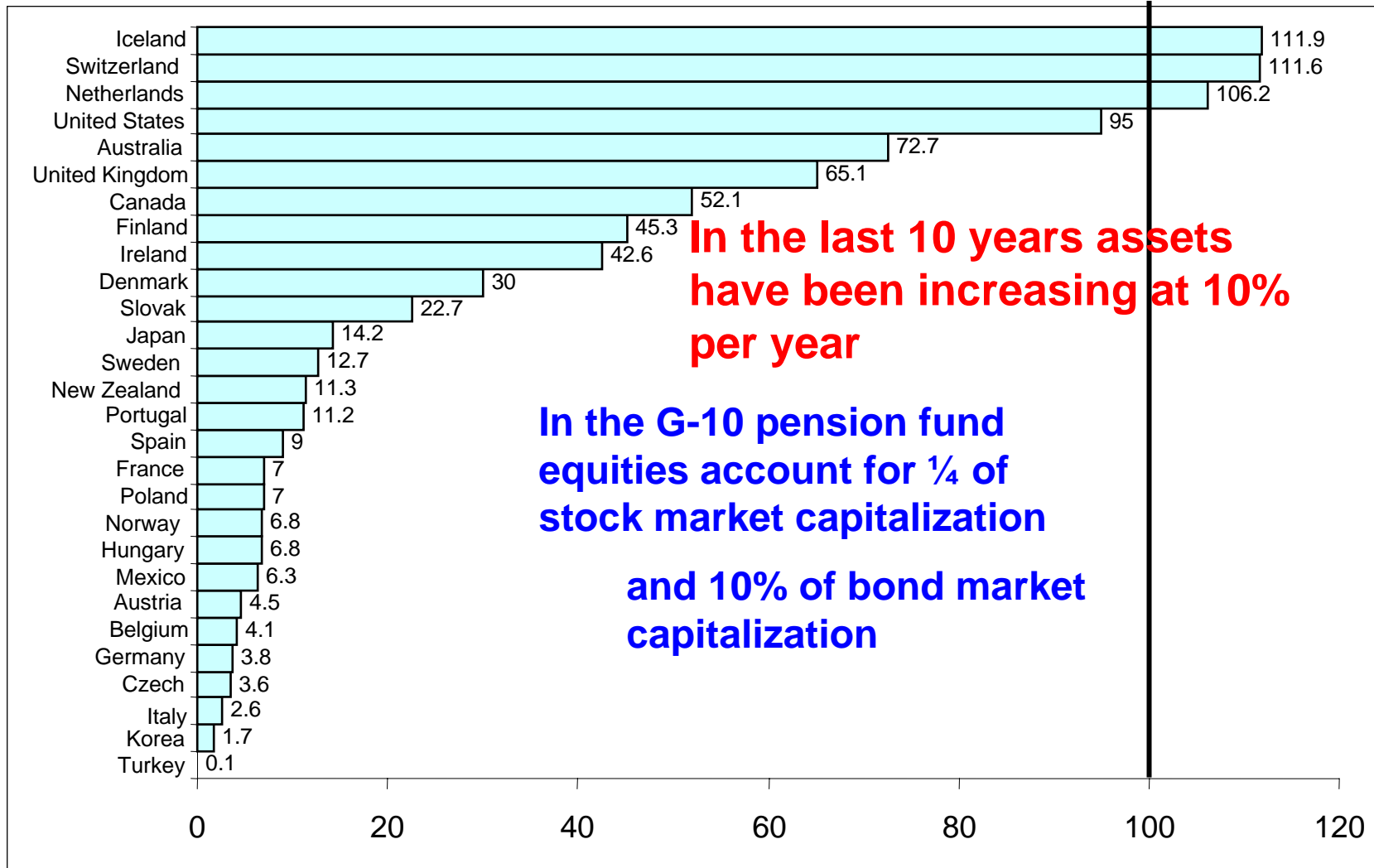


# Dealing with the New Giants

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Benoît Cœuré, Andrew Roberts*

# Pension funds assets (% of GDP)



Source: OECD, Pension Markets in Focus, 2005

# Outline of the Geneva Report

1. Facts about the pension fund industry
2. Looking into the black box: the optimal organization of a pension fund
3. Market-based solutions to match pension liabilities
4. Optimal risk-sharing arrangements
5. Labor market perspective

## One-handed approach

We take a stance in the debate on:

