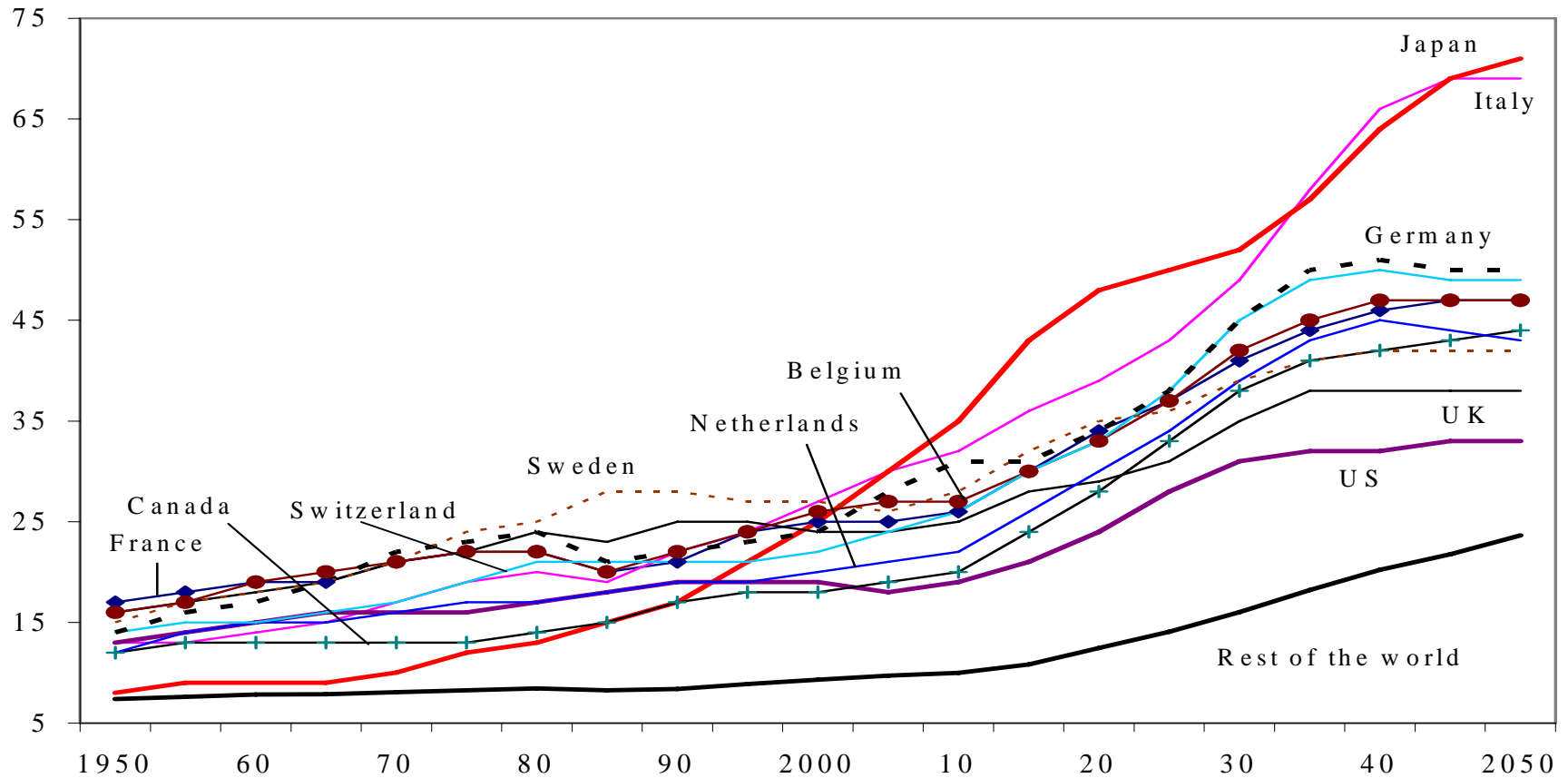


# **International Regulatory and Policy responses to Demographic Challenges**

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**8<sup>th</sup> international Sustainability  
Leadership Symposium, 27/28  
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# Ageing pressure

Ratio of the population aged 65 years or over to the population aged 15-64, in percent



Source : United Nations Population Division, *World Population Prospects, 2004 Revision Population Database* .

# Calling for policy action

- Increasing working age population
- Increasing retirement ages
- Reducing public pensions generosity
- Developing **private pensions**

# Private pensions reforms

- Allow for better Diversification
- Call for Well-regulated systems
- And Efficient financial markets
- But also face major challenges

# Selected challenges

- Increasing Longevity
- Asset-liability mismatch
- Shift towards DC schemes
- Some comments on impact on financial markets

