RETIREMENT SAVING AND THE PAYOUT PHASE:
HOW TO GET THERE AND HOW TO GET THE MOST OUT OF IT

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Times are changing for pension funds

- By the early 2000s many issues had already emerged
  - importance of aggregate longevity risk
  - the transfer of risk from governments and corporations to households and individuals
  - the impact of reallocations of pension fund portfolios
  - the adequacy of the regulatory and supervisory framework
- Three policy directions (G10 Report, 2005)
  - strengthening risk management practices
  - promoting the supply of suitable financial instruments
  - raising the standards of investor protection and financial education

Times are changing for pension funds

- The pension fund industry has already been badly hit by the crisis
  - US pension funds' assets in the four quarters to June 2008
    - ➢ -9.3%, or -874 billion dollars
    - ➢ Since June 2008 losses have probably doubled
  - IMF (2008): potential write downs for pension funds
    - ➢ between 125 and 250 billion dollars
- The current financial crisis is a watershed: it will not be business as usual anymore

Times are changing for pension funds

- Fundamental question: Are financial markets able to give workers a sufficient level of retirement income even over long-term investment periods?
  - issue of aggregate longevity risk still open
  - new awareness of the risks of disruptive financial market downturns
  - these “tail” events can be more frequent than one usually thinks
- Investors’ confidence has been shaken and this may well spread disaffection among DC plan members

Times are changing for pension funds

- The phases of accumulation and decumulation are closely intertwined
- Three main issues concerning the accumulation stage
  - appropriate level of contributions
  - adequate asset allocation
  - a safety net for pension fund returns?
- Main issues concerning the decumulation stage
  - cheaper pay-out products
  - safer pay-out products

Pension funds have continued to grow

- In this decade the pension fund industry has continued to expand relative to the size of the economy
  - although at a slower pace than in the 1990s (Table 1)
- Asset growth has differed considerably across OECD countries
  - stronger where pension funds are well developed (Figure 1)
- DC plans have increased further (Table 2)
- In the future, retirees will depend heavily on funded pension schemes (Table 3)

Retirement saving should increase further

- The financial crisis
  - creates problems for DB plan sponsors
  - may reduce confidence for DC plan members
- Risk of workers' tendency to under-save
  - myopia, lack of willpower
  - overestimation of future benefits
  - absence of target replacement rates for accumulation plans
  - conservative asset allocation

Retirement saving should increase further

- Policy levers to increase contributions
  - fiscal incentives: effective but expensive, possibly regressive
  - Employer-matching contributions: effect on net wages?
  - Greater flexibility for withdrawals against illiquidity: may backfire (short-sightedness and time-inconsistency)
- To raise fund returns
  - reduce fees; more transparency, transferability; competition
- Some policies are relatively cheap
  - information provision: estimates of future pensions, based on reasonable, transparent, standardized assumptions
  - well-designed default options: use opt-out instead of opt-in clauses, offer limited array of easy-to-understand options

From protected to unprotected DC schemes?

- In the long run, higher risks buy higher returns (Figure 2a)

- Even in the long run, large drops are still possible (Figure 2b):

  – past realizations may conceal structural breaks

  – catastrophic events are more likely than standard mean-variance frameworks suggest (the distribution of many asset prices has “fat tails”)

- There are market-based responses to tail risks:

  - “life-cycle funds”

  - market-based rate-of-return guarantees (using options and other derivatives)

From protected to unprotected DC schemes?

- Market-based protection is limited with tail events
  - these are typically aggregate shocks
  - markets can only deal with idiosyncratic shocks
- Some form of inter-generational risk-sharing is efficient
- It may involve subgroups of the population
  - for example, “hybrid DC plans” (younger workers share with older workers part of financial market risks)

From protected to unprotected DC schemes?

- It may also involve, through the government, the whole national community
  - swap arrangements between pension funds and the Treasury (Modigliani)
  - risky pension fund returns exchanged for a guaranteed rate of return (at market prices)
- Treasury compensation for the risk taking
  - a transparent ex ante solution, preferable to ex post bail outs
  - fairness implications: similar workers granted similar returns
  - solutions for intergenerational burden?

We need cheaper pay-out products

- A high degree of annuitization of private pension wealth is advisable, with benefits for
  - individuals (reduction of longevity risk)
  - the government (protection from opportunistic behaviour)
- Annuity provisions have to become more efficient and cost-effective than they actually are
- To get cheaper annuities, three main determinants of annuity prices should be addressed
  - aggregate longevity risk
  - adverse selection costs
  - administrative costs and profit margins

We need cheaper pay-out products

- To reduce aggregate longevity risk and adverse selection costs
  - timely and accurate mortality tables, and good projections (a "public good")
  - tables for different sub-groups of the population
- To keep margins and costs low
  - more competition
  - transparent and comparable prices and other product characteristics

We need safer pay-out products

- Inadequate range of annuity provisions that cover risks in retirement (inflation, longevity, interest rate risks)
- Insufficient supply of of inflation-indexed and ultra long-term bonds (not to say longevity bonds)
- Besides annuities: reverse mortgages
  - may get a blow: need of better design
- Insufficient supply of hedging instruments
  - lack of natural issuers in the private sector

We need safer pay-out products

- Due to their extended time-horizons, governments are a natural candidate to reinsure some of these risks
- The State could also directly intervene as an annuity provider
- However, guarantees should be
  - limited to the occurrence of tail events
  - sold at market prices which in normal times compensate the government for the risks
  - matched with correspondent downsizing of the public pension pillar (shift part of idiosyncratic risks to the market)

