GLOBAL TRENDS IN PRIVATE PENSION SYSTEMS AND OECD'S PERSPECTIVES

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OECD
BETTER POLICIES FOR BETTER LIVES

Structure of the talk

1. Framework of thought
   - Objectives and risks
2. Challenges facing pension systems
   - Ageing, low growth, low return environment
3. Changing pension landscape
   - Growth of funded pension arrangements
   - Strengths and weakness of DCs
4. Need for improvements: OECD Roadmap for the Good Design of DC Pension Plans
   - Accumulation: investments, risk-adjusted returns, defaults
   - Retirement phase: longevity protection/sharing

Objectives of pension systems

- The primary objective of pensions is to make sure that people have resources at old age (economic security)
- This includes

1. Reduce or eliminate poverty at old age: **poverty relief**
2. Make sure people save during their working life to finance their retirement: **saving for retirement – consumption smoothing**
3. **Insurance** against risks during working life and in old age

Objectives of pension systems: secondary goals

1. Financial and fiscal sustainability
2. Adequacy
   - What is adequacy? Minimum, living standard, income or RR
   - Balance act btw sustainability and adequacy
3. Coverage (mandatory, voluntary)
4. Efficiency
   - align charges / fees with the cost of providing funded pensions (choice)
   - defaults (lower risk big shocks for those close to retirement which have not chosen)
   - align accumulation and retirement phases

Objectives of pension systems: secondary goals

5. Make sure pension systems will deliver (security):
   - Robust regulatory and supervisory frameworks (OECD Core Principles of Private Pension Regulation)
   - Financial education and communication
   - Political shocks (low adequacy, coverage, high costs, financial sustainability)
6. Preserve inter and intra-generational equity
7. Support (not distort) incentives to work and save

Poverty relief

- The first objective is to bring people at old age above certain level of income (poverty relief)
- It leads to **redistribution**.
- It is part of the State safety net.
- They include basic, national or minimum pensions
- They are non-contributory public pensions
- OECD main message: finance them from the budget, from general taxation.

Saving for retirement – Consumption smoothing

- It is financed through **contributions** (savings)
- Contributory based pensions can be financed from current contributions (**PAYG**) or with assets accumulated to back pension benefits (**funded**)
- Mandatory or voluntary
- Funded pensions can be **occupational** (linked to an employment relationship) or **personal** (no employment link).
- Contributory based pensions (PAYG or funded) promise a pre-defined pension (**DB**) or pension benefits depend on the amount of assets accumulated (**DC**)

Risks involved in saving for retirement

- Planning for retirement (saving for the future) involves risks
- Future is uncertain, assumptions rarely materialise as expected: risks
- These risks need to be accounted for and monitored
- Examples are labour market, financial, macroeconomic and demographic risks

Different pension arrangements to achieve objectives and address risks

- There are many type of pension arrangements
- Countries have a combination, what varies is the weights of the different components in each country
- Different arrangements and different combinations depend on the ranking of objectives and risks that each countries sets out to address
- Criteria to assess different types of arrangements (no pillars)

Criteria to assess different pension programs within a country pension system

1. Whether they are mandatory or voluntary
   - ➢ Soft-compulsion, auto-enrolment with opt-out
2. How pension benefits are financed
   - PAYG: with current contributions
   - Funded: with assets accumulated
3. Relationship btw contributions and pensions:
   - **Defined benefits** plans (DB): pension benefits are pre-defined (e.g. public pensions, funded DB pension plans)
   - **Defined contribution** plans: pensions benefits depend on the amount of assets accumulated at retirement (automatic adjustment)
     - They may include some type of guarantees (e.g. minimum returns, minimum income floor)

Criteria to assess different pension programs within a country pension system

4. Employment relationship: occupational, personal. Role of the employer:
   - record keeping, contributes, set up the plan (sponsor)
5. Who manages the plans: public or private
6. Who bears the risk: employer (DB), State (employer, tax payer public pensions), individuals (DCs), or risk sharing.