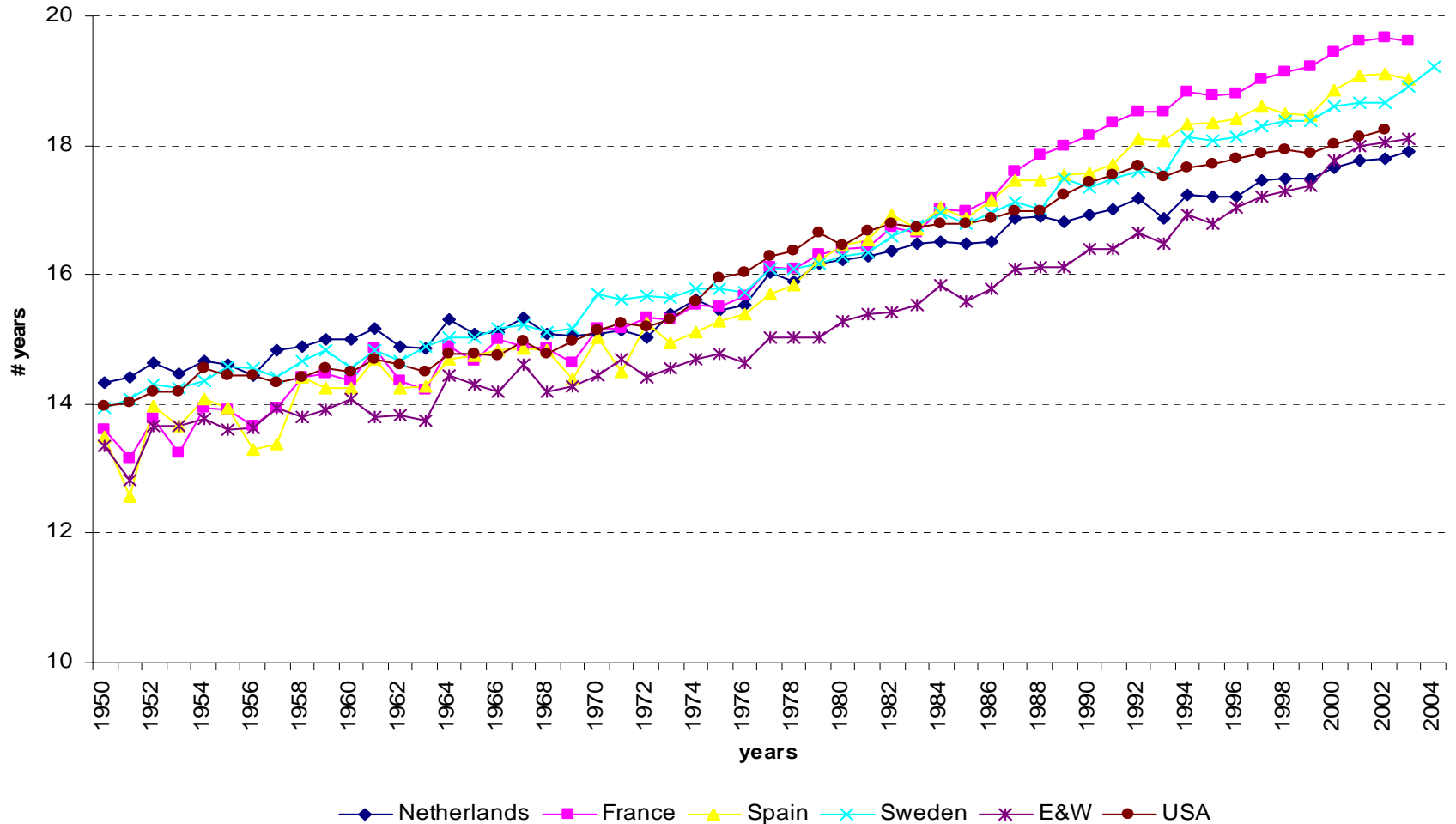
# I. Increasing life expectancy

Good news...

.....Which can become a nightmare

# Life Expectancy at 65, 1950-2003

## Life Expectancy at 65, 1950-2003



# Past gains in longevity

## Life Expectancy, 1900-2000

Increase in number of years per decade

- Life expectancy at birth has increased an average of 2.2 years per decade over the last century in OECD.

		at birth	at 65
	<i>20th Century</i>		
Canada (1921-2002)		2.8	0.7
France (1900-2003)		3.3	0.9
The Netherlands (1900-2003)		2.9	0.6
Italy (1900-2002)		3.8	0.9
Spain (1908-2003)		3.9	0.9
Sweden (1900-2004)		2.7	0.6
United Kingdom (1900-2003)		3.1	0.7
United States (1933-2002)		2.3	0.8
	<i>1960-2000</i>		
<i>EU15 Average</i> <sup>1</sup>		2.0	
<i>OECD Average</i> <sup>1</sup>		2.2	
Canada		1.9	1.0
France		2.2	1.3
The Netherlands		1.3	0.7
Germany		2.0	
Italy		2.6	1.2
Spain		2.5	1.1
Sweden		1.7	1.0
United Kingdom		1.7	0.9
United States		1.8	0.9

# Longevity: some issues

- Forecasts
- Mortality assumptions: outdated, lack of data, data from another country
- Annuities issues

# Annuities issues

(supply and demand sides)

- Annuities markets should explode: major role for insurance companies; still underdeveloped in several countries
- Things are changing but still Lack of policy awareness
- Major issue: baby-boomer de-cumulation phase will begin soon
- Problem: pricing, matching assets, complexity, understanding, regulation

# Solutions (annuities)

- Solutions are not obvious and may entail policy actions like mandating annuities developing tax incentives, developing proper financial instruments to match annuities
- But as recently underlined by Jeffrey Brown they may just begin with a better understanding of why consumers act as if they place so little value on annuities.
- As Modigliani said two decades ago, the reasons why annuities markets is not developing more is still "ill-understood".
- The OECD is developing a huge project involving several Committees

# Some policy responses to longevity issues

- Role of governments: maybe similar to role for other extreme or un-diversifiable risks – at least partly (extreme old age)
- Improve framework conditions: making sure mortality tables are up to date
- Issue securities to protect against greater-than expected longevity improvements (tail risks); problem with longevity bonds
- Ultra long bonds, indexed linked bonds
- Increased Awareness
- Incentives (tax, mandatory schemes)

