



# REFORMING PENSION SYSTEMS: THE OECD EXPERIENCE

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## Plan of the presentation

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- Objectives and risks of the pension system and how different arrangements address them
- Overview of pension arrangements and trends in OECD countries and their implications
- Main reforms to address the challenges to pension systems
- Implications for design of pension systems and the main trade-offs



# Long-standing OECD policy messages

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- Diversify the sources to finance retirement
  - PAYG public pensions financed through current contributions
  - Asset-based (funded) pensions financed with accumulated assets
- Funded pensions complement public pensions
  - Overall design of private system must take into account the existing or desired public system
- Separate the sources of financing for public systems
  - Non-contributory social protection financed through general taxation
  - Contributory pension with the objective of lifetime income-smoothing
- Key OECD Policy Guidance
  - OECD Core Principles of Private Pension Regulation
  - OECD Roadmap for the Good Design of Defined Contribution Pension Plans



# Characteristics to distinguish different types of pension arrangements

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- How pension benefits are financed
  - PAYG or asset-based
- Who manages the plans
  - Public or private
- Whether they are mandatory or voluntary
- The role of the employer
  - Establish the plan, contributions, administration
- The link between contributions and benefits
  - DB-type formula or DC-type formula
- Who bears the risks
  - Employer, provider, individual or taxpayer
  
- Countries have a mix of different types of pension arrangements



# How different pension arrangements meet the objectives of the pension system

	Public - minimum basic	Public – contrib. PAYG	Public – contrib. funded	Private – funded mand. DB	Private – funded mand. DC	Private – funded vol. DC
Poverty relief	✓✓	✓	✓	✓	?	
Consumption Smoothing	×	✓	✓	✓	✓✓	?
Redistribution	✓✓	✓	✓	✓	×	×
Adequacy	?	?	?✓	?✓	?✓	
Participation		?×	?	?×	✓✓	
Coverage	✓✓	?✓	?✓	?×	?×	×
Sustainability		?	?	?	✓✓	✓✓



# Consumption smoothing: funded or unfunded?

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- Advantages of funded
  - Incentive to participate
  - Pool of savings for wider economy
  - If DC, fewer labour market distortions
- Disadvantages
  - Lose redistribution of public PAYG (restore via taxes/parameters)
  - Shocks to private pensions
- Build complementarity !
  - Public to provide insurance and consumption smoothing
  - Private to provide consumption smoothing and adequacy



# Multiple risks for pensions

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- Labour market risks
    - Unemployment, career real wage paths
  - Social risks
    - Disability and survivors
  - Macro-economic risks
    - Growth, productivity, inflation
  - Financial market risks
    - Returns, interest rate
  - Demographic risks
    - Longevity, ageing
  - Operational risks
    - Costs, risk management
  - Political risks
    - Pension policy changes
- These will all affect the adequacy, coverage and the sustainability of pension policies



# Features of public pension systems across OECD countries

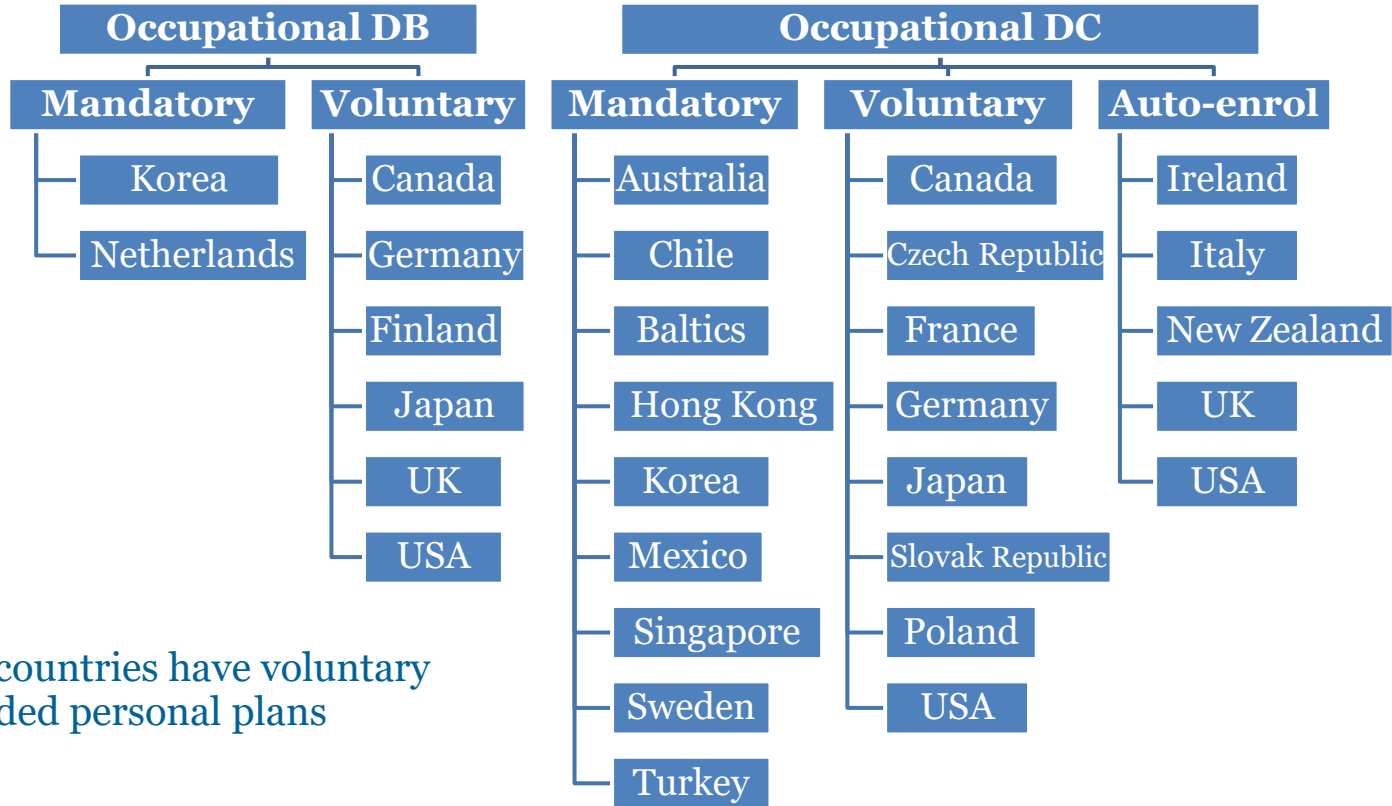
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- All have public pensions
- Non-contributory public pension (safety net)
  - Basic or minimum pension
  - Should be financed from taxes and the general budget
- PAYG financed contributory
  - Main source of pension income in most countries
  - Surplus should be put aside in earmarked fund





