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# Banking on US Social Security

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Private Social Security accounts will challenge financial institutions, but the opportunity is huge—and may be replicable in other countries as they reform their retirement systems.



**L**ast year's presidential campaign in the United States catapulted Social Security reform—once known as the “third rail” of the country's politics because nobody dared touch it—to the top of the political agenda. Many proposals, including those put forward by President George W. Bush and former Vice President Al Gore last autumn, had at their center the idea of creating private Social Security accounts held in financial institutions and invested in public markets. Reform of the system, with its huge tax revenues of \$500 billion a year, is now among the Bush administration's top legislative priorities.

This is a great opportunity for financial institutions—or is it?<sup>1</sup> Some of them should look more closely at the potential impact of creating large volumes of small private accounts. Brokerage houses, retail banks, insurance companies,

<sup>1</sup>This article is intended not to evaluate the recent proposals from a public-policy perspective but to assess their potential impact on financial-services companies.

and mutual-fund managers could all be affected in different ways. The size of accounts, the guarantees required for them, the way they are administered, what investment products are allowed or disallowed—any of these things could turn private Social Security accounts into money losers. And if institutions wait to see how reform takes shape before considering its implications, they will forfeit the opportunity to prepare for it and to influence its direction.

Of course, the case for reform stems from the widespread belief that the US Social Security system can't withstand the mounting pressure of a baby-boomer population aging its way toward retirement. With the number of retired people growing, a smaller number of young workers are shouldering more and more of the burden. This demographic reality is widely shared: the governments of countries as diverse as China, Germany, and Sweden are now debating pension reform. Nowhere is the pressure more intense than in Western Europe, where the demographic shift is taking place faster, the shortfall is larger, and high personal and corporate taxes leave little room for increases.<sup>2</sup>

The pension reform packages of a number of governments have included the investment of funds in public markets as a prominent feature. In certain countries, such as Australia, Chile, and the United Kingdom, these investments are channeled through privately managed accounts; in others, such as Singapore, through government-managed trusts. The innovators have taken different positions on how best to protect beneficiaries and to encourage performance while minimizing costs.

## Challenging economics

Since the spectrum of possible Social Security reforms is quite broad, we focused on the Bush and Gore proposals to illustrate what could eventually happen.<sup>3</sup> The new US administration can be expected to frame its legislative proposals around the Bush campaign ideas. And the ideas embodied in Democratic proposals, such as the one Mr. Gore made during last autumn's campaign, will likely be influential in shaping the debate. The Bush and Gore proposals would create 50 million to 110 million private accounts,

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<sup>2</sup>Retirees in Continental Europe depend overwhelmingly on government pensions. In Germany, for example, 82 percent of retirement assets come from this source, 5 percent from company pensions, and 13 percent from private savings. In other words, voluntary pension assets are extremely low—14 percent of gross domestic product per person in Germany and only 7 percent in France and Italy—compared with 71 percent in the United States and 77 percent in the United Kingdom. With effective tax rates at 46 percent in Germany (as opposed to 31 percent in the United States), it will be hard to finance any shortfall through tax increases.

<sup>3</sup>One alternative, to centralize account administration in a government agency, has been suggested by a number of interested parties, including the National Commission on Retirement Policy, chaired by Senator John Breaux.

with as much as \$100 billion a year in new funds flowing into the financial markets.<sup>4</sup> Although these figures are small as against the \$25 trillion currently invested in US financial markets, they are quite substantial when compared with the average net long-term equity inflow of \$225 billion into retail mutual funds since 1997. Eventually, money in private Social Security accounts would accumulate to form large pools of assets—pools larger than today’s \$2 trillion market for individual retirement accounts (IRAs) and, in the long term, perhaps constituting as much as 5 to 10 percent of the private financial wealth of the United States.