## II. Asset liability mismatch

Assets down



Decline of international markets

Liabilities up



Low interest rates + Increasing Longevity

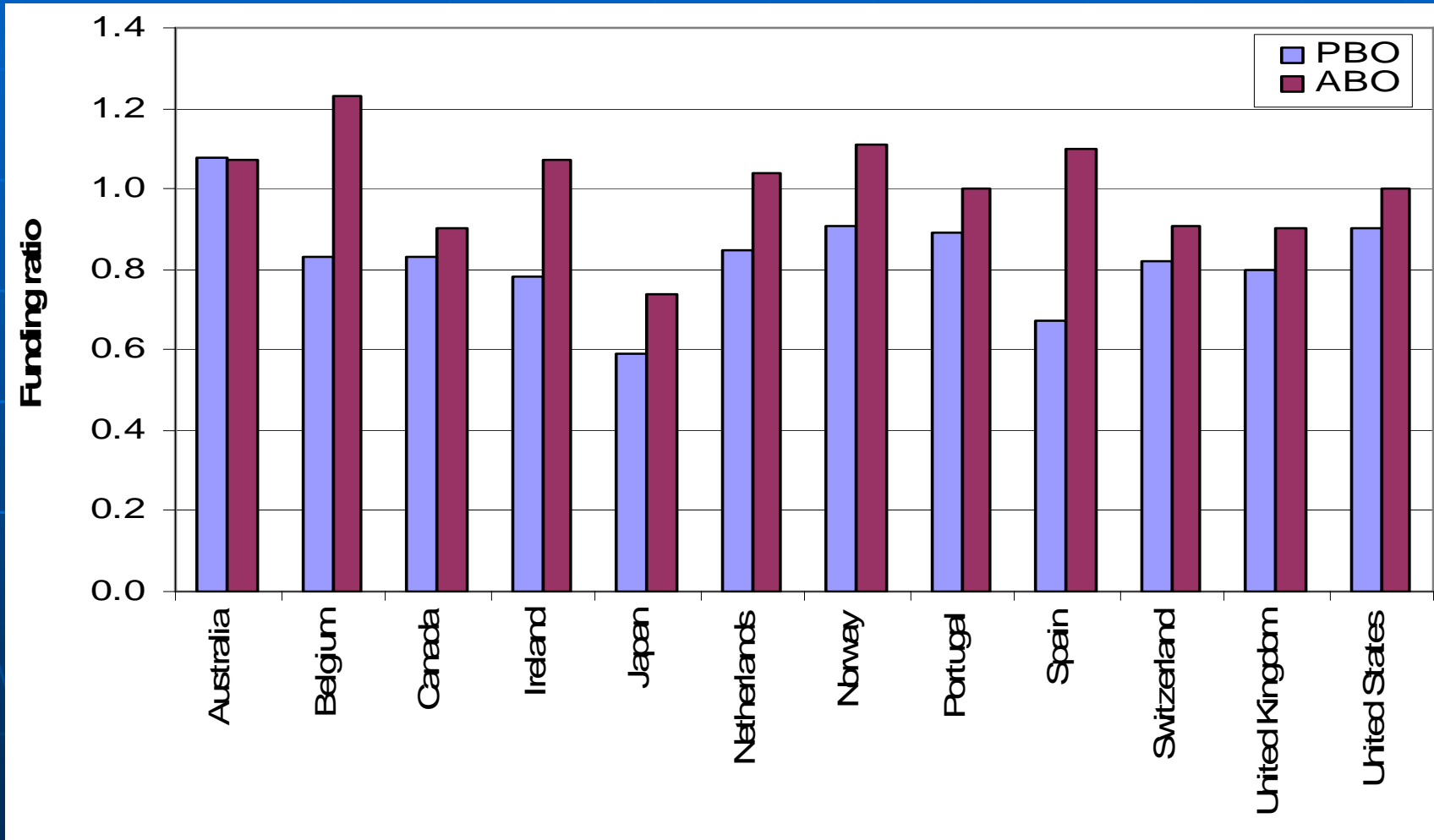
*Asset Liability mismatch caused those pension funds which did not set up sufficient buffers to move from surplus to deficit*

