Original Article

Pension systems and the crisis: Weathering the storm

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Anna Cristina D'Addio

is an Economist in the pension team of the Social Policy Division of the Organisation for Economic Co-operation and Development (OECD), Directorate for Employment, Labour and Social Affairs. She has contributed to a number of publications on pensions, among which are the last two editions of OECD Pensions at a Glance. She has also worked on the decline of fertility rates in OECD countries, with a particular emphasis on the role of policies, and on the intergenerational transmission of advantages and disadvantages. Before joining the OECD, Anna has taught and carried out research in micro-econometrics applied to the labour market at the Center for Applied Econometrics (CAM) at the University of Copenhagen, the Department of Economics at the University of Aarhus, the Higher Institute for Labour Studies (HIVA, catholic University of Leuven), the Center of Operations Research and Econometrics (CORE) at the Catholic University of Louvain-la-Neuve.

Edward Whitehouse

leads the pension team in the social policy division of the Organisation for Economic Co-operation and Development. He is co-author of the OECD's flagship report on retirement incomes, Pensions at a Glance, whose third edition was published in July 2009. He also works in the Pensions Unit of the World Bank. He wrote the joint World Bank/OECD report, Pensions Panorama: Retirement-Income Systems in 53 countries, published in November 2006. He has worked on pension reforms in many countries, most recently Canada and Egypt. Previously, Edward was a leader writer and social affairs correspondent for the *Financial Times* and worked at the Institute for Fiscal Studies in London. He has taught at University College, London and Oxford University.

ABSTRACT The financial crisis and the deep economic crisis that it spawned have dominated the news for over a year. It appears that no country and no pension system are immune to the crisis. In this perspective, our article looks at the implications of the crisis for retirement-income systems. The actions that governments have already taken to mitigate the impact of the crisis are discussed. Further challenges for pension policy are also assessed. Despite huge short-term political pressures, it is imperative that governments resist expedient reactions threatening the stability and sustainability of retirement-income provision. The long-term challenges of demographic change and population ageing have not gone away and will still have to be faced once the crisis is passed and economies start to recover.

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INTRODUCTION

No country and no pension system are immune from the effects of the crisis. The economic and financial crisis has exacerbated the structural problems facing the pension systems of many countries because of population ageing. However, if the financial crisis is responsible for the

diminishing returns of pension funds, other factors put a strain on the budgetary balance of public pension plans.

Pension funds have seen the value of their investments fall in real terms by 23 per cent in 2008, some US\$5400 billion in total in the OECD countries. At the same time, production (as the latest OECD projections suggest) shrank by 3.6 per cent in 2009. Unemployment, which reached its lowest point in 2007 (5.6 per cent) could reach 9.1 per cent in 2010. Owing to the downturn and implementation of recovery plans,

Correspondence: Anna Cristina D'Addio
OECD, Directorate for Employment, Labour and Social Affairs, Social Policy Division, 2 Rue André Pascal, F-75775 Paris Cedex 16, France
E-mail: anna.daddio@oecd.org

Figure 1: Economic and fiscal impact of the financial crisis.
Source: OECD.¹

public finances plunged a little deeper into the red. The budget deficits in OECD countries are expected to attain 8.4 per cent of Gross Domestic Product (GDP) in 2010 (Figure 1). This means that many people, who have lost a substantial amount of their retirement savings from pension plans and other assets, are at risk of losing their jobs. This problem is particularly serious for older workers who not only encounter greater problems in the labour market, if they become unemployed, but also have little time to wait for their pension savings to recover.

Thus, what was originally a financial crisis is now an economic and social crisis.

How can OECD countries' pension systems weather this storm? How should retirement-income systems respond to financial and economic pressures? These are some of the questions this article will try to answer.