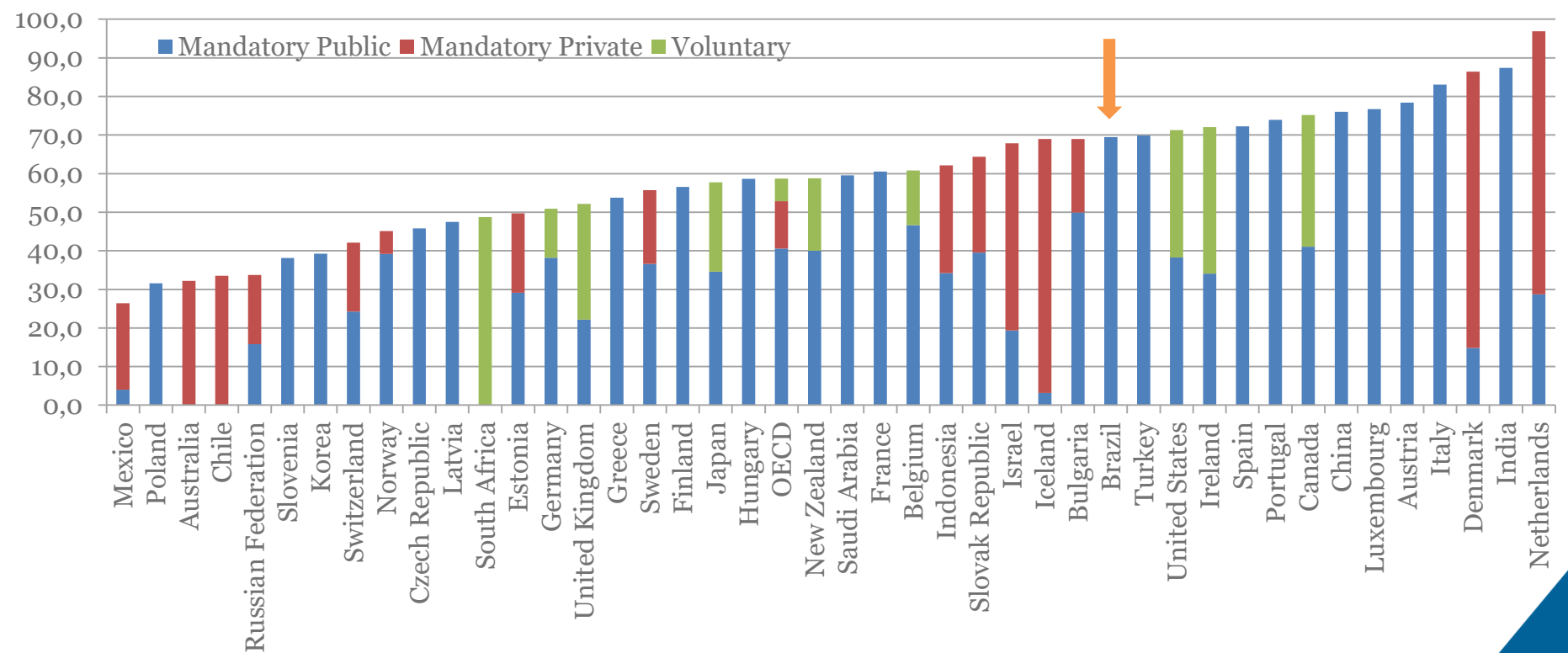
# Features of funded pensions across OECD countries



