

# Pensions in a financial crisis



How should retirement-income systems respond to financial-market turmoil?

Pension funds have shrunk dramatically this year as developed countries' stock markets lost 45% of their value. Private pensions play a large and growing role in providing for old age. How should policymakers react to the downturn? Are such large losses balanced by past and future gains? Or do we need a new pension paradigm relying less on financial markets?

Pension funds have had a very bad 12 months. In the OECD as a whole, the market value of retirement savings has fallen by over \$4 trillion.

Table I shows real investment returns over the past year in 11 OECD members or candidate countries with mandatory private pensions or broad coverage of voluntary plans.

Where the law requires funds to offer specific investment choices, the Table shows the returns earned on three different portfolios, depending on the degree of risk associated with each.

## I Real pension-fund returns over a year

per cent	Portfolio		
	Risky	Balanced	Conservative
Australia		-27.0	
Chile	-46.1	-23.1	0.0
Estonia	-30.5	-20.9	-9.7
Hungary	-35.0		-18.0
Iceland		-25.0	
Israel		-8.0	
Mexico	-8.3	-6.0	-0.5
Poland		-17.4	
Slovak Republic	-12.4	-10.3	-2.0
Sweden		-17.0	
Switzerland		-14.0	

Note: returns are measured year-on-year to the most recent data-point, typically end of September or mid-October 2008. For Sweden the figure is for the default fund measured to end July 2008.

Source: national pension regulators; World Bank estimates (Hungary).

Focusing on the balanced portfolio, pension funds have lost an average of 17% of their value this year. With more risky portfolios, the losses have been greater.

In 11 OECD countries – Australia, Denmark, Hungary, Iceland, Mexico, Norway, Poland, the Slovak Republic, Sweden, Switzerland and the United Kingdom private pensions play an important role in *mandatory* pension provision. The same is true of three OECD accession countries: Chile, Estonia and Israel. In addition, *voluntary* private pensions have broad coverage in a number of OECD economies.

Private pensions have expanded rapidly because many countries have scaled back public pensions. This growth of private pensions leaves workers' retirement incomes vulnerable to investment risks. This is especially the case in defined-contribution pensions, where pension benefits depend directly on accumulated contributions and investment returns.

Most mandatory private pension plans are defined contribution (in the countries in Table I, for example). Also, voluntary occupational pension plans are increasingly of this type. In the United Kingdom and the United States, for example, the shift from defined-benefit to defined-contribution provision has been rapid. It is also gathering pace in other countries, such as Canada and Ireland.

## Investment risk in different pensions

This trend towards defined-contribution pensions means that future retirement incomes have a *direct* dependence on investment returns. There is also an *indirect* effect of investment performance on retirement incomes in other types of funded pension.

First, in defined-benefit occupational plans, employers are required to step in to make up shortfalls between the benefits they expect to pay and their assets with extra contributions. However, these additional contributions – especially during a recession – can encourage employers to reduce the generosity of benefits. Some may even close their defined-benefit scheme and switch to defined-contribution provision.

Worse still, a coming recession may result in the bankruptcy of the employer while the pension fund still suffers from a shortfall. However, some countries with widespread defined-benefit occupational plans have established special funds to protect benefits in these circumstances. The Pension Benefit Guarantee Corporation (PBGC) in the United States is one example. The problem is that the finances of the PBGC are already stretched and some call on the public purse may be necessary. The same might apply to the Pension Protection Fund in the United Kingdom, which was established more recently than the PBGC.

Multi-employer pension funds are generally more robust to the collapse of a sponsoring company than single-employer plans. Such funds are widespread in a few OECD countries, such as Iceland and the Netherlands.

Secondly, many countries – including Australia, Canada, Ireland, Japan, Korea, New Zealand, Norway, Sweden, and the United States – have substantial public pension reserves. These are a way of pre-funding future public pension liabilities before unfavourable demographic conditions set in. In Japan and the United States, investments are only or mainly in government bonds. But other countries' reserves have diversified portfolios that include the kinds of assets that have lost value this year.

In theory, individual retirees should not be affected by the investment losses of public pension reserves because their benefits are defined. In the first instance, the investment risk is borne by the public purse: taxes and/or contributions (or, indeed, government borrowing) will need to be higher to meet pension liabilities.