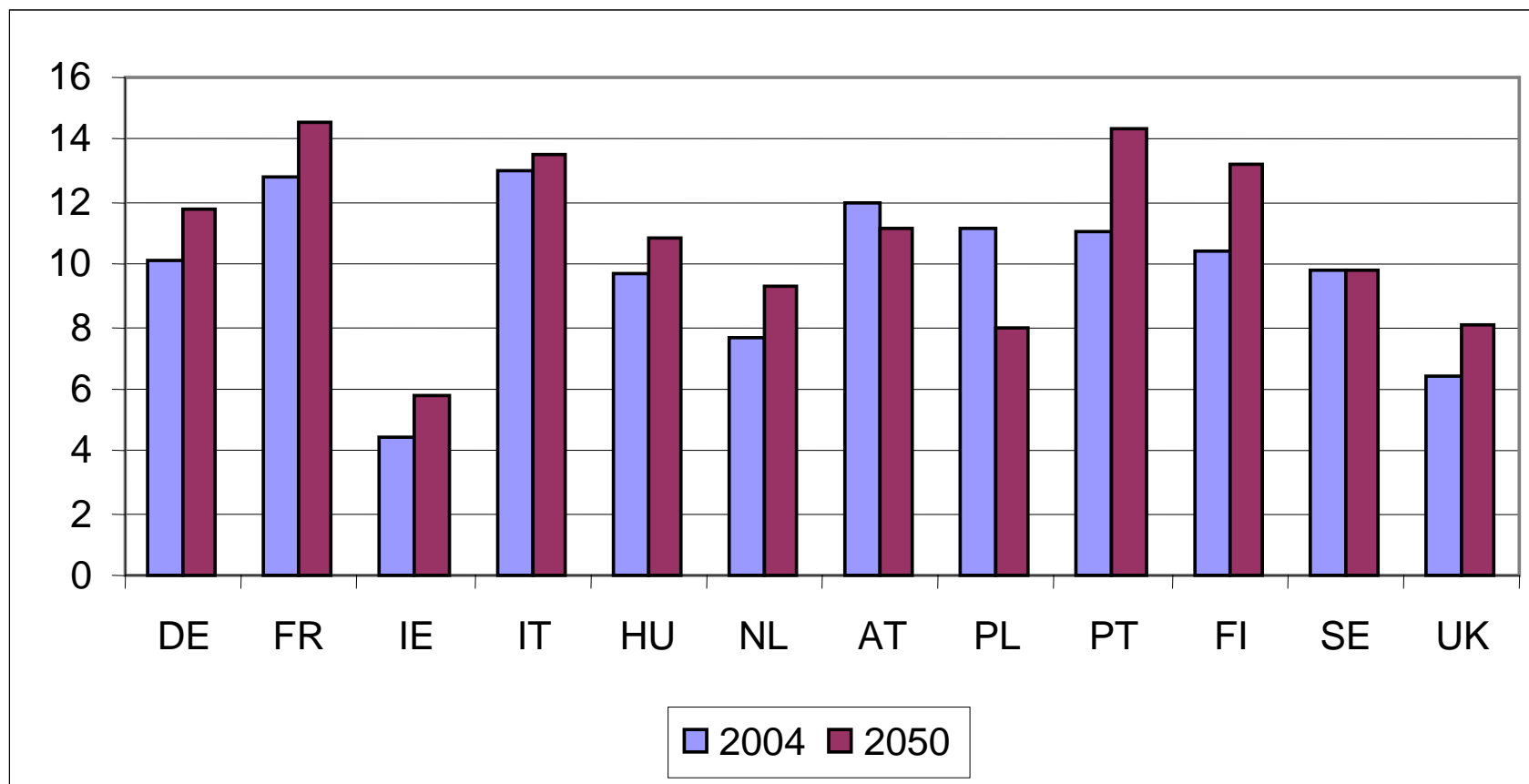
- Reforms of PAYG systems and labor markets
- Governance of pension funds and financial literacy
- Accounting and funding standards
- Risk-sharing arrangements and human capital investment

# Our recommendations

We take a stance in the debate on:

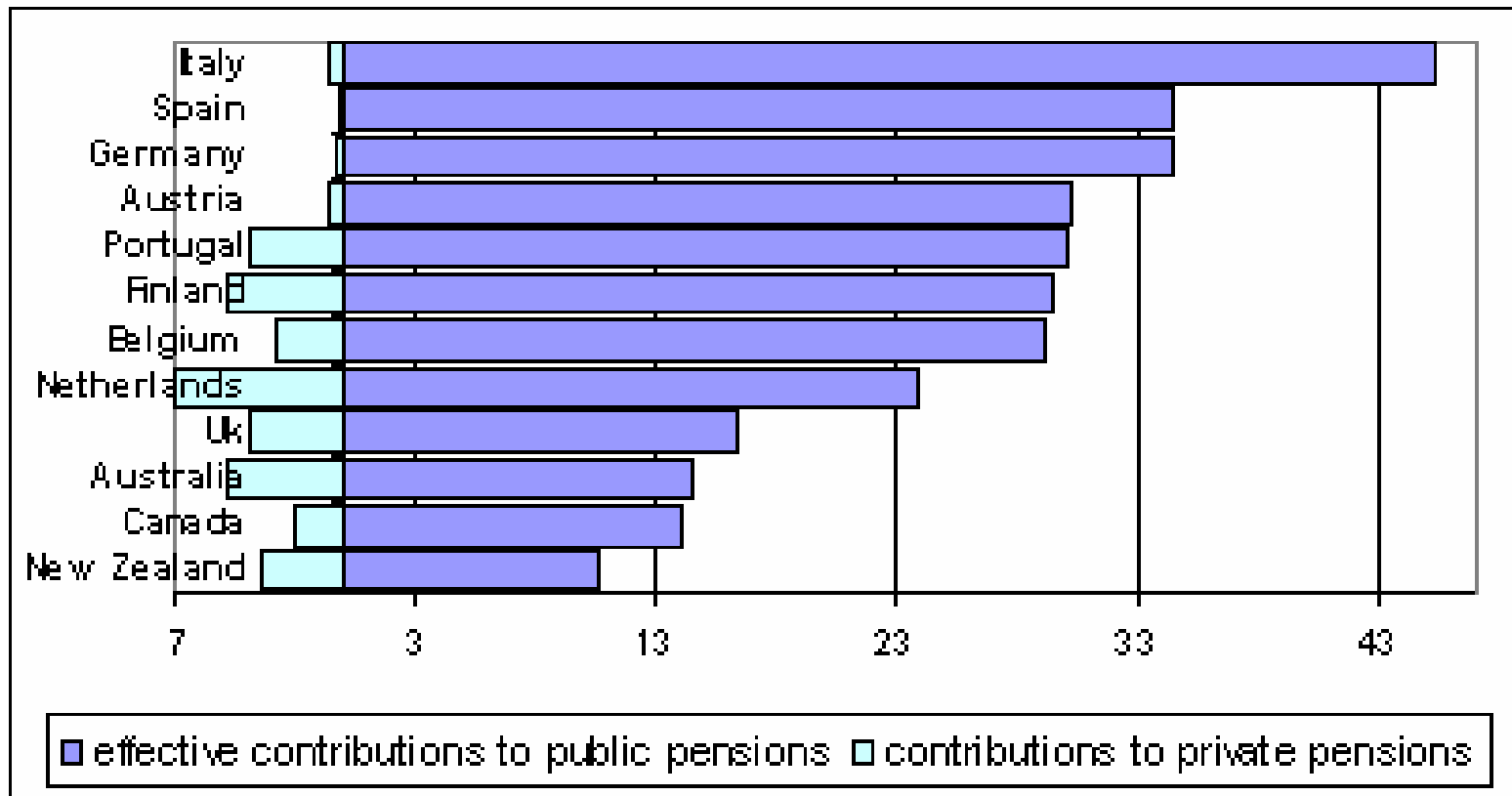
- **Reforms of PAYG systems and labor markets**
- Governance of pension funds and financial literacy
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## *Reform PAYG in order to reduce effective contributions*

