Challenges facing pension systems

• The financial and economic crisis:
  – reduction in government revenues to finance retirement promises and
  – Loss of public confidence in private pensions

• Response loss confidence: OECD strengthening pension regulation
  – Updating in collaboration with pension regulators across OECD countries the Core Principle of Private Pension Regulation to promote sound and reliable operation of private pensions plans and thus protect member’s savings
  – OECD Roadmap for the Good Design of DC Pension Plans approved and endorsed by pension regulators in OECD countries, provides guidelines for the design of these plans to strengthen retirement income stemming from these plans
Challenges facing pension systems

• Demographic change: the ageing of population
  – Intense fiscal pressures: dependency ratio
  – More years in retirement to be financed => adequacy problems

• Economic stagnation: low returns, low interest rates, and low growth
  - imply low internal returns in PAYG schemes, which raises financial sustainability issues
  - low financial returns generate retirement-income adequacy concerns
  - loss of confidence in private pensions, mistrust that public pensions will deliver promises

• The OECD PO 2014 examines the responses to these challenges
Proportion population 65+ as a proportion working age population
Ratio of years in retirement over years contributing (35 yrs, 1 year per decade)
• Ch1: Responding to the challenges posed by population ageing and longevity risk
• Ch2: Post-crisis pension reforms
• Ch3: Saving for retirement and the role of private pension provision in retirement readiness
• Ch4: Increasing private pension coverage and automatic enrolment schemes
• Ch5: Pension communication
Chapter 1. Responding to the challenges posed by population ageing and longevity risk
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- Population ageing: increase median age as a result of increases in life expectancy and low fertility rates.
- Population ageing: baby boom (temporary), increases in life expectancy (permanent)
  - Life expectancy at birth has increased 2.4 years per decade
  - Life expectancy at age 65 has increased at 1.1 years per decade
Chapter 1. Responding to the challenges posed by population ageing and longevity risk

• Challenges for pensions:
  – PAYG public pensions face financial sustainability problems
    • Increasing old-age dependency ratio
  – Defined benefit funded private pensions need to secure their continued solvency
    • Mortality assumptions and provisions fail to account for future improvements in mortality and live expectancy
  – Defined contribution funded private pensions need to address adequacy problems
    • Low return and interest rate environment, longer retirement periods
    • Annuity providers account for future improvements
Main messages:

- Contributing more and for longer periods, especially by postponing retirement as life expectancy increases, is the best approach to address these challenges.

- Address the problems posed by the uncertainty on future improvements in mortality and life expectancy.
Focus then on the uncertainty surrounding future improvements in mortality and life expectancy (longevity risk, LR) and how to address LR.

OECD work on “Mortality tables and LR”: companion publication

- It looks at the mortality tables that the regulatory framework requires pension funds and annuity providers to use.
- It examines whether required mortality tables or most commonly used tables include future improvements in mortality and life expectancy.
- It assesses the potential shortfall in provision due to potential longevity risk, and
- Discusses how to manage longevity risk.
Mortality assumptions in the regulatory framework and market practice

• Regulation does not always require accounting for mortality improvements in the provisioning for pensions and annuities
  – Required more often for annuity providers than pension funds
  – Typically assumed in market practice, though less often for pension funds

• Potential shortfall of provisions based on standard mortality tables used
  – Over 10% where no improvements are assumed
  – 5-10% where improvement assumptions are not updated and reflective of recent experience and current expectations
  – USA mortality tables seem to have from okay to moderate potential shortfall in provision

➢ The regulatory framework should establish clear guidelines for the mortality assumptions used, requiring that they include expected improvements, that they are regularly updated and that they are based on a relevant population. Furthermore accurate and timely mortality data should be made publically available to facilitate the measurement of mortality.
Managing longevity risk

- **Longevity Risk**: the risk that mortality improvements turn out to be higher than expected or provisioned for

- Solutions to hedge or mitigate longevity risk
  - Buy-ins/Buy-outs – full transfer of investment and longevity risk
  - Longevity bonds – index-based hedge for longevity risk (not yet implemented)
  - Longevity swaps – full or partial hedge of longevity risk

- Bespoke vs. index-based hedging instruments
  - Capacity constraints for bespoke transactions – limits of diversification for insurers, risk-based capital requirements
  - Need for index-based solutions – would address the misalignment of incentives between pension fund/annuity provider and capital markets investor

- Governments should encourage the development of a market for instruments to hedge longevity by **facilitating transparency and standardization** of longevity hedges. Furthermore the regulatory framework should encourage the management and mitigation of longevity risk through **solvency and funding requirements** which reflect longevity risk and **accounting rules** which value hedges appropriately.
Chapter 1. Main messages of LR

- Regulators and policy makers should ensure that pension funds and annuity providers use regularly updated mortality tables, which incorporate future improvements.

