

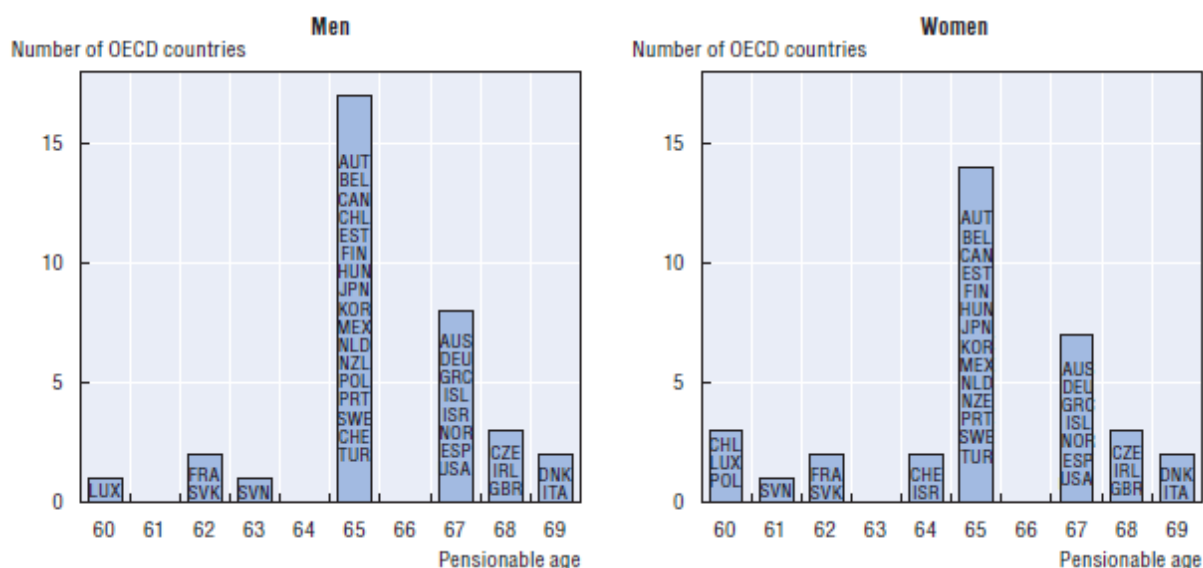
OECD PENSIONS OUTLOOK 2012

Recent pension reforms will lead to lower public pensions for future generations of retirees, around 20-25% on average. This first edition of the Pensions Outlook argues that countries should focus on two main policies to address the growing pensions gap: later retirement and extending the coverage of private pensions.

Overall, the pace of pension reform has accelerated over the last five years. Changes include increases in pensionable ages, the introduction of automatic adjustment mechanisms and the strengthening of work incentives. Some countries have also better focused public pension expenditure on lower income groups. However, some recent reforms have raised controversy, such as the decision of some Central and Eastern European countries to pull back earlier reforms that introduced a mandatory funded component.

Most OECD countries have already begun to increase pensionable ages, or plan to do so in the near future. Age 65 remains the modal age at which people normally draw their pensions, accounting for 17, or half, of OECD countries for men and 14 countries for women. But 67 – or higher – is becoming the new 65. Some 13 countries (12 for women) are either increasing pension ages to this level or, in the cases of Iceland and Norway, are already there. Italy, which links pension age and seniority requirements to life expectancy from 2013 and Denmark, which plans to link pension age to life expectancy from the mid-2020s, are forecast nearly to reach age 69 in 2050. The United Kingdom has accelerated the increase in the pensionable age, which will move from 65 to 66 by 2020 (6 years earlier than planned) and from 66 to 67 by 2026-28 (10 years earlier than planned).