Nonetheless, there is at least the potential that individual retirees will be affected if worse-than-expected performance prompts governments to reduce benefits rather than raising taxes or public pension contributions.

### **Pension-fund portfolios**

The impact of the crisis depends on the investment portfolios held by pension funds. These have become more diversified in recent years, with equities growing as a share of assets between 2001 and 2007 in 13 out of the 18 OECD countries for which data are available. Bonds have played a correspondingly lesser role. Private pension funds have large equity investments – more than one third of assets – in ten OECD countries: Austria, Belgium, Canada, Denmark, Iceland, the Netherlands, Poland, Sweden, the United Kingdom and the United States.

Pension funds, like many other investors, have sought additional returns from 'alternative investments', such as hedge funds, commodities, private equity and infrastructure funds.

Nonetheless, bonds still account for more than half of pension-fund portfolios in 13 out of 22 OECD countries for which data are available. Of these bond investments, 60% are government bonds which have, so far, generally done well during the financial crisis, although the risk premium on some countries' public-sector debt has increased.

Moreover, direct exposure of pension funds to 'toxic' assets, such as structured financial products and asset-backed securities, is generally small. These account for less than 3% of assets under management for the pension fund industry as a whole. Still, asset allocation differs between countries and individual pension funds: some are likely to face substantial losses in asset values. ■

---

## 'Don't panic, don't panic'

### Pensions are a long-term issue

The journalistic thesaurus has been well used this year: tsunamis and tidal waves, earthquakes and meltdowns, have regularly appeared in headlines. Much of the analytical response has equally relied on clichés and hackneyed phrases: knee-jerk reactions, babies and bathwater, for example, are often mentioned.

Yet, in the context of pensions, there is often little reason to panic.

First, most current retirees are unaffected because they have public retirement benefits and their private pensions have been converted into an annuity. In turn, the income stream from an annuity is backed by strict capital requirements on providers.

But it is not always the case that retirement benefits are annuitised. In Australia, for example, retirees tend to leave their money invested rather than annuitise their pension capital. This option has also proved increasingly popular in the United Kingdom and the United States, among other countries, as falling long-term interest rates have made annuities less attractive.

Secondly, pensions are, by their nature, long-term and so their performance must be evaluated over a lengthy horizon. The past decades have seen

healthy returns: a balanced portfolio equally weighted between equity and bonds has returned an average of over 7% a year in real terms in major OECD economies.

Other countries have also seen good investment performance over the long term. In Chile, for example, gross returns averaged 10% a year between 1981 and 2007 in real terms. Even including the decline of the balanced fund in 2008, the average return is 1.5 percentage points lower, at around 8.5%.

Younger workers can hope for some good years in the future to make up for recent falls in asset values. Indeed, current low asset prices might mean that future contributions earn a higher return. But these arguments may not hold for older workers, say those within 5-10 years of retirement, who will find it hard to recuperate these losses. Their plight is explored further below.

Thirdly, pension funds also have very small liquidity needs (to pay benefits and cover administrative expenses) relative to their total assets under management. They generally will not need to sell assets at the low prices currently prevailing to meet their liabilities since they can rely on a continual flow of contributions and investment income.

The main exception to this rule comes from defined-benefit plans that are closed to new members. These schemes are often running down assets to pay benefits. They are significant in countries, such as the United Kingdom and the United States, where the shift to defined-contribution plans has been most rapid.

Fourthly, the finances of defined-benefit schemes had substantially recovered from the 2000-1 stock-market downturn before the crisis hit. Most OECD countries reported aggregate pension-fund surpluses one year ago. Moreover,

the yields on corporate bonds, which are used to discount future pension liabilities under international accounting standards, have increased. This has offset some of the impact of the decline in asset values on the funding position of pension plans.

Nevertheless, funding levels are worsening in some countries. For example, the Pension Protection Fund in the United Kingdom recently reported that occupational schemes had an aggregate deficit of £97 billion (\$153 billion; €120 billion) at the end of October 2008 compared with a surplus of £84 billion a year ago. The Fund also found that 84% of schemes are in deficit now compared with 60% last year.