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Money in private Social Security accounts would **accumulate** to form large pools of assets—larger than the \$2 trillion market for IRAs

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Would private institutions manage these assets profitably? The new accounts will be equivalent to 25 to 50 percent of the volume of existing mutual-fund accounts, while the assets in the new accounts will be more fragmented and accumulate only slowly. In 1998, for example, 40 million people in the United States had incomes below \$8,500 a year—an income level that would translate into an annual flow of only \$170 a year.

To assess the economic feasibility of private Social Security accounts, we developed a proprietary model that analyzes the impact of different reform scenarios and the limits, if any, on the fees of the financial institutions that manage the new accounts. We also analyzed their business mix and cost position.

Our model generates two key insights. First, the fine print of reform matters enormously; for example, the profitability of managing private accounts will depend largely on drivers such as whether the system is “open” (so that participants can invest in third-party funds) or “closed” (allowing participants to invest only in the funds of the institution managing the account). Second, the more the eventual reform embodies the higher fee caps and larger fund flows provided for in the Gore plan, the more attractive such institutions will find it (Exhibit 1, on the next page).

Here, in brief, is how the two plans compare.

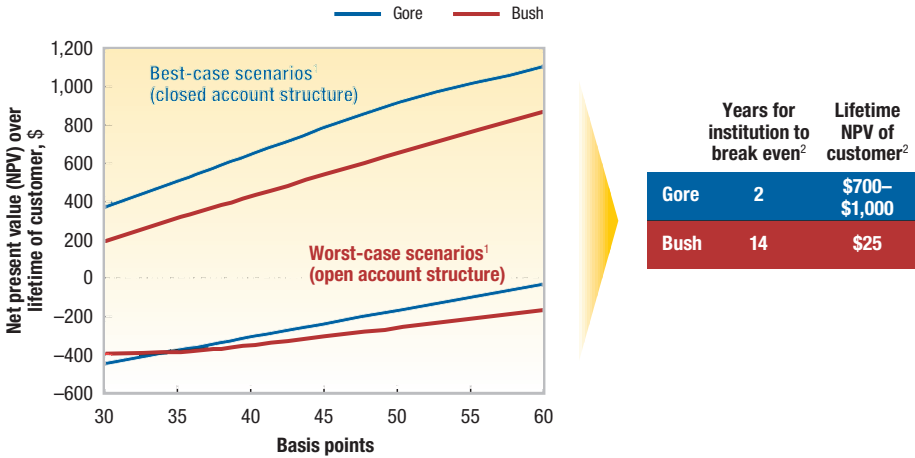
Under the plan Mr. Bush set forth, 2 percent of the 12 percent Social Security payroll tax (payable on income up to \$76,200) would be diverted to private accounts controlled by individual employees. An average account would have a fund flow of roughly \$700 a year, growing to roughly \$100,000 in assets

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<sup>4</sup>There is considerable debate about the impact these inflows could have on equity markets. This article is not intended to address it.

EXHIBIT 1

**Tale of the tape: The Gore plan is more profitable for financial institutions**



<sup>1</sup>Best-case scenarios assume closed account structure, large-scale money manager (with annual costs of \$20 per account + 10 basis points), and good marketing; worst-case scenarios assume open account structure (with ~70% of funds invested in third-party funds), small-scale money manager (with annual costs of \$30 per account + 20 basis points), and average marketing.

<sup>2</sup>Estimates based on a midrange scenario that assumes closed account structure, large-scale money manager (with annual costs of \$20 per account + 10 basis points), and average marketing.

at retirement. Our calculations, using the proposed 35-basis-point cap on fund expenses, suggest that even a big index-fund company—with its low costs, 100 percent proprietary share of an account’s business, and full fee—would struggle to turn a profit on such an account. The company would break even only after 14 years and earn a net present value of roughly \$25 over a contributor’s lifetime.

