates tend to rise with household income. The median household income among mutual fund–owning households is $105,000 compared with $65,000 across all US households. In 2020, 43% of mutual fund–owning US households had household income of less than $100,000 in 2019 (Figure 3.15), another 38% had household incomes between $100,000 and less than $200,000, and 19% had incomes of $200,000 or more.

A majority of mutual fund–owning US households (63%) were introduced to fund investing through retirement plans at their workplaces, which highlights the important role that employer-sponsored retirement plans can play in promoting saving and investing across a wide income range.

The share of households owning long-term investment funds is split across all income levels in **Germany**, but tilts somewhat towards the middle classes and higher income groups. In Germany, 17% of fund-owning households have household income in the lowest two-fifths of the national household income distribution, while 39% of fund-owning German households are in the top fifth of German households (Figure 3.15).

In **Japan**, too, a similar pattern emerges (Figure 3.15).

Figure 3.15
Individuals Across the Income Distribution Invest in Funds



Note: In the US and Japanese figures, income is household income. In the German figure, income is nationwide household income quintiles.

Source: IIFA Role of Investment Funds Survey (Investment Company Institute Annual Mutual Fund Shareholder Tracking Survey; Eurosystem's Personal Household Finance (PHF) survey; and Japanese Investment Trust Association 2019 Questionnaire on Investment Trusts: Summary of Survey Results)

Chapter 4. The rising role of investment funds in retirement saving

The returns generated by investment funds have proved substantially higher over the long term than bank deposits and government bonds, which is why the investment industry has become the rock on which many pension systems are built. Funds tend to be diversified across stocks and bonds, often within balanced, or mixed, asset strategies. The types of investments chosen by plans vary depending on cultural factors, financial market structures, member profiles and the underlying economy. A default investment strategy is a key component of pension plans, ensuring sound choices for people who are unable to make their own investment decisions.

Funded pensions, whether defined benefit (DB) or defined contribution (DC) in design, need investments. In the case of funded DB plans, or supplemental investments for government pension provision, typically the investments are directed by the plan. In the case of funded DC plans, individual plan participants often are given discretion over the investment of their accounts.

Thus, in funded DC pensions, investment funds play a central role: providing plan participants the opportunity to invest by providing access to capital markets. The returns generated by investing in capital markets via investment funds have proved far higher over the long term than saving through bank deposits or government bonds.

4.1 Investment funds have become the cornerstone of account-based pensions

Generating investment returns is the main goal of investment industry management. By investing in a range of securities, which provides diversified access to a wide array of market securities, asset managers can help savers to build stronger account balances to generate future retirement incomes.

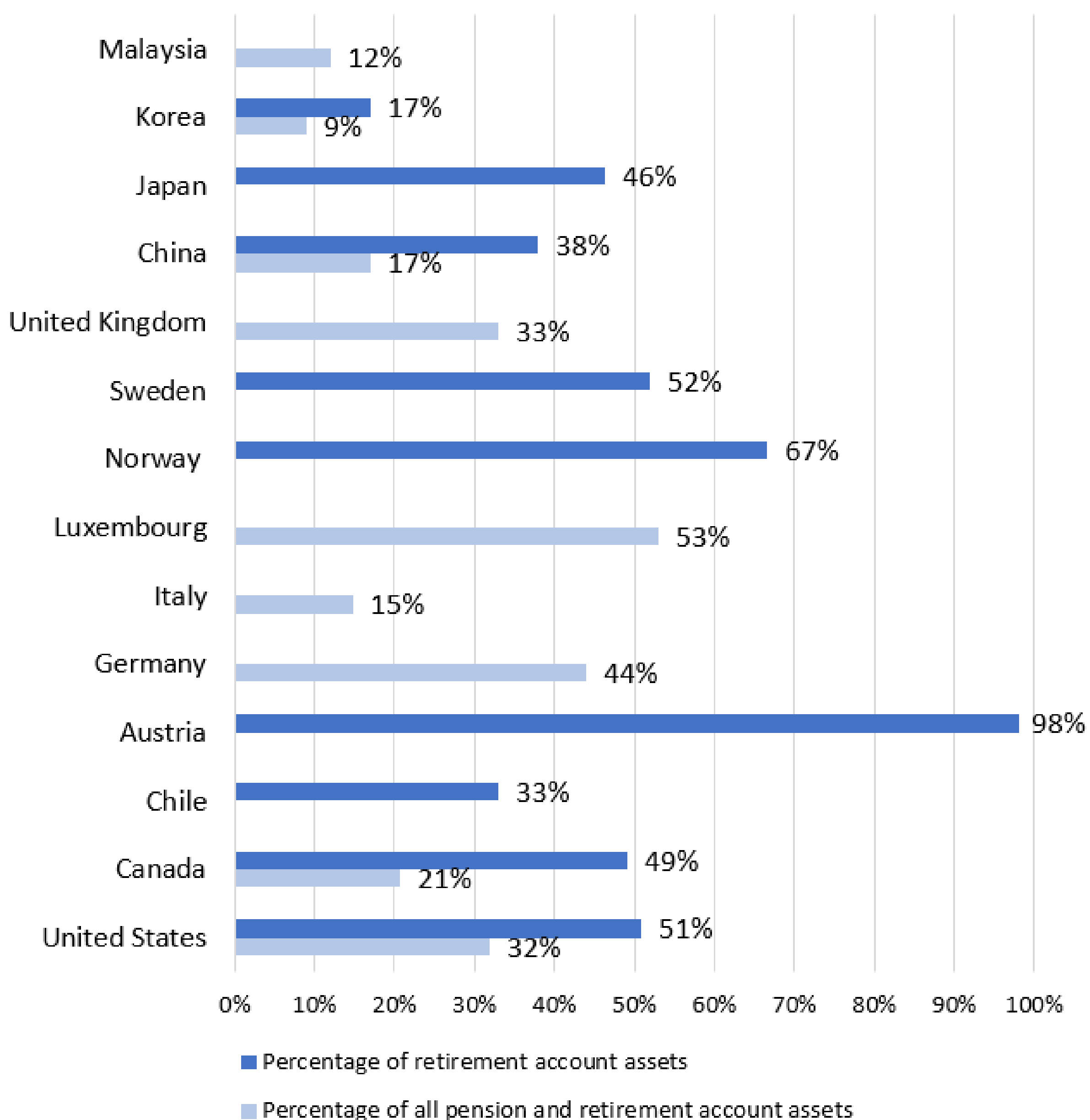
For this reason, the investment industry has become the rock on which many modern pensions systems are now built.

