Pensions and the Crisis
Pension fund assets dropped by over $5 trillion from $27 trillion during the crisis. The losses to benefits as a consequence will not affect all participants in pension funds equally, with older workers suffering most, while those in defined-benefit plans will probably be better off. Even before the crisis, though, there were calls to reform pensions.
By way of introduction ...

After the Deepwater Horizon oil platform exploded in the Gulf of Mexico with the loss of 11 lives, global attention focused on what would turn out to be the worst environmental disaster in US history. As the weeks went by and attempts to stop the leak failed, the costs of the cleanup plus potential damages began to mount, and markets became increasingly nervous about BP.

The UK media started to highlight another aspect of the story, typified by this headline in the Daily Express on 2 June 2010: “BP oil disaster sinks our pensions”.

The previous day, the BBC’s business editor Robert Peston had explained: “Given that BP is a core holding of most British pension funds, [BP’s £40 billion drop in market value] is tens of billions of pounds off the wealth of millions of British people saving for a pension. And with BP dividends representing around 8% of all income going into those pension funds (and a considerably higher proportion of all corporate dividends received by those funds), if BP’s oil spill in the Gulf of Mexico causes collateral damage to its dividend-paying capacity, well, many of us will be feeling a bit poorer.”

The case illustrates how pension funds are an integral part of the economic life of OECD countries and the people who live in them. Most workers are, or will be, affected by rises or falls in pension values, while with trillions of dollars in assets, their size makes the funds a major influence on world financial markets. They are heavily involved in the real economy too. Pension funds invest across a wide range of businesses as a way to reduce their vulnerability to shocks – including major ones like BP – and assure their long-term profitability.

But they are not all-powerful. The collapse of financial markets that would trigger the Great Recession had immediate effects on pension fund assets, wiping out in a few months the gains built up over years. This prompted concern that people would lose their pension or receive far less than they had expected.

Are these fears justified, and what should be done to prevent a similar situation arising in the future? This chapter looks at the impact of the financial crisis on different groups of workers and pensioners and examines which countries are the worst affected. It also discusses
possible government actions to help those already suffering, and to make sure future benefits are protected.

What happened?

Pension funds were worth around $27 trillion in 2007 just before the crisis. Total world GDP at the time was $55 trillion according to the World Bank. Around half the funds’ investments were in the property market and corporate bonds and deposits. After rising steadily for the previous five years, stock markets collapsed in 2008, as did property markets, and the value of pension fund assets fell by $3.5 trillion. Not all values suffered. With stock markets panicking and fears that the whole system could implode, dull but dependable government bonds started to look like an attractive proposition. The world government bond index increased by around 7% over 2008.

The overall figure for pension funds’ losses hides significant variations from one country and one fund to another, depending on the contents of their portfolios.

Ireland, with a loss of nearly 38%, and Australia, with 27%, showed the worst investment performance in 2008. The United States, which accounts for around a half of all private-pension assets in OECD countries, showed the third largest decline: around 26%. Values fell by more than 20% in another five countries – Belgium, Canada, Hungary, Iceland and Japan.

Losses were only around 10% in Germany, the Slovak Republic, Norway, Spain and Switzerland, and smaller still in the Czech Republic and Mexico. The main reason some funds did better was they invested mainly in bonds, especially government bonds. Equities represented only 6% to 12% in portfolios in the Czech and Slovak Republics, Germany and Mexico, for example. However, it is important to remember that over the long term, equities have delivered larger (though riskier) returns.

Thanks to the rebound in equity prices that started in March 2009, pension funds in some OECD countries completely recovered from their 2008 losses (Austria, Chile, Hungary, Iceland, New Zealand, Norway, and Poland). Pension funds in OECD countries recovered around $1.5 trillion of the $3.5 trillion they lost in 2008. Despite this, total asset values in the OECD area were still 9% below the December 2007 levels on average.

Funding levels for pension funds were still significantly lower at the end of 2009 than two years previously. The gap between assets
and liabilities was 26% at the end of 2009, compared with 23% a year earlier, and only 13% in 2007 before the crisis. Decreasing bond yields (which are used to calculate liabilities) in many countries meant that liabilities went up, offsetting the investment recovery.

