HIGHLIGHTS

OECD Pensions Outlook
2016

OECD

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PENSIONS SYSTEMS CONTINUE TO ADAPT TO THE CHALLENGES THEY FACE

Population ageing, the financial and economic crisis as well as the current environment of low growth and low interest rates pose fundamental and far-reaching challenges to pension systems. They increase financial pressure on defined benefit (DB) pension arrangements, which translates into fiscal difficulties for pay-as-you-go (PAYG) financed public pension arrangements, and strains on solvency for funded DB pension arrangements. Defined contribution (DC) pension arrangements in which individuals bear many of the risks of saving for retirement will see reductions in the retirement income they are able to deliver.

Pension systems are responding to these challenges. After far-reaching reforms during past decades, PAYG financed public pensions in many countries are now on more financially sustainable ground. These reforms have also made some progress on adequacy, especially for low income socio-economic groups, but substantial gaps remain in several countries. Simultaneously, pension arrangements in which assets back pension benefits have grown in importance, contributing to diversification of sources to finance retirement and complementing public pensions. In particular, arrangements with a more direct and straightforward link between contributions and benefits (DC) are becoming more prominent. As a result, individuals now have to make retirement decisions and bear the risks associated with saving for retirement, such as investment and longevity, which could result in shortfalls in retirement income. This is in contrast with DB pension arrangements in which employers or the State, bear those risks.

These developments call for improving the regulatory framework governing funded private pensions. The OECD Council has recently approved the Core Principles of Private Pension Regulation, which have been endorsed by pension regulators across OECD countries. The Core Principles cover all types of funded pension arrangements and strengthen the regulatory framework to make sure that funded pension arrangements work in the best interest of members, both those saving for retirement and current retirees. Regulatory restrictions to pension funds' ability to diversify risks and improve returns by investing abroad are being further relaxed in a number of countries, consistent with long-standing advice by the OECD, including the Code of Liberalisation of Capital Movements.

PAYG pensions reforms, coupled with the growth of DC pension arrangements, have led to concerns about whether pension systems will be able to deliver pension benefits that people would consider adequate to finance retirement. In this context, improving the design of DC pension arrangements would contribute to delivering better pension outcomes.

Most OECD countries have in place different tax treatments for retirement savings than for other savings in order to encourage people to save for retirement. This different tax treatment provides an immediate tax advantage to individuals as contributions are exempt from tax. Analysis in this Outlook goes further and shows that there is also an overall tax advantage for individuals over their life cycle, including both their working and retirement periods. Matching contributions and flat-rate subsidies will smooth out the tax advantage across the income scale.

Individuals in DC pension arrangements have to make essential decisions about managing their retirement. Those decisions include where and how to invest, when to retire, and how to allocate their retirement wealth to finance their years in retirement. In this context, integral components of a policy framework to improve retirement outcomes include: the quality, affordability and accessibility of retirement financial advice; the availability and sustainability of annuity products that protect individuals from longevity risk; and improvements in financial knowledge.