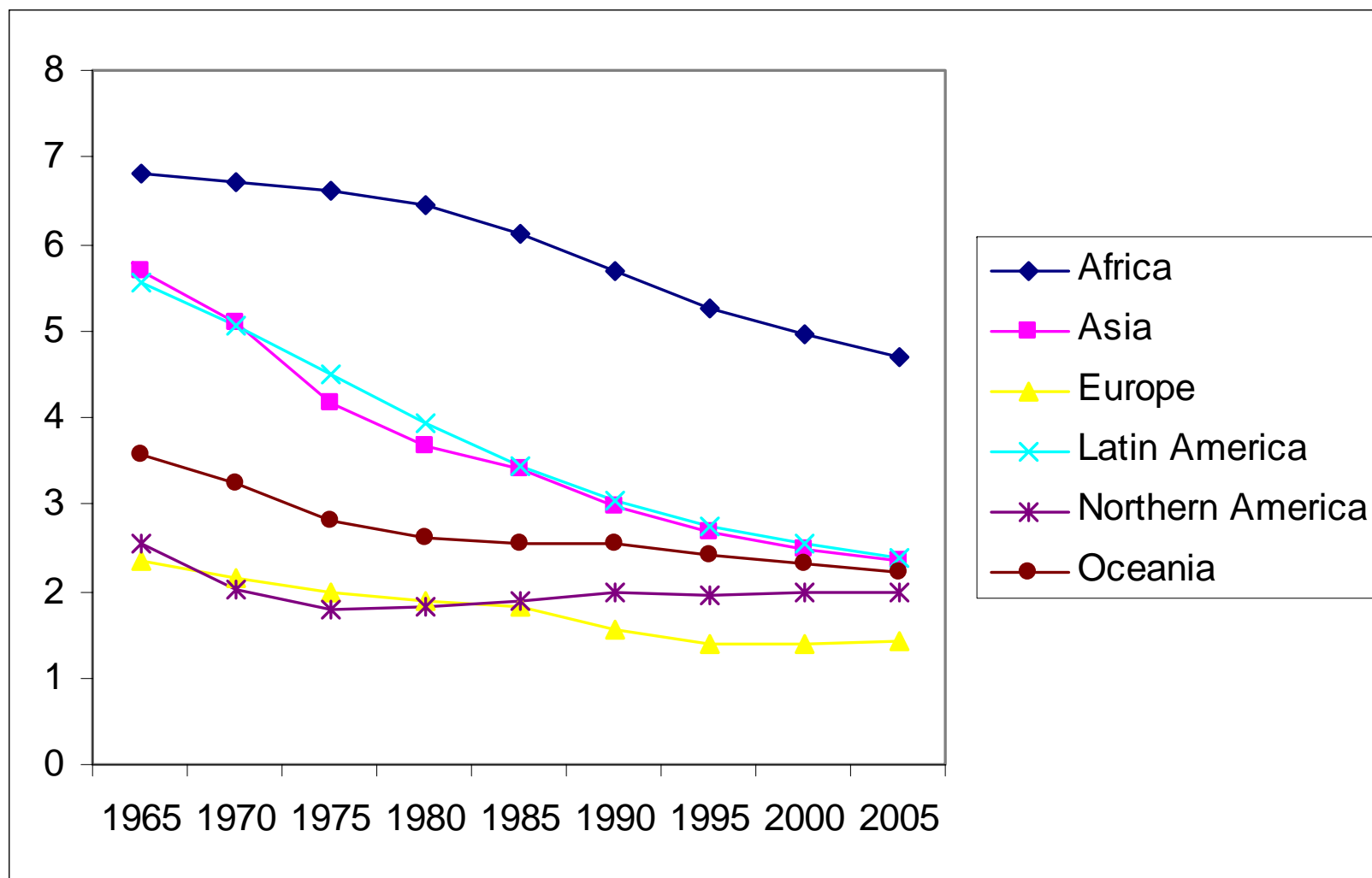


Equilibrium contributions as a % of GDP

# As large contributions to PAYG crowd-out private pensions...



# ..preventing diversification of risk (funded schemes can better cope with fertility risk)



Source: UN Population Division



# But reforms of PAYG are mostly going the other way round

Reforms of Public Pensions in Europe, 1986-2002

	<b>Decreasing Public Pensions</b>	<b>Increasing Retirement Age</b>	<b>Increasing Contributions</b>	<b>Increasing Generosity</b>
<b>Number of Reforms</b>	33	26	23	42

## ***Reform PAYG via automatic adjustments***

- Lengthy political decisions prevent timely adjustments of PAYG systems to demographic shocks
- And lags in adjustment crowd-out funded schemes
- Use automatic adjustment. Example: In notionally defined contribution systems, annuities can be indexed to life expectancy