The next section discusses the effects of the financial crisis on the performances of the pension funds. The subsequent section focuses on the factors making the countries more or less exposed to the effects of the crisis. Later sections look more deeply into the consequences of the crisis for individuals with respect to their age and choice of pension plan and analyse investment risks in the pensions' context together with the approaches to reduce them. The sixth section focuses on the effects of the crisis in relation to old-age poverty. The seventh section reviews the range of possible policy responses to mitigate the effects of the current crisis. The penultimate

section discusses further challenges for the pension system, which need to be tackled to make the pension system more robust to future crises. The final section concludes the article.

PERFORMANCE OF PENSION FUNDS

In many countries, the collapse of stock markets has had profound effects on private pensions. Overall, in 2008, international stock markets (according to the MSCI) lost almost half their value and experienced much greater volatility than in the past. In contrast, the world government bond index (Citigroup) increased by around 7 per cent. Real estate markets have also declined in many OECD economies, sometimes dramatically. These assets, plus corporate bonds and deposits, represent virtually all investments of pension funds.

In 2008, pension funds saw the value of their total assets fall in real terms by 24 per cent on average in a number of OECD countries (see Figure 2). The largest decrease, around 38 per cent in real terms, was observed in Ireland, but the value of investments also fell by over one quarter in Australia and the United States. Pension funds have begun a partial recovery during the first half of 2009, generating positive returns of 3.7 per cent in real terms. However, on 30 June 2009, total assets of pension funds held back by 14 per cent compared to the level of December 2007.

Figure 2: Pension funds' real investment rate of return in selected OECD countries.
Source: OECD.²

These differences in investment returns can be explained by the composition of the portfolios of pension funds. In countries with smaller losses, pension funds tend to be invested mainly in bonds, especially government bonds. In countries with larger pension fund losses, there is a greater exposure to equities. This is illustrated in Figure 3, which plots the real investment returns against the proportion of the portfolio invested in equities. The latter is measured for 2007 to give an idea of the picture before the financial crisis hit: equities' portfolio share has obviously declined along with stock markets.

There is clearly a very strong relationship. Ireland has both the largest losses and the largest proportion invested in equities: two-thirds of the portfolio. Both equity shares and losses were also relatively high in Australia and the United States. Canada, Japan and the United Kingdom, all with large equity holdings of 50 per cent or more of assets, did not perform as badly. Most of the countries with the smallest losses in 2008 had bond-dominated portfolios: the equity share was just 6–12 per cent in the Czech and Slovak

Republics, Germany and Mexico, for example. However, it is important to bear in mind that over the long term, equities have delivered larger (although riskier) returns.

WHICH COUNTRIES HAVE BEEN MOST AFFECTED BY THE CRISIS?

In this situation and given the context, it is essential to know which countries are most affected by the crisis. The implications will be different according to the design and the structure of the pension system.

Pension systems in OECD countries are very complex and made up of different components. In the typology adopted by the OECD,^{3–6} there are two mandatory 'tiers': a redistributive part and a savings part. Redistributive components of pension systems are designed to ensure that pensioners achieve some absolute, minimum standard of living. Savings components are designed to achieve some target standard of living in retirement compared with that when working. Voluntary provision, be it individual or employer provided, makes up a third tier. Within these

Figure 3: Pension funds' real investment returns in 2008 and equity exposure in 2007.
Source: OECD.³

tiers, schemes are classified further by their provider (public or private) and the way benefits are determined (defined benefit or defined contribution, for example).

All these elements of pension systems have been affected by the crisis – although to a different degree. The countries most affected are those where the share of private pensions is larger (Figure 4). For today's retirees, the capital income account for more than 40 per cent of revenues collected under the pension in Australia, Canada, the United States, the Netherlands and the United Kingdom. In contrast, they represent less than 5 per cent in Austria, Hungary, Poland, Slovak Republic and Czech Republic. On average, in those countries, retirees draw one fifth of their income from private pensions. However, the importance of private pensions will increase in the future. This suggests that resilience to future crisis is necessary.