Conclusions

- Path to an adequate and stable pension strewn with risks which may have been overlooked
- Risks can materialize both in the accumulation and in the decumulation phase
- Some of the risks are systemic
- These risks may best be addressed through forms of inter-generational risk sharing
- Possibility of government (transparent and efficient) guarantees sold to pension funds and to annuity providers

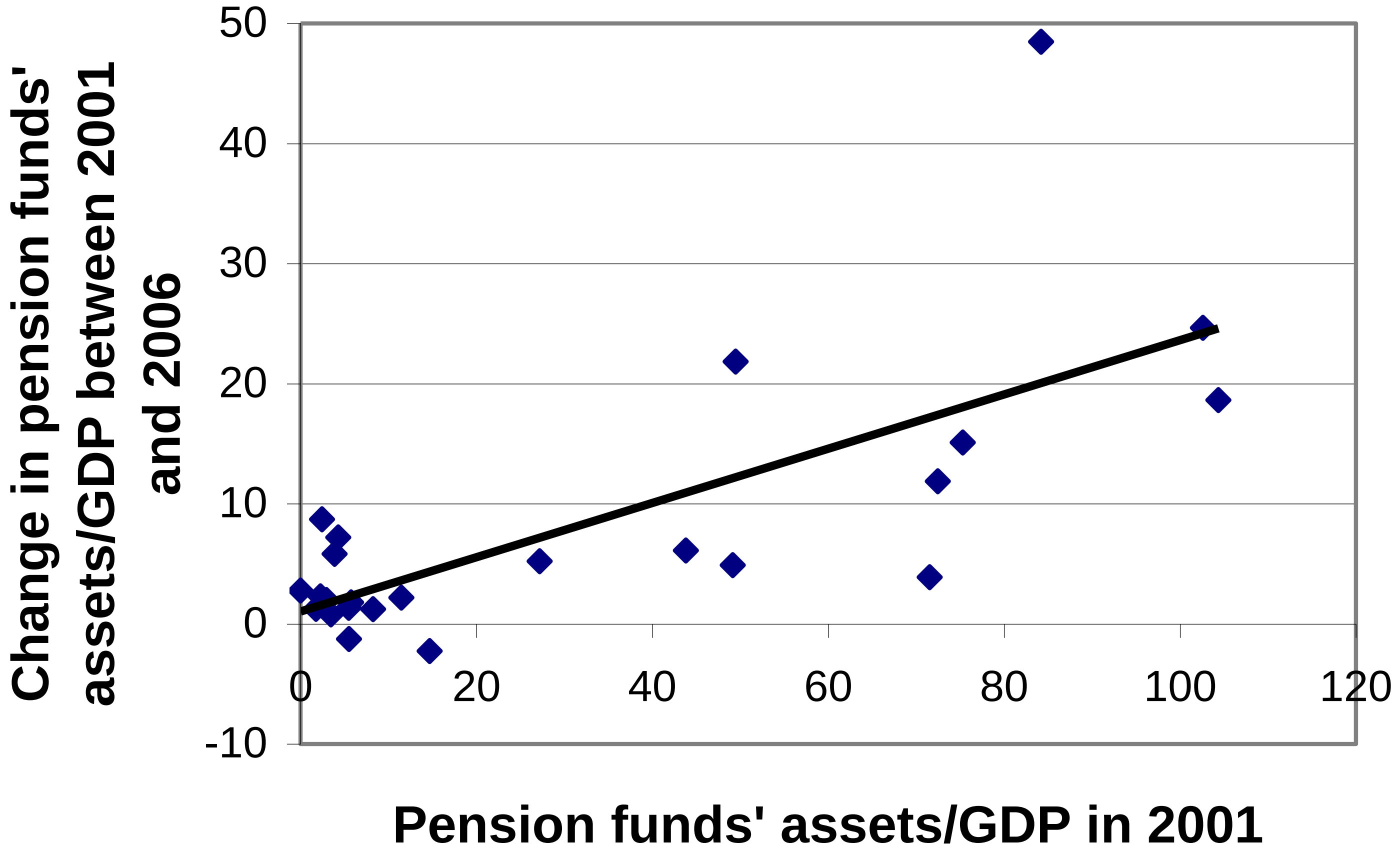
Table 1: Pension fund assets in percent of GDP

	1990	2000	2003	2006
Belgium	2	6	4	4
Canada	29	48	47	54
France		1	1	1
Germany	3	3	4	4
Italy	1	3	2	3
Japan	12	19	14	22
Netherlands	72	114	101	127
Sweden	2	3	8	9
Switzerland	56	105	104	123
United Kingdom	50	79	65	84
United States	42	69	73	75

Source: Group of Ten (2005) and OECD (Global Pension Statistics).

Figure 2: Pension funds' assets/GDP across OECD countries

(percent)



Source: OECD (Global Pension Statistics).

Table 2: Proportion of DC plans in selected countries

(% share of DC pension plans in autonomous pension funds' total assets)

	2001	2002	2003	2004	2005	2006
Canada				7		9.5
Italy			80.9	70.5	83.8	85.3
Japan	2.4	0.2	4.4	8.2	14.2	
United States	46.4	47.2	48.0	48.9	50.2	51.7

Sources: OECD (Global Pension Statistics); OECD, *Pension Markets in Focus*.

Table 3: Current and expected sources of income in retirement
(percent)

	Workers (Expected)	Retirees (Reported)
Social Security	80	94
An employer-sponsored retirement savings plan, such as a 401 (k)	74	36
Other personal savings or investments	73	48
An individual retirement account or IRA	69	34
An employer-provided traditional pension or cash balance plan	59	53

Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2008 Retirement Confidence Survey.

Figure 2: Long term asset returns