Role of the Enabling Environment

Financial planning and defined contribution retirement plans

Mike Orszag
June 2011

TOWERS WATSON

What a Potential Saver in India Sees…. The name of the product means essentially that it makes your life simpler

JEEVAN SARAL

GOLDEN PEACOCK AWARD WINNER PLAN

For Daughter's Marriage, Children's Higher Education, Happy Retirement & Any Emergency Requirement

चुनिए मनचाही सुरक्षा,आसानी के साथ

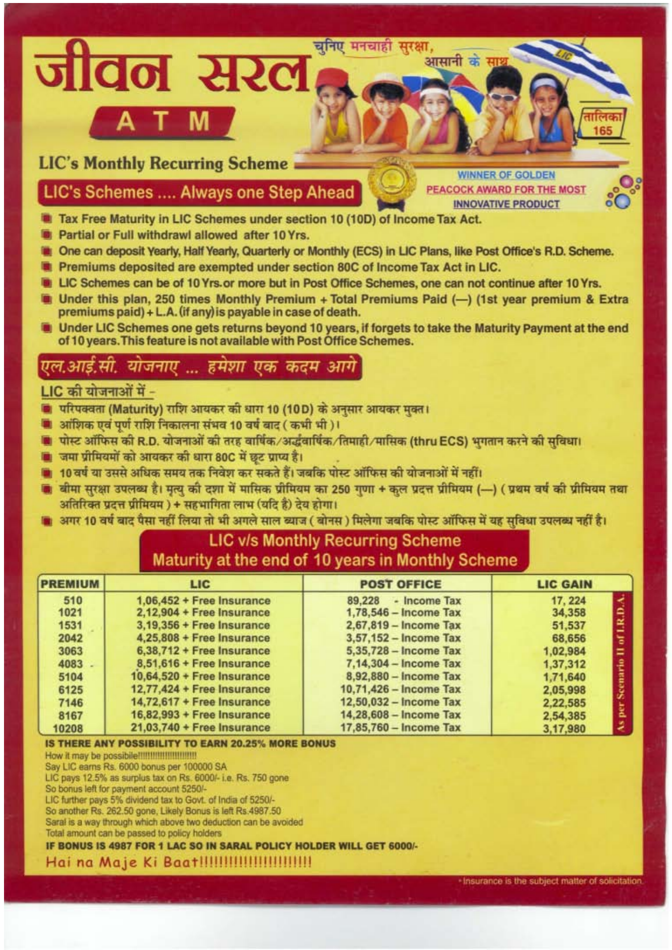
Trm#	255	510	766	1021	1531	2042	3063	4083	6125	8167	10208
1	0	0	0	0	0	0	0	0	0	0	0
2	0	0	0	0	0	0	0	0	0	0	0
3	5122	10244	15366	20488	30732	40976	61464	81952	122928	163904	204880
4	8199	16398	24597	32796	49194	65592	98388	131184	196776	262368	327960
5	11815	23630	35445	47260	70890	94520	141780	189040	283560	378080	472600
6	14698	29395	44093	58790	88185	117580	176370	235160	352740	470320	587900
7	17703	35405	53108	70810	106215	141620	212430	283240	424860	566480	708100
8	20835	41670	62505	83340	125010	166680	250020	333360	500040	666720	833400
9	24118	48235	72353	96470	144705	192940	289410	385880	578820	771760	964700
10	53227	106452	159679	212904	319356	425808	638712	851616	1277424	1682993	2103740
11	62526	125051	187577	250101	375152	500203	750304	1000406	1500608	1956892	2446114
12	72683	145366	218049	290733	436099	581465	872198	1162930	1744395	2258181	2822726
13	84085	168170	252255	336340	504510	672680	1009019	1345359	2018039	2589599	3236999
14	96820	193640	290460	387280	580920	774560	1161839	1549119	2323679	2954159	3692699
15	111099	222198	333298	444397	666595	888794	1333190	1777587	2666381	3355175	4193969
16	125842	251683	377525	503366	755050	1006733	1510099	2013466	3020199	3796293	4745366
17	141986	283970	425956	567940	851910	1135880	1703820	2271760	3407640	4281523	5351903
18	159705	319410	479115	638819	958229	1277638	1916457	2555276	3832915	4815276	6019094
19	179095	358190	537285	716380	1074570	1432760	2149140	2865520	4298280	5402404	6753004
20	200370	400740	601110	801480	1202220	1602960	2404440	3205920	4808880	6048245	7560305
21	223646	447291	670938	894583	1341874	1789166	2683749	3578332	5367498	6758670	8448336
22	249179	498358	747537	996716	1495074	1993433	2990149	3986865	5980298	7540137	9425170
23	277110	554219	831329	1108438	1662657	2216876	3325314	4433752	6650628	8399752	10499688
24	307749	615497	923247	1230995	1846492	2461989	3692984	4923979	7385968	9345328	11681658
25	341275	682551	1023826	1365101	2047652	2730202	4095304	5460405	8190607	10385462	12981824
26	378058	756115	1134172	1512229	2268344	3024459	4536688	6048917	9073376	11529610	14412008
27	418315	836630	1254944	1673259	2509889	3346518	5019778	6693037	10039555	12788172	15985210
28	462488	924976	1387463	1849951	2774927	3699902	5549853	7399805	11099707	14172590	17715732
29	510947	1021894	1532841	2043788	3065682	4087577	6131365	8175153	12262730	15695450	19619306
30	564128	1128256	1692384	2256511	3384767	4513022	6769533	9026044	13539067	17370596	21713238
31	622281	1244562	1866843	2489123	3733685	4978246	7467370	9956493	14934739	19213256	24016562
32	686265	1372529	2058794	2745059	4117588	5490117	8235176	10980234	16470351	21240182	26550218
33	756293	1512585	2268878	3025170	4537756	6050341	9075511	12100682	18151022	23469800	29337240
34	833233	1666466	2499699	3332932	4999399	6665865	9998797	13331730	19997595	25922380	32402964
35	917775	1835551	2753326	3671102	5506652	7342203	11013305	14684407	22026610	28620218	35775260

* Basic Sum Assured (Including Double Accident Benefit) #End of Policy Year Calculation as per Scenario-II of I.R.D.A.