In addition, as it has been already shown in Figure 3, within those countries, the systems most affected are those who held the largest

shares of equities in their investment portfolio (Ireland, Australia and United States).

However, the effects also vary according to the type of pension schemes. The investment losses directly affect individual defined-contribution pension accounts; however, they have also profoundly affected the finances of defined-benefit pension schemes. Many private, defined-benefit schemes are in deficit: their current and future pension liabilities are larger than the assets that they hold. This is measured by the 'funding ratio', that is the assets of the fund relative to pension liabilities.

- *Belgium and Finland:* between the end of 2007 and the end of 2008, the average funding ratios fell from around 130 per cent to 115 per cent.
- *Ireland:* In December 2008, the aggregate funding ratio was 75 per cent, compared with 120 per cent a year earlier.
- *the Netherlands:* the funding ratio for nominal pension benefits fell from 144 per cent at the beginning of 2008 to around 90–95 per cent

Figure 4: The role of private retirement savings.
Source: OECD⁷ and OECD.³

in early 2009, according to the Department of Social Affairs. (This does not allow for inflation adjustment of either pensions in payment or the accrued rights of workers.)

- *Switzerland*: the funding ratios were 116 per cent on average at the end of 2007, but had fallen to 102 per cent by the end of 2008.
- *United Kingdom*: the average funding levels sank to 76 per cent in February 2009, compared with 97 per cent a year earlier and 118 per cent at their peak in June 2007 (Pension Protection Fund⁸).
- *United States*: the average funding ratio in 100 large schemes fell from 109 to 78 per cent in 2008, according to Watson Wyatt, a large consulting firm.

The private pension plans have thus suffered from the downturn in stock prices and real estates. However, it is important to emphasise that no country, no pension system is immune to the crisis. The public pension schemes will also be

faced with financial difficulties: the gains are put under pressure by lower wages and reduced working times. The consequences of this are a reduction of the revenues from contributions on pensions, an increase in the demand for unemployment benefits (among others) and for the expenditures with redistributive purposes. Reserve funds for pensions, where they exist, have also suffered losses on their investments. In addition, in some countries like Ireland and Norway, these funds are put to recapitalise banks and finance public works programmes under the policies implemented to address the crisis.

HOW THE CRISIS HAS AFFECTED INDIVIDUALS?

In order to assess the social impact of the crisis in the area of pensions, it is not sufficient to focus on pension funds alone. The average investment losses mask a wide range of effects on individual workers' and retirees' living standards. This article, therefore, focuses on individuals and

their vulnerability in old age rather than on institutions, such as pension funds. It discusses the impact of the crisis on different groups of workers and pensioners, distinguished by a number of criteria, such as the age of the individuals and the choice of pension plan.

What are the consequences to an individual? Many people who have lost a significant portion of their retirement savings invested in pension plans or other financial assets. The magnitude of the impact of crisis on retirees depends on the age of the individuals concerned (see Table 1).

The effects for most of the younger, but also prime-age, workers have been rather limited. Although they may suffer the effects of the economic crisis on the labour market, they have 30 years or more to offset the depreciation of their investments and the effects of an incomplete career.

In addition, people who have already retired will not suffer the effects of the crisis unless: (i) they are in defined-contribution pension plans and have not purchased an annuity or have deferred the acquisition of an annuity (which would have allowed them to endorse the earlier gains and receive an annuity); and (ii) pensioners in countries where pensions in payment are subject to automatic adjustments based on the solvency of the pension scheme.

By contrast, the workers nearing retirement are those who have suffered most from the economic and financial crisis, being among those who are most at risk of losing their jobs in times of slow economic activity and of experiencing long-term unemployment. These two events can lead to a permanent reduction of income as retirees, because of an incomplete career. Moreover, they cannot wait for the financial markets to recover in order to rebuild their retirement savings. Even delaying their entry into retirement would enable them to offset only a portion of the losses they suffered.