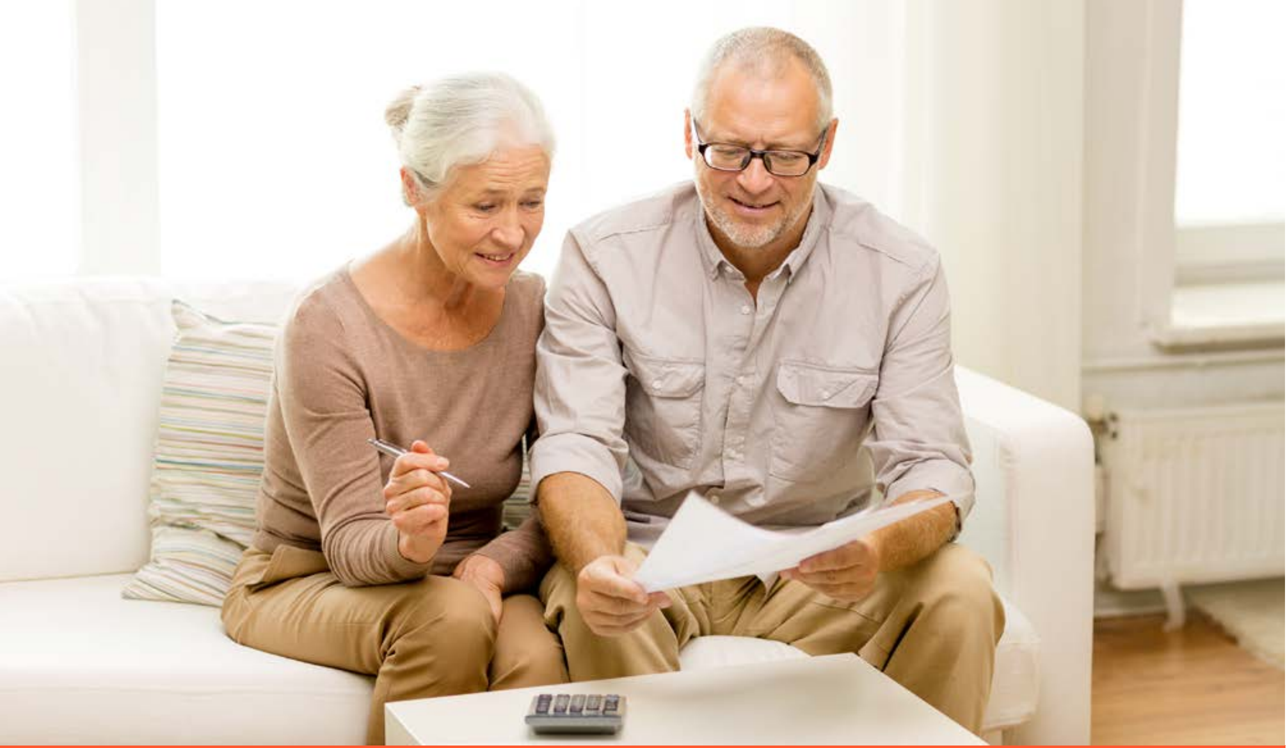
Policy makers need to ensure that people receive financial advice for retirement that is appropriate for their needs and that potential conflicts of interest of financial advisors are addressed. Working together, policy makers and the pension industry need to make sure that policies do not reduce the accessibility and affordability of financial advice – so called the advice gap -, particularly for people with low to moderate wealth. Technology-based advice has the potential to reduce any possible advice gap.

Life annuity products, i.e. insurance contracts that ensure lifelong benefit payments, protect people against the risk of outliving their financial resources in retirement. The OECD Roadmap for the Good Design of DC Pension Plans recommends partial annuitisation of accumulated assets, combining deferred life annuities that protect against the tail risk of longevity with drawdown programmes that provide flexibility and choice for individuals. However, this requires the sustainability of annuity products and their suitability for consumers. Both can be achieved by having a coherent pension framework to accommodate life annuities, comprehensive product disclosures, and a regulatory framework based on principles that allow for flexibility in capital requirements to adjust to changing product designs and that encourage appropriate risk management.

Policy makers also need to provide tools and mechanisms for individuals to make informed choices. National financial education strategies should ensure that people acquire at least basic financial skills. Financial education initiatives for retirement planning should take into account the extent of retirement planning challenges associated with different national pension systems and their structure, and with the financial environment. Governments and other stakeholders should ensure that information about pension systems, pension reforms, and private pension plans is available, clear and not overwhelming for individuals. Moreover, the information should be comparable and standardised.

Unifying pension schemes, covering private-sector and public-sector workers in a financially sustainable way, would also improve both equity and economic efficiency. Many of the original rationales for civil service pension arrangements are less relevant now, and recent reforms have brought the pension systems of many civil servants into line with those of the private sector. As a result, only a limited number of OECD countries maintain entirely separate schemes. Their implementation is often gradual though, which implies some legacy cost for the future.

In light of the challenges facing pension systems, the only long-term solution for achieving higher retirement income is to contribute more and for longer periods. Future work and policy discussions need to focus on how to achieve both.



EXECUTIVE SUMMARY

Pension systems across OECD countries are still addressing the challenges posed by population ageing, the financial and economic crisis and the economic environment of low growth and low interest rates. This Outlook continues the OECD's exploration of how pension systems are responding to these challenges.

The nature of funded private pension provision is changing, defined contribution and personal pension arrangements are growing in importance

The challenges facing pension systems have led to reforms that have increased the diversity of pension arrangements across OECD countries and the importance of arrangements in which assets back pension benefits, especially DC ones, in which pension benefits are linked to the value of assets accumulated. DC pension arrangements provide a clear, straightforward link between contributions and benefits, but put most risks (e.g. investment and longevity) onto individuals, and make them more responsible for managing their retirement.

To understand this changing landscape and distinguish among different pension arrangements, it is important to look at their characteristics: whether they are mandatory, how pension benefits are financed, who manages them, the role of the employer, the link between contributions and benefits, and who bears the risks.