# US example

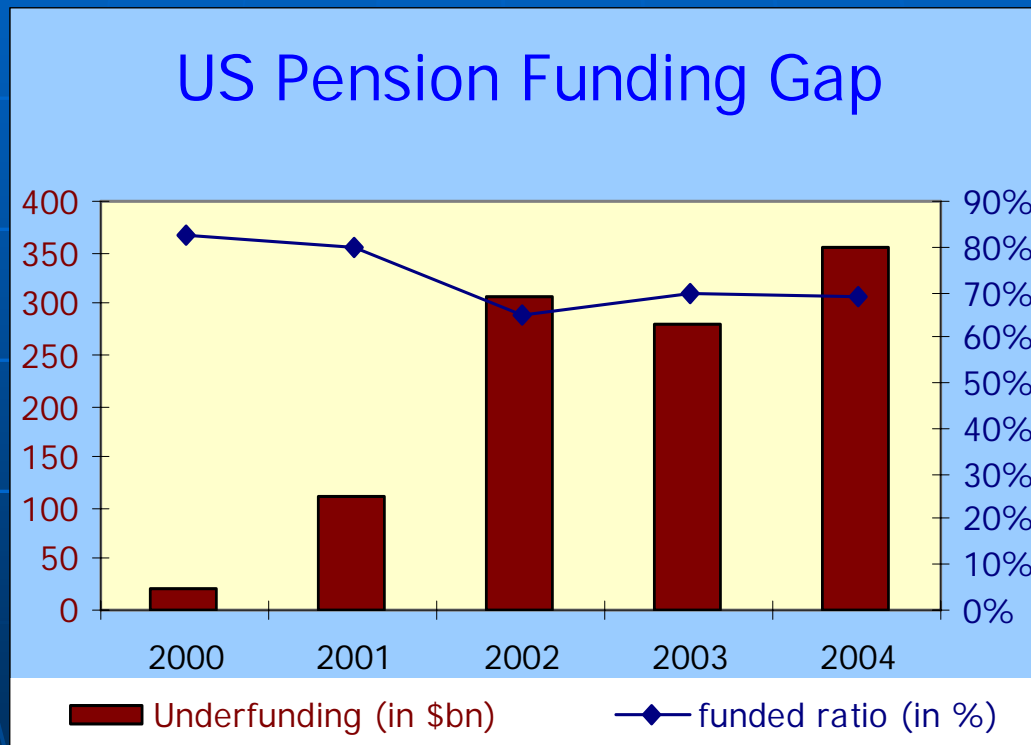
- *“Aggregate under-funding of guaranteed benefits in PBGC- insured single employer plans increased from about \$7 billion in FY2000 to \$313 billion in 2003....The average funding ratio fell from 144 percent to a historical low of only 84 percent. This drops reflects a 26 percent decline in plan ASSETS and a 28 percent increase in plan LIABILITIES” . PBGC, summer 2006.*

# ABO and PBO

Figure 2. Accounting measures of funding ratios (ABO and PBO) in selected OECD countries in 2005