In the **United States**, for instance, mutual funds are overwhelmingly used for account-based retirement savings. At year-end 2020, DC plan and individual retirement account (IRA) holdings of mutual funds amounted to about half (51%) of their total assets (Figure 4.1). This figure does not account for ETFs' share of the US retirement market.

In **Canada**, too, mutual funds are a major component of retirement schemes. For individual retirement plans, in particular, mutual fund assets investing predominantly in shares and bonds represent about half (49%) of their total assets (Figure 4.1).

In **Austria**, investment funds account for 98% of second pillar products, which are offered by special private institutions called *Pensionskassen* (Figure 4.1).

Figure 4.1
Investment Funds Play an Important Role in Retirement Plans
Percentage of country's retirement assets



Source: IIFA Role of Investment Funds Survey

Investment funds account for approximately 44% of total retirement assets in **Germany** (Figure 4.1). In addition to this, almost €1.2 billion of the assets channelled through other vehicles were invested in investment funds indirectly (as of mid-2019). The core vehicle for pension funds are *Spezialfonds*, which accounted for more than €1 billion.

In **Italy**, €18.2 billion of investment funds are held in the retirement system, of which €4.2 billion are held in Contractual Pension Funds, €4.2 billion in Pension Open Funds, €6.5 billion in Pre-Existing Pension Funds and €3.3 billion in new insurance-based personal pensions.

In **Luxembourg**, according to the regulator,[14] pension funds invest directly in bonds, but the majority are invested in funds. Over half (€316 million) of the assets in investment funds are exposed to equity markets, while €303 million is exposed to bond markets.

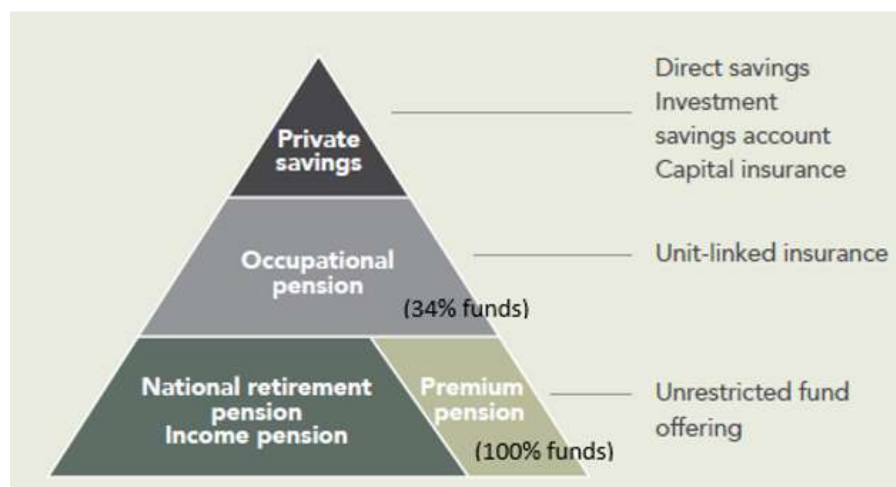
In **Norway**, funds play a dominant role in the second and third pillars of the retirement system. In the past 10 to 15 years, most Norwegian pension plans in the second pillar have changed from DB to DC schemes, with investment funds the main building blocks. DC schemes hold NKr300 billion ($36 billion) in total assets, according to Finance Norway, with investment funds managing about two-thirds of this (Figure 4.1). The third pillar's assets under management are small compared to the second pillar in size, but investment funds are the main investment tool for third-pillar individual investors.

Case Study: Investment funds are the backbone of Sweden's funded public pension system

*Funds also form a substantial part of **Sweden**'s pension system. The entirety of assets in Sweden's premium pension, the funded part of the country's basic universal pension is invested in funds (Figure 4.2). Swedish citizens receive information about the funded portion of their public pension through educational materials and the annual mailing of the "orange kuvert [envelope]," which discloses account information.*

Additionally, Investment funds also manage more than a third of occupational pension assets in Sweden (Figure 4.2).

Figure 4.2
Swedish Pension System Components



Source: IIFA Role of Investment Funds Survey

Popularity of funds is pervasive in Sweden, both inside and outside of the retirement system. More than three-quarters of Swedish adults with taxable income own funds (Figure 4.3). Nearly half (47%) of Swedish adults hold funds in their occupational pensions and nearly two-thirds (65%) have funds in their private savings. Sweden is particularly progressive in that two-thirds of Swedish children own funds.