- Capital markets can offer additional capacity to mitigate LR by addressing the need for transparency, standardization and liquidity:
  - Indexed-based financial instruments

- Regulatory framework should recognized the reduction in risk exposure these instruments offer

- Governments could facilitate transparency, standardization and liquidity by issuing longevity indices to serve as a benchmark
Chapter 2
Post-crisis pension reforms
Recent policy action

- Acceleration of pension reforms
- Future pensions are likely to look very different from those of current retirees
- Financial sustainability of pension systems has improved in the majority of OECD countries
- Pension benefits might be reduced in some as a result. Yet, about half OECD countries introduced measures improving adequacy for certain groups of people
- Serious challenges remain
Financial sustainability

• About two thirds of OECD countries took measures to improve the financial sustainability of their pension system

• The impact is expected to be especially important in countries worst hit by the crisis (Greece, Hungary, Italy and Portugal)

• No nominal cuts in benefits (except in Greece; in Portugal they were ruled out by the Constitutional Court)
Three main types of sustainability measures ...

• Less favourable indexation
CZE, ESP, FIN, FRA, GRC, ITA, LUX, POL, HUN, SVK

• Longer working lives (higher retirement age, longer contribution period, tightening of early-retirement, stronger financial incentives)
AUT, AUS, BEL, CAN, DNK, ESP, FIN, FRA, GRC, HUN, IRL, ITA, LUX, NLD, POL, PRT, SVN

• Increased taxation or contributions in DB schemes
CAN (Quebec), FRA, FIN, HUN, IRL, LUX, NLD
But also ...

- Move from funded private DC to public PAYG systems: HUN, POL
- Better administrative efficiency in PAYG systems: CAN, DNK, GRC, ITA, JPN
As a result pension benefits will be reduced in some countries, in particular in Greece, Italy, Portugal, but also in Finland, the Slovak Republic and Spain (unclear for CZE, FRA, LUX)

Some countries took some action to address adequacy concerns
Main adequacy measures

• Extended coverage:
  - pension credits (DEU, EST, FRA, JPN)
  - auto-enrollment/financial incentives (CHL, GBR, LUX, NZL)
  - new schemes (AUS, CAN, CZE, KOR)

• Increase in benefits targeting vulnerable groups (IRL, JPN, LUX)

• Increase in DC contribution rate (GBR, ISR, NZL)

• Lower taxes for pensioners (JPN, MEX, SWE, USA)

• Better governance of DC schemes (AUS, CHL, GBR, NZL)
Main trends

(1) Increase in older workers’ employment
(2) The poverty risk has shifted from the elderly to the young: poverty rates now higher for the young
(3) Labour market problems faced by youth in many countries might have long-term effects on retirement-income adequacy
(4) Differences in life expectancy across socio-economic groups / income seem to have increased
(5) Fast population ageing, which might compound some of these difficulties
Chapter 3. Saving for retirement and the role of private pension provision in retirement readiness.
Goal

• To determine whether people are saving enough for retirement and examine the role that private provision plays and could play in the retirement readiness of the working age population
Assess how much people aged 35 to 64 have already accumulated in pension rights and pension assets from PAYG and funded pension arrangements.

Complement this with what they may accumulate from now until they retire according to current rules and different scenarios.

Compare the potential pension income at retirement with appropriate reference incomes to assess the role of private pensions in retirement readiness.
Replacement rates at Retirement: Contribution of Actual Data and Projections
## Three Different Scenarios

<table>
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<th>Scenarios</th>
<th>Pessimistic</th>
<th>Intermediate</th>
<th>Optimistic</th>
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<td>Inflation</td>
<td>4%</td>
<td>2%</td>
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<td>Productivity</td>
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<td>1.5%</td>
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<td>Real investment return</td>
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<tr>
<td>Real discount rate</td>
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<td>Actual average age of retirement</td>
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<td>Private pension coverage</td>
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<tr>
<td>Employment status</td>
<td>Most likely/reasonable scenario</td>
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Important Role of Private Pensions in Complementing Retirement Income

- Greater importance of private pensions in the total pension income at retirement when they have a \textbf{mandatory} nature but also when voluntary private pensions have a \textbf{long standing} history in the country
- Yet, private pensions do not generally represent the main source to finance retirement
Other Factors Influencing the Importance of Private Pensions

- Level of contributions (incentives)
- Length of the contribution period (e.g. age of retirement)
- Economic environment (e.g. returns on assets, productivity)
- Maturity (younger generations more likely to rely on private pensions at retirement when the system is not mature: FRA and UK)
- Income level (main source to finance retirement for high-income individuals in NLD, UK and US)
Most w.a.i may retire with a pension income above the average pension income of recent retirees.

