Private Pension Provision: An OECD View

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Private pension arrangements are being promoted around the world to play a more central role in retirement income provision. One key policy concern of this trend is how risks inherent to funded arrangements will be addressed. Regulatory efforts are most successful when tackling informational asymmetries and other operational problems that hinder market efficiency. Over recent years, the OECD has issued a set of core principles that set out good practices in pension regulation. The principles and related guidelines focus on promoting high-quality managerial processes and effective internal governance and external monitoring. In addition, the guidelines identify a set of basic rules to protect the rights of members and beneficiaries and prudential standards to promote high levels of funding and appropriate investment strategies that take into account the structure of the pension plan's liabilities.

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Traditionally a voluntary complement to social security systems, private pension arrangements are being promoted around the world to play a more central role in retirement income provision. One key policy concern of this trend is how risks inherent to funded pension systems will be addressed. These risks can be categorized into two main types, financial and operational. In the former category are investment-related risks that may be compensated by a premium on expected returns and may therefore be worth taking on, especially for long-term investors. In the latter category are governance and agency problems that may worsen performance and pension benefits. Pension regulation and supervision in many OECD countries has often focused on the former while failing to recognize the importance of operational risks. A case at hand is the quantitative investment limits that in some jurisdictions may drain the pension supervisors' resources. The OECD has recently issued a set of core principles that set out good practices in pension regulation that aim to rebalance the policymaker's approach to dealing with financial and operational risks. The principles and related guidelines focus on promoting high-quality managerial processes and effective internal governance and external monitoring. In addition, the guidelines identify a set of basic rules to protect the rights of members and beneficiaries and prudential standards to promote high levels of funding and appropriate investment strategies that take into account the structure of the pension plan's liabilities.

New trends in private pension design and recent regulatory initiatives

Private pension arrangements are living through difficult times. In many countries, defined benefit plans are being scaled back or replaced by typically less generous

defined contribution arrangements. The consequences of this trend and the emerging risk transfer to households are as yet open questions, but seemingly low levels of financial literacy and inconsistent or irrational individual behaviour may call for careful design of defined contribution plans, especially those that offer product or portfolio choice. In particular, there is gathering evidence that a small number of well-crafted choices may boost individual welfare by simplifying complex or stressful decisions. There is also much debate about the design of default options. In some countries, life-cycle solutions (portfolios become less risky over time) are becoming increasingly popular. In other countries, default options that offer capital or return guarantees are preferred as they provide better protection against downside risk for those who, for whatever reason, do not make a choice. Such designs of default options may be especially relevant in countries where defined contribution plans form the core of the statutory pension systems.

Regulatory innovation is also intensifying in defined benefit systems, as governments attempt to provide better incentives for funding, asset liability management and efficient administration. Pension regulators are also starting to reform valuation methods for pension liabilities, in part as a result of the spread of new international pension accounting standards. The government's role as insurer of last resort (through insolvency insurance arrangements) is also being considered in some countries, which may in turn necessitate improvements in the design of these arrangements to avoid moral hazard problems. The concerns raised by these policy initiatives is that although they have a laudable objective in mind (promoting benefit security), they could exert such pressures on plan sponsors that could ultimately hasten the demise of defined benefit plans. While some reform of defined benefit plans is in order (to allow for increases in life expectancy and promote better asset liability management), there is also a general perception that plans providing some form of collective risk sharing and administration centered around a fiduciary have significant advantages over retail pension arrangements.

In general, the more funding and accounting methods move towards market or fair valuation, the greater the need will be to allow employers sufficient flexibility to close funding deficits. Pension funds are long-term investors that pay out benefits far into the future. Liability valuations based are therefore subject to much uncertainty, calling for gradualism and prudence when adapting funding and investment strategies as a result of changes in market conditions, such as declines in discount rates or asset prices. Moreover, defined benefits are normally backed up by employers, which offer pension funds a recourse to capital that is not available to financial institutions such as banks or insurance companies. Hence, the solvency regulations and capital adequacy rules common to these institutions cannot be simply transplanted to pension funds.

The regulatory framework of pension fund governance and investment is also undergoing significant reform in some countries. The goal of prudent pension fund management requires a solid and transparent governance framework that is sometimes lacking in occupational pension arrangements. Some of the weaknesses that have been identified in some countries include lack of clear accountability and personal liability as a result of the involvement of multiple fiduciaries, lack of adequate knowledge by members of the governing body of a pension fund, and lack of clarity over the role of

actuaries, auditors and external asset managers. In personal pension plans, pitfalls can arise when there is no fiduciary or external monitor that looks after the interests of the plan members.

Investment regulations in OECD countries are also moving away from quantitative restrictions to process-based rules, which call for the development of risk management models, a statement of investment principles and systems for performance assessment. The lifting of restrictions applies mainly to investments by asset class, as ceilings on investment in individual securities or securities by the same issuer have been retained, the most common being investments in securities issued by the plan sponsor. The diversification rationale behind these restrictions has not been put into question, although under a prudent investment policy they would in any case be imposed by the pension funds themselves.

