

Pension Guarantees

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Outline of the talk

- Why have guarantees?
- Types of guarantees
- Should guarantees be compulsory?
- What should be guaranteed?
- Who is the guarantor?
- How can guarantee costs be reduced?
- The need for co-ordinated policy

Why have guarantees?*

- Social imperative to protect against old-age poverty
- Caveat emptor, and the “money-back” guarantee
- Pension funds too big and too important to fail
- Reduces “hidden action” or “moral hazard”
- Greater transparency to consumers
- Corrects mistaken impressions held by consumers about long run risk in the stock market

* Adapted from Bodie (2007)

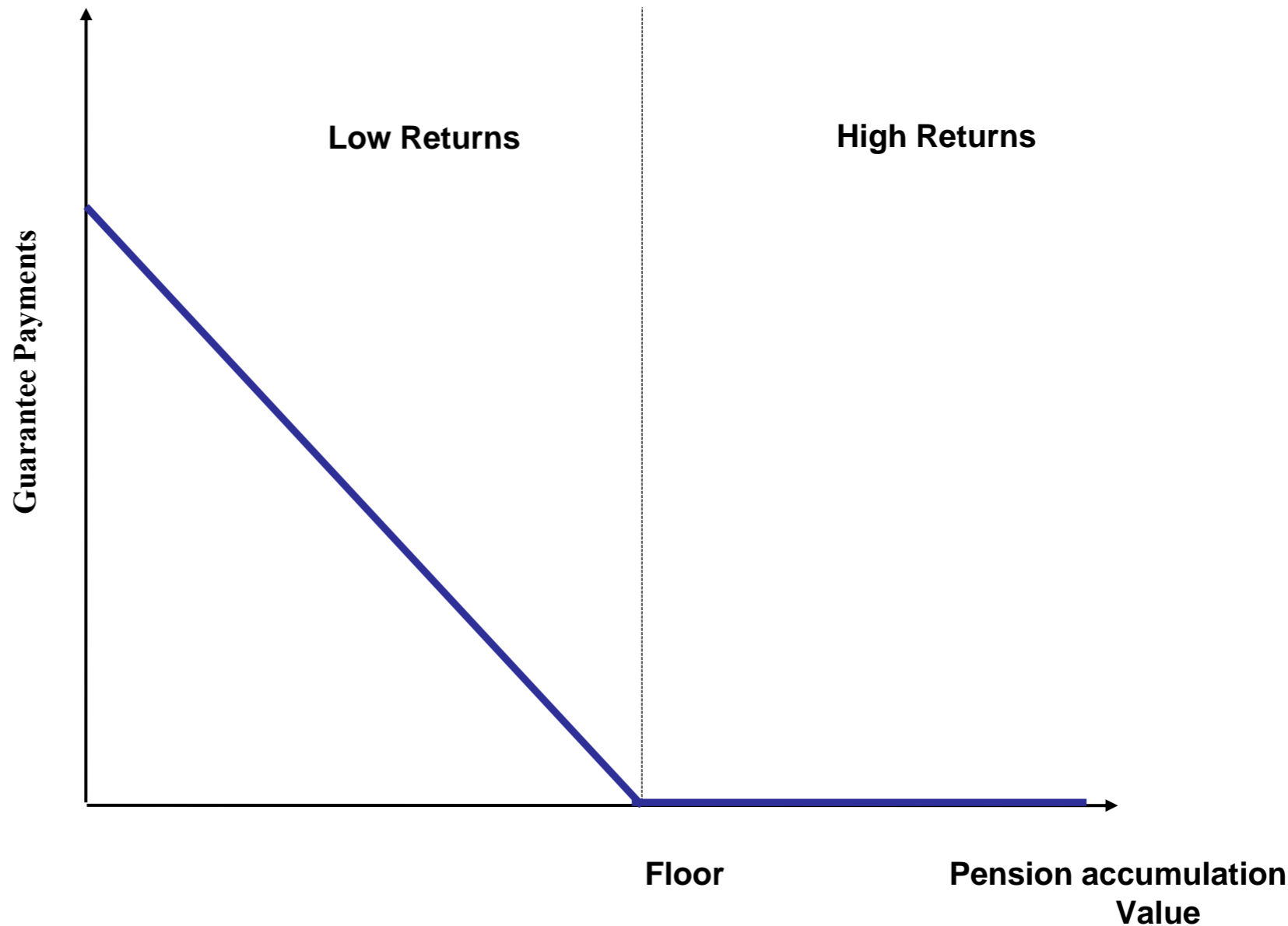
Challenges in guarantees design

- Overall, guarantees should
 - Ensure adequate social protection
 - Be transparent in its pricing structure
 - Not excessively burden either the tax-payer or the plan beneficiary
 - Not encourage perverse behaviour such as excessive risk exposure, or herding

Guarantees in context

- **Rate of return guarantees:**
 - Typically seen in the context of DC plans
 - The objective is to reduce individual exposure to investment risk
- **Minimum benefit guarantees:**
 - Traditional defined-benefit plans
 - Social security and public pension systems often promise consumption up to a floor

Guarantee Payments*



*Adapted from Mitchell

What is typically guaranteed?

- Nominal capital
 - Covers exposure to investment risk
- Real capital
 - Covers investment & inflation risk exposure
- Minimum annuity or basic pension
 - Covers investment, inflation and longevity risk

Rate of return structures

- Minimum rate of return guarantee
 - Principal guarantee (Nominal/Real)
 - Contributions plus some minimum rate of return
 - May be triggered over relatively short periods
- Absolute rate of return guarantee
 - Switzerland: Minimum return pre-specified
- Relative rate of return guarantee
 - Chile, Argentina: Minimum return related to the performance of other pension funds