Subgroups that are the more at risk to fall behind are low-income individuals, older generations, women, private sector workers and self-employed people.
… But Other Factors May Offset the Positive Impact of Growing Economies and Higher Private Pensions

- Reforms in public pension systems leading to lower benefits (e.g. increase in the official age of retirement, lower indexation of rights, life expectancy adjustment parameters)
- Lower contribution levels into private pension plans (including because of a shift from DB to DC plans)
- Lower accruals in DB plans
- Lower returns on assets going forward
Younger generations may be more at risk of failing to reach their country-specific reference replacement rate in CHL, FRA, NLD, NOR and USA.
The Complementary Role of Private Pensions Would Be Enhanced Under a Combination of:

- Higher coverage rates of private pensions and contributions
- Higher effective age of retirement (leading to longer contribution periods)
- Positive economic environment (higher returns on assets and productivity)
Policy Options to Increase the Complementary Role of Private Pensions

• Increase coverage (e.g. compulsion and automatic enrolment)
• Encourage people to contribute more and for longer periods (e.g. by postponing retirement)
• Target population subgroups that need better access to private pensions
• Improve the alignment between public and private sector pensions
Chapter 4
Increasing private pension coverage and automatic enrolment schemes
Goals

• Describe the main factors affecting the success of automatic enrolment in raising private pension coverage

• Assess the cost of such schemes for employers and the state
However, coverage levels are not yet on par with those found in mandatory systems.

Automatic Enrolment (AE) Has a Positive Impact on Coverage

ITALY

NEW ZEALAND

UNITED KINGDOM

UNITED STATES
Main Elements for a Consistent Policy Strategy for Successful AE Programmes

- Identify which population subgroups would need higher private pension coverage
- Make sure that entry barriers (e.g., age or earnings level) do not prevent people from beginning to contribute early and do not exclude individuals who may benefit from a private pension
- Encourage people outside the target population to voluntarily join the scheme to amplify impact on coverage
- Short irrevocable opting-out windows could help increasing coverage rates. Alternatively, automatic re-enrolment to allow people reconsider their opt-out decision
Main Elements for a Consistent Policy Strategy for Successful AE Programmes

- Define default contribution rates in coherence with the overall pension system.
- Matching contributions and flat subsidies can encourage low to mid-income people to stay enrolled.
- Allowing early withdrawals and contribution holidays can minimise opt-out rates but may lead to adequacy issues.
- Assess carefully complementarity with other existing incentives.
- Develop effective communication and education campaigns to accompany AE’s launch and implementation.
Chapter 5
Pension communication
Chapter 5. Pension Communication: Pension statements & National campaigns

- Pension statements (PS) and National Pension Communication Campaigns (NPCC) are key tools to the success of pension systems addressing the challenges they face.
- This last chapter looks at individual pension statements and it assesses how pension plans providers can best communicate projection of future benefits to make people pro-active.
- It also assesses NPCC implemented in OECD and non-OECD countries.
Chapter 5. Pension Communication: Pension statements & National campaigns

- PS should provide clear and simplified info, and they should combine info from all pension sources
- Set clear and measurable objectives
- It should aim to engage and encourage members to take active actions to improve their retirement: increasing contribution and postponing retirement
- Evaluate trade-off btw simplicity and the potential positive effect of projections
Chapter 5. Pension Communication: Pension statements & National campaigns

• NPCC should be part of an overall national strategy

• Major events (pension reforms and crisis) call for specific NPCCs

• Successful NPCC are driven by clear, realistic, and well-targeted objectives that produce outcomes that can be measured, evaluated and monitored against their goals and processes.

• Robust evaluation processes are essential

• Avoid having many messages and focus on less accessible groups
A lot of work remains on the agenda

- Balancing sustainability and adequacy
- Diversification between public PAYG and private funded pensions
- Tackling the costs of running private pensions (pension administration costs and management fees, including in the provision of annuities)
- Conflict of interest of pension advisors
- Improving the structure of the payout phase of DC plans by encouraging annuity products and combining with phased withdrawals
- Improve the functioning of financial incentives
THANK YOU VERY MUCH

www.oecd.org/insurance/private-pensions