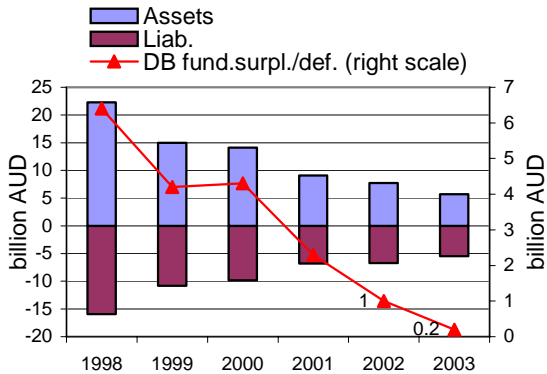


# Pension funding gaps

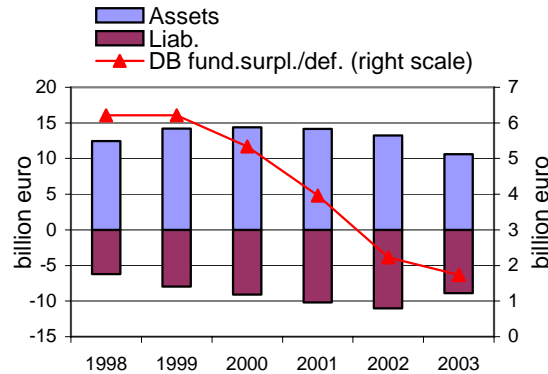


# Pension Underfunding in Selected OECD Countries

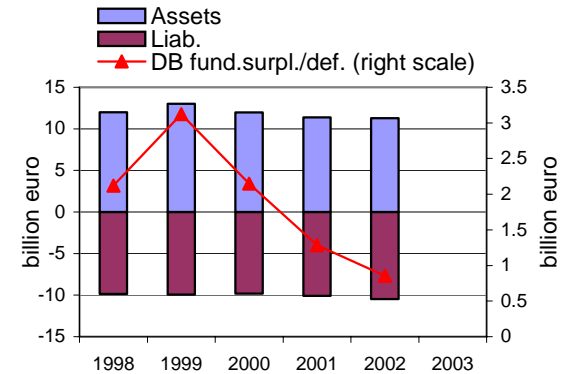
Australia<sup>a)</sup>



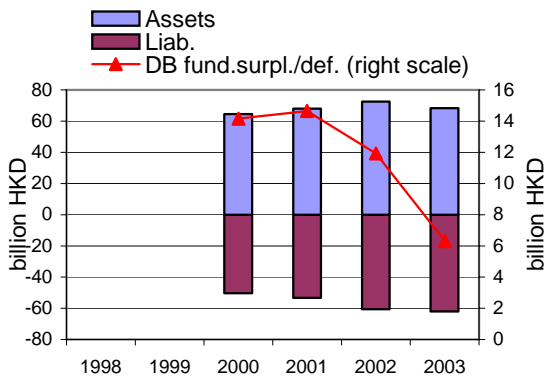
Belgium<sup>b)</sup>



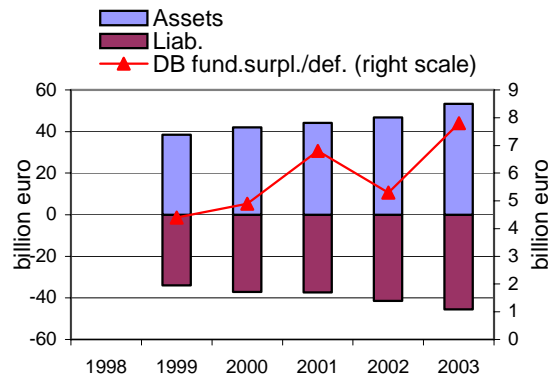
Finland<sup>c)</sup>



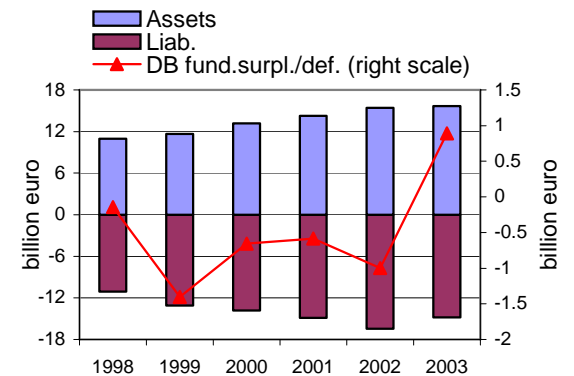
Hong Kong, China



Norway



Portugal



# Financial security: policy responses

- Reforming funding rules
- Promoting consistency with accounting standards
- Strengthening pension funds' governance
- Reforming investment regulation
- Developing sound supervision

# Funding rules

- --reforming funding rules . This includes funding rules promoting prudent funding levels for ongoing plans, but also with target set up in relation with termination liability, appropriate recovery periods for eliminating funding gaps, revision of mortality estimates and further disclosure of related projections, incentives for pension funds to hold buffers above the full funding level, but with appropriate flexibility greater policy coherence between funding and tax objectives,
- --promoting consistency with accountancy standards, with further compatibility between funding and accounting rules, including convergence in discount rates, smoothing and amortisation rules, and in assumption for measuring liabilities

# Governance and investment

- --strengthening pension fund governance focusing on suitability requirements for members of governing boards, clear monitoring responsibilities for actuaries and auditors (strengthening “whistle-blowing” functions), disclosure requirements
- --reforming investment regulations, towards prudent person approach while still promoting some few quantitative limitations like the limits on investment of securities issues by the plan sponsor), development of asset management strategies

# Supervision, guarantee schemes

- --developing sound supervision with focused goals, well-defined division of labour between various authorities, adequately equipped supervisory bodies, independent from under political interference. Preferably supervisory mechanisms should be based on a risk-based approach and promote sensitivity analysis and stress testing.
- Consideration may also be given to the role of guarantee schemes but also the dangers that can emerge from insurance arrangements where the pricing of premiums is not properly linked to risks exposures.

# Responses from Public Authorities

## Governments

- **Reduction in public pension levels**

*e.g. Japan National Pension contributions up / benefits reduced / retirement age rising / replacement rates reduce from 59-50%*

- **Introduction / reform pension fund insolvency schemes**

*e.g. UK Pension Protection Fund launched April 2005*

## Supervisors

- **Move to risk based supervision**

*e.g. Netherlands FTK system stress testing + buffers to cover declines in asset markets*

- **Increased Power of Regulators**

*e.g. UK 2004 Pensions Act increases the Pensions Regulator's investigatory and enforcement powers*

# Responses from Public Authorities

## Regulators

- **Stricter funding rules**

*e.g. USA Pension Protection Act 2006 requires schemes to return to full funding within 7 years + enhanced funding obligations for particularly under-funded schemes*

- Improved investment disclosure and governance rules (*e.g. in Canada, the Netherlands*)

## Accounting Authorities

- Trends towards market value based accounting standards + reflecting pension deficits on corporate balance sheet reinforcing regulatory changes

*e.g. FAS 87 (USA) + IAS 19 (Europe) moving towards FRS 17*

# Corporate Responses

## ALM

- *Move by pension funds to more closely match assets and liabilities*
- *Pension funds in some countries increased holdings in bonds ; Impacting asset prices*
- *Holdings in alternative assets also rising in search for yield*

# International responses

**OECD recommendation on core principles for the regulation of occupational pensions plans (2004)**

**OECD Recommendation on guidelines for the governance of pension funds (2005)**

**OECD Recommendation on guidelines on pension fund asset management (2006)**

**OECD public consultation on guidelines on funding and benefit security (2006)**

**IOPS Principles on pension supervision (2006)**

**OECD/IOPS guidelines on licensing (2007)**

**IOPS draft guidelines on off and on site inspection**

# OECD core principles

- Conditions for effective regulation and supervision
- Establishment and licensing
- Pension plan liabilities, funding rules
- Asset management
- Rights of beneficiaries
- Supervision

# OECD instruments on liberalisation

- Revision of OECD Codes of liberalisation of current invisible operations: new items on cross-border trade and establishment
- Freedom of Investment abroad by pension funds and insurance companies
- Promotion of international co-operation amongst supervisors (IOPS)

# OECD Guidelines on Pension Fund investment management

- Requires prudent person; allows some quantitative limits (e.g. self-investment)
- Includes "best interest" "expert knowledge", "duty of loyalty" and "due diligence"
- Promote sound risk management
- Written investment policy and risk control process
- Derivatives involving unlimited commitments should be prohibited
- Investment abroad should not be prohibited
- Market value preferable

# The Statement of Investment Policy

## Risk-return objectives and time horizon

- Consider risk aversion and nature of liabilities

## Establish strategic asset allocation, derivatives policy, and corporate governance, SRI and, if relevant, ETI policies

- Consider risk-return objectives

## Define investment styles and procedures

- Active or passive, in-house or external

## Identification of performance benchmarks

- Costs, risks, returns

## Valuation methods

- Consider assets not regularly traded at regulated markets

## Develop risk and performance monitoring mechanisms

- Risk measures, performance attribution measures, costs

# The OECD Funding and Benefit Security Guidelines: Guideline Group 1 - Funding

- General preference for pension funds and insurance arrangements in DB plans.
- Pension funds can be combined with external insolvency insurance arrangements and creditor rights
- Mandatory insolvency insurance for book reserve systems
- Pricing of insolvency insurance arrangements