However, also for this category of individuals, the magnitude of the impact of the financial crisis depends on the composition of their portfolio. Some workers have moved their investments to less risky assets as they were approaching retirement and therefore protect the investments. However, most did not.

Table 1: Degree of effects on retirement-income provision by age group and pension plan

	Younger/prime-age workers	People near to retirement	Retirees
Strongly affected		Individuals in mature, private DC schemes (especially: (i) where exposure to riskier assets is greater; and (ii) where people are required to annuitise their balances at retirement)	Retirees who did not annuitise their DC balances at retirement (especially those with greater exposure to riskier assets)
Moderately affected		Individuals in mature, private DB schemes Public, PAYG systems with deficits	Retirees in plans with automatic benefit adjustments (for example, conditional indexation, balancing mechanisms, sustainability adjustments)
Less affected	Most individuals in this group	Individuals with recently established private DC schemes	Retirees who annuitised DC balances before the crisis Most retirees with DB private pensions or public, PAYG benefits

Abbreviations: DB, defined benefit; DC, defined-contribution, PAYG, pay-as-you-go financed.

Source: OECD.³

In the United States, for example, nearly 45 per cent of 55- to 65-year olds held more than 70 per cent of their private pension assets in equities, according to the Employee Benefit Research Institute. This is only a little below the 50 per cent with such a portfolio under the age of 55. In Australia, more than 60 per cent of people stick with the default investment option of their private plan, and equities typically make up around 60 per cent of this portfolio.

The financial crisis also had a direct impact on retirement incomes for people with defined-contribution plans. In Iceland, the Netherlands and Switzerland, private pensions are defined benefit (or a variant): the value of the pension depends on individual earnings and the number of years covered by the scheme. In Canada, Ireland, Sweden, the United Kingdom and the United States, private pensions were traditionally also defined benefit. There has been a shift towards defined-contribution plans in all these countries (although at different speeds). Still, many or most of older workers in these countries will get all or most of their pensions from defined-benefit schemes.

INVESTMENT RISK AND PENSIONS

The crisis has undermined the confidence in private pension schemes. However, pensions are long-term investment and basing decisions solely on the past year will be extremely myopic.

On the basis of a quarter century's data on performance of equities and bonds, the OECD has simulated real investment returns over the 45-year horizon of retirement savings. The results (in Figure 5) show a range of portfolios across the horizontal axis; from pure bonds at the left to pure equities at the right. The white line shows median returns: half the time returns will be above this level, and half the time below. For a 'balanced' portfolio – half each in equities and bonds – the median real return is 7.3 per cent. It is higher for a portfolio of equities (8.9 per cent) and lower for bonds (5.2 per cent). The shaded areas of the fan show the likelihood of different outcomes, based on past experience. With a balanced portfolio, real returns are

expected to be 5.5 per cent a year or less, 10 per cent of the time. Equally, they are projected to exceed 9.0 per cent a year also 10 per cent of the time. Equities clearly give a higher return at the price of greater risk.^{9,10}

Excluding more risk-adverse individuals, retirees should not give up to invest part of their retirement savings into equities. A strategy that may reduce the investment risk without excessively sacrificing returns is life cycle investing. This strategy involves a shift from riskier assets, like stocks, to products that are less exposed, such as deposits and bonds, as retirement approaches. Indeed, it would be sensible that this shift be automatic and be the default option. This would make the investment of most employees on 'autopilot' while preserving the freedom of choice of the minority who want to manage actively its investments.

Mexico and the Slovak Republic have an investment choice in mandatory private pensions, with riskier options unavailable to older workers. However, for the moment, even the riskier funds tend to hold less than 20 per cent of assets in equities. Poland will also introduce investment choice and life cycle investing. In the United States, life cycle funds have not had much success. Although two-thirds of plans offer them as a choice, only around a quarter of members hold these funds and they account for just 7 per cent of assets. This proportion might increase as new laws let plans automatically enrol people into life cycle funds. But, simply ensuring that life cycle options are offered has not provided broad coverage.