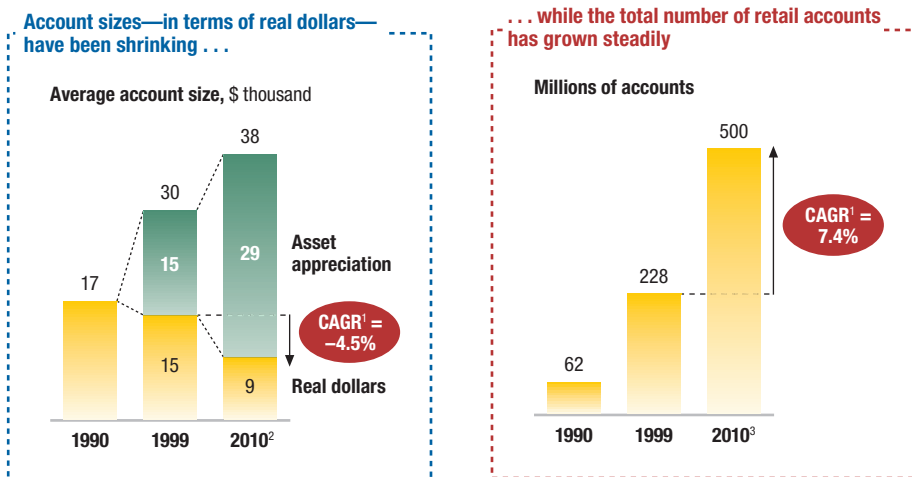
By contrast, Mr. Gore’s approach to private accounts is much kinder to financial institutions. The Gore plan, calling for the creation of an investment vehicle akin to an enhanced IRA, would give matching tax credits to contributors on a scale varying with their income; total annual contributions would be capped at \$2,000, and average accounts would build to \$250,000 to \$400,000 in assets by retirement. Using the proposed 60-basis-point fee cap, our calculations suggest that a financial company offering a low-cost index fund for these accounts could break even in two to three years and earn a net present value of \$700 to \$1,000 for each account over a lifetime.

**The strategic choice**

If reform leads to competition in private Social Security accounts, financial institutions will have to make tough decisions about whether and how they should participate. Despite the low potential profitability of the accounts, they could have great strategic importance. Companies must balance a number of considerations:

1. Private accounts may be these institutions' introduction to the assets of the next generation. Can a company afford to stay out of a market that might include every worker in the country? This consideration is especially important for active managers that find the fee caps restrictive but may not want to risk handing off all US first-time savers to index funds.
2. Private accounts may provide a platform for cross-selling, and an otherwise unattractive account may be quite profitable if it serves as the doorway for other product offerings to the account holder. While US retail banks have traditionally struggled with cross-selling, their European counterparts have been more successful. Recent trends in on-line account aggregation may eventually make cross-selling easier.
3. Small retail accounts are becoming the norm. Mutual funds are now mass-market vehicles, and the ease with which people can move their assets around on-line means that account sizes, in real terms, have been steadily shrinking, while retail accounts have proliferated (Exhibit 2). As a result, financial firms that profitably manage private Social Security accounts will probably gain valuable knowledge that can be transferred to other retail accounts.
4. Private Social Security accounts may substantially displace existing savings. Financial institutions will therefore have to guard against the "substitution effect" that occurs when savers switch from one savings

## EXHIBIT 2

**Money on the move: Small accounts proliferate**<sup>1</sup>Compound annual growth rate.<sup>2</sup>Forecast; assumes annual market growth of 9.8%.<sup>3</sup>Forecast.

Source: Sanford C. Bernstein; Investment Company Institute; McKinsey analysis

vehicle to another. Particularly under the Gore plan, flows to private accounts might end up displacing money that would otherwise have gone to more traditional approaches to saving, and these substitution effects would be significant.

5. It could in effect be mandatory to offer private Social Security accounts, since institutions may feel that they must do so as a convenience for their current customers. As with government-mandated insurance pools, however, these institutions may then have to accept accounts from customers at all income levels.