➤ All countries have voluntary funded personal plans

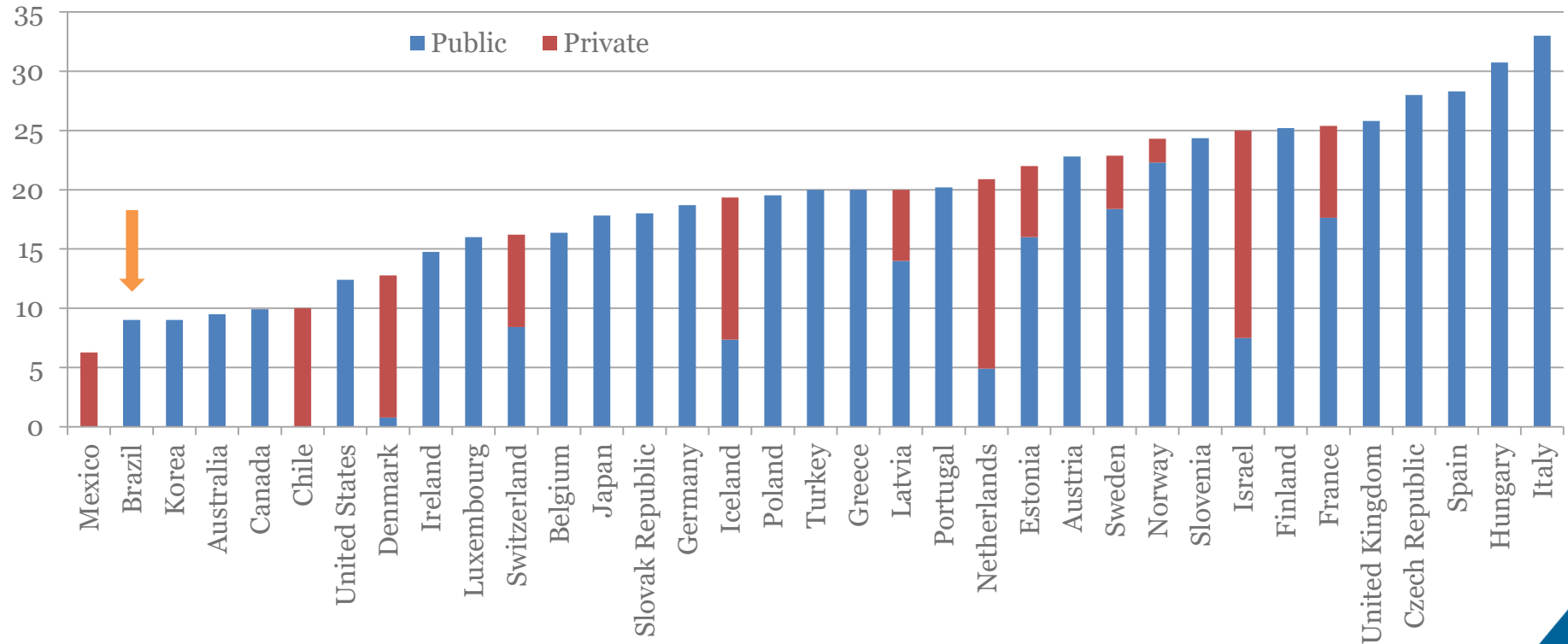


# Gross pension replacement rates, 2016





# Mandatory pension contribution rates for an average worker in 2016

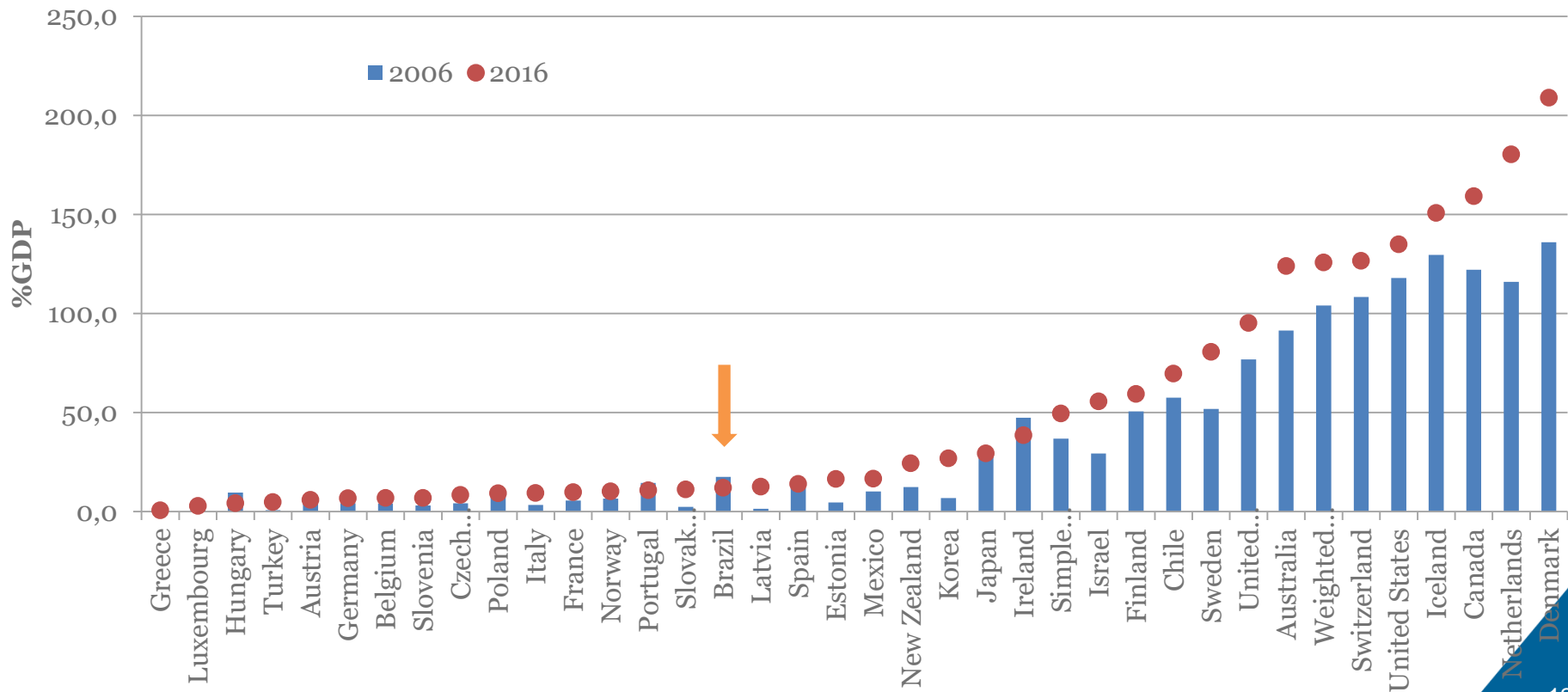


Source: OECD (2017)

Notes: Austria, Czech Republic, Estonia, Greece, Ireland, Norway, Portugal, Slovenia, Spain, UK and US include total social insurance contribution



# Total assets in funded and private pension arrangements, in 2006 and 2016



Source: OECD (2017)