WILL THE FINANCIAL LOSSES LEAD TO AN INCREASE IN OLD-AGE POVERTY?

Many OECD countries have programmes that act as 'social automatic stabilisers' and mitigate the impact of financial losses on the overall income of retirees. Most public retirement-income programmes – basic pensions and earnings-related schemes – will pay the same benefit regardless of the outcome for private pensions. However, many resource-tested

Figure 5: Distribution of simulated annual average investment returns.
Source: OECD³ and D'Addio *et al.*⁹

schemes interact with the value of private pensions. In Australia and Denmark, for example, most current retirees receive resource-tested benefits. The value of these entitlements increases as private pensions deliver lower returns, protecting much of the incomes of low and middle earners. The withdrawal rate of the benefit against other income sources is currently 40 per cent in Australia and 30 per cent in Denmark. In Australia, for example, each extra dollar of private pensions results in a 40-cent reduction in public pension. Conversely, a dollar less in private pensions results in 60 cents more from the public pension. More than 75 per cent of older people in Australia and around 65 per cent in Denmark receive at least some benefit from resource-tested schemes. The proportion of older people receiving such resource-tested schemes is also relatively high in Canada, Ireland and the United Kingdom (20–35 per cent). Low earners will have their overall pensions protected by resource-tested programmes. In some countries, however, the social safety nets for the elderly may be insufficient and therefore may be necessary to strengthen temporarily the social protection measures to overcome the current crisis.

However, not all resource-tested schemes use incomes from private pensions in calculating entitlements. The value of the guarantee pension in Sweden, for example, currently received by more than half of retirees, depends only on the value of the public, earnings-related scheme (which has a notional-accounts formula). Losses in private pension savings are thus not compensated for Swedish pensioners.

A second automatic stabiliser of net retirement incomes, faced with investment risk, comes through the personal income tax. In most OECD countries, pensions in payment are taxable. An average earner could expect to pay about 30 per cent of his or her pension in tax in Denmark and Sweden. In Belgium, Germany and Norway, the average earner would pay about 20 per cent of retirement income in taxes and this figure is around 15 per cent in Hungary and Poland. If investment returns turn out to be poor, then governments will collect less in taxes on pensions. The result is that individuals' net retirement incomes will fall by less than the decline in pension funds' asset values. In contrast, pensions are not taxable in the Slovak Republic and special credits, allowances and reliefs for pension income or for older people mean that only retirees with very large incomes from voluntary

pensions would pay much in income tax in Australia, Canada, Ireland, the United Kingdom and the United States.

Putting these two effects – taxes and resource-tested benefits – together, automatic stabilisers have much the largest effect in Denmark. The dampening effect on net retirement incomes is also substantial in Belgium, Poland and Sweden and is large in the United Kingdom and the United States.

WHAT ARE THE ISSUES AND POLICY OPTIONS FACING THE CRISIS?

Pension systems might play a part in helping recovery from the crisis. First, public pensions could be beneficiaries of fiscal measures to stimulate the economy. Second, many countries have large accumulations in private pension plans and public reserves. Third, private pension funds continue to play an important role in financial markets as long-term investors. Public pensions are, therefore, part of economic stimulus packages that have been announced in some countries. And, pension systems have undergone many changes as a result of the crisis.^{5,11}

Some countries have created special payment to the elderly. In the United Kingdom, for example, additional payments to pensioners, of at least GBP 110, have already been made and indexation of the basic pension and the pension credit, targeted at the low-income elderly, will be more generous, the latter at a cost of GBP 300 million a year in 2009–12. The economic stimulus in Australia also includes extra payments to pensioners. A one-off payment of AUD 1400 was paid to single pensioners and AUD 2100 to couples in December 2008. The United States will pay US\$250 to all recipients of public pensions in May 2009 at a cost of US\$13 billion. Greece has also made a one-off payment to people on low incomes, including pensioners, of between EUR 100 and EUR 200.

