Opening Keynote

Pablo Antolin-Nicolas
Principal Economist
Head of the Private Pension Unit
Financial Affairs Division
Organisation for Economic Co-operation and Development (OECD)
France

THE OECD ROADMAP FOR THE GOOD DESIGN OF RETIREMENT SAVING PLANS

Pablo Antolin
OECD Financial Affairs Division

OECD
BETTER POLICIES FOR BETTER LIVES

Background: Challenges

- Shift

from plans in which benefits are pre-determined (DB) and plan sponsors or the State assume most of the risks

to plans in which benefits depend on assets accumulated and individuals bear most of the risks

Positive and negative features of DC

- Positive feature of DC plans: direct and straightforward link between pension benefits and contributions
- Negative feature: risk squarely onto individuals, who may not be best prepared to bear them

OECD

Compounding the problem

- Additionally, shift accompanied by lower contributions
- Low financial literacy
- People unable or unwilling to make choices
- Worries about adequacy of pensions in the long-term and protection

Context

- Retirement income depends on several parameters, on some of them individuals, regulators and/or policy makers have some degree of choice (choice parameters: contribution rates, retirement age), but other parameters are uncertain (risk parameters: returns, labour market, life expectancy)
- The financial and economic crisis has highlighted the importance of these risk factors

OECD

Challenges: large volatility of retirement income in DC plans

USA France

70
60
50
40
30
20
10
0

1939 1942 1945 1948 1951 1954 1957 1960 1963 1966 1969 1972 1975 1978 1981 1984 1987 1990 1993 1996 1999 2002 2005 2008 2011

OECD

Policy response: OECD Roadmap

- DC plans becoming one of the main sources to finance retirement in many OECD countries.
- Need to make sure these plans are properly designed in order to improve the adequacy of retirement income stemming from this plans
- WPPP approved and endorsed *OECD* (regulators) *Roadmap for the Good Design of Retirement Saving Plans*

OECD

Guiding principles

- The set of policy options are established according to three ***guiding principles***:
  - Coherence
  - Adequacy
  - Efficiency

Coherence

- The design of DC pension plans need to be **globally** coherent: coherence with the overall structure of the pension system
- And **internally**: the accumulation and the payout phases need to be properly aligned
- Coherence in monitoring all risks affecting retirement income in DC plans

OECD

Adequacy

- DC pension plans are ***complementary*** to other sources to finance retirement (e.g. PAYG-financed pensions).
- They are an integral part of total retirement income
- DC plans need to be designed (e.g. contribution rates, contribution periods, payout phase, etc.) taking into account that they may provide a retirement income that complement other sources up to the target overall retirement income

OECD

Efficiency

- Efficiency means choosing investment strategies that reduce the impact of extreme negative outcomes on retirement income
- There are many investment strategies to choose from in the return-risk spectrum.
- If main concern (policy makers) to avoid sharp declines in retirement income as a result of extreme events (*e.g*. 2008 crisis), then they will set *default investment strategies* that avoid or limit these sharp drops, in particular for people close to retirement

OECD

Efficiency

- Efficiency is also required to properly *structure the payout phase*.
- Assets accumulated must be allocated to *protect retirees from longevity risk*.
- Among payout options, programmed withdrawals provide greater flexibility and liquidity, while life annuities provide better protection from longevity risk.
- Strike balance

ACTIONS POLICY MAKERS SHOULD TAKE

POLICY RECOMMENDATIONS

1. Ensure the design of DC pension plans is **COHERENT**

- internally coherent between the accumulation and payout phases: if choices in the former may need to allow choices in the later, or vice versa
- and with the overall pension system (target retirement income)
- robust governance framework that addresses and monitors all key risks (labour, financial and demographic) and the uncertainty inherent in saving for retirement.

OECD

2. Encourage high participation rates, adequate contributions and long contribution periods

- Compulsion vs. auto-enrolment
- Contributions and participation can be increased with the help of "nudge" measures: matching contributions (by employers and/or the State), auto-escalation schemes, appropriate incentive structure
- Contribute and contribute for long-period

Contribute and contribute for long periods

- Best way reduce uncertainty about achieving a target retirement income is to contribute large enough amounts and for long periods.
- Long contribution periods allow for higher retirement income for given level of contributions (compound interest)
- Lengthening contribution period by postpo. retirement more efficient approach of increasing retirement income.

OECD

Encourage people to contribute and contribute for long periods

- Δ contributions or the contribution period Δ the probability of reaching the target retirement income (RR)

	Prob (RR≥30%)	Prob (RR≥70%)
5% C – 40 years	61.6	13.9
10% C – 40 years	91.7	52.8
5% C – 20 years	2.8	0.1
10% C – 20 years	33.0	1.3

OECD

Contribution rates linked to age

60.0
50.0
40.0
30.0
20.0
10.0
0.0

Contribution rate link to age starting at age 35 from a low level (5%) to achieve 70% of final salary in 40 years

Contribution rate link to age, starting contributing at age 35 the same than fix to achieve 70% of final salary in 40 years

Fixed contribution rate to achieve 70% of final salary in 40 years

25 27 29 31 33 35 37 39 41 43 45 47 49 51 53 55 57 59 61 63

OECD

Contribution rates linked to age

- Reasonable to have contribution rates increasing with age. Young people lower income and more expenses (housing, kids)
- Contribution rates would have to increase to high levels at the end of one's career to achieve the same target retirement income.
- Time inconsistence problem: would be people be willing to pay such high contributions levels?