CHANGING PENSION LANDSCAPE CHALLENGES FACING PENSION SYSTEMS

Challenges facing pension systems

- Pension systems (PAYG DB, funded DB and DC, whether voluntary or mandatory) face many challenges
  - Population ageing:
    - financial sustainability, solvency and adequacy
  - Financial and economic crisis
    - Loss of public trust pension systems will deliver
  - Economic environment characterised by low interest rates, low returns, and low growth
    - Less resources to finance retirement => lower retirement income (?)

Implications of population ageing

- Differentiate btw baby boom (temporary) and improvements in life expectancy (permanent?)
  - Baby boom: costs already incurred
  - Life expectancy (increase years in retirement relative to years saving for retirement): account for it, problem with uncertainty about future improvement (longevity risk: financial markets)
- PA affects mainly PAYG-financed pensions because current workers pay for current pensions.
- Also indirectly through GDP growth and wage growth
- Affects also indirectly (through its impact on returns on investment) funded pensions.

Population ageing: implications

- Higher dependency ratio means
  - Intense fiscal pressures on PAYG DB pensions: fiscal ***sustainability*** problems
- More years in retirement to be financed (relative to years saving for retirement)
  - ***Solvency*** (financial sustainability) problems for fund DB pensions
  - ***Adequacy*** problems for DC pension

Economic environment low interest rates, low returns, and low growth

- Low internal returns in PAYG schemes (wage bill growth), which raises (compounds) financial sustainability issues
- Loss of confidence in private pensions, mistrust that public pensions will deliver promises
- Low financial returns generate retirement-income adequacy concerns, especially on DC
- Funded DB pensions and insurance companies providing promises (e.g. annuities) may be in trouble as their long-term promises cannot easily be adjusted and the assets backing those promises may lose value