Old-age safety nets

These countries and many others have also tried to improve the retirement benefits in the long term. Finland has proposed the most significant

change: a new safety net from 2011 to ensure that pensioners receiving less than 685 euros monthly be given an income 23 per cent higher than that provided currently. Other countries, such as Australia and Spain, will increase the minimum pensions beyond indexation rules. Belgium, Korea, France and the United Kingdom have also adopted similar measures. In Spain, for example, the increase is 6.4 per cent.¹²

In all these cases, the additional help will be worth most to low-income pensioners, which should help reduce old-age poverty. In Australia, for example, poverty of older people is more than double that of the population as a whole, and the old are also more likely to be poor in Greece. Other countries with high rates of old-age poverty might also consider additional short-term payments to older people as part of economic-stimulus packages.

As a matter of fact, the financial and economic crisis highlights and exacerbates the issue of safety-net benefits in retirement for workers with low earnings and career gaps. Figure 6 shows net replacement rates for full-career workers with earnings of half the national average.¹³

Spain has the same net replacement rate for low earners as the OECD average: 82 per cent. In six countries, the net replacement rate for low earners is above 100 per cent, meaning that net income is higher during retirement than when working. However, net replacement rates are less than 60 per cent in Germany, Japan, Mexico and the United States. Bearing in mind that this calculation is for a low earner, the earnings being replaced are already half of the economy-wide average: old-age safety nets in these countries are relatively weak.

Once a spell of late-in-life long-term unemployment or early retirement is also factored in, retirement incomes can be lower still. With weaker labour markets, many older workers may be forced to retire early or suffer long-term unemployment. Belgium, Finland, France, Korea, Spain and the United Kingdom have recently decided to improve old-age safety nets (not included in these calculations). Some other countries, which have weak old-age safety nets, should also consider action.

Figure 6: Old-age safety nets: net replacement rates for full-career workers with 50 per cent of average earnings (Percentage of individual net earnings).
Source: OECD.³

Early access to retirement savings

A less orthodox policy of ensuring that fiscal stimulus supports domestic demand is early access to retirement savings.

- Australia permits people to use their private pension savings to avoid foreclosure on their houses when mortgage payments are in arrears. Access to the pension accounts is controlled to ensure that all other options for dealing with mortgage arrears have been exhausted. It is difficult to argue that people should have ring-fenced retirement savings while losing their homes.
- Early access to account balances in the 'special pension' plan will be allowed in Denmark. Balances are relatively low – DKK 14 600 or US\$2600 – because the contribution rate is just 1 per cent of earnings and contributions have been suspended since 2004. The government expects around a quarter of people to withdraw their balances.
- Iceland will allow people to access their retirement savings in occupational plans beyond those needed to finance the mandatory replacement

rate. They will also be able to use funds generated from voluntary contributions to relieve financial distress. The Ministry of Finance¹⁴ estimates that around ISK 75 billion will be accessible, equivalent to more than 5 per cent of GDP. The replacement rate from the mandatory private pension in Iceland is well above the OECD average, and so there is no harm to adequacy of retirement incomes from allowing access to these additional retirement savings.

- In the United States, around 90 per cent of members are allowed to take loans from their 401(k) accounts. In 2007, only 18 per cent of those eligible had taken a loan and the average size was only 12 per cent of the account balance.¹⁵ Both figures have remained fairly constant over time, despite cyclical fluctuations in the economy. Detailed analysis suggests

The effectiveness of these measures seems limited because the people with more than enough retirement savings are less likely to get into financial difficulties when they are working. Care is needed to ensure that people do not

unduly threaten their retirement incomes, but early access to pension savings should not entirely be off the menu of policy options.

