



## **Financing Retirement: Private Pensions Policy Challenges**

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### **The framework: population ageing**

- Population ageing is set to affect all OECD countries, leading to higher elderly dependency ratios and ultimately smaller labour forces. Overall dependency will rise everywhere as the number of people outside the labour force outpace those within it. Increased longevity and better health are extremely good news but they may become a nightmare if societies cannot find mechanisms for sustainable progress, i.e. to provide resources which allow old people to benefit adequately from these developments.
- In OECD countries, where social protection and social security systems are extensive and generous, population ageing presents huge fiscal challenges. At the same time, this unprecedented demographic transition calls for pension systems that are more responsive to demographic risks and more attentive to the needs of populations.

### **Policy concerns: growing and growing as time goes by ...**

- Already in 1998, the OECD Ministers highlighted the importance of ageing for our policymakers, the need for comprehensive reform, encompassing all elements of the issue – financial, economic, social, fiscal – the urgency of far-reaching reform and the obvious conclusion that the solutions will be much more difficult and painful if such reforms are postponed. All agreed that the responses to the pension challenges required prompt action on many fronts. And a clear consensus emerged that ways had to be found to contain spending on public pensions while the structure of retirement income should be reformed and incentives to early retirement eliminated.
- Six years later, the issue is still very much with us – so it is not surprising that the topic was again on the agenda of the OECD Ministerial meeting held on 13-4 May 2004. Clearly, there are reasons to be worried. The full impact of ageing is now expected to hit our economies very soon, beginning the next decade in many countries. Still it is not certain that our policy makers have taken the full measure of its consequences: we are talking here about the sustainability of our future social and economic system. If substantial and sustained action is not undertaken we may face a major societal crisis.

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\* [www.conferecedemontreal.com](http://www.conferecedemontreal.com).

## No escape from policy action

- To avoid these dire consequences, governments around the world need to continue reforming their public pension systems by adjusting their parameters (increasing retirement age, linking benefits to life expectancy, providing appropriate actuarial adjustments to benefits for early/late retirement, raising contribution rates) and promoting policies which are expected to help making ageing population sustainable. This includes the promotion of faster technological progress, encouraging fertility, women work, the speeding of youth entry in labor market, reduction of disability and sickness rates or the consideration of the role of immigration. But, basically, the measures likely to be the most efficient are the painful ones – in other words those most difficult to sell in political terms: increasing retirement age and reducing the generosity of public pensions. These modifications are expected to encourage labour market participation among the older age group and help improve the long-term actuarial balance of social security systems.
- Another key axis of policy reform relates to private pensions. The 1998 OECD report recommended that retirement income should be provided by a mix of tax-and-transfer systems, funded pensions, private savings and earnings. The objective of such an approach is risk diversification, a better balance of burden-sharing between generations, and more flexibility for individuals over their retirement decisions. This implies increasing the size of advanced-funded systems in our countries, especially in those where PAYG systems are still dominant. But steering people to rely on private pension saving crucially requires that financial sector framework conditions inspire confidence in the safety and soundness of such saving.

## Challenges of private pensions reform

- We in OECD have long urged diversification of the sources for retirement income and the development of private pensions as a complement to public schemes. Taking account of the need to reflect national social and economic features, we do not recommend any specific type of private schemes. But we insist that, whatever form they take, private schemes must from a public policy viewpoint be well regulated and underpinned by efficient financial markets.
- From this perspective, we consider that the development of advance-funded pension systems should go hand-in-hand with a strengthening of the financial market infrastructure, including the establishment of a modern and effective regulatory framework for private pensions and, crucial to win people's confidence, the existence of safeguards to preserve the integrity of financial markets and institutions.
- Regrettably, private pension systems today face a number of major challenges which remind our policymakers of the need for good regulation and to rebuild trust in the system. Let me just mention some of these challenges.

### Increasing life expectancy

- A source of worry regarding funding for defined benefit pension arrangements, which is common to public schemes, is increasing life expectancy. Predictions over increases in life expectancy are notoriously difficult to make given the uncertainty surrounding medical advances and these uncertainties have increased exponentially in recent years. Yet, mortality tables and actuaries' ad hoc adjustments are unlikely to fully capture the "risk" of

rapid increases in the length of life as a result of medical progress. Under these circumstances, prudence and creativity are required to advance regulatory reforms adapting benefits and contributions calculations to new longevity parameters.

#### Coverage of private pension arrangements

- Private pension coverage is still low in many OECD countries, often less than 5-10 per cent of the labour force though the trend in coverage is clearly heading upwards. Still, even in countries with medium levels of coverage, richer households are most likely to participate in private arrangements while poorer households are often unable to benefit from the tax incentives offered to private pension plans. But a major tenet of public policy should be that the increasing role of private pensions should not take place to the detriment of the objective of reducing old age poverty. Expanding coverage will therefore have to rely on appropriate incentives for poorer households. Various options are available in this regard. Thus, some countries have chosen the route of mandating private pension schemes or at least requiring automatic enrolment into such arrangements. In any event, the more private pensions develop, the more their performance will have to be assessed against general social objectives.