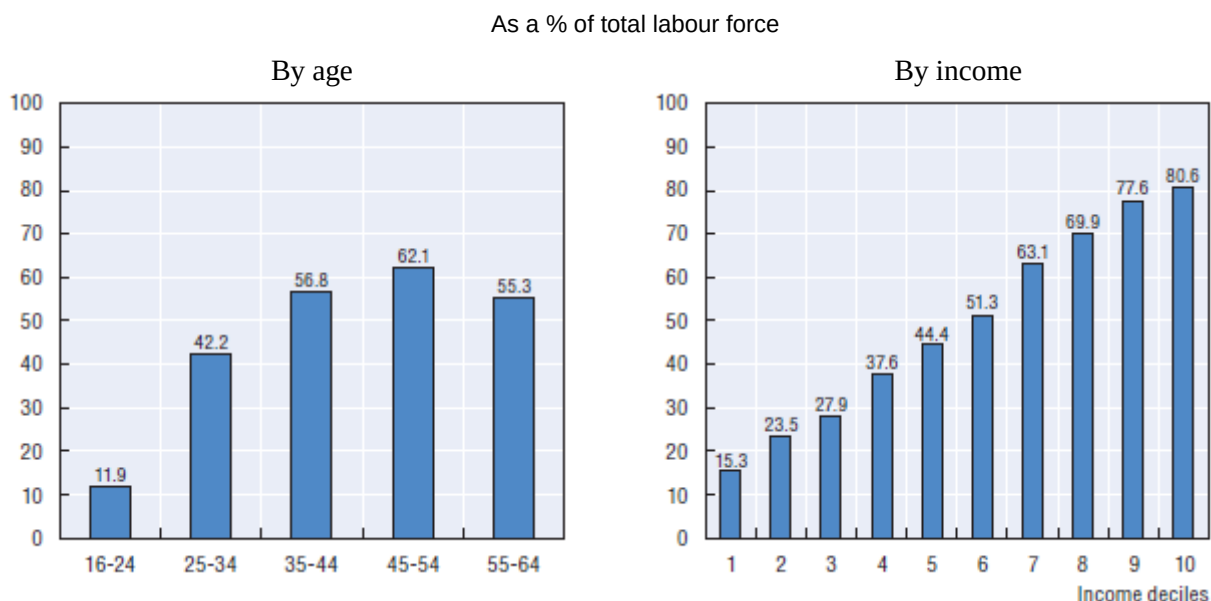
Figure 1. Pensionable age under long-term rules, by sex



Extending working lives will help enhance both the sustainability and adequacy of pension systems. However, planned increases in retirement ages are generally insufficient to address expected rises in life expectancy. In many countries, cuts in public pensions will also widen the gap between pre and post retirement income. In order to close this pension gap, a growing role for private pensions will be essential.

Currently, thirteen OECD countries have either compulsory private pension systems in place (e.g. Australia, Chile) or quasi-mandatory systems based on nation-wide or industry-wide collective bargaining agreements (e.g. Denmark, the Netherlands) to ensure that most workers are covered and therefore have access to a sufficiently high complementary pension. However, in some countries with relatively low public pension benefits, private provision remains voluntary and the highest coverage rates observed are around 50%. In all the countries analysed in the report, the young, low income, part-time and temporary workers are least likely to participate in voluntary private pension plans (see UK case below).

Figure 2. Coverage rate of private pension plans in the United Kingdom according to age and income



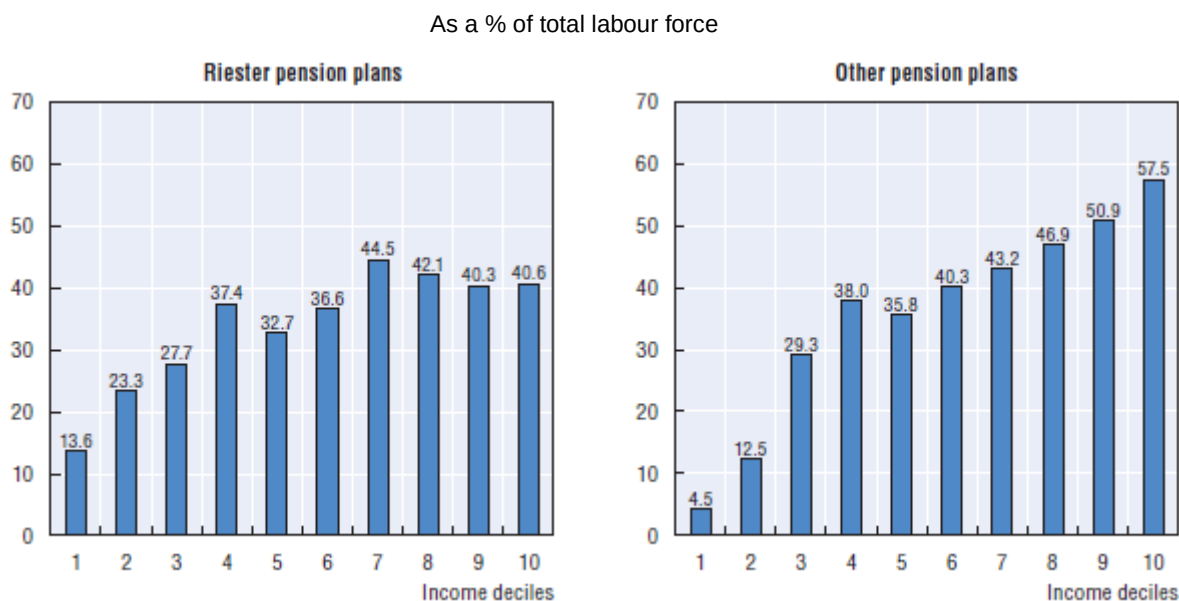
An alternative to compulsory enrolment that has gained popularity in recent years is automatic enrolment. At its essence, it involves signing up people automatically to private pensions but giving them the option to opt out with different degrees of difficulty. Auto-enrolment was introduced in New Zealand in 2007 and partly explains the rapid increase in the coverage of the KiwiSaver (about 55% of the working age population, the highest level among non-compulsory systems in the OECD). On the other hand, in Italy, the introduction of auto-enrolment in 2007 has only had a small effect on coverage rates.