Bail-out individual pension accounts

Another option available to governments is the 'rescue' of individual retirement accounts. The case for government intervention rests critically on the design of the retirement-income system. It is weaker in countries where there is a sizeable public pension. Where people have investment choices – particularly where there is a default that shifts to less risky assets as people near retirement – there is also less of an argument for intervention. Working in the opposite direction, governments may have a moral, if not a statutory, duty to help where defined-contribution pensions are mandatory rather than voluntary and annuitisation at retirement is obligatory.

A direct bail out, paying money into people's pension accounts, could prove to be very expensive. In addition, this cost would come at a time when the public finances are being squeezed by recession and economic-stimulus packages. The OECD expects that average government net borrowing in member countries will increase from a low point of 1.3 per cent of GDP in 2006 to 8.2 per cent in 2009 and 8.4 per cent on 2010. Moreover, in the short term at least, the money from a bail out of pension accounts would go into savings and, therefore, would provide little support for domestic demand during the recession.

In contrast, providing support to the retirement savings of those most affected by the crisis through the public pension system would have the advantage of spreading the cost over time. The payments would be made over the period of an individual's retirement rather than in one go either now or at the time of retirement. This would also allow for greater efficiency and flexibility: support could be targeted on low-income retirees, for example.

There is also a risk of moral hazard resulting from a direct bail out of pension funds. This is because the expectation of a bail out the next time something goes wrong will encourage people to behave more riskily once the current

crisis is over. A bail out would make most sense for people who are close to pension age. However, this poses great political difficulties. If it were restricted, say, to people within a few years of normal pension age, then workers just slightly younger than the cut-off age would feel cheated. Similarly, retirees who annuitised their pension only recently, locking in financial market losses, would complain if their contemporaries who kept their money in financial markets were to be compensated.

For these reasons, *ad hoc* guarantees of investment returns or compensation for losses in asset values should be avoided.

Issues of equity and the fiscal impediments to paying money directly into pension funds, mean that governments should, instead, rely on their public-pension schemes to ensure that negative returns on pension funds, over one year, do not translate into widespread old-age poverty for one generation of retirees. Paying any compensation, as a public pension benefit spreads the cost over the period of retirement of the individuals involved, reduces political tensions and alleviates problems of moral hazard.

OTHER CHALLENGES OF PENSION SYSTEMS

Political pressures exerted on governments to act in the short term are substantial and go beyond mere prevention of poverty among the elderly. The expected rise in unemployment could push the authorities to relax the rules or the management of early retirement or disability pensions. Experience has shown that the effects of these measures in the medium and long term on the labour market are negative. Such measures would send a wrong signal and would defeat the objective of raising the effective age of retirement, which is necessary to offset the effects of ageing. So far, member countries of OECD have resisted such pressures: vigilance is, however, set to avoid the pitfall of using early retirement and disability pensions to hide unemployment.

More worrying is evidence of reversal of pension reforms. For example, the Slovak Republic has prompted employees to return

to the public pension system instead of transferring some of their contributions into defined-contribution private pension schemes, and new entrants to the labour market are no longer required to adhere to private funds while membership in the public system is the default. This is an irreversible decision that will affect retirement-incomes in the long term. This change is because of budget problems in the short term. (To overcome these difficulties, a solution might be to temporarily reduce contributions to private pension plans. Although no OECD country has opted for this strategy, Estonia, Latvia and Lithuania, for example, will probably follow it.)

These policies undermine the stability of the pension system. First, demand for policy changes will simply recur. Although in the current gloom it may seem blindly optimistic, if investment returns were to be plus rather than minus 25 per cent in a couple of years' time, people might wish to switch back to the private scheme with retrospective effect. Second, if people are able to buy back their public pension rights, using the diminished asset values in their private plans, this will give a short-term boost to the public finances as the funds are transferred. Many cash-strapped governments would welcome this short-term gain. But, the cost to public pension spending will be greater in the medium- and long-term than the short-term gain.