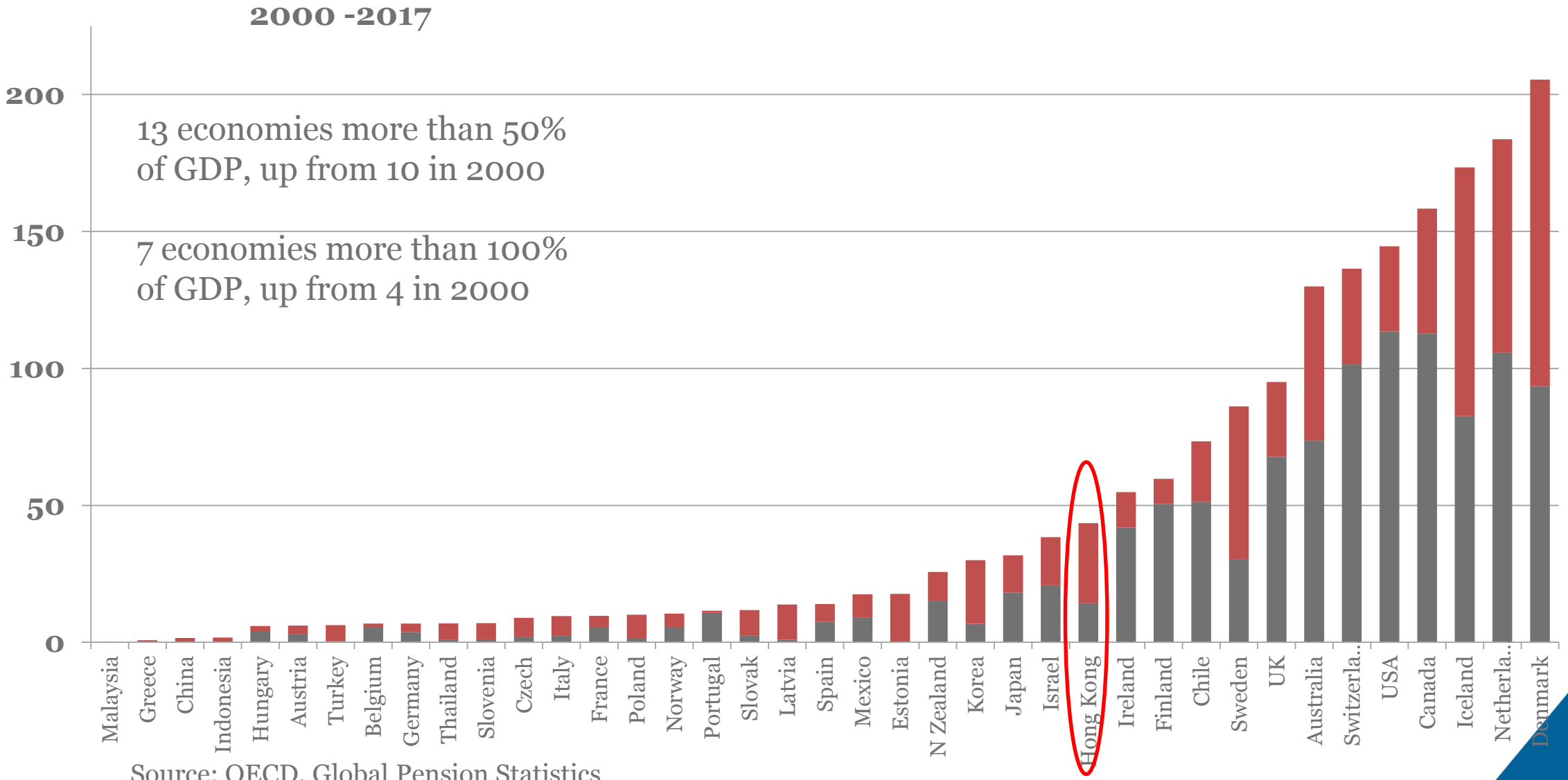
Consequences and changes: Trends

- Changing pension landscape: more diversified and balanced
  - Reforms of PAYG public pensions (parametric adjustments, increases life expectancy, automatic mechanisms, NDC) => lower role of PAYG public pensions in financing retirement
  - A shift from DB pension arrangements (based on a promise) to DC pension arrangements (direct and straight-forward link between contributions and pension benefits)

Changing pensions landscape: more diverse and balanced

- Increased role of funded pensions: pension arrangements in which assets back pension benefits
- In line with OECD long standing policy messages:
  - Diversify the sources to finance retirement
  - Encourage funded pensions

The growing importance of funded pension (assets as % GDP)



Source: OECD, Global Pension Statistics

Accumulating assets to finance retirement: Policy goals

- Increase of national savings
- Reallocate savings to long-term
- Develop financial markets
- More investment financed with national savings
  - Increase of long-term investment
  - Less borrowing from abroad to finance investment
- Higher investment ➔ increase productive capacity, increase productivity, increase GDP, higher wages and employment, higher tax revenues, lower deficits.

Messages

- The introduction of pension arrangements in which contributions are accumulated and invested to finance retirement, through pension funds, increase long-term savings.
- Finance retirement through asset accumulation and pension funds deepens financial and capital markets (if appropriate measures to address problems of small financial markets, low competition)
- Finance retirement through asset accumulation and pension funds increases growth if deep financial markets

Increased role of DC pension arrangements

- The growth in funded pension arrangements comes mainly from arrangements in which there is a direct and straightforward link between contributions, assets accumulated and pension benefits (DC pensions)
- Is this good?

DCs are here to stay, have advantages, but also disadvantages

- DC pension arrangements provide a transparent and straightforward link between pension benefits and contributions.
- It provides an *automatic mechanism* adjusting actual and projected parameters and thus removes the problem of generous pension benefits and how to finance them.
- Provides incentives to work

DCs are here to stay, have advantages, but also disadvantages

- Disadvantages:
  - Retirement income is uncertain
  - Burden shifted to individuals
- They put more of the risks of saving for retirement (e.g. investment and longevity risk) onto individuals
- Individuals need to take decisions on how much to save and for how long, how to invest, and how to allocate the resources available to finance retirement
- They may not be the best prepared to take them
  - Individuals have low financial knowledge
  - They suffer from behavioural biases (present bias, loss aversion, procrastination, inertia, use simple heuristics, overconfidence, overextrapolation, use simple rules of thumb, framing)