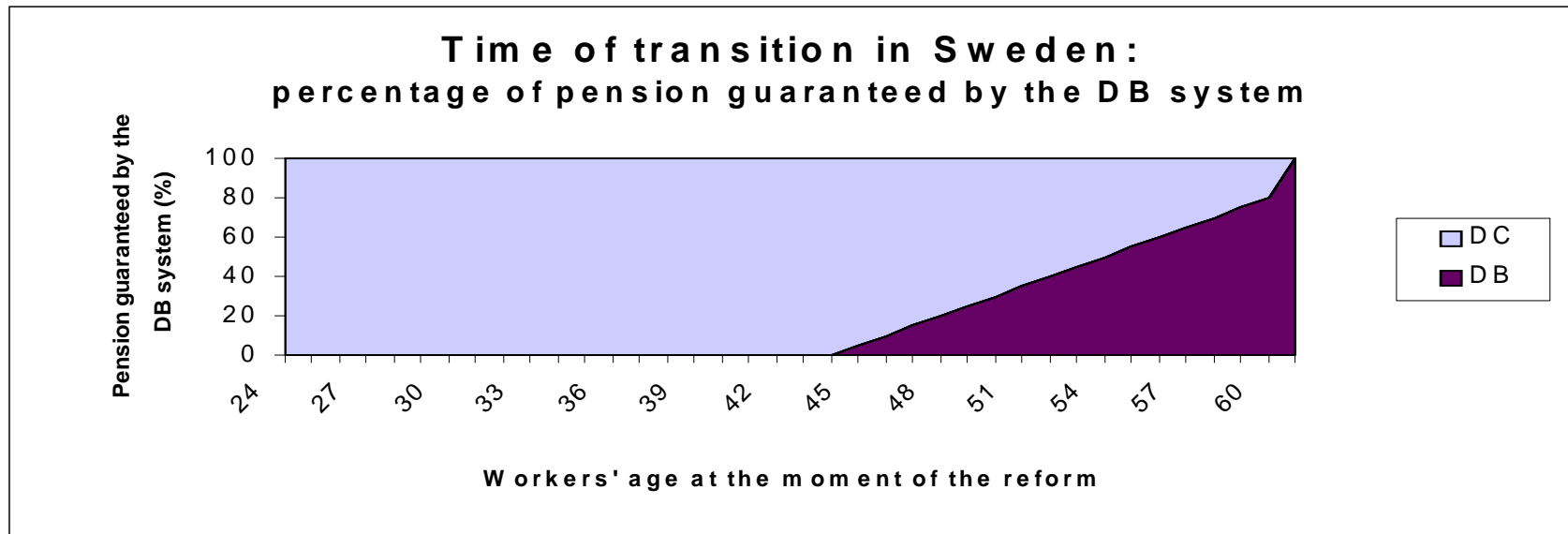
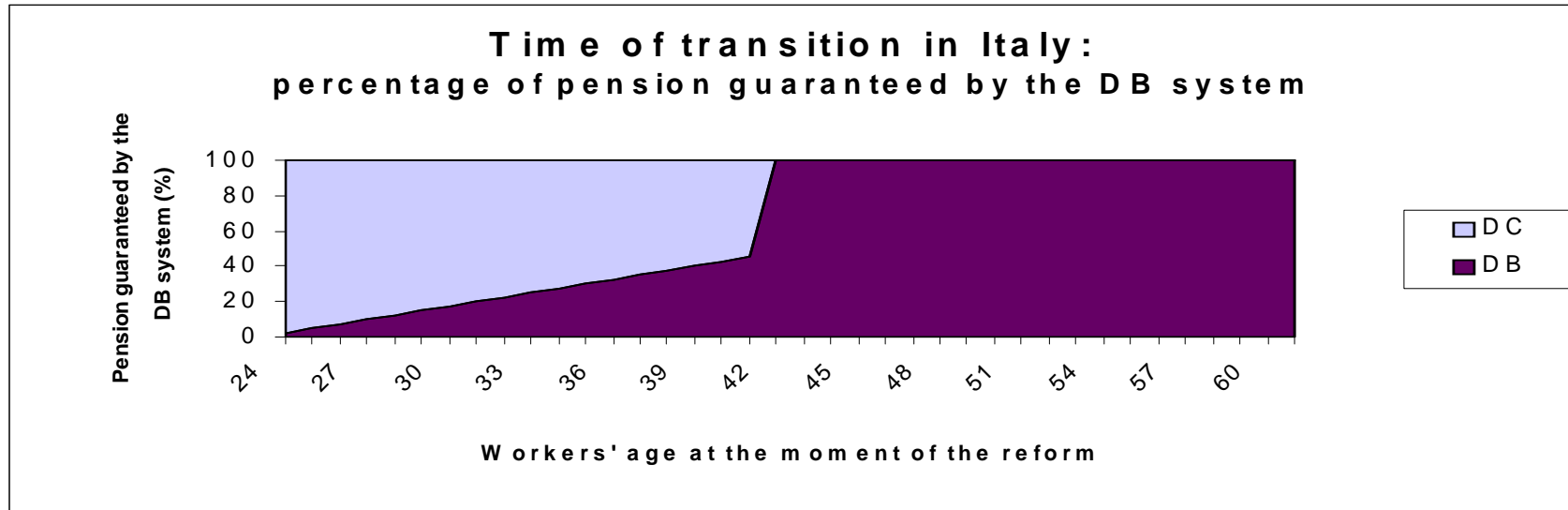
## ***Introduce notionally defined contribution systems***