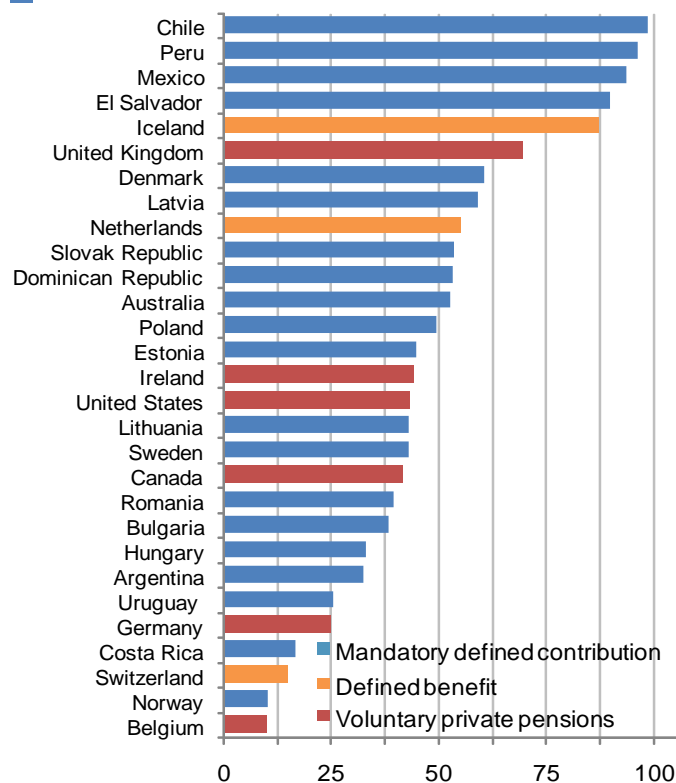
Moreover, relative to government bond yields, the finances of defined-benefit pension funds in all countries have deteriorated significantly. If and when the market pricing of risk of different bond returns to 'normal', then the shortfalls arising from lower asset prices will be clear.

### Which countries are affected?

Private pensions are part of a range of different provision for old age, which generally includes a strong public component. Figure 2 illustrates the role of private pensions in the overall retirement-income package for a range of OECD and non-OECD countries.

The calculations cover 20 countries with compulsory defined-contribution plans and three with mandatory (or near-mandatory) private defined-benefit plans: Iceland, the Netherlands and Switzerland. Also included are six countries where voluntary private pensions have broad coverage and data are available on contributions paid to these plans: Belgium, Canada, Germany, Ireland, the United Kingdom and the United States. The average private-pension share of the countries shown is just below 50%.

## 2 The role of private pensions



Note: calculations are based on weighted average pension wealth assuming a 5% real return on investments: see OECD (2007a). Parameters and rules are those for 2006 and calculations are for full-career workers. The data include only mandatory (public and private) and voluntary occupational pensions. Other sources of retirement income (e.g., voluntary personal pensions, other individual savings, and housing) are excluded.

Source: OECD pension models. See Whitehouse (2006), D'Addio, Seisdedos and Whitehouse (2008), Whitehouse, D'Addio and Reilly (2008) for details.

In the countries at the top of the scale, most retirement income is likely to come from private pensions: in Chile, Iceland and Mexico, for example. In these countries, the public plan provides a modest top-up aimed mainly at low-income workers. In Belgium and Norway, in contrast, contribution rates to private pensions tend to be low and so the government is expected to provide the great bulk of retirement incomes.

The appropriate response to the impact of financial turmoil on pension funds clearly depends on the role these plans play in the overall retirement-income package. The political

pressure for a public rescue plan is clearly greater for the countries at the top of the chart than at the bottom.

## Automatic stabilisers

In most OECD countries, pensions in payment are taxable. An average earner could expect to pay about 30% of pension in tax in Denmark and Sweden, according to the OECD pension models. In Belgium, Germany and Norway, the average earner would pay about 20% of retirement income on tax and around 15% in Hungary and Poland. If investment returns turn out to be poor, then governments will collect less in taxes on pensions and so individuals' net retirement incomes will fall by less than the decline in pension-fund asset values.