#### Corporate pension liabilities

- The emergence of astonishingly large pension funding gaps has been a source of major concerns for financial policymakers in 2003. The size of funding shortfalls speaks for itself: on a worldwide basis, it has been estimated that the shortfall was close to \$1,000 billion at the end of last year. Although some analysts believe that many companies will not have unsurmountable difficulties in meeting their pension obligations, it is generally recognised that these obligations could represent a serious drain on resources that would otherwise be available for investment in coming years. And it is of little comfort to know that the largest adverse effects of funding shortfalls are expected to be on firms operating in mature or sunset industries in manufacturing and transport.
- Worse, these views may be over-optimistic. Although funding deficit problems have lessened somewhat as a result of recently favourable financial market developments, several structural problems related to funding persist which, in our view, call for an adaptation of existing regulatory frameworks for private pension arrangements in the near future if we want to ensure their ability to provide adequate retirement incomes.
- We at the OECD are extremely concerned by the potential impact of this “time bomb”: the funding gaps events may just be an advanced flavour of an unprecedented societal crisis if future pension liabilities – which will be exacerbated by the arrival of baby-boom cohorts on the retirement market —are not matched due to inappropriate funding. The “early warning” provided by the gaps issues that have emerged in the past three years need to be taken into consideration very seriously.

#### Shift toward defined contributions schemes

- The recent moves toward defined contributions plans that are being experienced in a growing number of countries will ease pressures on defined benefit schemes. But let us be clear: this move will not be a panacea since they may just reallocate the risks away from companies (fund sponsors) and transfer them to the “ordinary people” in our societies. Here the problem arises of the capacity for individuals to protect themselves adequately, in the absence of

proper financial education and consumer regulation. How satisfied can we be that the existing levels of financial education are “adequate” in this regard? Although we must recognize that this is still very much uncharted territory, let me say that I have very serious doubts about the state of affairs on this ground.

- Be that as it may, there is a clear need to enhance a sound financial decision-making process for those individuals facing growing responsibilities to set aside and invest resources for retirement income. Against this background, it is not surprising that financial education has now become a key priority for policymakers. And I am proud that we at the OECD have undertaken a major project to develop benchmarking for the promotion of good practices in financial education. These good practices concern not only investment choices but also the more fundamental requirements to contribute to a sufficient level for adequate retirement income.

#### Asset meltdown hypothesis

- Another concern, which so far appears to have been the domain of a few specialists, is related to the fact that, over the next decades, changes in the age structure of populations will affect the economy’s saving behaviour, including the level of saving and the choices of saving vehicles. When baby boomers start entering retirement they will become net sellers of financial assets to finance retirement consumption. As subsequent generations are smaller in numbers, other things being equal, this would put downward pressure on financial asset prices (“asset meltdown hypothesis”). We may expect that this will impact not only on growth and investment but also on the adequacy of retirement income. In any case, even if there were no generalised financial asset sell-off, there might be a switch from equity to fixed-income instruments, reflecting life-cycle considerations – which will have difficult-to-foresee consequences on the functioning of our financial markets.

#### Danger of overregulation

- While policy action is badly needed, the temptation to overregulate must be avoided. This is especially important as private pensions systems are generally voluntary. This being said, a difficult balance must be struck: pension rules should provide adequate regulatory framework for these systems to function efficiently, but they should avoid creating disincentives to employer participation and the development of private pensions in general. On the contrary, incentives for enhancing competitive pension markets where financial institutions can operate freely are important. As important is the need to structure the system in a way that will make it amenable to the expected globalisation of pension markets.

#### **How is OECD responding to these challenges?**

- I am aware that the picture I have painted is far from rosy but both governments and the public at large need to face these risks squarely and take the courageous and unavoidable steps needed to prevent the time-bomb from exploding. As I noted earlier, many countries have already undertaken reforms and set mechanisms in place that will over time alleviate some of the most dangerous problems. But, clearly, complacency must be completely out of order here and vigorous political leadership is indispensable.
- My Organisation considers that the issue we have discussed is a top policy priority, and will continue to be so in the years ahead. Policymakers and experts are discussing on an ongoing basis the complex and varied aspects of ageing in our specialised committees

(economics, financial, social, financial education) where they can benefit from each other's experience. This is the fundamental role of the OECD: to enable our Members to learn from the successes and failures of their peers. In addition I may note that the Organisation had the foresight several years ago to establish a special group to deal with the regulatory aspects of private pension schemes. We have taken a three-pronged approach to this end: data collection, benchmarking of best practices, and development of principles and standards – for which OECD has worldwide leadership. It would be too long to detail the work already accomplished in this field but a brochure has been made available that I hope will satisfy your curiosity. Nonetheless, let me mention that a few weeks ago the OECD Council approved a new Recommendation on core principles for occupational pension regulation. This Recommendation provides a comprehensive set of principles addressing areas such as the establishment of pension plans and funds, the funding of pension liabilities, and the regulation of pension fund investment, the supervision of pension funds, as well as the rights of beneficiaries.

- We regard this Recommendation as a cornerstone around which we will continue to assist our countries in the difficult but essential task of making sustainable the financing of retirement for our future generations. The stakes are very high and, because of our responsibility vis-a-vis our children, the pension challenge is one that we cannot afford to fail.