## Lessons from the United Kingdom and Hong Kong

Financial institutions in countries where pension reform has already been enacted faced similar strategic decisions. Chile has the longest-running and most studied privatized pension system.<sup>5</sup> But the experiences of the United Kingdom and Hong Kong are probably more relevant for the United States. They suggest that many financial institutions should regard the private-account market as a strategic one.

### The United Kingdom

In 1988, the government of the United Kingdom allowed the country's people to opt out of its government-run pension system and to open individual accounts at private financial institutions. As difficult lessons have been absorbed, the reform has gone through a number of changes.<sup>6</sup> The most recent of them was the introduction of CAT (charges, access, and terms)-marked Individual Savings Accounts (ISAs), with mandatory basic financial advice, full disclosure of all commissions, and fee caps of 100 basis points. These CAT-marked ISAs are "government-approved" mutual funds, but individuals can choose to invest in actively managed products that carry higher fees. Many companies compete in the UK market, some more successfully than others, and their experience provides a number of important lessons for US financial institutions.

<sup>5</sup>Chile's tightly regulated pension reform is only marginally useful for assessing the private-account system envisioned in the Bush and Gore plans. The Chilean experience—the "grandfather" of pension reform—is widely viewed as successful despite its structural rigidities. About 95 percent of the country's employees participate. Assets under management have grown to \$34 billion (40 percent of GDP and projected to hit 134 percent by 2020). The average real rate of return for the past 18 years has been 11.1 percent, and administrative expenses are estimated to be 84 basis points a year over the life of an account—42 percent lower than those of the old government-run pension system.

<sup>6</sup>The government initially adopted an extremely decentralized program with no limits on fees or products. As a result, fees were quite high—estimates run up to 250 basis points a year—and many financial institutions competed. The results were negative for investors and financial institutions alike. Frequent switching and high fees rapidly dissipated account values by as much as 40 percent, and a "mis-selling" controversy erupted as financial institutions marketed unsuitable investment vehicles. See Mamta Murthi, J. Michael Orszag, and Peter R. Orszag, *Administrative Costs Under a Decentralized Approach to Individual Accounts: Lessons from the United Kingdom*, The World Bank Conference, September 1999.

First, if consumers are allowed to choose, active managers may want to play despite the presence of products with lower fees. One notable example in the United Kingdom is Framlington, whose popular NetNet fund, managed by the US company Munder Capital Management, has a 5.25 percent load (purchase fee) and an annual fee of 1.75 percent. Indeed, contrary to conventional wisdom, actively managed products have gained a healthy market share in the United Kingdom, taking approximately 17 percent of ISA sales last year.

Second, the rigors of the private-account market can be challenging, and low-cost strategies are vital. In Britain, for instance, Schroders is “stuck in the middle,” with actively managed funds that are too expensive to qualify for the government CAT standard and not compelling enough in performance or positioning to attract customers willing to pay higher fees. In contrast, Merrill Lynch has tailored its offerings to fit the ISA market’s needs: to cut its costs—and contrary to its practice in other parts of the world—it outsources the administration of accounts to the low-cost, high-volume company AMP (formerly the Australian Mutual Provident Society). Virgin Direct, launched by the ubiquitous Richard Branson with his usual savvy marketing, is very active in the ISA market, offering a low-cost, limited-advice domestic-index product.

## Hong Kong

Last year, with the introduction of the Mandatory Provident Fund (MPF), Hong Kong enacted a different version of reform. All employees must contribute 5 percent of their pretax income to privately managed accounts, and their employers contribute a matching 5 percent. Hong Kong’s government has not only imposed fee caps on these accounts but also prohibited the standard (in Asia) front-end 5 percent sales fee on retail mutual funds.

Despite the prospect of thin profit margins, this market has attracted many financial institutions, which reason that winners in the MPF business will have a good position for selling other investment products as Hong Kong’s population ages. In addition, banks such as AIG and Jardine Fleming, HSBC and Hang Seng, and Bank of China and Prudential (UK) are recognizing the importance of scale and banding together in consortia and joint ventures to provide MPF accounts.



