# Defined contribution pensions, guarantees and risk sharing, March 5, 2013, Lodon

## *Conference summary*

**Introduction**

The future development of Defined Contribution (DC) pensions and the risks DC imposes on individuals was the subject of the OECD conference held on 5 March at Cass Business School. The conference was led by Pablo Antolin, Principal Economist, Financial Affairs Division, and Juan Yermo Head of the Private Pensions Unit at the OECD. It was hosted by Professor David Blake, Director of the Pensions Institute and Professor of Pensions Economics at Cass Business School, and sponsored by the International Centre for Pension Management (ICPM). Steve Webb, Minister for Pensions in the UK, led a strong line-up of speakers, with representatives from NEST, BBVA, ICPM, Allianz Asset Management, risklab, World Bank, APG, DWP, COVIP, the Chilean Pension Regulator, and the ABI, all taking to the podium during the course of the event.

**The Conference**

The pensions industry is at a critical stage in its continuing evolution from a predominantly Defined Benefit (DB) model to one where DC is the norm and increasingly accounts for the bulk of individuals' private pensions savings. As countries and governments continue to review the best method to introduce and develop a sustainable DC system, the conference explored the pros and cons of the mandatory vs. voluntary approach, including an evaluation of auto-enrolment, full compulsion and voluntary participation in relation to the most effective ways to secure an adequate retirement income in the context of other sources, such as the public (state) pension. While it is possible to identify common factors in DC systems across the OECD group of countries, it is notable that each country has started their DC journey from a different point and that a system that suits one country may not be appropriate for another. The output from the conference clearly demonstrated that, while there is no one-size-fits-all solution, the OECD's provides a clear and robust framework that is relevant to all countries.

**Small pots and job mobility**

The danger of having multiple pension pots was a key issue flagged by UK Pensions Minister Steve Webb in his key note address. In a world of frequent job changes, the Minister took the opportunity to highlight the fact that pension pots are forgotten frequently as people move from one job to the next. The ability to keep track of pots and consolidate them easily was cited as critical if individuals are to make the most of their aggregate pension savings at retirement.

**Trust and the role of guarantees**

Mr Webb said that he is particularly concerned to avoid negative publicity in these early days for the UK's auto-enrolment system, which might reduce trust and encourage opt-outs. For this reason he is exploring whether DC schemes should incorporate a capital or minimum return guarantee – an issue of keen interest to the conference as a whole.

While there was general agreement that guarantees could help to build trust and to maintain participation, the OECD said that it had very real concerns about the complexity and purpose of such guarantees, and also the cost, which members would bear, and which could lead to lower returns over the long term. Such costs were seen to be particularly expensive in a low interest rate environment and closely linked to the investment strategy, in that costs were likely to increase in line with the level of risk undertaken. Lifecycle investment strategies could help to reduce the cost of guarantees by decreasing the amount of risk exposure for older members. The OECD recommended that schemes should look to assess both the price and the protection level when comparing guarantees. It warned that the complexity in modelling and evaluating the cost-benefit analysis hinders the comparison of products, making it difficult to shop around and that schemes should be wary of overcompensating for short term losses if this strategy compromised long-term returns. Nevertheless, Mr Webb argued that the cost of guarantees offered through certain risk-sharing mechanisms could be quite low, and that this cost would be more than offset if the result was higher rates of participation over longer periods. He is exploring with DC stakeholders a range of options presented in his proposals for 'defined ambition' (DA) that he hoped might offer an equitable solution for both employers and employees.

## Clear communications

The conference also focused on the importance of communicating clearly to members all relevant features of their DC scheme, including any guarantees and the full member cost. The early success of auto-enrolment (which to date has been introduced by the biggest UK private sector employers) has largely been attributed to the increased levels of trust and understanding fostered between these employers and their employees, which is a result of strong communications and effective member engagement.