The figure shows investment returns of pension funds in real terms (allowing for inflation) for the 2008 calendar year. Data are presented for 23 OECD countries where private pension funds are large relative to the economy (with assets worth at least 4% of national income at the end of 2007). The weighted average real return – of minus 23% – reflects the importance of the United States in the figures. The unweighted average (including each of the 23 countries equally) was minus 17%.


StatLink  
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Public pension reserve funds in some countries were hit badly by the financial crisis during 2008, but they recovered strongly in 2009, largely making up for the losses. By the end of 2009, the total amount of their assets was equivalent to $4.5 trillion, on average 7.3% higher than at the end of 2008, and 13.9% higher than in December 2007.
The funds that rode out the crisis best were those with conservative investment portfolios.

**Who suffered most?**

Most pension funds were wealthy enough to survive the crisis and wait for things to improve. However, some people paying into them were hit twice, losing their savings because of the financial crash, then losing their job as the crisis in financial markets started to take its toll on the rest of the economy. This is particularly serious for older workers, who have less time to build up savings again, and have more trouble finding a new job.

Public pension schemes are affected too, and again they could be hit twice. First, because their investments may be worth less. Second, unemployment and lower earnings mean less money is flowing into the system, but unless the rules are changed, it still has to pay out just as much as before.

Even if pension funds are already recovering, for individuals, the effects could be devastating, and permanent. Different countries have different setups, but figures for US 401(k) plans discussed in the next section (named after a clause in the tax code) show broad characteristics found elsewhere.

As mentioned above, age is the first factor in determining the impact of the crisis, and type of pension plan the second.

**Particularly hard for older workers**

Older workers face the worst impacts. The balances in private pension accounts of younger workers are generally small and financial losses in absolute terms are therefore also small compared with other age groups. For 25-34 year-olds with at least five years in the plan, additional contributions made in 2008 outweighed investment losses, with balances increasing by nearly 5%.

For people near to retirement however, investment losses in private pension funds, public pension reserves and other savings may not be recouped. Even postponing their retirement may allow them to offset only part of their loss. Declines in account balances in private pensions in the US were largest for the 45-54 year-old age group, ranging from a loss of around 18% for people with short tenures to 25% for longer periods of coverage.

The degree to which the crisis affects current pensioners depends on the composition of their old-age income. The purchasing power of
public pensions is usually protected by automatic indexation arrangements. But in a number of countries, the crisis will have an impact on the level of public pensions as a result of automatic adjustment mechanisms which could result in lower benefits. (We’ll discuss this below.) Private pension benefits are also generally protected, as occupational pension plans and annuity providers hold assets to back these benefits. The burden of rectifying shortfalls falls on others, such as employers, financial-service companies, government-backed guarantee programmes and plan contributors.

But any voluntary retirement savings or housing assets that pensioners were hoping to draw on during their retirement are, of course, hit by the crisis. For some pensioners, losses in these assets are substantial and interest rates are at historic lows, which may mean much lower living standards in old age.

**Type of plan**

Apart from public and private schemes, pension plans are split between two other broad categories: *defined-contribution* and *defined-benefit*.

In defined-contribution plans, each person saves for retirement in an individual account and the value of pension benefits is determined by investment performance. Riskier investments may pay out more when the stock market is booming, but in a financial crisis, they can lose value quickly, leaving people who depended on them poorer than they expected. Again, this doesn’t matter so much to younger workers who do not need the income immediately, and who, moreover, may actually benefit by being able to buy assets cheaply and enjoy good returns in the future.

For retirees with defined-contribution plans, the effect of the crisis depends on what they did with the funds in their account at the time of retirement. Many are protected because they purchased an annuity before the crisis, thereby benefiting from a life-long pension payment. The downside, at the time, may have been that they missed out on the high returns when the markets were buoyant. The opposite is the case for those who decided they could live off their dividends, or chose to wait and profit from the high returns for a bit longer.

In defined-benefit plans, pensions should be paid whatever the fund’s performance. However, the stock market crash means that the assets that fund the payouts are worth less, and many plans are now in deficit. The UK’s biggest defined-benefit plan, that of British Telecom, had a deficit of £9 billion at the end of 2008 (roughly the same as the actual market value of the company), and some estimates
say it could be as high as £11 billion. Plans such as this could try to make up the shortfall by increasing contributions or cutting benefits. The BT fund trustees say the deficit should be tackled through annual top-up payments of at least £500 million for 17 years. If the plan is run by a private company and that company goes bankrupt, beneficiaries could end up with nothing, or at best a much smaller sum paid out by government guarantee schemes.