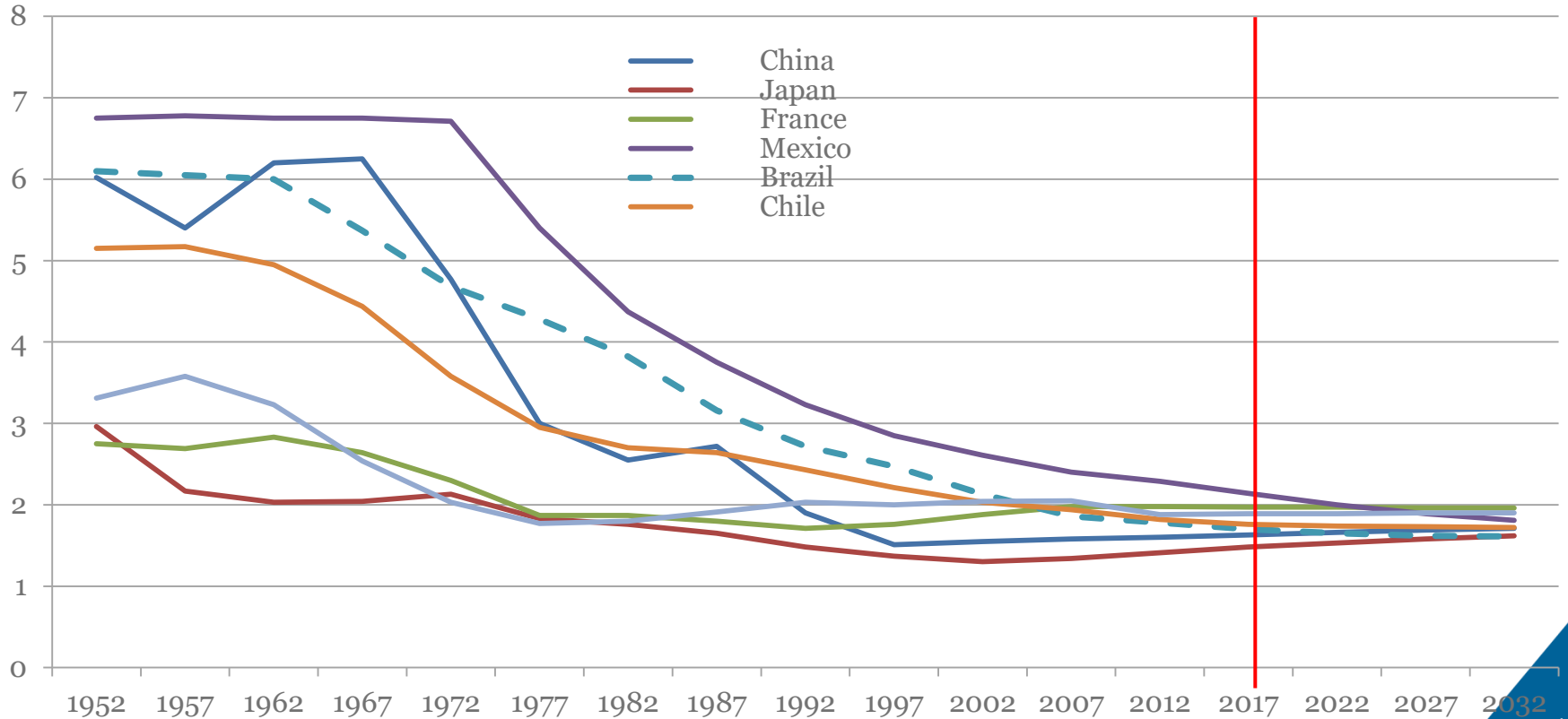
# Changing pensions landscape: more diverse and balanced

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- Main challenges of different types of schemes:
  - PAYG – sustainability
  - DB – solvency
  - DC - adequacy
- Main drivers
  - Ageing populations threaten sustainability, solvency and adequacy
  - The current environment of low economic growth and low returns threaten solvency and adequacy
  - The fallout from the financial and economic crisis has eroded trust in the system