Net retirement incomes are also protected by resource-tested benefits and minimum pensions. In Australia, Chile and Denmark, for example, most current retirees receive the resource-tested benefits. The value of these entitlements increases as private pensions deliver lower returns, protecting much of the incomes of low- and middle-earners. Coverage of such schemes is also relatively high in Canada, Ireland and the United Kingdom (20-35%). In these countries, low earners will have their overall pensions protected by resource-tested programmes. ■

---

## Policy responses

### What to do and what not to do

It is a time of sinking asset prices, declining economic growth and rising unemployment in most OECD countries. The short-term political pressures on governments to respond are huge. But it is important to resist expedient reactions that threaten the long-term stability and sustainability of retirement-income provision.

## Diversify retirement provision

The problems for private pensions arising from the financial turmoil are not a sufficiently good reason for replacing private pensions with public provision. Many countries are already in a weak fiscal position which is projected to worsen further as economies slow. The emerging costs of population ageing on healthcare, as well as pension systems, mean that such a policy would threaten medium- and long-term sustainability of the public finances.

The best approach to pension provision is to use a mixture of sources of retirement income, including both public and private, as well the two main forms of financing (pay-as-you-go and funded pensions). Relying solely or largely on one source may be imprudent, as all systems face major risks of different sorts. Public pension systems are under tremendous stress stemming from demographic ageing and falling labour force participation rates.

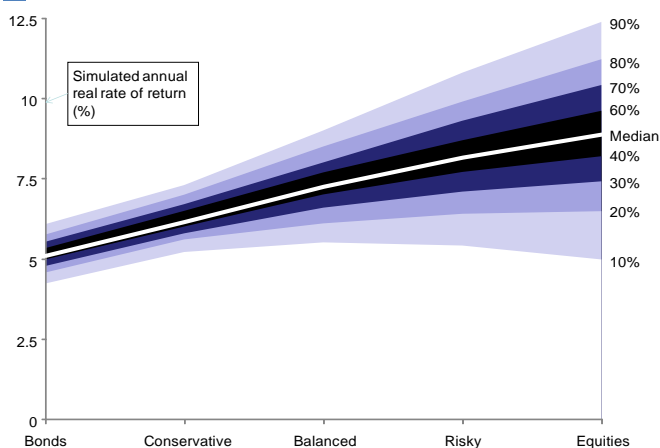
The OECD has long advocated diversified retirement-income provision, arguing that 'diversity has many virtues'. The report on *Maintaining Prosperity in an Ageing Society* went on to say that 'each of the elements of the system has its own strengths and weaknesses and a flexible balance among them not only diversifies risk but also offers a better balance of burden-sharing between generations'.

## Investment returns and portfolios

The data in Table I show that conservative portfolios have performed much less badly in recent times than balanced or more risky investments. This is because of the higher share of bonds in these pension funds and correspondingly lower equity share. In Chile, for example, the annual return on the risky portfolio over the last 12 months is minus 46% while the conservative portfolio broke even over the year.

However, equities have historically delivered higher investment returns than bonds, but they have been more risky. This is illustrated in Figure 3, which shows market investment returns simulated over the 45-year horizon of pension savings. The white line shows the median real return: half of the time returns will be above this level, and half the time below. This is 7.3% for a balanced portfolio, half-and-half in equities and government bonds. It is higher – 8.9% – for equities and lower – 5.2% – for bonds.

### 3 Real investment returns by portfolio



Note: based on historical data on returns for eight OECD countries: the G7 plus Sweden. Simulations based on analysis of these data for a 45-year investment horizon. Conservative portfolio is assumed to be 25% invested in equities, balanced 50% and risky, 75%. The remainder is assumed to be invested in government bonds with a range of maturities.

Source: D'Addio, Seisdedos and Whitehouse (2008) based on Datastream information.

The shaded areas of the chart show the likelihood of different outcomes, based on past experience. With a balanced portfolio, real returns are expected to be 5.5% a year or less 10% of the time. Equally, they are projected to exceed 9.0% a year also 10% of the time. The shaded areas fan out as the equity share in the portfolio increases, reflecting the greater volatility in returns on the stock market than on government bonds.