Not only private plans are concerned. A number of studies warn about the situation of public employees’ pensions too. A report by US National Public Radio in March 2010 looked at various estimates of the liabilities and assets of state pension funds and calculated how long it would take each state to make good on its pension promises if it spent all its tax revenue on pensions and nothing else. Vermont is best off, but would still take 1.7 years. At the other end of the scale, Ohio and Colorado would have to spend all their revenue on pensions for over eight years to balance the books.

National-level public pension plans are not in such a perilous state. For a start, only eight OECD countries have public pension reserves that were worth more than 5% of national income in 2007, and many countries invest massively in government bonds. These don’t pay as much as other investments, but they are a lot safer. The fund in the United States is invested entirely in government bonds, for example, and 80% of the portfolio of Korea’s reserve is in bonds. That said, some countries are more exposed to financial market risk. For instance, the government bond share is less than 20% in New Zealand and Ireland.

The crisis will still affect even national funds with risk-averse portfolios though. Unemployment and slower growth reduce the tax and contribution revenues of public pension systems. Demand for payouts could also increase if more workers opt for early retirement to avoid unemployment. Also, the need to finance bailouts and stimulus packages will put public finances under pressure for years to come. Governments have had to borrow to finance stimulus packages and compensate for lost revenue and budget deficits. In 2010, OECD governments are expected to borrow $16 trillion. This will increase pressure to cut pension spending, along with other public programmes.

**Automatic stabilisers and destabilisers**

Governments influence pension plans in a number of ways through regulation of financial markets and of the funds themselves, as well as through various statutory requirements such as legal retirement age.
The state also intervenes through what are known as “automatic stabilisers”.

The overall impact of the crisis on retirement income depends on these stabilisers and anti-poverty safety nets built into countries’ pension systems. Most countries have provisions that help prevent retirees from falling into poverty in their old age, which may buffer the impact of investment losses on retirement income for some people. Public retirement-income programmes – basic pensions and earnings-related schemes – will pay the same benefit regardless of the outcome for private pensions.

However, many countries have a set-up in which the amount paid out by the public scheme depends on the resources of the beneficiary and the value of private pensions. The payout is adjusted in line with rises and falls of the private pension. In Australia and Denmark, for example, most current retirees receive resource-tested benefits (more than 75% of older people in Australia and around 65% in Denmark). The value of these entitlements increases as private pensions deliver lower returns, protecting much of the incomes of low- and middle-earners. In Australia, each extra dollar of private pensions results in a 40 cent reduction in public pensions. Conversely, a dollar less in private pensions results in 60 cents more from the public pension.

In these cases, the public retirement-income programmes act as automatic stabilisers, meaning that some or most retirees are shielded from the full impact of the financial crisis on their income in old age. Canada, Germany and Sweden on the other hand have mechanisms in place that automatically adjust benefits to ensure the solvency of the public pension scheme. These could be termed “automatic destabilisers” as they have the reverse effect of the automatic stabilisers described above.

Although they protect the finances of the pension scheme, they do so by varying individual retirement incomes and current workers’ accrued benefits. These automatic adjustments – if they are not overridden – might result in reductions in real benefits for current pensioners due to a mix of the effect of the financial crisis on investment and the impact of the economic crisis on earnings and employment.

**Two-way influences**

So far, we’ve discussed the immediate interactions between pensions and the crisis, but pension funds, by their very nature, have to work with a long time horizon and their performance should also
be evaluated on this basis. Focusing on a single year, good or bad, can be misleading.

The decline in equity returns over 2000-02 was just as serious as in 2008, though the latter has been much faster. Despite the severity and proximity of these two downturns, pension fund performance has been positive over the last ten years and healthy over the last fifteen years.

Most pension funds also have very small liquidity needs (need for “ready cash”) in relation to their total assets under management. This means that they do not have to sell assets at current low prices to meet benefit payments and other expenditures, as they can rely on the regular flow of contributions and investment income, even if the latter is reduced. The main exception is plans that rely on running down their assets to meet benefit payouts, so when asset values decline sharply, they cannot wait until the market recovers to sell.

The longer-term outlook depends of course on what happens in the markets. Optimists could argue that the much faster drop in values compared to 2000-02 is a result of closer links in the financial system and that recovery could be just as rapid. Pessimists could point out that unlike today, the previous crash was not followed by a major credit crunch and a deep recession across the developed economies.

