PENSION SYSTEMS IN THE MIDST OF THE DEMOGRAPHIC TRANSITION: THE WAY FORWARD

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Ladies and gentlemen, good evening.

I am very pleased to be here today, and to have this opportunity to share with you some thoughts on the global outlook for pension systems. This international pension workshop – jointly organized by Netspar and CeRP – has put together an impressive list of contributions in the fields of pension economics and pension finance. The papers explore key issues that are at the forefront of the current policy debate.

This evening, I would like to offer a few thoughts on three topics: (i) The state of pension systems in the midst of the demographic transition; (ii) the to-do list for governments and industry participants ; and (iii) the long-term effectiveness of funded private schemes, with a focus on the crucial role played by strong and sustainable growth and the need to develop well-functioning annuity markets for the pension payout.

I. The challenges facing pension systems

Considering the current conditions of pension systems, it seems to me that the adjustment of pay-as-you-go schemes to the demographic transition is far from completed, because: (1) population ageing will continue; (2) most advanced economies will require robust fiscal consolidation measures; (3) in many of our countries the economic outlook will be weak for some time to come.

First, the ageing process is going on, and dependency ratios continue to rise. Life expectancy will lengthen in the coming decades. According to the UN Population Division's projections, in the OECD countries between 2010 and 2050 life expectancy at age 65 will increase by 3.1 years for men and 3.6 years for women.

A second driver of change in pay-as-you-go arrangements is fiscal consolidation. One of the main legacies of the global financial crisis is the unprecedented size of fiscal deficits in many advanced economies. This has led several governments to phase in fiscal consolidation programmes over the short and medium term. At this stage, fiscal consolidation programmes are fairly well-defined, for example, in the United Kingdom and the euro area, though still somewhat hazy in the United States and Japan. Cuts in pension outlays (e.g., increase in retirement age, reduced benefits and restrictions on early retirement schemes) have been announced by a number of countries, as these measures are important for longer-term fiscal sustainability. Ageing will also affect fiscal sustainability through rising health and long-term care expenditures, something that is coming to be realized with a lag compared to pension expenditures.

The third factor is the weak macroeconomic environment, because lower wages and fewer jobs shrink the revenues from pension contributions. The recovery from the Great Recession is expected to gain momentum only slowly and continues to be unstable, as indicated by the latest downward revisions of growth prospects for the United States. The recovery is also unbalanced: the advanced economies lag behind the emerging-market economies; global imbalances do not appear to be on the way of being reduced; in several countries households are highly indebted.

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Nor is the medium-term outlook for the world economy much brighter. In advanced economies public debt is high. The pressure of emerging market economies on energy and commodity markets creates upward risks for inflation. Labour market conditions are expected to improve only slowly and there is a concern that structural unemployment might increase. Geopolitical risks could remain high.

If the public pension sector is not yet out of the woods, defined-benefit (DB) pension schemes are in no better shape. The demographic trends and the weak macroeconomic environment have had severe repercussions on them too. What's more, DB plans have been put under pressure by the huge correction in asset prices triggered by the global financial crisis. The impact of the plunge in share price indices in 2008 has been magnified by the sharp decline in the yields on benchmark government bonds, which provide the backbone of the discount factors used to value future liabilities. As a result, since 2008 the funding gaps of DB plans have widened significantly across the board. According to OECD estimates, for more than 2,000 publicly traded companies headquartered in 15 countries, the median underfunding rate worsened from about one eighth in 2007 to one fourth in 2009. Since the autumn of 2010 the situation is likely to have improved but only slightly, owing to the low level of interest rates.

Particular concerns have been raised about the sustainability of DB pension plans for public sector workers. There is evidence that in a number of advanced countries these plans produce potentially large net unfunded liabilities. In the public sector, pension promises tend to be relatively generous (sometimes to make up for lower current earnings relative to the private sector); in some countries, they are also partially funded or paid out directly from government revenues, or their valuation and disclosure may lack transparency.

Because of these trends, retirement-income systems have continued to shift from public pay-as-you-go schemes and DB plans to defined-contribution (DC) pension schemes. In the United States, for example, over the last decade the percentage of workers participating in DB plans has declined further from 36 to 30 percent, while that of DC plan members has increased from 50 to 54 percent.