- NDC systems mimic funded DC systems
- Easier for workers to compare returns of the two systems and manage their pension portfolio
- Worker as residual risk bearer: more responsible about retirement savings
- More flexibility in retirement decisions
- Better labor market incentives

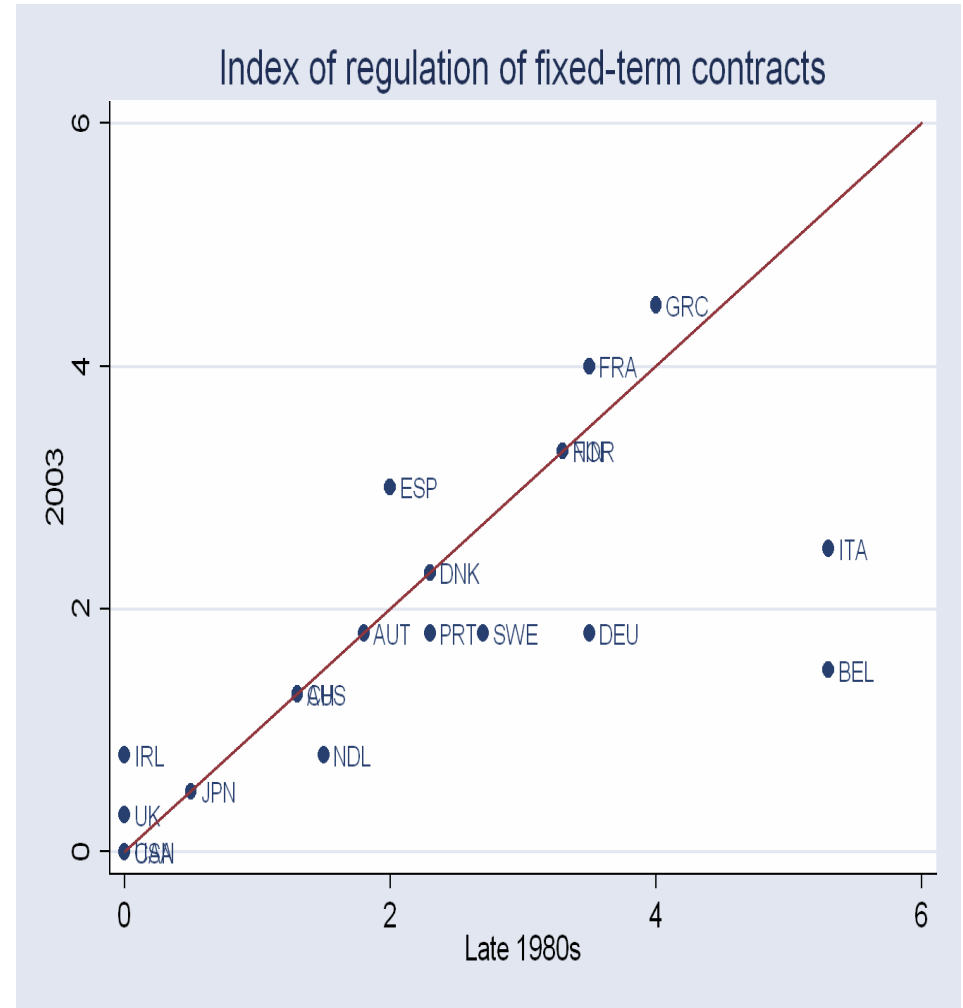
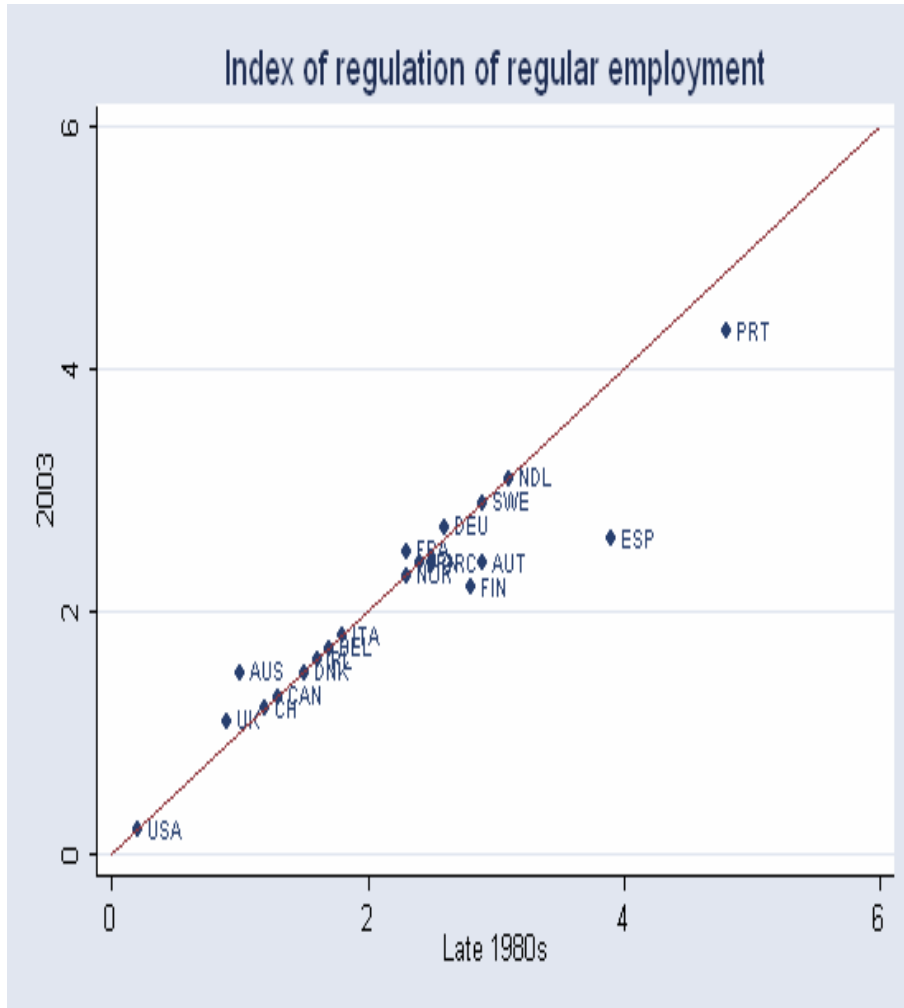
## ***Allow youngster to accumulate rapidly pension rights in collective schemes***