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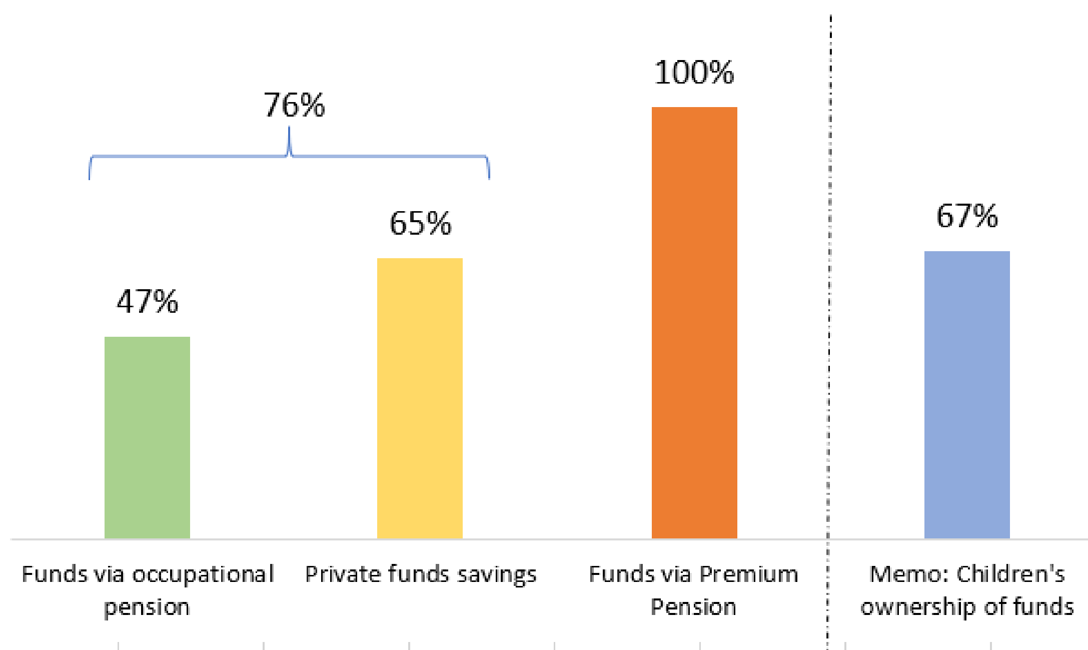
[14] CSSF Annual Report 2018

Figure 4.3
Essentially All Swedes Invest in Funds
Percentage of Swedish population age 18 to 76 with taxable income



Source: IIFA Role of Investment Funds Survey

In **China**, mutual fund management companies have become a leading force on the local pension landscape and have helped improve returns to investors. Chinese pension assets entrusted to mutual fund management companies at the end of 2018 was about Rmb1.7 trillion ($240 billion), or 17% of all pension fund assets (Figure 4.1). Mutual funds' share of investable assets is higher, 38%.

Assets managed by mutual fund management companies account for some 71.2% of the total assets of the National Social Security Fund (NSSF), the Chinese state-run pension fund. Since the NSSF started to allow investment managers to manage its assets in 2003, the NSSF has achieved an average annualized return of 15.76%, substantially higher than the rate available from risk-free assets over the same time period.

Mutual fund assets even manage some of the money in China's Public Basic Pension, which is a Rmb5.8 trillion ($830 billion) fund. The amount of assets managed by mutual fund management companies is Rmb271.3 billion ($39 billion), or 4.7% of the total.

In China's Rmb1.48 trillion ($210 billion) Enterprise Annuity Plan, the amount of assets managed by mutual fund management companies is Rmb517 billion (or $74 billion), around 35% of the total.

In **Korea**, investment funds account for few assets in DB schemes, but a much higher proportion of DC schemes. Collective investment funds make up 23% of Individual

Retirement Plans (IRP) and 15% of corporate DC pensions, or 17% of account-based retirement plans overall (Figure 4.1).

In **Japan**, investment funds account for 46% of all account-based retirement assets (Figure 4.1).

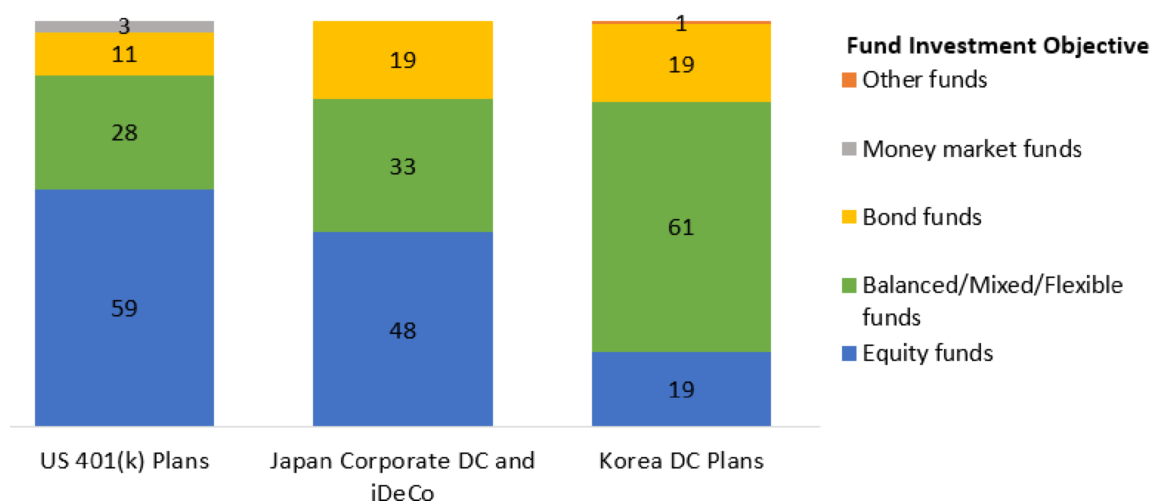
4.2 Fund investments held in retirement accounts are diversified for better return vs risk

Retirement savings that are invested in funds tend to be diversified across stocks and bonds, often within balanced/mixed/hybrid funds, as well as in multiple equity and bond funds.

Korea's pension plans, for instance, allocate to a wide variety of assets, with hybrid fixed-income investment funds most widely used in DC plans (56% of DC plans' investment fund holdings, included in Balanced/Mixed/Flexible in Figure 4.4). While Korean DB plans make a noticeable allocation to commodities funds (36% of their total fund investments), Korean DC plans do not (only 1% of their total fund investments; reported as "other" in Figure 4.4).

In the **United States**, 401(k) members have 59% of their mutual fund assets invested in equity, or stock, mutual funds and another 28% invested in balanced/mixed/flexible funds, which include target date funds (Figure 4.4).