BSA*	62500	125000	187500	250000	375000	500000	750000	1000000	1500000	2000000	2500000
ECS	255	510	766	1021	1531	2042	3063	4083	6125	8167	10208
QLY	766	1531	2297	3062	4594	6125	9187	12250	18375	24501	30625
HLY	1516	3032	4549	6065	9097	12130	18195	24260	36390	48520	60650
YLY	3002	6005	9007	12010	18015	24020	36030	48040	72060	96080	120100

*Insurance is the subject matter of solicitation.

… and the Key Terms



जीवन सरल

A T M

चुनिए मनचाही सुरक्षा, आसानी के साथ

तालिका 165

LIC's Monthly Recurring Scheme

WINNER OF GOLDEN PEACOCK AWARD FOR THE MOST INNOVATIVE PRODUCT

LIC's Schemes .... Always one Step Ahead

- Tax Free Maturity in LIC Schemes under section 10 (10D) of Income Tax Act.
- Partial or Full withdrawl allowed after 10 Yrs.
- One can deposit Yearly, Half Yearly, Quarterly or Monthly (ECS) in LIC Plans, like Post Office's R.D. Scheme.
- Premiums deposited are exempted under section 80C of Income Tax Act in LIC.
- LIC Schemes can be of 10 Yrs.or more but in Post Office Schemes, one can not continue after 10 Yrs.
- Under this plan, 250 times Monthly Premium + Total Premiums Paid (—) (1st year premium & Extra premiums paid) + L.A. (if any) is payable in case of death.
- Under LIC Schemes one gets returns beyond 10 years, if forgets to take the Maturity Payment at the end of 10 years. This feature is not available with Post Office Schemes.

एल.आई.सी. योजनाए ... हमेशा एक कदम आगे

LIC की योजनाओं में -

- परिपक्वता (Maturity) राशि आयकर की धारा 10 (10D) के अनुसार आयकर मुक्त।
- आंशिक एवं पूर्ण राशि निकालना संभव 10 वर्ष बाद (कभी भी)।
- पोस्ट ऑफिस की R.D. योजनाओं की तरह वार्षिक/अर्द्धवार्षिक/तिमाही/मासिक (thru ECS) भुगतान करने की सुविधा।
- जमा प्रीमियमों को आयकर की धारा 80C में छूट प्राप्य है।
- 10 वर्ष या उससे अधिक समय तक निवेश कर सकते हैं। जबकि पोस्ट ऑफिस की योजनाओं में नहीं।
- बीमा सुरक्षा उपलब्ध है। मृत्यु की दशा में मासिक प्रीमियम का 250 गुणा + कुल प्रदत्त प्रीमियम (—) (प्रथम वर्ष की प्रीमियम तथा अतिरिक्त प्रदत्त प्रीमियम) + सहभागिता लाभ (यदि है) देय होगा।
- अगर 10 वर्ष बाद पैसा नहीं लिया तो भी अगले साल ब्याज (बोनस) मिलेगा जबकि पोस्ट ऑफिस में यह सुविधा उपलब्ध नहीं है।

LIC v/s Monthly Recurring Scheme
Maturity at the end of 10 years in Monthly Scheme

PREMIUM	LIC	POST OFFICE	LIC GAIN
510	1,06,452 + Free Insurance	89,228 - Income Tax	17, 224
1021	2,12,904 + Free Insurance	1,78,546 – Income Tax	34,358
1531	3,19,356 + Free Insurance	2,67,819 – Income Tax	51,537
2042	4,25,808 + Free Insurance	3,57,152 – Income Tax	68,656
3063	6,38,712 + Free Insurance	5,35,728 – Income Tax	1,02,984
4083	8,51,616 + Free Insurance	7,14,304 – Income Tax	1,37,312
5104	10,64,520 + Free Insurance	8,92,880 – Income Tax	1,71,640
6125	12,77,424 + Free Insurance	10,71,426 – Income Tax	2,05,998
7146	14,72,617 + Free Insurance	12,50,032 – Income Tax	2,22,585
8167	16,82,993 + Free Insurance	14,28,608 – Income Tax	2,54,385
10208	21,03,740 + Free Insurance	17,85,760 – Income Tax	3,17,980

As per Scenario II of I.R.D.A.

IS THERE ANY POSSIBILITY TO EARN 20.25% MORE BONUS

How it may be possibile!!!!!!!!!!!!!!!!!!!!!!!!

Say LIC earns Rs. 6000 bonus per 100000 SA

LIC pays 12.5% as surplus tax on Rs. 6000/- i.e. Rs. 750 gone

So bonus left for payment account 5250/-

LIC further pays 5% dividend tax to Govt. of India of 5250/-

So another Rs. 262.50 gone, Likely Bonus is left Rs.4987.50

Saral is a way through which above two deduction can be avoided

Total amount can be passed to policy holders

IF BONUS IS 4987 FOR 1 LAC SO IN SARAL POLICY HOLDER WILL GET 6000/-

Hai na Maje Ki Baat!!!!!!!!!!!!!!!!!!!!!!!!

• Insurance is the subject matter of solicitation.