The Outlook also considers the policy context of these changes, finding them to be in line with the main OECD messages about diversifying the sources to finance retirement, and the complementary role of funded pensions. The growing weight of DC arrangements makes it imperative to improve their design in line with the OECD Roadmap for the Good Design of DC Pension Plans. What follows discusses some of those policy guidelines.

In most OECD countries, the tax treatment of retirement savings provides a tax advantage when people save for retirement

Most countries have a preferential tax treatment of retirement savings to encourage people to save for retirement. Calculating the amount that an individual would save in taxes paid by contributing to a private pension plan instead of putting the same amount into an alternative savings vehicle suggests that the tax treatment of retirement savings does indeed provide a tax advantage. The size of the overall tax advantage varies, however. Flat-rate subsidies and matching contributions can be used to target tax advantages at low-income individuals or to smooth out the tax advantage across the income scale. Tax advantages can encourage people to save for longer periods, but not necessarily to save more. Straightforward and simple tax rules may increase people's confidence and help to increase participation in and contributions to private pension plans.

Policy makers need to ensure that consumers receive appropriate financial advice for retirement

Measures are needed to address financial advisers' conflicts of interest and to help to ensure that consumers receive financial advice for retirement that is appropriate for their needs. Such measures can potentially lead to an advice gap, however, reducing the availability and affordability of advice, particularly for consumers with low to moderate retirement wealth. Technology-based advice has the potential to increase the accessibility and affordability of advice and to overcome the behavioural biases of advisors. However, policy makers need to ensure that there is regulation in place so that the same level of consumer protection is provided.

Policy makers need to ensure the sustainability of annuity products and their suitability for consumers

Annuity products can play an important role in helping individuals mitigate investment and longevity risks. Nevertheless, these products and their associated guarantees present challenges. The lack of consistency with respect to what is meant by an annuity product and the terminology used to describe the different types of products calls for defining a common language. A coherent framework for retirement is needed to accommodate and encourage the use of annuity products. Increased product complexity, however, highlights the need for appropriate financial advice and comprehensible product disclosures to ensure that consumers purchase products suitable for their needs. The regulatory framework should put in place tools for managing risk and the incentives to do so, in order to encourage appropriate risk management by annuity providers. Approaches based on principles are better suited than static formulas, as they enable capital requirements to adapt to changing product designs, ensuring sufficient capital to back the annuity liabilities and to guarantee their sustainability.

Well-designed financial education can improve people's financial knowledge, attitudes and skills for retirement and help decision-making

