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Executive Summary

This first edition of the *OECD Pensions Outlook* takes a close look at the two main trends in pension design observed over the last two decades: first, the introduction of reforms to pay-as-you-go (PAYG), public pension systems such as later retirement and automatic adjustment mechanisms to pension benefits to improve the financial sustainability of these systems; second, the growth of funded private pension arrangements complementing PAYG public pensions. These developments are interlinked, as many pension reforms have ultimately led to a reduction in the replacement rate offered by PAYG public pension systems, increasing the need for later retirement and complementary forms of pension provision.

The crisis has accelerated pension reform initiatives, while private pension policy makers have focused their attention on regulatory flexibility and better risk management

Overall, the pace of pension reform has accelerated over the period 2007-2010. Changes include increases in pensionable ages, the introduction of automatic adjustment mechanisms and the strengthening of work incentives. Some countries have also better focused public pension expenditure on lower income groups. However, some recent reforms have raised controversy, such as the decision of some central and eastern European countries to pull back earlier reforms that introduced a mandatory funded component.

The financial, economic and fiscal crisis experienced over the last five years has exerted major stress on funded, private pension arrangements. Most countries' pension funds are still in the red in terms of cumulative investment performance over the period 2007-11 (–1.6% annually, on average, in real terms). Even when measured over the period 2001-10, the pension funds' real rate of return in the 21 OECD countries that report such data averaged a paltry 0.1% yearly. Such disappointing performance puts at risk the ability of both defined benefit (DB) and defined contribution (DC) arrangements to deliver adequate pensions.

Policy makers' reaction to the crisis was focused on regulatory flexibility and risk management. Initiatives include an extension in the period to make up funding deficits in defined benefit pension plans, greater flexibility in the timing of annuity purchases (to avoid locking in unattractive rates), and new rules on default contribution rates and investment strategies to ensure better member protection.

Other policies, though understandable given the economic situation, have been more controversial, such as the decision in countries like Australia, Denmark, Iceland and Spain to allow members to withdraw money from voluntary pension plans, and the reduction of

contribution rates to funded private pensions in some countries that may have a negative effect on adequacy. The retroactive tax levy introduced on Irish pension funds has also raised eyebrows in the international pension policy community.

The introduction of automatic adjustment mechanisms in public pension systems will improve their sustainability, but may raise adequacy problems

Over the last fifteen years, various OECD countries have introduced automatic links between demographic, economic and financial developments and the retirement-income system. The automaticity of adjustments means that pension financing is, to some extent, immunised against demographic and economic shocks. It provides a logical and neat rationale for changes – such as cuts in benefits – that are politically difficult to introduce.

However, any automatic stabilisation mechanism in place today, or implemented in response to the crisis, might pose problems in terms of adequacy of future benefits and the capacity of systems to protect the living standards of beneficiaries. What will be the destiny of systems based on such rules? These rules have already come under pressure in countries such as Germany and Sweden where discretionary amendments were made to the rule to avoid cutting benefits excessively at a time of economic downturn.

Furthermore, automatic adjustment mechanisms are often complex, difficult to understand and create uncertainty over future benefits. In order for individuals to adjust to these new pension designs – by working longer or saving more in private pensions, there is a need for gradualism and transparency in their implementation. A fair and predictable burden-sharing across generations should help individuals to adapt their saving and labour supply behaviour in line with the changes.

The pension reform reversals in Central and Eastern Europe provide a short term fiscal boost at the expense of lower pension benefits in the future

Other major pension reforms started in the late 1990s, when some central and eastern European countries replaced part of their PAYG benefits with mandatory DC pension plans managed by the private sector. Part of the contributions to the PAYG public pension systems were transferred to the funded tier, creating a short term fiscal cost but improving the long-term sustainability of the pension system. During the crisis, some of these reforms were partially reversed, with reductions in contributions to the funded, private pension system in countries such as Estonia (temporary) and Poland (permanent). In Hungary, the reversal has been complete. Even the accumulated assets in the mandatory pension funds were reverted to the state.

The analysis of pension entitlements shows that the main cost of these reversals will be borne by individuals in the form of lower benefits in retirement. These are of the order of 20% for a full-career worker in Hungary and around 15% with Poland's partial reversal, using the OECD's standard assumption of a 3.5% rate of return on investments (or 1.5% above wage growth). Even with somewhat lower investment returns individuals will lose out.