What Do Consumers Do…

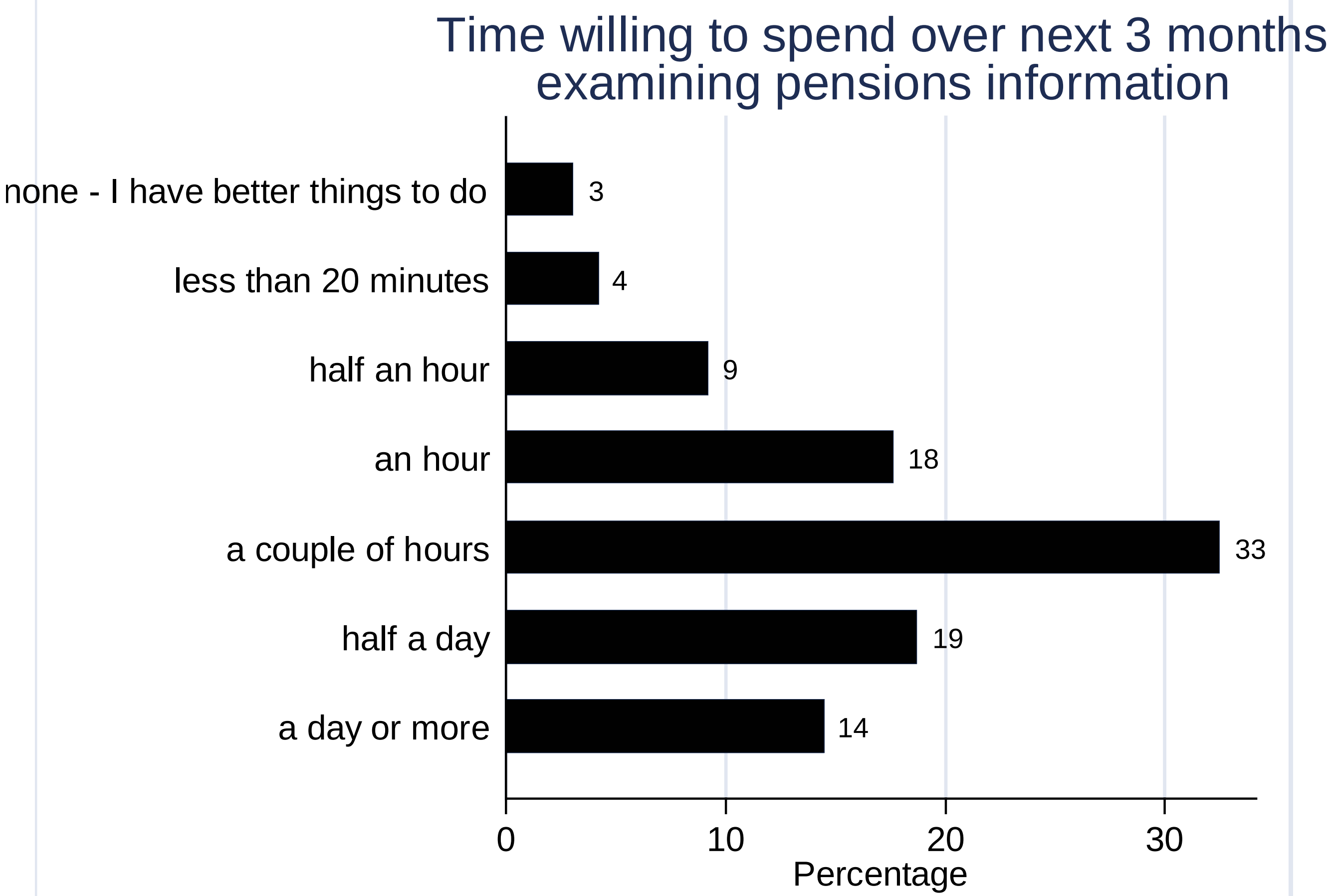
- Indian holdings of jewelry (mainly gold)

Income Category	Proportion of Assets in Jewelry – mean
USD 2 – 4/day	11.4%
USD 4 – 10/day	14.4%
USD 10 – 20/day	16.8%
USD 20/day and above	5.8%

Towers Watson analysis of SAGE survey

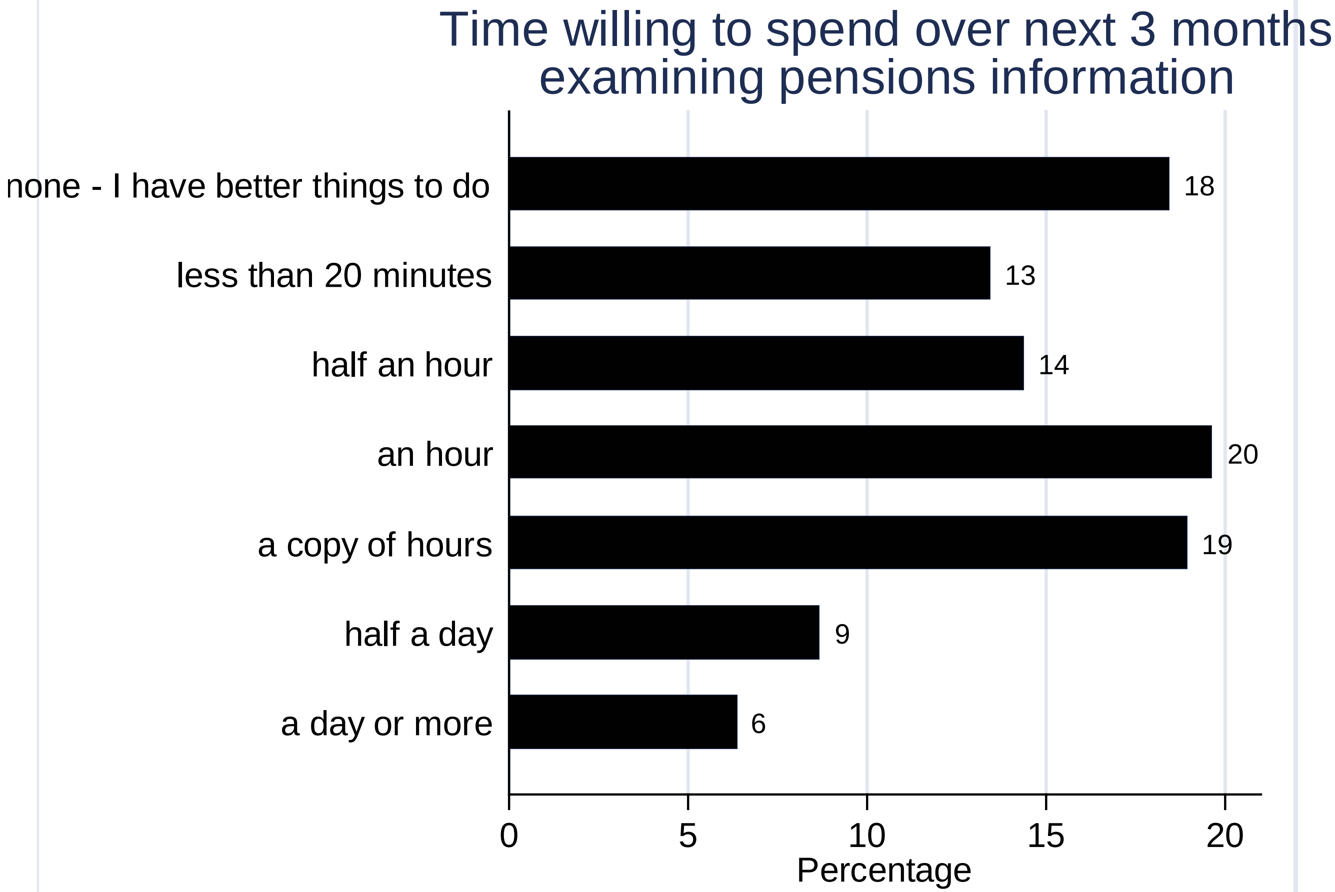
- Indian consumers are world's largest consumer gold market. In 2009 Indian consumers held about 11% of the world's gold stock
- Why?
  - History/culture
  - Fundamentals:
    - Asset class properties
    - Tax