Financial markets are a major influence on pensions of course, but with assets worth half world GDP, pension funds have a massive influence on markets too. The funds can be “market stabilisers”, smoothing out fluctuations in prices by selling when markets are high and buying when they are low. However, in the latest crisis, certain funds sold part of their equity portfolios (“flight from equities”). In some countries, pension funds have reacted by allocating new pension contributions to bank deposits and other financial products with government guarantees until the situation in capital markets stabilises.

A flight from equities affects defined-contribution plans in countries where participants can choose portfolios. In countries with mandatory systems, investment returns are reported monthly or quarterly, leading many participants to switch to lower-risk portfolios. Such behaviour, while rational from a short-term perspective, ultimately leads to lower pensions than if participants had stuck to their previous asset allocation into the long term. Participants risk missing out on the equity recovery, and if they do decide to get back into equities, face paying much more for shares than previously. That said, it’s hard to convince ordinary people that the best strategy is to hold on to their shares and wait for the storm to blow over when they see traders and other professionals selling as quickly as they can.
In defined-benefit plans, a shift in investments away from equities is also likely, though perhaps less pronounced than in defined-contribution plans. One important deciding factor is the implementation of standards and rules governing how funds value assets and liabilities. Governments and trustees insist on an obligatory ratio of reserves to payouts, and define what the fund has to do if reserves fall too low to meet legal requirements. This can mean that the funds have to sell part of their equity holdings, even at a loss, during a downturn.

Funds could react by looking for alternative investments with better returns (for example, hedge funds or speculating on future commodity prices). Many pension funds have been embracing alternative investments in a herd-like way, seeking the higher returns promised by these assets without fully understanding the underlying risks involved.

Some pension funds are also starting to move into the market for loans that fund indebted companies and buy-outs. This market is a potential boost to the lending system dominated by banks and a few investment funds. Certain pension funds have been pursuing a strategy to diversify into credit for a number of years and consider the turmoil as a good buying opportunity. Sometimes, however, the bets have not paid off. For example, ABP, the large Dutch pension fund, may have suffered major losses from an investment in Lehman Brothers made just before its insolvency.

Changes in risk

The way funds try to protect themselves from risk has been complicated by the crisis, and some of the strategies are risky, including derivatives (the reason they pay more than other investments is that the risk is greater). The types of derivatives most used by pension funds are financial instruments that derive their value from interest rates and are traded directly between two parties. This so-called “over the counter” trade does not pass through a regulated exchange and is not monitored or supervised by public authorities. In fact nobody really knows what is happening beyond their own immediate business, and when something goes wrong, as in the case of Lehman, markets panic because of all the uncertainty surrounding who could go under.

One immediate consequence of the market meltdown is a move against short-selling. Short-selling is the practice whereby sellers sell a security they don’t actually own yet, in the hope that they can buy it later at a lower price before having to deliver it. Hedge funds, for
example, often borrow stocks to implement popular strategies based on expected price differences of the stocks. Financial market regulators have restricted short-selling of stocks. Many pension funds have now stopped their stock lending practices since the fees they charged speculators did not justify the risk that they would not recover the value of the stock loaned. The funds also fear that they may have contributed to the financial crisis through these lending practices.

An extremely complicated situation has been made even worse by developments in bond markets. Government bonds don’t pay much compared with other investments, and they tie up funds for anything up to 40 years, but they are seen as a safe bet. Or rather they were. Worries about sovereign debt, plus the sheer amount of bonds governments issued in the wake of the crisis, have made them a much less attractive long-term option for investors, including pension funds.

Apart from investment risk, pension funds, especially defined-benefit ones, have to deal with another, longer-term “risk”: longevity. People are living longer and thus receiving payouts for a longer time. Nobody really knows how longevity will evolve in the future. On the one hand, actuaries have tended to underestimate future gains, while on the other, some demographers claim that the obesity epidemic could actually halt or even reverse the increases among some groups of the population. Historical evidence suggests that a continuing increase seems the most likely path, with direct consequences for the pensions industry. An article in *The Economist* in February 2010 reported that every additional year of life expectancy at age 65 increases the present value of pension liabilities in British defined-benefit schemes by 3%, or £30 billion ($48 billion). Total exposure to longevity risk in the UK is estimated at over £2 trillion by the Life and Longevity Markets Association (LLMA).