Figure 4.4
Defined Contribution Fund Investors Often Invest in Equity or Balanced/Mixed/Flexible Funds
Percentage of mutual fund assets held in defined contribution plans



Source: IIFA Role of Investment Funds Survey

In terms of diversification, corporate DC funds in **Japan** hold a broad range of assets. Balanced investment funds are sought after in Japan for their diversification benefits and risk-return profiles. Japanese corporate-type DC plans and individual-type DC plans (iDeCo) hold nearly half of their fund investments in equity funds (48%) and one-third of their fund investments in balanced funds (33%) (Figure 4.4).

In **Australia**, superannuation investors can choose from different investment options such as balanced, high-growth and other options. These portfolios contain a wide mix of assets which are designed to match the risk profile of a different types of investors at different stages of their lifecycle and career.

The power of default strategies

The OECD Roadmap for the Good Design of Defined Contribution Pension Plans recommends the establishment of appropriate default investment strategies to ensure that people who are unable or unwilling to make a choice, are offered an investment strategy that is the most appropriate for most people, given the expected role of the DC pension arrangement within the overall pension system.[15]

The OECD also allows that different objectives for the default may exist, which may lead to different default investment strategies depending on the scheme. If the objective of the default is to encourage younger members to take on some investment risk and to protect people close to retirement against extreme negative outcomes, then a lifecycle strategy may be an appropriate default. If the objective is to maximise pension assets at retirement time, then strategies involving a high exposure to higher risk assets may be more appropriate, even when approaching retirement age.

Participants may view the default as being endorsed by the sponsor. As a result, many participants actually choose the default investment (rather than defaulting into it because they do not actively select a strategy), resulting in more widespread investment in default strategies.

For example, in the **United States**, target date fund investing is more prevalent than target date fund use as a default investment strategy. More than half of 401(k) plan participants hold target date funds (the most common default), and more than one-quarter of 401(k) plan assets are invested in target date funds.

In the **United Kingdom**, UK Nest's default investment is their Retirement Date Funds, and the majority of Nest participants invest in those funds.

Case Study: The new pan-European default investment—the Basic PEPP

*In March 2021, the **European Union** finalized legislation to enable the creation of the so-called **pan-European personal pension product (PEPP)**, which is a voluntary personal*

[15] See *The OECD Roadmap for the Good Design of Defined Contribution Pension Plans*, available at https://www.oecd.org/daf/fin/private-pensions/50582753.pdf.

pension product that will complement existing public and occupational pension systems, as well as national private pension products.

This new type of product is designed to give savers more choice and provide them with more competitive products, while enjoying strong consumer protection. It could be offered by a broad range of financial providers such as insurance companies, asset managers, banks, certain investment firms and certain occupational pension funds.

PEPP providers may offer up to six investment options to PEPP savers. Another key feature of the PEPP regulation is that it requires PEPP providers to offer a default investment option – the so-called Basic PEPP – which is the version of the PEPP that consumers are likely to choose if they have difficulty making a choice between different investment strategies.

In the end, the European Parliament and the Council agreed that the Basic PEPP should be based either on a financial guarantee or on a life-cycling investment strategy. This flexibility will allow younger PEPP savers to have most of their contributions invested in equities, with a switching mechanism to increase the proportion in fixed-income assets as the saver approaches retirement. This will ensure higher return for most of the accumulation years, and a reduction in exposure to market volatility as investors approach retirement.

The co-legislators understood that lifecycle investment strategies, which are typically using investment funds as underlying assets, offer more benefits to consumers than guaranteed insurance products. Numerous academic studies have highlighted this point.[16]

PEPP providers are also free to offer – in addition to the Basic PEPP – other investment options with more aggressive or alternative investment strategies, which savers will be able to choose on their own initiative, following proper professional advice.

4.3 Retirement plans' selection of funds reflects many idiosyncratic factors

Pension plan design—whether investing for a DB plan versus a DC plan, or for the plan participants as a group or individually—influences investments held in the plan. With regard to individual participants, the factors can be cultural—pertaining to long-held beliefs about markets, or structural—reflecting the types of financial services firms active in the domestic markets (e.g., banks, insurance companies, asset managers). They can be based on member profile: some pension funds have younger members on average, who may be more willing to take on financial risk and focused on investing for growth, while some have older members, who may be more focused on investing for income.

Investments held by pensions can also be based on the underlying economy where the pension plan is situated. For instance, if an economy is highly dependent on fossil fuels, pension plans may wish to diversify from oil and gas to other sectors. This is the case for **Norway**'s national wealth fund and for several **Middle Eastern** countries. If a country does

[16] See in particular a Bocconi study.

not have highly developed capital markets, the pension might seek more global investments.

Chapter 5. How education and financial literacy can change the pensions conversation

It is essential that a broad range of public and private-sector organisations coordinate efforts to improve people's financial literacy. Education initiatives provided by governments, regulators, employers, plan sponsors, and financial services firms, increasingly use technology and are critical to encourage retirement saving. This paper recommends a number of key messages to be used in efforts to engage savers. These include: start investing early; invest for the long-term; diversify your investments; understand the risks; and realize that preparing for retirement is a shared responsibility.

As more and more countries shift focus from defined benefit (DB) pension plans to defined contribution (DC) pension plans, the importance of investor education assumes increasing significance – because the responsibility of making investment decisions for retirement purposes often rests with individuals in account-based retirement savings.

So education initiatives aimed at enhancing the knowledge of financial products and their associated risks, as well as policies strengthening consumers' financial competences and their overall financial resilience and well-being are essential.

5.1 Considerations for policymakers undertaking financial literacy programs

Financial education occurs through a range of channels (e.g., schools, universities, governments, regulators, financial services firms) and formats (e.g., pamphlets, seminars, webinars, websites, interactive tools). Regulators play two roles: first, setting regulations around disclosure and defining what constitutes education versus advice; and second, providing educational materials related to the financial markets or instruments they regulate.

Increasingly, governments, regulators, employers, plan sponsors, and financial services firms employ technology to engage savers and tailor education messages to individuals.