How much time are people willing to devote to pensions? (At Work)



Source: PRF Financial Communications Survey (January 2005)

How much time are people willing to devote to pensions? (At home)



Source: PRF Financial Communications Survey (January 2005)

Overview: Key Factors in the Enabling Environment

Contextual issues

- **Communications** - the importance of communications over incentives
- **Complexity** - individuals may be able to make simple decisions but not complex ones
- **Community** - friends and family are important
- **Credibility** – do not confuse defaults working in practice with irrationality
- **Complements** - other forms of non-retirement saving are key factors in many markets
- **Culture** - culture and history are important
- **Connection** - intermediaries/connection with means of saving is important

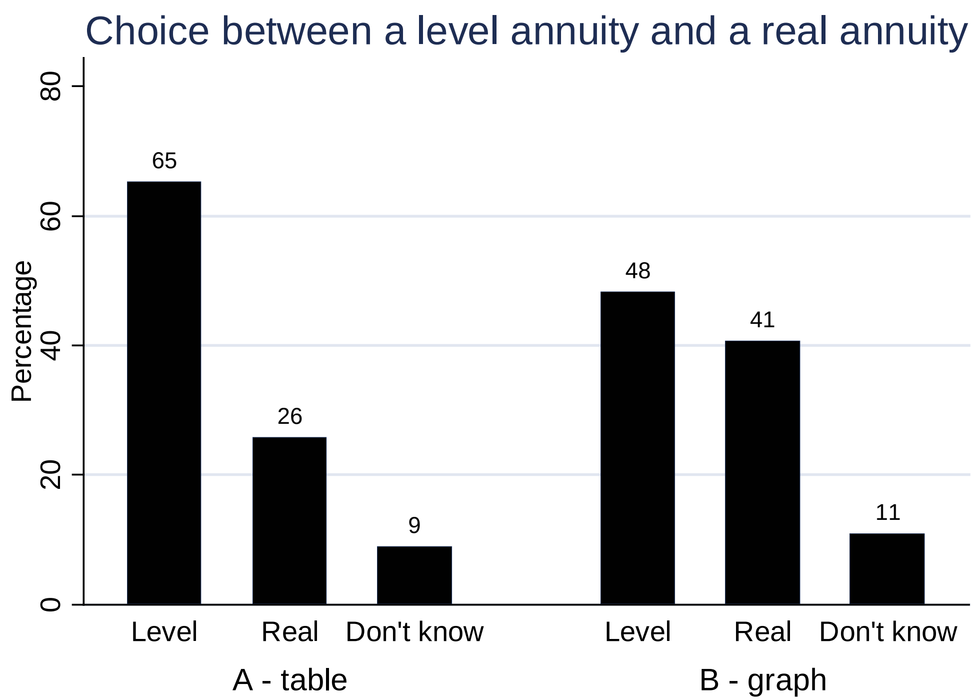
Communications: Visual presentation matters

Age	*Level Annuity*	*Inflation-linked Annuity*
65	*7,000*	*4,900*
70	*7,000*	*5,500*
75	*7,000*	*6,300*
80	*7,000*	*7,100*
85	*7,000*	*8,000*
90	*7,000*	*9,000*
95	*7,000*	*10,300*
100	*7,000*	*11,600*

— Choice between real and level annuity

— Details presented either by table or graph

The results

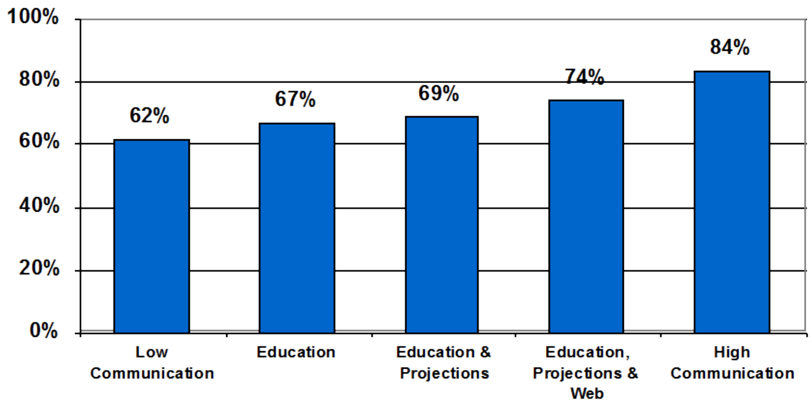


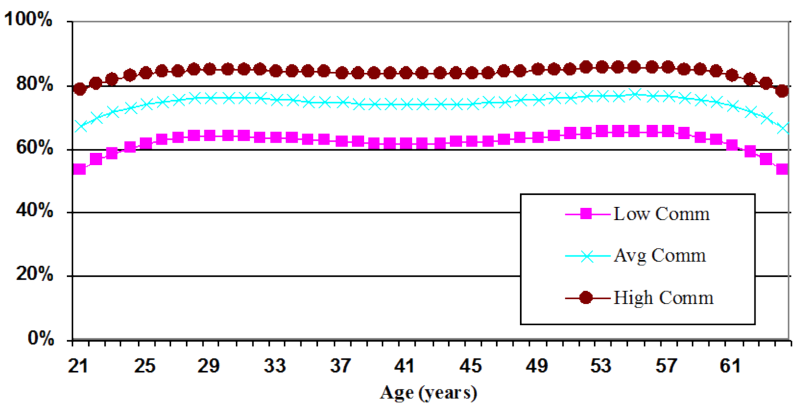
Choice between level annuity of £7,000 and real annuity of £4,900 at age 65

Source: PRF Financial Communications Survey (January 2005)