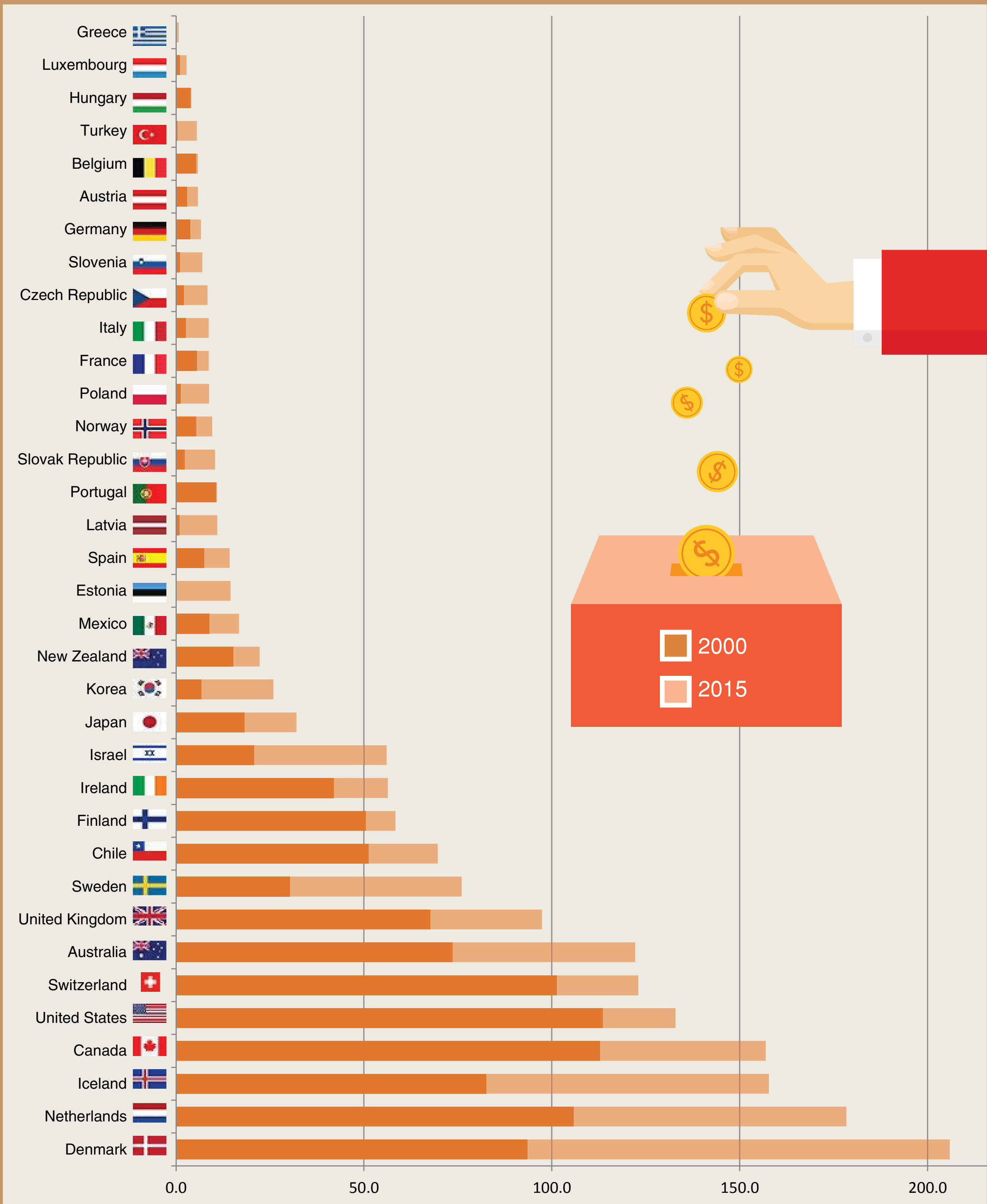
Low financial literacy poses serious challenges, as individuals are increasingly responsible for managing their own retirement wealth. Financial education initiatives for retirement planning should be implemented, taking into account national circumstances and the extent of retirement planning challenges due to the features of different national pension systems and of the financial environment. Governments and other stakeholders should ensure that information about pension systems, pension reforms, and private pension plans is available, clear and not overwhelming for individuals. Information about costs, performance, service quality, investment allocation and risk level should be comparable and standardised. Information regarding all of an individual's pension plans should be combined and pension statements should be complemented with calculators/simulators in order to maximise the impact of information. There should be national financial education strategies to ensure people are able to acquire general financial skills. Additionally, practical tools for policy makers exist, such as a matrix of financial education needs and tools to support retirement decision-making, and a checklist.

Most OECD countries have been aligning the pension systems for civil servants and private sector workers

In half of OECD countries, civil servants' future pension promises measured in terms of replacement rates are 20 percentage points higher for a full career than those of the private sector. This includes in Belgium, France, Germany and Korea, which maintain separate sector pension systems. Legacy costs exist in another quarter of those OECD countries that have aligned their pension systems since the 1990s. An integrated pension framework covering all workers identically might yield benefits in various dimensions. On the equity side, it is difficult to argue today that civil servants/public sector workers require higher income replacement in retirement than their private sector counterparts. On the efficiency side, there are significant economies of scale in managing unified pension systems, for example in contribution collection, recordkeeping and benefit payment. Moreover, restraining labour mobility across sectors (e.g. vested periods or limited portability) is inefficient, introducing rigidities in individual career management and restricting workers' capacity to adapt to sectorial shifts and new employment opportunities. A common pension scheme would make such choices easier and facilitate labour mobility.

The growing importance of funded pension arrangements

Total assets as a % of GDP in OECD Countries, 2000-2015



Source: 2016 OECD Pensions Outlook

MAIN OECD POLICY MESSAGES

The changes that have occurred in the pensions landscape are in line with the main pension policy messages that the OECD has put forward. The OECD has been working on pensions for more than two decades examining the different aspects of public and private, funded and PAYG financed pensions, as well as replacement rates, issues of coverage and pension policy in general. From this work, three main pension policy messages are:

1. Diversify the sources of financing retirement
2. Funded private pension arrangements are complementary to public pensions
3. Improve the design of DC pension plans

Diversify the sources to finance retirement

The OECD recommends combining PAYG financed pensions and pension arrangements in which assets back pension benefits, i.e. funded pensions. The analysis has shown that in the past decades there has been an increase in such pension arrangements. This increase has led to a greater diversification of the sources to finance retirement.