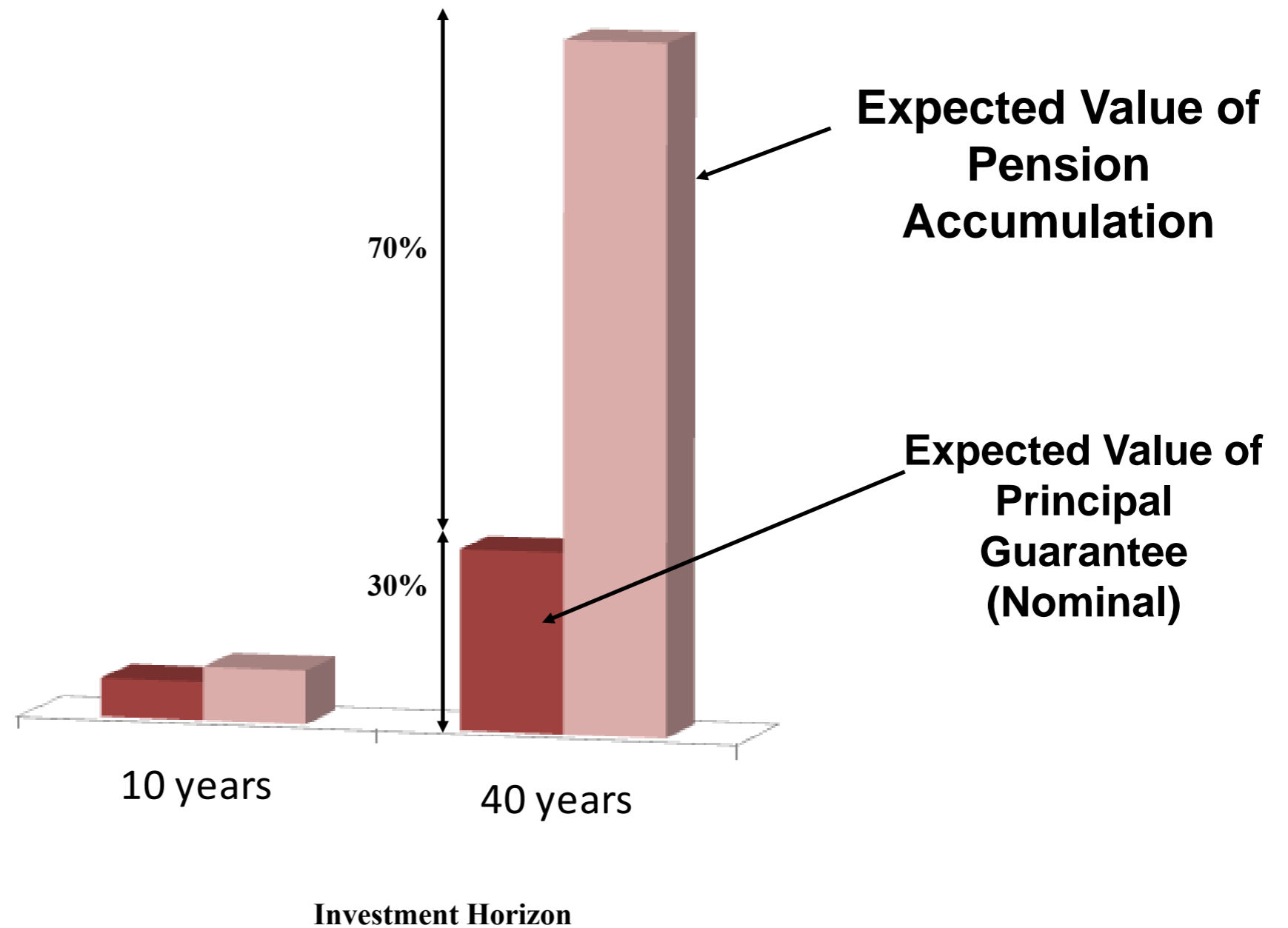
Portfolios

- Insure a standardized portfolio
 - Guarantee only to those participants who elected the standard portfolio
 - Guarantee payments using the standardized portfolio, rather than actual returns
- Might encourage herd behaviour
- Different outcomes for same cohort might lead to political economy problems

Private Guarantee Purchase

- Plan participants buy guarantees of their choice:
 - Private producers supply a menu of choices
- Might become unaffordable
- Requires high degree of financial literacy which is often missing
- Might suffer from lack of standardization of contracts

Guarantee cost depends on the promise*



*Adapted from Mitchell

Who is the guarantor?

- Private DC plans:
 - First round of guarantees from plan sponsor, paid for by reduced returns (a collar type portfolio strategy)
 - Ultimately, government, at least implicitly, offers a guarantee
 - Bail-out
 - Recourse to public support

Guarantees and compulsion

- Guarantee required
- Guarantee as default
- Guarantee required to be offered as an option
- No guarantee requirement

Typical minimum benefit guarantee structures

- Minimum benefit guarantee
 - Minimum annuity regardless of plan performance
 - Triggered usually at retirement
- Based on DC plan:
 - Hungary
- Means tested pension:
 - Australia

The Australian Guarantee

- Means tested pension, accessible from age 65
- Currently about 27% of average earnings for a single person, 40+% for a couple
- Full pension available to ~50% of the age-eligible
- Some pension available to >75% of the age-eligible
