Institute of Actuaries of Australia

Super Policy Forum

Reforming Social Security – A Global Challenge

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(Government Actuary of UK, 1989-2007)

PENSION REFORM

Problems facing social security schemes

> demographic ageing
> maturing of defined benefit schemes
> effective retirement age too low
> poor overall levels of coverage and benefit adequacy
> inadequate or volatile outcomes from DC schemes
> inadequate protection against longevity in DC schemes
> perverse incentives affecting behaviour, eg retirement
> obstacles to saving, eg means-testing

PENSION REFORM

Possible structural reforms of DB social security

> variety of parametric reforms
> introduce funded individual accounts
> move to notional defined contributions
> introduce non-contributory demogrant (basic pension)
> link pension to residence instead of contributions
> more targetting of benefits…
> …or reduce dependence on means-testing
> partially fund social security
> increase role of funded private pensions

PENSION REFORM

Possible structural reforms of DC social security

> introduce underpinning guaranteed level of pension

> introduce non-contributory demogrant

> improve investment returns and risk management

> reduce transaction costs

> increase competition and individual choice

> increase efficiency and transparency

> improve awareness of need for additional savings

> improve efficiency of pay-out with more annuitisation

> wholesale investment model rather than retail model

PENSION REFORM

Individual account reforms

> started in Chile in 1981

> by now includes most countries in Latin America

> Australian Superannuation Guarantee Levy from 1992

> also several countries in central and eastern Europe

> supplements or replaces DB social security pension

> competitive private sector investment vehicles

> purchase of annuities at retirement…

> …or strictly controlled programmed withdrawal

PENSION REFORM

Chile

> reform of 1981
> compulsory contributions to AFPs
> old scheme closed (with recognition bonds)
> underpin on annual return
> high levels of transaction costs (average 1.55% of salary)
> minimum pension guaranteed by state
> high fiscal costs arising from guarantee (and transition)
> coverage still rather low
> proposals now to introduce citizenship pension

PENSION REFORM

Mexico

> reform of 1997
> mandatory contributions into AFOREs
> protected rights from old system
> old scheme pensions paid from budget
> guaranteed minimum pension
> high transaction costs
> limited investment options
> high prevalence of fall-back on government guarantee

PENSION REFORM

Individual account reforms - experience

> coverage is still a problem in many cases…
> …individual account structure is not enough of an incentive
> transaction costs are generally quite high…
> …competition has not brought down the charges
> churning and mis-selling have been an issue
> pension levels may not be adequate…
> …too many people will qualify for the minimum pension
> minimum pension creates incentive problems of its own
> significant financial and demographic risk falls on individuals

PENSION REFORM

Problems with pay-out phase

> uncertainty about life expectancy
> programmed withdrawal has potential problems
> need for more annuitisation to protect pensioners
> compulsory annuitisation often unpopular
> insurance market not always receptive
> high concentration of longevity risk for insurers
> need for very long-dated bonds to match liabilities
> preferably index-linked if backing indexed annuities
> investment mis-match risk for insurers

PENSION REFORM

Alternatives for pay-out phase

> immediate life annuity – level or increasing
> unit-linked annuity
> with-profits annuity
> unitised fund
> partially annuitise with temporary annuity
> controlled drawdown
> …with eventual mandatory annuitisation

PENSION REFORM

Notional Defined Contribution

> structured as defined contribution…
> … but on a PAYG basis rather than funded
> clear link between contributions and benefits…
> …but not subject to investment risk
> targets lump sum at pension age…
> with ‘notional’ purchase of an annuity
> permits flexibility of retirement age
> passes on part of longevity risk
> some demographic balancing mechanism needed

SWEDEN

Swedish NDC

> DB state scheme replaced by NDC
> revalorisation of individual accounts by average wage
> credits for sickness and other absences
> automatic economic regulator of pensions increase
> notional annuity factor increased with improving mortality
> automatic balancing mechanism

SWEDEN

Individual accounts

> mandatory funded individual accounts (PPM)

> 2½% of earnings

> contributions collected with NDC contributions of 16%

> low administrative costs with wholesale model

> choice of 700 investment funds

> default arrangements if no funds selected

SWEDEN

Overall evaluation

> hailed by some (including WB) as a success story
> sustainable PAYG system
> increased level of savings achieved through PPM
> but little real public interest in investment choice
> rising concern about expected fall in replacement ratios…
> …and arbitrary effect of automatic balancing mechanism
> inequality of earnings mirrored in retirement income…
> …as with all DC structures

FINLAND

Improved targeting

> basic pension used to be flat-rate and contributory

> mandatory earnings-related scheme

> industry-wide rather than individual employer schemes

> basic pension turned into a minimum pension guarantee…

> …measured against the earnings-related pension

> …so no means-test or asset test

> dramatically cut the cost of the basic pension…

> …and focussed expenditure on lower paid

FINLAND

Dealing with demographic ageing

> objectives of reform of earnings-related scheme
  > to postpone average age of retirement by 2 to 3 years
  > to adapt the pension system to increased expectations of life
  > to reduce pressures for future increases in contributions
  > to unify and simplify the various separate schemes
  > to harmonise public and private pension schemes

> average of last 10 years ⟶ career average revalued

> variable accrual rate
  > 1.5% a year from 18 to 52
  > 1.9% a year from 53 to 62
  > 4.5% a year from 63 to 68