Some member countries of the OECD – including Germany, Canada and Sweden – have put in place mechanisms for automatic adjustment of pensions to ensure the long-term financial sustainability of their pension systems and the challenge of an ageing population. These could be termed 'automatic destabilisers' as they have the reverse effect of the automatic stabilisers described above. Although they protect the finances of the pension scheme, they do so at the cost of varying individual retirement incomes. In each case, the adjustment comes primarily through the indexation of pensions in payment. However, current workers' accrued benefits can also be affected. A similar mechanism operates in the defined-benefit occupational pension plans in the Netherlands.

These mechanisms link pension expenditures to life expectancy, higher wages or assets of the fund and have been designed in times of steady economic growth. They – if not overridden – might result in reductions in real benefits for current pensioners. This is because of a mix of the effects of the financial crisis on investment and the impact of the economic crisis on earnings and employment. Lower pension benefits might operate against any economic stimulus to maintain consumption during a recession. A temporary suspension of these adjustments is already in place in Germany, and other countries might want to follow suit. However, this would be more difficult in the Netherlands, as these adjustments relate to funded, defined-benefit occupational plans.

However, it is unfair to single out these four countries: other countries' retirement-income systems face the same fiscal and financial constraints. It is just that they do not have automatic mechanisms to adjust pension entitlements in such bad times.

The financial crisis has also brought issues of investor information and financial education to the centre of the debate again. Most individuals are not well informed about pensions, lacking both general facts about the pension system's structure and specific data on their own pension entitlements. This applies to pension systems of all types. Private pension plans often place greater responsibility on individuals for planning their retirement income than public programmes. For example, people might need to choose between a range of competing pension managers or between different investment portfolios. And, in many pension reforms, individuals had a choice over whether to join the defined-contribution pension scheme or to remain in a public, earnings-related scheme. Effective disclosure by providers and broad-based financial education programmes can help people make informed choices about their retirement provision.

This is highlighted in the current crisis, when the risk is that people make decisions based on short-term conditions that have negative implications over the long term. As a matter of

fact, the crisis has undermined public confidence in private pensions, bringing with it the risk that people will be more reluctant than ever to save for old age.

CONCLUSIONS

It is a time of sinking asset prices, shrinking economic output and rising unemployment in nearly all OECD countries. The short-term political pressures on governments to respond are huge. But, it is important to resist expedient reactions that threaten the long-term stability and sustainability of retirement-income provision. It is also crucial to keep in mind that the long-term challenges of pension systems – resulting from demographic changes and ageing of the population – have not disappeared and are even exacerbated by the economic and financial crisis.

Owing to the financial crisis, the investment risk is a central concern of public authorities. However, other economic, demographic, financial and social risks matter for pensions. In fact, pensions are a long-term issue because on average 60 years separate the first time the contributions are paid and when the last pension benefits are perceived. They are, therefore, intrinsically risky.

The problems for private pensions arising from the financial turmoil are not a sufficiently good reason for replacing private pensions with public provision. Many countries are already in a weak fiscal position, which is projected to worsen further as economies slow. The emerging costs of population ageing on healthcare, as well as pension systems, mean that such a policy would threaten medium- and long-term sustainability of the public finances.

It is important to highlight that risk zero does not exist. The best approach to pension provision is therefore to use a mixture of sources of retirement incomes, including both public and private, as well as the two main forms of financing (pay-as-you-go and funded) pensions. Relying solely or largely on one source in the face of different kinds of risk is imprudent.

The OECD has long advocated diversified retirement-income provision, arguing that 'diversity has many virtues'.¹⁶ The report on

Maintaining Prosperity in an Ageing Society also stated that 'each of the elements of the system has its own strength and weaknesses and a flexible balance among them not only diversifies risk but also offers a better balance of burden-sharing between generations'.

To avoid any backtracking on pensions, it is necessary to restore confidence in private pension savings and demonstrate convincingly the soundness of a diversified pension system. The diversity in this area is the best way to provide security for the elderly. The current crisis highlights the relevance of this message.

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