- Means test acts as a tax on capital income
 - Can be seen as a tax on a complement of untaxable retirement leisure
- The only Australian public pension guarantee

Guarantees in DB plans

- Final pension amount
 - This depends on years of work experience and contribution history
- Survivor benefits
- Indexation promises
 - Most benefits linked to inflation or community standards.

Expenditure on guarantees

- Costs often not transparent
- 'Contingent-claims methodology' used to value guarantees finds that these are very expensive (Penacchi 1998, Smetters 2000, Lachance and Mitchell 2003).
- **Important to note that these are not social costs**

Can the costs of guarantees be reduced?

- Costs depend on
 - What is guaranteed
 - Volatility of the risk being covered
 - Duration
- Costs can be kept low by
 - Making modest promises
 - Encouraging, or facilitating, better matching between assets and liabilities
- Government debt issues can help a lot:
 - Long duration inflation-indexed bonds
 - Longevity bonds?
 - Support for derivatives markets

Partial Guarantees

- Inflation insurance with a deductible
- Longevity in late life – a deferred annuity

→ The guarantee kicks in only after a threshold

Less expensive

Insurance when you need it

What role for policy and regulation?

- Depends on what other retirement protection is in place:
 - Policy should be viewed holistically
- Market failure interventions may help ALM
- More effective policy co-ordination
- Encourage cooperation between the public and private sectors

Thank you

Questions?

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