- Politically feasible reforms of pensions and rigid labor markets created dual regimes in pension entitlements, job security (temporary vs. permanent) and wages
- New problem of sustainability related to breaks in career and lower contributions (e.g., temporary worker in Italy after 40 years receives a pension of less than 5,000 Euros per year)
- Collective arrangement schemes should treat differently young and old generations. Hybrid DC (for young) - DB (for older people) schemes.

# Two-tier regimes in pension reforms



# Two-tier reforms in labor markets



# Our recommendations

We take a stance in the debate on:

- Reforms of PAYG systems and labor markets
- **Governance of pension funds and financial literacy**
- Accounting and funding standards
- Risk-sharing arrangements and human capital investment

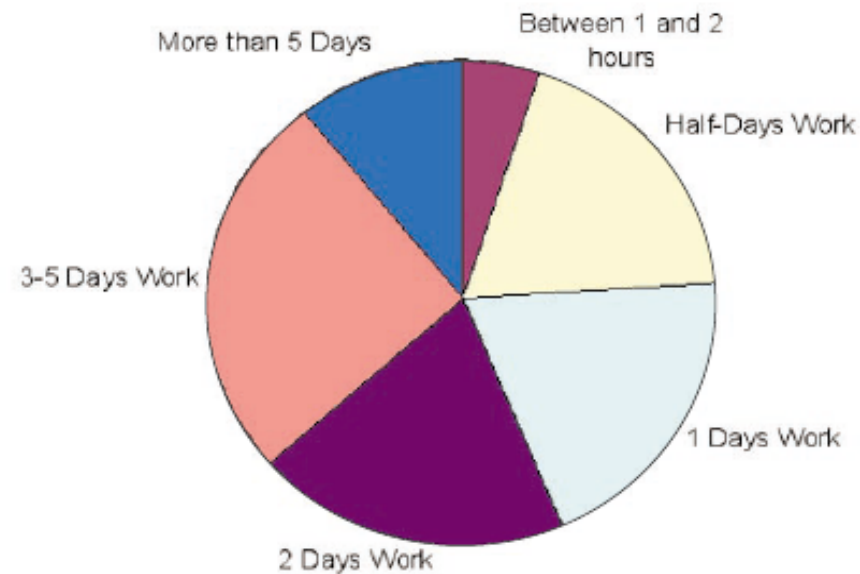
## ***A stand-alone, two-tiered governance of pension funds***

- Pension funds should be organized on a stand-alone basis (or at least be ring-fenced) with i) supervisory and ii) executive boards
- *Voted* employees representatives, organized in trade unions, should be represented in supervisory boards only
- Pension funds should exert their control rights on the companies they have a stake in, but at the level of investment managers only



# ***Train the trustees, include outside professionals, and limit reliance on pension fund advisers***

Time devoted to their role by UK pension fund trustees (per month)



Source: *Greenhalgh and Campion, 2005*

## ***Provide financial education ... and default investment options***

- Evidence of widespread financial illiteracy among older Americans and those with less financial education do not plan for retirement
- Risk of pension mis-selling
- Need to develop financial education
- Encourage collective pension plans with a few default options

# Define minimum standard for reporting ("Orange Envelopes")



## **You can receive a pension from more than one source**

Besides their national pension, many people also receive a pension from elsewhere. This may be an occupational pension from their employer or perhaps a pension from their own private pension saving. This money is not described here, but it makes your total pension higher.

## **If you draw your national pension from**

age 61: With 0% growth you receive SEK 8,800 per month      With 2% growth you receive SEK 13,000 per month

age 65: With 0% growth you receive SEK 11,600 per month      With 2% growth you receive SEK 18,400 per month

age 70: With 0% growth you receive SEK 16,700 per month      With 2% growth you receive SEK 29,300 per month

*Example:* Your national pension at age 65 and zero per cent growth consists of: SEK 9,400 income pension (incl. any supplementary pension) and SEK 2,200 premium pension (for the calculation assumptions for premium pension, see *Forecast* in the Glossary).

## **Make your own forecast on the internet**

Go to [www.pension.nu](http://www.pension.nu) and use the amounts below, which come from pages 2 and 5 of this annual statement:

SEK 702,476

SEK 18,385

## **Would you like more information?**

Visit [www.pension.nu](http://www.pension.nu) (the Insurance Office) or [www.ppm.nu](http://www.ppm.nu) (the Premium Pension Authority). You can also phone the Insurance Office's help line on 020 – 524 524.