# The OECD Funding and Benefit Security Guidelines: Guideline Group II - Measurement of plan liabilities

- Both termination and ongoing approaches are appropriate. No universal measure of pension liabilities.
- Prudence in economic and actuarial assumptions
- Consistent with generally recognised actuarial standards and methods and with val. methods of assets
- Triennial valuations by actuaries, more often may be needed. Governing body to seek advice of actuary

# The OECD Funding and Benefit Security Guidelines: Guideline Group III – Funding rules

- Funding target based on termination/ongoing liability but at least sufficient to meet accrued benefit payments
- Amortisation is appropriate to avoid contribution volatility
- To specify mechanisms for correcting underfunding
- Countercyclical, buffers, consistency of tax rules
- Additional capital for self-insured pension funds

# The OECD Funding and Benefit Security Guidelines: Guideline Group IV – Winding-up

- Asset/benefit allocation rules in case of termination of the plan to be clearly established
- Creditor rights of plan beneficiaries (directly or indirectly, via insolvency insurance arrangement) to be recognised
- Priority rights for due and unpaid contributions

# Guidelines on Pension Fund Governance

## I. Governance Structure

“

- Identification of responsibilities
- Governing body
- Expert Advice
- Auditor / Actuary / Custodian
- Accountability
- Suitability

## II. Governance Mechanisms

- Internal Control
- Reporting
- Disclosure
- Redress

***Good pension fund governance is a vital element for the efficient functioning of private pension systems***

# IOPS

## International Organisation of Pension Supervisors

- Created in 2004
- serving as the standard-setting body on pension supervisory matters (and regulating issues related to pension supervision), taking into account the variety of different private pension systems, while OECD is serving as standard-setting body on pension regulatory and policy matters;
- promoting international co-operation on pension supervision and facilitating contact between pension supervisors and other relevant parties, including policy makers, researchers and the private sector;
- providing a worldwide forum for policy dialogue and exchange of information on pension supervision;
- participating in the work of relevant international bodies in the area of pensions, including joint activities to improve statistical collection and analysis;
- promoting, conducting and facilitating the distribution and communication of research, and collecting information in co-operation with relevant international bodies

# IOPS Principles of Private Pension Supervision

- **Principle 1: Objectives**

- *National Laws should assign clear and explicit objectives to pension supervisory authorities*

- **Principle 2: Independence**

- *Pension supervisory authorities should have operational independence*

- **Principle 3: Adequate Resources**

- *Pension supervisory authorities require adequate financial, human and other resources*

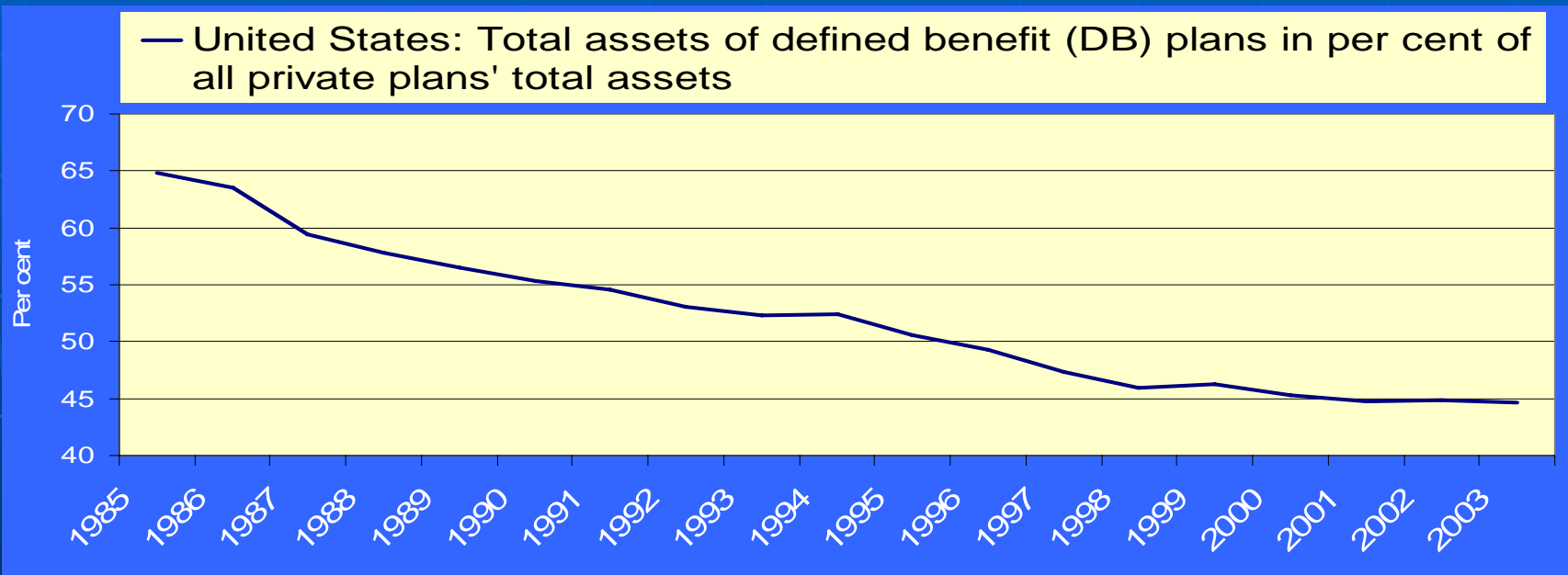
- **Principle 4: Adequate Powers**

- *Pension supervisory authorities should be endowed with the necessary investigatory and enforcement powers to fulfil their functions and achieve their objectives*