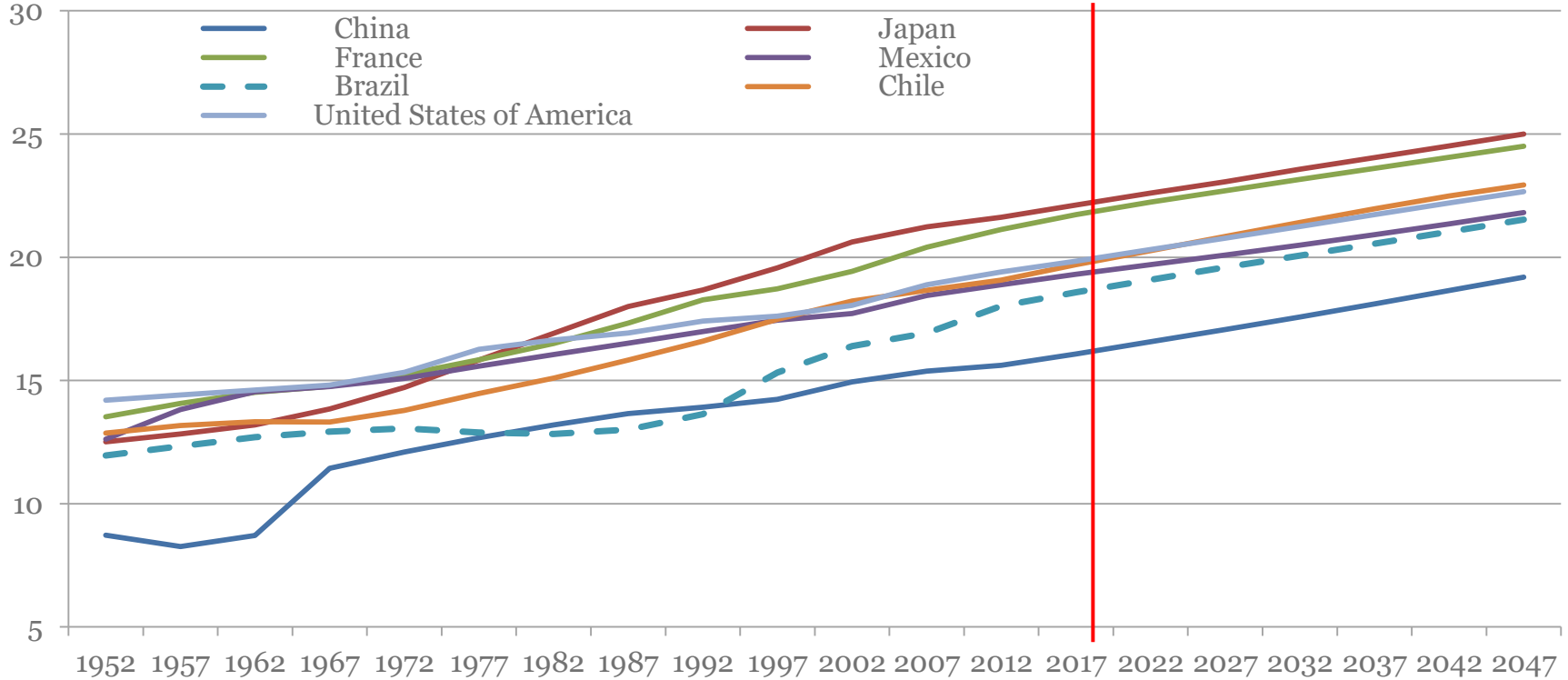
# Decrease in fertility



Source: UN (2017)