# Our recommendations

We take a stance in the debate on:

- Reforms of PAYG systems and labor market policies
- Governance of pension funds and financial literacy
- **Accounting and funding standards**
- Risk-sharing arrangements and human capital investment

## ***Value DB liabilities on a mark-to-market basis and encourage market innovations***

- Provides transparency and market discipline
- Allows for market-based risk management
  - Get rid of interest rate, inflation and currency risk through overlay derivatives
  - Once overlay strategies are in place, ‘free’ asset allocation
    - Move back to equity
    - Diversify into new asset classes (e.g. private equity, commodities)

## ***Harmonize standards at a global scale***

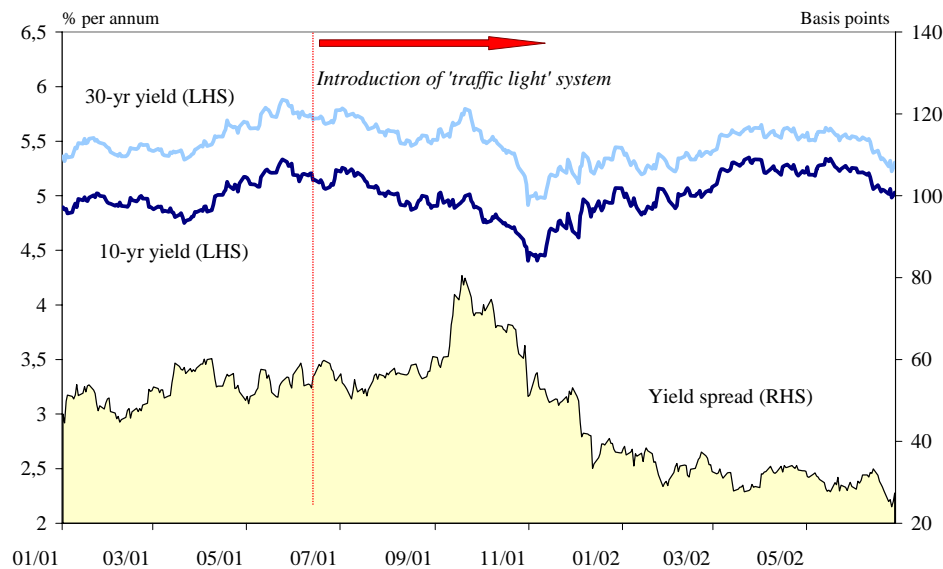
- Harmonize accounting and funding standards
  - Among each other (e.g. regulatory standard versus IAS19)
  - And across countries
- Valuation
  - Need to move to single (e.g. swaps) reference
  - Nominal funding requirements but real ambitions

## ***Limits to liability driven investment***

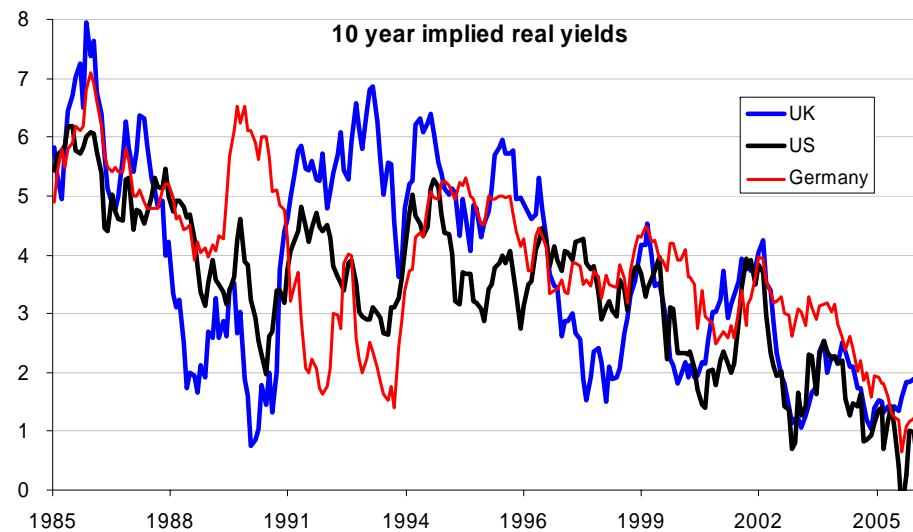
- Risk is piling up on banks balance sheets
  - Few payers of longevity, inflation, duration risk
  - Financial stability issue
- Danger of pro-cyclicality (flexibility versus discipline)
  - Falling bond yields have widened funding gaps and *increased* demand for bonds
  - Anomalous bond yields distort asset prices and confuse monetary policy
  - Low interest rates may raise saving and reduce investment
  - Demand-supply imbalance for long-dated and inflation-linked bonds
    - Obstacles to corporate issuance and limits to governments flexibility
    - Weakening of fiscal discipline
- Conclusion: Risk should be shed *within* pension funds

## The Danish experiment: Impact of 'traffic light' system on euro bond yields

## The secular shift in global bond yields



Source: *Ecwin*



Source: *Datastream*

- Real yields = nominal yields – CPI



# The demand-supply mismatch for long-dated bonds

All amounts in Million US\$	Outstanding supply		Potential demand	
	Corporate and Government bonds (10+ yrs)	Corporate and Government IL bonds (10+ yrs)	Pension fund assets	Assets as a proportion of total current supply (assuming 70% are allocated in bonds)
US	865,014	87,218	8,123,000	597%
EMU	820,725	51,212	1,274,000	102%
UK	497,182	71,352	1,621,000	200%
Japan	430,441	0	3,235,000	526%

Source: Watson Wyatt, Merrill Lynch global index system.

- EMU pension fund assets an aggregate of Netherlands, Germany, France, Ireland.

- Inflation-linked bonds outstanding calculated at face value.