# IOPS Principles of Private Pension Supervision

- **Principle 5: Risk Orientation**
  - *Pension supervision should seek to mitigate the greatest potential risks to the pension system*
- **Principle 6: Proportionality and Consistency**
  - *Pension supervisory authorities should ensure that investigatory and enforcement requirements are proportional to the risks being mitigated and that their actions are consistent*
- **Principle 7: Consultation and Cooperation**
  - *Pension supervisory authorities should consult with the bodies they are overseeing and cooperate with other supervisory authorities*
- **Principle 8: Confidentiality**
  - *Pension supervisory authorities should treat confidential information appropriately*
- **Principle 9: Transparency**
  - *Pension supervisory authorities should conduct their operations in a transparent manner*
- **Principle 10: Governance**
  - *The supervisory authority should adhere to its own governance code and should be accountable*

# III. Shift toward DC schemes



# Rise of DC Schemes

*Not only shift of occupation DB funds to DC  
Also rise of Mandatory Private DC systems*



In the last decade, 10 Central and Eastern European countries have implemented mandatory DC systems.

Sweden launched its Premium Pension System (PPM) in 2000, whereas Hong Kong introduced the Mandatory Funded Arrangement (MPF) on December 2002.

- Since 1999, all workers have to contribute to the Danish Special Pension Savings Scheme (SP).

- In 1997, Mexico introduced its system of individual accounts. 10 LA countries have a mandatory DC pillar.

- In 1993, Peru introduced a system of private individual accounts as an alternative to the existing PAYG system.

- Australia introduced its superannuation guarantee system in 1992.

- In 1981, Chile became the first country to privatize its social security system. Switzerland introduced a complementary, occupational DB/DC pillar in 1982.

# Shift to DC schemes

- Ease pressures on DB schemes; contribute to general objective of risk diversification
- Introduction of investment choice :logical response to shift of market risks
- BUT reallocation of risks away from companies and their transfer to individuals may raise serious concerns on the capacity of individuals to protect themselves adequately, in the absence of proper financial education and consumer protection
- Issues is not only for investment choice but even for the level of contributions
- Surveys consistently find low levels of financial education
- *Governance*: weak pension fund governance due to 'amateur trustees' / lack of governance structure for DC schemes /

## **Lack of financial knowledge relating to pension:**

- **Lack of understanding of the changing retirement environment**
- **Lack of understanding of the need to save**
- **Lack of understanding of investments**
- **Lack of trustee and fiduciary capability**

# Low level of financial education

- Japan: 71 % of respondents to a survey lack knowledge of equities and bonds
- Australia: 37 % of those with investments did not understand that investments can fluctuate in value

# Bad consequences

- USA: 4 out of 10 workers do not save for retirement
- New-Zealand: 52% of households spend more than they earn
- Ireland: 52% of households save for retirement

# Financial Education

## *OECD project*

- Recommendation on Principles and Good Practices for Financial Education and Awareness approved by the OECD Council June 2005
- Published the first major international study of financial education, *Improving Financial Literacy*, in November 2005
- 
- Encouraging communication and cooperation among countries
- Producing detailed studies on financial education and pensions, insurance, financial education in schools etc.
- Further work; G8 finance ministers mandate

# OECD Recommendation on financial education

- Governments and all concerned stakeholders should promote unbiased, fair and coordinated financial education;
- Financial education should start at school, for people to be educated as early as possible;
- Financial education should be part of the good governance of financial institutions, whose accountability and responsibility should be encouraged;
- Financial education should be clearly distinguished from commercial advice and codes of conduct for the staff of financial institutions should be developed;
- Financial institutions should be encouraged to check that clients read and understand information, especially when related to long-term commitments or financial services with potentially significant financial consequences: small print and abstruse documentation should be discouraged;
- Financial education programmes should focus particularly on important life-planning aspects, such as basic savings, debt, insurance or pensions;
- Programmes should be oriented towards financial capacity building, where appropriate targeted on specific groups and made as personalised as possible;
- Future retirees should be made aware of the need to assess the financial adequacy of their current public and private pensions schemes;
- National campaigns, specific websites, free information services and warning systems on high-risk issues for financial consumers (such as fraud) should be promoted.

# Most recent work

- New guidelines on financial education in insurance
- New guidelines on financial education in pensions
- Ongoing projects in field of credit, financial advice, financial education at school, methodology
- Partnership with private sector

# Financial Education and Pensions

## General Principles Apply

- Ensure programmes start early (school) / on-going
- Simple language / many sources of information (e.g. on-line calculators)

## Government + Public Authorities

- Explain pension system + reforms
- Awareness campaigns to highlight need to save for retirement

## Social Partners

- Survey member needs + provide training / information

## Plan Sponsors

- Encouraged to provide education members / train trustees
- Make individuals aware of responsibilities / choices
- Well designed range of investment choices / default option
- Consider automatic enrolment