Communication: Word is Mightier than the Match

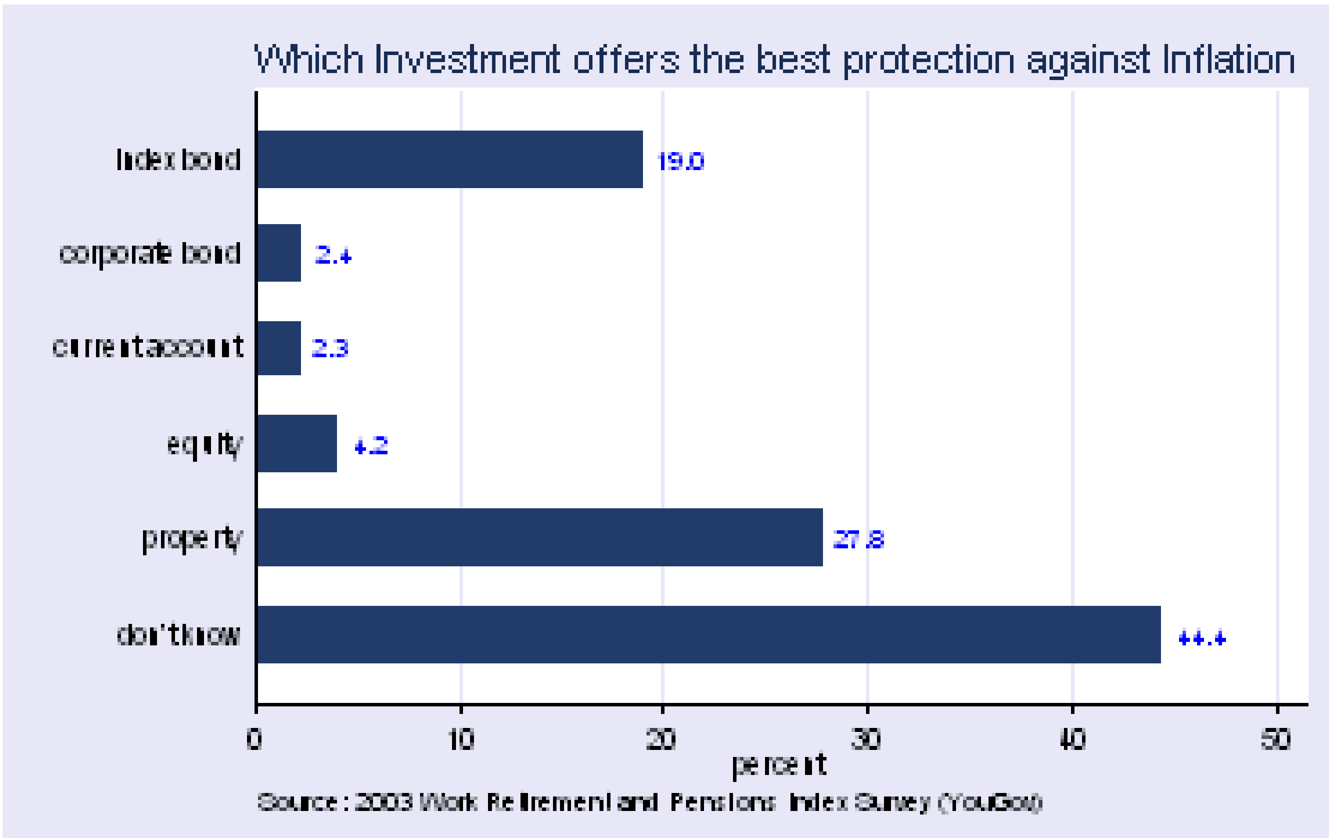
- Analysis by Steve Nyce (Towers Watson) of individual-level data (306,000+ workers at 48 firms) indicates communication has significant impact on contribution rates/participation





Complexity: Financial quiz (1): Best protection against inflation

Which of the following investments is the best protection against inflation?



Complexity: Financial quiz (1): Best protection against inflation

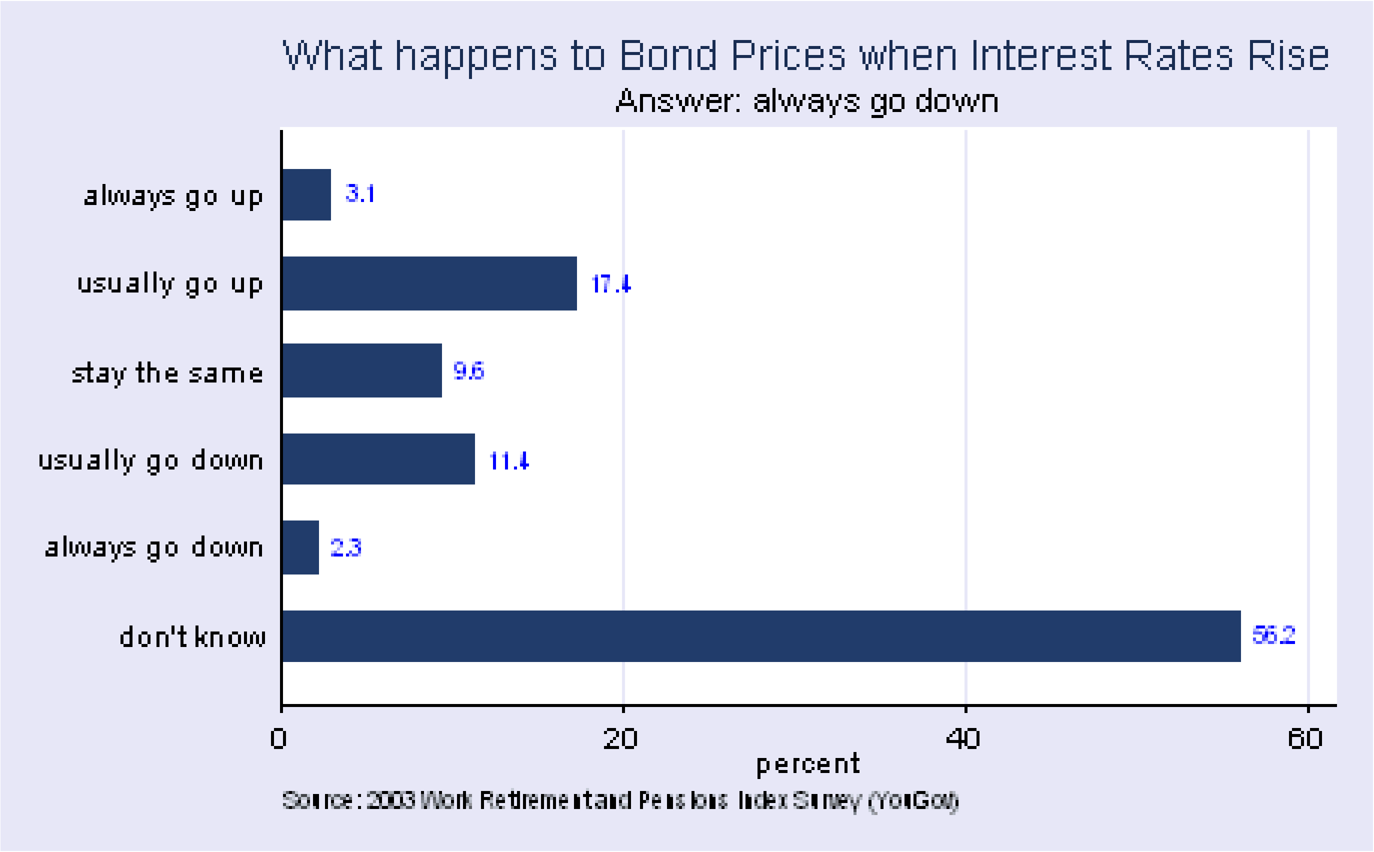
Which investment will provide the best protection against inflation?
Responses by Financial Education

