

15th Regional Social Insurance, Pension and  
Provident Fund Conference

**“Pensions in Crisis”**

Paphos, 2-5 March 2009

## **Pension Challenges and Pension Crises**

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# **Pension Challenges and Pension Crises**

## Structure of presentation

The changing demographic and social environment

Interpreting the experience (positively or negatively)

Deconstructing the challenge (dependency rates)

Meeting the challenge (policy responses)

New challenges through private provision

THE crisis – its impact on pensions

Lessons to learn

# Pension Challenges and Pension Crises

The changing demographic and social environment

Life expectancy going up

- more/most reaching retirement age
- living longer when in retirement

Fertility declining

- education/income/work effect

Behavioural changes

- longer time spent in education
- earlier retirement
- more female labour force participation

# Pension Challenges and Pension Crises

Interpreting the experience

Increased longevity

- ability to overcome many diseases and impairments

Retirement

- opportunity for leisure after work

Lower fertility

- lower infant mortality

Longer education

- more productive workforce, more self-development

More females working

- greater opportunities for independence and equality

# Pension Challenges and Pension Crises

Interpreting the experience (2)

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Looks like a “success story” not a “crisis”  
– at worse “a challenge”

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# Pension Challenges and Pension Crises

Deconstructing the challenge  
understanding “dependency rates”

## Age dependency rates

- total, youth and old-age
- and, possibly, youth cancelling old-age out

## Economic dependency rates

- workers/producers and non-workers/consumers
- more education and early retirement negative, female participation positive

## System dependency

- contributors and non-contributors/beneficiaries
- pension systems but also education systems, public versus private (household) costs
- system maturity

# Pension Challenges and Pension Crises

## Meeting the challenge

### Promoting higher female employment

- still barriers for women, working patterns, children and elder care
- but cultural objections
- infrastructural investment (child and social care provision and who bears cost)

### Increasing compliance

- recording wages, bringing in self-employed
- but requires enforcement capacity

### Increasing immigration (increasing contributors)

- but political objections to numbers

# Pension Challenges and Pension Crises

## Meeting the challenge (2)

### Increasing contribution rates

- objections to higher taxation (disincentives to work and disincentives to hire)
- rise is gradual, and the cake from which the bigger slice is being taken is also growing

### Tackling early retirement

- why introduced, whether successful
- but expectations introduced

### Raising age of entitlement (normal pension age)

- in line with life expectancy increases or fraction
- but political objections, and how to cope with those with bad working conditions

# Pension Challenges and Pension Crises

## Meeting the challenge (3)

### Cutting retirement benefits

- difficult to do so directly, but changes to indexation or years of contributions required
- longer-term backlash and costly repair work

### Placing reliance on non-state provision

- private savings, company and occupational schemes
- to fill gap from holding down state provision
- but employers increasingly unwilling to bear longevity costs or market risk

# Pension Challenges and Pension Crises

## Meeting the challenge (4)

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But also raising new challenges

- re-appraising reliance on private provision and funding

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# Pension Challenges and Pension Crises

New challenges through private provision

Funding not different from PAYGO

- both resource transfers
- direct transfers versus transfers over intermediary
- buy assets when working, sell assets when retire to those who are now working
- still vulnerable to demographic change

Funding less redistributive

- no credits for child rearing, sickness, employment
- but final salary can be regressive and can discriminate against mobile employees
- DC schemes proportional and reproduce inequalities in working life into retirement

# Pension Challenges and Pension Crises

New challenges through private provision (2)

## Charges eat up savings

- 1% of assets under management reduces savings by 20-25% over 40 years
- many higher (2% Hungary, 3% Nigeria)
- no evidence of competition holding them down (Chile)
- administration takes 0.1% of benefits paid for public PAYGO

# Pension Challenges and Pension Crises

New challenges through private provision (3)

Shifting demographic uncertainty and market risks

- increased longevity not a marketable risk and should be socialised
- DB to DC shifts risk from employer to employee (but employer risk impacts on employee, ultimately)
- market risk generating inequalities between otherwise identical people (different years of retirement, same years but different investments)
- pension savers want/need certainty
- insuring against market risk costly (cost of “put option” increases with time-horizon of investment)

# Pension Challenges and Pension Crises

New challenges through private provision (4)

Voluntary or mandatory?

- overcome inertia via auto-enrolment (have to opt out)
- employee choice can trigger employer contribution (employer pressure to opt out)
- mandating means contributions are, effectively, a tax
- political pressure to compensate underperformance (individual and collective) has public finance implications (and stronger if mandatory)

# Pension Challenges and Pension Crises

New challenges through private provision (5)

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Some of the “new” challenges are serious

- product of inappropriate responses?
- creating a “crisis” of pension provision?

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# Pension Challenges and Pension Crises

## THE crisis – its impact on pensions

### Rising unemployment

- fewer contributors (drop out of private schemes, at best receive credits under public schemes)
- losses to people in schemes with long vesting periods
- more early retirement (setback to attempts at reversal)

### Falling stock markets

- lack of trust in markets (declining willingness to save)
- declining value of assets to annuitise (esp. those not in life-style options)
- increased deficits in DB schemes (mark-to-market), more incentives to close

# Pension Challenges and Pension Crises

## THE crisis – its impact on pensions (2)

### Pension fund standards

- companies with DB schemes resist demands for cash infusions to make good underfunding
- companies cut their contributions to pension plans as only way of avoiding bankruptcy (USA, 401k)
- govt. allows diversions of pension funds to buy up bonds in “solid companies” (Finland, VER)
- trade union demands for responsible investment (UK)
- diversion of contributions from indiv. accounts to soc. sec. account to reduce “transition costs” (Lithuania)
- nationalisation of private funds (Argentina 2008)
- access to pension funds to help people over severe crisis (Iceland 3rd pillar) so that pension funds become provident funds (but NB Singapore)

# Pension Challenges and Pension Crises

## THE crisis – its impact on pensions (3)

### Government policy

- bank recapitalisations and tighter regulation (reducing faith in financial institutions and willingness to save)
- interest rate cuts (reducing income from assets and annuity rates and reducing willingness to save)
- debt build-up (limiting scope for increased age-related spending in medium-term)

# Pension Challenges and Pension Crises

## THE crisis – its impact on pensions (4)

### Cause for concern?

- government debt build-up temporary and only large by recent, not past, standards
- private annuitants have (only temporary) difficulties
- “pension funds are long-term investments” OECD (but the problem is not the probability of underperformance, it is the size of underperformance)
- mature DB funds running down assets (so closure brings little benefit to sponsors)

# Pension Challenges and Pension Crises

## Lessons to learn

“Improve financial education”

- failure to recognise cognitive deficiencies, reliability of information, lessons of behaviour economics

“Improve life-style asset allocation”

- necessary but by no means sufficient

“Greater care with alternative investments”

- hedging, swaps, LDI and the Lehman collapse
- more regulation of pension schemes?

“Nationalising” and recapitalising banks and underwriting deposits

- government-promoted private pensions also contingent liabilities that might be called upon