In October 2012 the United Kingdom will also see the introduction of a nation-wide auto-enrolment retirement savings system for all those workers who are not currently covered by private pension plans. This new mechanism should increase further the coverage rate of occupational pension schemes, currently standing at 43.3% of the working age population.

The design of financial incentives for retirement savings also needs to be reformed. Germany (Riester) and New Zealand (KiwiSaver) have introduced financial incentives based on direct state subsidies from the state to retirement savings accounts that also benefit workers that pay no or low taxes. In Germany, the state subsidy provided to Riester pension plans has promoted greater participation among lower income workers than among other private pension arrangements (see Figure 3 below). Low income workers do not normally benefit much from the tax incentives traditionally used to promote private pensions.

The success of these countries in expanding coverage in a relatively short period largely vindicates these policies, though financial incentives can create a heavy burden on already stretched public budgets. Furthermore, coverage gaps also remain in these countries, and overall enrolment rates are still below those observed in countries with mandatory or quasi-mandatory systems (over 70% of the working age population).

Figure 3. Coverage rate of private pension plans in Germany according to the income of the household and the type of plan, December 2008



Private pension plans, particularly mandatory and auto-enrolment ones, are increasingly of the defined contribution (DC) type. Such plans require careful design and regulation as individuals are often ill-prepared to manage their savings in an effective manner. The starting point for a successful DC plan is a sufficiently high contribution rate.

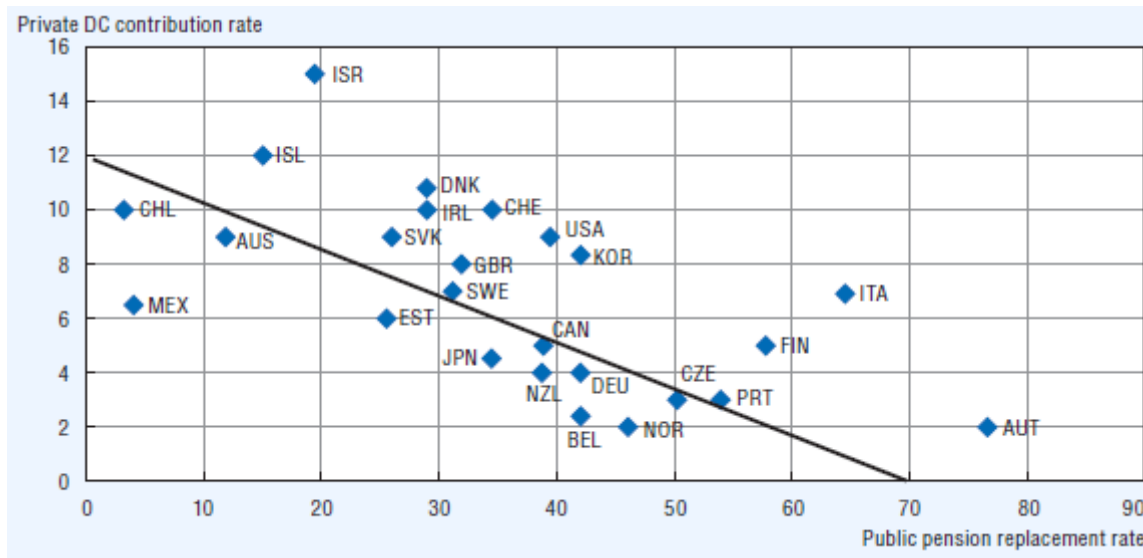
The chart below compares projected public pension benefits with the mandatory contribution rate in mandatory DC plans or the typical or average contribution rate to voluntary DC plans, depending on the country. The public pension projections are shown as replacement rates (benefits as a percentage of final salary) for a young male worker earning average wages and entering the workforce in 2008 who accumulated benefit rights throughout his whole career and retires at the official or normal retirement age.

The graph shows a broadly inverse relationship between public pension benefits and DC contribution rates. For instance, in the United Kingdom the contribution rate of 8% in the auto-enrolment system should allow the average worker with a full career to reach a gross replacement rate of nearly 70% (32% from public PAYG pensions and 37% from the auto-enrolment retirement savings system). The net replacement rate would be around 80% for workers on average earnings.