The traditional way of dealing with this was to sell the liabilities to a firm that agreed to run the pension scheme for a premium, but the expanding deficits in funds caused by the crisis have made this solution less attractive to buyers, and too expensive in many cases. One way of dealing with this risk may be “longevity swaps”: the pension fund pays another party an agreed revenue stream (so much per year or month) and receives an income that rises if longevity is higher than expected.

However, this idea is not likely to prove very attractive in situations of great uncertainty and concerns over risk. The LLMA, launched in London in February 2010 by a group of banks and insurers, hopes to tackle the issue by creating a separate market for this risk.
Policy responses

Work longer?

In past recessions, governments have used early retirement or entitlement to disability benefits first to protect the incomes of older workers who lose their jobs and are unable to find another, and second to keep unemployment figures down. This approach has short-term advantages (not least for the workers in question) but the long-term impact on labour markets is negative because it is difficult to undo the impacts of these policies even when the initial justification no longer exists.

In countries with large and relatively mature defined-contribution pension systems people may wish to work longer to repair their retirement savings. In theory, this would add extra contributions; reduce the number of years of retirement the pension finances; and allow time for asset values to recover. In practice, older workers may find it hard to get a job and the recovery in asset prices might be too far off to make a difference, so a social safety-net may be their only source of extra income.

More choice?

Individuals can choose their investment portfolio in most defined-contribution pension plans, and their choices have important implications for the effect of the crisis on their pensions. Data for the United States show that people tend to shift away from equities towards less risky investments as they approach retirement. For example, around 55% of 36-45 year-olds hold more than 70% of their portfolios in equities, falling to 43% of people age 56 to 65. Yet despite the tendency to go for less risky investments, the portfolio share of equities of workers close to retirement seems very high: more than one in five hold more than 90% of their 401(k)s in equities. Of course they may hold lower-risk deposits and bonds outside of their 401(k)s, but these workers will have seen their pension savings significantly eroded relative to the minority who held most of their portfolios in lower-risk assets.

What are the implications of this type of investment behaviour for policy? Should people be restricted in their choices to prevent them from having their old-age savings wiped out? Or should this be an individual decision and a risk to take at people’s own discretion?

At the least, government should encourage individuals to adopt a strategy towards less risk as they approach retirement. Often called
life-cycle investing, this strategy can reduce investment risk over a person’s career without sacrificing the benefits from a broader portfolio at younger ages. There is a case for making this shift automatic, and making it the default option. Using a life-cycle approach as a default puts investments on “automatic pilot” and is especially useful for individuals who do not want to manage their portfolio actively. This is probably the majority of people in most countries. In fact, a survey by the Royal Bank of Canada found that respondents consider choosing the right investments for a retirement savings plan to be more stressful than going to the dentist.

An automatic pilot policy can be adopted while preserving individual choice between portfolios with different risk-return characteristics (for the minority who do want to take their own investment decisions).

Allowing people who opted for private plans back into public ones is another possibility. This is tempting for governments to help tackle deficits in public pension systems, and for workers afraid of substantial losses from private plans. However, the gains are likely to be only short term, and there would be calls to switch back again when the economy picks up.

Should governments bail out private pensions?

Should governments bail out individuals’ pension accounts as they did for the banks? Governments already stand behind many countries’ occupational, defined-benefit schemes. Governments may have a moral, if not a statutory, duty to help where defined-contribution pensions are mandatory rather than voluntary and annuitisation at retirement is obligatory. A direct bailout, paying money into people’s pension accounts, could prove to be very expensive, and possibly not feasible anyway when the public finances are being squeezed by recession and economic-stimulus packages.

Providing support to the retirement savings of those most affected by the crisis through the public pension system would have the advantage of spreading the cost over time. The payments would be made over the period of an individual’s retirement rather than in one go either now or at the time of retirement. This would also allow for greater efficiency and flexibility: support could be targeted towards low-income retirees, for example.

A bailout would make most sense for people who are close to pension age. However, this poses political difficulties. If it were restricted to people within a few years of normal pension age, then
workers slightly younger than the cut-off age would feel cheated. Similarly, retirees who annuitised their pension only recently, locking in financial market losses, would complain if contemporaries who kept their money in financial markets were to be compensated.

There is also a risk of “moral hazard” resulting from a direct bailout of pension funds: the expectation of a bailout next time something goes wrong will encourage people to behave more riskily once the current crisis is over.