## Pension Plan Providers

- Provide timely, accurate and required information for members

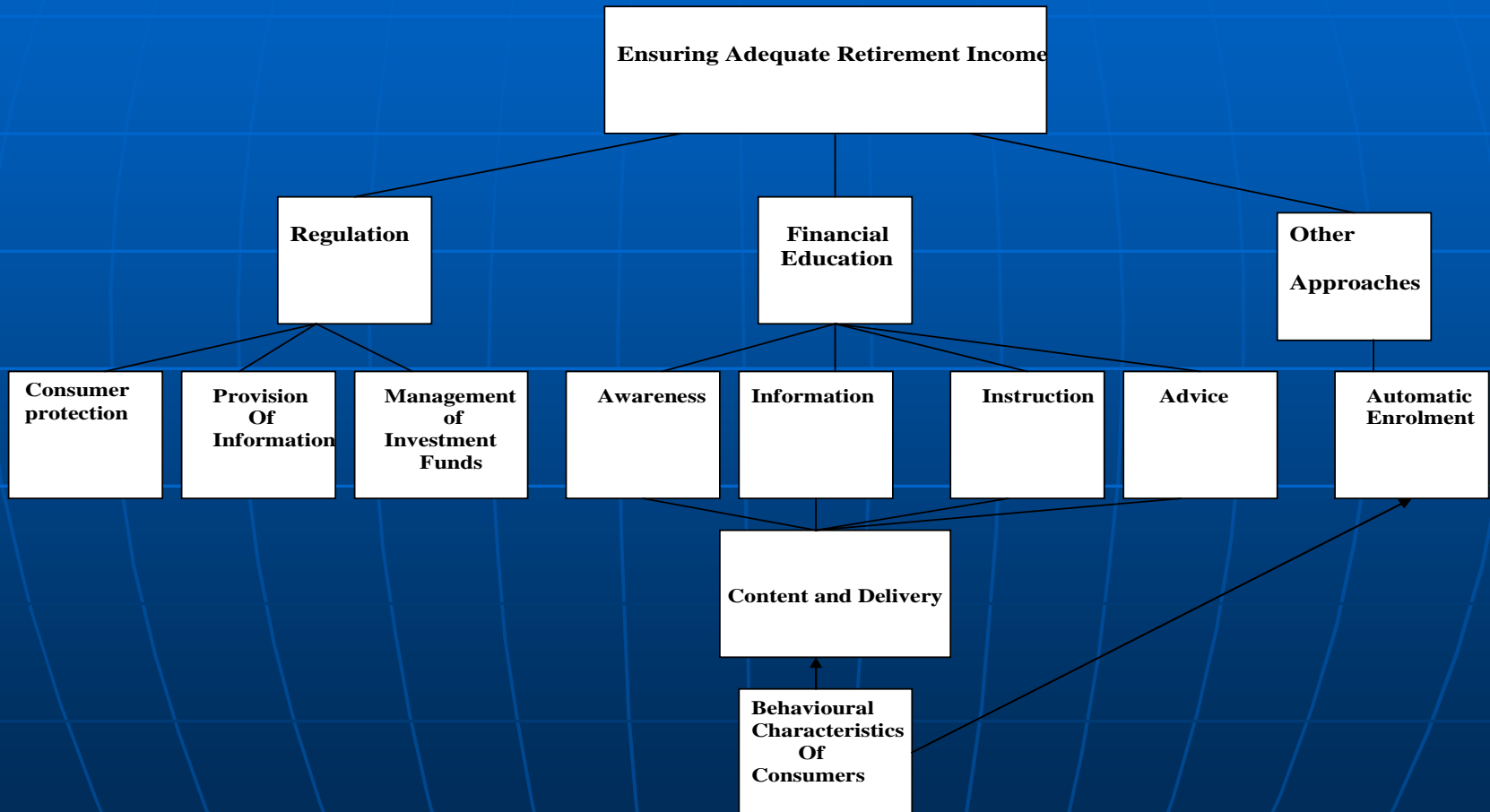
## Intermediaries

- Make clear distinction between education / advise / commercial selling

# Financial education is not enough

- Other measures are needed to overcome consumers myopia; passive behaviour; « easiest » option
- Automatic enrolments and Default mechanisms; shift option from opt in to opt out
- Fraud, miss-selling; need codes of conduct

# Financial education: part of a system



# IV. Impact on financial markets

- Assets meltdown hypothesis?

When baby-boomers start entering retirement, they will become net sellers of financial assets to finance retirement consumption. As subsequent generations are smaller in numbers, other things equal, this would put downward pressure on financial assets

# Impact on financial markets

## BUT

- No consensus
- Gradual dis-saving (Poterba), limited impact (50 basis point)
- Actual rise in financial asset prices (Brooks)
- Shift from equities to bonds
- Importance of behaviour assumptions
- Role of annuities markets
- Regulations
- Bequests
- International Demographic arbitrage
- Institutional investors

# Other triggers for a Meltdown?

Other risks or more: a combination of risks

- « a combination of **low pay out** due to reduced public and/or corporate pension benefits , with increasing **health costs** borne by ageing individuals in the framework of reduced public health generosity, with the maturation of adjustable **mortgages** and especially « interests only » when those are increasing, **unemployment** and expected increased **inflation**, plus **financial markets volatility**, if not crisis (with virtuous circles transforming in vicious ones) and why not to add some **catastrophic risks** in a world affected by climate change: this may provide all the ingredients for a **perfect storm**. Is it really just a pessimistic scenario?

# Danger of over-regulation

- Private pensions are often Voluntary
- Avoid disincentives and procyclical effects
- Frequent evaluation

# Conclusions

- Growing importance of private pensions
- Calls for adequate regulatory and supervisory framework
- Good Governance, transparency, integrity
- Adequate financial markets
- Improved Financial education and awareness