Pensions and the current crisis

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Impact of crisis on private pension systems

- Average OECD pension fund return -25% btw January-October 2008 (over USD 4 trillion).
- DC directly hit, worst for those close to retirement.
- Some DC default options at point of retirement >60% in equities.
- DB funding levels declined by about 5-20pp, depending on discount rate used
- “Toxic” assets estimated at less than 3% overall
Major Stock Market Indices (30Nov07=100)

World Equity (-42.8%)

Europe (-33.1%)

USA (-40.8%)

Emerging Markets (-47.3%)
Portfolio allocation in equities
(% total assets, 2006)

OECD, Global Pension Statistics
Prospective losses of pension funds across OECD countries
Reactions to the crisis

• Where fair value and quantitative risk-based solvency rules in place, pension funds selling equities

• Concerns over counter-party risk, pension funds shunning derivatives and swaps for risk management purposes

• Move into alternatives continues

• Private pension backlash (e.g. Argentina)
Pension funds still acting as automatic stabilisers

Figure S.2. Dutch pension funds: Net purchase for different investment categories
EUR million

Source: DNB
Investment regulation trends in OECD countries

- Gradual relaxation of quantitative investment limits
- Implementation of prudent person standard
- Quantitative risk measures (e.g. VaR, stress tests) starting to be used in both DB and DC systems.
Limits on shares
Limits on foreign investment

- Australia: No limit
- Austria*: No limit
- Belgium: No limit
- Canada: No limit
- Czech Rep.*: No limit OECD countries
- Denmark*: No limit OECD countries
- Finland*: No limit
- Germany: No limit
- Greece*: No limit in EU and EEA countries
- Hungary*: Subject to 20% ratio
- Iceland: No limit OECD countries
- Ireland: No limit
- Italy*: No limit OECD countries
- Japan: No limit
- Mexico: No limit
- Netherlands: No limit
- New Zealand: No limit
- Norway: No limit
- Poland: No limit
- Portugal*: No limit OECD countries
- Slovak Rep.: No limit OECD countries
- Spain: No limit
- Sweden: No limit
- Switzerland: No limit
- Turkey: No limit
- UK: No limit
- United States: No limit
Lessons from the current crisis

- Pensions are for the long-term, but short-term crisis can have damaging impact of pension funds and retirement income.

- Funding rules:
  - in the short-term introduce measures to ease them (e.g. extend recovery periods for underfunding)
  - in general, make funding requirements counter-cyclical.
Lessons from the current crisis

• Balance btw prudent person and quantitative restriction regulations.

• When DC main source of retirement income, more stringent regulation; when other sources of income, more flexibility.
Lessons from the current crisis

- Adequacy of retirement income: workers close to retirement (DC plans) face the prospect of drawing retirement income from smaller saving pot at the time of low asset values.
  - Provide default investment strategies that involve switching to less risky assets as people ages (e.g. life-styling or target date funds).
  - Extent of switch to bonds in default option should be greatest when annuities mandatory at retirement.
  - Consider deferred annuities that start paying at very old-ages as defaults.
Lessons from the current crisis

- Pension funds and annuity providers need financial instruments to hedge their risks (interest rate, inflation, longevity)

- However, they need instruments that avoid bringing in other risks such as counter-party risk.