## Pick your strategy

Any financial institution that decides to go ahead in the private-account market for Social Security must consider two basic questions: which reforms

would have the greatest impact and which strategy makes the best use of the institution's current market position and capabilities?

### Know the likely parameters of reform

Seemingly minor differences in the way accounts are structured will affect their viability, and a host of issues must still be resolved. Will financial institutions have to handle tiny private accounts (say, with a \$200 a year inflow), or will they be pooled? How much advice must be offered to investors, many of whom will be first-timers? What investment restrictions will be placed on these accounts—for instance, fee caps, asset allocation restrictions (such as

index funds-only), and provisions guaranteeing the principal? Is participation to be voluntary or mandatory? Will the decision to participate be revocable year by year? How often will investors have the right to change their investment choices or to move accounts?

The way all of these questions are resolved will affect the profitability of private Social Security accounts, and the resolution must benefit both individuals (in the form of minimal expenses and high account balances) and financial institutions (in the form of assets that, although small, are of high quality). The

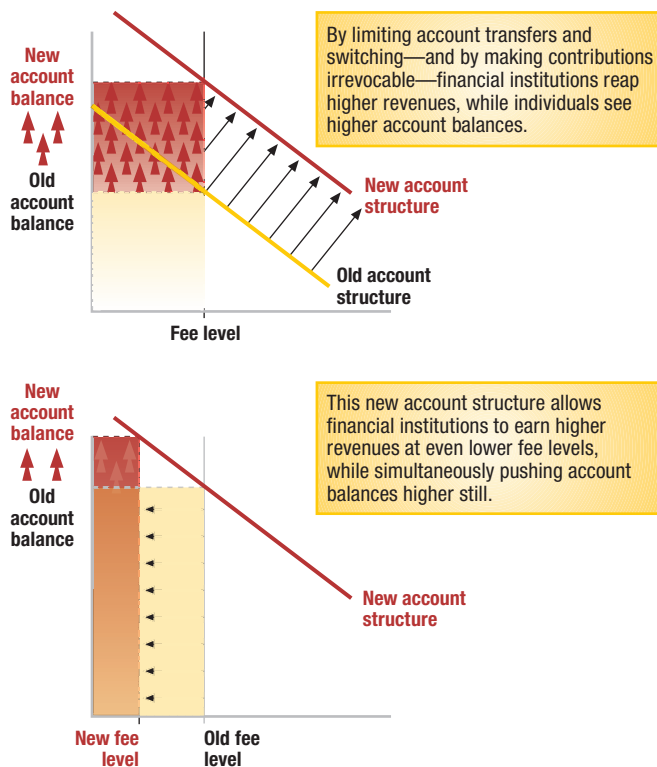
answers might include limits on account transfers and switching, provision for adequate but reasonable reporting, and incentives or requirements for a steady stream of contributions (Exhibit 3).

One last question remains: who will administer the accounts, assuming that the private sector is going to be at least partly involved—the employer, the

#### EXHIBIT 3

#### Everyone wins

Impact of private account structure on social security system



employee, the government, or some hybrid entity? The IRA and the 401(k) markets provide useful parallels. We believe that different kinds of financial institution may very well prefer different scenarios.

