

Policy Options to Strengthen Retirement Income in DC pensions

OECD DAF/FIN Pension Unit
Special Seminar on Annuities and
Pensions Mexico City – 8 June 2011

Background and motivation

- The OECD has been working for a few years on improving the design of DC pension plans in order to strengthen retirement income from these plans.
- We are now compiling some of the lessons into a set of policy options to be offered to countries.

Background and motivation

- The financial and economic crisis stressed further the importance of this work by highlighting the impact of risk factors
 - financial (returns on investment, discount rate, inflation)
 - demographic (life expectancy), and
 - labour market risks (unemployment, wage growth)
- on the retirement income from DC plans

Guiding principles

- The set of policy options are established according to three *guiding principles*:
 - Coherence
 - Adequacy
 - Efficiency

Coherence

- The design of DC pension plans need to be coherent.
- Globally: coherence with the overall structure of the pension system
- Internally: the accumulation and the payout phases need to be properly aligned
- Coherence in monitoring all risks affecting retirement income in DC plans

Adequacy

- DC pension plans are ***complementary*** to other sources to finance retirement (e.g. PAYG-financed pensions).
- They are an integral part of total retirement income
- What is an adequate retirement income is highly controversial. But assuming that for example, one can get by on 70% of pre-retirement income,

Adequacy

- DC plans need to be designed (e.g. contribution rates, contribution periods, payout phase, etc.) taking into account that they may provide a retirement income that complement other sources up to 70% of pre-retirement income.

Efficiency

- Efficiency means choosing investment strategies that reduce the impact of extreme negative outcomes on retirement income
- There are many investment strategies to choose from in the return-risk spectrum.

Efficiency

- If main concern (policy makers) is to avoid sharp declines in retirement income as a result of extreme events (*e.g.* the 2008 crisis), then they will set *default investment strategies* that avoid or limit these sharp drops, in particular for people close to retirement
- One type of investment strategies that fulfil that requirement are life-cycle investment strategies. Not panacea.

Efficiency

- Efficiency is also required to properly *structure the payout phase*.
- Assets accumulated must be allocated efficiently if retirees are to be *protected from longevity risk*.
- Among payout options, programmed withdrawals provide greater flexibility and liquidity, while life annuities provide better protection from longevity risk.

Efficiency

- In order to strike a proper balance between flexibility and protection from longevity risk, the OECD recommends combining programmed withdrawals with deferred life annuities

Main policy messages

1. The design of DC pension plans needs to be coherent
2. Ensure effective communication and address financial literacy
3. Encourage people to contribute and contribute for long periods
4. Improve the design of incentives to save for retirement to increase contributions and coverage (soft compulsion, “nudge” measures, tax incentives)

Main policy messages

5. Promote low-cost retirement savings instruments
6. Consider the pros and cons of investment guarantees
7. Establish default investment strategies with appropriate risk exposure
8. Establish life-cycle investment strategies as defaults

Main policy messages

9. Combine programmed withdrawals with deferred life annuities indexed inflation
10. Allow any provider of annuities as long as they are sufficiently regulated and fair competition is guaranteed
11. Promote the demand for annuities
 - using behavioural economics,
 - innovative products (sharing risks)
 - change framing (inv. to insurance product)

Main policy messages

12. Facilitate supply of annuities by further developing risk-hedging instruments
 - Longevity indexed bonds, ultra long-term bonds, swaps, etc.
 - Life tables should be updated regularly and include improvements
 - Government encourage development of a market for longevity hedging products by developing a reliable longevity index

Thank you
very much