# Our recommendations

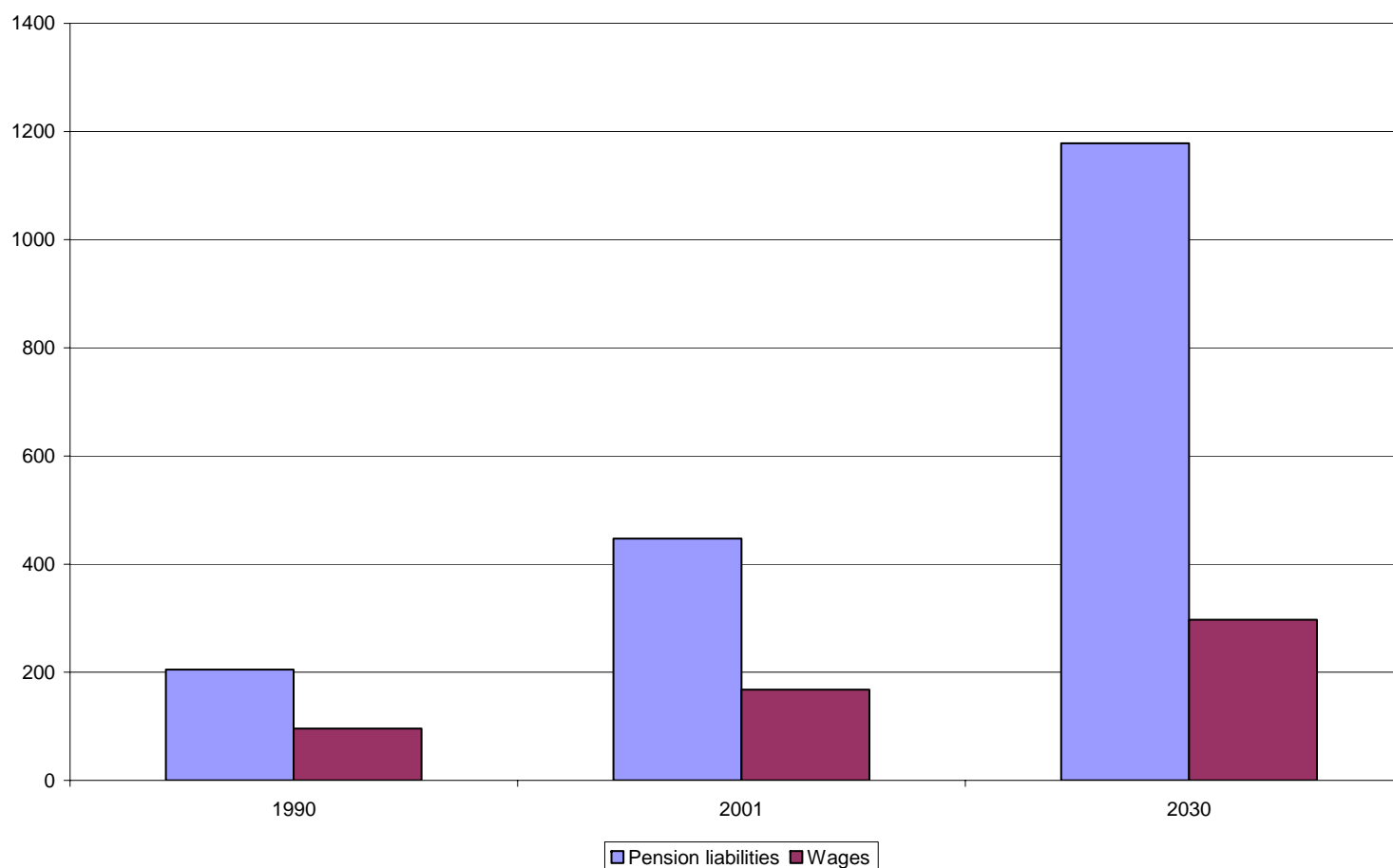
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## ***Develop explicit pension contracts within stand-alone pension funds***

- Firm-sponsored DB plans belong to the past
  - Guarantees have become so expensive that they dominate core business
  - Conflicts of interest, multitask monitoring
- Case for stand-alone, collective pension funds
  - Participants can share risks internally and exploit capital markets to shed risk externally
- Need for explicit contracts on how participants share demographic and financial-market risks
  - State-contingent rules
    - In which role recovery premia is reduced (less DB for young)

# Liabilities and premium base of Dutch pension funds, 1990-2030



Source: CPB Document 67, the Hague

# Pension wealth of young cohorts can fluctuate more than that of older generations

- Young participants depend on human wealth rather than pension wealth
  - Young, active participants bear most of priced risk ('soft' = DC) claims and longevity risk
    - They are the 'owners' of the pension funds
  - Old, retired participants hold most secure ('hard' = DB) claims
    - They hold debt-like claims on pension fund (wage indexed?)
- Consequences
  - Duration of fixed-income liabilities declines
  - Supply of risky capital is maintained
  - Behavior is less pro-cyclical
    - Exploits long horizon of the young to buffer shocks (lower marginal propensity to spend out of financial wealth)
    - Less need to adjust premiums to adverse shocks

***Encourage investment in human capital, lengthen and increase flexibility in work over the life course***

- Prevent decline in return on financial capital
  - Invest more in human capital of parents and children
    - Fight concentration work effort in child-bearing years
      - Combine career and parenthood over life cycle
    - Avoid vicious circle decline
      - Effective retirement age and maintenance human capital
- Flexible retirement as risk absorber to prevent risk-shedding scenario
  - Wage and career flexibility, lifelong training, flexible work arrangements
  - Tie worker less to single employer (employment security rather than job security)
    - Full portability of pension rights

## Cohort-specific average length of working life and life expectancy at 65

Cohorts	Average length of working life	Life Expectancy at the age of 65
1925	45.80	14.09
1930	43.92	16.12
1935	41.52	17.32
1940	37.64	17.57

Source: ECHP for average length of working life, OECD (2004), Health Data (2004) for life expectancy at the age of 65

## Who should do what?

- Specialized pension fund regulators to limit conflicts of interest
- Pension funds will increasingly impact the Single Market
  - Consumers of financial services
  - Pension liabilities as obstacles to M&A
  - Accelerate portability / tax harmonization
- A European Pension Regulator?