To support decision-making about saving, investment, retirement and pensions, the OECD Council on Financial Literacy's recommendations include that members and non-members:[17]

- Take into account national circumstances and the different extent of saving, investment, long-term and retirement planning challenges depending on factors

[17] See OECD, Recommendation of the Council on Financial Literacy, Section III (amended: 28/10/2020); available at https://legalinstruments.oecd.org/en/instruments/OECD-LEGAL-0461.

such as interest rates, the national pension systems, investment frameworks and of the financial environment more broadly.

- Promote an understanding of the changes in the demographic, social, economic and financial landscape, as well as any changes in public policy, that may have implications on individual financial decisions and outcomes, such as ageing and pension reforms.
- Provide individuals with clear, straightforward information and appropriate tools to understand how to best use saving, investment, retirement and pensions products for their personal or household situation.
- Promote individual awareness of the financial risks related to saving and investment decisions and the importance of risk diversification, understanding the balance of risk and reward, understanding the potential implications of investment decisions, and estimating the amount of savings, investments and pension entitlements needed to meet personal and family financial needs.
- Promote an understanding of the implications of saving and investment decisions on society and the environment, and of long-term economic and financial sustainability considerations in saving and investment decisions.

5.2 Key messages to highlight in the pension saving conversation

As the world continues to place emphasis on funded pensions, and in particular, individual account-based DC pensions, it is important to educate workers on how to succeed in saving for their future retirements.

Some of the key messages to foster pension savings include:

Start saving early to enjoy compounding returns. Workers should start to plan and invest for retirement as early as possible to leverage the effect of compounding. Tax advantages offered to retirement savings in many jurisdictions make compounding even more powerful, as the earnings, capital gains, and other investment returns are reinvested at a lower or zero tax rate.

Invest for the long-term. Financial education around retirement saving should stress that it is important to stay invested and not be distracted by short-term market volatilities. The further individuals are away from retirement, the more they are in a position to weather short-term market volatilities. Investors generally are served well by keeping their investments in the market at all times, since it is difficult to know when the market is about to rise or fall. An individual’s investment time horizon is a key consideration when selecting investments.

Diversification is important. When you choose investment funds for retirement purposes, you should take into consideration a range of factors in addition to the investment horizon. Investment funds offer diversification of investments, so that retirement savers don’t have

all of their eggs in one basket. Diversification is important to achieve the desired balance of risk and returns.

Understanding risk and return. Retirement savers need to determine the level of risk they are comfortable with, recognizing that generally to get higher returns, they must take on higher risk. Retirement savers typically invest more heavily in equity funds when younger to seek higher returns. As individuals move toward retirement, they typically reduce the allocation toward equity funds in favour of bond funds, as their goal changes from capital accumulation to provision of income and capital protection. Nevertheless, even in retirement, investors tend to continue to hold some allocation to equities to achieve some growth in their portfolios during what could be many years in retirement.

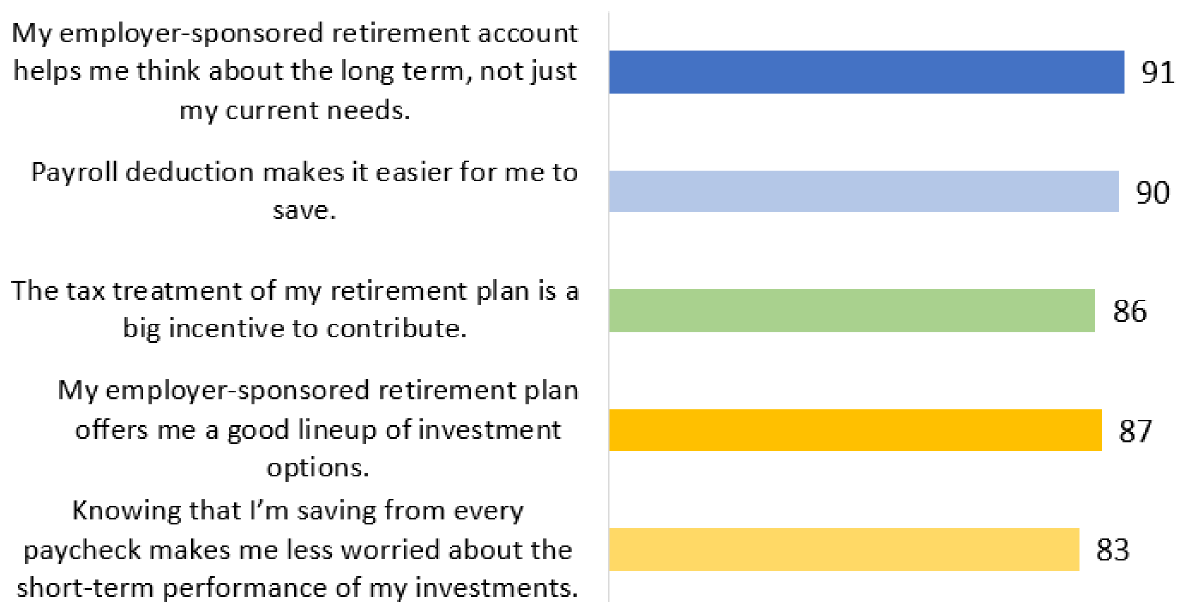
Managing income and assets. Guaranteed funds may be suitable for those who want some form of guarantee, but in today's very low interest rate environment guaranteed funds generate very low returns in nominal terms and possibly negative returns after inflation. Households approaching retirement typically consider their investment funds and other sources of income—e.g., state pension, DB payments, insurance annuities—as complementary, typically seeking to manage both assets and income streams in retirement.

Playing your part. Ultimately, there should be a clear message from all relevant authorities that preparing for retirement is a shared responsibility—the government typically providing a basic pension; tax policy providing incentives for employers and employees to save for retirement; and individuals doing their part by participating and contributing. It is simply not sustainable for the population to rely on the first pillar (a basic state pension), so, employers and employees need to leverage the second and third pillars if they are to enjoy a comfortable retirement.