There is an important caveat: the simulations are based on around 25 years of data but the series

analysed only reaches to the end of 2006. The more recent period includes both substantially negative returns on equities and much greater volatility.

### Investment choice

Pension-fund investment regulations have been liberalised over the last decade. For example, only 12 OECD countries still set quantitative limits on equity investments and these are set at relatively high levels. This allows pension fund managers to diversify their portfolios.

Individuals can choose their investment portfolio in most defined-contribution pension plans. In Australia, for example, around 85% of people are members of a scheme with investment choice, typically among five different funds. However, individuals are now free to choose among different pension providers: the menu of investments in retail funds averages 58.

There has also been an expansion in choice in the most common defined-contribution arrangement in the United States. In the late 1970s, only 16% offered investment choice but by 1994 this had climbed to 94%. More than half of schemes now offer five or more different kinds of investment.

Each provider in Chile, Estonia and Mexico, for example, is required to offer a small range of funds with different risk-return characteristics (see Table I).

Yet in some countries, such as Poland and Uruguay, there is no choice of investments in the mandatory private pension systems. This 'one-size-fits-all' investment arrangement means that people are unable to shift their investments from riskier to safer assets as they move towards retirement.

This shift, often called lifecycle investing, can reduce investment risk over the career without the sacrifice of financial returns from a broader

portfolio at younger ages. Investment choice between portfolios with different risk-return characteristics should be allowed in schemes where members bear investment risk. But there should also be a default portfolio pattern based on the lifecycle approach to put investments on automatic pilot for those individuals who do not want to manage their portfolio actively.

## Benefit choice

People with defined-contribution pensions are often required to buy an annuity at the time of retirement. A high equity exposure of the fund just before retirement risks much lower living standards after a financial crisis. In such a case, restrictions on investment choice – limiting it to lower risk options – may be appropriate for people nearing retirement.

Countries should also reconsider mandating individuals to annuitise the balance in defined-contribution at a specific time or age. This risks locking in low asset values, with lower benefits throughout retirement. Some already allow ‘phased withdrawals’, where a defined part of the fund balance can be withdrawn each year. Others might also adopt this more flexible approach.

However, phased withdrawals are not without their own risks: as with people near to retirement, some restriction of investment choice of people after retirement is needed. Furthermore, the rules determining the amount that can be withdrawn each year must be careful to avoid leaving people in penury in very old age. Governments should explore a combination of phased withdrawals with a ‘deferred’ annuity, to be bought at the time of retirement, which only pays out once individuals reach an advanced age (between 75 and 85 years, for example).

## Pension-plan choice

When countries shift part of their pension provision from public pay-as-you-go schemes to

private pensions, a number of policy issues are raised. A critical one is the extent to which current and future workers should be allowed, encouraged or forced to switch to the private defined-contribution plans.

Some countries, including Argentina, Lithuania and the United Kingdom, allowed both current and future workers the choice of remaining in the public pension or switching to mixed public/private provision.

At the other end of the spectrum, Mexico and Sweden, for example, forced all workers to switch. In other countries, new labour-market entrants and often, younger workers were forced to switch while people in their 30s or 40s were given a choice and older workers were required to stay in the public system.

The financial-market turmoil has already led to pressures to allow people to switch back into the public scheme. One example is the Slovak Republic. A six-month window was offered between January and June 2008 for people to opt back into the state scheme. The window for opting back has subsequently been extended, although in the first half of this year only 6% of members of the private plans had chosen to switch back.

This low take-up might result from inertia, but it could also indicate that people value the diversification of retirement provision that private pensions bring. For instance, some 60% of Slovak workers actively chose the defined-contribution pension option at the time of reform.

More significant for the long-term development of the Slovak pension system is a potential reduction in the flow of new contributors. It is no longer compulsory for labour-market entrants to join the private funds. Here, inertia might work in the opposite direction, reducing the numbers choosing private pensions.

There has been much discussion of allowing individuals to opt back in to public pensions in other countries that adopted mandatory private pensions, most notably in Hungary.

These policies undermine the stability of the pension system. First, demand for policy changes will simply recur. For example, if investment returns are plus rather than minus 25% in a couple of years' time, people might wish to switch back to the private scheme with retrospective effect.