What should be done?

Even before the 2008 crisis, there had been warnings about the need to reform private pensions. The OECD has been calling for stronger pension fund governance since the publication of a set of guidelines in 2001, which are currently being revised. The guidelines stress the need for effective monitoring of investment risks and performance and of the relationship between pension funds’ assets and liabilities. Greater expertise and knowledge are required on pension fund boards, including the appointment of independent experts.

The OECD has highlighted the interplay between scale and governance. Small pension funds are more prone to weak governance (and they are much more expensive to manage and supervise), so there is a strong case to consolidate the pension fund sector through mergers in some countries.

Regulatory reform of both defined-benefit and defined-contribution systems should also be on the policy agenda. Some regulations intended to protect participants of defined-benefit plans may actually make things worse by reinforcing the downward spiral in asset values. Even in a severe crisis, investors do not lose anything on an investment until they sell it at less than they paid for it originally (or the company goes out of business). Yet in some countries, the rules do not allow funds to sit out a crisis and wait for values to rise again. They have to sell to maintain asset to liability ratios, and given the major role pension funds play in some markets, this drives prices down even further.

The crisis will lead to further closures of defined-benefit plans as funding gaps widen and contribution requirements increase. Insolvency guarantee funds will also be active over the next couple of years bailing out the pension funds sponsored by bankrupt companies. As the defined-benefit pension sector shrinks further, the
possible role of regulations in reinforcing this trend should be examined.

For defined-contribution plans, responses could include appropriate default mechanisms and the design of “autopilot” funds that shift towards lower risk investments as retirement date approaches without the beneficiary having to intervene. A key goal of this regulation is to reduce the “timing risk” of transforming an accumulated balance into a regular benefit stream (an annuity).

Governments should also consider the suitability of different investment strategies as default options, taking into account the extent of choice in the payout stage, the generosity of the public pension system and the level of contributions, among other factors. Default investment strategies should be evaluated as to how adequate and predictable retirement income is.

Better policy design is also needed for the pension pay-out phase of defined-contribution systems. Some of the mandatory and default arrangements in place are far from safe and fail to integrate the accumulation and retirement stage in a coherent manner. In particular, making the purchase of annuities mandatory makes most sense in countries where public pension benefits are low. However, forcing individuals to purchase annuities goes against principles of free choice and may impose heavy costs on individuals when annuity rates are low or account balances have dropped as a result of bad market conditions.

A more flexible approach that could be introduced as a default option for the pension pay-out phase is to combine “phased withdrawals”, where a defined part of the fund balance can be withdrawn each year, with deferred annuities that start paying benefits after a certain age, such as 85. Such deferred annuities could be bought at the time of retirement with a small part of the accumulated balance.

In the context of the financial crisis and the rapid growth of defined-contribution plans in many countries, effective financial education programmes and information disclosure are very important to the functioning of the private pension system. Policy initiatives in this area should complement the regulations on investment choice and default options that already exist in some countries. As workers take more responsibility for saving for their own retirement, the role of governments changes, but it remains of paramount importance to promote the adequacy and security of old-age income.

The crisis hasn’t reduced the importance of private pensions in a well-balanced system. Private pensions are necessary to diversify the
sources of income at retirement and, as such, they complement public pensions. Moreover, the sustainability problems facing public pensions in some countries remain challenging, and could get worse as the workforce ages. As a result of the large projected increases in public pension expenditures in the near future, retirement income from public sources is expected to continue to decline, and therefore private pensions need to be expanded further to bolster income in retirement.

### A long-term issue

A simulation using 25 years of data on investment returns for the G7 economies and Sweden shows a real annual return of 5.5% for bonds and 9.0% for equities over the 45-year horizon of a full career’s pension savings. For a “balanced” portfolio – half in equities and half in bonds – the average (median) return is 5.0%.

The analysis also investigates the scale of risk and uncertainty over investment returns. In the worst 10% of cases, for example, returns are expected to be just 3.2% a year or less. In the best 10% of cases, annual returns are 6.7% or more.

However, the simulations are based on around 25 years of data, ending in 2006. The period since then includes both substantially negative returns on equities and much greater volatility. The equity market crash of 1987, included in the data, saw prices fall as much as in 2008. Also, the end of the technology-stock bubble, which led to substantial stock-market falls in 2000-02, is in the time period covered.