Diversification is important because the mechanisms through which shocks work into different pension arrangements vary. For example, population ageing has a different impact on PAYG and funded pension arrangements, or DB and DC pension arrangements. Population ageing may create fiscal sustainability problems for PAYG DB pension arrangements, solvency problems for funded DB arrangements, and adequacy problems for funded DC pension arrangements. Similarly, the environment of low interest rates and low economic growth affects funded private and PAYG public pension arrangements through different channels. Low interest rates increase the weight of pension liabilities in funded DB plans, it may lead to lower long-term accumulated assets in DC plans, and lower economic growth may affect the fiscal sustainability of public PAYG pension arrangements, especially if lower economic growth stems from lower employment.

The OECD also recommends separating the sources of financing non-contributory and contributory public pensions. Countries should not use contributions to finance the safety net, social assistance, universal pensions or resident based basic pensions (i.e. non-contributory pensions). These should be fully financed through the budget, through taxes, while contributory public pensions should be financed with current contributions.

Regarding funded DB pension arrangements, the OECD has argued that in plans where the employer is fully or partially responsible for any gap between assets and pension promises, employers should cover this gap by for example increasing contributions, but some flexibility in applying funding and recovery plans should also exist to avoid bankrupting the employer.

Funded private pensions are complementary to public pensions

Funded private pension arrangements are complementary to public pensions and not a substitute. The growing importance of funded pension arrangements has been in general to complement PAYG-finance arrangements, becoming a component of overall retirement income.

They need to be designed taking into account the overall structure of the pension system in each jurisdiction. For example, retirement income and associated replacement rates in DC pensions should be higher in countries where they are the main source to finance retirement. In countries where PAYG-financed public pensions and DB funded pensions already provide high pension benefits, DC pension plans will only need to target a low replacement rate to achieve overall retirement income adequacy. Additionally, some degree of annuitisation to provide protection from longevity risk should be in place in countries where DC pension arrangements are a main source to finance retirement.

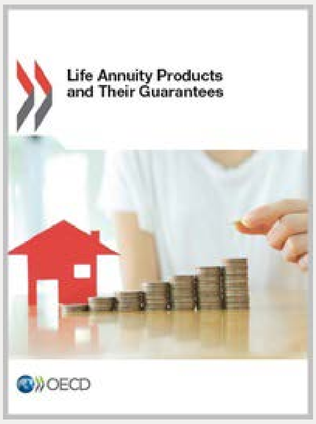
Improve the design of DC pension plans

The growing importance of DC pension arrangements has led the OECD to assess their potential drawbacks and to incorporate these arrangements into the regulatory framework in order to protect members. As a result, the OECD has recently approved the new Core Principles of Private Pension Regulation, which extends the original Core Principles to all types of funded pension arrangements.

In addition, the OECD Roadmap for the Good Design of DC Pension Plans, which has been endorsed and approved by pension regulators from OECD countries, in seeking to assist countries to strengthen retirement income adequacy in an environment of DC pension arrangements, makes the following recommendations:

1. Ensure the design of DC pension plans is internally coherent between the accumulation and pay-out phases and with the overall pension system.
2. Encourage people to enrol, to contribute and contribute for long periods.
3. Improve the design of incentives to save for retirement, particularly where participation and contributions to DC pension plans are voluntary.
4. Promote low-cost retirement savings instruments.
5. Establish appropriate default investment strategies, while also providing choice between investment options with different risk profile and investment horizon.
6. Consider establishing default life-cycle investment strategies as a default option to protect people close to retirement against extreme negative outcomes.
7. For the pay-out phase, encourage annuitisation as a protection against longevity risk.
8. Promote the supply of annuities and cost-efficient competition in the annuity market.
9. Develop appropriate information and risk-hedging instruments to facilitate dealing with longevity risk.
10. Ensure effective communication and address financial illiteracy and lack of awareness.

Life Annuity Products and their Guarantees



This complementary publication is designed to help policy makers to better understand annuity products and the guarantees they provide in order to improve the role that these products can play in financing retirement. Product design is a crucial factor in the potential role of annuity products within the pension system, along with the cost and demand for these products, and the resulting risks that are borne by the annuity providers. Increasingly complex products, however, pose additional challenges concerning consumer protection and risk management. Consumers need to be aware of their options and have access to unbiased and comprehensible advice and information about these products.

www.oecd.org/pensions/private-pensions

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Population ageing and the challenging economic environment, characterised by low returns, low growth and low interest rates, create serious problems for pension systems, affecting both pay-as-you-go financed public pensions and funded private pensions.

This booklet reproduces highlights from the 2016 edition of the OECD Pensions Outlook. Covering both public and private pension systems, the Outlook analyses the latest developments in pension policies in OECD countries and assesses trends in retirement income systems.

www.oecd.org/pensions/oecd-pensions-outlook.htm

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