Secondly, if people are able to buy back their public pension rights using the diminished asset values in their private plans, this will give a short-term boost to the public finances as the funds are transferred. Many cash-strapped governments would welcome this short-term financial boost. But the cost to public pension spending will be greater in the medium and long term than the short-term gain.

### **Informed choice**

Most individuals are not well informed about pensions, lacking both general facts about the pension system's structure and specific data on their own pension entitlements. This applies to pension systems of all types.

Private pension plans often place greater responsibility on individuals for planning their retirement income than public programmes. For example, people might need to choose between a range of competing pension managers or between different investment portfolios. And in many pension reform cases, individuals had a choice over whether to join the defined-contribution pension scheme or to remain in a public, earnings-related scheme.

Effective disclosure by providers and broad-based financial education programmes can help people make informed choices about their retirement provision. This is highlighted in the current crisis,

when the risk is that people make decisions based on short-term conditions that have negative implications over the long term.

### **Nationalising private pensions**

The government of Argentina nationalised its mandatory private pension funds, worth \$30 billion (€23 billion), in October 2008. The government presented this asset-grab to the public as a way of protecting contributors from alleged mismanagement amid the global financial crisis. But it is clear that an important motive was to replenish the government's coffers at a time when large repayments of public-sector debt are about to fall due.

The economic significance of this policy is not as large as it might appear at first sight. This is, first, because Argentina maintained a large public pension, unlike other countries in Latin America such as Chile and Mexico (see Figure 2). Secondly, most of the assets of the pension funds were already invested in non-marketable government debt.

Nonetheless, this policy shift is clearly destructive of stability and sustainability of retirement-income provision.

### **Regulating defined-benefit plans**

Governments generally impose funding or solvency rules on defined-benefit, occupational schemes. These rules, typically policed by independent supervisory agencies, are designed to ensure that the assets currently held in the pension fund will be sufficient to meet the stream of future liabilities, mainly in the form of pension payments to current and future retirees.

These funding rules have been tightened in recent years in a number of countries. Indeed, some sponsoring employers are still making additional contributions to make up for shortfalls created during the decline in financial markets in 2000-02.

One response to the current crisis might be to allow temporary extensions in the recovery periods during which sponsors must plug pension-fund deficits. This policy was adopted by countries such as Canada and Ireland during the last equity downturn.

Some countries are also reconsidering recent changes in the standards for valuing pension-fund assets, particularly the introduction of 'fair-value' or 'mark-to-market' methods that, among other things, use discount rates that account of the maturity of pension liabilities and the current level of market interest rates. For example, pension funds in Denmark will be allowed to calculate solvency on the basis of a return to 'normal' conditions. A similar policy has been adopted in Finland and is being discussed elsewhere.

Extending recovery periods makes most sense in a recessionary environment where company profitability is declining and access to credit is heavily restricted. Companies' cash-flows are already being strangled and so forcing employers to increase contributions to their underfunded pensions may only make matters worse. It may even threaten the solvency of sponsoring companies, which is obviously not in the interest of beneficiaries.

However, it is critical that any extension of recovery periods is clearly time-delimited and not a permanent weakening of funding regulations, as this would ultimately reduce the protection of workers' incomes in retirement. The presence of pension guarantee funds also means that public money is at risk.

### Non-pension savings

The financial crisis has not only affected pension savings. Indeed, people often save for retirement using other financial instruments or even through investment in housing or small businesses. Asset

values in all these cases are also threatened by the credit crunch and its wider effects.

Governments have already stepped in to prop up financially challenged banks. Many have also extended deposit insurance.

However, many retirees and older workers still face losses on their non-pension savings. This is a case *for* pensions. First, it is easier to structure pension plans to shift automatically to less risky investments as people get older. Secondly, it is safer for people to have a substantial part of their wealth in annuities than in many other kinds of investment during retirement.

### Public guarantees

Should governments bail out individuals' pension accounts in the same spirit as the public rescue of banks? As noted previously, governments already stand behind many countries' occupational, defined-benefit schemes. The discussion that follows focuses on defined-contribution plans.