OECD countries that have recently relaxed or altogether moved away from quantitative restrictions include Canada, Germany, Japan, Korea, Mexico, and Switzerland. Canada eliminated the 30 per cent cap on foreign investment in February 2005. In Germany, while restrictions remain for the *Pensionskassen* (see above), a new type of financing entity, the *Pensionsfonds*, was introduced in 2002, which is not subject to any quantitative restrictions on investment by asset class other than currency matching requirements. In Japan, pension funds were subject to the so-called 5-3-3-2 rule (a floor of 50 per cent on cash and bonds, a ceiling of 30 per cent on equities, a ceiling of 30 per cent on foreign securities, and a ceiling of 20 per cent on real estate) until April 1999, when the rule was eliminated and regulation veered towards the prudent person principle. New regulations introduced in Korea in September 2003 eliminated the 40 per cent limit on domestic listed equities, introduced a ceiling of 10 per cent for non-listed equities (not permitted previously), and lifted the foreign investment ceiling from 10 to 20 per cent. Mexico changed its investment regulatory framework in 2002. Pension funds were permitted to invest in securities denominated in foreign currency by any local issuer (not just the Mexican government and central bank). In Switzerland, pension funds face quantitative limitations on their investment in equities and foreign securities, but since April 2000 these can be surpassed if the fund can justify them as part of a prudent investment policy. In these countries, the relaxation of asset limits and the concomitant move towards the prudent person principle has been complemented with efforts to strengthen governance as well as enhanced risk management models to assess portfolio risks. For example, in Mexico, the reform of investment regulations in 2002 was accompanied by the establishment of a new system of supervision based on value-at-risk.

The OECD's pension standards

The OECD has been developing principles and guidelines for occupational pension regulation since 1998. Its "Recommendation on Core Principles for the Regulation of Occupational Pensions" was released in 2004,¹ with six main core principles addressing

¹ The Recommendation is available in <http://www.oecd.org/dataoecd/14/46/33619987.pdf>.

both prudential aspects and the rights of members and beneficiaries, covering the following areas:

- Conditions for effective regulation and supervision.
- Establishment of pension plans, pension funds, and pension fund managing companies.
- Pension plan liabilities, funding rules, winding up, and insurance.
- Asset management.
- Rights of members and beneficiaries and adequacy of benefits.
- Supervision.

Additional detailed guidelines set out basic good practices in regulation that aim at providing incentives for the management of pension funds in the best interest of plan members and beneficiaries. The governance guidelines² stress suitability requirements for members of governing boards, internal controls and policies to address conflicts of interest, clear monitoring responsibilities for actuaries and auditors (a strengthening of the so-called “whistleblowing” functions), and disclosure requirements that promote members’ role in overseeing the administration of pension plans. The guidelines on the rights of beneficiaries³ aim at bridging the information gap between plan members and pension providers by establishing basic protective measures such as vesting and portability rights on top of disclosure requirements. Currently, the OECD is preparing a set of guidelines on pension fund asset management and on funding and benefit security. These guidelines will be published in the course of 2005.

The OECD’s work in the area of private pensions has been driven by a desire to promote an international dialogue on good practices in regulation and supervision, collect data using standard methodologies and definitions, and provide member countries with high-quality research and policy advice. The Working Party on Private Pensions, established in 1998, has become the main source of official data, research, and independent policy advice for member countries and an increasing number of non-member countries that have been invited to join OECD activities in this area. In addition to the 30 OECD countries, Brazil, Israel, and Russia are currently observers in the Working Party. The OECD has been assisting countries in Asia, Latin America, and more recently in Africa in their efforts to improve the regulation of their private pension systems.

The OECD’s action has also helped to establish private pensions as a research and policy field in its own right, different though related to both social security and private insurance. The OECD has helped to recognize the value of defined benefit arrangements and other collective risk sharing arrangements that exist in the OECD area and has encouraged a more complete discussion of the merit of different valuation methods and of approaches to promoting benefit security in these plans. The OECD Core Principles and related guidelines have played no small part in this regard as they are the first international set of good practices in this area. The guidelines on asset management and the guidelines on funding and benefit security currently being

² See OECD (2002).

³ See OECD (2004).

considered by the group are also expected to play a reference role in the future of the prudential regulation of private pension arrangements.

In addition to the core principles and related guidelines, the OECD has developed other, broader initiatives that have implications for pension fund investment. The OECD Code of Liberalization of Capital Movements, a binding OECD instrument first adopted in 1961, stipulates the progressive, non-discriminatory liberalization of capital movements. In 1961, when the Code was first adopted capital account operations were excluded. The Code applied only to foreign direct investment. In 1992, portfolio flows were added to the list. The Code then required the elimination of restrictions to portfolio investment, but some country-specific exceptions were permitted for foreign investment by insurance companies and pension funds (so-called reservations to the code). These exceptions have been reduced over time as a result of the on-going peer review and discussion in the OECD to encourage the progressive removal of direct controls and promote alternative, non-restrictive ways of meeting prudential concerns.