Financial Education	*Index-Bonds*	*Corporate Bonds*	*Current Account*	*Equity*	*Property*	*Don't Know*
Common sense	16%	2%	2%	3%	28%	49%
Self-taught	30%	4%	3%	8%	32%	24%
Formal education	37%	4%	4%	11%	31%	13%
Other	18%	2%	1%	2%	26%	52%

Source: WRaPI Survey, August 2003.
Numbers are row percentages, i.e. percentage of responses by financial education category

Complexity: Financial quiz (2): Bond Prices

When interest rates go up, what happens to bond prices?



Complexity: Financial quiz (2): Bond Prices

What happens to Bond Prices when interest rates go up
Response by Financial Education
Answer: always go down (or usually go down)

Financial Education	*Always Go up*	*Usually Go up*	*Stay the Same*	*Usually Go down*	*Always Go down*	*Don't Know*
Common sense	3%	16%	10%	8%	2%	61%
Self-taught	2%	23%	10%	22%	4%	38%
Formal education	10%	27%	14%	25%	5%	19%
Other	1%	19%	8%	7%	1%	64%

Source: WRaPI Survey, August 2003.
Numbers are row percentages, i.e. percentage of responses by financial education category

Complexity: Simplifying the Language

- Around 6,000 employees from the Netherlands, United Kingdom and Germany participated in the Multideck survey
- These respondents work for private-sector organizations with more than 500 employees
- In the three countries, the percentage of respondents who rate the survey as good or average on these parameters of length, understanding, relevance and interface are 99 percent, 83 percent, 96 percent and 96 percent, respectively

First Deck

Standard questions on:

- Desired pension income
- Desired Retirement age
- Risk tolerance
- Desired Savings rate

Second Deck

- A dashboard to calculate and show a respondent how closely the respondents' desires correspond with real-life choices
- If there is a gap, respondents could modify their initial choices in up to 10 iterations to close it

Third Deck

Questions on Information that could influence individual choices such as

- Industry
- Education level
- Health status

The Multideck Survey: broad findings

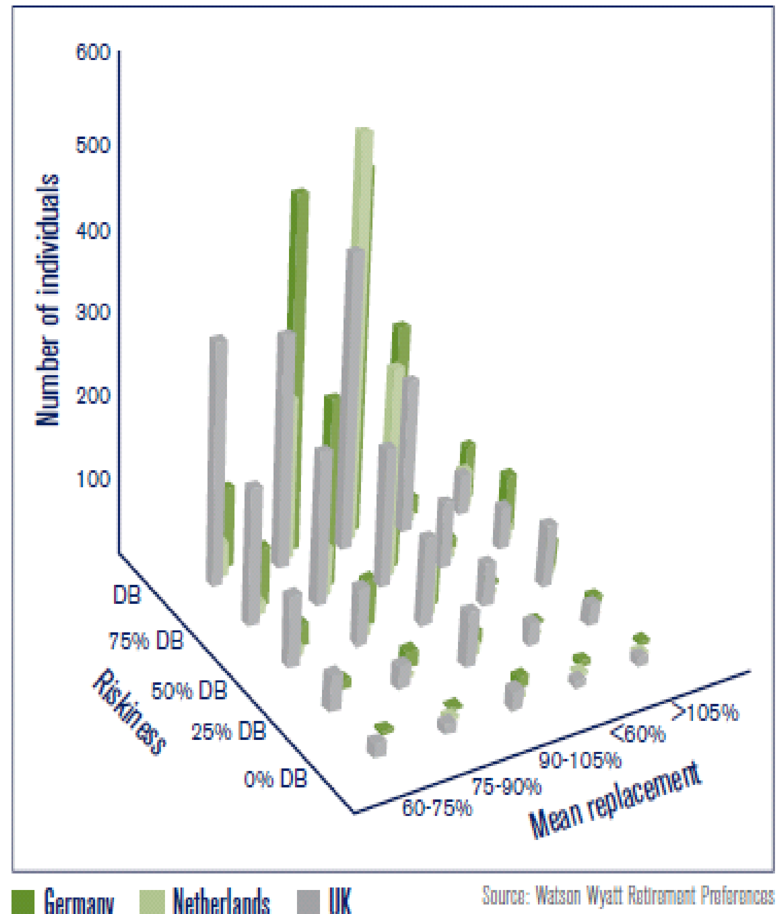
Results of the Survey

- Individuals appreciate risk-return tradeoffs in retirement benefits and were willing to pay more for secure benefits
- Individual preferences were highly heterogeneous. Individuals not only wanted very different levels of replacement rates but also dispersion of replacement rates to reflect their individual circumstances (see figure)