The case for government intervention rests critically on the design of the retirement-income system. It is weaker in countries where there is a sizeable public pension. Where people have investment choices – particularly where there is a default that shifts to less risky assets as people near retirement – there is also less of an argument for intervention.

Working in the opposite direction, governments may have a moral, if not a statutory, duty to help where defined-contribution pensions are mandatory rather than voluntary and annuitisation at retirement is obligatory.

A bail-out, however, would be very expensive. There is also a risk of moral hazard: the expectation of a bail-out next time something goes wrong encourages people to behave more riskily. For these reasons, ad-hoc guarantees of

investment returns or compensation for losses in asset values should be avoided.

A bail-out would make most sense for people who are close to pension age. However, this poses great political difficulties. If it were restricted, say, to people within a few years of normal pension age, then workers just slightly younger than the cut-off age would feel cheated. Similarly, retirees who annuitised their pension only recently, locking in financial-market losses, would complain if their contemporaries who kept their money in financial markets were to be compensated.

For reasons of equity – and the fiscal impediments to paying money directly into pension funds – governments should instead rely on their public-pension schemes to ensure that negative returns on pension funds over one year do not translate into old-age poverty. Paying any compensation as a public pension benefit spreads the cost over the period of retirement of the individuals involved, reduces political tensions and alleviates problems of moral hazard. ■

---

## Risk and pensions

### Security through diversity

All kinds of pension involve risk and uncertainty because they are long-term contracts. Much can change in the 40 or more years between the time people enter the labour market and the pension system and when they retire.

The financial crisis means that investment risk is at the forefront of the minds of both the public and policymakers. But it is important to remember that there is a range of risks and uncertainties that affect pensions.

Public pensions, for example, impose the risk that governments (or rather voters) change their

minds about what is a reasonable retirement income and pay lower pension benefits than expected. Taxpayers will be both fewer and more reluctant to part with their money if the financial crisis turns into an economic downturn.

Problems in the real economy will also affect retirement incomes as a result of higher unemployment and lower wages.

There are economic, demographic, financial and social uncertainties in pension systems and for individuals. It is clear that the best approach for an individual – and, by extension, for a government seeking to do the best thing for its citizens – is to use a mixture of ways of providing retirement incomes. Diversity of pension provision is the best way to deliver security in old age. ■

---

## Bibliography

- Antolín, P. (2008a), 'Pension fund performance', Working Paper on Insurance and Private Pensions no. 20, OECD.
- Antolín, P. (2008b), 'Policy options for the payout phase', Working Paper on Insurance and Private Pensions no. 25, OECD.
- Antolín, P. and E.R. Whitehouse (2008), 'Filling the pension gap: coverage and value of voluntary retirement savings', Social, Employment and Migration Working Paper no. 69, OECD.
- D'Addio, A.C., J. Seisdedos and E.R. Whitehouse (2008), 'Investment risk and pensions: measuring uncertainty in returns', Social, Employment and Migration Working Paper no. 70, OECD.
- Martin, J.P. and E.R. Whitehouse (2008), 'Reforming retirement-income systems: lessons from the recent experience of OECD countries', Social, Employment and Migration Working Paper no. 66, OECD.
- Mattil, B. and E.R. Whitehouse (2008), 'Rebalancing retirement-income systems: the role of individual choice under mixed

public/private pension provision', Social, Employment and Migration Working Paper, OECD, forthcoming.

OECD (1998), *Maintaining Prosperity in an Ageing Society*, OECD.

OECD (2005), *Pensions at a Glance: Public Policies across OECD Countries*, OECD.

OECD (2007a), *Pensions at a Glance: Public Policies across OECD Countries*, OECD.

OECD (2007b), 'Pension markets in focus', newsletter no. 4, OECD.

OECD (2008a), *Improving Financial Education and Awareness on Insurance and Private Pensions*, OECD.

OECD (2008b), *Private Pensions Outlook*, OECD, forthcoming.

Pugh, C. and J. Yermo. (2008), 'Funding regulations and risk sharing', Working Paper on Insurance and Private Pensions no. 17, OECD.

Tapia, W. (2008), 'Comparing aggregate investment returns in privately managed pension funds: an initial assessment', Working Paper on Insurance and Private Pensions no. 21, OECD.