1. **Retail banks:** On the whole, it is the country's retail banks that will benefit most from an employee-driven account (such as the Gore campaign plan calls for), thanks to their strong customer relations and their relatively low cross-selling costs. Citigroup, for example, has more than 75 million checking accounts and credit card accounts. While there is probably a fair amount of overlap among their holders, they certainly represent a huge base of individual customer relationships that could be targeted by Citigroup for additional services such as private Social Security accounts.
2. **Insurers:** A system run by employers (as in the Bush campaign plan) would suit insurers. Some of them, such as Prudential and The Principal Financial Group, have developed sizable positions serving employers in the 401(k) market. Moreover, insurers would be well positioned to incorporate a private Social Security account into their bundled offerings for small businesses.
3. **Asset managers:** Under any scenario that has been mentioned so far, asset managers in general would have a strong position. But a winner-takes-all approach in which the government administered the accounts and outsourced the money-management function to one or more large-scale institutions might benefit a few big incumbents—for instance, the Vanguard Group, State Street, and Barclays. The federal Thrift Savings Plan, with about \$100 billion in assets and 2.5 million federal government employees as participants, is an example of this approach; Barclays is the sole money manager. Although the plan was cited as a model for reform in the 1998 report of the National Commission on Retirement Policy, it may well be impossible to scale up such a program to handle up to 50 times as many accounts.
4. **Retail brokers:** Of course, the mass-market nature of private Social Security accounts runs contrary to the strategic focus of the retail brokerage houses on affluent and high-net-worth customers. Such brokers, we nonetheless believe, are going to participate defensively in the market, possibly by offering private accounts to existing customers in an effort to avoid losing them.

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Insurers would be well positioned to incorporate a private Social Security account into their bundled offerings for **small businesses**

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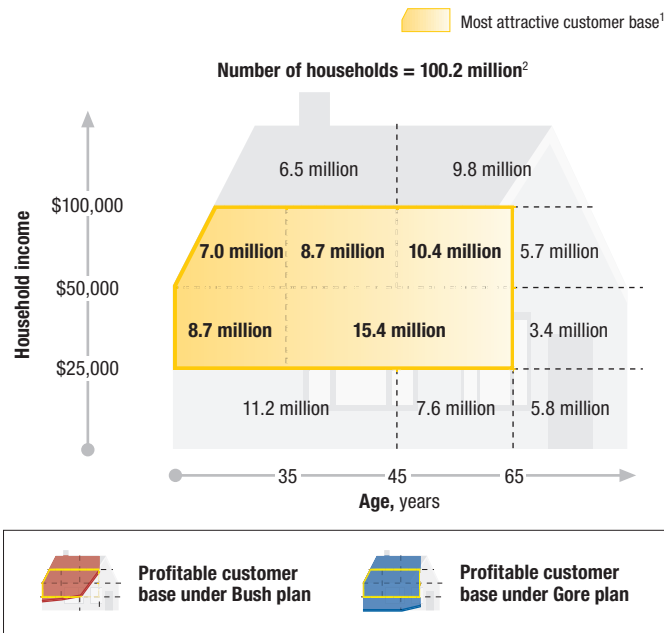
## Winning roles

Regardless of the precise strategy an institution chooses, winners in the Social Security private-account market will share certain capabilities. These include widespread and low-cost distribution to reach a large share of the millions of eligible contributors, particularly in the most attractive segments; low-cost processing and servicing; scaled asset management to generate steady investment performance over a large volume of assets; cost-effective advice for new investors; and successful cross-selling.

We envision three winning roles.

### EXHIBIT 4

#### Sweet prospects for aggregators



<sup>1</sup>Includes >20 million people classified as first-time savers.

<sup>2</sup>As of January 2000.

Source: PSI Global; McKinsey analysis

#### Customer aggregators.

Some institutions will acquire private-account customers in a cost-effective way—as individual retail customers or as employer sponsors, depending on the nature of reform—and develop advanced customer-relationship-management (CRM) capabilities to cross-sell additional products. These players will pursue an open approach to offer their customers the best products regardless of source. If necessary, they will outsource their record keeping.

Today's retail banks are probably in the best position to implement this strategy, since they have so many customers, but they will need to improve their ability to sell a number of different products. Although no one can be turned away, aggregators will have to develop a profitable customer base for private Social Security accounts, and the ideal target (because of the long-term cross-selling opportunities) would be young, middle-income, first-time savers. The “sweet spot” in this attractive market includes more than 20 million people in the United States (Exhibit 4).