The rising importance of DC arrangements implies that investment risks and longevity risk are increasingly borne by individual workers. Over the last decade, however, financial market returns have been disappointing, and the global financial crisis of 2007-09 has dealt a blow to the balances accumulated by many workers on their DC pension schemes. Especially hard hit were senior members nearing retirement. But the risk that DC schemes will deliver low income replacement rates is very serious also for young members. The disappointing performance of DC schemes over the last decade is likely to have sapped employees' confidence in the ability of the financial markets to provide adequate and secure returns. Where membership is not compulsory, this may affect employees' propensity to join DC pension schemes and pay pension contributions. The risk that DC schemes will provide a low pension income compounds the reduction in the coverage of public pensions. The possibility of policy reversals cannot be overlooked either. In this regard, it is telling that in some countries the choice of mandatory contribution to funded DC pension schemes has been called into question.

II. What to do

I now turn to some well-known policy responses to these challenges. While there is, I believe, wide consensus among academic experts and practitioners on the need for such responses, they are obviously demanding for policymakers. But it must be clear that delay in design and implementation could be very costly for our societies.

First and foremost, people have to be encouraged to work longer. Living longer is certainly a positive development, especially if we are in good health (and this should not be taken for granted).

But we need to have the resources to enjoy our longer lives, which means incomes and jobs. There is no question, then, that a return to what the G-20 defines as “strong, sustainable and balanced growth” is the fundamental objective of economic policy. This will help in furnishing the accumulation of funds necessary for retirement, but there is little question that the retirement age also has to go up.

Statutory pension ages have started to rise in a number of countries. However, according to the OECD, in all but five member countries the projected gains in life expectancy over the next four decades will outstrip the prospective increases in retirement age. To insure the financial sustainability of pay-as-you-go schemes, possible measures include raising the retirement age, introducing incentives for later retirement, cutting benefits and indexing them to life expectancy (as it has been done, for example, in the notional defined contribution systems). It could also be helpful to allow senior workers to combine work with pension income. In this regard, it is worth recalling that there is no evidence that employment of older workers reduces the number of jobs available to young people.

Second, for DC pension schemes to deliver on their promises, in my view there are three top priorities:

a) DC plan members must be aware of the likely degree of coverage provided by their retirement scheme. This is a crucial condition to persuade workers to increase retirement saving and to help them set target replacement rates for their accumulation plan. Clear information on the expected replacement rates and their likely decline under adverse investment scenarios must be provided.

b) Total costs to plan members must be reduced. As has been emphasized, among others, by the Turner Report in the middle of last decade and, more recently, by the Squam Lake Working Group on Financial Regulation, charges may have a major impact on the final balance accruing to plan members over an extended period of time. Costs can be reduced not only by increasing the volume of assets under management, with consequent economies of scale, but also by stimulating competition among pension schemes. This may call for various measures, including educating consumers about the effects of charges on pension fund returns; assuring transparency and comparability of charges between schemes; easing the portability of employer contributions between schemes; and intensifying competition among the financial institutions that manage pension funds.

c) Sound default options should be designed. While the regulation of DC plans has to take into account the characteristics of the national pension system as a whole (for example, what share of pension income is provided by DC plans), a good practice would be to make enrolment in DC plans automatic but subject to an opt-out clause. Moreover, the default plan must be carefully designed. In order to encourage workers to join (or not to opt out), the default contribution rate could be rather low initially and rise gradually over time. Furthermore, the default DC plan should have low fees and diversified investment objectives, in order to ensure a fair balance between security and yield in investing retirement saving in financial instruments.

These considerations also make it clear that the performance of DC pension schemes may be affected by workers’ degree of financial literacy, as has been highlighted by advanced scientific research. As was pointed out in the 2005 G10 report on *Ageing and Pension System Reform*, one of the policy challenges is to develop financial education programmes that “can help consumers avoid abuse and fraud, improve their investment choices, and raise their contributions to private pension plans”. Retirement-saving literacy programmes addressed to the labour force are thus important, although obviously they must go hand-in-hand with stronger consumer protection.