Tapia, W. and J. Yermo. (2007), 'Implications of behavioural economics for mandatory individual account pension systems', Working Paper on Insurance and Private Pensions no. 11, OECD.

Whitehouse, E.R. (2006), *Pensions Panorama: Retirement-Income Systems in 53 Countries*, World Bank, Washington DC.

Whitehouse, E.R., A.C. D'Addio and A.P. Reilly (2009), 'Investment risk and pensions: impact on individual retirement incomes and government budgets', Social, Employment and Migration Working Paper, OECD, forthcoming.

---

## Acknowledgments

This briefing was prepared by Edward Whitehouse of the Social Policy Division in the Directorate for Employment, Labour and Social Affairs at the OECD and Juan Yermo of the Financial Affairs Division of the Directorate for Financial and Enterprise Affairs.

The note has benefited from discussion at the Organisation's Working Party on Social Policy on 5-6 November 2008.

Many OECD colleagues have made substantial contributions. They comprise: Pablo Antolín, André Laboul, Jean-Marc Salou, Clara Severinson and Fiona Stewart of the Directorate for Financial and Enterprise Affairs; Anna D'Addio, Martine Durand, John P. Martin, Mark Pearson and Andrew Reilly of the Directorate for Employment, Labour and Social Affairs; and Monika Queisser of the Secretary-General's office.

---

## Follow-up

Edward Whitehouse: + 33 6 25 89 56 67

e-mail: [edward.whitehouse@oecd.org](mailto:edward.whitehouse@oecd.org)

Juan Yermo: + 33 1 45 24 96 62

e-mail: [juan.yermo@oecd.org](mailto:juan.yermo@oecd.org)

[www.oecd.org/els/social/ageing](http://www.oecd.org/els/social/ageing)

[www.oecd.org/daf/pensions](http://www.oecd.org/daf/pensions)

© OECD 2008



# In brief

## ■ Which countries are affected?

- Where most of the retirement incomes of today's workers is likely to come from private pensions – in Chile, Denmark, Iceland, Mexico, the Netherlands, the Slovak Republic and the United Kingdom, for example – the effect of the crisis on retirement incomes is deepest.
  - Resource-tested retirement benefits – as in Australia, Canada, Denmark Ireland and the United Kingdom – can, however, protect net retirement incomes.
  - Defined-benefit pension schemes predominate in countries such as Canada, Iceland, the Netherlands and Switzerland. This puts an extra burden on companies when economic downturn means they can ill afford it.
  - Government bonds have, so far, suffered less than other financial assets from the crisis. So pension funds that mainly hold these bonds have not been much affected. This has a welcome result in the short term but may not be a good long-term bet. Portfolio diversification is both less risky and more rewarding for long-term retirement savings.
- ## ■ Who is affected?
- Workers close to retirement face the prospect of drawing out their retirement savings at a time of low asset values.
  - If there is a recession, older workers are often the first to be made redundant, dealing a double blow to their finances.
  - But, for younger workers, pensions are long-term savings. These short-term losses should be balanced out by some good returns in the future.

- Because many countries have redistributive retirement-income systems, middle and higher earners will be most affected.

## ■ What not to do

- Just as the financial crisis does not necessarily spell the end of global capitalism, it does not mean that we have to abandon existing retirement-income policies. Pensions are a long-term issue.
- The crisis means both fiscal and financial pressure on pension systems. Diversification of retirement-income sources remains important: mixing public and private provision and pre-funding and pay-as-you-go financing is still the best option.
- Governments should also avoid knee-jerk reactions, such as allowing people to switch back to the public pension system or, even more destabilising, nationalising private pension schemes.

## ■ What to do

- With defined-contribution plans, ensure a choice of investments with different risk-return characteristics.
- Provide a default option that involves a switch to less risky investments as people get closer to retirement. Restrict investment choices for older workers to low-risk options, especially where retirees must buy an annuity.
- If funding requirements risk putting companies' solvency in peril, relax temporarily the funding rules for private, defined-benefit plans, allowing longer recovery periods to close funding gaps.
- Consider a temporary scheme to compensate older workers, close to retirement age, through the public pension system.