3. Promote well-designed incentives, in particular voluntary systems

- Compulsion
- Soft-compulsion: auto enrolment with an opt-out clause (Italy, New Zealand, UK). Take advantage of behavioral financial literature stressing the role of inertia or passive decision
- Strengthen the value of tax incentives for mid to low income people

OECD

Fiscal and other incentives

- Tax incentives favour high income individuals (marginal tax rates)
- Tax credits inversely related to income
- Matching contributions income neutral
- Add matching contributions and subsidies to contribute and contribute for long-period

OECD

Work in preparation

- OECD developing project to examine tax rules on pensions systems
- Tax rules on contribution, returns & benefits
- Tax rules on the accumulation, on the payout phase and on different products (annuities, PW, lump-sums)
- Assess the impact of tax incentives (country specific)
- Assess the impact of alternative ways of introducing incentives (country specific)

4. Promote low-cost retirement savings instruments

- Disclosure-based initiatives
- Caps may not work: modelling, ex-post versus ex-ante. Price searching mechanism: markets
- Complement them with structural solutions that introduce competition: such as appropriate tender mechanisms or default allocations to low-cost providers

Volatility

- Policy makers and regulators discussing how to reduce volatility ret. inc. in DCs
  - Introducing minimum return guarantees.
  - Setting up default life-cycle investment strategies
- OECD has assessed both approaches using stochastic modelling and with historical data (hypothetical impact).

Consider the pros and cons of investment guarantees

- Minimum return guarantees like capital guarantees by ensuring that the amount of accumulated savings does not fall below a certain value (e.g. the nominal value of contributions) protect retirement income in DC plans
- However, guarantees are costly.

Consider the pros and cons of investment guarantees

- Capital guarantees are relatively cheap, easy to implement and build confidence in private pensions.
- However, only under strong conditions –
  - fixed and long contribution period,
  - Once chosen investment strategy, constant
  - no switching providers
- Guarantees in DC plans less necessary if the PAYG-financed pension provides high inc.

5. Establish appropriate default investment strategies, but also provide individuals with a choice of funds with different risk profiles and investment horizons

- DC plans aimed at providing people choice
- Behavioural econ and financial literacy research show that some people are either unwilling or unable to choose among I strategies.
- Default I strategies concentrate on reducing the risk of extreme negative outcomes on retirement income.

Establish default investment strategies with appropriate risk exposure

- Choosing the appropriate default options
  - Balancing trade-off higher potential ret. inc. and associate risk.
  - Risk measured as ret. inc. in extreme negative outcomes
  - Choose the probability threshold established to assess risk: I strategies reduce downside risk by e.g. 99%

OECD

6. Use life-cycle strategies as the default option to protect people close to retirement against negative outcomes

- Life cycle I strategies reduce the exposure to risk assets (e.g. equities) as people ages. Easy to understand
- They provide protection for those close to retirement in case of a negative stock market shock just before retirement
- They provide protection when contribution periods are short
- The glide path important: ones with sharp decrease in equities in the last decade

Default I strategies

- Default I strategies concentrate on reducing the risk of extreme negative outcomes on retirement income

- Estimated probability that pension benefits based on LC strategies will be higher than those based on a fixed portfolio strategy for two different contribution periods

	Entire random sample (10,000 obs)			Negative stock market shock[1]	
	Contribution period			Contribution period	
Life-cycle investment strategies	20 years	40 years		20 years	40 years
Sharp decrease after age 55[2]	30.2	42.1		71.0	61.5

OECD

Establish life-cycle investment strategies as defaults

- Life cycle I strategies not a panacea: provide protection from extreme negative shocks for those close to retirement, but do not eliminate volatility, do not address adequacy
- LC strategies can be organised around one single fund (e.g. target date, US) or around several funds (e.g. multi-funds, Chile, Mexico)

7. Encourage annuitization as protection against longevity risks

- Combining programmed withdrawals and deferred life annuities could be an appropriate default for the pay-out phase
- Payout phase need to strike a balance btw flexibility and liquidity (PW) and protection from longevity risk (life annuities) keeping into account the overall structure of the pension system
- The main risks in the payout phase are outliving one resources (LR) and inflation (the erosion of purchasing power of ret. inc.)
- Solution: PW w/ deferred LA indexed inf.

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

- Remove tax disincentives
- Innovative products (Vas, reverse mortagages, products combine pension and health care). Careful with the design
- Change framing: annuities are not investment products; as investment products they are not attractive. Annuities are insurance products. They provide insurance against longevity risk and smooth out consumption through retirement
- Providers need instruments to hedge risks

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

- Hedging vs transferring risks
- Capital market solutions: bespoke vs. standardized
- Role for the State (transparent, liquid and standardized mkt): create longevity index, require regular update tables (include improvements, modeling), LIBs?

OECD

10. Ensure effective member communication and address financial illiteracy

- Members should be provided with regular individualised benefit statement. Including accounting info and projections on future benefits with prudent assumptions.
- Members able to access freely and readily comparative info on costs and performance
- Disclosure materials written using accessible language

OECD

Ensure effective communication and address financial literacy

- NPCC (targeted as broadly as possible) can be useful to inform the population about reforms and “ nudge” them towards specific choices (e.g. retire later).
- Training in financial education (inc. pensions) should start as early as possible (e.g. as part of school curricula) in order to encourage individuals to start saving as young as possible.

OECD

THANK YOU VERY MUCH

www.oecd.org/insurance/private-pensions

OECD
BETTER POLICIES FOR BETTER LIVES