The effects on the public finances will be a short-term boost from additional contribution revenues but a long-term cost in extra public spending just as the fiscal pressure of population ageing will become severe. Overall, however, it is projected that the extra revenues would exceed the extra expenditure, except in the case of the Slovak Republic. This reflects a problem with the detailed design in the initial reforms, which tended to over-compensate people for choosing the funded private pension option. People naturally responded to these incentives, with more switching than most governments had budgeted for.

The coverage of funded, private pensions is insufficient in some countries to ensure benefit adequacy

The cuts in public pension benefits that future generations of retirees will experience in many OECD countries call for longer working periods and an expanded role for funded, private pensions. The latter is critical in countries where the public pension system offers relatively low pension benefits. Hence, policy makers need to closely monitor the coverage (enrolment or participation rates) of private pensions. Currently, coverage is uneven across countries and between individuals, especially in voluntary systems.

Some countries have made funded private pensions compulsory (*e.g.* Australia, Chile) or quasi-mandatory (*e.g.* Denmark, the Netherlands) to ensure that most workers are covered and therefore have access to a complementary pension. However, in other countries with relatively low public pension benefits, private provision remains voluntary and the highest coverage rates observed are around 50%.

Policy initiatives in Germany (Riester) and New Zealand (KiwiSaver) in the last decade, involving the introduction of financial incentives – and in the case of New Zealand also national auto-enrolment to the retirement savings programme – have been effective in raising coverage to the highest levels among voluntary pension arrangements (about 55% in New Zealand). The state's flat contribution subsidies provided to private pension plans have also promoted greater participation among lower income workers. Such workers do not normally benefit much from the tax incentives traditionally used to promote private pensions. The success of these countries in expanding coverage in a relatively short period largely vindicates these policies, though financial incentives can create a heavy burden on already stretched public budgets. Coverage gaps also remain in these countries, and overall enrolment rates are still below those observed in countries with mandatory or quasi-mandatory systems.

Return guarantees are generally unnecessary and counterproductive but in some countries they may be justified in order to protect pension benefits and raise public confidence and trust in the private pension system

The growing role of DC private pensions raises concerns over workers' exposure to investment risk. In the context of the recent crisis, some countries are considering whether investment performance guarantees may be introduced during the accumulation phase to reduce the risk of major investment losses for individuals. Guarantees, however, can mean

a substantial burden for the government. If provided by market players, guarantees involve an additional cost for plan members, the insurance premium to be paid to the provider.

Guarantees setting high minimum investment returns are generally expensive and therefore reduce substantially the net-of-fee benefit from DC plans. On the other hand, capital guarantees that protect the nominal value of contributions in DC pension plans (a 0% guarantee) have a relatively low cost, protect plan members from worst-case scenarios, and can thus help raise public confidence and trust in the funded pension system. Such guarantees may be most appealing in countries where funded private pensions are mandatory and account for a large share of overall retirement income.

However, such guarantees can only be introduced relatively easily in a very specific context: a fixed contribution period, a predefined investment strategy and having the same provider throughout the guarantee period. Allowing plan members to vary contribution periods or investment strategies, or change providers, would raise major challenges for an effective and efficient implementation of return guarantees. This would increase the complexity and cost of administering the guarantee. Where guarantee providers manage the investments, this is also likely to result in conservative asset allocations, especially under increasingly demanding prudential (*e.g.* solvency) regulations. The lower risk provided by guarantees would be associated with lower expected benefits.

A new roadmap for defined contribution pension plans: policies to strengthen retirement income adequacy

Given the growing role of DC plans in pension systems, there is a need to improve their design and regulation to strengthen retirement income adequacy. The following set of policy measures can help achieve this objective:

- Ensuring that DC plans are coherent between the accumulation and payout phases, and with the overall pension system.
- Establishing effective pension plan communication and improving financial literacy.
- Encouraging higher contributions to DC pension plans and for longer periods in order to enhance benefit adequacy.
- Improving the design of incentives to save for retirement.
- Promoting low-cost retirement savings instruments.
- Establishing default life-cycle investment strategies to protect people close to retirement against extreme negative outcomes.
- Improving protection against longevity risk by establishing a minimum level of annuitization for the benefit payout phase as a default option. Such option could combine programmed withdrawals with deferred life annuities indexed to inflation.
- Fostering the annuities market by enhancing transparency and communication, promoting further development of risk-hedging instruments, and encouraging cost-efficient competition.

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