The above should not be construed as investment advice, but rather as representing some of the key tenets of successful retirement saving, judged by past experience.

Survey data from the **United States** indicate that DC-owning individuals appreciate the saving and investment features of DC plans and have embraced many of the tenets above. For example, 91% of DC-owning individuals agree that their employer-sponsored plans help them think about the long-term, and 90% appreciate the ease of payroll deduction (Figure 5.1). In addition, 86% indicate the tax treatment is a big incentive to contribute. On the investment side, nearly nine in 10 agree that their employer-sponsored retirement plan offers a good line-up of investment options (in the United States, and elsewhere, DC plan sponsors typically select a variety of investment options to cover a range of risk and return). And, the long-term mindset is evident as 83% of DC-owning individuals agree that knowing that they're saving from every paycheck makes them less worried about the short-term performance of their investments.

Figure 5.1
Financial Education Promotes Saving and Investing
Percentage of DC-owning individuals agreeing with each statement, fall 2020



Note: Figure reports the percentage of DC-owning individuals who "strongly agreed" or "somewhat agreed" with the statement.

Source: ICI tabulation of NORC AmeriSpeak® survey data (fall 2020); see "American Views on Defined Contribution Plan Saving, 2020," *ICI Research Report;* https://www.ici.org/pdf/21_ppr_dc_plan_saving.pdf

Each market should tailor their educational programs according to, *inter alia*, the local culture, structure of the retirement system and financial literacy and investment habits of the population.

5.3 How to ensure effective investor education

Basic financial education needs to start early

It is important for financial education to start early, because the earlier individuals learn financial basics, the greater their sense of individual responsibility, and the stronger their financial footing. Starting early is more effective because it engenders a greater sense of ownership. If a country incorporates key concepts about saving and retirement planning into its school education, employees will enter the workforce better equipped to prepare for retirement.

While financial education around basics of budgeting and saving can be taught in early school years, education around investing and planning for important financial goals (e.g., saving for a home, saving for retirement) could be included in high school or university.

Governments can create strong public-private partnerships to provide this education. When the public and private sectors undertake educational initiatives jointly, they can draw on the private sector's expertise and align this with the messages relayed through a broad government program, making the efforts coordinated and complementary.

For example, in **Chile**, the Chilean Mutual Funds Association (AAFM) has organized numerous financial literacy activities, including educational campaigns for schools. Since 2015, the AAFM has made available to schools a financial education program called ***A Fund for My Future***, which teaches children and young people the importance of early savings and responsible expenditures.

By 2018, the total accumulated reach of this free program was close to 6,000 students, and by the end of 2019, more than 9,000 young people had attended workshops. The students were drawn from 33 schools, including municipal, subsidized and private schools, from different areas of Chile.

Educational campaigns also take place in universities in Chile. The AAFM, together with Universia (a network comprising 1,000 universities in 15 countries), and other trade associations launched a program to provide information and basic tools for students to better understand and enter the labor market. During 2018, more than 21,800 students took the course in Chile. In 2019, similar figures were expected, with the expectation of a total accumulated reach, since 2014, of close to 106,000 young people from 18 higher education institutions in Chile.

In addition, managers of investment firms who are members of the AAFM visit universities to present in a simple and friendly way the importance of financial planning and the basics of mutual fund investing. In 2018, 14 talks were held for students from different institutions and careers in different cities. From the outset of the program, over 75 events have been held at different campuses in more than 15 universities.

In **Sweden**, the Swedish Investment Fund Association participates in the national programme Gilla Din Ekonomi (***Like Your Finances***), which focuses on education about personal finance. Gilla Din Ekonomi, initiated by the Swedish Ministry of Finance, is managed by the Swedish Financial Supervisory Authority and also involves the co-operation of 40 entities including private organizations and companies. The Swedish Investment Fund Association is responsible for the fund saving element of the training. The Association also holds lectures to boost interest in the project and co-finances Ung Privatekonom20 (***Young Personal Finances***), which educates more than 24,000 secondary school children in personal finance and how to save in stocks and investment funds.

Regulators can play an important role

Regulators need not confine their role to rule-setting. In many jurisdictions, regulators provide educational materials on the products in the markets they regulate. For example, in the **United States**, the Department of Labor provides educational materials (https://www.dol.gov/agencies/odep/program-areas/individuals/financial-education-asset-development) on investing, ranging from the more basic concepts of "the magic of compounding", to types of products, such as target date retirement funds, and retirement fees and expenses. Similarly, the Securities and Exchange Commission (SEC), provides a raft of resources on mutual funds, which are key building blocks of the US second and third pensions pillars. And, FINRA, a self-regulatory body, shows investors how to research investments and provides investors a tool called "Broker Check" to research their brokers.

The financial markets regulator in **Italy** has a section of its website dedicated to financial education (https://www.consob.it/web/investor-education/i-fondi-comuni). The materials include basic information on a variety of financial products, as well as interactive calculators, which address topics ranging from "Budget Planner" to "Impulsiveness" to "Investing is not a game".

In **Luxembourg**, the national regulator, the CSSF, has launched a dedicated financial education website (letzfin.lu). The website offers educational games and educational apps, as well as tools for the management of consumers' family budgets and surplus money. The CSSF says: "The best way to protect consumers is to teach them, and this process must start as early as possible."

The French regulator, the Autorité des Marchés Financiers (AMF), and the French National Institute for Consumer Affairs (INC) designed an online course aimed at teaching the general public in **France** about investing their savings and managing their finances. The course, launched in October 2020 during World Investor Week, is free on the France Université Numérique (https://www.fun-mooc.fr) platform. The MOOC (Massive Open Online Course) is technical as well as practical in its approach, providing tools savers need to assess investment opportunities based on their objectives and their particular profile. It also shows how to detect the signs of possible financial scams. A progress certificate is issued to people who score more than 50% in the tests at the end of each module.