But developing a sound, robust DC pillar is not enough to ensure that the retirement income provided by private pensions is adequate. In pure DC plans, members remain exposed to extreme financial market risks, as we have seen in the recent financial crisis. This is a serious risk, especially for workers nearing retirement, who may not be able or willing to wait for a full recovery in financial markets. Moreover, severe financial turmoil is typically associated with weak labour markets and older job seekers who have trouble finding work may end up retiring earlier than expected (rather than delaying retirement), with lower pension incomes. The importance of extreme (financial and counterparty) risks in long-term financial contracts is demonstrated by the fact that in a number of countries guarantee arrangements are in place to protect benefits against the insolvency of the DB plan sponsor; for a worker, moving from a DB plan to a DC plan implies abandoning dual protection (the sponsor's capital and the guarantee arrangement) in favour of no protection at all. This may call for some kind of return guarantee to DC plan members during the accumulation phase.

Available examples include both absolute return guarantees (as in Japan or in some US states), in which the guaranteed return is set against a pre-specified return, and relative guarantees (as in Chile and Denmark), where the return is tied to some industry average or market benchmark. There is evidence that only guarantee schemes in which the minimum return is set at a very low or negligible rate, such as return of principal, can surely withstand adverse financial market conditions. This is consistent with the findings of our own research conducted at the Bank of Italy, which suggests that in order for the guaranteed return insurance scheme to be cost-effective, credible, and robust to moral hazard, the guarantee should be provided by the government and funded by properly risk-based premia.

Another important challenge faced by pension systems is given by the changing nature of labour markets. Job mobility and flexibility may hinder the accumulation of retirement wealth. Pension schemes should allow for the fact that workers may change jobs and employers more frequently than in the past, and we should also think about ways to promote the cross-border portability of pension rights. Issues such as vesting periods and (implicit or explicit) penalty fees should be regulated and would be important to prevent any kind of predatory practice on retirement savings.

Finally, the pension fund industry may benefit greatly from the development of retirement schemes in emerging-market economies, as these economies will also face more or less rapid population ageing in the coming decades, with pension systems still to be developed especially in their fully-funded dimension. With the current pace of increase in living standards and the emergence of a sizable middle class, the vast potential demand for retirement saving vehicles in these economies would allow the global financial industry to generate important economies of scale and scope. At the same time, given the sheer size of the potential saving pools, competition among financial institutions should be adequately promoted and the risk of an excessive concentration of market shares properly countered.

III. Ensuring the long-term effectiveness of funded pension schemes

But there are also two other factors which in the future will considerably affect the ability of funded pension schemes to meet their goal of providing pensioners with adequate retirement income. The first is the crucial importance of robust economic growth. The second is the design of the decumulation phase.

Both funded and unfunded pension arrangements ultimately rely upon the ability of the economic system to create jobs and allocate resources to the most profitable investment opportunities. Economic growth is therefore the fundamental determinant of the sustainability and adequacy of any retirement system. However, as was highlighted in the IMF's recent *World Economic Outlook* of the IMF, in the advanced economies potential output threatens to remain considerably below pre-crisis trends, unless financial and structural policies are significantly strengthened. Partly as a result of lower potential growth in the advanced countries, the weight of emerging market economies on world output is expected to increase steadily over the coming decades. In particular, Asia is expected to have a great potential for growth. According to recent projections by the Asian Development Bank, between 2010 and 2050 its weight will rise from about a quarter of global output in 2010 to at least a third in 2050 under a pessimistic scenario, and to half if the current trend of sustained convergence were to continue over the next forty years.

If financial markets are well-developed, funded schemes make it possible for retirement wealth to expand at the same pace as that of the world economy. In order to do so, over the next few decades the asset allocation of funded pension schemes will have to gradually change its geographical scope, in order to reflect the rising weight of Asian and Latin American countries.

It is important to observe that it is not a matter of keeping investment returns afloat by taking more risks. A reckless chase after high-yield assets around the world would be useless if not counterproductive. Retirement saving has to be directed towards those business activities that may put the world economy on a path of strong and sustainable growth. This raises a number of important issues for the global financial markets.

On the demand side, pension schemes' trustees and asset managers will have to devote more resources to the analysis of emerging market economies and the contribution of emerging market bonds and equities. Moreover, to the extent that the geographical composition of portfolios will become a key driver of the asset allocation, DC plan members will also have to improve their understanding of new investment opportunities. Regulation, at both the national and international level, will have to respond to the changing needs of institutional investors. We have to ensure that both individual and institutional investors are accountable for their actions.