## The OECD Roadmap for good DC design

Despite the very different approaches and opinions of governments, regulators and industry bodies in OECD countries, it is axiomatic that DC pensions need to work better for their members. The OECD's 10 point Roadmap for DC, presented by Pablo Antolin, Principal Economist in the OECD's Financial Affairs Division, is now widely regarded as the blueprint for effective scheme design to achieve good member outcomes. The Roadmap urges policymakers and regulators to:

- Ensure the design of DC pension plans is internally coherent between the accumulation and payout phases and with the overall pension system;
- Encourage people to enrol, to contribute and contribute for long periods;
- Improve the design of incentives to save for retirement, particularly where participation and contributions to DC pension plans are voluntary;
- Promote low-cost retirement savings instruments;
- Establish appropriate default investment strategies, whilst also providing choice between investment options with different risk profiles and investment horizons;
- Consider the establishment of default life-cycle investment strategies as a default option to protect people close to retirement against extreme negative outcomes;
- For the payout phase, encourage annuitization as a protection against longevity risk;
- Promote the supply of annuities and cost-efficient competition in the annuity market;
- Develop appropriate information and risk-hedging instruments to facilitate dealing with longevity risk; and
- Ensure effective communication and addressing financial illiteracy and lack of awareness.

David Blake, Director of the Pensions Institute at Cass Business School, argued that, having established the Roadmap, it was important to implement it. This, in turn, requires that DC plans should be modelled effectively before they are sold to plan members. He set out a number of good practice principles in modelling DC pension plans which, if followed, would be completely coherent with the Roadmap.

The UK's National Employment Savings Trust (NEST), the government's flagship scheme for auto-enrolment, provides an excellent example of a scheme well-aligned with the Roadmap's principles for good scheme design. NEST's mission is to provide good-quality, low-cost pension provision for all employers, irrespective of their size and employee profile. Indeed it is unique in the UK's auto-enrolment system, as it is the only scheme with an obligation to accept any employer – a feature that will become increasingly important as auto-enrolment is extended to medium and smaller schemes.

## Designing DC to meet all members' needs

The conference included a keen debate on DC design and the imperative to incorporate the needs of different types of savers. Keith Ambachtsheer, Director of the International Centre for Pension Management (ICPM), Rotman School of Management, University of Toronto, argued that there must be as many pension strategies as there are retirement goals. He explained that in many instances younger people can't afford to contribute enough money to their fund, so the focus of their pension scheme should be on generating appropriate returns. Meanwhile, for older people, the investment strategy should give a greater focus to the certainty of pension payment.

The debate also questioned the workability of intergenerational solidarity (in which there are cross-subsidies and risk-sharing between younger and older generations) in the current economic context, with some strong arguments being presented both for and against this proposition.

### Barriers to good DC systems

Overall, the conference identified four main impediments to the establishment of a good scheme:

- Participation: According to the UK Office for National Statistics, only 32% of the UK private sector has pension savings. Tools, such as auto-enrolment/compulsion and financial incentives, were seen as strategies that should have a positive impact on this level.
- Adequacy: Adequacy was seen as a difficult factor to address, given the number of variables involved, including different patterns of employment, family structures and lifestyle requirements.
- Security: The uncertainty of the DC outcome was regarded as a huge "turn off" for savers. Schemes that can demonstrate a strong balance sheet, manage volatility and offer guarantees might mitigate this negative perception.
- Sustainability: Finding the right balance between personal and societal responsibility was seen as a key issue for policymakers.

### 'Nudging' members to make appropriate decisions

The final debate about scheme design focused on the need to consider behavioural psychology and so-called 'nudge' techniques. Research has demonstrated that an individual's perceived appetite for risk frequently is very different from their actual (demonstrated) appetite, which tends to be more risk averse, making the design of the default fund's investment strategy crucial to the member's journey and outcome. Moreover, scheme design and communication can influence specific behaviours, for example to increase contributions gradually over a long period through an automatic mechanism. Projects conducted in collaboration with the OECD in Chile have demonstrated that pension projections – included in the annual statement – were an effective tool for schemes to engage with their members and to trigger appropriate responses, such as a voluntary increase in contributions and the deferment of retirement/decumulation.

### The quest to identify the best DC system continues

As the quest for the most effective DC pension system is still under way, the conference closed with a clear commitment to the continuation of research – and the thanks to speakers and attendees – by Professor Blake, on behalf of the Pensions Institute and Cass Business School; and Pablo Antolin and Juan Yermo on behalf of the OECD.