In **Hong Kong**, the Investor and Financial Education Council (IFEC) was set up in 2012 to improve financial literacy. Supported by the four financial regulators and the Education Bureau, the IFEC organizes mass media campaigns; tailored education programs and seminars; financial education tools; and support for parents, social workers and teachers. It also collaborates with stakeholders and community partners to extend the reach of its work.

In **Brazil**, the CVM, the financial regulator, together with the OECD, created the Centre on Financial Education and Literacy in Latin America and the Caribbean

(https://www.oecd.org/finance/oecd-cvm-financial-education.htm). The centre promotes a range of activities including meetings, surveys, mutual learning through peer reviews, and research.

The Financial Sector Conduct Authority (FSCA) in **South Africa** provides free financial education in a drive to help consumers be financially literate. It has activated a nationwide financial education campaign called #FSCAMyMoney (https://www.fscamymoney.co.za/Pages/Projects/FSCA-Mymoney-Learning-Series.aspx) to provide young South Africans from all walks of life information that will improve their financial acumen. The FSCA said: "Consumers will be encouraged via various platforms to visit the FSCA's My Money website, where they will be able to access a wealth of easily understandable and very relevant financial educational tips, such as learning about their rights and responsibilities as a consumer when dealing with financial service providers, what to look for in an accredited financial adviser, how to budget and how to save."

Lastly, IOSCO, the international body that brings together the world's regulators, consolidates national financial education initiatives under one roof. The IOSCO Investor Education Gateway (https://www.iosco.org/investor_protection/?subsection=investor_education_gateway) provides information about IOSCO members' online investor education activities, as well as IOSCO events, publications and presentations regarding investor education.

Private sector is often the departure point for education

In preparing for retirement, employers and the financial services industry are key to retirement saving success because the investment education journey typically starts with an individual's first job.

For example, in the **United States**, plan sponsors and the financial services firms that provide services to retirement plans offer educational materials to help participants learn key concepts around compounding, saving, and risk and return. Participants in employer-sponsored retirement plans also have access to fund and account information, and a wide variety of calculators.

In addition, many organisations and websites are devoted to financial education, including the websites of IIFA members.

The Investment Company Institute (ICI) has resource centers and FAQs on its main website (https://www.ici.org/), in addition to educational materials on the ICI Education Foundation's website (http://www.icief.org/). ICI resources cover topics related to funds and investing concepts, including:

- Rule 12b-1 and Intermediary Payments Resource Center www.ici.org/rule12b1fees

- Glossary of Mutual Fund and Other Related Financial Terms www.ici.org/pdf/bro_mf_glossary.pdf
- Target Retirement Date Funds Resource Center www.ici.org/trdf
- Individual Retirement Account (IRA) Resource Center https://www.ici.org/iraresource
- 401(k) Resource Center https://www.ici.org/401k
- Global Retirement Resource Center https://www.ici.org/global_retirement
- Retirement Resource Center https://www.ici.org/retirement

In **Argentina**, the Argentine Mutual Funds Association ("CAFCI", after its acronym in Spanish), provides educational materials for fund investors, including:

- Fast Answers: Mutual Funds https://www.cafci.org.ar/conceptos-basicos.html
- Glossary of Mutual Fund and Other Related Financial Terms https://www.cafci.org.ar/glosario.html
- Search tool for funds https://www.cafci.org.ar/consulta-de-fondos.html
- Statistics information https://www.cafci.org.ar/estadisticas.html

The **Europe**an Financial Market and Asset Management Association (EFAMA) also focuses on investor education (https://www.efama.org/policy/investor-education). EFAMA published in 2014 a report entitled "Building Blocks for Investor Driven Investor Education Initiatives",[18] divided into three key topics:

- ***Goals for investor education***. An overview of the current landscape describes the necessity of implementing initiatives for investor education. Five independent experts in certain fields of financial services conveyed their views on the goals of investor education, and the actions that are most effective in achieving these goals.
- ***Best practices***. A comprehensive list of EFAMA best practice guidelines for investor education initiatives provide a template to encourage, inspire and support the development of investor education initiatives by organizations in the financial sector.
- ***Initiatives***. A description of investor education initiatives undertaken by EFAMA member associations and corporate members.

EFAMA will publish a new edition of this report in early 2021. And on October 6 2021, EFAMA published a leaflet entitled *Investing for a better future – Five tips to do more with your savings*, to help millennials make a good start at investing their savings. The leaflet is on the EFAMA website and available in many languages.

[18] See EFAMA, *Building Blocks for Investor Driven Investor Education Initiatives*; available at https://www.efama.org/sites/default/files/files/EFAMA_Investor_Education_Report.pdf.

Case Study: Brazil makes available extensive educational materials

*In **Brazil**, one of the four main areas of focus of ANBIMA, the Brazilian Financial and Capital Markets Association, is "educate". ANBIMA says it is committed to raising the bar for market quality standards and supports initiatives that broaden financial access through educational programs. To support its aims, the association certifies professionals through qualifying examinations, offers professional development courses on topics related to capital and financial markets, disseminates financial education content, fosters research, and encourages many other initiatives.*

Besides providing several free online courses about the financial market (both, introductory and more advanced ones), ANBIMA initiatives relating to financial education include:

- ***"How to Invest in You"** is an initiative offering current and potential investors easy access to information so they can make "mature decisions and conscious investments" and have financial autonomy. It consists of a free online course for university students, presenting an interactive experience to introduce investment fundamentals. It uses simple language to guide students to improve their relationship with money, consumption and investments.*
- *The **Capital Markets Award** encourages the production of academic information, in particular supporting research on the development of capital markets and financial intermediation in Brazil. The award is granted annually in two categories: masters and doctoral degrees.*
- ***"How to Invest"** is ANBIMA's financial educational portal containing information on personal finance and the main products available to investors, in clear language and with dynamic content.*
- ***"Let's invest"** is an initiative for those who want to understand and learn more about the investment universe. Its first edition was launched in 2021, and the seven-week course contains interactive and simplified content. Through video lessons on Instagram (for greater public access), the course covers essential financial concepts, through to more complex topics, such as foreign and ESG investments.*

5.4 Technology can be leveraged to boost financial engagement

To encourage engagement, regulators, plan sponsors, and the financial services industry are providing more online tools to facilitate interactions so that the investment process and its outcomes can be more personalized. Due to the long-term nature of retirement, people may find it difficult to think ahead to their future needs.