**Product innovators.** Other successful institutions will hit that sweet spot in two ways: first, with low-fee or enhanced index products whose principal will be guaranteed as funds accumulate and then with insurance or annuity-like products for the retirement phase. Large-scale asset managers have the best position to execute the first part of this strategy. For the second part, insurance companies, with their risk assessment and actuarial skills, are better prepared to provide estate-planning products that offer financial and health care security for people living on retirement incomes. Consortia or joint ventures may emerge to meld the best of both.

Active managers (for instance, Putnam Investments and the Capital Group Companies) will have to develop an appropriate mix of offerings, such as enhanced index products. In some cases, it will be necessary for these companies to create alliances either with banks (to obtain CD products or guarantees from the Federal Deposit Insurance Corporation) or with insurers. One possibility for such institutions may be to set up independent and uniquely branded Social Security products, with the idea of eventually graduating the private assets of people who hold them to products that are more actively managed.

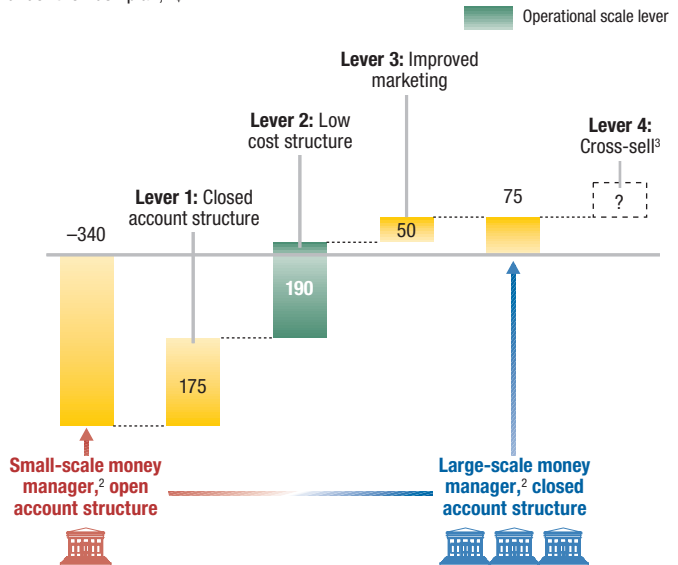
**Large asset managers or record keepers.** Achieving scale and cutting costs are vital for the profitability of private Social Security

accounts for the institutions that manage them. As Exhibit 5 shows, the preeminent driver of an account's profitability for the managing institution is its ability to increase the scale of its operations—and thereby to reap per-account cost savings. Winners will manage low-cost basic index products and keep records for millions of people. A few firms (for instance, Fidelity

#### EXHIBIT 5

#### Operational scale is the key

Effect of applying selected levers to the lifetime net present value of a typical account under the Bush plan.<sup>1</sup> \$



<sup>1</sup>Assumes individual enters plan at age 22 with a starting salary of \$20,000, earns 2% wage growth per year, retires at age 67, and dies at age 82, having kept the same money manager throughout.

<sup>2</sup>Small-scale money managers have annual costs of \$30 per account + 20 basis points; large-scale money managers have annual costs of \$20 per account + 10 basis points; open account structure assumes ~70% of funds invested in third-party financial products.

<sup>3</sup>Estimated as up to 4–5 times account value.

Investments and State Street) have succeeded in developing these bundled capabilities in-house. Other companies may try to develop them by resorting to alliances.

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Social Security reform is both a threat to and an opportunity for financial institutions, which must address the challenge now while the details of the transformation are still fluid. In order to win, each player must take a hard look at its internal scale competencies; fill any gaps, internally or through alliances with other companies; and develop strong products and cross-selling strategies. In the United States alone, the opportunity is huge, and the skills required to succeed will be valuable globally as other countries reform their retirement systems. *MQ*

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