On the other hand, there are some countries that clearly stand out in having both relatively low public pension benefits and DC contribution rates that do not seem to be sufficiently high. Such countries include Belgium, Germany, Japan, New Zealand, and Norway. These are also among the countries that fall below the black diagonal line, which shows the combination of public pensions and DC contribution rates (with a 40-year contribution period) that delivers an overall replacement rate of 70% on average. Other countries below the black line include Australia, Chile, New Zealand and especially Mexico. The Australian

government recently announced that it would raise the mandatory contribution rate from 9 to 12%, which would bring the country above the black line.

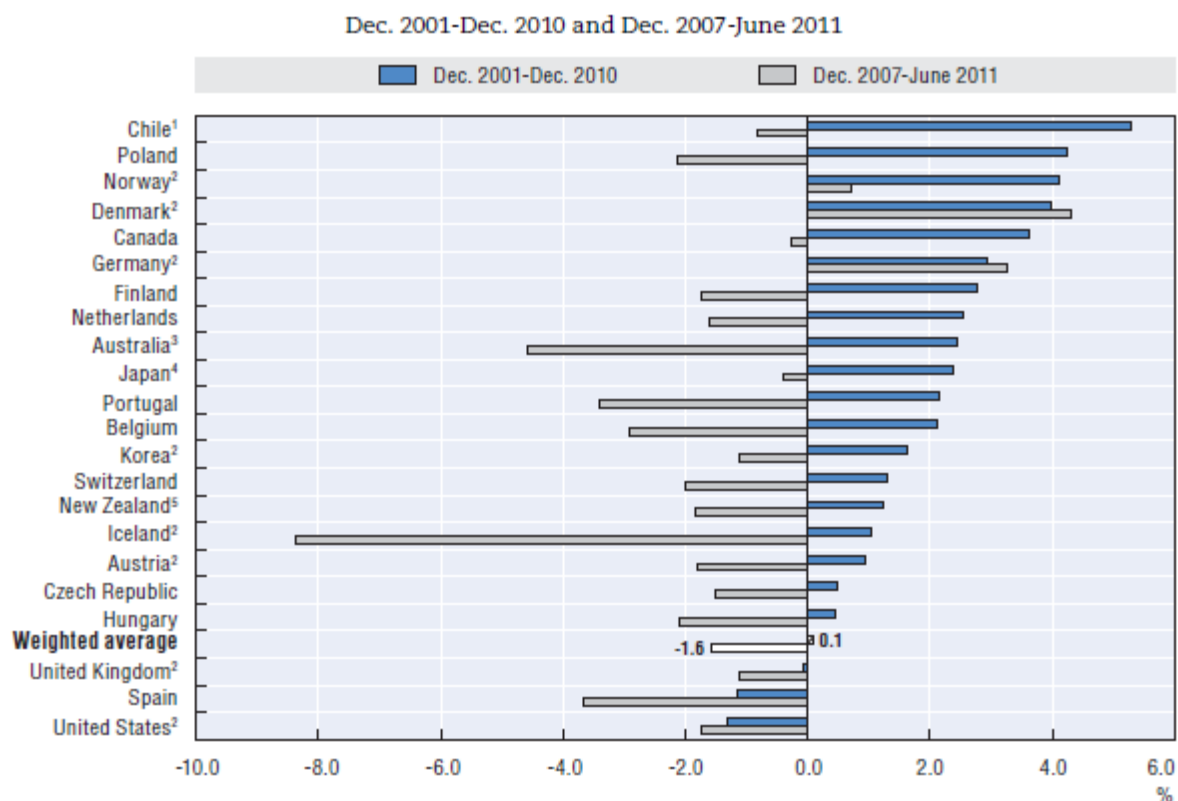
Figure 4. Public pension gross replacement rate vs. DC contribution rate



Another major concern in private pensions is investment risk. The financial and economic crisis has exerted major stress on private pension arrangements. Most countries' pension funds are still in the red in terms of cumulative investment performance over the period 2007-11 (-1.6% annually, on average, in real terms). Even when measured over the period 2001-10, the pension funds' real rate of return in the 21 OECD countries that report such data averaged a paltry 0.1%. Such disappointing performance puts at risk the ability of private pension arrangements to deliver adequate pensions. The United Kingdom follows the general trend, with average real investment returns of pension funds of -1.1% over the period 2007-10 and -0.1% over the period 2001-10.

In DC pension systems, one clear goal for policymakers should be to improve the design of default investment strategies so that investment risk is reduced as the worker approaches retirement. Such life-cycle investment strategies may need to be carefully regulated to ensure that workers are offered sufficient diversification and protection from market shocks in old age.

Figure 5. Average annual real net investment return of pension funds in selected OECD countries



1. The average annual return for the long period is calculated over the period December 2002-December 2010.
2. The average annual return for the short period is calculated over the period December 2007-December 2010.
3. The average annual returns are calculated over the periods June 2002-June 2010 and June 2007-June 2011.
4. Source: Bank of Japan.
5. The average annual returns are calculated over the periods June 2001-June 2010 and June 2007-June 2010.