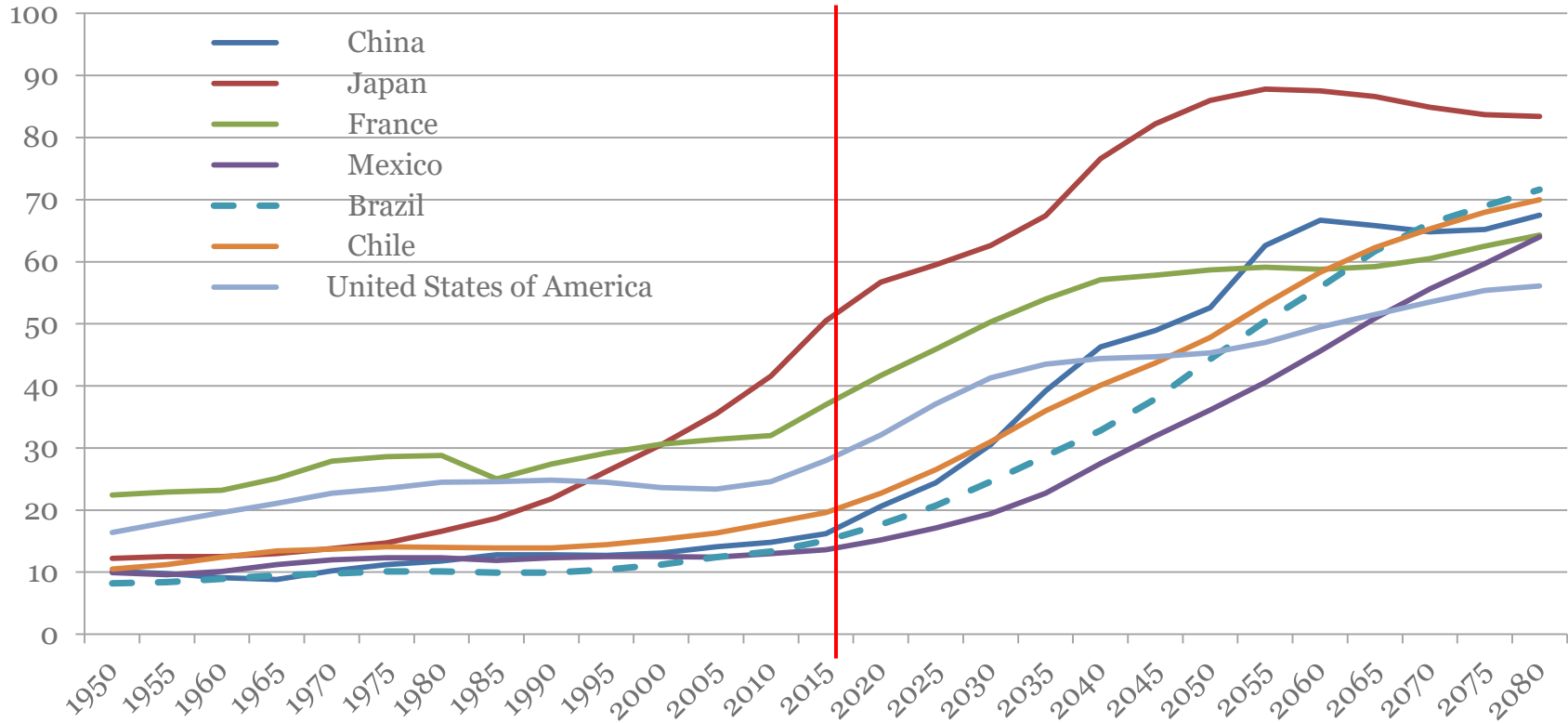


# Life expectancy at age 65





# Old age dependency ratio

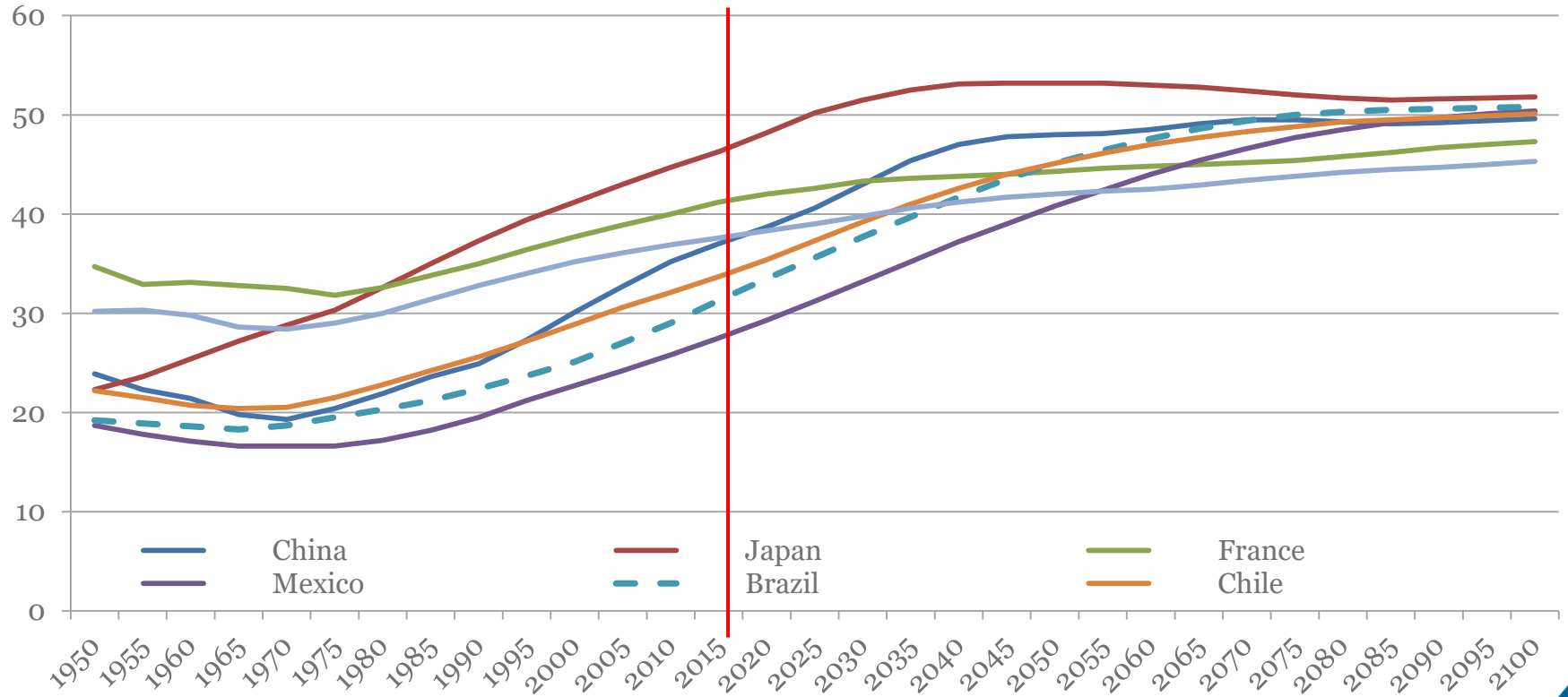


Source: UN (2017)





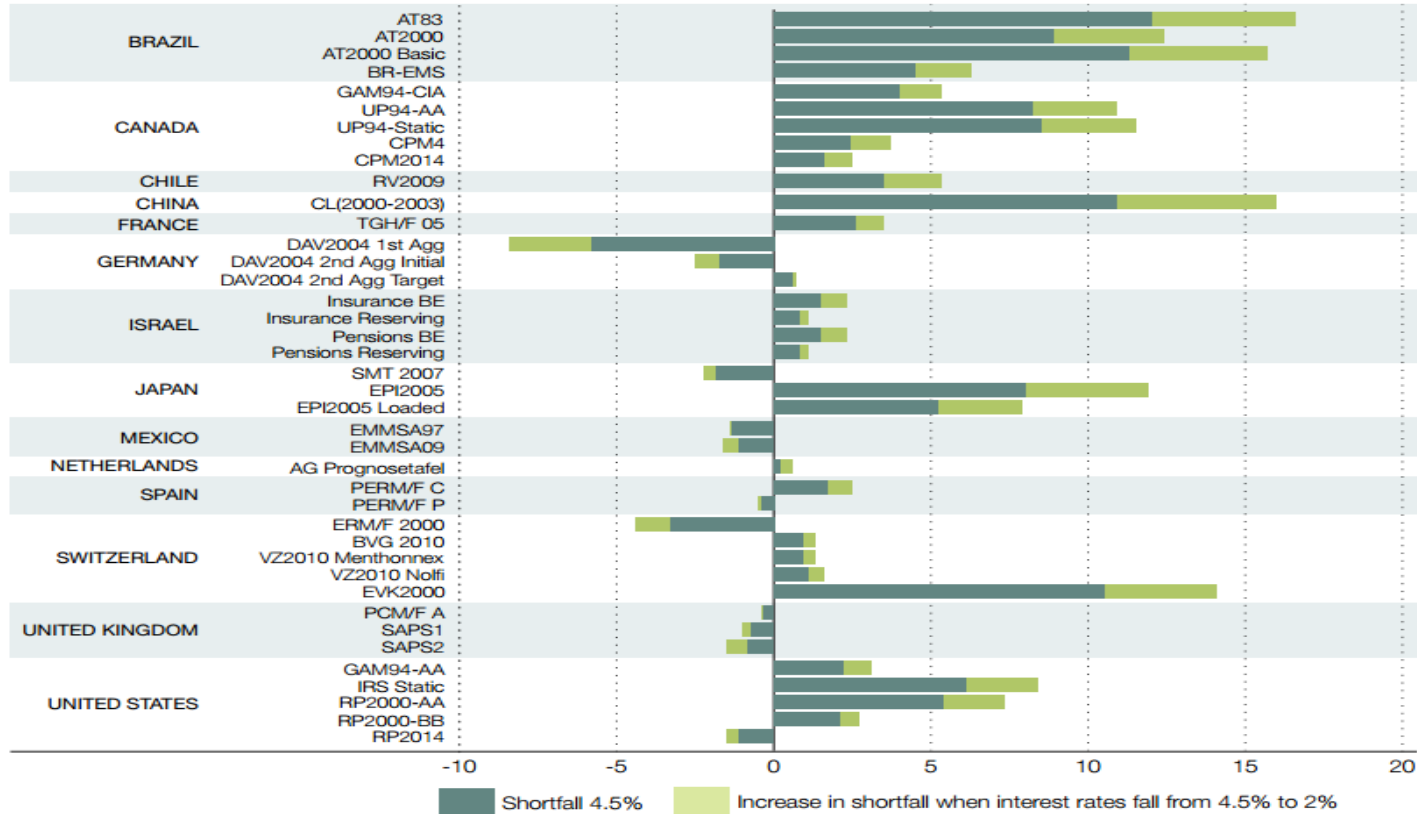
# Increase in the median age of the population