Technology plays a pivotal role in empowering investors by providing tools that are interactive. A common tool provided on regulators and financial service providers' websites is a retirement calculator. Retirement calculators provide projections of possible retirement-age account balances and increasingly indicate the withdrawals or income that could be pulled from that future account to spend in retirement. Typically, an individual can input key data (such as their income, expected age of retirement, expected returns and inflation during retirement). And based on these parameters, an outcome would be arrived at (e.g. how much does one have to save until retirement to reach the desired income, how much

does he/she have to top up). This type of tool is very helpful in that it can help an individual to translate something conceptual into something measurable and actionable.

Being able to see the likely amount of income they will receive helps people focus on whether their current saving rate has them on track to maintain their standard of living in retirement.

Another way technology helps savers is by offering new investment tools, such as those that automatically help individuals to set risk parameters throughout their lifecycles. Examples of these tools are target date funds and target risk funds, which allow savers to delegate to professional investment managers the responsibility of determining the appropriate asset allocation and investments.

While the **United States** is probably the leader in this space, the trend towards automated allocations has gained traction in other parts of the world. For instance, more Asian markets have introduced these types of funds. In **Korea**, for the Retirement Income Fund (RIF), simulation technology supports portfolio rebalancing by predicting the value of assets based on the rate of payment and current portfolio composition.

Yet another example where technology helps individuals is through so-called “robo-advice”. This has proved particularly valuable in attracting younger savers, who are comfortable with making important decisions online.

It also represents a democratisation of advice. Robo-advisers represent a low-cost way for savers to make investments, and this is especially important for low-income earners who cannot afford the cost of advice and risk ending up as “advisory orphans” – not having access to proper investment advice. The use of robo-advice in the investment process can potentially address the problem of the “advice gap.”

Germany is the biggest market for robo-advice in the European Union. German robo-advice platforms accounted for almost 60% of the funds robo-advice platforms manage across the whole of the European Union. In **Greece**, both target date fund and robo-advice offerings are growing to offer lower-cost options to investors.

In **Brazil**, three-quarters of Brazilians profess themselves interested in virtual advice. And in **Canada**, many firms have started using technology to analyze client cohorts and to generate predictive analytics for both assets and clients. Computer-generated investments allow investment firms more time to provide guidance on complex issues, such as estate planning.

In **Malaysia**, EPF i-Invest, which is a self-service online investment platform within the Members’ i-Akaun portal, is gathering momentum. EPF offers its members the option and flexibility to diversify their retirement portfolios and enhances retirement savings through the Members Investment Scheme (MIS).

The i-Akaun enables account holders gain access to information on holdings, performance, investment comparisons, transaction history, as well as the ability to execute investments. Like many other countries, Malaysia also has seen an increase in the range of fund supermarket platforms, allowing individuals to pick and choose their own investments from a wide array of choices.

5.5 Conclusion: the power of persuasion

The investment fund industry is making great strides to launch investor education initiatives. It is committed to further increase its role in financial education to help a greater number of people to save for important financial goals, including building a retirement nest egg to live more comfortably in their final years.

Fostering saving for retirement requires favorable tax treatment; good plan design, often including nudging mechanisms, such as auto-enrolment with opt-out clauses; good default investments that offer diversification and growth potential; and strong disclosures and educational materials. Education around retirement saving also requires teaching individuals to do their part—saving paycheck-by-paycheck, investing, and ushering their retirement accumulations to and through retirement.

Financially-literate individuals are more likely to make better-informed financial decisions and to understand the benefits arising from long-term investments.

It is essential that the broadest range of public- and private-sector organisations undertake action to improve people's financial literacy. Governments and private-sector entities will need to coordinate efforts to raise levels of financial education and literacy, particularly around basic financial concepts and the importance of saving.

Appendix

International Investment Funds Association (IIFA)

The IIFA is a global organization whose members are national and regional associations representing the investment funds industry. In addition, certain IIFA members represent the broader fund ecosystem, such as distributors and asset managers. The current membership comprises 37 national associations and two regional associations which, collectively, have funds under management of $63.06 trillion, as of December 2020.

The IIFA serves as a forum to bring market participants together, where appropriate, to discuss issues of common concern. One of the primary purposes of the IIFA is to enhance collaboration among members and to serve as a forum for exchanging information and sharing best practices. IIFA also serves as a communication platform for the global investment funds industry.

On a quarterly basis, the IIFA publishes the Worldwide Regulated Open-End Fund Data Quarterly report that includes assets, number of funds, and net sales by broad investment classification of funds in 46 jurisdictions worldwide (available at https://www.ici.org/research/stats/worldwide).

A worldwide regulated open-end fund is a substantively regulated, open-end fund that is constrained by some diversification limits, concentration limits, and/or leverage limits with a view to offering a high level of investor protection. Worldwide regulated open-end funds include mutual funds, exchange-traded funds (ETFs), institutional funds, guaranteed/protected funds, (open-end) real estate funds, and other substantively regulated funds.

The IIFA "Role of Investment Funds" Survey

In late 2019/early 2020, the IIFA fielded a survey of its members asking them to describe the retirement systems in their jurisdictions; the role of investment funds, in general; the role of investment funds in the retirement system; the hallmarks of investment funds in their jurisdictions; and information on the characteristics of fund investors. Results from this survey effort served as the basis for this report.

Disclaimers

Data are subject to revision. Although information or data provided by independent sources is believed to be reliable, the author (Phil Davis) and the International Investment Funds Association (IIFA) are not responsible for its accuracy, completeness, or timeliness. Opinions expressed by independent sources are not necessarily those of the author or the IIFA. If you have questions or comments about this material, please contact the source directly.