As for the supply side of financial markets, the challenges that we face may even be more demanding. First, if we want to ensure that financial markets keep track of the expansion of Asian and other rising economies, emerging market companies with good fundamentals and growth opportunities must have access to bond and equity markets. If the financial markets of the emerging market economies had limited capacity to absorb foreign resources, then capital inflows might fuel asset bubbles and even be counterproductive to economic growth in those economies. Second, while policies and practices may differ across countries depending on institutional and economic factors, there should be no uncertainty about some key policy areas, such as the governance of corporations, the legal and regulatory framework, the enforceability of contracts, and tax burdens. Finally, the financial infrastructures of both advanced and emerging economies should be integrated into the global financial system, open to foreign players, and compliant with international standards of transparency.

The last key priority is the need to develop well-functioning annuity markets. In a few years' time the number of pensioners for whom payout instruments will provide a significant fraction of retirement income is bound to increase, both in the advanced economies and in emerging and developing economies. At the moment, annuity markets around the world are rather thin, except in a handful of countries in which private pensions are more highly developed (such as in the United Kingdom, Switzerland, Chile and, to a lesser extent, the United States). Moreover, the payout phase arrangements differ markedly across countries, in terms of government intervention (through regulation and taxation), instruments and providers.

Policy action in this field should target two broad objectives: the choice of the payout instruments and their costs. The first goal is to develop products that better protect against the risks that materialize during the decumulation phase, namely inflation, longevity and financial market risk. We have to think about how to achieve an inflation-protected stream of income for life after retirement, also taking into account the possibility that people in old age – while spending on health-care services – might increasingly be able to combine work and pension income. On this issue, as has been repeatedly observed, an adequate supply of government inflation-linked and ultra-long-term bonds is an essential tool to help financial institutions to offer inflation-linked annuities or other instruments that serve pensioners' needs. Governments should also consider issuing longevity bonds, or providing financial institutions with guarantees against extreme (financial or longevity) risks.

The second broad policy goal would be to reduce the price of annuities and similar instruments. In this regard, a main policy tool is the timely release of accurate mortality tables, both for the total population and for different subgroups in the population. Improvements in mortality tables would help reduce adverse selection costs and lower the premium for the aggregate longevity risk. Fostering instrument transparency and comparability is another useful option, as it would be to promote competition among annuity providers.

IV. Conclusions

The adjustment of pension systems to the demographic transition is a complex process that needs close monitoring and that will continue to unfold for a number of years to come. Doubts about the viability of public pay-as-you-go arrangements and defined-benefit pension schemes persist. More importantly, there are growing concerns over the ability of defined-contribution pension schemes to provide adequate income. Some of the issues that we are dealing with now were identified by pension experts and policymakers half a decade ago or more, but so far they have been addressed only in part. At the same time, new issues have come to the fore. I am convinced that the evidence that we have gathered so far on ongoing trends, industry practices and policies – corroborated by the findings of the most dependable scientific literature – provide clear guidelines on how to ensure that pension systems will fulfil their mission of giving workers a decent standard of living in retirement.

Members of DC pension schemes must get sound information on their likely retirement income. The default options of DC plans have to be carefully designed. As the first waves of baby-boomers approach retirement, it is urgent to develop the markets for payout instruments. We have to promote competition among the providers of funded pension schemes and annuities. We have to be aware that market-based arrangements may not be able to cope with extreme financial or longevity risks. The centre of gravity of the global pension fund industry will increasingly shift towards the Asian and other emerging-market economies, both in terms of asset allocation and business opportunities.

To conclude, one of my favourite quotes on longevity risk is Lorenzo the Magnificent's rhyme of more than 500 years ago: "Youth is sweet and well / But doth speed away / Let who will be gay / To-morrow, none can tell" [trans. by Lorna de' Lucchi, 1922]. In our world of increasing longevity and population ageing, we face the risk that expectations of limited economic growth (and the associated liquidity constraints) may reduce the propensity to save for retirement and make Lorenzo's hyperbolic discounting an appealing though illusionary alternative. But in order not to be obliged to pay extremely high costs in the future we – individuals, market participants, policymakers – must shun any such illusion. There is no alternative to fostering economic growth by structural policies, maintaining incentives for retirement saving, facilitating the supply of long-term and indexed financial instruments, properly designing and protecting the pay-out phase, and upgrading the regulatory and supervisory framework.

Thank you very much for your attention.