Source: UN (2017)



# Lower interest rates increase pension liabilities and exposure to longevity risk

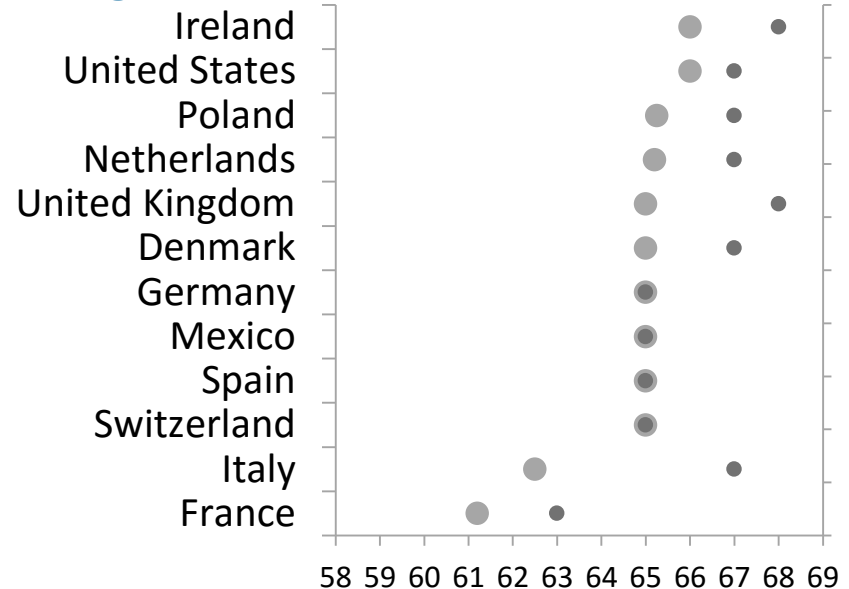




# Reforms to PAYG to improve sustainability

- Move towards career average salary
- Increases in statutory retirement age
- Linking retirement age to life expectancy
  - Italy, Spain Sweden
  - But life expectancy differs across socioeconomic groups...
- Move towards NDC plans
  - Italy, Poland, Sweden, Estonia

## Current and future retirement ages for a man entering the labour market at age 20





# Economic implications of the shift towards funded pensions

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- Funded systems result in an increase of national savings
  - Either increased or reallocated to long-term
  - Increase of long-term investment
  - Increased productivity and GDP
  - Less borrowing from abroad to finance investment
  - Promote development of capital markets
- Contributions towards unfunded systems could also result in higher public investment...
  - The manifestation of this is less certain



# Transitioning towards a more diversified system

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- Financed through current contributions
    - Contributions towards PAYG now go towards funded system
    - Transition cost of not having sufficient inflows to fund current PAYG benefits
  - Financed through higher contributions
    - Macro-economic implications of lower consumption
    - Difficult to implement during a recession
- In any case parametric adjustments to PAYG will be needed to better align pension benefits with pension contributions



# Some examples of transitioning to a more diversified system

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- *Success* - Sweden's transition to NDC + funded DC
  - Gradual transition to new system for older individuals
  - Weighted benefit calculation between the two formulas
  - 2% of contributions diverted to DC scheme
- *Needs improvement* - Peru's transition to individual DC accounts
  - Kept the public scheme, but significantly reduced the generosity of benefits
  - Individuals changing to DC accounts received Recognition Bonds for the benefits accrued under the public system
  - Maintaining two parallel systems has created an incoherent system and poor incentives for individuals
- *Failure* - Poland's transition to private DC accounts
  - Middle aged workers could choose between NDC and DC
  - Magnitude of contributions diverted combined with fiscal rules and accounting standards made transition costs unbearable
  - Significant account losses during the financial crisis
  - Reform ultimately reversed



# Transition lessons

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- Costs to transition are unavoidable - there needs to be a realistic plan to finance them
  - Costs driven by diverting contributions from PAYG
  - Where possible, increasing contributions would be preferable
  - Some sort of transition will likely be necessary
- Strong institutional set-up is essential
  - Public governance and accountability
  - Identify fiscal rules that could represent future constraints
  - Private sector must have administration and investment capabilities
- Communicate the change and help educate people to understand it
- Transition costs may be partially offset in the long term by positive economic effects
  - Reduction of poverty (Australia, Netherlands and Switzerland)
  - Development of financial centres (Warsaw)
  - Growth of financial markets and source of domestic financing (Chile)



# Shift in funded pensions from DB to DC to reduce solvency risk

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- Solvency concerns are driving the shift from DB to DC
  - Underestimation of life expectancy
  - Low interest rate/return environment
  - Accounting rules
- Legislative reforms
  - Closure of DB plans
    - E.g. Italy, Sweden
  - Creation of DC arrangements (mandatory or voluntary)
    - E.g. Australia, Latin America, Germany, Sweden, Ireland, UK, USA
  - Increased flexibility in risk-sharing arrangements
    - E.g. Netherlands, UK





# Advantages and disadvantages of DB and DC plans

	<b>Advantages</b>	<b>Disadvantages</b>
DB	<ul style="list-style-type: none"><li>• Certainty of pension benefits</li><li>• Risk sharing</li><li>• Better management</li></ul>	<ul style="list-style-type: none"><li>• Responsibility on plan sponsor to cover shortfalls</li><li>• Actuarial parameters need to be updated regularly</li></ul>
DC	<ul style="list-style-type: none"><li>• Transparent and straightforward link between benefits and contributions</li><li>• Labour mobility</li><li>• Individual choice</li></ul>	<ul style="list-style-type: none"><li>• Risks (investment, longevity) borne by plan members</li><li>• Lack of knowledge to make important decisions</li><li>• Low contributions</li></ul>