FINLAND

Dealing with demographic ageing

> introducing life expectancy coefficient

Life expectancy coefficient for year N (>2009) =

$$\frac{\text{cohort life expectancy for those reaching 62 in 2009}}{\text{cohort life expectancy for those reaching 62 in N}}$$

Multiply pensions of those reaching 62 in N
by life expectancy coefficient for year N

Thus adjusting a DB pension benefit for improving life expectancy

NEW ZEALAND

Citizen's pension

> flat rate of benefit at or just above means-testing level
> indexed to national average earnings
> eligibility dependent on period of residence in NZ
> individual entitlement, whether single or married
> not dependent on pattern of working life
> simple to understand and operate
> no savings disincentive effects

NEW ZEALAND

Kiwisaver

> new, voluntary, work-based savings scheme
> automatic enrolment for those starting new job
> opt out period from end of week 2 to week 8
> open to others to opt in if they wish
> contributions from employees at 4% (or 8%)
> contributions collected by Inland Revenue through PAYE
> individual choice of scheme (with default)
> employers must contribute 1%
> no withdrawal until age 65…
> …except for deposit on a first home (after >3 yrs contns.)

NEW ZEALAND

Kiwisaver

> $1000 kickstart
> $20 six-monthly fee subsidy
> first home deposit subsidy
> up to $1040 a year employee tax credit
> employer tax credit
> no requirement for annuitisation

UK PROPOSALS

Changes recently enacted in UK

> restore earnings link for basic pension

> raise pension age to 68 by 2046

> abolish DC contracting-out

> individual accounts with auto-enrolment

UK PROPOSALS

Basic Pension

> earnings upratings from 2012 (or so)
> increasing pension age
  > 65 for men and women from 2020
  > raise from 65 to 66 between 2024 and 2026
  > raise from 66 to 67 between 2034 and 2036
  > raise from 67 to 68 between 2044 and 2046
> only 30 years' contributions required for full pension
> home responsibilities credits on a weekly basis

UK PROPOSALS

Individual savings

- auto-enrolment into individual savings accounts from 2012
- employers responsible for auto-enrolment
- provision for opting out
- contributions on earnings from £5,000 to £30,000 a year:
  - 4% from employees
  - 3% from employers
  - 1% from tax relief
- contributions collected with National Insurance
- investment based on wholesale investment of funds
- rather than using existing retail pension products

DIFFERENCES BETWEEN NZ AND UK

New Zealand	United Kingdom
> basic citizenship pension	> high level of means-testing
> emphasis on long-term savings	> emphasis on retirement income
> open to all	> targeted on (lower) earners
> government subsidies	> tax relief
> compulsory for job changers	> big bang in 2012
> annuitisation not compulsory	> compulsory annuitisation
> ‘free’ central IR administration	> costs not subsidised
> centralised enrolment	> enrolment by employers
> register existing providers	> establish new PADA
> no limits on participation	> restricted entry and amount saved
> single simple scheme	> PAs are one option among many

PENSION REFORM FRAMEWORK

World Bank framework (1994)

1st Pillar

Mandatory unfunded public defined benefit social security

2nd Pillar

Mandatory funded and privately managed defined contribution

3rd Pillar

Voluntary savings retirement plan (or occupational pension plans)

PENSION REFORM FRAMEWORK

World Bank framework (2005)

Pillar zero

Non-contributory scheme providing minimal level of protection

1st Pillar

Mandatory unfunded publicly managed DB or NDC providing some longevity insurance

2nd Pillar

Mandatory funded and privately managed DC (or DB)

3rd Pillar

Voluntary savings plans – regulated and privately managed

4th Pillar

Informal intergenerational financial and non-financial support

SOME CONCLUSIONS

Wide range of solutions – defined contribution favoured

> each country has a different solution
> …but all are starting from different points
> economists widely favour DC for its incentive structure…
> …but lacks basic characteristics of social protection
> …unless in with-profits form or with strong underpin
> …exposes members to investment risk
> …and also collectively to longevity risk
> minimum pension or DB underpin seems desirable…
> …but care is needed with perverse incentive effects

SOME CONCLUSIONS

Wide range of solutions – new defined benefit thinking

> DB mostly moving to career-average revalued…

> …which is equivalent to a type of DC

> …or to NDC - really a DB structure dressed up as DC

> focus on fund at retirement facilitates longevity solutions

> indexing retirement age also a possibility

> cash balance is another alternative DB/DC hybrid

> …or DC on a traditional insurance "with-profits" basis

> more flexible revaluation might facilitate risk-sharing

SOME CONCLUSIONS

Wide range of solutions – encourage later retirement

> need stronger incentives to later retirement

> a reason for DC but possible also with DB

> higher pension age for unreduced pension forces trade-off

> target lump sum at retirement instead of pension

> annuitisation is needed – with innovative solutions

> need better risk-sharing in decumulation phase

SOME CONCLUSIONS

Wide range of solutions – efficient savings

> mandatory DC necessary to achieve full coverage…

> …or almost mandatory

> contributions should be collected centrally

> avoid insurance wrappers

> wholesale investment should be more efficient

> control commission and charges

> choice – but not too much choice – of investment funds

> minimum income guarantee desirable…

> …but needs to be designed carefully

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