Significance of the Results

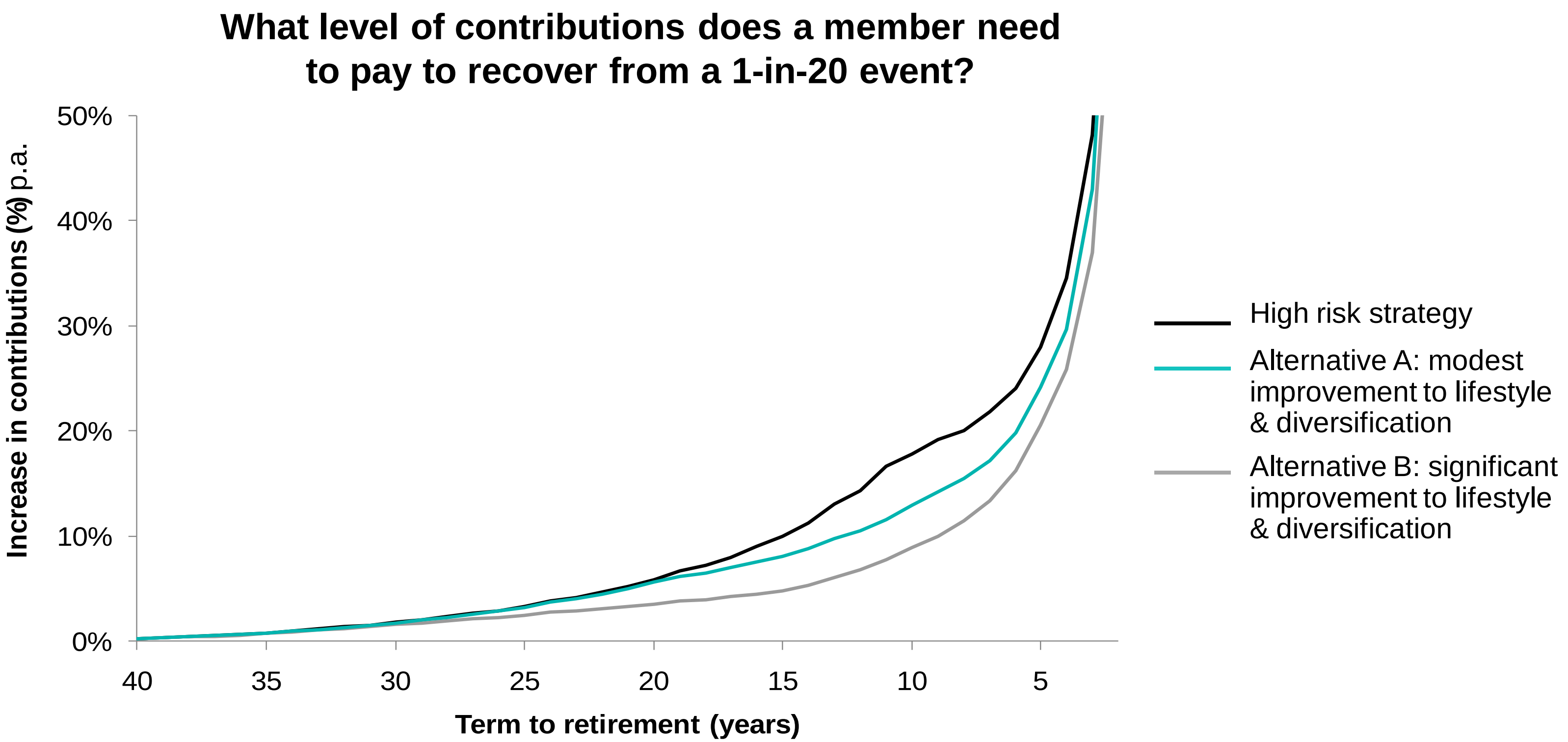
- People appreciate the value of DB plans and are worried about market risk
- People do not want a “one-size-fits-all” plan; they want flexibility
- If a DB plan is exactly aligned to an individual’s target preferences, they like the DB plan. But if it happens to be far off, they might prefer DC, even with all the consequent risks and issues