# OECD Roadmap of the Good Design of DC Plans

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1. Make the design of DC plan globally and internally coherent
2. Encourage individuals to enrol and contribute
3. Provide incentives to save for retirement
4. Promote low-cost retirement savings instruments
5. Establish appropriate defaults and investment options
6. Consider default life-cycle investment strategies
7. Encourage demand for annuities
8. Encourage the availability of annuities
9. Facilitate longevity risk management
10. Make communication effective given low financial literacy and awareness



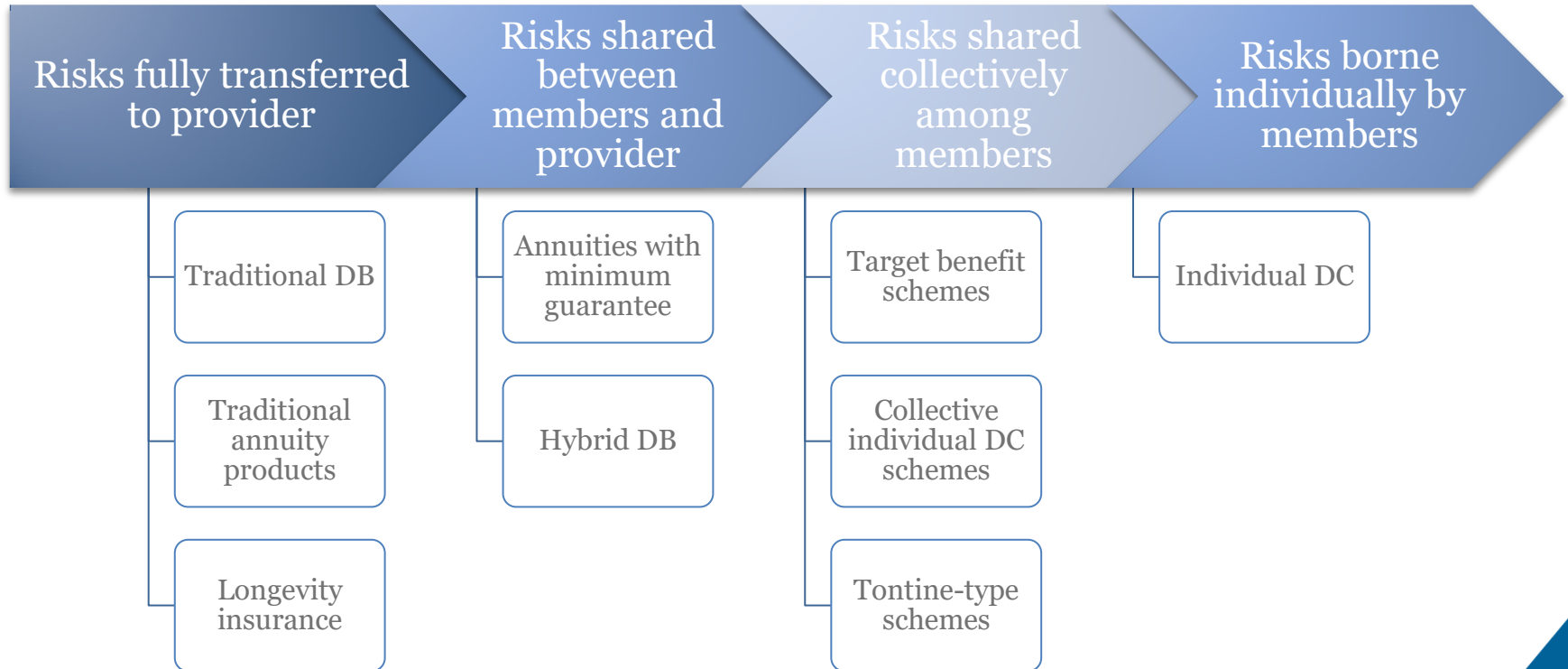
# Increasing the adequacy of DC pension benefits

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- Increasing contribution rates
  - Australia
- Matching contributions
  - Chile, UK, USA
- Auto-enrolment with opt-out
  - Ireland, Italy, UK, Turkey
- Default investment strategies
  - Hong Kong



# Spectrum of funded pension arrangements based on distribution of risk





# Case study: Netherlands moving towards less risk sharing

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- Moved from DB to target benefit schemes (CDC)
  - Kept DB benefit formula but with no guarantees
- Challenges that are moving them more towards individual DC...
  - Communication of benefits
  - Lack of transparency of benefits cuts (indexation, nominal benefits, accruals)
  - Average premium approach
  - Risk-sharing mechanisms pushing more risk on younger generations (longer forbearance, lower accruals)



## Case study: UK moving toward more risk sharing

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- DB -> DC with annuities -> DC freedom
  - Individuals currently bearing all risk
- Challenges that are moving them more towards collective DC...
  - Low interest rate environment make annuities expensive
  - Low innovation and value for money of existing products
  - Complexity of decision making for retirement
  - Unsustainability of DB schemes that haven't been closed



# The benefits and challenges of risk sharing

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- Trade-off between cost and certainty of benefits
  - Risk-sharing can result in higher pensions, but pension levels are not guaranteed
- Increased risk sharing tends to reduce flexibility...
  - Collective management of assets can lead to higher pensions, but at the cost of individual choice
  - Portability must be restricted in pay-out to effectively mitigate longevity risk
- ...and may present challenges for individuals
  - Tends to decrease transparency
  - May be seen as inequitable across generations



## Main messages

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- A ***diversified*** pension system will be better able to achieve its various objectives and be ***more resilient*** to the multiple risks to old-age financial security
- The best design will need to find the ***balance*** between ***financial sustainability and adequacy*** of benefits given social preferences
- Various policy measures can be taken to ***improve the design*** of the various components of the system





# OBRIGADA!

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