DCs are here to stay, but we need to improve their design

- The main concern with DC plans is **adequacy**
- Current contribution levels and contribution periods may not bring about as high retirement income as expected. No inherent negative feature of DCs.
- Contributions to DC plans tend to be low by design in almost all OECD countries, while contributions in DB pensions tend to be higher than in DC plans (25% as oppose to 10% on average)
- The question is then, given all those problems: ageing, environment of low growth and returns, with the growth of DC pension arrangements where people bear most of the risks and need to make many decisions (participate, how much, chose providers, investment strategy, allocate assets in retirement), but low financial knowledge and behavioral biases.
- How can DC pensions deliver pension income which it is up to people's expectations?

International best practices: 5 categories of policies

- *Automatic features:* increasingly used to make funded pension systems more inclusive and help participants reach an adequate contribution level (e.g. automatic enrolment and automatic escalation of contributions). They harness the power of inertia to keep people saving for retirement.
- *Default options* help people who are unable or unwilling to choose a contribution rate, a pension provider, an investment strategy or a post-retirement product.
- *Simplification of information and choice* can help people make better choices. Developing web applications, reducing the set of options, better disclosure of information or facilitating the comparison of options.

International best practices: 5 categories of policies

- *Financial incentives* are widely used to promote private pension arrangements as they exploit individuals' tendency to respond to immediate gratification.
- *Financial education* plays an important role in supporting individuals to make appropriate decisions. Conveying key information in a simple way through pension statements, financial education seminars and financial advice can improve decision making.

OECD response: Improve the design of DC pension arrangements

- OECD Roadmap Good Design DC Pension Plans
- Issues we need to deal with
  - Contribute more and for longer, How? (defaults, auto-scalation, save more tomorrow)
  - Compulsion vs voluntary,
  - Improve the functioning of financial incentives (voluntary arrangements): tax advantages, matching contributions
  - Align the charges and fees with the cost of providing services
  - Improve accumulation phase: use defaults and nudging
  - Improve structure retirement phase of DC plans: combining drawdown plans with deferred life annuities, longevity insurance
  - Financial knowledge and communication

OECD Roadmap

1. Ensure the design of DC pension plans is coherent, globally and internally
   - Take into account the overall pension system
   - Internal consistency between the accumulation and the retirement phase
   - Monitor all risks affecting retirement savings (labour market, macroeconomic, financial and demographic)
2. Encourage high participation rates, adequate contributions and long contribution periods
3. Promote well-designed incentives, in particular voluntary systems
4. Promote low-cost retirement savings instruments

OECD Roadmap

5. Establish appropriate default investment strategies, but also provide individuals with a choice of funds with different risk profiles and investment horizons
6. Use life-cycle strategies as the default option to protect people close to retirement against negative outcomes
7. Encourage annuitization as protection against longevity risks
8. Promote the supply of annuities, innovation and cost-efficient competition in the annuity market
9. Develop risk-hedging instruments to facilitate dealing with longevity risk
10. Ensure effective communication and address financial literacy

Participation, contributions, long contribution periods and improve incentives

- Compulsion (1st best), voluntary, automatic enrolment (2nd best, costly)
- Automatic escalation of contributions
  - Same more tomorrow, easy escalation
  - Link increase contribution growth of wages
- Financial incentives (voluntary contributions)
- Matching contributions on top of fiscal incentives (EET, TEE, etc.)
- Financial education and financial advice

How much to contribute?