### The outlook

Poverty rates of older people have fallen over the past three decades and children and young adults (people age 25 or under) have replaced older people as a group with a relatively high risk of poverty. The major social and economic change that will affect future incomes of older people is the changing role of women: greater labour-market participation, a narrowing gender pay gap and better protection for periods of childcare leave.

Pension reforms will also have a substantial impact on the evolution of old-age incomes and poverty. Countries that have cut benefits across the board are likely to see lower pensioner incomes and greater poverty in the future, unless individuals make up for these cuts by working longer or with voluntary retirement savings.
Average old-age incomes may well fall in countries that protected low earners from cuts, but this policy means that pensioner poverty will not be affected by reform.

In the countries that moved to a stronger pension-earnings link, average incomes of the old may increase, but overall pensioner poverty may be higher due to the lack of redistribution in the new pension systems.

Finally, the group that increased mandatory retirement provision should naturally see higher incomes in old age. In all of these cases, the changes will help low earners more, and so there should be a larger effect on pensioner poverty.

## Quantitative easing

The economic crisis has seen some obscure financial jargon pass into everyday language, subprime being the most infamous example. Quantitative easing is unlikely to gain similar notoriety, but as a measure that could have major implications for pensions, it is worth examining.

In April 2009, the average interest rate set by the central banks of the G7 nations fell to 0.5%. What happens when money is so cheap it can’t get any cheaper? In other words, what can you do when interest rates can no longer be cut because they are so low already?

Quantitative easing is one possibility. The central bank injects money into the economy by buying certain financial products, notably government bonds (also known as gilts). The sellers are expected to use the money to lend to businesses and households or to invest (although they may just leave it in bank deposits or send it offshore).

The US Federal Reserve applied quantitative easing during the banking crisis that followed the 1929 Wall Street Crash, and the Bank of Japan adopted a similar approach to dealing with the crisis in the 1990s following the crash of the property market.

The media often present this as “the government printing money”. The reason is that, instead of borrowing money in the usual way by issuing new bonds, the government, through the central bank, simply creates the money and uses it to pay the banks and other financial institutions it intends to help.
What does this mean for pensions? As such, it is bad news. If quantitative easing succeeds in making government bonds more attractive, the interest paid on these bonds does not have to be as high as it was previously. Pension funds are massive holders of government bonds, so a drop in the interest paid on them (the yield) translates directly into a loss of income to the funds. And since the pensions industry uses bond yields to calculate pension payments such as annuity income, pensioners will be affected.

Company pension schemes could be affected too. The yield on government bonds is an important element in calculating the future liability of pension funds, and when yields fall, liability increases. Moreover, pension scheme trustees generally estimate pension liabilities in terms of the price of gilts, so at the same time as yields are falling, liabilities are increasing.

Some industry analysts are afraid that the life insurance and pensions industry could become the victim of a fall in the yield from government bonds, combined with a significant increase in the number of companies defaulting on the debt that many pension funds bought, as well as a drop in the value of the stocks pension funds invested in.

The immediate outlook for pension funds is gloomy, and deflation could make it even worse. Deflation could, however, be good news for some pensioners. The reason is that in many schemes, the fund has to increase payments to offset inflation (at least partly), but few, if any, have a mechanism to reduce payments when there is deflation.

Sources: Bank of England, Provisional estimates of narrow money (notes & coin) and reserve balances; Deloitte LLP (2009), Quantitative easing contributes to FTSE 100 pension scheme deficits increasing to £180bn.
5. Pensions and the Crisis

Find Out More

OECD

On the Internet
For an introduction to OECD work on pensions, see www.oecd.org/pensions.

Publications


OECD Private Pensions Outlook 2008: This book guides readers through the changing landscape of retirement income provision. This edition presents a special feature on the implications of the financial crisis for private pensions, as well as in-depth, international analyses of private pension arrangements across OECD and selected non-OECD countries. The publication focuses on the role of pension funds, and also provides evidence on public pension reserve funds which complement the financing of social security systems.

Improving Financial Education and Awareness on Insurance and Private Pensions (2008): With public pensions under pressure and private pensions exposed to risk, individuals face an increasing variety of financial risks, particularly those linked to their retirement. This book analyzes the level of risk awareness of consumers and highlights good practices governments might initiate to enhance consumers’ awareness and education on insurance and private pensions issues.

Also of interest