Figure 1 | Individual preferences towards pension income and risk



Source: Watson Wyatt Retirement Preferences Multideck Survey

Complexity: Presenting Information Differently

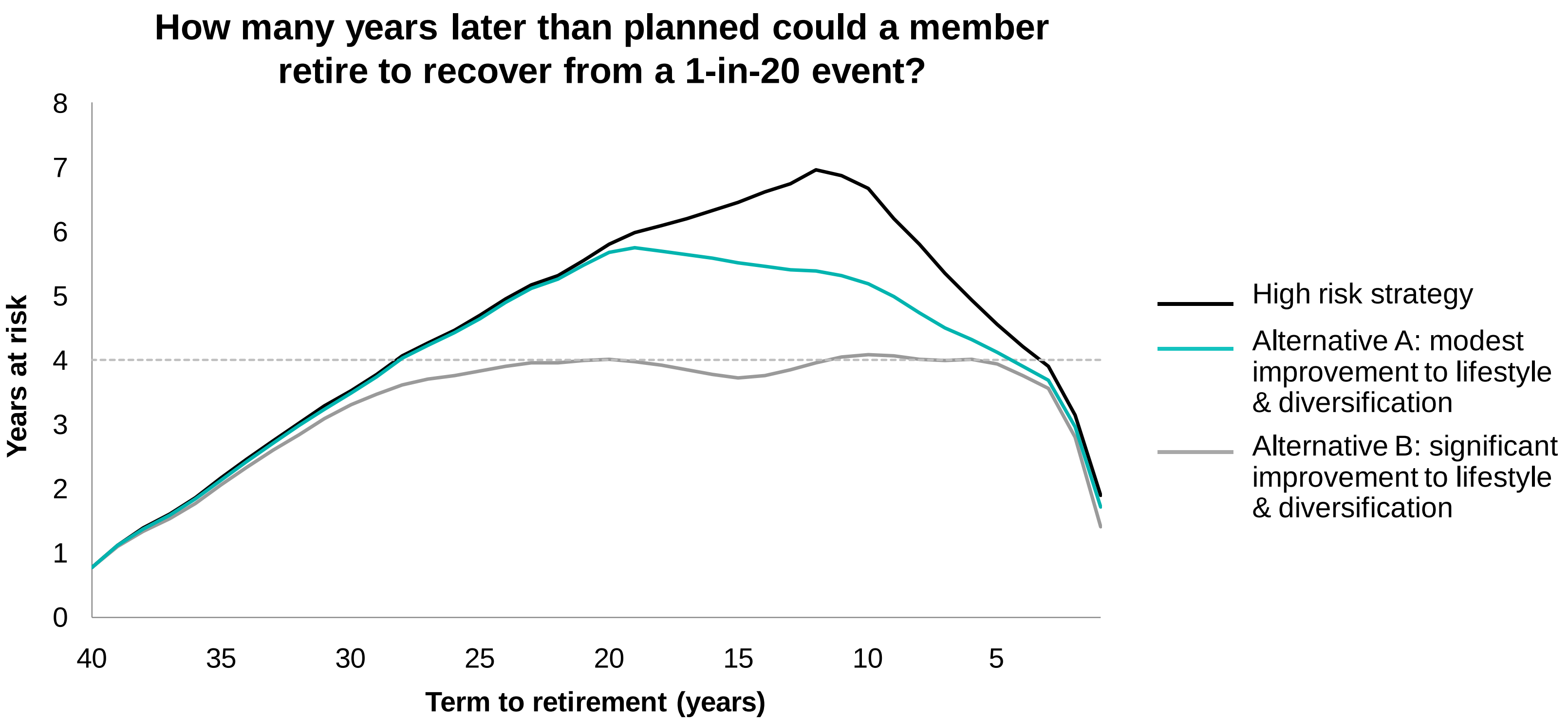


Source: Towers Watson

Contributions at Risk

Percentage of additional contributions a member needs to pay to recover from a 1-in-20 event occurring over 1 year, maintaining their expected replacement ratio at retirement

Complexity: Changing the Language



Source: Towers Watson

Retirement at Risk

Number of years a member needs to defer retirement to recover from a 1-in-20 event occurring over 1 year, maintaining their expected replacement ratio at retirement

Community: Friends and Family are Important

- Individuals make decisions based on information from what they view as credible sources and friends/family play an important role
- Who most do you trust for advice on how to save for retirement? (Towers Watson survey, May 2011)

	UK	Netherlands	Germany
Friends/family	36%	26%	53%
Co-workers	4%	4%	4%
Employer	10%	10%	7%
Government	4%	8%	3%
Financial Adviser	42%	43%	29%
Other	4%	9%	4%

Credibility: Source of Advice Matters

- One reason communication strategies and default strategies work is that they are implicit advice from credible sources.
- Example: an academic doing an experiment is credible because they are viewed as an expert. Individual: why not follow the default?
- Individuals do not follow ridiculous defaults – they only accept defaults they regard as "reasonable"

Credibility: Source of Advice Matters

- Survey in UK, Germany, Netherlands in May 2011 – looks at decisions on defaults by source of default and default level (“anchor”)

Table 1

Survey groups

	Anchor			
Social norm (SN)	None/ blank	Low	Middle	High
a) None	1	2	3	4
b) Employer		5	6	7
c) Friends and family		8	9	10
d) Peers		11	12	13

Middle is 10%; low is 5%; high is 20%

Table 2

Amounts per month (x)

		x value		
	Salary group	Low	Middle	High
G1	Less than £15,000 (assumed mean £12,000)	50	100	200
G2	£15,000 to £40,000 (assumed mean £24,000)	100	200	400
G3	£40,000 to £100,000 (assumed mean £60,000)	250	500	1000
G4	£100,000 or more (assumed mean £120,000)	500	1000	2000

Complements – Saving for Other Reasons

- China – individuals save because:
  - Health (lack of insurance markets)
  - Housing
  - Bequest motive

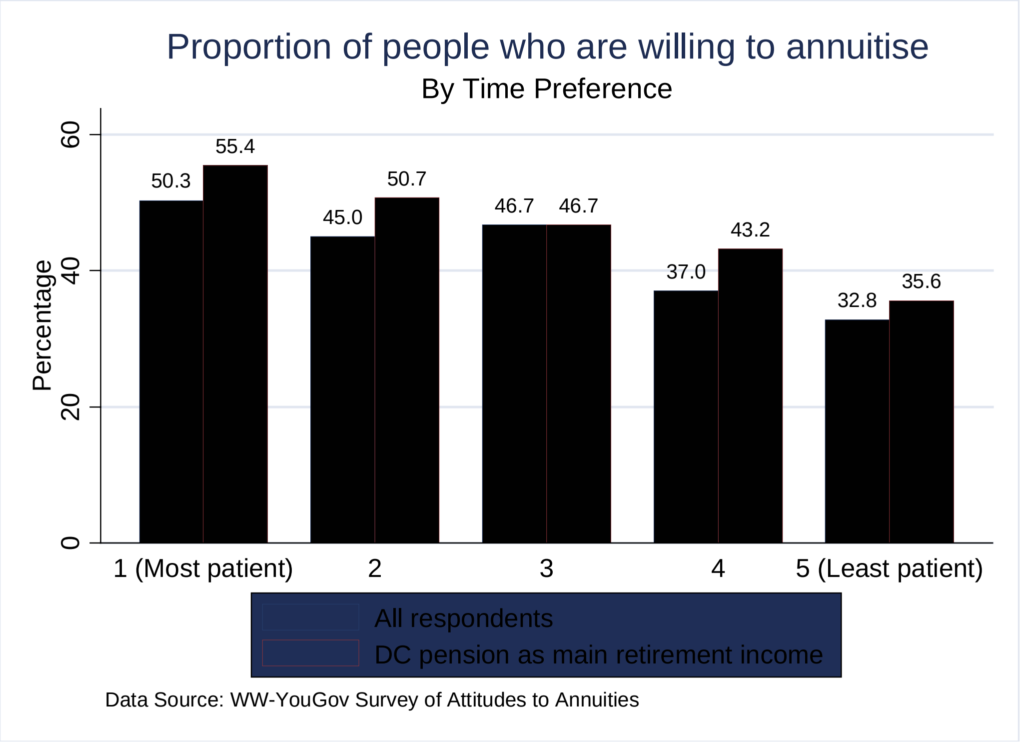
  So without thinking much about retirement, many are ready “accidentally”
- India – like China on many dimensions:
  - Weddings

Connectivity: Advisory Sector

- Independent advisers very scarce in most developing markets
- Tied advisers also often scarce and not that well developed either in most case
- Incentives for advisers are often focused too heavily on maximizing assets (and hence fees) and not enough on suitable outcomes for individuals
- Reluctance of individuals to share holistic information with financial firms

Culture and History

- Role of past crises/mistakes in product choice
- Historical preferences



Summary: Key Factors in the Enabling Environment

Contextual issues

- **Communications** - the importance of communications over incentives
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Observations

- It is important in implementing matching contributions to take into account each of the contextual factors…
- Still…none of the core environmental problems is really solved by matching contributions.
- That + matching contributions are unlikely to be progressive raises the following question:
  - Would resources that are spent on matching would be better allocated at dealing with the core environmental issues that impede retirement preparation?