

## **OECD Seminar addresses the payout phase of pensions and pension policy responses to the financial crisis**

Representatives from OECD governments, academia and private sector met yesterday (12/11/08) during a seminar on “the pay-out phase of pensions, annuities and financial markets” to discuss proposals to support private pension systems, and in particular improve the management of risks in the retirement stage of individual account (defined contribution, DC) pension systems. The seminar discussed the impact of the financial crisis, as well as longer term issues affecting the sector such as increasing life expectancy.

Private pensions have been severely affected by the financial crisis, with pension fund returns falling by over 20% on average across the OECD between January and October this year, or a loss of over USD 4 trillion in pension assets.

Both defined benefit and defined contribution systems have been badly affected. In DC pension systems, negative returns translate directly into a smaller pension pot. While young workers have a long period to make up these losses, for individuals close to retirement who expect or are required to buy an annuity with their savings these declines in asset values can represent an irremediable decline in living standards in old age. In DB systems, the main worry is the decline in funding levels (5-15 percentage point decline, depending on the discount rate used), with worse data likely to be reported at year end.

From a financial stability standpoint, one major concern is that pension funds in some countries are reacting by selling part of their equity portfolios, putting further downward pressure on equity prices. Fair valuation methods and quantitative risk-based valuation seem to be partly responsible for this pro-cyclical behaviour.

Delegates at the seminar discussed the following policy proposals:

### *Policy reactions to the financial crisis*

- Review funding requirements for DB plans:
  - In the short run, introduce measure to ease them, by for example, extending recovery periods to eliminate underfunding as was recently decided by the Dutch Central Bank
  - In the long-term, there is a need for counter-cyclical funding requirements
- New balance between prudent person and quantitative regulations. Countries where retirement income comes mainly for DC pension plans and annuities are mandatory at retirement may consider complementing the prudent person rule with quantitative investment regulations, reducing equity exposure gradually as the annuity date approaches.
- Instruments such a derivatives and swaps that allow pension funds and annuity providers to hedge traditional risks (inflation, interest rate and longevity risk) but expose them to other risks (counter-party risk) require an upgrade in risk management methods. The introduction of clearing houses where pension funds and annuity providers can trade those instruments in a more transparent manner would improve the management of counter-party risk.

- Co-operation between industry, governments and supervisory authorities is needed to enhance consumer protection and raise financial literacy standards. Such initiatives are critical in countries where retirement income systems rely largely on the DC model.

#### *The design of the payout phase of pensions and retirement income*

- In DC systems, protection against longevity risk is critical and is provided by annuities. Balance to strike between flexibility and protection via required levels of annuitisation.
- Country context is quite important. When main source of retirement income comes from assets accumulated in DC pension plans, protection from longevity risk and partial annuitisation becomes important.
- Proposal: to buy a deferred life annuity at the time of retirement that starts paying at very old age (e.g. age 85), using the remaining balance for a programmed withdrawal in the intervening period. This could be mandated or set as the default option.
- Problems affecting the well functioning of annuity markets need to be addressed, in particular, longevity risk and the lack of appropriate hedging instruments.
- Providers of annuity products (if different from insurance companies) need to adhere to adequate capital adequacy requirements.
- Annuity markets and prospective annuitants may benefit from innovative annuity products such as variable annuities that provide access to capital gains at retirement, or reverse mortgages that combine pension annuity payments and long-term care coverage. However, design and regulatory issues need to be worked out.
- Adequacy of retirement income also requires higher contributions, longer contribution periods (later retirement) and investment strategies that reduce exposure to risky assets as people reaches retirement.

#### *The role of governments and financial markets in managing risks of the payout phase of pensions and annuities*

- Pension funds and insurance companies need financial instruments in order to better hedge their liability risks (inflation, longevity, interest rates) and expand their role as providers of pensions and annuities.
- Governments can help with long-tail risks, in particular longevity risk at very old ages, and with aggregate longevity risk. There is a role for governments in encouraging the market for longevity hedging products by for example, producing an official longevity index.
- As part of a comprehensive programme including increases in retirement age in line with improvements in life expectancy (reducing their longevity exposure), governments could issue a longevity bond that would set a benchmark for private issuers.

- Governments should also consider issuing more long-term and inflation-indexed bonds, as was recently done by the Danish Central Bank, which issued a 30-year bond that was largely bought by domestic pension funds and insurance companies.
- An increased supply of government bonds of very long maturities would not only facilitate asset-liability management by pension funds and insurers but would also help develop the market for other long-term securities such as infrastructure bonds.
- Pension funds and insurance companies also use derivatives such as swaps to hedge interest and inflation risks but the counter-party risk of such products needs to be better evaluated by these institutions.