The work of the OECD in pension regulation is complemented by the supervisory activities carried out by the newly established International Organisation of Pension Supervisors (IOPS), which is expected to work in partnership with the OECD in developing further guidelines in the pensions field. The IOPS's work focuses on pension supervision, and currently a project on risk-based supervision is under way that will ultimately identify good practices in this area. Broad guidelines on pension supervision are also currently under development.

Implications for the future

Demographic and ideological pressures are driving a worldwide revolution in retirement provision. Increasing life expectancy is making the traditional defined benefit contract of both public and private pension arrangements increasingly untenable. Reforms to offset this trend, however, can take many forms. In many OECD countries, however, there is an expectation that replacement rates (at a given retirement age) from public pension systems will be lowered over time, while in others (such as Italy, Poland, and Sweden) such reductions will occur automatically as a result of the introduction of notional defined contribution formulas. Lower public pension benefits may be compensated by later retirement and higher private savings. There is no guarantee, however, that workers on their own will work longer or save more. Incentives are essential, especially in countries where replacement rates from public plans are set to decrease significantly over time. Old-age labour market participation is likely to increase if further reforms are implemented to eliminate the incentives for early retirement that still exist in some G10 countries. Further increases in statutory retirement ages may also be required. A relatively modest increase in statutory retirement ages of 1 year every 10–15 years (in line with increasing life expectancy) may compensate substantially for declining public pension benefits.

In many countries, governments hope that greater private pension saving will also ensure that total replacement rates (public and private) at retirement remain at the high levels enjoyed by current generations of pensioners (over 60 per cent for the

average worker in most OECD countries). Concerns remain over the take-up of private pensions, especially under defined contribution arrangements, and over the security of benefits offered. The shift away from defined benefit promises is not being contested in most countries. Even those, like the United Kingdom, that have introduced arrangements to protect these plans from the risk of bankrupt sponsors may be providing further reasons to sponsors to close them down and replace them by defined contribution plans.

Ultimately, neither type of plan has a net superior advantage over the other, which explains the popularity of hybrid arrangements in some OECD countries, like the cash balance plans in Belgium and the United States. In Denmark and Iceland, DC arrangements with collective risk sharing have also withstood well the financial pressures of recent years. The implementation of prudential regulatory policies and effective ongoing supervision will be as much a part of the success of private pension plans as their actual design.

The growth of defined contribution arrangements also necessitates financially educated individuals. Although high levels of financial education generate such benefits, surveys of financial literacy conducted in recent years in some countries show that consumers also lack the awareness of the need to be financially educated. Financial education programmes can help consumers avoid abuses and fraud, improve their investment choices, and raise their contributions to private pension plans. This impression has been confirmed by recent evaluations in the United States showing that financial education offered by employers, whether in the form of brochures or seminars, increases both the number of individuals with 401(k) retirement savings accounts and the average amount of savings.

Concluding remarks

Private pension arrangements are experiencing as much and sometimes even more rapid evolution than public pension systems. As their role in retirement income provision is expected to increase, there has been a recent flurry of policy efforts to improve their regulation and supervision. The OECD has played a central role in this regard, having developed a recommendation and guidelines on pension regulation.

Defined benefit plans remain important in some OECD countries, but the funding gaps of recent years have raised alarms over their ability to withstand economic and demographic shocks. Greater accounting and supervisory surveillance are expected to improve the institutional integrity of these plans, but they could also further undermine employers' support for defined benefit arrangements. Instead, employers are being drawn towards hybrid pension arrangement (such as the cash balance plans in the United States) and defined contribution plans. In many countries, concerns over workers' ability to make investment decisions may lead to calls for plans that ensure a high degree of protection against investment risk. Annuities markets are also likely to develop rapidly, especially if appropriate tax incentives are provided.

In the end, the success of private pension systems will be as much decided by the ability of plan sponsors and financial institutions in operating plans that meet consumers' retirement security goals as by policymakers' effectiveness in addressing

agency risks and other weaknesses inherent to private pension markets. Governments are also expected to play a role as issuers of long-term securities offering protection against inflation and perhaps even through securities that insure the holder against extreme-longevity risks.

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About the Author

Juan Yermo was educated at Cambridge (M.A. Economics) and Oxford Universities (D.Phil. Economics). He is currently in charge of private pensions projects in the OECD's Financial Affairs Division. As the secretary of the Working Party on Private Pensions, a body that brings together policymakers and the private sector from the 30 member countries, he manages a broad research programme on various issues related to the operation and regulation of privately managed retirement income systems. He also helped establish the International Organization of Pension Supervisors and has participated in various technical assistance projects in Asia and Latin America. Previously, he worked at the World Bank Group as an economist, supporting analysis and loans related to capital markets and pension reform.