Editorial
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 Codes 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.

Pierre Poret,
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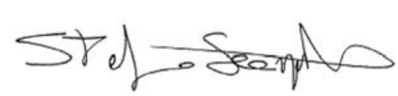

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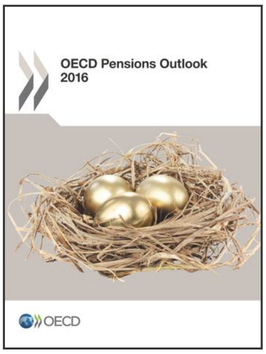

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