Target retirement income, different probabilities of achieving it (saving for the future uncertain => likelihoods): Contribution rates needed

		Target replacement rate (RR)							
		30	40	50	60	70	80	90	100
Probability of reaching the target RR	50	5.3	7.0	8.8	10.3	12.0	14.0	15.5	17.3
	75	7.8	10.5	13.0	15.5	18.0	20.8	23.5	26.0
	90	11.0	14.5	18.0	21.8	25.3	28.8	32.3	36.3
	95	12.8	17.3	21.8	25.8	30.5	35.0	39.0	43.3
	99	17.3	23.3	28.5	34.5	39.3	45.8	51.5	57.0

Aligning charges with costs of providing pensions

- Costs large impact on retirement outcomes (1.5% reduction 30%; 0.5% 11%)
- Market failures (asymmetric info, behavioural biases). Competition btw providers: increase costs (e.g. Mexico),
- Assess in different types of pension arrangements: more choice, more costly
- Measures to improve transparency (better disclosure) are essential but not enough. Accompany them by pricing regulation and structural measures

Aligning charges with costs of providing pensions

- Pricing regulation: caps on fees (Australia, HK, UK, Sweden).
- Structural changes
  - Defaults, passive investment (HK: DIS)
  - Centralised systems (e.g. Singapore, Sweden)
  - Chile: promote competition through auctions
- Other measures include the use of benchmarks and tying investment expenses to portfolio performance (performance fees)

7. Encourage annuitization as protection against longevity risks

- The main goal of saving for retirement and pension arrangements is to have a stream of income during retirement that protects individuals against the risk of outliving their resources (LR)
- Life annuities provide protection against LR, but illiquid, rigid and individuals dislike them (use of framing?). Different products with different options (expensive, risk management)
- Drawdown programs provide flexibility and liquidity, but lack protection from LR
- OECD recommends to combine drawdown programs with deferred life annuities (e.g. age 85). This strikes a balance between flexibility, liquidity and protection from LR (tail risk). At least as a default.

8. Promote the supply of annuities

8. Promote the supply of annuities, innovation and cost-efficient competition in the annuity market

- Different types of annuity products, with guarantees
- Risk management
- Change framing (no investment products but insurance)
- Providers need financial instruments to hedge risk
- Recognise risk, model it, incorporate it (dynamic tables) and update regularly.

9. Develop risk-hedging instruments to facilitate dealing with longevity risk

- Idiosyncratic versus aggregate LR (mechanisms to share them)
- Hedging vs transferring risks (longevity swaps instead of buy-ins)
- Bespoke solutions versus standardised solutions
- Role of the State: transparent, liquid and standardised market (issue longevity indices). Regulation (require tables including improvements and update them regularly). LIBs

Improve financial knowledge and effective communication

- Financial education is useful and important, but there are limits to what it can achieve
- Even well informed and knowledgeable people face high transaction costs assessing complex options
- Pension statement (simple) =>Promote people to be pro-active: save more and for longer.
- National programs: focus, cost assessment, evaluations

Main messages

- Most countries moving towards HK type of pension arrangements. The main future of pension systems in the past 15 years in the growth of pension arrangements in which assets back pension benefits.
- Promote funded pensions (accumulate asset to finance retirement)
- Improve governance and regulatory frameworks (OECD Core Principles)
- DC pension arrangements provide automatic mechanisms to make sure that pensions are financially sustainable.
- But put most of the decision on the shoulder of individuals. Adequacy (?)
- Taking into account behavioural biases and low financial education, automatic features, default options, simplification of information and choice, financial incentives and financial education are the main mechanisms used to address the problems, improve the design of DC funded pensions and achieve better retirement incomes.

Main messages

- Compulsion works better to achieve higher participation, coverage
- Increasing coverage (tax incentives, auto-enrolments),
- Encourage higher contributions (matching contributions, fiscal incentives for voluntary savings)
- Extend contribution periods, especially by postponing retirement
- Align charges and costs by combining disclosure with additional measures such as pricing regulations and structural solutions
- Promote good designed defaults: DIS
- Improve structure retirement phase of DC plans (combining drawdown plans with deferred life annuities (longevity insurance)
- Financial knowledge and communication (technology)

THANK YOU VERY MUCH!

OECD work on pensions
www.oecd.org/insurance/private-pensions

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